“National firms have the general advantage of better information about their country: its economy, its language, its law, and its politics. For a foreigner the cost of acquiring this information may be considerable” (Hymer, 1960, p. 34).
INTRODUCTION

China’s remarkable economic growth

China overtook Japan as the world's second biggest economy in the second quarter of 2010 and despite predictions, the Chinese economy is still growing at a fast pace and is experiencing an important financial shift: from being a net recipient of foreign direct investment (FDI) the country is becoming a major source of overseas investments\(^1\). According to the U.S.-China Economic and Security Review Commission (USCC) (2011) in the midst of a global recession, and in spite of the financial turmoil and the consequent drastic reduction in FDI registered after the 2008, China became the largest investor in developing countries and is now the fifth largest investor in the world\(^2\).

Moreover, the jump of Chinese’s foreign exchange reserves to US $3 trillion by the end of the first quarter of 2011 and the fact that Chinese enterprises are facing saturated domestic markets in industries such as manufacturers in electronics, automotive, mobile phone and textile, has made it urgent to the Chinese government to continue pursuing the Go Global policy aimed at encouraging companies to gain access to overseas markets (China Daily, 2011). In fact, several stimulus packages has been designed including export and value added tax reductions, financial and foreign exchange assistance and specific export promotion instruments to support expansion of selected industries (fabric, steel, metal, car manufacturing, petrochemical, shipping, electronics, communications, and light industries) into foreign markets (Pyo, 2009). The 12th Five-Year Program for China’s Economic and Social Development (2011-2015) includes a broad set of strategies to upgrade its industrial structure and also to accelerate globalization through exports (Yansheng, 2011).

China’s accelerated internationalization process

As a result of the accelerated and successful process of internationalization, in 2010, China ranked just behind U.S. (with 139 companies) and Japan (with 71 firms) in the Fortune

\(^1\) Chinese FDI is currently playing a pivotal role in its process of strategic asset seeking. As explained by the USCC (Saidjianova, 2011, p. 6) Chinese FDI is mainly oriented to: 1- secure access to raw materials and energy sources, 2- to acquire advanced technology, brands, and know-how, 3- to increase foreign exchange earnings, and more importantly, 4- to promote China’s exports, the main driving force behind China’s spectacular growth, China’s Outward Direct Investment (ODI) in the non-financial sector increased from $2.85 billion in 2003 to US $59 billion in 2010, an average growth rate of about 55 percent a year. In 2010, China's ODI through M&A was $23.8 billion compared with $19.2 billion in 2009 (Qingfen, 2011)

\(^2\) According to the New York Times (2011), China exports were worth 155.7 Billion USD in April of 2011. It is also to highlight that export of goods and services constitute 39.7% of Chinese GDP. http://www.investorvillage.com/smbd.asp?mb=4245&mn=615839&pt=msg&mid=10465801.
Global 500 list. From only 5 Chinese firms in the 2008, 46 Chinese firms made the Fortune Global 500 list in 2010 and three Chinese companies are already among the top ten: Sinopec (7) State Grid (8) and China National Petroleum (10) (Fortune, 2011). Moreover, Chinese firms are rapidly catching up in technology and are becoming strong technology world class companies. In fact, Chinese companies emerge as global players in high-tech industries such as solar power³ and shipbuilding.⁴ This is also the case for Huawei, a company in the telecommunications equipment sector established in 1998, that in 2008 registered 1,737 applications and ranked at first place in the WIPO’s Patent Cooperation Treaty (Lee & Kim, 2011)⁵.

In fact, as evidenced by the growing body of literature on the internationalization of Chinese multinational corporations (MNCs), the ‘Chinese miracle’ has captured the attention of scholars around the world. Coinciding with the extraordinary economic growth registered in China during the last three decades a growing number of studies have been published in recent years providing a wide-ranging analysis of Chinese multinational corporations’ strategies as well as analyzing the role played by the state and the institutional determinants in the internationalization processes (Bhagat, McDevitt, & McDevitt, 2010; Boisot & Meyer, 2008; Buckley, Clegg, Cross, Liu, Voss, & Zheng, 2007; Child & Rodrigues, 2005; Fornes & Butt-Philip, 2011; Mathews, 2006; Rugman & Li, 2007; Rui & Yip, 2008; Williamson & Yin, 2009).

However, it is surprising to note that very little has been said about the internationalization strategies of SMEs from China especially considering that SMEs account for 60 percent of China’s GDP, 66 percent of the country’s patent applications, 80 percent of its new products, 68 percent of China’s exports, and provide more than 80 percent of total employment (The Economist, 2009). In addition, there are more than 10 million SMEs in China which account for 99 percent of the total enterprises, 50 percent of tax revenue, and 80 percent of urban employment according to the Ministry of Industry and Information Technology (People's Daily Online, 2010). In this context, the study of Chinese SMEs appears as a need to complement the growing research on China’s multinational corporations.

³ Suntech Power, Yingli Solar, JA Solar, and Trina Solar held 47 percent of the solar power global market in 2010 (Lee & Kim, 2011)

⁴ In 2010, China became the world’s biggest shipbuilder according to three major indicators (number of contract orders, backlogs and volume of construction) (Lee & Kim, 2011).

