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# The influence of competition on international sourcing strategies in the service sector

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ABSTRACT

Rising importance of service industries and international trade in services led to increased competition in the service sector. The aim of this study is to analyze the international sourcing behavior of service firms as a strategic means to contend with competition. Our theoretical predictions suggest that there is a U-shaped relationship between a service firm's domestic competitive position and its pursuit of international sourcing: the relationship is first negative and at later stages positive. The international sourcing behavior of domestic competitors and inward investments of foreign rivals are expected to positively affect a service firm's international sourcing magnitude. A large-scale empirical analysis using a panel of 579 German service firms supports our hypotheses.



## 1. Introduction

The service sector has long been recognized as an energizing force in the global economy and determinant of national living standards (e.g., Riddle, 1986). Since the 1980s, a growing proportion of world trade is attributed to commercial services trade (WTO, 2013). For service firms, the strong and growing internationalization tendencies not only offer business opportunities in new geographic markets but also hold significant challenges related to fiercer competition. Previous research largely focuses on international market entry strategies for service firms to exploit foreign business opportunities and expand sales volumes (e.g., Brouthers & Brouthers, 2003; Ekeledo & Sivakumar, 1998; Swoboda, Elsner, & Morschett, 2014). Despite rising scholarly attention toward the service sector, the question of how service firms cope with the increased competitive pressures associated with internationalization remains unanswered. This study addresses this gap and explores to which extent international sourcing strategies are used by service firms as a means to contend with competition. To approach this question, we develop hypotheses on the effects of domestic and foreign competitive forces on international sourcing behavior of service firms. We empirically test our theoretical predictions using a unique panel dataset of 579 German service firms.

Authors propose diverse strategic means to counter domestic and foreign competitors, such as pricing considerations (Simon, 2005), advertising (Thomas, 1999), or innovation activities (Arend, 2009). In addition, firms might lever on a global configuration of their value chains and engage in sourcing of inputs from foreign locations in order to increase their international competitiveness and mitigate the competitive threats they face in the domestic market (Dunning, 1998; Wiersema & Bowen, 2008). There is a considerable body of literature on how manufacturing firms internationalize their value chains and employ international sourcing strategies in response to increased competitive pressure (Swamidass, 1993; Cavusgil, Yaprak, & Yeoh, 2008). Several studies report that manufacturing firms adapt their international sourcing behavior and location decisions for certain value chain activities as strategic reaction to foreign inroads into their domestic markets (e.g., Moxon, 1975; Arpan, De La Torre, & Toyne, 1981; Hutzschenreuter & Gröne, 2009; Kaufmann & Körte, 2010). As a result of such reactions, manufacturing firms can experience positive effects on their profitability resulting either directly from international sourcing of intermediate inputs (e.g., Murray, Kotabe, & Wildt, 1995; Trent & Monczka, 2003) or indirectly from value chain internationalization (e.g., Farrell, 2005; Hutzschenreuter, Lewin, & Dresel, 2011). Hence, international sourcing is recognized as a strategy that positively affects a manufacturing firm's financial (e.g., return on sales) and strategic (e.g., market share) performance (Kotabe & Omura, 1989; Murray et al., 1995; Kotabe & Murray, 1996).

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Whereas research on service firms in general is constantly growing, studies dealing with the internationalization of service industries are rather scarce (Kundu & Merchant, 2008; Pla-Barber & Ghauri, 2012). Kundu and Lahiri (2015) state that research on service firms' internationalization has not kept pace with the unprecedented growth of services and multinational service firms over the years. Some notable exceptions study the international sourcing behavior of service firms (Jaklič, Ćirjaković, & Chidlow, 2012; Kotabe, Murray, & Javalgi, 1998; Murray & Kotabe, 1999). To what extent service firms employ international sourcing as a response strategy to increased competition, however, remains untold. In fact, Porter's long standing claim that "( . . . ) little is known about competition in services ( . . . )" (Porter, 1990, p. 240) still holds regarding the paucity of studies that relate foreign and domestic competitive forces to strategic response opportunities open to service firms in an international context.

The need for a distinct research agenda for service industry internationalization stems from the special characteristics of services. These characteristics include the facts that services are "non-physical", their production and consumption typically take place simultaneously, and that services are linked to close customer interaction. Additionally, services are difficult to standardize and therefore offer high variability in the quality of services offered to the customer, which poses particular challenges for output control and quality assurance in international service delivery (Zeithaml, Parasuraman, & Berry, 1985). There is a common understanding in the fields of marketing (e.g., Edgett & Parkinson, 1993) and international business (e.g., Boddewyn, Halbrich, & Perry 1986; Dunning, 1989) that these distinct service characteristics have important implications for the internationalization process of service firms (e.g., Hellman, 1996; Sanchez-Peinado, Pla-Barber, & Hébert, 2007), their international strategies (e.g., Campell & Verbeke, 1994; Lovelock, 1999), and performance implications (e.g., Capar & Kotabe, 2003; Contractor, Kundu, & Hsu, 2003). Because of these service features, it is questionable whether strategies to cope with increased (international) competition identified for manufacturing firms are equally valid in the service sector (e.g., Kotabe, 1989).

