Offshore outsourcing and firm performance: Moderating effects of size, growth and slack resources

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ABSTRACT
This study explores the impact of foreign technology and professional services from outsourcing on firm financial performance. To this aim, we use a sample of 1710 Indian firms over a time period of 13 years, from 2001 to 2013. The empirical evidence obtained shows that the positive effects of technological knowledge and professional services on performance are moderated by firm size, business growth and slack resources. In particular, the benefits of outsourcing in terms of higher profitability are more pronounced for small than for large firms, especially when small firms have higher growth rates and financial slack. The work contributes to the resource based view and the internalization theory of the firm. Our results suggest that firms from an emerging country such as India may have alternative motives for offshore outsourcing different from the reasons of firms from advanced economies. Several managerial implications are also derived from our findings.

1. Introduction

Organizations are increasingly becoming leaner and more focused via outsourcing; i.e., locating certain specialized activities outside their boundaries. It helps the firm to become agile and in turn enhance its competitiveness (Gilley & Rasheed, 2000; Quinn, 1999). Anecdotal evidence highlights the prominent use of outsourcing by business organizations due to its positive impact on firm performance. For instance, an article published in Forbes reports that Apple corporation adds at least US$14 billion to its profit every year by outsourcing production into China (Chen, 2012). However, empirical research in this field is still evolving. Thus far, scholars have provided mixed results suggesting positive, negative or no relationship between outsourcing and performance. It seems that previous studies have not systematically captured the impact of outsourcing on firm performance and further investigation is warranted to bring some coherence (for details, see Ketokivi, 2016 and Lahiri, 2016).

Moreover, prior work has mainly focused on the outsourcing models of large Western multinational enterprises, which seek efficiency gains by relocating production to emerging economies, where the cost of production is lower (e.g., Guillén & García-Canal, 2009; Kang, Wu, Hong, & Park, 2012; Musteen, 2016). Meanwhile, less attention has been paid to outsourcing patterns of firms from emerging economies. Firms from such economies have higher needs and motivations for outsourcing because they are more likely to lack necessary resources compared to large Western multinational enterprises (Buckley, Munjal, Enderwick, & Forsans, 2016a; Ciravegna, Lopez, & Kundu, 2016; Ramamurti, 2012; Thite, Wilkinson, Rudhwar, & Mathews, 2016; Westhead, Wright, & Ucbasaran, 2001). Moreover, as a result of their continued expansion, the needs of emerging market firms for seeking specialized resources outside their boundaries are growing rapidly.

Previous studies (e.g., Buckley & Munjal, 2017; Chittoor, Aulakh, & Ray, 2015; Luo & Tung, 2007; Munjal, 2014a; Rabbiosi, Elia, & Bertoni, 2012) relate this growing need for specialized foreign resources with the increase in cross-border acquisitions. This strategy gives emerging market firms access to specialized resources tied with other firms. However, cross-border acquisitions are a complex and expensive mode of getting valuable foreign resources. In addition, it may not always be a viable alternative for the firm. In this context, we argue that firms can gain access to certain strategic resources through outsourcing. In particular, we focus on technological resources and professional services, such as marketing and managerial skills, because these are the typical resources and capabilities lacked by emerging market firms (Dunning, Kim, & Park, 2008; Luo & Tung, 2007; Munjal, 2014b; Ramamurti & Singh, 2010).

We draw on the resource based view (RBV) (Barney, 1996; Wernerfelt, 1984, 1995) and internalization theory (Buckley & Casson, 1976) to provide theoretical support for the relationships investigated...
in the study. The RBV is particularly apposite as it explains performance differences driven by heterogeneity in resources owned and controlled by the firm. Moreover, the modern perspective of the RBV suggests that ownership of resources is not a necessary requirement. By contrast, services of resources (for instance, through outsourcing, as postulated in our work) is a sufficient condition to generate differences in firm performance (Lavie, 2006). The use of the internalization theory, at the same time, offers the transaction cost rationale for a firm’s decision to outsource abroad.

For the empirical analyses, we use a sample of 1710 firms (13,875 firm-year observations) from India for a time span of 13 years, from 2001 to 2013. Our results show that outsourcing of technology and professional services from abroad has a positive direct impact on firm performance and that such positive impact is stronger in small firms. We also find that sales growth and slack resources positively moderate the outsourcing–performance relationship. The moderating effects of these two firm characteristics are also stronger for small enterprises.

Our research framework enables us to contribute to the RBV and internalization theory by bridging the gap between these two dominant theoretical explanations in the international business and strategy domains. We show that the relevance and implications of internalization differ among firms. Specifically, a firm’s country of origin and its size matter in its outsourcing decision. In particular, large multinational enterprises from Western countries face the risk of losing control of valuable resources, such as technological knowledge, when adopting an offshore outsourcing strategy. By contrast, small firms from emerging economies, given their lack of advanced specialized resources, do not face that challenge.

