

THE MOTIVATION BEHIND SUBCONTRACTING RELATIONSHIPS BETWEEN LARGE FIRMS AND SMALL AND MEDIUM ENTERPRISES IN THE MOTOR VEHICLE MANUFACTURING INDUSTRY IN KENYA

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ABSTRACT

The motivation behind subcontracting relationships in the motor vehicle manufacturing The purpose of this study was to determine internal and external constraints to subcontracting arrangements between large firms and small and medium enterprises (SMEs) in the motor vehicle manufacturing industry in Kenya in order to establish the reasons for the gap in those arrangements. The sector was chosen for the study because of the government's selection of the sector to promote subcontracting arrangements between small and medium enterprises and large firms in Kenya. Secondly, the sector was chosen because of the complexity of the motor vehicle industry with one motor vehicle comprising about 10,000 component parts, all of which would be difficult for one company to manufacture in-house. The research was mainly qualitative but quantitative data was also used. Content analysis approach was used to analyze the qualitative data and descriptive statistics to analyze the quantitative data. Data was collected from two of the three motor vehicle assembles in Kenya, nine out of thirteen franchise holders and 66 of the 72 component parts suppliers who are mainly small and medium enterprises. The results indicate that the level of subcontracting that takes place in the motor vehicle manufacturing industry is minimal. This is motivated mainly by a desire to remain in the good books of the government. The big enterprises are not willing to buy component parts from local suppliers and especially not local SME suppliers mainly due to the inability of the SMEs to supply quality products to schedule, lack of local suppliers for certain parts, the proliferation of makes and models and competition from imported second hand vehicles from Japan and Europe. The proliferation of makes and models also requires frequent technological changes which both assemblers and SMEs owners find difficult to keep up with. The study recommends that the government should reduce the age of imported second hand vehicles to not more than five years, find a way of compelling the franchise holders and assemblers to buy parts locally and put in place appropriate policies regarding the sector. SMEs should also acquire up to date technology and become more competitive.

Keywords: *Motor vehicle assemblers, franchise holders, subcontracting, large firms, Small and medium enterprises.*

INTRODUCTION

One of the main determinants for the success of SME growth and development is the establishment of useful linkages between large enterprises and SMEs through subcontracting arrangements (UNCTAD, 2001; Kumar & Subrahmanya, 2007). Subcontracting involves purchase-supply relationship where SMEs are the subcontractors who deliver product or service to the contractors, for the production requirements of the latter as per their

specifications (Kumar & Subrahmanya, 2007). In this case the motor vehicle assemblers and franchise holders are the contractors while the subcontractors are the SME component parts manufacturers.

The importance of SMEs to large firms in manufacturing is well documented, though more prominently in south East Asia than in African countries. Andersen (1999), reported that employment expansion of large firms attributed to the growth of small firms ranged between 40% and 53% for Korea, the Philippines, Turkey and Taiwan, and 67% and 70% for India and Colombia respectively, achieved mainly through subcontracting relationships. There is a possibility that these figures could be higher, considering that it is difficult to measure the subcontracting activity in many developing countries, due to the informality and lack of records in the SSE sector. It is also made difficult by the lack of a clear definition of the full extent of the varieties and impact of subcontracting. In other developing countries, assessment of the contribution of SMEs in real economic terms has been difficult due to the informality of the sector and due to the neglect of the sector by the government (ILO, 2005).

Small and medium enterprises (SMEs) play a predominant role in most developed and developing countries not only because of their number and variety and their involvement in all segments of the economy but more importantly, their role in employment creation (Baseline Survey, 1999; Thitapha, 2002; Kumar & Subrahmanya, 2007). The Poverty Reduction Strategy Paper (Republic of Kenya, 2001 – 2004), states that the potential of small and medium enterprises (SMEs) in both employment creation and raising incomes for many Kenyan families makes them an important element in the poverty reduction strategy. According to the Economic Survey (Republic of Kenya, 2008), overall, the economy generated 469 thousand new jobs in 2006 – 2007 financial years, an increase of 5.7 from the previous year. A large population of this labor force was absorbed in the informal sector which generated 418 thousand jobs. In the following year, the informal sector created 426.9 thousand new jobs in 2007 compared to 420.4 thousand jobs in 2006. An estimated 8, 33.5 thousand persons were engaged in informal sector economic activities in 2009, an increase of 4.9 per cent from the 2008 level. The sector has always provided the necessary employment interface between the modern sector and small scale farming and pastoral activities. The ease of entry into the sector has made it a fall back opening for those leaving training institutions as they await to join the modern sector, for those leaving the modern sector and for those who cannot secure formal employment due to lack of appropriate skills (Republic of Kenya, 2010).

