

Chapter 2

SME DEVELOPMENT IN CHINA: A POLICY PERSPECTIVE ON SME INDUSTRIAL CLUSTERING

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Abstract

The small and medium enterprises (SMEs) in China have achieved rapid and sustainable growth in the past two decades. Such growth has increasingly contributed to China's economic development. Yet, weak linkages with external market, weak technological innovation, and limited SME financing have limited SMEs' growth. This brings to the fore the need for more efficient and professional government services to SMEs to enhance their competitiveness.

The absence of high-quality services for enterprises should prompt government to provide SMEs with services that are more professional, more convenient and more individualized to enhance their competitive capability.

SME clustering is crucial to addressing social and economic objectives, the achievement of which can make them more competitive in the global economy; generating and spreading innovations; creating employment; and distributing broad-based income and welfare. Convergence of 1) production (cable SEs), 2) market (textile industry SEs), and 3) production chain (sewing machine SEs) comprises the main patterns of SME clusters. This essentially reflects the "one village, one product" and "one town, one industry" concept.

Future policy should expand the range of government services to SMEs. Local governments could learn some lessons from the Jiangsu government and devote attention to promulgating supporting policies for the development of small enterprises. Government should also develop an industrial cluster plan for small enterprises, as well as a financing and technological innovation system for SMEs.

INTRODUCTION

Most SMEs in China came about in the last 15 years. With the opening up of China to market economy in the 1980s as part of the market-oriented reforms initiated by Chinese leader Deng Xiaoping, private SMEs were finally recognised as vital to the country's economic development.

The ensuing economic reforms involving state-owned enterprises (SOEs) in China, major SOEs rapidly changed into small and medium non-SOEs until the end of 2004. Meanwhile, more SMEs sprouted, spurred by the implementation of non-SOE promotion policy. Since then urban collective enterprises, town and village enterprises (TVE), alongside the private and self-employment sector, have been sprouting and thriving all over China.

The development of SMEs has increasingly contributed to China's economic growth. They make up over 99 percent of all enterprises in China today. The output value of SMEs accounts for at least 60 percent of the country's gross domestic product, generating more than 82 percent of employment opportunities in China.

SME clusters greatly enhance SMEs' global competitiveness, generate and spread innovations, and distribute broad-based benefits.

This paper seeks to analyze the development of SMEs and SME clusters in China. The first section describes the current state of SME in China while the next section analyzes the constraints to and weakness of SME development. The succeeding section discusses SME cluster as an important feature of SME. This is followed by a discussion on the results of a field survey, which are presented in this paper. The final section provides policy recommendations based on the foregoing discussion.

2. STATE OF SMEs IN CHINA

2.1 Definition of SME in China

The Interim Categorizing Criteria on Small and Medium-sized Enterprises (SMEs), published in 2003 and based on the SME Promotion Law of China, sets the guidelines for classifying SMEs. It replaced the old guidelines that came into effect in 1988, and the supplementary criteria of 1992.

Table 1: Definitions of SMEs in China

Size Category	Industries	Employment-based	Total assets	Business revenue
Small	Industry	< 300	<¥ 40million	< ¥ 30million
	Construction	< 600	<¥ 40million	<¥ 30million
	Wholesale	<100		<¥ 30million
	Retail	<100		<¥ 10million
	Transport	<500		<¥ 30million
	Post	<400		<¥ 30million
	Hotel & restaurant	<400		<¥ 30million
Medium	Industry	300- 2000	¥ 40million-400million	¥ 30million-300million
	Construction	600-3000	¥ 40million-400million	¥ 30million-300million
	Wholesale	100-200		¥ 30million-300million
	Retail	100-500		¥ 10million-150million
	Transport	500-3000		¥ 30million-300million
	Post	400-1000		¥ 30million-300million
	Hotel & restaurant	400-800		¥ 30million-150million

Note: SME meet one or more of the conditions. ME should meet three conditions, the others are SE.

Source: SME promotion law of China,2003.

The guidelines mainly cover the payrolls, revenue and total assets of enterprises (see Table 1). Specific criteria apply to the industrial sector, construction, transportation, wholesale and retail business, and hotels and restaurants. Guidelines for the industrial sector requires SMEs to employ a maximum 2,000 people, and to have an annual revenue not exceeding RMB300 million. Their total assets should not exceed RMB 400 million. Medium-sized enterprises should employ a minimum of 300 people. Their annual revenue and total assets should not exceeding RMB30 million and 40 million respectively. The rest are classified as small enterprises.

The definition of an SME in China is quite complex and can include relatively large firms. In APEC (Asia-Pacific Economic Cooperation) 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. But the vast bulk of SMEs, comprising around 70 percent, employ five people or less or are run by self-employed individuals.

SME definition in China depends on the industry category and is defined based on the number of employees, annual revenue, and total assets comprising a company.

An industrial SME is defined as having up to 2,000 employees; while a medium-sized business has between 301 and 2,000 employees; and a small business has less than 300. Consequently, what is regarded as an SME in China may be quite large relative to an SME in other countries. This paper mainly focuses on small enterprises (SEs), including the problems of SE, the field survey of SEs, and the policy recommendations for SEs.

2.2 Increasing Role of SMEs

SMEs are an important part of China's economy. In 2007 a total of 4,459 large companies accounted for 0.19 percent of the total number of enterprises registered in the country; 4,2291 medium-sized businesses, or 1.78 percent; and 2,327,969 small enterprises, or 98 percent, of the total. Overall, SMEs account made up for 99.7 percent of the total number of companies operating in China at the time.

Business revenue of SMEs accounts for 60.42 percent of total earnings; small enterprises, 6.54 trillion, or 23.70 percent. The industrial income of SMEs accounts for 66.28 percent; 11.77 trillion of the small enterprises are about 37.29 percent.

The SMEs are increasingly playing an important part role in employment generation. Large enterprises employ 20,877.8 thousand individuals, or 18.11 percent of the total employment; medium enterprises, 35,464.3, or 30.76 percent; small enterprises, 58,947.8, or 51.13 percent.

2.3 Distribution Feature of Small Enterprises

Based on regional distribution (see Table 2), 68.58 percent of SMEs are located in the eastern area part of China, 20.14 percent in the mid-area of China, 11.28 percent in the western part of China. Small enterprises in the top five provinces make up 48.4 percent of all small enterprises. These provinces are all located in the eastern area of China, namely, Jiangsu, Zhengjiang, Guandong, Shanghai, and Shandong, which account for 11.6 percent, 11 percent, 10.4 percent, 9.9 percent, 8.9 percent, and 7.6 percent of all SEs, respectively.

By industry distribution (see Table 3), the business revenue of manufacturing industry accounts for 52.8 percent, followed by the wholesale and retail industries (35.2 percent); construction (4.6 percent); and transportation and storage (2.6 percent), etc.

