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Governance of Small Businesses in China: An Institutional Perspective

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Abstract

Governance reforms leave small businesses as a backwater. The purpose of this study was to analyze the governance of small businesses in China from an institutional perspective. Institutional theory suggests that corporations can be thought of as institutions in which their governance structures are moulded by the internal and external mechanisms found in their internal and external environments. These can be formal or informal, e.g. laws or social networks. The paper argues that there is a mismatch between the institutional governance mechanisms introduced in China and the governance of small businesses. It defines small business in China, identifies regulatory and financial reforms, and uses research supported by theories on business financing to explain how small business financial choices affects their governance. The paper concludes with a discussion of future research directions.

Keywords: *governance, small business, China, institution*

JEL classification*: K22, L51, L53, M21*

1. Introduction

Governance of publicly held corporations has become the focus of public debate in the past decade, accelerated by the corporate governance scandals in the 2008 US sub-prime mortgage. Books, articles and papers researching developing countries mainly concentrate on board structure, executive compensation, disclosure, the internal and external audit process, sanctions on director misconduct as well as the establishment of new standards and rules of integration for auditors, analysts and rating agencies (McCahery and Vermeulen, 2008). As a market-driven economy, China is no exception to these reforms.

Numerous governance reforms leave small businesses, in the form of family business, sole traders, partnerships, franchises and joint ventures (most of which are not listed on the stock market), as a backwater. Yet, small businesses play a crucial role in every economy around the world. Thus, it is not adequate to attend to the small business needs of quality governance by simply applying the same rules developed for their larger counterparts.

1.1. Research Question

The OECD report (2006) documented that the "one size fits all" model of best practice governance fails to address the diversified needs of small businesses. Hence, that lack of understanding of the governance mechanisms of small businesses flags a gap in the current literature. This research contributes to the literature by reviewing such governance mechanisms.

As to the Chinese institutional evolutions, prior to 1978, the private enterprise was prohibited in China. However, over the past three decades, China has initiated extensive market-oriented reform. Obviously, the party-state retains its significant role in the economic system, while gradually compromising its tradition of central planning. Among the reforms were encouragement to specific industries, privatization of state-owned enterprises and the encouragement of small business enterprises.

The Chinese leadership prioritized several industries as its "*jingji mingmai* 经济命脉" (economic lifeline), which enjoy privileges in soliciting government funding, and since 1992, the State Council has established a number of regulatory agencies to regulate major industries in infrastructure and financial service sectors. Positive institutional factors, influenced by a "top-down" approach, stimulated the development of enterprises. Privatization of state-owned enterprises started in the early 1990s.

In the small business sector, the Township and Village Enterprises (TVEs) initiative was a "bottom-up" approach, developed independently and complimenting the action in the mainstream institutions without the supervision of the "hard rules" (Li, 2010).

Despite the attention given to the small business sector, in early 2010, Chen Naixing, an economist and director of the Chinese Academy of Social Sciences, told *The Australian* that, during the climax of the global financial crisis from October 2008 to March 2009, 20 per cent of small businesses had crashed and another 20 per cent went "to the brink of bankruptcy".[1]

If small business enterprises are to be encouraged, the investigation of the institutional forces of governance in the Chinese context is of theoretical and practical significance. The research question of this study is:

> *What are the governance mechanisms of small businesses in China from the institutional economics perspective?*

The rest of the paper proceeds as follows: Section two provides the background of small businesses, including definition, characteristics and status quo, followed by a discussion of governance in Chinese small businesses from an institutional economics perspective in Section three. Section four uses small business finance as an example to illustrate how the institutional factors affect governance of financing in small businesses; Section five concludes with future research directions.

2. Small Businesses in China

This section introduces the small business definition in the Chinese context, followed by a discussion of small business characteristics and potential challenges hampering its development.

2.1. Small Business Definition

The definition of small businesses varies from country to country. A summary of the definitions used by different countries is provided by Li and Rowley (2008). In most of the cases, small businesses are defined by the number of employees they have, of which 100 is always used as the cutting-off point.

