Offshoring, Outsourcing, and Strategy in the Global Firm

Stephen Tallman, University of Richmond, United States

Offshore outsourcing of many of the activities of the firm has become a major issue of concern in welfare economics, politics, business management, and international business scholarship. From both practical and scholarly perspectives, though, we must recognize that this is not a new phenomenon, and that neither outsourcing nor offshoring is necessarily the problem that has been represented in the popular and scholarly press (Contractor et al., 2010; Engardio, 2006). The production of goods in locations other than those in which they are sold has been an established strategy of multinational firms for decades—as has the subset of situations in which offshore locations are used to produce for home country consumption. "Traditional" situations such as Nike moving shoe manufacturing to Asia have become commonplace and attract little attention. However, the dramatic increase of offshore service provision since 2000 was unexpected, affects the sort of knowledge work that was to be the refuge of the developed world, and imposes international competition on firms, jobs, and markets that had been seen as exempt—and has attracted new attention. In a similar vein, we are finding that offshore outsourcing is expanding rapidly in "new era" sectors such as alternative energy. Even as the science and engineering of alternative energy emerge from Western university labs, companies hoping to exploit these new ideas are finding not only that overseas manufacturing is less expensive but also that only countries like China retain the capacity to manufacture such goods. Perhaps we should take a longer look at offshore outsourcing to see what it can offer us both as scholars and as business practitioners—but without the distractions of populist hysteria.

This article addresses three issues where we international business scholars, collectively, could benefit from cooling down and considering what we already know about international markets and multinational firms rather than pursuing "hot" topics. First, I suggest that by focusing on the narrow issue of producing offshore for the domestic market, whether goods or services, scholars are adding to the overheated, even jingoistic, discussion of the issue and also are losing opportunities to gain theoretical and empirical insights. Second, the general lack of strategic perspective on the topic has put the focus on cost-reduction through location in emerging economies and has led to fears for undifferentiated wholesale relocation of value-production to these countries. Third, convergence on a 2x2 matrix of in-house versus outsourced operations and of on- versus off-shore locations has led to a focus on corner solutions that lock discussion into black-and-white considerations of what is happening as opposed to measured concern for the strategic whys, wheres, and hows.

The Global Firm and Intra-firm (or Intra-network) Trade

The offshoring discussion focuses on the eventuality that a domestic firm sends some portion of its value-adding activities, whether manufacturing, business processes, or software writing, to another country while continuing to sell its output into the domestic market. This leaves the domestic customer in the position of transferring money to foreign producers rather than to locals, thus draining liquidity out of the domestic economy—or so the story goes. This picture leaves little room for the growing phenomenon of the global firm. Rather, we should consider the overall reliance of global markets on networks of international trade and investment. If a global firm generates value—whether in product design, manufacturing, service support, distribution, marketing, customer service, or any other activity—in multiple differentiated locations around the world (or even within one or more regions of that world), uses intra-firm trade of intermediate goods and services to tie together its operations into an efficient whole, and then sells unique mixes of goods and services in multiple differentiated markets around the world (or region), just what makes the provision of some of these products to the original home market unique?

The reality of international trade and investment is that most flows of capital and goods and services are managed by multinational firms. Indeed, the levels of intra-industry and intra-firm trade and of foreign direct investment traditionally have been used to characterize the global scope of industries and firms (Kobrin, 1991). What is clear in today's marketplace is that better communication technology and increasingly sophisticated views of value-adding activities are allowing global firms to disaggregate or finely slice their activities and to more easily source intermediate goods from the most efficient location—much as Bruce Kogut prescribed in 1985 (Kogut, 1985). Indeed, using comparative advantage, or location-tied superior productivity, as a key basis for competitive advantage, or firm-specific production efficiency, is the great strength of the multinational firm.

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Prahalad and Doz's (1987) early characterization of the globally efficient multinational assumes centralized production facilities, but not necessarily home-country production. Bartlett and Ghoshal's discussion of differentiated subsidiary roles in the transnational firm (1989) clearly supposes that subsidiaries in some markets will create significant value that will be incorporated in products sold in others—or at home. Separating value generation from value consumption is a part of the issue, as is the idea of firms sourcing value from multiple locations, as is the reality of many ways of coordinating internationally dispersed, disaggregated value-adding activities. However, such production was never assumed to be only for the home market; rather it is production for a global or regional market. In the case, for instance, of US multinational firms setting up production facilities in a few Western European sites to serve the entire Western European market, the home country is on neither end of the production-consumption equation. Likewise, business services moved abroad as part of the overhead activities of local and regional headquarters, which would be expected to locate service and support activities at their locations.