⁵ According to Thomson Reuters (2008) China has become the third largest patent office in the world and will overtake Japan and the United States to become the World’s leading innovator by 2012. These are impressive achievements taking into consideration that China is still in transition from a centrally planned system to a market-driven economy. This is also evidence that not far away today’s Chinese MNCs were domestic small and medium-sized business only a few years ago (Cardoza & Fornes, 2009; Gang, Liyan, & Xiaofei, 2009).
Even though research on internationalization of Chinese SMEs is still scarce, some studies have made contributions to the understanding of SMEs development and their overseas expansion. For example, Chen (2006) presented a description of the changes that happened in China that led to the development of SMEs; Boisot and Meyer (2008) proposed different hypotheses on the environment faced by China’s SMEs through the analysis of transaction costs; Zheng, O’Neil and Morrison (2009) researched the impact that innovative HR practices can have in the performance of SMEs in China; and Ma, Wang, and Gui (2010) analyzed the influence of financing on technological innovation in SMEs. More specifically, Jansson, Söderman, and Zhao (2008) researched the take-off process; Sandberg (2009) analyzed the internationalization patterns and indirect exports and, Cardoza and Fornes (2009) studied the barriers to internationalization faced by Chinese SMEs. Nevertheless, no academic work has yet studied the liability of foreignness (LoF) (Johanson & Wiedersheim-Paul, 1975), one of the key elements of mainstream internationalization theories, in the process of overseas expansion of Chinese SMEs. In this context, this study has been designed to shed light on the barriers Chinese SMEs face overseas causing LoF and, as a consequence, to contribute to fill this gap in the literature.

In addition, the concept of LoF has been used almost exclusively to understand the obstacles faced by MNC’s subsidiaries in foreign markets. In effect, LoF notion has been used by different authors (Calhoun, 2002; He & Lyles, 2008; Hymer, 1960; Mezias et al., 2002; Petersen & Pedersen, 2002; Sethi & Guisinger, 2002; Zaheer, 1995) mainly to study the disadvantages that subsidiaries of MNCs face in foreign countries; however researchers have devoted limited attention to understand how barriers related to foreignness affect SMEs from emerging economies in their process of internationalization. This provides extra support to the need to fill this gap in the literature, since SMEs, particularly those from emerging economies, are increasingly going abroad and usually lack resources and capabilities to overcome these obstacles.

With this purpose in mind, this study extends previous research done mainly for MNCs and reformulate relevant questions from the perspective of SME’s from an emerging economy expanding internationally. Moreover, this paper attempts to disaggregate liability of foreignness with the purpose of identifying and understanding better the sources and determinants.
The present study’s goal is then twofold: 1- to differentiate among sources of liability of foreignness in order to better understand how the perception of specific barriers such as lack of information and contacts, socio-cultural differences and unfamiliarity with new contexts and foreign business practices affect SMEs’ internationalization strategies, and 2- to focus the analysis on the SMEs from emerging and transition economies in order to understand better the specific difficulties they may face in their international expansion and where it is possible, to enumerate the strategies they may have at their disposal to overcome them.

This study is relevant for both theory development and practice since it contributes, on the one hand, to unlock the liability of foreignness box in order to understand better the barriers SMEs from emerging economies face when doing business abroad and to discriminate between its different sources. On the other, the study has also implications at the company level as it will help managers to formulate better internationalization strategies allowing them to anticipate and overcome different types of LoF. Additionally, the study is also useful to inform the process of public policy making.

The paper is organized as follows. Section 2 presents a conceptual framework and provides a general overview of the main scholarly contributions to the theory of the liabilities of foreignness. Section 3 summarizes the main contributions and suggestions presented by different authors on overcoming LoF. Based on the analysis of shortcomings in the literature on how different factors create LoF and affect the internationalizations strategies of Chinese SMEs, we formulate the hypothesis in Section 4. Then, section 5 explains the methodology and research design and finally, after the discussion of the results, we discuss implications and possible directions for future research.

REVIEW OF THE LITERATURE

The Liability of Foreignness

The notion that foreignness is a source of liability for firms doing business abroad has been central in international management theories and the study of the multinational enterprise (MNEs). Theoretical approaches are based on the assumption that foreign firms doing business abroad are at a disadvantage vis-à-vis domestic firms. Stephen Hymer (1976) in his groundbreaking 1960 dissertation argued that companies doing business internationally experience costs of doing business abroad (CDBA) that were not experienced by local firms and therefore were in disadvantage vis-à-vis them. As pointed out by Hymer (1976), to
compete successfully in a foreign market entrant firms should manage and mitigate disadvantages stemming mainly from foreign exchange risks and the unfamiliarity with local business conditions (cultural, political and economic). More specifically, Hymer identified four sources of CDBA that local firms don’t have to bear: a. lack of information about the foreign market; b. discriminatory treatment from the host country government, buyers and suppliers; c- differential treatment from firm’s home government and, d. Exchange risks. In turn, Kindleberger (1969) related CDBA to the spatial distance between the subsidiaries and their parents firms in his studies on the internationalization of American firms, and then Buckley and Casson (1976) associated LoF to the lack of knowledge and unfamiliarity with the business, social, political and institutional environment in the host market.

Later, building on Hymer (1960), Zaheer (1995, pp 342-343) reframed the concept of the CDBA as the liabilities of foreignness. He defined it as “all additional costs a firm operating in a market overseas incurs that a local firm would not incur” and indentified four sources: a. spatial distance (i.e. costs of travel, transportation and coordination); b. company's unfamiliarity with local markets and cultures; c. costs associated with the lack of legitimacy of foreign firms in the host country and economic nationalism and, d. costs from restrictions imposed by the home country environment.