However despite the important role of SMEs, the sector is plagued by a number of concerns. According to Thitapha (2000), SMEs, especially in developing countries, have been exposed to intense competition due to the accelerated process of globalization which brings out the need for SMEs to develop competitiveness for their survival as well as growth. SMEs, in general are constrained in terms of infrastructural sources such as technology, finances, marketing and human resources, gender inequality, limited access to information and limited linkages to large enterprises, among others, according to Sessional Papers No2 (Republic of Kenya, 1992; 2005). The ability of SMEs to compete in the global market depends on their access to these resources and those SMEs which have better access to these infrastructural resources are able to exhibit better economic performance (Jenkins et al, 2007). One of the main determinants for the success of SME growth and development is the establishment of useful linkages between large enterprises and SMEs through subcontracting arrangements (UNCTAD, 2001; Kumar & Subrahmanya, 2007). The contribution of SMEs to the economies of developing countries is mainly emphasized in manufacturing. International Labour Organization (2005), for example, shows that small scale enterprises made up 95% of all registered enterprises in the manufacturing sector of developing countries. Subcontracting relationships with large enterprises, provides SMEs with a better scope for accessing these resources, and offers them a short cut to enhancing productivity and other non-price determinants of domestic and international competitiveness (Meyn, 2004).

LARGE ENTERPRISES

Globalization has generated both new markets and competitive forces for large firms. Constant pressure to reduce costs, shorten lead time and focus on core competences has driven firms to change their supply chain management strategies. Most large manufacturing companies now buy significant percentages of their inputs of both goods and services from other firms, with some spending as much as half of their revenues this way.

Managing the supply chain for an optimal mix of cost, quality, flexibility and strategic advantages such as access to innovation is becoming an increasingly important source of competitive advantage (Hermann, 2005). Cost pressure and presence in developing countries combine to create an interesting set of opportunities and challenges for Trans National Companies (TNCs). How to gain the local knowledge and contracts required for operating effectively? How to optimize cost, quality, flexibility and other considerations in the value chain? How to manage any social or political controversy surrounding company activities? How to preserve “social license to operate”? The message is clear. Companies need to be seen to be contributing and not simply exploiting (UNCTAD, 2006). There has, therefore, been an urgent need to forge stronger ties with the local communities in which these TNCs operate. While these challenges are particularly pronounced for foreign firms with alliances in developing countries, they are relevant to domestic developing country firms as well (ILO, 2005; Jenkins et al, 2007; Kumar & Subrahmanya, 2007).

In developing countries, business linkages with local SMEs, including procurement, distribution and sales, offer large firms an avenue through which to address some of these concerns. These relationships can allow large firms to reduce input costs while increasing specializations and flexibility. They can also increase local integration and “rooting,” providing access to local knowledge, and, by spurring growth and development in the local SME sector, bringing about positive social and economic impacts in the wider community. There are thus both competitiveness and corporate social responsibility arguments in favor of business linkages (Kumar & Subrahmanya, 2007). Large enterprises operating in developing countries can forge linkages with local SMEs in many different areas of their value chains. These opportunities may include procurement, agricultural out growers’ schemes, manufacturing, sales of financial services, information and communication technologies, distribution and retail outgrowing, non core functions and services franchising, leasing and subcontracting (UNCTAD, 2006).

STRUCTURE OF THE MOTOR VEHICLE ASSEMBLY INDUSTRY IN KENYA

The motor vehicle assembly industry in Kenya consists of four distinct categories of participants. The first category consists of the three assemblers: Kenya Vehicle Manufacturers (KVM), Associated Vehicle Assemblers (AVA), and General Motors East Africa (GMEA). The first two firms are contract assemblers while General Motors (EA), is a franchise holder as well as an assembler. GMEA is the only assembler that does not contract assembly services to anyone else. All of the assemblers have a government shareholding together with some of the major franchise holders in Kenya. The second category consists of 13 franchise holders, better known in Kenya as importers of the completely knocked- down- kits (CKDs). They hold licenses to import and assemble and distribute motor vehicles on behalf of principle car manufacturers in Japan France, Italy, United Kingdom, Germany and others. About half of these have some shareholding interests in at least one of the assembly plants. Also, there are distributors who merely provide outlets for major franchise holders.

The third category is the auto ancillary sub sector comprising a variety of independent SMEs who supply the industry with assembly and replacement parts. However, because the assemblers import as complete a CKD kit as possible and import most of the other inputs, this category has tended mostly to serve the replacement market. Yet it is in this category that prospects for a wide range of small enterprises are found. The fourth category consists of body fabricators who play quite a vital role in subcontracting in the motor vehicle industry in Kenya. The service and repair sub-sector constitutes a fifth category that, while vital for the industry, is not directly linked into the assembly or auto ancillary sub sectors. In Kenya, this latter category employs perhaps, the largest number of the small enterprise workers in the motor vehicle industry (Kenya Association of Manufacturers, 2006). The total installed production capacity of the three motor vehicle assemblers is 23,200 vehicles on batch basis. In the 2004, the total utilization of the assembly plants by the three assemblers was only 28.5%. The capacity of the three motor vehicle assembly plants is, grossly underutilized. This hinders subcontracting within the industry as local subcontracting depends on the amount of local assembly taking place.

STATEMENT OF THE PROBLEM

In no other industry has subcontracting been as extensively used as in the motor vehicle industry. One possible explanation for this could be that, apart from the service inputs, a typical vehicle model, for example, uses at least 10,000 different parts of components (Womack et al, 1990). Subcontracting, therefore, seems to be a logical production organization since no single manufacturer could possibly provide all these parts internally. It would appear, therefore, that the very nature of the technical process of motor vehicle manufacturing necessitates linkages involving several firms.

