

**Antecedents of the Offshoring Governance Mode and the
Sustainability of Offshore Outsourcing Relationships**

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Abstract

Offshoring concerns the relocation of white-collar business processes from one country to another. Research about the business- and economic rationales of this strategy is abundant; yet we cannot sufficiently explain offshoring governance decisions and their consequences. This dissertation elaborates on the antecedents of the mode of governance in offshoring, *i.e.*, it addresses the question whether offshoring is performed “in-house” with a captive entity, or with the support of a third-party service provider. Building on the insights into this “make-or-buy” decision, this dissertation further tackles the nature of client-service provider relationships. The literature suggests that in external service relationships (such as, for instance, auditing), the dissolution of contracts is a rare event (Levinthal & Fichman, 1988). I assume that offshoring relationships are similar in this regard. In order to facilitate the longevity of the relationships, mechanisms that aim at reducing potential agency costs need to be put in place. I will provide an empirical explanation for the sustainability of relationships between clients and service providers in offshoring.

Referring to the market entry mode literature, both transactional theories and the capabilities perspective provide fertile ground for an explanation of decision-making in offshoring. In the context of client-service provider relationships, I further find empirical support of hypotheses derived from agency theory. Research was conducted by applying two surveys. The first survey was launched among companies who are active in offshoring as a client. The second survey addresses providers delivering services in the offshore locations. Both surveys were launched on a global scale, with a particular focus on the US and Europe, on the one hand, and the most popular offshoring locations, on the other hand. Findings from this dissertation contribute to the theoretical understanding of the emerging offshoring practice. In particular, they show that initial governance mode decisions are primarily influenced by the characteristics of the functions offshored, by cultural distance, by isomorphic imitation, as well as firm-specific capabilities. Subsequent governance mode decisions are determined by path-dependent characteristics. Finally, the findings also contribute to recent research on the governance of offshore outsourcing relationships.

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List of Abbreviations

<i>ASM</i>	Alternative Service Model
<i>BPO</i>	Business Process Offshoring
<i>CBV</i>	Capability-Based View of the Firm
<i>CC</i>	Call Center
<i>DC</i>	Dynamic Capabilities
<i>GDW</i>	Globally Distributed Work
<i>FDI</i>	Foreign Direct Investments
<i>GOM</i>	Global Operating Model
<i>HQ</i>	Headquarters
<i>HR</i>	Human Resources
<i>IT</i>	Information Technology
<i>JV</i>	Joint Venture
<i>M&S</i>	Marketing and Sales
<i>MNC</i>	Multinational Corporation
<i>MSM</i>	Managed Service Model
<i>OLI</i>	Ownership-, Locations-, and Internationalization (Advantages)
<i>ORN</i>	Offshoring Research Network at Duke University in Durham, NC
<i>PD</i>	Product Development
<i>Proc</i>	Procurement
<i>R&D</i>	Research and Development
<i>RBV</i>	Resource-Based View of the Firm
<i>SCC</i>	Shared Service Center
<i>SCE</i>	Strategic Center of Excellence
<i>SCP</i>	Structure-Conduct-Performance
<i>TCE</i>	Transaction Cost Economics
<i>VRIN</i>	Valuable, Rare, Non-Imitable, Non-Substitutable

1. Introduction

“It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy...What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage.”

[Adam Smith, 1776, The Wealth of Nations]

This wise maxim, provided by the founding father of modern economic theory, was probably one of the first attempts to contradict the prevailing mercantilist point of view on international trade, which had focused on an almost dogmatic protectionism since the 16th century. On the one hand, Smith hints at comparative advantages, meaning that a country should focus on the production of goods whose opportunity costs are comparatively lower vis-à-vis the production costs of the same good abroad¹. On the other hand, he illustrates the interchangeable link between the broad theories of comparative advantages on the macro level to the make-or-buy decision on the individual level. The decision as to whether something should be produced in-house or bought from a third party is thus a question that has occupied economists for centuries. Since the 90s, however, a phenomenon with regard to one production factor, labor, has been gaining much momentum and affecting this discussion. A dramatic decrease in telecommunication costs, further reductions of national trade barriers, decreases in mobility costs, as well as increased education in emerging countries have given firms the opportunity to access work globally, wherever the quality and costs are most appropriate. The essence of offshoring, as it is discussed in modern research, is dealing with the prospects of these shifts in the business environment. In comparison to traditional internationalization questions, offshoring does not look at activities of the primary value chain. Production locations abroad, foreign sales offices or branches are therefore not considered. In focus are support activities that are used as inputs for the companies' primary activities at home.

¹ The theory of comparative advantages was developed and formalized later by David Ricardo. The classic reference, *the Principles of Political Economy and Taxation*, was first published in 1817.

1.1 Setting the Stage

Although the underlying phenomenon as well as the decision whether to make or to buy goods from abroad was described by Adam Smith as early as two centuries ago, Nobel laureate Paul A. Samuelson states that offshoring “is a hot issue now, and in the coming decade, it will not go away” (2004). From the literature we know that lower labor costs are a dominant driver for offshoring (Farrell, 2005; Levy, 2005; Lewin & Couto, 2007; Lewin & Peeters, 2006). However, if offshoring were to be limited to lower labor costs, the strategic management literature suggests that benefits from cost savings would be just a short-term phenomenon. Because competitors can easily replicate the strategy, it is difficult to achieve competitive advantages that are sustainable. An individual company is then not able to skim off any rents. So why should Samuelson have a point in arguing that offshoring remains topical in the field?

Companies are increasingly selecting offshoring for accessing (knowledge) resources, improving service quality, increasing flexibility and for many other reasons (Lewin & Peeters, 2006). Putting offshoring success on a par with cost savings would not capture the full picture of this strategy. Offshoring must be acknowledged as a strategy that is bound neither to a particular skill-level of labor, nor to a geographic region. Looking at Porter’s value chain (1985), all support functions that do not require any physical personal interactions may be relocated to their respective most efficient location. Recent developments underline this statement, and functions of human resource management, finance, accounting, engineering, product development, as well as supply chain management are increasingly subject to relocation (Robinson, Kalakota, & Sharma, 2005). Tasks are more complex, less standardized, and frequently require substantial operational interaction with other subsidiaries. If one assumes that this high-skilled labor is performing complex tasks that may be a source of innovation, sustainable competitive advantages can be achieved with offshoring. Successful companies are able to identify and mobilize critical knowledge, technology, market intelligence and capabilities scattered around the world. Furthermore, offshoring is a means to focus on core competencies and allows interacting with specialized partners abroad. This bears the potential to improve internal processes, which may finally result in an increased competitiveness of the products.

The offshoring discussion can also be conducted politically, as was clear when the chairman of the Council of Economic Advisers of the White House, Gregory Mankiw, was heavily criticized for saying that moving jobs abroad is beneficial for the domestic economy (Mankiw & Swagel, 2006). Although Mankiw finds theoretical support for his argument and from an economic perspective, focusing on core competencies should increase the overall welfare (*c.f.* Blinder, 2006), there are always individuals directly incurring disadvantages through labor dislocations (Farrell, 2004). This aspect is very interesting, though the dissertation will not elaborate on these political-economic issues. It will also not discuss differences in gains for different countries, but focus on implications for international business and strategy on a firm-level perspective.

With the existing body of literature on offshoring, which is complemented by the work of a number of consulting companies, we know a great deal about the advantages and risks of offshoring (Deloitte, 2005; Farrell, 2005; Lowes, Celner, & Gentle, 2004). While the antecedents on the macro-level are well represented in the literature, the business-level perspective provides ample room for further research. Of particular interest is the mode of governance in offshoring. A company deciding to pursue offshoring has two options in doing so. On the one hand, it is possible to outsource the activity and buy it from a third party service provider in a foreign country. This could, for instance, be General Motors offshoring IT tasks to the Indian company Wipro, or Procter & Gamble offshoring finance and accounting work to a subsidiary of the US company Hewlett Packard in India. On the other hand, it is possible to mandate one's own captive entity with the respective tasks. McKinsey has, for instance, pursued this strategy by building up a research center in Madras, India. In-between solutions with hybrid combinations of both modes exist as well, albeit rarely. (For simplicity reasons they are not discussed at this point.) In any case, offshoring implies that a task is transferred from the headquarters to a center abroad, or a task that is produced in each subsidiary is centralized in such a unit. With an additional unit interacting with the headquarters and the subsidiaries scattered around the world, this strategy poses a great challenge to the management.

The circumstances or the reasons for selecting a certain governance mode in offshoring have not yet been investigated in the literature. Thus, we do not know whether the decision is dependent on the functions offshored, the drivers or risks involved, or whether the headquarters or offshoring locations determine the decision. We do not know whether the management is just looking beyond firm boundaries and

is copying competitors' strategies, or whether the management is drawing on firm internal experience. As Manning, Massini, & Lewin (2008) point out, the offshoring strategy is predominantly bottom-up driven. Consequently, finding a "one-size-fits-all" pattern for the governance mode decision would not correspond to my expectations. More likely, the decision is based on a combination of the issues raised above, thus depending on both task- and firm-specific characteristics, the maturity of the offshoring activities, as well as their path-dependent behavior.

In particular, when offshoring to a third party service provider, the strategy implies a potential loss of managerial control. On the one hand, shifting tasks outside the firm boundaries creates interfaces that potentially cause friction. On the other hand, the relocation may jeopardize tacit knowledge, which could be appropriated by the service provider. Companies need to be aware of this fact and establish mechanisms in order to ensure the agreed service levels and prevent knowledge leaking. In research, finding a universal measure for the service levels and consequently for offshoring success is, however, difficult. The figure would need to reflect different levels and it would be very difficult to define it in a generalized manner. While acknowledging the general problem of capturing offshoring success, I build on the assumption that terminations of service provider contracts are rare events. While I do not claim that the continuity of offshoring relationships is a direct success criterion, I suggest that the discontinuation of contracts follows an escalation process. If at some point targets are not met, this does not necessarily imply a termination of a contract. Rather, dissatisfaction has to appear on a broad basis and reach certain levels in order to cause consequences. Alternatively, it is possible that contracts are terminated for non-financial reasons. Relationships may be broken up because key managers leave the firm or because services are brought back to the headquarters for some reason. The core transactional literature (*c.f.* Williamson, 1985) supports my suggestions, however, with some limitations. It argues that if the switching costs of contracts are lower than the opportunity costs, it is efficient to change a transaction partner. In addition, the literature suggests considering searching costs for alternative partners (Dyer, 1998). However, I suggest that companies are actively seeking the continuation of offshoring contracts. This behavior follows the argument of trust or other relational aspects (Chiles & McMackin, 1996). Companies are likely to employ mechanisms in order to align interests and to exert control in order to prolong offshoring relationships.

Following the introductory thoughts, I identify two overarching research questions: Firstly, what are the determining factors for the governance mode decision in offshoring? Secondly, what are the reasons for the continuation of offshoring contracts between clients and service providers? The two questions are addressed by shedding light on offshoring from two perspectives. On the one hand, from a client perspective, *i.e.*, companies offshoring business processes. On the other hand, from a provider perspective, *i.e.*, companies delivering services offshore. The methodology applied in this dissertation is a quantitative approach based on two large-sample surveys. The first survey, the “corporate survey”, is part of a comprehensive research project of the Offshoring Research Network of the Center for International Business Education and Research (CIBER) at Duke University. The survey was initially launched in the US in 2004. For the third wave in 2006, several research partners joined and data from the UK, Germany, the Netherlands, and Spain was gathered in addition to the US data. The online survey was returned by 486 companies. Since the survey was filled out individually for each offshoring implementation, the overall sample size includes 1381 observations. The service provider survey was launched among service providers only (and not among the captive center as well) for two reasons: On the one hand, the aim was to avoid overstraining the companies and confronting them with two surveys of this scope. On the other hand, third party service providers are more challenging to manage with regard to potential agency costs. In particular, the problem of knowledge protection and managerial control is more distinct in this sort of relationship. Launched in 2007 on a global scale, the online survey was returned by 125 companies providing information on 251 observations of services delivered.

After an in-depth discussion of the terminology of offshoring, I will provide an overview of the theoretical contributions, followed by the structural outline of the dissertation.

1.2 Offshoring and Globally Distributed Work

1.2.1 The Geographic Dimension

Due to its relatedness to outsourcing, the term offshoring causes much confusion. Looking at outsourcing, Bhagwati, Panagariya, & Srinivasan (2004) argue that the term has changed its meaning over time. In the early 1980s it referred to “situations when firms expanded their purchases of manufactured physical inputs...from outside the firm rather than making them inside” (2004: 93). These

inputs could be part of the final product or the final product itself. In the new millennium, the authors however argue that outsourcing has become a specific segment of international trade in services. The determining factor is that the trade is at “arm’s length” (*ibid.*), meaning that services are purchased from abroad, principally, but not necessarily, via electronic media. Blinder’s (2005) position is slightly opposite and he argues that outsourcing is a domestic phenomenon, “which has nothing to do with either international trade or globalization” (*ibid.*: 2). Mankiw & Swagel (2006) take a third path by using the term “offshore outsourcing”, referring to all company-internal activities that are relocated abroad and transferred to an outside provider. Finally, Hill (2007) stresses that relocation of resources only takes place in order to serve firm activities at home.

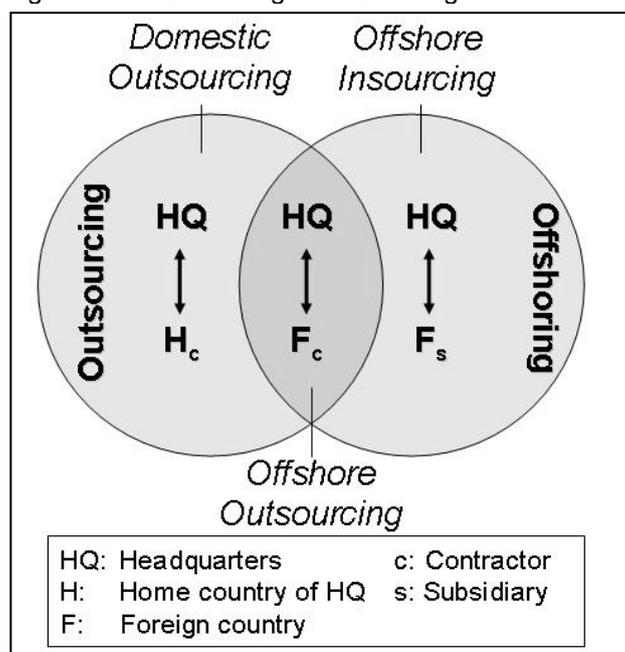
Looking at the most important journals in international economics and business, it appears that economics has not (yet) adopted the term offshoring. The *Journal of International Economics*, the *American Economic Review*, and the *Journal of Economics* have not published any articles including this term so far. Only the term outsourcing could be found in these journals. This is different in business research, and both terms are gaining a fixed status in journals like the *Journal of International Business Studies*, *International Business Review*, and the *Strategic Management Journal*. In highly applied journals like the *McKinsey Quarterly* and the *Academy of Management Perspectives*, offshoring is experiencing a large growth in popularity.

Figure 1.1 illustrates the term offshoring as it is used in this dissertation. With regard to outsourcing, I use the term to describe the transfer of a part of the company’s value chain to a third party. The crucial determinant is the involvement of a contractor, no matter whether located in the home country or abroad. In offshoring, the crucial determinant is no longer the contractor involved, but the geographic location. In this sense, offshoring can be understood as the international relocation of a process of the value chain in order to serve the home market. This can, but does not need to, be conducted with the support of a contractor, *i.e.*, a third party. Let us illustrate the relationships with a few examples:

Domestic outsourcing is very widespread and includes the example of a local bakery outsourcing its accounting work to a local trustee or a large bank outsourcing CV screenings to a local HR company. It is also possible that the client provides the workforce, and jobs are transferred from one company to another (London, 2003). As a precondition, the process relocation always takes place in the same country. *Offshore outsourcing* is basically the same, but the relocation takes place across

borders. This includes, for instance, General Motors offshoring a large chunk of its Information Technologies to the Indian company Wipro. Alternatively, Procter & Gamble offshores finance and accounting work to India by involving offshore entities of the US company Hewlett Packard. Finally, *offshore insourcing* is performed by the consulting company McKinsey, which established a research center in Madras, India.

Figure 1.1: Outsourcing vs. Offshoring



Source: Own figure

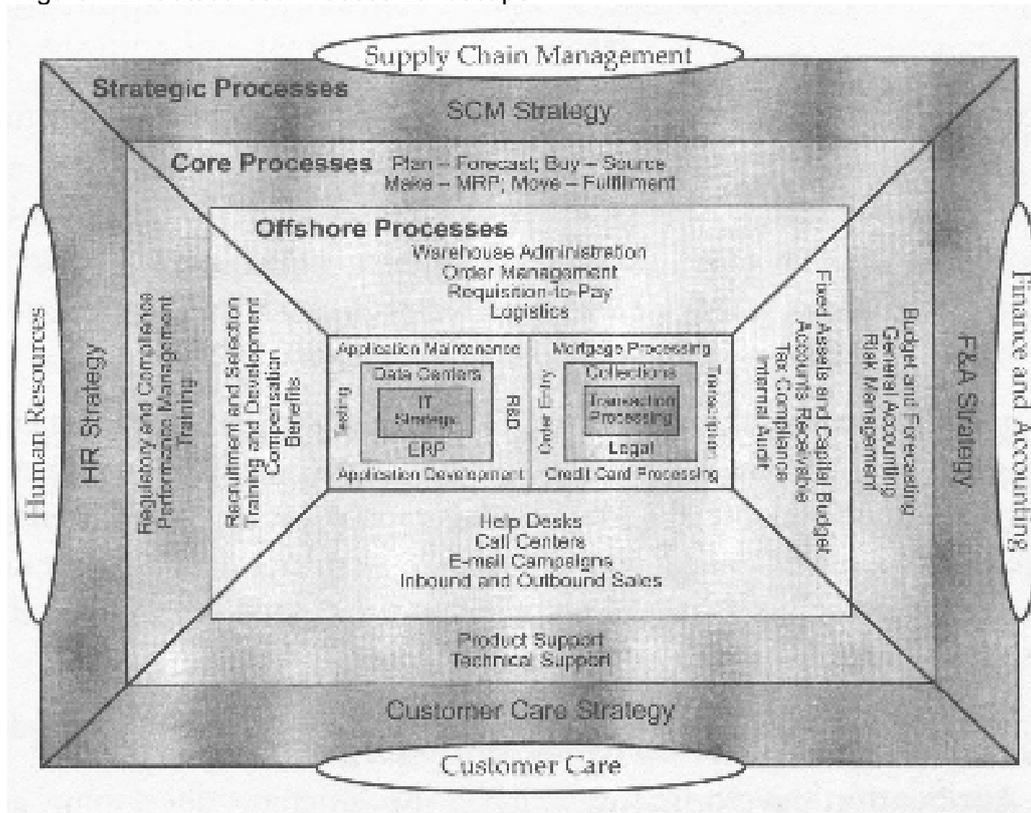
The term offshore insourcing is used interchangeably with the term captive offshoring. It is also possible that the governance mode will change over time, as is implied for instance in the “build-operate-transfer” (BOT) method. BOT refers to the contracting of a third party abroad, with the task of building up an offshore center. Once the center is established and the processes are running successfully, the ownership is transferred to the client and the unit becomes a captive center. Strictly speaking, offshoring needs to be further divided into near-shoring and far-shoring (Robinson *et al.*, 2005), depending on how far apart the host and the target countries are from each other. The Forrester Research Company suggests that offshoring is used for relocations to countries that are more than 500 miles away from the home country (Parker, 2004). Although this proposition seems arbitrary, the idea of having a limitation in distance is reasonable. For a European company, near-shoring is likely to refer to East-European countries and far-shoring to countries like India, China, or the US. A US company looking for a near-shore strategy would probably seek to have an offshore partner in Canada, Mexico or Costa Rica. In the case of far-shoring, Europe, India, or China are potential destinations. From this perspective, offshoring is

a relative term of which every country has a different understanding. It is thus possible that the term offshoring will give way to more flexible terms such as globally distributed work (GDW) in the future. GDW addresses the management of work distributed geographically across nations, economies, and cultures, and it includes both near and far-shoring. In addition, it accentuates the focus on the production factor labor.

1.2.2 The Functional Dimension

Having defined offshoring along the geographical dimension, I will now shed light on the functional dimension. In the early stages of offshoring, in the 70s until the 90s, the focus was primarily on relocating manufacturing to cheap locations like Mexico, Puerto Rico, South Korea, Malaysia, China, or Taiwan. The primary activities of the value chain were subject to offshoring, and inputs for the final goods at different manufacturing stages were bought from wholly owned *offshore manufacturing centers* or from partnered companies. As Bhagwati *et al.* (2004) argue, the meanings of outsourcing and offshoring have changed over time and today's offshoring strategies have shifted. The focus today is on the support activities of the value chain. *Offshore service centers* produce services supporting the production process, but they never produce the final product or components thereof. Figure 1.2 is an overview by Robinson, Kalakota, & Sharma (2005) showing functions that can be offshored. The probability that a function will become subject to relocation decreases from the inside towards the outside. This means that IT and transaction processing are more likely to be located outside the headquarters, compared to core processes or strategic decision-making functions. Normally, the functions in the centers are associated with lower risks and controlling is much easier. *Supply chain management* as well as *finance and accounting* are functions with low visibility for customers and therefore accounting, auditing, tax, and financial reporting are gaining increased attention. Human resources (HR), including compensation services, benefits management, employee relations, as well as workforce management, are different and require substantial interactions with the workforce across the whole company. The same goes for *Customer Care*, which may include marketing, sales, (technical) support, as well as customer analytics. Since these functions are very visible to customers, offshoring holds different risks. The number of companies that have had to backslash because they have experienced a lack of customer acceptance is particularly an issue in these cases (*ibid.*).

Figure 1.2: Outsourced Process Landscape



Source: Robinson, Kalakota, & Sharma (2005)

Finance and accounting, as well as HR are also considered core back-office business process offshoring (BPO) functions. BPO is considered core, because it best reflects the idea of offshoring. It contains the transmission of processes along with associated operational activities. Back-office BPO opposes front-office BPO functions that include customer contacts (customer interaction services or call centers), information technology offshoring (ITO), as well as high-end knowledge-based services. In both surveys underlying the dissertation, we are using six different offshoring functions: administrative functions, call centers, information technology, marketing and sales, product development, as well as procurement. Administrative functions include the traditional BPO functions of finance and accounting, as well as human resources support functions. Another clustered group is product development, including engineering, product design, as well as research and development. The common offshoring functions are displayed in figure 1.3.

In conclusion, my focus lies exclusively on offshoring in the sense of relocating support functions of the value chain to foreign countries with the purpose of serving the firm's activities at home. All six functions of figure 1.3 are considered. I understand offshoring as taking place with the support of a third party, called

“offshore outsourcing”, or it is performed “in-house”, which is also referred to as “captive offshoring”. The umbrella term “offshoring” covers both cases.

Figure 1.3: Offshoring Functions

Administrative Functions	Call Centers	ITO
<ul style="list-style-type: none"> • Accounts payable/receivable • Cash management • Payment processing • Regulatory compliance check • Credit card operations • Equity analysis • Financial planning • Benefits administration • Payroll processing • Workforce deployment • Recruitment and staffing support 	<ul style="list-style-type: none"> • Call center • Technical help desk services • Web-based/email-based customer support 	<ul style="list-style-type: none"> • Data entry and conversion • Data networks • Desktop systems support • Security control • Server farm management • Systems integration • Testing • Internet/intranet and web hosting • (used to be: many functions around year 2000 transition)
	Product Development	
Marketing & Sales <ul style="list-style-type: none"> • Data mining • Graphic design • Industry & company analysis • Market analysis • Order entry • Power-point presentations • Customer surveys 	<ul style="list-style-type: none"> • Engineering analysis • Design automation • CAD drawing • Quality assuring • Drafting & modeling • Re-engineering • Simulating • Engineering support • Tool design & manufacture • Code development • Research on new materials • Development of new technologies • Application development • Prototype design • Systems design • Software application development and maintenance • Software architecture and design • Database design and development 	Procurement <ul style="list-style-type: none"> • Buying support • Category management • Compliance reporting • Contract implementation • E-business solution • Local sourcing • Purchase order processing • Spend analytics • Strategic sourcing • Supplier services

Source: Own figure

1.2.3 Drivers to Offshore

As the previous chapter has shown, locating business processes abroad may raise concerns on the national level on the one hand. On the other hand, it is a strategy to increase shareholder value on the firm level. Shareholder value is generated primarily through cost savings and access to knowledge resources around the world. The importance of the cost saving drivers is undisputed in the literature and is constantly replicated in surveys (Deloitte, 2005; Farrell, 2005; Lewin & Couto, 2007). Cost savings are not only with regard to labor costs, but they also include other cost savings such as lower infrastructure costs. Over time, the initial attempt to lower costs are soon accompanied by other drivers such as access to qualified personnel (Lewin & Couto, 2007). In the early stages of IT, the emerging computerization caused knowledge gaps in the companies (Abramowsky & Griffith, 2006), which believed that they could fill those gaps with offshore employees. Accessing talented individuals was also an issue in connection to the Y2K (year 2000) problem. Firms lacked the capacity to implement the technical changes and

found the necessary workforce in offshoring locations such as India or China. Subsequently, the need to access qualified personnel has spilled over to other functions. Cutbacks in H1B visas have, for example, reduced the availability of engineers in the US (Lewin, Massini, & Peeters, 2007). Consequently, companies have been searching for talent by offshoring the respective functions abroad. Offshoring has thus increasingly developed to a balanced strategy, which aims at lowering costs and accessing talent. Academic discussion has adopted this phenomenon and its own literature stream on the “global race for talents” is emerging (Florida, 2005; Frymire, 2006; Hansen, 2006). The importance of cost savings and accessing talents is indeed striking, however, there are other drivers facilitating the strategy. Lewin & Couto (2007: 27) observe that “A high percentage of companies are using offshoring to improve the efficiency of business processes and accelerate speed to market, as part of their growth strategy”. Offshoring has thus a strong strategic component aiming at process improvement rather than mere cost savings.

1.3 Mapping the Theoretical Landscape

1.3.1 Offshoring in the Context of Strategic Management

The central matter spurring strategic management is the question of why some firms perform better than others and what managers can do about it. There have been many attempts to structure the underlying theories of the field (*c.f.* Makadok, 2004; Mintzberg, Ahlstrand, & Lampel, 2005), however, there is no consensus about a single differentiation. Makadok (2004) divides the theories of strategic management into four categories: Collusion-based mechanisms, competence-based mechanisms, flexibility-based mechanisms, and governance-based mechanisms. Collusion-based mechanisms draw upon the structure-conduct-performance (SCP) paradigm, which has its roots in the work of the industrial economists Mason (*c.f.* 1939) and Bain (*c.f.* 1956) and has been translated to strategic management by Porter (1979; 1985). It implies that the characteristics of an industry (*e.g.*, cost structure, differentiation, or concentration) influence the behavior of the companies (*e.g.*, price politics, R&D, marketing, *etc.*), which consequently affects performance (efficiency, price level, or output growth) (Bain, 1956). From this perspective, superior performance can be achieved by successful adaptations to changing environments. The underlying assumptions are rigid and assume that managers are completely rational and act in the best interest of the company, resources are entirely mobile, and all companies enjoy the same resource endowments (*ibid.*). Based on the same assumptions,

Porter (1979) shows that entry barriers, the threat of substitution, the bargaining power of buyers and suppliers, as well as rivalry among industry incumbents determine the inherent profit of a firm. It is thus the aim to impede these mechanisms in order to make profits.

Figure 1.4: Theories and Paradigms of Strategic Management

Theory Category	Collusion-Based Theories	Competence-Based Theories	Commitment-Timing-Based Theories		Governance-Based Theories
			Timing: Preemption	Timing: Flexibility	
Intellectual Heritage	Structure-conduct-performance, Prisoner's dilemma, Conjectural-variations models	Ricardo's theory of scarce productive resources, Demsetz's challenge on SCP	Von Stackelberg leader-follower model	Schumpeter's theory of creative destruction, Black-Scholes option valuation	Transaction Cost Economics, Agency theory, Property Rights/ Contract theory
Application for Strategic Management	Industry Analysis, Five Forces framework	Resource-based view, Competitive Advantage	First-mover advantages, Innovation	Evolutionary econ., Dynamic Capabilities, Real Options	Vertical Integration, Corporate governance
Mechanism	Artificially raise prices in product markets at the expense of customers, and/or lower prices in factor markets at the expense of suppliers.	Exploit competitive advantage to create superior economic value that weaker firms cannot fully compete away.	Irreversible commitment alters follower's choices, to benefit of leader.	Increase value of resource stocks & market positions through superior adaptation to change.	Efficient allocation of incentives and decision rights improves interest alignment, in order to ensure that decisions are more profit-maximizing.

Source: Makadok (2004)

In the early 90s, extensive criticism of the assumptions of the collusion-based theories arose. It was argued that firms should not be regarded as homogenous units, but heterogeneous with respect to the strategic resources and control. Further, it was argued that firms' resources are not perfectly mobile, and thus heterogeneity may remain over time (Barney, 1991). Under this new perspective, subsequently called the resource-based view of the firm (RBV), firms are able to accrue rents by owning scarce firm-specific resources. This is possible if the resources are valuable, *rare*, *in-imitable*, and *non-substitutable* (VRIN attributes). This approach allows viewing firms from an inside perspective and considers more complex processes. This complements the natural observation that some assets are simply not tradable, either because of their tacit nature or because firms are not willing to trade them. RBV has provided some very valuable inputs in describing the firm, and it has remained in the literature until today. However, researchers have experienced difficulties in testing RBV empirically (Silverman, 1999), and reality has shown that there is no immanent link between the successful acquisition of resources and the expected results (Teece, Pisano, & Shuen, 1997). A new approach not limiting the

perspective of firm resources on a static basis, but considering intertemporal relationships, became necessary.

The commitment-based theories in Makadok's (2004) framework address these issues by arguing that competitive advantages of firms lie with their managerial and organizational processes, shaped by its (specific) asset positions and the paths available to it. The pre-emption approach looks at the resources from an *ex-ante* perspective by highlighting innovation and first-mover advantages. The flexibility approach takes the *ex-post* perspective by focusing on the adaptability to changes. Hereby, the underlying question is "how and why certain firms build competitive advantages in regimes of rapid change" (Teece *et al.*, 1997: 509).

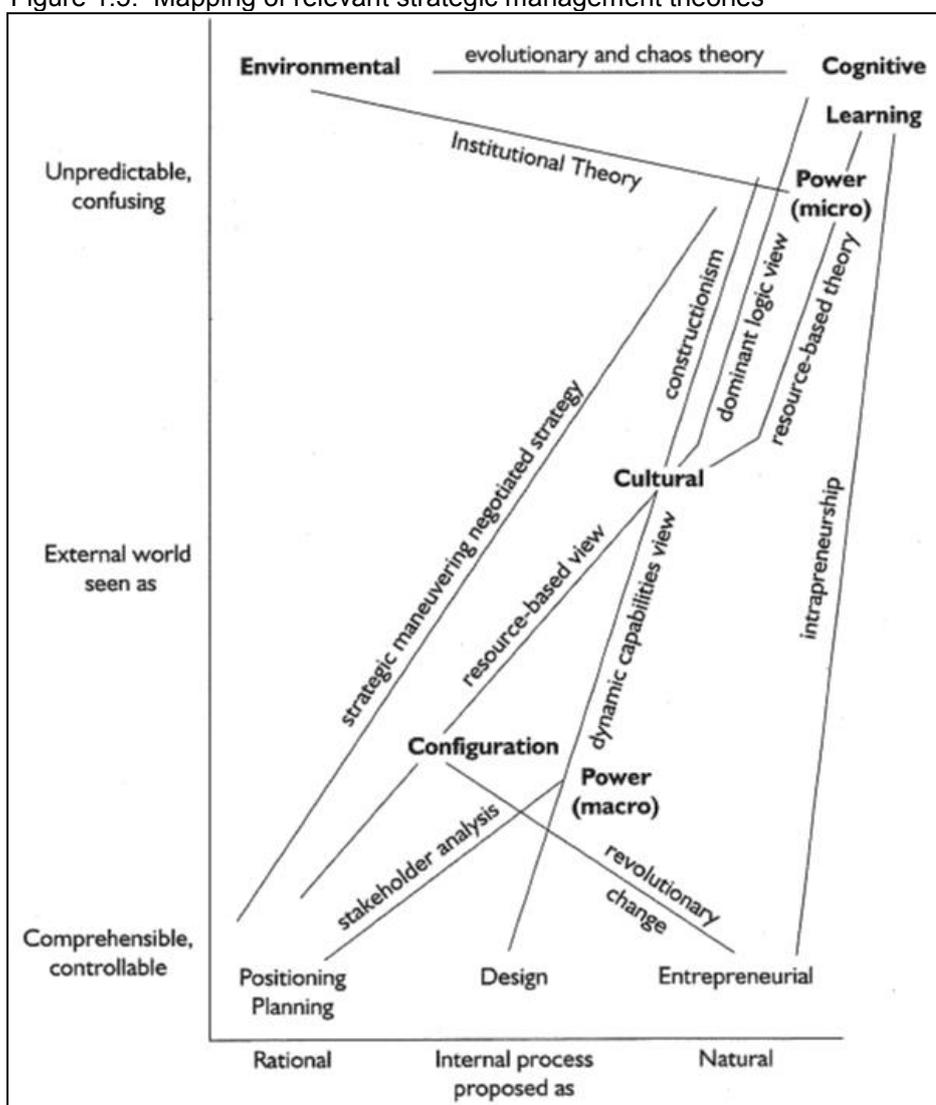
The final stream of theories embraces the governance-based theories. Like RBV, governance-based theories apply some fundamentally different assumptions as a response to collusion-based theories. In particular, it is assumed that individuals are, on the one hand, not entirely rational ("bounded rational"), and on the other hand, individuals tend to be opportunistic (Williamson, 1979). Within this stream of literature, agency theory regards the individual agent as the elementary unit of analysis and the firm as a nexus of contracts; and transaction cost economics (TCE) focuses on internal and external transactions (Williamson, 1988a).

Before determining the appropriate research stream in order to explain the governance mode decision in offshoring, an alternative framework needs to be introduced. By presenting ten schools of thought in strategic management, Mintzberg *et al.* (2005) use a different approach in explaining the theoretical landscape. They use a categorization according to the perspectives of theories. Depicted in figure 1.5, the distinction of internal processes into "rational" and "natural" (x-axis) refers to the ability to explain internal processes rationally. The perspective is not context-specific and decision-making assumed to be similar across firms. The natural logic assumes that the theory has a strong inside-out view. In focus is the path-dependent behavior of the firm, which is also dependent on top management. Separating the external world (y-axis) into comprehensible/controllable and unpredictable/confusing follows the degree by which companies have unlimited room for maneuvering in decision-making. On the one hand, theories focusing on pricing and free competition would appear on the bottom of the vector. Companies are assumed to have large degrees of freedom in this regard. Theories suggesting dependence on the environment and stressing limitations in the room for maneuvering would appear at the top of the

vector. Existing industry practices and the behavior of competitors is assumed to have substantial influence on the companies according to these theories.

The authors argue that the use of an appropriate approach depends on the different stages of firm development and the level of analysis respectively: “Every strategy process has to combine various aspects of the different schools” (*ibid.*: 367). There have been some attempts to use one single configuration approach embracing both descriptive and prescriptive theories. However, this is very difficult to realize because such approaches often substitute testable theories of high explanatory power with holistic models trying to explain the full picture.

Figure 1.5: Mapping of relevant strategic management theories



Source: Mintzberg *et al.* (2005)

This dissertation does not claim to use a one-size-fits-all theoretical approach. Rather, the ambition is to combine several related theories in order to explain the governance mode decision in offshoring, as well as the sustainability of offshoring

relationships from different perspectives. First of all, offshoring involves different functions whose characteristics determine the strategy to a certain extent. This rational logic is supported by transaction cost economics (TCE) and agency theory. As we will see in the subsequent chapter, these theories are also frequently used in the market entry mode literature, sharing many similarities with offshoring. Although I have identified different theoretical assumptions in the Makadok (2004) framework, TCE and agency theory can likewise be attributed to the rational perspective, which views the external world as comprehensible in the Mintzberg *et al.* (2005) framework. As the environmental school suggests, rational firms not only take decisions based on their own evaluations and planning, but they are driven by the behavior of competitors. The environmental school, represented by organizational isomorphism, covers this very line of thinking. Strategy formation is a reactive process and a response to the challenges imposed by the external environment. Nevertheless, the line of argument is still based on rational arguments. From both TCE and organizational isomorphism I would not expect to find heterogeneity among firms. As Manning *et al.* (2008) point out, offshoring is a bottom-up-driven process, making it necessary to augment the rational perspective with a natural perspective. The dynamic capabilities perspective is very appropriate in order to fill this gap in two regards. On the one hand, it is considered complementary to the TCE perspective, thus sharing many of the underlying assumptions (Williamson, 1999). On the other hand, it considers the firm-specific perspective, while still allowing for large sample research.

1.3.2 Offshoring in the Context of International Business

Offshoring is a very young research stream, but is becoming an important and promising field in the International Business (IB) domain (Lewin, 2005). Since existing research focuses on the (macro-) economic implications, is limited to discussions on low-key functions involving low-skilled labor, or discusses outsourcing only, there are ample possibilities for further contributions. Offshoring is not (yet) a stand-alone sub-field in IB. Hence, contributions normally draw on the insights from existing research streams. Werner (2002) categorizes the IB discipline into 12 distinct topics, ranging from the global business environment to questions of the internationalization process such as foreign direct investments or foreign entry modes to multinational team and expatriate management issues. In this context, the make-or-buy decision in offshoring (or the governance mode decision) is the closely related to the choice of entry modes. The market entry mode literature is significantly

influenced by TCE, providing a theoretical foundation for the optimal governance structure when entering new countries (Chi & McGuire, 1996; Makino & Neupert, 2000). Assuming that the antecedents or predictors of the entry mode decision are largely identical to the antecedents of the governance mode decision in offshoring, this literature provides substantial inputs. However, unlike the market entry mode discussion, accessing new markets (for the primary purpose of increasing the customer base) is not relevant in offshoring. Offshoring concerns the relocation of domestic processes abroad. Interaction of the offshore center with local customers is usually negligible. While I need to consider this difference, the market entry mode literature, building on the strategic management theories presented above, poses the most extensive foundation for the hypothesis development of the client perspective.

As Rugman & Verbeke (2001) argue with regard to the use of TCE in IB in general, it is necessary to consult complementary perspectives in order to gain a better understanding of process matters. Cross-cultural matters is one such aspect in market entry research that is, for instance, also addressed from a TCE perspective and a resource-based perspective (Makino & Neupert, 2000; Padmanabhan & Cho, 1999). TCE regards the cross-cultural aspect as a form of uncertainty, whereby the risk appetite and previous experience with foreign countries determines the proximity of a targeted market entry location (Buckley & Casson, 1998). At the same time, knowledge about dealing with foreign cultures can also be regarded as a resource that firms acquire and develop through learning (Doh, 2005). The cultural aspect in offshoring can be very strong, as offshore employees are frequently from very distant countries, with different attitudes and large salary differences.

Dunning's OLI framework (Dunning, 1980) of internationalization theory is an attempt to combine characteristics of TCE with resource-based components in IB. According to this framework, international investment decisions, priorities, as well as market entries are selected according to three characteristics: ownership advantages ("O") (control of inter-firm transactions), location advantages ("L") (resource commitments, availability and costs of resources), and internalization advantages ("I") (ability to reduce transaction costs by internalizing the processes) (Dunning, 1980). While the latter advantage strongly relates to transactional theory, the former two advantages stress the importance of resources that are specific to the firm. Doh (2005) outlines the implications of OLI on offshoring, while arguing that offshoring helps both reaffirming and challenging the OLI framework. As firms are seeking resources abroad (and require them to come at low costs), the location advantage is

very important. The importance of the “L” is, however, seen alongside with the lack of relevance of the “O” (Doh, 2005): “By disintegrating production stages along the supply chain and transferring them to other geographic locations, firms may create conditions for the erosion of ownership and internalization advantages” (*ibid.*: 698). However, this statement can be regarded differently. Considerations of IP protection stress the importance of the other two advantages, as they are becoming increasingly more important. In particular, in the context of internalization advantages, firms can offshore processes by maintaining (and developing) key processes at home. In fact, this is a critical issue in the governance mode decision and ownership and internationalization advantages need to be carefully analyzed. When discussing the governance mode decision, in offshoring from a transactional and a resource-based perspective, there will thus be implicit references and contributions to Dunning’s OLI framework as well.

1.3.3 Theoretical Foundation to Explain the Governance Mode Decision and the Client-service Provider Relationships in Offshoring

O’Donnell (2000) argues that an important step in building theory in international business is to apply and test different management theories in the unique context of MNCs. This is an “attempt to contrast their predictive ability and limitations in such a setting” (*ibid.*, 527). By combining the most relevant theories of the frameworks presented above, I will follow the argument by O’Donnell. Governance-based theories, including transaction-cost economics and agency theory form the first important pillar in the theoretical foundation. According to transaction cost economics, firms aim at producing something in-house as opposed to externally if market transaction costs exceed internal transaction costs (Williamson, 1999). In the operationalization of this theory, the focus is on the characteristics of the product and the related uncertainties involved in a transaction. The assumptions that individuals are bounded rational and opportunistic underlie the attempt to minimize transaction costs. Governance-based theories, in particular agency theory, are furthermore essential in the second part of the dissertation, which examines the sustainability of client-service provider relationships. In comparison to the transactional approach, agency theory focuses on individuals rather than transactions as a means of analysis. The underlying assumptions of agency theory build on the transactional approach, while it additionally assumes that there are conflicting goals among members of an organization.

RBV is frequently discussed in conjunction with offshoring, primarily because of the resource “labor”. As labor is a major reason for offshoring, focusing on this resource perspective is important. Labor is widely available in foreign countries and usually at lower costs. Cross-cultural management, with its strong ties to RBV, is a different approach to looking at labor. Mintzberg *et al.* (2005) even include RBV in the cultural school by arguing that resources are rooted in the evolution of organizations and their culture. The similarities in the underlying assumptions support this suggestion. RBV is a reaction to the traditional outside-in perspective of collusion-based theories; thus, it assumes heterogeneity between firms and industries. From this point of view, changes in a company happen inside-out and in an incremental manner. Cross-cultural management assumes that nations, organizations and individuals share common assumptions, ideas, beliefs, preferences, and values (Laurent, 1993). Various issues, strategic postures of firms, or operational differences are assumed to relate to differences among nations, organizations, or individuals. As resources within the RBV perspective, culture develops incrementally and has a context-specific value to a firm. Cross-cultural management can also have implications for competitive advantages. Having cultural proximity to a trade partner (either already existing or through learning) is an asset that may constitute a competitive advantage. As my exploratory interviews showed, cross-cultural issues are very important for offshoring, frequently remain over many years, and need the active involvement of the management (Interviewer A, 2007).

Organizational Isomorphism belongs to the so-called configurational approaches (Mintzberg *et al.*, 2005) and relates to the way organizations take decisions. It is a theoretical stream originating in the work of Max Weber investigating distinct characteristics commonly occurring in organizations. In this understanding, organizations legitimize their action by imitating the behavior of its environment (Meyer & Rowan, 1977). Unlike RBV, organizational isomorphism applies an outside-in perspective. Changes in a company do not happen incrementally but in a frame-breaking manner (Meyer, Tsui, & Hinings, 1993). The differences in the underlying assumptions of organizational isomorphism are primarily with regard to the capability-based theories discussed below and cross-cultural management. This issue can be addressed by adding the intertemporal component of the governance mode decision in offshoring. I argue that transactional and configurational approaches are more important in early stages of offshoring, while capability-based theories are more important for subsequent governance mode decisions.

The discussion of the static RBV perspective in the context of offshoring requires adding a dynamic component, which is, for instance, considered in the dynamic capabilities perspective. The dynamic capabilities perspective is a development of the above-introduced RBV which focuses on learning and the development of resources. According to its assumptions, firms develop capabilities based on their asset positions and their path-dependent application (Teece *et al.*, 1997). Offshoring regarded from an RBV perspective would be limited to (cheap) labor resources, or would regard know-how on effective offshoring processes as a resource. When analyzing governance mode decisions in offshoring, I am however also interested in looking at firm-specific developments of this strategy. On the one hand, I argue that the strategic posture of firms influences the motivation for offshoring and subsequently the governance mode decision. Although we cannot tackle the immediate link between the strategic posture and the motivations to offshore, we can observe the link between the different motivations and the governance mode selected. On the other hand, dynamic capabilities help explaining subsequent governance mode decisions. Firms are learning from their offshoring experience and develop the procedures while striving for best practice.

Agency theory is a component of governance-based theories and has a strong focus on the behavior of individual actors in a transaction. It is the core focus for the second part of the dissertation. The discussion of the client-service provider relationship has its primary contribution in the understanding of the sustainability of offshore relationships with service providers. In offshoring, it is likely that very critical knowledge transcends the firm boundaries. The combination of high knowledge intensity and the involvement of external actors raise the likelihood of agency problems. In response, firms establish mechanisms in order to align interests between the clients and the service providers.

1.4 Structure of the Thesis

The thesis follows the traditional setup of a quantitative research paper. The theoretical foundation chapter is followed by the hypotheses development chapter, the methodology chapter, the results chapter, and the discussion chapter. As the dissertation is based on two different surveys, each chapter is discussed from both perspectives. Since there are certain overlaps in the two surveys and their variables, the comparison can be drawn more easily when discussing the two perspectives within the same chapter, rather than dividing the whole dissertation into two parts.

When highlighting the client perspective of offshoring, I will normally refer to the “corporate survey”. When discussing the relationship between the domestic clients and the third party service providers in the offshore location, I will normally refer to the “service provider survey”.

The theoretical foundation follows the logic of the introduction. While TCE and dynamic capabilities provide the foundation stemming from strategic management, the market entry mode literature provides the structure and the hypotheses for the client perspective. The market entry mode literature builds on strategic management theories, while adding the international component to it (Buckley & Lessard, 2005). For the dissertation, this implies that the theoretical foundation has its focus on the strategic management theories TCE and dynamic capabilities, while the hypotheses chapter applies the theories according to the predictions of the market entry mode literature. TCE is an outside-in perspective that is very rational and regards firms as homogenous, while focusing on the different characteristics of the transaction. As the cross-cultural aspect is very particular in TCE, I will have a separate discussion on this important aspect in offshoring. In doing so, I will divert from the core transactional literature and discuss issues and challenges when doing research on cross-cultural matters. As I will note when discussing the theories, TCE is stronger in explaining initial governance mode decisions in offshoring, while dynamic capability is comparatively stronger in explaining subsequent governance mode decisions. It stresses firm-specific matters and takes path dependence into consideration as well. On both ends, the theories are enriched with discussions on organizational isomorphism, assuming external influence on decision-making. Finally, the service provider perspective focusing on interest alignment builds on agency theory. Hypotheses are derived from research on cost centers, as well as on relationship-specific discussions.

2. Foundations in Strategy and International Business

As illustrated in the introduction, a theoretical framework based on the structures of Makadok (2006) and Mintzberg *et al.* (2005) serves as an underlying foundation for this dissertation. This chapter will provide an in-depth discussion thereof. The strong focus on strategic management and other related disciplines is necessary due to the scantiness of stand-alone theories in IB (Buckley & Lessard, 2005). This is particularly clear in research related to the market entry mode literature, which turns out to be most important when analyzing governance mode decisions in offshoring.

2.1 The Foundations of the Make-or-Buy Decision

2.1.1 Introduction to the Transactional Approach

Transaction Cost Economics (TCE) adopts “a comparative contractual approach to the study of economic organization in which the transaction is made the basic unit of analysis and the details of governance structures and human actors are brought under review” (Williamson, 1988b: 66). TCE, as well as agency theory and property rights theory, all have their foundation in the seminal work of Ronald Coase (1937), *The Nature of the Firm*. The very first time Coase expressed his ideas, which subsequently became the foundation of his book, was in a letter to a friend in 1932. He argued that there are two reasons why the size of a firm is limited and therefore why separate firms exist. First, “[i]ncreasing cost for each additional market transaction until cost of organizing marginal market transaction was equal to marketing cost of that transaction” (Coase, 1988: 4). Second, “[t]hat as transactions increased, [they] might not carry out its object of reproducing market conditions” (*ibid.*). Put differently, firms exist because intra-firm organizing costs are lower than the costs of a transaction carried out through the market. The object of organizations is thus to produce at costs that are lower than the market transaction-costs. Coase’s work received little attention until the 70s, after he had published an article applying the same mindset to the relationship between the legal system and the workings of the economic system. Moreover, Oliver Williamson operationalized Coase’s ideas in two books in 1970 and 1975 (Williamson, 1970, 1975).

TCE, as discussed by Williamson, employs two critical assumptions. First, human agents have bounded rationality, meaning that they are assumed to be

“*intendedly* rational, but only *limitedly* so” (Simon, 1961 in Williamson, 1988b). Agents are not meant to be inefficient, but they simply do not have complete information, which is necessary to choose the best option. In particular, this is relevant when judgments about future developments are involved. Second, it is assumed that human agents are opportunistic in their behavior, meaning that agents give higher priority to their own interests than to general welfare. In agency theory, such opportunistic behavior is also called moral hazard, adverse selection, or hold-up². Both aforementioned assumptions are in this respect fundamentally different from industrial organizations and the commitment-based theories of strategy. In those theories, human agents are assumed to be perfectly rational, seek to gain market power, and act accordingly (Mintzberg *et al.*, 2005). Unlike this approach, the imperative arising from the two TCE assumptions is that firms shall “organize economic activity so as to economize on bounded rationality while simultaneously safeguarding the transactions in question against the hazards of opportunism” (Williamson, 1988b: 68). The magnitude of such transaction costs that appear whenever a good or service is being transferred between technologically separable stages (Williamson, 1999), is influenced by four attributes (Shelanski & Klein, 1995): (1) the degree to which relationship-specific assets are involved, (2) the amount of uncertainty about the future and about other parties’ actions, (3) the complexity of the trading arrangement, as well as (4) the frequency with which the transaction occurs. The most critical is the first aspect of asset specificity, which Williamson outlined in 1983 and referred to as assets that lose value if they are employed for other than their original, specific purpose. Such asset specificities encompass physical and human asset specificities, site specificity, as well as dedicated assets specificity. The first refers to specialized *physical* inputs that are an integral requirement to produce a component. Human asset specificity is the equivalent of the *intangible* side of the production process. It arises in a learning-by-doing fashion and constitutes a crucial part of tacit knowledge, as is mentioned in more recent literature (*c.f.* Von Krogh, Ichijo, & Nonaka, 2000). Site specificity deals with the degree of “cheek-by-jowl” relations of successive stations (Williamson, 1983: 526) and stresses the *location*

² The differences in these terms are along two dimensions: First, whether a problem arises before the closure of the contract (adverse selection) or afterwards (moral hazard and hold-up). Second, whether the opportunism can be detected after it has occurred or not. With moral hazard this is not the case; with hold-up it is.

proximity of different components of the production process. Finally, dedicated assets are contingent upon particular supply agreements and are *discrete investments* transacted for the prospect of selling a significant number of products to a specific customer. Those attributes are very important for empirical research.

