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Complying with entry mode theory or not?

How experiential learning drives firms to misalign the entry choice in business services offshoring

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Executive summary

Globalization allows firms to move their operations overseas, i.e. to adopt an offshoring¹ strategy. A series of events (e.g., Y2K Millennium Bug, the dotcom bubble, the development of the service industry, incentives and deregulation from home and host countries) and technological breakthroughs triggered such radical change. Specifically, the advancements in information and communication technologies favored firms to relocate not only production activities, but also service ones.

Offshoring develops at the beginning of 1960s, with the movement of manufacturing activities overseas. Lately, the trend has shifted towards the relocation of business services, seeking cost advantages as well as talents; high value added processes such as R&D, Engineering, and IT are increasingly offshored by companies. The public opinion has contrasting feelings about offshoring, given its positive and negative implications on the growth and distribution of worldwide employment, the effects on emerging countries, and the benefits gained by MNEs.

We rely on an eclectic theoretical framework, for the sake of our thesis, which combines the main theories on entry mode: the TCE, the OLI paradigm, the Institutional theory and factors related to the cultural and offshoring context. This helped us building the background for the formulation and examination of our hypotheses. The purpose of our work is to investigate to what extent the offshoring experience drives firms to comply with the theoretical models underlying the entry mode choice or to deviate from them. Additionally, we disentangle experience by distinguishing between successful vs. unsuccessful experiences and between in-function vs. out-function experiences (i.e., an in-function experience occurs when previous experiences mostly involve the same business function in analysis; an out-function experience occurs when previous experiences mostly involve different business functions respect the one in analysis), in order to understand whether they have different effect on the extent to which firms align or misalign their entry mode choice with the traditional theoretical models.

- **Hypothesis 1:** Firms with less experience in offshoring practices are more likely to select entry choices that are aligned with the conventional entry mode theories
- **Hypothesis 2:** Failure experiences increase the likelihood that firms choose entry modes in misalignment with theory

¹ In this thesis, we refer to offshoring as the activity through which a company relocates some of its business processes from the home country to a host country (i.e., a foreign country).

- **Hypothesis 3:** Out-function experiences increase the likelihood that firms choose entry modes in misalignment with theory
- **Hypothesis 4:** The interaction between failure and out-function experiences increases the likelihood that firms choose entry modes in alignment with theory

The first hypothesis analyzes the behavior of inexperienced firms. Firms with no entry mode or international experience have no data to elaborate and information to process, facing a situation of bounded rationality where the number of external and internal variables to consider, as well as their interactions, exceed the cognitive capacities of managers. Therefore, theory remains their sole reliable source of knowledge and they choose their entry mode accordingly. The second and third hypotheses deal with failures and out-function experiences, which push companies to look for alternative solutions with respect to the initial theory-driven choices (i.e., having found that inexperienced firms tend to start their overseas penetration following theory), in order to improve their business performance. The fourth hypothesis considers the interaction between failure and out-function experiences. In this case, managers face a situation of high uncertainty, caused by the lack of capacities to analyze the negative results coming from functions out of their area of competence. Consequently, the most efficient and effective solution for decision makers is to come back to theory and implement entry mode strategies according to what it proposes.

To test our hypotheses, we employ the ORN (i.e., Offshoring Research Network) database, assessing the offshoring of business services. Specifically, our empirical analysis is divided into two stages. In the first stage, we investigate the drivers of the entry mode choice, by relying on the theoretical frameworks described above and by distinguishing between captive offshoring and offshoring outsourcing. The second stage assesses our four hypotheses and brings the real innovation to the field, introducing two main variants to the international business literature. First, the adoption of the governance misfit (i.e., the misalignment between the entry mode predicted by the theoretical framework in the first stage and the one actually implemented by each firm) as the dependent variable (no more as a determinant of a company's performance); second, a deeper investigation of experience, exploring the different influences of successful and unsuccessful experiences and of in-function and out-function experiences on the entry mode decision, which has been completely overlooked by scholars and researchers.

We believe our thesis contributes to the enlargement and improvement of the international business literature, combining the organizational theory (i.e., the role of experience) as well as the entry mode theory, and giving sparks to further develop studies on these topics.

1 Introduction

We are living in the era of globalization, witnessing one of the biggest world-shaping phenomena in the history of humankind. Considering the business world, globalization has forced firms to modify their internal organizational structure, as well as the way they manage and implement their operations. Globalization has also created highly competitive markets in which firms have to adapt and evolve their business practices quickly. Companies are now increasingly disaggregating and dislocating their value chains, looking for better and cheaper resources overseas.

Offshoring is definitely the business activity of this era, being an economic and social event that has been attracting the attention of everybody: scholars, researchers, governments, firms and media. Among all the facets of the phenomenon, international business literature has particularly focused on the critical offshoring decision of how to enter a foreign market. Several studies and theories have been developed over the years to explain entry modalities and help managers to apply proper penetration strategies according to internal (i.e., company's conditions) and external variables (i.e., market's conditions).

Our thesis aims at shedding further light on this issue. However, given the large amount of analyses on the field, some doubts come to mind: Has every aspect been deeply explored yet? Can we actually conduct a research that is, at the same time, meaningful and innovative?

According to our concerns, in a challenging commentary, Shaver (2013) raises the provocative question of whether we really need further entry mode studies. The scholar stresses the substantive progress made in the understanding of the field, namely a clear comprehension of how to differentiate governance modes, of when a mode leads to better firm performance, and numerous insights on the determinants of entry mode choice. Therefore, he depicts the recent researches in the area as limited to small incremental steps, becoming increasingly marginal rather than potentially transforming contributions.

While the goal of this essay is primarily to challenge what scholars have been doing, it also sees a future for entry mode research and aims at reinvigorating and fruitfully stimulating it in this direction. In particular, Shaver suggests a list of "rules" that future papers should take into consideration in order to achieve real advances. He basically criticizes the never-ending chase for better results and missing aspects, which, although achievable, only results in decreasing marginal benefits.

A direct response to this paper comes from the commentary “Yes, we really do need more entry mode studies” by Hennart and Slangen (2015), which argue step by step with the doubts raised by Shaver, whose view of the current state of knowledge about entry mode is defined as overly optimistic. Indeed, literature on the field is definitely vast, but still incomplete, and scholars investigating the same topic have come up with different and often contrasting results (Slangen & Hennart, 2007).

The two authors claim that innovative research is not ended with Brouthers’ renowned work (2002), and that, conversely, many ensuing studies have extended this area of inquiry or have meaningfully altered the trajectory of existing scholarship by opening up new research avenues (e.g., Chen & Hennart, 2002; Brouthers & Brouthers, 2003; Chen, 2008; Brouthers et al., 2008). Furthermore, they also emphasize the significance of incremental and replication studies, considered vital to build up a cumulative body of thought that is reliable, since without replication, phenomenon-based empirical regularities cannot be developed and studied (Bettis, Helfat, & Shaver, 2014). Hence, Hennart and Slangen answer affirmatively to Shaver’s provocative question, and identify several opportunities to generate relevant new insights. Especially, they suggest that a decisive influencing factor of firms’ behavior is the concept of experience, which still presents many unexplored facets.

Our thesis originates from this suggestion and attempts to make clear the role of experience in entry mode decisions. Specifically, it investigates to what extent organizations learn from their past offshoring initiatives and whether they implement an imitation process of previous choices. In this respect, it is crucial to gather and use trustworthy data (both qualitative and quantitative) on actual mode choices, on the evolution of established operations, and on drivers explaining the longevity of international entries and their possible changes (Hennart & Slangen, 2015). Thus, we rely on the wide database elaborated by the Offshoring Research Network (ORN), one the most renowned source of information on offshoring practices worldwide.

For our purpose, we have developed an advanced statistical analysis based on econometrics techniques. Given the complexity of such work, we have been effectively supported by a team of expert researchers. In the first place, Professor Stefano Elia (Politecnico di Milano) has helped us in all the phases of the work and monitored our day-to-day outcomes. Furthermore, on the one hand, PhD Fellow Filippo Albertoni (Politecnico di Milano) has provided valuable advices on the empirical analysis; on the other hand, Professors Marcus Larsen (Copenhagen Business School) and Lucia Piscitello (Politecnico di Milano) have assisted us in building the fundamental conceptual framework.

This thesis is organized as follows:

- The description of the business services offshoring world
- The examination of the most important theories and studies on entry mode
- A focus on experience and the deployment of our hypotheses of research
- The empirical analysis, including the methodology, models and results
- Conclusions and future development

2 Offshoring of business services

What is *offshoring*? Scholars and researchers from all over the world have debated at length around this concept, without getting to a common definition as well as lacking a theoretical grounded explanation for this phenomenon (Jahns, Hartmann, & Bals, 2006). There is a massive amount of papers and articles that try to delineate the term offshoring, however the definition that strikes us the most is the following: “*the transnational relocation or dispersion of service related activities that had previously been performed in the home country*” (Doh, Bunyaratavej, & Hahn, 2009; see also Doh, 2005; Manning, Massini, & Lewin, 2008, for similar and consistent definitions).

In other words, offshoring is more a sourcing activity rather than a selling activity that supports global and domestic operations of a company (Lewin, Massini, & Peeters, 2009). Offshoring initiatives may be implemented through international outsourcing or captive solutions. A multinational company that sells products abroad but performs all its processes in the home-country is not adopting an offshoring strategy.

Offshoring of business services² is quite different from manufacturing offshoring, or at least it was. As Lewin and Volberda (2011) said, the two phenomena started at different times and in different ways, with manufacturing offshoring anticipating the relocation of service activities and targeting low-cost countries. However, in the last few years, we witnessed a shift in production and assembling activities since these processes (i.e., production and assembling) are becoming increasingly knowledge and quality intensive.

We will further discuss this topic in this chapter, which is organized as follows: first, we are going to give an historical view of what happened in the international business context when offshoring became popular and how it evolved. Second, we will analyze in detail the different drivers that push companies to offshore their operations and the current trend towards quality seeking. Then, we will highlight the positive and negative implications of offshoring, stressing managers’ mistakes and the concept of hidden costs. Finally, we will describe and present the differences between captive and outsourcing solutions.

² In this thesis, we refer to the externalization of business services as the relocation abroad of functions of companies belonging to both the manufacturing and the service sectors. The offshoring of business services refers to the advancing trend of global sourcing of white-collar work, including technical and administrative activities; as opposed to blue-collar work, that relates to manufacturing.

2.1 The explosion of offshoring of business services and its evolution

The offshoring phenomenon started shaping the international business panorama around 50 – 60 years ago, when manufacturing companies began to move blue-collar activities overseas. Cost savings and improved financial performances pushed many companies to offshore their operations. Since then, offshoring has evolved rapidly, shifting from the relocation of low value-added activities to high value-added activities, and from cost reduction to talent seeking (Nayyar, 1978).

Offshoring of business services (i.e., the relocation of services through both captive and outsourcing solutions) came in later with respect to the offshoring of manufacturing tasks. A series of events and contextual factors had to happen and come together in order to trigger what nowadays has become a common practice.

First, the service industry was not as developed as the manufacturing one in the middle of the 20th century. The intensification of the service practices in the last two decades of the 20th century increased the volume of transactions related to such tasks, allowing companies to gain margins from economies of scale and scope. What was applied only to manufacturing jobs, i.e., standardization and modularization, became familiar also with services, giving the chance to firms to offshore their operations overseas. A shift in the mindset of managers was necessary in order to foster such evolution. They thought services were too idiosyncratic to their firms or employees to be offshored to unknown third parties (Davenport, 2005; Metters & Verma, 2008).

Second, the revolution in communication and data transfer brought by technology. Since the late 1990s, the advances in information and communication technologies (ICTs) and the development of stable, secure, and high-speed data transmission systems (i.e., broadband communication) boosted the digitization of business processes and decreased global telecommunication costs. What was previously done through paperwork and transferred by ship, could be now managed through a phone call, fax, or a click. This definitely took the offshoring development to another level (Farrell, 2005; Levy, 2005; Lahiri & Kedia, 2011).

Third, the fear of the Y2K Millennium Bug and the burst of the dotcom bubble brought companies to move some of their activities overseas. To avoid the Millennium Bug, firms needed to update software and computer programs by the year 2000. This pushed firms to offshore particular programming and coding tasks to India, where they knew there were good experts. The situation turned out to be better than expected, since firms discovered a seemingly limitless supply of well-trained English-speaking IT specialists who could reliably fix and design IT applications at

significantly lower costs. Moreover, the economic recession due to the burst of the dotcom bubble caused companies in most industries to operate in a hypercompetitive environment. This led many firms to focus on cost-cutting strategies such as offshoring, locating activity to a wholly owned company or independent service provider in another country (Lewin & Peeters, 2006).

Finally, the investments of governments of home and host countries supported the offshoring of business services. Many host countries (most of which were developing and emerging ones) saw offshoring as an opportunity to create easily employment among their citizens (Wilson, 1995; OTA, 1985; Freeman, 2000). The main incentives were (Metters & Verma, 2008):

- Investments in infrastructure to support offshoring operations
- Specific tax incentives and duty free imports
- Assistance in worker training and reduced rents

Another fundamental factor was the lack of regulation related to services of some countries, for example U.S. The tariff structure of U.S. at that time considered services as if they had no value (since they were no physical goods), and therefore for several years, service related activities did not have duties.

Chadha (2001) gives a clear image of that period talking about export oriented companies working in the hardware and software industries in India. Those firms were exempted from taxes on profits from exports and did not pay duty-imports for business inputs.

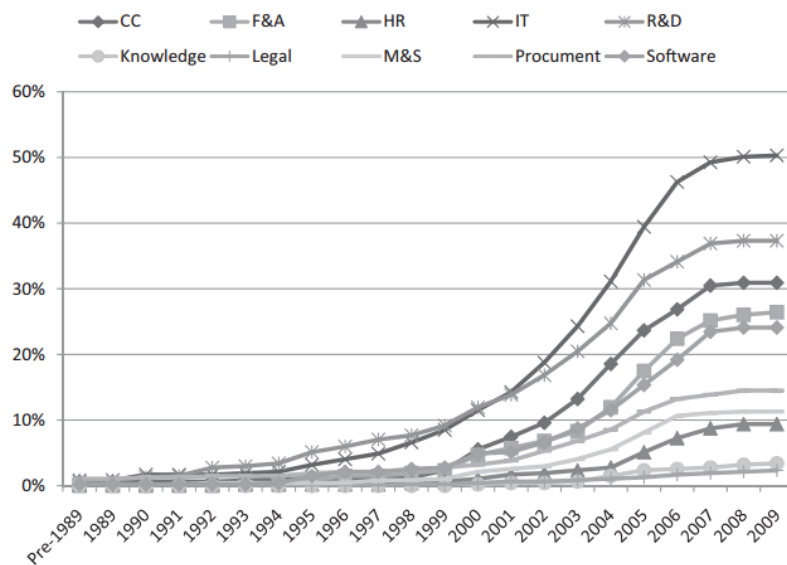


Figure 2.1 - Cumulative percent growth of companies offshoring business services by type of function (Source: Duke University Offshoring Research Network Survey (2005, 2006, 2007/8, 2009))

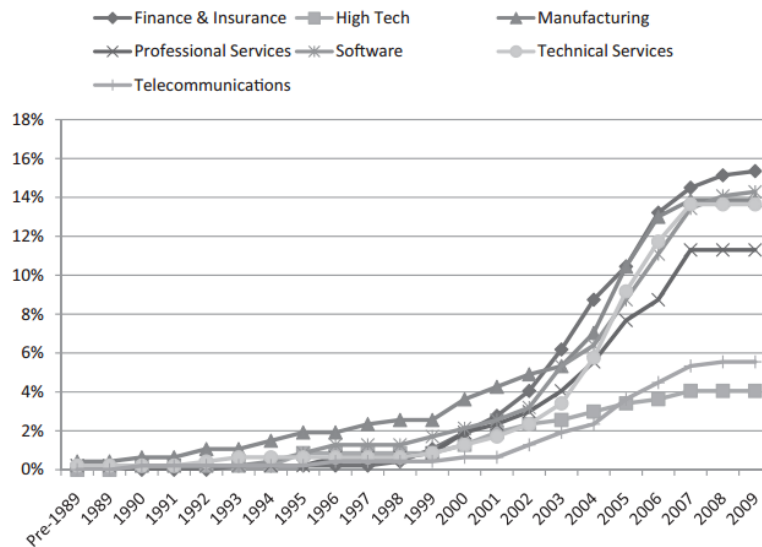


Figure 2.1 - Cumulative percent of companies offshoring business services by industry (Source: Duke University Offshoring Research Network Survey 2005, 2006, 2007/8, 2009)

Figures 2.1 and 2.2 give an idea of how the offshoring phenomenon developed chronologically, considering functions and service industries. We can see how, at the beginning of the 21st century, all the curves suddenly change slope. This is in line with the events previously explained and it is clear how functions and industries strictly related to the ICT world have a steeper curve.

The offshoring of business services has its beginnings with the relationship between American and Indian companies. Scholars consider the offshoring of American Express' accounts receivable processes to Tata Consultancy Services (1979) and the opening of a captive center in Bangalore from Citibank (1982) as the two main events which started the offshoring of business services era. Another major milestone, in the mid-1980s, involves Texas Instruments and Motorola, the first multinational companies along with Citibank to locate captive technology centers in Bangalore. Early adopters of offshoring practices in India include Dun & Bradstreet, British Airways, Hewlett-Packard, and Dell; also Indian companies, such as TCS, Wipro, and HCL gained benefits from the Y2K event. General Electric impacted the emergence of offshoring of services as well (see figure 2.3 for a short history of offshoring of GE). General Electric's experience worked as a catalyst for both US and Indian companies, since Jack Welch's characteristic culture of cost-cutting and efficiency (i.e., GE's CEO) taught them business skills that they leveraged for competing globally (Lewin & Peeters, 2006; Lewin & Volberda, 2011).

1990	Medical Division	Joint venture with Wipro to develop and market medical equipment.
1995	IT	Outsourcing of software development and maintenance to India.
1997	Back office	GECIS, captive shared services centre launched in India.
1999	Call Center	1 st GE international call centre launched in India.
COMPANYWIDE INITIATIVE: DIGITISATION OF BUSINESS PROCESSES		
2000	R&D Back office Asia Back office Americas	Jack Welch Technology Center, 1 st and largest GE R&D centre launched outside the US (in Bangalore) GECIS Asia, business processes captive centre in China. GECIS Americas, business processes captive centre in Mexico.
2002	Back office Hungary	GECIS Hungary, business processes captive centre launched in Hungary to serve the European market.
2004	Outsourcing Backshoring	Oak Hill Capital Partners and General Atlantic acquire controlling interest of 60 per cent in GECIS. Business processes remain unchanged. GE brings back its Indian call centre to the US.

Figure 2.3 - A short history of offshoring at General Electric (Source: Lewin & Peeters, 2006)

Nowadays, Indian service providers are facing fierce competition from new entrants, which want to exploit such a profitable business. The main competitors come from other Asian countries and Europe, and they are trying to develop offshoring practices not only for their own returns but also to improve their own nations. Countries such as Brazil, the Philippines, Malaysia, China, Russia, Hungary, the Czech Republic and Israel are aggressively taking their share of the market (see figure 2.4). The rapid growth of India has raised major issues, especially in the city of Bangalore, such as the increase of average annual wages (26 per cent in 2006), high employee turnover rates (often exceeding 120 per cent), rising property prices, lack of housing and infrastructure problems such as poor roads, lack of hotels, unreliable sources of electric power and an outdated airport system. More and more companies are favoring their neighbors as offshore locations, especially European ones (Lewin & Peeters, 2006).

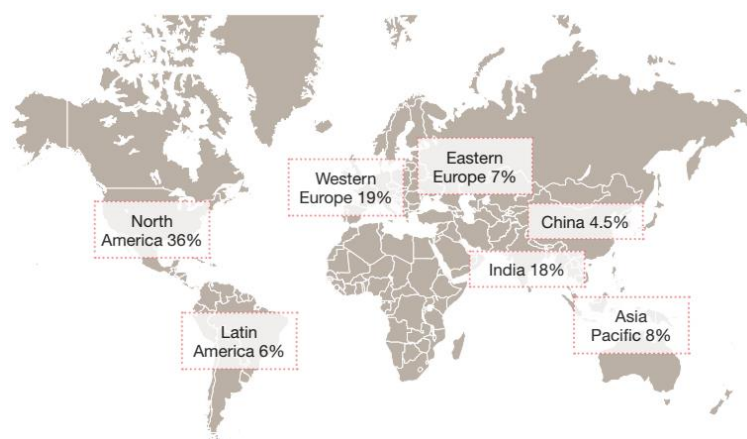


Figure 2.4 - Overall distribution of ORN service providers, by headquarters location (Source: Duke University Offshoring Research Network Survey 2010)

2.2 Offshoring drivers

We now want to analyse more in detail the reasons behind offshoring decisions, highlighting the transition from cost drivers to non-cost drivers.

2.2.1 Cost drivers

As offshoring of services has emerged as an affirmed and prominent business practice in the international panorama, there has been a flourishing extension in research literature around it. Initial studies investigated deeply on costs. The more attention paid to these issues the more researchers and companies realized that other drivers were important as well. However, in this section we are going to focus on drivers related to cost savings, since they still appear to be the most important factor guiding firms' choices to move operations across oceans (Bunyaratavej, Hahn, & & Doh, 2007; Stratman, 2008; Aksin & Masini, 2008; Lewin & Peeters, 2006).