The rest of the study is organized as follows. The next section, Section 2, provides a succinct review of the related literature and develops the testable hypotheses. This is followed by a description of the data, empirical specifications and methods in Section 3. Next, Section 4 explains the results from the descriptive and regression analyses, and provides a discussion. Finally, Section 5 concludes by detailing the theoretical contributions of the work and offering managerial implications that can be derived from our findings.

2. Literature review and hypothesis development

Outsourcing means locating an activity outside the boundaries of the firm. This implies that the firm buys intermediate goods and services in the external market rather than internalizing such tasks within its own hierarchy. It is important to note that outsourcing is not limited to those activities that were previously conducted within the firm and are later shifted to external suppliers. As Gilley and Rasheed (2000) suggest in their seminal work, outsourcing can be of two types: (i) substitution-based outsourcing and (ii) abstention-based outsourcing. The former type includes “something that a firm has been doing but decides not to do anymore and let other entities do it” (p. 765). In contrast, abstention-based outsourcing arises when “a firm purchases goods or services from outside organizations even when those goods or services have not been completed in-house in the past” (p. 765). In both cases, outsourcing implies the key decision of rejecting the internalization of an activity.

Prior research suggests that firms undertake outsourcing as a way to attain efficiency because, in general, outsourcing allows the firm to lower transaction costs that arise from undertaking production internally (Ang & Straub, 1998; Buckley, 2011a). Buckley and Casson (1976) stress that firms constantly reallocate activities inside (or outside) their boundaries to continue enhancing their performance. These authors also indicate that the decision to internalize an activity depends on several factors, including the scale of production and the resources available to the firm. In line with its principles, the internalization theory suggests that managers should constantly compare internal agency costs with external transaction costs, and endeavor to reduce internal agency costs to increase the boundaries of the firm. This line of reasoning implies that managers are compelled to check firm resources, especially slack resources, all the time to make sure that they are put to work to improve firm performance.

While scholarly attention on the internalization theory has primarily focused on the analysis of current costs and revenues, we argue that its true application also warrants managerial consideration for the future prospects of the business. This rationale means that the analysis made by firms that operate in growing environments or that face growth opportunities should also include the possibility of expansion when they decide whether tasks should be internalized or outsourced.

The decision to internalize also depends on the location where activities are performed (Buckley, 2011a). Multinational enterprises in industrially advanced economies outsource certain activities to developing countries, such as manufacturing to China and software services to India, because this allows them to become more efficient by exploiting lower labor costs in these countries (e.g., Saxenian, 2002). However, outsourcing of specialized services and knowledge-intensive activities, such as research and development (R&D), are also gaining increasing importance (Buckley, Munjal, Enderwick, & Forsans, 2017; Duysters, Jacob, Lemmens, & Jintin, 2009; Stanko & Ollers, 2013). Getting access to specialized services and knowledge-intensive activities through outsourcing allow the firm to tap into knowledge and resources tied with other firms (Quinn, 1999). Very often such outsourcing is undertaken outside the home country because specialized knowledge required by the firm to achieve competitive advantages is spread across the globe (Papanastassiou & Pearce, 2009).

It can be argued that outsourcing may have a negative effect on the firm as it simultaneously leads to loss of control, leakages and spillovers of knowledge and resources to other firms (Bettis, Bradley, & Hamel, 1992; Stanko & Ollers, 2013). Moreover, outsourcing entails transaction costs derived from managing the relationship with an external partner, which are likely to be higher than the costs of organizing and controlling activities internally (Geis, 2007; Parida, Wincent, & Oghazi, 2016). The negative externalities of outsourcing are likely to be higher in the case of large and technology-intensive firms from advanced economies. Firms originating from developing countries are less prone to such disadvantages as these firms often lack specialized knowledge and resources. A strand of research that suggests that firms from emerging economies seek access to specialized services and knowledge-based resources abroad is growing in the international business literature (e.g., Buckley et al., 2016a). Accessing strategic resources through outsourcing can be seen as a strategy for catching up with global peers (Duysters et al., 2009) and leap for stages for building competitive advantages (Luo & Tung, 2007), which are required to improve firm performance.

Moreover, the drawbacks of outsourcing related with knowledge leakages, spillovers and managing costs are likely to be lower for smaller firms. These firms are more flexible, dynamic and entrepreneurial (Núñez-Pomar, Prado-Gascó, Áñó Sanz, Crespo Hervás, & Calabuig Moreno, 2016). It is likely that some specialized activities are lacking since inception and therefore small firms do not have any choice but to buy specialized services and rely on the knowledge obtained from other firms to conduct their key operations.

From a resource-based perspective, outsourcing means accessing specialized resources and capabilities from a vendor who caters to the firm. This strategy allows the firm to utilize the capabilities and resources of a specialized provider without having to own them (Mudambi & Talmor, 2010). This interpretation aligns with the modern perspective of the RBV, which suggests that the firm does not need to own resources because it is services themselves that matters and not the ownership of resources as such (Lavie, 2006). Outsourcing of activities to third parties allows the firm to gain access to more specialized services, given that the vendor firm is an expert in that function, while at the same time allowing the firm to concentrate on its core activities. As a result, the core competencies of the firm are enhanced and its performance improves (Quinn, 1992).
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