Market Competition, Plan Constraints, and the Hybrid Business Groups: Explaining the Business Groups in China

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An increasing number of Chinese companies are now taking the form of the business group. The big business groups in China tend to have more state shares, be more heavily indebted, less profitable, and accumulating capital more slowly than non-group firms. The emergence of the business groups was an outcome of entry into new profitable business fields by the existing companies given that exit from the old business fields was not easy due to institutional constraints. In this case, entry or expansion into new business fields was often accompanied by asset diversion from old to new business fields conducted by new spin-off firms, leading to the creation of hybrid parent companies. The net effect of this kind of asset diversion is dubious because it was associated with asset striping and/or information hiding from the supervisory state agency. These hybrid form business groups are characterized by low long-term investment ratio and low weight of business income of the parent companies.

Keywords: Business groups, Hybrid parent company, Asset stripping

JEL Classification: D21, L21, P31

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I. Introduction

There has been heated debate on the policy of promoting business groups in China as the successive collapse of several *chaebols* (conglomerates) in Korea since 1997 and during the followed financial crisis was witnessed. It was reported that the Chinese policy makers agreed upon the need to have group-style firms in a developing country such as China, but that they decided not to follow the unsuccessful precedent of the Korean *chaebols*, such as pursuing overly rapid growth and excessive diversification into unrelated business areas (Institute for Macroeconomy, PRC 1998; Lee and Woo 2002). The occurrence of business groups has emerged as one of the most important policy issues in China as many large scale companies take the form of such groups, transforming themselves from traditional state-owned-enterprises (SOEs) into modern joint-stock companies. As of 2003, eleven Chinese business groups were ranked in Fortune Global 500 enterprises (Hahn and Lee 2006, Appendix Table).

Granovetter (1995) defines business groups as collections of firms bound together in formal and/or informal ways, characterized by an intermediate level of binding, namely neither bound merely by short term strategic alliances nor legally consolidated into a single entity. The Chinese business groups seem to fit this definition, although they might be different in terms of strength of the personal and operational ties among the member or affiliate firms.[1] The business group can be considered as one of the most recent experiments in a series of state enterprise reform experiments since the 1980s, which have sought to build different models of enterprise in China (Hahn and Lee 2006; Huchet 1997; McNally 1997; Keister 1998). The Chinese enterprise reform for large and medium-sized SOEs proceeded from the profit retention system initially, through the contract management system and joint-stock companies or modern corporations to, finally, the business groups (Lee 1993; Chen and Huang 1995; Han 1997).

Despite a series of reform efforts, a large proportion of SOEs are still losing money, while those that are profit-making tend to be converted into joint-stock companies and are no longer classified as

[1] This is how Strachan (1976) distinguishes the typical American conglomerate from the business groups.

SOEs. Thus, dealing effectively with the inefficient SOEs has been one of the most critical issues facing the future of the Chinese economy (Lee and Hahn 2004). This paper focuses on business groups, because this is the front-line issue in enterprise reform in China. However, the focus of the paper is neither to analyze the condition of the current business groups in today's China nor to suggest any policy solutions based on analysis of them. The paper aims, instead, at providing a more theoretical interpretation of the emergence of diverse types of business groups in China. The early to mid 1990s was chosen as the ideal time to analyze because this period was the start of business groups in China. Although Keister's (1998) study on the business groups in China goes back to the earlier period, such as the 1980s, the early to mid 1990s is the first time the business groups were listed on the stock markets and, therefore, there is more reliable data. To be precise, we are targeting the transformation of the traditional SOEs in a socialist economy into the business groups in a modern sense, therefore, the early to mid 1990s is the right time for such analysis.

We looked at diverse business groups in China during this period, with types ranging from production-oriented parent companies to pure holding companies, as well as more interesting types including hybrid form companies which lie somewhere between the above two extremes. We will argue that the emergence of the diverse forms of business groups was a response to the ever-tightening market competition in China. Further, we will argue that hybrid form groups emerged as enterprises tried to circumvent the constraints associated with the legacy of central planning by diverting assets to subsidiaries. Two important hypotheses we propose are that the *traditional parent companies were converting to the hybrid form as their own business incomes were decreasing, and that many of the current hybrid form parent companies are actually similar in nature to pure holding companies.*

The paper is organized as follows. In order to explain the emergence of the business groups in China, Section II examines the increasing market competition and discusses the expected or realized benefits from formation of the business groups. In Section III, we discuss the diverse paths leading toward groups and the basic characteristics of the business groups, such as ownership structure, debt ratios, profitability, and growth tendencies. In Section IV, we analyze the different types of business groups in China by using the three-year data of more than 100 groups listed on stock markets. We focus on the hybrid form of the groups and the issue of asset diversion among firms in the group. The paper concludes with a summary in the last section.

