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Quasi-Judicial Mechanisms in Asian Production Networks: Archetypes for Emerging Market Strategy

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Abstract

Despite their predominance in developing countries, production networks vary enormously among countries and yet attempts to systematically compare their nature have been done very sporadically in the literature. Drawing on relational contract theory, this paper presents a novel framework for analyzing the differences in the ways production networks organize themselves in emerging markets by utilizing successful Asian organizational structures to illustrate strategy archetypes. The paper analyzes three different relational employment and outsourcing contract forms through which the lead firm in a production network can maintain a quasi-judicial role in resolving the contracting problems inherent in multi-firm transactions. The production network templates embodied by Korean chaebols, Japanese keiretsus and Taiwanese guanxi relationships use different explicit and implicit contractual arrangements to adjudicate interparty disputes internally and can serve as more appropriate benchmarks for firms operating in emerging markets as opposed to existing templates based on mainstream strategy theories generated in developed countries.

Keywords:

Asia, emerging markets, production networks, relational contracting

1. **Introduction**

Emerging markets have again become prominent in the world economy, receiving growing attention over the past two decades because of their increasing share in world trade and foreign direct investment (Hoskisson, Johnson, Tihanyi, & White, 2005; Lorenzen & Mudambi, 2010; Ramamurti, 2009). This growing influence is reflected in the upsurge of management research on emerging markets in recent years (Drummond, 2012; Wright, Filatotchev, Hoskisson, & Peng, 2005).

Despite the positive fanfare, emerging markets remain as challenging places in which to do business due primarily to the weak institutional infrastructure, political uncertainty and lack of market-based management skills that characterize many of these places (Hoskisson, Eden, Lau, & Wright, 2000). This limited development of political institutions stunts the growth of complex transactions (North, 1997) by increasing costs related to the writing, monitoring and implementation of formal inter-party contracts (Arruñada & Andonova, 2005; Goldberg, 1976; Walsh & Seward, 1990). Since government contract enforcement and private property protection procedures remain erratic in many developing countries, firms substitute formal contracting processes with informal arrangements such as family ties, business groups, corporate structures and political connections, which then play a stronger role in corporate governance (Dieleman & Boddewyn, 2012; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008). These institutional constraints limit the applicability of mainstream strategy theories (Khanna & Palepu, 1997) with accumulating empirical evidence suggesting that strategic management models originating in developed economies do not properly fit the conditions prevalent in emerging markets (Narayanan & Fahey, 2005).

This rise in emerging markets has been facilitated by a sea change in the nature of international production patterns (Ando, 2006; Lee, Gereffi, & Barrientos, 2012). As global technological innovation intensifies the benefits of specialization, multi-firm production

arrangements have increasingly become an oft-exercised choice for many manufacturers (Arruñada & Vazquez, 2006; Milberg & Winkler, 2011). Firms are becoming increasingly linked in different productive network relationships, thereby blurring the boundaries of the firm to span the entire value-chain of production. Utilizing the production network as the unit of analysis instead of the firm more closely mirrors the new dominant realities of sourcing and production, particularly in the Asia-Pacific region where many of these manufacturing relationships thrive (Ando, 2006; Athukorala, 2011; Borrus, Ernst, & Haggard, 2000).

This conceptual paper is aimed at providing alternative strategy templates for organizing production networks in countries with limited third party contract enforcement procedures, using successful Asian organizational structures to illustrate strategy archetypes drawn from relational contract theory. Although the use of alternative firm structures to cope with these institutional problems has long been proposed in the literature (Khanna & Palepu, 1997), understanding the diversity of forms by which these hybrid firm structures have materialized has not been studied extensively in the literature (Schneider, 2009).

I contribute to this literature on understanding the variety of non-market, non-hierarchical production systems (Cuervo-Cazurra, 2006; Gereffi, Humphrey, & Sturgeon, 2005; Schneider, 2009) by focusing on the contract mechanisms by which the lead firms in these interfirm networks of production maintain a quasi-judicial role in resolving the inherent contracting problems in multi-firm transactions. Such a framework allows us to dissect the particular mechanisms utilized by each production network, and allow us to specify which of these characteristics operate in relation to one another, providing a template by which companies can organize themselves, in light of institutional problems inherent in emerging markets.

The first section of the paper describes the concept of production networks and the theories that describe how different production network structures can generate quasi-judicial

mechanisms to overcome institutional deficiencies in emerging markets. The subsequent section focuses on the three particular Asian production networks – the Japanese, Korean and Taiwanese networks – that correspond with relational contracting templates and that can be used as strategy archetypes to analyze inter-firm production arrangements in emerging markets. The final section discusses potential applications of the framework to other emerging market firms and enumerates avenues for further study.

