

# **A THEORETICAL FRAMEWORK OF COMPETITIVE ADVANTAGE FOR SMES IN CHINA UNDER NEW NORMAL ECONOMY**

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## **Abstract**

Small and medium-sized enterprises (SMEs) have grown to be an important force in promoting the development of the Chinese economy. As China's economy is making a shift towards new normal stage, Chinese SMEs are facing a myriad of problems and difficulties which have constrained their further development. The research integrates the industry organization approach and resource-based view which have emerged in the literature related to the concept of competitive advantage. Based on these two approaches, a theoretical framework is developed to put forward that Chinese SMEs' competitive advantage depends upon the identification of appropriate strategy and industry structure as well as developing and creating core capability in order to exploit opportunities and neutralize the threats faced in new normal economy.

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**Keywords:** SMEs, Competitive strategy, New normal economy, China

## **Introduction:**

China has undergone dramatic changes since China's WTO accession and SMEs are developing rapidly. The number of small and medium-sized enterprises (SMEs) in China reached about 43 million in 2014, accounting for 99.3% of the total number of Chinese enterprises. The output value of SMEs accounts for 55.6 percent of the country's gross domestic product, generating more than 75 percent of employment opportunities in China.

Chinese SMEs have grown to be an important force in promoting the development of the Chinese economy. In addition, they have played an indispensable role in promoting market orientation, improving industry structure, and creating job opportunities.

The new normal economy was presented by Chinese President Xi Jinping at the Asia-Pacific Economic Cooperation (APEC) on 2014. The new normal economy in China has several characteristics. Firstly, the Chinese economy is slowing down after 30 years of hyper-growth. In the 35 years between 1978 and 2013, annual growth of the Chinese economy averaged close to 10 percent and, between 2003 and 2007, it was over 11.5 percent. Chinese economy is in a new normal stage from the double digit growth to growth rates of 7 percent to 8 percent. Secondly, the economic structure in China is constantly improved and upgraded. Finally, China's economy is making a shift towards innovation-driven development amid the economic new normal of slower growth. Therefore, given the competitive pressures in the market, the fundamental problem that must be resolved by Chinese SMEs pertains to the decision on what capability and strategy to be deployed and developed in order to survive and remain competitive.

#### **Definition of SMEs in China:**

Although commonly used, the term 'small and medium-sized enterprises', is nevertheless vague, suggesting mainly the idea of a firm which is not large, without being more specific (Goss, 1991). Generally speaking, there are qualitative and quantitative criteria to define SMEs (Jafari *et al.*, 2007). Qualitative criteria refer to those enterprises with a relatively small-scale production and operation. For quantitative criteria, Western countries usually take employment, sales, turnover and invested capital, as measuring standards. Quantitative criteria have been widely used by most countries. In APEC economies, the definition of an SME also varies, but is generally most commonly is based on the number of employees. SMEs commonly employ 100 to 500 people.

In China, the new Classification Standards on the SMEs was published by relevant government agencies with the approval from the State Council on June, 2011. The new standards replace the old classification standards which came into effect in 2003. Major elements of consideration cover the payrolls, revenue and total assets of enterprises. According to this SMEs standard, specific criteria apply to the agriculture, industrial sector,

construction, transportation, wholesale, retail business and etc. According to this SMEs standard, guidelines for the industrial sector requires SMEs to employ between 200 and 1,000 people with annual revenue between RMB 50 million and RMB 2000 million (MIIT, 2011).

**Table 1 Definition of SMEs in China**

Type of Industries	Employment	Total assets (RMB)	Business revenue (RMB)
Agriculture			< 200million
Industry	<1000		< 400million
Construction		<800million	< 800million
Wholesale	<200		< 400million
Retail	<300		< 200million
Transport	<1000		< 300million
warehouse	<200		< 300million
Post	<1000		< 300million
Hotel & restaurant	<300		< 100million
Information transmission service	<1000		< 1000million
Software and Information technology service	<300		< 100million
Property management;	<1000		< 50million
Real estate		<100million	< 2000million
Leasing and business services	<300	<1200million	
Others	<300		

*Source: MIIT (2011).*

### **The development of SMEs in China:**

The development of Chinese SMEs is affected by and realized through the interactions between internal resources and external environment. Some factors, including entrepreneurs, internal conditions, and external environment, have been reported to influence the growth of Chinese SMEs.