We can identify four main sub-categories of cost drivers related to cost savings:

1. Labour arbitrages (i.e. wage differentials)
2. The cost of doing business (i.e. specific tax breaks, favourable rents and special tariffs on supplies and telephony)
3. Operational efficiency (i.e. economies of scale and scope)
4. The possibility to turn fixed costs into variable costs

The leading element among cost savings has been the differential in wages between advanced and emerging countries, since the first implementations of offshoring. Firms setting subsidiaries abroad could rely on the availability of lower cost of labour and the possibility to centralize operations in fewer locations exploiting economies of scale (Doh, 2005; Farrell, 2005). Farrell (2005) discovered that U.S. and German companies could save US \$0.58 and €0.52, respectively, for each dollar spent on jobs they moved to India.

Regarding offshore outsourcing, TCE theory explains how firms manage costs, externalizing low-volume work to take advantage of economies of scale at the provider side. The sole objective is cost minimization, not taking into consideration other possible advantages of an offshore strategy (Ellram, Tate, & Billington, 2008; Smith, Mitra, & Narasimhan, 1998). Youngdahl and Ramaswamy (2008) confirm that cost remains the most important factor for services offshoring, especially for basic, back office, routine and standardized activities. Figure 2.5 shows results from the Service Provider Survey

provided by the Duke University Offshoring Research Network. It is crystal clear the relevance of cost savings.

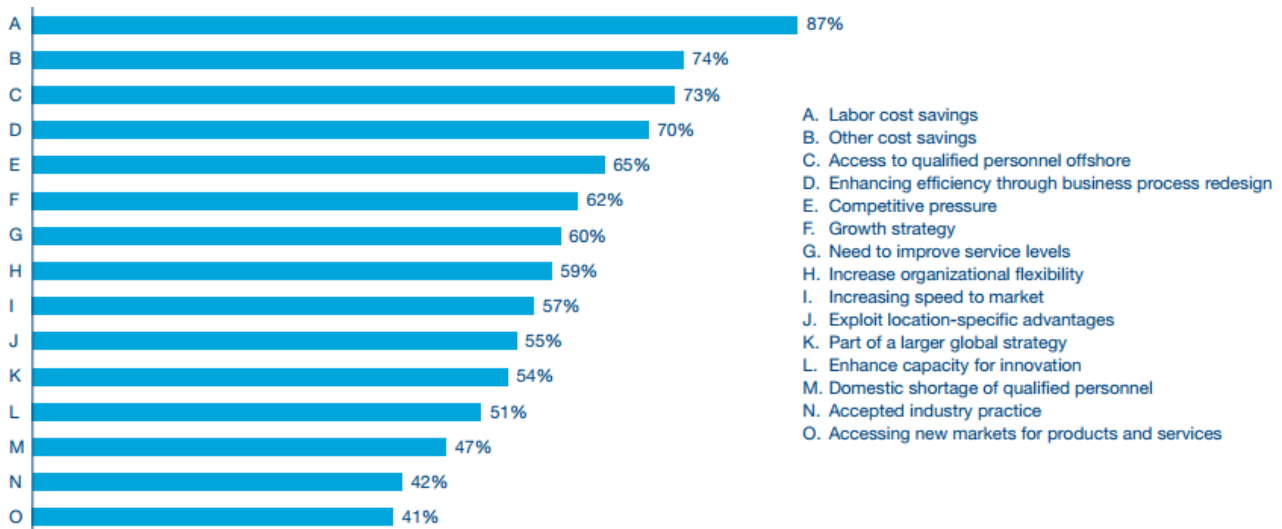


Figure 2.5 - Percent of providers rating drivers as “important” or “very important” reasons for their clients to outsource (Source: Duke University Offshoring Research Network 2007/08 Service Provider Survey - Duke University Offshoring Research Network 2009 Service Provider Survey)

The above statistics are confirmed also from the data gathered in 2011 from the same institution. Numbers are still significant, even though we can see a slight change in favor of less cost driven factors. Labor cost savings remain the most important driver, with almost 73% of the clients recognizing it as fundamental (just 17% for “other-cost savings”). On a Likert-type scale (1 to 6), both labor cost savings and other cost savings have an average around 4 for the choice of the location where to offshore and the function to offshore.

In their article “*Offshoring strategy: Motives, functions, locations, and governance modes of small, medium-sized and large firms*”, Roza et al. (2011) discuss the relationship between cost drivers and firm size. They hypothesize that cost drivers are more important when the size of firms increases. They argue that larger companies can benefit of scale economies to overcome, for example, set-up costs or have a greater pool of resources such as materials, financial and technological (Cavusgil & Kirpalani, 1993). However, offshoring is suitable also for SMEs, since moving business activities abroad requires less resources than starting a new business from scratch. Moreover, intermediate suppliers may create scale economies for SMEs managing several clients. In this way, SMEs can produce their products at competitive levels (Fagiolo & Luzzi, 2006; Lu & Beamish, 2001; Rothwell, 1989; Rothwell & Dodgson, 1993). Results, elaborated from the ORN (Offshoring Research

Network) database, are counterintuitive. They show that cost drivers are appealing for small and large enterprises, while medium firms prefer resource and entrepreneurial drivers.

As we can see, cost savings represent past, present and maybe also the future of offshoring initiatives. Nevertheless, there is a growing slice of literature which is moving away from the old paradigm and it is focusing on other aspects and possibilities of this new phenomenon. Companies are starting to look for quality and talents, as they offshore more and more value-adding activities (Doh, Bunyaratavej, & Hahn, 2009; Lewin & Peeters, 2006; Lewin, Massini, & Peeters, 2009; Lewin & Couto, 2007). We clustered these new drivers under the name of non-cost drivers.

2.2.2 Non-cost drivers

There are several reasons to adopt overseas initiatives. The dynamic environment in which companies operate nowadays evolves and changes day by day. Competitive pressures, such as pressures for cost reductions and pressures to be locally responsive, as well as resource constraints characterize what has been called the hypercompetitive economy, a highly aggressive environment in which firms must be able to focus on core competences and reduce costs and, simultaneously, leverage external resources, skills, knowledge, and capabilities in order to survive (Hätönen & Eriksson, 2009).

Given that comparative advantages between countries tend to dry out, MNCs should avoid the “*footloose behavior*” and instead should try to build up competitive advantages. The same thing can be said about cost reduction strategies. They are highly replicable and cannot be considered a well of continuous competitive advantage (Porter, 1985; Reed & De Fillippi, 1990). Moreover, the fast spread of offshoring is generating upward pressures on labour costs in emerging countries, lowering returns from labour arbitrage. Firms are expected to move towards offshoring practices that create value and allow growth and innovation. In addition, developing economies are beginning to realize the limits of labor arbitrage, shifting their investments to human capital resources, in particular engineering and IT sciences, in order to attract higher level technical jobs and thus constructing a talent-based advantage (Porter M. E., 1990; Lewin & Peeters, 2006).

We can clearly see this trend from figure 2.6. Cost reduction is still the leading driver, albeit access to qualified personnel and increased speed to market show a greater slope respect cost reduction and will catch up in the near future.

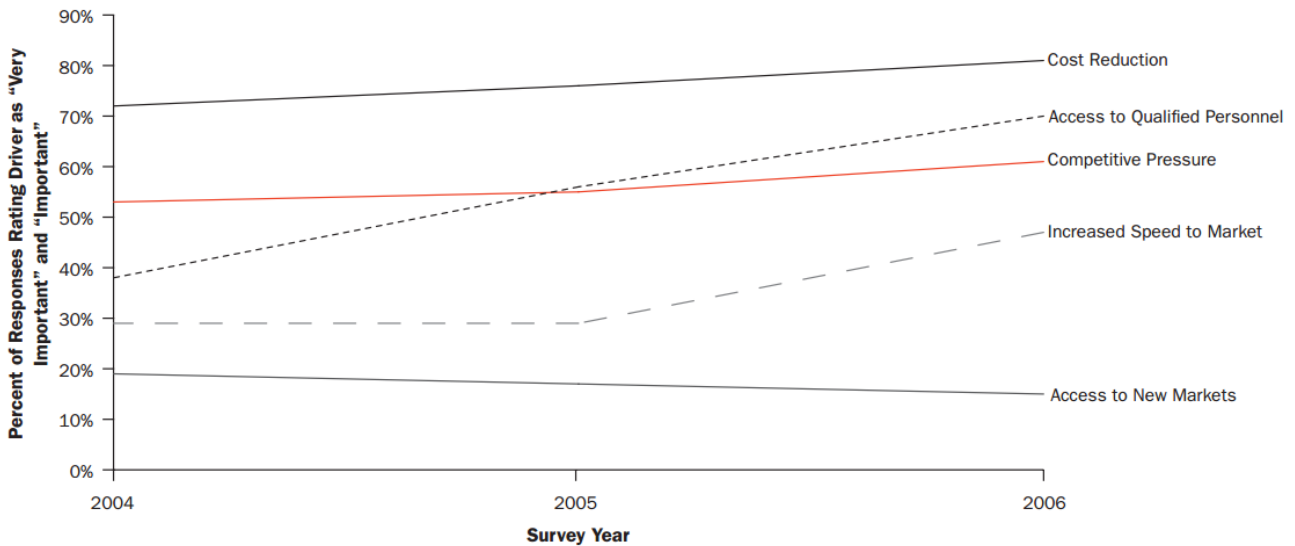


Figure 2.6 - Growth rate of offshoring drivers over time (Source: Duke University/Archstone Consulting Offshore Research Network 2004 and 2005 Surveys; Duke University/Booz Allen Hamilton Offshoring Research Network 2006 Survey)

Non-cost drivers can be divided into three main groups:

1. Market seeking drivers (i.e., new revenue generation and business models thanks to the access to new markets)
2. Organizational adaptability (i.e., organizational flexibility, increased speed to market)
3. Asset, resource and capability seeking drivers (i.e., access to talents, technology, skills, better service level)

A mounting number of companies are offshoring more value-adding activities which need capable and proficient personnel. The attitude of firms is moving towards a more strategic conceptualization of the offshoring phenomenon, which allows them to enhance organizational and decisional flexibility (Irving, Shojai, & Gupta, 2003). Lewin et al. (2009) sustain that the more innovative offshore operations are, the more firms look for specialized capabilities and qualified skills which are in relatively shorter supply in developed countries (i.e., home countries). The bargaining power of big companies allow them to obtain workers as good as onshore ones but definitely cheaper (Bunyaratavej, Hahn, & Doh, 2007). This is a must for all those firms working in the high-tech

sector; fierce competition creates new sources of talent which must be intercepted in order to optimize human resources (Ernst, 2006).

The trend seems to be clear now. Foreign operations are initiated no more just for cost minimization reasons, but also because of drivers such as growth strategy, speed to market and volume of transactions accommodation (Lewin & Peeters, 2006). Furthermore, the greater experience companies accumulate (especially regarding advanced activities) the less they seek cost drivers in favor of non-cost drivers (Jensen & Pedersen, 2007).

Companies focused on growth strategies (i.e., accessing new markets and developing new business practices) require engineers and scientists able to innovate existing processes or products or even create new ones (especially for companies competing in innovative and highly technological sectors). These firms will move their product development activities, with a high probability, to those countries where such human resources are plentiful, for example, India (Barthélemy & Geyer, 2001; Bahli & Rivard, 2005; Fixler & Siegel, 1999; Willcocks, Kern, & Van Heck, 2002).

Companies may leverage offshoring initiatives to increase their speed to market in order to introduce new products faster than their competitors. Firms may become faster by improving organizational competences for accessing the global pool of talents which allows to react to changes in demand, taking advantage of market and technological opportunities and enabling product development around the clock (Massini, Perm-Ajchariyawong, & Lewin, 2010).

Dossani and Kenney (2007) argue that offshoring strategies started in larger companies before moving to smaller ones. This learning opportunity is very important for small entrepreneurial firms which cannot battle for talent with large companies (Lewin, Massini, & Peeters, 2009). Roza et al. have also demonstrated that resource and entrepreneurial drivers are fundamental for medium enterprises, while small companies tend to focus on offshoring competence creating activities.

To summarize our reasoning we can see that as offshoring turns into a universally embedded strategy, companies shift their attention from cost savings to a variety of quality driven factors such as access to qualified personnel and increased speed to market. Firms not having a clear international plan will adopt offshoring as a mere instrument to take out part of their cost structure. Results presented by Massini et al. (2010) demonstrate that American and European companies adopting offshoring as a strategy look for country-specific advantages, skilled workforce, knowledge and speed to market instead of concentrating solely on cost reduction.

2.3 Value chain disaggregation and dispersion

The implementation of offshoring practices brings companies to the global disaggregation of their value chain. This is the result of the combination of companies' capacities and resources with comparative advantages of geographic locations in order to increase their competitive advantages (McCann & Mudambi, 2005). Firms clashing in this globalized world have to rethink their value proposition, restructuring their organizational structure (i.e., boundaries of the firm) and stretching the geographical dimension of their operations. Mudambi presented for the first time in 2007 the visual representation of this phenomenon and he called it “*the smile of value creation*” (figure 2.7).

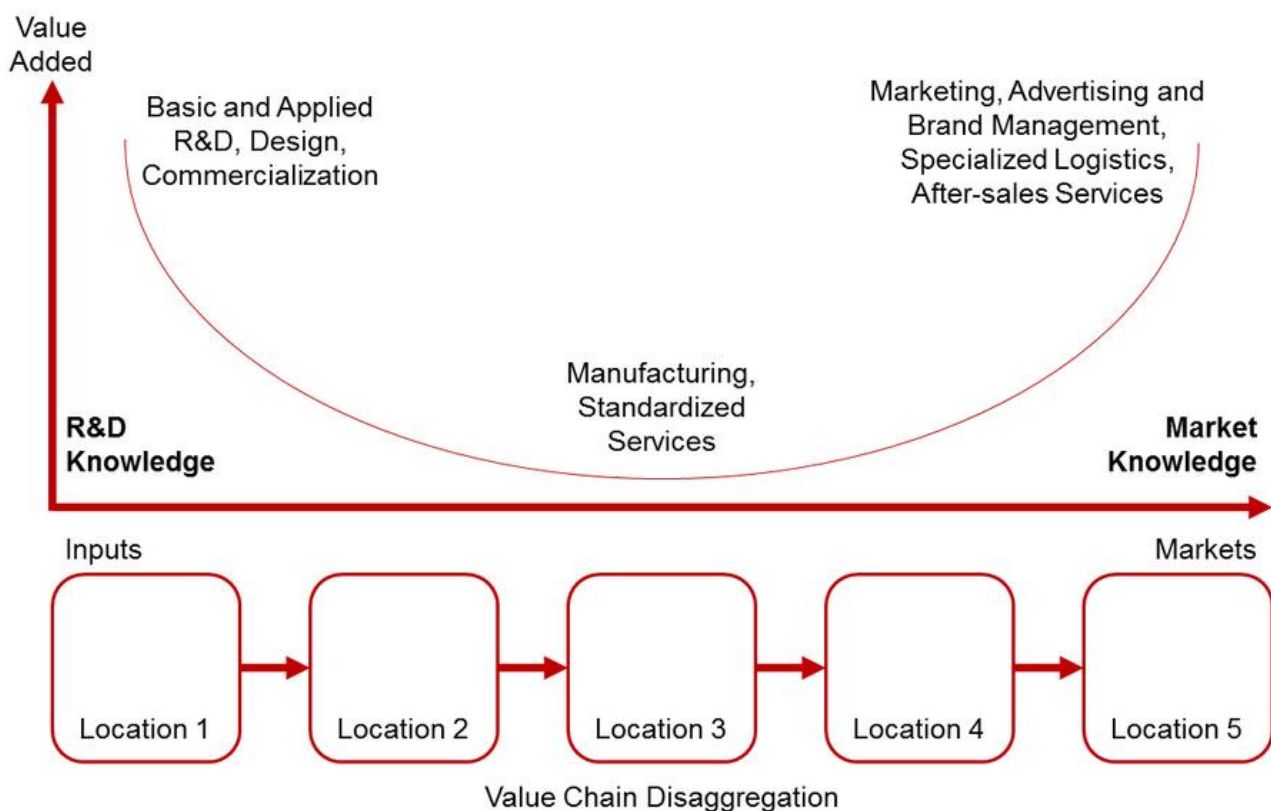


Figure 2.7 - *The smile of value creation* (Source: Mudambi, *Offshoring: Economic geography and the multinational firm*, 2007)

We can see from the graph the typical behavior of a MNE. Activities, from input to output processes, are “dispersed” in several locations around the world and what is particularly relevant is that those at the ends of the smile are placed in more advanced countries, while activities in the middle of the value chain are moved to emerging or low cost market economies. The objective of a MNE, over time, is

to connect the two ends of the smile in order to use marketing knowledge to calibrate R&D and design operations thus sustaining its competitive advantage (Winter, 2003; Leenders & Wierenga, 2002).

What gives the U-shaped curve to the graph? The improvements in technology tend to lower the middle of the curve and pull up the ends. At the same time, customization in delivery and design, as well as knowledge and skills in R&D and advanced activities, which are inimitable and peculiar to each company, stress further the shape of the curve (Wernerfelt, 1984). Finally, standardization and efficiency in operations, which are common to all firms, drive down the central part of the graph (Maskell & Malmberg, 1999). Lately, scholars and researchers are arguing if the situation reproduced by Mudambi's chart still holds. A series of changes are remodelling the curve:

- The catch-up effect of emerging economies firms
- The commoditization and standardization of high value-added activities (e.g., R&D)
- The move of “*sunset industries*” to emerging economies
- Manufacturing activities are increasingly knowledge and quality intensive
- Administrative and technical tasks “follow” production

All these events are flattening the curve, as we can see from figure 2.8.

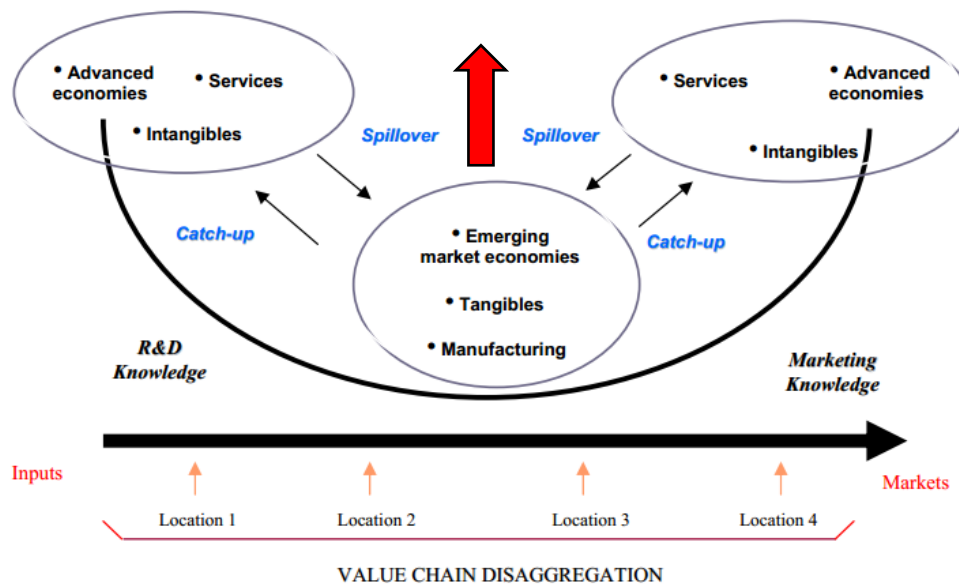


Figure 2.8 - The smile of value creation: a dynamic perspective (Source: Mudambi, Location, Control and Innovation in Knowledge-Intensive Industries, 2008)

The value chain disaggregation and dispersion is a serious matter for companies nowadays. Contractor et al. (2010) present a thorough work in which they suggest how companies should deal with this complex organizational mutation. The objective is to find the optimal level of distribution and division of the value chain into finer small pieces without incurring in additional costs and unmanageable complexity.

The reconfiguration of operations comprises two main dimensions:

- Function: into how many sub-activities can a firm slice its value chain? Then, for each smaller task, it must be decided
 - The organization mode, which goes from in-house to outsourcing, considering all the hybrid implementations in between
 - The geography, where to locate the activity according to environmental variables
- Time: the right entrance moment chronologically coherent with the global system

It is not easy to determine which is the best solution. Disaggregation and dispersion are two interrelated dimensions, often considered separately by companies. The restructuring of sub-activities depends on the characteristics of each task, company's characteristics and the external variables of the international context.

Contractor et al. (2010) propose a method in order to simplify the overall process. They were inspired by the work of Quinn (1999). According to their research, each company should analyze in detail its processes and tasks before undertaking offshoring initiatives. Managers should be able to distinguish among true core activities (i.e., fundamental tasks to sustain the competitive advantage, embedded in the architectural structure of the company), essential activities (i.e., advanced tasks which are complementary to true core tasks) and non-core activities (i.e., tasks that can be easily outsourced). The next step is the modularization and codification of these activities in order to reduce the increasing complexity that this mechanism entails. Thanks to advancements in ICT technologies, managers can reduce and avoid communication and managerial problems. The subdivision of activities proposed previously can also diminish spillover effects, allowing firms to understand which are the task to keep in-house.

2.4 The dark side of offshoring

Usually, managers and media consider and report only the positive aspects of offshoring. However, this accelerating and revolutionary business practice hides several challenges that might give birth to negative consequences. In this section, we are going to examine risks related to bad managerial methods, deepen our understanding about the sources and the possible implications of hidden costs in offshoring actions.

2.4.1 Mistakes and related risks when undertaking offshoring initiatives

Most firms think that to offshore business functions or processes is an easy task. They underestimate the possible difficulties and complications along the way, thus incurring in unexpected costs or bad results. Offshoring is a serious matter and it must be tackled with a systematic approach. According to Aron and Singh (2005), companies lacking experience in the offshoring panorama or those without a method commit at least one of these three mistakes.

