



# Global outsourcing, explorative innovation and firm financial performance: A knowledge-exchange based perspective



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## ARTICLE INFO

### Article history:

Received 6 February 2016  
Received in revised form 17 September 2016  
Accepted 15 October 2016  
Available online xxx

### Keywords:

Global outsourcing  
Explorative innovation  
Knowledge-based view  
Relational capital  
Epistemic communities  
Firm financial performance

## ABSTRACT

Global outsourcing can be an effective strategy to reduce costs and gain access to worldwide knowledge, however, research reports conflicting results regarding its performance effects. Building on knowledge and relational capital literatures, I submit that firms experience higher cognitive and normative barriers in knowledge exchange in global outsourcing, and this causes explorative innovation to negatively mediate the relationship between global outsourcing and firm financial performance. However, this negative mediation effect can be positively moderated by building relational capital with foreign suppliers. I test the theory using data from 223 manufacturing firms in the Netherlands, and find support for the hypotheses.

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## 1. Introduction

Global outsourcing is the practice of sourcing from independent suppliers in the global market for goods and services across geopolitical boundaries. As such global outsourcing is part of offshoring, which also includes captive modes of sourcing through the internal organization of the multinational enterprise. Some scholars observed some confusion in the literature regarding the use of these labels (e.g. Bunyaratavej, Hahn, & Doh, 2008; Mol, van Tulder, & Beije, 2005). However, the nature of outsourcing through the market can be fundamentally different from sourcing through internal organization (e.g. Buckley, 2011; Hennart, 2009; Kogut & Zander, 1993). In this study, we focus specifically on global outsourcing defined as the buying by one firm in one country from another independent firm in another country.

Global outsourcing is often considered a critical element of low-cost strategies (Petersen, Prayer, & Scannell, 2000), in gaining access to innovative high-tech inputs (Li, Liu, Li, & Wu, 2008; Linder, 2004), advanced services (Bunyaratavej, Hahn, & Doh, 2007; Kshetri, 2007), global human resources and talent (Lewin, Massini, & Peeters, 2009), and software applications (Verwaal, Commandeur, & Verbeke, 2008). Thus, global outsourcing may be

an effective strategy to reduce costs and gain access to worldwide knowledge (Di Gregorio, Musteen, & Thomas, 2009; Li et al., 2008).

However, research on the relationship between global outsourcing and firm performance is rare and reports conflicting results (e.g. Jiang, Belohlav, & Young, 2007; Lampel and Bhalla, 2011; Mol, van Tulder, & Beije, 2005). Jiang et al. (2007) estimate the impact of global outsourcing on the market value of Japanese firms. They estimated one model for domestic outsourcing and one model for global outsourcing. They find that global outsourcing has a positive and significant effect on market value, whereas domestic outsourcing has a negative effect. Mol et al. (2005) examined the impact of global outsourcing and firm performance measured as a composite measure of return on sales, return on assets, market share and sales growth relative to the largest competitors. They report that global outsourcing for both measures had no significant impact on firm financial performance. Lampel and Bhalla (2011) find that both benefits and risks increase when high value activities are outsourced, and suggest that the degree to which knowledge is codified and embedded in an activity or location constitutes a barrier to the effective global mobility of knowledge. Furthermore, an increasing number of studies report concerns with respect to global outsourcing on quality (Gray, Tomlin, & Roth, 2009; Steven, Dong, & Corsi, 2014), knowledge and intellectual property rights protection (Roy & Sivakumar, 2011), particularly for high-added value products and services (Lampel & Bhalla, 2011). However, few

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studies investigated the role of innovation in the relationship between global outsourcing and firm financial performance.

Scholars have argued that companies' choices to engage in international business might positively impact their innovation (e.g. Sapienza, Autio, George, & Zahra, 2006; Siedschlag & Zhang, 2015). Innovation can be directed towards the *exploration* of new knowledge and skills or the *exploitation* of existing knowledge and skills (March, 1991). This distinction is important because explorative innovation depends on a higher level of social interaction (Mesquita, Anand, & Brush, 2008), rich (face-to-face) communication (Espinosa, Slaughter, Kraut, & Herbsleb, 2007; Jean, Sinkovics, & Hiebaum, 2014; Mom, van Neerijnen, Reinmoeller, & Verwaal, 2015), and it is more vulnerable to opportunistic behavior, particularly in the absence of proper institutions that protect knowledge and intellectual property rights (Jean et al., 2014). These conditions are often more difficult to realize in global outsourcing relationships. This raises concerns about the impact of global outsourcing on the explorative capacity of the outsourcing firm, and its capacity to generate financial rents from its knowledge assets (Buckley & Strange, 2011).