Table 2: Basic data of the incorporated SME (grouped by region)

Item Grouping	Unit¥ Legal Entity	Employment¥ person	Business Revenue of Whole Year¥ thousand	Total Assets¥thousand yuan
Total	2,327,969	58,947,778	6,535,425,319	7,229,524,125
Beijing	98,674	1,470,505	207,285,861	657,757,029
Tianjin	55,807	1,024,926	127,213,911	183,215,064
Hebei	87,605	2,696,972	278,018,746	260,643,092
Shanxi	49,637	1,477,966	117,159,956	161,678,971
Inner Mongolia	22,053	606,530	67,269,521	71,756,861
Liaoning	110,081	2,323,698	231,823,792	323,912,284
Jinlin	32,418	816,716	85,096,910	105,668,596
Heilongjiang	40,790	1,027,397	86,283,651	134,806,517
Shanghai	207,535	2,892,309	490,727,489	520,598,329
Jiangsu	270,669	6,563,781	885,977,068	741,983,051
Zhejiang	241,220	5,705,517	807,014,644	712,725,889
Anhui	59,902	1,758,246	151,277,230	148,582,691
Fujian	77,230	2,151,462	234,096,548	244,422,928
Jiangxi	43,605	1,424,390	110,038,669	108,360,418
Shandong	177,407	5,001,380	576,783,722	477,638,376
Henan	110,182	3,566,630	337,158,734	265,175,536
Hubei	51,682	1,621,358	139,841,497	175,295,610
Hunan	57,720	2,004,921	173,679,267	154,595,563
Guangdong	230,474	6,376,904	666,692,455	803,158,592
Guangxi	33,473	957,281	81,077,721	103,616,338
Hainan	7,836	147,402	15,204,345	33,739,621
Chongqing	34,683	1,143,975	105,127,683	97,136,789
Sichuan	75,330	2,138,436	200,793,576	271,805,434
Guizhou	19,134	647,977	47,661,656	62,891,774
Yunnan	29,160	837,651	72,241,664	108,011,660
Tibet	851	37,834	2,587,052	6,585,768
Shanxi	45,906	1,173,463	109,487,046	116,132,571
Gansu	23,879	677,594	50,300,257	66,582,624
Qinghai	4,693	141,599	9,363,128	16,833,170
Ningxia	4,693	141,599	9,363,128	16,833,170
Xinjiang	18,648	340,509	46,743,236	66,910,179

Source: the data from the first national economic census.

Table 3: Basic data of the incorporated SME

Item Grouping	Unit/Legal Entity	Employment/ person	Business revenue of whole year/million yuan	Total Assets/ thousand yuan
Total	2,327,969	58,947,778	6,535,425	7,229,524
Agriculture, Forestry, Animal Husbandry and Fishing	4	76	3	9
Mining	77,891	3,024,762	220,728	198,027
Manufacturing	1,228,354	38,325,314	3,612,196	3,337,852
Processing of food agriculture products	68,154	1,553,258	214,453	167,323
Manufacture of textile	77,944	3,191,356	307,665	256,836
Manufacture of textile wearing apparel, foodware and caps	47,569	2,532,159	150,835	121,334
manufacture of Raw chemical material and chemical products	72,459	1,961,833	239,781	22,847
Manufacture of plastics	69,400	1,826,806	201,139	179,242
manufacture of metal products	82,028	2,210,821	226,891	205,788
manufacture of general purpose machinery	112,752	3,011,552	328,035	299,384
manufacture of special purpose machinery	54,713	1,497,445	152,095	171,829
manufacture of transport equipment	51,576	1,512,932	149,955	147,745
manufacture of electrical machinery and equipment	56,889	1,746,124	193,540	192,538
Production and distribution of electricity, gas and heat power	34,041	666,073	42,347	131,282
Construction	107,186	7,157,427	436,184	556,532
Transport, storage and post	59,702	2,089,113	160,921	507,142
Information transmission, computer service and software	1,703	59,190	6,175	355,334
wholesale and retail trade	819,054	7,625,545	2,056,859	2,143,321
Hotel and restaurants	3	12	1	1
Financial intermediation	4	118	9	19
Leasing and business services	15	47	1	3
Scientific research, technical service and geologic prospecting	5	28	-	-
management of water conservancy, environment and public facilities	2	58	-	-
service to households and other services	1	-	-	-

Sources : the data from the first national economic census.

Table 4: basic data of the incorporated SMEs (by types enterprises of SME)

Item Grouping	Unit/Legal Entity	Employment/ person	Business Revenue of Whole Year/thousand	Total Assets/thousand yuan
Total	2,327,969	58,947,778	6,535,425,319	7,229,524,125
Domestic enterprises	2,237,185	53,951,581	6,044,526,465	6,550,301,584
Private enterprises	1,538,315	32,481,099	3,950,057,989	3,084,959,621
Enterprises with funds from Hongkong, Macao and Taiwan	46,315	2,814,528	246,579,103	340,220,847
Foreign funded enterprises	44,469	2,181,669	244,319,751	339,001,694

Sources: The data from the first national economic census.

Distribution of registered types of small enterprises (see Table 4) is as follows: domestic enterprises in mainland China make up 96.1 percent of the total; HK-, Macao- and Taiwan-based enterprises, 2 percent; and foreign enterprises, 1.9 percent. Meanwhile, private enterprises comprise 66.1 percent of all SEs.

Based on the number of small enterprises in the top three industries in the manufacturing sector (see Table 3), manufacture of general- purpose machinery leads with 9.2 percent, followed by metal products (6.7 percent), and textile (6.3 percent).

3. PROMOTIONAL POLICY OF SME AND THE PROBLEMS OF SME

3.1 SME Policies and Programs

The government tasked to oversee SMEs in China consists of four administrative departments: the National Development and Reform Commission, China Coordination Center for Cooperation of SMEs with Foreign Countries, China Association of SMEs, and local SMEs department in every province. Development policies and plans of governing SMEs were issued in 2003.

There are various ways by which government supports SMEs. First, the SME promotion law, enacted in January 2003, lays the groundwork for public support for small and medium enterprises. Under this law, the government protects the lawful investments of SMEs and their equity investors alongside their investment earnings.

Government administrative departments protect the legal rights of SMEs, including their rights to fair competition and fair trade. The state also identifies priority sectors for SME development through various means.

Second, in 2005, the government issued a document titled “State Council on Encouraging, Supporting and Guiding the Development of Private and Other Non-Public Owned Economies” (containing 36 Articles on Non-Public Owned Economies), which eased up market access conditions for non-public economies, thus according them broader development space.

Third, the government published the SME Growth Project in 2006. Its aims were as follows:

- a. To promote the system building of policy and regulation for SMEs;
- b. To cultivate the social service system of SME;
- c. To facilitate SME structural adjustment;
- d. To sustain the SME reforms;
- e. To strengthen SME training;
- f. To improve innovative ability;
- g. To resolve financing difficulties affecting SMEs;
- h. To encourage SMEs to expand offshore through the provision of FDI incentives, among others;
- i. To improve the overall supervision of SMEs

The government also adopted a series of promotion regulations and measures in further support of SMEs. These are as follows:

Financing for SME development. The state-allocated budget for SME financing includes an item dedicated to supporting SME development. It also set up an SME development fund to encouraged donations through tax incentives extended to SMEs. The government also required financial institutions to improve the financing environment for SMEs, strengthen their support to SMEs in terms of enhanced credit and direct financing channels. It likewise enjoined various types of venture capital to increase investments in SMEs by giving them tax incentives.