First, firms tend to focus on selecting the right locations, vendors and prices without understanding which processes they can offshore and which not. Executives are not aware of all the activities within the value chain of their companies and their relative connections. As we said before, a classification like the one presented by Quinn (1999) is essential to the development of a correct offshoring strategy. The risk in this case is associated to the possible loss of know-how and the additional expenses due to reshoring.

Second, managers perform simple cost-benefit analyses to make decisions without looking at the larger picture. They consider only their point of view, without taking into account possible misbehaviors on behalf of the provider. Once activities are transferred, the vendor's bargaining power increases. Why is that? Because firms cannot reabsorb processes in the short-term and therefore, the seller can charge exorbitant price increases when the contract has to be renewed. The risk is to lose all the savings gained thanks to outsourcing.

Finally, most of the times, companies do not consider the continuum of options related to the different governance modes applicable to each specific offshoring case. The consequence is reducing all the viable options to outsourcing and captive modes, ending up in choosing the wrong modality. The risk is associated to the complete failure of the offshoring implementation, since location and governance mode decide the fate of such strategies.

Aron and Singh (2005) recognize two kinds of internal risk: operational and structural risk. Operational risk is more critical in the short-run, while structural risk gains importance in the long-run.

Operational risk depends on the degree of codification of activities and on the capacity of the firm to build metrics to measure the quality of processes. The more a task is codifiable (i.e., easy to document and describe) the easier will be for foreign employees to carry it out in the right way. On the contrary, a service which relies on specific experience and tacit knowledge, information about client's customers, geography and market dynamics, unlikely will be performed correctly from overseas providers for a long time. The measurement of the output of processes is crucial in this context. A firm cannot offshore well what it does not measure properly. The more a firm is accustomed to formulate metrics and assess its employees and operations, the more it will be able to evaluate continuously performances of its overseas activities. It is a time consuming and costly work but it pays off since it avoids errors and customer losses due to low service levels.

Structural risk arises from the relationship between the client and the service provider. Sellers may not behave as agreed. For example, they can stop training their employees or they can hire people with no competences to carry out the service requested by the client. There are two elements that worsen the situation for the client. First, the amount of knowledge transfer to outsource processes. The greater it is, the higher the investment in time and money to train providers' employees. Second, the stabilization time of certain processes (i.e., the time that elapses before the seller reaches the required service level). Both these variables increase switching costs, weakening buyers' bargaining power. However, clients have two instruments to mitigate this risk. They should write and sign contracts as complete as possible in order to defend themselves from possible misbehaviors of the provider and they should try to build a network of suppliers to always have a back-up plan and a way to put them in competition, thus lowering costs.

Moving the perspective outside the firm, we have to consider also external risks. In particular, we want to focus the attention on country and compliance risks, because they are related to our work and empirical investigation. We support our argument through the complete work of Kumar, Kwong and Misra (2009) "*Risk mitigation in offshoring of business operations*". In their article, the researchers point out and explain the possible risks companies may encounter during offshoring initiatives and propose a mitigation strategy to combat such risks.

In figure 2.9, we can see a fishbone diagram showing the cause-effect relationship of offshoring risks.

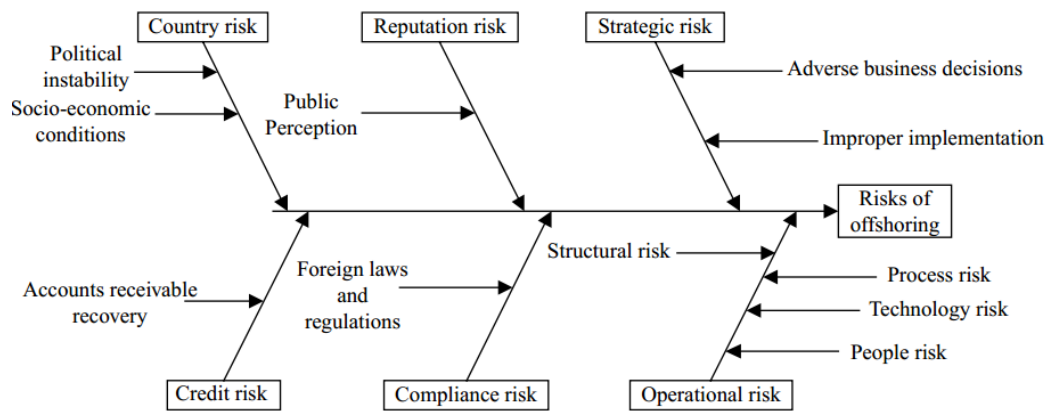


Figure 2.9 - Offshoring risks cause-effect fishbone diagram (Source: Kumar, Kwong, & Misra, 2009)

Compliance risk is related to the possible loss of money due to the infraction of particular laws and regulations of a country (FDIC, 2004). Before entering a country, a firm should gather information about the legal and fiscal system of a country and comprehend it. Failing in recognizing and obeying certain laws may bring to the payment of expensive penalties or to the exclusion from the country's business. An organization should consult foreign bodies on the regulations and laws governing the offshored process and adapt its operations accordingly.

Country risk deals with issues related to the socio-economic conditions and the political situation of a specific country (FDIC, 2004). It studies the effects on a firm relative to changes in both or one of these variables. Civil unrest and political instability are the worst conditions to offshore operations. A firm wanting to move activities in a country where, for example, a civil war is happening, must consider the high degree of uncertainty and that it will never know the possible damages the war may cause. Political instability affects also laws of a country, increasing compliance risk. To deal with such risks, a firm should implement a fine study of the country of interest. It must investigate the past history of the country, its infrastructures and cultural aspects, especially those that can impact the performance of the company.

2.4.2 Hidden costs

Hidden costs can be defined as implementation costs that are unseen by managers during the strategic decision phase (Ocasio, 1997). They are part of every business practice. Several factors can trigger

hidden costs. Looking at the firm from within, individual biases may alter decision makers' capabilities (Das & Teng, 1999); routines and a dominant logic may create blind spots and limit managers' autonomous judgements (Nelson & Winter, 1982; Prahalad & Bettis, 1986). Considering offshoring, invisible costs become even more crucial for the outcome of the initiative, since operations across oceans are more difficult to control respect those onshore and a series of exogenous variables increase the uncertainty of the whole implementation.

Literature on hidden costs is vast. Larsen et al. (2013) summarize in their work the main streams related to invisible costs (see table 2.1)

Table 2.1 - Three streams of research on hidden costs of offshoring (Source: Larsen, Manning, & Pedersen, 2013)

Theoretical focus	Research question	Examples/consequences of hidden costs	Indicative literature
Performance indicator	How might the practice of offshoring eventually undermine anticipated financial value?	<ul style="list-style-type: none"> ● Costs of selecting a vendor ● Costs of layoffs ● Cultural costs ● Ramp-up costs ● Costs of managing an offshore contract 	<ul style="list-style-type: none"> ● Barthélemy (2001) ● Overby (2003)
Noncontractual costs	How does international outsourcing (in contrast to vertical integration) create unexpected costs for firms?	<ul style="list-style-type: none"> ● Reduce learning capabilities ● Reduce robustness ● Reduce long-term responsiveness ● Reduce coordination ability ● Undermine core competences 	<ul style="list-style-type: none"> ● Bettis <i>et al.</i> (1992) ● Hendry (1995) ● Reitzig and Wagner (2010)
Costs of reconfiguration and relocation	How does the global relocation and reconfiguration of business tasks and activities create unexpected costs for firms?	<ul style="list-style-type: none"> ● Coordination costs ● Design/specification costs ● Control costs ● Knowledge transfer costs 	<ul style="list-style-type: none"> ● Dibbern <i>et al.</i> (2008) ● Kumar <i>et al.</i> (2009) ● Stringfellow <i>et al.</i> (2008) ● Srikanth and Puranam (2011)

Larsen and its colleagues contributed greatly to the enrichment of the research on offshoring and hidden costs. The work published in 2013 tries to understand the relation between cost estimation errors and hidden costs, in the international context. Drawing from the three research streams presented above, and focusing particularly on the third one, they analyze why in the reconfiguration of the value chain through both captive offshoring and offshore outsourcing, managers fail in recognizing certain costs in the initial estimation phase. The reasons reside in the complexity of offshoring, which is motivated by configuration complexity and task complexity.

First, configuration complexity grows because the number of interconnections within the organization and among business functions rise (i.e., structural complexity). Second, the number of tasks of each business unit increase as well, since the disintegration of the value chain creates a multitude of sub-processes which previously were managed by a single function (i.e., operational complexity). Third, differences in culture, language and a lack of face-to-face contact to enhance reciprocal understanding compromise the efficiency of operations and create resistance within the structure (i.e., social complexity).

Task complexity arises from the intricacy of the single offshoring activity. A task will be more complex the more it requires tacit knowledge with respect to standardized actions; the more the number of sub-tasks; the less the final output is specified; the greater the presence of path-goal multiplicities (Campbell, 1988). Moreover, as previously stated, companies are offshoring more and more complex and advanced activities, which boost uncertainty and bounded rationality in managers.

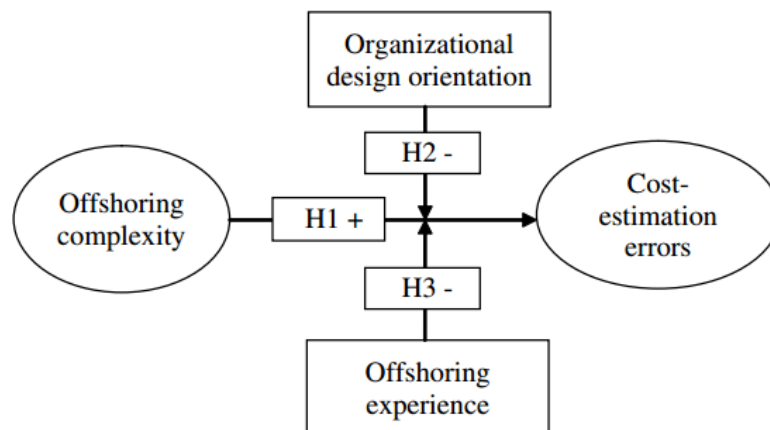


Figure 2.10 - Hidden costs of offshoring: a theoretical framework (Source: Larsen, Manning, & Pedersen, 2013)

Larsen et al. (2013) try to demonstrate that offshoring complexity, which positively impacts cost estimation errors (i.e., it increases the probability of errors in the decision-making phase), is negatively impacted by the orientation of the firm towards organizational design and by the firm's experience (see figure 2.10). The empirical results of their work support and confirm their hypotheses, highlighting that in case of captive offshoring, hidden costs increase due to configuration complexity, while considering offshore outsourcing, task complexity is the main driver of hidden costs.

In a subsequent research, Larsen (2016) takes a step further, connecting cost estimation errors due to hidden costs with the performance of the company. He suggests that the higher the degree of cost estimation errors relative to offshoring initiatives, the weaker the performance of the firm. Moreover,

he introduces in the research two coordination mechanisms: modularization and on-going communication. According to Larsen, modularity alleviates the negative consequences of wrong estimations, since the simplification of tasks and the reduction of their interdependencies allow companies to solve problems locally. The effect of a high level of modularity is stronger as errors in estimation increase. On the contrary, on-going communication strengthens the effect of cost evaluation errors, since it requires a continuous transfer of information between the offshored unit and the home unit, which is clearly problematic. In this case, the higher the cost estimation error, the lower the offshore process performance (see figure 2.11).

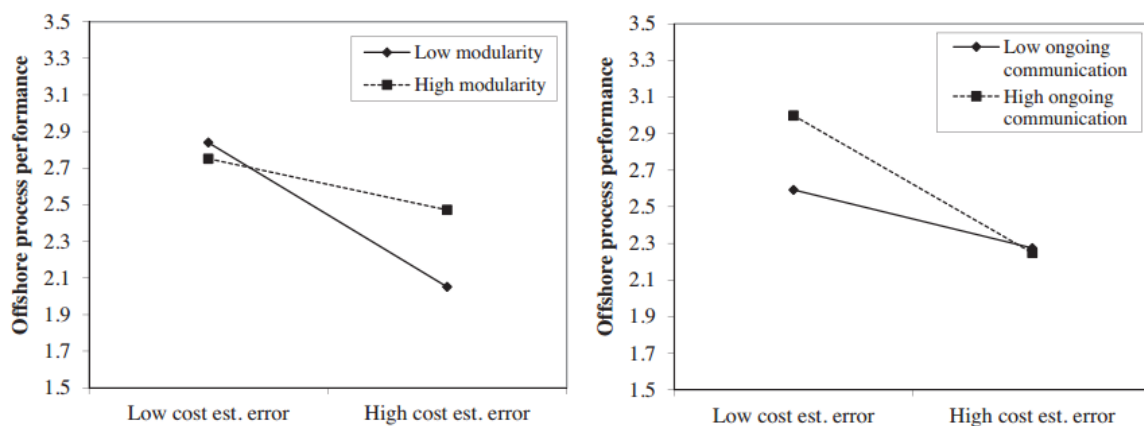


Figure 2.11 - Two-way interaction on process performance with modularity and on-going communication (Source: Larsen M. , 2016)

To conclude our argument on hidden costs, we need to consider the work by Stringfellow et al. (2008). In their theoretical treatise, they start saying that quantifying accurately invisible costs is not a simple matter, however, it is possible to find those factors that affect hidden costs from organizational and cultural perspectives. The cornerstone of their conceptual framework is the interaction of the customer with the service system. Hidden costs may arise for the unique characteristics of services and their level of intangible components, and for the degree of involvement of the client in the service process. For example, there are services that require the presence of the customer and services that depend on the client's subjective evaluation of the task. A bad service experience can make companies lose actual and future customers. This is a kind of hidden cost that firms do not consider. There are two main dimensions of interaction: the interaction intensity and the interaction distance.

Interaction intensity depends on the service offering and the service process. The service offering is the content of the activity. The more the content of the service is clear to both providers and customers, the easier the communication will be, consisting simply of minimal and programmable

dialogues. If the content is not clear to one of the parties (e.g., providers do not understand what kind of web platform a client wants), a deeper interaction between the two entities is required. The service process includes the production and delivery phases. Three elements characterize service processes and therefore impact interaction intensity: standardization, interdependence among steps and the need for judgement. The higher the interdependence and the need for judgement (i.e., employees need to work close to each other since the different phases of the process are not sequential and a great amount of tacit knowledge is required), the higher will be the interaction intensity. On the contrary, the more standardized a process is, the lower the interaction intensity. The lower the interaction intensity, the lower the probability for a company to incur in hidden costs.

The interaction distance is a consequence of the offshore location chosen. There are many more elements to take into account in this case. For each location, a company should assess spatial and temporal distances (i.e., geography) and the existence of an available communication and interpretation system (i.e., language and culture). Considering geography, the greater the travel distance and the difference in time zones, the greater the effect on interaction distance. The same can be said about language and culture. The larger the distance in cultural and language aspects, the stronger the effect on interaction distance.

To conclude, Stringfellow and its colleagues state that the positive relationship between invisible costs and interaction intensity is strengthened by interaction distance. A deep understanding of their conceptual framework allows companies to embark offshoring initiatives with a more solid strategy that reduces the risk to be subjected to invisible costs (see figure 2.12).

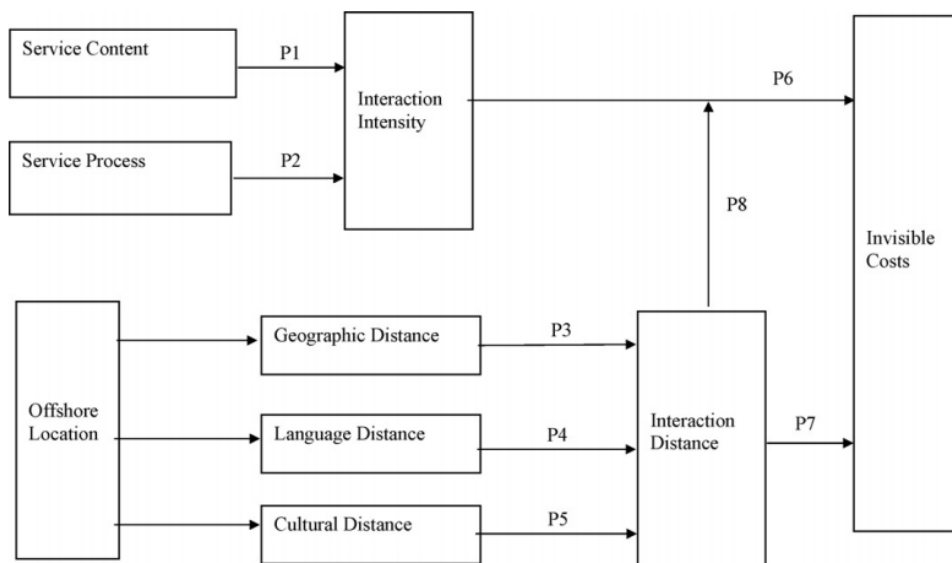


Figure 2.12 - Invisible costs conceptual framework (Source: Stringfellow, Teagarden, & Nie, 2008)

2.5 Captive offshoring versus offshore outsourcing

Among all the governance modes firms may choose to implement service offshoring initiatives, for the sake of our work, we are going to concentrate on captive and outsourcing offshoring. This dichotomy is often used in the research world because it simplifies and enhances calculations and results of empirical investigations. Figure 2.13 summarizes the continuum in between these two modes.

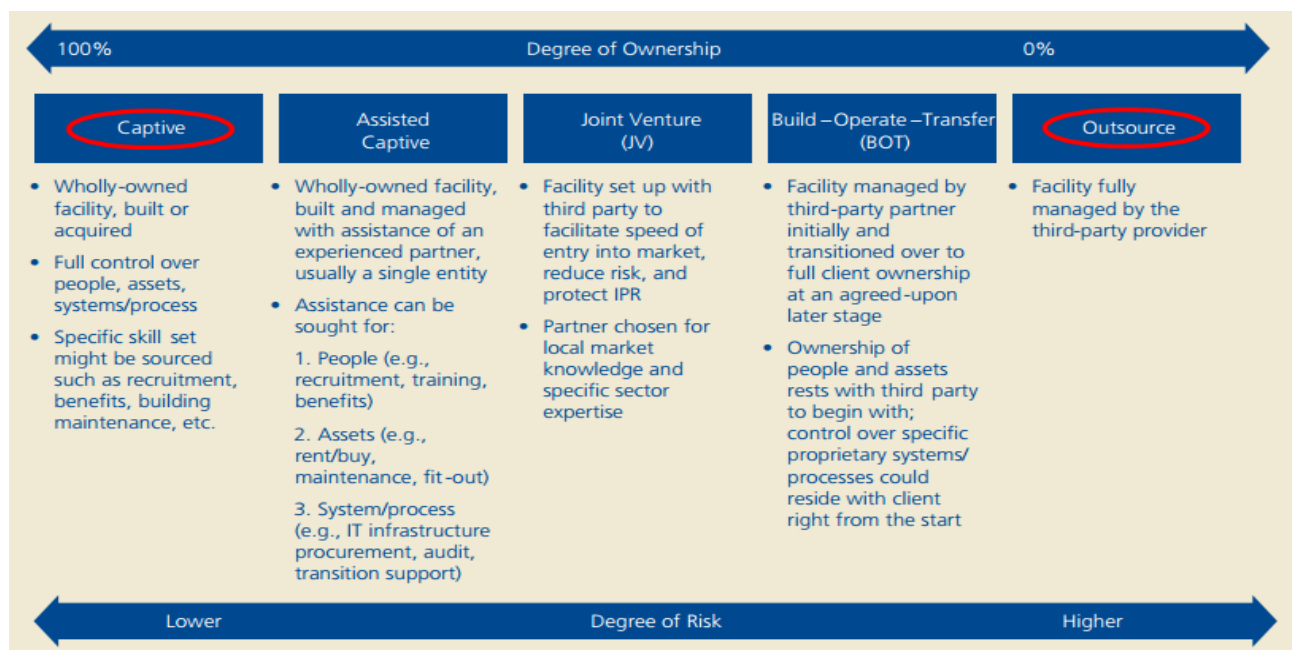


Figure 2.13 - Offshoring/Outsourcing business models (Source: Deloitte, 2008)

As we can see from the chart, captive offshoring is the modality which gives the higher degree of ownership as well as the lower degree of risk. Examples of captive offshoring initiatives are greenfield investments and M&As, which enable to obtain partially or wholly owned subsidiaries. Having a higher control on strategic processes and assets allow companies to differentiate more with respect to competitors, enhance brand reputation and develop proprietary technology to maximize the value for the customer. The higher internal coordination of people and processes permits improving scheduling and time delivery, especially across cultures. Captive offshoring is also the best way to retain knowledge within the firm (avoiding possible spillovers or technology leakage) and reverse the transfer of know-how. Finally, it is the mode that facilitates specialized investments the most.

The negative aspects of such modality are observable in the possible high set-up costs, since a lot of capital is required to start a captive mode. The amount of information to access new markets is enormous and expensive as well. Therefore, companies will suffer from short-term financial costs and risks, since benefits will show up in the long-term. In the end, the administrative structure of this mode may become heavy. Additional costs might incur due to slacking behaviors by employees.

On the other hand, there is offshore outsourcing, which is the modality with the least control and the higher degree of risk. Usually the firm using this mode relies on a facility completely managed by a third-party provider. Offshore outsourcing gives a greater strategic flexibility because firms can easily switch orders among suppliers as circumstances dictate. They can also adapt to volume fluctuations in demand, and access faster to up-to-date expertise in rapidly changing technologies. The administrative and bureaucratic structure is almost inexistent, reducing inefficiencies and costs of vertical integration. Benefits and returns are faster as well as speed to market. There is less short-term financial risk and the possibility to learn interacting with the network of suppliers.