In China, the definition of a small business or small business enterprise (SME) is based on three indicators: number of employees, sales volume and total assets. The criteria of total assets only apply to the Industry and Construction sectors. To qualify as a small business, the enterprise needs to meet only one of the criteria listed in Table 1.

Table 1 Definition of SMEs in China

Industry	Criteria		
	Employee (Million RMB)	Sales volume (Million RMB)	Total assets
Industry	2,000	300	400
Construction	3,000	300	400
Wholesaling	200	300	N/A
Retailing	500	150	
Transportation	3,000	300	
Postal service	1,000	300	

Source: State Economic and Trade Commission, State Development Planning Commission, Ministry of Finance, and State Statistical Bureau, "Small and Medium-sized Enterprise Promotion Law of the People's Republic of China", 19th February 2003.

As in most other countries, the Chinese authorities selected the terms used to define small businesses for the convenience of administration (Li, Armstrong *et al*., 2011). Given that small businesses are endowed with preferential treatments, in particular, tax benefits, the Chinese government is considering to re-adjust the small business definition later this year.[2] The government's official news release also mentioned that the revision of the definition was intended to benefit the micro and small size businesses by easing difficulties in accessing finance.

The blurriness of the small business definition may also be due to the mystery of policy objectives. In developed economies, the distinction between small and large enterprises is mainly targeted at exempting disclosure burdens for small businesses. Though the Chinese government is planning to render direct benefit to small businesses by narrowing down the group, one has to admit that small businesses are still a large proportion of the national economy, and the expected impact might be discounted if the leadership fails to consider restricting other related regulations.

2.2. What Is a Small Business in China?

Small businesses are the engine room of the Chinese economy. According to a *China Daily* report, there are 10.3 million registered companies, 99 per cent of which are small businesses. The small businesses in China employ 80 per cent of the people in urban areas and contribute to 60 per cent of the national GDP. Small businesses contribute 55 per cent of the national tax revenue. Their business accounts for 60 per cent of the total volume of imports and exports and are providing 75 per cent of employment in cities and towns overall. Up to 65 per cent of the national invention patents are created by small businesses and 80 per cent of the research and development of new products are provided by small businesses (Wang, 2010).

A standard small business normally has the following characteristics (Francis and Armstrong, 2006; Li, 2011):

- They have a relatively small share of their marketplace. They often operate in only one location servicing local customers but may have operation in a niche market or be part of a franchise.
- They are usually owned by one person, or a small number of individuals, often linked by family ties. Because of this, although many are registered as companies, ownership is often restricted and takes the corporate form of sole proprietorships or partnerships. These latter forms leave the small corporation without the protection of limited liability.
- They are privately, often family owned. In the USA family businesses represent 35 per cent of all businesses, in Europe over 50 per cent and in Asia over two-thirds of businesses.

- They are managed by owners, often owner/managers who make all the critical management decisions and undertake many of the management functions such as financial management, personnel, marketing and production that might be distributed in a larger corporation.
- Succession in ownership and management is often a problem.
- They may have resources constraints. Access to financial and other resources is often a major constraint.
- Because an owner/manager undertakes most management roles without the support of internal specialists, the small business is often dependent on other professionals such their accountant or lawyer for advice.
- Small business is closely associated with entrepreneurship and innovation.
- They are independent, in the sense that they are not part of a larger enterprise. In fact, some are deliberately kept small because their owners value the lifestyle associated with "less hassles, less politics, more flexibility and better work-life balance".
- They are not cooperative with one another in order to voice for themselves in the political arena.
- The majority of small businesses are not willing to innovate and are reluctant to change.
- The high technology related industries grow fastest owing to the preferential policy.