One conceivable way to improve the quality of social interaction and communication between buyers and suppliers is to build relational capital (Carmeli & Azeroual, 2009; Cousins, Handfield, Lawson, & Petersen, 2006; Kale, Singh, & Perlmutter, 2000). Relational capital refers to the quality of relationships in terms of the extent to which they are perceived to be close and trustful (Moran, 2005). Relational capital together with the structural configuration of relationships forms social capital (Adler & Kwon, 2002), however, recent studies indicate that relational capital plays a more important role in explorative innovation (Kijkuit & van den Ende, 2010; Mom et al., 2015), and it is closely intertwined with knowledge exchange (Mom et al., 2015). Relational capital with a supplier refers to the extent to which the buying firm operates within close and trustworthy supplier relationships (Cousins et al., 2006). Building relational capital with suppliers is often considered difficult because of differences in organizational cultures and practices (Dyer & Nobeoka, 2000), and building relational capital with foreign suppliers may be even more difficult as firms also need to exchange knowledge that is codified and embedded in a different business environment (Lampel & Bhalla, 2011). However, for firms that succeed to overcome these obstacles, relational capital may have the potential to make knowledge exchange available from a wide variety of suppliers in the global market place (Chang & Gotcher, 2007).

We aim to contribute to the literature on global outsourcing by exploring the role of relational capital in the relationship between global outsourcing, explorative innovation and firm financial performance. As firms differ in their exploration needs and capabilities, the relationship may have different forms for firms introducing explorative innovation to a greater extent. These various degrees of exploration may also lead to different levels of firm financial performance as organizations in global outsourcing relationships are more at vulnerable to the risks of bounded rationality and opportunistic behavior in knowledge exchange, which may dampen the financial returns for outsourcing firms. More precise understanding of this relationship is also important for international business strategies and government policies that underlie innovation policies and international trade agreements. Finally, we contribute to the insights on the relational capital and knowledge-based literatures (Dyer & Singh, 1998; Dyer & Nobeoka, 2000; Fransson, Håkanson, & Liesch, 2011; Håkanson, 2005; Kogut & Zander, 1993, 1996; Mom et al., 2015; Moran, 2005) by deepening our understanding of the effectiveness of relational capital in a global outsourcing context.

We organize the paper as follows. In the next section, I examine previous literature and develop the hypotheses, focusing on the

nature of the relationships between global outsourcing, explorative innovation and the role of relational capital with foreign suppliers in the formation of firm performance. I empirically test the proposed theoretical relationships using survey and lagged performance data from manufacturing industries in the Netherlands, home to several innovative manufacturing industries. I present evidence that global outsourcing negatively impacts firm financial performance through reduced explorative innovation of the firm. The model estimates suggest that explorative innovation can be reduced by more than 12% at high levels of global outsourcing. However, I also find that relational capital with foreign suppliers can be an effective way to mitigate this negative effect. I conclude with a discussion of the results, limitations of the study and some managerial and policy implications.

## 2. Background and hypotheses development

Modern-day industries increasingly operate in global supply chains where firms outsource large parts of their value chain to suppliers across geopolitical borders (Baldwin, 2008; Ethiraj & Levinthal, 2004). Managing such global value chains raises many challenges including quality control (Gray et al., 2009; Steven et al., 2014), knowledge and intellectual property rights protection (Roy & Sivakumar, 2011), and complex coordination (Lampel & Bhalla, 2011). One way to reduce the complexity of these global supply chains is to apply modular production and design (Kedia & Mukherjee, 2009). Modularization of the supply chain reduces coordination costs and increases flexibility (Kedia & Mukherjee, 2009), and reduces the risks of knowledge leakage and violation of intellectual property rights (Henkel, Baldwin, & Shih, 2013; Tiwana, 2008). Thus, modularization may be a successful response to reduce complexity and increase the exploitation efficiency of the global supply chain.

However, reconfiguring or developing a new modular system is more difficult than a comparable interconnected supply chain (Baldwin & Clark, 1997; Ethiraj & Levinthal, 2004; Miozzo & Grimshaw, 2005). For example, design of a new modular system requires more knowledge of the overall process in order to make the modules function effectively as a whole. The module designers need to coordinate, communicate and specify these rules in advance. Problems in modular systems only tend to appear when the modules come together and prove to work poorly. Thus, the benefits of modular global supply chains come at a price as the reconfiguration and adaptation of modules need more advanced communication and coordination between the module partners (Liu, Feils, & Scholnick, 2011). Such advanced communication and coordination may be more difficult to realize if buyers and suppliers work at distant locations and exchange knowledge which is codified and embedded in different business environments (Lampel & Bhalla, 2011).

One perspective that explains the role of knowledge in international business theory is the knowledge-based view (Kogut & Zander, 1993, 1996, 2003). The knowledge-based view assumes that organizational members have a need for identity and social embeddedness and that organizations function as knowledge-based relational networks or epistemic communities in which organizational members acquire and synthesize knowledge and build new applications from recombination of those knowledge resources (Kogut & Zander, 1992). These epistemic communities are better able to handle the exchange of knowledge because their common norms, procedures and practices constrain the risks of bounded rationality and opportunism in knowledge exchange. However, at the same time organizational members can be members of multiple epistemic communities (Håkanson, 2010), such as professional epistemic communities which often operate across different countries (Fransson et al., 2011), and relational

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