Journal of International Management xxx (2013) xxx–xxx

Contents lists available at SciVerse ScienceDirect

Journal of International Management

Fox School of Business
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Home–Host Country Distance in Offshore Governance Choices

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ARTICLE INFO

Article history:
Received 31 January 2012
Received in revised form 9 February 2013
Accepted 14 February 2013
Available online xxxx

Keywords:
Offshoring
Home–host country distance
Governance mode
Global value chains
Transaction cost economics
Logistic regression

ABSTRACT

This paper studies the effect of home–host country distance on the choice of governance mode in service offshoring. Using a Transaction Cost Economics approach, we explore the comparative costs of the hierarchical and contractual models to show that different dimensions of distance (geographic, cultural and institutional), because they generate different types of uncertainties, impact offshore governance choices in different ways. Empirical results confirm that, on the one hand, firms are more likely to respond to internal uncertainties resulting from geographic and cultural distance by leveraging the internal controls and collaboration mechanisms of a captive offshore service center. On the other hand, they tend to respond to external uncertainties resulting from institutional distance by limiting their foreign commitment and leveraging the resources and local experience of third party service providers. Finally, we find that the temporal distance component (time zone difference) of geographical dispersion between onshore and offshore countries plays a dominant role over the spatial distance component.

1. Introduction

Offshoring has been described as the fine slicing of firms' value chains to take advantage of factor cost differentials across countries (Beugelsdijk et al., 2009) and realize other efficiency gains that the international reconfiguration of business services enables (Bunyaratavej et al., 2008; Doh, 2005; Lewin and Peeters, 2006; Lewin et al., 2009). Also referred to as global sourcing, it reflects firms' growing need and possibility for "proactive management of location and corporate resources on a global basis" (Kotabe and Mudambi, 2009 — p.121). As firms locate portions of their value chains in various countries, they must choose between vertically integrating the business services in captive subsidiaries and outsourcing them to third party providers (Hutzschenreuter et al., 2011). According to Kumar et al. (2009), the distance between value chain activities that such global reconfigurations impose potentially makes the interaction, communication, coordination and integration of processes more difficult and uncertain. Building on Anderson and Gatignon (1986), this paper studies how these distance-related uncertainties influence the choice between a captive (hierarchical) or outsourced (contractual) offshore governance mode.

Distance has been found to mediate and moderate a series of International Business (IB) phenomena including for instance firms' internationalization process (Johanson and Vahlne, 1977), foreign entry mode choices (Kogut and Singh, 1988), subsidiary control mechanisms (Wilkinson et al., 2008), and the effectiveness of knowledge transfers in multinationals (Ambos and Ambos, 2009). In this paper, we follow recent recommendations for a differentiated study of the impact of distance in IB (e.g. Ambos and Ambos, 2009; Berry et al., 2010; Håkanson and Ambos, 2010; Nachum and Zaheer, 2005). Using a Transaction Cost Economics (TCE) approach, we study how different dimensions of distance (geographic, cultural and institutional) between home and host countries of offshored services, because they generate different types of uncertainties (internal versus external), impact offshore

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http://dx.doi.org/10.1016/j.intman.2013.02.002

governance choices in different ways. Internal uncertainty originates from the need for interaction between home and host countries units, whereas external uncertainty originates from the environment of the home and host units. Since the effect of geographic distance may differ whether a business service is moved across different time zones (West–east) or along the same time zone (North–south), the measure of geographic distance is further decomposed into a spatial distance and a temporal distance component.

To test our hypotheses we use original data from the Offshoring Research Network (ORN) on 949 offshoring initiatives by companies based in various countries (the United States — US, the Netherlands, Germany, Belgium, Spain and the United Kingdom — UK), over the period 1995 to 2009. The ORN dataset is complemented with measures of geographic, cultural and institutional distances obtained from independent sources. The empirical results show no significant influence of the spatial distance between onshore and offshore countries on the choice of governance mode. In contrast, time zone differences, cultural distance and institutional dissimilarities all have significant effects. On the one hand, we find that firms are more likely to respond to internal uncertainties resulting from geographic and cultural distance by leveraging the greater controls and collaboration mechanisms of a captive offshore service center (hierarchy). On the other hand, they tend to respond to external uncertainties resulting from institutional distance by limiting their foreign commitment and leveraging the resources and local experience of third party service providers (contract).

