Offshore Outsourcing: Implications for International Business and Strategic Management Theory and Practice

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ABSTRACT In this essay, I discuss the implications of the debate over offshoring for our collective understanding of international business and management theories. I review several core theories in international business expansion and management strategy to assess which elements of these theories may need to be re-specified in light of the offshoring phenomenon and which aspects remain relevant. I then present normative implications and recommendations for public policy and corporate strategy, drawing from emerging insights regarding the global responsibilities of corporations. I suggest that international labour and environmental standards and corporate codes of conduct could mitigate some of the most intense concerns raised about offshoring but conclude that offshoring is likely to present challenges to societies, corporations, and stakeholders for many decades.

INTRODUCTION

As the previous two essays illustrate, there is considerable divergence over the causes and consequences of offshoring (Farrell, 2005; Levy, 2005). Inherent in this debate are disagreements over basic assumptions in economic theory and management decision-making. Indeed, although offshoring is not new, its acceleration – real or perceived – may challenge established theoretical orthodoxy regarding the operation of the global economy generally, and management practice, in particular. In this essay, I explore the implications of the debate over offshoring for our collective understanding of some leading international business and strategic management theories.

Recent efforts to reconceptualize the IB field, especially as it relates to global strategic management, have stressed globalization, the changing strategy of MNEs...
and their impact on the world economy (Buckley and Ghauri, 2004), the factors that determine the success or failure of firms within this competitive environment (Peng, 2004), and the growing importance of Civil Society and NGOs to the theory and practice of IB (Teegen et al., 2004). These research directions capture the context (culture, geography, institutions), firm-level goals (performance), and societal impact (globalization and its challenges) that are critical to analysis of offshoring and its impacts. Ramamurti (2004) recently identified offshore outsourcing of services as an emerging research theme in IB, however he notes that to date, the IB research community has paid limited attention to this important phenomenon.

In addition, the strategic management literature has grappled with the application of resource-based perspectives on strategy in environments characterized by turbulence and change. In particular, recent work in the area of dynamic, co-evolutionary processes in organizations (Lewin and Volberda, 2003) is directly relevant to the challenges for the firm of maintaining competitive advantage in the face of pressures to reduce costs and shift production brought about by shifting technology, markets, and competition, the principal forces at work in offshoring.

**IMPLICATIONS FOR MACRO THEORIES OF INTERNATIONAL BUSINESS**

Fundamentally, offshoring presents challenges to core theories which underpin many assumptions within IB research. For example, the ease by which corporations shift operations and employment among countries has direct implications for the relevance of a traditional comparative advantage view of global competition (Maneschi, 1998). Although Porter (1990) and others have long criticized traditional Ricardian comparative advantage theory as too narrowly focused on the role of factor endowments, offshoring provides further evidence that traditional factors of land and labour are not sufficient (and may not even be necessary) conditions for advancing economic development. At the same time, however, the combination of one critical endowment (labour) with an additional, more variable factor (education), does appear to provide a powerful inducement for firms to consider decoupling their core production and service activities. The explosive growth of offshoring in India attests to this reality. In addition, Porter’s (1990) requirement of home market demand as a necessary condition for internationally competitive industries is anachronistic in an environment where new, efficient industries have rapidly developed in regions with little home market demand for their outputs.

Dependency theory emerged in the late 1960s and early 1970s to counter the presumption that the growth patterns of developing and developed countries would converge, and that barriers to capital and technology flows prevented this
convergence. Dependency theorists countered that the development of industrialized nations occurred at the cost of the developing nations who were the victims of uncontrollable global forces such as multinational corporations and international development institutions (Cardoso and Faletto, 1979; Frank, 1967). In much of the world, the dependency and related Import Substitution Industrialization (ISI) model have been repudiated as research increasingly suggests that foreign direct investment (FDI) may be as or more important to a country's growth than domestic investment, since investment by MNCs brings improved technology and does contribute, eventually, to convergence (Taylor, 1999).

Although most of the concerns about offshoring have been directed to the developed countries in which jobs and wages appear threatened, offshoring raises concerns about a new kind of dependency. Offshoring, when unrelated to domestic demand, may exacerbate reliance by developing countries on the capital and resources of industrialized nations. If so, developing countries become vulnerable to the vagaries of MNCs who may choose to shift production from developed to developing countries, or from one developing country to another.

On the other hand, there is some evidence of convergence between the wages of developed and developing countries in high-end service industries. The wages in Ireland, once a fraction of those in the EU, have now caused many firms to move call centres and other back office operations elsewhere. In India, wages in business services have been increasing steadily, suggesting the emergence of a global market (rather than a national one) for many of these positions (Scheiber, 2004).