2. Production Networks in Asian Emerging Markets

Production networks are defined as firms engaged in the joint production of goods and services whose activities are linked to specific product areas (Brookfield & Liu, 2005; Sturgeon, 2002). This process has been facilitated by the fragmentation of the different product components, which allows firms to specialize in the creation of separate parts of the final product and allows production to spread geographically to where resources for production provide the highest level of competitive advantage (Arndt & Kierzkowski, 2001; Feenstra, 1998). The main production decisions are organized globally by a lead buyer firm whose decisions have the largest effects on the output of the entire production network (Gereffi et al., 2005; Majumder & Srinivasan, 2007). Production networks operate with the lead firm initiating the contracting process, followed by contracts propagating through the tiers of the supply chain, both upstream and downstream (Majumder & Srinivasan, 2005). These networks encompass the relationships not only between the lead firm and its affiliates, but also including its subcontractors, suppliers, service providers and other firms participating in cooperative agreements (Borrus et al., 2000).

Apart from understanding the capabilities of the different firms that comprise the production network, the modality of relationships between these firms is equally important in ensuring cost-effectiveness and quality control over the entire production process. The traditional view of supply chain management is that of the arm's-length or market model,

which advocates minimizing dependence from suppliers and maximizing lead firm bargaining power (Dyer, Cho, & Chu, 1998). This view involve the purchase of intermediate goods through detailed short-term spot contracts from independent firms (Ménard, 2000; Williamson, 1991). This preponderance of the market arrangement has been popularized by mainstream strategy research which has long highlighted supplier power as among the prime forces to be managed by firms (Porter, 1980). The key implication of this production framework is that firms are encouraged to avoid any form of commitment to the supplier (Dyer et al., 1998), lest the firm become overly dependent and thus beholden on that economic entity.

However, the use of market arrangements is problematic in emerging markets. In fact, the development of complex market transactions is made possible only through the flourishing of institutional mechanisms that permit impersonal exchanges to take place (North, 1997). As market transactions requires agreement between independent parties, a third-party adjudicator, generally the state, becomes necessary to provide a legal environment capable of increasing the capacity of parties to define the terms of exchange and to enforce these agreements in light of unforeseen circumstances (Arruñada & Andonova, 2005).

If avoiding inter-firm dependence is not possible, firms are then advised to organize themselves into vertically-integrated hierarchies to overcome the problems posed by opportunistic behavior by dominant members of the supply chain (Williamson, 1985). Hierarchies govern exchanges through flexible, long-term contracts that are enforced internally via fiat or other intra-hierarchical incentives.

This dichotomous framework of arms-length market relations vis-a-vis vertical integration had been widely accepted to be the most effective way to manage supplier relationships until the success of Japanese firms using alternative models forced its re-evaluation (Dyer et al., 1998). Further reevaluation became necessary when Korean and

Taiwanese economies emerged as manufacturing powers, with alternative production systems reflecting the diverse institutional processes in their home countries. These reevaluations tie into a growing acceptance of the existence of the varieties of capitalism and business systems that abound in different countries (Fitzgerald, 2000; Hall & Soskice, 2001; Whitley, 1999), a literature thread that has led to an enumeration of a growing number of heterogeneous business form-typologies (Carney, Gedajlovic, & Yang, 2009), with an equivalent need for greater understanding of the similarities across these diverse network structures.

This is paralleled with work in the institutional economics and sociology which talked about the presence of hybrids (Williamson, 1991) and networks (Powell, 1990). Networks and hybrids are neither hierarchical nor market-like in their structure or form of governance, but instead incorporate certain market features, such as autonomous parties, as well as those of the hierarchy, such as bilateral dependence and contract flexibility (Williamson, 1991). The variety in theoretical and actual hybrid forms has led authors to similarly seek mechanisms by which these forms can be distinguished and compared (Ménard, 2004)

There are two theoretical streams of reasoning for the existence of different production networks structures in emerging markets (Hoskisson et al., 2000). The first, New Institutional Economics, describes how certain institutions – property rights, governance structures, and rules of exchange – enable the existence of exchange markets by defining the behavior of actors during the transactions and defining the rules of the game (North, 1990). Different historical antecedents generate national institutional contexts that encourage distinctive forms of business and market organization by promoting and constraining the development of particular ways of organizing economic activity (Fitzgerald, 2000; Whitley, 1992). These institutional theories explain why Japanese, Taiwanese and Korean-led production networks generally maintain distinct organizational characteristics which they

retain even as they internationalize (Buckley, 2009; Hatani, 2009; Lin & Chaney, 2007; Peng, Wang, & Jiang, 2008).

The second theoretical framework draws on Transaction Cost Economics that highlights how institutional imperfections and greater information asymmetry in emerging markets expose contracting parties to opportunistic behavior (Peng, Lee, & Wang, 2005); thus raising the costs of market transactions (Williamson, 1985) and require institutional innovations, such as business group formation, for internalizing returns (Leff, 1978). This line of reasoning has been formalized into the extensive literature of business groups (Khanna & Palepu, 1997; Khanna & Yafeh, 2007), which has also been criticized as having inconclusive results and potentially misleading conclusions due to its inability to deal with enormous variation in business group structures (Granovetter, 2003; Luo & Chung, 2005).

