The Formation and Evolution of Inter-firm Governance in China's Emerging Automobile Groups

Yue Wang
School of Strategy and Entrepreneurship
University of New South Wales

Akira Tanaka
Graduate School of Economics
Nagoya City University

The research background

- The Phenomena
  - The rise of business groups in China
    - appeared in China's official documents in 1986
    - 189 large state-owned business groups by 2003
    - 18 appeared on the list of *Fortune* Global 500 by 2005 (e.g. Sinopec, Haier, Lenovo)
  - The development of automobile industry
    - 1994 Automotive Industry Policy: the restriction on private purchasing abolished
    - 2001The 10^{th} Five-year plan: 'Cars enter into families'
    - 2006: 22 million private passenger cars, sales exceeded 7 million
    - Automotive factories under construction in 23 provinces and cities
    - The 2004 Automotive Industry Development Policy: a pillar industry of China by 2010 + consolidation from currently more than 120 to a few major auto groups

2

The research question

- Phenomena-driven research
  - Theory-driven context-free vs. Context-specific theory-based research (Tsui, 2004, 2006; White, 2002; Peng, 2005; Meyer, 2006; Cheng, 2006)
- The research question
  - What explains the formation and evolution of automobile group governance (inter-firm relationship) in China?
    - Case study: Tianjin Auto Group (TAG)
    - 67 onsite interviews from 1997 to 2004
- Key Results
  - the interfirm system of TAG has shifted from hierarchy-based under administrative guidance before mid-1990s to quasi-market type of governance after 2000
  - three main factors (the changes in the institutional arrangement between the state and the TAG, the changes in the market conditions in automobile industry, and the transfer of Japanese management system) interacted in shaping the changing nature of inter-firm relationship in TAG

3

Theoretical background (1)

- Increasing interest in business groups from developing countries
- Definitions of business groups
  - a group of companies that does business in different markets under a common administrative or financial control (Leff 1978)
  - an organizational form characterized by diversification across a wide range of businesses, partial financial interlocks among them, and, in many cases, familial control (Ghemawat and Khanna 1998)
  - a collection of formally independent firms under single common administrative and financial control, that are owned and controlled by certain families (Chang and Hong, 2002)

4

Theoretical background (2)

- Definitions of business groups (continued)
  - a collection of firms bound together in some formal/informal ways (Granovetter 1994)
  - legally independent but organizationally affiliated companies…often connected through cross-shareholding, reciprocal trading agreements and intra-group financing (Delios and Beamish 2004)
  - a set of legally-separate firms with stable relationships …under common ownership and control (Cuervo-Cazurra 2006)
- The key to understand business groups
  – inter-firm relationships

5

Inter-firm Governance (1)

- Literature on the inter-firm relations in automobile industry
  - Auto groups in the west:
    - Arm's length contracting (Cusumano and Takeishi 1991, Helper 1991, Sako 1992, Sako et al. 1994)
    - Moving towards closer buyer-supplier relationship (Dyer 1996a, 1996b)
  - Auto groups in Japan:
    - relational/obligational contracting (Smitka 1991, Aoki 1994, Miwa 1994, Nishiguchi 1994, Fujimoto 1999, Dyer 1996c, Dyer and Nobeoka 2000)
    - Shifting towards more arm's length governance (Sako 2004)

6

Inter-firm Governance (2)

- The theoretical explanations
  - TCE: the nature of transactions
    - The problem: the marked differences in the inter-firm relations were not mainly caused by asset-specificity
    - Ex ante firm strategy dictates the ex post asset-specificity (Nishiguchi, 1994)
  - Institutional perspective: the US/UK vs. Japan
    - Formal institutions
      - weak vs. strong bank-firm ties
      - Short term vs. long term orientated
      - Low vs. high incidence of cross-shareholding
    - Informal institutions
      - Japanese *Keiretsu*: The restoration of *de facto Zaibatsu*
        - The *Zaibatsu* elite intensified personal ties
        - Informal but institutionalized *kais*
        - Industrial groupings without the *honsha*
  - Learning perspective (Ahmadjian and Lincoln 2001)

7

The Case: Tianjin Automotive Group (TAG)

