Abstract

In practice, offshore outsourcing has been gaining popularity, but scholars have not been widely interested in this topic. Most of the research done in this area has been centered on the activities of multinational enterprises (MNE’s) in the manufacturing sector, leaving somewhat behind small and medium enterprises (SME’s) and those firms in the services sector. Using a theoretical approach, the purpose of this paper is to question if SME’s and services firms could also benefit from offshore outsourcing given their particular characteristics, and to inquire about the possible tangencies and differences in the motivations that these firms might have to subcontract internationally in comparison to manufacturing MNE’s. Knowing what drives SME’s and services firms to do offshore outsourcing is important for the countries and foreign suppliers in order to adapt and expand their offerings to the needs of these firms. Propositions were established in an attempt to model the motivations.

Keywords: offshore outsourcing; SME’s; services firms

Introduction

Although offshore outsourcing is one of the most popular topics today (Hätönen & Eriksson, 2009), and also one that is experimenting an accelerated pace in practice (Doh, 2005), it has received little consideration among scholars (Hätönen & Eriksson, 2009 citing Ramamurti, 2004). Most of the studies related to offshore outsourcing have been in the context of MNE’s and rarely this topic has been addressed from the perspective of SME’s (Sinha, Akoorie, Ding & Wu, 2011 citing Doh, 2005; Di Gregorio et al., 2009; Kotabe, 1992; Scully & Fawcett, 1994) and services firms (Bandyopadhyay & Hall, 2009).

The case of SMEs finds almost no interest in the literature when it comes to this topic, perhaps because researchers have typically seen these firms as basically serving domestic markets and/or as users of locally available resources although scholars have recognized that SME’s also play important roles in the international arena (Mohiuddin, 2011). Liesch & Knigh (1999) have mentioned that different authors and journals (Bell, 1995; Craig & Douglas, 1996; The Economist, 1993) state the importance of these firms for their local economies in terms of export growth and employment, and George, Wiklund & Zahra (2005) have taken a quote from the Organization for Economic Co-operation and Development (OECD) that says: “SME’s account for between a quarter and two-fifths of worldwide manufactured exports (2002, p.13)” Similarly, the subcontracting of services internationally is a growing phenomenon, but little research exists in this area (Tate, Ellram, Bals & Hartmann, 2009). However, some scholars have started to pay attention to the offshore outsourcing of professional services (Sinha et al., 2011 citing Di Gregorio et al., 2009; Ellram, Tate &Billington, 2009), creating an interesting opportunity for research.

Using the theoretical framework of Hätönen & Eriksson (2009), the purpose of this paper is to question if SME’s and services firms could also benefit from offshore outsourcing given their particular characteristics, and to inquire about the possible tangencies and differences in the motivations that these firms might have to subcontract internationally in comparison to manufacturing MNE’s. Knowing what also drives SME’s and services firms to do offshore outsourcing is especially important for the countries and the foreign suppliers in order to adapt and expand their offerings to the particular needs of these firms. Propositions will be established in an attempt to model the possible motivations.

Profiling the Firms

MNE’s

A multinational enterprise is a firm that engages in foreign direct investment (FDI), and additionally, either owns or in some way controls value-added activities in more than one country (Dunning & Lundan, 2008). A distinctive feature of MNE’s is that besides exchanging goods and services across national boundaries, goods and services are transacted internally before or after carrying out a value-added activity owned or controlled in a foreign country (Dunning & Lundan, 2008). According to the authors, this means that MNE’s access, organize and coordinate multiple value-added activities across national boundaries making them the only institutions that engage in both cross-border production and transactions.
Typical MNE’s possess some degree of market power from the possession of intangible assets such as advanced technology, brand name and marketing skills (Fujita, 1995). Furthermore, MNE’s usually have an independent department of research and development (R&D) in the home country; however, its internationalization is growing because of the increasing importance of economies of scope, shorter product cycles and access to better scientific and technical personnel (Fujita, 1995 citing United Nations, 1992). The overseas operations, including the foreign sourcing of intermediate goods and knowledge, have become the basis of global competitiveness for the world’s leading industrial and services MNE’s (Dunning & Lundan, 2008 citing Dunning & Lundan, 1998; Dunning & Mckaig-Berliner, 2002).

SME’s

Internal lack of resources and skills seems to be a distinctive characteristic and the one most agreed on among researchers (Chetty & Agndal, 2007; George et al., 2005; Kamyaby & Devi, 2011; Oviatt & McDougall, 2009; Reuber & Fischer, 1997). Additionally, George et al. (2005) have also included international inexperience as a particular feature of SME’s.