The Government of Kenya has deliberately attempted to develop the assembly of motor vehicles by requiring assemblers to shift from semi knocked down kits (SKD) to completely knocked down (CKD) levels of assembly (Republic of Kenya, 1986). Nevertheless, low demand for vehicles on the domestic front, and the absence of a long term strategy to foster transition from assembly to manufacture, have limited the growth of the sector and its ancillary sub-sectors. Currently, the sector is plagued by importation of cheap second hand reconditioned vehicles and a proliferation of makes and models.

Until the establishment in 1991 of the Kenya Subcontracting and Partnership Exchange (KSPX) to promote industrial subcontracting in the country, Kenya had not taken deliberate steps to utilize the linkages between large and small businesses. Recognizing the potential of the motor-vehicle industry for external sourcing and subcontracting activities, and in view of the successful experiences of this sector in industrial development in Europe (Becattini, 1991) and in Japan (Sato, 2000), the government selected the automotive industry as the pilot sub sector for the initial promotion of the Kenya Subcontracting Partnership Exchange (KSPX) activities and inter-firm linkages in industry. The KSPX was set up in 1991 by the Kenya government with the help of United Nations Development Programme (UNDP), to bring together large, medium and small enterprises in a formal interaction (UNDP/Republic of Kenya Project Document, 1990), and to build a data bank to facilitate these activities. It was expected that its linkages with the various membership organizations assisting business people will ameliorate this situation.

However, according to Sessional Paper No. 2 (Republic of Kenya, 2005) and the Private Sector Development Strategy Paper (Republic of Kenya, 2006 -2010), the current situation is that linkage between Kenya's SMEs and large firms is weak. As a result, Kenyan SMEs remain passive and underdeveloped. Research has shown that linkages between large firms and SMEs can enhance the growth and competitiveness of the latter and provide the much needed employment (McCormick & Atieno, 2002; Thitapha, 2002; UNCTAD, 2006; Kumar & Subrahmanya, 2007). Yet, firm to firm linkages in the form of franchising, leasing, production complimentaries, subcontracting and other inter-firm linkage opportunities between large firms and SMEs, is still untapped in Kenya (Masai, 1991; Republic of Kenya, 1992; 2005; 2006-2010; Masinde, 1996). Despite the importance of business linkages in promoting the growth of SMEs, empirical research on subcontracting is inadequate. This paper is an attempt to narrow the information gap. Previous research on subcontracting in Kenya has concentrated on other sectors namely: the Pharmaceutical Sector (Owino, 1991), the Metal Fabrication Sector (Oketch, Mitullah, & Atieno, 2002), the Garment Manufacturing Sector, (Ongile & McCormick, 1996), the Food Processing Sector (McCormick & Atieno, 2002). The only studies conducted on subcontracting in the motor vehicle sub sector in Kenya were done much earlier by Masai, (1991), and Masinde, (1996). No recent studies have been carried out. The study by Masinde (1996), points out that effort to rationalize the industry and encourage assemblers to procure some of their inputs locally through subcontracting had not been very successful. Yet there exists an inherent capacity for subcontracting arrangements in the industry and it is, therefore, important to explore the reasons for the reluctance of the assemblers and franchise holders to enter into subcontracting arrangements with local SMEs. This paper is an attempt to bridge that information gap.

LITERATURE REVIEW

Motivation behind Subcontracting Arrangements

According to Harrigan and Newman (1990), to understand inter-firm relationships, the motivation and propensity of firms to relate must first be understood. By this it is meant that the firm's desire to and inclination

to relate with another firm, perhaps to access resources, markets or technology is decided by the management. Recent global experiences suggests that answers can be found by examining the external pressures causing such developments, particularly those related to changes in demand patterns (Jenkins et al, 2007) These pressures are, however, difficult to replicate in an economy. Since it is the decisions of individual firms which aggregate into what is considered industry behavior, other more intrinsic managerial explanations are suggested, namely: (i) that firms are searching for competitiveness by focusing on 'core competency' (Prahalad & Hamel, 1994); (ii) the increasing importance of the strategic implications of the efficiency of the supply chain to the competitiveness of the firm (Porter, 2001); (iii) the replacement of internal markets with external markets as one strategy to increase the value of the supply chain (Porter, 2001); (iv) the development of cooperative strategies by firms as strategy for entering markets and accessing resources and finally, (v) the development by smaller firms, of cooperative strategies for entering markets hitherto inaccessible because of scale related barriers (Brusco, 2004). Hence this category of explanations recognizes that the explanation for industry behavior can be found by examining individual firm behavior; decisions about production organization, organizational structure, sourcing activity and subcontracting.

Harrigan and Newman (1990) have also argued that this decision is largely predicted on the benefits of the linkage to the firm; whether the resource or the market offered by the 'partner' is critical to its activities; the costs of the cooperation/ linkage, including transaction costs, opportunity costs, strategic inflexibility resulting from cooperation and the damage to a firm's strategic advantage when such linkage occurs; whether alternative strategies exist or whether other sources of inputs or markets can be found; and the need to cooperate in order to access desired markets or resources; the centrality, urgency and necessity of the resource or market to the other activities of the firm. Clearly, the central concern is the motivation of a firm to form relations with another firm, and how it perceives the possibilities of achieving its objectives using this strategy. The factors motivating firm to firm linkages with other firms as part of its business strategy is therefore of central interest to this study.