**The role of entrepreneurs in Chinese SMEs.** The success of Chinese SMEs is largely attributed to top managers' ability to develop effective strategies that are compatible with environmental conditions. Most SMEs were started by rural entrepreneurs. It is these individuals who have led the SMEs into fairly modern business entities. In the continuous evolution toward a free market, SMEs entrepreneurs have demonstrated a unique role that includes the fundamental entrepreneurial values of high adaptability to change and proactiveness in terms of dynamic market

demand. Also Chinese SMEs entrepreneurship is exhibited in an eagerness on the part of top managers to seek unexploited market opportunities as well as a willingness to take risks. With relationship (Guanxi) as an important element in Chinese culture, the entrepreneurs exhibit a strong orientation towards relationship in their behavior and background. Top managers in Chinese SMEs are concerned for employees and getting along well with people. They also establish good networks with different parties like the suppliers, trade association and other professions, and seek advice, assistance, resources and business opportunities through such networks. It is important to note that such relationships are considered to be long-term and built upon trust, rather than short-term or contractual relationships.

**Internal effective management of Chinese SMEs.** Many SMEs position their business in areas where there SOEs are uncompetitive. Most are small and autonomous compared with SOEs, and thus have flexibility to respond to market changes quickly. Their management is also more market oriented. Communication channels between SMEs managers tend to be both shorter and simpler compared to those for the SOEs, thus engendering greater efficiency. Furthermore, the greater flexibility and autonomy in management has meant that inter-firm alliances have produced a ‘networked’ approach to industrial production. Many SMEs have put special emphasis on human resources and product quality. With their autonomous and flexible systems, it is common for them to recruit highly competent engineers and technicians from SOEs, pay them attractive salaries and actively pursue technology improvement and innovation.

In order to maintain and improve SME competitiveness, it is necessary to enhance the management system by expanding the operations of the business and strengthening the marketing function. SMEs in China put much effort into establishing close and good relationship with the buyers and government officials. Though the Chinese economy is now becoming more market-oriented, traditional influences still prevail. Also, when small firms practice marketing by themselves, they have nobody to learn from, except the large state-owned enterprises, which are production-oriented (Siu, 2001). Nevertheless, this specific politico-economic structure also makes SMEs aware of the importance of good relationships with customers, government officials and other business practitioners.

**External environment influence on Chinese SMEs.** The outstanding performance and development of Chinese SMEs can be

attributed to many economic, political and socio-economic factors. During the planned period, China lacked institutional framework and the incentives rather than the capacity to develop a proper industrial sector. Once the reforms took effect in 1980s, enterprises were provided with the opportunity to retain profits, thus providing the first stage of an incentive structure. Some specific policies for SMEs have also been implemented. For example, the Chinese government published the SMEs Promotion Law in 2002, which strengthened the role of SMEs. With the introduction of the SMEs Promotion Law, Chinese SMEs could broaden their financing approach and get favorable taxation policies to support their development. Therefore, these incentives were later enhanced when SMEs assumed responsibility for their own profits and losses, and when profit retention was replaced by taxation.

Actions by local governments play an important role, especially for collective SMEs in the initial development phase. One of the main reasons for this has been the gradual decentralization of the fiscal system, which has allowed local governments' revenues to be used, in part, to facilitate local socio-economic growth. Once in control of their own revenues, local authorities have a greater incentive to develop their administrative areas, to increase their tax income, and to invest in new infrastructure, and in new SMEs (Chang and Wang, 1994). The role of local government is also important in promoting rural enterprises when there are social benefits, in terms of local governments. Under such circumstances the risk is then shared throughout the community and the long-term prospects for development are more secure. Moreover, Chinese SMEs have access to credit, productive inputs, and information, and possess an advantage when applying for legal permits and arranging market linkages. However, this can produce distortions, often damaging "private" enterprises in investments and markets.