- 1956: Tianjin Automobile Industry Company (TAI) established
- 1962: Parts production began (28 parts factories)
- 1982: TAI and other car manufacturers and parts suppliers merged into Tianjin Auto Company (TAC)
  - An affiliated company of the Jing-Jin-Ji Auto Consolidated Company (JJJ) under central government's 'seven business group' policy
- 1985: TAC gained 'independence' from the JJJ
  - 1986: commenced production of *Xiali*
  - 'seven business group' policy failed
- Late 1980s: greater 'independence' from the central government
  - new 'big three, small three' policy
- 1996: TAC gained 'independence' from the local Tianjin government
  - renamed Tianjin Automobile Industry (Group) Corporation – TAG
- 2002: TAG was merged into FAW Group Corporation
  - TAG: 19 SOEs, 9 COEs, 23 IJVs, 1 holding company (GC), 60,000 employees

8

Inter-firm relationship within TAG: 1996-1999 (1)

- Contracting
  - An individual contract between the General Corporation (GC) and the parts subsidiaries on a yearly basis
    - The confusing role of GC (more of a HQ than a holding company)
    - Lack of recognition of assembling and parts subsidiaries as independent companies
    - Top-down coordination dominated/replaced inter-firm contracting between assemblers and suppliers
- Compared to Japan
  - basic contract + monthly schedules
  - one to one dealing
- Compared to the US
  - A general contract covers all (amount, cost and design etc.)

9

Inter-firm relationship within TAG: 1996-1999 (2)

- Settlement of payment
  - Monthly payment distribution meeting organized by TAG Sales Company
    - Distributed according to the costs of parts
    - If the costs of finished cars not covered, payments not made
      - 'triangle debts' expand upstream as stocks of unsold finished cars increase
  - Suppliers not treated as profit centers rather as internal departments to bear the costs for the group
    - 'inter-firm' exchanges considered 'business within the group'
- Compared to Japan
  - Payment settled on monthly terms according to the quantity supplied

10

Inter-firm relationship within TAG: 1996-1999 (3)

- Price negotiation
  - GC held the right to set the parts price
    - Aggressive demand for price cuts
      - Lower than the production costs in some cases
  - Renegotiation for price changes held with suppliers once a year
    - Could extend for prolonged period
      - Parts supplied in the absence of fixed prices
- Compared to Japan
  - Renegotiation on parts unit prices every 6 month
  - The reduction in unit price less than the reduction in production costs of suppliers
    - Offer market incentive for suppliers to cut supply costs

11

Inter-firm relationship within TAG: 1996-1999 (4)

- Exclusiveness in dealings
  - An extremely high level of exclusiveness
    - Historical practice
      - the priority of dealing within the group
        - *xian nei, hou wai*
      - the priority of dealing within the city
        - *xian benshi, hou waibu*
  - Diversification of customer base gradually adopted by some subsidiaries
- Compared to Japan
  - Intra-group dealings were once a feature (before mid-1980s)
    - The exclusiveness has weakened significantly

12

Inter-firm relationship within TAG: 2000-2002 (1)

- Problems with the old inter-firm governance
  - Inaccurate market demand estimate plus administrative guidance – ill-informed production plan – chain reaction
  - Compared to Japan: order-based production
- Triggers for change
  - Slump in *Xiali* sales since late 1999
    - *Xiali* normally accounted for 2/3 of TAG's sales volume
  - TAG did not have the technology to develop a new product
  - Forced to learn from Toyota

13

Inter-firm relationship within TAG: 2000-2002 (2)

- Introducing a dealers' network
  - Tianjin Xiali Sales Co. Ltd.- more accurate market information
- Price renegotiation more often
  - Every 6 months
- Supplier dealing outside the group liberalized
  - Expect to continue as long as market remains competitive
- Learning from Toyota
  - The Tianjin *Kyohokai*
    - JV between the 2 groups in parts supply (late 1995)
    - Piecemeal diffusion by the Toyota-affiliated suppliers
  - The establishment of Tianjin Toyota Group
    - JV for finished car production
    - Systematic diffusion of Japanese style of supply chain management

14

Discussions (1)

- Before 1999/2000: top-down administration (hierarchy)
  - Contracting, pricing, payment settlement, group dealing
- After 2000: the shift towards hybrid mode of governance
  - More independent subsidiaries
  - More market-based inter-firm relationship
- The changing inter-firm relationship is best understood through a combination of factors
  - institutional arrangement between the state and the group
  - market conditions in the auto industry
  - learning from JVs with Toyota

