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Offshoring, local market entry, and the strategic context of cross-border alliances: The impact on the governance mode

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ABSTRACT

International alliances have been studied in considerable depth, but almost entirely as host market entry options. And while much global value production is done through international alliances, the organizational forms used to control dispersed value chains are often reduced to “make or buy”—that is, captive operations vs. market-based outsourcing. We examine how strategic purpose (vertical or offshore production vs. horizontal or production for local market entry) affects the choice of cooperative governance form. We contend that an offshore production role, as opposed to a market entry strategy, makes an alliance more likely to be governed as a contractual alliance than as a joint venture. Data on 261 cross-border alliances in the major appliances industry largely support our hypotheses. Further, strategic purpose moderates the effects of alliance activities and of the institutional environment of the host country on the choice of governance form.

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1. Introduction

International alliances are defined as collaborative agreements involving multiple business organizations located in different countries. They can be governed as simple contractual alliances (international contractual alliances) or as shared equity alliances (international joint ventures) in which a jointly owned entity is created (Contractor & Ra, 2002; Gulati & Singh, 1998). The choice of the appropriate transactional governance mode is a major consideration in studies of cooperative strategies (Child, Faulkner, & Tallman, 2005; Hennart, 1988; Hutzschenreuter, Lewin, & Dresel, 2011; Madhok & Tallman, 1998). In the literature, this choice has mainly been addressed in the context of local host market entry within a market-seeking (horizontal) strategy on the part of a multinational corporation (MNC) (Brouthers & Hennart, 2007). The decision by an MNC to use a long-term contract as opposed to a joint venture when the strategic purpose of the alliance is to access offshore value-adding activities (vertical strategy) has been largely overlooked (Jahns, Hartmann, & Bals, 2006; Tallman & Mudambi, 2013). However, the increasing use of joint production in global value chains suggests to us that a better understanding of how

strategic purpose (horizontal vs. vertical) affects governance choices for international alliance strategies is a relevant concern to international strategy.

The increasing importance of geographically dispersed global value production (commonly, offshore production or just “offshoring”) for goods and services is linked to economic, political and legal changes, socio-demographic trends, and rapid increases in technology development in potential host countries. In its broadest explanation, offshoring refers to situating value-adding activities within a vertical value chain in locations outside the target market country’s boundaries (Monczka, Markham, Carter, Blascovich, & Slaughter, 2005). It occurs when companies disperse their value chain activities to those locations in which they can be carried out most effectively and efficiently, independent of the market(s) in which the products are sold, thereby creating arbitrage opportunities for geographically dispersed value production (Mudambi, 2008).¹ Firms use a variety of organizational forms to implement and control offshoring, but these often have been reduced to the choice of ‘make or buy’; that is, captive (i.e., wholly owned) operations

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¹ Offshoring is often defined as moving production from the home market to a foreign production site while continuing to sell in the home market. Our definition includes this application but is intended to represent the separation of value production and delivery by MNCs more generally by representing sales to all non-local markets.

versus outsourcing via market transactions to specialist suppliers. This stark contrast suggests that only the simplest, least strategic supply agreements should be exposed to market transactional risks—more complex or essential activities should be internalized. However, it is clearly the case for both manufacturing and services that critical value-adding activities frequently are outsourced to offshore suppliers (Lewin & Volberda, 2011).

We believe that the extensive use of outsourcing in global value chains is better interpreted using Mudambi and Tallman's (2010) argument that most outsourcing transactions actually are structured as alliances—"allying to access" resources rather than "buying from the external market". They propose that when the resources that the firm is trying to access are complex or involve tacit knowledge, international alliances are likely to improve trust and coordination and introduce a more stable, more collaborative and lower risk transactional setting than arms' length markets, but at a lower cost than wholly-owned subsidiaries (Gulati & Singh, 1998; Phene & Tallman, 2012). Indeed, the growing use of international alliances in global value chains is well documented (McDermott, Mudambi, & Parente, 2013) in diverse industries such as electronics, aircraft manufacturing, or pharmaceuticals.