Research in TCE has been developing into a large variety of economic relationships, such as vertical and lateral integration, corporate finance, marketing, organizational structures, long-term commercial contracting, franchising, regulation, the MNC, and other contractual relationships (Shelanski & Klein, 1995). The literature on vertical integration, *i.e.*, the question of to what extent units should be back- or forward integrated, constitutes the paradigm problem. I will now have a closer look at this theoretical arm.

2.1.2 Vertical Integration and the Market Entry Mode

Vertical integration or the “make-or-buy” decision is a core focus in TCE, which Williamson originally addressed in his 1971 article. The decision follows the assumption of opportunism, and it is asked what level of integration is required in a transaction in order to maximize profits. Integration is necessary because it reflects the ability to control transactions. A company’s need for control is higher if the potential for opportunistic behavior is high and if company-specific resources are at risk. A firm can decide between several levels of integration.

Market governance refers to transactions where no mutual dependency is involved and it represents a classic contract. Buyers and sellers can easily turn to alternative sources which protect both sides from opportunism. The major transaction costs take the form of bargaining expenses. In particular, this form is used when investments are not specific, information about the transaction partner can be obtained from rating services or other buyers, or a company can rely on its own experience (Williamson, 1979). In a hybrid form, a sort of bilateral dependency is established in order to assure some degree of continuity, a common understanding, and a better knowledge flow. In many cases, transaction-specific human and physical capital investments are made, which, contingent upon successful execution, lead to benefits (*ibid.*). A change of the transaction partner can in this case no longer be performed for free. Finally, full integration aims at economizing on transaction costs at best and aims at more flexibility in decision-making. However, hierarchy comes at costs of increased bureaucracy and large sunk costs, making overall benefits contingent.

Three variables have proven to influence the decision on vertical integration: asset specificity, uncertainty, as well as frequency. Asset specificity refers to the degree of non-redeployability of assets in a transaction. Specificity exists if assets cannot be used for a purpose other than the specific transaction. As it was stated in the previous chapter, potential opportunistic behavior is only a problem if assets are specific and precious for a company. If there is no asset specificity, a company can change transaction partners at very little cost and flexibility can be maintained with disintegrated modes. In the presence of asset specificity, uncertainty raises the need for control. Control refers to the ability to influence systems, methods, and decisions (Anderson & Gatignon, 1986). Also under uncertainty, a company tends to require full control. Uncertainty can manifest itself in potentially opportunistic behavior of the partner, or if there is uncertainty about future developments. Control can better be exerted if processes are integrated in the firm. Nevertheless, control comes at costs and sufficient resources need to be committed. These effects determine the optimal level of integration. Uncertainty is usually very broadly defined and different interpretations can be found in the literature (Mayer & Salomon, 2006). Williamson (1971) primarily refers, on the one hand, to uncertainty about future events, and on the other hand, to the firm's inability to accurately assess its agent's performance with readily available output measures (Anderson & Gatignon, 1986). Most frequently used approximations in empirical studies applying TCE refer to the volatility of technologies, followed by demand fluctuation and price volatility (David & Han, 2004).

The logic of TCE has been adopted by the market entry mode literature in several ways (Anderson & Gatignon, 1986; Brouthers, 2002; Shelanski & Klein, 1995; Zhao, Luo, & Suh, 2004). Originating in TCE, the major adaptation in this stream of literature concerns the internationalization component. Anderson & Gatignon (1986) differentiate between four variables influencing vertical integration: asset specificity, external uncertainty, internal uncertainty, as well as the free riding potential. Asset specificity and its effect on the level of integration is adopted one-to-one from the TCE literature. Uncertainty can be understood from different angles. The market entry mode literature suggests a distinction between external and internal uncertainties (*c.f.* Anderson & Gatignon, 1986; Zhao *et al.*, 2004). External uncertainty refers to the unpredictability of future macroeconomic events, such as political instability, economic fluctuations, or currency changes. It is expected that an integrated mode is only necessary if external uncertainty is accompanied by asset specificity. Only in this case, are assets potentially at risk. While external uncertainty

is expected to be dependent on asset specificity, internal uncertainty is less dependent on it (Williamson, 1981). In comparison to internal uncertainty, external uncertainty can only be addressed in a reactive way (David & Han, 2004). Internal uncertainty can be reduced or eliminated through learning (such as gaining experience in a foreign market). Uncertainty exists “when the firm cannot accurately assess its agents’ performance by objective, readily available output measures” (Anderson & Gatignon, 1986: 15). In the absence of performance measurability, firms are better at evaluating inputs than outputs. TCE therefore suggests that controlling is more important in the presence of internal uncertainty (Williamson, 1971).

However, controlling in an international context is difficult and requires experience. Control in the presence of internal uncertainty presumes that management knows how people should behave and how to judge results that are hard to quantify. Entrants new to the international setting are unlikely to know how to overcome internal uncertainty (Anderson & Gatignon, 1986). Control can only be exerted if a company has sufficient knowledge about how to do it.

Finally, the free riding potential refers to situations in which a partner can benefit from profits without having to bear any costs. In the presence of such potential, a company will also have an incentive to control the transaction and is likely to choose an integrated mode. An integrated mode allows the collecting of all profits associated with a transaction. While the influence of the free riding potential on the level of vertical integration is discussed in the seminal article by Anderson & Gatignon (1986), its operationalization is very difficult and it is rarely tested in the literature (Zhao *et al.*, 2004).

2.1.3 Discussion of the Transactional Approach

TCE has received more citations than any other traditional work on organizational studies, such as institutional theory, organizational ecology, and resource dependence (David & Han, 2004). More than 600 studies published in acknowledged journals have used TCE as a framework (Williamson, 1999). In particular, the market entry mode literature frequently refers to this theory (Zhao *et al.*, 2004). Also, it is expected that asset specificity and uncertainty are highly relevant in a firm’s decision about whether to operate its own captive offshore center or to contract a third party abroad.

TCE has, however, received considerable criticism by authors like Perrow (1981), Granovetter (1985), or Ghoshal & Moran (1996). In particular, Ghoshal &

Moran argue that prescriptions drawn from TCE are wrong and dangerous for corporate managers. In their point of view, opportunism is limited to a few firms; such behavior is not observed in the vast majority of firms in mature and advanced industries. Further, they argue that relationship-specific assets such as distance and routines are an instrument for reducing transaction costs. They claim that the results of studies building on Williamson's work are biased (Ghoshal & Moran, 1996: 40). This is a very fundamental criticism. In Bartlett & Ghoshal's (1993) studies of organizational structures, they further argue that an organizational structure building on TCE assumptions is too heavily focused on hierarchy and control (for an overview on organizational studies from a TCE point of view *c.f.* Poppo, 2003). From their point of view, an organizational structure should be dynamic with a low degree of hierarchy and of decentralized decision-making, and management's role should be limited to making sense of the corporate strategy (Bartlett & Ghoshal, 1987). However, as David & Han (2004) argue, Ghoshal & Moran's comments are not based on any empirical findings; thus, they do not have sufficient arguments to exclude TCE.

Finally, Bartlett & Ghoshal's (1993) discussion of new organizational forms is to a large extent limited to one single case. The meta-analytic view by Shelanski & Klein (1995: 352) thus seems reasonable in asserting that "empirical evidence shows that the make-or-buy decision and the structure of long-term contracts, in particular, overwhelmingly confirm transaction cost economic predictions".

The continued importance of TCE theory also seems evident from the point of view of David & Han (2004). Their meta analysis shows a continuous support of TCE, in particular in context of the market entry mode literature. Nevertheless, it is frequently suggested to apply the theory in an integrated manner, combining it with related theories. This suggestion is also supported by TCE scholars (Williamson, 1999), strategy/knowledge management scholars (Teece *et al.*, 1997), as well as business scholars (Dunning, 2000). TCE is not contradictory to many theories, such as the dynamic capabilities perspective, because the underlying assumptions are shared (Williamson, 1999). For instance, the assumptions of governance-based theories hold for the capabilities perspective. They are based on the efficient allocation of incentives and decision rights. Furthermore, the theories take heterogeneity among firms and flexibility within firms or units into consideration. I will apply the theoretical foundation of TCE primarily in the context of the market entry literature and further elaborate on this stream of literature in the hypothesis development section.

2.2 The Cross-National Component of International Business

2.2.1 From Cross-National to Cross-Cultural Research

Cross-national research has a very long tradition and is very widespread, if not omnipresent, in many fields of research. Cultural anthropologists, sociologists, psychologists, economists, as well as business and strategy scholars have been regularly incorporating cross-national variables in their studies for decades. Initially, spurred by the globalization movements in the late 60s and by several events in the aftermath, there were various shifts in the way of looking at national differences. The major reasons were the coverage of new markets, the collapse of the iron curtain, the increased mobility, as well as decreased costs in communication and mobility. The many facets of cross-national research make a clear definition very difficult and pose great challenges to operationalization. Limitations of this important stream of research need to be carefully considered.

Kohn (1987) differentiates between four types of cross-national studies. First, there are studies in which the nation is the object of investigation. In these cases, a specific country is in the focus, and comparative aspects of other countries are investigated. For instance, such a study would compare institutional or political systems of a country to another. Second, there are studies in which the nation is the context of the research. The primary interest is in testing the generality of findings across nations. While in the first case the focus is on the country itself, we are now looking at a certain phenomenon and comparing it to the same phenomenon in other countries. Third, studies can also have the nation as the unit of analysis. In focus is the question of how processes are systematically related to variations in national characteristics. It is thus required to know which of the many differences between countries are the “pertinent analytic variables” (Kohn, 1987: 31). Once identified, relationships among characteristics of the nations can be empirically tested. Finally, studies can be transnational in character, viewing countries as part of larger global systems. Transnational studies show that countries are not isolated entities, but that research is interrelated in the international context. Usually these studies are on a rather complex level.

At the time when Kohn (1987) wrote his paper, the focus was very much on direct comparisons between countries or on analyzing them in a contextual manner. He used a comparative study between the US and Poland for illustration. During the Cold War and before the iron curtain fell, comparing capitalist with socialist countries

was particularly interesting and the political systems had salient differences. International trade was very important in cross-national research. It was largely determined by physical distance, the ties to former colonies, trade zones, common currencies, *etc.* Using this comparative cross-national approach, various sub-fields such as cross-economic, cross-political, or cross-cultural differences are already implicitly covered to a large extent. The continued relevance of cross-national research from the macro perspective is evident. In recent years, however, cross-cultural aspects have been gaining attention in cross-national research. With increasing mobility, cultures are more frequently interacting, encountering cultural clashes, and cultures are admixing to a certain extent (Leung, Bhagat, Buchan, Erez, & Gibson, 2005). In short, managers are more frequently confronted with cross-cultural issues.

Kohn (1987) almost discarded cross-cultural research by saying that it is only possible when looking at sub-cultures as well. It is difficult to isolate one component of cross-national research, and there is never complete certitude that an observed finding originates in cultural difference. That there are difficulties in measurement does not constitute a strong enough reason to put this important topic aside. The large number of cross-cultural studies supports the continuous relevance of this literature in IB (Javidan, House, Dorfman, Hanges, & de Luque, 2006; Kirkman, Lowe, & Gibson, 2006; Leung *et al.*, 2005). While providing some further implications in the following chapter and shedding critical light on the most frequently used cross-cultural approach afterwards, I will present alternative measures of cross-cultural distance that address Kohn's (1987) critique.

2.2.2 Cross-Cultural Research and Offshoring

The essence of offshoring is to transfer business processes from one country to another. Just as with market entry situations, this strategy almost always involves cross-cultural activities. In the analysis of the governance mode decision in offshoring, the cross-cultural aspect has to fit the framework of the different theories applied. We can look at cross-cultural research from both an RBV- or a TCE perspective. Cross-cultural management assumes that individuals hold particular sets of assumptions, ideas, beliefs, preferences, and values (Laurent, 1993). Such characteristics may be shared on three levels: the individual level, the organizational level, as well as the national level. From an RBV perspective, the firm's goal is to achieve sustainable competitive advantages by possessing resources that fulfill the VRIN attributes. Both culture and resources originate in a given endowment

(Mintzberg *et al.*, 2005). The link between the theoretical streams in its underlying assumptions originates in the understanding of heterogeneity between nations, firms, and individuals and that understanding foreign culture can be viewed as a resource leading to sustainable competitive advantages for a firm. In this way, there is also a direct link to the transactional literature. TCE assumes that uncertainty increases transaction costs (Williamson, 1979). Equating Cross-cultural distance with uncertainty makes it an important variable for research (Anderson & Gatignon, 1986). Cross-cultural distance is thus likely to increase costs in market transactions. Since firms have a strong interest in economizing on costs, cross-cultural issues are likely to influence the governance mode decision as well.

However, there is an important difference to the market entry mode discussion. In market entry situations, companies face the trade-off between making or buying a unit abroad (Anderson & Gatignon, 1986). This is possible either with greenfield investments or with acquisitions of existing local companies. There is empirical evidence for the selection of any of the modes in the presence of cultural distance (Harzing, 2003). However, the logic that cultural distance is positively related to the probability of choosing greenfields is dominant (Drogendijk & Slangen, 2006). In this case, it is not necessary to integrate a distant culture into the organization and risks are lower. In offshoring, this situation is different. The managers do not have to choose between greenfields or acquisition. Rather, the choice is between “greenfields” (captive modes) and outsourcing. In this dichotomy, the culturally risk-averse strategy would be to select third party offshoring. By preventing cultures from mixing, the stability reduces ambiguity and less control is necessary (Leung *et al.*, 2005).

While culture can be regarded from the uncertainty perspective, we can also have a much broader perspective on why culture is relevant for the offshoring discussion. In international business research, we frequently observe interaction between companies from industrialized countries and their joint venture partners, contractors, affiliates or network partners in less developed countries. But these network partners and their employees often belong to an elite in their home countries. They possess wealth that is above average, are better educated, and are thus not representative of the entire population. Leung *et al.* (2005) cynically speak of the “Davos group of managers” (referring to the annual World Economic Forum in Switzerland), who travel a lot and share a common culture. In offshoring, we are also looking at the relationship between companies of industrialized countries and their

partners or captive entities in less developed countries. However, as cost savings are highly important in this strategy, offshoring does not target the upper elite, but a wide range of well-educated workers. I expect to be able to capture a representative workforce in the offshore destinations. Domestic employees working for industrialized companies are paid at a lower level when viewed from a Western perspective, but decently paid (however not “overpaid”) from a local perspective. The argument of the “Davos group of managers” brought forward by Leung *et al.* (2005) is therefore not an issue for this sort of cross-cultural research.

2.2.3 Culture and the Level of Analysis

The many facets of cross-*national* research are reflected in the complexity of cross-*cultural* research. In this context, culture can be defined in several ways. One famous definition dating back to 1874 was written by the social anthropologist Edward Burnett Tylor: “Culture or civilization, taken in its wide ethnographic sense, is that complex whole which includes knowledge, belief, art, morals, law, custom, and any other capabilities and habits acquired by man as a member of society” (Tylor, 1994). The definition illustrates the many layers and perspectives culture has. Once we have determined the focus on cross-cultural research, we further need to decide on the internal or external perspective, as well as the cultural level of analysis.

Hofstede (2001) argues that there are three distinct levels on which culture can be analyzed: The national level, which looks at the “average” culture within a country, the organizational level, as well as the occupational or individual level. Leung *et al.* (2005) add two cultural levels: the superordinate global level and the group level, located between the organizational and the individual level. Differentiating according to the size of the group is just one way of looking at the topic. Schein (1992) takes a different perspective and differentiates cultural analysis along three different dimensions. First, his model contains an external layer of artifacts and behaviors that are highly visible from outside. Second, there is a deeper level of values which are not observable but testable. Third, the deepest level consists of basic assumptions which are invisible and taken for granted (internal perspective). Since both the macro-level and the micro-level can additionally be investigated according to external and internal layers, we have a large number of perspectives that cross-cultural research can take. From the nature of the different perspectives there are, however, some implied limitations. For instance, with a survey methodology it is only possible to capture a level that is measurable by individual responses. Cultural analysis is therefore limited to values and attitudes.

The survey methodology applied in this dissertation limits the potential focus to cultural values. While the external layer would need to be measured in a case-by-case manner, the internal layer is not measurable at all. In reference to the previous paragraph, I acknowledge the limitations of this focus and will discuss one of the most prominent foundations of cross-cultural studies in IB. Based on the limitations, I will subsequently present alternative approaches in measuring distances between countries.

2.2.4 The Dispute surrounding Geert Hofstede's Cross-Cultural Study

In the field of IB, the cross-cultural work by Geert Hofstede is prevalent, very often applied, but also frequently disputed. The importance of Hofstede's work in research on market entry modes is, for instance, discussed in Harzing (2003). Its wide acceptance makes it an obvious choice for research on offshoring as well.

Hofstede bases his work on an extensive global survey, which he conducted twice among 116'000 employees working for IBM (Hofstede, 2001). This enormous dataset generated findings on the perception of employees on their national cultural values in more than 50 countries. Analyzing the results lead to a categorization of IBM employees' values into five bi-polar dimensions³. Supported by a large number of replications, it is evident that Hofstede's work is extremely elaborated and sophisticated. This is particularly true from a statistical point of view. However, the nature of the research, the underlying assumptions and the methodology raises some critical issues. Brendan McSweeney has published a very pronounced critique on Hofstede's work in Human Relations (McSweeney, 2002), which primarily addresses Hofstede's underlying assumptions. A more nuanced critique can be found in Kirkman *et al.* (2006), dismissing several of McSweeney's arguments, while still claiming the use of alternative approaches.

As introduced above, Hofstede assumes that there are three distinct levels of national culture: A national, an organizational, as well as an occupational level. By choosing one single company and very similar jobs, Hofstede assumes to control for organizational and occupational differences. This first assumption has not only been

³ "Power distance" is looking at the acceptance of inequality in power distribution, "uncertainty avoidance" is looking at unambiguousness and predictability, "individualism" is looking at the importance of own interests, "masculinity" is looking at interpersonal relationships, and finally "time orientation" is looking at the time horizon.

challenged by McSweeney (2002), as Schwartz (1992) outlines, it is generally the most critical assumption of his work. McSweeney argues that it is impossible to isolate national culture because the different levels are interrelated and organizational culture is likewise varying across countries. It is even possible that organizational culture is not just varying across countries, but that several cultures exist within an organization.

The second assumption suggests that all individuals of a nation carry the same national culture. Variance is not taken into consideration and national culture is an “average” of the different scores within the countries. “Individuals do not all share common ‘subcultures’, but most or all are said to share a common national culture” (Hofstede, 2001). Hofstede does not make any differentiation whether someone has lived abroad for a long time, whether there are different cultures within a state, *etc.* McSweeney challenges this assumption with the argument of inconsistency. While individual and organizational cultural difference is assumed constant, it is consequent to assume constancy in national culture as well. Hofstede assumes that individuals are not sharing common ‘subcultures’ but they are sharing a common national culture. The large variance found within the national cultures is therefore contradictory to the assumption of homogeneity in the other two levels of analysis.

Third, Hofstede assumes that the reason for a specific answer in the survey is the result of cultural affiliation of the respondent. Other sources influencing the specific responses are factored out. However, response variation could also have its origin in very different reasons, such as religion, language, race, *etc.* The responses might therefore not only be biased due to a lack in the definition of national culture (as suggested in assumption 1), but originate from very different aspects. The question arises whether there might be unobserved variance.

Finally, cultural differences are measured by looking at the variance in the responses among countries. If the previous assumption on manifestation of culture in the variation of responses is challenged, the logical consequence is that it is also not possible to draw conclusions from cross-national differences in the responses.

This specific critique of Hofstede’s work has generic implications for doing research in a cross-cultural setting. It shows how difficult it is to perform reliable cross-cultural research with a high degree of generalizability. The “perfect” cross-cultural study addresses the above assumptions, is up to date, has been designed for the purpose of measuring cultural distance, and whose respondents are

representative for a country. These requirements are very ambitious and probably provide an explanation for why unconditional cross-cultural studies do not (yet) exist. Projects such as Schwartz (1992), GLOBE (for an overview *c.f.* House, Hanges, Javidan, Dorfman, & Gupta, 2004; or Javidan *et al.*, 2006) or others are attempts to meeting some of the criticisms.

2.2.5 In Search of Alternatives in Cross-Cultural Research

During the 90s and in the current decade, some research projects have developed, trying to address the shortcomings of Hofstede's work. Schwartz (1992) changed the focus of analysis to the individual level and generated an exhaustive set of 56 individual values recognized across cultures. Switching to the individual level has been achieved by asking questions that have a stronger focus on practices. Targeted respondents were schoolteachers in 54 countries and college students in 56 countries. Applying a similar methodology like Hofstede resulted in seven cultural dimensions⁴. While Schwartz's work is more recent and addresses some of the shortcomings of Hofstede's work, the number of countries analyzed is limited and several of the larger countries are missing. This makes it difficult to use the measure when involving many countries. The second alternative to Hofstede's work is a study by Smith, Peterson, & Schwartz (2002) conducted among 7000 department managers in 47 countries. The authors used a survey methodology asking questions on how respondents handled common work events. While the number of countries covered in this study is even smaller, the value dimensions have not yet found extensive empirical foundation. Probably the most extensive alternative to Hofstede's work is the GLOBE project conducted by 160 researchers around the globe (House *et al.*, 2004). Based on a very strong theoretical foundation, the authors assume that "attributes defining a specified culture are predictive of leadership styles and

4 Drogendijk & Slangen (2006: 364) provide a condensed description of the dimensions: "Conservatism represents a culture's emphasis on maintaining the status quo, propriety, and restraining actions or desires that may disrupt the solidarity of the group or the traditional order. Intellectual and affective autonomy refer to the extent to which people are free to independently pursue their own ideas and intellectual directions, and their affective desires, respectively. Hierarchy denotes the extent to which it is legitimate to distribute power, roles and resources unequally, while egalitarian commitment refers to the extent to which people are inclined to voluntarily put aside selfish interests to promote the welfare of others. Mastery expresses the importance of getting ahead by being selfassertive, while harmony denotes the importance of fitting harmoniously into the environment".

organizational practices in that culture” (*ibid.*: 898). They are thus taking an organization and societal perspective. The authors further argue that values are reflected in day-to-day action. This will result in observations on the organizational and national level. While Hofstede raised an extensive critique on various levels to this study (Hofstede, 2006), empirical superiority has yet to be proven.

All of the three alternative studies have an implicit or explicit attempt to challenge Hofstede’s work, to address its shortcomings, and to improve the understanding of culture. While the survey methodology has been kept similarly, all studies were designed for the specific purpose to compare cultures (which was not the case for Hofstede’s work), and they are looking at other levels than the national (as well). Nevertheless, each study has an inherent shortcoming because of the methodology (Smith, 2006). Results are either based on aggregated self-perceptions or are based on aggregated perceptions of others in one’s society. Limitations are consequently jointly applicable to the cross-cultural studies.

As a next step, we can ask the question, to what extent culture relates to national wealth. This is a very crucial question in the analysis of cross-national research. While Hofstede claims that national wealth is something different from culture (Hofstede, 2001), GLOBE does not control for it and consequently finds it to be correlated with several dimensions (Inglehart, Basañez, & Moreno, 1998). It is a vicious circle, because on the one hand we have to ask what drives national wealth. On the other hand, we have to ask the question to what extent national wealth influences culture (Javidan *et al.*, 2006). Smith (2006) argues that a uni-directional study would therefore have a short life-span. Redding (2005) suggests that the nature of this relationship is co-evolutionary and that culture and macro-economic factors are interacting. Going further into this discussion would probably be similar to opening a Pandora box and I will refrain from doing so. However, from a theoretical perspective it has an important implication. In particular, the weaknesses of the discussed studies shift the attention back to the overarching cross-*national* research in the search of alternative measures.

2.2.6 Alternative Distance Measures

We have seen that cross-cultural research as presented above has some fundamental limitations in the methodology. It is rarely possible to collect reliable data about sufficient countries for rigorous statistical analyses. Furthermore, it is almost impossible to study sufficient countries at the same level of depth so that proper

analysis can be conducted (Kohn, 1987). There is a trade-off between the number of countries studied and the level of depth. Due to a lack in proper alternatives, this should not imply a dismissal of the studies discussed (Drogendijk & Slangen, 2006). However, it suggests testing alternative measures as well. When using culture not as a subject of the study but as an independent variable, there are different options.

One approach is to use the concept of psychic distance that incorporates cultural distance, but is broader in its definition. Usually the term psychic distance includes "...a firm's degree of uncertainty about a foreign market resulting from cultural differences and other business difficulties that present barriers to learning about the market and operating there" (O'Grady & Lane, 1996: 330). The focus is thus on uncertainty that is originating in the geographical separation of two parties. Other operational or strategic uncertainties are not included in psychic distance and are dealt with separately. Psychic distance is usually observed in context of a survey asking respondents to what extent they observe distance towards foreign employees or foreign business partners in general. This does usually involve cultural aspects, but it is not limited to them.

Authors like Evans & Mavondo (2002), Mjoen & Tallman (1997) or Taylor *et al.* (1997) have measured cultural distance by asking about the subjective perception of cultural distance in surveys. I will discuss the specific measurement of the variables in the methodology chapter. At this point, I just want to exemplify the approach of these studies. Measures of psychic distance have been empirically tested in several ways, and are usually correlated with the traditional measures of cross-cultural research (for an overview see Drogendijk & Slangen, 2006). Nevertheless, we have to acknowledge the limitations of psychic distance measures as well. The value dimensions generated by Hofstede, Schwartz, and colleagues, were collected in order to study cross-cultural patterns. When using the distance measures in research as an independent variable, data is not context-specific and independent. For psychic distance, however, the variables are generated in context of the study. This needs to be taken into consideration. Alternatively, psychic distance allows including both non-cultural questions and other cross-national questions.

To conclude the discussion on cross-national research, I argue that a mere consideration of cross-cultural issues in the sense of Hofstede, Schwartz, or GLOBE is not sufficient. In line with Ghemawat (2001) and Kohn (1987), I argue that besides cultural measures, it is important to consider other (economic) distance measures as well. These measures include variables such as GDP, physical distance, language

difference, colonization history, common policies, *etc.* In this regard, Kohn (1987) argues that companies are seeking to trade with partners from countries they have experience with. Usually, companies have experience with partners in nearby countries, with a similar GDP, common politics, or with countries that are adjacent through common history. I will adhere to this claim and include macroeconomic measures as alternatives of measuring cultural distance. As Leung *et al.* (2005: 375) put it: "Culture is such a fuzzy concept that we need to probe it with all the tools we have at our disposal, and we look forward to the bloom of multi-method approaches for moving the field of international business research forward by leaps and bounds".

2.3 An External and Internal Perspective on Experience

Both the transactional and the cross-cultural approach are largely factoring out internal and external learning, as well as firm-specific considerations. Explaining the governance mode decision based on TCE and cultural distance limits the focus on functional and national characteristics. Although the uncertainty variable of TCE pinpoints at experience, we need to widen the perspective from the comprehensible, rational perspective to the perspective of learning. In particular, we are looking at organizational isomorphism and dynamic capabilities. Isomorphism refers to alternative forms of imitation and learning from outside. This is particularly important if knowledge is lacking in-house. The dynamic capabilities perspective focuses on fostering and developing internal knowledge (through learning) in order to create sustainable advantages.

2.3.1 The Legitimation of Action

Organizational isomorphism suggests that companies' knowledge is assumed and replicated by competitors for certain reasons. In particular, if new strategies and trends are emerging or if in-house experience is lacking, companies make use of outside experience. This replication takes place for the primary purpose of legitimizing the company's own action. If companies see that competitors have successfully pursued a strategy, they are likely to replicate it in a similar manner. It is much easier to justify a strategic posture if others have exemplified it successfully.

The literature on organizational isomorphism is rooted in a seminal article by DiMaggio and Powell (1983). In "the iron cage revisited" the authors explain why companies are in fact so similar. This phenomenon is a paradox: Within the competitive market place, actors are changing the firms, but what they are actually

doing, is making them more similar. This phenomenon takes place in three processes: coercive, mimetic, and normative isomorphism. *Coersive* isomorphism stems from political influence (or formal and informal pressure) and the problem of legitimacy. *Mimetic* isomorphism stems from standard responses to uncertainty, and *normative* isomorphism is associated with professionalization. The latter point is about exchanging information among professionals, leading to commonly recognized hierarchy of status and of center of periphery (*ibid.*).

Differences in the underlying assumptions compared to other strategic management theories include the holistic mode of enquiry, the nonlinear relationships among attributes, the frame-breaking rather than incremental mode of change happening in the form of episodic bursts, as well as equifinality as effectiveness assumption (Meyer *et al.*, 1993). Stressing the importance of the industry as a whole is a shared assumption with collusion-based theories. However, collusion-based theories assume an active role of the managers in the competitive marketplace. Organizational isomorphism, alternatively, does assume that industry patterns and trends are given while companies are adapting to them. For this dissertation, organizational isomorphism appears in conjunction with TCE and dynamic capabilities, which is why we need to have a closer look at their compatibility. Martinez & Dacin (1999) argue that a combined perspective of TCE and organizational isomorphism enhance organizational theorizing. The two theories share assumptions that go beyond the outside-in perspective. While TCE focuses on transactions, organizational isomorphism has its focus on the social construction of organizational behavior. In the latter perspective, the economic rationale is limited by social constraints. It is particularly helpful if transaction cost efficiency does not provide “a complete accounting of the motivations or context underlying these organizational decisions” (Martinez & Dacin, 1999: 77). In particular, “firm and market activity are explained from the imperative of legitimacy-seeking behavior which, in turn, is influenced by socially constructed norms and rules of acceptable conduct” (*ibid.*). TCE has shortcomings in three respects. First, managers are boundedly rational at the individual level, yet economically rational at the aggregate level. This is contradictory. Second, transaction costs that derive from social-level phenomena are not considered in TCE. Finally, individual-level transaction analysis does not adequately account for transaction costs that accrue from power structures and political processes (Ghoshal & Moran, 1996). Organizational isomorphism is able to address at least part of these shortcomings; however, it has in turn different

shortcomings. It ignores the role of interest, power, and agency, a central aspect of TCE, and the theory has also no explicit assumptions on efficiency, which is a central matter in strategic management. Martinez & Dacin (1999) developed a framework showing how TCE and organizational isomorphism can conjointly be applied. While firms are efficiency seeking, they also desire to achieve a fit with the organizations' normative context. The importance of either aspect depends on the concern for survival and on the degree of ambiguity. The degree of ambiguity hereby refers to the ability to identify and calculate transaction costs. First, in presence of immediate concerns for survival and difficult TCE judgment, companies frequently *indicate* efficiency rather than *achieve* it. Isomorphism and replication in industries is very important. Second, if transaction cost considerations are low, firms are likely to be self-confident and rational, even if there are concerns for survival. Commitment to the legitimated course of action is symbolic. Third, efficient imitation leads to high importance of control, while imitation becomes a matter of efficiency. This situation results if there are low survival concerns to adaptation and if transaction costs are ambiguous in measurability: "...given the ambiguity surrounding the identification and interpretation of transaction costs in this case, and the fact that information search is not costless (Cyert & March, 1963) it may simply be most *efficient* for the organization to look at the actions of its peers or competitors in order to determine the appropriate course of action" (Martinez & Dacin, 1999: 89-90). Firms would not just imitate for the sake of legitimation of their own action, but the goal would be to imitate best practice. Fourth, low concerns for survival and a low degree of ambiguity are reflected in efficient operations. In this situation, TCE concerns are more important and the legitimation of action would focus on potential concerns for the future. In this framework, the third situation is very likely to be observed in offshoring. Companies do not face immediate concerns for survival, but they face difficulties in estimating transaction costs in view of the cultural distance and the lack of experience with this strategy. Organizational isomorphism and the replication of action can thus be understood as an efficient strategy that is in line with TCE considerations. Within the understanding of organizational isomorphism, the aspect of replication is especially relevant with regard to mimetic and normative isomorphism. Usually, there is no institutional pressure to offshore. On the contrary, offshoring is frequently accompanied with political outcry and resistance. However, if firms can legitimize their action with mimetic and normative isomorphism, it facilitates withstanding resistance from the public. Isomorphism may also be helpful to explain why inexperienced firms take certain decisions. Firms imitate the behavior of other

respected corporations and thereby enhance their own legitimacy with regard to their strategic posture (probably also because the degree of ambiguity is higher). In offshoring, isomorphism is very important for initial governance mode decisions. Companies have no internal experience, which makes mimetic structuring of the processes more likely.

2.3.2 Learning by Doing: A Capabilities Perspective

The dynamic capabilities perspective or capability-based view of the firm (CBV) is a response to the paradigm perspective in strategic management, the resource-based view of the firm (RBV). Both are attempts to explain how firms can achieve superior performance based on unique resources and capabilities. The intellectual work that underlies the discussion of CBV is the Schumpeterian world of innovation-based competition and the concept of “creative destruction” (Schumpeter, 1942). Before going into the details of this perspective, let us take a closer look at its resource-based foundation.

2.3.2.1 The Resource-Based View of the Firm

At its core, the RBV is a translation of Ricardo’s theory of scarce productive resources into strategic management. Influenced by the work of Penrose (1959), Rumelt (1984) and Wernerfelt (1984), Barney (1991; 1986) made a first attempt to formalize the perspective. The result is a tool that can be used to determine resources available to a firm which ought to be exploited in order to achieve sustainable competitive advantages. Compared to collusion-based theories like Porter’s five forces framework (Porter, 1985), RBV has four important distinctions in its underlying assumptions. (1) It assumes that firms within an industry or a group may be *heterogeneous* with regard to their resource endowment. (2) Heterogeneity may persist over time because firm resources are *not perfectly mobile* (Barney, 1991). Peteraf (1993) adds that competition for any resources leading to rents must be (3) *ex ante*, and (4) *ex post* limited. *Ex ante* competition limitation refers to the foresight or good fortune of companies to acquire an inimitable resource position. *Ex post* competition limitation refers to the need for heterogeneity to be preserved, primarily through imperfect imitability and imperfect substitutability. The first assumption is the source of Ricardian or monopoly rents, allowing for superior resources. The second ensures that rents are bound to a firm. The third prevents the costs of acquiring resources, which are necessary to implement strategies, from

offsetting the rents. The final assumption ensures that resources are not only bound to the firm, but that their respective rents are sustainable over time.

According to Daft (1983), *firm resources* include all assets, capabilities, organizational processes, firm attributes, information, knowledge, *etc.* controlled by a firm that enable the firm to conceive of and implement strategies that improve its efficiency and effectiveness. Barney (1991) clusters firm resources into physical, human, and organizational capital resources. Based on the four assumptions above, four conditions are derived that resources need to encompass in order to be the source of sustainable competitive advantages. They must be valuable, *rare*, non-imitable, as well as non-substitutable (VRIN attributes). If these attributes are met and under the condition that a *strategy* using these firm resources cannot be simultaneously implemented by rivals, a firm can achieve *competitive advantages*. Moreover, if the *rents* generated through the strategy cannot be replicated with similar strategies, the firm can achieve *sustainable competitive advantages* (*ibid.*).

This rather complex understanding of comparative advantages can be put across with an example. In 1980, Microsoft purchased QDOS operating system (the precursor to MS-DOS) for only USD 50,000 from Seattle Computer products. As it is commonly known, the consequential IBM PC standard generated several billions of dollars in revenues in the following decades (Makadok, 2001). The *resource* that was successfully acquired was QDOS; however, the *firm resources* leading to the competitive advantage represent the entirety of all physical, human and organizational capital resources of Microsoft. This bundle of resources fulfills the VRIN-attributes. Microsoft obviously had accurate expectations when evaluating the potential of QDOS, for which reason they engaged in the market transaction. The company assumed that embedding the resource in the firm strategy would lead to competitive advantages. Because of limits to the *ex ante* competition, Microsoft could outsmart Seattle Computers, which simply did not have the necessary complementary firm resources and which lacked the information about how to successfully generate rents with this resource. The limits of the *ex post* competition mean that even after rivals took notice of Microsoft's success, they were not able to replicate the product. In addition and according to RBVs' assumptions, IBM PC standard is a heterogeneous product that cannot be sold to another company not having the appropriate knowledge about how to manage it.

As its name points out, RBV focuses on firm resources, and profits can be generated by making use of the firm's competences. Crucial is the successful

identification of valuable resources and their targeted exploitation. Since this approach is rather static, a new stream of research has developed up – the capability-based view of the firm.

2.3.2.2 *Dynamic Capabilities Perspective*

RBV has taught us which attributes resources need to have in order to allow firms to achieve sustainable competitive advantages. The dynamic capabilities perspective (DC) acknowledges this form of competitive advantage, but criticizes that the mechanisms enabling the isolation of firm resources is not discussed. Hence, the focus of this new perspective is on the processes, the development of management capabilities, and difficult-to-imitate combinations of organizational, functional and technological skills (Teece *et al.*, 1997). The idea is inspired by the work of Joseph Schumpeter on competitive processes and “creative destruction” (Schumpeter, 1942). According to this logic, an innovative entrepreneur can skim off rents and increase long-term economic growth, even as he destroys the value of established companies enjoying some degree of monopoly power.

Important contributions to the research stream have been made by Nelson & Winter (1982), Prahalad & Hamel (1990), Teece (1976; 1986), or Hayes, Wheelwright, and Clark (1988). Before going into the discussion of the implications of DC and how competitive advantages can be achieved, some clarifications with regard to terminology must be made. Amit & Schoemaker (1993: 35) make an attempt to differentiate capabilities from resources, by saying that...

...“Capabilities (...) refer to a firm’s capacity to deploy Resources, usually in combination, using organizational processes, to effect a desired end. They are information-based, tangible or intangible processes that are firm-specific and are developed over time through complex interactions among the firm’s Resources. They can abstractly be thought of as ‘intermediate goods’ generated by the firm to provide enhanced productivity of its Resources, as well as strategic flexibility and protection for its final product or service”.

Moreover, and in line with the definition by Daft (1983), Makadok (2001: 389) argues that capabilities are a special type of organizationally embedded non-transferable firm resource, “whose purpose is to improve the productivity of the *other* resources possessed by the firm”. While RBV focuses on “resource-picking”, dynamic capabilities stress the need for “capability-building” (*ibid.*). Firm capabilities cannot be understood in terms of balance sheet items and they cannot be bought in the market (Teece *et al.*, 1997). Capabilities need to be created internally and must

be understood in terms of the organizational structures and managerial processes which support productive activities.

As discussed in the context of RBV, it is necessary to elaborate on the question of how competitive advantages can be achieved under this perspective. Teece *et al.* (1997: 509) state that “the competitive advantage of firms is seen as resting on distinctive processes (ways of coordinating and combining), shaped by the firm’s (specific) asset positions (such as the firm’s portfolio of difficult-to-trade knowledge assets and complementary assets), and the evolution path(s) it has adopted or inherited”. In other words, *positions*, as well as *paths*, shape the managerial and organizational *processes*. Analogously, because processes are influenced by positions and paths, they will equally help to determine a firm’s distinctive competence and therewith competitive advantages. Finally, dynamic capabilities reflect the ability to achieve new and innovative forms of competitive advantages (*ibid.*).

The importance of processes in the dynamic capabilities discussion makes it necessary to render some further remarks. Processes can be static, dynamic, or transformational and constitute routines or patterns of current practice or learning. *Static* refers to coordination and integration, internally or externally, and embraces forms such as strategic alliances, virtual corporations, *etc.* Learning is probably the most important component (Teece *et al.*, 1997) and constitutes an integral part of the process as the *dynamic* component. The authors thus regard learning on an “operational” level, relating it to repetition and experimentation, enabling tasks to be performed better and creating new product opportunities. Finally, the *transformational* component embraces the reconfiguration of the firm’s asset structure, which is accomplished through internal and external transformation. The aim is thereby to adopt best practice from the market. Each of these components represents a way of handling resources, understood as firm-specific assets. Those assets include very tangible assets such as technological, structural, or financial assets, as well as difficult to trade knowledge assets and reputational assets.

As defined above, *paths* influence these processes. This aspect takes a central role in the path dependency literature. In path dependency, the firm’s history is considered and the firms’ opportunities are a function of the current position and the paths ahead.

In sum, according to the dynamic capabilities perspective, the winners in a marketplace are not the firms merely successfully acquiring valuable resources, but those firms “that can demonstrate timely responsiveness and rapid and flexible product innovation, coupled with the management capability to effectively coordinate and redeploy internal and external competences” (Teece *et al.*, 1997: 515).

2.3.2.3 *The Implications of the CBV on Offshoring*

Applying the resource-based view to the offshoring discussion raises a problem with regard to Barney’s (1991) attributes on the determination of sustainable competitive advantages. Barney argues that imitable resources cannot generate sustainable competitive advantages. As cost reductions are a major driver for offshoring (Lewin & Peeters, 2006; Lowes *et al.*, 2004) and relocation to cheaper locations can easily be imitated by competitors, offshoring would not lead to such advantages. Once imitated, we would expect savings on labor costs to be compensated with wage increases over time. Consequently, offshoring would appear as a temporary strategy. There are two arguments against this imputation. On the one hand, we have to acknowledge that talent seeking is increasingly a driver for offshoring (Lewin & Couto, 2007). Companies in the West are growing faster than the talent pool in the same locations, while developing countries have a growing number of well-educated workers available. Companies are aware that talent seeking cannot fully be combined with the cost savings driver. The labor market of highly educated employees is sufficiently mobile so that a certain convergence in salaries needs to be accepted. In addition, the formation of knowledge clusters in offshore locations and visa restrictions in the developed countries raises the wages in the offshore locations. Rather than looking at offshoring from a cost savings perspective, we should look at the long-term strategic component of accessing highly skilled labor. Offshoring is a way to acquire (labor) resources abroad. The related new impetus and structural changes can improve internal processes and finally lead to sustainable competitive advantages. On the other hand, dynamic capabilities underline the aspect of learning (Teece *et al.*, 1997). The learning process in offshoring refines and develops the strategy, makes it firm specific, and inimitable for other companies. As one of the interview partners stressed, offshoring is only successful if fully integrated into corporate strategy (Interviewer A, 2007). In the large Swiss Bank A which was interviewed, the captive offshore centers are encouraged to learn and develop themselves further, even to an extent that they become eligible to take over more

and more tasks from the headquarters. This continuous process enables firms to make fully use of the global talent pool.

The explanatory power of DC is however not limited to talent seeking and learning. While I have argued that the cost savings are an imitable strategy, we can also look at this aspect from a different point of view. The common knowledge of focusing on core competencies usually relates to primary activities of the value chain (Prahalad & Hamel, 2006). In particular, in diversified companies it may be efficient to focus production on fewer products. Higher margins and profitability in those areas consequently lead to higher firm performance. From a resource perspective, the same logic can be transferred to offshoring. Although support functions are not a core competency for a firm, some of them have established more efficient processes than others. While the term “focusing on core competencies” would not be appropriate, offshoring can be a means to relocate support functions that companies are not better in performing at home. In comparison to the resource-based perspective, it is important to divert the focus from resources *per se* to the knowledge on how to manage and develop resources. Offshoring can be used as a strategy to recombine current capabilities and improve existing processes. The resulting new (and superior) ways of cooperating with internal or external service providers cannot be easily acquired by competitors, because they build on social relationships that already exist in the firm (Kogut & Zander, 1992). In this respect, I expect that the firm-specific capabilities are manifested in drivers and motivations, making them a predictor for the governance mode decision.

Adding the dynamic capabilities perspective to TCE and organizational isomorphism requires a discussion of the underlying assumptions. The link between TCE and organizational isomorphism has been discussed in chapter 2.3.1, while I found that the theories are complementary in nature. Complementary is also the link between dynamic capabilities and TCE (Teece et al., 1997; Williamson, 1999). As argued above, TCE focuses on the assumption of bounded rationality and opportunism of economic actors (Williamson, 1979). Dynamic capabilities assumes that “competitive advantage of firms is seen as resting on distinctive processes (ways of coordinating and combining), shaped by the firm’s (specific) asset positions (such as the firm’s portfolio of difficult-to-trade knowledge assets and complementary assets), and the evolution path(s) it has adopted or inherited” (Teece et al., 1997: 509). Companies are seen as heterogeneous units with distinct capabilities, developing in a dynamic manner. Both perspectives share an “inside the firm” view

(Rumelt *et al.*, 1992 in Williamson, 1999). While a dynamic component is considered in TCE (for an overview see Williamson, 1999) and Langlois (1992) elaborates on the concept of dynamic transaction costs, the perspective is still considered rather static (Teece *et al.*, 1997) and the whole concept of learning is missing in TCE (Williamson, 1999). In response, Williamson (1999: 1103) argues that the central question of TCE should be reformulated in view of the dynamic capabilities. The question “‘What is the best generic mode (market, hybrid, firm, or bureau) to organize X?’, which is the traditional transactional cost query, the question to be put instead is ‘How should firm A – which has pre-existing strength *and* weaknesses (core competencies *and* disabilities) organize X?’”. The drivers and motivations for offshoring are exactly of this kind and therefore correspond with both theories

Furthermore, different assumptions in the underlying theories are unproblematic when applying at different points in time. I acknowledge that there are different forces in a governance mode decision in offshoring. These forces may be inside-out driven or outside-in driven, but I argue that the forces change depending on the stage of the decision. While in initial stages of offshoring firms are inexperienced with this strategy, I assume a greater importance of transactional considerations. This however changes with experience and dynamic aspects such as learning and recombination of existing capabilities become more important.

As a foundation for the second part of the dissertation, I will look at the nexus of relationships involving actors with different interests. In offshoring, this situation is distinctive between clients and service providers.

2.4 Aligning Interests: Agency Theory and the Nature of Cost Centers

Agency theory is primarily concerned with situations and their consequences where ownership and control are separated in an economic activity. It is thus a perspective looking at the behavior of individual or collective actors depending on incentive structures. The emerging agency costs resulting from different incentives can take the shape of costs for control, monitoring, contracting, bonding, as well as residual losses (Jensen & Meckling, 1976). If those measures are not directly applicable or if they are costly, appropriate incentive structures can be an alternative in order to reduce costs (Eisenhardt, 1989).

The cognition that a separation of ownership and control in a company leads to conflicts of interests was first described by Berle and Means in 1932 in their book "The Modern Corporation and Private Property". Jensen and Meckling (1976) formalized and proved this effect statistically. Because individuals maximize their utility, the agents (managers) attempt to maximize their personal wealth, while the principals (shareholders) seek shareholder-value maximization. Since these contradicting aims would lead to a collapse of the economic system, Fama and Jensen (1983) further explain that the survival of organizations can be ascribed to effective controlling approaches and contract structures in the organizations. Such control mechanisms can, for instance, be the organization of the board of directors, executive compensation of the management, ownership structure, market for corporate control, capital structure policy, auditing and monitoring by financial institutions, or product market competition (Allen & Gale, 2000). Corporate control issues are discussed in Fama and Jensen (1983) and Jensen and Ruback (1983). They define corporate control as „the rights to determine the management of corporate resources – that is, the rights to hire, fire and set the compensation of top-level managers” (Fama & Jensen, 1983: 313).

The underlying assumptions of agency theory build on the assumptions of TCE. Common assumptions of TCE and agency theory include bounded rationality, self-interest at the individual level, goal conflict at the organizational level, information asymmetry, as well as preeminence of efficiency (Eisenhardt, 1989). Risk aversion and information as a commodity are assumptions exclusive to agency theory. The focus of the unit of analysis in both theories is just slightly different, while shifting from the transaction to the contract between principals and agents. Agency theory and TCE are sharing a parentage in economics, but each has its own focus and independent variables (*ibid.*). When looking at client-service provider relationships in offshore outsourcing, agency theory is an appropriate theory to consider. It considers different interests of the parties involved and compared to TCE it does not focus on the boundaries of the firm. Based on the underlying assumptions, the theory helps in understanding why and how information asymmetries of offshore centers should be aligned with companies' goals using different incentive mechanisms.

While agency theory has largely been developed by (financial) economists (*c.f.* Fama & Jensen, 1983), it is increasingly applied in the literature on the relationship between headquarters and subsidiaries (Roth & O'Donnell, 1996). In such situations, agency costs arise because of potential conflicts of interest in the knowledge transfer

from agents to managers higher in the organization. The related nature of the offshoring discussion thus contributes to this body of literature. Likewise, we can observe agency costs between clients and service providers.

A traditional subsidiary of an MNC has the task to represent the company abroad and is responsible for sales in the respective country (Birkinshaw & Hood, 1998). The performance measurement of such a unit is straightforward and matches with local performance measures such as sales, margins, cash flows, *etc.* Offshore outsourcing is different in two ways. On the one hand, the task is not performed by a subsidiary but by a third party service provider. On the other hand, performance of the tasks is very difficult to measure. If, for instance, a US company offshores its CV screening processes in human resources to an Indian provider, the outcome of the service is hardly measurable. The client and the service provider typically have different interests. While the clients' goals are to employ the best employees and produce at the lowest possible costs, the service provider wants to fulfill his task as efficiently as possible and charge as much as possible. For this reason, Aron & Singh (2005) suggest that tasks whose outcome is not directly measurable should not be outsourced to a third party service provider.

In a later paper, Jensen & Meckling (1999) outlined and formalized the determinants of effective performance measurements for various divisional forms. In the framework including cost centers, revenue centers, profit centers, investment centers, as well as expense centers, captive centers in offshoring most likely correspond to the nature of cost centers or expense centers. These structures have a focus on efficiency enhancement in the production process. A cost center produces a specific output for the remaining parts of the value chain, but they do not generate any direct revenues. Expense centers similarly produce services for the rest of the organization, while the consuming units are not charged for the services they consume (Jensen & Meckling, 1999: 14). While for cost centers the produced quantity is measurable, but quality is not, neither quality nor quantity can be measured for expense centers. The incentive of a cost center manager is thus to produce at the lowest average cost regardless of demand and quality. A manager of an expense center has an incentive to maximize the budget. We can translate both situations to third party offshoring. Popular performance measurement in such cases is via cost savings (Jensen & Meckling, 1995). However, by limiting performance measures to cost reductions, it is evident that quality issues may become critical. This is particularly apparent in our CV screening example. On the one hand, one can

hardly measure how many CVs have been screened by the service provider. On the other hand, the quality of the CV screening can scarcely be checked. The performance of such an offshoring activity can only be captured in the long run, when it is apparent that the company has hired good employees. Price negotiations for such services are particularly difficult because performance measures are based on vague figures. Given that the production would theoretically be at the efficient firm-level optimum, service providers still have scope to increase their output by claiming insufficient workforce, too little budget, *etc.* Most likely, the client will hardly be able to object and is only able to judge the output based on experience and the costs the company faced before outsourcing. Even more difficult is the situation where multiple products are delivered by the service provider. If the quantity of these products is not, or cannot be, specifically defined, the management of an offshore center has an incentive to focus on the cheaper products in order to minimize his overall costs. A problem that can only be managed through the active controlling and involvement of the client. The conclusion of Jensen & Meckling (1995) that outsourced services are frequently overpaid is likely to be applicable for outsourcing as well. However, I suggest that firms have developed mechanisms to reduce agency costs substantially.