3. Governance of Small Businesses: A New Institutional Economics Perspective

3.1. Definition of Governance

Governance refers to the ways in which organizations are directed and controlled (Francis and Armstrong, 2004). Traditional theories of governance, agency theory and stakeholder theory, explain the relationships between shareholders and managers and between an enterprise and a range of stakeholders. More recently institutional theory (Williamson, 1975) emerged from transactional theories in economics to suggest that corporations can be thought of as institutions in which their governance structures are moulded by the internal and external mechanisms found in their internal and external environments (Nam and Nam, 2004; Bebchuk, Cohen *et al*., 2009).

The internal mechanisms refer to the corporate governance standards within corporations such as board policies, structures, risk management, financial and IT controls, remuneration, etc. (Armstrong, 2004). Examples of internal policies related to finance, investment and accounting include for example, managerial incentive plans, capital structure, and policies related to risk and return, asset management and dividend growth policies or financing policy such as whether to seek finance by issuing stocks or debt instruments. Debt or leverage is also a corporate governance mechanism.

External mechanisms are those factors in the external environment, such as regulation, and the business environment. Regulatory governance mechanisms related to financial management strategies are accounting regulation and securities law, corporate law, laws specifying diversification requirements related to ownership by institutional investors and financial intermediaries, capital and financial market characteristics, and industry practices. Factors in the business environment include the influence of capital market size and liquidity, banking and financial institutions, and product market competition (Allen and Gale, 2000; Bushman and Smith, 2001; Heinrich, 2002; Douma and Schreuder, 2008). The role of banks and financial institutions as outside monitoring institutions makes these institutions among the corporate governance external mechanisms.

Institutions can be either formal or informal. Formal institutions are those established and structured by formal rules such as government and banks. Informal institutions are recognized as networks of relationship which may be governed by formal rules such as between investors and managers or by social norms such as those between an enterprise or its stakeholders. In particular, kinship networks (discussed below) are a major factor in the Chinese business environment.

Bell defined governance using the new institutional economics perspective as "the use of institutions, structures of authority and even collaboration to allocate resources and coordinate or control activity in society or the economy" (Bell, 2002). Research drawing on institutional theory into the governance of large corporations at the macro-level by both Bell (2002) and Williamson (1975, 1985, 1996, 2005 and 2007) identified three business governance options, hierarchical, market, or hybrid that influence different types of decision making. Following research at firm level, Williamson (1995) and Ostrom (1990) drew on economics theories based on behavioural assumptions of bounded rationality, opportunism and uncertainty to explain decisions about the governance mechanisms that influenced financial decisions.

The research of informal institutions extended governance mechanisms to personal networks, clienteles, corruption, clans and mafias, civil society, traditional culture and a variety of legislative, judicial and bureaucratic norms (Helmke and Levitsky, 2004).

3.2. Definition of Institution

By regarding the economic process as a game, Gagliardi reviewed prior theoretical and empirical research on institutions (Gagliardi, 2008) and identified three main definitions of institutions: (1) institutions are rules of game (North, 1990; Ostrom, 1990); (2) institutions are the players of the game (Nelson, 1994); and (3) institutions are the equilibrium between the rules and players (Schotter, 1981).

Informal institutions, known as social norms, can be classified into four types by their interaction with the formal institutions, including complementary, substitutive, accommodating and competing informal institutions (Helmke and Levitsky, 2004).

Fan, Wei *et al*. (2011) proposed a framework to understand institutions in China from three levels, including country institutions, markets and firms. Apparently, small businesses are institution-takers, be it formal or informal.

3.3. Legal Requirements

The legal reforms can be classified into two unbalanced parts, one, the corporate law reforms, and the other one the small business-related policy reforms. It is disappointing that not much evaluation has been done on any of the policy reform initiatives.