What are the cons of offshore outsourcing? First, the client will face additional costs due to transaction costs (i.e., research of the right supplier, negotiation, contract monitoring). Secondly, know-how may be lost, especially for advanced and knowledge intensive activities (i.e., spillovers). Finally, the firm may incur in intellectual property losses and technology leakage.

Kedia and Mukherjee (2009) propose an evolution of John Dunning's eclectic paradigm (1977, OLI framework, i.e., Ownership-Location-Internalization related advantages) that tries to explain a firm's decision to embark in an offshoring initiative through three types of interrelated advantages perceived by the firm itself (DLE framework). The advantages are:

- Disintegration-related advantages
 - The incremental focus on core competences bring innovation, better resource allocation and increased quality of products and services
 - Modularization brings increased flexibility, speed and cost reduction
- Location-specific resourcing advantages
 - Country level advantages such as better infrastructures and governmental policies
 - Human capital advantages such as labor arbitrage, knowledge arbitrage and time arbitrage
- Externalization advantages
 - Advantages related to relationship capital, co-specialization and mutual organizational learning

According to the sequential (from disintegration to externalization) perception and seizure of the aforementioned advantages, firms can adopt different kinds of governance mode for their offshoring implementations (see figure 2.14). We are particularly interested in the sourcing models of quadrants II and III. Companies within quadrant II face high external pressures due to growing demand for better products or services from customers, fierce rivalry from competitors and institutional pressures. This may push organizations to disaggregate their value chain, maintaining core activities onshore and contracting out the rest to overseas suppliers with superior capabilities. In this context, the perceived cost, quality and learning advantages counterbalance transaction costs and risks related to

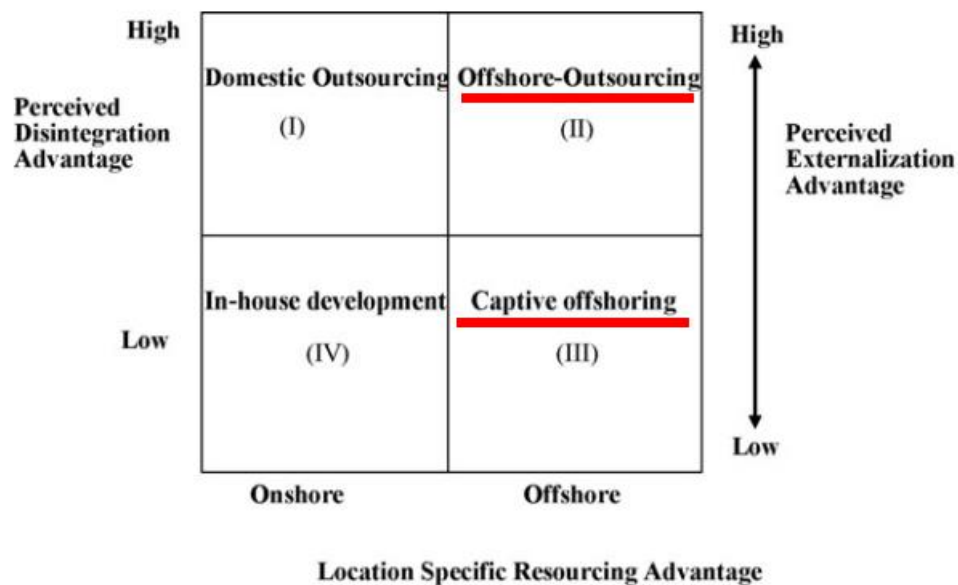


Figure 2.14 - A DLE explanation of different sourcing models (Source: Kedia & Mukherjee, 2009)

the specific location. Firms placed in the III quadrant differ from those in quadrant II in the perception of disintegration advantages. Pressure remains high, however transaction costs related issues (i.e., opportunism) and risks associated with the specific location, spillovers and unknown suppliers drive companies to internalize benefits related to resources found overseas. Moreover, such companies usually are MNEs with the financial possibilities to set their own captive centers abroad. They take advantage of labor, time and know-how arbitrage.

Top managers have a crucial role in determining the modularization of activities and in identifying core functions, as losing the control of some of these tasks may cause “competence destruction” or even worse, create advantages for competitors.

The presentation and the description of these two broad entry mode categories allow us to easily connect our reasoning to the next chapter, which deals with the main theories on entry mode as well as the contributions of several authors that made this field further develop.

3 Entry mode

Entry modes can be defined as the channels through which companies, specifically multinational enterprises (MNEs), enter a new international market. In the first chapter, we reported the main forms of governance that firms adopt when implementing offshoring initiatives; in particular, we focused on the dichotomy between captive offshoring and offshore outsourcing, which will represent the basis of our empirical analysis.

Scholars have largely dealt with the determinants of entry mode choices, producing specific theories in order to support their arguments; furthermore, recent papers have increasingly investigated how entry decision affects the investment results and, more in general, overall firm performance. Therefore, in this part we first present all the existing theories and perspectives on the topic; we then illustrate extant empirical findings on the effect of entry mode on performance; finally, we conclude by discussing some crucial researches for our work on entry mode.

3.1 Theories on entry mode

A number of theories have been developed to explain companies' governance choices. Theories typically differ in terms of framework, analytical benefits and in the particular context to which they are related. Consequently, each perspective is well-suited to describe some facets of the phenomenon, but none of them can capture the phenomenon in its entirety.

The most widely used theoretical frameworks in entry mode studies are the transaction cost economics (TCE), the institutional and cultural perspectives, the OLI paradigm and the resource-based view (RBV).

3.1.1 The transaction cost theory

The transaction cost economics (TCE) is certainly the most adopted theoretical approach in international business research, recurring roughly in half of the works about entry mode (Brouthers & Hennart, 2007). It is commonly associated with the publications of Oliver Williamson (1975; 1985), albeit the first insights can already be found in the work of Coase (1937) and Simon (1957).

As the name suggests, this theory is strongly built on the notion of transaction cost. A transaction cost is defined as the cost of participating in a market or, more precisely, the cost of searching for, negotiating with and monitoring an appropriate partner. Companies choose the form of governance that minimizes transaction costs and thus guarantees the most efficient structure; namely, market based mode or vertical integration. According to TCE, firms normally prefer market based modalities (e.g., outsourcing) in order to benefit from economies of scale of the market place. However, as transaction costs increase, they tend to switch their preference toward more hierarchical solutions (i.e., captive initiatives).

Such increase derives from the general managers' condition of bounded rationality (Simon, 1957) and from the concept of opportunism. By bounded rationality, Simon means that firms have incomplete, often unreliable, information about market opportunities, as well as, limited ability to predict and predetermine responses to future events. Opportunism follows from bounded rationality, and adds the element of self-interest (i.e., the subversion of morality to profit). Economic agents tend to act in their own interests, not respecting agreements with third parties, given to the costs associated with observing and sanctioning their behavior (i.e., condition of information asymmetry). When these two factors become critical in a market, companies internalize the transactions.

The following dimensions represent additional sources of transaction costs:

- Asset specificity
- Uncertainty
- Frequency

As firms progressively disperse their activities globally, asset specificity occurs whenever the offshore activities are strategic for the offshoring company (i.e., essential for the future well being of the company). Indeed, high-value activities (e.g., R&D, engineering services) commonly incur in high transaction costs due to the risk of assets misappropriation, technology dissemination and knowledge leakage. In particular, the latter represents “the deliberate or accidental loss of knowledge to unauthorized personnel within or outside of an organizational boundary” (Annansingh, 2012: 271). In order to prevent these risks, firms are pushed to vertically integrate their core business units.

According to Williamson (1985), asset specificity occurs also in the event of supplier's investments that are specific to the customer and that lose their value outside that particular relationship (i.e., the so called sunk investments). This is critical for a company, because the more a part becomes committed to a transaction, the more the partner might exploit such non-reversible situation by

reformulating the provision of the contract in his own favor. Empirical evidence of the effects of this type of asset specificity on entry mode is mixed: some studies have shown that firms facing this problem are inclined to undertake high control governance structures (e.g., WOS) (Gatignon & Anderson, 1988; Hennart J. F., 1991; Makino & Neupert, 2000). However, other researches have come up with the opposite effect (i.e., softer governance modes) (Delios & Beamish, 1999; Palenzuela & Bobillo, 1999) or with no significant interrelation between specificity and entry mode choice (Kim & Hwang, 1992; Brouthers & Brouthers, 2003).

Uncertainty is associated with the general condition of bounded rationality. TCE suggests that transactions are regulated by contracts with a relevant degree of complexity and uncertainty, generated by the difficulty to foresee and take into account all the possible circumstances. Nevertheless, uncertainty is really problematic only when coupled with asset specificity, such that contracts turn out to be not only incomplete, but also inefficient. In these instances, vertical integration becomes the predominant choice.

Finally, frequency refers to the degree of recurrence of transactions. As asset specificity and uncertainty increase, it is unlikely that the market will offer scale and scope benefits; in this case, if transactions are recurrent, firms may internalize the activities and exploit internal economies of scale (see figure 3.1).

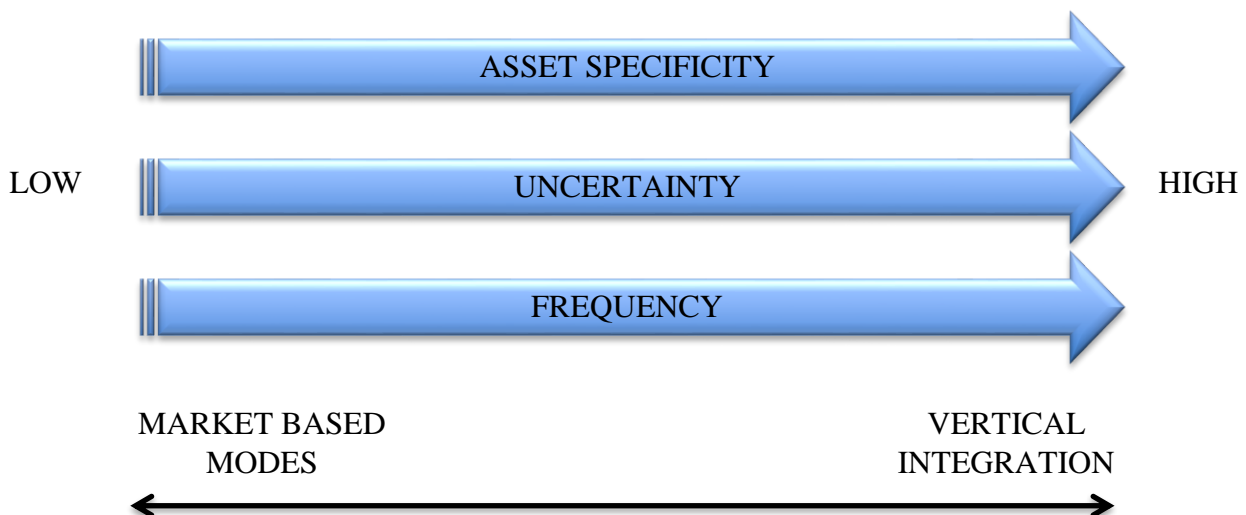


Figure 3.1 – TCE and entry mode choice (source: adapted from Spina, 2008)

Williamson’s works represent the reference and the starting point for the entry mode studies of many authors (e.g., Anderson & Gatignon, 1986; 1988; Hill, Hwang, & Kim, 1990; Erramilli & Rao, 1993;

Cleeve, 1997; Taylor et al., 1998; Makino & Neupert, 2000), whose intention has been to verify and extend this theory.

3.1.2 The institutional and cultural perspectives

TCE plays an essential role in describing the behavior of companies that enter a foreign market. However, it does not explain why firms frequently adopt captive modalities even in case of low transaction costs or, conversely, why they may choose outsourcing when transaction costs are high. Hence, scholars have started to investigate the governance choices through extended TCE models by integrating TCE with the institutional and cultural contexts (e.g., Brouthers & Brouthers, 2000; Brouthers, 2002; Elia et al., 2014).

The institutional environment affects firm boundary choices because it “reflects the rules of the game by which firms participate in a given market” (Brouthers & Hennart, 2007: 405). In other words, institutions provide the structure in which transactions occur. For example, it might happen that host country governments raise high barriers to entry, such as legal restrictions and obligations to create joint ventures with local partners (e.g., in China). Since the first attempts to combine the TCE with the institutional perspective (North, 1990), researchers have typically directed their attention to the host country (e.g., Davis et al., 2000), analyzing the impact of country risk (e.g., Delios & Beamish, 1999; Brouthers & Brouthers, 2000; Brouthers, 2002) and industry structure (Chen & Hennart, 2002) on entry mode decision; furthermore, some studies have highlighted how the home country institutions also influences the firm governance (Erramilli M. K., 1996; Pan, 2002). All these studies agree that investing companies perceive high uncertainty and risks in countries characterized by weak political and market institutions, since such locations usually present political instability, widespread corruption, legal restrictions and weak law enforcement. In this situation, firms preferably opt for a softer governance mode to limit their exposure and to potentially quickly disinvest. Specifically, offshore outsourcing is often adopted, but offshoring companies frequently seek for legitimacy by relying on a local partner. Conversely, the higher the quality of institutions (and the lower the investment risk), the higher the likelihood of implementing captive initiatives, which assure higher returns (Kim & Hwang, 1992; Erramilli & Rao, 1993).

A further crucial element related to the destination of offshoring practices is the host country attractiveness. Following Brouthers (2002), whenever firms invest in high growth markets, they are likely to choose a more integrated governance mode for the purpose of exploiting economies of scale and establishing long-term presence in the market (also Agarwal & Ramaswami, 1992). On the

contrary, low potential markets lead companies to lower intensity forms of governance in order to “improve the returns on investments by minimizing resource commitment (if returns are low); reduce the impact on the competitors, thus avoiding a further reduction of prices; and minimize market exit costs if firms decide to withdraw their investments when sales do not grow” (Elia et al., 2014: 188).

As far as the cultural context, literature has concentrated on the cultural distance between host and home countries. Such distance is estimated by scholars in various ways, such as the perceived similarity in cultures (Kim & Hwang, 1992; Brouthers, 2002) and the familiarity with the host country (Gomes-Casseres, 1990). Extant research typically operationalize distance using the measure developed by Kogut and Singh (1988), which relies on the cultural dimensions first identified by Hofstede (1980).

In particular, Hofstede proposes five different cultural dimensions along which national cultures can be analyzed:

- *Power distance*: the extent to which the less powerful members of organizations and institutions accept and expect that power is distributed unequally;
- *Individualism vs. collectivism*: the degree to which people in a society emphasize the “I” vs. the “We”;
- *Masculinity vs. Femininity*: the preference in society for masculine values (e.g., achievement, heroism, assertiveness) compared to feminine values (e.g., cooperation, modesty);
- *Uncertainty avoidance*: the degree to which a society is comfortable with, uncertain situations, risk-taking, and change;
- *Long-term orientation vs. short-term orientation*: the fostering of virtues oriented toward future rewards (e.g., perseverance and thrift) compared to virtues related to the past and present (e.g., respect for tradition).

There is a general consensus on the relevance of cultural distance in affecting companies’ entry mode choice. Specifically, as cultural distance increases, the misunderstanding of social norms and values between the acquiring and target firms may entail increasing operational and managerial complexities. Such misunderstanding generates uncertainty “by reducing the probability of succeeding in the deal, thus pushing firms to implement a risk reduction strategy and adopt a lower control in their governance mode” (Elia et al., 2014: 186).

3.1.3 The eclectic framework

Based on Dunning’s works (1977; 1993), the OLI paradigm is not a formal theory, rather a helpful framework that brings together elements of various streams of research to identify the factors that underlie a firm’s decision to become a MNE. The framework identifies three potential sources of advantage, namely ownership (O), location (L), and internalization (I) advantages.

First, ownership-specific advantages refer to the competitive advantages that investing companies may possess over competitors in supplying a certain market (e.g., production technique, returns to scale, entrepreneurial skills, trademark). The greater the ownership advantages, the more investing firms are likely to engage in their foreign production (Dunning, 2000). Second, Internalization advantages occur whenever the own production is preferable over the market; consequently, firms usually prefer to undertake foreign investments (e.g., exporting) rather than licensing. Finally, given the existence of the two aforementioned advantages, the more a foreign location offers favorable resources and conditions (e.g., low cost of labor, presence of raw materials, special taxes or tariffs), the more firms tend to engage in foreign direct investments (FDI) to fully exploit such environment (see table 3.1). In few words, companies actually become multinational enterprises when all the advantages exist and are significant (Dunning, 1993; Brouthers, Brouthers, & Werner, 1999).

Table 3.1 – OLI paradigm and entry mode choice (source: Dunning, 1981)

		Category of advantage		
		<i>Ownership</i>	<i>Internalization</i>	<i>Location</i>
Forms of market entry	<i>Licensing</i>	Yes	No	No
	<i>Export</i>	Yes	Yes	No
	<i>FDI</i>	Yes	Yes	Yes

According to Dunning, four different types of FDI can be distinguished. In the section that follows, we focus on the three that are relevant for our analysis on the offshoring of business services:

- *Market-seeking FDI* aims at expanding the corporate business by supplying services to the host country. In this respect, a physical presence in the foreign market (i.e., captive modalities)

favors an effective response to local customers' needs (in terms of both delivery lead time and adaptation to local tastes). Moreover, it favors brand recognition, which leads to a deep penetration of the market (e.g., Franco et al., 2008). Conversely, other forms of governance (e.g., joint venture, offshore outsourcing) turn out to be less appropriate (Meyer & Estrin, 1998).

- *Efficiency-seeking FDI* aims at increasing firm efficiency. Depending on their strategy and objectives, companies prefer either to externalize their services or to vertically integrate. Specifically, on the one side they may take advantage of lower costs of traditional factor endowments (e.g., labor) in the host country through the employment of external providers. On the other side, they may exploit economies of scale and scope by redesigning the business process and internalizing the activities (Dunning, 1993; Franco et al., 2008).
- *Asset-seeking FDI* aims at acquiring foreign corporations' assets and improving the firm's global competitiveness. Lewin et al. (2009) identify human resources as one of the most important strategic assets, with multinationals increasingly searching and competing for talents globally. Typically, they implement full acquisitions in order to take complete control of the resources of a target company (De Baule, Piscitello, & Elia, 2014). However, firms may also acquire knowledge and access to qualified personnel through the externalization of activities to expert suppliers. Therefore, also in this case, there is not an evident governance mode predictable a priori (Albertoni & Elia, 2010).

3.1.4 The resource-based view

The resource-based view (RBV) is a theoretical approach considering resources central to obtain better firm performance. Particularly, Barney (1991) suggests that companies achieve sustainable competitive advantage only when resources are endowed with all the VRIO attributes (i.e., valuable, rare, hard to imitate, supported by the organization). According to RBV, foreign markets represent the environments to acquire and develop new capabilities, as well as the location where to export resources in order to extend the benefits of a competitive advantage also outside the national boundaries (Tsang, 2000; Luo, 2002). Hence, this perspective substantially differs from the TCE (although it is still defined as valid), shifting from cost to value in the analysis of entry decision (Madhok, 1997).

The typical resources associated with the governance choice are firm-specific assets and capabilities such as experience (we dedicate the whole next chapter to it), proprietary technology, skilled workers, firm size and tacit know-how. Madhok (1997) posits that companies opt for internalization when foreign investments involve VRIO resources (in particular inimitable resources) in order to preserve their peculiarity and whole value. Indeed, in such investments the replication of the know-how by other firms (e.g., outsourcing and franchising) hardly occurs without loss in value (since it is difficult to imitate), while a transfer in-house (i.e., transfer of the resources within the same company, from the home country to the host country) allows for the complete conservation of the know-how. In addition, other studies have shown the preference for internalized over market modalities when companies possess greater resource-based advantages (Dev, Erramilli, & Agarwal, 2002; Erramilli, Agarwal, & Dev, 2002).

3.2 Entry mode choice and performance

3.2.1 Initial insights on performance

How does the entry mode choice affect the firm performance? Does the best governance mode exist for all the initiatives or the optimal choice depends on the specific investment? Should extant theories be taken into account when firms consider to offshore activities? From the late nineties, scholars have increasingly debated these issues, coming up with various recommendations to succeed in the international expansion.

Commonly, the first studies explored performance differences between wholly owned subsidiaries and joint ventures by strictly referring to the transaction cost theory (e.g., Woodcock et al., 1994; Nitsch et al., 1996; Pan, Li, & Tse, 1999; Shrader, 2001). They basically suggest that entry mode choices based on TCE guarantee the most efficient structure (i.e., the least cost) to companies, while firms choosing other forms of governance (i.e., not suggested by the transaction cost theory) underperform and are probably driven out of business by competition (Roberts & Greenwood, 1997).

Although these papers represented a relevant starting point for the research on the field, it is now well accepted that they typically suffered from an endogeneity problem.

3.2.2 The endogeneity problem

Shaver (1998) first sheds light on the meaningful risks that studies can incur when investigating the relationship between entry mode choice and firm performance. The author claims that firms self-select their form of governance or, in other words, managers choose the corporate strategies (specifically the entry mode) based on industry conditions, as well as, company's characteristics (i.e., capabilities) that are expected to maximize the performance. Therefore, governance choice is endogenous (Brouthers, 2013). Empirical models normally assume a random-distribution of the explanatory variable, and as such do not capture these decision-making factors (either because they are unknown or not measurable). However, these factors can affect firm performance and not taking them into account can thus result in biased estimations.

In particular, statistical analyses suffer from an endogeneity problem when the governance mode is used as the explanatory variable of performance, since the former is also influenced by the expected levels of the latter (Shaver, 1998; Brouthers, 2002). Thus, in order to control for this issue, governance should not have a direct impact on performance; rather, it is the alignment (or fit) between a governance arrangement and the theoretical predictions that affect firm results (Leiblein et al., 2002).

