

Western Small Business facing Institutional Barriers in China: A Perspective of Institutionalism

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Abstract

In previous decades China experienced an extensive inflow of Foreign Direct Investment (FDI). After a rush towards China investors became more aware of the risks of investing into business in China. This trend can, for example, be illustrated by decreasing numbers of contracts between Western and Chinese companies whereas at the same time total FDI continued to rise. This development further indicates that big business contributed a bigger share of total FDI in recent years and at the same time foreign investment by smaller business decreased. In this context one could ask whether formal and informal institutional constraints faced by western small business could have had a bigger impact on FDI compared to big business.

Hence the main questions of this paper are (1) “What institutional barriers is western small business confronted with when entering the Chinese market” and (2) “are these obstacles more serious for small business compared to big business? Based on the perspective of constitutionalism, this paper analyzes both formal and informal institutional barriers as possible obstacles for foreign companies and in particular small business. The research analysis data of FDI in China from 1998 to 2009 and market failures of foreign small business as the dependent variables; the independent variables are determined by the institutional framework in China. Finally, the research findings based on qualitative analysis are expected to provide possible influential factors and institutional constraints which western small business is confronted with when entering the Chinese market.

Keywords: Foreign Direct Investment, institutional barriers, western small business

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Introduction

The aim of this paper is to show the difficulties that western small business faces when entering the Chinese market in terms of institutional barriers. The case of the company “Paws aboard”, which will be introduced subsequently, is only one example for a western small business struggling to establish business relations in China. For the paper the case provides information for further analysis of this field. Based on a theoretical framework of institutional theories¹ this paper includes experiences of businesses when entering the Chinese market. Finally this issue can be looked at from a broader range by making conclusions about patterns of western business approaching the Chinese market in general. By doing so it will be easier to give possible answers to the leading question whether institutional constraints that western small business faces in China are more serious compared to big business as well as what kind of constraints foreign small business is confronted with in particular. During the course of discussion the business failures of small western companies are the dependent variable which is determined by the institutional framework in the PR of China, i.e. the independent variable.

Most cases of business failures of small companies are not made public, but media cover predominantly issues of big companies. Despite this fact it is worthwhile to look at the specific difficulties of small business, because this way it is possible to dismantle certain issues that are less obvious when analyzing popular cases. The company Paws Abroad produces a set of gear for dogs, especially designed for usage on boats. Products include handcrafting boat ladders, life jackets and waterproof leashes. When business expanded the owner decided to outsource production to China. Following the recommendation of another entrepreneur the owner contacted an engineer in Shenzhen. The low production costs promised high profits, but then severe problems emerged: The quality of the products was unacceptable, the contact in China did not answer and a total delivery of leashes (3000 pieces) was defective. Furthermore the factory denied to make good on the order. Unable to sell the defective products Paws aboard had to burden a big loss.

Not only small business had to acknowledge that outsourcing to China included high risks of losses, but in particular small companies faced big challenges. Similar to Paws aboard they often can not afford to overlook the production process and monitor the quality of manufacturing. Likewise the service of consultant companies would exceed the budget of small companies in many cases. After the first setback, the owner of Paws aboard found a consultant at “One World Sourcing”, a local trade show, who took over the manufacturing, quality control and shipping. In the result the costs dropped dramatically and business continued smoothly afterwards.² This example points at serious problems including among others legal matters, business culture, and economic efficiency. Therefore the paper will discuss all kinds of obstacles for foreign small business in China. After the key concepts are briefly introduced, the paper will show the development of Foreign Direct Investment (FDI) in China and subsequently discuss all kind of institutional constraints faced by foreign small business when entering the Chinese market.

Institutional constraints, small business, variable and fix costs

In this paper institution is considered as a framework including various kinds of constraints that determine economic activity. Institutions are the "rules of the game",

¹ North Douglas C., *Institutions, Institutional Change and Economic Performance*, Cambridge University Press.