Costs associated with the poor measurability of quality and quantities actually have two implications for performance measurement and the sustainability of offshoring relationships. So far, I have only elaborated on insufficient quality or so-called hold-up and moral hazard problems. Hold-up problems refer to situations where the inefficient behavior of the partner is never observed. In moral hazard situations, ex-post inefficiencies are detectable after the contract is settled, so it is difficult to re-contract in order to achieve an overall efficient solution. The other implications of agency costs refer to potential expropriation of knowledge by service providers. Björkman, Barner-Rasmussen, & Li (2004) emphasize the incentive alignment in order to allow for an optimal knowledge outward flow from subsidiaries. In particular, if there are differences in goals, it may hinder the transfer of knowledge, because subsidiaries have an incentive to develop their own technology. In a sample of 134 Finnish and Chinese MNC subsidiaries, the authors find that the use of knowledge transfer as a component in the evaluation of performance, in the subsidiary management compensation, as well as the involvement of expatriate managers in the subsidiary has a positive effect on the outward knowledge flow. Mudambi & Navarra (2004) discuss the topic from a slightly different perspective. They elaborate on the more fundamental question of what drives the principal-agent

problem among units of an MNC. Focusing on 275 UK R&D subsidiaries of non-UK MNCs, the authors show that bargaining power has a strongly positive effect on rent-seeking. This bargaining power can be actively managed through a high level of research intensity, of autonomy, and procedural self-control. Alternatively, it may be passively obtained through knowledge inflow from other units and through tenure. In this sense, knowledge can be equated with a certain degree of power, which in turn leads to rent-seeking behavior. In offshore outsourcing, I expect that knowledge flow hindrance in the sense of Björkman *et al.* (2004) is relevant. With regard to the bargaining power as described by Mudambi & Navarra (2004), third party service providers will most likely try to improve their negotiating power by using the knowledge inflow. There are very strong incentives for service providers to gather operational knowledge from clients in order to use it for attracting other clients. For many companies this is a very sensitive issue and is frequently a reason to select integrated modes. If companies are not aware of this issue and there is a long continuation of offshoring relationships, this aspect can remain unobserved for a long time and lead to dependencies.

Clients may frequently be willing to engage in such long-term relationships because perpetualness can be beneficial to the offshoring strategy. However, companies need to have control over their external strategies and processes. One way to address this issue is through social control (Granovetter, 1985) or trust (Langfield-Smith & Smith, 2003). Large service providers are particularly dependent on their reputation and cannot afford to exploit clients' knowledge. Besides the soft factors of control, companies are likely to consider governance mechanisms aligning the goals of the clients and the service providers.

The above-introduced theories are very generic in their nature and form a part of the main classes/mechanisms explaining positive profits in strategic management (Makadok, 2004). As stand-alone theories are, with a few exceptions, lacking in IB (Buckley & Lessard, 2005), the literature is frequently drawing on insights of strategic management or other related social sciences fields (Werner, 2002). In the following chapter, I will provide a review on the relevant literature emerging in the offshoring field. The subsequent chapter will then draw on offshoring-related IB discussions (such as the market entry mode literature), which largely build on the predictions of the broader underlying strategic management theories presented above and form the basis for the hypotheses development.

3. Conceptualizing Offshoring Governance Relationships

3.1 Offshoring in the Literature

The literature on offshoring has received increased attention in the last couple of years. International business (IB) oriented journals such as the *Journal of International Business Studies*, the *International Business Review*, the *Journal of International Management*, or the *Journal of Management Studies* have launched or are about to launch special issues designated to this new stream of literature. At this point, I will provide a broad summary of the major ongoing discussions in the field. I will focus on the literature that concentrates on offshoring exclusively. The literature on (domestic) outsourcing is manifold and has largely been discussed in the journals (for an overview *c.f.* Lankford & Parsa, 1999). A summary of the offshoring-related literature based on Manning, Massini, & Lewin (2008) can be found in appendix 9.1.

3.1.1 Internationalization of the MNCs and Offshoring

While offshoring is a new phenomenon in the literature, it is necessary to differentiate the field from traditional and recent discussions on the structure and internationalization of the MNC. In a seminal article, Vernon (1966) developed the product life cycle model, explaining how competition would affect the behavior of MNCs in international trade. Based on the example of the US, the theory suggests that firms in industrialized countries develop capital-intensive and sophisticated products at home. In a second step, production shifts to other developed countries, and only in a third stage, does production shift to developing countries. Offshoring in the current discussion has a different meaning. It is not about producing inputs that form a part of the final product or the final product itself. As offshoring is about support functions of secondary functions of the value chain, it requires constant interaction with the headquarters or the client.

Insights into the offshoring discussion can also be derived from the literature on the internationalization of the firm. This stream of literature does not focus on the production, but on, for instance, the percentages of foreign sales, foreign assets, or foreign employees and their link to performance (Sullivan, 1994). Put differently, the discussion is about the measurement and description, antecedents, as well as consequences of the internationalization process (Werner, 2002). In particular, the latter aspect can provide some insights into the offshoring discussion.

In the relationship between internationalization and performance, Ruigrok & Wagner (2003) find a u-shape relationship for German companies. This implies that companies are learning during the internationalization process. Companies are likely to enter neighboring countries with high degrees of cultural similarity, where access is comparatively easy. Once companies enter distant countries, performance is substantially lowered because of a lack of experience. If companies show stability of presence, are successful with learning, and gain routines, they are able to increase profits at a later stage. Despite the differences between offshoring and the international leveraging of companies' activities, we can expect that offshoring follows likewise a sequential process with different stages of learning. Initial offshoring attempts are frequently rewarded with high cost savings and a high level of satisfaction. There is subsequently a high risk of disenchantment because of disappointment with quality or more comprehensive cost calculations. Firms can then increase cost savings again at a later stage, once they show stability of presence and can improve processes through learning. While insights from the literature on the internationalization of MNCs are very relevant for analyzing the consequences of offshoring, it lacks explanatory power for analyzing the antecedents of offshoring.

The antecedents of offshoring can be regarded in conjunction with the literature on organizational forms of the MNC. In the 1980s, there was extensive debate about how firms should adapt their organizational structure in the international context. Researchers like Williamson (1985) or Burton & Obel (1988) followed a transactional approach and argued that companies have to address bounded rationality and opportunism with a sufficient degree of control and incentives when organizing a firm. In contrast, researches such as Bartlett & Ghosal (1989) defended a new form of organizing with autonomous sub-divisions scattered around the world. Management responsibilities are kept to a minimum and their major task is to create purpose and to challenge the status quo. The front-line managers in the subsidiaries hold extensive responsibilities and are the entrepreneurs.

Literature that is more recent departs from pre-defined structures. Organizational forms are the result of flexible and efficient capability deployment across organizational units (Eisenhardt & Brown, 1999; Karim, 2006). A sub-stream of this literature, the literature on modular business unit changes, focuses on the reconfiguration of internally developed and acquired units (Karim, 2006). Reconfiguration can hereby imply the addition of units, the deletion of units, or the recombination of units. Karim (2006: 800) finds "that acquired and internally

developed units serve different roles in the process of change, and that firms perceive reconfiguration to be beneficial". She finds that more acquired units are reconfigured, and that they are reconfigured sooner. This strategy enables firms to extract knowledge and provide organizations with opportunities to experiment with structures. As the literature does not provide a detailed definition of a "unit", the logic may also apply to traditional subsidiaries, just as it may apply to offshore centers or third party service providers. Collaborating with offshore entities allows firms to extract knowledge and reconfigure existing processes. Units can become closely embedded, weakening the boundaries between different (internal and external) units. Analyzing the governance mode decision in offshoring according to this literature would add too much complexity to the discussion. Nevertheless, also in connection with this literature, the peculiarities of offshore centers compared to traditional subsidiaries need to be stressed. The flexible deployment of resources makes sense if the output of the entity can be measured and units have to compete with each other. While this is hardly the case for initial offshoring activities, subsequent governance mode decisions are likely to be taken from a competitive point of view.

As I will show later on, companies which offshore using both governance modes achieve higher savings than companies that are focused on one governance mode. The other argument why offshoring needs to be treated separately in this discussion is because of the focus on the offshore entities. While traditional subsidiaries are output oriented, offshore centers are concerned about inputs, such as land, labor, and infrastructure. For this reason, Levy (2005) argues that offshoring has to be separated from the traditional internationalization perspective. In this regard, I will refer to the underlying theory of dynamic capabilities, but will not touch upon the discussion on organizational structure.

3.1.2 Global Trends and Drivers of Offshoring

The *Journal of Management Studies* was one of the first journals to designate an entire section of an issue to the offshoring discussion. It was an attempt by the authors to make the point that offshoring is a significant strategy for both the manufacturing and the service sectors, and it is generating "considerable debate among practitioners and policymakers" (Cornelissen, Floyd, & Wright, 2005: 673). However, they left open the question of whether offshoring is just "the latest scam peddled by consultants" or whether it represents an important attempt to enhance the competitiveness of large corporations in mature economies (*ibid.*). Several consulting companies are promoting the discussion well, and their research shows that

offshoring creates value for both companies and the whole economy (Deloitte, 2005; Farrell, 2005).

From a *macroeconomic perspective*, Blinder (2006) is reluctant to state unequivocally that it is an unconditional benefit for all countries involved, and he builds his argument on Jagdish Bhagwati's "kaleidoscopic comparative advantages". Kaleidoscopic comparative advantages imply that comparative advantages are dynamic and can shift from one country to another (Bhagwati, 1994). Blinder argues that offshoring is can potentially be considered for all services that are mobile and can be performed remotely. Offshoring is not about high-skilled or low-skilled labor; rather, it is about work that does not require physical interaction with customers or internal clients (nonpersonal services) versus work requiring on-site physical interaction (personal services). Decreased communication costs and technological advances have increased the mobility of nonpersonal services. Consequently, competition of potentially offshorable goods is increasing and prices are decreasing. Decreasing prices imply that the relative prices of domestic personal services are increasing and demand is decreasing. This would then have a negative effect on the home country, and comparative advantages might shift. Blinder suggests that countries should react to this situation by strengthening their workforce in jobs that are performed on site. Creativity and capital can then lead to innovative new functions that are performed domestically.

Along these lines, Farrell (2004) argues, based on the German example, that countries have to perform structural changes in order to facilitate the shifts in the labor market. Levy (2005) is even more reluctant regarding the positive effects of offshoring for nations, and he argues that wealth creation takes place for shareholders only. Many workers face difficulties in "trading up" (Cornelissen *et al.*, 2005: 673) to higher-skilled jobs, which can weaken the economic power of a country. This argument can, however, be challenged with Blinder (2006), who states that the shift should take place from non-personal services to personal services. Finally, Doh (2005) suggests that companies have to address macroeconomic concerns as well. Companies should implement appropriate codes of conduct as well as international labor and environmental standards in order to mitigate the concerns about offshoring. The assertion that firm-internal guidelines should be introduced in the context of offshoring paves the way for extending the offshoring discussion into business ethics.

On the border between the macroeconomic and the microeconomic discussions, the extent of offshoring, *i.e.*, the magnitude and facilitators of the strategy, can be discussed from an *institutional perspective*. Ksheteri (2007) examines the mechanisms by which regulative rules, social rules, culturally supported habits and subconsciously accepted rules and customs influence the assessment, selection as well as continuation of outsourcing projects. Based on a conceptual framework, Ksheteri makes several suggestions in order to make offshoring beneficial for both companies and countries as a whole. In particular, institutional changes (such as the European Union expansion) should be designed to facilitate offshoring and offer great opportunities for the countries involved.

3.1.3 National and Cross-National Studies

Both Blinder and Farrell argue that offshoring is only beneficial for a country if the domestic labor market is kept flexible enough to facilitate structural changes (Blinder, 2006; Farrell, 2005). This fact has spurred researchers to look at specific countries, how these countries can benefit from offshoring in particular, and what the effects on the domestic labor market are. Based on the example of the UK, Amiti & Wei (2004) find that offshoring did not cause any unemployment during 1995-2001. They conclude that the anxiety of offshoring is not justified in the UK. On the contrary, the rest of the world is offshoring more to developed countries than the reverse. Harrison & McMillan (2006) provide a more nuanced conclusion for US manufacturing employment. They find that the offshoring of jobs that are performed parallelly at home does cause unemployment, while offshoring tasks that are not performed at home does not cause any unemployment. This argument is in line with Blinder's (2006) distinction between jobs that require physical personal interaction and those that do not. Other issues such as declining prices for consumer goods, import competition, and falling prices for investment goods seems to be much more decisive. Mankiw (2006) even argues that increased employment in offshore affiliations is associated with more employment in the US parent companies.

Offshoring does not seem to have a greater impact on the unemployment rates of home countries. Nevertheless, some jobs actually experience a drop in salaries as a consequence of relocation. Engardio, Bernstein, & Kripalani (2003), for instance, report a decrease from USD 130,000 in 2000 to USD 100,000 in 2003 for an average senior software engineer in the US. The authors attribute the decline to the competition from offshore locations. However, this decline in salaries could additionally relate to the bursting of the IT bubble, which had a negative effect on

salaries. In the literature there seems to be agreement that certain sectors indeed incur disadvantages from offshoring. The different stakeholders however demand different reactions from the governments. While unions support a protectionist approach for jobs that are potentially offshorable, economists translate Blinder's (2006) suggestion to focus on non-personal jobs and to facilitate structural changes on the national level. Garner (2004) suggests that policy makers in the US should conduct international negotiations to open foreign markets and guarantee international property rights. Combined with an improved educational system, trade adjustment programs, as well as appropriate monetary and fiscal policy, full employment should be achieved. If this is successfully carried out and the workforce can be moved into higher value adding jobs, the living standard can even be increased.

3.1.4 Offshoring Strategy and its Evolvement

So far, we have learned that firms are likely to be confronted with domestic opposition when offshoring. Although the overall economic effect does not *per se* have to be negative (Blinder, 2005), some individuals must suddenly compete with offshore employees and may be worse off in the domestic economy. The opportunity for cost savings and the potential to access qualified personnel abroad is however stronger and drives companies to select this strategy. Furthermore, companies can feel pressure to offshore in order to remain competitive. Companies subsequently face the question of how they can benefit from this potential on a firm-specific level. Particularly important are the location choice, the functional decision, as well as the governance mode decision. The literature does not only address these issues, but high variation in decision-making over time has also led researchers to investigate the trajectories of offshoring (Manning *et al.*, 2008).

The adoption of the offshoring strategy in companies is a core issue in Lewin & Peeters (2006). They raised the question whether the strategy is a top-down or a bottom-up-driven process. Building on the 2005 survey wave of ORN, they conclude that in most cases offshoring follows an opportunistic, bottom-up, sequential process. Cost savings and service level figures exceed expectations in early stages of offshoring. As offshoring strategies mature, savings become more realistic (which might be because cost calculations are more detailed and elaborate) and the strategy is formalized. Vivek *et al.* (2008) argue that offshoring strategies are initially led by opportunism. However, we can assume that the increasing scope of offshoring leads to a shift of this issue upwards in the organizational hierarchy. Offshoring is replaced

with competence building and non-economic trust over time (*ibid.*). Expressed in theoretical language, decisions are initially driven by transactional considerations. Subsequently, companies form dynamic capabilities and increase process value through trust-based relationships. Firm-internal resources and capability considerations come into focus over time.

When discussing strategic decision-making in offshoring, probably the most central questions regard the offshoring location, the offshoring function, as well as the offshoring mode. Aron & Singh (2005) argue in the context of governance mode decision that the offshoring question should be based on the question of whether a function creates value for the customer and to what degree processes allow businesses to capture value. This is directly linked to the question of what is core and non-core for a business. Companies are well advised not to offshore functions that are critical or that make them dependent on third parties (Ansari, Sidhu, Volberda, & Oshri, 2007). More difficult is the definition of what “critical” is. The boundary between critical and non-critical is frequently very nebulous. It may be very difficult for firms to identify which knowledge they can afford to lose or which they could easily buy on the market. Once identified, it does not yet imply that a critical task may under no circumstances become subject to offshoring. Keeping certain key processes or a certain stage of the service delivery at home can make even a critical process offshorable. Frequently, the identification of such key activities is a process of learning and is established with offshoring experience. Holcomb & Hitt (2007) share the argument that, in particular, initial offshoring decisions are very much determined by transactional arrangements. They suggest that – as in my prediction for the governance mode decisions – the development of offshoring strategies can be explained with the resource-based view. The authors show that interaction with offshore providers can generate competitive advantages by bridging firms with intermediate markets. In this manner, the interaction with providers generates synergies that companies could not create alone. With this form of learning, offshoring can generate sustainable competitive advantages for the firms. The idea of strategy development with foreign operations has also been adopted by Subramaniam & Venkatraman (2001). They find that organizations using cross-national teams, teams with members who have prior overseas experience, or teams whose members communicate frequently with overseas managers acquire information about tacit differences among countries. Consequently, those firms have “greater transnational product development capabilities” (*ibid.*, 359). Further research

on capabilities development could lead to insights on how to achieve sustainable competitive advantages through offshoring.

As argued above, the most important strategic decisions in offshoring concern the location, the function, as well as the governance mode. The governance mode decision will be discussed further in a separate sub-chapter, as it is the central aspect in this dissertation. Regarding the offshore location, Farrell, Laboissière, & Rosenfeld (2006) performed a cross-national study on different countries and their offshoring potential. They find that India, China, Malaysia and the Philippines have the highest cost saving potential. Furthermore, Mexico and Canada are the most attractive for the US from a business environment perspective. Hungary, the Czech Republic and Poland are more attractive, for instance, for Germany. The specific decision is thus dependent on the drivers to offshore and on physical proximity. Bunyaratavej, Hahn, & Doh (2007) adopt a parity perspective to empirically examine the location choice decision. They find that a country is more likely to become an offshoring destination as average wages of the country *increase*. At first, this finding is counter-intuitive as we observe labor cost savings as a major driver. However, Bunyaratavej *et al.* (2007) follow the argument that firms require a certain educational level in order to consider a nation as an offshoring destination.

From a functional perspective, offshoring in early stages involved mainly IT. Nowadays, all different kinds of support functions not requiring physical personal interaction are potentially offshorable. In planning and executing the strategy, not every function can be treated equally and operational strategies need to be adapted. In the literature, we thus find discussions on a variety of functions, with papers on IT and Research & Development accounting for the largest number of publications. The discussion on IT offshoring has been following the increased interest in this strategy. Lacking capabilities after the emergence of the IT era and the requirements with regard to the year 2000 modifications spurred companies to offshore. Academic publications in the field are normally very applied, focusing on contracts and performance development (*c.f.* McFarlan & Nolan, 1995), success factors (*c.f.* Erber & Sayed-Ahmed, 2005) or technical/operational issues (Abramowsky & Griffith, 2006). The literature on product development likewise has a strong focus on success factors. However, as those functions require particularly high interaction among domestic and foreign employees, the relationship and planning components are dominant in this literature (*c.f.* Helper & Khambete, 2005).

3.1.5 Managerial Issues in Offshoring

While the location, function, and mode are the core strategic questions in offshoring, management faces a variety of operational issues once a decision is taken. As the core resource in offshoring is labor, HR-related topics form an important sub-stream. The current discussion focuses heavily on managing, recruiting, and retaining employees, as well as the development of HR strategies. As another interview shows, in particular turnover appears to be a difficult issue in offshoring (Interviewer B, 2007). High demand in the offshore locations combined with different cultural understanding result in many unfulfilled contractual obligations. For companies it is challenging to invest in the training of employees and retain the employees at the same time. Incentives to transfer knowledge to a competitor in exchange for a higher salary are significantly high (Technologie & Management, 2007). There are several strategies suggested to mitigate the problem of employee retention and development. Companies can either invite employees to the headquarters for training in order to get them acquainted with corporate culture. The effectiveness of this strategy might however be questionable if the gap between salaries in the home country and the host country is excessive. An alternative strategy would be to send an expatriate manager to the offshoring location who is charged with communicating corporate culture and who is actively responsible for retaining the workforce.

Besides the issue of potentially high employee turnover in the offshore location, offshoring needs to find internal acceptance. (Middle-) managers tend to oppose offshoring when fearing loss of control. Dossani & Kenney (2006) argue that managerial control can be retained by assigning little offshore teams to managers at headquarters. Due to the lower labor costs abroad, domestic managers can even increase the number of employees reporting to them. Offshoring would then be perceived as an opportunity rather than a threat to domestic jobs.

As a last component, relationship management between clients and service providers falls into the category of offshoring management. As the sustainability of such relationships is a core issue of this dissertation, I will address it in a separate chapter. The analysis of the relationships is however also discussed from different perspectives, such as for instance network theory. Drawing on evidence from case studies in the investment banking area, Grote & Täube (2007) find that vertical networks and the actors involved determine the offshoring strategy and its development. One of their examples depicts the variety of operational issues that

may arise through offshoring. In accordance with the current trend, banks frequently attempt to outsource basic analyst services to offshore locations. At the same time, senior analysts working at the headquarters are normally recruited from the pool of junior analysts. Banks consequently face the challenge of selecting from among the following three options: (1) recruiting the workforce externally, (2) from the offshore location or (3) they can relocate those senior positions. Researching questions like these or the question of how to deal with cultural issues are highly interesting and provide room for further research.

3.2 A Conceptual Framework for the Governance Mode Decision and Client-service Provider Relationships

In the literature review, I have left out two important topics: the discussion on the governance mode decision, as well as the relationship between the client and the service provider. As these are the central topics in this dissertation, I will provide a more detailed discussion at this point.

3.2.1 An Integrative View on the Governance Mode Decision

In order to generate sustainable advantages and to leverage the full potential of offshoring, the “offshoring tool” has to be integrated in the firm strategy. Firms need to be aware of what they can expect from offshoring. This requires an in-depth analysis from several perspectives. Aron & Singh (2005) argue that most companies focus their efforts on choosing countries, cities, and vendors, as well as on negotiating prices, but they do not spend time evaluating which processes they should offshore and which they should not. Another issue that is critical in offshoring is the choice of the organizational structure, thus, the governance mode decision. The decision on the governance mode should follow the question of how much value it creates for the customer and to what degree each process enables the business to capture value (*ibid.*). Furthermore, the authors argue that in the presence of operational risk, *i.e.*, the risk that processes will not operate smoothly after being offshored, a captive mode should be selected. Similar is the situation in the presence of potential structural risks, *i.e.*, the risk of opportunism of the service providers. The Aron & Singh (2005) *Harvard Business Review* paper is a conceptual, practitioner-oriented paper and, to my knowledge, the only one published in this particular sub-field so far. My attempt is to formalize this perspective, put it in a theoretical context, and test it empirically. In the context of the traditional “make-or-buy” literature,

Leiblein & Miller (2003) show that the governance in the production decision is influenced by transaction-level characteristics, firm-specific capabilities, and the product-market scope. This finding is in line with the findings of the meta analysis by Shelanski & Klein (1995). Leiblein & Miller (2003) test their hypotheses based on an analysis of 469 make-or-buy decisions in 117 firms. The transactional measures asset specificity, uncertainty, and experience show significant influences on the decisions. As depicted earlier, asset specificity has a positive effect on vertical integration. Uncertainty is conditional on whether it can be reduced through integration or not. Finally, experience is a form of uncertainty that is positively correlated with the level of vertical integration, meaning that experienced companies are more likely to “make” than inexperienced companies. Consistent with option-theoretic arguments, the authors further show that product-market diversification as a measure of firm strategy is associated with a greater likelihood of internalizing production. As their example shows, combining transaction cost economics with dynamic capabilities can be powerful when determining the decisions on vertical integration. Similar to Leiblein & Miller (2003), I argue that the governance mode decision follows the traditional transactional pattern that is applied by the market entry mode literature (*c.f.* Zhao *et al.*, 2004). As this perspective has a strong focus on the underlying transaction, *i.e.*, the nature of the functions offshored, as well as the uncertainties involved, the use of complementary approaches is apparent. Organizational isomorphism stresses the adaptation to the environment and the legitimation of action (*c.f.* DiMaggio & Powell, 1983). As offshoring involves the relocation of the domestic workforce, this bears a large potential for domestic opposition. Legitimizing one’s own action becomes very important in response. Replicating the behavior of competitors as suggested by organizational isomorphism is therefore expected to be highly relevant in the determination of the governance mode. While this effect is expected to be very strong, it does also have limitations. In particular, if firms do not have a clear reference group, they have to rely on a different basis for decision-making. Nevertheless, firms may not be inclined to replicate the environment’s strategy. The dynamic capabilities perspective is an “inside-out”, firm-specific perspective analyzing governance mode decisions from an internal perspective. According to this perspective, firms can have different motives for offshoring, independent from the function involved and the environment. While this perspective is relevant for initial governance mode decisions when looking at the motivations to offshore, it is even more so for subsequent governance mode decisions. Once companies establish effective internal processes surrounding a

strategy, dynamic capabilities suggest that firms develop these capabilities through learning (Teece *et al.*, 1997). In offshoring, this has an important implication. Even though the functional perspective would suggest a different governance mode, I expect that, according to the firm-specific perspective, firms replicate their successful past behavior. If a company has succeeded in offshoring, I would expect companies to replicate governance modes even when going to completely different offshoring locations or when offshoring different functions. The combination of the transactional perspective, isomorphism, as well as the dynamic capabilities perspective thus provides an overarching perspective on the governance mode decision in offshoring.

The second part of the dissertation focuses on one particular governance mode, third party offshoring, or offshore outsourcing. As knowledge leaking considerations are distinctive in this mode, I will examine the sustainability of offshore outsourcing relationships more closely.

3.2.2 An Integrative View on the Client-service Provider Relationships

TCE suggests that if costs for switching transaction partners and asset specificity are low, market solutions are selected (Williamson, 1971). Unsatisfactory performance results in the termination of contractual relationships, and different partners are selected. In offshoring, I build on the assumption that the termination of contracts with service providers is a rare event. Even if clients are not satisfied with outcomes, there are reasons for abstaining from switching transaction partners. From a transactional perspective, obstacles in the switching of transaction partners arise through search costs, *i.e.*, the costs for searching for a new partner, contracting costs, *i.e.*, the costs for negotiating a new contract (Dyer, 1998), as well as switching costs, *i.e.*, transferring costs of specific assets (Barthélemy & Quélin, 2006). However, inertia and other relational aspects reach beyond the transactional explanation.

Although we are able to model the strategic behavior of firms in offshoring, it is much harder to predict why a certain provider in a given location is selected. We know that offshoring is a process that is initially bottom-up driven (Manning *et al.*, 2008). This also manifests itself in the selection of service providers which can be made based on prior business relationships of key actors, recommendations of consulting companies, inputs from offshore subsidiaries, *etc.* As there are many reasons to select providers in different locations, we would also have to expect to see a high variation in the termination rates of contracts. This contradicts the original

assumption of rare contract terminations. Building on the transactional approach and operationalizing switching costs, Barthélemy *et al.* (2006, 1778) introduce in this context core-related specificity as well as adapting human assets. *Core-related specificity* refers to “the extent to which the resources that underlie an outsourced activity contribute to a firm’s competitive advantage”. In particular, if the underlying resources are highly specific to a relationship, firms are reluctant to switch service providers. No longer in focus are the underlying resources, but the interaction among resources and capabilities. Service providers play an important role in this regard because they may possess both experience knowledge and process knowledge that are valuable to the client. In this respect, the client does not only have to fear knowledge leaking; it can also benefit from capabilities and processes of the service provider. New offshoring relationships are thus a challenge for both parties. While a client can be uncertain about knowledge protection, it is also a risk for a service provider, for instance, to tap into a new industry. However, if performed successfully, it is a benefit for both the client and the service provider. The client is likely to save costs and improve the processes, while the service provider can gain experience in a new industry (*e.g.*, with regard to practices, regulations, environment, *etc.*). *Adapting human assets* “refers to the extent to which specific assets have been developed to deal with a particular vendor as opposed to the activity’s execution in-house” (*ibid*). This aspect has a human and a procedural dimension (Zaheer & Venkatraman, 1995). Companies develop skills and relationships with vendors that form sunk costs and it is costly to switch from one vendor to another. Both aspects stress relational components of client-service provider relationships that go beyond quantifiable costs.

From an empirical perspective, Levinthal & Fichman (1988) use an event-history analysis to examine the relationship between auditors and clients. Related to my suggestion in offshoring, they find that contracts with auditors are rarely dissolved. This phenomenon is however changing over time, with higher dissolution rates in early stages of the relationships and steadily decreasing probabilities for dissolution over time. Contractual relationships create a form of asset specificity over time, which increases contractual continuity. This form of asset specificity is not nestled in the characteristics of the tasks, but is given with the continuation of relationships (*ibid.*). The transactional argumentation of client relationships is augmented with arguments of capability development in the sense of dynamic capabilities (*c.f.* Teece *et al.*, 1997) and trust building. Using structural equation modeling based on data from 157 organizations, Gainey & Klaas (2003) find socially-

oriented trust to mediate the relationship between client satisfaction and the vendor characteristics when outsourcing high-level training and development functions. While the authors do not offer a direct link between trust and the longevity of client relationships, we can interpret the results in a way that client satisfaction is related to the motivation to maintain a business relationship. Strategically, the creation of asset specificity is very important for creating sustainable comparative advantages. If trust and learning-by-doing in offshoring relationships generates competitive advantages, it is the most important explanation of why the longevity of client-service provider relationships is important.

The logic of intertemporal capability development underlies the assumption that markets are not completely friction-less and that changing transaction partners are always associated with costs. While these costs are very specific in a transactional manner, there are relational “costs” that are linked to capabilities over time and that are essential in the determination of contractual relationships. However, building trust and facilitating mutual learning also require a minimal degree of control, in particular in the initial stages of offshoring. The governance literature as presented in the literature review provides some rich insights into how governance mechanisms can help to align interests.

In line with agency theory, companies need to establish mechanisms that reduce the potential for opportunism (Eisenhardt, 1989). As I have elaborated above, mutual client-specific investments, the involvement of the client in the operations, or contracting can be an effective means. These mechanisms, however, are in my argumentation more hygienic factors than a sufficient means to manage offshoring relationships. Relationships effectively facilitating learning-by-doing and capability development show additional characteristics. Depending on their origin, personal ties and collaborative experience between key actors can explain both the repeated selection of partners as well as the decline of client relationships. This has been shown in numerous studies in the tie maintenance and network literature (e.g. Gulati, 1995; Uzzi, 1997; Beckman *et al.*, 2004). Those aspects will however remain issues that can only be analyzed in-depth on a case-by-case basis. In the quantitative work, I will focus on the testable measures aiming at decreasing agency costs.

4. Hypotheses Development

The theoretical foundation of chapter 2 strongly focuses on discipline-based theories originating in strategy and economics. The reason for this focus is the lack of stand-alone theories in international business (IB) (Buckley & Lessard, 2005). However, as elaborated based on Werner's (2002) areas of research in IB, the relatedness of offshoring with the entry mode literature is salient. In turn, the market entry mode literature builds on various discipline-based theories, as presented earlier. While keeping offshoring attached to the market entry mode literature, it is important to point out the important difference to offshoring. With market entries, firms seek to leverage their primary value-adding activities (for an overview *c.f.* Zhao *et al.*, 2004). The purpose is to access a new customer base and generate sales abroad. Most likely, the new market is accessed either via greenfields (establishment of a firm's own subsidiary) or via acquisitions. Strategic alliances or joint ventures are possible alternatives. Because market entry strategies involve accessing new markets with different customer behavior and customer needs, the market entry mode literature is very important for marketing scholars (Werner, 2002). This is different for offshoring. In offshoring, service centers do not interact with the local market and knowledge about domestic customer needs is not necessary. Nevertheless, MNCs engaging in offshoring need to obtain knowledge about the foreign labor market, regulatory and legal issues, accessing resources and infrastructure, *etc.* In this regard, the difference to market entry is limited to the market knowledge of the target location.

In line with the general set-up of this dissertation, I will first elaborate the hypotheses related to the antecedents or predictors of the initial and subsequent governance mode decisions. This is followed by hypotheses suggesting how firms prolong client-service provider relationships.

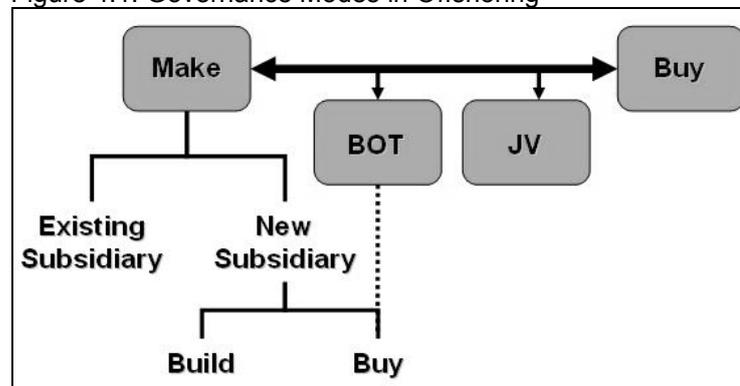
4.1 Antecedents of the Offshoring Governance Mode

4.1.1 Introduction to the "Make-or-Buy Decision"

When deciding on the offshoring governance mode, firms have a choice between two distinct models. On the one hand, it is possible to outsource the activity and buy it from a service provider abroad. On the other hand, it is possible for the

firm to mandate its own entity with the respective tasks. The latter choice may involve a charter extension of an existing subsidiary or the formation of a captive center.

Figure 4.1: Governance Modes in Offshoring



Source: Own figure

A captive center can be built from scratch, or an existing provider can be acquired. A mixture between captive centers and third party service providers is possible, for instance, when hiring a vendor to establish an offshore center. The vendor gets it running before full control is transferred to the principal company. In practice, this process is called “build-operate-transfer” (BOT) (Lowe *et al.*, 2004). The dotted line in figure 4.1 implies that BOT and buying a provider are basically the same. However, with BOT the offshore center has previously only existed with the purpose of being subsequently sold to the client. The second mixture between make-or-buy is a joint venture (JV). A JV can be between the host country company and an offshore partner, or it may involve an additional partner of the home- or a third country. The latter combination refers to so-called tri-national JVs.

Once services offshoring became popular several years ago, the governance mode decision was almost self-explanatory. Offshored tasks were relatively simple, risks were limited, and because almost exclusively low-skilled labor was involved, most companies strove for third party contracting. If the supply of the service did not exist abroad, a captive center had to be established. As offshoring evolved from a short-term, cost-cutting tool to an integral part of long-term strategy, it changed the way companies think about the governance mode. As companies have the full scale of options available, the governance mode choice became a sensitive management decision (Deloitte, 2005). Today, various challenges and risks need to be balanced against the opportunities. Most importantly, the potential for cost saving and the need to access talent counter the threat of losing company knowledge and impeding service quality (Lewin & Couto, 2007).

In the theoretical foundation, I introduced the transactional approach in its traditional form. Looking at the governance mode decision from an IB perspective, the discussion is very closely related to the market entry mode literature. Companies that are going international have to ask themselves the question whether to enter a market via an acquisition or via greenfield investments. This decision, which is also a “make-or-buy” decision, is frequently discussed in the transactional context (for a meta analysis of the transactional approach in the market entry mode literature *c.f.* Zhao *et al.*, 2004). This literature accentuates two components of TCE, the influence of asset specificity as well as the influence of uncertainty. Because of the international context, the cross-cultural component is receiving special attention in the discussion on uncertainty. In this respect, the market entry mode literature provides a rich contribution to the offshoring discussion as well.

4.1.2 Asset Specificity and the Nature of the Task Offshored

The rationale of TCE suggests that the governance mode in offshoring is chosen based on the premise to economize on bounded rationality and opportunism. The nature of the tasks offshored (*i.e.*, the asset specificity and frequency) and the risks involved are critical in determining the level of integration. *Asset specificity* implies that assets lose value if they are employed for anything other than their original, specific purpose (Williamson, 1983). Specificity exists when one or both parties to the transaction make investments that involve design characteristics or unique resources specific to the transaction (Zhao *et al.*, 2004). This becomes particularly important with regard to incomplete contracts. If investments in relationship-specific assets are involved, trading partners may attempt to expropriate rents accruing to the specific assets (Shelanski & Klein, 1995). Offshoring complex and low standardized tasks may have such effects, potentially resulting in hold-up or moral hazard of the transaction partner. Knowledge from the clients can be used to develop a firm’s own capabilities and used to acquire new clients. If sufficient contracting is not possible, it is likely that companies will select captive governance modes instead. However, this strategy has downsides as well. While the amount of resources involved is substantial, most investments are sunk costs. In addition, the internationalization benefits cannot be exploited as good as with a third party mode and offshoring cannot be used as a means to focus on core competencies.

Asset specificity can take the form of physical-, human-, or site-specific assets, as well as dedicated assets, brand name capital, or temporal specific assets (Williamson, 1999). In the context of offshoring, it is logical to look at asset specificity

primarily from a human asset perspective. For instance, Klein, Frazier, & Roth (1990) empirically showed that if specialized knowledge is required to perform a task, the ability of the market to curb the opportunistic tendencies of outside intermediaries is limited. Based on a sample of 925 Canadian export firms, they report a positive relationship between asset specificity and the likelihood of vertical integration. In order to measure asset specificity, the authors used a seven point Likert scale. The questions addressed “how easy it is for outsiders to learn a specific process, how much time is required to get to know the customers, how long it takes to learn about a product thoroughly, as well as whether large specialized facilities or investments are needed for an activity”. A similar positive relationship was also obtained by Monteverde (1995). He hypothesized that the necessary level of interpersonal communication between engineers in different stages of the production process in the semiconductor industry is positively related to the efficiency of a vertically integrated structure. Similarly to Klein *et al.* (1990), he operationalized asset specificity by asking about the amount of time that an individual requires to discuss and clarify processes on an operational level. Although limited to this industry, the author finds strong support for his hypothesis. I follow the suggestion of TCE and the market entry mode literature, suggesting that complex and knowledge-intensive tasks are more likely to be performed in captive centers.

H1: Functions with high asset specificity are more likely to be offshored using captive governance modes.

4.1.3 Uncertainty and the Governance Mode Decision

Asset specificity is an important, though straightforward, variable in TCE. Various forms of uncertainties, such as uncertainty about future developments and potential opportunistic behavior of transaction partners form the other pillar of this theory. As elaborated in the theoretical foundation, I expect uncertainty to increase the need for control and lead to a higher likelihood of integration (Williamson, 1985). For instance, if it is not certain whether a supplier is able to keep up with technological changes, it is efficient to acquire the respective company in order to have control over its processes. The assumption of uncertainty is supported by empirical studies (David & Han, 2004). However, the extent of the support is frequently very low. The meta analysis by David *et al.* (2004) shows that 24 percent

of a sample of 87 published TCE articles finds the predicted positive relationship between uncertainty and the level of integration. Many studies even come up with significant opposite relationships. This finding can have several reasons. On the one hand, it is difficult to analyze uncertainty under contingency. Very low asset specificity (which relates to market solutions) is rarely observed together with high asset specificity (which is related to integrated solutions) in the same sample. Functions under investigation are usually too similar in their asset specificity characteristic. Thus, the suggested relationships cannot be observed in a significant manner. In offshoring, I expect a similar effect. Every national and firm boundary-transcending strategy involves idiosyncratic process restructurings. Variation in asset specificity among different functional offshoring implementations is limited (this is also a reason why I only use a dummy variable to proxy asset specificity). While variation is supposed to be limited, I assume that asset specificity is comparatively high on average. Offshoring functions, *i.e.*, secondary functions of the value chain, are closely intertwined with the business processes and need to be adapted to the business strategy. In most cases, it is costly to change the transaction partner, and functions are not very low on asset specificity *in absolute terms*.

Since the uncertainty variable finds limited support in the literature, I will present a different approach in interpreting the survey data. Theory suggests looking at country risk on the one hand and the risk of opportunism of transaction partners (which can also be reflected in other forms of risk) on the other hand (Anderson & Gatignon, 1986). In particular, the latter variable is difficult to operationalize. It is difficult to capture the difference between risks leading to a governance mode decision *versus* the existence of risks associated with an existing governance mode. According to TCE, a company will select an integrated governance mode if risks are high. The company is more agile using integrated modes and can reduce or eliminate risks. When capturing risks in a survey, we have to address the problem that objective approaches in measuring these variables are frequently lacking. Respondents are likely to bias their responses on risks they have been facing at the time of decision-making with the current risks in the company. If companies are not yet offshoring and are in the evaluation stage, we are likely to observe a positive relationship between uncertainty and the level of integration, as suggested by the theoretical foundation. Once companies are active in offshoring, however, I suggest that they have addressed risk issues with their governance mode decision. The observed risk after decision-making is thus expected to be lower for captive

governance modes. I use the important risk factor “loss of internal capabilities” to depict this situation:

H2a: Among the subsample of companies considering offshoring for the future, there is a positive relationship between the risk of losing internal capabilities and the likelihood to opt for captive governance modes.

H2b: Among the subsample of companies actively offshoring, high risk of losing internal capabilities is less likely to be observed in captive governance modes.

The suggested relationships are likewise applicable for risks or uncertainties that can be reduced through integration, risk that cannot be measured on an objective scale and that is measured at different stages of the decision-making process. I will also test the relationships of *H2a* and *H2b* in an integrated manner, *i.e.*, by taking the inverted values of risk for companies actively offshoring. This leaves us with a consistent relationship throughout the sample, which is in accordance with the TCE prediction. If the findings support the hypothesis, we could conclude that potentially reducible risks lead to a higher likelihood of selecting captive governance modes. Besides suggesting a positive relationship for the risk of opportunism (with adjusted values) and the likelihood to select captive governance modes, I test the same relationship for business and process risks. These forms of risk have the same characteristics as the risk of knowledge leaking. Consequently, I assume that integration is an effective means to reduce such risks.

H2c: There is a positive relationship between business and process risk and the likelihood to select captive governance modes.

The relationships look different when considering risks that cannot be reduced through integration. Such risks include, in particular, economic risks or risks that are related to the offshoring strategy *per se*. Outsourcing “high risk” functions to service providers will not eliminate the uncertainties; however, I assume that external

partners are more efficient in economizing the risks. Service providers usually have more offshoring experience and provide an opportunity for risk sharing. Such risks are particularly distinctive and critical for captive modes if manifested in deficiencies in the knowledge about foreign markets. Milliken (1987) shows that the presence of “external” uncertainty surrounding a transaction compels firms to opt for a flexible entry mode rather than an ownership-based entry mode. Uncertainty is thus strongly related to knowledge about the foreign market. Besides the benefit of lower external uncertainties, collaborating with service providers has three operational advantages. In particular, if asset specificity is high or if the loss of managerial control is at stake, the company can decide to limit offshoring to basic tasks. Second, if the expected benefits of offshoring are not achieved, offshored functions can more easily be brought back to the home country. Third, if the operations do not appear to run smoothly and if there are interface management problems between the client and the service provider, it is comparatively easy to switch service providers. In this way, third party offshoring can also be used as a “trial and error” strategy. In comparison, a captive center requires large scales and the strategy cannot be revoked easily if necessary.

H2d: There is a negative relationship between economic risks in offshoring and the likelihood to select captive governance modes.

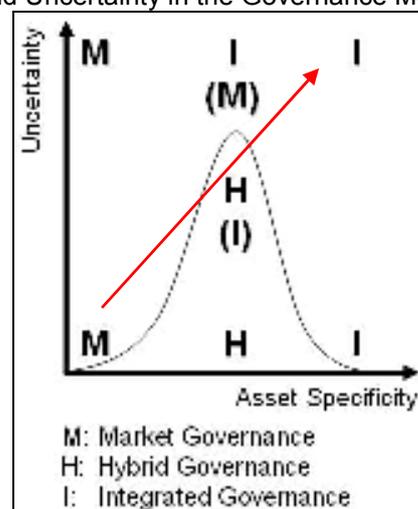
H2e: There is a negative relationship between offshoring risks and the likelihood to select captive governance modes.

Since economic risks and offshoring risks cannot be reduced through integration, I do not have to take the point of decision-making into consideration. If companies are facing comparatively high economic and offshoring risks and they are still selecting captive governance modes, the reason most likely has a different nature. However, I do not expect that this risk will substantially change from the planning phase compared to the operational stage.

Williamson (1985) suggests looking at the different aspects of TCE in an integrated manner. If asset specificity is low, uncertainty should have little influence. In this case, uncertainty can be reduced by negotiating appropriate contracts. If the

transaction partner is not complying with the contract, it can be settled with legal instruments or in court. In addition, risk is limited because contracts can be terminated at little cost and a new transaction agreement can be settled with another supplier. This is different when asset specificity is high. High asset specificity implies that the task cannot easily be performed by another supplier because assets are hardly redeployable. This also has an impact on the importance of the uncertainty variable. Figure 4.2 illustrates the relationships. As asset specificity and uncertainty are low, a market governance mode is more likely to be selected. If uncertainty is increased but asset specificity remains low, an integrated governance mode is not yet necessary. In this case, continuity matters little and alternative transaction partners can be selected. An integrated governance mode becomes only a priori the preferred solution if asset specificity is high (Shelanski & Klein, 1995).

Figure 4.2: Asset Specificity and Uncertainty in the Governance Mode Decision



Source: Own figure, based on David & Han (2004)

When adapting *H2c-H2e* to this logic, I suggest that the effect of uncertainty on vertical integration is amplified under high asset specificity. In the case of low asset specificity, the consequences of a failed transaction are not very severe and other influencing factors may be more important. Although I have argued that variation in asset specificity is likely to be low, I will test the joint impact based on the internal risk variable:

H2f: The positive relationship between internal risk and the likelihood to select a captive governance mode is moderated by asset specificity.

4.1.4 The Cross-Cultural Component as a Form of Uncertainty

In the context of uncertainty, the cross-cultural aspects play a crucial role in the market entry mode literature (Brouthers & Brouthers, 2001; Harzing, 2003; Kogut & Singh, 1988; Makino & Neupert, 2000). In fact, uncertainty variables bridge TCE literature with the cross-cultural literature. However, empirical studies show an ambiguous picture of the support of uncertainty variables in general and cross-cultural variables in particular. There are two lines of argument conducted from TCE logic. Authors like Anand & Delios (1997) or Padmanabhan & Cho (1996) follow the argument that if the costs of finding, negotiating and enforcing a cooperative agreement are greater than the costs of direct control, a wholly owned subsidiary is the preferred governance mode. Since these costs are higher in culturally distant countries, the relationship between cultural distance and vertical integration is positive. Further, the authors assume that contracting is too expensive due to difficulties in anticipating contingencies. The potential for opportunism increases due to the limited availability of partners or difficulties in assessing the performance of external partners. Different is the argument, for instance, by Kogut & Singh (1988) or Erramilli & Rao (1993). The larger the cultural differences between countries are, the larger the differences in the organizational and managerial practices of the firms are. The authors argue that the costs of internal coordination and control are higher than the coordination costs of the market solution for culturally distant countries. On the one hand, they refer to higher organizational and administrative costs; on the other hand, companies face higher costs associated with managing more diverse employee expectations. The preferred governance mode is in this case disintegrated, with an assignment of coordination and control to a local partner.

Although not very strongly, empirical evidence is more in favor of the latter line of argumentation and suggests a negative relationship between cultural distance and vertical integration (Zhao *et al.*, 2004). The vague results have led researchers to conduct further studies in order to provide better understanding. Brouthers & Brouthers (2001) agree with the negative relationship, however, find it positive when cultural distance interacts with investment risk. If the perceived stability of the social, economic, and political environment in the target country is low, the investment risk is high and a company is expected to favor wholly owned subsidiaries. Tihanyi, Griffith, & Russell (2005) find the relationship between cultural distance and the mode of entry to be negative, but not significantly. While Brouthers & Brouthers (2001) argue that the foreign investments are protected from opportunism, Tihanyi *et al.* (2005)

argue that large investments are not even undertaken by US MNCs, but that the tasks are subcontracted to partners.

Primarily based on the large volume of criticism of cross-cultural research raised in the theoretical foundation but also due to these inconsistent findings, I do not assume a direct relationship between cultural distance and the likelihood to select captive governance modes in offshoring. Rather, I argue that cultural distance has an indirect effect via trade flows between two countries. I argue that companies can reduce uncertainties (which increase the likelihood to select integrated governance modes) by offshoring to countries with large overall trade activities with the home country. For instance, Papadopoulos & Denis (1988) suggest using geographical distance as the external uncertainty variable instead of cross-cultural distance. This physical distance measure is also objective and correlates with many aspects such as macroeconomic differences, financial differences, as well as language differences. "Trade flow" is similar to geographical distance. However, it considers path dependency as well. It is possible that despite cultural distance, countries have a high level of trade activities with each other (for instance, because of colonial relationships, language similarity, trade block, common currency, or physical proximity). High trade activity increases experience and decreases uncertainty. As companies face lower uncertainty, they are more likely to offshore using captive governance modes. In comparison, geographic distance does not make any statement whether physical proximity is actually leading to higher trade activity and lower uncertainty. As empirical evidence on cross-cultural variables is frequently weak (Harzing, 2003), it is necessary to consider alternative measures of distance. Evans *et al.* (2002) suggest the use of geographic proximity as a measure for distance. Although costs of communication and mobility have dramatically decreased and physical distance should no longer matter, the argument of path dependency would still support the hypothesis that countries offshore to geographically close offshore locations. However, I suggest the use of a superior measure to geographical proximity. Path dependency suggests that a strategic posture is the result of previous activities. The literature on geographic proximity builds on the logic that countries are likely to interact with close neighbors. It is thus also possible that path dependency has led countries to have close relationships with more distant countries (for instance, because of colonial relationships). Using trade flows between two countries as a proxy is more precise in this regard, as it looks at actual trade relationships. In essence, trade flow is a broader understanding of distance than cultural distance.

Frankel & Rose (1996) find that trade flows are, for instance, also influenced by countries' wealth (GDP) and size. Thus, it is not the cultural proximity in particular that is relevant for the determination of the governance mode decision, but the experience of a nation in doing business with the respective country.

H3a: There is a negative relationship between cultural distance and the trade flows between two countries.

H3b: There is a positive relationship between trade flows between the home country and the offshoring country with the likelihood to select captive governance modes.

Before introducing a different form of distance measure, I need to discuss the findings of cross-cultural studies in terms of the definition of vertical integration. Interestingly, many of the market entry mode studies do not elaborate extensively on the definition of the level of integration (Brouthers & Brouthers, 2000; Harzing, 2002; Kogut & Singh, 1988). Kogut *et al.* (1998) use a comparison between wholly owned subsidiaries and joint ventures as an approximation for integration, while Brouthers *et al.* (2000; 2001) or Harzing (2002) compare wholly owned subsidiaries with acquisitions. In my point of view, greater attention should be drawn on this differentiation. While a joint venture clearly constitutes a lower level of integration than a wholly owned subsidiary, an acquisition may just temporarily have a lower level of integration. Eventually, an acquired unit will also be integrated into the company at a later stage. This could be one possible explanation why Zhao *et al.* (2004) find support for the negative relationship between cultural distance and vertical integration, while Drogendijk & Slangen (2006) find positive relationships between cultural distance and the likelihood to choose wholly owned subsidiaries. Drogendijk & Slangen (2006) argue that integrating an acquired unit with large cultural distance is difficult. In particular, the post-acquisition integration is troublesome because of difficulties in communication, different business orientations, different attitudes, *etc.* In the presence of cultural distance, it can be more reasonable to build up a wholly owned subsidiary from scratch. With a new unit, it is possible to establish a new culture that corresponds to the existing culture of the home country organizational culture. If a subsequent integration is however not considered (as with

a joint venture), a disintegrated mode involves less uncertainty than an integrated mode (according to Kogut *et al.* (1988)). This latter situation relates to offshoring where the choice is between captive governance modes and third party offshoring. Service providers are not integrated at a later stage and the business is conducted at arm's length. In particular, in situations of cultural distance, this strategy involves less risk for the client. Furthermore, the client is not required to have extensive knowledge about the foreign culture because integration is not necessary.