This paper assuages some of these criticisms by shifting the unit of analysis on the particular mechanisms used by the different organizational structures to achieve for quasi-judicial control to overcome limitations of state contract enforcement instead of the business group or network itself. Since quasi-judicial control is not an inherent property of the structure of the production network per se – given that different mechanisms have been developed to govern non-integrated networks as if they functioned as integrated systems -- the focus of research must shift from the type of integration of the production network to the control-coordination relations between the lead firm and the other member firms (Heide, 1994).

Apart from their success globally, the Japanese, Korean and Taiwanese production networks were selected for this paper because although they have different structures for organizing production (Redding, 1995), they maintain organizational features that offer similar means in ensuring quasi-judicial control over the other producing firms. In essence, production networks can overcome such institutional imperfections by instead using

relational contracts with its own enforcement structures (Rajan & Zingales, 1998). The self-enforcing structure requires that the value of the future relationship must be sufficiently large that neither party will wish to renege (Baker, Gibbons, & Murphy, 2002; Gibbons, 2005). Most importantly, these relational contracts are isolated from state regulatory imperfections because they are implicitly governed by forbearance which provides a quasi-jurisdictional barrier to minimize state interference in intra-network disputes (Williamson, 1991).

At the same, the lead firm in each production network uses its authority to evaluate its own and the other network members' performance, as well as to impose due sanctions on underperforming members. Safeguards against opportunistic behavior on the part of the lead firms follow directly from the lead firms' own interest in maintaining their reputation, their relationship with their suppliers and through the continuing double role of judge and interested party (Arruñada, 2000).

What makes these production networks distinct yet successful is that the lead firm is able to focus their resources only on integral aspects of the quasi-judicial process, and yet maintain retvain sufficient control over the entire network, albeit through different means. Korean production networks rely mainly on extensive, centralized vertically-integrated multinational production systems that source mainly form wholly- or partially-owned subsidiaries that align ownership and management functions very tightly. The Japanese production networks are comprised of separate firms united by collaborative agreements driven by strong inter-organizational relations, mutual interdependence and long-term commitment. Taiwanese production networks are also comprised of separate corporations that instead draw upon close personal relationships and trust among the respective firm owners (Whitley, 2000). In contrast, North American production networks generally display arms-length market-based contracting, lacking the partnership-like characteristics of their Asian counterparts (Borrus et al., 2000).

The implicit assumption in this framework is that as institutions develop, the need for such relational contracting diminishes and production networks should become dominated by market relationships (Chung, 2006; Khanna, 2000; Peng, 2003; Peng et al., 2005) and thus should more likely mimic North American-style supply chain structures dominated by arms-length spot market contracting. However, due to the historical persistence of organizational logics and the dynamic benefits of these relational contracts overlooked by mainstream strategy theories, this may not necessarily be the case. In Asia, organizational forms of production networks have failed to converge to a particular dominant model over time, even during the 1990s when Japan, South Korea and Taiwan all faced economic crises (Borrus et al., 2000). Although it has been argued that enduring globalization, improving institutional quality and the sheer passage of time may decouple these forms from their national origins, certain aspects of the network governance structure will likely remain, given how markets tend to reward companies whose governance structure best matches with the environment (Young, Ahlstrom, & Bruton, 2004). In fact, the continued existence of these peculiar yet highly successful organizational forms may even be an indication of their being a source of comparative advantage rather than an indication of institutional inertia-caused maladaptation.

In summary, the remarkable success of these Asian production networks in the global arena indicates that each of these network structures can serve as a viable avenue for structuring production in other emerging markets. The network structures studied in this paper were selected also because they closely correspond to different relationship contracting paradigms proffered in the economic literature. Detailing how these production networks conform or diverge from theory can provide alternative strategic templates which firms may imitate in order to efficiently overcome institutional deficiencies.

3. Quasi-Judicial Role of the Lead Firm in Korean, Japanese and Taiwanese Production Networks

The Japanese, Korean and Taiwanese business groups utilize organizational forms that bestow a quasi-judicial function to the lead firm in order to overcome contract enforcement constraints posed by imperfect institutional voids. To ensure the proper exercise of these quasi-judicial functions, the selection of optimal contracting solutions which strengthen the enforcing capacity of the internal judge becomes of prime importance (Arruñada, 2000). Although all of these organizational forms utilize arrangements based on self-enforcing relational contracts, they utilize diverse contract forms that allow these networks to achieve performance. In fact, the relational governance structures have been seen as a source of comparative advantage by allowing parties to economize on information costs related with enforcement, lower inter-firm transaction costs and generate management against risk and uncertainty (Dyer, 1996).

This study focuses on the particular quasi-judicial mechanisms to understand how these networks obtain production efficiency through the use of the relational contract typology is borrowed from the framework developed by Baker, Gibbons and Murphy (2002). These authors distinguish between formal spot contracts that require third-party enforcement and relational contracts which are self-enforcing via the value of the future relationship that must be sufficiently large that neither party will wish to renege. North American production networks generally utilize more spot market-based contracts as compared with their Asian counterparts (Borrus et al., 2000).

