

# **Internal Market Orientation, a Novel Approach to Improve Firm Performance in China**

**Abstract:** This study extends knowledge of internal market orientation (IMO) as a management tool to facilitate employer-employee relation. Employing a quantitative research in China, a conceptual model is presented and tested on 275 companies with 3 respondents from each. IMO is examined as a predictor of firm performance mediated by employee commitment and retention. The results support all the proposed hypotheses and highlight the moderating effect of internal customer-supplier relationships and interdepartmental communication. Ownership type as the third moderator indicates different influence of IMO on the posited causal chain. This study contributes in practice by providing managers and scholars with empirical support of IMO's effectiveness in firm performance in China. It provides managers from different firms competing in China with a new angle to boost firm performance by inspecting their internal market situation as well as to improve it via understanding internal customers better.

**Keywords:** *Internal Market Orientation, firm performance, China*

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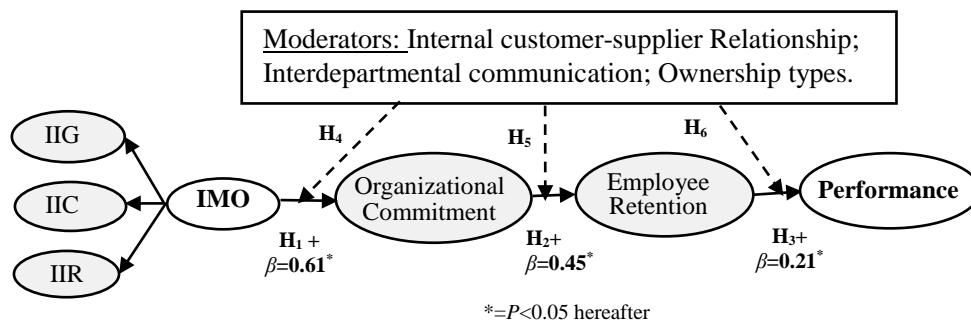
## **1. Introduction**

Internal market orientation (IMO) is increasingly proposed as a means of facilitating employer-employee exchanges. Past research examines the direct relation between IMO, employee satisfaction and customer satisfaction (Lings&Greenley, 2005), and other outcomes. Yet existing works fail to investigate IMO's impact on a firm's overall financial performance, overlooking the potential of IMO as an effective employee management tool. Despite its influence on employee satisfaction, none of the previous work has examined IMO's impact on employee commitment, ignoring the pressing matter that commitment is often a more important indicator of employee retention than satisfaction (Finlay, Martin, Roman&Blum, 1995). Whilst organizational research has become more international, our study extends current knowledge to assess whether IMO – a western initiated organizational theory can be applied in countries that are culturally distinct from the west (Farh, Hackett&Liang, 2007). The findings from this paper are that: 1) this study proves that IMO leads to higher employee commitment, better retention and finally improved firm performance in a casual chain. Firms adopting IMO can perform better in market competition via changed employee attitudes and behavior; 2) this paper highlights the moderating effect of internal customer-supplier relationships (ICSR) and interdepartmental communication (IDC), which interact with the causal chain in various ways. We propose that firms with well-identified customer-supplier systems perform better in terms of employee retention and market performance. Additionally, firms that have better IDC can actually turn high employee retention rates into high market performance. Finally, this study empirically supports the role of IMO in managing Chinese employees. Findings reveal that the IMO's effectiveness on the posited causal chain varies among firms of different ownership types. This study provides managers from different types of firm in China with a new angle to boost their financial performance by inspecting their internal market situation as well as improving it via understanding internal customers.