While I have argued that cultural distance has only an indirect influence on the governance mode decision via trade flows, I suggest looking at psychic distance as well. Psychic distance is a promising example of an alternative approach to measuring cultural distance (Drogendijk & Slangen, 2006). In comparison to the objective cross-cultural measures, it looks at the actually perceived distance between two countries. Psychic distance is defined as “factors preventing or disturbing the flow of information between potential or actual suppliers and customers” (Nordström & Vahlne, 1992 in O'Grady & Lane, 1996). The literature incorporating psychic distance assumes that “psychically close countries are more easily understood [by each other] than distant ones; and offer more familiar operating environments (O'Grady & Lane, 1996: 309). The meta-analysis by Drogendijk & Slangen (2006) finds considerable support for this subjective measure, and frequently it is the better predictor in comparison to the traditional cross-cultural measures. In accordance with the literature, I suggest that psychic distance reflects an increased level of uncertainty, which decreases the likelihood of selecting integrated governance modes.

H3c: There is a negative relationship between psychic distance and the likelihood to select captive governance modes.

4.2 The Impact of External and Internal Offshoring Experience

In the market entry mode literature, experience is a very important variable (Andersen, 1997). The theoretical origin of this variable lies in the uncertainty variable of TCE. Experience, expressed in various forms, leads to capability development (or learning) and is a means to decrease uncertainty. Similarly to the discussion on cross-cultural management, experience occurs on different levels, the

individual, organizational, as well as the national level. Experience is important for (international) strategies, just as it is for improving operational processes. In my dynamic offshoring model, we need to differentiate between internal and external experience. In initial governance mode decisions, firms normally do not have any experience related to offshoring. It is possible that they have some experience with domestic outsourcing and they have experience in doing business in a potential offshore location. Nevertheless, this form of experience is different from the experience companies need for successful offshoring. Companies need to have process experience in serving the whole value chain on a global scale from a remote operation. I argue that if such experience is lacking (which is usually the case when taking an initial governance mode decision), companies access experience from the industry by replicating strategies. Alternatively, companies base their decisions on the motivations for offshoring. I consider this a form of experience as well because a driver always originates in capabilities and experience.

4.2.1 External Experience in Initial Governance Mode Decisions: Isomorphism

In the theoretical foundation, I argued that there are three forms of isomorphism: coercive, mimetic and normative. While coercive isomorphism is less important for offshoring because there is usually no institutional pressure to offshore, mimetic and normative isomorphism are much more important. Companies tend to replicate the strategies of other actors in the market. In particular, for politically difficult decisions it is easy to legitimize one's own action with the behavior of the environment (Davis, Desai, & Francis, 2000). Further, the professionalism and interaction of the executives leads to similar strategies.

Rosenzweig & Singh (1991) use institutional isomorphism in the context of market entry modes in order to show commonalities across firms in market entry mode decisions in a particular location. From their point of view, the reason for the similarities is imbedded in isomorphism between the subsidiaries of the MNC, but also in adaptations to the local market. Davis, Desai, & Francis (2000) use organizational isomorphism in order to explain market entry modes as well. Based on a survey among 1383 managers, the authors find that the entry mode choice is affected by the host country institutional environment as well as the internal institutional environment. They find a positive relationship between business units using integrated entry modes and parent isomorphism. Furthermore, they find a significant relationship between the use of disintegrated entry modes and the presence of host country isomorphism. In offshoring, host country isomorphism is

likely to be lower, as interaction with the domestic market is practically non-existent. Parent isomorphism is likely to be present for subsequent governance mode decisions and likely to relate to the prediction of dynamic capabilities presented below. However, I also assume that observe isomorphism can be observed among offshoring clients within a home country at initial stages of offshoring.

H4: The existing captive experience (measured on the functional level) is positively related to the probability of opting for captive governance modes.

4.2.2 Internal Experience in Initial Governance Mode Decisions: The Capabilities Perspective

The transactional perspective has received a lot of attention in the context of the market entry mode literature (Brouthers, Brouthers, & Werner, 2003). When linking offshoring to the market entry mode literature, hypothesis development is straightforward and closely follows the logic of the literature. Chang & Rosenzweig (2001) argue that an entry mode decision may alternatively be taken in the absence of any major transaction cost considerations. While the dynamic capabilities perspective is a valuable perspective, it is much less clear in its prediction than TCE (Leiblein & Miller, 2003). Primarily, this is because of the firm-specific nature of this perspective. For this reason, many studies apply a qualitative approach when applying dynamic capabilities (Eisenhardt & Martin, 2000; Zollo & Winter, 2002). While I have conceptually strong arguments for this perspective, it is more difficult to test them empirically. However, there are indirect approaches in capturing firm-specific characteristics. We know that cost savings are a dominant driver in offshoring (Agrawal & Farrell, 2003; Levy, 2005; Lewin & Couto, 2007; Lewin & Peeters, 2006). However, offshoring can also have very different motivations. For instance, companies can reach capacity limits at their headquarters, making offshoring a convenient approach in solving this problem. Similarly, offshoring can have the primary motivation in the expansion plans of the company in the context of its global strategy. As this is a leveraging strategy, I suggest that companies are more likely to select captive governance modes.

H5: If offshoring is part of an MNC's growth strategy, the likelihood of opting for a captive governance mode is increased.

In this context, "growth strategy" cannot be equated with efficiency enhancing, such as increased speed to market. Efficiency enhancement can be achieved using both governance modes, because lower labor costs can be accessed and processes improved using either strategy. Offshoring in context of the growth strategy is more likely to be achieved using captive governance modes.

Nevertheless, the most important motivation for offshoring, cost savings, is likewise expected to be reflected in governance mode decisions. Although the vast majority of companies would mention this driver, variation in its magnitude is considerably high. There is a capabilities argument to this motivation as well. From a capabilities point of view, we expect that the focus on core competencies results in sustainable competitive advantages (Teece *et al.*, 1997). Offshoring concerns support functions of the value chain; thus, it would not be correct to speak about focusing on core competencies when offshore outsourcing. However, we can look at this issue differently. The numbers in the workforce at the firm's headquarters are limited, and if the employees are not working in support functions, there is a high likelihood that they can be redeployed to tasks of the primary value chain. While the core value-adding capabilities are kept in-house, the secondary support functions are relocated abroad. The cost saving potential can normally be leveraged best if services are outsourced to service providers.

H6: The driver to lower costs is negatively related to the likelihood of opting for a captive governance mode.

4.2.3 Experience in Subsequent Governance Mode Decisions

From this point on, we change the focus from initial governance mode decisions to subsequent governance mode decisions. Dynamic capabilities provide further understanding to the governance mode decision when looking at capability building. I will link it back to the TCE logic. TCE suggests that a market solution is the preferred governance mode decision, at least as long as external control costs are lower than internal control costs (Zhao *et al.*, 2004). As I have hypothesized before,

cultural distance is associated with uncertainty, which is in turn associated with disintegrated governance modes. With increased experience and interaction with foreign cultures, these internal costs are assumed to diminish on the one hand. On the other hand, the experience with the local partner is expected to reduce external control costs as well. The dominating effect is therefore not evident. In offshoring, dependency on local partners and its related threat of hold-up might therefore be the dominant effect over time. This could explain the integrating of offshoring activities after sufficient experience has been gathered with third party contractors. While hold-up constitutes a cost-related effect, there is also an effect on the revenue-side speaking in favor of integrated governance modes over time.

Increasingly, offshoring is used for the purpose of seeking highly skilled labor on a global scale (Lowe *et al.*, 2004). In order to integrate these individuals into the company, a substantial amount of critical process knowledge needs to cross the border. This critical knowledge may, but need not, be associated with the core activities of the firm, *i.e.*, the knowledge that is most important for the production process. It is tacit knowledge that embraces the potential risk of being diffused outside the firm's boundaries. Alternatively, the high-skilled labor may also lead to new knowledge, which a firm wants to exploit as much as possible. An integrated governance mode also becomes, under this perspective, the apparent solution. Kogut & Zander (1992) define the boundaries of the firm, stating that everything should be outsourced that does not lead to a recombination of economic value. A recombination of capabilities takes place when present information and know-how are exchanged through internal learning (*e.g.*, experiments, accidents, or reorganizing) or external learning (*e.g.*, acquisitions, JV, new people). This process of recombination is heavily moderated by the fact that people identify themselves with the company's goals (*ibid.*). In this sense, an offshoring strategy is only successful and leads to competitive advantages if new knowledge can successfully be created. The governance mode in international operation is no longer dependent on market failures, bounded rationality, opportunism, or knowledge buying or selling, but revolves around an optimal structure allowing for superior transfer of knowledge across borders (Kogut & Zander, 1993). Kogut *et al.*'s (1993) empirical results show that the less codifiable and harder to teach a certain technology is, the more likely a transfer within a wholly owned subsidiary becomes. This argument sounds similar to Williamson's (1985) asset specificity, however, Kogut *et al.* (1993) stress the potential of a recombination of capabilities and therefore of learning. Knowledge that

is gathered from offshoring can therefore be used to improve firms' processes of international operations. This argument can be used to carry further the train of thought of the governance mode decision. As the offshoring tasks become more complex, we can assume that captive offshore models become the dominant governance mode, safeguarding the internal knowledge flows. This is in line with hypothesis *H1*. However, there is also a strong argument regarding why it is not necessary to switch the governance mode.

The dynamic capabilities perspective stresses the need for firms to identify the critical knowledge that is necessary to allow for capabilities recombination. In this regard, it is assumed that learning from previous offshoring activities allows firms to develop tailored governance models. Such modes allow highly skilled labor and even core activities to be outsourced, as long as there is an efficient interface management in place and as long as critical knowledge can be safeguarded. Consequently, an innovative knowledge transfer can even take place in disintegrated governance modes, with the help of the occupation of critical positions in the partner's firm or with the establishment of sophisticated knowledge transfer platforms. If the most critical component of the knowledge can be protected, it is still possible to outsource. This strategy can allow firms to benefit from both external knowledge and lower labor costs. This argument does not allow us to make a clear prediction on the governance mode, and I do not expect that one governance mode will be clearly dominant in the future. Based on the capabilities perspective, I assume that firms develop their governance mode in such a way that it is the most efficient mode for them. As they improve processes over time, companies are likely to select the same mode for subsequent governance modes. Most importantly, I assume that this mode is also selected when offshoring a different function or to a different location. This latter component then dominates the transactional and capability argument of the initial governance mode decision.

H7: Experience with captive governance modes increases the likelihood of choosing the captive governance model in subsequent years (independent of the function and the offshoring location).

4.3 Effects of the Governance Mode Decision on Cost Savings

The essence of strategy is to generate sustainable competitive advantages (Barney, 1991). In one way or the other, sustainable competitive advantages should be reflected in profitability. Increases in profitability can be achieved with cost savings, price increases, increases in sales volume, or a combination thereof. Even if offshoring frequently aims at accessing qualified personnel, the cost component is on average (still) more important as a success criterion. The reason is the substantial salary differences between the home country and the offshoring location.

Research linking the boundaries of the firm to performance exists, though with limitations (*c.f.* D'Aveni & Ravenscraft, 1994; Harrigan, 1986; Leiblein, Reuer, & Dalsace, 2002; Rothaermel, Hitt, & Jobe, 2006). D'Aveni & Ravenscraft (1994) find that vertical integration “results in economies even after industry effects and economies of scope and scale are controlled” (*ibid.*:1167). There is always a trade off between outsourcing and insourcing. While outsourcing allows accessing specialized knowledge, which can deliver services more efficiently, the provider will always ask for a margin on the services. This margin reduces the cost savings potential of the client and increases the costs for coordination. Insourcing, however, normally requires substantial investments and companies can benefit less from economies of scale or scope. Firms may also want to keep processes in-house in order to retain control. As Leiblein *et al.* (2002) suggest, we could also assume a negative relationship between vertical integration and performance. The authors suggest that the question of the link between vertical integration and performance depends on the sets of underlying assumptions. In outsourcing situations involving mature, autonomous technologies, there is less uncertainty involved and benefits from pooling the services in specialized suppliers are higher. If appropriation problems are significant and critical knowledge is involved, performance is driven by second- or higher-order interactions among a set of value chain interactions. The selection of an integrated mode can be recommended. (*ibid.*).

While the literature does not suggest an impact of the level of integration on performance, we need to have a closer look at performance variation. We know that captive centers are normally associated with high initial investments and high involvement of the client (Aron & Singh, 2004). These (financially) higher risks are subsequently likely to be reflected in higher variation in the cost savings achieved with captive centers. If firms can exploit the cost savings potential, if they can benefit

from scales and make use of specialization, captive centers are likely to perform better than third party service providers. However, if offshored processes to captive centers add complexity and still require high investments, the cost savings potential is lower compared to third party service providers.

H8: Variation in cost savings is higher for captive governance modes than for third party governance modes.

This implies that the best captive centers can perform better than the best third party service providers can. If offshoring however fails, it is likely to be more costly if a captive mode rather than a third party mode has been chosen.

Rothaermel *et al.* (2006) criticize the binary view on the make-or-buy discussion. Based on a longitudinal study of 3500 product introductions in the global microcomputer industry, they find the notion that firms achieve superior performance when carefully balancing vertical integration and strategic outsourcing. Combining the two governance modes increases innovation, optimizes the products and services delivered, and finally increases overall performance. In offshoring, using both governance modes further allows for comparing achieved service levels among competitors and new projects can be put out to tender to inside and outside providers. Finally, a dual system allows for the flexible assignment of offshoring tasks. This corresponds to Eisenhardt & Brown's (1999) view on dynamic capabilities and the notion that organizations should be organized in a such way that they can flexibly deploy their resources. As an Interviewer argued, it is not sufficient to have simply both governance modes in place. However, the two governance modes require an explicitly formulated corporate offshoring strategy with the support of the senior management. In order to make offshoring successful, the offshoring strategy needs to be permanently refined, reviewed, and adapted when necessary (Interviewer A, 2007). In line with the suggestions of Rothaermel *et al.* (2006), I therefore suggest that cost savings for clients are significantly higher if the client makes use of both governance modes simultaneously.

H9: Companies with both captive and third party governance mode experience can achieve higher savings than companies with a single governance mode.

Having discussed the two governance modes and their implications on performance, I will in the next step focus on offshore outsourcing. In particular, I suggest mechanisms to align interests between clients and service providers. The effective application of such mechanisms is likely to increase the longevity of the client-service provider relationship and to decrease the termination rate of contracts.

4.4 The Sustainability of Client-service Provider Relationships

Developing the hypotheses in order to explain the sustainability of client-service provider relationships primarily builds on the governance literature. If companies successfully apply governance mechanisms, they are able to align interests between clients and service providers, making offshoring a sustainable strategy. I will build the hypotheses according to the different mechanisms that are the most common and the most effective.

4.4.1 Control and Client Involvement

Probably the most obvious mechanism to reduce agency costs is controlling. Controlling can take several forms and can range from direct supervision by expatriates (Eisenhardt, 1985), controlling on an ad-hoc basis or indirectly via bureaucratic monitoring (O'Donnell, 2000). Monitoring by expatriates is more difficult in third party offshoring compared to the monitoring of subsidiaries. Service providers will not be willing to let clients exert much influence on operational issues of the service delivery. Inherent in this situation are potential arguments over the most efficient procedures and the consequences on performance. Moreover, it slightly countervails the idea of outsourcing, because the purpose is to delegate operational control. O'Donnell (2000) finds that possibilities for bureaucratic monitoring decreases as lateral centralization and subsidiary autonomy increases. This subsidiary autonomy is a situation comparable to third party offshoring. Therefore, bureaucratic monitoring is expected to play a subordinate role in third party offshoring as well, and other forms of control are dominant. I suggest that monitoring by client involvement increases the success of the strategy. This client involvement is understood as a form of interdependence, not as hierarchical control. Controlling on

an ad-hoc basis and training are potential forms. In such situations, controlling takes place indirectly through collaboration and is a middle course between permanent supervision and bureaucratic control.

An active involvement of the client can only be beneficial if the client has sufficient knowledge about the process that is outsourced (Martinsons, 1993). This issue was particularly important in context of IT in the 1990s. At that time, companies did not directly acquire the knowledge because the knowledge was lacking in-house; rather, they were buying it from service providers from the beginning. This situation changed in the past decade and we can assume that clients have experience in providing the services themselves. I assume that if the client is involved in the delivery of offshore services, the companies have sufficient knowledge in order to evaluate the outcome. If the outcome can be evaluated by the client, control can be exerted better, and I expect that relationships will remain over a longer time period. Takeishi (2001) investigated success factors in outsourcing and reported the importance of client involvement as a moderating variable. In his point of view, client involvement embraces problem-solving processes with the client, frequent face-to-face communication, as well as a sufficient level of knowledge transfer. The benefits of client involvement is also observed by Malek (2000). His finding shows that the involvement of senior management has a positive effect on R&D outsourcing in the pharmaceutical industry. Although client involvement is not easy to operationalize, I suggest that it is indispensable to successful, long-lasting offshore outsourcing strategies.

H10: The involvement of the client in offshore outsourcing increases the longevity of client relationships

4.4.2 Contracting

There is no single mechanism that reduces agency costs in an isolated manner. Successful outsourcing can only be performed when using several mechanisms together. Frequently, it is not possible to have direct influence on the service provider. This can have different reasons, but as elaborated above, the most obvious is the lack of knowledge in-house.

An alternative mechanism to align interests has its origin in transaction-cost economics. If possible, resources or processes are bought from the market if costs are lower than the production in-house. However, market transactions are only possible if proper contracting is possible (Coase, 1937). Contracting is a means to guarantee the fulfillment of the obligations of each party. Contracting as a requirement for doing business is so fundamental that it is almost tautological to mention it. While there is consensus, however, about the general importance of contracting, the attachment of importance is quite different. Aksin, de Véricourt, & Karaesmen (2008) note that in offshoring the parties face a choice between volume-based and capacity-based contracts. The authors mention the example of a call center. In order to answer a call, capacity is required. If there is no capacity, volume cannot be generated and the call cannot be answered. Capacity means however costs. In turn, lower capacity is associated with lower costs. It is very difficult to trade off between the two aspects and there is theoretically no optimal solution. This situation refers to the challenge of measuring quality and quantity. As Jensen *et al.* (1995) point out, contracting is easier if quality and quantity are easily measurable. The easier quantity and quality are to measure, the easier it is to find an optimal volume-capacity mix and the higher success is. Since there is no unique way to proxy the ability to measure the quality and quantity of a service, we have to find alternative measures. For this reason, I assume the ability to measure quantity and quality to be associated with a subjective and an objective measure of contracting. The objective one is very simple and assumes that a large number of issues are covered in a contract. A basic contract would only describe the services provided and their quantity, the location of litigation, as well as information on the characteristics of the deal. Very elaborate contracts would, however, include the number of employees involved, gain sharing, maximum allowed wage increases, investments, or the organization of training. Following the assumption that including more aspects in the contract is associated with attaching greater importance to contracting, I suggest the following hypothesis:

H11: A strong emphasis on contract specification is positively related to the longevity of client relationships

4.4.3 Financial and Non-Financial Investments

Both control and contracting are very difficult to put into practice if quality and quantity of a service are difficult to measure. Other companies may be too new in the market for appropriate signaling. It is thus necessary to find alternative measures for reducing agency costs. A possible approach is to negotiate with service providers and require that they make client-specific investments. Client-specific investments give service providers an incentive to maintain a long-term relationship in order to make the investments beneficial in the long-term. This creates a mutual dependency and lowers agency costs. Grossman & Helpman (2005) use a general equilibrium model to study the effectiveness of relationship-specific investments. They find that particularly in situations of poor contracting, relationship-specific investments are a means to align interests. Their finding is strongly based on manufacturing outsourcing. Although I do not focus on this component of outsourcing, the implications of service offshoring are similar. Further, the authors find that for clients it is best if many providers are present in a market. For service providers it is best if they have many clients. This has something to do with the general competitiveness in the market.

H12: Mutual (client-specific) investments are positively related to the longevity of client relationships.

5. Research Design and Methods

The aim of observing or understanding what no one has ever observed or understood before drives researchers to apply superior methodologies in order to come up with significant, consistent, and relevant results (Robson, 2002). While the offshoring literature has been focusing on qualitative approaches so far (*c.f.* Manning *et al.*, 2008; Pyndt & Pedersen, 2006), I try to advance the literature based on a quantitative approach. I will now introduce the two surveys that serve as an underlying foundation for the dissertation. The first survey, which looks at the client perspective (corporate survey), was launched before this dissertation project. Put differently, the analysis builds on existing data. The original questions were asked in order to research general patterns and trends in offshoring. In order to use the data for the current research questions, the variables were reconfigured and enriched with objective measures. Those additional variables were collected from secondary sources. The second survey, which examines the service provider perspective (service provider survey), was launched in 2007, and serves two purposes. One goal is to validate findings from the corporate survey and investigate the functional and geographical demographics of the service provider landscape. The second goal is to investigate the hypotheses of this dissertation, investigating relationships between clients and service providers.

I will discuss the quantitative methodology against the background of the qualitative alternatives in the business literature, most notably case studies. The data and variable operationalization is subsequently discussed separately from the client perspective and the service provider perspective. This allows for individual discussions of the two surveys, which are then used as foundation for this dissertation.

5.1 Methodologies in the Strategy and International Business

Field

In research, a good theory is a precondition for coming up with consistent hypotheses and subsequently valuable results. Theories must be replicable and have the potential to be developed by being tested with appropriate methodologies (Black, 1999). Research approaches can largely be divided into quantitative and qualitative methods. According to Scandura and Williams (2000), sample surveys, laboratory

experiments, as well as field studies with primary and secondary data are the most frequently used quantitative research methods in the top tier journals in management research. Among qualitative studies, the case study is the most important methodology (Denzin & Lincoln, 1994).

5.1.1 The Sample Survey Method

Due to the applied character, sample surveys are a popular and frequently used methodology in quantitative research (Kirkman & Law, 2005). A survey is a process of gathering quantitative information about members of a population without detailed verification of the activity under research. A survey is particularly useful when a limit with secondary data has been reached, which may be in terms of their availability or in terms of their expressiveness. This methodology is very often linked to the aim of gaining knowledge about factors that are not measurable, like attitudes, perceptions, views, and opinions of the decision-maker behind an observation (Black, 1999). When talking about surveys in general, Robson (2002) points out that the sole consideration of postal questionnaires can be too narrow and telephone surveys, email surveys, and certain forms of interviews should be taken into consideration as well. Interviews can only be considered quantitative research if it is an extreme form of a structured interview, *i.e.*, if the partner is limited in the depth of his answers, because they are either binary or categorical in nature. In a survey, every respondent faces the same questions and the responses should be formulated in a way that they can be structured and analyzed on a quantitative basis.

Facilitated by technological advances, methodologies have changed substantially. For the survey methodology this implies that email surveys, fax, PC disk-by-mail, as well as web-surveys became an alternative to the traditional mail survey (Klassen & Jacobs, 2001). The most striking advantages of the email survey as applied for this dissertation are the low costs, the convenience for the respondent, as well as the fast response rates (Ilieva, Baron, & Healey, 2002). This is very appropriate for cross-sectional and international comparisons. However, there are also limitations to this methodology. Email surveys, particularly when filled in via a URL, are less transparent with regard to the identity of the respondent. Although this problem can occur with other forms of surveys as well, it is possible that the survey has been filled out by a person who that has potentially insufficient knowledge about the phenomenon under research. It is likely that this problem is more distinct in view of the anonymity of this form of survey. It is therefore necessary to influence the response rate actively. While Cocyota & Harrison (2002) do not find incentives,

advance notifications, follow-ups, and personalization to influence response rates in a statistically significant way, the measures are still a means to improve the quality of the responses. It is very likely that, for example, an advance notification leads to a commitment of an executive to respond to a survey personally.

The rigorous character of quantitative studies makes them a highly accepted methodology among top-tier journals. For instance, in the *Academy of Management Journal*, surveys are the most frequently represented methodology (Kirkman & Law, 2005). The factors measured on the individual level are expected to be reflected in firm behavior. Scandura and Williams (2000) argue that sample surveys offer greater generalizability across time, settings, and individuals. A strong criticism of the survey methodology, however, is internal validity. A survey can only be as good as the way it is run, with the most critical phases of planning, sampling, question-wording, and answer coding (Robson, 2002). Another issue and limitation of surveys is the response rate, which should be adequately high in order to be able to derive valuable conclusions. The minimal number of responses is not defined in the literature. This depends primarily on the variation in the results leading to statistical significance. In order to end up with a sufficient sample, Black (1999) proposes that one should be very careful with the wording of questions, restrain the temptation to produce too long questionnaires, and ensure a professional appearance of the form. When dealing with sensitive information, it is imperative to assure confidentiality. Under the condition that these basic principles are met, the survey methodology is a very promising approach for quantitative research.

5.1.2 Quantitative versus Qualitative Methodologies

While a survey is able to tackle a phenomenon across a large population, it does not allow for a great level of depth. Such an attempt would need to be covered through qualitative research, most likely case studies. Yin (1994) defines a case study as “a strategy for doing research which involves an empirical investigation of a particular contemporary phenomenon within its real life context using multiple sources of evidence”. Rather than analyzing a pattern among several companies, a few companies are selected and analyzed in depth. A detailed categorization with regard to the case study methodology is provided by Hamersley & Gomm (2000). They show that unlike quantitative research methods, case studies have a very limited sample size, and they focus neither on control variables nor on interfering variables. This allows for questions such as “how?” and “why?” to arise (Black, 1999), while quantitative research methods focus on questions such as ‘what is the

direction and the intensity of a relationship between selected variables in a certain population?'. The most convincing advantage of case studies is the in-depth analysis of a particular case with a high understanding of the details. In particular, if data availability is very poor, if the subject is newly emerging, or if the subject is lacking measurability, case study methodology is appropriate. However, case studies are very situational and have limited ability to generalize results (Lincoln & Guba, 2000; Wacker, 1998). In addition, the methodology faces the critique of not being theory testing (Eckstein, 2000). With the results of a single case, it is not possible to formulate conclusions that are not context-free. Linked to this argument is the problem of poor replicability, meaning that results cannot be verified, which is a crucial aspect in research.

While there may also be strong reasons to opt for qualitative studies, we need to have a closer look at the validities of the different approaches as well. According to Cook & Campbell (1979), there are four types of validities: *Reliability* is an issue that addresses all methodologies and refers to the issue of random errors, asking whether a result can be ascribed to thorough research or to a random occurrence. Ruigrok, Gibbert, & Kaes (2009) claim that research must be carried out in a transparent way, with comprehensible documentation and high replicability. *Internal validity* examines the cause-and-effect relationship and "can only be asserted if there is true covariation between the variables under investigation" (Scandura & Williams, 2000: 1252). It thus looks at whether a methodology succeeds in explaining the "because" in a relationship (Robson, 2002). When using case studies, Ruigrok *et al.* (2009) argue that researchers should formulate a clear research framework and provide logical reasoning to defend the research conclusions, empirically observed patterns should be explained with either predicted or established patterns, and theory triangulation should be used in order to enhance internal validity. This is most likely to happen during the data analysis phase. While internal validity tends to be generally high in case studies, surveys can only achieve such validity if questions are free of ambiguity. *External validity* refers to generalization across time, settings, and individuals (Cook *et al.*, 1979), meaning that results are applicable to different populations, measures, and circumstances. Thus, surveys tend to offer higher external validity, except when their sampling is poor (Punch, 1998). On the other hand, this is more difficult with case studies, due to their lack in generalizability. External validity is high for sample surveys, whereas it is low for case studies. Finally, *construct validity* is concerned with how well the measures employed fit the theories

for which a test is designed (Scandura & Williams, 2000). The underlying question therefore is “does it measure what you think it measures?” (Robson, 2002). While sample surveys are usually very specific about construct validity, case studies often show a certain negligence (Ruigrok *et al.*, 2009). Establishing a clear chain of evidence and explaining the steps from the initial research question to the conclusion are important to meeting this claim. In addition, appropriate sampling increases construct validity (Punch, 1998).

Because of the different advantages of different methodologies, Jick (1979) suggests applying methodologies combining qualitative with quantitative approaches. While this triangulation approach appears to be very promising, it would go beyond the scope and the purpose of this dissertation. However, in order to increase the expressiveness of the quantitative data, I conducted several interviews in order to validate the questions on the one hand, as well as to validate the results on the other hand.

5.2 Research Design of the Client Perspective

5.2.1 Sample

The quantitative research approach, including the two surveys, adopts primarily a cross-sectional methodology. Both surveys were established in the setting of the Offshoring Research Network (ORN) of Duke University. ORN was launched in 2004 as a part of the Center for International Business Education and Research (CIBER). The corporate survey was launched in three consecutive years in 2004, 2005, as well as 2006. While the surveys of 2004 and 2005 only focused on companies within the US, the survey from 2006 was extended to the UK, the Netherlands, Germany, and Spain.

The survey was developed to research the patterns, practices, and trends of MNC offshoring activities. Seven main areas are covered: the functions offshored, locations selected and rationales of this choice, the governance modes, strategic drivers of offshoring, perceived risks, performance metrics, and companies' future offshoring plans. The survey tracks offshoring at the level of implementation. This implies that every specific function that a company has offshored in a particular location is identified by the year it was launched and is treated as a separate observation. By asking for the year of each implementation, the survey allows for analyses over time. Service functions are categorized into call centers, procurement,

finance and accounting, human resources, research and development, engineering, product development, as well as IT. Manufacturing offshoring, *i.e.*, offshoring of primary functions of the value chain, relates to earlier discussions on internationalization and foreign direct investments (Dunning, 2000; Dunning & Rugman, 1985). It does not share the same drivers and risks as services offshoring. Furthermore, manufacturing offshoring is different in terms of incentive structures because outputs are easier to measure and offshore centers can be organized as profit centers. From this perspective, looking at manufacturing offshoring would imply examining a different phenomenon and has been excluded from the survey.

In order to allow for cross-national comparisons, only the 2006 data were used for the analysis. This was also necessary because the questions had been reformulated over time and a direct comparison would be difficult. The survey was launched on-line, which was necessary in view of its scope and global scale. After the firms had been informed about the survey, they could log in on the website and fill out the survey. The names of the companies were randomly selected by ORN and its network partners. 537 companies filled in the survey. With an average of approximately 2.6 offshoring implementations per company, the overall sample size reaches 1381 data points. This number is reduced by the fact that companies just considering offshoring, or even those companies not considering offshoring at all, were addressed as well. For companies not considering offshoring at all, the response rate was, however, low.

Table 5.1: Sample Size of Corporate Survey

	Company level		Functional level		Implementational level	
	full sample	l'year*	full sample	l'year*	full sample	l'year*
US	224	105	378	222	717	370
UK	34	12	72	31	147	51
D	70	33	131	68	241	118
NL	91	14	58	26	140	34
E	49	18	71	38	136	51
Total	468	182	710	385	1381	624

*launch year: cases in which launch year has been provided by company.

Source: Own table

The sample size reaches a total number of 976 implementations. Since the development of offshoring governance modes is the critical aspect in this dissertation, it is furthermore only possible to consider companies that have actually provided the launch years of their offshoring implementations and the governance

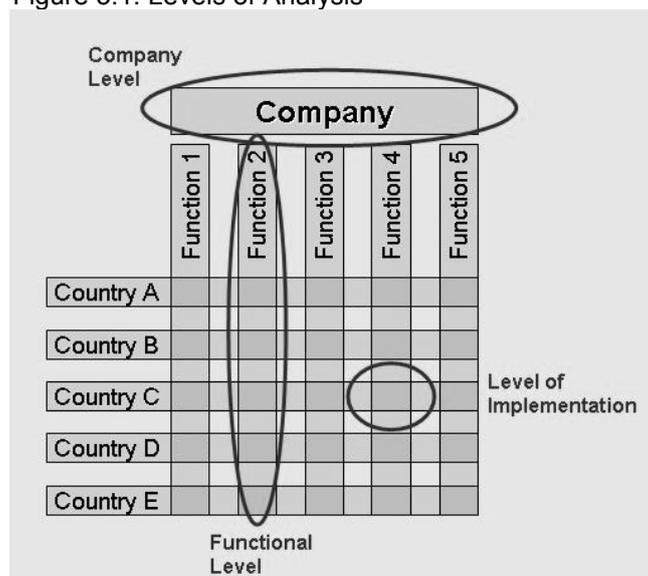
mode. This leaves us with an overall final sample size of 624 offshoring implementations. Even when looking just at the initial governance mode of every individual company, we still have a sample size of 182 implementations. While we elaborated on the advantages and limitations of the survey methodologies, there are also some peculiarities with regard to data analysis. Survey data have the characteristics of non-linearity. As is common practice, we used a five point Likert scale for questions addressing non-metrical issues. A question addressing an opinion or a rating is usually followed by the response options “not important at all”, “not important”, “neutral”, “important”, “very important” or “very low”, “low”, “average”, “high”, “very high”.

5.2.2 The Level of Analysis and Status of Offshoring

Both the corporate survey and the service provider survey are very large in scope. Companies were asked to give detailed information about their offshoring activities, risks, drivers, governance modes, operational issues, as well as their future plans. Service providers were asked about the services they provide, the client relationship, as well as operational issues. Offshoring can take place in different functions and within different countries. Nevertheless, asking each question for every single combination of offshoring function and –country would have been beyond our scope. Some questions were asked on a functional level, thus, independent from the locations offshored. Other questions were asked on the company level, meaning that they would apply equally to all functions.

In the corporate survey, as many variables as possible were collected on the level of implementation. However, in order to keep the survey at a reasonable scope, many questions were addressed on the functional or company level. Questions regarding the future offshoring strategies, the usage of savings, or why a company has started offshoring were asked on the company level, because they are expected to have little variation among functions. Questions at the functional level concern the risks and drivers for offshoring a particular function. Finally, the level of each implementation looks at the specific location- and governance mode choice, all performance metrics, HR issues, as well as future plans for the specific offshoring unit. In the analysis of the data, we need to be aware of the different levels of analysis. Since we are making a distinction between initial governance mode decisions and subsequent governance mode decisions, we can add strength to the analysis. A potential problem of multicollinearity is particularly present in the analysis of subsequent governance mode decisions.

Figure 5.1: Levels of Analysis



Source: Own figure

In such cases, it is likely that we might find multiple observations of the same function represented in different countries. As the market entry mode literature suggests looking at uncertainty variables and since risk variables are only collected at the functional level, I need to limit the data set accordingly. When including risk variables as a proxy for uncertainty, I will only look at those samples that do not have a second implementation in the same function. If this is the case, we cannot specify whether risk has changed from the first implementation to the second implementation. We can only compare the risk measures if there is a new implementation of a different function for which the risk measures had to be evaluated separately. Additionally, we have to consider this effect when looking at subsequent governance mode decisions. If we want to look at companies using a different governance mode, we can only do so to the extent that the governance mode change does not take place within the same function. In this case, I have different implementations from a single company. Stata’s clustering function controls for the fact that there may be multiple observations from the same company.

While we have three different levels of analysis, we have additionally three different offshoring statuses. The survey could be returned by firms actually offshoring, by firms considering offshoring, as well as by firms not offshoring at all. The last category is not relevant for my dissertation, as they were asked about the reasons for not engaging in offshoring. While the first category is relevant for the analysis for subsequent governance modes only, both the firms actually offshoring category and the firms considering offshoring category are relevant for the analysis of

the initial governance modes. Despite the methodological caveat I raise in the analysis of uncertainty variables, the data can be analyzed interchangeably. Firms were asked the same questions, and since initial governance modes do not include any offshoring-related experience variables, there are no further differences to consider in the analysis.

5.2.3 Data Analysis: The Probit Model

Many of the choices that companies are facing are “either-or” in nature. The question whether to offshore using captive governance modes or contracting with third party service providers is exactly of this kind. There are also hybrid models emanating in the market. However, they still represent a very small fraction of the currently used offshoring modes and are usually similar to captive modes. My model for the corporate survey will thus apply a binary variable, *i.e.*, a dummy variable, as the dependent variable. The dependent variable takes the following shape:

$$y = \begin{cases} 1 = \text{Choice of a captive governance model} \\ 0 = \text{Choice of a third party governance model} \end{cases} .$$

If dichotomous dependent variables are integrated into econometric models and if there is an unobserved latent variable involved, usually probit models are applied (Greene, 2003). A probit model estimates the probability that the dependent variable takes the value one, given the latent variable $y^* > m_j$ (*ibid.*). The estimated *continuous* (latent) dependent variable y^* corresponds to the dummy variable and is usually unobserved, with the shape of:

$$y^* = x'_i \beta_i + \varepsilon .$$

In the case of the governance modes in offshoring, I will estimate “level of organizational integration” for y^* . Further, it is assumed that the error term is normally distributed, *i.e.*, $\varepsilon | x \sim N(0,1)$. The model is then used to estimate the cut-off point m_j , which defines the range of values of y^* corresponding to the dummy variable.

$$y \stackrel{def}{=} \mathbf{1}_{(Y^* > m_j)} = \begin{cases} 1 & \text{if } y^* > m_j \\ 0 & \text{if } y^* < m_j \end{cases} .$$

The hypothetical cut-off point m_j gives us an estimation above that level of integration a captive governance mode will be selected. Given the estimation of y through y^* , I will estimate the following probit model:

$$p_i = P(y = 1) = F(\beta_0 + \beta_i x_i) \text{ for } i = 1, \dots, n ,$$

with x_i contributing to the explanation of the likelihood that the dependent variable y takes the value one. Value one represents the choice of a captive governance mode.

The interpretation of signs and the significance are the same in probit models as in OLS models. An increase (decrease) in X is associated with a higher (lower) likelihood in Y (all else being equal). The interpretation of coefficients in probit models is however more difficult than in OLS models. While in an OLS regression an increase of 1 unit in the independent variable corresponds to an increase of β_i units in the dependent variable, it is different in probit models. The effect of independent variables is only linear in the latent variable (Y^*), but not in the observed variable Y . In probit models, the coefficient reports the difference of a unit change in the independent variable in terms of the cumulative normal probability of the dependent variable (*ibid.*). In this sense, the probability of the dependent variable is not a linear but a cumulative function. This means that the effect of a unit change in the independent variable on the probability of the dependent variable depends on the level of the independent variables. Therefore, to assess the effect of probit coefficients it is necessary to opt for some level of the independent variables as a reference point. The standard reference point is when all independents are at their sample means.

5.3 Operationalization of the Client Perspective

5.3.1 Captive Offshoring

The dummy variable reflecting the offshoring make-or-buy decision builds on the degree of vertical integration, *i.e.*, the options to establish one's own captive entity abroad or to outsource the services to an external provider. If a captive governance mode is selected, the variable takes a value of one; if a third party service provider is involved, it takes a value of zero. Due to the possibility of establishing hybrid governance modes, a clear-cut distinction between captive modes and third party modes is not always possible. The level of integration of offshore units can be defined along three dimensions (Deloitte, 2005): The degree to which the processes are kept in-house, the degree to which the management and employees are kept in-house, as well as whether the financing is arranged by the client or the service provider. Hybrid modes can also be analyzed according to the dependency between headquarters and the offshoring unit. If the offshoring unit is financially independent but it is performing the tasks only for one single client, the mutual interdependency is high. Alternatively, a captive unit can also offer its services to different clients. In the vast majority of cases, the categorization is straightforward and functions are either kept in-house or outsourced equally along all three dimensions. The situation in which a captive center is servicing competitors or other clients is extremely rare as well and is likely to be found in transition phases between governance modes. As we have only a handful of such cases, all modes that were not attributable to the binary decision were excluded in the model.

The distinction between captive governance modes and third party governance modes follows the logic of the market entry mode literature. This literature makes a distinction either between greenfields and acquisitions (Brouthers & Brouthers, 2000; Drogendijk & Slangen, 2006; Harzing, 2002; Hennart & Park, 1993; Padmanabhan & Cho, 1995) or between greenfields and joint ventures (Barkema & Vermeulen, 1998; Padmanabhan & Cho, 1995). Greenfields can be understood similar to a firm opening up its own subsidiary, or in this case, a captive center. The major difference between acquisitions and joint ventures lies in the ownership structure. While acquisitions are companies that are bought and subsequently owned by another company, a joint venture implies shared ownership in an established or an existing company. In the latter case, responsibilities are shared, generating different incentive structures. In our research question, ownership

of the offshore entity is a crucial element. A captive center is always owned by the offshoring company, while a third party service provider is never owned by the service providers. Consequently, we have to consider this difference in the data analysis and refer to the fact that with regard to incentive alignment, third party offshoring has more characteristics in common with joint ventures than with acquisitions.

Another important determinant for captive centers is the differentiation towards subsidiaries. Compared to traditional subsidiaries, a captive center usually has no obligations to interact with the domestic sales market and is primarily set up in order to serve the headquarters at home or the subsidiaries scattered around the world. Similarly, third party providers do not have any tasks that regard the primary functions of the value chain. Their charter includes support functions, which can be understood in a broad sense and may range from low-skilled tasks such as data entry up to high-skilled functions in research and development centers.

5.3.2 Asset Specificity and the Offshoring Functions

Asset specificity is the most important variable in the TCE model. The variable is supposedly an even better predictor than uncertainty (Zhao *et al.*, 2004). However, all TCE variables pose some challenges in measurement (Shelanski & Klein, 1995). A highly specialized firm producing high-tech products may have a very different understanding of complexity than a low-tech firm. A clear definition is difficult. Asset specificity is given if an exchange requires at least one party to invest in assets, whether physical or intangible, that have no alternate usage of that exchange (Williamson, 1971). Since switching costs from one partner to another are high, the market is not an effective instrument to safeguard against opportunistic behavior. In the operationalization of the variables, some authors adhere very closely to Williamson's work. For instance, Dyer (1996) proxies site-specificity with the distance between the supplier plant and the main manufacturing plant. With regard to physical assets, he supposes specificity to be reflected in the percent of the supplier's total capital equipment investments, which would have to be scrapped if they were prohibited from conducting any future business with the client. Finally, Dyer (1996) measures human asset specificity by the "man-days" of the interaction between a client and a supplier, as well as the average number of co-located "guest engineers". However, there are also attempts to measure asset specificity in a qualitative manner. Klein *et al.* (1990) proxy asset specificity on a seven point Likert scale. Questions involve issues such as the time required to learn a process, requirements

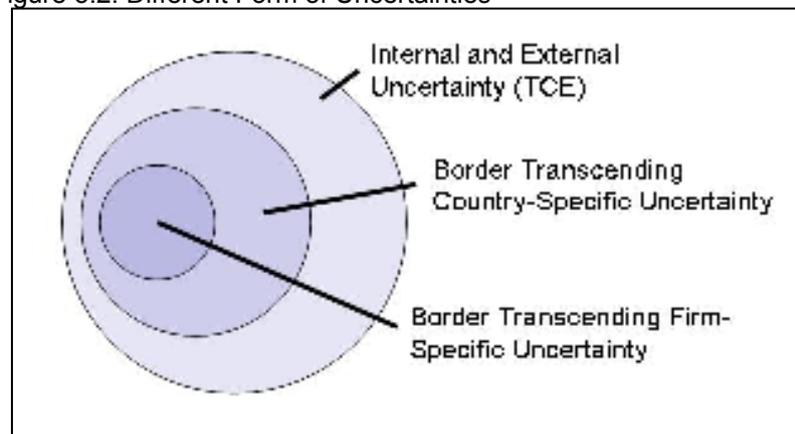
for communication in order to perform a task, as well as the educational level and/or experience that is necessary to perform a task.

I used a functional dummy for product development to proxy asset specificity. The reason for this simplification is that it is very hard to measure complexity on a continuous scale. In the service provider survey, we asked respondents to report on complexity and standardization measures. However, I have to be careful to use the service provider results for the analysis of the corporate survey because it might cause a bias. Looking at the characteristics investigated in the service provider survey (a survey that focuses on functions *outsourced*) would not give the full picture on the characteristics of functions *offshored* in general. I have to assume that complex functions are kept in-house; thus, they do not appear at all in the service provider survey. Nevertheless, an intuitive distinction between complex and non-complex functions is in line with the findings of the service provider survey. Complex functions are less standardized, require a more highly skilled workforce, require more training, and involve more operational interaction with the client. The following functions showed that they have on average higher asset specificity: engineering, product design, as well as research and development. If such a function is offshored, I use a dummy variable indicating the increased asset specificity. The dummy variable takes the value 0 for all other functions. Product development (the aggregate of the above functions) further involves a simplification in an intertemporal manner. It is a function requiring high investments, thus asset specificity is evolving over time. By investing in product development, firms hope to achieve sustainable competitive advantages in the future. When offshoring this function today, firms are not likely to lose the knowledge instantly. Usually it takes a while until knowledge is diffused to the offshore center or until specificity is generated in new development projects. When using product development as a proxy for asset specificity, I have to bear the differences caused by its temporal component in mind. Consequently, it would be necessary to differentiate whether offshoring involves an existing product development function, a new product development function, or a function that is just supportive to product development. The risk for knowledge losses is highest in the first case. I assume, however, that on average firms are taking the governance mode decision based on expectations about current and future (potential) knowledge considerations. The governance mode decision is a reflection of asset specificity that arises today or may arise in the future.

5.3.3 Measuring Uncertainty

The traditional TCE literature has a broad understanding of uncertainty. Williamson (1971) mentions uncertainty in relation to the predictability of future events and pinpoints potential volatility in the market. This approximation has frequently been used in empirical studies, operationalized, for instance, by the variance in sales (Milliken, 1987). On the other hand, Williamson (1971) talks about potential opportunistic behavior of the transaction partner as a form of uncertainty. In the market entry mode literature, uncertainty measures are frequently limited to international experience and cultural distance (Zhao *et al.*, 2004). While international experience is a form of an internal uncertainty, cultural distance refers to external uncertainty. Cross-cultural risks are similar in nature to macroeconomic risks.

Figure 5.2: Different Form of Uncertainties



Source: Own figure

Figure 5.2 depicts a hierarchical structure of uncertainty measures. TCE uses the broadest definition of uncertainties and the concept is applicable for both offshoring and outsourcing. Costs for controlling a transaction are supposed to increase if there is uncertainty about future events and if the transaction partner is likely to show opportunistic behavior. Among these risk variables, we can look at risks that are particularly important for offshoring as a border transcending strategy. Such risks are similarly applicable to all companies and are therefore called external risks. This form of risk is specific to offshoring and other forms of international collaboration. Finally, there are risks that are specific to a firm and which I call internal risks. In the market entry mode literature, internal risks include, for instance, the lack of international experience. In offshoring, internal risks concern different capabilities and the ability to protect and develop them. I will emphasize both the internal and external as well as cross-national risks (the inner two circles in figure 5.2). The internal and external risks are measured on the Likert scale indicating the

risk perception by managers (respondents). The variables include the risk of lacking acceptance (internally and from customers), the loss of managerial control, the loss of internal knowledge, the lack of buy-in of offshoring in corporate culture, insufficient data security, poor service quality, poor disaster recovery plans, potential decreases in operational efficiency, employee turnover, political backlash, decreasing company morale, political instability, wage inflation, influence of trade unions at home, as well as contractual risks (see appendix 9.2, question 9). In order to add expressiveness to the uncertainty variable, I have conducted factor analyses including the risk factors with the highest response rates. The results support clustering the risk factors into three categories: business and process risk, economic risks, as well as offshoring risks. Besides the three clusters, I treat the loss of internal capabilities separately. Capabilities are the lifeblood of companies, for which reason it is critical to assess the indispensability of capabilities crossing the border. If potential knowledge drain has to be feared, we expect adaptations in the offshoring strategies.

Business and process risk is a form of risk that is firm specific and that can be reduced through integration. It includes the risks of losing managerial control, the risk of data security loss, the risk of loss in service quality, as well as the risk of a lack in intellectual property protection. Each of these variables has a very high loading on the same factor (between 0.70 and 0.81), and the eigenvalue is substantially higher than one. In addition, the Cronbach's alpha measuring the reliability of the composite measure is high, with a value of 0.72. The external risk factors are clustered in the variable "economic risks". It includes the risk of high employee turnover, political instability, wage inflation, as well as legal risks. I assume that these variables cannot be reduced by integrating the offshoring unit. The factor analysis is almost as good as for the business and process risk, however with a slightly lower Cronbach alpha of 0.6. The third uncertainty variable cluster, offshoring risks, includes risks that directly relate to the offshoring strategy. It includes the risk of lacking acceptance from internal clients, the risk of lacking acceptance from customers, the lack of buy-in in corporate culture, as well as political backlash at home. We consider those risks as external risks; however, there is also an internal component to them. Depending on the operational component of the strategy, the company can still influence the related risks. However, I argue that companies cannot influence the risks through integration. The Cronbach alpha of the factor analysis is again stronger, with a value of 0.7.

While I will look at the experience variable only when discussing subsequent governance modes, I will now have a closer look at the other core variable in the market entry mode literature, *i.e.*, the cultural distance variable.

5.3.4 Cultural Distance

In the cross-national literature, cultural distance measures are frequently used (David & Han, 2004). Due to the importance of this variable, I am discussing cultural distance separately in this chapter. In line with Drogendijk & Slangen (2006), I will compare the expressiveness of the Hofstede measure (Hofstede, 2001) with psychic distance measures of cultural distance.

Cultural distance is defined as the extent to which shared norms and values differ from one country to another (Hofstede, 2001; Kogut & Singh, 1988). The theoretical foundation has revealed that measuring cultural distance is very difficult, and major disputes about the measurements have played themselves out in several management journals (Hofstede, 2002; Kirkman *et al.*, 2006; McSweeney, 2002; Smith, 2006). Rational arguments and statistical findings are frequently challenged with subjective argumentation and methodological issues. However, subjective studies frequently lack generalizability. The market entry mode literature largely adopts distance variables that are derived from the Hofstede measures (Zhao *et al.*, 2004). The five dimensions identified by Hofstede (2001) include “Power Distance”, “Uncertainty Avoidance”, “Masculinity”, “Individualism”, as well as “Long-Term Orientation”. In order to convert the measures into one single testable variable, the Kogut-Singh index is generated (Kogut & Singh, 1988). Kogut *et al.* (1988) developed a composite index that is based on deviations of cultural values across countries along the dimensions developed by Hofstede:

$$CD_j = \sum_{i=1}^4 \left\{ (I_{ij} - I_{ik})^2 / V_i \right\} / 4$$

where CD_j is the cultural difference between one country and another, I_{ij} represents the index of the i th cultural dimension in the j th home country, k represents the host country, and V_i is the variance of the index of the i th value dimension. Using Kogut & Singh’s Index for measuring cultural distance is particularly widespread in the literature on market entry modes. Drogendijk &

Slangen (2006) suggest using a slightly adapted version of the Kogut-Singh index. The Kogut-Singh index assumes that the differences in the scores on each dimension are equally important in determining cultural distance between countries. However, the measure suggested by Drogendijk & Slangen (2006) computes distance in a “fourdimensional space” as the square root of the sum of the squared differences in the scores on each cultural dimension. This calculation also refers to the Euclidean distance (*ibid.*). Formally, this implies that

$$CD_j = \sqrt{\sum_{i=1}^4 \{(I_{ij} - I_{iN})^2 / V_i\}}.$$

Similarly, we can use this cross-cultural distance measure in offshoring. As my interviews have shown, cross-cultural issues are a continuous challenge in offshoring practice (Interviewer B, 2008; Interviewer A, 2007), and careful consideration seems very important. I collected the cross-cultural measures from the book “Culture’s Consequences” by Geert Hofstede (Hofstede, 2001). For each implementation, I then calculated the Kogut-Singh index between the home country and the offshoring country.