More recently, Mezias (2002a, p. 266) redefined liabilities of foreignness as the “phenomena that cause foreign firms to incur costs domestic firms do not, incur costs to a greater extent than domestic firms do, or be denied benefits only domestic firms are eligible to receive”. And Sethi and Guisinger (2002), using the resource-based theory, proposed to distinguish between traditional LoF (spatial distance, unfamiliarity with the environment and discrimination) and liability of foreign operations ( “all costs incurred by any domestic firm from the moment it undertakes cross-border operations”). Then Eden and Miller (2004, p. 2) differentiated between LoF and CDBA and argued that the main source of LoF is the “institutional distance (cognitive, normative and regulatory) between the home and host countries” while for CDBA, is a broader concept that comprise LoF but also includes economic activity-based (production, marketing, distribution) costs related to geographic distance”.

On their part, building on the conceptualization of Eriksson et al. (1997) and considering the lack of different complementary resources, Cuervo-Cazurra et al. (2007) proposed to analyze the barriers to internationalization through three types of liabilities: 1- the liability of
expansion, stemming from the lack of resources needed to operate at a larger scale; 2- the liability of newness associated to the lack of resources needed to compete in a new market; and 3- the liability of foreignness resulting from the lack of resources needed to operate in a new institutional environment.

All these studies have addressed LoF faced by MNC’s doing business in foreign countries but very few have been written about the subject in relation to the internationalization strategies of SMEs. The only exception probably is a study by Lu and Beamish (2001) on the internationalization and performance of Japanese SMEs. These authors mentioned that SMEs face liabilities of foreignness mainly due to political, economic, legal and cultural differences between the host and the home market. They also observed that due to LoF, SME’s performance decreases during the first phase of internationalization and as a consequence suggested that to overcome these barriers, to gain legitimacy, to mitigate the associated political and operational risks, and to obtain the capabilities and resources needed firms should: a- acquire new knowledge; b- recruit and train new employees and most importantly, c- build business relationships, networks and alliances. Also, in his descriptive article on the globalization of Korean SMEs, Jung M-S (2011) proposed several strategies based on market entry, use of new communication channels, collaboration with domestic companies, and competence enhancement through networking and securing resources from overseas markets.

Liability of Foreignness in MNCs

Most theoretical and empirical studies on LoF have focused on how MNCs should address this competitive disadvantage. For instance, Zaheer (1995) argued that to overcome competitive disadvantages derived from LoF, MNEs doing business in developed economies should better provide resources and/or capabilities to the foreign subsidiary than to practice ‘local isomorphism’, i.e. to emulate the advantages of successful local firms. On their part, Barkema et al (1996), using an organizational learning perspective in their study of large nonfinancial Dutch firms, found that to overcome cultural barriers companies should take advantage of the learning gained from previous experiences and also consider acquisitions and joint ventures when first entering a new foreign market. Also they argued that in addition to learning-by-doing, companies expanding internationally facing different difficulties related to their foreignness can diminish these liabilities by building reputation and legitimacy in the host country (Barkema, Bell, & Pennings, 1996). Following the same line of reasoning, Lu and Beamish (2004) observed that the total costs for the LoF declined and
leveled when firms learn from their experiences in various countries but, they warned that transaction and coordination costs increase with the degree of geographic diversification.

Applying a socioeconomic framework and building on Hymer (1960), Zaheer (1995) and Kostova and Zaheer (1999), Luo et al. (2002, p. 285) observed that to overcome LoF MNEs usually make use of defensive and offensive mechanisms. Among the defensive mechanisms they included: a- contract protection to manage and control its relationships with different business stakeholders; b- parental control through integration and control by the headquarters; c- parental service through services or supports by the headquarters and d- output standardization oriented to reduce foreign subunit’s dependence on host country resources. In turn, the offensive mechanisms consist of: a- local networking with senior managers and other stakeholders; b- resource commitment to consolidate its competitive position; c- legitimacy improvement oriented to increase its local acceptance and, d- input localization by increasing the uses host country production factors.

Zaheer and Mosakowski (1997) observed that technology adoption and nonhierarchical modes of control increased the rate of survival of foreign firms from a specific industry (currency trading rooms) and most importantly, they suggested that the liability of foreignness will diminish overtime when firms increased access to local information networks and understand better the local market. Along the same line, Petersen and Pedersen (2002) employing an organizational learning perspective in their study on international firms from Sweden, Denmark and New Zealand, observed that in order to reduce market unfamiliarity, foreign firms may initially learn about local business environments externalizing specific operations to local companies.

In this sense, Zaheer and Mosakowski (1997, p. 445) contended that foreign firms face liability of foreignness mainly from ‘not being sufficiently embedded in the information networks in the country of location’ and Johanson and Vahlne (2009) added that relationships with different stakeholders and participation in the appropriate business networks (insidership) facilitate learning and building trust and commitment, preconditions for successful international expansion.