## **2. Theory and Hypothesis Development**

Echoing the existence of internal exchange relations, internal marketing is proposed to facilitate these relations by using marketing-like ideas to satisfy internal customers/ employees' needs and wants (Lings&Greenley, 2005). Companies with a stronger orientation towards the internal market are effective in their competitive position in the external market (Flipo, 1986). IMO developed from the market orientation dimensions identified by Jowarski and Kohli (1993) involves internal market information generation (IIG) and communication (IIC) and responsiveness to the identified information (RII) (Lings&Greenley, 2005; Gounaris, 2006). Current research has demonstrated many consequences linked to the application of IMO mostly at the employee level. As a means of changing employee attitudes and behavior, IMO constitutes a core firm competency not only in terms of creating a potential competitive advantage but also increased market share or profits. This is particularly important for companies seeking alternative growth paths to be more competitive. Drawing on literature on employee management, workers in transitional societies have different expectations of relationships with firms. It is particularly true for those Chinese workers who have different attitudes towards traditional values (Hui, Lee&Rousseau, 2004). Chinese employees are more likely to be influenced by their interpersonal relationship within the firm rather than their relationship with the firm itself (Chen&Francesco, 2000) compared with their western counterparts. The conceptual framework below is developed to examine the IMO practice in China (see Figure 1).

Figure 1: Conceptual Framework



## 2.1 The Hypothesized Causal Chain

Employee commitment can be described as an employee's involvement in, identification with, and attachment to their firm (Bansal, Mendelson & Sharma, 2001). Past research proposes that employees' commitment can be influenced significantly by internal marketing (Lings & Greenley, 2005). Substantial empirical research has demonstrated that employees who are committed to a firm are less likely to leave (Mathieu & Zajac, 1990). Employee commitment has been argued as a path to increase employee retention and performance. Firms that fail to retain high performing staff will reduce their ability to remain competitive (Rappaport, Bancroft & Okum, 2003). Losing critical employees may therefore come at a significant cost. There is a significant economic impact on the firm from losing any of its critical employees. Excessive employee turnover may jeopardize efforts to attain the firm's objectives and consequently the firm's expected financial performance (Whitt, 2006). In line with the discussion, we hypothesize that:

H1: The higher the level of IMO in a firm, the more committed the employees are to their firm.

H2: The higher the level of a firm's employee retention, the better the firm's performance.

H3: A high level of employee retention will have a direct positive impact on the firm's performance.

## 2.2 Moderation Hypotheses

### 2.2.1 Internal customer - supplier relation and interdepartmental communication

An internal customer can be anyone in a firm who is supplied with products and services by others (Gremier, Bitner & Evans, 1995), or a functional department which is served by another department (Wilson, 1995). Research finds that the final outcome of customer satisfaction and loyalty relies greatly on the smooth flow of internal service delivery which enables employees to be satisfied and committed (Heskett et al., 1994). The market success also depends on how well and effectively functional departments collaborate and cooperate (Dibb & Simkin, 2000). Based on the idea of reducing internal barriers, smoothing out the implementation of management strategies and achieving a firm's objectives, we propose that:

H4: The relationship between (a) IMO and employee commitment; (b) employee commitment and employee retention; (c) employee retention and firm performance will be moderated by the level of ICSR such that the positive relationship will be stronger when the ICSR is better.

Interdepartmental communication refers to ways by which departments in the firm transfer information. Employees need information to be able to perform their tasks as service providers to internal and external customers (Conduit & Movando, 2001). Effective IDC helps

improve the relation between different functional departments so as to achieve the overall objectives of the firm. The internal integration among departments is positively related to financial performance and market share, acting on the premise that frequent exchange of information reduces misconceptions and misunderstandings. When effective interdepartmental communications are available, there is greater opportunity for departments to coordinate and integrate their resources to achieve overall objectives (Lings, 2004).

Therefore, we posit that:

H5: The relationship between (a) IMO and employee commitment; (b) employee commitment and employee retention; (c) employee retention and firm performance will be moderated by IDC such that the positive relationship will be stronger when the IDC is better.