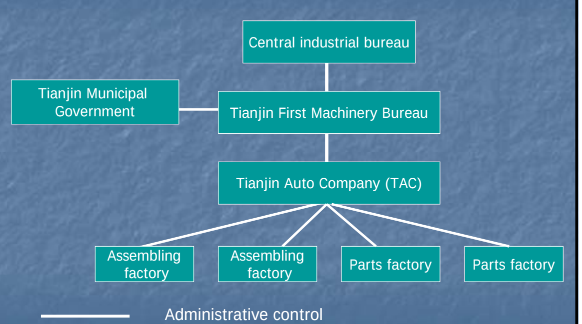
15

Discussions (2)

- The initial inter-firm relationship of TAG took its shape under strong influence of the old planned economy system
  - hierarchy-administrative ties embedded in history made it difficult to transform into truly inter-firm relationship between legally independent firms
- Changes in the institutional arrangement between the state and the TAG changed the way inter-firm relationship was governed
  - increasing distance between the state and the TAG (governed more by ownership, less by administrative control) allowed more independence of group member companies

16

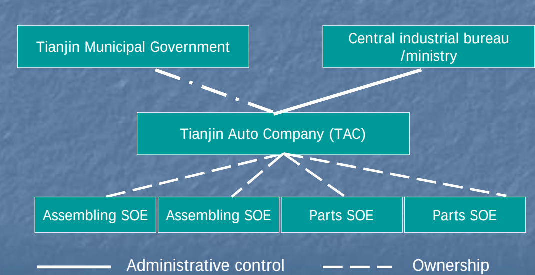
TAG Administrative Structure: before 1984



17

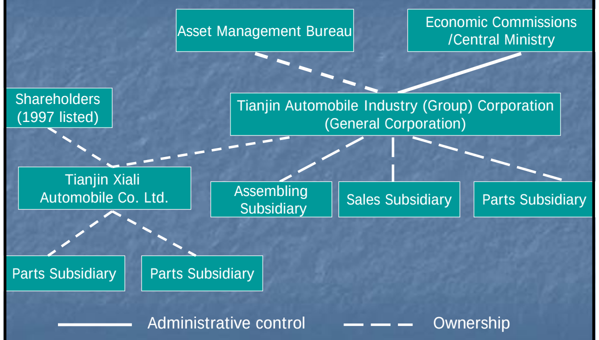
TAG Administrative/Ownership Structure: 1984-1996

- From 'state-operated' to 'state-owned': 1988 SOE Law



18

TAG Ownership Structure: after 1996



19

Discussions (3)

- Changes in the market conditions of the car industry affect the nature of inter-firm relationship in the TAG
  - The increasing pressure to improve efficiency in supply chain management
- Learning from Toyota started to play an important role when the TAG's institutional ties with the state weakened
  - only when institutional reform at the macro-level changed the nature of relationship between the state and the TAG, then we can expect that Japanese management practice can be transferred under the new governance model of business group
- Changes in institutional arrangement + changes in market conditions + diffusion of the Japanese practices of intra-group supplier governance = more quasi-market governance in TAG
  - a truly network structure consisting a core firm and quasi-independent associated companies

20

Theoretical Implications (1)

- For business group research:
  - NIE explains better both the formation and evolution of inter-firm relationship in automobile groups in China
  - Institutions and institutional changes influence strongly the way automobile groups organize their inter-firm relationships in emerging economies such as China
    - The dynamic, turbulent and uncertain transitions necessitate an institutional approach (Peng et al. 2004)
  - In a stable institutional environment, TCE and learning perspective explain better the changes in the inter-firm relationship in business groups
    - e.g. the shift from hybrid to the extremes of arm's length and hierarchy mode of governance in the Japanese auto industry (Ahmadjian and Lincoln 2001)

21

Theoretical Implications (2)

- For strategy research in emerging economies:
  - Answer the question: Why do firm strategies differ? (Rumelt, Schendel and Teece, 1994)
    - Firm strategies are more likely to be conditioned upon the institutional environment – institution-based view of strategy (Peng, 2002)
  - Shed light on the evolution of firm strategies in emerging economies
    - Institutions – business group governance strategies – nature of transactions (e.g. asset-specificity), and the propensity to learn (consequently heterogeneity in firm competence)
    - When institutional stability can be expected by firms and market forces played a more important role in shaping firm behavior, we can then expect firm strategies be more industry-based and resource-based

22