**Liability of Foreignness and Chinese MNCs**

In their studies on Chinese multinational enterprises, Child and Rodrigues (2005) and Li (2007) observed that the internationalization process of Chinese firms usually address
relative disadvantages, included those associated with the liability of foreignness, through the establishment of international links such as strategic alliances with local firms. Child and Rodrigues (2005) also contended that original equipment manufacturer/joint venture (OEM/JV) contracts offer an additional way to Chinese firms to become familiar with international business practices and therefore to reduce its future liability of foreignness. Also, Zaheer (1995) and Child and Rodrigues (2005) asserted that organic expansion and hiring and training their own employees enables Chinese firms to reduce its liability of foreignness. Other authors argued that personal ties\(^6\) and ethnic networking favor Asian firms’ outward FDI, tend to facilitate international trade, and help to reduce risk and to overcome the liability of foreignness (Cai, 1999; Chen & Chen, 1998; Quer, Claver, & Rienda, 2011; Rauch & Trindade, 2002). As suggested by these authors, further studies should be carried out to verify if the proportion of ethnic Chinese in the host country and more specifically, the existence of ‘ethnically-based social networks’ based on interpersonal relationships (*guanxi*): a- favors Chinese outward FDI and international trade, b- influence the choice of host country for Chinese outward FDIs; c- reduce the risks and costs associated with identifying business opportunities by Chinese companies, and d- helps Chinese companies to overcome the possible cultural barriers and other obstacles related to LoF.

**HYPOTHESES**

Previous sections have shown that LoF in emerging markets-based SMEs is under researched. They also show that the great majority of the studies refer to firms operating in home markets that are relatively homogeneous in institutional, regulatory, and cultural terms; but this is not necessarily the same in emerging economies, China in particular"The sky is high and the emperor is far away", and old Chinese saying, makes reference to the level of accomplishment local businessmen/women and officials can achieve by themselves with little supervision from above. This idea needs to be factored in any study of China as today the country’s vibrant expansion and much of its growth is driven by local initiatives rather than by directives from the central government (Zhiming, 2010). The fact that local governments have beaten Beijing’s growth targets every year in the last 3 decades, that provinces have more ambitious plans for the expansion (for example, of their rail networks or clean energy) than those stipulated by national targets, and that SMEs represent the most

\(^6\) A similar observation has been done by Li et al (Li, Meng, Wang, & Zhou, 2008) in their study of personal ties for doing business in China. Their findings suggest that ‘ties can initially help firms assimilate the new environment, become more legitimate, and increase their chances of survival’.
important part of the country’s economic activity as seen at the beginning of this article provide evidence of the importance of the different local environments for the analysis of China. The local empowerment that began with the decentralization in 1979 and has continued until today has also created different patterns of development of the business environments inside China. A good example of these differences is the contrast between the villages of Huaxi (Jiangsu province) and Nanjie (Henan province) and their township and village enterprises (TVEs).

- Huaxi is China’s richest village where every family has had a net worth of more than RMB1m since 2005 as many of the former village farmers are large shareholders of the village enterprise, Jiangsu Huaxicun Co Ltd, listed since 1999 on the Shenzhen Stock Exchange with a current market capitalization of more US$1.1bn. On the other hand, in Nanjie communism is alive and well and the “works of Chairman Mao are still revered. The village and its enterprise run on a long-forgotten salary plus supply or need system (instead of a cash bonus), where basic resources such as food, property, schools and healthcare are first allocated on a needs basis” (Markus, 2002; Zhiming, 2010, p. 15). The co-existence of these two villages, located around only 700 kms away, is evidence of the contradictions currently encountered in China but especially of the open-minded and explorative nature of its citizens which surely have an impact on the international expansion of the small and medium-sized firms operating in these regions.

The home environment affects LoF as it is the starting point to measure the distance with the target market and the potential costs of operating abroad as presented in previous sections. Therefore the diversity in patterns of development inside China needs to be included to understand how Liability of Foreignness impacts (if at all) the internationalization of Chinese SMEs which lays the foundation for the first hypothesis.

**H0: on average, there is no difference in the perceived Liability of Foreignness between SMEs operating in regions with different patterns of development.**

On the other hand, there is a growing consensus in the literature about the liability faced by MNCs stemming from the lack of information and knowledge on the host country business environment; however there is very little understanding of the sources of LoF for SMEs and especially of how managers can mitigate these adverse factors and disadvantages in host
countries. In addition, there are no empirical studies on how LoF affect the internationalization of SME’s from emerging countries, in particular, about the effect that the unfamiliarity with local business conditions and the lack of information and knowledge on markets and customers may have on the SME’s internationalization strategies.

Thus, it is possible to argue that due to the lack of information and data sources on external markets and customers characteristics and preferences, the internationalization of Chinese SMEs is negatively affected by this information asymmetry. This reasoning leads to the formulation of the following hypothesis:

**H1:** Chinese SMEs not having access to the relevant information on external markets and lacking knowledge about characteristics and preferences of customers in international markets tend to exhibit poor internationalization outcomes.

In addition, and as suggested by different authors (Calhoun, 2002; Johanson & Vahlne, 2009; Li et al., 2008; Zaheer, 1995), in order to reduce the liability stemming from its foreign condition, to adapt to local environment and to foster competition in the host market, foreign firms need to establish relationships with local stakeholders such as managers, customers, suppliers and government bodies, a difficult task for an entering firm in a new foreign market. As argued by Johanson and Vahlne (2009), relationships with different stakeholders and participation in the appropriate business networks (insidership) facilitate learning and building trust and commitment, preconditions for successful international expansion. In effect, it can be argued that firms perceiving difficulties to identify customers and finding and controlling reliable representatives and middlemen in markets overseas tend to exhibit fewer propensities to internationalize. Following this line reasoning a third hypothesis is formulated:

- **H2a:** Shandong SMES perceiving difficulties to identify and contact potential customers and finding and controlling reliable representatives and middlemen in overseas markets tend to exhibit fewer propensities to internationalize.
- **H2b:** Chinese SMEs perceiving difficulties to identify and contact potential customers and finding and controlling reliable representatives and middlemen in overseas markets strengthens the association between the lack to the relevant information and knowledge on external markets and poor internationalization outputs.
Besides the cultural distance, another source of liability of foreignness is the institutional distance defined as “the difference/similarity between the regulatory, cognitive, and normative institutions of the two countries” (Kostova & Zaheer, 1999, p. 71). In effect, the differences between institutional environments and the unfamiliarity with governance structures, bureaucratic procedures, business practices, and the legal and regulatory frameworks that coordinate business transactions create LoF, affect the legitimacy of the foreign firm and consequently increase the costs of companies doing business in overseas markets (Calhoun, 2002; Kostova & Zaheer, 1999; Zaheer & Mosakowski, 1997). Thus considering that the unfamiliarity with institutional environment, regulations and business practices constitute important additional sources of LoF we can formulate the following hypothesis:

- **H3a:** Shandong SMEs’ unfamiliarity with institutional environments, regulatory frameworks and business practices in host markets tend to affect negatively internationalization outcomes.

- **H3b:** Chinese SMEs unfamiliarity with institutional environments, regulatory frameworks and business practices in host markets strengthens the association between the lack of relevant information and knowledge on external markets and poor internationalization outputs.

As explained by Cai (1999) the lack of knowledge about the business environment and the ‘intricacies of international legal frameworks, international finance, taxation, modern communications, customs regulations’ constitute additional barriers for foreign firms. Similarly, political instability and trade barriers (usually entry and license fees and quantitative restrictions), increase the costs of doing business in the host country and therefore create competitive disadvantages vis-à-vis the local firms. In effect, the perception of political instability combined with the lack of quality information and local contacts increase the risk perception of foreign firms and affect their performance. In addition, as explained by Deng (2004), in order to face protectionist barriers, especially in countries belonging to regional economic blocs, foreign firms are forced to establish subsidiaries which translate in higher expenses. Then, it can be argued that the perception of high competitiveness, high trade barriers, and political instability tend to deter foreign firms to expand their operations in these markets and cause poor internationalization outcomes. Then, it can be argued that the perception of high competitiveness, high trade barriers, and political instability tend to deter
foreign firms to expand their operations in these markets and cause poor internationalization outcomes.

- **H4a**: Shandong SMEs perceiving highly competitive international markets, high trade barriers and political instability tend to exhibit poor internationalization outcomes

- **H4b**: Chinese SMEs perception intense competition, high trade barriers and political instability in overseas markets strengthens the association between the to the lack of relevant information and knowledge on external markets and poor internationalization outputs.

Cultural differences between home and host countries are often cited in the literature of international business as an important source of LoF (Calhoun, 2002; Child & Rodrigues, 2005; Johanson & Vahlne, 1977; Kogut & Singh, 1988; Mezias, 2002b; Zaheer & Mosakowski, 1997). The notions of psychic distance (Calhoun, 2002; Child & Rodrigues, 2005; Johanson & Vahlne, 1977) and cultural distance (Kogut & Singh, 1988; Mezias, 2002b; Quer et al., 2011), concepts that include different linguistic and institutional dimensions of culture (laws, rules, and regulations), have been used to refer to different types of barriers that cause information asymmetry, affects social legitimacy, and generate LoF for firms entering into a new market.

In effect, it is widely accepted that gaps in this understanding due to cultural differences generate disadvantages to the foreign firm in comparison to native firms and that the greatest source of information asymmetry and liability for the foreign firm come from the limited understanding of the informal and unwritten cultural values, norms, ideologies, practices, and procedures (Calhoun, 2002; Zaheer & Mosakowski, 1997). Following this reasoning we can formulate the last hypothesis:

- **H5a**: Shandong SMEs perceiving socio-cultural differences (religion, values, customs, attitudes, etc.) and experiencing differences in verbal and non-verbal language tend to exhibit poor internationalization outcomes

- **H5b**: Chinese SMEs perception of socio-cultural differences (religion, values, customs, attitudes, etc.) and experiencing differences in verbal and non-verbal language strengthens the association between the lack to the relevant information and knowledge on external markets and poor internationalization outputs
To recapitulate, we summarize in Figure 1 a theoretical framework that shows the different factors, and their interactions, that create liability of foreignness and their effect on internationalization strategies of Chinese SMEs.
SAMPLE, DEFINITIONS AND METHODOLOGY

The data was collected through a survey applied to a sample of 582 senior managers and directors of SMEs in the Chinese provinces of Anhui (170), Jiangsu (137), and Shandong (115), and in the Ningxia Hui Autonomous Region (160) gathering information about the companies along with data on managers’ perception using 5-Point Likert-type scales (data from only 507 questionnaires were used as the replies from the other 75 were not complete). Participants operate within similar idiosyncratic characteristics (managerial, organizational, and environmental) making the responses operative (Barret & Wilkinson, 1985) and, as a consequence, a similar contextual view of the challenges faced by their firms was obtained.