Casson (2000) groups the factors influencing the choice of contractual relationships against internal development into four broad categories: a) the nature of the advantage sought from the relationship. This means the advantage the firm is seeking in forming the relationships. Consequently, if a firm does not perceive an advantage, it is less likely to pursue subcontracting arrangements or any other form of inter-firm relationships; b) the nature of the firm, and its ability to 'support' the relationship; c) the nature of the industry, and norms, relative stability, levels of uncertainty and other factors. This means the industry environment within which the firm operates. Consequently, if the firm seeking a relationship concludes that the nature of competition or industry activity are best addressed using inter-firm linkages, then such a strategy will be used and d) the nature of the wider business environment. This refers to the country or international setting within which managers have to make their decisions. As Porter (2001) has argued, the wider environment determines, to a large extent, whether a firm uses internal or external sources such as suppliers. The most prominent of these conditions is the extent to which the supplier offers adequate infrastructure choices for a large firm to use it.

Kumar and Subrahmanya (2007), point out that a corporation participates in subcontracting activities for two basic reasons: because it good business and out of a sense of responsibility for community service. To say that it is good business means that linkage contracts provide the corporate buyer with needed inputs of the required quality and quantity at competitive prices, delivered in a timely manner thereby reducing costs and enabling the corporation to concentrate its capital and management skills on a more limited range of activities (its "core business"). Jenkins et al (2007), indicate that what motivates a company to engage in subcontracting are: to reduce and control operating costs in manufacturing, to improve company focus, and to access world class capabilities, to free resources for other purposes, to access resources not available internally, to accelerate re-engineering benefits, to improve the efficiency of functions difficult to manage or out of control and to make capital funds available to share risk to induce cash flow.

Large firms in the motor vehicle industry considered control over resources (suppliers), markets, the government and its competitors as more important in making decisions about subcontracting. The most frequently cited motive was access to and control of suppliers, in this case the CKD kits. This priority was

linked to the need to comply with government regulations as a way of ensuring access to import licenses for scarce resources. Thus, allowing for variations depending on the activity in question, for various components and sub assemblies, decisions to externalize or internalize transactions were made not necessarily with cost in mind, but to maintain this control (Masinde, 1996).

A study in South Africa by Annim and Machethe (1998), established that the other reason why small firms seek linkages with large firms is the desire to avoid rules, specifically to avoid paying taxes, to escape the regulations, or to employ workers in patterns not consistent with union agreements or bargaining council decisions. However, even though this factor appeared significant, in general, the same study continues, there are linkage suppliers that are most competently managed, are growing most rapidly, and are generating the highest returns for both owners and workers within the enterprise. It is not necessary for small suppliers to operate outside the rules for them to be part of a competitive and efficient supply system.

In industrialized countries, changes have also occurred at the level of the competition. The basis of competition changed from price to quality and product differentiation. Consequently, competitiveness is measured by the value delivered to the consumer, and also to the extent to which a firm can access a large number of market segments. Competition is on the level of scope, an ability to serve as many market niches as possible. Consequently, high product differentiation is demanded by the nature of the market. Secondly, the growing importance of the dis-aggregated organizational components of production implies that the organization has to restructure to deal with such high differentiation. These changes fundamentally recognize the primacy of organizational change in addition to the changes taking place at various levels of productive restructuring (Kaplinsky et al 2004).

According to Tumbull (2000), at inter-firm level, because of the need to control inventory costs and to outsource, the efficient use of outside suppliers has become imperative and competitiveness is defined by access to good quality, reliable suppliers, or denying competitors access to such suppliers. Hence, merely having more efficient production techniques is not enough for competitiveness. It has become important to have more efficient relationships with suppliers of inputs and distributors of inputs. The importance of the whole of the supply and distribution chains is emphasized. Consequently, the buyer-supplier relationship is increasingly changing from an adversarial one based on price, to a cooperative one based on collective competitiveness through customer satisfaction (and resultant loyalty). For example, in the Japanese model where zero defects means that the supplier has to work closely with the buyer in order to achieve the quality and delivery standards required, short term cost minimization is not important. As Sako (2005) notes, buyers often invest time and personnel in making sure that the supplier's product meets the required quality standards without any rejects. In the western model, the concept of zero defects does not exist. Instead, the quality of products is controlled at the end of the production process, often too late to make alterations. For the supplier, it is only the quality approved items which enter the buyer's production process. For example, Tumbull (2000) notes that in the UK, manufacturers have adopted 'corrupted' forms of JIT where warehouses are located close to the plant, timed deliveries are made to the buyer's plant and invoices are made only when parts enter into the assembly plant. Hence, the supplier has to bear the cost of defects in addition to warehousing as well as inventory costs (Thongpadke et al, 2002). The buyer is, therefore, unlikely to be interested in the problems causing such defects since the costs are borne by the supplier. Both the buyer and the supplier are then left with no basis for bargaining, other than price.

