

Barriers of supporting the SMEs entrepreneurs financially in China –a structural analysis and policy implications

Guoying Li

Director of Education and research, Department of International trade
Zhejiang changzheng vocational & technical college
Hangzhou, P.R.China
Email:21237062@qq.com; sunlinda@sohu.com

Abstract—Statistical records showed that China mainland is having a decline of state-owned enterprises and a fast growth of small and medium enterprise. It has been proved to be of great importance for the country's economic transformation in the past decades. However, there is still several critical weaknesses in the country's system of innovation that prevents most of entrepreneurs in struggle because of financial factors. In this paper, we carried out an analysis on the development of SMEs in China and the financial supportive policies. And a comparative analysis of Korea is also discussed. Implications and policy recommendations is suggested in the last section.

Keywords- *Entrepreneurial Environment, Financing, SME in China*

I. INTRODUCTION

According to the World Bank and IMF's Surveys on, China SMEs are facing strict financial constraints, and have limited access to private finance comparing to other Asian countries included in the survey (like, Korea, Korea, Singapore, etc). The survey also shows that the use of formal finance declines with the scale of the enterprise. SMEs use less formal finance than large firms in all countries, since they are too small and there's a lot of uncertainty comparing to that of the large firms. However, in China, the difference is even larger, comparing it to other Asian economies.

Also, a very important factor is how finance is available to small firms. The Project Group of Research in Chinese Private Enterprises organized by China Industrial and Commercial Union and Research Commission of Chinese Private Business showed in their recent survey that self-accumulated money was the major source for starting up firms, which is around 55%, complemented by money borrowed from relatives 31.6% and bank and Rural Credit Corporation loans, 23.4%.

In our research, the problems related to the SME funding and financing will be first addressed. Then a comparative analysis of Korea which has a similar innovation system is followed. Recommendations and policy implications are discussed in the last section.

II. BARRIERS WITHIN THE FINANCING SYSTEM FOR SME IN CHINA

In this section, we will discuss the barriers from the Macro and Micro level respectively

A. In the Macro level

As known, the large Chinese national commercial banks have a very high market share of deposits. However, their requirements for loans are surprisingly high so it is normally can't be met by SMEs. The rural credit cooperatives in China cannot fill this gap because of their own structural and financial capacities. Regarding the capital market in China, it started being developed by the sale of state-owned companies' shares. From this perspective, the liquidity is inefficient and there is a lack of institutional investors with regional and national background. On the other side, the insurance companies and securities investment funds are encouraged to invest in a stock market, and they are expanding rapidly.

Second, using appropriate collateral agents can enhance informational transparency in financing SMEs. In general it is easier to assess the value of assets instead of the value of expected future cash-flows. For example, in North America, around 89% SME debt is supported by collateral and 52% of debt is secured by the owners. The collateral can make the SMEs operates safely. However, if we look back at the SMEs in mainland China, there is insufficient amount of appropriate collateral to support their credit ability when they are working with the national banks. Reliable collateral that can be used is determined by the PRC Guarantee Law, Article 34, which is a barrier for the SMEs.

Third, there are important economies of scale in the activity related to lending from banks. These economies of scale cannot be exploited at the typical borrowing scale of SMEs, and consequently banks will prefer large loans to the bigger firms comparing to the Small and Medium enterprises.

Last but not the least, the private SMEs have disadvantages in accessing credit and receiving approval due to their weaker connection to local authorities (as compared to Chinese national enterprises (state owned) or former national firms (the privatized ones). Comparing to the national firms and foreign firms, the local SMEs have less access to the investment and tax incentives and enjoy related policy. However, for example, the foreign firms can enjoy special tax exemption programs in their first a few years in China. In many places in China, foreign firms exempted for two years after the first year of profits registration.

B. *In the Micro level*

Mostly importantly, the transparency of accounting and financial structure of private firms in China is relatively low. There is a lack of transparent, reliable and audited accounting records. There are restrictions in the registration under different forms of incorporation that gives incentives to firms to misrepresent financial flows, total employees, stocks, assets and other elements in the accounting system of the SMEs in China. The taxation system and structure also can be cracked by under-recording, misleading information, and misreporting. As a matter of fact in China, firms are said to keep different accounting books: one for the government, one for banks and the last one for the stakeholders.

Second, though a nationwide credit assessment system for SMEs was proposed in the early 2000s, which targets to improve the information processing and transmission of the credit situation of SMEs. China mainland does not have a reliable credit rating system or a credit rating organization for the local SMEs. Along with the low investment and tax incentive and policy, it is hard for the SMEs to build up the reputation of their own. And even they can put limited record in their file; it still cannot give a direct effect on their loan from the state-owned banks. It is a negative effect on the quality and amount of loans and prevents further the credit rating and reputation building of the local SMEs.

III. CURRENT SME FINANCING POLICIES AND REGULATIONS IN CHINA

Overall speaking, the Chinese mainland government has paid plenty of attention on the development and support to the SME development, because they gradually found the local SMEs are the real enablers and solid foundation for the country's economy. There are plenty of policy and regulation to push the financial markets and local governments to support the development of SME and the local entrepreneurs.