II. Why the Business Group Emerged in China

The enterprise survey conducted by the Chinese Academy of Social Sciences in 1996 identifies the reasons for and benefits from the formation of business groups as follows (Hahn and Lee 2006). The primary three include: 1) to deal with the surplus workers; 2) to increase size by pooling capital; and 3) to use the existing resources more efficiently. The secondary reasons include: 4) to circumvent state interference; and 5) to promote managerial accountability and transparency.

These five factors leading to the formation of business groups can be understood in terms of an increasing need to cope with market competition. In other words, the ever-increasing market competition caused companies to experience, more heavily, the burden of surplus workers; and to recognize a strong need to achieve scale economy and more efficient resource utilization. Before we discuss this matter in more detail below, let us first document the increasing market competition in China.

A. Market Competition in China: Three Factors

Increasing market competition in China can be traced to three origins. First, strong new entry by private and FDI-backed firms contributed to increased market competition. Second, market-oriented reform since 1978 transformed the planned economy into a market economy, *i.e.* featuring excess supply rather than supply shortages as in the past. Third, market-driven integration of the domestic economy substantially reduced the notorious provincial protectionism. These three are interrelated, as discussed here.

First, there is abundant evidence that increasing market competition in China is driven by the new and strong entry of private and FDI-backed foreign companies. The 1996 enterprise survey indicates that Chinese SOEs perceive rural enterprises (36.9%) and foreign companies (21.5%) as their main rivals. Only 26.7% of the respondent SOEs identified other SOEs as their main competitors. Competitive pressure from the heavy presence of foreign enterprises was real, with the share of foreign companies in total output and profit values of many secondary sectors as high as 30% or 40% (Lee and Woo 2002). Foreign share, especially, was higher than 40% in the five growth-leading industries: apparel and textiles, leather and fur, educational and sports goods, measurement and scientific instrument and office goods, and electronics and communication equipment.

Second, demand-constrained economy started to feature in the Chinese economy because of increasing supply and new entries. As is well argued by Kornai (1980), one of the most important distinctions between market and planned economies, is the contrast between the demand-constrained and resource or supply-constrained economy. This can be one clear-cut and simple criterion used assessing the progress toward a market-oriented economy. In China, the buyers' market emerged as early as the mid-1980s with speeds dependant upon the type of industry (Byrd 1987). In the 1990s, the problem of excess supply was reported to be serious in a number of industries including textiles, consumer electronics, and some intermediate goods industries. In textiles, for example, excess capacity was estimated to be approximately 40% of the market demand. In electronics, the proportion of the number of items with excess supply had increased from 66.3% in 1995 to 75% in 1996 (IIE, CASS 1997). As a result of this excess capacity, operating rates fell to serious levels; below 25% in PCs and film; around 30% in air-conditioning equipment, copying machines, and microwave ovens; around 40% in VCRs, washing machines, engines, automobiles, color TVs, paint; and around 50% in telephones, cooking oil, bicycles, auto-bikes, sugar, cameras (IIE, CASS 1997). Although this information regarding excess capacity is not directly from the data of the sample firms we are dealing with here, it is reasonable to observe that these conditions should have similarly affected the business groups and other firms in the same industries.

Third, the increasing degree of national economic integration has contributed to reducing regional protectionism. As reported in Hahn and Lee (2006), the 1996 Chinese Academy of Social Sciences survey found 76.4% of the firms of 681 firms which responded, answered affirmatively to the question "whether the competing products from other provinces can be sold freely in your regions." In regard to the question asked about identifying major difficulties when trying to sell products in other localities, only 24.9% of the 667 firms, singled out entry barriers from local governments as the major source of difficulty. The more major difficulties turned out to be 'difficulty in getting relevant market information' with this response claiming 44.1% of the answers.

B. Expected or Realized Benefits from the Group Formation

The five benefits from group formation stated at the beginning of this section can be summed up as, firstly, more efficient utilization of existing resources and acquisition of lacked resources; and secondly, information manipulation from outsiders and better arrangement for internal incentives. The reasons stated above as 1), 2), and 3) are related to the former benefit, while the reasons stated above as 1), 4), and 5) are related to the latter benefit.

According to Penrose's (1959) view, the firm is a bundle of resources utilizing existing resources and acquiring lacking resources as the most critical matters determining the fate of firms. Diversification can also be interpreted as a better way to utilize existing resources when the firm has important resources locked into less profitable businesses and a more profitable use of resources emerges. In such a situation, it is natural for the firm to switch from old and less profitable to new more profitable lines of business with both existing and newly mobilized resources.

