



Self-employment in urban China: Networking in a transition economy

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ABSTRACT

This paper investigates the relationship between self-employment and social networks in urban China, an economy rife with informational and institutional imperfections, under-developed financial markets, but a growing and important non-state sector. Having a social network can help the self-employed access supply and credit networks, and assist in navigating an uncertain institutional environment where permissions and licenses often require interpersonal relationships to facilitate and reduce the informational costs of enforcement by dealing with known persons. Thus, holding other productive and observable traits constant including attitude toward risk where possible, social networks are expected to be a significant correlate to self-employment which is borne out by the evidence. Examining three tranches of the self-employed (those who are self-employed, those who are self-employed as a second job, and a sub-sample who have experienced unemployment and then became self-employed), the paper finds that social networks significantly predict self-employment except for those who are working for themselves as a second job. Gender differences are also notable.

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1. Introduction

Private economic activity, including starting self-employment, is an important driver of growth, particularly for an economy such as China where partial marketization relies on the rapid growth of the non-state sector in driving the transition from central planning (Fan, 1994). China's gradualist reforms are associated with a high degree of market imperfection where many sectors are still controlled by the state and private economic activity is characterized by a great deal of uncertainty. Moreover, China is a developing country where there are numerous information-related obstacles which can impede obtaining credit and starting a business.

Self-employment is a challenging proposition in a developing economy characterized by imperfect credit markets, supply chains, and product markets (Banerjee & Newman, 1993). Existing studies focus on institutional factors, such as credit constraints, and individual traits as determinants of those who choose to enter into self-employment or start small and medium sized enterprises (Blanchflower & Oswald, 1998; Rees & Shah, 1986). Both sets of approaches would support the importance of social networks in fostering self-employment, as well as point to motivation and attitude toward risk as determinative factors. Social networks can arise from a need to work within imperfect formal institutions, such as a regime of uncertain property rights (Frye & Zhuravskaya, 2000) or evolve in the context of community and cultural factors (Portes, 1998) as well result from individual preferences (Glaeser, Laibson & Sacerdote, 2002). It is likely that social networks have both an economic and non-economic function. For instance, social networks can help ease financial constraints and provide needed contacts for operating a business in a partially marketized environment such as China (Oi, 1999; Zhang, Zhang, Rozelle & Boucher, 2006), but also serve a primarily social function with some economic uses (Komter, 2005).

In China, the private sector has rapidly overtaken the state sector as a contributor to GDP even though the system is characterized by a poor legal system that provides incomplete protection of private assets, along with credit constraints for private

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enterprises, and regulatory opacity. Despite these challenges, there is a growing segment of entrepreneurial activity that has propelled China along its gradualist transition path and helped it to achieve remarkable growth rates in the reform period. In such an imperfect legal and financial system, the characteristics of those who are able to enter self-employment are of interest. Moreover, the dominance of informal and relation-based contracting in China suggests that the elements fostering private sector development are likely to evolve around social networks, as well as other traits associated with managing uncertainty such as motivation or drive, and traditional characteristics such as the willingness to embracing risk.

The determinants of becoming self-employed in China, particularly in urban areas, are yet to be well understood despite the growing importance of the *de novo* private sector. Studies of self-employment include analyses by Wu (2002), Zhang et al. (2006) and Mohapatra, Rozelle & Goodhue (2007) as well as a survey of entrepreneurs by Djankov, Qian, Roland & Zhuravskaya (2006). The study of rural China by Mohapatra et al. (2007) emphasizes education as the key determinant of rural farmers leaving the agricultural sector and moving into self-employment while Wu (2002) finds that education deters self-employment in urban areas. As with most issues in China, there are significant urban–rural differences.

Zhang et al. (2006) and Djankov et al. (2006) concur that entrepreneurship is more likely if the entrepreneur has friends or family who were entrepreneurs. In the Djankov et al. (2006) study, the most robust determinant of entrepreneurship was knowing people who had tried entrepreneurship. This is consistent with the work on the importance of social networks. The original data used this paper, with measures of social networks, motivation and attitudes, can be used to build upon these findings.

Therefore, China is an appropriate economy to study the rise of self-employment and a segment of the rapidly developing privately owned firms since it is transition economy and developing country which has a significant lack of formal institutions in the areas of property rights and other features crucial for private economic activity, such as well functioning credit markets, certainty in contracting and investment protection. Moreover, China has traditionally had a cultural and historical emphasis on inter-personal relationships or *guanxi*, which informs business dealings both within and outside of China. This suggests that networking is possibly an important factor in determining non-state sector development in transitioning China.¹

Section 2 examines the factors affecting self-employment in China and setting out the hypothesis regarding the importance of social networks. Section 3 presents the data, followed by a section on the estimation approach of the paper. Section 5 discusses the results. Section 6 summarizes the findings and concludes.

2. Self-employment in China

Self-employment should require many of the same personal traits as employed persons working for a wage, such as education, in a transition labour market. However, the self-employed must also contend with the need to obtain credit to start a business and buy inventory, gain access to suppliers and distributors, as well as the knowledge to navigate the uncertain regulatory and legal environment in China where licenses are often required for starting a business. Social networks would be useful in all of these respects.

2.1. Credit and supply networks

In China, self-employed persons often encounter severe credit constraints due to the credit allocation system which is skewed toward state-owned enterprises (SOEs) (Fan, 1994; Lin, 2007). Small and medium enterprises find it difficult to obtain credit and often rely on family and friends, including remittances from migrated family members, to start a business (Oi, 1999). Alternatively, self-employed persons use their social networks to arrange for inventory to be issued without advance payment. Anything which is sold is then split between the vendor and the supplier of the inventory, such as peddlers receiving their goods in advance. The author encountered this type of trust-based relationship in conducting a household survey in China in 2000, notably in Liaoning which has a substantial proportion of heavy industry that was hard hit by the large-scale downsizing of the SOEs in the mid 1990s. Access to suppliers and distributors is a significant challenge in a partially marketized economy, and having a social network would facilitate self-employment by helping to overcome such obstacles (see e.g., Wu, 2002). With the stagnation of the state-owned sector during the reform period and the beginning of market liberalization facilitating the growth of the non-state sector, it is also likely that urban workers began to seek other sources of income and thus became self-employed.

When asked the main reason why the respondent started his or her own business, 37% replied that it was because he or she had the requisite skills and experience, 7% had funds, 11% had real estate, and 17% started a business by joining in with relatives.² Given the small proportion of the self-employed who started with their own funds, credit is likely to be a constraint that social networks can help with by improving information flows to attain credit or indeed access credit from personal networks. This figure may be under-stated since having funds may be a subsidiary reason because respondents were limited to one response. Having real estate in China suggests a social network because all urban land is state-owned and land/buildings were only beginning to become privatized. Those who had the resource of real estate would likely have had the connections to attain such an asset. This finding supports the argument that one of the motivations for entering self-employment is having overcome credit and wealth constraints.

¹ Networking and *guanxi* were found to be important under the administered economy as well (see e.g., Bian, 1994).

² The remaining respondents chose “other.” As this was during the period of the *xigang* policy where there were large-scale layoffs in the SOE sector, it is likely that some became self-employed or more likely small goods peddlers out of necessity (Knight & Yueh, 2004).

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