### **Challenges faced by Chinese SMEs under new normal economy:**

Being the major force in Chinese economy, SMEs have played an important role in promoting economy growth, expanding and creating job opportunities. Despite their rapid development, many SMEs still suffer from a number of challenges in the new normal stage, as highlighted in the following three aspects.

**Innovation challenge faced by Chinese SMEs.** Innovation capability can be considered as a subset of dynamic organizational capabilities. According to Tidd *et al.* (2001), the innovation capability is very

important to the company's business. It is associated with renewal and evolution of the business, renewing what the company has to offer and how it creates this. Innovation capability offers the potential benefits for Chinese SMEs to reduce the cost of production, increase the technical feasibility of Chinese undertakings, and further improve their market growth.

Many Chinese SMEs are family businesses and most of them focus on being suppliers to large companies or serving predictable and stable industries. They suffered from operating inefficiencies due to poor management skills, outmoded equipment and technology, and old operating mechanisms. On the other hand, most SMEs in China haven't their own R&D department so that they can't conduct research and experiments in order to pursue innovation. They have to rely on government agencies, research institutes and universities for new technology knowledge transfer. Successful new technology knowledge transfer between these organizations and SMEs is yet still questionable since many SMEs are still having difficulties to run their production smoothly. In the new normal economy, the most important direction of reform and policy orientation is to re-balance the relationship between fairness and efficiency, which is the key to the transition from factor- and investment-driven growth to innovation-driven growth. Therefore, there is a need for Chinese SMEs to improve their innovation capacity so that they could achieve success in the new normal stage.

**Inadequate financing for Chinese SMEs.** Although the Chinese government implements favorable loan and taxation policies to support SMEs, it is not directly investing in SMEs as it does with large enterprises. Especially, the start-up and growth capital for many Chinese SMEs was usually provided by the owner, with family or friends often helping out. Because large enterprises have substantial capital, and an earnings track record or government guarantees to protect them from loss.

With large enterprises, banks feel comfortable to offer financing. This logic also makes banks unwilling to loan to SMEs which typically lack sufficient history and stability of earnings. For example, only 23.2 percent of bank in china loans were extended to SMEs, and 4.7 percent of short-term loans went to SMEs in 2013(CBRC, 2014). According to Tsai (2015), there are five factors resulted to inadequate financing of Chinese SMEs, including political concerns, developmental priorities of governments on-going financial repression, limited organizational and technical capacity of bank

system, and ideological and political sensitivity. Therefore, due to SMEs weakness in scale and limitations in technology, management and especially financing, the development of these enterprises does not go smoothly. To promote employment, economic development and social stability, effective measurements and policies must be adopted to support SMEs in China.