Drogendijk & Slangen (2006) show in a meta analysis that empirical support of the Hofstede measure is not very strong. However, the measure has a strong justification and cannot be dismissed as outdated. Because the results are usually not very strong, cultural distance should be regarded in the context of additional variables.

I use trade flows as an alternative objective distance measure. While I assume that cultural distance does not influence the governance mode decision directly, I assume that cultural distance influences trade flows and trade flows in turn influence the governance mode decision. Trade flow is a variable that correlates to other distance measures, for instance, geographical distance (Dow & Karunaratna, 2006). Geographic distance, however, is very static and looks at the impact of physical distance on a dependent variable. Trade flow considers path dependency as well. It is possible that nations exchange goods and services because of colonial relationships, language similarity, trade blocks, or common currency. In existing research, trade flow appears as both independent and dependent variable. The

economics oriented research is primarily interested in the reasons why nations and firms are doing business with each other. The center of gravity model (*c.f.* Anderson & Wincoop, 2003), for instance, measures the impact of institutional arrangements on trade flows between nations. Anderson & Wincoop (2003) use national boundaries as proxy for institutional arrangements and find a negative impact of national boundaries on trade flows. In IB, as in my research, trade flow is used as an independent variable in order to research the effects of distance on strategic postures. Dow & Karunaratna (2006) compare trade flow to various other distance measures in a set of 38 nations. In order to allow for comparability with the economics oriented studies and because of the meta-analytic nature of the paper, they use the variable as dependent variable. The result of the Hofstede measure is not significant, but the authors find strong correlation of language, industrial development, education levels, political systems, religions, time zones, as well as colonial links with trade flows. They conclude that this is a strong variable for measuring distance. High trade activity increases experience and decreases uncertainty. As companies face lower uncertainty, they are more likely to offshore using captive governance modes. I collected trade flow data from the Global Market Information Database (Euromonitor International). The percentage of exports going from the home country to the country of the offshore provider is then related to the overall exports of the home country. While the large offshoring destinations such as India, China, or Brazil would cause an imbalance toward smaller countries such as the Czech Republic, small countries have been clustered into regions, *i.e.*, “Eastern Europe”, “Latin America”, “Other Asia”, and “Africa”.

One alternative for measuring cross-cultural distance on an objective scale is the use of psychic distance. As elaborated above, psychic distance is defined as “factors preventing or disturbing the flow of information between potential or actual suppliers and customers” (Nordström & Vahlne, 1992 in O’Grady & Lane, 1996). Evans & Mavondo (2002) use five measure to operationalize psychic distance: Legal and Political, Market Structure, Economic Environment, Business Practices, as well as Language similarity. The literature incorporating psychic distance assumes that “psychically close countries are more easily understood than distant ones; and offer more familiar operating environments (O’Grady & Lane, 1996: 309). The meta-analysis by Drogendijk & Slangen (2006) finds considerable support for this subjective measure, and frequently it is the better predictor in comparison to the traditional cross-cultural measures. Mjoen & Tallman (1997) or Taylor, Zou & Osland

(1997) have chosen a simple way by asking about the subjective perception of cultural distance between the home country and the host location. The authors further asked about dissimilarities between the headquarters and the joint venture partner. As further suggested by Evans *et al.* (2002), I measured the variable on a five point Likert scale, *i.e.*, respondents had to judge subjectively whether the cultural distance between the headquarters location and the service provider location is perceived as very strong or very weak.

5.3.5 External Experience Influencing Initial Governance Mode Decisions: Isomorphism

As organizational isomorphism is a very broad topic looking at the legitimation of action, the empirical foundation of this literature is manifold. Frequently, the studies refer to adaptations to regulatory or legal environments. When it comes to isomorphism on the firm level, the literature frequently refers to survey questions asking about firm behavior in comparison to industry behavior, the level of autonomy, resource interdependence, as well as resource sharing (Davis *et al.*, 2000). As these are sometimes subjective figures and difficult to measure on an objective scale, surveys using Likert scale responses are an appropriate alternative (Stimpert & Duhaime, 1997).

In my case, it is easy to measure industry behavior on an objective scale. Information on both the governance mode and the year of implementation is gathered in the survey. In this way, it is possible to tackle the prevailing governance mode in the industry at the time of implementation. Three patterns are assumed to influence the likelihood to select a captive governance mode: the observed frequency of captive modes for the particular function, the observed frequency of captive modes of the particular offshore location, as well as the observed frequency of captive modes that other companies in the home country are using. I suggest that isomorphism does not just take place within a particular offshoring function, but across functions, industries, and across offshoring locations. As I am using an overall likelihood measure to select a captive governance mode, I need to calculate the geometric mean:

$$\bar{x} = \left(\prod_{i=1}^3 x_i \right)^{1/3} .$$

The geometric mean \bar{x} is calculated by the third radical of the product of the probabilities to select a captive governance mode x_i . The third radical is taken because we are looking at three origins of isomorphism, functional isomorphism, isomorphism originating in the offshore location, as well as isomorphism originating in the home country. The geometric mean is preferred over the arithmetic mean because we do not have a weighting of the component's headquarters location, offshoring location, or function. The result of this figure \bar{x} is an overall figure of isomorphism, suggesting the likelihood for selecting a captive governance mode.

5.3.6 Drivers for Cost Savings and Growth Driver

Organizational isomorphism is the first approach that is complementary to the transactional perspective. The transactional approach tells us to what extent we have to react to opportunistic behavior of transaction partners (Williamson, 1985). The market entry mode literature then hints at the fact that uncertainty can only be reduced if sufficient experience is available in the company. This provides a bridge to the capabilities perspective, stating that the performance of a company is determined by the positions (available capabilities) and paths in the firm (Teece *et al.*, 1997). With that in mind, I suggest that the governance mode decision is not only the product of economizing on transaction costs and the consequence of industry trends. Offshoring is likely to be driven by internal capabilities and efficiency enhancing strategies as well. I argue that firm-specific capabilities are manifested in the drivers to offshore. In particular, I am interested in looking at two different forms of drivers: the driver to save costs and the driver to optimize the business processes. In the corporate survey, we asked respondents to indicate the most important drivers for offshoring. Drivers are measured on a five point Likert scale asking about the level of importance. They include "enhancing efficiency through business process redesign", "labor cost savings", "other cost savings", "growth strategy", "enhancing system redundancy", "access to qualified personnel", "improved service levels", "competitive pressure", "accepted industry practice", "access to new markets for products and services", "part of a larger global strategy", "increasing speed to market", and "differentiation strategy". The variable "accepted industry practice" seems like an alternative measure for isomorphism. As it was not related to governance mode decisions directly, its analysis would however be biased. From the theoretical perspective, I have suggested that the cost saving driver increases the likelihood to select third party governance modes, while the global strategy driver increases the likelihood to select captive governance modes. Factor analysis allows us to cluster

the variables of labor cost savings and other cost savings together. The results of the Likert scale of the two variables are added for the data analysis.

While the importance of cost savings supposedly leads to disintegrated governance modes, growth drivers are expected to lead to integrated governance modes. "Growth strategy" and "part of a larger global strategy" are the two variables reflecting the aim to establish offshoring as an integral part of internal restructuring activities. As for the cost savings driver, growth drivers are measured on the Likert scale and are added for data analysis.

5.3.7 Internal Experience in Subsequent Governance Mode Decisions

Until now, data analysis is limited to initial governance mode decisions. As a next step, I look at subsequent governance mode decisions. Subsequent governance mode decisions are decisions that have been taken at least a year after the first offshoring implementation. For subsequent governance mode decisions, I am particularly interested in looking at the extent to which capabilities from existing governance modes are developed and replicated later on.

In discussing the market entry mode literature, I excluded the experience component for the reason that I am looking at initial governance mode decisions. Empirical evidence suggests a positive relationship between experience and the level of integration (Zhao *et al.*, 2004). Companies are better able to control processes in integrated governance modes (Anderson & Gatignon, 1986). International management literature frequently measures international experience with foreign sales as a percentage of total sales, foreign employees as a percentage of total employees, or foreign assets as a percentage of total assets (Sullivan, 1994). In offshoring, we are talking about relocating support functions of the value chain. This is different from analyzing market-leveraging strategies and requires different forms of experience. Consequently, we have to measure experience with different internal and external offshoring-related variables. In order to study the effect of previous governance mode decisions on current governance mode decisions, I calculate the firm-specific probability for choosing captive governance modes by calculating the fraction of captive governance modes implemented at least one year before the actual governance mode decision. *Governance mode decisions are considered independent from their function and the country of offshoring.* A dummy variable tackling this issue would not be able to differentiate between experience with captive centers and experience with third party offshoring models. Therefore, the variable

has been specified and adapted to the dependent variable by specifying it to captive offshoring experience. If the dummy variable takes the value one, it means that a company choosing a captive governance mode has already chosen the same governance mode decision at least one year before this decision. While I am calculating the probability for selecting a captive governance mode, it automatically reflects the probability of choosing third party governance modes. This is because the likelihood to select a third party governance mode is the reverse situation of the captive governance mode selection.

5.3.8 Cost Savings

Cost savings is a very prominent measure of success in offshoring. While there appears to be less discussion on the definition of this figure, it is sometimes very difficult to estimate costs at all. Support functions often build on shared costs that cannot be clearly allotted, which makes it difficult to estimate cost savings in the aftermath. Lewin (2008) assumes that companies initially underestimate the costs of offshoring. While it is sometimes not possible to estimate the costs (or cost savings), it is also in the interest of the managers promoting the strategy to downplay its associated costs. Once the strategy becomes operational and there is full transparency of the processes, cost calculations become more accurate. For some companies, particularly those which do not have a long-term orientation, the true costs may be a reason to pull back on the strategy. With that in mind, Misra (2004) argues for an integrative success measure involving all parties – the outsourcer, the outsourcee, as well as the end user. However, such an output measure is even more ambitious than a simple cost savings measure, and this figure does not have a consistent definition. For want of better alternatives, I had to use the percentage of cost savings indicated by the respondents as an approximation of the effective cost savings resulting from offshoring.

5.3.9 Control Variables

5.3.9.1 Size

I use two control variables for the analysis of the corporate survey: size and the origin of the client headquarters. Size is a commonly used measure in the IB literature in general (Werner, 2002), as well as in the market entry mode literature in particular (Harzing, 2002). The variable is, in the latter case, measured in absolute terms (Kogut & Singh, 1988), however, sometimes also as a relative figure measuring the size of the foreign investment relative to the investing company

(Padmanabhan & Cho, 1995). In this context, it is very reasonable to use relative figures, as researchers are interested in observing the scope of an entry mode project in a given location in terms of the size of an investing firm. In offshoring, the size of the units can vary greatly (Lewin & Couto, 2007) and is normally dependent on the scope of the functions that are relocated abroad. In the distinction between greenfield investments and acquisitions, Drogendijk & Slangen (2006) find that acquisitions generally require more financial resources than greenfield investments. I expect a very similar situation in offshoring. While third party offshoring involves contracting, but no major financial investments, captive offshoring normally involves a large amount of fixed costs. The costs for establishing the center can be substantially high, normally to such an extent that certain scales are required in order to run the entity successfully. In many cases, only sufficiently large companies are able to bear these costs. In measuring size, we have the option to look at the number of employees, sales, assets, etc. In line with internationalization literature (*c.f.* Sullivan, 1994) and a common measure in the market entry mode literature (Harzing, 2002), I use the number of employees as a size figure for the client engaging in offshoring.

5.3.9.2 *Location of the Headquarters*

In the determination of the market entry mode choice, other common control variables include R & D intensity, the level of diversification, foreign experience, or timing of the investments (Harzing, 2002). As offshoring concerns the relocation of support functions of the value chain, and since I am primarily looking at initial governance mode decisions, it would not be reasonable to apply these measures. Alternatively, Lewin *et al.* (2007) observe differences in the governance mode depending on the location of the client headquarters. For instance, German companies generally have a higher preference for captive governance modes than, for instance, US companies do. While they do not provide a clear explanation for this phenomenon, they conjecture that it has something to do with general preferences. In this regard, German companies have a higher preference for control and a high need to have deep process knowledge in the entire value chain. As this can only be achieved through integrated governance modes, we would observe more captive entities among German companies. Another argument for differences among companies from different locations would be isomorphism. We could assume that the environmental factors in a given country would also favor a certain governance mode over the other. As I am incrementally reducing sample size when building the model,

the headquarters location cannot be used as a control variable throughout the full model.

5.4 Research Design of the Service Provider Perspective

5.4.1 Sample

Since governance mode analysis formed one of seven core issues covered in the corporate survey, enough data was available in order to analyze the suggested hypotheses. The focus on the client perspective, however, made it necessary to launch a specialized survey in order to address the second part of this thesis. Similarly to the corporate survey, the service provider survey was launched from ORN at Duke University. The survey focuses on the relationship between clients and service providers, the mechanisms for incentive alignment, as well as the implications for success. In addition, the survey investigated the geographical and functional distribution of offshoring services as well as acquisition and retention of qualified personnel. Targeted companies were service providers in the common offshore locations in India, China, Philippines, Brazil, Latin America, and Eastern Europe. However, it is also possible that a service provider is headquartered in the US or Europe. In this context, we speak of an international service provider as opposed to a domestic service provider. Hewlett Packard taking responsibility for Procter & Gamble's offshoring activities in India would be such an example. For Procter & Gamble this is an outsourcing activity and since the service is performed abroad, this is likewise a case of offshoring. The companies were targeted through the International Association of Outsourcing Professionals and the network of ORN. A draft version of the survey was reviewed and commented on by a member of a consulting company. The primary purpose of this review was to find out whether we were addressing the relevant questions and whether we were using the proper terminology. In order to allow for maximum comparability between the two surveys, the wording of the questions and the methodologies in the data collection were kept similar and any categorizations, such as functions and the geographical regions, were harmonized. The survey was pre-tested by ten offshoring service providers. Based on their feedback we made some further minor adaptations to the survey. In particular, we had to reduce the scope of the survey so that respondents were able to complete the survey in approximately 45 minutes. Just as with the corporate survey, the service provider survey was launched online, accompanied with an email guiding

the respondent to the URL, and subsequent emails were sent to remind companies about the survey if no response had been received within a few weeks.

The overall sample size of the service provider survey is 280 observations from 125 companies. We asked respondents to forward the survey to each head of a service delivered. The functional differentiation allowed us to receive multiple responses from a single company, which I then took into consideration in the data analysis. On average, each service provider performs 3.3 different offshoring functions. All questions that did not involve absolute figures or percentages, but addressed perceptions, preferences or other subjective data, were measured using the standard Likert scale ranging from one to five.

5.4.2 Level of Analysis

We have discussed the different levels of analysis in context of the corporate survey in chapter 5.2.2. The same issue arises for the service provider survey, however, with one level less. While the corporate survey has three levels of analysis, the company level, the functional level, as well as the level of implementation, the service provider survey has just two levels of analysis. On the company level, we addressed issues such as the selection criteria for a service provider, contractual issues, length of client relationships, and the pattern of the workforce and its recruiting strategy. Questions on the functional level addressed the countries to which services are delivered, drivers, savings, margins, further contractual issues, task characteristics, size measures, as well as plans for future development. Basically, all variables used for this thesis were collected on the functional level. The data gathered on the company level provide a general overview of the service provider landscape and are complementary in the descriptive part of the results section.

5.4.3 Data Analysis

Data analysis was performed in a manner similar to that for the corporate survey. In this regard, I refer back to chapter 5.2.3. The major difference is the use of the model, which is in this case a two-sided truncated Tobit model instead of a standard Probit model. A Tobit model is a model to describe the relationship between a non-negative dependent variable and an independent variable (Greene, 2003). The dependent variables in the service provider model are the percentage of deals terminated and the percentage of long-term clients. Since the dependent variables take the shape of percentages that cannot be negative and that cannot be more than

100 percent, I use the two-sided truncated Tobit model. The lower limit is 0, while the upper limit is 100. Similarly to the Probit model, the Tobit model uses a latent variable y^* , assuming a constant relationship between the dependent and the independent variable. The latent variable is linearly dependent on a vector β that determines the relationship between the independent and the latent variable. Stata was used as a computer tool in order to run the regressions.

5.5 Operationalization of the Service Provider Perspective

5.5.1 Longevity of Client Relationships and Deal Termination Rate

The bottom line of every business strategy is to generate profits, either directly or indirectly. As noted earlier, the measurability of quality and quantity can sometimes be difficult for offshoring services. Consequently, success variables have to reach beyond measuring revenues and costs saving. I look in particular at two aspects of client relationships, termination rates of contracts, and the length of client relationships. Accounting-based figures and financial performance figures are very common measures in the IB literature (Sullivan, 1994). In offshore outsourcing, we can capture financial measures by looking at cost savings and margins. Savings are measured from the client perspective and margins from the service provider perspective. Both figures have, however, major weaknesses. If a client achieves high savings with an offshoring activity, it simply implies that the costs of the production in-house were higher than after offshoring the activity to a service provider. Savings is just a relative measure without much expressiveness. If the client used to be very inefficient in providing a service and the provider is able to deliver the services at a reasonable price, savings are high. If the client was already efficient in providing the service at home, the savings achieved through outsourcing are lower in absolute terms. In fact, even if the offshore provider is more efficient in the second case than in the first case, savings in absolute terms remain lower. Thus, a provider attracting less efficient companies can stand in a better light than a provider who is more efficient. There is a similar problem with margins. While high margins are beneficial for providers, clients do not benefit directly from margins. On the one hand, high margins can imply that both the client and the provider are generating large savings (and gains) and thus the strategy is beneficial. On the other hand, it can be an indication that the competition within the market is very fierce. Lower margins can in this way also be an indication of efficient operations.

The inconsistency in the expressiveness of the savings and margins variables is probably also an explanation of why companies have different conceptions of offshoring success. In a study on the performance of strategic alliances, Ariño (2003) uses an approach combining financial and non-financial performance indicators. The indicators she uses include overall performance satisfaction, goal fulfillment, spillover effects, longevity, contractual changes, as well as survival. I focus particularly on the latter variables, which measure contractual changes and longevity. The underlying assumption suggests a long-term relationship between clients and service providers is also an indication of success. A successful client relationship is in turn reflected in low deal termination rates. A high termination rate would imply that contracts are terminated at expiration. Put differently, contracts are not renewed once current contracts expire. The termination rate only refers to individual contracts and not to the client relationships as a whole. Given that fact, it is possible that contracts are terminated but that the relationship with a provider is maintained in a different form. The longevity of the client relationship is different in this regard. Client relationship measures the number of years that an average client does business with a service provider. Since deal duration may be dependent on the functions, I need to control for this determinant. Call center or IT offshoring generally involves longer contracts than knowledge-based functions that are delivered on a project-by-project basis.

The measure of the termination rate of contracts is very straightforward and includes the overall percentage of contracts that are terminated at expiration. The calculation of the longevity of the client relationship is more complex. If I simply calculated the number of years of a relationship, we would neglect the fact that new providers are not able to have long-term relationships. I calculated the longevity of client relationships as follows:

$$CI = \frac{\sum_{i=1}^x (p_x \times y_x)}{\ln(y_{t_exp})}$$

I generated six categories reflecting the percentage of clients with certain durations of relationships. Respondents were asked to indicate the percentage of the client base that has a relationship to the service provider of less than 1 year, 1 to 2 years, 2 to 4 years, 5 to 6 years, 7 to 9 years, as well as more than 10 years. I

multiplied the percentage with the average years of relationship of the respective category. In the denominator, I corrected for the logarithm of the total experience of the service provider. With this approach, I control for the natural positive relationship between experience of a company and the longevity of a client relationship.

5.5.2 Client Involvement

The second measure that is assumed to increase the success of offshoring is the direct involvement of the client in the offshoring activity. I suggest that this direct way of exerting influence also increases the ability to control for the quality of the work as well as the compliance with the contract. Further, I suggest that this direct involvement of the client leads to higher success. Measuring the involvement of the client can again be determined by directly asking about the relative frequency of client involvement when performing a task. Alternatively, we asked whether there was a high interdependency with the processes in client organizations. Due to the high correlation of the two variables that are measured on the Likert scale, the variables were summed-up and jointly considered in the model. The corresponding question was: For each service that your company provides, how would you rate the following characteristic to describe the work involved: involvement of the client in performing the task/interdependence with the client in performing the task.

5.5.3 Contract Specificity

Jensen & Meckling (1999) suggest that the ability to specify transactions in a contract lead to lower costs associated with the transaction. Tasks that can easily be measured in quantitative and qualitative terms can be controlled better, and it is therefore easier to specify the conditions in contracts. However, it is difficult to estimate this level of specificity of contracts. Poppo & Zenger (2002) measure contractual complexity using a seven point Likert scale, while asking respondents to indicate the level of customization and legal work required to develop the contract. With the help of external experts and by studying several contracts, I identified the most important specifications that appear in a very elaborate contract. All 12 attributes that I identified were subsequently included in the survey. We subsequently asked whether it was possible to specify them in a contract of the individual functions offshored. In that way it was possible to estimate the level of specificity. As mentioned above, I suggest that if many attributes are dealt with in the contract, there is a positive correlation to attaching more importance to contracting. As an additional

control question, we asked to what extent the contractual specifications were important in performing a task.

5.5.4 Relationship-Specific Investments

Investments are another important tool to align interests between the client headquarters and the service provider. Investments can be made either by the client headquarters, the service provider, or both of them. The nature of the investments can be categorized into investments in infrastructure, investments in software, as well as investments in training. As the results show, there is a high correlation among investment figures, which allows for clustering them into one variable. The variable included in the model is therefore the sum of the importance of the mutual project-specific investments in the three categories. Also in this case, it was necessary to capture the variable in a qualitative way. Some functions like IT or Call Centers generally require higher investments than for instance knowledge functions. A comparison of the dollar value of the investments would therefore not be possible; thus, we asked the question in relative terms. Given a certain function, to what extent are the following characteristics relevant for providing offshore services: investments in software, training, as well as infrastructure? Three variables were generated and put together in a single investment variable.

5.5.5 Control Variable: Regional Aspect

The effect of regional issues is quite ambiguous. There are two approaches regarding how to look at the effect of regional clusters. First, it is important to look at India in particular. India has established a huge cluster for providing services. The recent development of the country has, however, a significant effect on its currency, a situation that other Asian countries, such as China, are experiencing as well. Most of the offshoring contracts are settled in US dollar. This currency has experienced significant devaluation over the past few years due to several macroeconomic factors. In contrast, the Indian rupee has a strong upward pressure due to the country's economic growth and its vast foreign direct investments. This phenomenon contains a substantial risk for service providers in India. While they have to pay their employees in Indian rupees, they receive the payment from their clients in dollars. If the dollar is increasing, they have less money available to pay their employees and they have to cut costs. If this issue is not dealt with in the contract, service providers incur losses. This effect may become more important in the future. Service providers will certainly have an incentive to renegotiate contracts, and for clients, India might

become less attractive for offshoring. While this effect is only expected to happen in the longer term, the picture in the short term might look different. India specializes in providing offshore activities. The specialization and experience would imply that Indian companies are more successful, which could be explained with the literature on clustering or with economies of scale. From this perspective, we would assume that outsourcing to India has a positive effect on the expected success.

6. Results

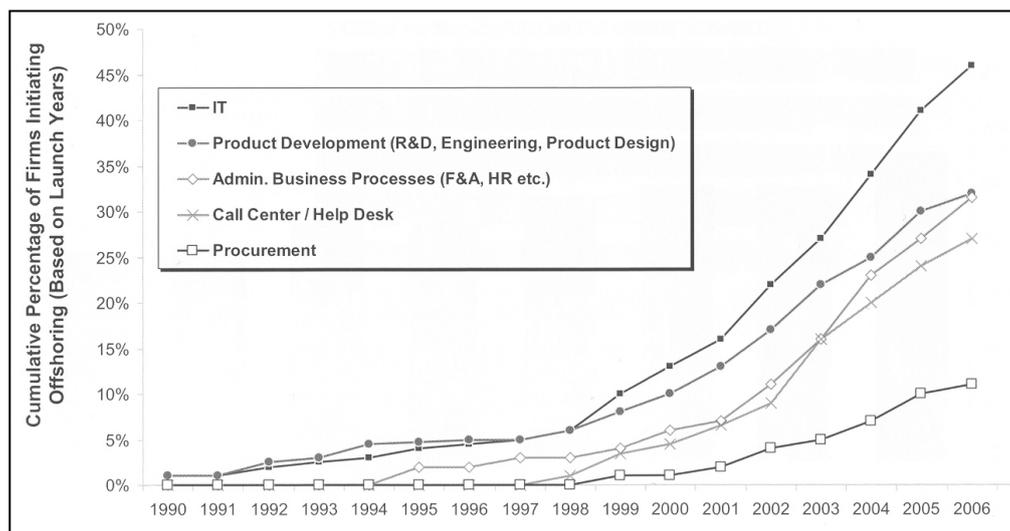
6.1 Results of the Corporate Survey

6.1.1 Descriptive Statistics

6.1.1.1 General Pattern of the Offshoring Landscape

My results on the governance mode decision can better be understood if put in context with the general patterns and trends in the offshoring landscape. Therefore, I first include the most important findings of the ORN database that have been published in a descriptive report (Lewin & Couto, 2007). Key findings include the observation that offshoring is moving from a strategy to lower costs to a strategy of global innovation. Traditional offshoring functions such as IT, call centers, and other business processes are increasingly accompanied by offshoring high-end, white-collar work. Furthermore, while offshoring was a bottom-up process in early stages (Manning *et al.*, 2008), the latest findings of the ORN survey wave show that the offshoring strategy is increasingly reaching the executive floor. While the strategies initially used to be bottom-up driven, they are increasingly integrated into corporate strategy.

Figure 6.1: Cumulative Percentage of Firms Initiating Offshoring, by Function

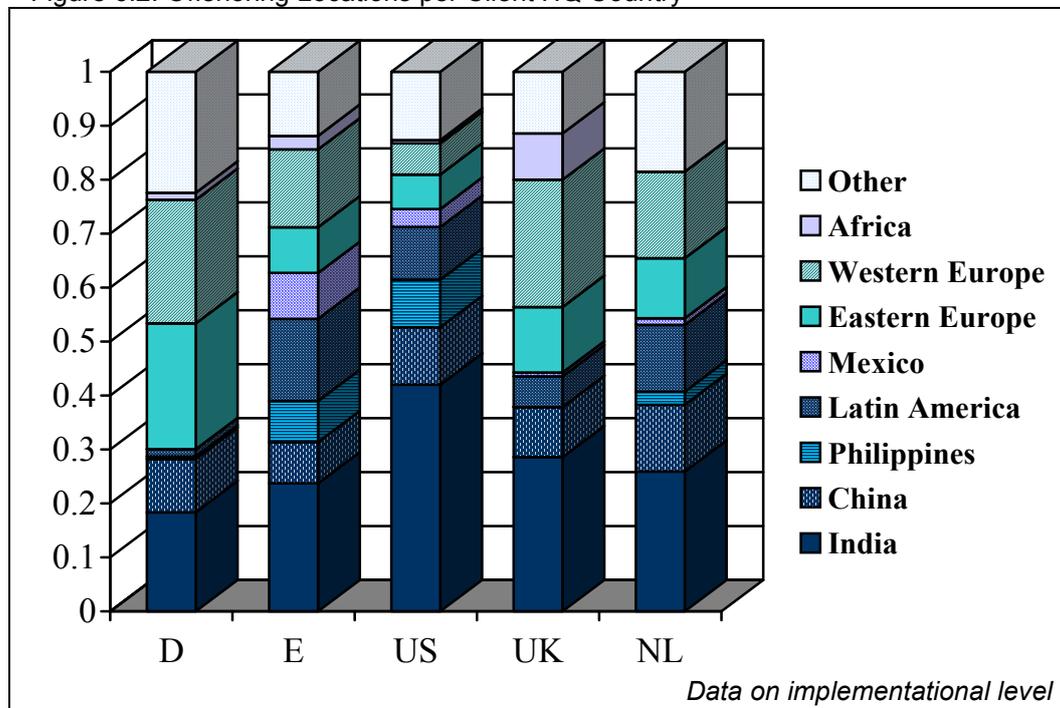


Source: Lewin *et al.* (2007: 19)

Figure 6.1 depicts the growth in offshoring, measured by the cumulative percentage of firms initiating offshoring. While IT and other traditional BPO functions are always important, product development is increasingly receiving attention.

Product development functions can range from drafting & modeling, to engineering analysis, quality assurance, development of new technologies, application development, systems design, and many more.

Figure 6.2: Offshoring Locations per Client HQ Country



Source: Own figure based on ORN data

Figure 6.2 provides an overview of the headquarters locations covered in the survey and the most popular offshoring locations. The US and the UK obviously prefer offshoring to India. The US has 42 percent of its offshoring implementations in Asian countries, the UK has 29 percent. An obvious explanation for this preference is the prevalence of well-educated and English speaking personnel. Language similarity is obviously also important for Spanish companies which offshore to Latin America and Mexico. While we observe that offshoring to countries with the same language is popular, geographical proximity appears to be important as well. In the US, companies like to go to Mexico and Latin America, while European Firms offshore to Eastern Europe. The significant proportion of offshoring to Western European countries primarily refers to Ireland. Ireland has developed tremendously in recent years. It has accumulated very specialized knowledge, in particular in IT and BPO services (OECD, 2005).

Variation in offshoring functions expressed per headquarters location is low. This implies that all of the countries observed offshore the common functions equally. The most established offshoring task, IT, accounts for 20 to 29 percent of all

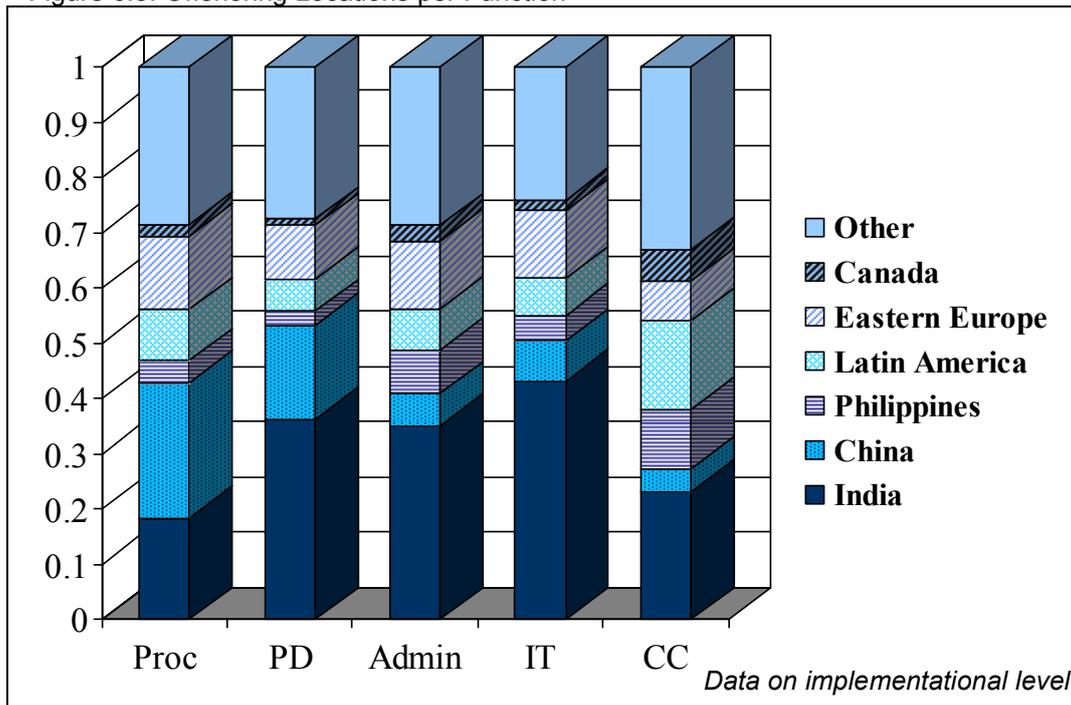
implementations. Remarkable are the Netherlands, with a high share of high-end offshoring functions, and the UK, with significantly more administrative functions. The most commonly mentioned functions of IT are application maintenance and development, data base design and development, testing, data entry and conversion, internet and intranet design and support, and network. Marketing and sales includes power point presentations, graphic design, as well as customer surveys. Administrative functions are separated into finance and accounting (F&A), human resources (HR), and also legal services. F&A is a fairly large sub-category including credit management, cash management, accounts payable/receivable, credit-card operations, accounting, *etc.* HR includes payment processing, benefit administration, recruitment & staff support, as well as workforce deployment. Legal services refer to legal document management, patent management, or legal research. Finally, procurement refers to strategic sourcing, contract implementation, category management, purchase order processing, supplier services or compliance reporting.

While the companies in our sample have adopted offshoring across all functions and on a global scale, we are also interested in seeing whether certain offshoring countries are specializing in providing certain services. A specialization on a regional scale would be in line with recent work on clusters. For instance, Porter (1998) argues that a critical mass of supply leads to competitive advantages. Local knowledge, relationships, and motivation are identified to be key success factors which distant rivals cannot match. China has a long tradition of providing manufacturing offshoring and is highly attractive for blue-collar offshoring (Ketels, Lindqvist, & Sälvell, 2006). The dominance in procurement offshoring could therefore have its origin in the tradition of manufacturing offshoring. In contrast to China, India has specialized in services requiring a highly educated workforce. By establishing a network of highly acknowledged business and technical schools, India is able to keep up with international standards. Combined with the enormous population of the country, a huge pool of talented individuals is made available to the industrialized countries, which are increasingly facing shortages in their highly educated workforce (Lewin & Peeters, 2006).

Call center (CC) services represent a function that is driven by language rather than by clusters. There are many efforts to teach Indian employees a flawless American or British English dialect so that the call center can entirely replace domestic call centers. This is, however, a very challenging endeavor and acceptance among customers is difficult to attain. In this regard, companies try to find locations

with a cheaper workforce but sharing the same language: Latin American countries offer call centers to Spanish and, increasingly, US companies. A Dutch company might consider South Africa or Suriname for establishing a call center. The large share of “other offshoring locations” primarily refers to Ireland, which is likewise popular for establishing call centers. Other countries with sufficient knowledge of the home country language fall into this category as well.

Figure 6.3: Offshoring Locations per Function



Source: Own figure

As a next step, I will shed light on the question of to what extent these findings influence the governance mode decision. After the descriptive statistics, the results of the data analysis are presented in the following chapter.

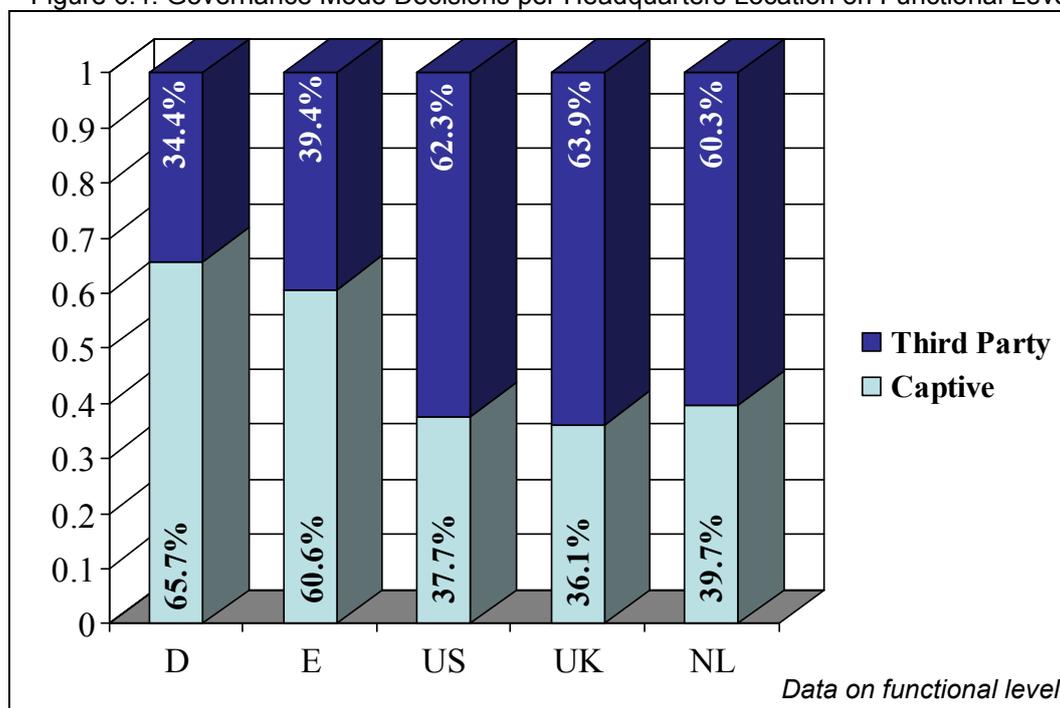
6.1.1.2 The Geographic and Functional Perspective on the Governance Mode Decision in Offshoring

I start my analysis on the governance mode decision by following the logic from above and link the general offshoring pattern to the decision on vertical integration. Figure 6.2 reveals that the country of the headquarters has a major influence on the location choice, while the functions offshored are fairly independent from the country of the headquarters. For the choice between captive and third party governance modes, the location of the headquarters seems to matter. Since we collected the data on the implementational level, it is possible that an implementation is performed using both governance modes simultaneously. An implementation

refers to an offshoring activity of a specific function and a specific offshore location. For instance, if a German company performs product development offshoring in India in one year and additionally in China in a subsequent year, the respondent was asked to fill out the survey twice. However, if the company used third party offshoring in India in the first year and built a captive center in the subsequent year in India as well (same function), this would only appear as one observation in the survey. Measuring offshoring along all three dimensions, the country, the function, and the governance mode, would, on the one hand, have gone beyond the scope of the survey. On the other hand, the number of observations with different modes in the same location and function are very low; thus, eliminating those observations is the more reasonable approach.

In figure 6.4, we can see that German companies have a strong preference for captive centers. The chart is based on the data of companies actually offshoring and considering offshoring. Companies prefer to retain control over their processes and are therefore unwilling to transfer the tasks to a third party service provider. The reasons for this preference cannot be determined unambiguously.

Figure 6.4: Governance Mode Decisions per Headquarters Location on Functional Level

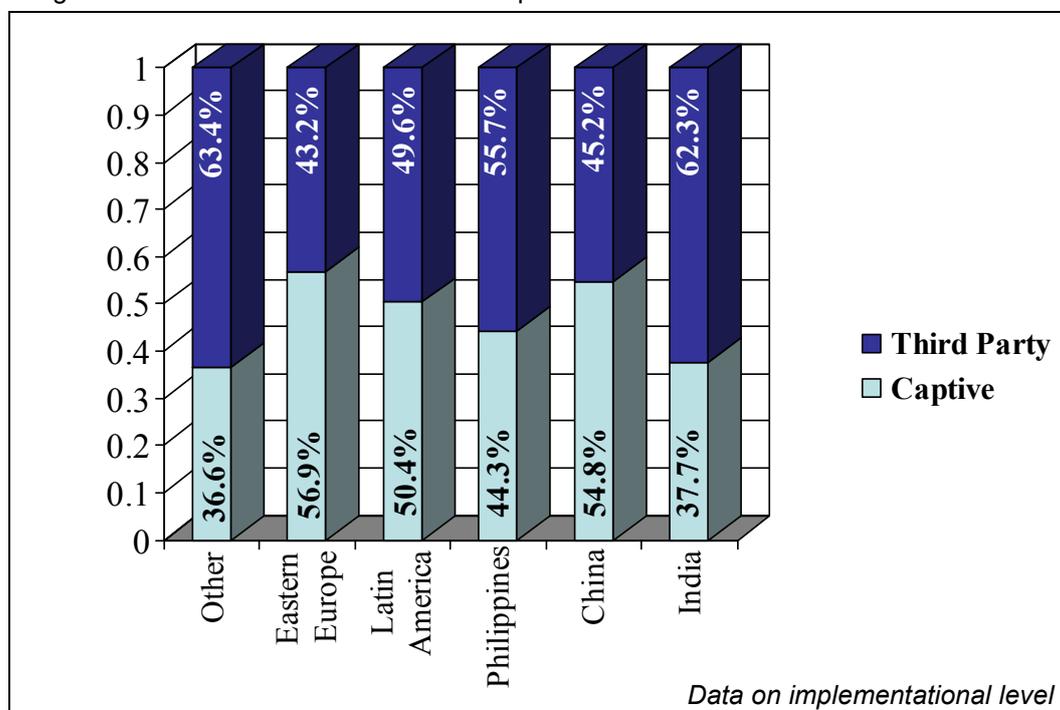


Source: Own figure

The preceding chapters have shown that Germany has no particular preference for offshoring a certain function or to a certain offshoring location. In relative terms, however, we can observe an above average rate of procurement

offshoring. Procurement has a higher likelihood to be performed in captive centers and to be performed in China. Although the descriptive statistics support this finding, it is not based on a theoretical foundation and is probably a simplified explanation for the captive preference for German companies. Lewin (2008) argues, based on expert interviews, that the preference for captive modes originates in the need to understand business processes in great detail. The need to understand the processes in detail is directly linked to the need for control, which is in turn linked to a higher likelihood to select integrated governance modes. While Germany and Spain prefer captive modes, the US, UK, and the Netherlands obviously prefer third party governance modes.

Figure 6.5: Governance Mode Decisions per Location



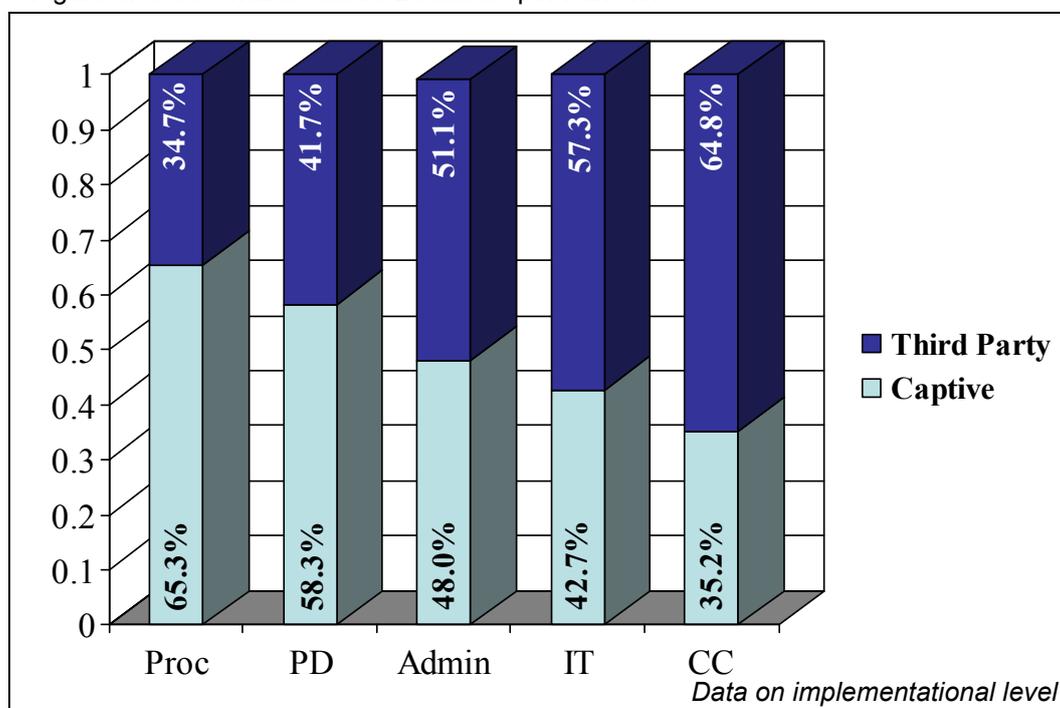
Source: Own figure

Figure 6.5 depicts the governance mode decision according to the offshoring destinations. I have clustered the countries into six categories in order to have a sufficiently large sample size in each case. The most important observations are the percentages for India and China. The likelihood for selecting disintegrated governance modes when offshoring to India is almost two-thirds. The explanation for this high number is likely to be in line with Lowes *et al.* (2004), who argue that the availability of service providers is best in India. The large competition among providers increases the likelihood that the required service is offered offshore and that the quality is sufficiently high. In China, the situation is slightly different and the captive mode is dominant in this location. China has always been an attractive

destination for manufacturing offshoring (Gu & Tse, 2007). When it comes to services offshoring, relocations remain closely related to the product and most commonly involve product development or procurement. Hardly any companies offshore call centers or administrative functions to China. As the functions are very close to the product, offshoring requires more control and supervision, for which reason captive governance modes are more frequently selected.

The finding that product-related functions are more likely to be offshored using captive governance modes is also reflected in figure 6.6. While procurement and product development functions are more likely to be offshored using captive governance modes, IT and call centers are more likely to be offshored using third party governance modes.

Figure 6.6: Governance Mode Decisions per Function



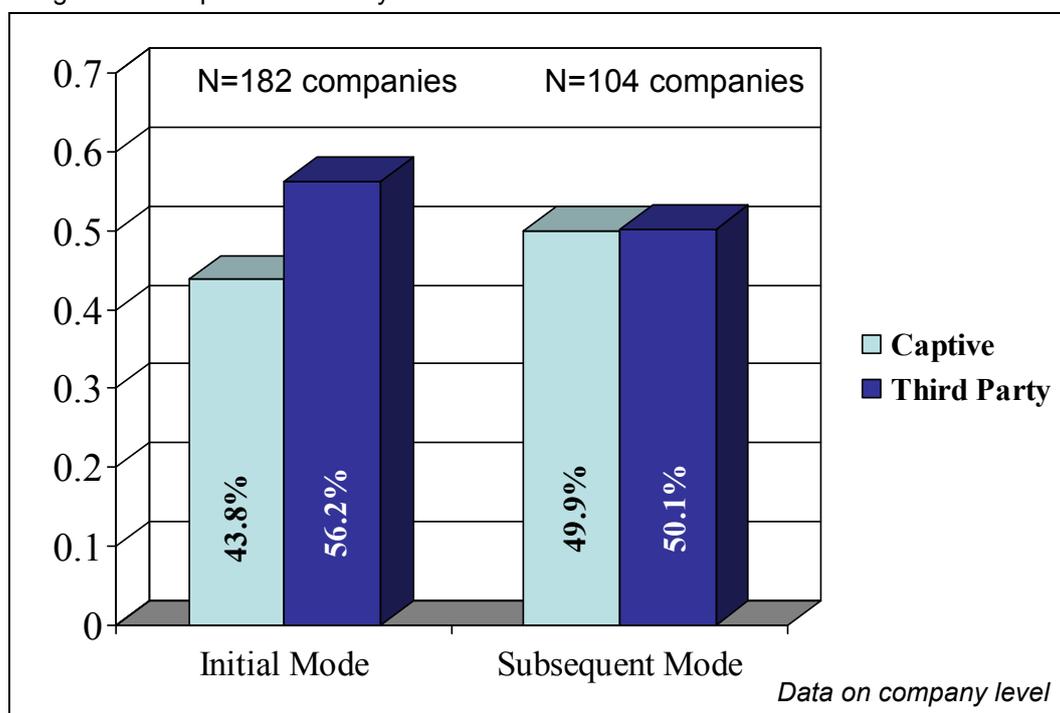
Source: Own figure

6.1.1.3 The Intertemporal Perspective on the Governance Mode Decision in Offshoring

Based on the theoretical predictions, we assume that companies prefer third party governance modes in the presence of uncertainty. This governance mode is, however, only selected if uncertainties cannot be reduced through integration. If risks could be reduced through integration, Williamson's (1971) TCE framework would argue in favor of integrated modes.

Figure 6.7 supports the predictions of TCE and the market entry mode literature. I assume that the lack of offshoring experience is a form of uncertainty; thus, third party modes are the more frequent choice in initial governance mode decisions. For subsequent governance mode, the result is very balanced. Almost exactly 50 percent of the governance modes are captive modes, and 50 percent are third party modes. On a functional basis, there is no major difference between initial and subsequent modes. The only exceptions are IT and call centers. IT is a typical function for initial offshoring, while call centers are more frequently established as a subsequent offshoring activity.