SME financing. The relevant departments of government have since actively pursued the establishment of a credit guarantee system for SMEs, and provided tax incentives to encourage the establishment and growth of SMEs. Incentives, including tax reduction and income tax waivers, are given to SMEs that meet the state-stipulated number of jobs that are expected to be generated each year; SMEs operating in economically underdeveloped or impoverished areas, and SMEs which employ a prescribed number of physically challenged people.

Market access. Government also assists SMEs to improve their market access by helping them enhance their skills.

SMEs are enjoined to conscientiously implement the nation's industrial policies, industrial planning regulations, specifically those on market access. Such stipulations, among others, allow them to gain access to or avail themselves of vital services, such as those involving monopoly industries, public utilities and infrastructures, social undertakings, financial services, and national defense science and technology industries, which are now open to these enterprises, provided they secure prior government approval.

Existing regulations, rules and policy stipulations that tend to restrict market access for non-public economic sectors are currently under review by the applicable departments and local governments for possible revisions. Market competition mechanisms will also be introduced in the electric power sector, telecommunications, railway, civil aviation, petroleum and other industries and fields. At present, government procurement system tends to favor products and services generated by SMEs.

Government encourages SMEs to expand their markets by enforcing financial policies that allow, among others, imports and exports credit, export credit insurance, etc. It enjoins qualified SMEs to invest in foreign markets.

Networking with other enterprises. Government encourages qualified enterprises to expand their network. It also promotes specialization and coordination among SMEs so they can pursue collective development of materials supply, production, sale, and technological innovations in a bid toward market expansion. The state also promotes merger and acquisition activities among SMEs, alongside reorganization and optimized

resource utilization. Provision of government subsidy or loan facility is intended to support and encourage SME technological innovations with large enterprises.

Efficient SME supervision. Given the production and management characteristics of SME, the state is also working toward better management system. There are also efforts toward standardized charges collected by public organizations and institutions so as not to unduly burden SMEs.

Improved social services for SMEs. Government is vigorously developing various types of social intermediary service organizations, intensifying policy support for needed automatic funding of specific undertakings, supporting the conduct of trainings among enterprise personnel, strengthening services for science and technological innovations, supporting enterprises in opening up domestic and foreign markets, and actively pushing for the creation of a credit system for enterprises.

Other state undertakings, begun in 2004, are as follows:

- a. Provision of innovation funds for technology-based SMEs
- b. Administrative management of development of private and other non-public owned economies
- c. Financing of technology-based SMEs
- d. Regulation of entry of non-public investments into cultural industry
- e. Entry of non-public investment into railway construction was published recently
- f. Guiding opinion of development and reformation of commercial SME

Notwithstanding the foregoing efforts of the state, there are still some constraints in the government service system, which affect the SME operations. In recent years, some positive steps have been taken to improve the delivery of government services to SMEs. Admittedly, however, businesses do not just expect support and advice from the government. The former also want the latter to complement the private sector by filling gaps in supply and addressing market failures. For instance, problems of duplication and inconsistency in the quality and sources of services remain. Access to public funds is also difficult in terms of time and cost. At present, government services include advice, grants, skills and training and specific support for manufacturers, such as the

manufacturing advisory service. By providing these services, government hopes to make the target enterprises more competitive.

Businesses also report difficulty in accessing public funds, both in terms of time and cost (see Table 5). While there are signs of improvement in some services, there are still government agencies whose approach to business is poor. Much more work is required for government services to be become efficient and accessible to all enterprises considered coherent, accessible and of a high quality.

Table 5 also shows that business sector feedback on government services for SMEs is by and large poor. For instance, where state services in the areas of preferential policy, finance guarantee service, tax burden alleviation, market condition management, and public service are concerned, nearly all respondents to the survey (on which the data presented were based) said they were “too general“ and that there were still many obstacles and constraints to the SMEs’ pursuit of their business goals. One common cause of complaints is the lack of assistance catering to their different needs. These shows that government should provide small and medium enterprises with services that suited to SMEs needs.

Table 5: Valuation of government service

Approval	valuation ratio		difficult 9.4	General 58.4	Easy 32.2
Preferential policy	valuation ratio		much 7.4	Less 66.6	few 26
Finance guarantee service	valuation ratio		good 7.8	General 65.4	Bad 26.8
Tax burden	valuation ratio		High 52	Fair 45.4	low 2.6
Market condition management	valuation ratio	Very good 3.3	good 35.2	General 54.3	Bad 7.2
public service	valuation ratio	Very good 4.5	good 39.7	General 51.3	Bad 4.5

Source: Analysis of Questionnaire of SME financing in 2006. N=736.

[Http://www.sme.gov.cn](http://www.sme.gov.cn)

3.2 Problems in SMEs' Operations

The following were identified as the specific concerns of SMEs:

Weak linkage with external market. SME contribution to China's total exports accounted for 62.3 percent of the total in 2006. Yet, the small enterprises contributed only between 5 and 10 percent to exports, according to data from *the China Private Economy Year Book* for 2004-2006 (see note 2). SEs' modest contribution to China's economy is further reinforced by the result of a survey conducted among 29 provinces and 10,000 enterprises in 29 provinces (of which 3,339 were qualified enterprises) during that period (see Table 6). The ratio of SE external market of small enterprises to total exports is only around 18 percent, significantly lower than that of the medium enterprises. The resulting data resulting from the survey showed that SE products are mainly focused on the domestic market.

Table 6: Product distribution of SME in China based on enterprise number

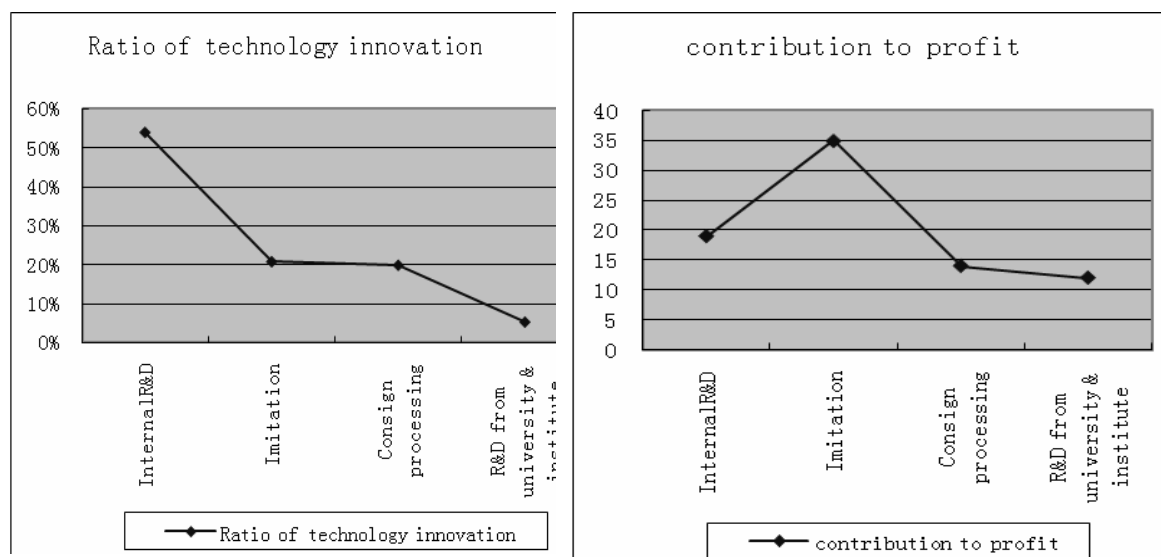
	SME	ME	SE	Eastern area	Middle area	Western area
Province market	33.63	19.56	43.46	33.77	26.82	43.21
Other province market in China	39.65	41.68	38.38	34.69	48.5	39.94
World market	26.72	38.76	18.16	31.54	24.68	16.85