At the same time, Baker et al distinguish between two types of relational contracts: employment contracts, where the productive assets are owned by the principal versus relational outsourcing contracts, where the productive assets are owned by the agent (Baker et al., 2002). Korean chaebol production networks are based on relational employment contracts as these production networks are characterized by vertically integrated firms. On the other hand, Japanese keiretsu and Taiwanese guanxi production networks are based on

relational outsourcing contracts, as they are both characterized by non-integrated supply transactions, with each firm owning its own assets. While Japanese relational outsourcing contracts are enforced by inter-organizational ties, Taiwanese contracts are enforced through interpersonal ties. A stylized typology to illustrate the differences among these relational typologies is located in Figure 1, which includes the US production network as contrast.

Insert Figure 1 about here

To analyze the quasi-judicial organizational structure for each production network, I utilize the framework developed by Arruñada (2000) used to analyze the contract enforcement functions of large retailers on European supply chains. This framework distinguishes three different aspects of the contracting process such as explicit contracting, implicit contracting and disciplinary mechanisms. Table 1 summarizes the salient points of the quasi-judicial mechanisms inherent in each of these networks.

Insert Table 1 about here

Prior to describing each network in detail, it must be noted that the Asian production networks are not monolithic in its adherence to the stylized framework described (Hoetker, 2008). The unique nuance of each firm means that there are networks that do not reflect the dominant pattern of their domestic economic configuration. Moreover, within each production network, there exists a great variation in the relationships between firms, subsidiaries and subcontractors based on the characteristics of the production component. These exceptions do not invalidate the conclusion that there exists a dominant production network configuration in each area, different from the US business model (Whitley, 1992).

3.1. Korean Chaebol Production Networks

The larger Korean production networks are organized as highly diversified, vertically-integrated firms called chaebols (Hamilton, 1996). These firms had their origins in the Korean industrialization process, when underdeveloped markets and weak economic institutions required particular organizational mechanisms built to overcome such deficiencies (Chang & Hong, 2000). The chaebol did this by organizing itself in an extension of the traditional hierarchical multi-divisional form with strong centralized control through cross-share ownership as it grew (Chang & Choi, 1988). Since capital, labor and intermediate product markets were non-existent, chaebols had to generate these resources internally. Early chaebol expansion was characterized by extensive vertical integration to procure necessary supplies and overcome market risks (Gamble, Morris, & Wilkinson, 2003; Kim, Hoskisson, Tihanyi, & Hong, 2004).

3.1.1. **Explicit contracting.** The quasi-judicial role of the chaebol is based mainly on explicit relational arrangements undertaken through a formal bureaucratic hierarchy organized by the headquarters of the lead firm of the production network (Chang & Choi, 1988). Although the companies comprising the chaebol are legally independent entities, their ownership and membership in the production network is unambiguous (van Hoesel, 1999). As such, chaebol firms tend to vertically integrate suppliers of necessary parts rather than enter into agreements with independent entities (Biggart & Guillen, 1999). Through these relational employment contracts, these production networks are organized by top-down decision making by the owners, internal enforcement of hierarchical relationships and little autonomy by middle-management on decisions made above them (Whitley, 1992).

Although individual subsidiary companies have some autonomy on day-to-day operations, strategic choices and resource allocation are made centrally often by the president of the chaebol himself (Whitley, 1992). The epicenter of this decision-making structure is the

group headquarters, which allocates financial and human resources, coordinates decisions between affiliates and generates of long term strategies (Kim et al., 2004). This centralized decision-making means that the chaebols are more integrated than conglomerates controlled by purely financial mechanisms. In fact, the lead firm makes all pertinent decisions, including decisions on personnel and labor management policies at the subsidiary levels with managerial careers and rewards directly managed by the owner. Chaebol supplier-subsidiaries are also provided ample assistance by the lead firm in areas of quality control, cost reduction, factory layout and inventory management, among others (Dyer et al., 1998).

This administrative structure is organized through an extensive bureaucratic structure comprised of formal procedures and rules. Personal and collective loyalties are weak within the chaebol and so compliance is secured through bureaucratic mechanisms, such as managerial coercion and explicit incentive structures. There is no manifest belief that the employees share the collective objectives of the firm, and so their compliance with firm objectives is facilitated through strong leadership and forcefulness (Whitley, 1992).

3.1.2. **Implicit contracting.** Among the major distinguishing features of the Korean chaebol is the dominance of the founder and its family (Hamilton & Biggart, 1988). Such family ownership translates into strong family control, with most management positions in the chaebol held by close relatives of the founders (Kim, 2003; Whitley, 1992). Because of the low personal trust expected among firm employees, personal loyalty to the family owners becomes increasingly important for managers to be appointed to senior roles. Moreover, the application of the bureaucratic and control systems is unstandardized, providing scope for personal variation and discretion by the business owners.

