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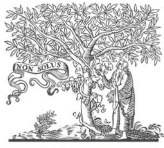

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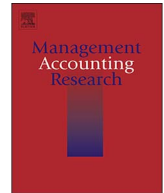

Research Paper

Contracting abroad: A comparative analysis of contract design in host and home country outsourcing relations

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ABSTRACT

Cross-border business relationships often involve significant risk because they entail greater information asymmetry and complexity to manage collaboration than domestic relationships. Yet, little is known about the contractual design of such relationships. We examine a prominent form of cross-border collaboration − firms' strategic outsourcing in a host country where they operate − and contrast contracting choices with those made for similar home country relations. We collect survey data from Japanese subsidiaries operating and outsourcing in the Netherlands, and from Japanese firms outsourcing in Japan. Results show that contract complexity does not differ between similar home and host country relationships; however, consistent with our hypotheses, host country contracts have a shorter duration, more renewal provisions, less flexibility, and relatively greater contracting costs.

1. Introduction

Interfirm relationships increasingly transcend national boundaries (Handley and Angst, 2015). Prior studies recognize that cross-border collaboration can provide firms with significant benefits such as cost reduction, but also that such relations can be fraught with risk. The literature on interfirm collaboration identifies two types of risk in interfirm collaboration: relational risk (i.e. lack of cooperation between partners which could result in opportunistic behavior); and performance risk (i.e., failure despite full cooperation) (Das and Teng, 1996; Langfield-Smith, 2008). While just as in domestic collaboration, firms engaging in cross-border collaboration are exposed to such risks, they face greater information asymmetry and complexities in managing relationships due to spatial, legal, institutional and cultural differences, increasing informational frictions, and heightening monitoring and coordination costs (Asmussen et al., 2016; Aulakh and Gençtürk, 2008; Boeh, 2011; Costello, 2013; Handley and Angst, 2015; Jung and Lee, 2017). Therefore, cross-border relations are considered more 'risky' than equivalent relationships with domestic business partners (e.g., Giannetti and Yafeh, 2012; Larsen et al., 2013). Notably, although a considerable amount of research has examined the use of interfirm contracts as a primary mechanism for managing risks of interfirm collaboration (e.g., Anderson and Dekker, 2005, 2014; Ding et al., 2013; Macher and Richman, 2008; Schepker et al., 2014), few studies have done so in a cross-border setting where the greater information asymmetry and complexities in managing relationships can evoke different contract design choices.

We examine contract design in a particular form of cross-border collaboration, namely outsourcing by firms' subsidiaries in a host country where they operate. Host country outsourcing differs from other forms of cross-border collaboration, such as international alliances and offshoring, as it involves foreign subsidiaries outsourcing to local partners.[1] Examining this setting enables us to provide insight into how, as compared to domestic outsourcing relationships, firms outsourcing in a host country make different contract design choices in order to cope with the greater information asymmetry and complexities they face. In addition, as contracting in a cross-border setting can be fraught with additional inefficiencies, a critical question to address is how this impacts contracting costs, which will influence the cost-benefit tradeoffs that firms make in contracting. Addressing these questions not only provides insight into differential contract design and cost-benefit tradeoffs for host country outsourcing, but also enhances insight into the organizational complexities and costs of maintaining foreign operations for which local sourcing is typically a necessity (Jung and Lee, 2017).

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[1] While part of a foreign entity, the subsidiary is located in the host country, which reduces effects of spatial distance (which though remains for the parent firm), and over time can reduce the impact of other (e.g., cultural, institutional, legal) differences with the home country.

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To address this question, we conduct a comparative analysis of contract design between host country outsourcing relationships and comparable domestic outsourcing relationships. The outsourcing by firms' subsidiaries in a foreign host country to local business partners (i.e., 'host country outsourcing') is a commonly occurring form of cross-border collaboration (e.g., Jung and Lee, 2017) that to date has received only limited attention in interfirm research.[2] We focus on 'strategic outsourcing,' in which firms in the pursuit of value creation outsource the delivery of key products, parts, or services to another firm (Holcomb and Hitt, 2007; Quinn, 1999). A key motive to engage in strategic outsourcing is to leverage firm capabilities by obtaining access to a partner firm's unique capabilities and resources. Such relations, however, also create significant demands to develop good contracts to mitigate the risks of locating critical tasks outside the firm.

Based on prior contracting studies, we identify four key design dimensions of interfirm contracts: complexity, duration, renewal and flexibility. Following the argument that firms outsourcing abroad face greater information asymmetry and complexities in managing relationships, we theorize that contracting differences will exist with domestic outsourcing relations. In particular, we predict that host country outsourcing contracts will be more complex, have a shorter duration, include more renewal clauses, and provide less flexibility than home country outsourcing contracts. In addition, we examine differences in the cost of contracting as relating to negotiating and drafting contracts. We predict that host country outsourcing will involve greater contracting inefficiencies and consequently relatively greater contracting costs. Finally, we explore the effects of host country experience, which through learning reduces information asymmetry and inefficiencies (e.g., Basuil and Datta, 2015), and test whether the hypothesized effects hold primarily for firms with limited experience in the host country.