Source: Analysis of Questionnaire of SME financing in 2006. N=3339.

[Http://www.sme.gov.cn](http://www.sme.gov.cn)

Weak technological innovation. Technological innovations among SMEs in China come in four ways: internal R&D, imitation, licensing of know-how, and university- (and related institution)-led R&D. Figure 1 shows that the ratio of internal R&D to technological innovations is 54 percent; those of other three are 20 percent, 19.9 percent and 5.3 percent, respectively. Contributing the highest to income generation is imitation technology, followed by internal R&D, licensing of know-how, and external R&D (or such efforts being pursued with university-based R&D and institute is the lowest. It appears that imitation is restricting the technological innovation of small enterprises, which in turn is borne of a inadequacy of funds (Liang 2007).

Figure 1: Technology Innovation of small enterprise



Source: Data from the questionnaire of Small enterprises, NDRC.N=592. [Http://www.sme.gov.cn](http://www.sme.gov.cn)

Inadequate financing. Lack of financial support is a major stumbling block to SME development in China. In particular, SMEs are beset by poor credit guarantee system, dearth of financial institutions supporting SMEs, extremely high stock market threshold, and inability to obtain bank loans owing to imperfect management and poor accounting system that discourages banks from lending to them.

Based on a survey of 948 SEs on the issue of financing (Table 7), 73.3 percent of the respondents cited lack of a credit guarantee system (with an equivalent ratio of 36 percent relative to all other responses to the questionnaire) as their foremost concern, 73.3 of questionnaire SEs choose it (questionnaire enterprises can make several choices about the financing difficult of SEs).

Next to this is the lack of professional information on obtaining bank loans, with 24.7 percent and an equivalent ratio of 12 percent. The other responses were poor profit ability (11.5 percent), capital scarcity of banks (11.4 percent), poor bank valuation ability (10.20 percent), lack of credit history (8.9 percent), and lack inadequate credit institutions (7.1 percent), etc. Still another major barrier to the rapid development of the SME sector is the shortage of equity financing and a more supportive legal and regulatory environment.

Table 7: Difficulties of SE Financing

Reason of loan difficulties				Measure for SME financing			
Item	Number of replies N=1928	Share in total 948 enterprises (%)	Share of total 1928 Replies (%)	Item	Number of replies N=1928	Share in total 948 enterprises (%)	Share of total 1928 Replies (%)
lack guarantee system, though it has compensation ability	695	73.30%	36%	Increase policy loan	726	75.00%	28.90%
Cannot offer the information that bank needs	234	24.70%	12%	Non-estate asset can be mortgage	413	42.70%	16.40%
Poor profit ability	223	23.50%	11.50%	need government support fund	320	33.10%	12.70%
Capital scarcity of bank or financial institution	219	23.10%	11.40%	Develop guarantee institution	301	31.10%	12%
Poor Valuation ability of bank or financial institution	198	20.90%	10.20%	Develop SME bank	201	20.80%	8.00%
Lack Credit history	170	17.90%	8.90%	Promote business credit development	197	20.40%	7.80%
Lack credit institution	136	14.30%	7.10%	Improve law environment	151	15.60%	6%
Exceed Credit history	53	5.60%	2.70%	Develop venture capital	83	8.60%	3.30%
				Develop non-bank institution	74	7.60%	2.90%
				Develop second Board market	50	5.20%	2.00%

Notes: Due to multiple replies, 1928 replies was submitted from 948 enterprises.

Source: Analysis of Questionnaire of SME in 2006.N=592. [Http://www.sme.gov.cn](http://www.sme.gov.cn)

4. INDUSTRIAL CLUSTERING AS AN IMPORTANT COMPONENT OF SME DEVELOPMENT

An important aspect of SME development is industrial clustering. This refers to various industrial colonies composed of enterprises in identical and closely connected industries in specific areas. SME clustering, in particular, is the centralization of SMEs in their location, considered an important feature of SME development.

4.1 Reinforcing SME Competitiveness

An SME cluster can maximize regional accessibility to produce and market by capitalizing on joint ventures, cooperation, and alliances. A specialized division in the cluster helps the enterprises not only to supply the consumers with diverse products but also reduce business expenditures by creating a commercial network and taking advantage of region accessibility, thus enhancing their competitive power.

Many enterprises belonging to one industry band themselves together into a SME cluster. These are mostly manufacturing enterprises along with allied industries. Doing so leads to higher economies of scale, which in turn enhances the host town's economic competitiveness. Take Zhejiang province, for example, which is one of the most vibrant areas in China. Its growth was fueled by the clustering of SMEs in the area into specialized industrial zones (Sheng et al. 2004).

According to a report titled *China's SMEs development for 2007*, there are 604 industrial zones in the province, with a combined output values exceeding 100 million yuan. Of these, 283 clusters (?) have an output of 1 billion yuan; 35 clusters, about 10 billion yuan; and five clusters, more than 30 billion yuan. Cluster output accounts for about 50 percent of the total industrial output; taxes, 60 percent, export volume 70 percent, and employment 80 percent.

Many small towns in China depend on township enterprises for their economic growth. Such enterprises are expected to generate more employment opportunities for the rural surplus labor force. A small town's development must be supported by its industry. Such support can come from SME clusters of enterprises in the secondary and tertiary industry, could provide this kind of industry support, and attract rural surplus

labor force to enter into the small town, which could accelerate the transfer of the rural surplus labor force.

In Guangdong and Zhejiang provinces, typical SME clusters are mainly engaged in costume, textile, ceramics, hardware, household electric home appliances, among others and so on. These enterprises are basically traditional labor-intensive manufacturers, employing rural surplus labor force work (Shi 2004).

Most SMEs clusters are based in towns found in the developed areas along the eastern coastal areas of in China, such as small towns in the Pearl River Delta and Yangtze River Delta. Well established enterprise clusters have found that small enterprise clusters develop very well in Jiangsu, Zhengjiang and Guangdong provinces. The more small enterprise clusters are specialized, the more competitive they are. SME clusters in the in mid-area and western area of China (Zhang 2007) are still in the early stage of their development.