Figure 6.7: Captive Probability

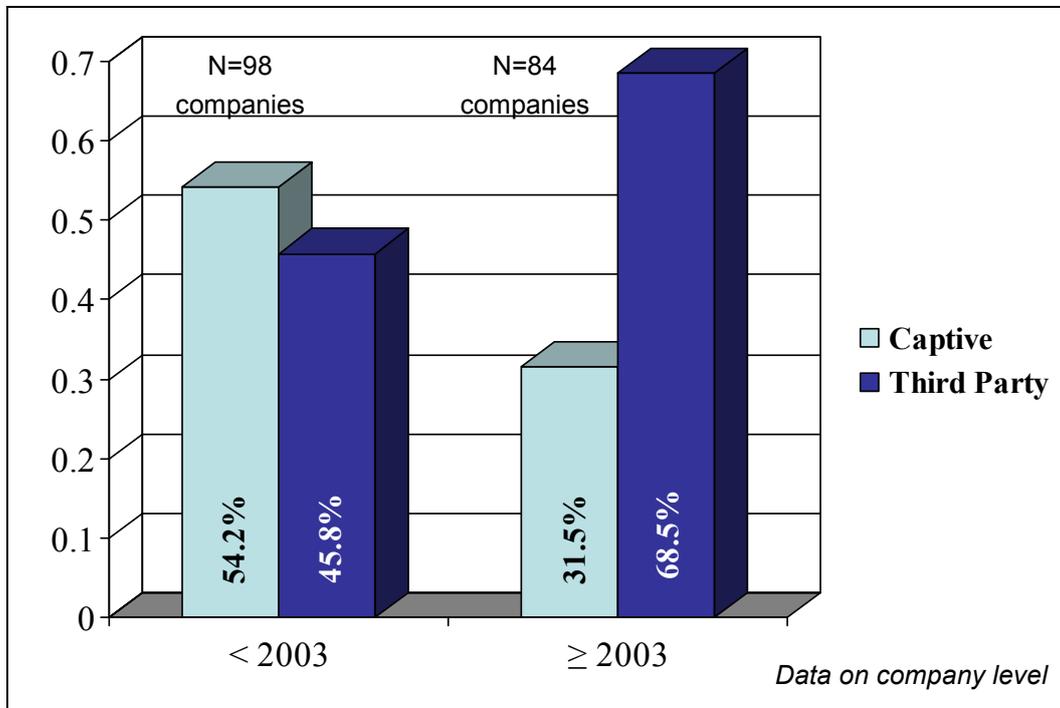


Source: Own figure

The argument that the governance mode decision is, among other things, dependent on the availability of service providers (Lowe *et al.*, 2004) can be raised at this point again. This statement assumes that in the early stages of offshoring, companies prefer captive governance modes, while the increasing supply of providers causes a shift towards disintegrated governance modes. Figure 6.8 depicts this situation by splitting the sample into implementations before the year 2003 and after the year 2003. The distinction pre- and post-2003 was made in accordance with the median value of the year of implementation. The likelihood to select initially a captive mode decreases from 54.2 percent before the year 2003 to 31.2 percent after the year 2003. This result is very distinctive and is likely to be associated with the increased availability of third party service providers. The preference for third party

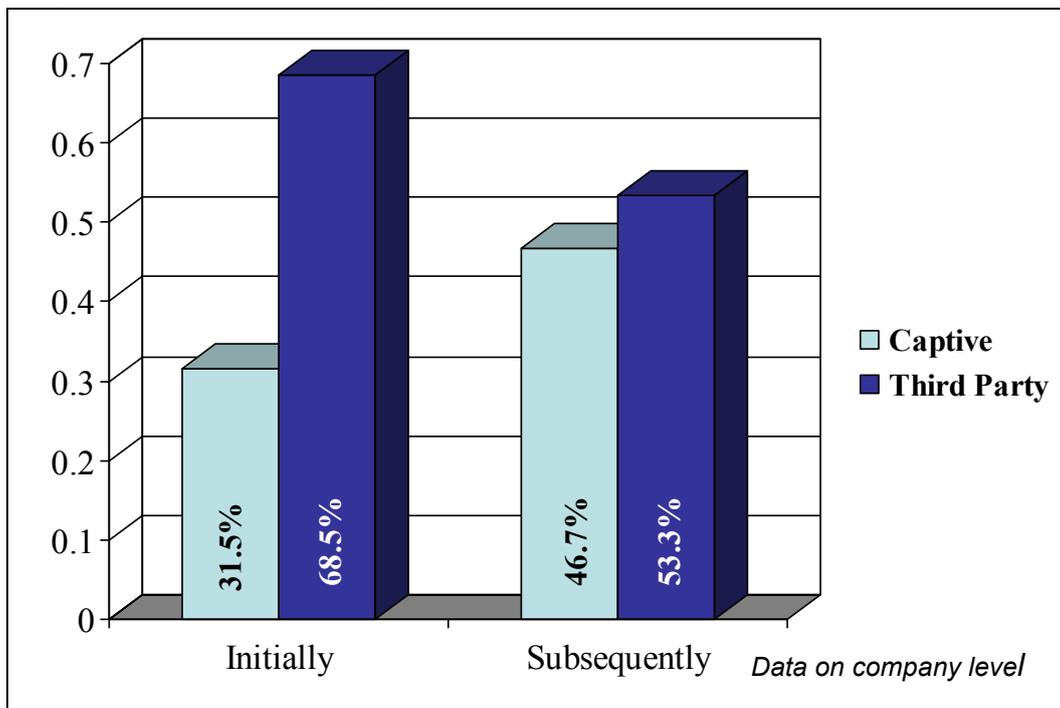
modes in figure 6.7 is thus the result of offshoring implementations after 2003. In fact, initial offshoring implementations taken before 2003 were more likely to be performed using captive governance modes.

Figure 6.8: Captive Probability for Initial Governance Mode Decisions



Source: Own figure

Figure 6.9: Captive Probability after 2003



Source: Own figure

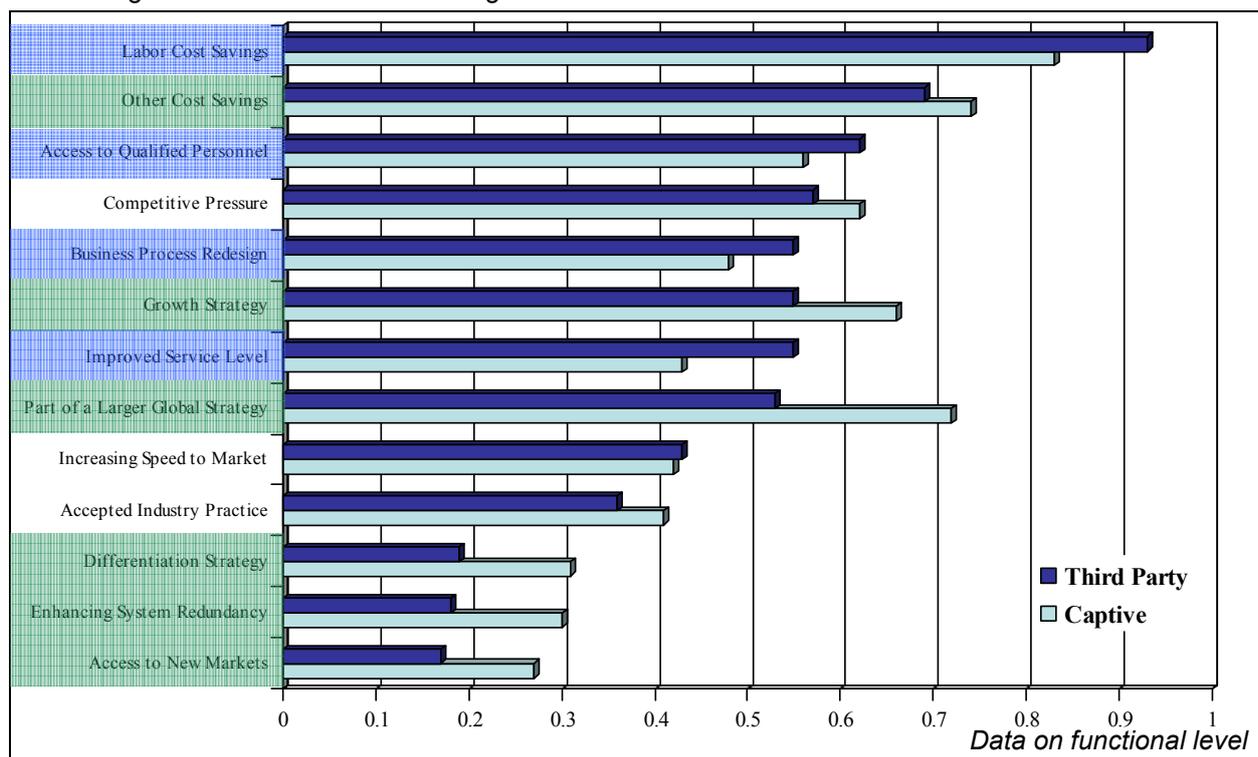
Is it possible to conclude that the governance mode decision is simply a matter of historical shifts in supply and preferences? Unfortunately (or luckily for research), the explanation is not that simple. Looking at figure 6.9, I observe that my argument of preferred third party governance modes only holds for initial governance mode decisions. When looking at subsequent governance mode decisions, the ratio is not statistically different from 50:50. While this is a replication of figure 6.7, it shows that the balanced result in the governance mode decision is consistent, even when taking the year of implementation into consideration. The regression models will provide some further insights into this decision and provide an answer to why the preference for a governance mode might be shifting.

6.1.1.4 Drivers and Risks for the Governance Modes

Figure 6.10 depicts the major drivers in offshoring. The importance of cost savings is obvious. I generated pair-wise t-tests measuring whether the drivers are more important for captive centers than for third party service providers or vice versa. Interestingly, the labor cost driver is more important for third party offshoring, while other cost savings are relatively more important for captive centers. Captive centers can offer cost saving potential in labor-unrelated areas such as tax savings or lower infrastructure costs. Access to qualified personnel is the second most important driver in offshoring. Firms are growing internationally to such an extent that they are facing serious difficulties in hiring a well-educated workforce. Engineers and IT personnel are the most important functions being relocated for this reason (Lewin *et al.*, 2007; Stringer, 2007). Our data suggests that third party service providers are statistically more related to the driver to access talents. Their domestic knowledge and network is obviously an effective means to acquire the necessary workforce. The competitive pressure, which is related to the argument of isomorphism, is important in offshoring *per se*, but it is not related to a specific driver in offshoring. This finding is, however, not astonishing because also from a theoretical perspective, we cannot identify a preference for one governance mode over the other that might be reflected in this figure. Redesigning processes and an improved service level are the remaining two drivers that are significantly more important in third party governance modes compared to captive governance modes⁵.

⁵ Significant at least on the 10 percent level.

Figure 6.10: Drivers in Offshoring



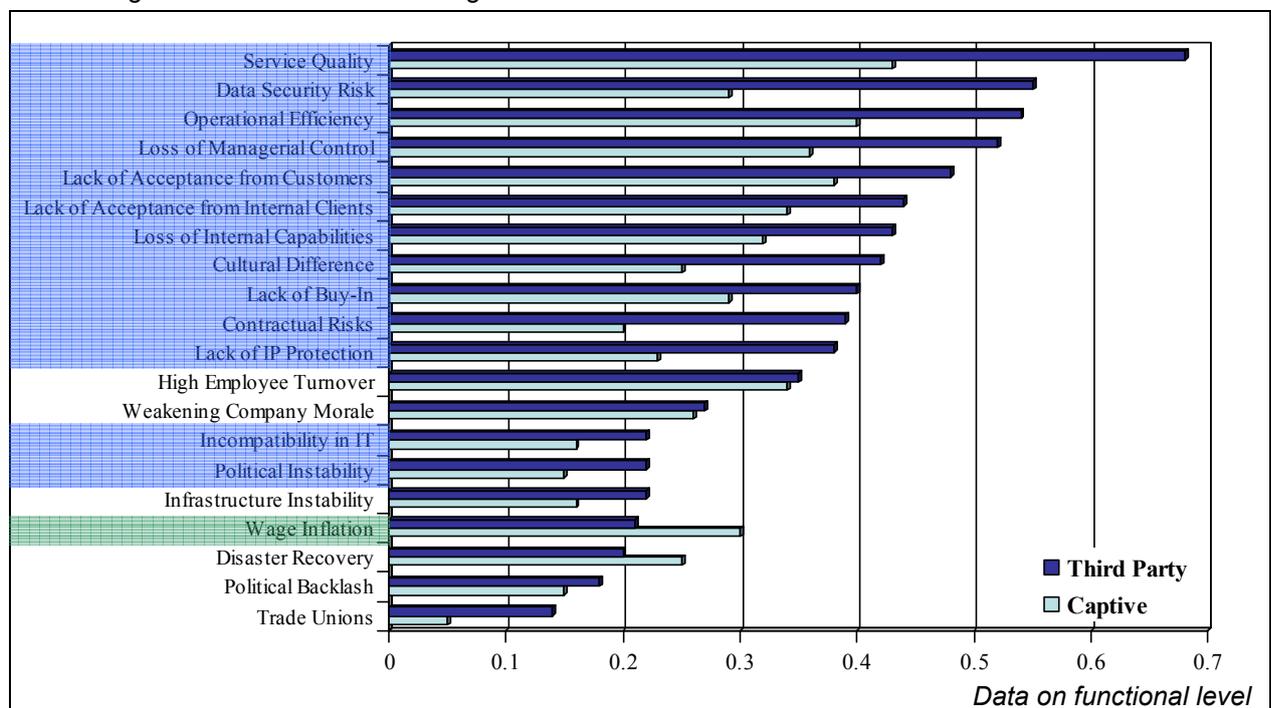
Source: Own figure

Drivers that are more important for captive centers than for third party governance modes are related to changes in corporate strategy. Very frequently, the decision accompanies a reconceptualization of global sourcing, international expansion strategies, or corporate-wide process redesigns. The argument of global strategy might also speak in favor of third party governance modes. Third party governance modes and outsourcing in general can be an effective means to concentrate on core competencies and to increase efficiency. Obviously, the data support the hypothesis that strategic redesigns are associated with the establishment of captive centers. As we will see in the inductive statistics discussion section, this effect most likely has something to do with knowledge protection in the firm. The less important drivers differentiation strategy, enhancing system redundancy, and access to new markets are related to captive governance modes. All these aspects are related to corporate strategy redesign and follow the same line of argument as above. In this sense, a captive center can be used flexibly to support the business processes in the headquarters. However, access to new markets is not directly related to offshoring. The contact of an offshore center with domestic customers is usually limited and a subsidiary with marketing and sales competencies would be the more appropriate mode of entry. Nevertheless, an offshoring activity could be the first

step toward becoming acquainted with the culture and the habits of a country. In this way, it can indirectly serve the purpose to enter the country later on.

While figure 6.10 outlined the drivers in offshoring, figure 6.11 focuses on the major risks. The results show on average higher risks for third party governance modes than for captive modes. The only exception appearing to be more important for captive centers is the potential wage inflations abroad. While companies offshoring to third party service providers can usually agree on wage increases in the master contract or at least in contracts of the individual projects, it is much more difficult for captive centers.

Figure 6.11: Risks in Offshoring



Source: Own figure

In accordance with my predictions, I find that risks related to quality of the outcome and risks concerning knowledge protection are very high in third party offshoring. The strong focus on cost savings is likely to cause negative effects on quality. Although the workforce is usually well educated, cultural distance or different working styles in the offshore locations can result in lower quality. If integrated in a captive center, influence can be exerted better by the headquarters. In line with the theoretical prediction, quality-related risks are cases of uncertainties that can be reduced with integration (in accordance with Williamson’s (1970) TCE literature). In our survey, we therefore expected respondents to report lower perceived risks when measuring at a point in time after the offshoring implementation is completed. Risks

that can be reduced through integration primarily concern the product and its quality (*business and process risks*). Besides the risks that can be reduced through integration, there are those that cannot be reduced with integration. Risks that are hard to mitigate with integration can partially be addressed with the experience of third party service providers. In this case, I refer to local *economic risks*. In this category, only wage inflations show a significant lower risk in third party offshoring. The other variables, high employee turnover, infrastructure instability, political instability, and trade unions, do not show a significant difference between governance modes or even show an opposite relationship. Also *cross-cultural risk* would fall into this category. Finally, *offshoring strategy risks* look at domestic acceptance among internal and external partners as well as political backlash. They seem to be perceived as higher in offshoring using third party governance modes.

6.1.2 Regression Models and Statistical Tests

I developed my hypotheses following a sequential model of the governance mode decision in offshoring. In this model, initial decisions can largely be explained with the transactional approach. Later on, it is augmented with environmental and firm-specific rationales formalized in organizational isomorphism as well as the capability-based view of the firm. Before building the transactional and the “full” model, I will first have a closer look at the cross-cultural considerations of offshoring. Although this is later an integrated part of the uncertainty variable of the transactional model, the importance and scope require discussion of the results of hypotheses 3 and 4 first.

6.1.2.1 Cross-Cultural Model

Cross-cultural management is one of the core pillars in IB and the debate about the implications of national distances is an ongoing issue in the literature (Javidan *et al.*, 2006). In my research, distance is the most important variable measuring uncertainty. A large number of studies – not to say, however, the majority – use measures processing the cross-national dimensions identified by Hofstede (2001). The Kogut-Singh index is one example (Kogut & Singh, 1988). In the offshoring discussion in general and the offshoring governance mode decision in particular, however, I argued that the Kogut-Singh index influences macroeconomic measures, but not the governance mode decision directly. I assume that macroeconomic relationships are facilitated by the cultural proximity between countries. Cultural proximity is a conducive but not sufficient explanation for high

trade activity between two countries. As depicted in table 6.1, the governance mode is influenced by the trade activity rather than by cultural proximity. If trade activity between two countries is high, the risks are lower and the likelihood of selecting captive governance modes is increased.

In accordance with this hypothesis, I do not find any direct correlation between the Kogut-Singh Index (KSI) and the likelihood to select captive governance modes. On the other hand, the correlation between KSI and trade flow is very high. The correlation is 0.5 and significant at the 99.9 percent level. Column 1 in table 6.1 depicts the strong relationship in the Tobit model, with objective distance (trade flow \times -1) as a dependent variable and the Kogut-Singh index as an independent variable. The coefficient has a positive sign, meaning that countries with high cultural distance are more likely to have *low* trade activities among each other. Put differently, countries that are of cultural similarity are likely to have large trade flows among each other. Column 2 depicts the control variables used for the cross-cultural model. The size of the company measured by the number of employees shows a positive, though not significant, relationship to the captive governance mode decision. This relationship follows the logic that captive offshore centers are cost intensive and need a minimal scale in order to be profitable. The mean value of 0.56 in the correlation matrix in table 9.3 (appendix 9.3) is not directly interpretable because I used a logarithmized and adjusted value. Among the sample of initial offshoring activities, the average number of employees is 23,000 employees and the median value is 1,750 employees. This implies that I could cover a wide range of companies, ranging from very small to very large.

The origin of the headquarters has an impact on the governance mode decision as well. In comparison to the reference category US, German and Spanish companies tend to prefer captive governance modes. Compared to the mean company, the likelihood to select a captive mode is 36 percent higher for a German company and 27 percent higher for a Spanish company. The British and Dutch companies have a balanced preference in terms of vertical integration. The result for the *UK* is not very stable across the sample, and as we will see in the full model in column 5, the preference of third party models is becoming significant. The reasons why companies of a certain country generally prefer certain governance modes are not subject to my investigations. I assume that this can have various reasons, such as isomorphism, control requirements, risk appetite, *etc.* I will resume the discussion

on the control variables in the discussion section and present alternative control variables.

Table 6.1: Regression Analysis for Cross-Cultural Model

Sample	Initial offshoring decisions and companies considering offshoring (functional level)				
Model type	TOBIT	PROBIT, adjusted for company level variance			
Dependent variable	Objective Distance	Captive offshoring			
	1	2	3	4	5
Size		0.332 (0.415)	0.316 (0.418)	0.521 (0.419)	0.763* (0.423)
UK		-0.425 (0.370)	-0.436 (0.367)	-0.553 (0.442)	-1.500*** (0.303)
Germany		0.941*** (0.230)	0.968*** (0.245)	0.796*** (0.242)	0.781*** (0.257)
Spain		0.697*** (0.259)	0.673** (0.269)	0.599** (0.278)	0.826*** (0.313)
Netherlands		0.171 (0.323)	0.180 (0.381)	0.044 (0.326)	0.095 (0.330)
Kogut-Singh Index	0.036*** (0.006)		0.022 (0.063)		
Objective distance				-1.224*** (0.410)	-1.436*** (0.441)
Psychic distance					-1.141*** (0.330)
Constant	0.684*** (0.016)	-0.626** (0.266)	-0.655** (0.298)	0.288 (0.422)	-0.790* (0.427)
N	525	508	485	498	450
LR/Wald χ^2	39.23***	28.35***	26.86***	34.61***	73.74***
Pseudo R^2	-	0.088	0.089	0.129	0.195

Source: Own table

As expected, integrating the Kogut-Singh index into the model neither improves its explanatory power, nor is the coefficient significant (column 3). This is different for the trade flow variable reflected in the objective distance measure. The coefficient is highly significant at the 99 percent significance level. When offshoring to a country that has no trade activity with the home country, the likelihood of selecting a captive governance mode is 47 percent lower than when offshoring to a country with a hypothetical 100 percent trade flow rate.

Distance measured by trade flows is a very objective measure. In comparison, psychic distance is a subjective measure of distance. In accordance with my

expectations and the suggestions by Drogendijk & Slangen (2006), psychic distance has a negative relationship to the likelihood to select captive governance modes. As depicted in column 5, the relationship is also significant at the 99 percent level. This finding supports hypothesis 3c, suggesting that uncertainty leads to a decreased likelihood to select integrated governance modes. The slope at the mean level is -0.43, which – translated to the Likert scale – implies that a one-step increase in the Likert scale decreases the probability of selecting an integrated governance mode by 9.9 percent. While uncertainty, according to Williamson (1971), should lead to an *increase* in the likelihood to select integrated governance modes, there is an important difference for cross-cultural considerations. Williamson argues that integration can decrease uncertainty because it is easier to control processes. While integration leads to a decrease in uncertainty in this case, integration does not eliminate cross-cultural issues. In the presence of cross-cultural distance, companies want to avoid cultural clashes and favor disintegrated governance modes. My findings, reflected in the full model (column 5), support the two hypotheses *H3a* and *H3c*.

The correlation table depicted in table 9.3 in appendix 9.3 does not show any issues with multicollinearity. It is, however, striking that the distance variables are also correlated to company size. On average, large companies face more objective and subjective (psychic) distance in offshoring. Because of the greater experience of large companies, we should have expected that objective distance might be comparatively high, while subjective distance might be comparatively low. Subjective distance (such as the perception of cultural distance) is a matter of internal capabilities that we would expect to be reduced through experience. Obviously, size is not an appropriate proxy in this context. I find positive correlations between distance and size for both measures. This aspect contains fertile ground for further research. Findings might go in the direction that large companies are able to afford risks and can offshore to countries that are more distant from their home country. While this diversification strategy allows large companies to access more difficult but also more lucrative markets, companies are obviously not able to evade psychic distance.

6.1.2.2 Transactional Model

The cross-cultural model is an integral part of the transactional model. In particular, it reflects the uncertainty variable, which is one of the three core variables

in TCE. Even more important in the transactional model is asset specificity. I formed a dummy variable product development including the functions engineering, product design, and research & development. These functions reflect tasks that are high on asset specificity. The results depicted in table 6.2 support hypothesis *H1*, suggesting a positive relationship between product development and the likelihood to select captive governance modes. If functions are complex and not standardized, service providers need (sensitive) knowledge from the client company in order to perform the task. The likelihood to select an integrated governance mode is thus higher. In my sample, the likelihood of captive governance modes increases by 16 percent if a product development function is offshored compared to non-product development functions. Acquiring sensitive knowledge from clients can lead to incentives that contradict clients' intentions. Service providers gain power by obtaining irreplaceable knowledge, and complex functions are performed in captive centers. The more knowledge is transferred to service providers, and if the knowledge is not maintained in-house, the more clients become dependent on service providers. As a result, companies are more reluctant to outsource such functions.

Column 3 adds the two distance measures from the cross-cultural model to the transactional model. Their significance is unchanged, also when controlling for product development. While the objective and subjective distance measures refer to the cultural component of uncertainty, I included another uncertainty component that addresses a core consideration in offshoring: knowledge protection. The significant positive relationship of this variable, depicted in column 6, is very rich in two regards. On the one hand, it supports the suggestion of hypothesis *H2a* and *H2b*, indicating that the risk of losing knowledge is associated with a higher likelihood to select captive governance modes. On the other hand, I find support for the methodological consideration of measuring control. I have argued that there are risks that cannot be reduced through internalization (such as cultural risk), as well as risks as described by Williamson (1971) that can be reduced through internalization. The presence of the latter form of risk would result in an increased likelihood to select integrated governance modes. What happens if we do not have an objective approach in measuring this form of risk in a survey? Respondents are likely to report on the current risks and not on the risk they were facing at the time of decision making. If a captive governance mode has been selected, it is likely that we will receive responses indicating that risks of knowledge leaking are lower. Only if companies are not yet offshoring will we find our originally suggested relationship derived from

theory. At this stage of decision making, firms evaluate the current risks that are not biased by an already implemented offshoring strategy. Columns 4 and 5 depict the relationships. In column 4, I look at the sub-sample of companies that are *actually* offshoring. I observe a significant negative relationship in the knowledge protection variable, implying that companies using a captive governance mode face lower risk of control. In column 5, I look at the sub-sample of companies *considering* offshoring. Since they have not yet started to offshore, I observe a positive relationship with respect to knowledge protection as suggested by theory. If knowledge is at risk, companies are more likely to select integrated governance modes. If we were to interview the same respondents after implementation, I would expect them to have solved the problem of knowledge protection once they had selected a captive governance mode. Column 6 reflects the joint measure of knowledge protection with the values of “considering offshoring” companies as they stand and “active offshoring” companies taken in an inverted manner. The relationship of this combined variable is significant at the 99 percent level. For all models including the knowledge protection variable, I had to leave out the control variable for the country. Because this variable does not have such a large population, sample size for country-specific statements would be too low. Looking at the R^2 , we could assume that the explanatory power of the knowledge protection variable is not that strong. This is not true because the reduction of the sample size reduces our R^2 . In fact, the knowledge protection variable explains almost 6 percent of the variation in the model.

In column 8, I finally test the interaction effects between asset specificity and the uncertainty variable. According to the theoretical foundation, an interaction effect should be observable. While I can show a positive sign of the relationship, I cannot establish the result in a significant manner. Obviously, the uncertainty variables are robust across all functions. One explanation for this finding is the lack of any group of functions in the sample that is entirely standardized, extremely low on complexity, and does not include critical firm-specific data. Further research would help to understand better the effects of the underlying functional characteristics on the governance mode discussion. This, however, requires a larger set of data, allowing for a more finely drawn differentiation of the functions.

Table 6.2: Transactional Model

Sample	Initial offshoring decisions and companies considering offshoring (functional level)							
Model type	PROBIT, adjusted for company level variance							
Dep. var.	Probability for captive offshoring							
Sub-sample	Full	Full	Full	Active	Cons.	Full	Full	Full
	1	2	3	4	5	6	7	8
SIZE	0.332 (0.415)	0.455 (0.419)	0.913** (0.435)	1.739*** (0.515)	-2.709*** (1.006)	0.951 (0.641)	0.697 (0.616)	0.950 (0.626)
UK	-0.425 (0.370)	-0.360 (0.352)	-1.414*** (0.300)					
Germany	0.941*** (0.230)	0.060*** (0.226)	0.776*** (0.253)					
Spain	0.697*** (0.259)	0.749*** (0.259)	0.820*** (0.309)					
Netherlands	0.171 (0.323)	0.168 (0.339)	0.003 (0.331)					
Asset Specificity (Product Development)		0.406** (0.191)	0.482** (0.197)	1.078*** (0.276)	0.070 (0.397)	0.748*** (0.283)	0.686*** (0.292)	0.589** (0.342)
Objective Distance			-1.569*** (0.454)	-3.022*** (0.961)	-5.132** (2.637)	-3.277*** (0.698)	-3.230*** (0.711)	-3.329*** (0.683)
Psychic Distance			-1.177*** (0.324)	-1.253** (0.523)	-1.903*** (0.678)	-1.529*** (0.453)	-1.466*** (0.483)	-1.644*** (0.488)
Knowledge Protection (KP)				-0.063** (0.028)	0.107*** (0.044)			
Integrated KP variable						0.714*** (0.278)	0.834*** (0.258)	0.638** (0.302)
Business and Process Risk							0.010 (0.071)	
Economic Risk							-0.085 (0.150)	
Offshoring Risk							-0.065 (0.153)	
Specificity × Uncertainty								0.715 (1.064)
Constant	-0.626** (0.266)	-0.796*** (0.288)	0.714* (0.428)	1.622** (0.821)	4.707** (2.376)	1.581*** (0.591)	1.594*** (0.621)	1.717*** (0.604)
N	508	504	450	149	109	258	248	258
Wald χ^2	28.35***	34.87***	81.07***	46.08***	28.34***	43.33***	49.81***	45.27***
Pseudo R ²	0.088	0.102	0.206	0.231	0.265	0.214	0.226	0.216

Source: Own table

6.1.2.3 *The Full Model Predicting the Governance Mode Decision*

Following the transactional perspective, I will now integrate considerations of isomorphism and the capabilities perspective in my model. In hypothesis *H4*, I argue that firms look across their boundaries and replicate strategies from competitors. This also happens in offshoring. For each company, I looked at the year of the initial offshoring implementations. Based on that year, I analyzed the offshoring practice of other companies preceding the year of initial implementation. This analysis was performed on the level of the particular headquarters location, offshore location, as well as the particular function offshored. Based on the three indicators, I established a predictor reflecting the external probability for selecting a captive governance mode. In my model, the effect of this variable is very strong and highly significant (column 2 in table 6.3). While the transactional variables retain their explanatory power, I find that the argument of isomorphism adds a strong explanation to the governance mode decision. Unfortunately, I cannot make a direct interpretation of the coefficient. The slope at the mean level is 2.11, implying that an incremental increase of 1 unit in the predictor for a captive governance mode increases the likelihood to actually select a captive governance mode by 2.11. In this manner, the positive relationship implies that the external environment plays an important role in determining the governance mode.

Since we are still looking at initial offshoring decisions, the capabilities perspective plays a subordinate role at this point. Firms have not yet gathered enough experience to be a predictor of the governance mode decision in offshoring. There are two exceptions, of which one is experience with manufacturing outsourcing. Because the sample size of companies with such experience is too small, it was not possible to include this variable. However, an alternative predictor stemming from the firm-specific capabilities perspective is the motivation to offshore. I argued that if companies are offshoring with the intention to grow internationally, it is an indicator of a preference for integrated governance modes. My composite variable measuring the importance of the growth driver shows a strongly positive effect on the likelihood to select integrated governance modes. For 25 percent of the companies in my sample, offshoring is important for the company's growth strategy and global (expansion) strategy. In this population, the likelihood to select captive governance modes is around 16 percent points higher, significant at the 95 percent level. The increases in the Wald χ^2 of 8.25 and the increase in the R^2 of 0.05 are substantial and make it a valuable predictor for the governance mode.

Similar, though in the opposite direction, is the effect of the cost saving driver. *H6* suggests a negative relationship between the driver “cost savings” and the likelihood to opt for captive governance modes. Of the companies studied, 61.2 percent indicated that cost savings was important or very important for their offshoring strategy. Only 11.6 percent of the companies mentioned that cost savings are not important to them. While I cannot establish a significant relationship towards the governance mode decision, I observe a negative relationship. In this context, companies using offshoring against the background of reducing costs tend to prefer third party governance models. This finding follows the general assumption that offshoring potential can best be exploited with disintegrated governance models.

Table 6.3: Model the Initial Governance Mode Decision

Sample	Initial offshoring decisions and companies considering offshoring (functional level)			
Model type	PROBIT, adjusted for company level variance			
Dep. var.	Probability for captive offshoring			
	1	2	3	4
Size	0.951 (0.641)	2.019*** (0.757)	1.987*** (0.733)	1.978*** (0.776)
Product Development	0.748*** (0.283)	0.503* (0.302)	0.464 (0.338)	0.549 (0.351)
Objective Distance	-3.277*** (0.698)	-2.563*** (0.717)	-2.672*** (0.783)	-2.782*** (0.852)
Psychic Distance	-1.529*** (0.453)	-1.225** (0.576)	-1.087* (0.602)	-0.713 (0.638)
Knowledge Protection	0.714*** (0.278)	0.649** (0.325)	0.885** (0.397)	0.925** (0.405)
Relative (external) captive probability		6.683*** (1.730)	5.834*** (1.752)	5.303*** (1.718)
Growth Driver			0.439** (0.212)	0.633*** (0.228)
Cost Savings				-0.180 (0.255)
Constant	1.581*** (0.591)	-3.073*** (1.226)	-3.379*** (1.189)	-3.228*** (1.304)
N	258	149	141	138
Wald χ^2	43.33***	42.58***	50.83***	46.80***
Pseudo R ²	0.214	0.376	0.426	0.449

Source: Own table

6.1.2.4 Toward Subsequent Governance Mode Decisions

In my final model predicting the governance mode decision, I switch the perspective from initial governance mode decisions to subsequent governance mode decisions. Subsequent governance mode decisions are taken, at the earliest, the year after the first implementation. In column 1 (table 6.4), I again show the findings of the previous (initial) model for comparative reasons. In column 2, I run a similar regression based on the subsequent governance modes. I had to remove the knowledge protection variable because it was designed to depict the difference between companies considering offshoring and companies initially offshoring. Instead, I use a slightly broader variable measuring the operational and process risk of offshoring. Besides the risk of losing capabilities, it includes considerations of a lack of managerial control, data security, service quality, *etc.* I observe a negative relationship, meaning that process risk is lower for captive centers. This finding must also be interpreted in the logic of the knowledge protection variable. If companies fear process risk (which can presumably be reduced through integration), the likelihood of selecting captive models is increased. Since we were asking respondents to report risks after the offshoring implementation in the survey, we can use a *low* value of process risk as an indicator for a *higher* likelihood to select captive governance modes. The causality that the risk has an impact on the governance mode decision and not the other way round is not violated with this interpretation. I show this effect in the context of the knowledge protection variable.

Macroeconomic risks have no explanatory power for predicting initial governance mode decisions but are supportive for subsequent governance mode decisions. The interpretation of this variable, which includes risks such as wage inflation or political instability, is inverted compared to process risks. Integrating an offshore unit does not reduce these risks; service providers might instead be able to react better to such issues, and consequences can be settled to a certain extent in contracts. The significant positive relationship implies that managers are more concerned about macroeconomic risks in captive governance modes. Finally, I looked at offshoring risks that are directly related to the relocation strategy. It involves issues such as acceptance by employees or clients, political backlash or the weakening of company morale. Although the sign is negative, the results are not significant.

Compared to the initial governance mode decision, the Wald χ^2 and the pseudo R^2 of the subsequent model are lower. This tells us that we need to consider

different variables that can better explain the likelihood to select a captive governance mode for subsequent modes. It is interesting, though, that I find the effect of the cost savings driver to be significant in this model. If cost savings are an important or very important driver in offshoring, the likelihood of selecting a captive governance mode is approximately 14 percent lower than if this driver is not particularly important. Due to multicollinearity, I removed the distance measures in column 4. Objective and psychic distance are both correlated to the risk variables. This finding is intuitive because distance is a form of uncertainty and therefore strongly related to risk.

In column 4, I add the most important variable for the prediction of subsequent governance mode decisions. The internal governance mode experience has a highly significant effect on the subsequent governance mode decisions. Even if companies are offshoring a different function or if they are offshoring to a different location, it is likely that they are using the same governance mode as previously. Critically, it could be argued that companies are just offshoring similar functions to different countries. For this reason, I ran the model again in a very rigorous way, only considering functions that had not been offshored initially and were introduced in subsequent governance mode decisions only. Because risk is measured on the functional level, I could only consider those data points that did not include initial and subsequent governance modes within the same function but in different locations. My finding for the internal captive predictor is so strong that it dominates to a certain extent findings from the transactional model. If companies have previously exclusively used captive governance modes, the probability for replication is approximately 80 percent. While this figure is very high, it raises some questions as well. From the descriptive statistics, we know that the preference for captive models increases from initial to subsequent governance modes. This transition of the mode goes beyond the replication argument that I can find in the large sample data. What I can observe in my model is that the capabilities perspective, in particular the drivers for offshoring, become more important in determining the governance mode. With the internal captive experience variable, I can measure that the percentage of captive models existing in the firm is a good predictor of the likelihood to select a captive governance mode. However, I cannot measure to what extent firms have developed firm-specific capabilities that “motivate” companies to replicate the strategy. Having looked at the results of the service provider perspective, I will resume the discussion on the subsequent governance mode decisions and outline potential future research topics.

Table 6.4: Model Subsequent Governance Mode Decision

Sample	Initial modes	Subsequent offshoring decision, only if same function has not been used initially			
Model type	PROBIT, adjusted for company level variance				
Dep. var.	Probability for captive offshoring				
	1	2	3	4	
Size	1.978*** (0.776)	0.026 (0.743)	-0.116 (0.720)	0.694 (0.591)	
Asset Specificity (Product Development)	0.549 (0.351)	-0.102 (0.371)	0.021 (0.394)	0.430 (0.290)	
Objective Distance	-2.782*** (0.852)	0.148 (0.989)			
Psychic Distance	-0.713 (0.638)	-0.943 (0.779)			
Knowledge Protection	0.925** (0.405)				
Business and process risk		-0.192** (0.093)	-0.222** (0.093)	-0.091 (0.085)	
Economic risks		0.350** (0.145)	0.335** (0.149)	0.056 (0.142)	
Offshoring risks		-0.024 (0.133)	-0.069 (0.133)	-0.022 (0.137)	
External captive experience	5.303*** (1.718)	5.420*** (1.699)	5.489*** (1.641)	3.700* (2.004)	
Growth driver	0.633*** (0.228)	0.392** (0.199)	0.412** (0.200)	0.211 (0.196)	
Cost savings	-0.180 (0.255)	-0.371* (0.210)	-0.358* (0.207)	-0.266* (0.150)	
Internal captive experience				2.255*** (0.305)	
Constant	-3.228*** (1.304)	-2.469 (1.514)	-2.543** (1.120)	-3.338*** (1.227)	
N	138	192	192	190	
Wald χ^2	46.80***	40.12***	39.36***	94.77***	
Pseudo R ²	0.449	0.246	0.236	0.475	

Source: Own table

6.1.2.5 Effects of the Governance Mode Decision on Cost Savings

Although offshoring is not exclusively performed to save cost and the savings variable has major caveats, it is necessary to have a closer look at this figure. Cost savings can only capture the difference between the costs existing before offshoring and after offshoring. The variable does not, however, provide any indication of the

base level of the costs incurred before and after offshoring. Nevertheless, I assume that in a large sample observation, cost savings are correlated with other factors reflecting success. Such variables might include overall satisfaction, the achievement of agreed service levels, as well as the sustainability of the offshoring strategy. Table 6.5 shows that there is no significant difference between the cost savings achieved through third party service providers compared to captive governance modes. However, there is a strong difference in the standard deviations of the two governance modes. For captive governance modes, the standard deviation of the cost savings is higher. This implies that, on the one hand, poorly performed captive offshoring strategies achieve less cost savings than poorly performed offshore outsourcing strategies. On the other hand, the most successful captive centers achieve higher cost savings than the best offshore outsourcing strategies. A potential explanation of this phenomenon is that in captive modes the offshore processes can be better integrated into the firm. Furthermore, there are fewer problems with potential knowledge leaking, tasks can be more flexibly assigned, and no margin has to be paid to a third party. In order to achieve superior cost savings, the appropriate knowledge needs to exist in the firm and the unit needs to have sufficient scale. This would explain why the downward risks are also higher for captive centers.

Table 6.5: Cost Savings Variance Analysis

	Mean	Std. Dev.	F-Stat of Std. Dev.
Third Party Modes	33.20	18.46	F-Stat $_{(174,211)} \sim 1.39 < 1.78^{***}$
Captive Modes	32.32	24.65	

Source: Own table

Table 6.6 sheds a different light on the cost savings variable. We are no longer interested in looking at differences between the governance modes, but whether both governance modes are used simultaneously. In the sample of subsequent governance modes, I find that companies simultaneously using both governance modes achieve significantly higher cost savings compared to companies adhering to one governance mode. While this phenomenon can certainly be partly explained by experience, there is also a component of dynamic capabilities. Offshoring with both governance modes allows clients to assign tasks in a flexible manner and to compare the effectiveness of both modes directly.

Table 6.6: Cost Savings and the Application of Both Governance Modes

	Mean	Std. Dev.	T-Test.
Single Governance Mode	32.72	20.73	Two tailed T-Test ₍₂₁₈₎ ~ 2.58 < 4.12***
Simultaneous Governance Mode	49.41	23.73	

Source: Own table

If the tasks are more critical, they can be assigned to the captive center. More operational tasks or tasks that require specialized knowledge are better outsourced to third party service providers. Furthermore, the internal performance of a captive center can be compared with services or offers from external providers. When offshoring to third party providers, companies, however, need to make sure that they address potential dependencies, potential losses of capabilities, or knowledge leaking. In the following chapter, I will discuss the findings of the client-service provider relationship analysis and the mechanisms for aligning interests in offshore outsourcing.

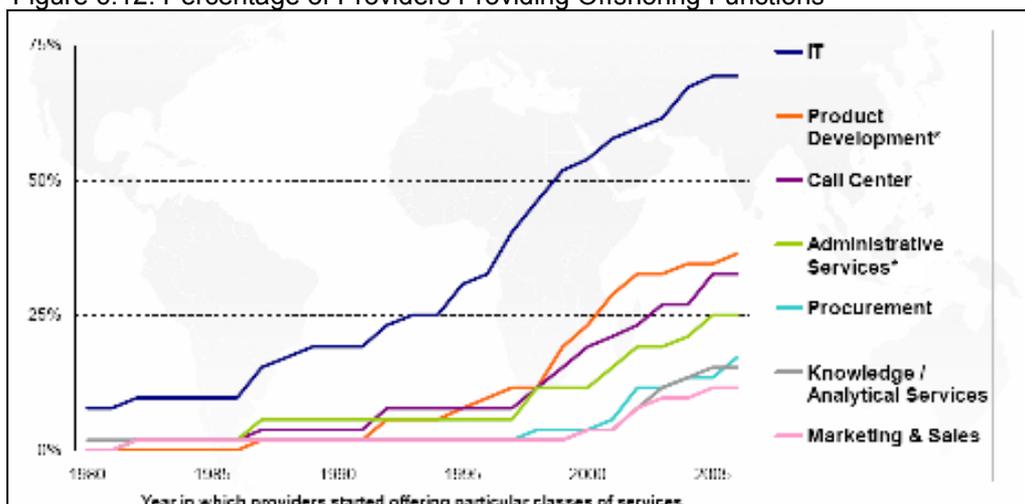
6.2 Results of the Service Provider Survey

6.2.1 Descriptive Statistics

6.2.1.1 The Service Provider Landscape

Having collected more than 100 variables through 47 questions leaves us with an abundance of results. I will first provide a brief overview of the demographics and the findings from a macro perspective. Secondly, I will take a closer look at the findings that support the theoretical argumentation in particular. Offshoring activities emerged after telecommunication costs were reduced through technological advancements in the 90s and globalization entered a new stage. It was a time when companies started to build up an IT infrastructure and started using the internet. Because IT knowledge was very scarce within the companies, they were forced to outsource. Availabilities abroad and lower labor costs subsequently set an incentive for offshoring. The corporate survey shows the importance of IT in offshoring. Parallel to this observation, I find that service providers started to focus early on IT services and constantly developed the capabilities later on. This emphasizes the argument that IT is a matter of offshore outsourcing rather than captive centers. More than 70 percent of all service providers deliver – at least among other functions – IT services.

Figure 6.12: Percentage of Providers Providing Offshoring Functions



Source: Duke CIBER Database

The service providers covered in the survey are headquartered to 50 percent in the US, 38 percent are in India, and the rest are spread around the globe. While it can be costly to find an appropriate service provider offshore, it may be easier to cooperate with domestic providers such as IBM or Hewlett Packard in the US. These companies have an extensive infrastructure and network in the popular offshore locations. From there, they perform the activities abroad or subcontract them to partners. Following the order of attractiveness, the most popular destinations for delivery are in India, China, Europe⁶, Latin America, Canada, Mexico, the Philippines, Russia, Australia, and South Africa. Twenty-two percent of the service providers are very large and have more than 10,000 employees. Twenty-seven percent are mid-sized companies with 500 to 10,000 employees, and the remaining 51 percent of the service providers have less than 500 employees on their payroll. Small providers are usually targets for small clients. Sixty-two percent of the clients have less than USD 100m in sales. Analogously, large service providers deliver their services to large clients, with more than USD 2bn in sales. The reason is obvious, since large providers usually have a broader geographical scope and provide several services that are more comprehensive. While small providers usually offer one and two different services, the large providers offer between three and seven classes of services on average. This allows large companies to deal with just one service provider. The median experience of the companies is 10 years, and they generate average annual revenues of USD 54m.

⁶ In particular Ireland for Western Europe

We have seen that IT is still the dominant function provided by the service providers and the importance of product development functions is increasing dramatically, but which industries are demanding offshore services? My findings reveal that finance and insurance, telecommunications and software companies have the highest fraction of offshoring activities. Manufacturing, health care, professional services firms, and retail trade companies follow on the list. Less represented are media and public administration companies.

6.2.1.2 Offshoring Drivers from the Service Provider Perspective

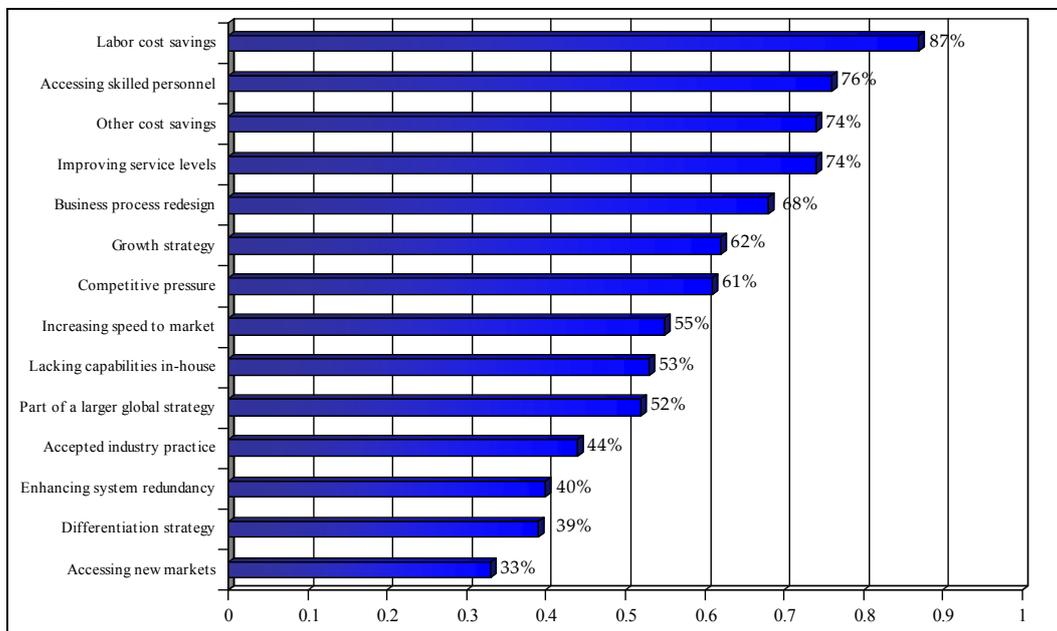
Looking at offshoring from two different perspectives allows validating and comparing several variables. At this point, I compare the above-introduced drivers to offshore from a client perspective with the service providers' perspective on why they think their clients are offshoring. Both the clients and the service providers agree on the dominance of labor cost savings in offshoring. Eight-seven percent of the respondents agree that benefiting from lower labor costs is an "important" or "very important" driver. Almost equally important is "access to skilled personnel". The longitudinal *US* data of the corporate survey show that this driver has become more and more important over the past few years⁷ (Lewin & Couto, 2007). It underlies the argument that offshoring is becoming a strategically important activity necessary to ensure the stock of qualified personnel. Qualified personnel onshore have become scarce, due to immigration restrictions as well as the enormous growth of large MNCs. Offshoring is a good strategy to address this problem.

Accessing qualified personnel has, however, become a challenging issue for service providers as well. The enormous competition in the popular locations has increased in such a manner that "availability of talent" is becoming a relative term. Taking the example of India, American and Western European clients seek to acquire or work together with the best talent from the renowned Indian Institutes of Management and Indian Institutes of Technology. The enormous demand these students has not only increased wages in those locations, but office space is becoming rare and real estate prices are exploding. Service providers are therefore facing the tradeoff between moving to popular locations, where they face fierce competition for talented individuals versus moving to less popular locations, with the

⁷ I do not include the longitudinal US data in this survey due to its geographical limitation.

risk of a lack of available talent. The driver to obtain qualified personnel is particularly distinctive when offshoring innovative functions such as engineering, product design, research & development, etc.

Figure 6.13: Offshoring Drivers from the Service Provider Perspective



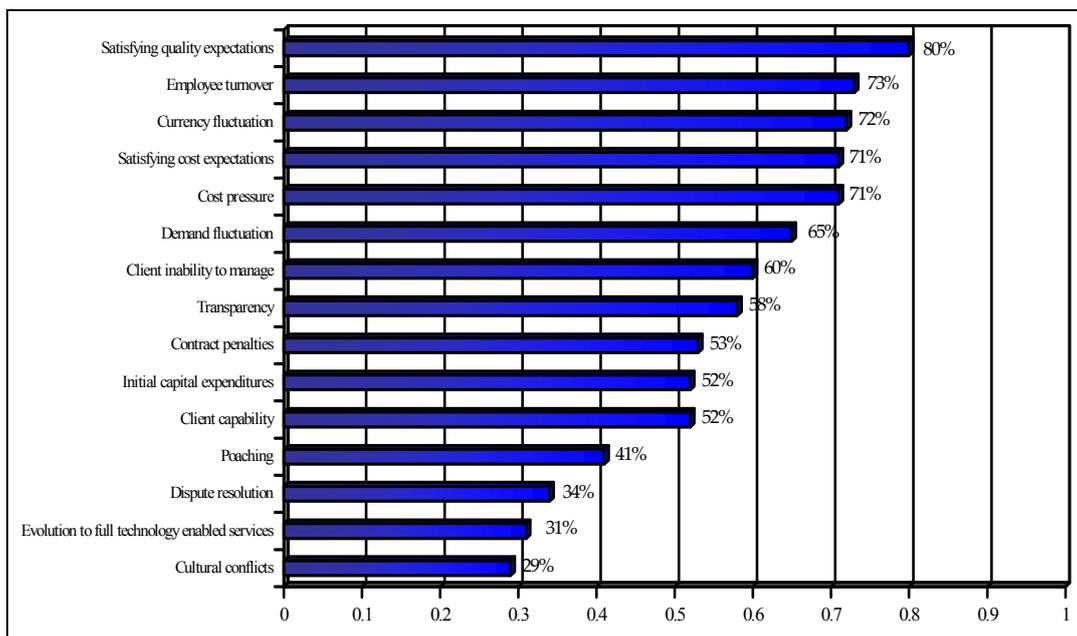
Source: Own figure

While service providers understand very well their clients' concerns regarding labor cost and access to qualified personnel, they overestimate other drivers. In particular, "improving service levels" and "business process redesign" are not as important for clients as service providers assume. While three-quarters of the service providers regard this driver as very important, only half of the clients share the same opinion. Linking this observation to the findings of the corporate survey underlines the observation that restructuring activities are more frequently performed using captive governance modes. Other significant discrepancies between clients and service providers can be observed in the "enhancing system redundancy" and the "accessing new markets" drivers. Those issues are not so important for clients, while service providers think they are. In particular, the latter driver shows that offshoring is rarely used to leverage the primary activities using third party service providers. Nevertheless, it is conceivable that cross-cultural knowledge and experience could subsequently be used to open a sales office or a whole subsidiary in order to access the market, but there is no empirical evidence supporting this suggestion.

6.2.1.3 Risks in Offshoring

Similarly to the analysis of drivers in offshoring, we asked service providers to state the major risks they are facing. Risks do not refer to the perception of providers about clients' risks, but addresses the risks of service providers themselves. In line with the findings presented in figure 6.14, I find that meeting quality expectations is the greatest challenge in offshoring. This major risk is acknowledged by the service providers and they attach much importance to this issue.

Figure 6.14: Offshoring Risks from Service Provider Perspective



Source: Own figure

While resource protection as well as internal and external acceptance are the second most important bloc of risks of clients, service providers are more concerned about operational issues in the second stage. In particular, the above-mentioned race for talent has a side effect involving employee turnover. Since companies are mutually poaching their employees, continuity is becoming a problem. Given this fact, it is not clear why firms that are facing high employee turnover do not consider poaching a major risk in the survey. An explanation for this gap could be the competitiveness in the market. Companies are not actively poaching employees, but incentives are indirectly set in this direction. Employees know that changing their employer is most likely associated with higher salaries. This argument also was raised by one interview partner (Interviewer A, 2007). It became apparent that employee commitment in offshoring is very low, and it requires several employment contracts being sent out in order to get one position filled.

