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Behavioral factors in offshoring decisions: A qualitative analysis

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ABSTRACT

Using the behavioral lens as a theoretical complement of rational models, I examine factors that influence decisions related to offshoring of business activities. A qualitative analysis of 22 cases of companies from six diverse industries provides evidence that besides the commonly acknowledged offshoring decision related factors, such as labor cost, risks, access to markets, and quality of talent, there are other important influences. These reflect decision makers' personal experiences, attitudes and emotions and cognitive limitations. I discuss findings in light of current theory and practice.

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1. Introduction

No longer a new phenomenon, offshoring is becoming more common for smaller, entrepreneurial firms. Companies no longer offshore only simple manufacturing tasks or IT, but various other business activities including customer care, book keeping, and engineering. Indeed, in some industries, firms routinely offshore product development and other traditionally "core" and knowledge-intensive functions. Thus, some have identified offshoring as "the most important phenomenon transforming the workplace" (Youngdahl & Ramaswamy, 2008, p. 213). Research on offshoring has indicated that while offshoring often leads to cost savings, firms can also reap other benefits as a result of offshoring their business activities. These include greater innovation (Nieto & Rodríguez, 2011), learning, human and organizational capital (Musteen & Ahsan, 2013) and enhanced international competitiveness (Di Gregorio, Musteen, & Thomas, 2009). However, studies have suggested that offshoring can also lead to negative outcomes including loss or deterioration of capabilities (Grimpe & Kaiser, 2010), quality problems (Kinkel & Maloca, 2009), and failure to realize expected cost savings (Larsen, Manning, & Pedersen, 2013). These are especially detrimental for smaller firms which tend to lack organizational slack. The suboptimal outcomes of offshoring have been argued to lead to "reshoring", or corrective reversal of offshoring arrangements (Kinkel & Maloca, 2009). Such moves have been covered by popular press and are also beginning to attract the attention of academics. For international business (IB) scholars, the recent trends in offshoring practices raise questions about the factors that drive offshoring decisions at first place (Gray, Skowronski, Esenduran, & Rungtusanatham, 2013).

To date, research has viewed the decision to offshore as a function of various external and internal drivers, including lack of affordable human capital in the home country, lower labor costs, desire to achieve greater efficiency and tap global talent (Musteen & Ahsan, 2013). The offshoring choice has been explained using various theoretical approaches such as the transaction cost economics (Mudambi & Venzin, 2010), the OLI framework (Dunning, 1993), and resource-based view (Doh, 2005). Interestingly, all of the theoretical approaches have implicitly assumed that managers, when making decisions about offshoring their business activities, make fully rational and comprehensive decisions. In other words, offshoring decisions have been traditionally viewed as optimization choices derived from managers' careful analysis of risks, costs and benefits.

In this study, I examine the decision to offshore from the boundedly rational and behavioral perspective which has been increasingly used in the broader IB literature. Specifically, I examine whether, besides the commonly acknowledged offshoring decision related factors, such as labor cost, risks, and access to markets, there are other influences reflecting personal characteristics of the decision makers. The behavioral lens, as a theoretical complement of economic models, is an important theoretical perspective which has been used to explain various organizational phenomena. In this study, I draw on a qualitative analysis of 22 cases of small- and medium-sized companies (SMEs) in five industries. I find evidence that the behavioral approach provides a more complete picture of the offshoring decision for companies across different industries and in different stages of lifecycle. In fact, my findings suggest that the behavioral perspective may differ in its predictions from the more traditional theoretical models. Specifically, personal factors and

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biases may lead decision makers to lean toward "manager-focused rationality" in their offshoring decisions which may be in contradiction to "firm-focused rationality", or rationality that maximizes the interests of the firm (Buckley, Devinney, & Louviere, 2007, p. 1085).

This study was designed to make several contributions to the current literature. It adds to the existing literature on offshoring by offering a richer insight into the influences leading managers to send work abroad. Specifically, the study suggests that managers are susceptible to make decisions to offshore or not to offshore work that may not be consistent with the current theoretical models based on economic efficiency. Instead, these decisions are, in part, based on emotions and/or deeply held attitudes and personal experiences. My study provides a more nuanced explanation of offshoring and the reasons why smaller companies take the risk to disperse value chain activities around the globe. By taking into account contextual factors affecting managers' attitudes and preferences, it adds to the growing stream of IB literature grounded in the behavioral paradigm.

