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What makes a joint venture: Micro-evidence from Sino-Italian contracts

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ABSTRACT

This paper provides new contract-level evidence on control rights allocation in order to define what makes a joint venture. Property rights theory of the firm identifies circumstances under which joint control alleviates investment distortions due to contract incompleteness. We compare predictions of the theoretical literature with actual governance structures of Sino-Italian joint ventures, as reported in a questionnaire submitted to the entire population of Italian enterprises operating in China. With an exceptional response rate of 60%, our evidence confirms most of the theoretical predictions and helps select among competing approaches to model joint ventures.

1. Introduction

In the last two decades, the world stock of inward Foreign Direct Investment (FDI)[1] has increased almost ten-fold, from 2 trillion USD in 1990 to the record value of 19 trillion USD in 2010. Over the same period, world flows of inward FDI rose by almost 900%, peaking at 1.9 trillion USD in 2007 (UNCTAD, 2011). A substantial share of these flows and stock is in partnership with local enterprises, with joint ventures (JVs) and international alliances playing a prominent role (Buchel, 2003; Moskalev & Swensen, 2007). The literature on the foreign entry mode focuses on equity JVs as opposed to wholly owned affiliates. This is a neat distinction, but it does little to unveil the nature of partnerships between foreign and local firms. Widely used in international business studies (Wei, Liu, & Liu, 2005), attention is on the determinants of equity shares leaving unanswered questions about control. Nonetheless, control features prominently in anecdotal evidence about business relations and is shown to be of paramount importance when and where contract enforceability is an issue (Midler, 2009). A framework to address the issue of control allocation between cooperating partners is provided by the residual rights of control or property rights theory of the firm (Grossman & Hart, 1986; Hart & Moore, 1990). According to the theory, optimal allocation of control rights depends on the nature and importance of the parties' investments and it can take the form of sole ownership or joint control.

In this paper we ask: do joint venture contracts present features consistent with the predictions of the property rights theory? Do we observe joint ventures when the optimal allocation of control rights is joint control? In brief: what makes a joint venture? To answer these and other related questions, new contract-level evidence is provided. Survey interviews submitted by the authors in the period 2010–2011 to the entire population of Italian enterprises with JVs in the People's Republic of China (PRC) are the source of the original data for this research. The choice of the home and host markets is inspired by recent evidence about cross-country alliances. The well documented preference of Italian entrepreneurs for joint ventures vs. wholly foreign owned enterprises makes Italy a suitable focus of our study (see, among others: Bontempi & Prodi, 2009; Gattai, 2010; Morresi & Pezzi, 2011). The largest FDI recipient in the world after the US, China is known for shared ownership of foreign affiliates, even though wholly foreign owned enterprises have been allowed since the 1980s (Moskalev & Swensen, 2007). According to the China Statistical Yearbook (2012), over the period 2005–2011 JVs account for a notable 20% of total FDI inflows, both by number of projects and capital flows. Finally, cultural distance and the very fast pace of change characterising the Chinese economy make FDI operations in China particularly suitable to study how firms select governance when contract incompleteness is pervasive.

With an exceptional response rate of 60%, we document the main characteristics of 77 Sino-Italian joint venture contracts, offering an unprecedented large number of details about the negotiation process, establishment of JVs and investment decisions, as well as control rights, equity shares and governance issues. To the best of our knowledge, this is the first attempt at collecting survey data on international

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[1] Consistently with IMF/OECD definitions, FDI is an investment in a foreign company where the investor owns at least 10% of the ordinary shares, undertaken with the objective of establishing a lasting interest in the country, a long-term relationship, and a significant influence on the management of the firm (IMF, 1993; OECD, 1996).

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partnerships at the contract, rather than country, industry or firm level, providing a comprehensive picture in terms of sample representation and topic coverage.[2] This markedly differentiates our contribution from previous studies aimed at providing an overview of general trends in inter-firm alliances through already existing databases (see, for instance: Hagedoorn, 1996, 2002; Moskalev & Swensen, 2007; Morresi & Pezzi, 2011). Having designed the data-collection questionnaire, we were able to include questions suitable to understand what makes a JV and to what extent the empirical evidence supports the theoretical predictions. Hence, even if we narrow down the scope for research by adopting a single home/single host perspective and selecting JVs within the broader array of contracts considered in Hagedoorn (1996, 2002), Moskalev and Swensen (2007) and Morresi and Pezzi (2011), we still cover all classes of industries and firms and comment on a wider spectrum of contractual features adding to sector, country and ownership structure. As a result, our analysis is strongly complementary to previous ones. To summarise, we believe that the main contribution of the present paper is not to derive novel theoretical predictions, but rather contribute to establish the empirical relevance of existing theories, thus providing an exhaustive definition of JVs. Put another way, the novelty of the paper is not so much in the question we ask as in the fact that we use contract-level evidence to try and answer it. The property rights approach is notoriously difficult to put to the data as it requires very detailed information on the partners' investment decisions and allocation of control rights. Contract-level data provide this information and allow us to explore the empirical relevance of the JVs' determinants postulated by the theory. Our main conclusion is that what makes a JV in theory mostly makes a JV in practice, given the impressive match between theoretical predictions and empirical evidence.