3.3.1. Corporate law reforms

In general, corporate law reforms since 1978 can be divided into three categories: (1) clarifying the relationship with foreign investors, i.e. Equity and Joint Venture Law in 1979, Regulations for the Implementation of the Law on Joint Ventures using Chinese and Foreign Investment in 1983, and The Law on Enterprises Operated Exclusively with Foreign Capital in 1986; (2) standardizing the establishment and operations of domestic companies, i.e. China's Security Law in 1999 and Revised Company Law in 2005; (3) re-regulation of both foreign and domestic enterprises, i.e. The Enterprise Income Tax Law in 2008 (see details in Chen and Song, 2007; Lo and Qian, 2009).

Small businesses did benefit a lot from such deregulation in the form of preferential export policies and tax favours. However, recent de-regulation put the same red-tape and compliance burdens on small businesses as their larger counterparts, which is beyond their capacity (Lo and Qian, 2009).

3.3.2. Small business-oriented regulatory reforms

In fact, the national government did not list SMEs development on its agenda until TVEs were recognized as a vehicle to increase rural income as well as absorbing rural labour surplus without extra government investment. Then, in the mid-1980s, the policy toward SMEs shifted from tolerance to encouragement. During 1979-2009, seven major deregulation initiatives were identified, including the National "863 Plan" in 1986, National Torch Program in 1988, National SMEs Galaxy Training Project in 1990, SMEs Innovation Fund in 1999, SMEs Promotion Law in 2003, Several Opinions on Encouraging, Supporting and Guiding the Development of Self-employed and Private Economy and Other Non-public Sectors of the Economy in 2005, and Several Opinions on Further Promoting the Development of SMEs in 2009 (09 Opinion) (see details in Yao, 2003; Lei, 2008; Innofund, 2009).

All the SME-related reforms before 2008 had a focus on high-tech using financial support and political favours easily precluded TVEs from such benefits. Meanwhile, these regulatory reforms failed to analyze the problems and challenges that TVEs or SMEs are facing, while prescribing changes without providing solid evidence to support the initiatives. The *09 Opinion* is targeted at encouraging the SMEs to improve their technological innovation capacities, enhance the product quality, and promote development in energy conservation and clean production. Whether such initiatives will have a positive impact on TVEs is worthwhile to investigate in the future.

3.4. Formal Contracts and Relational Contracts

The key issue in China's economic reform is how to convert the earlier system of hierarchical state-driven enterprises into a system of market-driven property ranking of rights (Cheung, 1998). In the expected market-driven economy, contracts play a central role when a market is functioning well.

In the pre-reform planned economy, private business contracts were of no use. As the reform became more extensive and the market began to play a more important role in the economy, both the formal and relational contracts came into use and became prevalent. In the past three decades, the law for contract enforcement in China experienced four major reforms: Economic Contract Law in 1981, Foreign Economic Contract Law in 1985, Technology Contract Law in 1987 and Contract Law in 1999.

Hu and Qiu (2010) empirically examined the determination of contractual options of 1500 Chinese firms using World Bank survey (Hu and Qiu, 2010). The survey was administered in five major cities and ten industries during 1998-2000. Their research found that some 80 per cent of firms had formal contracts with their clients or suppliers and the rest of 20 per cent relied on relational contracts.

3.5. Social Networks and Other Informal Institutions

Due to culture and traditions, social networks have served as an important governance tool utilized by small businesses in China (Peng, 2004; 2010). The creation and enforcement of informal rules, in the form of social networks, have been identified as a focus of economic exchange and personal interactions. Peng (2004) focused on the economic payoff from kinship networks in the context of China's rural industrialization and argued that kin solidarity and kin trust played an important role in protecting the property rights of private entrepreneurs and reducing transaction costs during the early stages of market reform, when formal property rights laws were ineffective and market institutions underdeveloped. Data from 366 villages show that the strength of kinship networks has large positive effects on the count and workforce size of private rural enterprises and insignificant effects on collective enterprises.