IMPLICATIONS FOR THEORIES OF INTERNATIONAL EXPANSION

In 1966, Vernon described a theory of international competition known as the international product life cycle model (PLC). The PLC proposes that capital intensive and technologically sophisticated innovations are typically developed in the USA for the domestic market, and progress through various stages in which production shifts to other developed countries and finally to developing countries that become platforms for MNC exports to their home country and other developed markets. As a complement to Vernon’s macro orientation on cycles in international trade, Johanson and Vahlne (1990) developed a model of sequential internationalization on a firm level that emphasizes incremental internationalization through acquisition, integration, and use of knowledge of foreign markets.

Recently, scholars have questioned the validity of the PLC model (Cantwell, 1995) and of the internationalization perspective (Anderson, 1993; Itaki, 1991) to contemporary IB phenomenon. Vernon himself suggested the PLC may lose utility in an increasingly complex and integrated international trade environment (Vernon, 1979), and other researchers argue that many international ventures do
not follow the slow, sequential process anticipated by the PLC and internationalization perspectives, but rather may experience a more uneven or accelerated process of internationalization (McDougall et al., 1994).

Vernon (1966) emphasized the importance of local demand conditions as a catalyst for export abroad, and the subsequent commoditization of products as an impetus for FDI. Contrary to this slow, sequential internationalization, the inputs to final production of many services may be ‘de-coupled’ from intermediate inputs early in the internationalization process under offshoring schemes. Hence, the linkages between production location and core knowledge-based activities may be weak. Examples include film production, programming, back office, and call centre functions in audio-visual, software, legal, and accounting services. For production of these services, local demand is less (or un-) important, while specific country factors – land, labour, and infrastructure – are proportionately more important. Moreover, as Levy (2005) notes, the development of communications technologies and the requisite mobility of labour have allowed for an accelerated internationalization of production that accords neither with the product life-cycle nor the sequential internationalization perspective. Indeed, some have argued that many firms are now ‘born global’ (Knight and Cavusgil, 2004) and that the notion of sequential internationalization – whether on a country, industry, or firm scale – is outmoded and anachronistic.

A third perspective on international expansion, ‘internalization’ theory (Buckley and Casson, 1976), suggests that firms seek to develop and deploy their resources across international boundaries to take advantage of asymmetries in knowledge and capabilities. Internalization theory, when combined with constructs related to location and ownership, has provided a sophisticated and multi-dimensional rationale for international production collectively known as the ‘OLI’ perspective on international investment. The OLI framework (Dunning, 1980, 1981) proposes that firms will choose investment locations, develop international strategic priorities, and select entry modes by considering three sets of variables: ownership advantages (control and the costs and benefits of inter-firm relationships and transactions), location advantages (resource commitments and requirements, and the availability and cost of resources), and internalization advantages (the ability to reduce transaction and coordination costs and prevent opportunistic exploitation of tacit knowledge).

The phenomenon of offshoring would appear to both reaffirm and to challenge the OLI framework. Location, an important variable for market-seeking, resource-seeking, and cost-minimization strategies, is prominent in the apparent motivations for offshoring. The relevance of ownership and internalization advantages, on the other hand, is somewhat less evident. By disintegrating production stages along the supply chain and transferring them to other geographic locations, firms may create conditions for the erosion of ownership and internalization advantages. Indeed, recent concerns over the intellectual property protection in software pro-

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duction in India are an early indication of what could be a growing phenomenon. This could cause firms to reexamine which aspects of their production must remain close – both geographically and conceptually – to their core activities. For example, Dell was forced to repatriate some of its call centre staff from India to Texas due to quality control problems (Houston Chronicle, 2003). For a company that has little on-site service, the call centre capability is core to Dell’s competitive position. Contracting out – as opposed to simply changing production locations – could further undermine some of the advantages associated with both ownership and internalization.

For some firms, however, the service of offshoring is intrinsic to their business model. For these companies, capabilities in developing focused offshore outsourcing service requires specialized expertise in managing and coordinating disparate activities across geographic, sectoral, and functional boundaries. These strategies may reinforce the importance of the OLI framework, albeit with distinct competencies not related to production and markets but rather efficiency in organizing and assembling work process, often as a service to other firms. Business process outsourcing specialists such as EDS and IBM, and contract manufacturers Flextronics and Solectron, are developing new ways of exploiting OLI-type advantages by combining low labour costs, specialized technical capabilities, and organizational coordination expertise.

**IMPLICATIONS FOR STRATEGY: THE RESOURCE-BASED VIEW AND DYNAMIC CAPABILITIES**

Offshoring also has implications for strategic management. In particular, it poses challenges to collective understandings related to the development and deployment of firm-level capabilities. Offshoring potentially constitutes a firm-level capability and a resource to be developed and deployed as under internalization theory. It may also serve to undermine or reduce the value of firm-level advantages, especially those that are immobile or tied to core activities.