That said, there are a few limitations to this research that should be considered in the evaluation of the empirical findings. First, despite the high response rate, the limited number of observations prevents us from conducting a proper econometric exercise. Hence, the main characteristics of Sino-Italian partnerships are presented in a descriptive way, by means of graphs and summary statistics. Second, even though we believe that it is of particular interest to focus on JVs involving Italian and Chinese enterprises, we cannot generalise these results too much, given the single home/single host nature of this study. On the contrary, we suggest considering the present exercise as a first attempt at characterising JVs on international markets, and providing a theoretically grounded and empirically documented definition.

The remainder of this paper is organised as follows. Section 2 overviews Sino-Italian trade and investment relations, providing a description of the environment in which our JVs operate and thus assessing their relative importance. Section 3 presents the conceptual framework and reviews the main JV features emerging from the theoretical literature. Section 4 is entirely devoted to the empirical analysis, presenting the survey design and the most important results. Section 5 concludes and sets future lines of research.

2. Sino-Italian trade and investment relations

In this Section we offer a brief description of Sino-Italian trade and investment relations. Our purpose is to provide information on the context in which Sino-Italian JVs operate, as a natural framework for our empirical exercise. As our survey was conducted between 2010 and 2011, we focus particular attention on the period 2005–2011.

Trade statistics show that European countries are China's main trade partners outside Asia. In 2011, they account for 20% of China overall trade volume. Exports towards Europe represent 25% of total exports, while imports from Europe account for 15% of the total. The ensuing commercial surplus amounts to 154.9 billion USD for the PRC, making China a net exporter with respect to Europe (see Table 1).

[2] For instance, Bai et al. (2004) collect survey data on JV contracts signed in China in the period 1986–1996, but they restrict attention to control rights and equity shares.

Table 1
Import to and export from China (billion USD) by geographical area, 2005–2011.
Source: Authors' elaborations from data available at http://www.mofcom.cn.

	2005	2006	2007	2008	2009	2010	2011
Import to China							
Total	660	791.5	956.1	1132.6	1005.9	1394.8	1743.5
Asia	441.5	525.5	619.9	706.7	603.5	834.6	1004.1
Europe	96.4	114.9	139.7	168.1	162.2	217.9	287.2
Italy	**6.9**	**8.6**	**10.2**	**11.6**	**11**	**14**	**17.6**
North America	56.3	66.9	80.4	94.2	89.5	117	144.3
South America	26.8	34.2	51.1	71.9	64.4	91.2	119.7
Africa	21.1	28.8	36.3	56	43.3	67	93.2
Oceania	18.1	21.3	28.4	40.2	42.6	65.8	88.9
Export from China							
Total	762	969	1220.5	1430.7	1201.6	1577.9	1898.4
Asia	366.4	455.8	568	663.3	568.6	732.1	899
Europe	165.6	215.4	287.9	342.9	264.7	355.2	413.6
Italy	**11.7**	**16**	**21.2**	**26.6**	**20.2**	**31.1**	**33.7**
North America	174.7	219.1	252.2	274.2	238.6	305.9	350
South America	23.7	36	51.5	71.5	57.1	91.8	121.7
Africa	18.7	26.7	37.3	50.8	47.7	60	73
Oceania	12.9	16	21.1	25.9	24.9	33	40.9

In 2011, Italian exports to China increased by 25.6% over the previous year, bringing the Italian share in total Chinese imports up to 1% and placing Italy 21st in the world ranking of main exporters to China. With a share of 6% in Chinese imports from Europe, Italy is third among European countries, preceded only by Germany and France. In turn, Italy accounts for 2% of total Chinese exports in 2011. With a notable 8.3% increase over the previous year, Italy becomes the 8th destination market for Chinese exports in the world and the 4th within Europe. In 2011, Sino-Italian trade volume amounted to 51.4 billion USD, the third largest after Germany and France, and exceeding US overall trade volume with the PRC. As shown in Fig. 1, since 2005 and with the only exception of 2009, Italian exports to China, Italian imports from China and Sino-Italian overall trade volume have increased.

As for the composition of trade flows, industrial machineries, machine tools and high performance equipments account for 50% of Italian export to China (ICE, 2013). The remaining 50% is due to automotive products and chemicals (plastics and rubber), alongside with the traditional Made in Italy products (textile, leather goods, home furnishings and jewellery). At the same time, a third of Italian imports from China are from traditional industries, such as textiles, clothing and leather

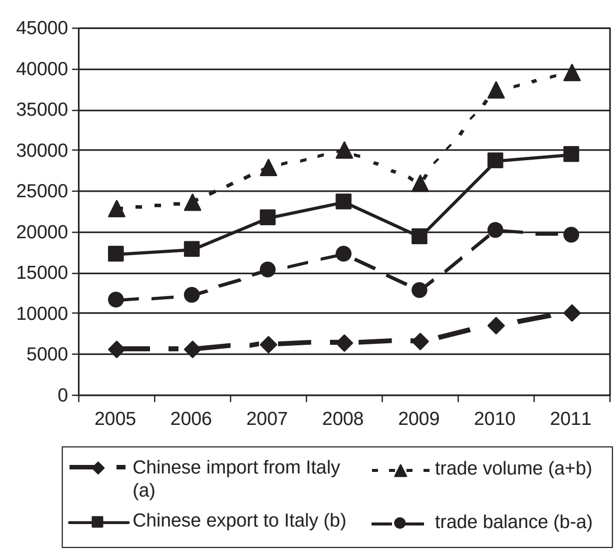

Fig. 1. China–Italy bilateral trade (mln Euro), 2005–2011.
Source: Authors' elaborations from data available at http://www.mofcom.cn.