Despite all the discussion, offshoring seems to be explained largely by comparative advantage, albeit a sophisticated version in which differentiated inputs are clearly recognized, and communication and governance technologies through which geographically distant operations can be integrated. However, consideration of the developing model of the global firm as a differentiated network of distinct subsidiaries, affiliates, alliances, and contracts all tied together by a small headquarters focused on communication and coordination rather than command and control offers a variety of new directions in organizational economics and management theory. The responses of global firms to the demands of international markets and international sources of products in an increasingly complex global setting offer arrays of strategies and organizations that are changing concepts of management and of organizational and management theory.

Strategic Purpose and Core Competency

The two-dimensional characterization of offshoring and outsourcing focuses on location and transaction governance, but ignores issues of strategic purposes and capabilities—the discussion is one of outcomes, not of inputs or drivers. Firms are likely to have strong capabilities and stocks of resources in those parts of the value-adding chain that are at their strategic core. In other value-adding steps, any individual firm may have fewer resources or less effective capabilities, and strategic management scholars are largely united in proposing that such activities should be located in other, more competent, firms. The idea that a complete value-adding chain, from idea to final sale, should be internalized within a single economic entity is essentially obsolete—yet discussions of outsourcing seem to treat this as the preferred norm. I find that in overlaying a strategic perspective on the location x governance matrix, an obvious outcome is that core strategies and resources are likely to be kept internal to the firm, while market means, based on price and supplier reliability, are ideal for delivering generic inputs. However, a large proportion of the assets and capabilities deployed by any firm fall between these extremes—they are complementary or co-specialized assets. That is, they will be essential to the firm's ability to actually generate economic rents from its truly unique firm-specific assets, even if the firm does not expect to gain advantage based on these assets themselves. Improvements in IT and contracting and the rise of reliable partner firms from low-cost locations together have made access to such assets through networks of alliances much more likely than in the past.

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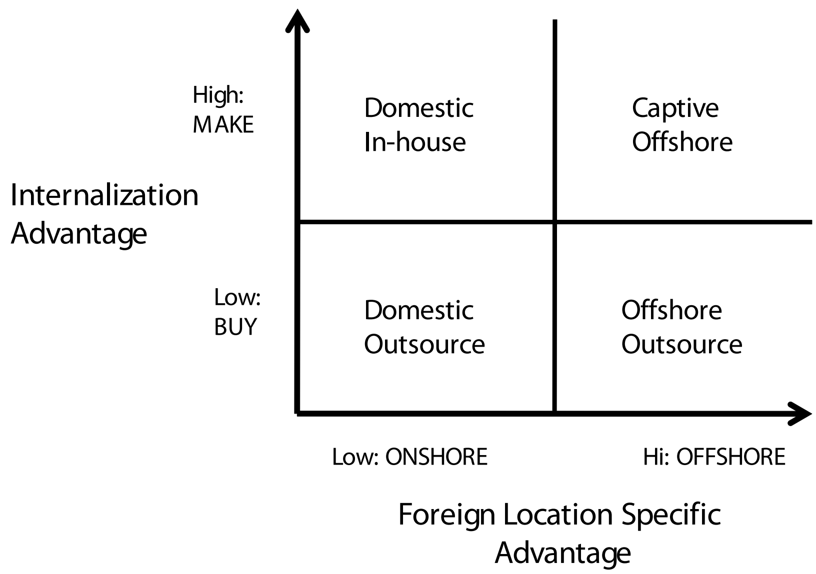
Strategy is also relevant to the location issue. Comparative advantage is alive and well—not just as a cost minimization consideration, but as a net value-producing process. From a strategic perspective, a core activity may well be kept close to the core location, but twenty years of discussion of transnational strategies suggests that the core for any particular business may not be in the home country—the strategic leader subsidiary is a fact as well as an ideal. There is no inherent reason in today's world to assume that strategic leadership comes from the home country or that the home market is the dominant focus of the firm. Global firms such as Hewlett Packard or DuPont or General Electric do not necessarily headquarter every business in the same country, state, city, or building as the corporate headquarters, and have not done so for some time. A production site with a set of country-specific advantages that offer unique value in combination with the firm-specific resources and capabilities of a particular multinational company could well become a regional or global center for value-added production (Birkinshaw, 2001; Rugman, 1981). Such a site may certainly supply the home market, but perhaps only as a small part of its overall mission.