² http://money.cnn.com/2007/07/26/magazines/fsb/china_sourcing.fsb/index.htm, 14.12.2008

consisting of both the formal legal rules and the informal social norms that govern individual behaviour and structure social interactions.³ Hence it will not only be looked at political institutions but at any kinds of institutional constraints with a particular focus on settings that limit economic activity of foreign small business entering the Chinese market. According to Simmons it is unquestionable that institutions matter, therefore the subsequent sections instead seek to answer the question how institutions matter in the prevailing context.⁴

Institutional constraints state big obstacles particularly for small business and for this reason the paper will focus on small business. A company needs to fulfil at least two of the following criteria to be considered a small business: (1) The gross operating revenue is less than \$10 million for the year, (2) gross assets are less than \$5 million at the end of the year and (3) there are fewer than 50 employees at the end of the year.⁵

For those companies institutional constraints are often a bigger obstacle when entering the Chinese market, because the fix costs of a establishing a business weigh much heavier than for big companies, but fix costs must be paid whether any unit is produced or not. In contrast variable costs depend on the quantity produced, i.e. fix costs have a higher proportion of the total costs for smaller quantities.⁶ Even though this basic model excludes many aspects of the reality, for example it does not point out the different cost structure of small and big companies, but the fundamental assumption remains valid: For higher quantities of production the fix costs have a smaller proportion. Accordingly all kinds of fix costs state a higher barrier for small businesses, for example market entry costs or costs of gathering information. Furthermore are fix costs determined by a given institutional framework. Small and medium companies (SMEs) have their special challenges, for example, higher transaction costs, difficulties of external financing, liquidity constraints and are therefore more vulnerable than large companies.⁷

Therefore the subsequent sections will discuss possible institutional constraints that could explain higher fix costs for foreign small businesses when approaching the Chinese market.

FDI in China

The total foreign investments continuously increased during the last decades. Since the opening of the market foreign direct investment in China surpassed \$700 billion⁸ Globalization increased competition worldwide and companies are looking for places with low production costs as well as new markets. This trend can also be shown in Table 1: The utilized foreign direct investment in China grew from \$59.3 billion to \$95.3 billion in 2008. However the number of projects peaked in the year 2005 and since then declined.⁹

[Insert table 1 about here]

³ North Douglas C., Institutions, Institutional Change and Economic Performance

⁴ Martin L.L., Simmons B.A., Theories and Empirical Studies of International Institutions, Cambridge University Press, in : International Organization, Vol. 52, No. 4, International Organization at Fifty: Exploration and Contestation in the Study of World Politics (Autumn, 1998), p. 729-757

⁵ Commission of the European Communities. 1996. Commission Recommendation Concerning the definition of small and medium-sized enterprises

⁶ Mankiw N.G., *Macroeconomics*, Palgrave Macmillan.

⁷ Chow C., Fung M. 2000

⁸ New York Times, Foreign investment in China rises 12 percent in 1st quarter, April 12, 2007

⁹ PRC Ministry of Commerce (MOFCOM); PRC National Bureau of Statistics (NBS), China Statistical Yearbook 2009

It appears that foreign investment took not place without setbacks, but it remains uncertain how big the impact of FDI by foreign small business is in correlation with the decreasing number of projects. In this context it is only comprehensible that in September 2009 the State Council announced measures to further promote Small and Medium-Sized Enterprise (SME) Development.¹⁰

This measure might be an attempt to remedy obstacles that foreign companies are confronted with when establishing business in China. Already in 2006 the consultant company Ernst & Young published a survey that shows how German medium-sized business estimates chances and risks of the Chinese market: Most companies consider their businesses in China positively, but 78% emphasize the lack of legal security and the insufficient reliability of the legal framework as a medium to high risk for their investments in China. Likewise the enforcement of contracts is costly and takes a long time. They further stress patent infringement and the insufficient protected property rights as serious problems, particularly correlated with the Chinese market. Finally 62% of the entrepreneurs argue that corruption in the Chinese bureaucracy appears to be a serious problem.¹¹ In deed many companies, like Paws aboard, are now rethinking their investments into China and became more aware of the risks.¹²

After the first rush towards China investors became more cautious of the risks. In theory this pattern is broadly applied in Game Theory, i.e. actors will adjust their strategies after games are repeated. Nowadays even business consulting companies take a rather critical position when estimating the business prospects of their clients in China. The following sections seek to provide an overview about possible reasons behind the above described trend. For this purpose the paper will discuss fix costs, institutional constraints, both formal and informal, as well as transaction costs.