Table 1 presents selected answers from the survey. In this table it is possible to see that around 21% of the SMEs in the sample are completely owned by the state. The companies in the sample operate mainly in manufacturing (34%), wholesale (12%), and retail (7%). Most were founded between four and ten years ago, and the great majority of their managers are men (77%) between 35 and 54 years old. These companies show a relatively high active participation by members of the managers’ families. Most of these SMEs have funded their operations using loans/overdrafts, mainly from state-owned banks, in the last two years. The definition taken for SMEs is that given by the National Bureau of Statistics of China (2007) and can be seen in Table 2.
# TABLE 1: SELECTED ANSWERS FROM THE SURVEY (N=582)

<table>
<thead>
<tr>
<th>Age of respondent</th>
<th>Gender of respondent</th>
<th>Studies of respondent</th>
<th>State-owned</th>
<th>Active Participation of family members</th>
<th>Funding sources in the last two years</th>
<th>Years since start-up</th>
</tr>
</thead>
<tbody>
<tr>
<td>35-44</td>
<td>M</td>
<td>UG</td>
<td>38%</td>
<td>Sons, Husband/wife, Father/mother</td>
<td>Loans from banks, Own savings, Previous years' profits</td>
<td>6-10, &gt;10</td>
</tr>
<tr>
<td>45-54</td>
<td>F</td>
<td>PG</td>
<td>29%</td>
<td></td>
<td>14%, 32%, 15%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>23%</td>
<td></td>
<td>33%, 14%, 16%</td>
<td>22%, 41%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Profits during last year</th>
<th>Main Activity*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decreased</td>
<td>Manufacture</td>
</tr>
<tr>
<td>Slightly decreased</td>
<td>Hotel/Restaurant</td>
</tr>
<tr>
<td>Kept at same level</td>
<td>Retail</td>
</tr>
<tr>
<td>Slightly increased</td>
<td>Wholesale</td>
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<tr>
<td>Increased</td>
<td>Prof. Services</td>
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<td>IT</td>
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<td></td>
<td>Constructi</td>
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<td>on</td>
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<tr>
<td></td>
<td>Transport</td>
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<tr>
<td></td>
<td>Real estate</td>
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<td></td>
<td>Finance/insurance</td>
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<td>Health/</td>
</tr>
<tr>
<td></td>
<td>Education</td>
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<tr>
<td></td>
<td>Others</td>
</tr>
<tr>
<td>10%</td>
<td>34%</td>
</tr>
<tr>
<td>12%</td>
<td>5%</td>
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<tr>
<td>17%</td>
<td>7%</td>
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<tr>
<td>31%</td>
<td>12%</td>
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<tr>
<td>28%</td>
<td>8%</td>
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<td></td>
<td>6%</td>
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<td>5%</td>
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<td>5%</td>
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<td>4%</td>
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<td></td>
<td>4%</td>
</tr>
<tr>
<td></td>
<td>18%</td>
</tr>
</tbody>
</table>

*: total may not equals 100% as some SMEs reported more than one activity, like retail and wholesale for example.
TABLE 2: DEFINITION OF SMALL AND MEDIUM-SIZED ENTERPRISES
(National Bureau of Statistics of China, 2007)

<table>
<thead>
<tr>
<th>Industry</th>
<th>Employees</th>
<th>Sales</th>
<th>Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry</td>
<td>2,000</td>
<td>3,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Construction</td>
<td>3,000</td>
<td>3,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Wholesale</td>
<td>200</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td>Retail</td>
<td>500</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Transportation</td>
<td>3,000</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td>Postal Service</td>
<td>1,000</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td>Accommodation &amp; Restaurant</td>
<td>800</td>
<td>3,000</td>
<td></td>
</tr>
</tbody>
</table>

This theoretical sampling (Eisenhardt, 1989; Eisenhardt & Graebner, 2007; Pettigrew, 1990) was designed to capture the different patterns levels of development inside China as presented in H1. On the one hand, Jiangsu and Shandong, two of China’s four largest economies, were chosen to represent the Eastern region which accounts for 54% of national GDP, 60% of bank assets/loans, 70% of mortgages, 86% of imports and 89% of exports; the region is home to 65% of the nation’s securities companies, 82% of insurers, and 95% of investment funds. On the other hand, Anhui and Ningxia were included in the sample to represent inland China, in particular the Central and Western regions respectively. The Central region has never attracted attention for high economic growth, but has benefited from being in the middle of the rich East and the resource-rich West. In the last years has emerged as a manufacturing hub for low-end manufactures due to the rising costs in the East, convenient location, good transport links, and abundance of cheap labor. The Western region is China’s poorest in GDP terms (the average province’s GDP is about a quarter of that in their Easter region counterparts) with income dependent on fiscal transfers from Beijing. It has been the fastest growing since 2005 and is rich in natural resources (66% of coal, 60% of natural gas and 40% of crude oil reserves) with a good potential for wind and solar energy (Zhiming, 2010).
The analysis for H1 is based on an independent two-sample \( t \) test where the two independent groups are (i) the Eastern region (Jiangsu and Shandong) and (ii) the Central and Western regions (Anhui and Ningxia) to see if there is any difference between the mean scores of the two groups. The model for H1 can be seen below:

\[
    t = \frac{\bar{X}_1 - \bar{X}_2}{S_{X_1X_2} \cdot \sqrt{\frac{1}{n_1} + \frac{1}{n_2}}}
\]  
(Equation 1)

The analysis for H2, H3, H4, H5, and H6 is based on multivariate regression analyses using export intensity (the ratio of international sales to total sales) as a dependent variable and the answers from the survey as independent variables. The definition of internationalization for SMEs used in this work is that proposed by Leonidou (2004, p. 281): “the firm’s ability to initiate, to develop, or to sustain business operations” outside their home market; in this context, export intensity (a measure of expansion firm performance (Bonaccorsi, 1992; Calof, 1994)) is used as a proxy for engagement in international economic activities in the models.