We ask two basic research questions to illuminate the impact of strategic purpose on the control of alliances. *First*, does the strategic purpose of an international alliance – that is, the use of the alliances to produce for local host markets as opposed to generate value for non-local (regional, global or home) markets – moderate the use of contractual vs. equity-based governance modes? *Second*, does the set of activities engaged in by an alliance relate differently to the choice of governance mode depending on this strategic purpose? To address these questions, we incorporate the body of knowledge tied to international alliances (Dunning, 1995; Osborn & Baughn, 1990; Pan & Tse, 1996) with that of offshoring and global value chains (Khan, Shenkar, & Lew, 2015; Lewin & Volberda, 2011). In doing so, we contribute to the literature on international alliances by showing how offshoring, seen as a strategic purpose of the alliance, invites the adoption of contractual governance modes, while market-seeking is preferably managed through joint ventures. This argument implies that global value-adding activities are likely to be constructed of centrally directed networks of contractual alliances. We also suggest that offshoring interacts with the type of value chain activities shared in the alliance and with the host country institutional factors to determine the governance mode. While a transaction cost perspective is compatible with our conclusions, we mostly base our reasoning on the idea that equity solutions in international alliances are driven by the need for coordination in complex transactions (Madhok & Tallman, 1998; Rugman & Verbeke, 2003).

To test our hypotheses, we study the effects of the strategic purposes of international alliances in the home appliances industry, which has a long history of cross-border deals that industry players have used both to pursue offshoring and to enter new markets. Home appliances are globally ubiquitous, the core technologies used in different markets differ relatively little, and cost competition is intense. International sourcing is common and has been in place for decades. Our findings show that indeed strategic purpose does matter, in that the use of joint ventures is less frequent than contractual alliances for offshore-production alliances than for market entry. We also find that the strategic purpose of the alliance moderates the effects of various activity and location variables on the choice of alliance governance form, e.g., a manufacturing role makes a joint venture significantly more likely in the case of an offshoring strategy, but less so for a market entry strategy.

The next section of the paper addresses the literature of alliance governance, followed by the development of a model of governing offshore outsourcing and the statement of various hypotheses. This

is followed by a set of empirical tests and discussion of the impact of strategic purpose on alliance governance. We close with an appeal to consider how important the explicit adoption of a cooperative alternative is to understanding the drivers and consequences of governing geographically dispersed value-adding activities.

2. Background and hypotheses

2.1. The governance of international alliances

Two theoretical perspectives of the several applied to international alliances (Brouthers & Hennart, 2007) are most relevant to our analysis. First, from a transaction cost analysis perspective, international alliances are intermediate forms between markets and hierarchies (Henisz & Williamson, 1999; Oxley, 1997). As levels of transaction specific investment increase under conditions of uncertainty and small numbers, the value of more hierarchy-like forms increases. While various models offer somewhat different mechanisms, they all reflect the concept that the more complex, strategic, and uncertain the international alliance, the more likely a joint venture will be put in place.

Second, a resource-based perspective suggests that the need for coordination in more complex transactions (Madhok & Tallman, 1998; Rugman & Verbeke, 2003), rather than fears of partner opportunism, drives the choice of equity solutions. Joint ventures are expected to allow for a more adaptable cooperative transaction. Coordination costs in the resource-based view are tied to the complexity of international alliance transactions that increase interdependencies between the partners, both technological and social (White & Lui, 2005). Sharma and Erramilli (2004) state that contractual modes are likely when the transaction is driven by easily transmissible explicit knowledge, while joint ventures will occur when complementary resources are tacit. The firm-like structure of joint ventures facilitates joint activities, enables tacit knowledge sharing, and supports the development of relationships among partners to the joint venture (Liu, Adair, & Bello, 2015; Osborn & Baughn, 1990; Oxley & Wada, 2010; Tallman & Shenkar, 1994). Oxley and Sampson (2004) show that a broader scope of knowledge and activities, such as the combination of manufacturing and R&D capabilities, makes the use of equity forms of governance more likely in international alliances.

Overall, both perspectives suggest that more complex transactions involving greater interdependencies between partners with more reliance on tacit knowledge will make the hierarchy-like governance structures of joint ventures more likely (Gulati & Singh, 1998). Superior coordination of resources and capabilities in joint ventures will offset greater transaction specific investment, while giving both partners reason to avoid opportunistic actions (Madhok & Tallman, 1998; Phene & Tallman, 2012). However, international alliances can be established for different purposes, in particular to govern offshore outsourcing rather than enter foreign markets, raising the question of how these purposes impact on factors that drive governance mode decisions. We address this question in the next sections.

2.2. Market-seeking vs. offshoring as strategic purposes of international alliances

We focus on whether a horizontal strategy to better access the local host market leads to different tendencies in governance of an international alliance than does vertical offshoring in the global value chain. The alternative governance choices considered are non-equity contractual alliances versus equity-based joint ventures, since the decision to use or not use equity participation is the

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