Puffer, McCarthy *et al*. (2010) also found that the Chinese economy can be characterized by underdeveloped formal institutions, which often result in an unstable environment and creating a void usually filled by informal ones. Entrepreneurs thus face more uncertainty and risk than those in more developed economies. They examined the relationship of institutions and entrepreneurship in Russia and China in the context of institutional theory by analyzing private property as a formal institution, as well as trust and "*guanxi* 关系" as informal institutions and concluded that full convergence toward entrepreneurs' reliance on formal institutions may not readily occur in countries like Russia and China due to the embeddedness of informal institutions. Instead, such countries and their entrepreneurs may develop unique balances between informal and formal institutions that better fit their circumstances. Implications for the theory and practice of entrepreneurship in such environments are also offered.

3.6. Government Assistance to Small Businesses in China

An often used instrument designed to assist the small business development is to provide provisions of financing. In 2009, the central government earmarked 10.89 billion yuan ($1.77 billion) to support the development of small businesses. A tax break was also offered for small low-profit enterprises with an annual taxable income of less than 30,000 yuan. They only needed to pay tax on 50 per cent of their income at the rate of 20 per cent.[3]

Given that the enforcement of contract protection is fairly weak, networking and other informal institutions have been used more often than the hierarchical approach (Cull and Xu, 2005).

3.7. Over-regulation of Small Businesses: A Mismatch between Governance and Institutions

The small business sector is experiencing unnecessary compliance costs from regulation. Literature suggests that the regulation of firms is directed to, and best suits the needs of, the largest companies (those that are public, listed and well-resourced) (Clarke, 2007). This bias in regulatory frameworks is particularly evident when it comes to self-regulation, a version of responsive regulation that it is conducive to the market and aimed at a particular group, in this case listed public companies as exemplified by the Best/Good Practice Recommendations provided to listed companies.

These self-regulatory practices favour large, wealthy firms that enjoy plentiful in-house expertise and elaborate compliance systems; while small corporations with fewer resources are left with the costly and onerous task of complying with compulsory regulation. The regulation of small businesses fails to adequately respond to the needs of small businesses and is preventing small corporations from performing at their best (Clarke, 2007). McCahery and Vermeulen (2008) also argued that, though small businesses are facing the same compliance requirements as per the corporations' law, they are not benefiting from the spill-over effect of the aforementioned reforms. Responsible and fair governments assume the role of developing well-balanced institutions to suit the diversified need of all businesses.

4. Small Business Financing: An Example

Given that small business faces an alarming credit crisis[4], small business financing is selected as an example to illustrate how institutional factors influence the governance of small business financing.

4.1. Theories on Business Financing

A review of the competing theories explaining the behaviour of firm financing governance from the institutional perspective can be found in Li (2011). Modigliani and Miller (1958) began the modern theory of capital structure, pointing to the directions that the "modern theory of capital structure must take by showing under what conditions capital structure is irrelevant". Only in perfect capital markets does the aforementioned "irrelevance" holds. By definition, perfect capital markets means: (1) no frictions; (2) perfect competition in product and securities markets; (3) information efficiency; and (4) the agents are perfectly rational and search to optimize their utility (Briozzo and Vigier, 2007).

In reality, the assumptions for perfect capital markets are largely violated by corporate and personal taxes, transaction costs and information asymmetries, making the capital structure and furthermore financing strategies relevant. Three themes of literature address the violations of Modigliani and Miller's perfect capital market assumptions pertinent to small business financing, namely trade off, credit rationing, and pecking order.

The trade off theory predicted a targeted optimal structure in order to balance costs and benefits or risk and returns (Prasad *et al*., 1997). The trade off theory is focused on demand. Copeland *et al*. (2004) identified the balanced optimal structure as equilibrium effects trading off permanent influences whose effect is industry-wide, i.e. taxes, bankruptcy costs, and agency problems. For small businesses, given that owners and managers have a large stake in the businesses, they will asymptotically prefer debt rather than equity in financing. The drawback of the trade off theory is that the associated costs and benefits are difficult to quantify as the tax system is complex.