Institutional constraints in China for foreign small business

Excessive costs for foreign small business derive among others from a particular Chinese institutional framework which is determined by formal rules, informal constraints, uncertainties, inefficient bureaucracy, and information asymmetries. The different kinds of constraints affect small and big business differently, as will be shown subsequently.

Barriers to entry

Barriers to entry are costs that a potential competitor faces when seeking to enter a market.¹³ China offers cheaper production costs for labour intensive sectors and at the same time itself stands as a huge market, while many Chinese still lack a sufficient purchasing power to buy foreign products. These are some of the main reasons why many big companies started early to establish their business in China. They simply can not risk not obtaining their share of the Chinese market and getting access to the Chinese market is only possible by cooperation with a Chinese business partner. Sharing business with a local partner states the first example of increased fix costs.

Previous to the market entry entrepreneurs need to gather information, make a business plan, calculate the economic prospects and go through the process of establishing business. All these activities need both time and money. Similarly all these kind of costs are considered fix costs and need to be taken into account. Whilst big

¹⁰ World Bank, China Quarterly Update, November 2009

¹¹ Ernest & Young. Mittelstandsbarometer 2006.

¹² <http://alangutterman.typepad.com/emergingcompanies/2007/08/reasons-for-uns.html>, 21.12.2008

¹³ Schmalensee R. Economies of Scale and Barriers to Entry. Chicago University Press.

companies can afford to consult with professional consultant company, small business often can not afford to plan their business start properly. The example of Paws abroad shows: Small companies often rely on easily accessible information and hence risks are not taken into account properly.

Formal rules

Formal rules are an essential part of institutional constraints which determine the efficiency of economic performance. They determine, for example, the extent of risks due to uncertainty about an effective implementation of formal rules. Risks not only arise from information lacks, but also from an uncertain enforcement of agreements.¹⁴ The legal system in China is much less liable than, for example, in the US. The successful enforcement of agreements in China in many cases lacks consistency as it depends among others on personal relations as well as a good standing with governments. One reason is the concentration of political power, instead of a division of powers. The PR of China lacks a system of checks and balances which makes it critical in many cases to rely on the legal enforcement of contracts.

The establishment of a reliable legal system in China is further difficult because of the long tradition of strict hierarchies in the Chinese society, i.e. informal constraints. According to this tradition disputes are settled by mechanisms relying on relations. Hence still today private business in China continues to rely on personal connections.¹⁵

According to North formal rules offer protection, justice, the reduction of internal order and the protection of property rights. They aim to overcome cooperation problems and reduce transaction costs by transferring power to institutional bodies, for example, the courts. That is why the state often takes the part of a third party who is responsible for enforcing contracts, but states themselves often follow their own interests. In these situations a reliable legal system which protects the property rights of individuals or companies against the state are a significant keystone for a stable business environment. The lack of such a system results in higher transaction costs which is a particular barrier for small business. Finally the one-party-system in China hinders the efficient implementation of a reliable legal system.

Furthermore the enforcement of agreements implies costs. Particularly small companies are confronted with relatively high costs of filing a suit. In case that the chances of winning a case are considered low then the aggrieved party restrains from an impeachment. The example of Paws Abroad shows such a dilemma: The small company had to burden the loss due to the defective delivery.

Another formal constraint is the rule that foreign companies need to cooperate with a Chinese company when doing business in China. This rule further increase the fix costs of companies who seek to do business in China. Accordingly foreign companies have to form a Joint Venture. This measure states another barrier for small business. The search for a Chinese business partner further increases the fix costs.