Another distinguishing feature of the chaebol is its diversified scope, involving the ownership of other firms in businesses only tangentially related with each other (Feenstra, Huang, & Hamilton, 2003; Kim, 2003). Such diversified group structure provides additional

mechanisms to make up for inadequate institutions, like underdeveloped financial and labor markets, and to hedge against market risks (Chang & Choi, 1988; Khanna & Yafeh, 2007). As a mechanism for implicit control, these diversified business portfolios allow the chaebols to build internal markets and share functions (Kim et al., 2004), making subsidiary firms more dependent on the mother company. Good performing managers and engineers are promoted within or across member companies both as a reward and as a means to transfer expertise and control throughout the network. This movement of skilled staff enhances both the overall capability of the chaebol and promotes the focal role of the owner (Whitley, 1992).

3.1.3. **Disciplinary mechanisms.** Because decision-making is conducted by a strong central planning group that is responsible for allocating resources among member firms, subsidiary firms have little scope for non-compliance. The authoritarian bureaucracy coupled by the headquarters' control over resources and internal policies make chaebol subsidiaries absolutely dependent on the lead firm. Non-provision of bonuses, employee dismissal, withdrawal of financial resources and other bureaucratic rules provide strong incentives for each subsidiary firm to comply with production requirements of the network.

3.1.4. **Summary.** Korean production networks are characterized by centralized and bureaucratic decision-making based on an extensive integrated set of firms and subsidiaries owned by a dominant founder. These bureaucracies rely mainly on explicit contracts to ensure quasi-judicial control by the owners over the subsidiaries, although laxity of formal rule enforcement provides scope for implicit contracting based on personal connections with the firm owners. Because of the centralized nature of production, links between the chaebol and firms not integrated with the chaebol are weak and provide little scope for cooperation.

3.2. Japanese Keiretsu Production Networks

Large Japanese firms are organized as non-integrated business groups or keiretsu. The origins of this Japanese form has been attributed to differences in regulatory practices in Japan, such as the limited institutional litigation capability, that made contract enforcement difficult until recently (Ginsburg & Hoetker, 2006; Hoetker, 2008). This system is characterized by a core lead firm surrounded by numerous long-term linkages between suppliers and other members of the production network (Aoki & Lennerfors, 2012; Dyer, 1996; Lamming, 2000; Lenien, 2007). Each firm tends to incorporate only sub-sections of the production process required to manufacture products. Subsidiary firms manufacture the basic parts for major firms and other labor intensive aspects of production are subcontracted to independent other enterprises with whom they develop close, stable, long-term relationships (Whitley, 1992). This organizational structure is aimed at providing a mutually-beneficial, self-sufficient industrial structure that effectively guards against market uncertainties (Orru, Hamilton, & Suzuki, 1989; Tabeta & Rahman, 1999) without full vertical integration which suppresses market incentives (Khanna & Yafeh, 2007).

3.2.1. **Explicit contracting.** The quasi-judicial mechanisms inherent in Japanese production networks are based on relational outsourcing contracts promoting long-term interdependence between the lead firm and its independent suppliers (Dore, 1983). Where the Korean production network generally utilizes explicit contracts which include detailed job descriptions, responsibilities, performance measures and hierarchical arrangements both across subsidiaries and among employees within the subsidiaries, Japanese firms utilize more supplier screening and socialization techniques to ensure goal congruence among firms and employees by inculcating trust, commitment and group morale, over particular individual roles and responsibilities (Whitley, 1992). The nature of such bilateral relationships requires a stringent initiation process for employees and suppliers that include not only an assessment of skills but also an assessment of organizational attitudes and values. Such stringent supplier

selection processes are costly; for example, once a network affiliate finds a potentially qualified supplier, it may take up to nine months to have the new supplier accredited by the lead firm (Ernst, 2000). Essentially, such socialization procedures seek to eliminate goal divergence and align incentives *ex ante* (Heide, 1994) and allow Japanese production networks to experience lower transaction costs *ex post* than comparable arms-length-based production networks (Dyer, 1996).

Once accepted into the production supply chain, member firms are rewarded with the assurance that excellent performance would be rewarded with continuing business (Lamming, 2000). These relationships generally limit the possibility of the supplier conducting business with other firms (Tabeta & Rahman, 1999). The closeness generated by these long-term contracts limits opportunism (Tabeta, 1998) and encourages the development of suppliers that are more tailored to the lead firm's requirements (Dyer et al., 1998). These same long-term, mutual-dependence driven network practices are reflected in the employment practices of individual firms, as lifetime employment and firm-specific skill-building among managers are prevalent practices in Japan (Whitley, 1992).

Members of the production network are provided decision autonomy, not only for employment, work practices and salaries, but also on how to organize production, ensure quality control and even procurement (Ernst, 2000). Thus, the lead firm is able to concentrate only on its immediate suppliers, with interference by the lead firm in the relationship between the supplier and further subcontractors are believed to promote confusion (Lamming, 2000).

Because this system relies on organizational congruence among members, much of the operational rules and practices have been explicitly formalized and systematized. Personnel matters and procedures have clear highly-specified rules and codification. The cooperative nature of the organizational structure requires detailed work descriptions, although these responsibilities are assigned to teams rather than individuals (Whitley, 1992).