Given the Chinese context, with its legacy of a planned economy, exiting from existing lines of business is very difficult. Therefore, entry into a new business is more likely to take the form of setting up new subsidiaries. The new subsidiaries tend to be more joint ventures with other domestic or foreign partners with the effect of pooling new capital, technology or brand name. Thus, a positive purpose in setting up new ventures is to increase competitiveness associated with size or new inputs.

An additional benefit of setting up a new subsidiary rather than a new division when a firm considers diversification, can be discussed in terms of insider control problems and incentives (Lee and Hahn 2004). The point is, there can be two opposing implications between managerial transparency and economic efficiency. With regard to outsiders being included by the supervisory state agencies, setting up another tier of enterprise in the form of subsidiaries tends to have the effect of information manipulation by adding more agency tiers, making it easier to hide information from outsiders. On the other hand, from the intra-firm point of view, setting-up a new firm rather than a new division can provide strong incentives and higher managerial transparency. In an independent firm, the manager and workers in subsidiaries would have more incentives and feel a greater sense of responsibility, and would be subject to more transparent accounting.

In terms of Chinese enterprises, the first dimension of circumventing interference and monitoring from state bureaucrats would be more important than increasing worker accountability. As discussed in Section IV below, transition into the business groups often led to transformation into hybrid holding companies, which involved irregular diversion of the parent company's resources to the benefit of subsidiaries. Such a diversion can also be a leeway for diverse types of expropriation of state property in the form of asset stripping, tax evasion, debt reductions and dividend manipulation. For example, Fan (1996) documents opportunistic cases of leaving profits with subsidiaries and leaving debts with parent companies.

The positive side is the fact that new subsidiaries set up by the parent companies can often provide a solution for surplus or retired worker problems. The authors know of a case where a paper-producing company in Shandong solved their retired worker problem by setting up a new service firm and sending these retired works to the new firm.[2] This happened when the company was being turned into a joint venture with a foreign partner. The parent company promised limited five-year subsidies to this new firm to motivate the employees to work harder. Although individual company's situations might be somewhat different to this example, many Chinese companies are reported to use newly established subsidiaries to deal with surplus workers.

In sum, the net efficiency effect of the business group and asset diversion in China is not certain.

III. Basic Characteristics of the Business Groups

As discussed in Hahn and Lee (2006), three paths toward the business groups in China have been identified by a survey conducted by the Chinese Academy of Social Sciences, such as

[2] Information from a field work in Shandong in 1997.

spin-offs, M&A, and joint ventures. The form most frequently adopted is the establishment of subsidiaries through spin-offs, which sometimes involves the establishment of new firms not only with money from the parent firm but also includes those with an investment from other independent companies. The latter case might well be called joint ventures. This is how we distinguish the two terms, spin-offs and joint ventures, in this paper.

First, we examine the basic characteristics of business groups in China. For this, we rely on our database consisting of data for both business groups and non-group firms listed on stock markets in China. This data is taken from the annual reports published in the January to May issues of *Shaghai Zhengquanbao, Zhengquan Shibao,* and *Zhongguo Zhengquanbao* for the years 1995, 1996, and 1997. The annual reports provide the financial statements of the parent companies and the consolidated financial statements for the groups. Regarding the guidelines on the accounting method of the consolidated financial statements, we have relied on Ministry of Finance, PRC (1993; 1995; 1996). In 1995, there were a total of 323 companies listed on the stock markets (188 in Shanghai and 135 in Shenzhen), and the data base covers 243 firms for the years of 1994 and 1995.

Out of these 243 companies, we have identified 191 business groups which have at least one affiliated company. It might be that this definition of the business group is too broad, however, let us start with this broad definition. According to this distinction, the remaining 52 firms are considered as non-group firms. Based on this classification, we can tell that the business groups are the dominant form of business organization, at least among those listed on the stock market. Given that the listed companies are the best performing firms in China, this is important. As a matter of fact, the importance of the listed companies is increasing rapidly. For example, the market capitalization of the listed companies was approximately 8% of GDP in 1994, but increased to approximately 25% of GDP in 1998.