However, although competition based on cost minimization is important, it is not necessarily primary. Both the Japanese and European models assume that production organization is aimed at increasing productivity and efficiency; hence, subcontracting is seen as a function of these goals. Consequently, keeping the costs of the supplier chain low becomes one of the key elements for achieving efficiency, and by extension, competitiveness. The main difference in the two models is that in the Japanese approach, competitiveness is seen in terms of the long term benefits while the British model takes a short term view to competitiveness (Sako, 2005).

In developing countries, however, supplier chain efficiency may not necessarily be a valid motivation since one of the primary concerns of industrialization is the localization of industry and capital. Subcontracting, particularly between SMEs and TNCs are more likely to be affected by political implications of resource ownership and control. Hence, keeping the costs of the supplier chain low is not as important as gaining access to and controlling resources. Due to uncertain economic conditions in many developing countries, firms have had the incentive to integrate as assurance against endemic resource scarcity. In these circumstances, the government is more likely to make subcontracting mandatory to encourage it (Sako, 2005).

A study conducted on subcontracting in Thailand by Thongpadke et al (2002) points out that industries usually subcontract out for several reasons. The finished product usually consists of various parts and components parts. The cost of establishing several manufacturing capabilities for some of these components do not always justify themselves. Thus it is sometimes more desirable for firms to establish subcontracting agreements when the cost savings exceed the transaction costs of such arrangements. Second, the production of these industries is usually in the mature stage of their respective product cycle. Therefore, there is no critical or strategic technology involved in the production of these parts and components. Finally, since these industries are modern and involve high technology, entrepreneurs in these industries are relatively well educated compared to others. They know how to manage the subcontracting arrangements. Furthermore, since the industries are rather competitive, subcontracting agreements to reduce costs sometimes become a necessity (Thongpadke et al, 2002).

The reasons for engaging in subcontracting arrangements vary among firms. The most frequently cited reasons for large firms are production flexibility, subcontractor's specialization, local content requirements, and avoidance of labour management problems. Reasons given by SMEs involved in the subcontracting arrangements include greater use of production capacities, assistance from parent firms and reduction of marketing costs. The most important consideration of the large firms is the ability of the SME to meet delivery schedules. The quality, price of the products and technological capability of the suppliers is also important. Suppliers, however, have tended to overlook the importance of on time deliveries, thinking that product quality and price are the large firms main priorities (Thongpadke et al, 2002).

METHODOLOGY

The overall objective of this study was establish the internal and external motivation behind the subcontracting arrangements between small and medium enterprises (SMEs) and large firms in the motor vehicle manufacturing industry in Kenya so as to establish the reasons behind the gap in subcontracting in Kenya. The specific objectives were: 1) to examine the internal motivation behind the subcontracting arrangements between large firms and small and medium enterprises in Kenya's motor vehicle industry 2) to establish the external motivation behind the subcontracting arrangements. The study adopted mainly a qualitative approach although some quantitative data was also included. Kothari (2005) states that typically, qualitative research is concerned with the assessment of attitudes, opinions, demographic information, conditions and procedures. The purpose is to portray an accurate profile of events or situations. The approach provides an insight into attitudes of the parties involved in subcontracting. The qualitative data was analyzed using conceptual content analysis. Content analysis is a qualitative research tool used to determine the presence of certain words or concepts within the text. It uses inductive reasoning by which certain words, patterns, concepts, phrases, themes emerge from raw data. Kombo and Tromp (2006), propose use of themes to analyze qualitative data. Gaskill (2001) used the same approach. The theme categories evolved during data collection but the researcher ensured that the categories are relevant to the research questions of the study. Descriptive statistics was used to analyze the quantitative data. A census was conducted on the 88 businesses in the motor vehicle manufacturing industry consisting of three motor vehicle assemblers, 13 franchise holders and 72 component parts suppliers (mainly SMEs and a few large companies engaged in supplying the first two groups with component parts). Managers of two assembly plants and of nine franchise holders were interviewed. 66 suppliers filled and returned questionnaires. The study was conducted between November, 2009 and July 2010.

RESULTS AND DISCUSSION

The production capacity of two of the three motor vehicle assembling plants in Kenya is clearly underutilized (see Table 1 below). Could motivation be a contributing factor?

Table 1: Plant capacity utilization of General Motors (EA) and Kenya Vehicle Manufacturers (2009)

Name of Assembling plant	Installed Capacity	Vol. of Assembled vehicles (2007)	Capacity Utilization %	Vol. of Assembled vehicles (2008)	Capacity Utilization %	Vol. of Assembled Vehicles (2009)	Capacity Utilization %
GMEA	7,100	2,629	37	2700	38	1993	28%
KVM	6,600	1,108	17	980	15	900	13.8%
Totals	13,600	3,737	54	3680	53	2893	41.8%

MOTIVATION BEHIND SUBCONTRACTING

The main objective of the study was to establish the motivation behind the subcontracting arrangements between large firms and their mostly SME component parts suppliers. As established by this study, the main force behind subcontracting in Kenya is the mandatory requirement by the government that assemblers include at least 30% local content in their locally assembled motor vehicles. All the managers in the study who were interviewed indicated that the main reason why they sourced locally was because they were required to do so by the government. The managers argued that in view of the current supplier infrastructure status, it is logical to continue importing as complete a CKD as possible. The production organization in motor vehicle assembly has an inherent potential for outsourcing and external transaction, given the complexity of the production process and the myriad of parts and components that go into it. Secondly, the current production organization in the firms interviewed allows subcontracting to take place. Finally, given the small and fragmented market for cars in Kenya coupled with high set up costs in the sector, the assemblers and importers are reluctant to invest in in-house production. Despite this amenability of the sector to subcontracting, the findings reveal a reluctance to subcontract locally, particularly from local SMEs.