3.2.3 Critics on past studies and progress toward a more integrated view: focus on K. D. Brouthers' work

The endogeneity issue is not the only problematic aspect of the initial performance-related studies based on TCE. Literature has underlined that considering only transaction cost theory is too limited and neglects fundamental elements influencing firms' outcome. Following TCE only, companies are able to minimize costs (i.e., obtain the most efficient structure), but they do not implement the best performing mode, given that the value enhancement potential of international entry is completely ignored (Contractor F. J., 1990; Zajac & Olsen, 1993; Dyer, 1997; Tse, Pan, & Au, 1997; Brouthers, Brouthers, & Werner, 1999).

Through the paper "Institutional, cultural and transaction cost influences on entry mode choice and performance" (2002) Brouthers first effectively integrates factors associated with both efficiency and value enhancement. As the title suggests, the author proposes a combination of TCE (efficiency related) with the institutional and cultural contexts (value enhancement related). Hence, on the one hand transaction cost theory is extended by including location specific attributes affecting the revenue potential, such as country specific investment risk (Brouthers & Brouthers, 2000) and the market

attractiveness (i.e., the market growth) (Agarwal & Ramaswami, 1992); on the other hand, institutional theory completes the scenario by encompassing the impact of host country institutions in restricting entry choice (Davis, Desai, & Francis, 2000).

Brouthers' work represents a milestone in the international business research. While several previous studies had also recognized the importance of institutional and cultural contexts besides TCE (Roberts & Greenwood, 1997; Delios & Beamish, 1999; Davis, Desai, & Francis, 2000), Brouthers is the first to successfully incorporate them and provides a comprehensive overview of the relationship between governance mode and firm performance. In particular, he hypothesizes and verifies that forms of governance that are consistent with extended TCE predictions (i.e., fit situations), result in better-performing outcomes than forms not complying with the theory (i.e., misfit situations).

Furthermore, the novelty of Brouthers' approach also lies in the methodology applied to deal with the endogeneity problem. Following Shaver (1998), the paper relies on a two-stage approach à la Heckman (1979) through which the entry mode choice does not directly explain companies' results. Thanks to its efficacy, this approach has been the basis for many subsequent studies regarding the determinants of firm performance (e.g., Elia et al, 2014).

3.2.4 The aftermath of Brouthers' work

Brouthers' contribution goes well beyond the aforementioned advancements introduced in his seminal 2002 article. He has in fact pointed international business research toward new promising directions and paved the way for new debates. In general, a growing number of studies have attempted to explain the entry mode choice by exploring uncommon perspectives and attributes. They have extended the transaction cost theory with, for example, a real option perspective (Brouthers, Brouthers, & Werner, 2008b), the concept of foreign market governance quality (Slangen & Van Tulder, 2009) and the resource-based view (Brouthers, Brouthers, & Werner, 2008a; Meyer et al., 2009). Moreover, scholars have also widened the institutional context by expanding the definition of institutional distance through the use of innovative measures (Berry, Gullen, & Zhou, 2010; Dow & Ferencikova, 2010) and the investigation of sub-national institutions instead of the traditional national-level affects (Meyer & Nguyen, 2005).

Concerning the performance implications of firms' governance, literature has been thoroughly digging into the matter in order to certify and broaden Brouthers' suggestions. So far, researchers have generally confirmed the relevance of theory-driven mode decision, showing that offshoring

companies need to adopt governance choices consistent with transaction features and local context. Most of them focus on large multinationals (e.g., Chen & Hu, 2002; Brouthers, Brouthers, & Werner, 2003), however others also refer to small firms (e.g., Brouthers & Nakos, 2004).

Particularly important for our purpose is the work by Leiblein et al. (2002). Although its theoretical framework is essentially limited to the TCE (neglecting critical elements such as institutional factors), it develops an effective method to measure governance misfit, defined as “the probability that another governance form is more appropriate given the contractual hazards surrounding the exchange” (Leiblein, 2002: 822). Additionally, based on this variable and the two-stage technique à la Heckman, it demonstrates that appropriate governance mode choices enhance firms technological performance.

Such methodology is also similarly employed by Castañer et al. (2013), who tries to address gaps in the alliance literature by underlining the peculiarity of make-or-ally decisions with respect to the make-or-buy ones. In particular, the authors suggest that, regardless of the governance mode adopted, the alignment of the entry choice with surrounding exchange and production conditions (i.e., the activity’s resource requirements and the company’s resource endowment) improves activity-level performance (i.e., shorter time-to-market and greater unit sales). However, contrary to extant literature (Shaver, 1998; Leiblein et al., 2002), they posit that even when accounting for the endogeneity issue, make-or-ally decisions can have direct consequences on specific investment outcomes, since the “advantage of collaborative governance lies in the resource diversity rather than in their sheer collective volume” (Castañer et al., 2013: 1395).

Finally, the paper by Elia et al. (2014) investigates the antecedents of performance (in terms of both cost savings and service quality) achieved by firms offshoring business services. It makes use of the two-stage approach à la Heckman to account for the endogeneity problem (Leiblein, 2002) and extends the TCE with insitutional and cultural contexts and location attributes specific to the offshore destination (similar to Brouthers, 2002). Following Martin (2013) “What if” reasoning, the authors aim at examining whether substantive asymmetries in the costs of wrongly choosing one form of governance rather the other do emerge. In this regard, they highlight how the failure to undertake an outsourcing entry mode does not considerably compromise the offshoring performance, while the failure to undertake a captive modality negatively impact on the investment outcome. Additionally, the cost-saving performance is less affected than quality by governance misalignment. Thus, the governance misalignment not only reflects an asymmetric effect on performance, but also, more importantly, it does not necessarily entail a negative impact on performance (contrary to what existing researches commonly claim).

Our thesis precisely arises from this work and, in particular, from its considerations upon the governance misalignment. Indeed, companies sometimes adopt entry modes that are far from theoretical “recommendations”. This might be due to a mistake (generally with consequent negative performances); however, we presume that firms frequently do not follow theory on purpose in order to search for new and more effective solutions, leveraging their experience in offshoring practices. Therefore, it is essential to explore the role of experience in depth to understand its influence on entry misalignment.

4 The Role of Experience

The following discussion marks a turning point in our thesis. We presented several evidences from the literature about the evolution of the offshoring phenomenon, its international context, the forces driving it and the difficulties and risks managers have to face in such a complex scenario. We discussed the importance of the entry mode choice, its relation to the performance of a firm, theories and frameworks around it and the intricacy of the different ideas researchers have about it. We now aim to explore the relationship between experience and the related decisions of entry mode. Extant literature on this topic has reached important results and managerial implications, however, several gaps and contrasting opinions underline the necessity and the possibility to further investigate this field.

It is necessary to deepen our understanding of the interdependence between previous and actual entries; the learning mechanisms that originate from past choices; the processes of imitation at several levels (i.e., within the same firm and among firms of the same industry) and it is essential to determine decision makers' behavior in relation to new entries. The information they extract from past experiences may come from the frequency with which previous choices were selected or from the level of performance reached thanks to earlier entries. Experience itself has different facets. Do decision makers learn more from successful or unsuccessful experiences, contextually similar or dissimilar experiences? Moreover, which is the influence of entry mode theories on subsequent entries? When do managers align their choices to what theory suggests, and when do they implement their own strategies? Previous studies have demonstrated that entry mode in misalignment with theory not always worsen the performance of a company, and therefore we want to further investigate this field with greater detail. As we can see, there are still plenty of research possibilities around entry modes and the role of experience (Hennart & Slangen, 2015).

4.1 Experience and Organizational Learning

What is experience? What is organizational learning? Are these two concepts always correlated? Both experience and organizational learning have many definitions. Experience is the process of gaining knowledge or skills from doing, seeing or feeling things (Cambridge, 2016). Organizational learning is a change that occurs in the organization as the latter acquires experience. The change is relative to the variation of knowledge, which can be tacit or explicit, and the modification of behaviors within

the organization. These two ideas have evolved for several years, creating contrasting opinions among scholars.

The period before the nineties is dominated by the concept of routines. Behaviors and organizational learning within a company are governed by routines. Actions derive from a logic of appropriateness (i.e., the combination of procedures and situations) rather than a logic of consequentiality and intention. Routines are path-dependent. They are an interpretation of the past and they adjust to experience through the acquisition of information resulting from feedback from outcomes. Firms are aligned to targets. Their behavior changes according to the gap between actual outcomes and expected outcomes. In such a scenario, organizations are considered entities learning by assimilating inferences from experience and transforming them into routines to guide behavior (Nelson & Winter, 1982; Steinbruner, 1974; Siegel, 1957).

Organizational learning, as a form of intelligence and strategic tool, may be converted into competitive advantage, enhancing the performance of a company. Effective understanding of past experiences involves several issues related to the complexity of the structure of organizational experience. First, experience may be scarce. The nature of history influences the information obtainable from experience. In dangerous and fast changing environments, this information may be inadequate. Second, the redundancy of experience may stabilize too much routines eliminating the experimentation necessary for the evolution of the learning process. Finally, the complexity within the firm can be too high due to frequent interactions among sub-units and intricate causal systems (Levitt & March, 1988).

In 1990, Cohen and Levinthal introduced the concept of “*absorptive capacity*”. Absorptive capacity is the ability to identify, assimilate and apply the value of new information as a function of previous related knowledge. Experience (i.e., the storage of knowledge) enhances the learning capabilities of a company, since new concepts are memorized through associative connections with pre-existing ideas. This implies that learning is cumulative, and the more it is associated with what is already known, the greater the related performance will be. Consequently, learning in novel domains is much more difficult. Another important aspect is diversity of knowledge. In uncertain and changing environment, having a wide background of knowledge helps a company in capturing incoming information. What we want to highlight is the transfer of knowledge within the organization. Experience and knowledge increase not only through the interaction between the company and the external environment, but also through the internal communication among business units. The distribution of expertise within the company improves when the absorptive capacity of gatekeepers (i.e., individuals standing at the interface of either the firm and the external environment or at the

interface between subunits within the firm) and those who receive information is high. This situation creates a trade-off between shared knowledge and diversity of knowledge. Shared-knowledge allows a better communication among sub-units, while diversity of knowledge or specialized knowledge allows the absorption of new information thus fostering innovation. Commonality should not be carried so far that diversity across business functions is substantially reduced. Likewise, specialization should not be pushed so far that communication is undermined.

To conclude our discussion, we present the work by Argote and Miron-Spektor (2011), which summarizes theories around experience and organizational learning. The two authors provide a theoretical framework to analyze the process of organizational learning (figure 4.1).

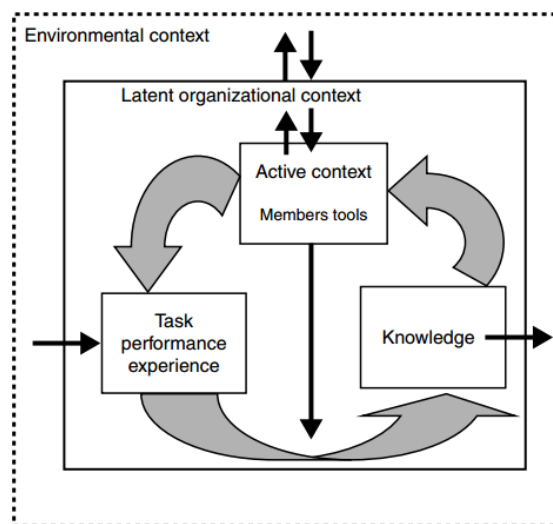


Figure 4.1 - A theoretical framework for analyzing organizational learning (Source: Argote & Miron-Spektor, 2011)

Figure 4.1 shows how organizational learning is a continuous cycle through which task performance experience is transformed in knowledge that in turn impacts the active context of a company and its future experience. Organizational learning occurs in a scenario that consists of the company and the environment. The company is divided between an active context (i.e., members and tools of a firm) and a latent context, which affects which individuals are members of the organizations, what tools they have, and which tasks they perform. The environment is made of external elements such as competitors, clients, institutions, and regulators, which affect the experience acquired by the company. The two contexts interact with experience to generate knowledge.

The authors then list all the possible forms of organizational experience, considering several dichotomies such as successes and failures, direct and indirect experience, experience acquired

through novel tasks or repeated tasks, recent and past experience, and heterogeneous or homogeneous experience. Later, we will discuss in greater detail some of these dimensions. The message that the two authors want to convey is that the more fine-grained the analysis of experience and of its context, the easier it is for managers to understand its positive or negative implications on learning. Furthermore, managers can design experience in order to enhance organizational learning. Determining the types of experience that are most valuable in organizations and the contextual conditions that encourage the realization of the experience's value helps managers to improve the performances of companies.

4.2 Experience and Entry Mode

We are coming to the core of our treatise. The purpose of this section is to investigate the relationship between experience and entry mode. We are going to present the different views of the field related to this issue, as well as the hypotheses of our thesis.

Several authors have found limitations in earlier works. Despite several years of studies, it seems that there is still a certain degree of uncertainty about how companies enter and conduct business in foreign markets. Empirical results from previous researches are weak and conflicting. For instance, Kogut and Singh (1988) found no significant relationship between experience and the choice of wholly owned subsidiaries or partial ownership; Hennart and Park (1993) did not find any connection between experience and the preference of acquisition or greenfield; Erramilli (1991) suggested that companies behave according to a U-shaped relationship between the desired degree of control and experience. Earlier entrants and more mature firms prefer wholly owned solutions while companies with moderate experience prefer partial ownership solutions.

Problems of antecedent works arise due to poorly designed studies. They are cross-sectional in nature, clustering together a huge number of entries and analyzing them through aggregated values, however, they do not explicitly consider a sequence of foreign entries. They assume entries are discrete and the related decision making process is static. Previous entries do not influence subsequent ones, so each entry mode is independent from others. Moreover, these studies do not examine in detail the sources of uncertainty and its context, considering it as mere lack of knowledge about local markets (Chang & Rosenzweig, 2001).

Literature on experience and entry mode takes a step forward through the introduction of the knowledge-based theory of the firm, which states that companies compete using their learning

capabilities and knowledge. Multinational firms are no more seen as only means to relocate efficiently resources overseas, but they become groups of social individuals specialized in the fast and valuable creation and transfer of knowledge. Following this reasoning, foreign entry can be seen as an intention to exploit existing knowledge or to increase the knowledge base through exploration. Consequently, the entry mode choice is more than a simple quest for cost reduction and efficiency; it is a process to enhance organizational learning. The more experience a company gets, the better it can manage knowledge creation and transfer within the company, influencing subsequent entry mode choices which can vary according to changing circumstances (March, 1991; Kogut & Zander, 1996; Teece, Pisano, & Shuen, 1997). The same thought is shared by Petersen and Welch (2002) which go against existing literature saying that firms change and add operation modes to existing ones, creating what they call “*mode combinations*”. They continue by saying that it is very difficult to empirically prove such dynamics, since it is hard to obtain valuable information from respondent companies because the underlying process is complex and evolves rapidly.

Benito et al. (2009) introduce one of the first dynamic frameworks to explain mode choices and changes (figure 4.2). Even though the authors focus more on operation modes rather than entry modes, the model clearly give us a picture of the multiplicity of phases and factors that affect the final mode use and outcomes. Besides incremental experience, modes evolve due to changing market circumstances, institutional modifications and new relationships with foreign partners. It is a process of organizational adaption as experience in focal and other foreign markets grows, integrating learning and drivers of change that bring to the improvement of the mode set. Experience has both positive and negative influences on future decisions and generates its own bias. It impacts decision drivers and managers which often fall back on their past experiences (Eisenhardt & Sc Martin, 2000).

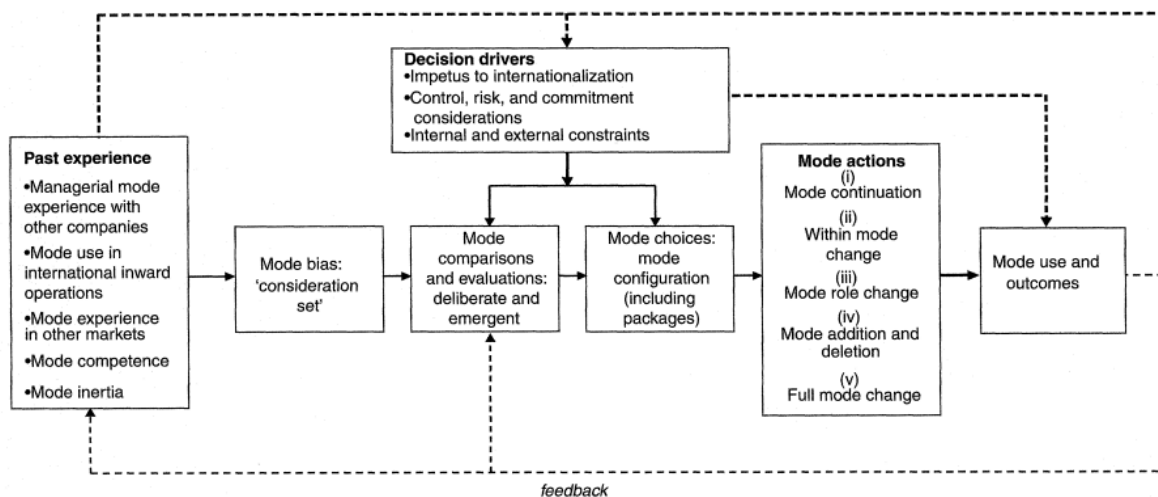


Figure 4.2 - Mode choice and change (Source: Benito, Petersen, & Welch, 2009)

Nevertheless, experience and knowledge creation are the best tools that companies can use to connect and combine different entry modes with the final objective of supporting the overall penetration strategy. Different combinations may be helpful in different countries and at different levels of the value chain.

4.2.1 Experience and entry decision

Our first hypothesis aims at investigating how companies with experience and companies with no experience behave in relation to their entry decision. Which will be their approach to such a complex decision-making process? We believe experienced firms and inexperienced firms face the decision-making process in two different ways. Moving from existing literature, we consider the concept of misalignment. Our interest does not lie in understanding which entry mode companies select based on experience (i.e., “make or buy”, captive or outsourcing), although this aspect will be taken into account in our analysis, but rather how companies carry out the reasoning process that leads to the final entry choice, specifically, whether firms stick to theories on entry mode (i.e., fit behavior) or not (i.e., misfit behavior).

Drawing from organizational theory (i.e., knowledge-based theory and dynamic capabilities theory, see paragraphs 4.1 and 4.2) we suggest that more experienced companies tend to assume behaviors in misalignment with theory, while inexperienced companies follow theory suggestions.

Experienced companies can count on a pool of precious information and specific resources coming from their past history, which allow them to continuously re-elaborate and re-shape their penetration strategies looking for better results. This may lead such firms to distance themselves from what theory proposes as the best solution.

Firms with no entry mode or international experience have no data to elaborate and information to process, facing a situation of bounded rationality where the number of external and internal variables to consider, as well as their interactions, exceed the cognitive capacities of managers. The lack of a solid base on which to construct the penetration strategy of the company may bring catastrophic results, such as huge monetary losses (e.g., sunk costs, penalties) and the impossibility to exploit foreign market opportunities. Therefore, their sole reliable source of knowledge is what has been studied and confirmed over the years by scholars and researchers, i.e., theories on entry mode. Accordingly, their first entries will be in alignment with what is suggested by theory.

***Hypothesis 1:** Firms with less experience in offshoring practices are more likely to select entry choices that are aligned with the conventional entry mode theories.*

In the last two decades, studies on entry mode and its relationship with experience have developed, bringing to the table new important concepts, such as those of international experience, international speed, and path dependency. The general idea, shared by most of scholars and researchers, is that as international experience (i.e., the degree to which a firm has been involved in cross-border business activities) and international speed (i.e., the number of foreign markets a firm enters within a specific period or how rapidly the firm accumulates foreign market entries) increase, the tendency of companies to adopt path dependent behaviors intensifies as well (Padmanabhan & Cho, 1999; Gao & Pan, 2010). This means that the more preferred entry modes are adopted systematically in subsequent entries, and the higher the frequency of such implementations, the stronger the mode inertia effect will be. Cumulative entry experience influences also those firms used to adopt isomorphic behaviors, changing their point of view from external to internal. They stop imitating other firms in the same business environment, even if these firms are successful, and they start building expertise and confidence with previously adopted entry modes. Path dependency is not a simple repetition of previous modalities. It is the use of learning from prior experiences with similar structures that generates value for the firm (Chang & Rosenzweig, 2001; Lu, 2002; Guillén, 2003; Swoboda, Elsner, & Olejnik, 2015).

However, extant literature does not look at the multiple facets of experience, lacking the explanatory power that a more detailed analysis could have. We believe that the collection of different kinds of experience bring companies to different kinds of learning and so to entry mode choices that can differ from those proposed by path dependent behaviors. Therefore, we took Hennart and Slangen's (2015) advice to heart, and developed a more fine-grained study of companies' entry mode experiences, examining which are the experiences that make companies follow theory and vice versa.

4.2.2 Failure and distant experience influence on subsequent entries

In our work, we make a leap forward, addressing what past literature has overlooked: a more detailed analysis of experience. We deepen our understanding of the relationship between cumulative experience and entry mode through the study of two dimensions of experience: successful and unsuccessful experiences; in-function and out-function experiences (i.e., experiences in the business function considered and experiences in other business functions). Our objective is to investigate the

effects of these two dimensions (both taken separately and their interaction) on the alignment between actual entry modes and theory about entry mode.

Successful vs. unsuccessful experience

The top management of a company has to deal with success and failure every day, trying to understand the causes of positive and negative outcomes of their activities. Success and failure are a powerful dichotomy to keep up the attention of decision makers and enhance organizational learning. Managers define this dichotomy confronting the actual performance of a certain task with the expected one. When results are above the specified threshold, a success is experienced; on the contrary, results below the threshold fill the “failure experience” box (Cyert & March, 1963; March & Simon, 1958).

