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What keeps SMEs entrepreneurs away from the financial assistance in China and Why–an analysis on SMEs supporting policy

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***Abstract*—after the "open-door policy" back to late 1970s, China mainland suffered a decline in state-owned enterprises and a fast expansion of SMEs. It has been very important for the economic reform and transformation of the country in the past decades. However, there is still some shortcoming in China's innovation system that keeps most of SMEs in the struggles, especially financial factors. In this paper, we developed an analysis on the development of SMEs in China and the main financing factors. Furthermore, comparative analysis of Korea, which has a similar innovation system, is also discussed. Implications and policy recommendations are addressed in the last section.**

Keywords- Entrepreneurial Environment, Financing, SMEs 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, Japan, 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 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 & Research Commission of Chinese Private Business showed in their recent survey that self-accumulated money is the major financial source for starting up firms, which is above 55%, complemented by money borrowed from relatives 31.6% and bank and Rural Credit Corporation loans, 23.4%.

In 2008, the central government prepared 500 million CNY special funding supports for the development of SMEs (increased by 25% from the previous year) and a 1200 million CNY support for international marketing (20% increase). Also from the January, 2008, the new enacted China Income Tax Law of Enterprises start to give a special tax reduction for the SMEs, which ranges from 15% to 20% [11]. In September, 2009, the State Council carried out the Advisory policy on promoting the development of SMEs in China (2009 No.36) which listed out the fundamentals for promoting SMEs development in terms of financing, infrastructure, product development and basic R&D [12]. It also gave specific policy recommendation on domestic & international trading and social service.

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 we know, the large Chinese national commercial banks have a very high market share of the deposits. However, their requirement for loans is surprisingly high so it cannot be easily 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.

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.

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 benefit from the 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

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, SMEs 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 2000 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 some of them can put limited records in their file; it still cannot give a direct effect on their loan from the state-owned banks. It is a negative factor on the quality and amount of loans and keeps SMEs from better credit rating and reputation building.

III. Current SME Financing Policies and Regulations in China

Generally speaking, the Chinese mainland government 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 policies implemented in order to restructure the SMEs sector in China, especially in the Southeast China. Some pilot programs include the exit of non-viable small firms and the set up of business development services to assist SMEs. Subareas include consulting, marketing, funding, credit guarantee, technical and administrative support and governmental relationship services.

In early 2000, the central government carried out the SME Promotion Law and it was enacted in 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). Also the People's Bank of China raised the maximum on interest rate of SME loans. However, it is believed that the best solutions is providing low interest rates to the SMEs and subsidize the bank from the country's 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 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. However, there are no thresholds for the minimum capital, liquidity risk and risk-sharing ratios.

The China National 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 encourages contracts from the government procurement to the 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 Southeast 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 [1] of agencies and supporter giving collective external technical support and consulting service. This support includes technical assistance, training programs, informational counseling, and joint research opportunities with local and international firms. 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 conquer the marketing difficulties and reduce the costs in what refers especially the penetration of external exporting market. As we all know, usually SMEs do not have much financial resources available 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 was specifically established to provide import/export services to support the 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, 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 sub-contracting system between large and small firms [2]. 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 supporting structure forSMEs 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.

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*

Based on the international experience, support for inter-firm cooperation involving SMEs can be considered a best practice for China [5]. 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. 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 [3].

Implement a better national financial and accounting information system is also important for the vertical integration of the SMEs in the national level [4]. 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 [6,7] to the SMEs from the government side.

Besides the conventional direct financial support and auditing, indirect alternatives should be also considered (like office rental subsides, housing and working location issues and transportation and relocation incentives [8]). Most of them are available to the returnees of China; however, the returnees only represent a small portion of entrepreneurs and their SMEs and it is fair to only finance and subsidize the returnees with higher education experience heavily.

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 supports in all social areas and associated services, like personnel recruitment. This should include a 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 the 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 RESEARCH

Key barriers for governmental supporting SMEs in China were addressed 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. Future possible future directions includes, but not limited to, 1) empirical studies on the specific SMEs cases in China, 2) investigation regional policy and national integration on special economical zones of China, and 3) network analysis of the Chinese SMEs and international ones on their collaboration and competition.

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