3.2.2. **Implicit contracting.** Decisions-making among network firms is facilitated by constant interaction and monitoring between suppliers with the management of the lead firm (Tabeta, 1998). Information sharing, technology transfer and cooperation are facilitated by the provision of formal and informal avenues for discussions and meetings. Major suppliers are sometimes organized into associations to disseminate managerial and technical know-how (Gamble et al., 2003). To increase indirect control, the lead firm may provide expatriate Japanese managers and engineers to aid in the coordination and help implement decisions made by the lead firm (Buckley, 2009; Ernst, 2000). There can also some minority financial investments, interlocking directorates and cross-share ownership by the lead firm in the network firms (McGuire & Dow, 2003; Tabeta, 1998) not only to increase internal network cohesion (Orru et al., 1989), but also to encourage management from instead of focusing on its own shareholder value maximization and to pay attention towards long-term group productivity (Lenien, 2007).

Ultimate control is retained by the lead firm by ensuring that strategic decisions and high-value added production remains in their hands (Ernst, 2000). These control mechanisms ensure that Japanese production network arrangements do not function as partnerships, since the lead firm clearly has the dominant commercial interest (Lamming, 2000). The result has been, despite decades of production network internationalization, a Japan-centered production system consisting of captive suppliers highly dependent on the lead firm (Buckley, 2009).

3.2.3. **Disciplinary mechanisms.** The main mechanism for disciplining production network member firms, absent in the Korean chaebol case, is the retention of high-powered market incentives. Japanese production network alliances, as opposed to vertically integrated chaebols, are provided greater scope for access to residual profits and thus have stronger incentives to improve and perform (Dyer, 1996). Although the lead firm generally sets prices

for the suppliers, all profits generated by cost reductions accrue to the supplier – until the prices are reset by the lead firm. This market incentive coupled with high specialization of the production network supplier firms encourages significant efficiency improvements.

Generally, non-performance by the supplier means greater managerial involvement by the lead firm in aiding the supplier in achieving the required targets. However, the non-integrated network provides a final albeit seldom used disciplinary tactic, the potential to dismiss the supplier and source from another firm. Although this mechanism is hardly used due to the difficulty in replacing and retraining suppliers, increasing evidence indicates that the recent economic recession in Japan coupled with the technological improvements in companies operating in East Asia, have encouraged Japanese firms to utilize this 'last-ditch' mechanism more often (Lamming, 2000).

3.2.4. **Summary.** Japanese production networks are characterized by the widespread use of organization based relational outsourcing in Japanese companies enables these networks to overcome institutional deficiencies (Aoki & Lennerfors, 2012), generate certain advantages of hierarchical systems while retaining the high-powered incentives inherent in market transactions (Dyer, 1996). The considerable investment in organizational socialization and screening increases the trust and cooperation among members and lowers transacting costs throughout. The quasi-judicial structures promoted by these mutual obligation supplier networks are seen not only as a mechanism for these firms to overcome the market deficiencies they encountered during the origin of the Japanese economic miracle, but also as playing a key role in the firms' competitive advantage today.

3.3. Taiwanese Guanxi Production Networks

Taiwanese production networks are similar to the Japanese keiretsu network in its structure comprised of independent firms that incorporate only subsections of the production process and are coordinated by outsourcing contracts (Hamilton, 1996). However, the key

difference is that the network is characterized by small and medium-sized enterprises whose competitiveness relies on the close interpersonal familial or clanship ties called guanxi rather than organizational linkages (Hamilton & Biggart, 1988; Wang, 2007). Even as the production networks internationalize, they generally do so through ethnic and personal connections of the owners (Sim & Pandian, 2003).

3.3.1. **Explicit incentives.** The quasi-judicial mechanisms utilized by Taiwanese lead firms are based on family ties and strong reciprocal ties rather than explicit incentives. Hence, the coordination of these networks are conducted not by a chaebol hierarchy or by organized keiretsu consensus, but instead via a set of core leaders who occupy leadership positions in the various group firms (Chung, 2003). This inner circle functions mainly as a means to disseminate information throughout the network and to provide certain services like training, public relations and consulting. Unsurprisingly, the use of formal coordination and control procedures among firms in the production network is very limited (Whitley, 1992). This lack of explicit contractual safeguards is important for the quasi-judicial functions of the lead firm to ensure that the intrinsic personal motivation is not undermined (Fehr & Falk, 2002).

Nonetheless, for certain investments explicit ownership sharing arrangements and duplicate chairmanships among partners may be created to inject further strength into the interpersonal ties governing the production network (Chung, 2003). Particularly as businesses require more substantial financing or access to different social networks, production network member firms enter into cross-ownership alliances and joint ventures with trusted guanxi partners (Whitley, 1992). Unlike their Japanese lead firm-subordinate relationship, these production networks are characterized as partnerships united by mutual trust and common investments among the persons involved.