It is straightforward that decision makers behave differently respect to success and failure. Successful experiences may lead managers to be overconfident about the state of existing organizational knowledge, which in turn is considered a proper representation of the world in which the company operates and that further development of knowledge is not needed. Successful experiences bring managers to focus on incremental sources of information (close to existing organizational knowledge), seeking efficiency and refinement of funded assumptions and approaches. This makes the company blind to information coming from the external world and prevents it from capturing improvement possibilities (Weick, 1984; Louis & Sutton, 1991; Lant, 1992; Audia, Locke, & Smith, 2000).

On the other hand, to counterbalance the stability created from previous successes, there is failure, which challenges the organizational knowledge of the firm. Failure pushes managers to discard existing models of the reality and make them look for new models that can explain better the business environment in which the firm operates. The sense of urgency created by failure leads decision makers to face issues with a problem-solving mindset, which is deeper and involves more complex thought processes with respect to the one adopted with successful experiences, thus, fostering new and divergent ideas. Moreover, unsuccessful experiences not only highlight the gap between expected and actual performance, but they can also provide the indication of where the gap is. Any organizational search started following success encounters much greater uncertainty. In other words, experience with failure is more likely than experience with success to create two of the necessary conditions for experiential learning discussed above: the motivation to alter knowledge, and the ability to extract valuable knowledge from experience (March & Simon, 1958; Cyert & March, 1963; Cameron, 1984; Levinthal & March, 1993).

Following the reasoning developed for our first hypothesis, in which companies start to penetrate foreign markets adopting strategies advanced by theory, we suggest that the collection of successful experiences prompt a naïve continuation of old routines, thus maintaining the alignment with theory. On the contrary, failures prompt a proactive search for new and innovative solutions to complex problems, thus deviating from theory.

***Hypothesis 2:** Failure experiences increase the likelihood that firms choose entry modes in misalignment with theory*

In-function vs. out-function experience

The second dimension of experience we consider is its “relatedness” or “distance” with respect to the business function of interest. Each business unit of a company may gain useful information through its own experiences or through the experiences of other business units. Our speculation here is that business functions can learn from each other and gain valuable knowledge developed by other units. Communication of know-how among functions fosters mutual collaboration and the firm’s capacity to innovate (Kogut & Zander, 1992; Tsai & Ghoshal, 1998). Two necessary conditions are required so that this might happen. First, functions must have external access to other units’ expertise; second, they need the internal capacity to understand and acquire such expertise (i.e., absorptive capacity). Not all units have the same external access and absorptive capacity, so their ability to exploit and interpret knowledge from other functions differs. This creates a positive proliferation of new and divergent ideas which extends the range of knowledge of the company. In order to spread what has been learned throughout the company, managers should then build a solid network of interunit links (Huber, 1991; Hansen, 1999). It is necessary that each business function tries to understand similarities and differences with other business units, stimulating a deeper comprehension and elaboration of company’s knowledge which in turn results in a greater generation of alternative solutions with respect to what theory advises.

On the other hand, when experiences come from and cumulate within the same business function, the intensity of the firm’s cognitive process is definitely lower, since the lack of differentiation elements weakens the propensity to thoroughly investigate the information acquired. Moreover, business units tend to imitate previous choices to reduce costs related to the exchange of information with other business functions. Therefore, confirming the assumption that inexperienced firms enter new markets

following theory, the acquisition of experience within the same function drive companies to confirm previous choices which are aligned with theory.

We consider international firms which offshore specific business functions, for instance, Finance and Accounting, Product Design, R&D and others. From the company's point of view, a in-function or related experience occurs when previous experiences mostly involve the same business function in analysis; a out-function or unrelated experience occurs when previous experiences mostly involve different business functions respect the one in analysis. We suggest, similarly to what we said about success and failure, that in-function experiences induce the company to continue with old practices, while out-function experiences stimulate the research of alternative solutions which move away the firm from what it has always done.

***Hypothesis 3:** Out-function experiences increase the likelihood that firms choose entry modes in misalignment with theory*

The interaction effect

Finally, we examine the interaction between these two dimensions, failure and out-function experiences. We want to understand the influence of cumulative experiences related to both unsuccessful and out-function activities on the decision-making process of a firm. Following the previous two hypotheses, we would expect a further development of non-traditional solutions and divergent ideas from theory. However, managers deciding which entry mode to adopt, face a situation of high uncertainty, since they cannot rely on their knowledge, given that the service or the function offshored is not within their area of competence, and at the same time feedback of the implemented activity bring negative results. Moreover, managers do not know the cause or the causes of failures, given that information comes from a business function out of their interest. Errors might have arisen due to wrong entry mode implementations from the specific unit, a sudden change of external conditions in the market selected, internal issues or a combination of all these elements. It is clear how complex and difficult to analyze is such a scenario in managers' eyes. Therefore, the only way decision makers can implement a proper penetration strategy in such circumstances is through the employment of entry mode theories.

***Hypothesis 4:** The interaction between failure and out-function experiences increases the likelihood that firms choose entry modes in alignment with theory*

5 Empirical analysis

In this chapter, we accurately present the empirical analysis elaborated in order to support and verify our hypothesis of research. In particular, the following issues will be discussed:

- The sample
- The variables employed
- The models applied

5.1 The sample

Our analysis relies on primary data gathered by the Offshoring Research Network (ORN). ORN is an international research project promoted by the Center for International Business Education and Research (CIBER), Fuqua School of Business, Duke University, aimed at studying the emergence of trends in the offshoring of business services.

In the early phase (i.e., 2004) the research was directed only to U.S. companies, carrying on the peculiar idea to investigate global sourcing practices of the “White-collar work” exclusively. Although the original intent (i.e., focus only on services) has remained unchanged over time, the extension of ORN has evolved: from 2006 the project has rapidly expanded also outside the American territory, creating an effective network of scholars and organizations from Australia, Europe (Belgium, Denmark, France, Germany, Italy, the Netherlands, Spain, UK) and the U.S.

Since its foundation, the ORN team has annually conducted surveys to collect progressive updated information on the phenomenon of offshoring. Typically, respondents fill out the questionnaires online through e-mail invitation or external links; all the project’s partners are responsible for registering, approving and gathering data in their home countries. The final outcome is a common comprehensive database including statistics from all the geographic areas considered. Initially, surveys were only related to corporate clients, but in a short time, with regard to the addition of Asian partners to the network, also new surveys dedicated to service providers were performed (the first one in 2007).

ORN is still one of the most renowned sources of research and analysis of offshoring’s development, thanks also to the great reputation of its founder and leader Arie Y. Lewin, professor of strategy and

international business and CIBER director at the Duke University. As discussed above, ORN can count on two types of surveys, i.e. corporate clients-based and service providers-based. They both offer a valuable overview of the offshoring phenomenon and they are potentially appropriate for our study; however, to test the hypotheses that have been developed in our thesis, the clients-based database resulted to be more appropriate.

The distinctive trait of this database is the focus on each single firm’s initiative of offshoring, instead of the company’s overall experience. In other words, each observation (i.e., the unit of analysis) corresponds to a single function offshored by the company, such that, separate information of respondents on different functions are recorded as separate answers. In general, the questionnaires investigate firms’ risks, strategic and location drivers, performance outcomes and future plans (whose logic scheme is shown in figure 5.1).

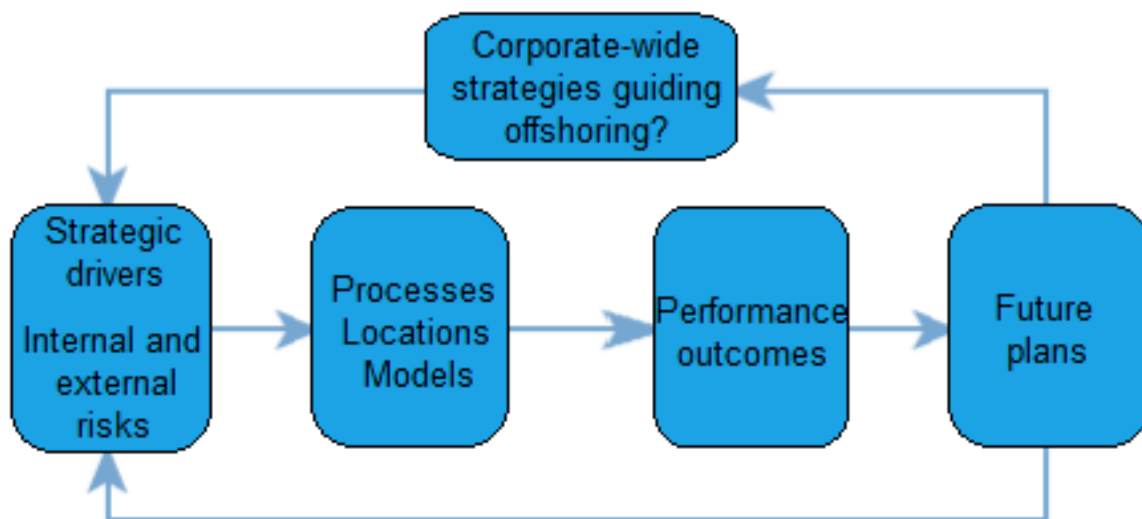


Figure 5.1 – Logic structure of surveys (source: Duke University/The Conference Board - Offshoring Research Network 2009 survey)

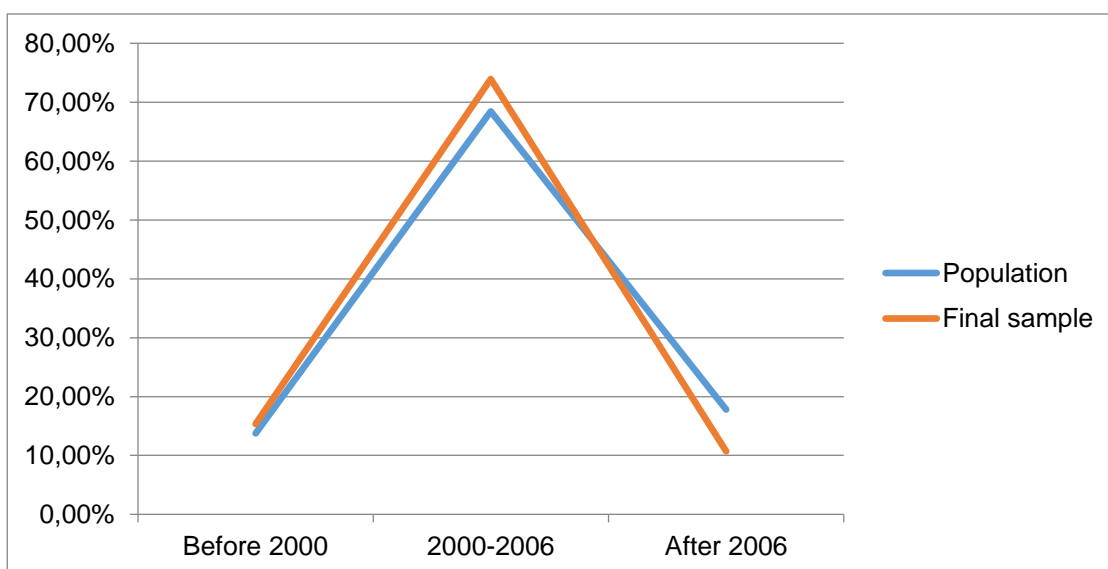
Specifically, we can delve into the above categories and identify nine main areas of interests of the survey:

- Status of offshoring: whether it is currently ongoing, taken in consideration or not even considered;
- Firms’ strategy and characteristics (e.g., headquarter, size, primary industry sector) and initiative’s features (e.g., launch year);
- Offshored functions;

- Drivers influencing the offshoring decision (e.g., labor cost savings, access to qualified personnel);
- Internal (e.g., loss of internal capabilities, loss of managerial control) and external (e.g., lack of intellectual property protection, political instability in offshored location) risks;
- Offshoring location and reasons behind the geographical choice;
- Form of governance adopted: captive offshoring, offshored outsourcing, joint venture with local partners;
- Outcomes of the initiatives;
- Future plans with a time horizon of 6-12 months.

The ORN database derives from 5 repeated surveys occurred in the years 2005, 2006, 2007, 2009 and 2011 for a total of 4062 observations. Certainly, the entire database cannot be used for our empirical analysis and we necessarily proceed to data cleaning. First, we are only interested in firms actually implementing offshoring; secondly, the number of observations is drastically reduced due to missing values in variables essential for our models (e.g., location, launch year, function, achieved and expected savings, offshoring drivers). The final sample size amounts to 560 units and involves 173 separate firms; thus, each company has information for an average of 3.2 offshore initiatives.

Given the significant decrease of observations, a descriptive analysis is requested to determine whether our final sample is a compelling representation of the population (i.e., the overall initial ORN database). In the first place, graphic 5.1 illustrates the distribution of initiatives over the years.



Graph 5.1 – Distribution of initiatives over years in the population and in the final sample.

In order to investigate whether our final sample is representative with respect to the population, we perform a chi-square test. It is defined by the equation:

$$X_{K-1}^2 = \sum \frac{(n_i - \Pi_i^* n)^2}{\Pi_i^* n} \quad (H_0 : \Pi_i = \Pi_i^*) \forall i$$

Where $k-1$ are the degrees of freedom, n_i represents the size of group i in the sample, and Π_i^* represents the percentage of group i in the population. The null hypothesis is that our final sample is representative for the total ORN sample. In particular, the test is performed in relation to the distribution of initiatives in two significant macro-periods: the older initiatives (i.e., before 2000) and the more recent ones (i.e., after 2000). The resulting p-value is equal to 0.27; thus, the null hypothesis is not rejected.

The geography is a key and influencing factor of offshoring. Commonly, companies implementing offshoring projects are either European or US, mostly looking for low cost labor and new talents outside their territory. Table 5.1 shows the home countries of the offshoring initiatives in the population and in the final sample. Specifically, we cluster them in five main areas to get an overall idea of the panorama: Australia, Asia, Europe, US, other countries in America.

Table 5.1 – Home countries and areas of the offshoring initiatives in the population and in the final sample

Home country	Population		Final sample	
	Frequency	Percentage	Frequency	Percentage
Australia	78	1.92%	-	-
Asia	55	1.36%	-	-
Bahrain	11	0.27%	-	-
China	3	0.07%	-	-
India	15	0.37%	-	-
Indonesia	4	0.10%	-	-
Japan	10	0.25%	-	-
Philippines	6	0.15%	-	-
United Arab Emirates	6	0.15%	-	-
Europe	1598	39.32%	191	34.11%
Austria	1	0.02%	-	-

Belgium	150	3.69%	60	10.71%
Denmark	34	0.84%	1	0.18%
Finland	8	0.20%	-	-
France	35	0.86%	3	0.54%
Germany	239	5.88%	1	0.18%
Ireland	5	0.12%	-	-
Italy	11	0.27%	-	-
Luxembourg	1	0.02%	-	-
Netherlands	343	8.44%	96	17.14%
Norway	6	0.15%	-	-
Scandinavia	53	1.30%	-	-
Spain	276	6.79%	22	3.93%
Sweden	17	0.42%	-	-
Switzerland	112	2.76%	-	-
United Kingdom	307	7.56%	8	1.43%
USA	2283	56.20%	369	65.89%
America (US excluded)	48	1.18%	-	-
Brazil	4	0.10%	-	-
Canada	35	0.86%	-	-
Chile	1	0.02%	-	-
Colombia	6	0.15%	-	-
Mexico	2	0.05%	-	-
Total	4062	100%	560	100%

As expected, US and Europe are, by far, the most represented areas in the population (56.20% and 39.32%, respectively). In detail Europe offers a significant number of observations from Belgium (3.69%), Germany (5.88%), Netherlands (8.44%), Spain (6.79%) and United Kingdom (7.56%). Regarding the other groups (i.e., Australia, Asia and other American countries), they all denote values of little interest for our research, remaining under 2%. Such distribution is roughly confirmed also in the final sample: USA accounts for the 65.89%, Europe 34.11%, while the other areas completely lose representation. Within Europe the aforementioned countries (i.e., Belgium, Germany, Netherlands, Spain, UK) are still present, albeit in different proportion.

The chi-square test related to the five macro-areas gives a p-value equal to 0,15; thus, it does not reject the null hypothesis.

The second relevant dimension concerning geography is the host country. Literature suggests that the foreign location choice has a considerable impact on the performance of organizations, which tend to look at specific drivers to address their decisions; the typical firm, for instance, focuses on those regions with remarkable wage differentials (i.e., developing countries). Following this reasoning, table 5.2 summarizes our data about host countries by grouping Nations in developed and developing economies.

Table 5.2 – Host countries of the offshoring initiatives in the population and in the final sample.

Host country	Population		Final sample	
	Frequency	Percentage	Frequency	Percentage
Developed economies	791	26.38%	162	28.92%
Australia	36	1.20%	3	0.54%
Austria	4	0.13%	1	0.18%
Belgium	11	0.37%	1	0.18%
Bulgaria	4	0.13%	-	-
Canada	69	2.30%	14	2.50%
Czech Republic	42	1.40%	8	1.43%
Denmark	4	0.13%	2	0.36%
Finland	6	0.20%	1	0.18%
France	29	0.97%	8	1.43%
Germany	56	1.87%	11	1.96%
Hungary	33	1.10%	9	1.61%
Ireland	42	1.40%	8	1.43%
Italy	19	0.63%	4	0.71%
Japan	15	0.50%	3	0.54%
Lithuania	6	0.20%	-	-
Luxembourg	11	0.37%	1	0.18%
Netherlands	24	0.80%	12	2.14%
New Zeland	5	0.17%	1	0.18%
Norway	5	0.17%	4	0.71%

Poland	60	2.00%	15	2.68%
Portugal	12	0.40%	1	0.18%
Romania	33	1.10%	11	1.96%
Russia	34	1.13%	10	1.79%
Slovakia	26	0.87%	4	0.71%
Spain	27	0.90%	6	1.07%
Sweden	12	0.40%	3	0.54%
Switzerland	4	0.13%	1	0.18%
Ukraine	23	0.77%	-	-
United Kingdom	66	2.20%	10	1.79%
USA	59	1.97%	10	1.79%
Others	14	0.47%	-	-
Developing economies	2205	73.62%	398	71.08%
Argentina	54	1.80%	7	1.25%
Brazil	49	1.64%	14	2.50%
Chile	14	0.47%	-	-
China	249	8.31%	60	10.71%
Colombia	18	0.60%	3	0.54%
Costa Rica	32	1.07%	7	1.25%
Ecuador	7	0.23%	2	0.36%
Egypt	7	0.23%	-	-
El Salvador	6	0.20%	1	0.18%
India	1198	39.99%	204	36.43%
Indonesia	8	0.27%	4	0.71%
Israel	13	0.43%	1	0.18%
Jamaica	11	0.37%	3	0.54%
Malaysia	33	1.10%	9	1.61%
Mexico	102	3.40%	14	2.50%
Morocco	14	0.47%	2	0.36%
Pakistan	13	0.43%	1	0.18%
Panama	10	0.33%	-	-
Peru	8	0.27%	2	0.36%
Philippines	172	5.74%	42	7.50%
Singapore	39	1.30%	3	0.54%

South Africa	16	0.53%	5	0.89%
South Korea	8	0.27%	4	0.71%
Taiwan	13	0.43%	3	0.54%
Thailand	5	0.17%	3	0.54%
Tunisia	7	0.23%	-	-
Turkey	11	0.37%	-	-
UAE	7	0.23%	-	-
Uruguay	13	0.43%	2	0.36%
Vietnam	4	0.13%	2	0.36%
Others	64	2.13%	-	-
Total	2966	100%	560	100%

Our expectations are verified: the most popular destinations of projects in the population are emerging markets (73.62%), while only a minority of initiatives is conducted in developed economies (26.38%). At single country level, the uncontested leader is India, which accounts for 39.99% (probably due to the huge concentration of talented personnel in the Indian territory), followed by China (8.31%) and Philippines (5.74%). Also in this case, the final sample provides an excellent representation of the total ORN dataset, producing a distribution of host countries very close to the values in the population (i.e. developing economies 71.08%, developed economies 28.92%, India 36.43%, China 10.71%, Philippines 7.50%). Such similarity is confirmed by the chi-square test (related to the groups: developed economies, India, China, Philippines, other developing countries), which does not reject the null hypothesis (p-value equal to 0.68).

A further element of interest is the firm size. Table 5.3 exhibits the categories proposed by the ORN, which classifies initiatives depending on the number of employees worldwide of the implementing firm: firms with more than 20000 employees are considered large; firms with a number of employees between 500 and 20000 are midsize; firms with less than 500 employees are small.

Table 5.3 – Firms' size in the population and in the final sample

Firm size	Population		Final sample	
	<i>Frequency</i>	<i>Percentage</i>	<i>Frequency</i>	<i>Percentage</i>
Small	619	18.38%	146	26.07%
Midsize	1205	35.79%	230	41.07%
Large	1543	45.83%	184	32.86%
Total	3367	100%	560	100%

In the population we observe a predominance of offshoring projects implemented by large companies (45.83%); clustering them also with the midsize class, the occurrences even increase to more than 80% against a low 18.38% of the small firms. Such description is not surprising; indeed, small companies are often limited to their home country, given the lack of financial resources to enter new markets. In the final sample midsize firms become the most represented (41.07%), overcoming the large segment (32.86%); small firms are still the smallest group (26.07%). A possible explanation to this variation derives from the way we obtained our final 560 observations (i.e., mainly by ignoring all those initiatives affected by missing values in fields of interest). We hypothesize that managers of large companies barely reach a complete overview of all their ongoing projects and, consequently, they might find complicated to produce a quantitative estimation of aspects such as entry mode decision drivers and projects' outcome. Moreover, ORN classification of firms is suitable for the US environment, where companies are typically bigger than in Europe. In the European context enterprises with more than 250 employees are already evaluated as large (Eurostat, 2016). Therefore, a reclassification that takes into account not only the number of employees, but also the home country of firms might results in better outcomes (unfortunately, we cannot do so due to the frequent lack of information on the number of employees). According to the inconsistent observed distributions, the chi-square test rejects the null hypothesis that our final sample is representative for the total ORN sample when considering firm size (p-value equal to 0.02).