Several reasons touching on the lack of competitiveness in the supplier market were suggested by managers interviewed to explain this reluctance to transact with local SMEs. In addition to a poor policy framework governing the sector, lack of control over imported Fully Built Units (FBUs) and poor incentives to motivate to procure locally, the quality of the products in the market was perceived to be lower than that of the imported parts and components. There was also widespread concern that because of the production deficiencies and poor technical and managerial capacity of local firms, the local products were relatively more expensive than their imported counterparts. Consequently, only those items listed in the Legal Notices were currently being outsourced with little indication that further voluntary deletion of items from CKD kits would be implemented in the near future. In these circumstances firms are compelled to outsource in order to maintain good relations with the government. As it is, buyers are continually looking for exemptions from local sourcing for existing components, stating that locally procured products do not meet the required specifications.

However, the study established that that despite this mandatory requirement, other internal organizational considerations have contributed to their subcontracting strategy. a number of SMEs who used to supply the company with certain items have now closed down because franchise holders now prefer to import almost complete vehicles from abroad. This was supported by the manager at KVM who stated that a number of SME had closed down due to competition from China. One manager added that:

We procure locally because some local products are cheaper and lead time is reduced considerably since it takes about six months for imported parts to arrive into the country. Local suppliers are also more flexible in terms of meeting assembler demands.

The other reason given for sourcing locally was tax exemption. There was a penalty for importing items or parts listed as protected in the legal notice. The other factor that has forced local assemblers to source locally is the East African Customs Union. Tanzania, for example, has insisted that Kenyan assemblers have to meet at least the required 30% local content before they can export locally assembled vehicles to Tanzania. Information obtained from managers at Toyota E.A. and GMEA, indicated that inspectors from Tanzania have even been to their assembly plant to physically inspect the assembly process to establish the level of local content. The manager at GMEA, however, protested quite strongly that this insistence on a specific percentage of local parts is rather misguided for the specific reason that:

CKD assembly is not just a ‘simple assembly’ but a ‘substantial transformation’ which involves the intensive use of local labour. This employment of intensive local labour should not be ignored when local content is being measured.

Only one manager said that some local products were of good quality for example, leaf springs that are manufactured locally are more suitable and last much longer on the poor roads than imported ones. The main vehicles that are currently being assembled in Kenya that do not seem to have been much affected by the proliferation of makes and models or importation of second hand and reconditioned vehicles are pickups and trucks. This is because importing CKD kits for trucks and assembling them locally is cheaper as it conserves space in the container to carry more units. As mentioned elsewhere in this study, importing the completely built unit (CBU) would take too much space in the container. This is not the case when it comes to importing saloon cars as they take less space. This, together with the proliferation of makes and models of saloon vehicles in the country has forced the three assemblers to halt the local assembly of saloon cars. The importation of saloon cars is also driven by market demand or customer preference; economic drive or affordability is another factor as locally assembled vehicles are more expensive due to a number of factors. Most Kenyans are now buying cheaper reconditioned vehicles from Japan and Europe.

Another reason that was often quoted was that they sourced locally to avoid paying import duty charged on imported component parts. However the suppliers complained that the 10% duty levied on imported component parts is not heavy enough to deter assemblers and franchise holders from importing parts. One manager indicated that the company sourced locally because they wanted to promote local industries and create employment. Another reason that came up was that it was for the sake of after sales service as it is easier and cheaper to replace local parts with than imported parts. End user specification was also raised as some end users clearly specified whether local parts may be used or not.

Contrary to the motive of the primacy of cost (efficiency) as a determinant of transaction behavior, all the firms interviewed considered control over resources (supplies), markets, the government and its competitors more important in making decisions about their transaction patterns or about their organizational structures. The most frequently cited motive was access to and control of supplies, in this case, CKD kits. This priority is linked to the need to ‘remain in the good books of the government’ as a means of ensuring access to import licenses for scarce productive resources. The franchise holders make specific efforts to target specific government officials in order to ensure that licenses were issued on time. Thus, allowing for variations depending on the activity in question, for the various services, components, and sub assemblies, decisions to externalize transactions were made not directly with cost reduction in mind, but to maintain this control.

However, even in cases where cost was an important consideration, for example, in the case of choosing between alternative suppliers, the actual selection of the supplier was not predicted on lower costs. Rather, firms tended to choose the supplier who was willing to supply on the terms stated by the buying firm, particularly those assuring the buyer of good quality products delivered on time, and who could cope with the technological demands of the buyer. This is not surprising since observers view the components market as a buyer’s and not a supplier’s market, allowing buyers to state their own terms.