The more specialized small enterprise clusters are, the more competitive they are. A large number of SME clusters based on private enterprises are economic drivers for small towns.

The cluster economy is made up of professional towns and villages functioning as production hubs, with one or more towns focusing on one product. Some areas have set up large-scale specialized production and marketing, which shows great potential for success. This essentially illustrates the concept of “one village, one product” or “one town, one industry” as exemplified by provinces like Jiangsu, Zhejiang, and Guandong. The concentration of production of certain products in these areas has given rise to such catch phrases as Shengze textiles, Hengshan sewing machines, Ningbo costumes, Wenzhou shoes, Shaoxing synthetic textiles, Haining leather coats, Yiwu small commodities, Yongkang hardware, to name a few.

The SME cluster facilitates information exchange and knowledge extension sharing, which not only attracts talent and other vital components of production but also encourages the entry of new enterprises, or industry players, into the trade (Li 2006). Therefore, clustering has become a major strategic choice of key SMEs to enhance their competitiveness, which benefits their host small towns economically.

From a regional economics perspective, the drive for greater profit pushes SMEs to pursue industrial cluster formation. This results in a host of economic benefits to the

individual enterprises making up the cluster, which a single enterprise may not have. Through economies of scale, SMEs could enhance their efficiency and reduce their operational costs. Their collective presence in a small town pushes the latter to improve its infrastructure and develop new services that serve as incentive to existing enterprises and boost the town's development (Liu 2001). A cluster's development fuels the host town's competitive power.

4.2 Challenges to SME Clusters

Notwithstanding the potentials for small town growth that SME clusters fuel, certain problems still hound these enterprises, which limit such potentials for growth. SME clusters in Jiangsu Province, for instance, are burdened by limited financing or access to credit, especially for technological innovations (Zhao 2007).

Overall, the cost of doing business in industrial areas and host towns is high; physical infrastructure is poor; and operational costs are high. Furthermore, access to finance and information technology is limited. These problems are disincentives to doing business and restrict SMEs to organized clusters in the industrial towns. Infrastructure development depends only on small- and medium-sized enterprise clusters while small town economic development relies on private capital and government fiscal support.

Small enterprise clusters depend highly on local resources for their operation. SME operations are generally family run enterprises with limited, instead of large-scale, factory production. The industrial structure tends to be rigid, with limited entrepreneurial and managerial skills. Such factors inhibit the enterprises' competitiveness and result in a lack of enterprising spirit or willingness to take calculated risks, as well as management inefficiency (Zhao 2003), highlighting the need for training. The quality and cultural levels of the managers and the management systems of small enterprises have to be improved.

4.3 Survey of Small Enterprise Clusters in Jiangsu Province

The following examples highlight the challenges confronting industrial SME clusters, based on field surveys of three kinds of small enterprise clusters in Jiangsu province (see endnote 3).

4.4 One Product, One Town

Three towns clearly illustrate the concept of “one product, one town” in the Jiangsu province:

The Guanlin cable cluster (comprising 12 small cable enterprises), the Shengze textile cluster (including six small textile enterprises), and the Hengshan sewing machine cluster (consisting of six small sewing machine makers) are engaged in the manufacture of metal products, textiles, and general machinery, respectively. These comprise the top three industries of China.

The town of Guanlin is in Yixing City, Wuxi, Jiangsu Province. Started in the early 1980s, cable production in this town now boasts more than 200 cable enterprises, 20 of which have assets of at least 100 million yuan, and eight have assets of 10 billion yuan or more. Cable output and sales account for 78 percent of the total industrial output of the town. Sales of cable enterprises in Guanlin and its surrounding towns account for more than one-third of the entire economic output of Yixing City, the largest cable production base nationwide.

Inspired by the rapid development of the cable industry, its auxiliary enterprises engaged in non-ferrous metal processing increased rapidly. Today, there are around 200 enterprises forming a complete industrial chain engaged in the manufacture of machines, auxiliary materials, metal rolls and cable coils. Guanlin also prides itself on having some 100 types of cable products with about a thousand specifications and over 10,000 varieties, including high-quality products.

Shengze, known as the “silk town,” has an extensive production line. It is one of four towns (the others being Suzhou, Hangzhou and Taihu) that were collectively called the major silk towns of China during the Ming and Qing Dynasties. The silk industry of Shengze has shifted from low- to high-quality materials, from textiles to R&D, from low to high-value added. Shengze has about 2,000 textile factories now, which have a combined 75,000 shuttleless looms. It has formed a textile production chain from silk reeling, polyester spinning, weaving, dyeing and finishing, deep processing of textiles to the manufacture of clothes and garments. It produces 2 million tons of polyester filaments, 6 billion meters of textiles, dyes and finishes, 2 billion meters of textiles; deep-processes 2 billion meters of textiles; and makes 50 million garments every year.

In 2006, the output value of Shengze's textile industry was 36.032 billion yuan, accounting for over 90 percent of the total output of the town. The industry's total taxes amounted to 600 million yuan, up 20.03 percent from 2005. Its employed personnel numbered 88,600, excluding 51,000 individuals working for it in the countryside.

The development of Shengze's textile industry also helped to establish textile enterprises in its surrounding areas. Today it boasts a highly competitive textile production base operating in the areas around Shengze, which include Wujiang City, Jiaxing in Zhejiang, and some towns in Huzhou.

The sewing machine industry in Wanping, Hengshan began in the 1970s, continued on till the 1980s, and developed in the 1990s. Since then, SME clusters have been formed, which are marked by a closely coordinated production chain, strong collaboration among the small enterprises involved, strong and independent R&D efforts, and orientation to the domestic and international markets. Today there are over 30 sewing machine manufacturers and 162 related spare parts makers, who rely on a full gamut of production operations. The output of middle standard and thick-material sewing machines in Hengshan accounts for 30 percent of the total national output. At least 4,000 varieties of spare parts are produced in this town. Now the industry in Hengshan has over 170 patents, of which 30 to 40 patents are used every year.

These small enterprise clusters are marked by the following:

Localization. Centralized production in a certain region at a considerable quantity is one distinctive feature of small enterprise clusters. SE clusters are driven by leading major enterprises, followed by affiliate enterprises, self-developed enterprises clusters, leading to the gradual evolution of the one industry, one region and one product, one town type of operation. Its regional reach has brought about expansion of production (Li Donglei 2005). The cable town in Guanlin, the silk town in Shengze, and the small sewing machine clusters in Hengshan exemplify the concept of such a regionalized layout.

The presence of a large number of related enterprises in the same region will facilitate skills upgrade and enhance competitiveness, which in turn could speed up the sector's pursuit of industrial clustering and technological innovation, as they take advantage of proximity, coordination, and ease of communication.