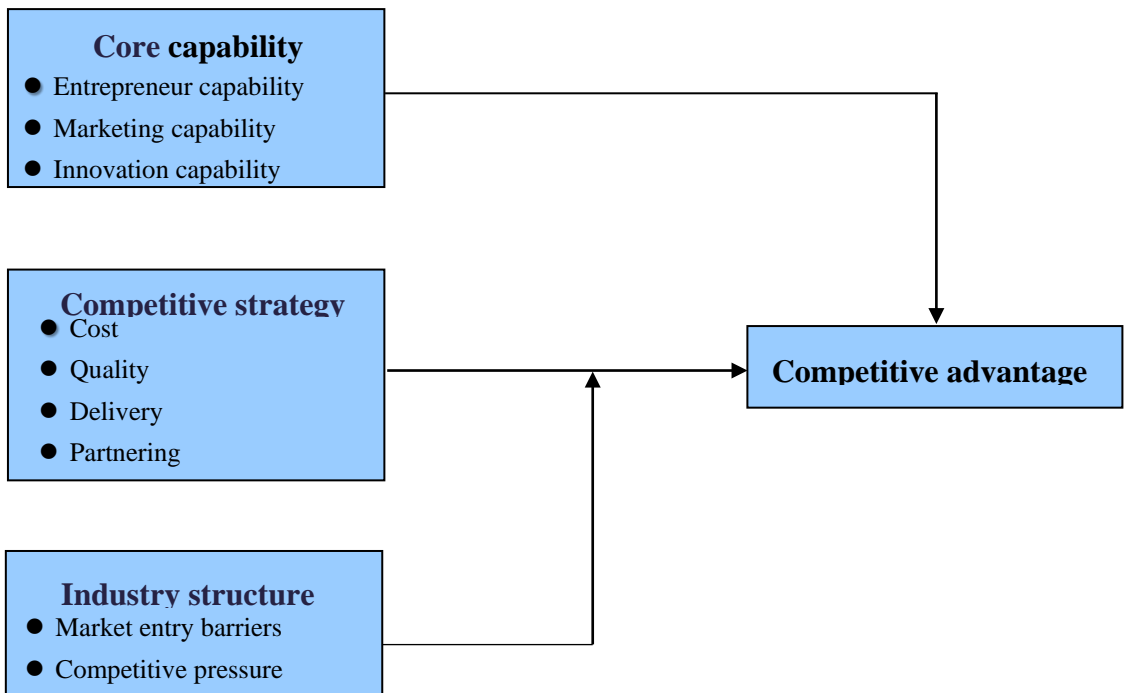
**Rising business cost.** Traditionally, SMEs in China took advantage of low-cost rural labor and locally available raw materials. Cost advantage resulted in above-average performance. Improving relative cost position in unsustainable ways may allow a firm to maintain cost parity or proximity, but a firm attempting to achieve low cost strategy must also develop sustainable sources of cost advantage.

Rising labor cost has been a fact of life for SMEs in China for years. According to Gale and Arnade (2015), the labor's wage has risen dramatically. The rural wage was about RMB 34-35 per day in 2000-2003, and it reached over RMB 100 in 2013. Compared to that in 2013, the rural wage increased about three times. High labor cost is just one element in a series of factors that have led to cost inflation in China. Many other costs that influence business operations of SMEs have also spiked in China recently. In China, land markets using new data based on auction sales from 2003-2011 in 35 major cities, on average the last nine years have seen land values skyrocket in many markets, not just those on the coasts. The typical market has experienced double-digit compound annual growth in real values on average. According to Sirkin *et al.* (2011), industrial land cost 17.29 US dollars per square foot in Shanghai, \$21 in Shenzhen, 11.15 in Ningbo, but the national average in \$10.22 per square foot in China in. Industrial land in Tennessee and North Carolina, the price ranges from \$1.30 to \$ 4.65. Therefore, rising wages, shipping costs, and land prices, combined with a strengthening RMB, are rapidly eroding Chinese SMEs' cost advantages.

### **A theoretical framework of competitive advantage for Chinese SMEs:**

The concept of competitive advantage has received much academic attention and has become well established in the literature (Barney, 1991; Porter, 1985; Coyne, 1986). Regardless of which theoretical perspective is represented, there is a general agreement that the purpose of strategic competitive activity in the firm is to achieve a sustainable competitive advantage, and thereby enhance a business' performance (Porter, 1985; Coyne, 1986; Hall, 1993; Bharadwaj *et al.*, 1993).

The industrial organization approach, which emphasizes the importance of forces outside of the firm, acknowledges that a profitable and sustainable position against the forces that determine industry competition is the aim of competitive strategy (Porter, 1985). On the other hand, resource-based view stresses that any member of an industry can successfully compete through the wise use of resources and careful strategic decision-making ((Barney, 1991). The conceptual model presented here integrates the two dominant perspectives based on earlier frameworks that were proposed or adopted in previous studies. The conceptual framework in this study proposes that Chinese SMEs’ performance is critically dependent on three key constructs: core capability, competitive strategy and industry structure. Figure 1 describes the theoretical framework for this research.