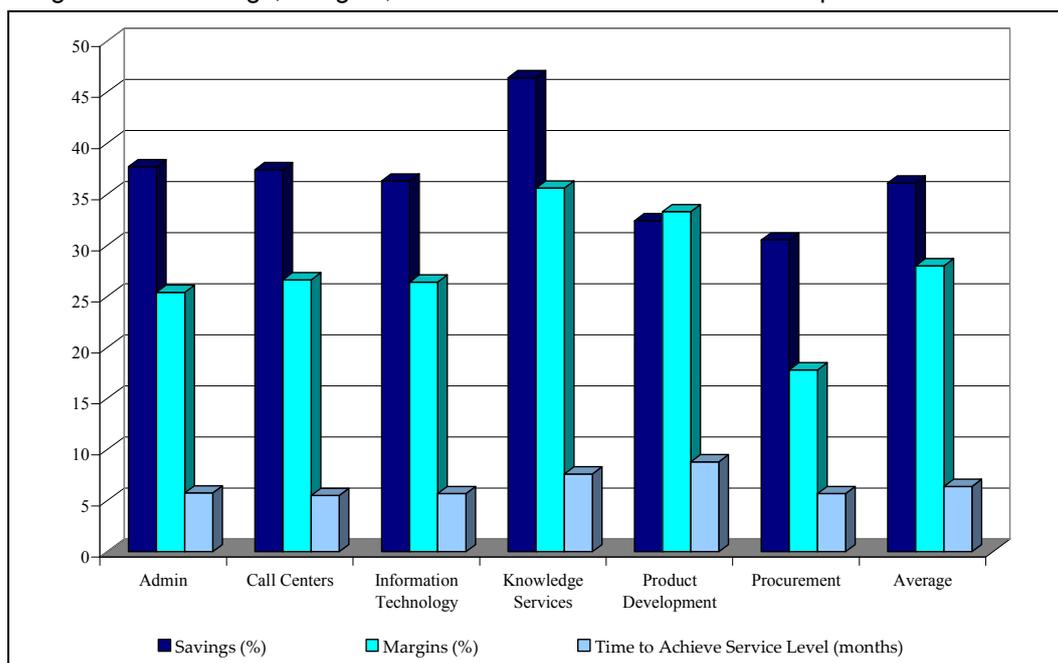
The third most frequently listed risk, currency fluctuation, is not to be underestimated. Except for contracts with Eastern European providers, most offshoring contracts are settled in dollars. However, service providers have to pay their employees in Indian rupees, Brazilian real, Mexican pesos *etc.* In particular, the Asian currencies are currently facing pressure to appreciate. The enormous investments and high economic growth rates of the past years spurred demand for the local currencies in the Asian developing countries. As major appreciation has not taken place yet, companies want to be sure that it would not affect their offshoring contracts. If money received from the clients is worth less, they would not be able to pay their staff in the local currency. Either the contracts would need to be settled in different currencies, or costs would need to be reduced. This risk factor ties in with the following risk factors of satisfying cost expectations and cost pressure.

Finally, it is interesting to find cultural risks at the bottom of the table. While there is no clear explanation for this finding, we can conjecture that service providers do not have to care about the cross-cultural considerations that clients are facing. It would, on the other hand, underline that clients are taking the right decision with regard to governance mode decisions, so that they do not face any problems once the mode is implemented.

6.2.1.4 Performance of Offshoring Functions

Figure 6.15 depicts an overview of the savings that clients can achieve, the margins on which service providers are operating, and the time to achieve negotiated service levels. Knowledge services obviously generate the largest savings for clients, and margins for service providers. Knowledge services is a newly designed category focusing on highly skilled work primarily in the area of finance and accounting as well as analytical services. However, it takes almost 8 months on average to achieve service levels in this category. Since savings for knowledge functions are the highest, we should also expect that savings for product development functions are high. This is not supported by the data, and providers estimate that their clients can only achieve 32.4 percent in savings when offshoring product development tasks. Comparing this finding with that from the corporate survey reveals that service providers underestimate savings by approximately 8 percent.

Figure 6.15: Savings, Margins, and Time to Achieve Service Level per Function



Source: Own figure

The lowest savings and margins are achieved in the functions involving the most commoditized and least complex functions, and more mature services show the same pattern. This is probably the case because competitiveness is stronger for functions that have a longer offshoring tradition and therefore the margins are growing smaller. However, maturity and complexity are correlated values and it is not possible to draw a reliable conclusion in this regard.

Looking at the overall figures, clients can expect to achieve 36 percent in savings, service providers add a margin of 28 percent to their costs on average, and services are delivered at the agreed level after 6.4 months. While margins and time to achieve service level figures have not yet appeared in offshoring research studies, the savings figure is almost perfectly in line with the findings from Deloitte Research, suggesting a figure of 37 percent (Deloitte, 2005).

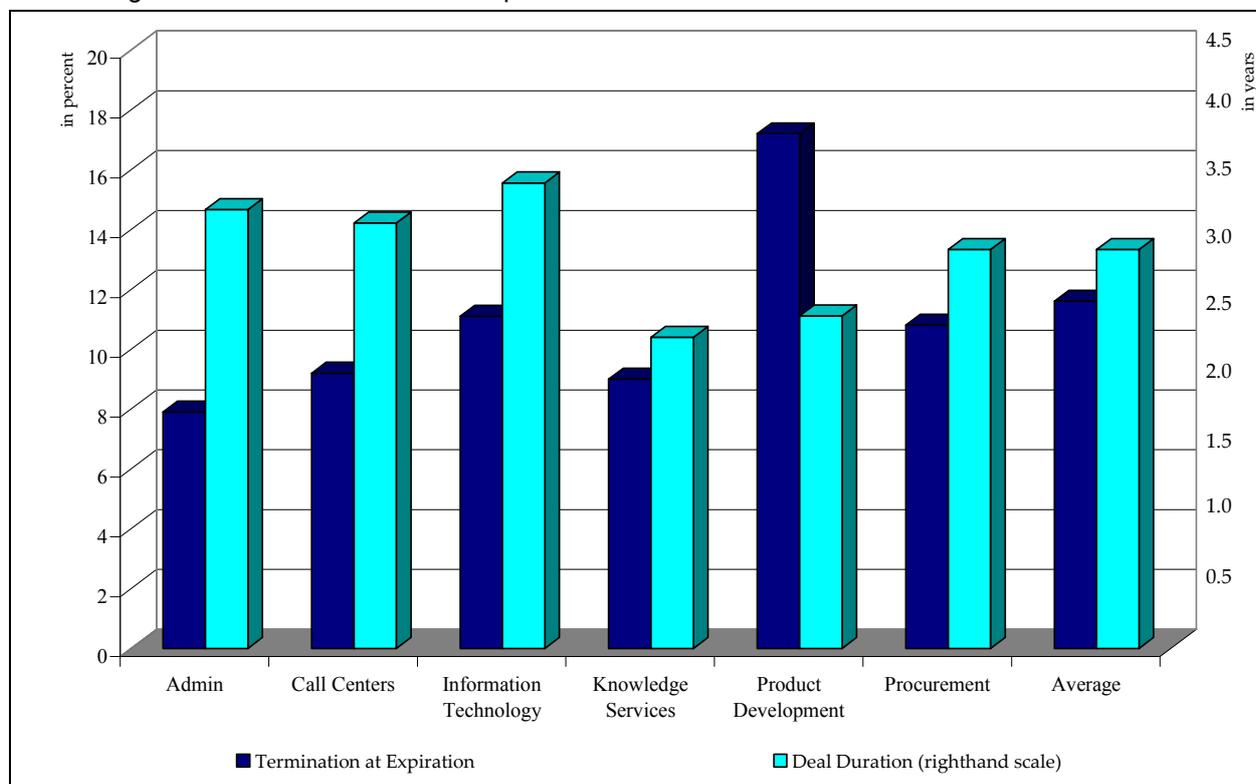
One final remark must be made with regard to marketing and sales. Since the sample size of this function is too small, the results are not depicted in the figures. The findings would not be representative and no reliable conclusions could be derived.

6.2.1.5 Contracting and Longevity of the Client Relationships

In the theoretical foundation, I argued that contracting is a powerful tool to align interests between clients and service providers. Aligning interests is subsequently a means to make client-service provider relationships sustainable.

Business in offshore outsourcing is almost exclusively settled at arm's length, across large geographical distances and involves different cultures. Since clients are frequently involved in the operations, setting the targets properly may be a very difficult endeavor.

Figure 6.16: Deal Characteristics per Function

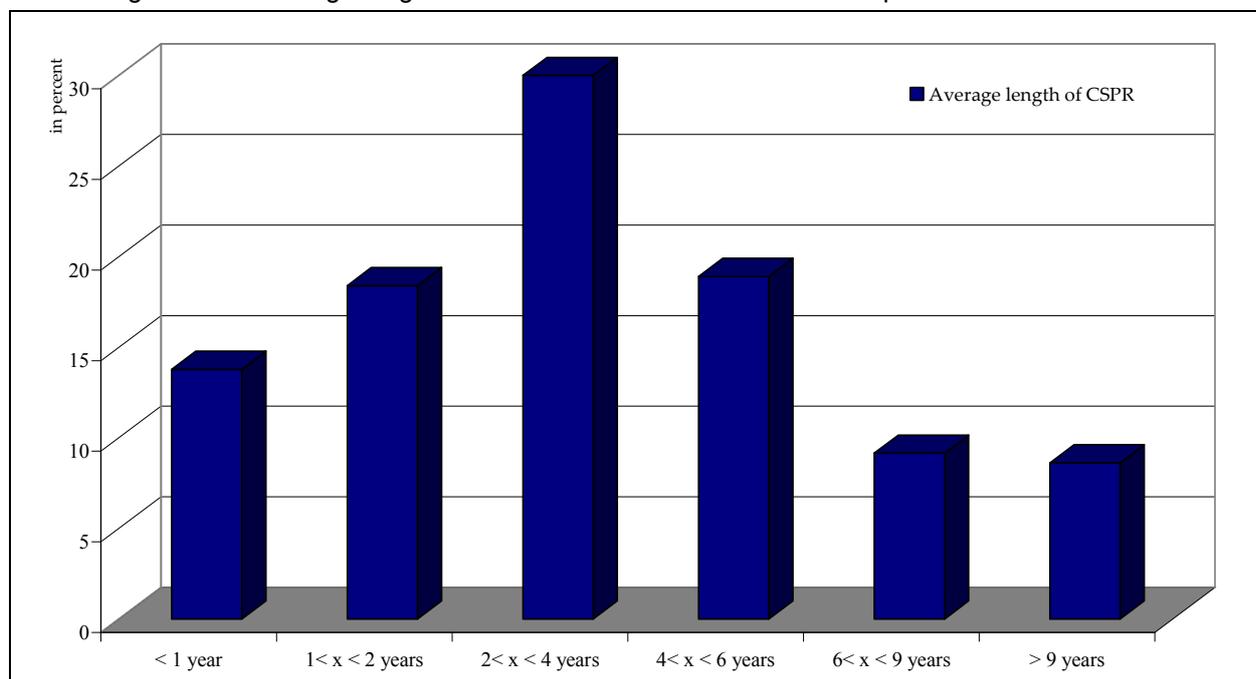


Source: Own figure

There are several components reflecting the performance of contracting. The renewal rate is expected to reflect the satisfaction of both the client and the service provider. In line with the predictions, deal renewal rate is highest for functions involving large investments such as, for instance, call centers. Accordingly, we see lower deal renewal rates for knowledge services and product development. Product development contracts are more often on a project-by-project basis. This implies higher turnover in service providers, lower deal renewal rates, and higher termination rates at expiration. Higher termination rates are, however, only visible *at* expiration. Pre-mature contract terminations are less frequent for knowledge-intensive functions than for capital-intensive functions. On the one hand, this finding is counter-intuitive because we would expect that the two termination variables are correlated. On the other hand, when taking the deal duration variable into consideration as well, we see that product development contracts are shorter than, for instance, call center contracts. With shorter contracts clients need less patience if promised target levels

are not achieved and they can switch providers faster without terminating the contract.

Figure 6.17: Average length of Client-service Provider Relationships



Source: Own figure

As an alternative measure for the sustainability of the client-service provider relationship, I also look at the adjusted number of years of business relationships. It is termed adjusted because I control for the fact that a service provider may be very new and is therefore not able to have long-term relationships with clients. While this variable is very useful for the regression analysis, the analysis for the descriptive statistics is very lean. On the one hand, it is an adjusted measure, and on the other hand, we collected the variable at the company level. As an offshoring relationship frequently goes beyond one function, it would have caused a bias to ask the question on the more detailed level. For this reason, I cannot draw any conclusions on the functional level from this perspective.

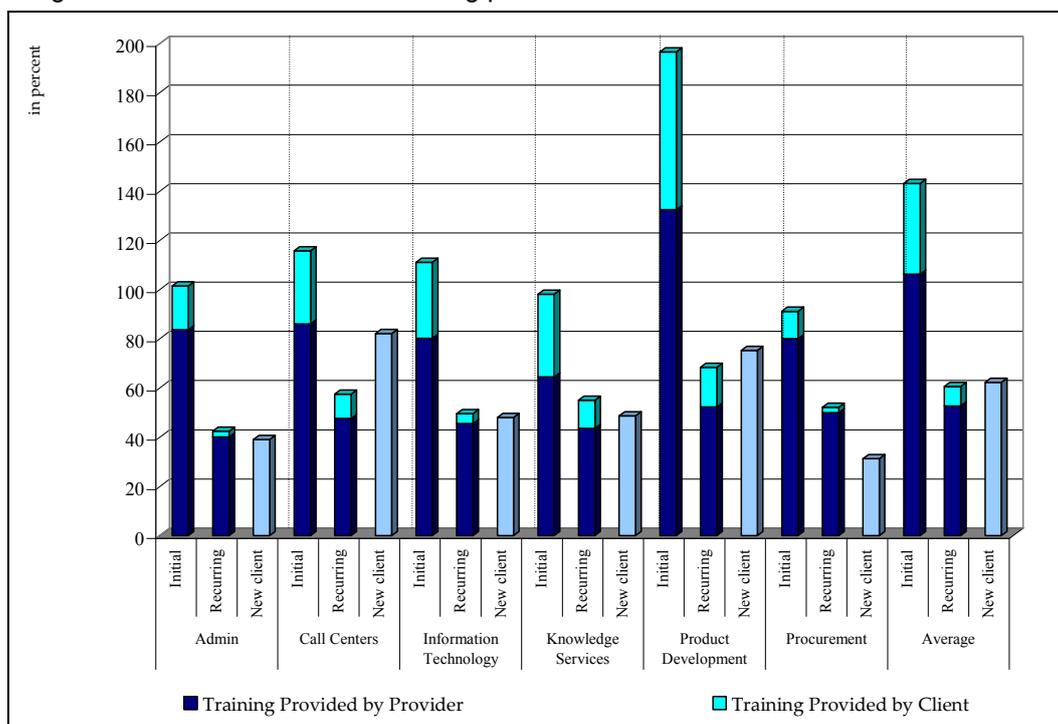
Figure 6.17 depicts the absolute numbers of years an average client has with the service provider. Influenced by the fact that offshoring is a young strategy, the average client-service provider relationship is between 2 and 4 years old.

6.2.1.6 Investments, Training, and Involvement

In the question about training, we asked about the number of hours that providers need to invest for a new employee, for recurring training, and for training if there is a new client project. Further, we asked to what percentage clients perform

the training themselves. “Training provided by the provider” is the difference between the total number of training hours and the total provided by the client. The recurring training refer to regular, annual, or even more frequent updating of employee skills. This is performed internally by the provider or by an employee from the client’s headquarters.

Figure 6.18: Investments and Training per Function



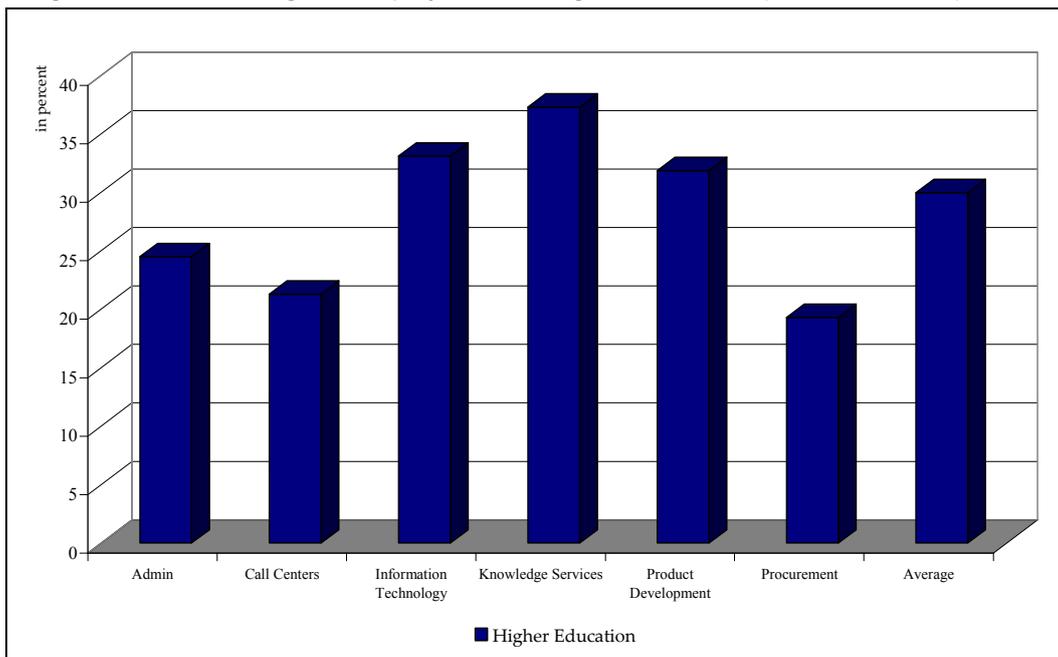
Source: Own figure

Results show that product development requires much more training than the other functions, reflecting the complexity of the tasks involved. I would have expected the same phenomenon from the knowledge services functions. The absence of such a finding can have two reasons. On the one hand, the involvement of high-skilled labor performing complex tasks does not necessary imply a lot of training. On the other hand, the number of observations in this category is very low. More important is the finding that the percentage of the training performed by the client is highest for knowledge services and product development (34 and 33 percent). This underlines the argument that the client wants to retain tight control in this function.

Figure 6.19 reflects the highly skilled component of the functions, while highly skilled is defined as the percentage of the workforce holding a Masters or PhD degree. As we gathered the employment questions on the company level only, we have to limit the expressiveness of the figures: Companies performing (among others) the functions depicted in figure 6.19 employ x percent of highly skilled labor.

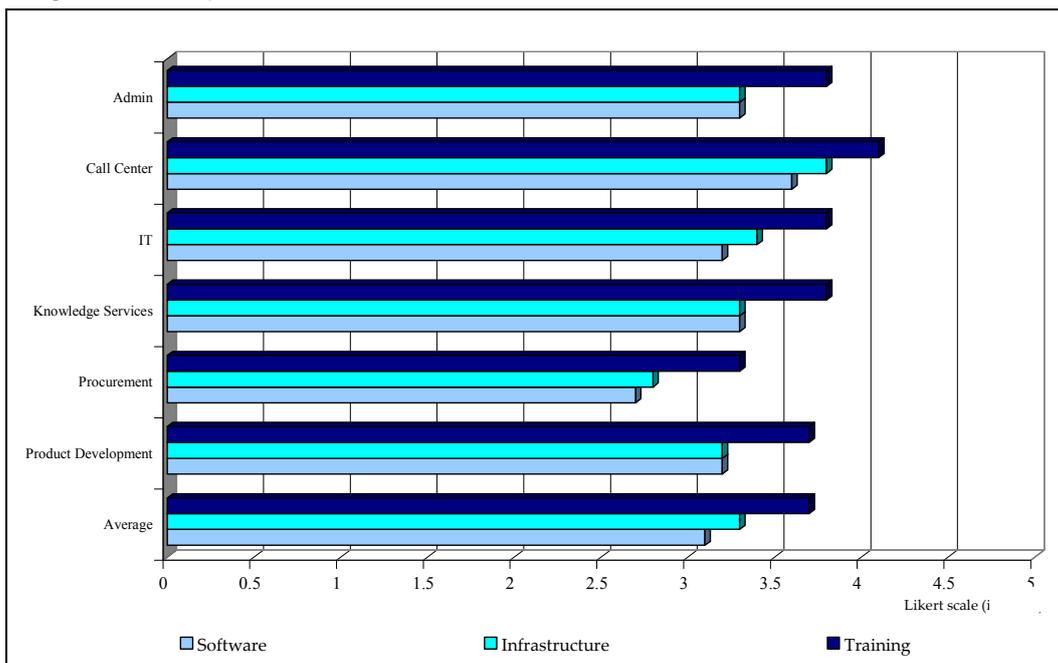
In particular, for knowledge services and product development this finding is in line with the theoretical prediction. In the former case, 37 percent of the workforce holds a Masters or a PhD degree, in the latter case 32 percent. Obviously, IT functions are performed in companies employing a large share of highly skilled labor as well. Graduates from the renowned Indian Institutes of Technology contribute substantially to this share.

Figure 6.19: Percentage of Employees with Higher Education (Masters or PhD)



Source: Own figure

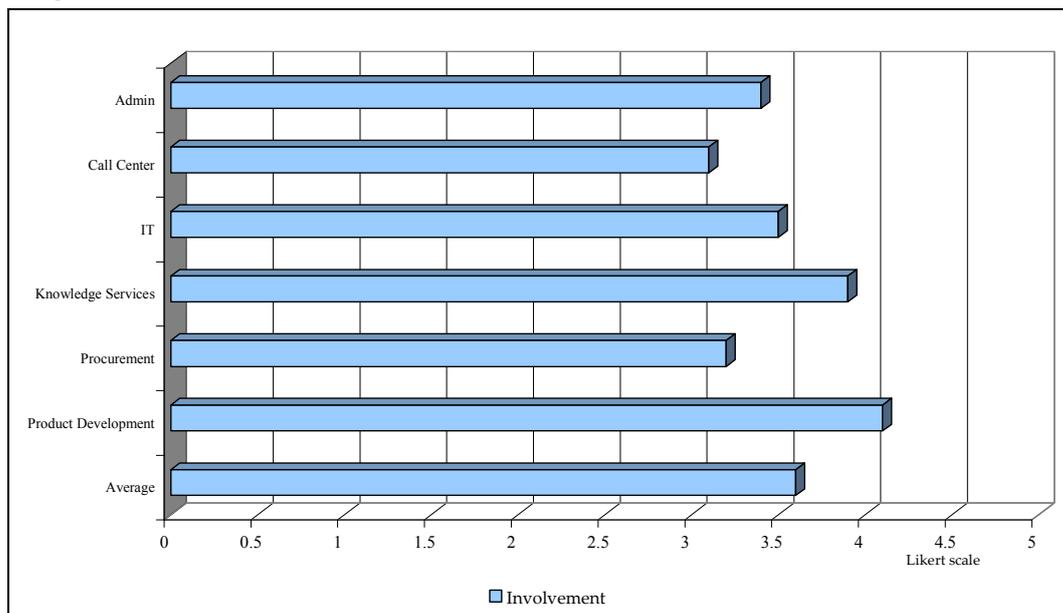
Figure 6.20: Importance of Investments



Source: Own figure

Besides contracting, investments are a way to align interests between clients and service providers. Both clients and service providers can make investments in software, infrastructure, and training. While the numbers of training hours were presented in figure 6.18, figure 6.20 does not depict absolute numbers, but rather, the results according to the “importance” of investments for each function. This was measured on the Likert scale. Using absolute numbers for this question would not have returned reliable conclusions because absolute numbers vary depending on the size of a company and the function. On average, investments in training are considered more important than investments in infrastructure and software. This order never changes when looking at the function. Call centers usually involve extensive client-specific investments because the compatibility with the client’s infrastructure must be guaranteed in order to provide access to customer data. On the other hand, procurement requires very little investment, and the function is independent from the client’s activities. IT and administrative functions approximately reach the levels of product development.

Figure 6.21: Client Involvement



Source: own figure

Aligning interests may be very effective if partners have to commit resources. As Jensen *et al.* (1999) point out, the involvement of the headquarters may be an effective means for controlling subsidiaries. The client is then better aware of what is happening with his knowledge. If the company fears knowledge leaking, appropriate measures or even relocation can be considered. While training is a form of involvement as well, involvement as asked in this question refers to the client participating in the process of delivering of the service offshored. The involvement is

highest for knowledge services and product development, with average values of 3.9 and 4.1 on the Likert scale. The distinction between training and involvement is particularly visible when looking at call centers. While call centers require a lot of training, both at initial stages and on a regular basis, the involvement of the client is comparatively low. Call centers perform a function that is very particular for the client and therefore involves substantial fixed costs in early stages. However, as the task is normally highly standardized, it is not necessary to have an in-depth involvement of the client.

6.2.1.7 Small versus Large Service Providers

While the size of the service provider variable did not lead to significant results in determining the sustainability of client-service provider relationships, the descriptive statistics show interesting results in this regard. The distinction between large and small providers is made at the mean of the sample size, which is at 200 employees. While providers of any size can be found in any location and delivering any function, small providers are more specialized and they have different deal characteristics and different operational procedures compared to their large counterparts. Looking at selection criteria, large providers are selected because of their global reach, their industry know-how, as well as their market reputation. Companies are more exposed and supposedly more concerned about their reputation. In contrast, small service providers are more frequently selected based on personal relationships and the word of mouth. They significantly more often deliver product development services (38 versus 24 percent), while client relationships are built on a contract-by-contract basis. Together with shorter maturities of contracts, clients do not become dependent on the service providers and are flexible enough to make changes in the strategy where necessary. While product development is a task performed by smaller service providers, call centers and IT functions are more frequently performed by large providers. Administrative and BPO functions require more client-specific investments, and service providers are frequently selected because of their experience rather than their size. While the reasons for selecting a large or small provider differs depending on the motivations to offshore and the tasks involved, client characteristics are relevant as well. While I observe that large providers tend to serve large clients and small providers small clients, Lewin (2008) argues, based on expert interviews, that large providers usually serve companies with little offshoring experience. This implies that companies have frequently unclear perceptions about offshoring strategies. Furthermore, they do not know what they

can expect with regard to service delivery and performance metrics. This would again relate to my observation that large providers are more concerned about meeting clients' cost and quality expectations. For this reason and because of scales, large providers offer more standardized processes and clients can choose from a pre-defined palette of services. For companies with little experience this implies in turn less risk.

Table 6.7: Small versus Large Service Providers

	Variable	Provider size	Mean	Std. Dev.	t-test [mean(small)-mean(large)]
Task-specific	Product development	small	0.44	0.50	1.49*
		large	0.32	0.47	
	Investments	small	1.1	0.15	0.58
		large	0.94	0.12	
	Involvement	small	1.0	0.10	-0.53
		large	1.1	0.10	
Relationship-specific	Contract specification	small	5.4	2.3	-12.05***
		large	8.6	2.3	
	Deal duration	small	1.6	1.0	-4.71***
		large	4.3	4.7	
	Deal termination rate	small	16.2	1.9	3.43***
		large	8.4	1.2	
	Percentage of long-term client relationships (adj.)	small	0.47	0.02	-3.50***
		large	0.56	0.02	
Company-specific	Certifications	small	7.8	3.1	-2.33**
		large	9.0	3.6	
	Higher education	small	37.7	23.8	6.09***
		large	19.2	11.1	

Source: Own table

Table 6.7 gives an overview of the variables discussed above and used in the regression model depending on the size of the provider. There is no significant difference in investments and involvement according to size. As product development is frequently performed by small providers, we could have assumed that these characteristics would also depend on the size of the service provider. However, as this is not the case, both investments and involvement are more important for certain functions and, as we will see below, for the determination of the client-service provider relationship. Finally, the observation of higher education is very distinctive

and correlated to product development. Following figures 6.18 and 6.19, this shows the importance of the highly skilled labor that is associated with this function. In the following chapter, I will show the results of the regression analysis, looking at the effects of governance mechanisms on the termination rates of contracts and the longevity of client relationships.

6.2.2 Regression Models

Derived from the literature on contractual relationships, the termination of client-service provider relationships is assumed to be a rare event. This assumption is actually reflected in the data. On average, only 12 percent of the contracts are terminated at expiration. The median is even lower at 10 percent. This value increases sharply when looking at product development functions, where the termination rate is at 17.2 percent. Again, this is related to the finding that product development functions are more frequently project-based and performed by specialists. For this reason, the relationships between clients and service providers tend to be shorter.

As the dynamic capability perspective suggests, there are many reasons to enter long-term client-service provider relationships. Building trust and learning-by-doing can generate distinct (tacit) capabilities that can subsequently lead to sustainable competitive advantages. Determinants reflecting these attributes and goals are firm-specific and can hardly be captured in a survey. I tested various governance mechanisms that supposedly prolong offshoring relationships instead. I assume that the longevity of the relationship is associated with capability building. Table 6.6 depicts the results of the regression model. The coefficients of the control variables experience and product development show the negative and positive signs as predicted. The termination rate of contracts decreases with the experience of the company, albeit not significantly. This negative relationship is, however, not significant. Much more important than experience is the functional component. As indicated above, product development outsourcing contracts tend to have higher likelihoods of being terminated than traditional administrative or BPO functions. I also controlled for regional effects, in particular India. India is the most popular offshoring location; thus, I suggested that the experience of this cluster would have a negative effect on the likelihood of contract termination. However, the results do not show any differences stemming from the origin of the service provider.

The core of my analysis, the governance mechanisms, shows some interesting results. I find that both mutual investments in software, training, infrastructure, and contract specificity show a negative effect on the termination rate. In this regard, I can confirm that the two governance mechanisms are an effective means to prolong client-service provider relationships. Contracting appears to be even more important for operational tasks such as traditional BPO functions. As the transactional approach suggests, contracting can best be performed if outcomes are easily measurable (Jensen & Meckling, 1995).

Table 6.8: Regression Analysis of the Client-service Provider Relationship Model

Sample: Service Provider Survey, full sample on functional and on company level						
Model: Two-sided truncated Tobit model						
Dependent variable	Deal Termination	Deal Termination	Deal Termination	Deal Termination	Deal Termination	Longevity of Client Relationship
	1	2	3	4	5	6
Experience (functional level)	-2.278 (1.450)	-3.124** (1.383)	-2.132 (1.397)	-1.461 (1.456)	-2.353 (1.359)	
Experience (company level)						-0.016 (0.042)
India	1.297 (2.562)	2.179 (2.430)	1.736 (2.465)	2.051 (2.541)	2.732 (2.351)	-0.048 (0.059)
Product development	8.380*** (2.815)	9.334*** (2.716)	7.904*** (2.686)	9.051*** (2.895)	8.177*** (2.729)	
Investments (functional level)		-3.377*** (1.003)			-2.649*** (0.982)	
Investments (company level)						0.009*** (0.003)
Contractspecificity (functional level)			-10.123*** (2.720)		-7.924*** (2.709)	
Contractspecificity (company level)						-0.068 (0.094)
Involvement (functional level)				-2.500* (1.465)	-0.322 (1.696)	
Involvement (company level)						0.019** (0.010)
Constant	13.825*** (3.646)	17.329*** (3.558)	20.482*** (3.900)	13.897*** (3.697)	20.876*** (3.792)	0.327** (0.146)
N	120	118	119	118	116	41
LR χ^2	11.89***	21.66***	24.47***	11.62***	26.55***	9.49*
*p<0.1 **p<0.05 ***p<0.01						

Source: Own table

In turn, the variable is not significant when looking at the longevity of the client relationships. This finding is very much in line with theory, suggesting that *non-contractual* relationships are responsible for the longevity of relationships in the long run. One example of a non-contractual mechanism is client involvement. As depicted in column 6 in table 6.8, this variable becomes significant when switching the dependent variable. Only the investments as a governance mechanism have a high importance for both the termination rate of contracts and the longevity of client relationships.

Table 9.6 in appendix 9.3 indicates that the regression model reported above does not suffer from multicollinearity, as the highest correlation between pairs of independent variables included in the same model is only 0.288, a figure which refers to the correlation between client involvement and contract specification.

7. Discussion, Limitations and Conclusions

7.1 Governance Mode Decisions in the Transactional and Cross-Cultural Framework

7.1.1 The Functional Aspect of the Governance Mode Decision

Offshoring research is gaining importance in IB (Lewin, 2005). However, as a stand-alone sub-stream has not yet developed, it is necessary to relate offshoring studies to established bodies of literature. In the case of offshoring, the market entry mode literature is the most closely related, but we have to acknowledge two important differences. In market entry mode situations, a company faces the question of how to enter a new market in order to deliver the final products abroad (Anderson & Gatignon, 1986). Of primary interest is the market of the host country, which has to be approached appropriately. While in market entry mode situations firms want to leverage their primary activities abroad, offshoring is about relocating business processes supporting the primary activities. As the market entry strategy is limited to the primary activities of the value chain, there is no interaction with the domestic market. Another important difference concerns the level of integration. The market entry mode literature looks at the basic question of whether to make or buy a foreign entity in order to leverage the company's activities (Agarwal & Ramaswami, 1992). While the two strategies imply differences in the short term, most market entry situations end up with an integrated foreign entity. Even an acquired entity will subsequently be integrated as well. In offshoring, this situation is different and the business process is either offshored to a captive entity or it is offshore outsourced to a third party service provider. Nevertheless, the similarities in the underlying concerns related to both strategies allow us to use similar frameworks for the analysis.

As is common for the market entry literature, I have used the TCE framework and complementary capability-based and isomorphic approaches for the analysis of the governance mode decision in offshoring. The number of empirical studies focusing on TCE is immense. Williamson (1999) reports over 400, while also in recent years, the theory has been able to maintain its position and has continued to be applied in top-tier journals. TCE, in particular when looking at vertical integration, employs three important variables: asset specificity, uncertainty, and frequency (Williamson, 1971). David *et al.*'s (2004) TCE meta analysis or Carter & Hodgson's

(2006) study reports strong support for the positive relationship between asset specificity and vertical integration. The authors conclude that this factor is dominant, while uncertainty may have different facets. Their finding is in line with Williamson's (1979) argument: Vertical integration is more efficient when involving recurring transactions as well as when investments are idiosyncratic (high asset specificity) and uncertainty is either high or medium or when investments are mixed (medium asset specificity) and uncertainty is high.

The market entry mode literature also has a high emphasis on asset specificity, whereas frequency plays a subordinate role (Andersen, 1997; Zhao *et al.*, 2004). This is primarily because it is very difficult to operationalize (*ibid.*). The measurability of asset specificity is a very common challenge in the market entry literature (Zhao *et al.*, 2004), and this is even more distinct in offshoring. Potential offshoring functions can be very different in nature, making it impossible to rank in a standardized manner or assign a degree of asset specificity. In order to overcome this problem, I have used the service provider survey to discover the relative complexity and standardization of a task. The results support the intuition that product development is particularly high on complexity and low on standardization, thus high on asset specificity. Product development is not just the function highest on asset specificity; the function stresses a different motivation for offshoring. It is more frequently offshored because the highly educated workforce at home is scarce and companies are forced to access the rich pools of talent in developing countries around the globe.

Measuring asset specificity in my model has to consider the availability of information from the surveys. While data on complexity and standardization of tasks was raised in the service provider survey, we cannot use them for the analysis of the corporate survey. I assume that functions high on asset specificity are less frequently outsourced or the functions are only outsourced if knowledge can be protected. In the service provider survey, we have to expect that knowledge functions are on average less critical in this regard. Building a linear measure from this survey would therefore cause a bias. Further research in this area is necessary, and the development of a unified measure would be a substantial contribution to the offshoring discussion.

However, I find that there are some limitations to the variation of asset specificity. The majority of offshoring functions include valuable client knowledge, which companies need to safeguard. Put differently, each offshoring function has a substantial degree of specificity. This effect is visible in the limited variation in the

complexity and standardization measures in the service provider survey. Furthermore, while I frequently observe a significant relationship between product development and the selection of a captive governance mode in the corporate survey, the significance of the result varies across the models. When it comes to subsequent governance modes, the functional aspects seem to play a subordinate role. Other variables such as experience are more decisive. Nevertheless, despite the caveats from above, a variable reflecting the specificity and complexity of the underlying function is necessary and improves the results. This is particularly necessary when analyzing initial governance mode decisions using corporate survey data. As the corporate survey includes both governance modes, it captures the full range of functions, and the limited variation in specificity described is smaller. My significant findings are thus reliable. Using a binary functional distinction between product development and non-product development functions is an alternative measure to specificity. It is broad enough and indirectly reflects the different levels of specificity.

7.1.2 Uncertainty and the Governance Mode Decision

In empirical research, the uncertainty variable shows very mixed results when predicting the level of vertical integration (David & Han, 2004). One reason is the various facets that this variable takes. Uncertainty in the market entry mode literature is closely related to the cross-cultural dimension and international experience (Anderson & Gatignon, 1986). In offshoring, the cross-cultural dimension can be tested in a similar manner. However, we have to take into consideration that the dichotomy in offshoring is between captive entities and third party offshoring, while in market entry mode situations, the dichotomy is between building a subsidiary abroad and buying an entity, which is most likely integrated at a later stage.

Cross-cultural differences are a form of uncertainty which is very difficult to reduce with integration. It may even be more difficult to deal with uncertainty when the foreign entity is integrated into the firm (Drogendijk & Slangen, 2006; Zhao *et al.*, 2004). Managing employees of different cultural backgrounds and exercising control are very challenging in such situations. In the IB literature, it is common to use Hofstede's distance measures for cross-cultural analysis. Due to the complexity and subjectivity of this research, there is, however, no undisputed approach to the topic. Drogendijk & Slangen (2006) show in a meta analysis that empirical support for the Hofstede measures is not very strong. They regard the Schwartz model to be superior. Schwartz collected data on the individual level as opposed to the national

level. Furthermore, the research is more recent (*ibid.*). My findings from the Kogut-Singh Index (which is based on Hofstede's value dimensions) show major weaknesses as well. However, I am not able to conclude whether the weakness of this variable originates in the weaknesses associated with the measure (for an overview *c.f.* Kirkman *et al.*, 2006; McSweeney, 2002) or whether it is a matter of offshoring. Further research in this direction can help to improve understanding of both the cultural aspect of offshoring and cross-cultural research. As an alternative approach, I collected the Schwartz measures from the book "Individualism and Collectivism: Theory, Methods, and Applications" (Schwartz, 1994). As it turned out, the problem with the Schwartz measure is the limited scope in terms of countries investigated. Most importantly, India was not covered in the cross-cultural survey. For the analysis of offshoring, this country is crucial. While I am able to observe a significant positive correlation between the Kogut-Singh Index and the Schwartz index, an inclusion of the variable in the model would have distorted my results and would have reduced the sample size in an unjustifiable manner.

As an alternative to the cross-cultural distance measure, I propose a different line of argument in order to incorporate distance. I argue that companies tend to follow the path of the domestic industry. The goal in offshoring is to access talent around the globe and to access labor at low costs. If this is possible in a closely related country (closely related refers to mutual trade activities) offshoring is facilitated. In offshoring, it is not essential to learn about the demand and the culture of the foreign markets, but it is important to have relationships, routines, and supportive institutions facilitating relocation. I argue that this is more likely to happen if two countries have high trade activities with each other. Such trade activities normally develop in a path-dependent manner. In this regard, it is not the general international experience of a company in any country that is relevant, but the individual and aggregated experience with the particular offshore country. In this way companies learn about the "the rules of the game" when doing business in a particular country. If the specific knowledge is not available in the company, it is likely that consulting companies have sufficient experience in the respective country. Results are very supportive of my line of argument. In line with the market entry mode literature and with the different approach of measuring distance, I find that trade flows between the home country and the offshoring country decrease uncertainty while facilitating the establishment of captive governance modes.

Complementarily to the trade flow variable, I have collected a different variable looking at distance. Language difference looks at whether the same language is spoken in the country of the offshore location as in the home country. The definition of such a variable is not very clear-cut, as, on the one hand, countries may have several official languages (such as in India) or a language may be widespread although it is not an official language (such as German in Western Poland). In both my interview examples, Bank A and Bank B, captive centers were established in Poland because the German language is very widespread. However, using language difference as a predictor for the governance mode decision would be biased depending on the definition on the term. A basic test of the variable (defined according to the official languages) showed a considerably high correlation toward trade flows; thus, I consider the latter variable to be superior.

The methodological issue raised in the survey analysis is specific to this dissertation. In the survey, we observe three different populations: companies offshoring, companies considering offshoring, as well as companies not offshoring at all. When asking a respondent who is actually thinking about offshoring (considering offshoring) whether he runs the risk of knowledge leaking, we are likely to get a response that follows the transactional prediction. In the presence of such risk, the respondent is likely to mention that he will select a captive governance mode. In a captive governance mode, it is much easier to exercise control. The situation is different when asking a respondent that is actually offshoring. He has already taken the decision on the governance mode and has addressed the related risks. In the same situation, he is therefore expected to report lower risks if a captive mode has already been selected. To my knowledge, this fine differentiation has not yet been addressed in the literature. On the one hand, we need to consider the point in time of the strategy decision making. On the other hand, we have to consider whether the risk can be reduced with integration or not. While I look at the distance measure on an aggregate level, further research should shed more light on the direct relationship between “other” experience with a potential offshoring country and the actual decision to relocate to that country. International experience, as it is discussed in the transactional perspective of the market entry mode literature (*c.f.* Brouthers *et al.*, 2003), is a firm-specific capability linking the transactional literature with the dynamic capabilities perspective.

7.1.3 Practical Implications

Besides the contribution to the transactional and cross-cultural literature, the governance mode decision analysis has several practical implications. The results from the corporate survey showed a positive relationship between complex functions and the likelihood to select integrated governance modes. Although this is far from claiming significance, the validating interviews with the two Swiss banks confirmed the basic parameters of the transactional framework. As Aron *et al.* (2005) explain, functions that are high on operational and structural risks should not be outsourced to service providers. Codifiability of the tasks offshored and the use of performance metrics are the instruments to reduce operational risk. Operational risk refers to the risk that processes will not operate smoothly once offshored.

Structural risk refers to the risk that relationships with service providers may not work as expected. Expressed in more theoretical language, Aron *et al.* (2005) have a functional approach stressing asset specificity and their operational risks relate to my category of business and process risks. Structural risks refer to agency problems that we will discuss later. In the interview with Bank A, the functional component of the governance mode decision was an issue as well. Business units are basically free in deciding whether they want to outsource a service to an external provider or to one of the two captive centers. Only banking secrecy poses some limitations regarding what sort of data can be forwarded to an external provider. Other than that, the decision remains with the business unit manager and the function is not a sufficient predictor for the governance mode.

Although I find a positive relationship between product development and the likelihood to select captive governance modes, all functions can be offshored using both governance modes. Aron *et al.* (2005) have an operational understanding of risk (comparable to my business and process risk variable). However, they do not take risks surrounding a transaction into consideration. It is well possible that a function is asset specific, *i.e.*, that it cannot be used for a purpose other than the specific transaction (Williamson, 1999), while the risks involved are low. For instance, if it is possible to keep one key component of the process at home, the knowledge leaking potential is limited. This can even happen if the function is very complex and not well standardized. Uncertainty regarding knowledge protection has to be treated separately from specificity and is a critical issue. If the potential for capabilities or knowledge leaking is high, firms are better off when offshoring the process using a captive mode. This finding complements the functional perspective. However, while I

find strong support for the knowledge protection risk factor, the other risk variables are rather weak in the empirical model. In line with Aron *et al.* (2005), I find a positive sign in the relationship between business and process risks and the likelihood to select captive governance modes. Although the result is not significant, it shows that risks that can be reduced with integration are likely to be mitigated using captive governance modes.

The effect of the economic risks and the offshoring risks is also in accordance with the predictions. The relationships support the assumption that, in the presence of economic risks, services are offshored to third party service providers. For service providers this may pose a substantial risk. In particular, appreciating currencies may threaten the internal cost structure of service providers, as contracts are more frequently settled in the currency of the client. The insignificance of the result shows that this form of risk is, however, not decisive for the governance mode decision. Similar is the finding for the offshoring risk primarily involving the internal and external acceptance of the strategy. There are arguments in favor of both directions of the relationship. If acceptance of offshoring is low, a company can decide to outsource to a third party service provider in order to keep the unit disintegrated and keep interactions to a minimum. Low interaction then leads to lower contact. Alternatively, a company can decide to select a captive governance mode in order to set common standards for all employees, consider them as their own and integrate them as much as possible (and necessary). If domestic employees regard this workforce as co-workers, acceptance is likely to increase as well. As offshoring risks are a very situational matter, there is no best practice that can be established from an empirical perspective. As the variables stand, risks are a weak predictor of the governance mode decision. The only exception is the risk of knowledge leaking, making it necessary to consider further uncertainty variables.

Both the data and the validating interviews showed that distance is an important determinant that needs to be carefully managed. In particular, distance measured in terms of trade flows significantly contributes to the governance mode decision model. Measuring trade flows as a form of uncertainty relates to cultural distance, but stresses the path-dependent relationship between two countries. Countries can be very different in their cultural values, but can still have a long tradition in doing business with each other. I argue (and find in the data) that close ties between countries facilitate the establishment of captive offshore centers. As mentioned above, I cannot say whether the insignificant result of the cross-cultural

variable originates in weaknesses of the cultural measure or in insignificances in the offshoring context. Both interviewed banks have established a captive center in India and one in Poland, while third party projects can be assigned to any country. In both cases, the proximity of Poland to Switzerland facilitated the establishment of the captive center.

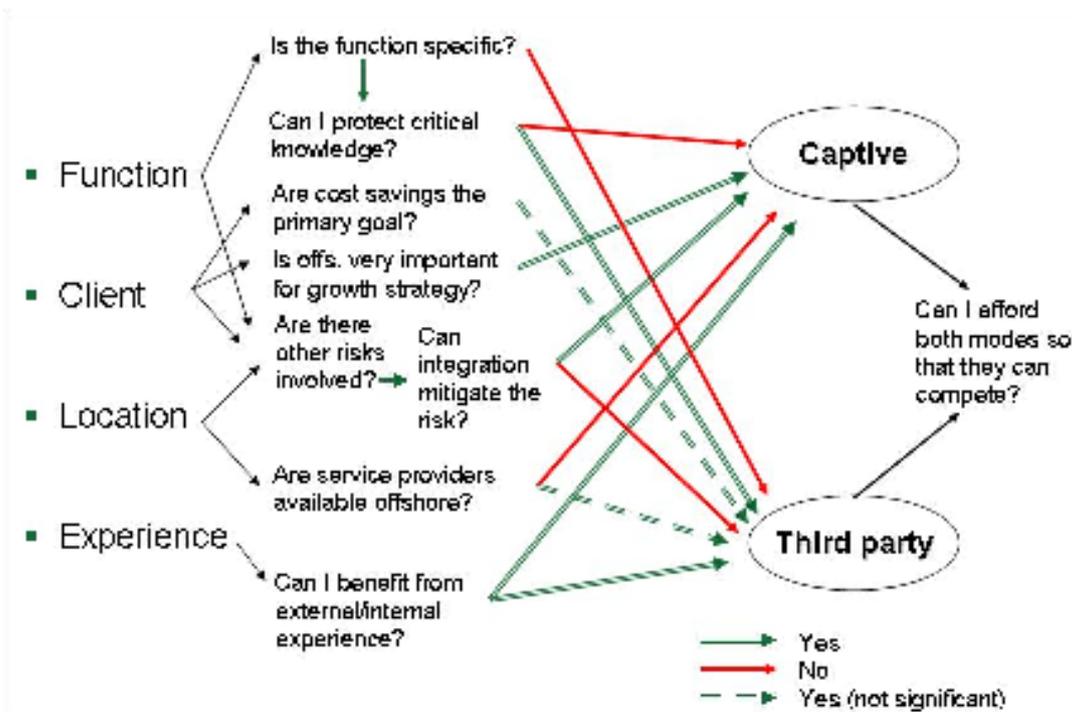
While distance was an important issue for the governance mode decision, this is an ongoing issue in daily operations. In particular, it is extremely difficult to find a balance between integrating the foreign employees under the bank's brand while still offering substantially lower salaries than at the headquarters. However, as employee turnover is an increasing issue (Lewin & Couto, 2007), it is very important to diffuse the group-wide culture into captive centers. Both companies tackle distance by emphasizing company values. One approach to doing so is sending an expatriate to the offshore center or inviting the captive center management to the headquarters for seminars and workshops. In particular, Bank A has a strong local CEO in charge of the captive centers. He is responsible for establishing a common culture and is frequently trained at the headquarters in Switzerland. In the interviews it also became clear that exchange can only take place on the management levels, as the mobility of the employees would create the opportunity for discussions of salaries.

The necessity for cultural integration is very important when looking at turnover and the loyalty of employees. The yearly double digit salary increases makes employees stay for less than a year and the turnover rate may reach as much as 20 percent. Interviewer B (2007) argued for Bank B that the company frequently needs to send out five job contracts in order to fill one position, as loyalty is so low. If in such situations companies (or their consulting companies) have experience in doing business with the respective countries, the problem of distance is likely to be substantially reduced.

Figure 7.1 provides an illustration of the practical implications of the findings from the client perspective. The double-line arrows represent a significant impact of a question asking for a functional, client-specific, location-specific, or experience-specific characteristic on the probability to select a captive or a third party governance mode if the question is answered with a "yes". The single-line arrows represent a significant effect of a "no" to a question from the above-mentioned categories on the likelihood to select a captive or a third party governance mode. A dotted line represents a relationship that shows the respective sign but is not significant. In the first case, for instance, a specific function that is offshored is just a

necessary, but not sufficient condition for selecting an integrative governance mode. Only if the knowledge cannot be protected, a captive governance mode is selected. All other relationships are self-explanatory and are according to the relationships outlined above.

Figure 7.1: The Governance Mode Decision in Offshoring



Source: Own figure

The results predicting the governance mode decision in offshoring are strong. Nevertheless, it is important to state that they are based on a survey focusing on past behavior. Results rely on benchmarking of the companies and measure trends and patterns. While the theoretical and statistical explanation for the relationships can be proven, further conclusions or predictions for future behavior of offshoring companies would lack sufficient empirical foundation. In order to fulfill this purpose, a separate survey investigating future intentions and relating them back to the governance mode decision would be necessary.

7.2 Governance Mode Decisions Based on Experience

David *et al.* (2004) conclude that although there is strong support for asset specificity, no study is fully consistent with the TCE argument. In the best case, they are only partly consistent, if not partly consistent and partly inconsistent. Nevertheless, no study can disprove the TCE argument. Carter & Hodgson mention that in order to prove TCE, all variables, *i.e.*, asset specificity, uncertainty, and

frequency, need to be significant. Since normally – and also in my case – not all requirements are fulfilled, it is necessary to reinterpret the studies in terms of a competence or capabilities approach. Studies like Argyres (1996) or Poppo & Zenger (1998) attempt to do so. The studies argue that TCE factors out the capabilities involved. According to their logic, a firm may simply outsource because of superior knowledge possessed by a client or a supplier. A decision to outsource can be taken without any transaction cost considerations. This argument is intuitively very sound. This is similar to a argument raised by Dunning (2000) in the OLI framework, in which TCE is an important, though not an exhaustive, perspective. While the transactional framework pinpoints experience in context of uncertainty, this variable has much deeper implications for the governance mode decision and needs to be addressed from different perspectives as well.