2. Literature review and research question

Previous literature has used various definitions of offshoring. For the purpose of my study I adopt Lewin, Massini and Peeters' (2009, p. 902) definition as "the process of sourcing and coordinating tasks and business functions across national borders." Literature has investigated various offshoring arrangements; however, most firms typically consider either international outsourcing (i.e. contracting out an activity to a foreign vendor) or a captive model (i.e. performing an activity in a firm's own subsidiary). Given these two basic forms of offshoring, research on offshoring typically falls into two literature streams. Outsourcing models of offshoring have been investigated in the broader literature on purchasing and make-or-buy decisions, international sourcing and alliances. Captive offshoring, on the other hand, has been addressed, at least to some degree, by the literature on foreign direct investment (FDI). Researchers have relied mostly on the transaction cost theory (TCE) (Williamson, 1975) to explain offshoring as a firm's decision to disaggregate its value chain and hand some activities over to external parties (i.e. offshore) (Mudambi & Venzin, 2010). The TCE approach, which focuses on make-or-buy decisions, has addressed primarily the degree of control and governance structures in the offshoring arrangements. The geographical aspect of offshoring decisions (i.e. the location) has usually been examined using Dunning's (1993) OLI (ownership-location-internalization) framework. According to OLI, firms would select offshore location based on the advantages they provide (e.g. lower labor cost). According to both TCE and OLI frameworks, the primary motivation for firms to offshore their activities has been cost advantage. More recently, research on offshoring has acknowledged other strategic benefits of offshore arrangements. For example, researchers used the resource-based view (RBV) to explain offshoring as a way of firms seeking to expand and complement their resource base and develop new capabilities (Doh, 2005; Musteen & Ahsan, 2013). Researchers have also used the dynamic capabilities and organizational learning perspectives to capture firms' decision to offshore in order to enhance their knowledge and ability to innovate by collaborating with their offshore partners (Kedia & Mukherjee, 2009).

The theoretical approaches discussed above received empirical support in previous studies. For example, Luo, Wang, Jayaraman, and Zheng's (2013) study of business process offshoring (BPO) ventures in China and India supported the TCE-derived assertions that companies will more likely engage in captive offshoring when the activity is not easily codifiable or involves high information security (i.e. having high transaction costs). Using a sample of European and US companies, Martinez-Noya, Garcia-Canal, and Guillen (2012) found that firms tend to offshore less when transaction costs are high due to higher tacitness of the offshored activity. In some cases, however, research provided a mixed or somewhat counter-intuitive picture of offshoring decisions or failed to find evidence for arguments based on the traditional theoretical approaches (Vivek, Richey, & Dalela, 2009). Bunyaratavej, Doh, and Hahn (2009), for instance, found that firms are more likely to offshore services to countries with higher wages. In their study of large Danish firms, Jensen and Pedersen (2012) did not find any connection between market seeking and the likelihood of offshoring. Thus, it may be that, while providing valuable insights, the traditional theoretical approaches such as the TCE or OLI framework may not be able to fully explain the offshoring phenomenon. Alternatively, it is possible that managers do not always follow the normative prescriptions of such theories — that is, do not offshore activities for the "right" reasons. Indeed, the recent literature on reshoring (Gray et al., 2013) suggests that managers may be forced to bring previously offshored activities back to their home country as a result of poor decisions leading to offshoring. For example, a study by Kaufmann, Carter, and Buhrmann (2013), which examined decision-making process related to selection of suppliers, indicated that managers' judgments may not always follow the economic model when it comes to offshoring activities. In other words, offshoring decisions may be subject to idiosyncratic behavioral influences and bounded rationality.

The topic of bounded rationality in the context of strategic decision making has been investigated by studies on the upper echelons and managerial cognition. The basic premise of this body of literature (sometimes collectively named the "behavioral" perspective) is that firms' strategies and, ultimately, performance are a function of executives' psychological and demographic characteristics (Hambrick, 2007; Li & Tang, 2010). According to the upper echelon theory, managers make decisions based on their perceptions of reality which is influenced by their personal experiences (often reflected in their demographic attributes), attitudes and interpretation of external stimuli. The managerial cognition perspective further suggests that managerial judgment may be subject to cognitive biases and managers' decisions reflect factors that influence how they subjectively think about and make sense of the issues at hand.

The behavioral perspective has also been used to investigate phenomena related to international business (IB) phenomena (Aharoni, Tihanyi, & Connelly, 2011). In this literature, studies have most commonly focused on the role of managerial experience in IB-related decisions; particularly those related to the internationalization process and FDI (Johanson & Vahlne, 1977). More recently, the behavioral approach in the IB literature has expanded to also focus to managerial cognition, managerial personal experiences and characteristics and its impact on decisions and, ultimately, firm-level performance.

In a small but growing literature stream grounded in the behavioral/cognition perspective, IB researchers have begun to design studies that not only enrich and complete the traditional models based on logical positivism and economic efficiency but sometimes provide evidence in contradiction to those models. For example, Schotter and Beamish (2013, p. 524) argued that location choice models may require consideration of contextual factors influencing managers' cognitive heuristics, biases and preference. In their study, specifically, they found managers often shun certain foreign locations because they deem them personally unpleasant. Buckley et al. (2007) also found evidence that suggested that in some instances involving decisions regarding foreign direct investment location, managers may behave more to reflect their idiosyncratic experiences and interests as opposed to interests of the firm as a whole. In this study, I seek to explore whether such "individual-manager-rationality" as opposed to "firm-focused rationality", or rationality related to the interests of a firm as a whole (Buckley et al., 2007, p. 1085) is in play in the context of offshoring decision. In doing so, I seek to respond to calls to further incorporate the concept of bounded rationality and provide a more realistic description of decision making in IB research (Aharoni et al., 2011).

The decision to offshore a business activity is an important strategic decision, one involving a mixture of strategic and tactical issues. The decision should involve a careful assessment of firm's business model, requires evaluation of alternative offshore partners, locations and

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