As a next step, we have attempted to rank the 191 business groups in terms of their size measured in assets (Table 1). In this way, we have identified the top three business groups, the top 30 business groups, and the remaining smaller business groups. Comparison of relative asset size show, firstly, that there is a large

TABLE 1

COMPARISON OF SIZE BETWEEN GROUP AND NON-GROUP FIRMS IN CHINA

Business groups	Number of samples in this category	Asset size (10,000 Yuan)
Top 3	3	1,591,688
Top 30	30	444,255
Top 4^{th}-30^{th}	27	316,763
Other small groups	161	67,002
All	191	129,186
B. Non-group firms		
	52	82,026
C. All firms		
	243	119,183
D. Relative asset size ratio		
Top 3 / Top 4^{th}-30^{th}		5.0
Top 30 / Other groups		6.6
Top 30 / Non-groups		5.4
Other small groups / Non-groups		0.8

Source: Authors' calculations using the database. See the text.

difference between the top three and the other business groups. The ratio between the top three and the top 4^{th}-30^{th} is five to one. The asset size ratio between the top 30 and the remaining small business groups is even larger, 6.6 to one. The difference between the small business groups at the bottom and non-group firms, however, seems to be much smaller, with a ratio 0.8 to one (small business groups are smaller than non-group firms on average). Thus, at least in terms of size, one might say that these top 30 or so business groups would be more interesting cases to focus on. It should be noted, though, that smaller business groups tend to have almost equally large numbers of affiliated companies as the top 30 groups.

Table 2 shows that in the case of the top 30 groups, the average number of the affiliates included in the consolidated balance sheet (usually more than 50 % owned affiliate companies) is 9.63, which should not be taken as small, even when compared to Korean *chaebols*. The smaller business groups are shown to have, on average, 7.8 affiliated companies. This is also important since it

TABLE 2

AFFILIATED COMPANIES IN THE BUSINESS GROUPS IN CHINA

		Total	Included in consolidated balance sheet	Wholly-owned (by the parents)	More than 50% owned	Less than 50% owned
Top 3	No. of affiliates	8	6.67	5.33	2.67	0
Top 30	No. of affiliates	13.5	9.63	5.47	4.17	3.867
4^{th}-30^{th}	No. of affiliates	14.1	9.96	5.48	4.33	4.3
Small groups	No. of affiliates	10.806	7.806	5.45	2.84	3

Source: Authors' calculations using the database.

implies that, regardless of size, the Chinese listed companies prefer to take the form of business groups.

Table 3 compares the ownership structure of the listed firms in China. The table also suggests a significant difference between the top 30 business groups and others. In terms of the ratio of state shares, 42.9% is the average in the top 30, while in the small business groups it is only 26.5%, and 27% in non-group firms. The *t*-test results show a significant difference between the top 30 and the non-group firms. Thus, we first conclude that the big business groups in China tend to have substantially higher state shares than other firms. Furthermore, given our interests in big business groups, we can safely focus our analysis on top 30 groups, rather than cover all the business groups in China.

Table 4 compares the capital structure of the listed firms in China. It reveals a significant difference between the top 30 and the non-group firms. The top 30 groups tend to be more heavily indebted with a debt-equity ratio of 138.7%. However, the top three compared to non-group firms, have a debt-equity ratio of 86.9 percent. The *t*-test shows that this difference is significant, both in terms of the debt-equity ratio and the equity to asset ratio.

Table 5, comparing the profitability of the two sets of firms, shows that profitability differences are not that significant between the two groups. Before taxes and interests, profit to sales ratios are higher in the top 30 groups but the difference is not significant. The profit to

TABLE 3
STRUCTURE OF OWNERSHIP IN BUSINESS GROUPS AND NON-GROUP FIRMS IN CHINA

	No. of samples in this category	State share	Legal person share	No. of shareholders holding more than 1%
A. Business groups				
Top 3	3	0.412	0.212	2
Top 30	30	0.429	0.23	3.033
Other	161	0.265	0.312	4.348
All	191	0.291	0.3	4.141
B. Non-group firms				
	52	0.27	0.347	3.673
C. All firms				
	243	0.287	0.31	4.041
D. *t*-test of the significance of the mean difference				
		Top 30	Non-group	Significance
State share ratio		0.429	0.29	0.02
		Top 30	Non-group	Significance
Legal person share ratio		0.23	0.35	0.07

TABLE 4
CAPITAL STRUCTURE IN BUSINESS GROUPS AND NON-GROUP FIRMS IN CHINA

	No. of samples in this category	Equity/ Asset	Debt/ Equity	Long-term debt/ Total debt	
A. Business groups					
Top 3	3	0.617	0.578	0.299	
Top 30	30	0.497	1.387	0.224	
Other	152	0.613	0.757	0.115	
All	182	0.594	0.861	0.133	
B. Non-group firms					
	49	0.587	0.869	0.139	
C. All firms					
	231	0.592	0.862	0.134	
D. *t*-test of the significance of the mean difference					
		Top 30	Non-group	*t*-statistics	Significance
Equity/Asset ratio		0.497	0.587	-2.21	0.031
		Top 30	Non-group	*t*-statistics	Significance
Debt/Equity ratio		1.387	0.869	2.25	0.03