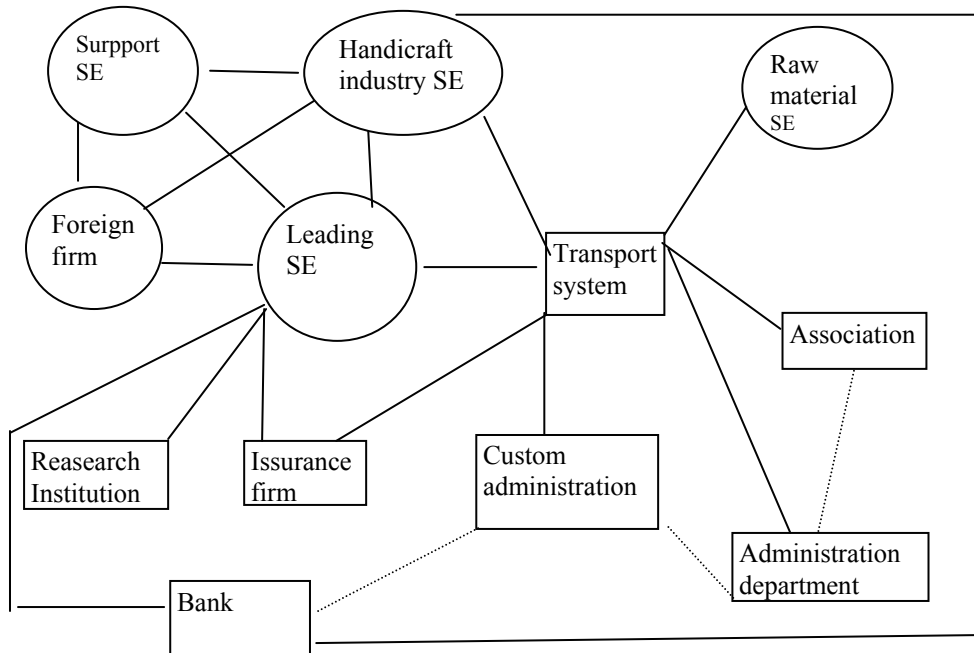
Specialization. Small enterprise clusters' specialized operations help ensure their steady progress. Specialization comes about when enterprises clusters develop to a certain degree, resulting in the creation of professional divisions and steadily improving coordination. Along the way, some definite production processes will be spun off and turn into affiliated enterprises for some special processing. Hengshan town, for instance, is the production base of sewing machines for medium and heavy-duty materials. What started out as a small number of companies have grown to 162 parts manufacturing enterprises that now comprise the clusters of enterprises possessing a high degree of specialization. These produce over 200 kinds of parts for sewing machines annually. They supply both the domestic and export markets. Enterprises in clusters can make fully utilize infrastructure because of a centralized regional layout, and lower the utilization cost of infrastructures and services under the same level of supplying.

Market-oriented interaction. Shengze, dubbed "Kingdom of Clothes and Quilts," has many enterprises producing textile and silk. It is also well known as an oriental silk market. This is an example of regional branding, a result of more efficiently run and more developed enterprises that have developed a niche for their extensive and sustainable brands. Thus mention thin silk lining or materials, and Shengze town in Wujiang easily readily comes to mind. The same is true for Hengshan town, which is known for its machines for medium and heavy materials; Wujin for its lamps; and Yangzhong in Jiangsu for its low-voltage electrical equipment.

The efficiency with which these manufacturers are run can be seen in reduced costs of operation and increased profit, as have been the experience of more than 200 IT companies operating on the 12 sq. km land in the developed zone of Wujiang city. This sector is also an example of a centralized cluster of enterprises that can easily obtain the latest technological information from the market and spread it efficiently through interpersonal channels. As such, enterprises could devote the a greater part of their time and resources to developing their markets (Zhang 2005).

Socialized coordination. Service-oriented enterprises have developed systems that make efficient and coordinated operations possible (see Figure 2). For example, Hengshan town in Wujiang city is widely known as the national hub for wool-sweater

Figure 2: Socialized Coordination of Small enterprises



production. Producing 100 million sweaters yearly, the cluster of enterprises operating in this town carries out all operations—from production to distribution—in its base of operation. Order, transaction, packing, and delivery systems services are all also provided in a coordinated manner by those service enterprises. One town, for instance, has 3,500 enterprises producing wool sweaters; 600 enterprises handle the nationwide distribution; 500 others are engaged in affiliated operations; 400 enterprises produce materials; 200 are engaged in transportation; 100 enterprises repair equipment, all of them form an enterprise cluster with firm connection.

Meanwhile, people, products, capital and information are all essential components of enterprises cluster, which collectively can accelerate the development of transportation, storage, telecommunications, restaurant, hotel, entertainment, education, sanitation, agency, financial insurance and real estate, etc.

Local government. Local government units provide an enabling environment through appropriate policies and regulations as well as vital infrastructure, which are all essential to business. Small enterprises located in the areas between Shanghai and Zhejiang enjoy the convenience of having these facilities, which allow them to do

business with local and foreign enterprises. Besides, local governments arrange for enterprise visits to other places, and organize them to participate in international trade exhibits every year. These governments also support various spare part associations and service companies and provide technical and R&D services.

4.5 Networking among Small Enterprises

Networking among 24 sample small enterprises was found to be strong, given their close coordination with other small enterprises for specific business operations. For instance, nearly all cable enterprises cooperate closely with other small enterprises to buy raw materials, purchase intermediate products, sell products to other small enterprises as well as introduce other small enterprises to customers when their orders exceed their production capacity. The same level of coordination applies to small textile enterprises. The small sewing machines enterprises cooperate very closely with other small enterprises.

4.6 Subcontracts with Big Enterprises in Textile Industry

Subcontracting among small enterprises, as another business strategy, is limited so far to the textile sector, with five out of six industry players having signed subcontracting arrangements with major companies, one of which has similar arrangements with big foreign firms at the same time.

The percentages of subcontracted products vary across the enterprises involved, ranging from 20 to 100 percent. In the sewing machine sector, five of them have signed subcontracts with big domestic enterprises and one of them has signed subcontracts with big international enterprises at the same time. Four of these five enterprises have had simultaneous subcontracting businesses and with many enterprises at the same time. Two big domestic companies signed subcontracts with these textile enterprises for quality, one for production capacity, and one for OEM.

Based on a survey conducted, five small textile enterprises selected product quality as the most important factor for establishing and engaging in conducting subcontracting business as they all hoped to receive proposals about quality management from such business.

All the 12 cable enterprises, however, have yet to sign subcontracts with big enterprises.

4.7 Export Competitiveness Ability and Higher Level of Technological Innovation

Export competitiveness among textile and sewing machine manufacturers is strong compared to other sectors. Aside from enjoying good domestic sales, the textile industry has also successfully tapped the export market. Proof of its strong performance abroad is that four out of six of its enterprises get 50 to 100 percent of their sales receipts from the international market. Similarly strong internationally are five of six sewing machine makers. Only the cable industry players make whole machines and serve the domestic market entirely.

The cable enterprises sell their products in the domestic market, which, based on a survey conducted, is so huge that serving the international market may have to wait for now.

Cable enterprises are technology-intensive enterprises, whereas the textile enterprises and sewing machine enterprises sectors are either technology- or labor-intensive businesses, depending on their stages of operation. Two cable enterprises have their own product patents.