Back to the late 1990s, there are already a pipeline of policies were implemented in order to restructure and finance the SMEs sector in China, especially in the Southeast China. Some pilot programs includes the promotion of firm groups, the exit of non-viable small firms, and the set up of business development services to assist SMEs in information consulting, marketing, funding, credit guarantee, technical support, administrative and governmental relationship services.,

In early 2000s, the central government carried out the SME Promotion Law and it was enacted 2003, emphasizing the just treatment and a reasonable playing ground for local entrepreneurs of SMEs. In details, the Law includes better chance to finance and encourage for national firms (state-owned enterprises), VC (venture capital) and PE (private equity) investments in SMEs.

From the perspectives of the financial sector of China, there are several intended supportive policies for SMEs. For example, there is an establishment of the maximum interest rates of loans for the entrepreneurs from the local SMEs (Though some scholars believe the low interest rate may prevent the bank borrowing money to the SMEs). In December 2000, the People's Bank of China raised the

ceiling on interest rate for SME loans. However, we believe the best solution is providing low interest rates to the SMEs and subsidize the bank from the monetary inventory.

The CGSs (Credit guarantee schemes) were first introduced in the relatively developed cities of China (such as Shanghai, Chongqing, Guangzhou, and Shenzhen). At the beginning, CGSs are consisted of MGFs (mutual guarantee funds and other funds). The first few commercial guarantee firms appeared in Sichuan and Guangdong in the early 1990s. In the new century, CGAs have introduced at provincial and sub-provincial levels under government sponsorship. Also, there are provincial credit re-guarantee agencies (PCGAs) and municipal guarantee agencies (MCGAs) available for the entrepreneurs. CGAs account for about 90 % of the total credit guarantee business for SMEs, and obtain re-guarantee services from the other institutions. Prudential regulation and supervision of CGS is still preliminary and far away from implementation. It includes some ratios and policy to control for exposure to operational risks.

The SMEs Technology Innovation Seed Fund was carried out in 2000. The Law did not include any specific funding, program monitoring or enforcement. There are also several complementary measures, like procurement. For example, the Government Procurement Law of 2002 encourages contracts to SMEs and pushes of the Bank of China so that banks can implement easier loan and seed fund approval process for SMEs and the entrepreneurs with good credit records.

IV. EXPERIENCES FROM KOREA: AN OVERVIEW OF THE FACTS

A. *An overview of the Korea innovation system for SMEs*

The system supporting SMEs and the entrepreneurs of Korea has been traditionally focused on three types of support: technical support, marketing assistance and financial and taxation incentives.

The idea of technical support is based upon the fact that SMEs have greater difficulties in accessing knowledge and information about new technologies and emerging advances around the world and how to introduce them profitably into their production processes and get into the local market, especially the market in the South-east Asia. This can be overcome by the set up of an external support system from the government and its sub systems. The Korea government gives an extensive and scalable network of agencies and supporter giving collective external technical support and consulting service. This support includes technical assistance, training programs, informational counseling, joint research opportunities with local and international firms, and consulting support. These services are often complemented by financial incentives from the government. An important feature of the Korea innovation system is composed by the network of public research institutes and universities around Korea, which try to assure that SMEs can benefit from technology transfer from the basic research institutes. The other important component of the Korea system is formed by non-profit private agencies around the country. It was recorded that SMEs used often this technical support system,

but complained that the assistance was not always effective because of the lack of experience that public agencies have in manufacturing. However, they are generally believed to be helpful in supporting the SMEs in Korea.

Furthermore, Marketing and administrative support helps the SMEs to conquer the marketing difficulties and reduce the costs in what refers especially the penetration of external markets for exports. As we all know, usually SMEs do not have much in-house resources as the large firms, especially the MNC (multi-national corporations), since market information and knowledge is hard to get and transactions and operational costs are usually surprisingly high for the beginner in the market. The Korean government implemented a variety of institutions and regulations to help SMEs in marketing their service and product to the domestic market and to export. One of the biggest players in the field in Korea is the Korea Trade Promotion Corporation (KOTRA) which offers information and service about foreign market opportunities and international business intelligence, market research, informational assistance with trade fairs, conference and overseas marketing guidance, and identification of other services such as export insurance and custom clearance. Within KOTRA, the Korea Trading Company (KTC) was specifically established to provide import/export services to support the local Korea SMEs. Though it operates commercially and for-profit and all the marketing support services are public, most of the entrepreneurs in Korea still believe it is helpful.

Another player is the Korea Traders Association (KTA), a large association representing the interests of firms, including the big one and SMEs. These agencies support public affairs, international relations and lobbying for firms and other governments, but also promote knowledge sharing, patent licensing and knowledge transfer within the association.

The Korea Government financial assistance for SMEs adopts from many different successful forms from the western models. At the beginning, the major source of financial support for SMEs came from unregulated non-bank financial institutions, mainly credit markets based on reputation and family relations with no tradable assets, informal commercial paper trading markets segments, mutual savings, loan funds, popular funds, private finance firms, and angel investors. The interest rates for SMEs in these markets were usually high, like China. It is always between two to three times higher than those in formal markets. After the implementation of supportive regulation from the government, the main collective source for SME finance support was the SME Restructure Fund in Korea in 1978.