TABLE 5
PROFITABILITY IN BUSINESS GROUPS AND NON-GROUP FIRMS IN CHINA

	No. of sample firms in this category	Profits	Profit/Sales	Profit/Equity	Profit/Asset
A. Business groups					
Top 3	3	107,269	0.103	0.111	0.069
Top 30	30	25,085	0.575	0.13	0.055
Other	152	4,020	0.464	0.094	0.057
All	182	7,493	0.483	0.1	0.056
B. Non-group firms					
	49	7,329	0.175	0.133	0.076
C. All firms					
	231	7,457	0.413	0.107	0.061
D. *t*-test of the significance of the mean difference					
		Top 30	Non-group	*t*-statistics	Significance
Profit/Sales		0.575	0.175	1.12	0.27
		Top 30	Non-group	*t*-statistics	Significance
Profit/Equity		0.13	0.133	-0.08	0.94
		Top 30	Non-group	*t*-statistics	Significance
Profit/Asset		0.055	0.076	-1.82	0.07

equity ratio is 13% in the top 30 groups and 13.3% in the non-group firms, and the difference is not significant. Only the difference in terms of profit to asset ratio appears marginally significant at the ten percent level with the ratio of 5.5% in the top 30 groups and 7.6% percent in non-group firms.

Table 6 compares growth rates of sales, equity capital and total assets. Except in sales growth where the difference is negligible, non-group firms are shown to have increased both equity capital and total assets faster than the top 30 groups. The growth rate differences should be regarded as substantial as the asset growth rate of the non-group firms is 32% compared to 14.6% in the top 30 groups. In terms of growth in equity capital, the difference is 32.8% *vs.* 8.5%.

We can summarize the results of the above comparisons as follows. The comparisons suggest that the big business groups in China tend to have more state shares, be more heavily indebted, are less profitable, and accumulate capital more slowly than non-group firms. In summary, big business groups in China seem to be quite

TABLE 6
GROWTH PROPENSITY IN BUSINESS GROUPS AND NON-GROUP FIRMS IN CHINA (GROWTH RATES IN %)

	No. of sample firms in this category	Assets	Equity capital	
A. Business groups				
Top 3	3	0.113	0.161	
Top 30	30	0.146	0.085	
Other	151	0.166	0.17	
All	181	0.163	0.156	
B. Non-group firms				
	47	0.32	0.328	
C. All firms				
	228	0.195	0.191	
D. *t*-test of the significance of the mean difference (Top 28 groups *vs*. Non-group firms)				
	Top 28	Non-group	*t*-statistics	Significance
Sales	-0.04874	-0.1013164	0.71	0.48
	Top 30	Non-group	*t*-statistics	Significance
Assets	0.145684	0.32007193	-2.5599	0.013
	Top 30	Non-group	*t*-statistics	Significance
Equity capital	0.08469	0.32797698	-2.313	0.0247

different from, or in some sense inferior to, non-group firms in these respects.

IV. Asset Diversions and the Four Types of Business Groups

In this section, we discuss the business groups formed *via* spin-offs or joint ventures. For this purpose, we have selected 118 companies for 1994, and 168 companies for 1995 and 1996. They are selected according to some criteria out of the 191 listed business groups in our data base.[3] We have classified the sample enterprises

[3] Only those enterprises satisfying the following three criteria are selected. First, the required information is available for all three years. Second, as at the end of 1996, the amount of long-term investment conducted by the parent company is greater than 10% of total assets of the parent company.

into four types according to the following two criteria:

The first criterion is the ratio of long-term investment (into their affiliate companies) to total asset. The long-term investment contains the listed parent company's long-term equity investment and long-term debt investment to the affiliations. According to Tenev and Zhang (2002) and Meyer and Lu (2004), diverse forms of agency costs are serious in the listed companies in China, and long-term investment or loans from the listed to unlisted subsidiaries are often used as channels for tunneling or asset stripping. Numerous anecdotes have suggested that controlling shareholders treat listed firms as cash machines, from which they can withdraw money for as long as they wish, and the managers want to gain further autonomy from their supervising agencies by breaking up existing enterprises to form subsidiaries, joint ventures with foreign or domestic partners.

If this ratio of long-term investment is 1, then it means that the company is a pure holding company. In other words, the higher the long-term investment ratio (LIR) is, the closer to a pure holding company a company is. For 1994-96 period, the average LIR was 0.3 for the sample companies we have chosen.

The second criterion is the relative importance (weight) of business income of the parent company in the whole group. This variable, relative business income ratio (RBIR), is measured by the following formula.