Notwithstanding the strong export performance of some industries in the small enterprise sector, technological innovations are hampered by the scarcity of funds.

The cable makers among the small enterprises operating in the town have a combined labor force of at least 350 senior and middle engineers and over 20,000 production workers. Yet, these companies have to rely on foreign organizations for technological innovations owing to scarcity of funds and limited R&D capability. As for the textile sector, only one manufacturer has a product patent. They generally have joint R&D undertakings with domestic and international institutions.

The sewing machines cluster, though equally hobbled by lack of funds and limited R&D capability, have nonetheless enterprise-led R&D. In fact, three enterprises have their own product patents—proof of their strong and independent technological innovation ability as well as keen orientation toward the domestic and international markets.

The sewing machine industry in Hengshan presently has more than 1,000 professionals, or 8 percent of its total manpower, including 250 mid-level and senior engineers. It has forged partnerships with the Suzhou University and Jiangsu University of Science and Technology. Some of the spare part enterprises have become the training sites of these educational institutions.

Imitation is restricting technological innovation among standard small enterprises. Yet, the average R&D input accounts for 10 percent of the sales of the sewing machine and textile enterprises. This shows that small enterprise clusters in Jiangsu Province are more adept at technological innovation ability.

5. FIELD SURVEY

5.1 Objectives Field Survey

The field survey sought to analyze the 1) industrial clusters of small enterprises and subcontracting arrangements between small enterprises and large enterprises in typical industries in Jiangsu Province; and 2) to determine the extent of development and level of professionalization of the manufacturing industries. The survey was conducted in Jiangsu Province in November 2007.

5.2 Industrial Clusters of Small Enterprises: SE's Development Trend

Based on the survey, 30 percent of the respondent enterprises are doing affiliated production for large enterprises, 100 percent sell products in the local market, while 50 percent cater to the export market.

Small enterprises facilitate development. Jiangsu province takes the lead in the market economy. Adequate infrastructure such as information technologies, excellent geographical location, favorable investment policies, cheap labor, and rich natural resources have collectively enabled the SEs operating in the area to coordinate their production to global standards and attract foreign capital and technologies. Moreover, they get support from the local government and benefit from the collective efforts of all enterprises to pursue growth.

The survey shows that a fourth of the enterprises have established strategic alliances with relevant enterprises, 100 percent do production by themselves, sell products locally and have very good collaborative efforts with other SMEs. On the average, the enterprises maintain close relations with 14 enterprises among those that have market alliance, 50 percent of them in Jiangsu, Zhejiang and Shanghai. Each of the companies with technological development alliances with other firms keeps close relations with three enterprises; 55 percent concentrate in the same areas. Enterprises in the Changjiang Delta area in Jiangsu province also receive support from other enterprises.

Convergence of similar enterprises for production (in the cable industry), convergence of similar enterprises for the market (in the textile industry), and convergence of similar enterprises for the production chain (in the sewing machine industry) are characteristics of the main business development patterns among small enterprise clusters in the three industries, respectively. Hence these industries are technology- and labor-intensive, respectively.

Small cable enterprise clusters is the convergence of similar enterprises for production. Their production chain is short and product varieties abound. Similarly small enterprises converge horizontally and cooperate with both big enterprises and small enterprises. China's construction industry currently enjoys great demand amid efforts to boost the infrastructure in the countryside. Domestic cable products have a steady market share, which is mainly in China. The products mainly comprise midscale cables and lines. The skill level of enterprise employees is low, which prompts some companies to seek technical cooperation and development with research institutes or universities to facilitate skills upgrade. Prospects for such cooperation and development are still being explored.

Small textile enterprise clusters are the convergence of similar enterprises for the market. The textile industry is in the midways through the production chain.

The development pattern among small enterprise clusters in the Shengze Town in Jiangsu is typified as horizontal convergence, that is, across similar enterprises, or as vertical convergence, that is, they are in collaboration with big enterprises, i.e., working as subcontractors for them. Small and big enterprises cooperate closely mainly to

process and customize textiles for big European and American enterprises. Cooperation between small enterprises is also very close.

China's textile industry still has the advantage of low labor costs. Located in the Yangtze River Delta, these enterprises operating there have captured both the domestic and international markets, each of which accounts for 50 percent of their sales.

Increasing competition for a share of the market has prompted small enterprises to collaborate with research institutions or universities in pursuit of technical development. Others have gone into joint R&D undertakings with domestic scientific research institutes. The Shengze town's textile enterprises have formed such undertakings with partners conveniently located within 5 km of their base of operations.

Small sewing machine enterprise clusters is the convergence of similar enterprises for the production chain. The sewing machine industry belongs to the processing industry, which has an extensive production chain. The small sewing machine enterprises in the Hengshan Town of Wujiang in Jiangsu mainly cooperate vertically with big domestic enterprises and foreign enterprises while some small spare parts enterprises work closely with big enterprises. These cater mainly to big enterprises in Shanghai, Japan, South Korea, and Europe. Meanwhile, the small enterprises are in close coordination with one another, which has been a big boost to the expansion of their domestic and foreign markets. They are located in the Yangtze River Delta.

Hengshan Town, as the production hub of sewing machines suitable for medium and thick materials, has longer horizontal and vertical production chains than the former two industries as well as diversified features. It is a labor- and technology-intensive industry. These enterprises' R&D efforts are company-driven. Many of them have their own patented technologies. They collaborate with domestic scientific research institutes in R&D in varying degrees and their products are relatively well known locally and internationally.

5.3 Difficulties of Small Enterprises

Certain problems persist in the small enterprise industry: These are as follows:

- a. Lack of core technologies and intellectual property rights
- b. Poor cooperation between foreign companies and local enterprises

- c. Lack of preferential policies and advantageous labor costs that are disincentives to foreign companies, some of which have moved from China to Vietnam, India and other Southeast and South Asian countries in recent years
- d. Limited access to funding
- e. Weak local government service system

6. POLICY RECOMMENDATIONS

6.1 Strengthen service quality among SMEs

The government must ensure that initiatives funded with public money are responsive to business demands, address market failure, and provide added value. It must also see to it that the business support network provides the targeted service to businesses. Policymakers, both at the national and regional levels, must recognize that the process of business growth has significant policy implications for government services, and determine ways to address these implications. Aside from ensuring that employers get high-quality training from colleges and private institutions providers brokerage services on training are often key for many small firms.

6.2 Learn from the Experience of Jiangsu Government

The Jiangsu government has promulgated supporting policies on the development of small enterprises. These mainly cover pioneering support, innovation promotion, market expansion, capital support, service guide, and rights protection.

Local government units should insist on reforming the property rights system, and encourage individual and private enterprises to become share holders or owners of state-owned and collective small enterprises. They must also develop joint-stock enterprises, advocate unequal stock ownership, and reform conditional joint-stock enterprises into standard company-system enterprises.

Local government should accelerate to encourage small enterprises to provide coordinative services for big companies, thus facilitating the pursuit of merger and acquisition activities. It should alleviate the burden of small enterprises, such as some charges in reorganization of enterprises can be deducted.