Stiglitz and Weiss (1981) demonstrated that, due to information asymmetry, the banks ration credit, instead of increasing the interest rate, if there is excess demand in order to avoid riskier borrowers. As small businesses have restricted access to capital markets, due to the high fixed costs or legal form limitations, the effect of credit rationing is expected to be strong, thus pursuing more expensive financing forms, equity being an alternative.

The pecking order theory, proposed by Hamilton and Fox (1998) and Hutchinson *et al*. (1998), provided a hierarchy in the financing choices, first internal funding, then debt, last external equity. Chittenden *et al*. (1996) stated that issuing external equity may be particularly costly for SME, because of the relatively fixed costs of initial public offerings, the small firm effect on the cost of equity, and the potential loss of control by the original owner managers. Zoppa and McMahon (2002) describe a small and medium enterprise (SME) pecking order, where the first choice is internal equity, then short-term debt, then long-term debt, possibly loans from owners, family and friends, last comes the new equity. Though the pecking order provides rationale for small firm financing decision making, Fama and French (2002) pointed out that the pecking order provides no incentive for firms to issue debt if they still have internal funds to finance their investment.

4.2. Formal and Informal Financing of Small Businesses in China

Despite the weaknesses in its banking sector and that only a small number of businesses utilize formal bank finance, Ayyagari, Demirguc-Kunt *et al*. (2010) empirically found that formal financial system is associated with faster firm growth while informal financial system is not. However, Tsai found opposite evidence that formal financing options are not as efficient as the informal financing (Tsai, 2004; 2006).

The fast growth of Chinese private sector firms is taken as evidence that informal finance can facilitate firm growth better than formal banks in developing countries. Ayyagari, Demirguc-Kunt *et al*. (2010) examined firm financing patterns and growth using a database of 2,400 Chinese firms. While a relatively small percentage of firms utilize bank loans, bank financing is associated with faster growth whereas informal financing is not. Controlling for selection, they find that firms with bank financing grow faster than similar firms without bank financing and that their results are not driven by bank corruption or the selection of firms that have accessed the formal financial system. Their findings question whether reputation and relationship-based financing are responsible for the performance of the fastest-growing firms in developing countries.

Tsai (2004) observed that banking authorities in China attempted to limit most forms of informal finance by regulating them, banning them, and allowing certain types of microfinance institutions which aims to increase the availability of credit to low-income entrepreneurs and eliminate their reliance on usurious financing. Nonetheless, the intended clients of microfinance continue to draw on informal finance in rural China. This article argues that the persistence of informal finance may be traced to four complementary reasons – the limited supply of formal credit, limits in state capacity to implement its policies, the political and economic segmentation of local markets, and the institutional weaknesses of many microfinance programmes.

Though no consensus has been reached with regards to whether formal financing or informal financing plays a more important role in funding small businesses, the aforementioned evidence shows that small businesses in China are adopting the hierarchical governance mechanism as their funding form, which leads to the tentative conclusion that pecking order theory well explains the small business financing option. Since the pecking order type of governance mechanism is associated with high risk of default, uncertainty and economic cost compared with other alternatives, future reforms should target at establishing institutions to transform small business financing to other means with lower costs.

5. Future Directions

While the regulators are obviously endeavouring to promote small business enterprises, inappropriate reforms, over-regulation and lack of understanding of financial decision making in the small business sector will continue to inhibit their effectiveness.

Following the case study tradition in New Institutional Economics, future research will focus on developing cases for the institutional analysis of specific questions in the Chinese context. Future research also expects to transform from a case-based approach to empirical tests on how institutional factors such as financial decisions influence various economic outcomes at the firm level. It might also be necessary to explore whether transaction cost theories can be adopted to analyze the governance mechanism of small businesses in China in that medium-sized businesses have similar properties as their large counterparts in terms of the asset specificity, frequency and uncertainty. In addition, the establishment of new institutional reforms to equip the transformation of small business financing from pecking order to lower cost mechanisms also merits further investigation.

Notes

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