More recent trends in the development of SMEs in Korea, as we discussed above, have implied an increasing role of SMEs in the Korean economy with respect to large corporation and family businesses. An important aspect of this more prominent role is the set of a subcontracting network between large and small firms. Access to successful large firms and other firms can be an important means for SMEs to overcome some of the constraints and restrictions on their development, under the right environment, like a

business competition or idea contest for solving a particular problem. So the multi-tiered subcontracting system is regarded as transaction-cost efficient and effective. Nevertheless, subcontracting between different levels of firms is a very important role for Korean SMEs.

B. the Innovation system structure of supporting SMEs in Korea

Specifically, the innovation structure of Korea has the following merits, comparing to its Chinese counterpart addressed above:

One of the biggest supports is from the industrial Association and cooperation. Korea has promoted vertical and horizontal integration of their SMEs inside and outside of their industrial sectors. Special credit and taxation incentives are secured for the SMEs firms that belong to specific associations and cooperation.

There is also technical support available and consulting has been oriented mainly to the creation of public R&D research institutes and prototype development centers for the creation, diffusion and adoption of new idea, emerging technologies and scientific advances. Facilities are available for SMEs both for direct technical support or to support the infrastructure for testing and prototyping. SMEs can also get assistance for technology transfer, patenting, intellectual property law assistance, foreign and domestic acquisition, licensing and adoption. These support centers have local and regional branches.

As we mentioned above, the Joint marketing scheme for associations and cooperatives of SMEs and other big firms are implemented in Korea. The supportive measures include technical services for marketing and the diffusion of information on local and foreign markets. The objective of this type of the supports is the promotion of the internationalization and adaption of SMEs and expanding the business sensitivity of the entrepreneurs of Korea. Trade fairs, exploratory tours, foreign visiting, identification of technology, export insurance and the diffusion of market information are available to the SMEs. Special training for international trade and product promotion is also available.

The financial support and incentive are also available; the first type of financial support is related to loan support from the banks and other related investment institutions, which is usually examined through cooperatives and associations in Korea. Though the public funds equity does not represent the main source of finance, it is an important indicator for its involvement in the private sector.

Last but not the least, the Korea banks are required to give a specific percentage of loans they released to the local SMEs. It is mandatory. Special guarantee funds are also created to face the problem of collateral. The last type of financial support is associated with tax incentives and seed funds for investments in equipment, R&D, prototyping and personnel training.

V. A PROPOSAL TO IMPROVE SMES FINANCING IN CHINA

A. From the Micro level

From international experience, support for inter-firm cooperation involving SMEs can be considered a best practice for China. These should include support for marketing in local and especially international markets, associations to facilitate efficiency and effectiveness enhancement knowledge and marketing intelligence sharing and help in the establishment of subcontracting networks between large and a small firms in China, as mentioned in the last section. Support should be provided for several SMEs and it should be avoided to create a large administrative system to implement these policies. In sum, instead of making the Chinese SMEs struggle inside of China, the government should try to make them collaborate and compete with the ones from other countries in the international market.

Implement the better national financial and accounting information systems should improve for SMEs. This involves a proper financial accounting system for SMEs, which has to give proper disclosure of financial information. The information disclosure may allow banking institutions to be better informed on the governance of SMEs, in order to evaluate more adequately their credit risk. The support system for SMEs should involve support in receiving the information storage, processing and retrieval information systems. The improvement of better communication with credit providers can be also achieved by providing IT support to the SMEs from the government side.

B. From the Macro level

Government funds and equity supports can be directly used to promote the development of local SMEs and be governed by an expert panel and management team based on commercial and administrative criteria. SMEs also need a favorable external environment and infrastructure support, composed by support in all social areas and associated services, like personnel recruitment. This should include an legal system, capital venture support, fiscal and taxation support, professional and technical training and information and consultation system.

Also, the China's credit system should be improved for the promoting the development local SMEs. Currently, all the banks in China do not have all the resources to correctly evaluate credits for SMEs, most banks need to arrange have specialized departments for this type of credits. There should be also a more flexible interest rate floating system to SMEs. The maximum interest rate may represent an important constraint on SME.

Furthermore, specialized financial institutions and regulations towards SME financial credit should be gradually developed. To accomplish this goal, the current financial

structure should be appropriately reformed and restructured. It could include different types of specialized institutions: stock markets, regional and provincial banks initiated by non-state investors, small credit guarantees, small leasing firms, stock markets, small finance firms and national banks. All this structure should be complemented by a justifiable regulatory framework, in order to prevent risks, specifically the financial ones.

VI. CONCLUSIONS AND FUTURE RESERACH

Key barriers of supporting SMEs in China are analyzed in this paper, along with a comparative analysis of the Korea innovation system for its SMEs development. We believe that improving the financial sector, giving direction supports to the SMEs are greatly needed from a macro level perspective and improving the transparency of SMEs, networking and subcontracting are needed from a micro level analysis..

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