The differences in the economic development of the regions are factored in in the analysis. The regressions will be run for three groups, (i) for the whole sample (coded WS), (ii) for the Eastern region (coded as ER), and (iii) for the Central and Western regions (coded as CW). The aim of these three analyses is to know, on top of the differences (if any) in the mean scores studied in H1, if there is any difference in the sources of LoF in China’s regions. The models for H2, H3, H4, H5, and H6 can be seen below, and the definition for the variables can be seen in Table 3, the scale variables were based on Leonidou (2004)

| TABLE 3: DEFINITION OF VARIABLESScale Variables Using a 5-Point Likert-Type Scale |
|------------------------------------|-----------------------------------------------|
| InfoSources                        | Preferences                                    |
| The company does not have access to the relevant information sources to identify external markets for the company’s products and services | The different preferences, patterns, prices, and communication of customers in international markets make exports more difficult |

19
<table>
<thead>
<tr>
<th>Data</th>
<th>The company does not have the relevant data to assess the possibilities that the international markets are offering</th>
<th>Competitiveness</th>
<th>The target international markets are perceived as highly competitive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contacts</td>
<td>The company has difficulties to identify and contact potential customers in markets overseas</td>
<td>PolInstability</td>
<td>The political instability in external markets is seen as a barrier to exports</td>
</tr>
<tr>
<td>Price</td>
<td>The retail price of the company’s products are not adequate for the final consumers in international markets</td>
<td>HostRegulations</td>
<td>The different regulations in external markets make access and operations more difficult</td>
</tr>
<tr>
<td>Representatives</td>
<td>It is difficult to find reliable representatives abroad</td>
<td>Tariff &amp; NTB</td>
<td>The tariff and non-tariff barriers in international markets restrict export activities</td>
</tr>
<tr>
<td>Control</td>
<td>It is difficult to exercise effective control over the middlemen in international markets</td>
<td>Familiarity</td>
<td>The lack of familiarity with commercial practices abroad affect the company’s operations</td>
</tr>
<tr>
<td>Verbal</td>
<td>The differences in verbal and non-verbal language affect the activities carried out in external markets</td>
<td>Socio-cultural</td>
<td>The socio-cultural differences (religion, values, customs, attitudes, etc.) are considered obstacles to export activities</td>
</tr>
</tbody>
</table>

**Ordinal Variables**

<table>
<thead>
<tr>
<th>Industry</th>
<th>Manufacture, Hotel/Rest, Retailer, Wholesaler, Professional Ss, IT, Construction, Transportation, Real estate, Finance/insurance, Health/Education/Social SS,</th>
</tr>
</thead>
<tbody>
<tr>
<td>Years</td>
<td>Number of years since start-up</td>
</tr>
</tbody>
</table>
Limited knowledge of external markets (H2)

$$WS_i; ER_i; CW_i = \alpha + \theta_1 \text{Exports/GDP} + \theta_2 \text{Industry}_i + \theta_3 \text{Years}_i + \theta_4 \text{InfoSources}_i + \theta_5 \text{Data}_i + \theta_6 \text{Preferences}_i + \theta_7 \text{Price}_i + \epsilon_i$$  \hspace{1cm} \text{(Equation 2)}

where $WS_i; ER_i; CW_i$ is the export intensity of company $i$ analyzed in three groups (for the whole sample, for the Eastern region, and for the Central and Western regions), Exports/GDP of the province of origin, Industry and Years since start-up are control variables, and InfoSources, Data, Preferences and Price are the variables defined in Table 3.

Lack of contacts, reliable representatives, and control (H3)

$$WS_i; ER_i; CW_i = \alpha + \theta_1 \text{Exports/GDP} + \theta_2 \text{Industry}_i + \theta_3 \text{Years}_i + \theta_4 \text{Contacts}_i + \theta_5 \text{Representatives}_i + \theta_6 \text{Control}_i + \epsilon_i$$  \hspace{1cm} \text{(Equation 3)}

where $WS_i; ER_i; CW_i$ is the export intensity of company $i$ analyzed in three groups (for the whole sample, for the Eastern region, and for the Central and Western regions), Exports/GDP of the province of origin, Industry and Years since start-up are control variables, and Contacts, Representatives, and Control are the variables defined in Table 3.

Unfamiliarity with context and foreign business practices (H4)

$$WS_i; ER_i; CW_i = \alpha + \theta_1 \text{Exports/GDP} + \theta_2 \text{Industry}_i + \theta_3 \text{Years}_i + \theta_4 \text{Familiarity}_i + \theta_5 \text{HostRegulations}_i + \theta_6 \text{PolInstability}_i + \epsilon_i$$  \hspace{1cm} \text{(Equation 4)}

where $WS_i; ER_i; CW_i$ is the export intensity of company $i$ analyzed in three groups (for the whole sample, for the Eastern region, and for the Central and Western regions), Exports/GDP of the province of origin, Industry and Years since start-up are control variables, and Familiarity, HostRegulations, and PolInstability are the variables defined in Table 3.
Competitiveness in international markets (H5)

\[ WS_i; ER_i; CW_i = \alpha + \theta_1 \text{Exports/GDP} + \theta_2 \text{Industry}_i + \theta_3 \text{Years}_i + \theta_4 \text{Competitiveness}_i + \theta_5 \text{Tariff\&NTB}_i + \varepsilon_i \]  
(Equation 5)

where \( WS_i; ER_i; CW_i \) is the export intensity of company \( i \) analyzed in three groups (for the whole sample, for the Eastern region, and for the Central and Western regions), \( \text{Exports/GDP} \) of the province of origin, \( \text{Industry} \) and \( \text{Years} \) since start-up are control variables, and \( \text{Competitiveness} \) and \( \text{Tariff\&NTB} \) are the variables defined in Table 3.