Here, There, or Everywhere? A Matter of Distance

My third concern is that even though the focus of the offshoring/outsourcing discussion has been on location factors and transactional governance, analysis of these structural issues is underdeveloped. The presentation of the business process offshoring/outsourcing decision has devolved into a 2x2 matrix, contrasting in/outsourcing with on/offshoring (see Fig. 1). This is certainly a major improvement on the five-year-ago discussion that commonly confused where an activity was happening with who was doing it, but it reflects a disregard for extensive and carefully developed bodies of work on locations and

Figure 1: The Offshoring/Outsourcing Matrix or "Make/Buy–Here/There"



internalization. Looking first at the location question, we should see that this simple approach tends to exaggerate both the risks and the benefits of offshoring. A first consideration is that "offshore" as a generic indicator of any and all non-home country locations commoditizes foreign locations—if you are not at home, you are simply offshore. Therefore, if "home" is high on familiarity and low on risk, "away" tends to become the opposite—even if this is not the intent of the original modeler. The "near-shore" construct suggests that this outcome is becoming recognized, but really reduces the issue to geographical distance—suggesting for instance that Canada and Mexico represent similar distances from "home" for a US-based firm. Do we believe this? As every basic international business textbook is at pains to discuss, the economic, cultural, and institutional contexts of international business vary from country to country in varied and complex fashion. At a minimum, this dichotomy should be replaced by a multi-faceted "International Distance" dimension, whether the CAGE model proposed by Ghemawat (2007) or some other version.

At the same time, the benefits of foreign location tend to be exaggerated, so (and again from the US position that is so often assumed) that cost differences, as the most apparent expression of comparative advantage, become the primary, even only, benefit to be set against the uncertainties of the foreign. However, as a variety of scholars have begun to emphasize (Doh et al., 2009), while costs do matter in offshoring, they are never the entire story. So, while place matters, whether seeking an offshore value production platform or foreign market entry, it must be recognized and incorporated into models as a complex and multifarious construct of location specific characteristics and degrees of distance from both home country and market, not a simple "here vs. there" comparison!

Make-Buy or Make-Ally-Buy?

The other side of the location x governance matrix relates to who owns and controls the activity in question. This is typically represented as a "make-buy" decision in which the value-adding activity is either internalized, whether at home or abroad, or outsourced to a supplier in a market transaction. This dichotomy is reminiscent of the early market-hierarchy choice presented in transaction cost economics (Williamson, 1985), though the outsourcing model assumes that an activity is initially pursued inside the company and is moved into the market only when it is less expensive or can be done better by an outsourcing specialist—how it came to be inside the firm is not at issue. The make-buy comparison suggests that outsourcing is done in a market transaction. As such, the transactional costs of markets, particularly from investing in transaction-specific assets, described by Williamson and others, make the outsourcing choice seem particularly high risk. Presuming that the decision has been made to outsource, the focal firm then should minimize its risks by avoiding transaction-specific investments—but this is likely to make the outsourcing transaction inefficient and may risk a poor fit between supplier and client, trading one cost for another.

A generation of work on alliances suggests that the "make-buy" decision is in reality a "make-rent-buy" question, in which access to the services of certain competences can be managed through a wide array of cooperative governance choices. Indeed, in most non-internalized offshoring transactions, the client and the provider engage in a time-extensive, semi-customized, more-or-less flexible relationship that evolves over time—or what is commonly called an alliance, whether an extended contract or an equity joint venture. From a resource-based perspective (Madhok & Tallman, 1998), alliances permit firms to focus on applying their most specialized resources and capabilities, those that offer the greatest potential for generating economic rents, while outsourcing other critical activities to alliance or joint venture partners that special-