The assumption made by traditional economic theories regarding the primacy of cost and efficiency implies that if the market price is lower, firms will transact externally when choosing between external and internal supply.

Based on this argument, it would also be expected that because small firms are postulated to have lower overheads, such cost saving can be achieved by transacting with them. Contrary to these expectations, all of the firms interviewed considered a price differential between in-house supply and external sourcing, and between large and small firms, less important than prompt delivery and quality assurance. It was therefore unlikely that firms in the market or small firms quoting lower prices, perhaps due to lower overheads, would be preferred to larger firms quoting higher prices, if the small firms did not demonstrate an ability to deliver good quality products on time.

A previous study on the sector by Masinde (1996) found that GMEA, keen on building a local supply network of components as a matter of company policy, had embarked on a quality and delivery standards improvement programme for its current suppliers. In addition, a rigorous selection criterion ensured that progressive suppliers independently improve their standards before entering into contract with this particular franchise holder. They would then enter into a supplier development programme. At the time of this study, however, GMEA had stopped this, hence these findings contradicting the findings of Masinde (1996). The only evidence of supplier development at GMEA was a car upholstery supplier, who has been given space within the GMEA assembly plan to make and supply GMEA with car cushion materials. It was clear that all the other franchise holders buy products from suppliers who meet their quality standards themselves, and will immediately change suppliers when they fail to do so. What this implies is that there is yet a limited commitment by many franchise holders to the development of a supplier base, the weakness of which is used to justify imports of parts and components.

The various reasons that motivates assemblers and franchise holders to enter into local sourcing arrangements with local suppliers are summarized in Table 2 below. The majority do it merely because it is mandatory government requirement that they use at least 30% local content. This was so that the government does not deny them license required to import the CKD kits required for motor vehicle assembly. This was followed closely at (33%) by those who source locally to avoid paying import duty since you only pay VAT when you source locally. However, a number of SME suppliers were of the opinion that a heavier penalty should be imposed on imported parts. Also, one of the reasons quoted frequently for sourcing locally was that the lead-time, which is much shorter and in one case, quality, specifically leaf springs, because they are better suited to the local conditions such as the poor state of the local roads.

Table 2: Motivation for subcontracting

	Franchise holders	Assemblers	Total
Government requirement	37%	17%	50%
To avoid paying import duty since you only pay VAT when you source locally	25%	8%	33%
Shorter lead time	18%	14%	33%
End user specification	4%	0%	8%
To concentrate on the core business	4%	4%	8%
To provide employment to locals	3%	4%	8%
To conform to the local conditions such as roads	4%	4%	8%
Wanted to promote local industries	8%	0%	8%
After sales services available locally quickly for local parts	8%	0%	8%
Total	67%	33%	100%

DISCUSSION OF MAJOR FINDINGS

This study established that the main reasons why firms procure locally are: the short time required for local procurement (lead time) and the desire to remain in the good books of the government so that they could get licenses and continue in business. The other reason was to avoid paying tax charged on imported components. These findings contradict those of Kumar and Subrahmanya (2007). In a study on linkages in the motor vehicle industry in India, their study found that corporations participate in subcontracting activities with local SMEs

because they are ‘good business.’ This means that the SMEs provide the corporate buyer with needed inputs of the required quality and quantity in at competitive prices, delivered in a timely manner thereby reducing costs and enabling the corporation to concentrate its capital and management skills on a more limited range of activities (its “core business”). In Kenya, the situation is the opposite, as this study reveals. None of the managers of the large enterprises who were interviewed consider local SMEs as good business. Most of the SMEs in the sector have been unable to produce quality components on time as required by corporate buyers. In fact, the poor quality of local products was the major reason given by all the managers as to why they prefer not to source locally.

Jenkins et al (2007), indicate that what motivates a company to engage in outsourcing are: to reduce and control operating costs in manufacturing, to improve company focus, and to access world class capabilities, to free resources for other purposes, to access resources not available internally, to accelerate re- engineering benefits, to improve the efficiency of functions difficult to manage or out of control, to make capital funds available to share risk to induce cash flow. The Kenyan scenario is quite different where out sourcing seems to be more because they have to and not for the above advantages. The buyers are not able to reduce manufacturing costs because the local components are more expensive than imported ones. This is because the component parts SME manufacturers themselves import raw materials, as this study established.

The findings of this study indicate that decisions to externalize or internalize transactions were made not necessarily with cost in mind, but because of the need to remain in the good books of the government as a way of ensuring access to import licenses for the supply of CKD kits. However, even in cases where cost was an important consideration, for example, in the case of choosing between alternative suppliers, the actual selection of the supplier was not predicted on lower costs, but rather on who was willing to supply on the terms stated by the buying firm, particularly those assuring the buyer of good quality products, delivered on time and who could cope with technological demands of the buyer. These concur with findings by Masinde (1996), which established that cost took second place as assemblers and franchise holders purchased locally mainly because it was mandatory for the to do so.