The form of governance is another crucial issue of our analysis; table 5.4 displays the distribution of the entry modes adopted by offshoring firms.

Table 5.4 – Entry mode implemented in the population and in the final sample

Entry mode	Population		Final sample	
	Frequency	Percentage	Frequency	Percentage
Captive	717	47.36%	269	48.04%
Joint Venture	51	3.37%	-	-
Outsourcing	746	49.27%	184	51.96%
Total	1514	100%	560	100%

Concerning this variable, the number of missing values is extremely critical; we have knowledge of the governance mode performed in only 1514 projects out of the total 4062 observations. Furthermore, among these remaining initiatives the joint venture modality occurs so occasionally (i.e., 51 observations) that it results impossible to be effectively studied; therefore, our research will focus on the dichotomy between captive offshoring and offshored outsourcing. Since the two forms of governance are almost perfectly distributed both in the population (47.36% captive, 49.27% outsourcing) and in the final sample (48.04% and 51.96% respectively), the chi-square test does not reject the null hypothesis (p-value = 0,17).

Finally, table 5.5 concludes our descriptive analysis, showing the business functions involved in the offshoring initiatives and the primary industry sectors of the companies implementing projects. Namely, the most common offshored functions are IT infrastructure (19.76% of the total ORN database, 21.79% of our final sample), Call center (14.99% versus 16.07%), Software development (10.68% versus 8.57%), Finance/Accounting (10.01% versus 9.64%) and Engineering services (8.21% versus 10.71%).

As concerns the industry, projects are mostly carried out by companies whose primary activities are Software and IT services (21.76% of the total ORN database, 27.50% of our final sample), financial services (21.15% versus 11.61%) and manufacturing (11.01% versus 20.18%).

The chi-square test is performed also for these measures and in both cases the null hypothesis is not rejected (p-value = 0.43 and 0.24 respectively).

Table 5.5 – Offshored functions and primary industry sector of firms implementing offshoring initiatives in the population and in the final sample.

Business function	Population		Final sample	
	<i>Frequency</i>	<i>Percentage</i>	<i>Frequency</i>	<i>Percentage</i>
Analytical/knowledge services	190	4.70%	-	-
Call Center	606	14.99%	90	16.07%
Engineering services	332	8.21%	60	10.71%
Finance/Accounting	405	10.01%	54	9.64%
Human Resources	216	5.34%	15	2.68%
IT infrastructure	799	19.76%	122	21.79%
Legal Services	65	1.61%	5	0.89%
Marketing and sales	222	5.49%	46	8.21%
Product design	178	4.40%	30	5.36%
Research and development	253	6.26%	43	7.68%
Software development	432	10.68%	48	8.57%
Supply chain and procurement	267	6.60%	47	8.39%
Other	79	1.95%	-	-
Total	4044	100%	560	100%
Industry sector				
Aerospace and Defense	95	2.41%	3	0.54%
Arts, Entertainment, Recreation	18	0.46%	2	0.36%
Automotive	99	2.51%	14	2.50%
Construction	24	0.61%	1	0.18%
Energy, Utilities, Mining	97	2.46%	5	0.89%
Financial service industry	834	21.15%	65	11.61%
Government/Public services	7	0.18%	-	-
Healthcare	46	1.17%	2	0.36%
Manufacturing	434	11.01%	113	20.18%
Pharmaceuticals, Life science	106	2.69%	16	2.86%
Professional services	318	8.06%	50	8.93%
Retail and consumer goods	158	4.01%	24	4.29%
Software and IT services	858	21.76%	154	27.50%

Telecommunications	313	7.94%	36	6.43%
Transportation and logistics	136	3.45%	28	5.00%
Other	400	10.14%	47	8.39%
Total	3943	100%	560	100%

In conclusion, table 5.6 summarizes the outcomes of the chi-square test for all the measures analyzed. It appears that only in a single situation (i.e., the firm size) the null hypothesis is rejected; therefore, we claim that our final sample is overall a faithful representation of the total ORN database.

Table 5.6 – Outcomes of the chi-square test when considering year, home and host country, firm size, entry mode, offshored function and industry sector.

Measure	<i>Year</i>	<i>Home country</i>	<i>Host country</i>	<i>Firm size</i>	<i>Entry mode</i>	<i>Offshored function</i>	<i>Industry sector</i>
Chi-square	1.21	6.8	2.29	7.67	3.52	12.14	18.37
P-value	0.27	0.15	0.68	0.02	0.17	0.43	0.24

5.2 The methodology

As the sample has been defined in all its facets, in this part we proceed to the deployment of the methodology applied and the presentation of our models.

Literature suggests that firms select the offshoring entry mode based on their expectation of future performances, which leads to a self-selection bias (see paragraph 3.2.2 for details); accordingly, studies typically suffer from an endogeneity problem when using the governance mode as the explicative variable of firm performance (Shaver, 1998). As a consequence, scholars (e.g., Brouthers, 2002; Leiblein, 2002; Elia et al., 2014; Caniato et al., 2015) have started to adopt a two-stage approach à la Heckman (1979) to successfully control for the endogeneity issue.

Although our research does not take into account the determinants of firm performance, we perform a two-stage analysis as well, developing a methodology that initially replicates past studies, but that, eventually, turns out to be original. Hence, our first stage follows earlier papers (e.g., Elia et al., 2014) by estimating a probit model in which the form of governance (i.e., the dependent variable) is

regressed against a set of measures proxying different theories (i.e., TCE, institutional and cultural perspectives, OLI paradigm). Additionally, in this phase we evaluated the cornerstone of our work, that is, the misalignment between the entry mode choice predicted by the combination of the aforementioned theories and the one actually implemented by each firm of our sample.

The second stage finally brings about the real methodological innovation, considerably diverging from the common Heckman-based studies, which usually employ the governance misfit as explanatory variable of firm performance. In our approach this measure (i.e., the misfit) directly turns into the dependent variable, investigated in respect of company experience.

5.2.1 First stage

Dependent variable

In the first stage, we examine the determinants of the entry mode choice; accordingly, the dependent variable is the form of governance that firms adopt to enter a foreign market, which derives from the ORN survey's question: "What is the service delivery model currently used for this offshoring implementation?" Specifically, we label it as *Outsourcing*, assuming the value of 0 in the case of captive offshoring and the value of 1 in the case of offshored outsourcing initiatives.

Explanatory variables

In order to explain firm entry decision (i.e., captive vs. outsourcing), we build up a specific theoretical framework. It is now well accepted that researches cannot exclusively rely on TCE to achieve trustworthy results; thus, following Elia et al. (2014), we deal with explanatory variables related to transaction cost, institutional and cultural context, as well as, other relevant location attributes of the offshored destination. Furthermore, we include some measures associated with Dunning's OLI paradigm.

First, TCE suggests that the activities of finding, negotiating with and monitoring a partner entail transaction costs. These costs highly impact firm governance, since, as they increase, companies opt for more hierarchical solutions (see paragraph 3.1.1 for further details). We define a single explanatory variable regarding this perspective:

1. *High value assets* refers to the classification proposed by Youngdahl, Ramaswamy, and Dash (2010), which categorized functions involved in offshoring initiatives into low, medium and high value added activities (as shown in table 5.7). The variable is a dummy taking the value of 1 whether the respective offshored functions belong to the high value class (i.e., Engineering services, Product design, Research and development) and 0 otherwise.

Table 5.7 – Classification of business functions involved in offshoring projects depending on their value added.

High value added function	Medium value added function	Low value added function
Engineering services	Analytical/knowledge services	Call Center
Product design	Finance/Accounting	
Research and development	Human Resources	
	IT infrastructure	
	Legal Services	
	Marketing and sales	
	Software development	
	Supply chain and procurement	

High value assets accounts for the asset specificity dimension of the TCE. Indeed, high value functions are usually characterized by high knowledge linkages and misappropriation risks, which, inevitably, result in higher transaction costs than low value functions. Accordingly, we expect a negative correlation between this measure and our dependent variable *Outsourcing*.

The second set of independent variables concerns the cultural and institutional context:

2. The variable *Cultural distance* is a proxy for the cultural distance between the home and the host country. In particular, we rely on Hofstede’s (1980) cultural dimensions, which describe distinctive attributes of countries: Power distance index (PDI), Individualism versus Collectivism (IDV), Uncertainty avoidance index (UAI), Masculinity versus femininity (MAS), Long-term orientation versus short-term orientation (IND). For each initiative, we consider the Hofstede-based cultural values for both the home and the host country and we calculate the combined Euclidean distance proposed by Morosini, Shane and Singh (1998) as follows:

$$\begin{aligned}
 & \text{Cultural Distance}_{A-B} \\
 & = \sqrt{(PDI_A - PDI_B)^2 + (IDV_A - IDV_B)^2 + (MAS_A - MAS_B)^2 + (UAI_A - UAI_B)^2}
 \end{aligned}$$

Where A is the home country and B the host country.

As cultural distance increases, firms tend to implement a risk reduction strategy and adopt a lower control in their governance mode (see paragraph 3.1.2 for further details). Consequently, we expect a positive effect of this measure on our dependent variable (i.e., *outsourcing*).

3. Literature has highlighted how institutions deeply influence firm boundary choice by determining the environment in which companies operate. In order to account for the institutional environment, we estimate the variable *Institutional context* through a factor analysis, which employs items from the Worldwide Governance Indicators (WGI). WGI is a long-standing research program performed by the World Bank since 1996 to capture six key dimensions of governance. Basically, they measure the quality of governance in over 200 countries based on data provided by over 30 organizations worldwide. Typically, the source of data is a very diverse group of respondents (e.g., firms, individuals, public officials, NGOs), whose perceptions are collected in surveys. Specifically, we consider data between 2005 and 2011 (i.e., the period in which ORN surveys were conducted) and we rely on five WGI dimensions for our analysis:

- *Political Stability and Absence of Violence/Terrorism*: the perception of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism.
- *Government Effectiveness*: the perception of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
- *Regulatory Quality*: the perception of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.
- *Rule of Law*: the perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.
- *Control of Corruption*: the perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

To evaluate the reliability of our factor analysis we control for the value of the Cronbach's alpha, which is a measure of internal consistency, i.e., how closely related the set of items are as a group. In our construct it amounts to 0.9696, well above the accepted threshold value of 0.60 (Child, 1990). Furthermore, we observe high values of factor loadings (i.e., how much an item explains the overall variable), confirming the accuracy of our analysis (see table 5.8 for further details).

As far as the expected effect of *Institutional context* on the governance mode, we follow paragraph 3.1.2 arguments. Thus, whenever political and market institutions are weak, firms tend to adopt a less hierarchical structure; conversely, a situation of high quality of infrastructures reduces the likelihood of implementing an outsourcing entry mode.

The factor analysis is also performed to account for location attributes of the offshore destination; in particular, we introduce three explanatory variables about this context:

4. *Market potential* is approximated by a factor obtained from several items of the World Competitiveness Yearbook (WCY). WCY is an annual report produced since 1989 by the International Institute for Management Development on the competitiveness of 60 countries. Among the hundreds of criteria used to measure different sides of Nations' competitiveness, we focus on five indexes consistent with our variable *Market potential*:

- *Gross Domestic Product (GDP)*
- *Gross Fixed Capital Formation*
- *Direct Investment Inflows Inward*
- *Government Consumption Expenditure*
- *Household Consumption Expenditure*

The Cronbach's alpha, equal to 0.7939, and the high values of the factor loadings certifies the reliability and the accuracy of the construct (see table 5.8).

Following Brouthers (2002), firms investing in high growth markets opt for a wholly owned governance mode in order to better exploit scale economies and establish long-term market relationships. Conversely, companies prefer softer forms of governance in low potential markets (see paragraph 3.1.2 for further details).

5. *Low cost labor* is a factor built on four items stemming from the WCY database:

- *Remuneration Call Center Agent*: Gross annual income including supplements such as bonuses of call center agents
- *Remuneration Manufacturing Worker*: Total hourly compensation for manufacturing workers (i.e., wages plus supplementary benefits).
- *Remuneration Department Head*: Gross annual income including supplements such as bonuses of department head.
- *Remuneration Personal Assistant*: Gross annual income including supplements such as bonuses of personal assistant.

The Cronbach's alpha amounts to 0.7849, showing the reliability of the construct and the high values of factor loadings verify the analysis accuracy (see table 5.8).

6. *Skilled labor* again depends on WCY database with respect to the items employed in the factor analysis, which are:

- *Information Technology Skills*: the extent to which the country can rely on information technology skills.
- *Qualified Engineers*: the extent to which qualified engineers are available in labor market
- *Skilled Labor*: the extent to which skilled labor is readily available in labor market

Also in this case, the Cronbach's alpha (equal to 0.9237) and the factor loadings confirm the reliability and the accuracy of the construct (see table 5.8).

Table 5.8 - Exploratory factor analysis on institutional, cultural and location variables (principal components with varimax rotation)

First order construct	Items	Source	Loading	Alpha
Market Appeal	Gross Domestic Product	WCY	0.9864	0.7939
	Gross Fixed Capital Formation	WCY	0.9519	
	Direct Investment Inflows Inward	WCY	0.8724	
	Government Consumption Expenditure	WCY	0.9726	
	Household Consumption Expenditure	WCY	0.9698	

Political Stability	Political Stability and Absence of Violence/Terrorism	WGI	0.8783	0.9696
	Government Effectiveness	WGI	0.8556	
	Regulatory Quality	WGI	0.9011	
	Rule of Law	WGI	0.8859	
	Control of Corruption	WGI	0.8544	
Location Costs	Remuneration Call Center Agent	WCY	0.7480	0.7849
	Remuneration Manufacturing Worker	WCY	0.7606	
	Remuneration Department Head	WCY	0.7254	
	Remuneration Personal Assistant	WCY	0.7622	
High Value-Added Resources	Information Technology Skills	WCY	0.8036	0.9237
	Qualified Engineers	WCY	0.9310	
	Skilled Labor	WCY	0.9000	

The last set of explanatory variables refers to the OLI paradigm (Dunning, 1977; 1993):

7. *Driver efficiency* is based on the survey question: “Please indicate the importance of enhancing efficiency through business process redesign as a strategic driver for the offshore implementations” by asking the respondents to rank the importance on a five point Likert scale (1 = not important at all; 5 = very important). It is related to the Dunning’s efficiency-seeking dimension (i.e., FDI aims at increasing internal efficiency)
8. *Driver qualified personnel* is based on the survey question: “Please indicate the importance of the access to qualified personnel offshore as a strategic driver for the offshore implementations” (five point Likert scale, 1 = not important at all; 5 = very important). This variable accounts for the asset-seeking dimension (i.e., FDI aims at acquiring foreign corporations’ assets).
9. *Driver new market* is based on the survey question: “Please indicate the importance of the access to new markets for products and services as a strategic driver for the offshore implementations” (five point Likert scale, 1 = not important at all; 5 = very important). In this case, the dimension associated with our variable is the Dunning’s market-seeking (i.e., FDI aims at penetrating the host country in order to expand the corporate business).

As discussed in paragraph 3.1.3 the market-seeking driver is typically associated with higher intensity governance modes (i.e., captive), while both the efficiency-seeking and the asset-seeking drivers push companies to adopt either captive or outsourcing modes depending on specific firm strategies.

Accordingly, the effect of *Driver qualified personnel* on *Outsourcing* cannot be predicted a priori, since companies may acquire knowledge and access to talented resources through both full acquisitions and externalization of activities to expert suppliers. Instead, as the survey question related to *Driver efficiency* precisely refers to business process redesign, we expect a negative correlation between this measure and our dependent variable.

Finally, we introduce an explanatory variable related to experience, which has a crucial role in our analysis:

10. *Company experience* is a discrete variable indicating for each initiative the total number of previous offshored projects performed by the implementing company. In other words, it is a precise count of past experiences left-limited by the value of 0, occurring whenever the considered initiative is the very first for the implementing firm (while the maximum value that this variable assumes in our final sample is 21). *Company experience* takes into account any type of project, without distinctions among governance modes adopted or functions and locations involved.

Literature provides contrasting conclusions concerning the influence of experience on entry mode choice and authors usually concentrate on the dichotomy JV and WOS (or acquisition and greenfield investments) rather than on captive versus outsourcing. We generally suggest that firms with little experience opt for softer governance modes (i.e., outsourcing) in order to limit their exposure and to be able to quickly disinvest in case of wrong decision; conversely, expert companies are familiar with offshoring practices and prefer captive modalities, which allow for higher returns.

Control variables

We also include some control variables that strengthen our model and help explain the entry mode choice. In total we make use of four measures:

1. *Company size* is based on the number of employees worldwide of the implementing company; in particular, following the classification introduced in the sample's description, it is equal to 1 in case of small firms (i.e., with less than 500 employees), equal to 2 in case of midsize firms (i.e., with more than 500 employees, but less than 20000) and equal to 3 in case of large firms (i.e., with more than 20000 employees).

The effect of size on our dependent variable is controversial and cannot be foreseen a priori. Indeed, on the one hand, larger firms find reason to implement a captive modality from their

great amount of financial resources and from the opportunity to exploit economies of scale (since they deal with larger volumes); on the other hand, an outsourcing strategy is favored by the avoidance of managerial complexity and resources' duplication, as well as, the possibility to rely on higher bargaining power during negotiations with third parties.

2. The second control variable regards the industry sector of the offshoring company. As our sample manifests a high heterogeneity in this field, we cluster the industries according to the 2007 Eurostat-OECD classification (OECD, 2007). Table 5.9 displays the different categories built on the concept of technological and knowledge intensities; each sector of the sample is assigned to a specific category.

Table 5.9 - Classification of industry sectors with respect of their technological and knowledge intensities (Source: Eurostat-OECD classification, 2007)

High-technology	<i>Aerospace & Defense; Pharmaceuticals & Life science</i>
Medium-high-technology	<i>Automotive</i>
Medium-low-technology	<i>Construction; Manufacturing</i>
Low-technology	<i>Other</i>
Knowledge-intensive high-technology services	<i>Software and IT services; Telecommunication</i>
Knowledge-intensive market services	<i>Transportation and logistics</i>
Knowledge-intensive financial services	<i>Financial service industry</i>
Other knowledge-intensive services	<i>Arts, Entertainment & Recreation; Healthcare</i>
Less-knowledge-intensive market services	<i>Energy, Utilities & Mining; Professional services; Retail & consumer goods</i>
Other less-knowledge-intensive services	<i>Government/Public services</i>

Hence, we create a set of dummies, such that, each variable refers to a specific group of the OECD classification (as table 5.10 explains).

Table 5.10 – Operationalization of the control variables related to the primary industry sector of the offshoring company

Dummy	Operationalization
HT	Indicates whether the industry refers to high technology (=1) or not (=0)
MHT	Indicates whether the industry refers to medium-high technology (=1) or not (=0)
MLT	Indicates whether the industry refers to medium-low technology (=1) or not (=0)
LT	Indicates whether the industry refers to low technology (=1) or not (=0)
KIS_FS	Indicates whether the industry refers to knowledge-intensive financial services (=1) or not (=0)
KIS_HT	Indicates whether the industry refers to knowledge-intensive high-technology services (=1) or not (=0)
KIS_MS	Indicates whether the industry refers to knowledge-intensive market services (=1) or not (=0)
KIS_OT	Indicates whether the industry refers to other knowledge-intensive services (=1) or not (=0)
LKIS_MS	Indicates whether the industry refers to less-knowledge-intensive market services (=1) or not (=0)
LKIS_OT	Indicates whether the industry refers to other less-knowledge-intensive services (=1) or not (=0)

3. Given the substantial number of offshoring projects implemented by companies from United States, we employ the binary variable *Home country USA* equal to 1 if the home country is indeed United States and equal to 0 otherwise.
4. Finally, we also deal with the temporal dimension by introducing a variable that controls the age of the offshoring initiative. Specifically, *Age* is computed as the difference between the year 2011 (i.e., when the last ORN survey was conducted) and the year in which the initiative actually occurred.

In conclusion, table 5.11 summarizes the multitude of measures described (i.e., dependent, explanatory, control variables) that are going to constitute our model of the first stage.

Table 5.11 – Summary of all the variables involved in the first stage.