In the transaction cost literature, in particular in the context of the market entry mode literature, experience variables are important (Anderson & Gatignon, 1986; Zhao *et al.*, 2004). Experience is a means to reduce uncertainty and is frequently observed through cultural distance and international experience (*ibid.*). Above, I briefly mentioned that traditional international experience variables⁸ are not a suitable measure in the context of offshoring. In international expansion, the goal is to leverage the home country activities in a foreign country and to generate profits by accessing or penetrating a market. The activities in focus are primary functions of the value chain and the foreign entities form sales offices and perform representative functions. It is essential to have experience with foreign market structures, different demand populations, and local taste. This is, however, different with respect to the experience required to offshore. While I do not contend that international experience does not have an influence on offshoring as well; firms primarily need knowledge on how to establish processes that support the core activities around the globe. As this knowledge is similar across firms, experience can also be gathered from outside, including from consulting companies. This is particularly beneficial in initial governance modes, in which companies have no such experience internally. The strong result on the isomorphism variable supports this hypothesis. Firms are very

⁸ International experience is frequently measured as foreign sales as a percentage of total sales, foreign assets as a percentage of total assets, or foreign employees as a percentage of total employees (Sullivan, 1994).

likely to replicate the behavior of the competitors in order to legitimize their own action (DiMaggio & Powell, 1983). This is also interesting in the two interview example. After Bank B had established two captive centers, one in India and one in Poland, the competitor Bank A subsequently also established two captive centers in the very same countries. Both respondents claimed that this was coincidence and the result of their internal analysis.

From a macro perspective, isomorphism could also be an explanation for the large clusters that are developing in the offshore centers. The major cities in India are already becoming so crowded that real estate prices are exploding and firms anticipate much higher labor costs than previously expected (Lowe *et al.*, 2004). An interesting analysis following this observation would look at the performance implications of this behavior. It is somehow questionable whether the followers are still able to achieve the goals set in their offshoring strategy. On the other hand, replicating the successful behavior of competitors saves costs in planning the strategy. Additionally, there is a certain likelihood that the strategy will be successful in the new instance as well.

Besides isomorphism, an alternative would be to examine previous experience with manufacturing outsourcing. I collected this variable in the form of a dummy variable, asking whether companies have any experience in this regard. Interestingly, the number of observations turned out to be very low and the sample does not cover enough respondents with the respective experience. Finally, it would also be difficult to predict the direction of the relationship toward the likelihood to select captive governance modes. On the one hand, it could be argued that manufacturing outsourcing experience decreases uncertainty and facilitates the establishment of a captive governance mode. On the other hand, we could argue that companies have experience in dealing with third party service providers, facilitating this governance mode.

Finally, I have argued that offshoring-unrelated experience and capabilities are a good predictor for the governance mode decision. The statistics confirm this result. Airlines, for instance, were among the first companies to offshore (Robinson *et al.*, 2005). They have a global reach on a daily basis and it is very easy for them to control foreign operations. This example shows that there is an individual component to the discussion. Such examples are difficult to capture in large sample data. However, I was able to identify two relevant firm-specific parameters contributing to the determination of the governance mode decision.

Companies that offshore for the primary purpose of saving costs are more likely to collaborate with third party service providers, while companies that want to restructure their operations are more likely to select integrated governance modes. The two goals are certainly not mutually exclusive; however, we are addressing the top priority of the offshoring strategy, and one of the two should be more important. The two variables are a simple but effective way to capture capabilities and the basic intentions of the companies. Companies in which the highest priority is saving costs and outsourcing to third party service providers show that an external provider has better capabilities for achieving the desired cost savings. This is confirmed by the observation that service providers achieve on average higher savings (Deloitte, 2005). Alternatively, companies that strive for restructuring global activities are more likely to select captive governance modes. It reflects that capabilities are kept in-house and companies are confident about their operations.

The finding that seems initially straightforward shows that offshoring bears substantial risks for the clients. It is very tempting to outsource inefficient processes to third party service providers. However, as the interviews and the business-oriented literature show (Agrawal & Farrell, 2003; Agrawal, Farrell, & Remes, 2003), offshoring processes that are already problematic at home are more likely to fail when being offshored. Only functions that run smoothly at home should become subject to offshoring. The finding that the need to save costs is a predictor for selecting third party governance modes at least does not reject the observation from the business world. As Deloitte (2005) shows and my findings confirm, third party governance modes are still the best mode to achieve higher savings on average. However, variation in captive modes is higher. While an average provider achieves higher savings than an average captive center, the best captive centers perform better than the best service providers. Companies need to be well aware of this fact and carefully consider the governance mode based on their internal capabilities. Further research in the area should link the observation to the failure rate of offshoring, which is likely to provide interesting new insights into the success of the offshoring strategy.

The experience component certainly also becomes very important in subsequent governance mode decisions. Firms gather experience with their offshore operations and adapt and improve their strategy. Therefore, it is important that the strategy reaches the executive suite and is established in the overall corporate strategy (the ORN database has observed this phenomenon). Depending on how the

offshore center or how the third party relationship is developing, different kind of tasks are transferred to the provider. In this regard, the governance mode decision is no longer selected based on the functional characteristics; instead, existing experience with a governance mode is transferred to different functions. This logic finds empirical support in the very strong finding in the analysis of subsequent governance mode decisions. For subsequent decisions, companies are more or less no longer evaluating the transactional and functional components of the task offshored. While this is an interesting finding and shows how firms learn about offshoring and develop their capabilities further, it would be interesting to test the performance implications for the behavior. While reduced uncertainty in subsequent governance decisions is a cost saving as well, the best governance mode decision should still be determined in each individual case of offshoring.

7.3 The Future of the Governance Mode Discussion

The statistical results are the core contribution of this dissertation to the body of scholarly work on governance mode decisions. The findings are enriched with interviews conducted with managers responsible for offshoring at the two largest Swiss banks, Bank A and Bank B. I did not conduct case studies on the banks; however, the examples of these experienced companies provide some further insights into the governance mode discussion and its future development. So far, we know that there is a functional component to the governance mode decision, the risk of knowledge leaking is important, the distance between the home country and the offshore location matters, as does internal or external experience. I suggest that future research look at performance implications of the governance mode decision. This is, however, a difficult endeavor, as there are difficulties with regard to measurability. Because offshoring takes place in a lower level in the company and involves support activities, we cannot consider traditional measures such as sales, revenues, or stock price increases as performance metrics. The more appropriate measure seems to be cost savings for the clients or margins achieved by the service provider. However, those measures have major flaws. If we look at the cost savings achieved, performance may be the result of offshoring a poorly managed service to a very effective service provider, or a very well managed service to an average provider. Thus, there are serious limitations to the use of the savings figures. Nevertheless, besides the findings that service providers achieve on average higher savings than captive centers and the best captive centers perform better than the

best service providers do, I observe another finding with regard to savings. Companies using both governance modes achieve on average the highest savings. This finding underlines the argument that there is no superior governance mode. If companies can compare offers from internal and external providers and can flexibly assign tasks, it will provide the best opportunity for leveraging offshoring potential. This finding is independent from the experience expressed in the number of years that a company is offshoring.

Empirical evidence does not favor one governance mode in the long-run. Subsequently, we have to ask whether there are governance modes that can be established that go beyond the dichotomy between captive and third party models. In the theoretical foundation, I outlined how hybrid modes can define the level of integration on three different levels: the processes, the employees, and the management (Celner, 2006). We asked respondents to report on hybrid modes, but the sample size was so small that I excluded these cases. In most cases, the hybrid modes were joint ventures. However, even within the dichotomy of the governance modes, there are slight differences within a governance mode. While Bank A uses both third party offshoring and two captive centers in Hyderabad and Krakow, their captive centers have two different management models: a managed services model (MSM) and an alternative service model (ASM).

Offshoring is usually a bottom up driven process, initiated by the business unit managers and supported by an internal advisory, the business development function. As all functions can be offshored using either governance mode, the captive centers have to compete internally against the offers from the service providers. If a captive mode is selected and the choice is for the MSM, employees at the offshore center work for different business units. In this situation, the captive center management has full control of the employee headcount and can work with most flexibility. The business units pay for the services as they would for a service provider. While the management of the captive center has to manage the outcomes and has to deliver, the final responsibility for the strategy remains with the business unit. The challenge of this model is that the captive center can deliver services appropriate for all business units. Sub-cultures across business units vary greatly and pose a significant challenge to the captive model.

In the ASM, the business unit has more control over the process that is performed at the offshore center. The model preview ensures that the captive operation is set up exclusively for the internal client. Office space and the headcount

as requested by the business unit are designated on a project basis. In order to have sufficient control, an expatriate is usually sent to the offshore facility. The business unit manager is free in selecting either the MSM or the ASM and the decision usually depends on the level of control and the required cost saving potential. The MSM has lower cost savings than the ASM because the delivery of standardized services to different business units enables a reduction in the costs per unit and the captive center can organize its activities most flexibly. On the contrary, the ASM offers the highest degree of control, as knowledge issues can be critical across business units.

In sum, the MSM is de facto equivalent to outsourcing within the company and offers the highest savings. While contracting is not necessary, there is still a need to agree on the terms of the offshore center. Such service level agreements include the scope, hours, escalation points, documents, processes, as well as how the services should be provided and detailed metrics. The ASM has some advantages from a cultural perspective. As an expatriate is sent over or a manager hired to oversee the offshoring process, this person is able to transfer the cultural values abroad.

7.4 The Development of the Client-service Provider Relationship

Offshoring has not only become very attractive because of the potential to save costs but also because of the opportunity to access knowledge around the globe. In comparison to captive offshoring, outsourcing to service providers leverages the potential the best. Service providers specialize in providing the services and can benefit from scales. As mentioned above, offshore outsourcing may be accompanied by agency problems and potentially bears the risk of knowledge leaking. This risk is increased if the measurability of the service output is limited (Jensen & Meckling, 1999). The importance of knowledge protection is thus a paradox. Companies want to benefit from lower labor costs by outsourcing to service providers, but they actually do not want to share knowledge.

I have identified several mechanisms to overcome the dilemma and align interests between clients and service providers. We can divide them into three categories: Control, relationship-specific investments, and contracting. Control is among the most frequently used methods to reduce agency costs (Eisenhardt, 1989); however, it normally involves substantial costs. Furthermore, it may have negative effects on the motivation of employees. Control can be performed either by an expatriate sent to the facility abroad or by formal reporting of the offshore unit. In captive centers, control can best be performed if the workforce is integrated into the

company and if employees truly belong to the company's brand and community (Interviewer A, 2007). Control can then take the form of direct supervision of an expatriate, formal reporting on achieved service level agreements and key performance indicators, as well as supervision of the management. For client-service provider relationships, the possibilities for direct control are limited. However, my findings show that the involvement of the client in operational matters increases the longevity of client-service provider relationships.

An even more fundamental approach to mitigate the costs associated with agency problems is contracting. Contracting is an effective method that can, however, only work if the output of the underlying service can be measured (Jensen & Meckling, 1999) and if the contract can be enforced (Klein, Crawford, & Alchian, 1978). As contracts usually contain sensitive data, it is difficult to gather information on them. While Poppo *et al.* (2002) measure contract specification using the Likert scale, I looked at the diversity of contracts. This variable is, however, correlated to the measure on the Likert scale, which we also collected. The finding for contracting shows that this mechanism is an effective means to reduce the risk of contract termination. Thus, carefully developed contracts can be regarded as a hygiene factor for successful offshoring relationships. However, they are not a guarantee of long-term client-service provider relationships. While I observe a negative relationship to the termination rate of offshoring contracts, I do not observe a positive relationship to the longevity of the relationships. This finding suggests that contracts are an important instrument for aligning interests but cannot be used to enforce long-term relationships.

More effective in facilitating long-term relationships are client-specific investments by the service provider. Such investments include investments in training, in software, as well as in infrastructure. While such investments are to a certain extent dependent on the service provided, they are an effective means to prolong client-service provider relationships. Investments further have the positive side-effect that they facilitate the transfer of corporate culture (Interviewer A, 2007). It is thus a very effective means to align interests.

Levinthal *et al.* (1988) observe that relationships between clients and auditors are more likely to be terminated in the early stages of relationships. Once the relationship has endured a certain time, the likelihood of dissolution decreases. The authors argue that relationships – similar to a task – can become asset specific over time. I can confirm this finding in the offshoring context. The correlation value

between the longevity of the client relationship and the termination rate at expiration is -0.42, thus highly significant at the 99.9 percent level of significance. If relationships are sustained for a sufficiently long time-period and become asset specific, it implies that clients are satisfied with the offshoring activities or the costs for switching provider are too high. I do not find any correlation between the longevity of the relationship and savings; thus, this is obviously not a decisive argument. Firms have to be aware, however, that the establishment of the mechanisms for interest alignment and the development of asset specificity in the relationship may lead to interdependencies. An option to overcome such a problem might be, for instance, the use of both governance modes that are equally able to perform a task.

7.5 Limitations

Offshoring is about to develop its position in the IB field. In explaining the phenomenon, the resource-based view (*c.f.* Barney, 2001) or developments thereof are frequently considered for two reasons. On the one hand, the essence of offshoring is to save costs by relocating activities and to access talent abroad. Both arguments focus on the resource labor, which is why much of the literature is based on this foundation (*c.f.* Angeli & Grimaldi, 2007; Lewin & Peeters, 2006; Massini, Lewin, & Manning, 2007; Pisani & Ricart, 2008). On the other hand, the qualitative nature of the majority of studies poses limitations in the use of different theoretical foundations. Alternative approaches, however, include co-evolutionary approaches (Manning *et al.*, 2008), the OLI and FDI frameworks when looking at the location choice (Contractor & Thakur, 2008; Demirbag & Glaister, 2008) or relate to the social responsibility and ethics of the companies (Doh, 2005).

My study is an early attempt to find empirical evidence on the governance mode decision in offshoring. The link to the market entry mode literature is obvious; however, it poses some limitations as well. The major advantage of applying this stream of literature, in particular in context of the transactional framework, is its high acceptance in the literature and the comparability to existing research. The decision in the market entry mode literature is between greenfield and acquisitions, which is conceptually independent of the choice between partial and full subsidiary ownership (Harzing, 2002; Padmanabhan & Cho, 1999). In offshoring, this situation is different, and captive centers are always related to full ownership, while clients usually have no ownership in third party governance modes. The comparability of the results with the market entry mode literature is therefore limited and further research in the offshoring

domain should be conducted in order to confirm the findings. A similar situation appears when looking at the literature on headquarters-subsidary relationships (*c.f.* Paterson & Brock, 2002). The literature focuses very much on foreign entities that serve the purpose to leverage company activities abroad. In the context of offshoring, discussions such as the subsidiary role stream (Birkinshaw & Morrison, 1995; Jarillo & Martinez, 1990) need to be extended for offshore centers that generate support activities for the entire value chain. Gupta and Govindarajan (1991), for instance, analyze subsidiaries with regard to their knowledge inflow and outflow. While I have built the service provider argument on agency theoretical consideration, linking the discussion to the headquarters – subsidiary relationship discussion is likely to provide some further insights.

To date, there are not many large sample studies available focusing on the offshoring phenomenon. The global reach of both the corporate survey and the service provider survey is extensive; however, this poses some limitations at the same time. Although the surveys were launched from the US and four European countries, the responses are clearly highest from the US. Most likely, there are two reasons for this. On the one hand, the survey was initially launched in the US only. The subsequent survey waves have built on the existing pool of respondents, as they could simply update their profile and responses online. On the other hand, US firms started earlier to offshore than European firms. US firms have also gained more experience with this strategy. It is possible that different governance modes before offshoring has led companies to show differences in the governance mode selection (because of path dependency). The survey has thus resulted in a much higher sample size for the US than for the European countries. With this imbalance, we could not collect a representative sample of firms (*c.f.* Groves *et al.*, 2004), reflecting the full population of offshoring companies and which is according to the weight of the respective economies. As Lewin (2008) argues, the large number of observations, however, almost entirely offsets potential problems with non-representativeness. Because of the different response rates, the problem of representativeness might rather be a problem when comparing the results depending on the country of origin. As I do not draw any conclusions based on the headquarters location, the differences in sample sizes do not affect the analysis of the governance mode decision. Further research using a larger sample could lead to interesting cross-national results for the offshoring governance mode.

A further limitation to the data concerns its cross-sectional nature. In research, longitudinal analyses are higher on external validity than cross-sectional analyses (Robson, 2002), as findings can be replicated across years. I addressed this problem in a different manner. As we asked respondents to indicate the launch year of their operations and as we launched the survey on the implementational level, the validity of the results is almost as high as that of longitudinal analyses. In many cases, companies have only a few offshoring activities and the validity of the responses of earlier implementations is as high as for the current implementations. This is particularly true as we are asking about the current situation on risks, drivers, performance, *etc.*, and not about the situation at the time of implementation.

The final limitation concerns the use of two surveys in order to observe the governance mode decision and its implications. While the corporate survey addresses the clients, the service provider survey addresses the providers delivering the services. Launching the two surveys in an integrated manner would, however, have had other limitations, as questions need to be adapted depending on the perspective. Using two surveys even has some advantages. In particular, it was possible to compare the findings from the two perspectives and it was possible to identify gaps between the responses from one side and the perceptions of the other side. For instance, we asked service providers to indicate what they thought the motivation was for clients to offshore. This question can be compared with the actual motivations to offshore indicated by the clients. The reason for having two surveys is primarily that the corporate survey was the only available data set which was appropriate for this study. However, because it did not allow for analyzing the client-service provider relationships it was necessary to launch an additional survey. As mentioned in the section on the practical implications, the survey-based dissertation forms a comparative study and does not allow to derive further managerial implications.

In sum, extending the database and including further variables is likely to produce results that are even more robust. With regard to the governance mode variable, it is difficult to measure a variable beyond the “make or contract” dichotomy. Rather, further research should tackle the alternative approaches that companies select in order to save costs and protect their knowledge.

7.6 Conclusions

Decreasing information and communication technology costs and increasing global mobility, coupled with shortages of a well-educated workforce in the home market drives companies to offshore. Offshoring concerns the relocation of services supporting the value chain at home or in their global operations. The foreign sales market is not of interest for this strategy. Determining factors are the cost level abroad and the availability of an educated workforce. The decision to offshore is followed by the question of governance mode, *i.e.*, the question of whether the company should establish its own offshore entity abroad (captive offshoring) or mandate a third party service provider. The main contribution of this dissertation is the understanding of the antecedents of the governance mode decision. In order to test hypotheses linked to this question, I used data from the ORN corporate survey. Furthermore, this dissertation sheds light on the understanding of the sustainability of relationships between clients and service providers. For this purpose, we designed an additional survey focusing on service providers around the globe.

From a theoretical perspective, this dissertation contributes to the offshoring literature by drawing on insights of the market entry mode literature. Market entry mode decisions deal with the question of whether to “make or buy” a foreign entity when expanding international activities. This is related to offshoring and frequently discussed from a TCE perspective (Zhao *et al.*, 2004). It follows the logic that transactional arrangements have to economize on bounded rationality and opportunism. I also use the TCE perspective in order to explain initial decisions regarding the governance mode. As this is a very functional perspective, I followed the argument by Jacobides & Winter (2005) and supplemented the theoretical foundation with hypotheses derived from the dynamic capabilities perspective. In addition to the two complementing perspectives (Williamson, 1999), organizational isomorphism introduces a third perspective on governance mode decisions. It suggests that firms imitate the behavior of competitors in order to legitimize their own action. The theoretical contribution therefore has several facets, and the three streams of literature are useful in explaining the governance mode decision in offshoring. The discussion on the sustainability of client-service provider relationships shifts the focus to the literature on agency theory, to the literature on interest alignments with cost centers (Jensen & Meckling, 1995, 1999), and the literature on the sustainability of contractual relationships (Levinthal & Fichman, 1988).

The major findings of this dissertation can be summarized as follows:

- *The governance mode decision can be explained from different theoretical angles:* The main contribution of the statistical model is the finding that the governance mode decision has three components: a transactional and an isomorphic component, as well as one based on dynamic capabilities. Using several perspectives to describe an offshoring phenomenon has, for instance, been suggested by Volberda, van den Bosch, & Roza (2007). The transactional component looks at the specificity of the task involved, as well as the uncertainties surrounding the transaction. My findings support the notion that asset-specific functions and functions dealing with the risk of knowledge leaking are associated with a higher likelihood of selecting captive governance modes. This finding is in line with the theoretical prediction. Further, I successfully apply trade flows as an alternative measure for distance and find that the proximity between countries is a way to reduce uncertainties. The dynamic capabilities perspective focuses on the firm and its need to develop capabilities. I find that the drivers in offshoring are also a good predictor of the governance mode. In particular, the cost savings driver is associated with a higher likelihood of selecting third party governance modes, while the driver for global restructuring is a good predictor for captive governance modes. Finally, the findings based on organizational isomorphism show that there is a strong component to the legitimation of action. Firms are likely to replicate offshoring strategies and the governance modes of their competitors.
 - *The governance mode decision follows an alternating pattern:* When I look at subsequent governance modes, I observe that the significance of the three theoretical pillars is shifting. In particular, for subsequent governance modes, I find that companies replicate previous governance modes. This happens independently from the decision about what is offshored and where it is offshored. While this finding of inertia is very strong, it raises the question of performance implications. I suggest that further research should focus on this issue. Building on the insights from the descriptive statistics, I observe that offshoring companies were forced to build captive centers because third party service providers were not available in earlier days. As supply increased over time, firms were able to benefit from third party governance modes. Given that services can be delivered by service providers, firms are today initially more likely to offshore using third party governance modes. Most likely, the reasons
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include the lower financial commitment and lower risks. However, over time the likelihood to select either mode is about equal. At some point, companies therefore overcome the inertia described above. The establishment of captive governance modes is particularly important when offshoring complex functions, when interdependencies have to be mitigated, and when a higher level of control is required. This is likely to happen when companies have learned to deal with general offshoring risks and they want to reduce further risks with integration. In the long run we are also likely to observe that operations are optimized and companies have found effective ways to extract and protect knowledge. From then on tasks can be flexibly assigned using both governance modes. This is supported by the observation that companies with both governance modes achieve the highest overall savings.

- *Measuring risk in a survey may be biased:* A methodological contribution of this dissertation concerns the measurement of risk. In the sample, I look at companies actively offshoring, considering offshoring, as well as not offshoring at all. When analyzing the population in one sample, we have to make an adaptation to the analysis if risk can be reduced through integration. If risk can be reduced through integration (such as the risk of knowledge leaking), a respondent who is still evaluating the governance modes is likely to report the risk as it is regarded at this point. However, when asking a respondent who is already offshoring, we have to assume that the company has integrated (or disintegrated) the risks and we should therefore observe the predicted relationships in an inverted manner.
 - *Third party providers perform on average better, however, only on average:* In offshoring, it is very difficult to measure whether performance and success is dependent on satisfaction and the fulfillment of negotiated service level agreements. Nevertheless, I tested this variable, which is commonly used in the applied literature (Celner, 2006; Farrell, 2004). While third party governance modes report higher savings on average, the best captive centers perform better than the best third party service providers. The reason most likely relates to the fact that service providers reduce the saving potential by asking for a margin on their services delivered.
 - *The right governance mode has to consider many facets:* Combining the perspectives reveals that the decision on the governance mode is very individual. In a first stage, firms have to analyze the function involved and
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evaluate the specificity of this function. In the case where the function is asset specific, the knowledge leaking potential has to be evaluated. If critical knowledge cannot be decoupled from the function, a captive governance mode is necessary. If the risk of knowledge leaking is not substantial or can be decoupled, other risk factors need to be taken into consideration. Important is the question whether the risk can be reduced through integration or not. If risks can be reduced through integration (as this is the case with operational risks), companies should prefer captive governance modes. If the risks cannot be reduced with integration (such as economic risks), the governance mode selection depends on the contract negotiation with the partner and the ability of the provider to mitigate the risks. The risks related to distance are critical and difficult to mitigate. It is essential that they be carefully addressed and sufficient resources designated. Companies thus need to find a balance between integrating the offshore employees in the firm, while still benefiting from the cost saving potential. If distance is very high, my findings show that the selection of a third party mode is more likely. If the function or the risks involved do not suggest a clear prediction on the governance mode, internal capabilities should be considered. First, it is not possible to offshore processes that already cause problems at home. Both the interviews and the studies from the consulting companies stress this issue. Given this caveat, it should be evaluated whether the service provider can achieve scales and has superior capabilities in delivering the service. Companies should therefore determine who can deliver the service more efficiently in relative terms. Finally, if cost savings are the main reason for offshoring, firms are more likely to achieve their goal with outsourcing (unless the captive center is performing well above average). If a company wants to use offshoring in the context of global restructurings, the captive model is closer to the current situation, allows for internal flexibility, and protects knowledge and capabilities.

- *Different providers fulfill different needs:* If the decision falls on a third party governance mode, companies face the question of which provider to select and how to align interests. I observe that large companies are more likely to select large providers, while small providers are more likely to select small providers. However, there is also a functional component to the decision. Product development functions are more likely to be outsourced to small and specialized providers. Lewin (2008) raises a second aspect to the size
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discussion. Large providers (which are frequently active on a global scale) have very elaborate, but also very standardized, processes in offshoring. Firms “who want to be taken by the hand” (*ibid.*) are therefore more likely to transfer services to large service providers. *Long-term client-service provider relationships require governance mechanisms to align interests*: My findings show that client-service provider relationships are long lasting and contracts are rarely terminated. In order to be successful over time and in order to keep control over interdependencies, clients need to establish governance mechanisms to align interests. While contracting is a necessary instrument for reaching agreement on service levels and decreases the likelihood of contract termination, mutual investments and the direct involvement of the client is an effective means to align interests in the long run. Effective interest alignment is subsequently reflected in the longevity of the client-service provider relationships. As Poppo *et al.* (2002) argue, long-term relationships are a form of asset specificity. While this may lead to interdependencies, it may also lead to comparative advantages.

Offshoring is developing into an important and promising field in international business research (Lewin, 2005). While existing research has focused on the advantages and disadvantages of offshoring in general, on the location choice, or (macro-) economic implications, it is necessary to gain a better understanding of operational issues. Using large sample surveys at this level of analysis is rare. However, it complements the case studies with the external validity that is necessary for a better understanding of the field. Together with the location choice and the decision of what to offshore, the governance mode decision is a core strategic decision. A better understanding of the antecedents and consequences helps to provide a better theoretical understanding and is of high practical relevance for the companies.

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9. Appendix

9.1 Research on the Cross-Cultural Impact on Vertical Integration

(see next page)

Table 9.1: The Cross-Cultural Component in the Market Entry Mode Literature

	Cultural Distance (CD)	Vertical integration	Direction CD	Methodology	Sample Size	Country
Agarwal & Ramaswami (1992)	n/a	- Export - Licensing - Joint Venture (JV) - Wholly owned (WO)	n/a	Survey	285	US
Agarwal (1994)	- Absolute difference between standardized index of each of the value dimensions of Hofstede	- JV - WO	negative	Secondary data	148	US
Aulakh & Kotabe (1997)		- channel integration		Survey	108	US
Brouthers & Brouthers (2001)	- Aggregate cultural distance as the square root of the sum of the square of the distance of each of the four cultural attributes of Hofstede (acc. to Morosini, Shane, & Singh, 1988)	- JV - WO	negative, but positive in relation to risk	Survey	231	EU
Brouthers (2002)	Cultural context variables: - Market potential of the target Market (MP) - Investment risk: Need for location-specific knowledge and Need to minimise resource commitment (IR)	- Export - Licensing - JV - WO	negative, w/ IR being (-) and MP (+)	Survey	178	EU
Delios & Beamish (1999)	n/a	- percentage ownership of the Japanese parent(s) in the foreign investment	n/a	Secondary data	2594	Japan
Chang & Rosenzweig (2001)	- Composite index acc. to Morosini <i>et al.</i> (1988)	- Acquisition or JV - greenfield	negative	Secondary data	816	EU & Japan
Tihanyi, Griffith, & Russell (2005)	- Estimate average correlations among variables weighted by sample size of the studies involved	- Amount of capital invested - Equity position - Level of control	negative (not sign.), strongly negative for US MNCs	Meta-analysis	24,152	Global

Source: Own table, papers partly selected based on Zhao, Luo, & Suh (2004)

9.2 Overview of the Literature in Offshoring

Table 9.2: Overview of the Offshoring Literature

General topic	References (Examples)	Outlet/Type	Focus of Study (Methodology)
Global Trends and Drivers of Offshoring			
Macroeconomic perspective of offshoring	(Antràs & Helpman, 2004; Blinder, 2006; Levy, 2005; Markusen, 2005)	Academic	Trends in international trade of services, comparative advantage of locations (economic modeling)
Institutional perspective	(Kshetri, 2007)	Academic	Effects of institutional settings on offshoring decisions (conceptual)
Microeconomic perspective of offshoring	(Bajpaj, Arora, & Khurana, 2004; Deloitte, 2005; Lewin & Couto, 2007; UNCTAD, 2005)	Consulting, Practitioner-oriented	Offshoring trends, drivers, risks, location choices, savings, <i>etc.</i> (company surveys; FDI statistics)
Cost savings and technical drivers of offshoring	(Abramowsky & Griffith, 2006; Ernst, 2002; MacDuffie, 2007)	Academic	Role of IT, modularization and standardization and digitalization of processes (conceptual)
Global race for talent	(Florida, 2005; Frymire, 2006; Hansen, 2006; Lewin & Peeters, 2006)	Books, Press	Prediction of a global race for talent in a globalizing economy (references to recent surveys)
National and Cross-National Research on Offshoring			
Domestic job impact of offshoring	(Amiti & Wei, 2004; Farrell, 2004, 2005; Farrell <i>et al.</i> , 2006; Harrison & McMillan, 2006)	Academic	Prediction of job gains vs. losses as a result of offshoring: distinction between low-/high-skilled jobs (FDI, Employment Statistics)
Domestic vs. offshore talent pool (in particular science & engineering)	(Cervantes, 2004; Dossani & Kenney, 2006; Farrell <i>et al.</i> , 2006; Freeman, 2006; Kuptsch & Pang, 2005; Lewin & Couto, 2007; Lowell & Salzman, 2007; Martin, 2005)	Books; Business Press and Academic	Talent supply in the US, Europe and emerging economies, role of education and migration policies and institutions (Mostly based on annual statistics)
Other impacts on domestic economy	(Engardio <i>et al.</i> , 2003; Garner, 2004; Lieberman, 2004; Mankiw & Swagel, 2006; Olsen, 2006)	Policy-oriented reports	Impact of service offshoring on prices, productivity, exports, wages (FDI, Annual statistics)
Impact on Developing Economies	(Patibandla & Petersen, 2002; Reddy, 1997)	Policy-oriented; Academic	Role of investors in promoting economic development offshore (surveys, primary focus: India)
Role of Innovation Systems and Clusters in Emerging Economies	(Carlsson, 2006; Ernst, 2002; Intarakumnerd, Chairatana, & Tangchitpiboon, 2002; Manning, 2007; Zhou & Leydesdorff, 2006)	Academic	Interdependence of innovation systems, clusters and global economy/MNCs (conceptual, partly based on surveys)

Offshoring Strategy and Organizational Issues			
The emergence of the offshoring strategy and offshoring trajectories; development of offshoring strategies (Core and non-core activities)	(Angeli & Grimaldi, 2007; Dossani & Kenney, 2006; Holcomb & Hitt, 2007; Jensen & Pedersen, 2007; Leiblein, 2003; Leiblein & Miller, 2003; Lewin & Peeters, 2006; Maskell, Pedersen, Petersen, & Dick-Nielsen, 2007; Subramaniam & Venkatraman, 2001; Vivek <i>et al.</i> , 2008)	Academic	Stages of offshoring (conceptual, empirical and case studies) and the development of offshoring capabilities
Offshoring decisions and strategies	(Bunyaratavej <i>et al.</i> , 2007; Farrell <i>et al.</i> , 2006; Lewin & Couto, 2007; Pyndt & Pedersen, 2006)	Academic	Drivers of offshoring, choice of location, role of experience, demand for talent (survey-based and case-study-based)
Implications for organizational structure and governance mode decisions	(Aron & Singh, 2005; Leiblein & Miller, 2003; Leiblein <i>et al.</i> , 2002)	Academic, Practitioner-oriented	Implications of offshoring for organizational structure and generic discussion on governance mode decisions (conceptual)
Strategy Development and Managerial Issues			
HRM strategy	(StepStone, 2006)	Consulting	Recruitment, retainment and HR development strategies and challenges
Role of managers in offshore operations	(Levina, 2007; Manning, Sydow, & Windeler, 2007)	Academic	Managers as boundary spanners and embedding agents (case studies)
Managing the client-service provider relationship	(Gainey & Klaas, 2003)	Academic	Incentive alignment between clients and service providers (conceptual and empirical)
Innovation/R&D capability	(Manning <i>et al.</i> , 2007; Subramaniam & Venkatraman, 2001)	Academic	Building offshore innovation capabilities; knowledge transfer (primarily case studies)
Functional Level			
Engineering/R&D	(Helper & Khambete, 2005; Maskell <i>et al.</i> , 2007; Patel & Vega, 1999; Reddy, 1997)	Academic	Drivers of offshoring R&D (conceptual; survey-based)
Financial Services	(Krishnaswamy & Pashley, 2007; Lowes <i>et al.</i> , 2004)	Consulting, Academic	Drivers and risks of offshoring financial services (survey-based)
Call Centers	(Ren & Zhoo, 2007)	Academic	Performance, service quality of call center offshoring
BPO	(Kshetri, 2007; Mehta, Armenakis, Mehta, & Irani, 2006)	Academic	Antecedents, constraints and risks of BPO (empirical, conceptual)

ITO	(Erber & Sayed-Ahmed, 2005; Gu & Tse, 2007; Henley, 2006; McFarlan & Nolan, 1995)	Business Press; Academic	Drivers of IT offshoring and outsourcing (survey-based, mostly focused on India)
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Source: Largely based on Manning *et al.* (2008), modified and extended by author

9.3 Correlation Matrix

Table 9.3: Descriptive Statistics and the Correlation Matrix of Cross-Cultural Model

Correlation table for cross-cultural model		CAP	SIZE	UK	GER	SP	NET	ODIST	PDIST
	Mean (STD)								
Captive (CAP)	0.403 (0.491)	1.000							
Size (SIZE)	0.557 (0.346)	0.135***	1.000						
UK	0.139 (346)	-0.138***	-0.265***	1.000					
GER	0.168 (0.374)	0.272***	0.227***	-	1.000				
SP	0.087 (0.282)	-0.074*	0.001	-	-	1.000			
NET	0.081 (0.273)	-0.015	-0.153***	-	-	-	1.000		
Objective Distance (ODIST)	-2.997 (8.205)	-0.243***	0.162***	0.030	-0.247***	-0.012	-0.344***	1.000	
Psychic Distance (PDIST)	6.436 (3.766)	-0.185***	0.183***	-0.009	-0.079*	0.139***	0.065	0.140	1.000

* p<0.1, **p<0.05, ***p<0.01, N=437

Source: Own table

Table 9.4: Correlation Matrix Initial Governance Mode Decisions

Correlation table for initial governance mode decisions		CAP	SIZE	PD	PDIST	ODIST	KP	ECP	GROWTH
Captive (CAP)		1.00							
Size (SIZE)		0.100**	1.00						
Product Development (PD)		0.126***	-0.138***	1.00					
Psychic Distance (PDIST)		-0.185***	0.184***	0.018	1.00				
Objective Distance (ODIST)		0.197***	-0.181***	-0.074*	-0.134***	1.00			
Knowledge Protection (KP)		0.228***	0.001	0.022	-0.105*	0.068	1.00		
External Captive Probability (ECP)		0.469***	-0.117*	0.267***	-0.078	0.326***	0.056	1.00	
Growth Driver (GROWTH)		0.211***	0.006	0.181**	-0.032	0.108*	0.107*	0.221***	1.00

Source: Own table

Table 9.5: Correlation Matrix Subsequent Governance Mode Decisions

	CAP	SIZE	PD	PDIST	ODIST	ECP	KP	ER	OR	ICE
CAP	1.00									
SIZE	0.095*	1.00								
PD	0.103**	-0.0117**	1.00							
PDIST	-0.134**	0.244***	-0.090	1.00						
ODIST	-0.007	-0.225***	-0.032	0.025	1.00					
ECP	0.344***	0.028	0.286***	0.010	0.179***	1.00				
KP	-0.0209***	-0.115	0.0242***	0.403***	0.250***	-0.009	1.00			
ER	0.067	0.283***	0.249***	0.311***	-0.101	0.043	0.422***	1.00		
OR	-0.148**	0.082	0.210***	0.469***	0.132*	-0.123*	0.6712***	0.501***	1.00	
ICP	0.662***	0.036	0.066	-0.085	-0.066	0.338	-0.262***	0.083	-0.206	1.00

Source: Own table

Captive (CAP)
 Size (SIZE)
 Product Development (PD)
 Psychic Distance (PDIST)
 Objective Distance (ODIST)
 External Captive Probability (ECP)
 Knowledge Protection (KP)
 Economic Risks (ER)
 Offshoring Risks (OR)
 Internal Captive Probability (ICP)

Table 9.6: Correlation Matrix Regression Model Client-service Provider Relationships

Correlation matrix	DEALT	EXP	INDIA	PD	INV	CONTSP	CLNTINV
Deal termination (DEALT)	1.000						
Experience (EXP)	-0.107 (0.225)	1.000					
INDIA	-0.063 (0.449)	-0.011	1.000				
Product Development	0.251*** (0.003)	-0.080	-0.169**	1.000			
Investments (INV)	-0.208***	-0.162*	-0.006	0.198	1.000		
Contract Specification (CONTSP)	-0.286***	0.024	0.069	-0.031	0.164**	1.000	
Client involvement (CLNTINV)	-0.100	0.013	0.092	0.274**	0.256***	0.288***	1.000
N= 118							
*p<0.1 **p<0.05 ***p<0.01							

Source : Own table

9.4 Questions of the Corporate Survey

[Where questions refer to perceptions, attitudes or other subjective determinants, questions were asked using a five point Likert scale. Closed questions were asked using a binary scale (e.g., yes/no).]

- 1) Is your company/business unit currently offshoring any of its business functions?
- 2) Which of the following functions have you offshored? (Finance/Accounting, Human Resources, Marketing and Sales, Information Technology, Call Center/Help Desk, Procurement, Legal Services, Engineering Services, Research and Development, Product Design, Other)
- 3) In which country or countries did you offshore each function?
- 4) Why did you choose these specific regions for each implementation? (Low cost of labor, Low costs [besides labor costs], Cultural proximity, Geographic proximity, Co-locating with existing manufacturing plant offshore, Co-locating with existing business processes facility offshore, Matches language requirements, High level of expertise, Government incentives [e.g. tax breaks] in

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- host country, Quality of infrastructure, Location of the best service provider, Talent pool available, Avoiding problems of offshoring “hot spots” [wage inflation, turnover, real estate cost...], Access to local market, Supporting existing customers locally, Political stability in host country, Other)
- 5) In connection with Y2K, did you offshore some programming or code updating work in order to take advantage of the supply of low cost qualified programmers?
 - 6) Did you use shared services (consolidated operating business units on-site or outsourced to perform certain standardized services) before initiating offshoring?
 - 7) Which service delivery model did you use for each implementation?
 - 8) For each implementation, what particular tasks are offshored?
 - 9) For each function, please evaluate the importance of the following risks in your decision to offshore. (Lack of acceptance from internal clients, Lack of acceptance from customers, Loss of managerial control, Loss of internal capabilities / process knowledge, Lack of buy-in to offshoring in corporate culture, Cultural differences with employees in offshore location, Concerns about data security, Concerns about service quality, Concerns about operational efficiency, High employee turnover in offshore service center, Wage inflation in offshore location, Incompatibility / differences between IT systems, Lack of intellectual property protection, Legal / contractual risks, Political backlash at home, Concerns about industrial relations / trade unions at home, Political instability in offshore location)
 - 10) For each function, please evaluate the importance of the following strategic drivers in your decision to offshore. (Enhancing efficiency through business process redesign, Labor cost savings, Other cost savings, Growth strategy, Enhancing system redundancy, Access to qualified personnel, Improved service levels, Competitive pressure, Accepted industry practice, Access to new markets for products and services, Part of a larger global strategy, Increasing speed to market, Differentiation strategy)
 - 11) To the best of your knowledge, what is the percentage of savings (off baseline costs) you have actually achieved?
 - 12) How long did it take to achieve expected savings?
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- 13) What is the approximate percentage of savings you have used for the following purposes? (used to finance business growth, reinvested at home, reinvested offshore, returned to shareholders through stock buy-back or dividends, passed on to customers in lower prices, used to retire debt, used for other purposes)
 - 14) What is the approximate date when you first launched the offshoring pilot for each implementation?
 - 15) For each implementation, what are your plans for the next 18-36 months?
 - 16) In each of the following functions, do you plan to launch a new implementation offshore in the next 18-36 months?
 - 17) For each implementation, what has been the net effect of offshoring on the number of jobs
 - 18) For each implementation, about how long did it take for operational service levels to reach targeted levels after implementation?
 - 19) Did you offshore the manufacturing of goods before offshoring administrative and technical work?

9.5 Questions of the Service Provider Survey

- 1) Which of the following classes of outsourcing/offshoring services does your company provide?
 - 2) For each class of services that your company provides, which particular functions or processes does your company provide?
 - 3) For each class of services that your company provides, from what country are the services provided?
 - 4) For each class of services that your company provides, are subcontractors involved in providing these services on a regular basis?
 - 5) For each class of services that your company provides, are subcontractors involved in providing these services on a regular basis?
 - 6) Which types of service delivery models do you use?
 - 7) In your opinion, for each class of services that your company provides, how important is each of the strategic drivers listed below in a client's decision to outsource these functions (to any provider)?
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- 8) In your opinion, to what extent are the following factors important in order for a client to select YOUR company as a service provider?
 - 9) For each class of services that your company provides, please estimate as best you can the percentage of savings (off baseline costs) that your clients actually achieve when outsourcing these particular services?
 - 10) For each class of services that your company provides, what is the actual achieved margin on deals (once deals have been implemented)?
 - 11) For each class of services that your company provides, how long does it take, on average, to achieve target service levels?
 - 12) In your opinion, for each class of services that your company provides, how commoditized* has this service become? (Highly commoditized services are services in which expertise is widely shared in the industry and differences in quality are minimal. Clients choose a provider primarily based on costs)
 - 13) For each class of services that your company provides, what is the average duration of deals currently under contract with your company?
 - 14) For each class of services that your company provides, how do you expect the average duration of deals to change in the next 18 to 36 months?
 - 15) For each class of services that your company provides, how do you expect the average size of deals to change in the next 18 to 36 months?
 - 16) For each class of services that your company provides, looking solely at the first contract with each client, please indicate:
 - 17) Percentage of deals that are renewed at expiration of the first contract
 - 18) Percentage of deals that are re-bid at expiration of the first contract
 - 19) Percentage of deals that are re-contracted with additional services prior to expiration of the first contract
 - 20) Percentage of deals that are terminated at expiration of the first contract
 - 21) Percentage of deals that are terminated before expiration of the first contract
 - 22) Based on the experience in your company, how important are the following reasons for the termination of contracts? (Cost savings are not achieved, Service quality is not achieved, Disagreement on other contractual specifications, Disagreement on non-contractual issues, Substitution with
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- another contract, Responsible manager at client company has changed position or has retired, Change in target operating model, Competitor entices customer away, Client establishes captive center for this work, Client consolidates offshoring activities at different locations, Conflicts due to unanticipated work, Service no longer needed, Other reasons that you consider to be important)
- 23) What proportion of contracts are terminated at the initiative of your company?
- 24) Which of the following details are specified in your company's contracts?
- 25) How many clients have entered into a corporate-wide master service (or framework) agreement with your company?
- 26) We are interested in the longevity of your customer relationships. Looking at your company's entire roster of clients, please indicate the percentage of your clients that you have partnered with by length of time as shown below. (<1 year client relationships, 2-4 years client relationships, 5-6 years client relationships, 7-9 years client relationships, >10 years client relationships)
- 27) What strategies, if any, has your company developed to nurture and reinforce long-term client relationships? (For example: assign senior executive to cultivate relationship with key individuals on client side, create custom software, etc.)
- 28) For each class of services that your company provides, how would you rate the following characteristics to describe the work involved? (Complexity of tasks, Standardization of tasks, Contractual specification of tasks, Client-specific knowledge needed to perform tasks, Involvement of client in performing tasks, Interdependency with processes in client organization, Collaborative technologies used in performing tasks, Access to client's software and tools needed to perform tasks, Access to client databases needed to perform tasks, Frequency of disagreement with client in performing tasks,
- 29) For each class of services that your company provides, to what extent does your company have to make client-specific investments that cannot be used for other clients? (Investments in software, Investments in infrastructure, Investments in training)
- 30) For each class of services that your company provides, how extensive are the company training processes? (Initial training needed to be able to perform tasks, Recurring annual training needed to perform tasks, Initial training needed
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- to serve new clients, To what extent are clients involved in delivering initial training?, To what extent are clients involved in delivering recurrent training?)
- 31) For each class of services that your company provides, please indicate the percentage of the workforce recruited from the following sources. (Directly from universities/technical schools, From competitors, Transferred from clients, From head hunters/agencies, Industry hires, Other)
 - 32) Please indicate what percentage of your workforce holds the following degrees, indicating only the highest degree attained. (High School Diploma, Bachelor, Master, PhD, Other Certification, No certification)
 - 33) For each type of university degree, what percentage of your company's employees graduated from the best universities (top 10 percent)?
 - 34) Please indicate how long it takes your company to staff job vacancies based on the type of educational qualification required.
 - 35) How important are the following challenges in attracting and retaining talent? (Availability of talent, Availability of talent with managerial skills, Competition from other providers, Competition from multinational captive centers, Competition from local companies,
 - 36) Providing challenging work, Financial compensation, Non-financial benefits, Ability to guarantee convenient working hours, Demonstrate career paths, Establish and maintain identity with company, Prestige of working for company, Job security concerns for staff, Attitudes towards women in the workforce)
 - 37) For each class of services that your company provides, what is the average tenure of the staff?
 - 38) For each class of services that your company provides, what is the average work experience of the staff?
 - 39) Research shows that provider companies often overstaff to compensate for high attrition in the offshoring business. For this and other reasons, the overall workforce is typically not totally billed out to client work. For each class of services that your company provides, what is the average workforce utilization rate – that is, the percentage of billable working hours in relation to total working hours?
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- 40) What is your company's expected average increase in compensation for next year?
 - 41) What was your company's average rate of attrition/turnover last year?
 - 42) Given your company's experience, please indicate how important the following risks are. (Penalties in contract, Transparency of charges, Initial capital expenditures, Employee turnover, Fluctuation of demand, Satisfying cost expectations, Satisfying quality expectations, Cost pressure, Currency fluctuation on dollar denominated contracts, Cultural conflicts with clients, Competitors poaching clients, Potential dispute resolution, Client inability to manage, Client capability, Evolution to full technology enabled services)
 - 43) In your opinion, how important are the factors below in explaining why outsourcing deals are dissolved? (Inability to deliver services, Poor Planning in work transfer, Clients' expectations are unrealistic, Client has no clear outsourcing strategy, Lack of change management, Too many change orders, Inability to manage client relationship, Client lacked skills / resources to implement and manage relationship, Scope of project, Too many contracts under a master agreement, Poorly negotiated contract, Client has no prior experience with shared services, Domain knowledge did not match the task, Poor deal structure, Inappropriate pricing structure, No engagement of an outsourcing advisor, High employee turnover, Poor procurement process)
 - 44) For each class of services that your company provides, what are your company's plans for the next 18 to 36 months?
 - 45) For each class of services that your company provides, does your company expect to grow organically, through acquisitions, or through a combination of both?
 - 46) In the next 18 to 36 months, what new classes of services is your company planning to offer and from which locations (country/city) will the company provide the new service?
 - 47) In which areas of expertise is your company planning to invest over the next 18 to 36 months? (For example: encryption, network security, business process reengineering *etc.*)
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- 48) For each class of services that your company provides, what is your estimate of the change in demand that your company will experience in the next 18 to 36 months?
 - 49) In your opinion, which top three industries will experience the highest growth in demand for offshoring services in the next 18 to 36 months?
 - 50) For each class of services that your company provides, which location (region or country) will experience the highest growth rate in providing offshoring services in the next 18 to 36 months?
 - 51) Please indicate the number of clients that your company serves, broken out by size of client company. (Small companies (<\$100m Sales), Mid-cap companies (\$100m -\$ 2bn Sales), Large companies (> \$ 2bn Sales))
 - 52) Please indicate the total number of employees working in your company.
 - 53) Please indicate the number of years that your company has been in the outsourcing business
 - 54) Please indicate the total revenue of your company for the last fiscal year
 - 55) For each class of services that your company provides, please indicate the total number of staff employed in each service area.
 - 56) For each class of services that your company provides, please indicate the number of years that your company has been providing this service.
 - 57) Please indicate the total revenue of your company for your last fiscal year.
 - 58) For each class of services that your company provides, please indicate:
 - the proportion of total revenue that each service area accounts for
 - the growth rate for the past three years.
 - 59) Please list the top three industries served by your company, and give the percentage of revenue generated from serving each of these industries.
 - 60) Please list the countries in which your company's top five clients are based
 - 61) Please list your company's three most important competitors and explain the nature of the competitive threat. For example, a particular competitor may almost always be on the short list of bidders or have specialized capabilities that your company needs to build, *etc.*
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9.6 Interviews Conducted

Booz Allen Hamilton, Zurich: Dr. Jens Schaedler, Vice President. Interview conducted on Tuesday, 23 October 2007 at 3.00 pm in St. Gallen.

Bank A, Zurich: Interviewer A, Executive Director, Bank A Group Offshoring. Interview conducted on Friday, 14 December 2007 at 9.30 am in Zürich.

Bank B, Zurich: Interviewer B, Bank B Group. Interview conducted on Friday, 22 February 2008 at 10.00 am in Zürich.

Offshoring Research Network, Durham, NC: Prof. Arie Lewin, Director. Various informal discussions in 2007 and 2008.

Curriculum Vitae

15.10.1979 Born in Berne, Switzerland



Academic Positions

2008 Visiting Scholar, Marketing and Strategy Section, *Amsterdam Business School*, Amsterdam, the Netherlands

2007-2008 Visiting Scholar, Center of International Business Education and Research, *Duke University*, Durham, NC, USA

2004-2007 Research and Teaching Assistant, Research Institute for International Management, *University of St. Gallen*, St. Gallen, Switzerland

Education

2004-2009 Dr. oec. in International Management, *University of St. Gallen*, St. Gallen, Switzerland

1999-2004 Lic.rer.pol and MSc in Business and Economics, *University of Basel*, Basel, Switzerland

1998 Matura at the *Gymnasium Liestal*, Liestal, Switzerland

Professional Experience

2004 Internship, *Amrhein Treuhand AG*, Aarau, Switzerland

2003 Internship, *UBS Wealth Management & Business Banking*, London, UK

1999-2001 Part-time position, *UBS Asset Management*, Basel, Switzerland