3.3.2. **Implicit incentives.** The Taiwanese production networks are run mainly through implicit incentives. Rather than a central administrative hierarchy, these firms are connected through a network of alliances and particular guanxi ties between the owners which vary in performance and cohesion (Hamilton, 1996; Whitley, 1992). The dependence on family and clanship ties to promote greater cooperation and social embeddedness is based on an inherent instinct among individuals to cooperate with people they are related to (Arruñada, 2005), which promotes stronger trust and reciprocity (Luo & Chung, 2005) that promotes information sharing, reduces risk of contract disputes, and allows for firms to transact with less monitoring and explicit contractual safeguards (Chiles & McMackin, 1996; Khanna & Palepu, 2000). Although this lack of explicit incentives and formalized procedures reduces transaction costs, the establishment of guanxi itself consumes much time and energy (Richter, 2002), as well as provides limits to the ability of these firms to locate partners with the ideal set of resources that may be outside the guanxi network (Arruñada, 2005; Kao, 1996).

The strongly personalistic aspects of network management are also reflected within the internal structure of member firms. These member firms rely mainly on informal personal means for coordinating decisions rather than formal authority relations. The need for strong personal control for each firm makes achieving scale problematic for individual enterprises and has led to extensive subcontracting among small- and medium-sized firms (Redding, 1995). In fact, Taiwanese firms historically grow not by enlarging, but by spinning off additional small firms (Biggart & Guillen, 1999). As such, these production networks are able to achieve scale and competitiveness through the network's ability to share orders, production facilities and personnel among members of the production network, without losing the flexibility required to compete in dynamic industries (Hamilton, 1996; Wang, 2007).

The presence of the strong interpersonal network ultimately reduces pressures for costly vertical integration (Granovetter, 1985) and promotes a production system that allows for greater production flexibility, quick response to market changes, complex adaptation and opportunity-seeking for the entire network (Biggart & Guillen, 1999; Kao, 1996; Whitley, 1992). The extensive network of small-firms not only provides the critical role of aligning the manufacturing process but also for mobilizing capital and obtaining market information.

The owners of each firm maintain strong control over financial, strategic and personnel matters, being reluctant to trust formal information systems or formal managerial hierarchies. As such, there is great reluctance to delegate decision-making to managers who do not have close personal ties with the owners of the lead firm (Richter, 2002). The entities maintain lower degrees of work specialization and standardization, with tasks and jobs more diffusely delineated and loosely defined (Whitley, 1992). Even recruitment decisions are based on personal connections and contacts (Kao, 1996). The critical role of family ownership and informal control of the production network results in a highly personal decision-making style that is flexible and responsive to environmental change (Uzzi, 1997).

3.3.3. **Disciplinary mechanisms.** Much like in the Japanese case, the main mechanism for discipline is the retention of high-powered market incentives. Taiwanese firms retain their financial dependence and are subject to changing market forces. The market risks faced by each individual firm are managed largely through the guanxi network itself, via its ability to provide financing, resource flexibility and diversification into other businesses.

For ensuring compliance with the production network needs, the lead firm relies mainly on the strong interpersonal ties built among the individual firm owners. Given the importance of guanxi, not just in the business sphere but also the social spheres of the individual owners, non-compliance with the requirements of the group provides a strong

disciplinary sanction to owners. The extent of these interpersonal ties is so strong that additional disciplinary mechanisms are unnecessary or even counter productive.

3.3.4. **Summary.** Taiwanese production networks are comprised of independent small and medium-sized firms united by the interpersonal connections between their owners. The quasi-judicial enforcement mechanisms used by the lead firm in this case relies solely on the strong reciprocal ties among firm owners which limit the need and usefulness of explicit contracting arrangements. This personalistic nature of the organizational structure allows for greater flexibility and unencumbered decision-making, while the strong interpersonal connections among the firm-owners provide mechanisms for managing against market risks.

4. Discussion

This conceptual paper aims to contribute to the field of emerging market strategy theories by highlighting the different mechanisms by which production networks can be organized in areas where third-party contract enforcement is problematic. Each of the three East Asian archetypes described above utilize alternative means of relational contracting that generates a quasi-judicial role for the lead firm in the network. Under each network structure, the lead firm focuses on particular mechanisms of the quasi-judicial process, be they formal or informal contracting systems, allowing it to achieve control while minimizing transaction costs through the non-duplication of costly hierarchical or extra-contractual instruments.

In the Korean case, the chaebol utilizes a large bureaucratic structure where the asset ownership and centralized decision-making provides full control over the production process and provides explicit incentives to ensure subsidiary compliance. In the Japanese case, the keiretsu forms long-term outsourcing contracts with independent organizations that provide both market incentives and explicit controls through interdependence. In Taiwan, the guanxi-

based production networks are comprised of independent firms tied together through implicit contracts enforced by strong interpersonal ties.

For each of these archetypes, the use of a dominant relational contract precludes the use of alternative means of contract enforcement to minimize transaction costs and also achieves other benefits such as production flexibility and risk management. For example, the reliance of Taiwanese firms on interpersonal ties allows it to do away with costly bureaucratic practices and layers of management that may impede the managerial processes.