Di Gregorio, Musteen & Thomas (2009) have mentioned that some investigations (Chetty & Holm, 2000; Korhonen, Luostarinen, & Welch, 1996) have found evidence indicating that the internationalization process of SME’s usually begins with the sourcing activity instead of direct and indirect exports. Also, Agrawal, Goswami & Chatterjee (2010) have stated that the small set-up makes it difficult to fully achieve economies of scale, consequently making the overhead costs high.

Additionally, Di Gregorio et al. (2009) have pointed out that SME’s have strong entrepreneurship and an ability to adopt innovations that arise from their relations abroad, while others (Liesch & Knight, 1999) have underlined the ability of SME’s to adapt their structures and processes to the dynamic of overseas competition. In this line, Etemad (2004) has mentioned that these firms are known for having a rapid pace, which shows in the short life cycles of products and technology and the high cost of R&D.

Manufactures

Lovelock & Wirtz (2007) have pointed out that the inputs and outputs needed for operational activities tend to be consistent. Also, the authors have stated that inventory is possible given that goods can be stored. Additionally, the client is not involved in the production of the good, and finally, manufacturing requires physical distribution channels.

All of these characteristics, in some way, make possible the subcontracting of manufacturing activities in foreign countries. For example, when standardization of production is achieved, replication is feasible. Similarly, one of the advantages of inventory is that during the time span needed for goods to move from a location to the consumer, demand can be met with the product in storage. Moreover, production processes can be established in remote locations since the client is not involved in them. Finally, goods need to be moved from the fabrication site to the buyer through physical channels regardless of the location of the customer.

Services

Service firms usually carry out activities that can be classified into two types: the core service and the supplementary services (Kotabe & Murray, 2004 citing Anderson & Narus, 1995; Carman & Langeard, 1980; Lovelock, 1992). The core service includes those activities that the company must provide and perform well to stay in business, while the supplementary services are those needed to carry out the core service or to improve its quality (Kotabe & Murray, 2004). Therefore, the latter are more likely to be internationalized.

Academics have come up with a variety of characteristics to differentiate services from goods, although they seem to agree particularly in four of them (Lovelock & Gummesson, 2004). These are intangibility, heterogeneity, inseparability and perishability. Most of these characteristics represent a challenge for this type of firms when it comes to carrying out particular activities overseas.

The degradation of intangibility is critical given that it provides a way to classify service firms as “pure” or “non-pure” depending on the amount of tangible or intangible elements embedded in the activities (Kotabe & Murray, 2004 citing Bateson, 1992). Service activities with a higher degree of intangibility usually require the involvement of people (Kotabe & Murray, 2004 citing Lovelock & Yip, 1996) and have a tendency of being more customized to fit the needs of particular customers (Kotabe & Murray, 2004 citing Bitner, Brown &
Meuter, 2000). In contrast, service firms that engage in activities with a lower degree of intangibility typically make use of physical goods, meaning that there is a gap between the order and the actual delivery of the good (Kotabe & Murray, 2004).

Lovelock (1983) has presented a classification scheme that considers the nature of the service act, the relationship between the service firm and the customer, the customization and judgment in the service delivery, the nature of demand and supply, and the method of service delivery. This classification makes it possible to define which activities can be more easily outsourced abroad.

**Offshore Outsourcing: The Motivations Underneath**

Academics have combined different theoretical approaches to address the motivations of firms to seek the subcontracting of activities either domestically or overseas. The cost, resource and organizational perspectives have been the most reiterated, but usually they have been seen through the MNE’s lens. However, some authors (Di Gregorio et al., 2009; Sinha et al., 2011) see no reason to not apply the same frameworks to SME’s since the benefits are not completely dissimilar. This paper addresses these theoretical perspectives specifically in the context of offshore outsourcing, including both MNE’s and SME’s, but additionally making a distinction between manufacturing and services firms.

**Transaction and Production Costs Perspective**

Coase (1937) has stated that all economic exchanges have a cost, and businesses will continue to grow until the costs of undertaking an additional activity inside the firm are equal to doing the transaction in the market or to subcontract it to another firm. Later on, Williamson (1985) has separated transaction costs from production costs; the former embodies all the costs related to the movement of the product from one partner to the other within the supply chain, and the latter refers to all the costs associated with the production of a good or service (Kotabe, Mol & Murray, 2009).