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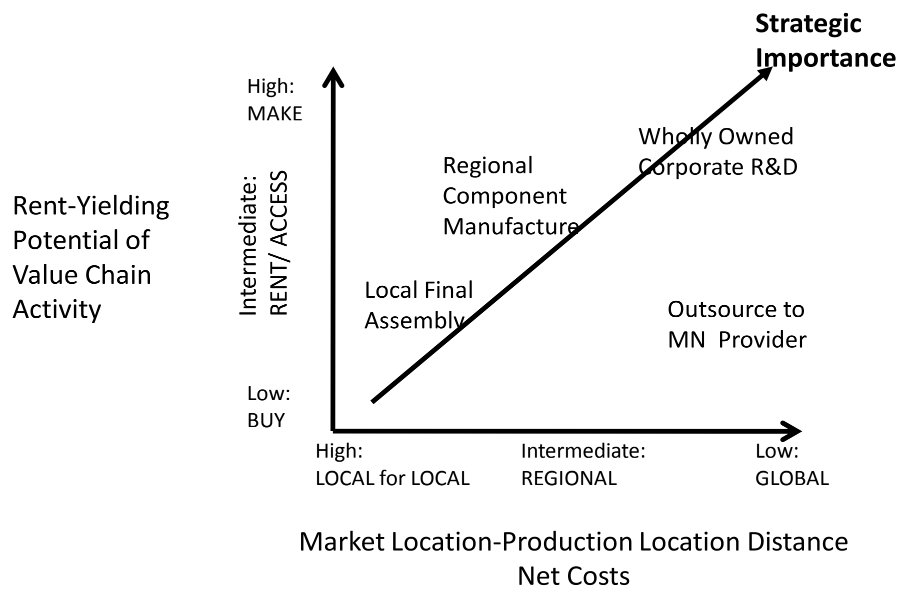
Figure 2: An Alternative Model of Offshoring and Outsourcing



ize in those areas (see Fig. 2). By investing in transaction and partner specific resources, both sides can consistently improve the efficiency of their complementary sets of assets while making abandonment of the relationship consistently more costly and thereby providing protection from opportunism. How often do real companies actually buy critical services, say payroll administration, in a one-time, arms-length transaction based on price/performance that is re-bid on a frequent basis? Recognition that outsourcing is primarily carried out through alliance transactions changes the risk-return relationships that are expressed in the stark make-buy choice. It also opens up the scholarship relating to outsourcing to influence from the extensive literature on cooperative strategies, particularly international alliances and joint ventures, which addresses in considerable detail most of the governance concerns expressed about outsourcing.

Offshoring/Outsourcing Is Not New

The effort to treat offshoring/outsourcing as a new or unique strategic action has resulted in its apparent lack of success in developing theory or advancing the study of either internationalization or strategic management beyond observation and simple empirical studies. This same attitude toward the phenomenon limits the potential for scholarship to say much of value to managers—who are already deeply engaged in international sourcing and quickly learning when, where, and how to pursue it in practice. Right now, the literature tells managers who are engaged in deconstructing their firms' value chains and seeking to maximize efficiency and effectiveness through supplier networks and through judicious use of foreign locations that they can gain from accessing comparative advantage in location choice and from considering outsourcing non-critical activities. But they already know those things! If scholars are going to add to the conversation, to provide value to practice, they must do so by connecting current phenomena to much-better-understood historic happenings and concepts. If we can apply what we know about multinational firms and their capabilities and strategies as they interact with the vagaries and challenges of the global economy, we should be able to offer recommendations for action and predictions of performance to practitioners. If we continue to look at offshoring and outsourcing as unique, isolated, modern phenomena, we will end up as catalogers and scolds, but with little to offer either to practice or, in the end, to scholarship.

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Stephen Tallman (Stallman@richmond.edu)is the E. Claiborne Robins Distinguished Professor of Business at the University of Richmond. His research in international strategic management, alliance strategies, knowledge management, and industrial clusters has been published in *Academy of Management Review, Academy of Management Journal, Strategic Management Journal, Organization Science, Journal of International Business Studies,* and other scholarly journals, as well as various chapters and books. He is a founding co-editor of the new *Global Strategy Journal* and an Associate Editor for *Strategic Management Journal.* He is a past chair of the International Management Division of the Academy of Management and the Global Strategy Interest Group of the Strategic Management Society. He is a Fellow of the Academy of International Business.