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Transaction costs theory and coordinated safeguards investment in R&D offshoring[☆]Vinit Parida^{a,b,*}, Joakim Wincent^{a,c,1}, Pejvak Oghazi^{d,2}^a Luleå University of Technology, Luleå, Sweden^b University of Vaasa, Vaasa, Finland^c Hanken School of Economics, Helsinki, Finland^d Linnaeus University, Växjö, Sweden

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ABSTRACT

In a multi-case study of R&D offshoring relationships in large manufacturing firms, this study develops an alternative view to that of transaction-cost theory, which argues that safeguard investments during the transition lead to higher transaction costs. This study outlines how fear of opportunism and the potential to violate agreements drive the need for complex safeguard devices. Results show that the sample firms benefit from high initial coordinated safeguard investments, because those investments reduce transactional costs overtime. More specifically, the study lists critical activities of such coordinated self-enforcing safeguard investments and calls for future attention to how firms manage transaction costs in R&D offshoring to secure long-term value.

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1. Introduction

Offshoring refers to “the process of sourcing and coordinating tasks and business function across national boundaries” (Lewin, Massini, & Peeters, 2009, p. 902). Although certain organizational processes are historical targets for offshoring (e.g., information technology), an increasing trend is to offshore high-value processes that relate to advanced engineering services and research and development (R&D) activities. According to several studies (Dossani & Kenney, 2007; Lewin et al., 2009; Varadarajan, 2009), R&D offshoring is the “next generation offshoring practice” and is going to become one of the fastest-growing offshoring segments in BRIC regions (NASSCOM Report, 2006).

Despite these projections, analyses highlighting reasons, outcomes, and governance issues regarding advanced offshore activities are scarce (Hsuan & Mahnke, 2011; Lewin et al., 2009). The lack of extensive empirical studies on the topics necessitates further investigation (Kenney, Massini, & Murtha, 2009). This study focuses on a debate in the literature suggesting that the extent to which companies can achieve long-

term value through R&D offshoring is questionable (Parida, Wincent, & Kohtamäki, 2013; Rilla & Squicciarini, 2011). Offshore suppliers may misrepresent their abilities, overstate the possible inputs of their efforts, and attempt to maximize their interests at the investing company's expense. Such behaviors require greater investments in complex governance structures (i.e., more complex contracts, monitoring, coordination, and enforcement mechanisms) to eliminate behaviors such as shirking, bargaining, and opportunism (Barthélemy & Quélin, 2006; Ellram, Tate, & Billington, 2008).

The transaction-cost theory suggests the need for safeguard investments that increase transaction costs (Williamson, 1985). This perspective paints a negative picture for successful long-term cooperation in an offshore setting. The implication is that once transaction costs increase, the reason for offshoring may disappear in long-term inefficiency (Rilla & Squicciarini, 2011; Williamson, 2008). Thus, this study contributes to low-value-oriented research (Kremic, Tukul, & Rom, 2006) by focusing on transaction costs in the context of offshoring high-value services such as R&D.

This study documents the experiences of four R&D offshore relationships involving six multinational companies. The empirical insights reveal a contrasting picture of the transaction costs to initiate R&D offshoring. By doing so, this study contributes to the discussion in the transaction-cost theory and the debate in the scarce literature addressing R&D offshoring. Specifically, the study contributes to theoretical development by suggesting an operative framework on transaction costs that pinpoints certain safeguard investments and how such investments can help develop sustainable R&D offshore relationships. Importantly, results emphasize that heavy, upfront investments to establishing coordinated safeguards can be a viable strategy and not necessarily drive transaction costs.

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2. R&D offshoring, transaction costs, and safeguards

Over the long run, asset-specific investments in offshore competence seem inconsistent with transaction-cost theory. The general literature on transaction-cost theory advocates that investments in specialized assets increase transaction costs by introducing fears regarding exchange problems such as potential bargaining and opportunism (Williamson, 1985). Because customers and their offshore suppliers are striving to gain as much as possible (Das & Kumar, 2007), a risk exists in that they might act opportunistically to secure self-interests. As a result, transaction costs may increase, and the offshoring relationship would risk losing its competitiveness and collapsing over the long-run (Rilla & Squicciarini, 2011). Transaction costs that are potentially bothersome in a offshoring situation include *search costs* of evaluating offshoring partners, *contracting costs* when negotiating agreements, *monitoring costs* to ensure obligations' fulfillment, and the *enforcement costs* of ex-post bargaining and sanctioning underperforming partners in the offshoring relationship (Dyer, 1997).