RBIR (relative business income ratio)$=$A/B,
where A$=$(parent's business income)/(business income of group total),
and B$=$(parent's total assets$-$long-term investment)/(group's total assets$-$long-term investment).

In other words, the relative business income ratio (RBIR) is defined as the ratio of weight of business income of the parent company to the weight of operating assets of the parent company. This variable aims to reflect the degree to which the parent company is making money from its own business rather than from those of subsidiaries. Therefore, we can say that the lower the RBIR is, the closer to a

Third, as at the end of 1996, the number of the subsidiaries included in the consolidated financial statements is greater than or equal to 4.

pure holding company a company is. For the 1994-96 period, the average RBIR was 0.65 for the sample of the listed companies.

Now, using the two criteria (LIR and RBIR), we have classified the listed companies into the following four types: pure holding companies, business holding companies, hybrid parent companies, and business parent companies (See Figure 1). The companies are classified into pure or business holding companies if the long-term investment ratio (LIR) is greater than 0.7.[4] The companies are classified into business parents or business holding companies if the relative business income ratio is greater than 0.65, the average for the whole groups. For simplicity, classification criteria can be summarized in the figure below.

Type I is a 'pure holding company' which has a very high long-term investment ratio and a lower than average business income ratio. Examples include: Tianjin Bohai Chemical Industry (Group), Northeast Electrical Transmission & Transformation Machinery Manufacturing, Shantou Electric Power Development, Kunming Wuhua Industry (Group).

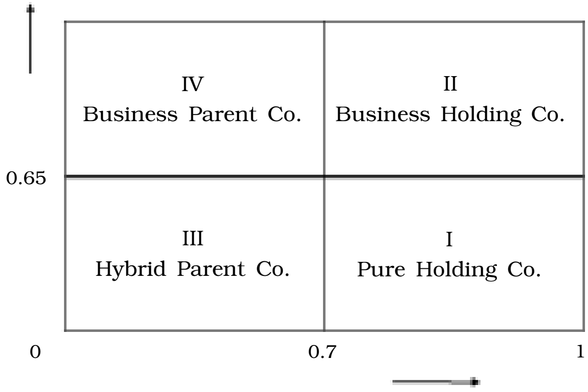
Type IV is the opposite of Type I, and is a parent company with its own business income ratio higher than the average and low to medium long-term investment ratio. We call this a 'business parent company', with such examples as the SVA and Shanghai Electrical Apparatus Co. The remaining two types (Types II and III) are a mix of types between the two extremes of a pure holding and a business parent company. Type II is called a 'business holding company', which is characterized by a very high long-term investment ratio and a higher than average business income ratio. This type of company owns a substantial share in their subsidiaries, but simultaneously conducts much of its own business. In this sense, it is an odd combination, and subsequently, there are very few companies belonging to this category.

A more controversial case we are going to focus on is Type III, a 'hybrid parent company'. Examples include: Jiangling Motors, Shenzhen Petrochemical Industry (Group), Huayuan Industrial

[4] Of course, the criterion of 0.7 is arbitrary. Actually, we have tried several values, ranging from 0.5 to 0.9, however, the choice does not change the basic results. We decided, therefore, that to be called a pure holding company the ratio of long-term investment should be at least higher than 0.7 although the average ratio of long-term investment for the whole sample in 1996 is as low as 0.4.

Part A: Classification Method

Relative Business Income



Relative Long-Term Investment

Notes: 1) Relative Long-Term Investment = (long-term investment)/(total asset)
2) Relative Business Income = Weight of business income of parent company relative to weight of business asset of parent company (simply, relative weight of parent business income) = A/B
where A = (parent business income)/(business income of group total)
B = (parent's total assets − long-term investment) /(group's total assets − long-term investment)

Part B: Examples of the Firms in Each Category

(The firms listed below had belonged to each category in all three years)

I. Pure Holding Co.: Tianjin Bohai Chemical Industry (Group), Northeast Electrical Transmission & Transformation Machinery Manufacturing, Shantou Electric Power Development, Kunming Wuhua Industry (Group)
II. Business Holding Co.: None
III. Hybrid Parent Co.: Jiangling Motors, Shenzhen Petrochemical Industry (Group), Huayuan Industrial (Group), China Baoan Group, Wanke Group, Guangdong Midea Group, China Kejian, *etc*.
IV. Business Parent Co.: SVA, Shanghai Electrical Apparatus, *etc*.

