Long Range Planning ■■ (2016) ■■–■■

Contents lists available at ScienceDirect

Long Range Planning

journal homepage: http://www.elsevier.com/locate/lrp

Examining Managerial Preferences and Choices: The Role of Value Creation and Value Appropriation Drivers in Strategic Outsourcing

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A significant volume of research examines value creation (total value created in a given relational transaction between two or more firms) and value appropriation (level of value the focal firm captures) as two major components managers examine when considering the outsourcing choice. However, scholars have paid far less attention to the trade-offs managers of a focal firm make when they consider the total value an outsourcing choice creates and the value they expect the firm to capture. In a study of 1,728 decisions made by 72 managers with outsourcing experience, we examine how managers distribute importance (i.e., utility) between these two important value components, and whether or not heterogeneity exists in managerial preference models. Our analysis finds that managers' expectation about the total value an outsourcing engagement will create has a positive influence on the decision to outsource. Moreover, the level of value managers expect to appropriate strengthens this relationship when the value an outsourcing engagement creates involves shared investments in resources and capabilities. We also find significant idiosyncrasy in managerial preference models. In several cases, the characteristics of the decision maker explain a large portion of the variance in the decision to outsource.

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Introduction

Firms pursuing strategic outsourcing rely on intermediate markets to provide specialized capabilities that have the potential to create value beyond cost economies alone (Contractor et al., 2010; Holcomb and Hitt, 2007; Quinn and Hilmer, 1994). Most studies view outsourcing choices as rational decisions based on economic factors (e.g., Bettis et al., 1992; McIvor, 2009; Walker and Weber, 1984; Williamson, 2008) or resource-based factors (e.g., Holcomb and Hitt, 2007; McIvor, 2009; Quinn, 1999, 2000), and hence argue that these decision-making processes are influenced by expectations about value creation (e.g., cost reduction and revenue enhancement synergies) in an outsourcing relationship, and the focal firm's ability to capture this value (Mayer and Salomon, 2006; Verwaal et al., 2009). These studies suggest that managers hold certain expectations about value creation and value appropriation. In turn, these expectations influence the choices they make about strategic outsourcing. However, work in this area has not addressed questions about the extent to which the value component influences managerial decisions, nor has it examined whether heterogeneity exists in these decisions.

In this study, we examine the extent to which different relational factors affect managerial choice when considering discrete outsourcing engagement options between a focal firm and its outsourcing provider(s) (i.e., contracts). We view the choice of strategic outsourcing engagement as a function of the value (i.e., utility) managers of focal firms associate with value creation (the total value a given outsourcing relationship creates) and value appropriation (the total value the focal firm captures from the outsourcing relationship). Specifically, we examine the extent to which managers weigh specific value creation and value appropriation factors when choosing among discrete outsourcing options. Further, we conduct a post-hoc analysis to examine heterogeneity in the preference models of strategic outsourcing. In particular, we consider idiosyncrasy in the preferences managers hold about their choice of different outsourcing governance forms, thereby moving away from firm-based logics to micro-foundational behavioral logics to understand forces that drive managerial choice. While the decision to engage in an outsourcing relationship is made collectively within an organization, individual managers' perceptions and expectations constitute the micro-motor that guides their judgments about the benefits of outsourcing (Mantel et al., 2006), and coalesce to constitute a collective-level decision about which outsourcing engagement the firm will pursue. Because decision makers often base valuation judgments and choices on idiosyncratic knowledge and preferences, these judgmental decision outcomes can vary across managers (Felin and Foss, 2005; Felin et al., 2012; Foss and Lindenberg, 2013).

http://dx.doi.org/10.1016/j.lrp.2015.12.022
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Please cite this article in press as: Nidthida Lin, Timothy M. Devinney, Tim R. Holcomb, Examining Managerial Preferences and Choices: The Role of Value Creation and Value Appropriation Drivers in Strategic Outsourcing, Long Range Planning (2016), doi: 10.1016/j.lrp.2015.12.022

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We use a utility-based experimental method — discrete choice experimentation (Louviere et al., 2000; Train, 2003) — to untangle the degree to which the different value components influence managerial choices of outsourcing. The experimental methodology permits us to take a fine-grained approach by focusing on the decision models of the individual managers. This approach requires managers to make trade-offs among choice options and, therefore, establishes a more realistic context to examine managerial decision-making than traditional Likert survey-based approaches provide. Further, the orthogonal design we use also allows us to look at the effect of each value components separately, thereby avoiding confounding effects related to correlations that naturally exist amongst the components of a decision. Finally, our use of a Bayesian approach to estimate covariance enables us to consider the extent to which managers consistently value certain well-known outsourcing drivers, and, if heterogeneity exists, this approach allows us to examine factors that contribute to this variance.