To test these expectations, we have collected survey data from Japanese firms with strategic outsourcing relations in a domestic setting (i.e., in Japan) and from Japanese firms outsourcing in a host country (i.e., in the Netherlands). This approach, in which the nationality of the outsourcing firm remains constant, enables us to conduct a comparative analysis of contracting differences. To conduct an adequate comparison, we match similar home and host country observations regarding outsourcing characteristics that proxy for exchange hazards. Consistent with prior research rooted in transaction cost economics (TCE), we find that with greater exchange hazards (as proxied by transaction characteristics), firms develop more complex contracts of longer duration, which make more use of renewal clauses and, particularly when facing high uncertainty, provide greater flexibility. Our analysis of interrelations among the four contract design dimensions also support the idea that these choices are interrelated decisions that need to be considered in conjunction. Over and above these effects, we find that contract design choices differ when the outsourcing relation is located in the host country. While we observe no differences in contract complexity, host country contracts have a shorter duration, make more use of renewal provisions and provide less flexibility. In addition, controlling for variation in contract design and outsourcing characteristics, we find that contracting costs are greater for host country outsourcing, and that this relates to the relatively greater cost of contract complexity. Finally, consistent with the idea that information asymmetry and inefficiencies are reduced through learning, we find that the identified comparative differences hold primarily for firms with limited host country experience.

[2] For instance, a recent survey of the Japanese Ministry of Economy, Trade and Industry on firms' overseas business activity reported that subsidiaries of Japanese manufacturing firms in Europe procured 36.2% of their total procurement amount in the local (host) country, 27.7% from other European countries, and 26.5% from the home country Japan (Ministry of Economy, Trade and Industry, 2015). Jung and Lee (2017) report a local sourcing ratio of 48% in a sample of 171 international subsidiaries of Korean firms across 31 countries in 2007.

This study contributes to the evolving literature on the management and control of interfirm relationships by examining the influence of cross-border relations on interfirm contract design, particularly in the setting of host country outsourcing. While prior studies have considered interfirm contracts as mechanisms for the management of interfirm risks that arise from transaction characteristics (Anderson and Dekker, 2014), we show that in a host country setting contract design differs from home country contracts for otherwise comparable transactions. These differences are consistent with theoretical predictions of the effects of heightened information asymmetry and complexities to manage relations in a host country that evoke different design choices. We also provide evidence on differential economics of contracting for host country outsourcing, which we find to be more costly than for home country relations. Finally, we provide evidence of the influence of host country experience, which through learning and reduced information asymmetry and inefficiencies, reduces the differences in both contract design and costs. In the next section, we review the relevant literature and develop hypotheses. In the sections thereafter we discuss our research method, data and analyses, and provide a discussion of the results, implications and limitations of the study.

2. Literature review and hypothesis development

2.1. Contracting for strategic outsourcing

Interfirm contracts are a key mechanism in the governance of interfirm relations as they provide the formal arrangements on which collaboration is based and a framework within which cooperation proceeds (Anderson and Dekker, 2005, 2014). In particular, contracts enable firms to manage exchange hazards relating to relational risks and performance risks (Reuer and Ariño, 2007; Schepker et al., 2014). While relational risks relate to potential opportunistic behaviors by an exchange partner, performance risks relate to coordination needs that ask for communication, coordination and adaptation across firm boundaries to realize collaborative objectives (Das and Teng, 1996; Langfield-Smith, 2008). Well-developed contracts provide clauses that align and safeguard partners' interests and facilitate coordination and adaptation.

Prior TCE-based studies have shown that exchange hazards affect contract design in terms of contract complexity (e.g., Anderson and Dekker, 2005; Ding et al., 2013; Macher and Richman, 2008; Reuer and Ariño, 2007; Poppo and Zhou, 2014). Complex contracts provide for greater control as they allow firms to safeguard their interests against misappropriation by exchange partners by supporting the enforcement of agreements and incentivizing partners to act in their interests. In addition, they facilitate coordination by specifying a division of labor and providing guidelines to integrate partners' activities, resulting in simplified decision making and reduced disagreements about how to accomplish tasks (Ding et al., 2013; Reuer and Ariño, 2007; Schepker et al., 2014). More complex contracts are characterized by greater inclusiveness of agreements, greater detail with which terms, clauses and issues are specified and codified, and greater use of provisions that facilitate adaptation to anticipated contingencies (Ding et al., 2013; Luo, 2002; Luo and Tan, 2003; Schepker et al., 2014).

In addition to contract complexity, prior studies have shown that exchange hazards also influence other contract design choices (Anderson and Dekker, 2014). First, a range of studies has examined the duration of interfirm contracts, finding that exchange hazards induce partners to engage in longer-term contractual commitments (Costello, 2013; Harris and Holmstrom, 1987; Joskow, 1987; Lyons, 1996; Schepker et al., 2014; Weber et al., 2011). Often (but not necessarily) longer-duration contracts are more complex as the contract needs to cover agreements for a longer period, in which more contingencies can emerge. In addition, the economic value of long-term collaboration is typically greater than that of short-term relationships, making investments in complex contracts economically more feasible.

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