Building on earlier work by Penrose (1959) and Nelson and Winter (1982), proponents of the resource-based view (RBV) examined the economic returns to resources that a firm owns, acquires, or develops (Barney, 1991). In order for resources to be valuable in facilitating exploitation of an opportunity in the business environment or in neutralizing a threat, they must be scarce or must come together in a unique way as a result of how the firm packages or bundles them, immobile such as those that are idiosyncratic to the firm, those for which property rights are not well defined, or those that are co-specialized with other assets (Teece, 1986). In addition, they must be difficult to imitate so that the firm can maintain rent-earning status for a period of time. For a firm to be in a position to exploit a valuable and rare resource, it must have a resource position barrier preventing imitation by other firms.
Offshoring, both as internal process and business strategy, could be an outcome of successful management of resources, and may itself represent a direct application of firm-level capabilities as envisioned by the RBV. At the same time, however, offshoring may reflect the commoditization of a production function and erode benefits derived from management of resources and capabilities if it becomes an activity that is widely imitable and not unique to a firm or confederation firms. The Dell example, and others unreported, may argue that there are real limits to the competitive benefits of offshoring, at least for some industries and companies.

The RBV has been criticized for lacking sufficient focus on how and why certain firms have competitive advantage in situations of rapid and unpredictable change (Eisenhardt and Martin, 2000), and for overlooking the managerial coordinative processes by which firms assemble and leverage knowledge assets. In response, strategy researchers have offered an extension of the RBV and other strategy perspectives in the form of a ‘dynamic capabilities’ view of competitive strategy (Kogut and Zander, 1992; Teece et al., 1997). Dynamic capabilities refer to capabilities by which managers ‘integrate, build, and reconfigure internal and external competencies to address rapidly changing environments’ (Teece et al., 1997). Kogut and Zander (1992) refer to ‘combinative capabilities’ as the ability to acquire and synthesize knowledge resources and build new applications from those resources, especially in a changing environment.

The focus of the dynamic capabilities perspectives on rapid change captures the environment in which firms consider – often under intense pressure from competitors and the external environment – how and where to deploy and redeploy assets across geographic space. As both Farrell and Levy acknowledge, this process is at the core of the motivations for outsourcing (Farrell, 2005; Levy, 2005). As is the case under the RBV framework, some firms’ combinative capabilities lie in their ability to arrange, organize, and coordinate offshore outsourcing for others.

The combinative contributions of offshore outsourcing may, in fact, be more important than the pure cost motivations. Microsoft recently revealed the company has been paying two Indian outsourcing companies, Infosys and Satyam, as much as $90 an hour for software architects to do work at its US facilities, or a yearly rate of more than $180,000 (Lohr, 2004). Although it paid only $23–36 an hour for software programmers in India, these rates were a multiple of the wages received by the workers themselves. This suggests that the added value was less in the skilled labour and more in the strategic deployment of that labour. This gap, however, also reinforces Levy’s concerns about the shifting balance of power in global strategy (Levy, 2005). And many Indian companies are beginning to develop these very capabilities globally, as evidenced by their investments in European and North American call centres and business processing outsourcers. The Indians ‘are looking to build a global model quickly’, according to a partner with WestBridge Capital Partners, a Silicon Valley venture-capital firm that invests in outsourcing companies (Kripalani, 2004). Hence, the dynamic process by which firms develop
and preserve unique capabilities in offshoring may constitute a positive and vibrant contributor to global economic development. Others, however, are concerned that firms will become hollow, virtual organizations with little allegiance or responsibility to any of the disparate geographic regions in which they operate and unaccountable to regulators or the social impact of their activities.

A NORMATIVE PERSPECTIVE: GLOBAL CORPORATE RESPONSIBILITY

Despite these limitations, offshoring will remain an important tool for managing and deploying international human resources. If anything, the trend is accelerating. Forrester Research recently estimated that 830,000 US service jobs will be moved abroad by 2005, a 40 per cent increase from a projection of 588,000 jobs it made in November 2002. Forrester also estimated that US companies will send 3.4 million service jobs offshore by 2015 (Geewax, 2004). A survey by UNCTAD showed that the offshoring trend is quickly catching on in Europe, with four out of 10 European firms already relocating service operations offshore (UNCTAD, 2004). Although subcontracting provides important flexibility in the human resource practices of MNCs operating globally, it also requires skilled international managers to coordinate and oversee the complex relationships that arise from it.