Socio cultural differences (H6)

\[ WS_i; ER_i; CW_i = \alpha + \theta_1 \text{Exports/GDP} + \theta_2 \text{Industry}_i + \theta_3 \text{Years}_i + \theta_4 \text{Socio-cultural}_i + \theta_5 \text{Verbal}_i + \varepsilon_i \]  
(Equation 6)

where \( WS_i; ER_i; CW_i \) is the export intensity of company \( i \) analyzed in three groups (for the whole sample, for the Eastern region, and for the Central and Western regions), \( \text{Exports/GDP} \) of the province of origin, \( \text{Industry} \) and \( \text{Years} \) since start-up are control variables, and \( \text{Socio-Cultural} \) and \( \text{Verbal} \) are the variables defined in Table 3.

Robustness Checks

The model for H1 was checked for the two-sample \( t \) test, in particular the distribution of the dependent variable, the variance of the two groups, and the independence of the groups. The models for H2, H3, H4, H5, and H6 were checked for regression assumptions. The first check was specification, the omission or inclusion of irrelevant variables and the selection of an incorrect functional form; all the variables in the models are based on the review of the relevant literature that frames this research. This process was carried out to test the robustness of the model, to avoid losses in the accuracy of the relevant coefficients’ estimates, and to avoid a biased coefficient by estimating a linear function when the relationship between variables was nonlinear (Schroeder, Sjoquist, & Stephan, 1986). Secondly, different measures were put in place to avoid measurement errors, such as back translations and pilot testing of the questionnaire, data collected in similar contexts (as explained above) and the use of reliable sources to obtain second-hand data. Thirdly, \( t \)-statistics were adjusted by a
heteroskedasticity correction in the regressions (White, 1980)\(^7\) to test if error terms depend on factors included in the analysis. Finally, autocorrelation was checked by calculating the Durbin-Watson coefficient, and multicollinearity was tested through an analysis of the correlation coefficients between the variables in the model and the calculation of the Variance Inflation Factor (VIF).

**DISCUSSION**

The results of this paper seem to support what has being debated in the literature in the last years, that mainstream internationalization theories do not necessarily apply to the case of China and therefore a theoretical extension is needed. For MNCs, this debate can be seen in the works of Child and Rodrigues (2005), Mathews (2006), and Buckley et al (2007). The studies on SMEs also seem to suggest this, for example, Sandberg (2009) explained that Chinese small firms need to go through indirect exports to go international, Boisot and Meyer (2008) hypothesized that China’s SMEs would target international markets before domestic ones due to the high internal transaction costs, and Cardoza and Fornes (2009) showed that small firms from China face fewer and different barriers than those faced by their Western counterparts.

For LoF, the results show that it does exist in the case of SMEs from Shandong, but the question seems to be how it impacts Chinese companies. The fact that firms find it difficult to understand the *Socio-Cultural* aspects of the target markets along with the limited knowledge of the *Preferences* of the consumers in international markets confirm this. But at the same time these results seem to suggest that LoF operates differently in China as the elements that affect Western business do not appear to have the same effect in Chinese companies.

**Limitations**

Although the empirical results of this study help to unlock the LoF box and differentiate among different sources of liability and strategies to overcome them, it is important to keep in mind that the study was carried out on a sample of Chinese SMEs from one of the more developed region in China and therefore, they cannot be generalize for all provinces. A similar caution should be taken when generalizing these findings and the specific recommendations to other emerging economies in the world.

\(^7\) White proposed to analyse the \(R^2\) of a regression equation that includes the squared residuals from a regression model with the cross-product of the regressors and squared regressors.
SUMMARY AND CONCLUSIONS

Recommendations

From the point of view of practitioners and managers responsible for designing and implementing SMEs’ internationalization strategies, this study offers a more comprehensive understanding of LoF, provides useful insights to anticipate it and summarize several recommendations presented in the literature to overcome LoF. A common advice consists on accelerating learning through networking with local business partners. Strategic alliances such as joint ventures when first entering a new foreign market can provide the necessary knowledge to reduce competitive disadvantages. Also, to diminish the risks associated with LoF firms should get protection through better contractual arrangements and receive better services and orientation from parent companies. Likewise to build their reputations and legitimacy in the host country, foreign companies should work to improve their relations with the local business community and government. Similarly, to reduce transaction costs and gain legitimacy SMEs can rely on personal ties, ethnic networks and most importantly, to establish strong links with local managers and network of suppliers and middleman. As mentioned above, relationships with different stakeholders and participation in the appropriate business (insidership) networks facilitate learning and building trust and commitment, preconditions for successful international expansion.

Finally, the study also offers some practical insights helpful for policymakers responsible of developing enabling policy frameworks for SME’s internationalization. In fact, the research results bring into evidence the need of creating better information systems on foreign markets, including potential partners, suppliers, logistic operators,….. and externalization of specific operations to local companies.
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