This paper aims to investigate how competition in the domestic market affects the international sourcing strategy of a service multinational enterprise (SMNE). We argue that an SMNE's international sourcing strategy is influenced by its competitive position in the domestic market (i.e., market share) and the respective market environment (i.e., international sourcing activities of domestic competitors), as well as the intensity of inroads by foreign competitors into that market (i.e., inward foreign direct investments). To the best of our knowledge, the effect of different domestic and foreign competitive forces on a service firm's decision to engage in international sourcing has not been investigated before. We predict a U-shaped relationship between a service firm's domestic market share and its reliance on international sourcing. The relationship is first negative and at later stages positive. International sourcing behavior of domestic competitors and inward investments of foreign rivals are expected to have a positive effect on a service firm's decision to source internationally.

Our study contributes to two streams of literature. First, the results add to the existing knowledge on internationalization strategies of service firms. Previous literature predominantly focuses on market-seeking motivations to internationalize (e.g., Brouthers & Brouthers, 2003; Swoboda et al., 2014). We show that service firms also internationalize their value chain at the upstream end in order to fend off competition in their home market. Second, we deliver novel insights for literature that deals with firms' global sourcing practices (e.g., Hutzschenreuter & Gröne, 2009; Wiersema & Bowen, 2008). Existing literature mostly draws on the manufacturing sector when analyzing outsourcing and/or offshoring decisions. The study illustrates that not just manufacturing firms use international input sourcing as a means to cope with competition. Rather, service firms are influenced by their rivals when deciding on international sourcing strategies, too. Before we develop and test our hypotheses, we deliver a brief review of the relevant literature on international sourcing in the service sector in the next section.

## 2. State of the field: literature on international sourcing in the service sector

Early studies on the internationalization of service firms are predominantly conceptual. A major goal of these studies is delivering a fresh view on the so far commonly assumed non-tradability of services across country boundaries (Rathmell, 1966; Zeithaml et al., 1985). A common feature of this early work on the internationalization of the service sector is the restriction on international marketing of services across national and cultural borders enabling service firms to exploit market opportunities abroad (Hellman, 1996; Roberts, 1999). Only very few conceptual articles consider international sourcing as strategy for service firms in their quest for exploring new sources of sustainable competitive advantage at the upstream end of the value chain. Those who do frequently differentiate between a firm's core service and supplementary elements accompanying their core service offering (e.g., Anderson & Narus, 1995; Lovelock, 1992). It is argued that global sourcing of value-adding supplementary services offers opportunities for differentiation and represents a vital strategic lever for obtaining a competitive advantage vis-à-vis international competitors (e.g.; Kotabe et al., 1998; Lovelock, 1999).

The studies of Kotabe et al. (1998) and Murray and Kotabe (1999) are among the first that adopt the perspective of a service firm as buyer rather than seller of services and offer empirical evidence for service firms' international sourcing practices for core as well as supplementary services. Guided by a modified global sourcing strategy framework originally developed for manufacturing firms, Murray and Kotabe (1999) find that the nature and structure of the service industry affect service firms' international sourcing strategies. When a service firm's competitive advantage in the home market decreases due to abundant supply of its core service, it may source supplementary services from abroad to stay competitive. Furthermore, availability of supplementary services on global markets positively affects the likelihood of foreign sourcing. Kotabe et al. (1998) show that the appropriate use of sourcing strategies for core and supplementary services can increase a service firm's market performance.

Much of the empirical research that has developed in the area of service sourcing during the last decades is focused on specific questions studied in particular geographical contexts rendering service sourcing research a highly fragmented field (Nordin & Agndal, 2008). More recent analyses aim to bridge the gap between traditional research on international sourcing pursued by manufacturing firms on the one hand and service firms on the other hand. For this purpose, the scope of the traditional "service"-notion is broadened and (similarities and) critical differences between both types of firms concerning the antecedents and consequences of service sourcing practices are dismantled.

In this vein, the traditional service core paradigm (i.e., the assertion that four specific characteristics – intangibility, heterogeneity, inseparability, and perishability – make services uniquely different from goods) has been largely abandoned in favor of a more activity-based perspective. In this view, the notion "service" represents a "perspective on value creation rather than a category of market offerings" (Edvardsson, Gustafsson, & Roos, 2005, p. 118). This further stresses the possibility of physical separation of