Companies engage into the use of safeguards to protect themselves from opportunism (Williamson, 1985). Safeguards can have many forms, with the most popular being the contract. As asset-specific investments rise and become increasingly complex, as with offshoring R&D rather than simple services, transactors try to formulate complex contracts that leave room for contingencies. According to Barthélemy and Quélin (2006), detailing such contingencies is virtually impossible and complicates R&D offshoring management. In that situation, transaction-cost theory predicts that all transaction costs (including search, contracting, monitoring, and enforcement costs) will increase significantly. Although the literature often discusses control mechanisms and other legal forms of safeguards, studies identify trust and goodwill as potential safeguards and investment hostages (Sako, 1991) that may reduce transaction costs (Dyer, 1997). Few studies investigate these conditions' implication within R&D offshoring as a relationship-management mechanism (Rilla & Squicciarini, 2011).

3. Method

3.1. Research approach and data collection

This study analyzes four R&D offshore relationships involving six multinational companies (Table 1). The research follows an exploratory multiple-case study research design (Eisenhardt, 1989). In total, 49 in-depth, individual interviews, and four group interviews provide the data during different stages of the relationships. More specifically, ten interviews take place in Company A, eleven interviews in Company B, six interviews in Company A1, seven interviews in Company A2, seven interviews in Company B1, and eight interviews in Company B2. Early

interviews within the two customer companies focused on factors that motivated these companies to initiate R&D offshore relationships, and on early challenges with the relationships. The following stage involved interviews within four supplier companies in an iterative way to capture their perspective on early drivers, challenges, and safeguard investments examples. Finally, focus group interviews with customer companies (6–10 participants) provided details on the outcomes of investing in safeguards and validated earlier findings. The interviews and workshops included diverse individuals who had significant experience in being active in R&D offshore engagement.

Observations or archival data provided the secondary data. In particular, the study analyzes offshore pre-study documents, intranet pages, Internet Web sites, offshore growth progress documents, published news articles, internal documents, and internal company presentations by senior managers to validate and triangulate the findings.

3.2. Data analysis

Using constant comparison techniques (Nag, Corley, & Gioia, 2007), the study identifies grounds for patterns and links within large, complex, empirical data. The data analysis emphasizes the need for a series of iterations leading to different themes and overarching dimensions to develop frameworks with a theoretical and empirical basis. This approach forms the foundation for the first-order codes, which appear mainly in the exact language that the respondents' used to express their views.

During the next stage, the study divides the identified links into theoretically distinctive groups, the second-order themes. The analysis resulted in four second-order themes, which were at a higher abstraction level in comparison to the first-order categories. Internal validity tests used follow-up interviews and email correspondence. The final stage involved generating third-order dimensions with a higher level of abstraction. The analysis of the second-order categories generated such overarching dimensions (Fig. 1).

4. Findings

4.1. Opportunism and increasing transaction costs in the initial phase

Prior studies on R&D offshoring provide several compelling reasons to use external offshore partners for R&D tasks in comparison to undertaking similar work internally (Parida et al., 2013; Rilla & Squicciarini, 2011); results suggest that transactional costs are quite high at the initial stage because of the need to deal with potential opportunism for both the provider and the supplier. Because of the partners' inability to stipulate offshoring outcomes clearly in formal contracts, the discussion of the likelihood for opportunism and contractual evasion arises often. Respondents share their concerns regarding relational uncertainties toward the

Table 1
Company background information.

	Relationship 1		Relationship 2	
	Company A	Company A1	Company A	Company A2
Total revenue	€209 million	€3.6 billion	€209	NA
No. of employees	3500	88,000	3500	150
Main products/services	Aerospace component provider	IT service provider	Aerospace component provider	R&D service provider
Type of R&D services provided in the particular relationship	Prototype design, engineering support, CAD drawing, and simulations		Product tailoring, product design, prototype construction, and code development	
Partner evaluation switching time	6–12 months		24–36 months	
	Relationship 3	Company B1	Relationship 4	Company B2
	Company B	Company B1	Company B	Company B2
Total revenue	€1.225 million	€3.6 billion	€1.225 million	NA
No. of employees	13,000	83,000	13,000	3900
Main products/services	Construction equipment and related services	IT services, business support services, and advance engineering	Construction equipment and related services	Advanced engineering and new product development services
Type of solutions provided in the relationship	Product development, reengineering, programming, and application development		Prototype development, system design, testing, and engineering support	
Partner evaluation switching time	6 months		24–36 months	

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