

# Transformational offshore outsourcing: Empirical evidence from alliances in China<sup>☆</sup>

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## Abstract

Adopting a transformational offshore outsourcing perspective, we examine empirically the relationship among the motive to acquire tacit knowledge from outsourcing partners, formal and social control mechanisms, and innovation outcomes among Sino-foreign as well as local alliances. We constructed our theoretical model incorporating knowledge management, social exchange, and alliance risk perspectives, and hypothesized that motives to acquire partners' tacit knowledge through offshore outsourcing will affect firm innovation via two forms of control, namely social control and formal control. Our empirical testing, utilizing two subsamples composed of Sino-foreign offshore outsourcing alliances and local outsourcing alliances, respectively, reveals that the motive to acquire outsourcing partner's tacit knowledge and different control mechanisms are significant predictors of incremental and radical innovation outcomes, and that there are some intriguing differences between the Sino-foreign alliances and local alliances.

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## 1. Introduction

For firms in developed countries, offshore outsourcing began as an effective means to reduce manufacturing and processing costs and to focus on core business activities. As these firms continue to

search ways to gain competitiveness, offshore outsourcing is gradually gaining significance as an important source of business renewal and corporate transformation (Kakabadse and Kakabadse, 2005; Khan and Fitzgerald, 2004; Linder, 2004). In recent years, multinational enterprises in sectors from telecommunications to electronics to aerospace to pharmaceuticals have turned their attention to outsourcing partners in other countries for new designs, product development, and more importantly for corporation transformation (Engardio and Einhorn, March 21, 2005).

Offshore outsourcing entails the transfer of parts of a Western firm's value chain activities to partners in emerging economies such as China and India for a period of time, usually at least a few years. The main forms of offshore outsourcing include technological cooperation, manufacturing agreements, and distribution services.

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Clearly offshore outsourcing utilizes a variety of inter-firm collaboration. Because of the greater need to collaborate closely with partner firms especially if such outsourcing relations become more central to a firm's overall position, inter-firm collaboration and strategic alliances have become a vital form of offshore outsourcing arrangement. As technological management became absorbed within the broader field of knowledge management, alliances for offshore outsourcing have been viewed from a knowledge management perspective (Grant and Baden-Fuller, 2004). Acquiring the partner's tacit knowledge through offshore outsourcing then becomes central to inter-firm collaboration. Transformational offshore outsourcing indeed relies on tacit knowledge acquisition to accomplish goals of strategic change, and corporate renewal (Linder, 2004). By acquiring and exploiting tacit knowledge developed by others, firms can speed capability development and minimize their exposure to technological uncertainties (Grant and Baden-Fuller, 1995). Following this perspective, innovation becomes a central outcome for firms pursuing transformational outsourcing. Comparing with this emerging trend, the research lags (Ramamurti, 2004). We have limited understanding how offshore outsourcing partners develop innovation, and furthermore, if the innovation generation dynamics in offshore outsourcing arrangements will exhibit the same pattern as those in domestic outsourcing arrangements. Conceptually a number of conflicting theoretical perspectives are available to inform scholars and managers effective management of offshore outsourcing. Empirically there is limited research in how offshore outsourcing facilitates innovation.

We therefore developed a theoretical model linking the motive to acquire tacit knowledge in inter-firm outsourcing cooperation, control mechanisms, and innovation outcomes based on knowledge management, social exchange theory and alliance risk perspective. Furthermore, we empirically tested our model using two sub-samples, with data collected in China, of Sino-foreign offshore outsourcing alliance, and local firm outsourcing alliances. Thus, through this study we examined inter-firm outsourcing collaborations with a central focus on innovation outcome, and with a unique setting of China. Compared with their Western counterparts, most Chinese firms possess relatively limited resources and capabilities but are actively working to catch up (Mathews, 2002). Further, considering China's increasing importance in global economies and significant growth of firm's new product development in this country (Li and Atuahene-Gima, 2001), a focus on these firms can help Western competitors better

understand the innovation choices of these firms, and hence they can be better prepared to compete and collaborate with these firms. From a conceptual perspective, our theoretical model building integrates seemingly conflicting theories to explore factors contributing to innovation in inter-firm outsourcing alliances.

We first review the relevant theory and the context specific situation of China's transitional economy. We rely on the social exchange theory and alliance risk perspective to provide an overview of the research framework. Utilizing this framework we develop hypotheses concerning the effects of tacit knowledge acquisition motive in outsourcing alliances and control mechanisms on incremental and radical innovations. Following that, we describe the research methodology, and report the analysis and results. We conclude by discussing the study results and implications.

## 2. Theoretic background

Traditionally, companies pursuing offshore outsourcing had two important motives. By migrating *peripheral* business processes and value chain activities to outsourcing partners in other (especially in emerging economy) countries, the outsourcing originator may be able to derive cost advantage, and also to focus on areas of core competences (Kakabadse and Kakabadse, 2005). Recent thinking in transformational outsourcing and business practices in outsourcing innovation however point out an even more important benefit of offshore outsourcing. The central theme of transformational offshore outsourcing relates to relocating *core* business processes and value chain activities to partners in other countries and coordinating those outsourced activities tightly with the originator's strategic moves in order to realize strategic renewal and corporation transformation (Engardio and Einhorn, March 21, 2005; Farrell, 2005; Linder, 2004)! Researchers identify a number of important benefits associated with transformational offshore outsourcing.

Those multinationals focusing on transformational offshore outsourcing will be able to tap into new suppliers as more cost effective technologies become available. With transformation in mind, offshore outsourcing would allow for quick responses to changes in the environment (Dess et al., 1995), without the attendant increase in bureaucratic costs associated with internal organizations (D'Aveni and Ravenscraft, 1994). In addition, utilizing, and integrating innovations from outsourcing partners will enable these firms to multiply and amplify their innovation outcomes. As

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