### *2.2.2 Ownership types in China*

Since China's reform in the late 1970s diverse ownership types of firms have emerged. With the development of the economy and further transitions, two new types of ownership (i.e. privately-owned enterprises and foreign-invested enterprises) have emerged in addition to the original two types of firms (i.e. state-owned enterprises and collectively-owned enterprises). Each ownership type enterprise has its strengths and weaknesses relating to capital, human resources, organizational structure and institutional issues. For example, State-invested enterprises (SIEs) are greatly constrained by the industry and are rigid because of bearing workforce burden left by previous firms, which leads to limited success in terms of performance (Sun & Tong, 2003). Privately-owned Enterprises (POEs) in China represent the opposite group of firms which are usually small and nimble, and not as adequate investment in R&D as SIEs. POEs usually adopt a simple, flexible structure but with aggressive strategies to react quickly and proactively to market opportunities. Foreign-invested Enterprises (FIEs) in China enjoy better performance in general due to their existing experience (Peng et al., 2004). However, FIEs are facing significant challenges in recruiting and retaining skilled workers (Jackson&Bak, 1998). Based on these arguments, we, therefore, posit that:

H6: The typology of ownership in China has a moderating effect between (a) IMO and employee commitment; (b) employee commitment on employee retention; (c) employee retention and firm performance.

## **3. Methods**

### *3.1 Samples and procedure*

The study was carried out by survey. The fieldwork was undertaken after a pilot study. 275 usable questionnaires were collected in China. The overall response rate (42.3%) reaches a satisfactory response rate (Saunders, Lewis & Thornhill, 2009). In this study, each firm included three participants. A middle manager was required to complete the first part of the survey on IMO, the level of ICSR and IDC within the firm. A human resource manager was asked to complete the second part to give their overall opinions on employee commitment, retention and the company profile. A financial/marketing manager was asked to complete the third part to indicate firm's financial performance.

### *3.2 Measures*

Building upon the previous empirical research, IMO in this study refers to a higher-order construct of three sub-dimensions with multiple items (Lings & Greenley, 2005; Gounaris, 2006). Employee commitment was measured by seven items taken from Jaworski and Kohli (1993). Employee retention was measured by three items from Lings and Greenley (2005),

and firm performance was measured by three items (i.e. sales growth, market share growth and profitability) using measurement items taken from Govindarajan and Gupta (1985). To measure the moderation variables, ICSR was measured by scales modified from Conduit and Movando (2001). IDC was measured by items adapted from Gounaris (2006).

## **4. Results**

### *4.1 Reliability and Validity*

We tested the data for reliability and validity using LISREL 8.72 measuring the seven constructs. In every case, the Cronbach's alpha coefficient was greater than 0.76, indicating acceptable internal consistency (Nunnally, 1978). CFA was used to assess the correspondence of all items with their respective latent variables. The resulting indices demonstrate a good model fit. Convergent and discriminant validities were also tested for the three antecedent constructs (i.e., IMO, employee commitment, and employee retention). The items and scales exhibited acceptable levels of reliability and validity.

### *4.2 Hypotheses testing*

The overall fit of the proposed model ( $\chi^2 / \text{d.f.} = 207.083 / 180$ , CFI=0.994, GFI=0.933 and RMSEA=0.023) is acceptable using SEM. This supports the assumption that internal information generation, internal information communication and internal information responsiveness all contribute to the measurement of IMO. Figure 1 indicates that each path in the proposed causal chain is positively related. H1, H2 and H3 are supported.