This study established that it was also evident that buyers were keen to avoid dependence on one supplier, mainly because of the uncertainty in the supplies component parts business environment and therefore retained more than one supplier for most items. This contradicts findings by Masinde (1996) who established in her study that GMEA had problems with monopoly suppliers because they inflated prices at will and GMEA had little control over this decision by the supplier to dictate prices. As a result of liberalization buyers now have a variety of suppliers to choose from. The SME suppliers in this study contend that they have little say in the transactions and that they were entirely at the mercy of the large enterprise buyers; in addition, as a measure against quality; the assembler maintained control over the transactions by providing time and quality specifications for the various orders, while also taking measures to control price fluctuations. They concur with the findings (Kimura, 2001) which indicated that SMEs felt sometimes they were not fairly treated by assemblers and franchise holders as having invested a lot of money on machinery to meet orders, they were not guaranteed of future orders. The findings of this study support those of Ananim and Machethe (1998) which found that one of the reasons large enterprises source locally is to avoid paying taxes. Buyers in this study stated categorically that one of the main reasons why they engaged in local sourcing was to avoid paying import tax.

Conclusions

To achieve more lasting solutions, institutional and policy support is required to improve the assemblers’ confidence in the capabilities of suppliers, particularly SMEs. The government must take measures to rationalize the industry and remove policy and institutional impediments which make small suppliers riskier and more expensive for the assemblers. The proliferation of makes and models must be controlled, while providing institutional support for small firms in the ancillary sub sector by removing impediments in the import licensing system. Further, smaller firms need to understand the principal reasons why large firms are reluctant to deal with them. For these local small firms to benefit, the government must focus on removing the policy impediments which prevent the assemblers from using local suppliers of parts, components and services.

Assemblers and franchise holders, therefore, appear to have little incentive to procure their requirements locally, particularly from small manufacturers, unless the government intervenes. Yet, according to current thinking, government should reduce its regulatory role in industry, and should, instead, provide a conducive policy and institutional framework for the sector. The current dependency of the motor industry on the government legislation requiring assemblers to procure certain items locally is a manifestation of the fragile relationship between buyers and suppliers in the sector and the lack of commitment of large buyers towards supplier development, owing to lack of incentives. It is apparent that there is need for incentives within the sector's environment itself, rather than government regulations and controls. This may have been a sound strategy in the business environment prevailing ten or more years ago, but it is no longer feasible in an environment where market forces predominate.

RECOMMENDATIONS

The following specific recommendations can be made. The minimum age of imported second hand vehicles should be changed from the current eight years to five years. Such vehicles will be more expensive and people will be motivated to buy locally assembled vehicles as Motor vehicle assemblers should be encouraged to use local suppliers and locally manufactured products and only import those parts that are not available locally. This should involve specific efforts to motivate assemblers and franchise holders to source voluntarily from local SMEs. The study revealed that it is the perceived inherent weakness of the capacity of local SMEs that has hindered more linkages with them. One of the most important starting points is an evaluation of the supply side of the ancillary sector in order to highlight the weakness of the suppliers as perceived by the buyers. Comments by respondents regarding their perception of SME suppliers, in the words of one manager are that "they are ineffective and insufficient for our needs". Approaches which have helped ameliorate such deficiencies in other countries include strategies which reduce the atomization of small firms through networking and clustering at industry and enterprise levels. In Kenya, this is even more critical, given the atomization and weakening of small firms, particularly African owned small firms. It was interesting to note that all suppliers in this industry are Asians. The only African was the one given space in the assembly yard at GMEA to make and supply seats for locally assembled vehicles. Thus, in strengthening the supply side as well as motivating the buyers to source locally, policies must be put in place to address the institutional frame work to strengthen the capacity of SME component suppliers.

There is need for the government to support the sector by sourcing all its major vehicle requirements locally. These include not just the Government ministries but also its major departments. By so doing, it would not just be the assemblers, but many downstream producers of components for local assembly and spare parts would also benefit from such a policy. This would also indirectly support upcoming small scale operators in the informal sector, which would have a cheaper for their spare parts requirements, arising out of the support given to local component manufacturers to produce at higher capacities. Stiff competition due to the massive importation of second hand motor vehicles, which started with liberalization of the economy in 1993, has reduced the capacity utilization in vehicle assembly plants drastically. A major loophole has been the valuation method used to determine the dutiable value, which leads to under- invoicing. There is need to make the valuation clear and transparent.

The government must provide guidance within a sound, well articulated industrial policy, for industrial development in general, and the development of the motor vehicle industry in particular. As things stand, it is difficult to identify a specific and coherent policy towards the sector. It is therefore the role of the government, in consultation with the concerned parties, to set out the policy aspirations. Also, it is critical that the participants of the sector come together regularly to decide how best to develop the sector within the articulated policy framework. A supporting environment must be put into place. The study revealed that while large firms have an inherent capacity to outsource from local firms, there were no incentives in the environment to encourage this. For example, the proliferation of makes and models continues to prevent a rationalization of production organization in the industry. This is aggravated by the importation of cheap second hand vehicles. In turn, the parts and components sub sectors are not able to cope with the complexity and variety of requirements

of the replacement market. Consequently, it is difficult to accumulate experience to meet the quality standards demanded by assemblers and franchise holders. If this vicious cycle is to be broken, it is imperative that the rationalization programme proposed in the 1980s be enforced seriously, and the importation of cars be limited.

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