**Figure 1 Theoretical framework of competitive advantage for Chinese SMEs**

**Core capability and competitive advantage.** As indicated in this framework, core capability has direct impacts on SMEs’ performance. This is consistent with the resource-based view. In the resource-based view, resources in a firm can be classified into financial, physical, human, organizational and technological resources (Man, 2001). However, resources themselves cannot become competitive advantage unless they are organized



into capabilities. Core capability represents the potential dimension of competitiveness from the firm's performance. Premaratne (2001) identifies two types of resources, namely entrepreneurial resources and gratis (supporting) resources, which contribute to SMEs' success. Hyvonen and Tuominen (2006) argued that sustainable competitive advantage is resulted from the possession of innovation capability, which are further linked to intangible resources. Rangone (1999) developed a model in which superior performance in SMEs is based on innovation capability, market management capability and production capability. Thus, it expects Chinese SMEs with entrepreneurial, marketing and innovation capabilities to have a broader range of possible actions and to be able to exploit numerous resources, thus enhancing organizational performance.

**Competitive strategy and competitive advantage.** Competitive strategy determines the relative competitive position and performance of Chinese SMEs. This is consistent with the industry organization approach that the firm's performance is proposed to be determined by firm conduct and industry structure (Porter, 1985; Bharadwaj *et al.*, 1993). The competition strategy is the strategic choice that can influence Chinese SMEs' performance. In analyzing the strategies of firms, the Porter framework has been the dominant tool for the past two decades. Porter's (1985) model of the five relevant forces in an industry and his generic strategies are still popular concepts. Sandberg (1986) found that business strategies and industry structure have direct influence on growth performance of SMEs. In addition, such factors as strategic types, the adoption of new technologies, quality products and services, customer relations and other organizational strategy related factors are also revealed to have important influence on superior performance of SMEs. Lee *et al.* (1999) further suggest that SMEs can free-ride on the bigger firms' market development efforts and/or they can form strategic alliances to force accommodation by the bigger rivals. Chew *et al.* (2005) built up a conceptual framework for the competitive strategies for Chinese SMEs, which includes strategic alliances, innovation and differentiation. The framework was also illustrated by a case study of a prominent Chinese SME.

Given the limited resources in terms of finances, human expertise and production process, Chinese SMEs' can address the scope of competition by adopting a broad or narrow product/service and market approach. Also SMEs can address the mode of competition in an infinite number of ways,

but literature points out that the most important ones include: competing on quality of products/services, competing on product/service, and competing on time and cost. The Chinese SMEs' competitive strategy includes four types of variables: cost, quality, delivery, and partnering. These variables present significant potentials for gaining and sustaining competitive advantage.

**Role of Industry Structure and competitive advantage.** Industry dynamics provides a window to market opportunities and threats, and Chinese SMEs are a deliberate response to those dynamics. Dethier *et al.* (2010) stated that the business environment affects the company through its influence on incentives to invest and by inflicting pressure over firms. During economic transition, industry structure in China has revealed several characteristics.

First, growth in sales and profitability varies markedly due to the industrial policy that allows only some sectors to be privatized and also to the deep-rooted imperfections in industry structure. Second, government regulations frequently changed due to idiosyncratic paths of decentralization and government needs for controlling strategically vital industries. Third, competitive pressure varies by the level of equilibrium between market demand and market supply. These three characteristics individually represent different attributes of an industry's structure and yet collectively reveal this industry's profile about opportunities and threats. These characteristics of the industry have a direct impact on the nature of competition and the competitive strategy available to Chinese SMEs. Drawing on the literature, two industry structure factors- market entry barriers and competitive pressure, would appear to have a strong moderating effect on the Chinese SMEs' performance.

### **Conclusion:**

The conceptual model presented herein was a generic framework that allowed industry practitioners and academic researchers to understand, sustain and extend the competitive advantage of Chinese SMEs. The conceptual model implied that Chinese SMEs' competitive advantage depends upon the identification of appropriate strategy and industry structure as well as developing and creating core capability in order to exploit opportunities and neutralize the threats presented by competition. Based on the conceptual model, future research will put forward hypotheses which are

built up to test patterns of core capability, competitive strategy and industry structure on performance of Chinese SMEs.

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