Hence, offshoring is a reality that is unlikely to recede, and quite likely to accelerate. What can management scholars contribute to this debate, and more importantly to government policy-makers and company managers who are grappling with how best to respond? Diana Farrell proposes an insurance scheme developed by Kletzer and Litan that would provide adjustment assistance to workers displaced by offshoring (Farrell, 2005; Kletzer and Litan, 2001). But the concerns about global sourcing and the transfer of jobs abroad go beyond the economic challenges facing those displaced by specific lay-offs. Instead, offshoring suggests a broader examination of the global responsibilities of corporations.

Corporate social responsibility refers, in part, to the activities of the firm to provide social contributions that include, but are not necessarily limited to, the economic returns to investors (Wood, 1991). In the global environment, many MNCs have come under pressure from civil society and nongovernmental organizations (NGOs) to be more responsive to the range of social needs in developing countries, including addressing concerns about the working conditions in factories or service centres, and attending to the environmental impacts of their activities. Dunning (2003) has recently argued for a more responsible global capitalism that incorporates the interests of individuals, corporations, NGOs, governments, and supranational agencies.

Criticisms have been especially sharp in relation to the activities of multinational companies – such as Nike, Levi’s, United Fruit, and others – whose sourcing practices in developing countries have been alleged to exploit low-wage
workers, take advantage of lax environmental and workplace standards, and otherwise contribute to social and economic degradation. More recently, business process offshoring firms have been implicated as well. Many governments, international organizations, and both local and multinational NGOs have criticized the low-cost labour seeking behaviour of MNEs in developing countries, suggesting such firms scan the globe for the cheapest, least regulated, and most exploitive situations in which to source raw materials and semi-finished products (Singer, 2002).

Global corporate responsibility – the actions, practices, policies, and procedures governing the conduct of firms when doing business internationally – provides a useful heuristic for examination of possible proscriptions associated with the externalities described in David Levy’s essay. MNCs, with prodding from governments, NGOs, and other representatives of civil society, are increasingly agreeing to agreements and codes of conduct under which they commit to maintain certain standards in their domestic and global operations (Doh and Guay, 2004). These agreements, which include, *inter alia*, the UN Global Compact, the Global Reporting Initiative, the social accountability ‘SA8000’ standards, and the ISO 14000 environmental quality standards, provide limited assurances that when corporations increase production in developing countries, they will maintain a minimum level of social and environmental standards in the workplace and community in which they are doing business. These codes help offset the real or perceived concern that companies move jobs to get around higher labour or environmental standards in their home market. They may also contribute to rising standards in the developing world by ‘exporting’ standards of developing countries and MNCs to host countries and local firms in those countries.

The application of these standards, however, becomes further complicated when offshoring also incorporates outsourcing via contracting out services that have previously been part of a firm’s activities. It is difficult – but not impossible – for firms to trace the standards of their contractors, subcontractors, etc. There are, however, several precedents that would suggest such efforts are not outside of the reach of MNCs. For example, the rules of origin under the North American Free Trade Agreement and other trade agreements require importers to verify the origin of the products they source using a very technical process that in many cases can only be met with the cooperation of producers, contractors, subcontractors, etc. In the area of anti-corruption, the *Transparent Agents Against Contracting Entities (TRACE)* standard, which was developed after a review of the practices of 34 companies, applies to business intermediaries, including sales agents, consultants, suppliers, distributors, resellers, subcontractors, franchisees and joint venture partners, so that final producers, distributors, and customers can be confident that no party within a supply chain participated in corruption.

Individual companies have also taken steps to extend core standards to suppliers. Motorola is engaged in efforts to certify literally thousands of suppliers for meeting its global corporate responsibility standards. In some instances, it has
accepted comparable standards of those suppliers as meeting or exceeding those of Motorola itself. Mattel’s Board independently contracts with the International Center for Corporate Accountability, an NGO, to provide unscheduled on-site audits of its factories and first and second-tier suppliers to determine compliance with the company’s Global Manufacturing Principles.

CONCLUSIONS

In the end, offshoring represents a natural continuation of a process that has been underway for centuries. Paradoxically, the apparent acceleration of offshoring reflects both the successes and failures of economic globalization. Labour – not just capital – has now become a mobile factor that can be deployed – and redeployed – at a moment’s notice.

Yet other institutional rules and norms that are designed to buffer the potential negative spillovers of capitalism are not so portable. While all human capital has, to some extent, become itinerant, the social fabric that envelops our collective productive capacities has not become uniform, creating an asymmetrical distribution that has had disruptive and dislocating impacts on some regions, firms, and workers, while providing added economic stimulus to others. The development of global corporate responsibility standards and adoption of agreements and codes of conduct governing labour and environmental practices regularize these norms. In so doing, these initiatives may help to mitigate – or at least reassure – those most concerned about some of the most extreme disruptions associated with offshoring.

REFERENCES


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