### *4.3 Test of Moderating Effects*

To check the moderating effect of ICSR, we ran the main model separately for each subgroup (i.e. low or high). The results show that ICSR has no moderating effect on the IMO - commitment path. A chi-square difference test was conducted to test the statistical significance of this moderating effect ( $\Delta\chi^2=0.05$  with  $\Delta\text{d.f.} = 1$  is insignificant at the .05 level). However, the results show that ICSR has a positive moderating effect on the commitment - retention and retention - performance paths. The chi-square difference is significant with  $\Delta\chi^2=5.82$  and  $\Delta\chi^2=5.04$ ,  $p<0.05$  respectively. The results also show that IDC has no moderating effect on the IMO - commitment and commitment - retention paths. The chi-square difference is insignificant at the .05 level ( $\Delta\chi^2=1.310$  and  $\Delta\chi^2=2.865$ ). However, the results show a positive moderating effect of the IDC on the retention - performance path. The chi-square difference ( $\Delta\chi^2=5.26$ ,  $p<0.05$ ) between high and low groups is significant. Multi-group SEM was used to test the moderating roles of ownership types. A categorical split along the values of the moderator variable Type I (SIEs), Type II (POEs) and Type III (FIEs) to create three subsamples was performed. We constrained one path to be invariant across the three categories and then freely estimated this path. The multi-group comparison showed that the IMO-commitment path was variant for type III firms when compared to the type I firms and type II firms. The path coefficient of type III firms ( $\gamma=0.748^*$ ) was significantly larger than type I firms and type II firms ( $\gamma=0.68^*$  and  $0.49^*$ ). For the commitment-retention path, the path coefficient of type III firms ( $\gamma=0.59^*$ ) was significantly larger than for type I firms ( $\gamma=0.24^*$ ). Only type II firms was significant and variant on the retention-performance path.

## **5. Discussion**

The study confirms that the hypothesized indirect impacts of IMO on firm performance. The findings enrich our understanding of IMO as a novel managerial tool to change

employees' attitudes and behavior beyond traditional HR practices. We empirically prove the effectiveness of IMO for employee commitment and retention. This study also extends the literature in China by revealing the positive causality of IMO on employee and firm outcomes. Companies with a higher level of IMO are rewarded with highly committed employees and better market performance. The results also demonstrate the critical moderating effect of ICSR on the proposed causal chain. When there is an identified ICSR within a firm, employees turn their commitment into behavior which can be reflected in market performance. The result also shows IDC has a moderating effect on the retention - performance path. Communications between internal customers and suppliers on expectations, providing feedback, offering help and being aware of potential problems in a firm link positively to both internal and external performance (Reynoso&Moore, 1995).

The current result shows that the impact of IMO differs among different ownership types. The paths in the conceptual model are all significantly positive for POEs, which suggests IMO is specifically important and beneficial for POEs in China. It is understandable that POEs face more challenges in terms of recruiting and retaining skilled employees in the competitive Chinese labor market (Zhu,Cooper,Fan&Cieri, 2004). The result exhibits that increasing the IMO level can have more impact on employee commitment in both SIEs and FIEs than in POEs. The result also shows the FIEs enjoy the highest causality between commitment and retention whilst the SIEs appear to show the lowest. The findings indicate that employees staying with SIEs are not necessarily committed. Although SIEs may have more advantages in policies, industrial experience and good government relationships, they may still have to carry out traditional planned economy social responsibilities, such as keeping employees who do not perform well. A high rate of employee retention for those SIEs in China does not necessarily lead to better performance (Xu,Pan, Wu&Yim, 2005). The only significant relation between retention and performance is among POEs. FIEs normally represent advanced management styles and their approach tend to have better designed working process, established internal systems, technological advanced online office systems etc. The company performance relies more on the development and perfection of the systems, rather than on individuals (Wang,Bruning&Peng, 2007). There is no clear indication that the foreign-invested companies perform better than Chinese firms. This suggests that those performing better than any other type of firms may have better IMO practices.

## **6. Conclusion**

In conclusion, this is the first study demonstrating the effectiveness of IMO as an employee management tool to predict employee commitment, employee retention and firm performance. This research contributes to theory by empirically examining the causal relations between these constructs from an internal market perspective. It also contributes in practice by providing managers and scholars with findings about IMO's contribution to firm performance in terms of profitability, market and sale growth. It is particularly useful for companies competing in the Chinese market and other emerging economies. However, the research needs to be investigated beyond China for its generalization. Further research may also investigate other firm factors which may lead to different outcomes. As the data are collected at one period of time, there could be a delayed effect of IMO on the performance. A longitudinal study is recommended for future research. Additionally, the answers relating to firm performance are subjective. Future research may seek ways to obtain objective data.

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