Kotabe et al. (2009) have stated that the establishment of a subsidiary may reduce the transaction costs related to institutional, cultural and language barriers; the authors also argue that firms subcontracting activities abroad can benefit from lower production costs considering that foreign suppliers typically produce more efficiently. Overall, offshore outsourcing becomes an attractive option when the savings in production costs outweigh the transaction costs (Sinha, Akoorie, Ding & Wu, 2011 citing Farell, 2005; Kang et al., 2009).

Manufacturing firms, regardless of their size, usually require a significant amount of labor; this cost can be reduced when the related activities are subcontracted overseas. The production of many services, however, cannot be separated from their consumption; this makes the offshore outsourcing of labor-related tasks less viable. Rather, the aim is the reduction of administrative costs. The increasing internationalization of R&D has made MNE’s, both from the manufacture and services sectors benefit from a cost reduction in this activity. Instead, manufacturing SME’s can reduce costs by achieving economies of scale through offshore outsourcing, while services SME’s can avoid initial set-up costs and its related fixed costs. Technology has played an important role in the reduction of transaction costs by reducing information asymmetries, benefiting particularly services firms given that they are mainly dependent on information technology and telecommunications to be offered (Tate et al., 2009). Altogether, reducing costs frees financial resources that can be invested in other profit generating activities such as new lines of production or R&D, employee training or adding a new business venture (Bahrami, 2009). Then, when it comes to the motivations of doing offshore outsourcing from the transaction and production costs perspective, we propose the following:

**P1a:** MNE’s will subcontract activities overseas when the savings in the production costs outweigh the transaction costs.

**P1b:** MNE’s will establish a subsidiary when the transaction costs of doing business abroad outweigh the savings in the production costs.

**P2a:** Manufacturing MNE’s and SME’s mainly seek a reduction in labor costs.

**P2b:** Services MNE’s and SME’s mainly seek a reduction in administrative costs.

**P3a:** Manufacturing SME’s mainly seek economies of scale.
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P3b: Services SME’s mainly seek to avoid set-up costs and its related fixed costs.

Resource-Based View Perspective

The perspective based on resources has surfaced with the objective of analyzing the sources of sustainable competitive advantage of the firms. Barney (1991) has mentioned that the resources of the firms are strengths that allow enterprises to develop and implement strategies (Learned, Christensen, Andrews, & Guth, 1969; Porter, 1981) and Grant (1991) has highlighted that resources allow firms to obtain core competences that create competitive advantage.

Taking advantage of the resources available overseas is an important strategy for firms’ survival, given the increase of competition between companies (of all sizes) (Bahrami, 2009; Kamyabi & Devi, 2011 citing Gooderham et al., 2004). In this way, MNE’s have the option of establishing international subsidiaries, while SME’s depend on doing business with enterprises outside their home country. Smaller firms need this strategy to compensate for their lack of capabilities and resources (Kamyabi & Devi, 2011 citing Gooderham et al., 2004). Nevertheless, such as in the cost perspective, under RBV there are also motivations for MNE’s to do offshore outsourcing.

Considering that core activities are those that offer competitive advantage, firms most likely will keep these under their control and subcontract abroad those non-core. For manufacturing multinationals, given their branding and marketing skills (Fujita, 1995), the activities that provide competitive advantage do not necessarily have to be manufacture-related. For example, firms like Nike specialize in the design and marketing phases, while outsourcing abroad the manufacturing of their products. By contrast, the intangibility, inseparability and perishability of services make it more common for these companies to gain competitive advantage from a service-related activity, even when other manufacturing or service activities are performed in-house or outsourced overseas (Kotabe & Murray, 2004). Moreover, the heterogeneity of services increases their asset specificity resulting in a smaller amount of the core business being subcontracted abroad. In the case of manufacturing firms, although those activities with high asset specificity remain difficult to imitate, and therefore more challenging to outsource, over time technology is making it possible (Kamyabi & Devi, 2011 citing Chang et al., 2009; Jiang et al., 2007). [As a result, the manufacturing industry is becoming saturated], making offshore outsourcing an attractive tool for multinationals to access new markets (Gilley & Rasheed, 2000). For manufacturing SME’s, the decreasing transportation and communication costs are allowing them access to sources of innovation and dynamic capabilities (Sinha et al., 2011).

Offshore outsourcing allows firms to take advantage of the existing experience around the world (Bean, 2003), where suppliers are specialized companies that offer higher quality and expertise in a particular area, and therefore can contribute to the creation of knowledge (Agrawal et al., 2010 citing Quinn & Hilmer, 1994). Through this interaction between firm and supplier occurs a co-creation of value (Songailiene, Winklhofer & McKechnie, 2011). Multinationals have the financial resources to take advantage of the available worldwide capabilities through the establishment of subsidiaries, whereas smaller firms do not have the same option. Consequently, we propose:

P4a: Offshore outsourcing is a matter of choice for MNE’s.

