

# **Institutional Conditions for Developing Venture Capital Industry in China**

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## **Abstract**

Why some countries have better performance and progress in venture capital industry than others? Many scholars have been looking for reasons. Black and Gilson (1997) argued that in the bank-central financial system venture capital has not good developed by lack of active stock market. Lerner and Gompers (1998) studied venture capital market in the United States and said it is the demand factors that decide the size of venture capital market, i.e., the degree of entrepreneur looking for capital. These studies have analyzed the venture capital from the view of institutional arrangement.

In recent years, scholars and policy makers pay more attention to the relationship between institutional conditions and venture capital development. Hellmann (2000) studied the genesis of Germany venture capital and found that the shortages in institutional conditions were the basic reasons resulting in failures in Germany venture capital. According to points of complementarities theory establishment of venture capital firm looks like a single institutional innovation in a complementarity's system. If there are not other innovations coming forth, the benefit from this single institutional innovation is negative. Kuemmerle (2001) compared the development process of venture capital industry among United States, Germany and Japan. He pointed out Germany and Japan has obvious differences with United States in initiatives of private sector, science base for competition and law environment. When the regulatory environment of these two countries changed venture capital industry started its development. Germany adjusted its regulatory environment earlier than Japan even ten years a much faster development has occurred in Germany. Dossani

and Kenney (2002) figured out with such a complex institutional system as venture capital, if not a minimum support environment it is impossible for venture capital industry development.

Institutional system for venture capital includes law system, financial system and major forms of venture capital organization. Analyzing venture capital industry from the view of institutional system there are two basic levels. The first level is studying elements or conditions of institutional environment that venture capital needs. Bruton, Ahlstrom and Yeh (2004) studied the institutional differences based on the regulatory elements, normative elements and cognitive elements among Hong Kong, Taiwan, Singapore and United States. It belongs to a macrolevel study. The second level is studying operation features of venture capital by institutional environment. Since the differences in institutional environment there are big differences in sources of capital, liquidity, law and contract structure, labor mobility and risk tolerance between United States and Japan (Milhaupt, 1997). All these studies seemed to emphasize the development of venture capital is not a self-progress but a process pushing by institutional innovations.

Building and improving institutional environment for venture capital has a great relation with government policies and actions. Reasonable policies will promote the institutional environment better. In order to encourage venture capital industry many countries in the world pay much more attention to it at large. Those countries that want to develop venture capital actively designed policies or implemented programs. The consequent question is what roles should the government play in developing venture capital. Lerner (2002) considered government involved in venture capital should select sound methods and policies. Through model analysis Keuschnigg and Nielsen (2001) suggested that when government designed venture capital policies it should measure them by the relation of cost and benefit. A more empirical study done by Günseli Baygan (2003) setup a analysis framework with five aspects of investment regulatory, taxation incentives, equity program, angel investing networking and second board capital market to examine the country policy in venture capital among OECD members.

Reviewing the history of venture capital in China if we set the start point from China New Technology Venture Capital Ltd. Co. in 1986 China venture capital was close to twenty years. Even through the China New Technology Venture Capital Ltd. Co. was not been proud as a pioneer it was worthy for memory as its milestone position. After a rapid development since 1998 a “winter” season came in China with a rapid drop in venture capital fund raising and deals. How does China protect and develop its infant venture capital industry? In the beginning of 2004 a new policy related to venture capital industry was issued by central government. It states again capital market for new ventures should be developed, which was the second document with some relations to venture capital in 5 years. However, besides the capital market for new venture what else the venture capital needs.

This paper will explain the necessary for venture capital to make institutional innovation based on theory. Only providing capital and exit channel cannot we solve the problems existing in base and environment. At same time government should constitute scientific policies and sufficiently absorb experience from other countries. This paper will be organized as follow. After describing the theoretic foundation and methodology we open out the rise and fall process of the first China venture capital with ten years information, which provides an impartment clue for understanding institutional environment of China. By comparing the institutional environment and performance of venture capital in China with several other countries we can find out the gap of institutional environment in China and propose suggestions in improving institutional environment and designing policies.