Our work makes four primary contributions. First, this work extends our understanding of value creation and value appropriation in strategic outsourcing decision-making (see Leiblein, 2003; Verwaal et al., 2009). Specifically, we demonstrate how managers' expectations about value appropriation and value creation interact to affect their choice from among discrete outsourcing options. Second, while a significant body of research has examined outsourcing selection, we know less about individual variance in outsourcing choices. In this paper, we use a Bayesian model to examine idiosyncrasy in individual decision models. Bayesian models recognize that decision makers often have imperfect information concerning some important aspect of their decision-making settings, about which they form (possibly incorrect) subjective beliefs. This approach allows us to extract unexplained variance that we cannot capture by simply examining an error term. In response to calls for studies on micro-foundational issues (Devinney, 2013; Foss and Lindenberg, 2013), we also attempt to explain how the variance in individual- and firm-level characteristics can produce *variance in preference models* for managers making simulated discrete outsourcing choices. As a result, we provide a deeper understanding of when and why the choices of outsourcing relationships are likely to be heterogeneous. Third, by utilizing structured experimental methods and Bayesian estimation, we move beyond a focal emphasis on the development of generalized singular model of outsourcing choice to individual decision models used by managers. These individual decision models allow us to capture and explain individual level variance in strategic outsourcing engagement choices. Finally, a combination of experimental discrete choice modeling and Bayesian econometrics potentially opens up a new avenue for the examination of the micro foundations of strategy. To date, most work in applying micro-foundational thinking applies behavioral logics but has yet to coalesce around an appropriate and accepted set of methodologies that link theory to proof in a structured and direct manner (see, for example, Devinney, 2013).

Decomposing strategic outsourcing decisions

We conceive the strategic outsourcing decision to be a function of managers' expectations about the total potential (latent) value an outsourcing engagement creates, and the level of value they expect their focal firm to capture from the outsourcing engagement. In this way, managers maximize expectations about the size of the pie (i.e., value creation) and the fraction of the pie they can capture (i.e., value appropriation). Following Leiblein (2003), we integrate transaction cost economics (TCE) and resource based view (RBV) to decompose strategic outsourcing choices. More specifically, we draw on RBV to examine potential sources of value creation in outsourcing relationships and TCE to delineate how firms efficiently appropriate this value.

The mainstream outsourcing literature suggests two types of outsourcing: *tactical* outsourcing, which focuses intensively on near-term cost savings, and *strategic* outsourcing, which focuses on longer-term relational value or rents. Assumptions about the value managers expect outsourcing to create figure importantly in this assessment. The first type of value created in an outsourcing engagement is the economic value that cost savings produce in the near-term. This type of value is a focus of tactical outsourcing. Cost advantages from outsourcing arise from outsourcing provider's superior efficiency in performing such activity at lower costs and in a shorter time (Barney, 2001; Peteraf, 1993). According to this view, outsourcing reflects the firm's efforts to operate more efficiently by leveraging providers' resources and capabilities.

A second type of value is the strategic value that resource complementarity creates. This value type is typically the focus of strategic outsourcing engagements. Research in this area considers outsourcing as a strategic tool focal firms use to access and leverage specialized resources and capabilities from exchange partners (Holcomb and Hitt, 2007; Quinn, 2000; Quinn and Hilmer, 1994). We argue that strategic value emerges from two possible sources: 1) the direct benefits an outsourcing provider's resources and capabilities create; or 2) the indirect benefits of combining complimentary resources and capabilities. Specifically, outsourcing not only creates value for a focal firm by providing it with access to an outsourcing provider's specialized resources and capabilities, but also creates synergistic value (Dyer and Singh, 1998) when the focal firm combines complementary resources and capabilities with the outsourcing engagement.

Research has also examined the role of value appropriation in outsourcing decisions. According to TCE, the risks of opportunism and bounded rationality are a major component of transaction costs and pose a serious threat to parties in cross-boundary transactions (Williamson, 1985, 1991). While value appropriation is rather straightforward in a full ownership arrangement, the absence of ownership or direct control in an outsourcing transaction raises the question of how value appropriation can be enforced (Verwaal et al., 2009), especially in the case of innovation (Arrow, 1962; Schumpeter, 1934; Teece, 1986), where future value is uncertain and difficult to predict ex-ante. We discuss below a model of strategic

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