FIGURE 1

CLASSIFICATION OF THE ENTERPRISE GROUPS IN CHINA

(Group), China Baoan Group, Wanke Group, Guangdong Midea Group, China Kejian, and so on. It, too, is an odd combination since it does not have substantial long-term investment over its subsidiaries, as does a pure holding company and, at the same time, does not have much of its own business income. An interesting and

TABLE 7A
TYPES OF ENTERPRISE GROUPS IN CHINA (ASSET VALUES: 10,000 YUAN)

Types	1994		1995		1996	
	Number	Asset Values	Number	Asset Values	Number	Asset Values
I	7	570,874	4	377,420	4	522,488
Pure Holding Co.	5.93%	5.46%	2.38%	2.53%	2.38%	3.09%
II Business Holding Co.	0	0	0	0	0	0
III	36	2,903,386	76	6,136,911	82	7,863,361
Hybrid Parent Co.	30.51%	27.75%	45.24%	41.20%	48.81%	46.48%
IV	75	6,987,885	88	8,381,885	82	8,531,183
Business Parent Co.	63.56%	66.79%	52.38%	56.27%	48.81%	50.43%
Total	118	10,462,145	168	14,896,216	168	16,917,032
	100%	100%	100%	100%	100%	100%

important fact is that in terms of numbers, many of this type of company exist and their numbers are increasing rapidly in both absolute numbers and relative shares. Before going into more detail on this type of company, however, let us first discuss the overall picture of the typology. Figure 1 presents the basic typology of the business groups in China.

According to Table 7A, business parent companies, the most traditional form, are the largest in number. However, their relative importance has been decreasing over the years. In contrast, Type III companies, hybrid parent companies, are increasing rapidly in both absolute and relative terms. One of the important hypotheses we propose is that the *traditional parent companies are converting to this hybrid form as their own business incomes are decreasing*. The second important and related hypothesis is that *many of the current hybrid form parent companies are actually similar to pure holding companies* in that the actual, not accounting, values of their long-term investments are much higher than shown in the accounting books. Both of these hypotheses are consistent with the common interpretation that many parent companies are diverting their assets to the benefits of subsidiaries in diverse irregular manner; and that the motivation for this type of behavior is to bypass state regulations in order to increase company benefits at the expense of the state as both tax collector and major shareholder. Let us focus on this issue below.

TABLE 7B
TYPES OF ENTERPRISE GROUPS AFTER ADJUSTMENTS OF LONG-TERM INVESTMENT

Types	1994		1995		1996	
	Number	Asset Values	Number	Asset Values	Number	Asset Values
I	16	1,446,274	17	1,938,567	12	1,477,062
Pure Holding Co.	13.56%	13.82%	10.12%	13.01%	7.14%	8.73%
II	0	0	1	31,270	0	0
Business Holding Co.			0.60%	0.20%		
III	27	2,027,986	61	4,511,913	74	6,908,787
Hybrid Parent Co.	22.88%	19.38%	36.31%	30.29%	44.05%	40.84%
IV	75	6,987,885	89	8,414,466	82	8,531,183
Business Parent Co.	63.56%	66.79%	52.98%	56.49%	48.81%	50.43%
Total	118	10,462,245	168	14,896,216	168	16,917,032
	100%	100%	100%	100%	100%	100%

In many of the hybrid parent company cases, the long-term investment is low only in the accounting books. In reality, much of the fixed or variable assets are used for business activities of subsidiaries in somewhat irregular ways. An investigation of the balance sheets shows that there are many arbitrary items such as 'unrealized receivable from related companies' and 'internal transactions' within the category of variable assets. The amounts listed under these items are *de facto* long-term investments which are being utilized by subsidiary companies.[5] The number of companies that have made up such items in their balance sheets was 24 in 1994, 36 in 1995, and 30 in 1996, most of which are hybrid parent companies. Table 7B is a new classification after those arbitrary items to long-term investments are added.

The number of pure holding companies increased more or less substantially after this adjustment for arbitrary items was made. For example, in 1995 there were only four pure holding companies before adjustment, but the number increased to 17 after adjustment. The relative share of pure holding companies has also increased after the adjustment. The tendency of both absolute and relative increases of shares in hybrid companies, and the tendency of decrease in the share of the business parent companies, remains valid after the

[5] We were able to confirm this by personal interviews of enterprise personnel and stock market staff.

adjustment. The importance of hybrid companies, measured in relative share in number, has increased from 22.9% in 1994 to 36.3% in 1995, and finally to 44.1% in 1996.

The next question addressed is the nature of this hybrid form of parent company. Initially, they are difficult to understand because they show low long-term investment figures while their own business incomes are relatively small. A plausible explanation for this phenomenon could be that many of the hybrid companies are diverting their assets for utilization by their subsidiaries without reporting it in the balance sheets. This interpretation is consistent with the fact that whereas the average long-term investment ratios are quite stable over the three-year period, the average ratio of relative business income is rapidly decreasing. This strategy was to bypass the restriction in Clause 12 of the Enterprise Law that prohibited a company from placing greater than 50% of its net assets in long term investments into other companies, with the exception of investment companies or pure holding companies approved by the State Council.