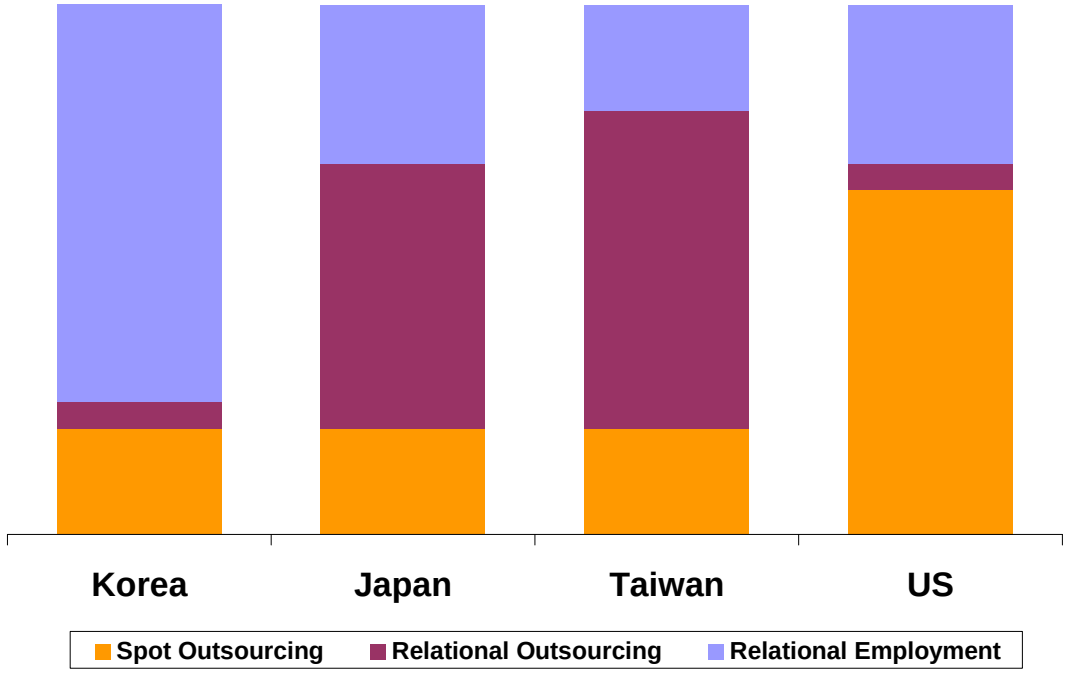
Based on these archetypes, one can make arguments that firms in emerging markets can improve performance by more closely streamlining the organization's control mechanisms toward the dominant relational-contract type, rather than copying strategy norms generated in developed countries. For example, instead of following the call for chaebols to improve performance by deconglomeration, it may be more optimal to argue that the chaebol should instead becoming more bureaucratic and professional by limiting the use of informal contracts like ties to the patriarch-owner for achieving managerial control. This premise is validated by empirical findings demonstrating how although chaebol memberships still adds value by lowering transaction costs, facilitating resource pooling and risk sharing (Chang & Choi, 1988; Chang & Hong, 2000), governance improvements through the use of independent directors and minimizing family control do improve performance in Korean firms (Choi, Park, & Yoo, 2007; Joh, 2003). Empirical findings also highlight the usefulness of family relations in improving performance among Taiwanese firms especially during times of institutional change and uncertainty (Luo & Chung, 2005). Although other studies indicate that the positive impact of chaebol integration or guanxi reliance diminish over time (Chang & Hong, 2002; Chung, 2003, 2006; Joh, 2003), these changes occurred mainly as governance institutions improved, which may not necessarily be the case in many emerging markets.

It is hoped that these three contracting archetypes can be further quantified and used to analyze the strategies of firms from other emerging markets that have become increasingly important in recent years. It would be helpful to understand how archetypal production networks from India, China, Southeast Asia and Latin America measure up against these templates to ascertain whether their conformance or non-conformance aids in their overall performance. This may reveal alternative relational contract forms that may be applicable to other emerging markets.

Table 1
Summary of Quasi-Judicial Role of Lead Firm in the East Asian Archetypes

	Korean Chaebol	Japanese Keiretsu	Taiwanese Guanxi
Contract Type	Relational Employment	Relational Outsourcing – Organizational	Relational Outsourcing - Interpersonal
Explicit Contracting	Direct ownership	Customer-supplier relationships	Interpersonal partnerships
	Centralized decision making	Long-term contracting	Alliances and joint ventures
	Bureaucratic procedures	Screening, socialization, and formal procedures	Limited bureaucracy, personal decision-making
Implicit Contracting	Paternalistic – family ownership	Intra-network coordination, associations	Kinship – family ties
	Cross-ownership of unrelated firms	Control over key components	Personal control
Disciplinary Sanctions	Bureaucratic sanctions	Market sanctions	Market sanctions
	Withholding of resources	Cooperation and remote possibility of termination	Saving face, reputation and trust

Figure 1
Illustration of Relational and Spot Contracting Propensity by Different Production Network Archetypes



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