P4b: Offshore outsourcing is necessary for the survival of SME’s.

Subcontracting overseas the non-core activities can provide certain benefits to all type of firms, whereas it is still important to perform in-house the core activities, which provide competitive advantage. Therefore, we propose:

P5a: Manufacturing MNE’s perform in-house the core activities, which can be manufacture or service-related.

P5b: Manufacturing SME’s perform in-house the core activities, which are manufacture-related.

P5c: Services firms perform in-house the core activities, which are service-related.

When it comes to manufacturing firms, the main motivation to search for international suppliers differs depending on the size. Smaller firms lack more resources than larger firms, but have an advantage in capturing niche markets. Thus, we propose:

P6a: Manufacturing MNE’s seek new markets through offshore outsourcing.
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P6b: Manufacturing SME’s seek access to sources of innovation and capabilities.

Nevertheless, all firms, regardless of their size and industry, equally benefit from the expertise and knowledge of international suppliers. As a result, we propose:

P7: All firms, regardless of size and industry, seek co-creation of value by partnering with international suppliers.

Organization Perspective

Within the broad range of theories that exist about the organization and the firm, Hätönen & Eriksson (2009) have pointed out that the systems theory (Alexander, 1964; Simon, 1962) and the network theory (Hakansson & Johanson, 1992; Johanson & Mattson, 1988) have been used in the literature to explain the motivations of MNE’s to do outsourcing. The authors have highlighted the need to transform the organization into an adaptive system in an era where sustainable competitive advantage not necessarily lies in cost-efficiency or in the resources, but in the flexibility of the organization.

For all types of firms, finding a supplier who they can trust and establish a long term relationship facilitates the decision of doing offshore outsourcing (Agrawal et al., 2010). Establishing and managing a partnership is particularly easier for SME’s given their entrepreneurial skills and ease of doing business (Etemad, 2004). For MNE’s, these relationships with foreign companies are important because they allow a degree of flexibility that vertically integrated organizations do not usually have (Agrawal et al., 2010 citing Carlson, 1989; Domberger, 1998; Harrison, 1994). Also, they enable business transformations that facilitate 24/7 operations (Bahrami, 2009; Bean, 2003). Finally, through these partners MNE’s acquire knowledge about culture and consumption patterns in other countries (Bahrami, 2009) that facilitate product adaptation.

On the other hand, SME’s equally benefit from gathering information about culture and consumption patterns although their focus is directed towards finding niche markets. Additionally, these small companies can achieve increased operational capacity and a reduction of risk (Sinha et al., 2011 citing Lysons & Farrington, 2006; Rasheed & Gilley, 2005; Simchi-Levi et al., 2003). MNE’s can gain from the latter, but to a lesser extent. For all firms, finding a supplier they can trust and establishing a long-term relationship are important aspects for doing offshore outsourcing. However, the benefits that multinationals and smaller firms gain from these partnerships may differ. So, we propose the following:

P8: MNE’s seek through partnerships with suppliers to increase flexibility and business transformations to operate 24/7.

P9: SME’s seek through partnerships with suppliers to increase capacity and share the risks.

P10: Both MNE’s and SME’s seek through partnerships with suppliers to gain knowledge about foreign cultures and consumption patterns, however, MNE’s pursue information valuable for product adaptations, while SME’s focus on finding niche markets.

Concluding Remarks

In practice, offshore outsourcing has been gaining popularity, but scholars have not been widely interested in this topic. Additionally, most of the research done in this area has been centered on the activities of multinational enterprises in the manufacturing sector, leaving somewhat behind small and medium enterprises and those firms in the services sector. Therefore, the purpose of this paper is to question if SME’s and services firms could also benefit from offshore outsourcing given their particular characteristics, and to inquire about the possible tangencies and differences in the motivations that these firms might have to subcontract internationally in comparison to manufacturing MNE’s. The propositions established in this paper are an attempt to model the possible motivations based on the existing literature, but further research is needed for their confirmation. This work addresses a topic that has been left behind in the literature. It also suggests that manufacturing MNE’s are not the only firms that can benefit from offshore outsourcing. Knowing what drives SME’s and services firms to subcontract internationally is especially important for the countries and the foreign suppliers in order to adapt and expand their offerings to the particular needs of these firms.
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