Other cases illustrate the importance of the protection of property rights. Dan'l Pierce, chief executive of Access Analytics International which provides software solutions in Asia, mentioned that he would never offer his services in mainland China, because he is afraid that those business partners could copy, sell or use his software even though it is licensed and legally protected.¹⁶ Even though the Chinese government already paid lots of efforts to solve this problem, but without an efficient legal system

¹⁴ North Douglas C., *Institutions, Institutional Change and Economic Performance*

¹⁵ Hudson C., Blecher M.J., Curry J. *The China Handbook: Questions and Answers*. Fitroy Dearborn Publishers. New York, 1997.

¹⁶ Dan'l Pierce at a speech during his visit at the National Cheng Kung University in November 2008.

including a system of checks and balances there still remains uncertainty about the protection of property rights in China.

Informal constraints

In addition formal rules need to be backed by informal rules to be inefficient in terms of overcoming any informal limitations of human interaction. Only by adequate informal norms it is possible to lower the costs of supervision, enforcement, measurement and monitoring. Both legal norms as well as informal constraints are more or less well established in developed countries, whereas they lack efficient implementation in China. North, for example, argues that the costs of transaction in Third World countries are bigger than in developed countries.¹⁷

Apart from the legal norms companies could even offer replacement when the legal enforcement of the contract is uncertain. Unfortunately Chinese suppliers, for example, have a poor record of business moral. In the case of Paws aboard the Chinese supplier denied replacing the shipment and making good on it. This supports the argument that in China both formal as well as informal constraints are comparably higher than in Western countries which is particularly an obstacle for foreign small business.

In contrast to formal rules informal constraints are relatively stable and only alter during a period of time. Despite that the Chinese government implemented new laws that protected private property rights in the year 2007 but informal constraints, such as business culture, will only change gradually. The Chinese government furthermore aimed to promote the establishment of a civil code. The Chinese entrepreneurs on the other side will not adopt this new codex into their daily life until they are accommodated to the Chinese value system. As the example of Paws aboard shows: the new norms are not yet implemented in China.

The new private property right is one of the most important and distinct legal changes in the Chinese legal framework, but even before there were already laws that aimed to protect the interests of entrepreneurs. Nevertheless business in China is still based on informal agreements as the underlying principles behind each contract.¹⁸ For small foreign companies it is even more difficult to comply with all unwritten norms and rules as they are closely correlated with tradition and cultural values. Their lack of competitive advantage compared to multinationals as well as their poor understanding of Chinese negotiation styles are, among others, major obstacles.¹⁹

By cooperating with local governments and business men problems, such as described in the Paws Aboard case, could have been avoided, but only by spending more money, for example for bribery. Corruption is an inseparable element in the Chinese business culture. Exchanging expensive gifts in China, for example, is not considered as bribery. That shows that bribery is an integral part of the daily business routine in China, but it also states additional transaction costs. For small companies this procedure is often not profitable, because the margins of their business prospects do not allow for it under the condition of staying profitable.

As mentioned before, there are big differences correlating business culture, language and the value system in each country. Apart from written norms there are many unwritten rules and those rules are eminent in each business sector. The business culture in the U.S., for example, differs significantly from the situation in mainland China. Business cultures emerged during a long-term process in the context of a

¹⁷ North D.C., *Institutions, Institutional Change and Economic Performance*

¹⁸ Hudson C., Blecher M.J., Curry J. *The China Handbook: Questions and Answers.*

¹⁹ Leung T. , Yeung L.L. *Negotiation in the People's Republic of China: results of a survey of small businesses*

historical path of try and error. The underlying principles are determined by culture and their corresponding values. A “Yes” in Japan for example is less worth than a “Yes” in Germany. In Japan, for example, Japanese contractors often suddenly change their statements and no longer refer to previous agreements unless agreements are written down and signed. Similarly entrepreneurs in China are not used to write down all details in a contract as it is broadly exercised in American businesses culture. Also, in the highly sophisticated market in America companies care more about the details of their products including packaging than in China. Again, one should consider that if legal norms are not backed by informal rules then laws are barely exercised efficiently. However most foreign companies are used to their business culture, but do not understand the procedures in China.