With respect to extant knowledge of the role of distance in IB, the present paper offers three main contributions. First, we confirm that distance is not a dead construct (Ambos and Ambos, 2009; Berry et al., 2010; Ghemawat, 2001; Nachum and Zaheer, 2005) but, with the growth of IT-enabled international activities, the relevant dimensions of distance may evolve. It is therefore critical to complement the measures of spatial distance with other measures that reflect for instance the temporal, cultural and institutional differences between countries. Second, we show that the widely used geographic distance construct is in fact made of at least two dimensions (spatial and temporal), whose importance would vary in function of the type of international activity. While past research has extensively documented the impact of spatial distance on the international production of goods (see for instance the results of widely used gravity equation models; e.g. Anderson and van Wincoop, 2003; Bergstrand, 1985), temporal distance would play a dominant role in the internationalization of business services. Finally, our research shows that different dimensions of distance have diverging effects on offshore governance choices because they generate, on the one hand, internal uncertainty – relational hazard between domestic and offshore units – and, one the other hand, external uncertainty resulting from the unpredictability of the host-country environment and difficulty to deal with multiple host-country stakeholders. Differentiating the dimensions of distance and associated sources of uncertainty therefore allows for a more nuanced understanding of the role of home–host country distance in international governance mode choices.

The study also points to the importance for managers of understanding the sources of uncertainties their firms face when relocating activities to foreign countries as the captive and outsourced governance modes do not equally answer to, on the one hand internal control and collaboration challenges of distant and cross-cultural interactions, and on the other hand external sources of uncertainties in the offshore country environment.

The next section builds the theoretical background of the paper with a focus on Transaction Cost Economics. Section 3 reviews relevant research on the service offshoring empirical context of the study. In Section 4, we develop the conceptual model with hypotheses pertaining to the effect of each dimension of distance on the choice of a captive or outsourced governance mode. Section 5 presents the dataset and empirical model. The results are discussed in Section 6 before we conclude with the contributions of the paper in Section 7.

2. TCE and international governance choices

The choice to vertically integrate or outsource activities of the value chain has traditionally been studied through the lens of Transaction Cost Economics — TCE (Coase, 1937; Williamson, 1975). TCE postulates that the decision to vertically integrate an activity ('make') or sourcing it from the market ('buy') depends on the level of transaction costs. It follows that firms choose the governance mode that minimizes organizing costs by comparing the costs of a hierarchy – coordination and shirking costs – to those of a contractual arrangement with a third party provider – controlling costs and opportunistic behavior of the supplier (Hennart, 1994; Williamson, 1991).

Anderson and Gatignon (1986) first formalized and applied TCE to firms' entry into foreign markets. They argued that the home–host country distance is a source of uncertainty that leads to increased transaction costs for the internationalizing firm. As the review by Zhao et al. (2004) shows, Anderson and Gatignon's (1986) paper was followed with numerous, and often conflicting, empirical applications of TCE in research on foreign entry modes. The effect of cultural distance is the most equivocal (see also Hitt et al., 2006; Wilkinson et al., 2008). Certain scholars conclude that the higher the cultural distance, the lower the commitment and the level of control (e.g. Gatignon and Anderson, 1988; Kogut and Singh, 1988). Others show the opposite, that cultural distance encourages integration and control to moderate and prevent the culture-related uncertainty (e.g. Anand and Delios, 1997). Moreover, asset specificity often conditions the relationship between the uncertainty and the degree of control (Anderson and Gatignon, 1986). There seems to be a larger consensus on the adoption of low control entry modes in institutionally uncertain host-countries (i.e. with weak formal institutions, see Arora and Fosfuri, 2000; Delios and Beamish, 1999; Meyer, 2001) and in host-countries that are institutionally dissimilar from the home-country (see also Eden and Miller, 2004; Xu and Shenkar, 2002). In those foreign environments, because of the liability of foreignness in managing relationships with local stakeholders, the costs of a hierarchical model would outweigh the transaction costs of a market solution (Meyer, 2001; see also