In our sample, the number and share of the companies violating this restriction amounted to 54 and 45.7% in 1994, 77 and 45.8% in 1995, and 79 and 47% in 1996. Of course, many companies with lower than 50% long-term investment ratios would actually be helping subsidiaries in the form of diverse, disguised, long-term investment without even reporting it in the balance sheets. This poses a serious problem for any rigorous economic analysis. For example, we cannot attempt any serious comparison of economic efficiency among the different types of groups, given that the classification does not fully reflect the true type of the firms. Therefore, we are not doing any rigorous test of any statistical significance in this section, but are stopping at identifying several plausible hypotheses and related tendencies.

To examine the hypothesis that business parent companies are being changed into hybrid parent companies, we have checked each case of business group to learn if it is actually happening. Table 8 shows the results. First, over the 1994 to 1995 period, out of a total of 18 companies that changed their type, the majority, ten, have changed from business parent to hybrid parent. Over the 1995 to 1996 period, out of a total of 23 companies that changed their type, 14 companies have changed from business parent to hybrid parent. There are, in fact, diverse patterns of type changes for various

TABLE 8
CHANGES OF THE GROUP TYPES

A. Change over the 1994-95 period (from 1994 to 1995)

1994 Type	1995 Type			
	I	II	III	IV
I			4	
II				
III	1			3
IV			10	

B. Change over the 1995-96 period (from 1995 to 1996)

1995 Type	1996 Type			
	I	II	III	IV
I			1	
II				
III	1			7
IV			14	

reasons and for data ambiguity problems. However, it seems reasonable to interpret that in more than the majority of cases, the change is from business parent to hybrid parent, although we cannot claim statistical significance of the difference.[6]

As discussed in Section II, pooling of capital to increase size is one of the main reasons for the formation of business groups. Pooling of capital not only increases the size of the company, but is also accompanied by new technology, both of which are important in meeting market competition. In this case, group formation occurs when a parent company sets up a new company, combining its own funds with funds from other companies.

V. Summary and Concluding Remarks

An increasing number of Chinese companies have been taking the form of business groups. This paper first shows that big business groups in China tend to have more state shares, be more heavily

[6] Out of a total of 18 type changes over the 1994-95 period, there are three cases of the reverse change; and out of a total of 23 cases of type changes over the 1995-96 period, there are seven cases of the opposite direction change.

indebted, are less profitable, and accumulate capital more slowly than non-group firms. The emergence of business groups appears to have been a response to increasing market competition in the plan-constrained environment. Forming a group, with the apparent effect of higher visibility, acted like a signaling device during the half-fledged nature of the capital market in China in the 1990s. It was also an outcome of entry into new profitable business fields by the existing companies because exit from old business fields was difficult due to institutional constraints. These constraints included social functions attached to the old businesses, such as job provision. Entry or expansion into new business fields were often accompanied by implicit or explicit asset diversion from old to new business fields, conducted by new spin-off firms.

This paper suggests evidence, albeit not conclusive, that asset diversion tended to lead to the creation of hybrid parent companies out of the traditional parent companies. The net effect of this type of asset diversion was dubious because it might have been associated with asset stripping and/or information hiding from the supervisory state agency by adding another layer to the firms. These hybrid form business groups are characterized by low long-term investment ratios and low weight of business incomes of the parent companies relative to that of the whole group. When irregular long-term investment into subsidiaries is taken into account, some of the hybrid parent firms turn out to be more similar to pure holding companies with high long-term investment ratios and little business income of their own.

This paper should be regarded as an attempt to understand the reasons for the emergence of business groups in China. Evidence provided here cannot claim full authority; however, this paper has at least succeeded in identifying several important aspects of business behavior which can be a basis for further analysis and policy formulations. First, business groups, although initiated originally by the government, had a rationale to emerge in the Chinese economy in the 1990s. Second, despite more state-owned and less dynamic big business groups, there exist many dynamic, small and medium sized business groups which have emerged voluntarily and have the potential to become main players in the future Chinese economy. Third, given the very competitive nature of Chinese markets, compared to early Korean and Japanese markets of oligopolistic nature, the Chinese business groups cannot afford to diversify into many unrelated fields (Lee and Woo 2002). Fourth, given the transitional nature of the Chinese economy and that the related market failure and/or plan constraints will continue to exist for a while, we will see more and more business groups emerging from the organizational changes of the old state-owned companies. Fifth, this change then gives the central government a policy challenge in dealing with business groups in terms of taxation and monitoring over these business practices.

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