It becomes obvious that there are immense differences between the countries in Asia when one examines the legal systems, business culture, language gaps and other obstacles. The experience of previous business relations have significant impacts on the decisions made by western companies whether to start business in Asia. Particularly for Western companies it is essential to understand the Chinese business culture better in order to be successful in the Chinese market. One example is having good relations with both business partners as well as officials to overcome any kind of obstacles.

Transaction costs

In general foreign business in China has to raise more resources in the process of gathering information, signing contracts as well as transaction. This results in higher transaction costs for foreign business. Many companies act through a local agent who carries out their directives. In fact most companies consult agents who smoothens communication between the foreign company and the local business partner. Yet many small companies can not afford professional assistance and take the increased risk of a business failure.

Further costs emerge from hiring interpreters or paying contributions to the bureaucracy, i.e., as mentioned before, bribery. The complex and slow bureaucratic processes in China could be accommodated by bribery, but this custom further increase the average transaction costs for businesses in China, particularly for foreign small business. Even though bureaucracy is not designed to be efficient necessarily²⁰, but the special procedures in China differ significantly from foreign countries and state higher transaction costs for foreign enterprises.

The above mentioned costs are mainly based on information asymmetries which cause higher levels of uncertainty. Information asymmetries are also correlated to an insufficiently reliable legal framework, because the possible loss due to unenforceable property rights means that companies have to take a possible loss into account. In contrast the transaction costs would be significantly lower in a system with a relatively high success rate of agreement enforcements. In such a case the logical chain starts from information asymmetries that causes higher transaction costs due and imply higher levels of uncertainty which state increased transaction costs.²¹

Conclusion

The globalization of economic systems not only creates new opportunities, but at the same time cause new challenges. Different political, economic as well as social concepts have no choice but to closely interact. This development is naturally accompanied by turbulences, especially when concepts differ so significantly like in the

²⁰ Moe T. M., p. 147

²¹ *ibid*

case of foreign business in China. Many critiques, for example, argue that international standards are insufficiently implemented in the Chinese economy. Those standards include the working conditions of the working force, environmental protection, food standards, banking standards, property rights, etc. One could also argue that international standards are not prepared to comply with Chinese standards. The debate whose standards should prevail on an international level is another debate, but obviously Western and Chinese norms as well as values often show major differences. As a result economic efficiency suffers as the case of Paws Aboard shows.

The obstacles discussed above show what difficulties foreign business is confronted with when approaching the Chinese market. It further became clear that the specific economic framework in China states higher hurdles for foreign small business compared to big companies. Furthermore, institutional barriers in China appear to be comparably high. In conclusion there seems to be no shortcut to the Chinese market, but all kind entrepreneurs are advised to pay attention to the special written and unwritten rules in China.

In order to overcome the above mentioned constraints entrepreneurs could, for example, consult with Chambers of Commerce or renown consultant companies, first produce a prototype before starting the actual mass production, bribing officials or establish sound business relations. But finally those measures will increase costs for the foreign investor. For example, small agents charge a minimum of \$2000 for just finding a suitable factory and up to \$20,000 for more complex issues. In the end fewer ideas would due to the limited budget of small companies be translated into action. On the contrary big companies often have no choice but to burden increased costs because of strategic goals. At the same time it is easier for them to accommodate and overcome losses.

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Table 1.

Non-Financial Foreign Direct Investment (FDI) Inflows, 2000-09										
Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total FDI										
Number of projects	22,347	26,140	34,171	41,081	43,664	44,001	41,473	37,871	27,514	23,435
Growth (%)	32.1	17.0	30.7	20.2	6.3	0.8	-5.7	-8.7	-27.3	-14.8
Utilized FDI (\$ billion)	59.3	49.7	55.0	56.1	64.1	63.8	67.1	78.3	95.3	91.8
Growth (%)	11.5	-16.2	10.7	2.0	14.3	-0.4	5.1	16.8	21.6	-3.6

Source: PRC Ministry of Commerce (MOFCOM); PRC National Bureau of Statistics (NBS), China Statistical Yearbook 2009