Then, too, local government should support the establishment of a technological innovation mechanism that, among others, would allow technological development costs to be incorporated into the corporate budget. If the cost increases 10 percent more than the previous year's, profit-making enterprises in national and collective industries can have a 50 percent tax cut.

Local government should expand financing channels. Commercial banks should set up credit organizations for small enterprises. Local place should found credit guarantee funds and venture capital. High-quality assets of small enterprises can come into market through equity and assets replacement, so as to realize direct capital market financing.

Local government should establish small enterprise-centered technological innovation service system, information consulting service center, management consulting center, and product distribution center.

6.3 Develop an Industrial Cluster Plan to Enhance SME Competitiveness

Government should provide a policy framework that would serve as a guide in the setting up of industrial clusters of small enterprises. Such a framework should indicate how such clusters could be formed, provide public funds for SME clusters, and set up promotional institutions that will enhance technological collaboration among SMEs, university and research institutions.

The same framework should provide business support, specifically for innovation; cultivate markets; and foster human resources, among others. It should also build financing institutions for SMEs.

Where SMEs are concerned, the countermeasures to develop SE clusters should be as follows:

- *Improve small town infrastructure.* Improved and low-cost infrastructure, such as energy, transportation, communications, and Internet, is vital to SE clustering.

Small town infrastructure development could be pursued gradually but steadily while ensuring that SEs continue to produce and develop while getting the services that they need.

- *Develop the industry that has competitive power.* Small towns specializing in production, trade, and tourism industry should develop potentially competitive industries.

Undeveloped small towns should develop the industry using locally available resources and potential regional markets. This can be achieved through the industrial chain's extension and new product research and development, external scale economy and healthy competition and cooperation within the SE cluster.

Implement the macroeconomic regulation and supply the local government service. The government should draw up a preferential policy for the development of SEs, help SEs to choose appropriate region and adjust their development direction. The local government should help to cultivate entrepreneur spirit. The entrepreneurs of Small-medium sized enterprise cluster have been regarded as important human resources in the development of the enterprises. It is necessary to create a suitable environment for the entrepreneur development and supply a preferential policy, completed law system, fair market rules and so on. The point is to build a culture of the local society to promote competition and cooperation in order to cultivate an innovative entrepreneur efficiently,

6.4 Complete Financing System of SME

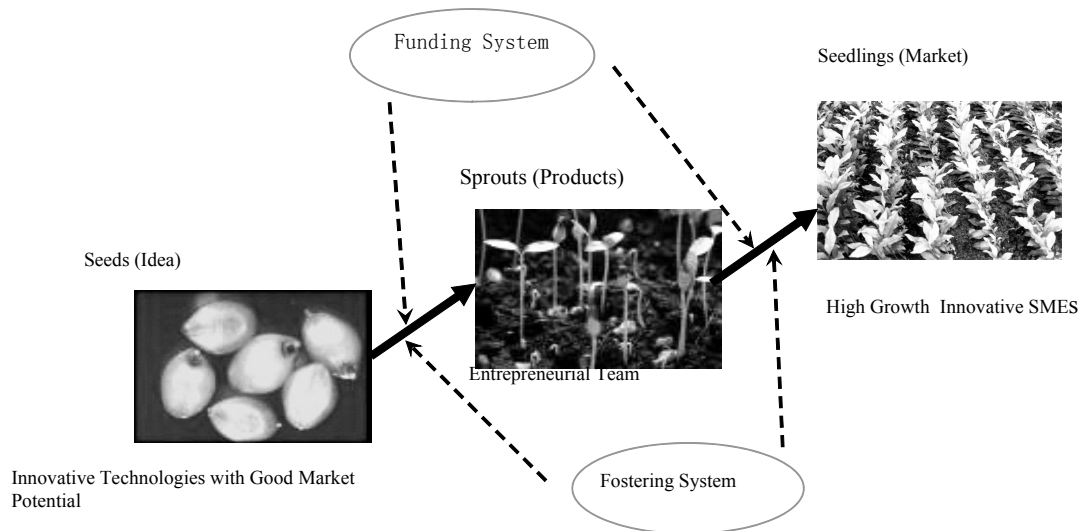
The policy for SE development should focus on financing. Following are some proposed measures toward this end:

- Expand the list of SE financing tools to include fiscal, banking, security market, commercial credit, and private financing sources
- Build policy bank of SE
- Develop a credit guarantee system
- Encourage utilization of foreign direct investment and expand external markets
- Develop a second board market
- Provide a finance and taxation support system for the promotion of SEs' technological innovation

6.5 Complete technological innovation system of SE

Support for technological innovation will be accorded to SEs that meet industry standards. This could take the following forms (see Figure 3):

Figure 3: “Growing Seedlings” of Technology Innovation of SME



- *Create innovation source* (e.g., “Growing Seedlings”). In particular, reinforce the development of technology-based SE community, and lower the risks and costs of innovation activities undertaken by technology-based SEs.
- *Develop innovation clusters and reforestation*. Guide the random innovation activities of SEs to follow the national development strategy so as to build up the innovation ecosystems representing national competitiveness.

Environment building is also important (“The Soil”). It should cover the following:

- Capital
- Technology
- People

Encourage the upgrading of the value chain, including technology-based export promotion, that is, from OEM (Original Equipment Manufacturing) to ODM (Own Design and Manufacturing) & OBM (Own Brand Manufacturing), etc.

Coordinate integrated fostering system. First, strengthen technological innovation system with enterprises as the core hub, and facilitate collaborative efforts among industry, university, and research institutions. Government should promote the networking, interaction and collaboration among key innovation players, foster technological innovation alliances, establishing innovation relay centers (otherwise known as CIRCs) to make it easier for SEs to access applicable innovation resources, lower their information, transaction, and organizational costs of innovation activities.

Second, promote the incubation mode of entrepreneurial tutor (or SCORE) combined with professional incubation promote joint innovation partnership between Chinese and foreign innovative SEs through cooperation with counterpart innovation agencies in other countries.

NOTES

1. Small enterprises have less than 300 employees and business revenue of no more than 30 million yuan. Total assets amount to less than 40 million yuan. Such enterprises are the focus of this paper. Individual industrial and commercial households are not covered by the statistical data for “Legal Persons.”

2. Among small enterprises, private economy is nearly about 70 percent. The contribution of private economy to total export is about 3.6 percent (*China Private Economy* year book, 2004-2006) in 2005. Total SE contribution to total export is estimated at nearly 5 percent.

3. Sales of the leading enterprises in the Jiangsu Databank of Industrial Clusters Innovative Service Projects account for over 50 percent of the sales of industrial enterprises in such colonies. After expert appraisal, 241 enterprises are compiled into the databank.

4. The role of local governments is very different. Local governments in Jiangsu is very important for Small enterprises, government guide the enterprises and economic development. The local governments in Jiangsu concentrate on the development of basic infrastructure and optimize of investment environment. Local governments in Zhengjiang are the reverse, given their seeming inaction where the needs of the SMEs are concerned.

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