Variable	Operationalization	Role
<i>Outsourcing</i>	A dummy indicating whether the offshore implementation is captive offshoring (=0) or offshore outsourcing (=1)	Dependent variable
<i>High-value assets</i>	A dummy indicating whether the offshored function belong to the high value group (=1) or not (=0)	Independent variables
<i>Company experience</i>	The total number of previous offshored projects performed by the implementing company	
<i>Cultural distance</i>	The distance between the home country and the host country based on the method proposed by Morosini, Shane and Singh.	
<i>Institutional context</i>	A continuous variable proxied by a factor obtained from the following items: country's Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, Control of corruption	
<i>Market potential</i>	A continuous variable proxied by a factor obtained from the following items: country's GDP, Gross Fixed Capital Formation, Direct investment Inflows Inward, Government Consumption Expenditure, Household Consumption Expenditure	
<i>Low cost labor</i>	A continuous variable proxied by a factor obtained from the following items: remuneration call center agent, remuneration manufacturing worker, remuneration department head, remuneration personal assistant	
<i>Skilled labor</i>	A continuous variable proxied by a factor obtained from the following items: information technology skills, qualified engineers, skilled labor	
<i>Driver efficiency</i>	Based on the question: "Please indicate the importance of enhancing efficiency through business process redesign as a strategic driver for the offshore implementations" (1=not important at all; 5=very important)	
<i>Driver qualified personnel</i>	Based on the question: "Please indicate the importance of the access to qualified personnel offshore as a strategic driver for the offshore implementations" (1=not important at all; 5=very important)	
<i>Driver new market</i>	Based on the question: "Please indicate the importance of the access to new markets for products and services as a strategic driver for the offshore implementations" (1=not important at all; 5=very important)	
<i>Company size</i>	An integer based on the total number of employees worldwide of the implementing firm (<500 employees: small size=1; between 500 and 20000 employees: medium size=2; >20000 employees: large size=3)	Control variables
<i>Industry sector</i>	A set of dummies defined in table 5.11	
<i>Home country USA</i>	A dummy indicating whether the home location is USA (=1) or not (=0)	
<i>Age</i>	Years since the respective offshoring initiative was implemented	

First stage model

The equation of the first stage is the following:

$$\begin{aligned} \text{Outsourcing}_i = & \beta_0 + \beta_1 \text{High value assets}_i + \beta_2 \text{Company experience}_i + \\ & \beta_3 \text{Cultural distance}_i + \beta_4 \text{Institutional context}_i + \beta_5 \text{Market potential}_i + \\ & \beta_6 \text{Low cost labor}_i + \beta_7 \text{Skilled labor}_i + \beta_8 \text{Driver efficiency}_i + \\ & \beta_9 \text{Driver qualified personnel}_i + \beta_{10} \text{Driver new market}_i + \beta_{11} \text{Controls}_i + \varepsilon_i \end{aligned} \quad (1)$$

Where i is the offshoring initiative, ε_i is the error term and *Controls* include *Company size*, *Home country USA*, *Age* and the set of variables related to the *Industry sector*.

Given the dichotomous nature of the dependent variable, we employed a robust Probit model (model 1) to estimate equation (1). Table 5.12 provides the correlation matrix and the descriptive statistics of the variables employed in model 1. Given that the correlation matrix displays some high values (e.g., 0.47 between *skilled labor* and *institutional context*), we computed the variance inflation factors (VIF) to check for potential multicollinearity problems. The highest value is for *Institutional context* and amounts to 1.89, while the average is 1.37, well below the threshold value of 10.00 (O'Brien, 2007).

Misalignment

The first stage is also used to estimate the misalignment between the entry mode predicted by Model 1 and the one actually implemented by each company. Based on Leiblein et al. (2002), we first compute the predicted governance misalignment from the first-stage probit regression as a continuous variable (which ranges from 0 to 1), equal to Φ in the case of captive and to $1 - \Phi$ in the case of outsourcing, where Φ is the standard normal cumulative distribution function defined as follows:

$$\text{Prob} (Y_i = 1) = \Phi (\beta' X_i)$$

We then create the dichotomous variable *Misfit*, similar to Brouthers (2002), which assumes the value of 1 whether the value of the continuous variable defined above is greater than 0.5 (i.e., when misalignment occurs) and 0 otherwise (i.e., when Model 1 prediction is in line with the actual implementation).

	1)	2)	3)	4)	5)	6)	7)	8)	9)	10)	11)	12)	13)	14)
1) Outsourcing	1.000													
2) High-value assets	-0.034	1.000												
3) Company experience	-0.106	-0.011	1.000											
4) Cultural distance	0.011	-0.023	0.151	1.000										
5) Institutional context	-0.213	0.024	0.126	-0.214	1.000									
6) Market potential	-0.055	0.076	0.045	0.105	0.137	1.000								
7) Low cost labor	-0.088	-0.035	0.141	-0.014	0.466	-0.027	1.000							
8) Skilled labor	0.119	-0.057	-0.170	-0.288	-0.470	-0.263	-0.447	1.000						
9) Driver efficiency	-0.094	-0.054	0.220	0.019	0.111	-0.066	0.136	-0.069	1.000					
10) Driver qualified pers.	0.053	0.113	-0.153	-0.083	-0.007	0.085	0.017	-0.005	0.027	1.000				
11) Driver new market	-0.255	0.165	0.186	0.027	0.205	0.047	0.181	-0.183	0.217	0.020	1.000			
12) Company size	0.076	-0.049	0.085	-0.056	-0.237	-0.192	-0.128	0.236	0.105	0.031	-0.173	1.000		
13) Home country USA	0.213	0.038	-0.142	-0.002	-0.357	-0.055	-0.293	0.250	-0.093	0.271	-0.267	0.462	1.000	
14) Age	-0.121	0.019	-0.121	-0.044	0.204	-0.081	0.214	-0.028	0.056	-0.095	0.070	-0.009	-0.116	1.000
Observations (No.)	560	560	560	560	560	560	560	560	560	560	560	560	560	560
Mean	0.519	0.237	2.442	2.085	-0.844	0.432	-0.509	0.703	3.346	3.669	2.517	2.067	0.659	8.200
Std. Dev.	0.500	0.426	3.681	1.085	0.984	1.133	0.841	1.368	1.321	1.222	1.425	0.765	0.474	4.600
Min	0.000	0.000	0.000	0.020	-2.120	-0.684	-1.518	-2.625	1.000	1.000	1.000	1.000	0.000	3.000
Max	1.000	1.000	21.000	4.830	1.723	6.292	2.738	2.175	5.000	5.000	5.000	3.000	1.000	47.000

Table 5.12 - Correlation matrix and descriptive statistics of variables employed in the first stage (Model 1)

5.2.2 Second stage

In the second stage we estimate three distinct models (i.e., Model 2, Model 3 and Model 4) in order to test and verify our research hypothesis. In particular, each model aims at studying the influence of firm experience (at different levels) on governance misalignment.

Dependent variable

The three models of the second stage present the variable *Misfit* (estimated in the first step) as dependent variable; it is the misalignment between the governance mode predicted by Model 1 and the one actually implemented by each company. In this regard, we claim that the first stage has been functional to the creation of this variable and to the development of the second phase.

Explanatory variables

All the explanatory variables are associated with firm experience; however, depending on the model, the experience is analyzed from different perspectives, with different intents and through different measures.

In model 2 we employ the variable *Company experience*, already defined in the first stage (i.e., for each initiative, the total number of previous offshored projects performed by the implementing company). Previously, we suggested that firms with little experience are likely to choose outsourcing modalities (see the first stage); actually, according to our hypothesis 1, these “inexpert” companies face a situation of high uncertainty and incomplete information, such that, traditional theories become their leading source of knowledge. Consequently, we expect them to adopt governance modes aligned with theory (i.e., with the theoretical prediction of Model 1) and, thus, we foresee a positive correlation between *Company experience* and the dependent variable *Misfit*.

In Model 3 and 4 our analysis relies on a subsample composed by only “expert” firms (i.e., *Company experience* greater than or equal to 1). Indeed, regarding these models, we are interested in disentangling the impact of different types of experience intensity on the *Misfit*, meaning that we consider only the firms that can rely on at least one past initiative and whose past experience can be classified (i.e., successes versus failures, related versus non-related services). As a consequence, the number of observations decreases to 327.

In model 3 we disentangle *Company experience* in order to explore firms' behavior (i.e., alignment/misalignment with theory) in relation to particular types of experience. Specifically, two dimensions are highlighted:

1. The first dimension concerns the degree of success of offshoring projects. Thus, we split *Company experience* by following Larsen's (2013) definition of hidden cost, that is, the difference between the cost savings expected from the offshoring project and the achieved cost savings. As cost savings is typically a leading driver of offshoring practices, we consider a project as a failure in case of hidden cost greater than 0 (i.e., expected cost savings greater than achieved cost savings), while whenever achievements are in line or even superior to expectations (i.e., hidden cost less than or equal to 0), the project is evaluated as a success. Therefore, we first employ the two integer measures *Company successful experience* and *Company unsuccessful experience* (whose sum is equal to *Company experience* for each observation), which count for each initiative the number of previous successful (or unsuccessful, respectively) offshored projects performed by the implementing company. Then, we compute our explanatory variable *Failure experience intensity* as follows:

$$\text{Failure experience intensity} = \frac{\text{Company unsuccessful experience}}{\text{Company experience}}$$

2. The second dimension regards the service relatedness. Particularly, we suggest that two initiatives are related if they refer to the same offshored business function (e.g., Call Center, Engineering services, IT infrastructures). Also in this case, we divide *Company experience* by introducing the two integer measures *Company in-function experience* and *Company out-function experience*, which count for each initiative the number of previous offshored projects performed by the implementing company within (or outside, respectively) the considered business function. Finally, we estimate our second explanatory variable *Out-function experience intensity* as:

$$\text{Outfunction experience intensity} = \frac{\text{Company outfunction experience}}{\text{Company experience}}$$

Hence, following our hypotheses 2 and 3, the higher the *Failure experience intensity* and *Out-function experience intensity*, the higher the probability that firms search for alternative, non-traditional solutions (i.e., deviate from theory); consequently, we expect a positive effect of both *Failure experience intensity* and *Out-function experience intensity* on governance misalignment (i.e., *Misfit*).

In conclusion, model 4 aims at verifying hypothesis 4 by demonstrating that the interaction effect between the two explanatory variables employed in model 3 (i.e., *Failure experience intensity* and *Out-function experience intensity*), is negatively correlated with our dependent variable *Misfit*.

Table 5.13 summarizes the dependent and independent variables involved in the second stage.

Table 5.13 - Summary of the dependent and explanatory variables involved in the second stage.

Variable	Operationalization	Role
<i>Misfit</i>	A dummy indicating whether the entry mode implemented by the company complies with theory's prediction (=0) or not (=1)	Dependent variable
<i>Company experience</i>	The total number of previous offshored projects performed by the implementing company	Independent variable (Model 2)
<i>Failure experience intensity</i>	The percentage of previous unsuccessful initiatives over the total previous initiatives performed by the implementing company	Independent variable (Model 3)
<i>Out-function experience intensity</i>	The percentage of previous initiatives outside the considered function over the total previous initiatives performed by the implementing company	

Control variables

As far as control variables, we use those already employed in the first stage, i.e., *Company size*, *Dummy USA*, *Age* and the set of dummies related to the *Industry sector*. Furthermore, we also add those measures that in the first stage assumed the role of explanatory variables (i.e., *High-value assets*, *Cultural distance*, *Institutional context*, *Market potential*, *Low cost labor*, *Skilled labor*, *Driver efficiency*, *Driver qualified personnel*, *Driver new market*), since they are still elements somehow influencing firm boundary entry choice.

Second stage models

Given the nature of the dependent variable *Misfit* (i.e., binary), the outcome equations are estimated through robust probit models as follows:

Model 2:

$$Misfit_i = \beta_0 + \beta_1 \text{Company experience} + \beta_2 \text{Controls} + \varepsilon_i$$

$$\text{Model 3: } Misfit_i = \beta_0 + \beta_1 \text{Failure experience intensity} + \beta_2 \text{Out function experience intensity} + \beta_3 \text{Controls} + \varepsilon_i$$

Model 4:

$$\text{Misfit}_i = \beta_0 + \beta_1 \text{Failure experience intensity} * \text{Out function experience intensity} + \beta_2 \text{Controls} + \varepsilon_i$$

Table 5.14 provides descriptive statistics and the correlation matrix of variables included in model 3 and 4. As some correlations are high, we again compute the VIF to check for potential multicollinearity problems; the highest value is 1.95 and the average value is 1.37, well below the threshold of 10.00.

	1)	2)	3)	4)	5)	6)	7)	8)	9)	10)	11)	12)	13)	14)	15)
1) Misfit	1.000														
2) Failure exp. intensity	0.015	1.000													
3) Out-function exp. int.	0.140	0.028	1.000												
4) High-value assets	-0.159	0.155	-0.003	1.000											
5) Cultural distance	0.060	0.049	-0.114	-0.023	1.000										
6) Institutional context	-0.119	-0.068	-0.217	-0.016	-0.205	1.000									
7) Market potential	-0.135	0.070	0.001	0.130	0.077	0.110	1.000								
8) Low cost labor	-0.116	-0.093	-0.247	-0.058	-0.095	0.430	-0.040	1.000							
9) Skilled labor	0.120	0.006	0.260	-0.109	-0.262	-0.426	-0.290	-0.402	1.000						
10) Driver efficiency	-0.017	0.118	0.094	-0.082	-0.023	0.146	-0.099	0.125	-0.081	1.000					
11) Driver qualified pers.	-0.013	0.047	-0.103	0.128	-0.120	0.040	0.071	0.040	-0.070	-0.022	1.000				
12) Driver new market	-0.000	-0.082	0.058	0.132	-0.006	0.203	0.039	0.190	-0.163	0.208	-0.065	1.000			
13) Company size	-0.013	0.026	0.130	-0.004	-0.083	-0.267	-0.186	-0.168	0.261	0.047	0.062	-0.185	1.000		
14) Home country USA	0.027	0.145	0.078	0.061	0.037	-0.344	-0.025	-0.315	0.176	-0.234	0.327	-0.367	0.459	1.000	
15) Age	-0.036	-0.198	-0.104	-0.013	0.003	0.190	-0.058	0.159	-0.039	0.121	-0.168	0.149	-0.069	-0.275	1.000
Observations (No.)	327	327	327	327	327	327	327	327	327	327	327	327	327	327	327
Mean	0.330	0.352	0.677	0.235	2.186	-0.766	0.462	-0.432	0.543	3.513	3.571	2.565	2.162	0.675	7.525
Std. Dev.	0.471	0.417	0.375	0.424	1.138	1.016	1.172	0.867	1.372	1.272	1.291	1.444	0.743	0.468	3.550
Min	0.000	0.000	0.000	0.000	0.020	-2.120	-0.684	-1.518	-2.625	1.000	1.000	1.000	0.000	3.000	3.000
Max	1.000	1.000	1.000	1.000	4.835	1.723	6.292	2.671	2.136	5.000	5.000	5.000	3.000	1.000	37.000

Table 5.14 - Correlation matrix and descriptive statistics of variables employed in the second stage (Model 3 and 4)

6 Results

Table 6.1 reports the results of the first stage analysis. Particularly, econometric estimates confirm that the choice of governance mode, i.e. captive (= 0) versus outsourcing (= 1), is dependent upon specific location attributes and OLI paradigm-related factors. Indeed, both *Institutional context* and *Driver new market* displays the expected negative sign ($p < 0.01$). Concerning the other explanatory variables, they do not offer significant values; however, as previously mentioned, this first step is only functional to the evaluation of the governance misalignment and to the investigation of our research hypothesis in the second stage.

Table 6.2 shows the results of the second stage analysis. Namely, the first column refers to the relationship between governance alignment and the overall company experience (i.e., Model 2), while the other two columns present the outcomes of Model 3 and Model 4. *Company experience* has a meaningful and positive impact on our dependent variable *Misfit* ($p < 0.10$); specifically, delving into the concept of experience, previous unsuccessful initiatives (i.e., *Failure experience intensity*) and previous initiatives related to “distant” services (i.e., *Out-function experience intensity*) display a positive effect on governance misalignment ($p < 0.05$ and $p < 0.01$, respectively). Finally, Model 4 outcome (i.e., the last column) confirms these results and the expected negative coefficient of the interaction between the two explanatory variables (i.e., *Failure experience intensity* and *Out-function experience intensity*). Concerning the control variables, both *High-value assets* and *Market potential* have a negative impact on *Misfit* in all the second stage models. Thus, it appears that high asset specificity and high attractiveness of the host market do not influence the governance mode decision (since in the first stage their relationship with *Outsourcing* is not significant) as typically suggested by literature; rather they push companies to make choices consistent with the overall theoretical framework.

Table 6.1 – First stage: governance mode selection (Model 1)

Variables	Coefficients	Marginal effect
High-value assets	1.111 (0.49)	0.027
Cultural distance	-0.042 (-0.43)	-0.010
Institutional context	-0.387*** (-2.90)	-0.096***
Market potential	-0.109 (-1.15)	-0.027
Low cost labor	0.089 (0.65)	0.022
Skilled labor	-0.064 (-0.71)	-0.016
Company experience	-0.007 (-0.23)	-0.001
Driver efficiency	-0.084 (-1.08)	-0.021
Driver qualified personnel	0.019 (0.21)	0.004
Driver new market	-0.229*** (-3.12)	-0.057***
Company size	-0.214 (-1.34)	-0.053
Home country USA	0.399 (1.48)	0.099
Age	-0.032 (-1.37)	-0.008
Dummies industry sector	Yes	Yes
Constant	1.205* (1.81)	-
Observations (No.)	560	
Chi-square	89.561	
P-value	0.000	
Pseudo R-square	0.1413	

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$; z-statistics in parentheses

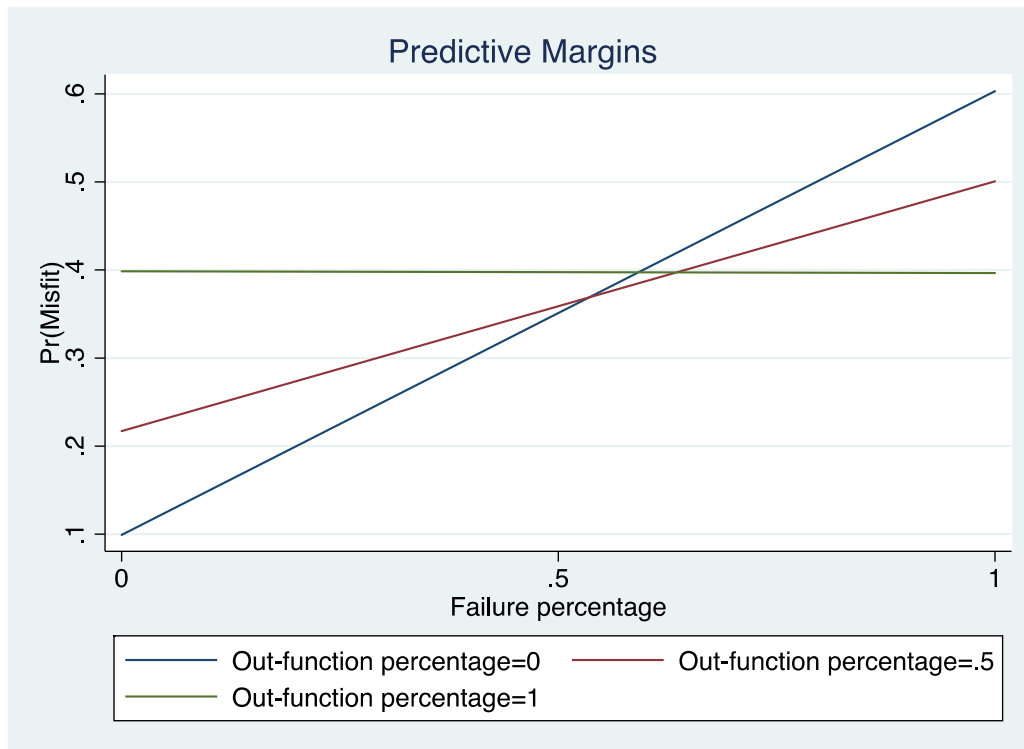
Table 6.2 – Second stage: governance misalignment and experience (Model 2, 3, 4)

Variables	Model 2		Model 3		Model 4
	Coefficient	Marginal effect	Coefficient	Marginal effect	Coefficient
Company experience	0.052* (1.84)	0.011*			
Failure experience intensity			0.753** (1.98)	0.154**	3.142*** (3.18)
Out-function experience intensity			1.060*** (2.60)	0.217***	2.097*** (3.92)
Failure exp. int. * Out-function exp. int.					-3.151*** (-2.89)
High-value assets	-0.546** (-2.22)	-0.110**	-0.855** (-2.40)	-0.157**	-0.962*** (-2.63)
Cultural distance	0.055 (0.55)	0.011	0.110 (0.89)	0.022	0.142 (1.09)
Institutional context	-0.167 (-1.19)	-0.036	-0.201 (-1.21)	-0.041	-0.178 (-1.08)
Market potential	-0.215* (-1.75)	-0.046*	-0.363*** (-2.81)	-0.074***	-0.358*** (-2.97)
Low cost labor	0.261* (-1.80)	-0.056*	-0.246 (-1.23)	-0.050	-0.282 (-1.27)
Skilled labor	0.046 (0.47)	0.009	0.040 (0.31)	0.008	0.003 (0.02)
Driver efficiency	-0.098 (-1.22)	-0.021	-0.097 (-0.89)	-0.019	-0.121 (-1.03)
Driver qualified personnel	0.148 (1.62)	0.031	0.143 (1.18)	0.029	0.173 (1.43)

Driver new market	0.075 (1.01)	0.016	0.081 (0.81)	0.016	0.048 (0.48)
Company size	-0.083 (-0.50)	-0.017	0.163 (0.63)	0.033	0.194 (0.70)
Home country USA	-0.429 (-1.44)	-0.094	-0.655 (-1.36)	-0.140	-0.692 (-1.38)
Age	-0.028 (-1.03)	-0.006	-0.025 (-0.50)	-0.005	-0.024 (-0.48)
Dummies industry sector	Yes	Yes	Yes	Yes	Yes
Constant	-0.127 (-0.19)	-	-0.598 (-0.59)	-	-1.208 (-1.09)
Observations (No.)	560		327		327
Chi-square	45.70		47.99		52.42
P-value	0.000		0.000		0.000
Pseudo R-square	0.078		0.1342		0.1612

*p < 0.10, **p < 0.05, ***p < 0.01; z-statistics in parentheses

In graph 6.1 we plot the significant interaction term by using the coefficient estimates (Zelner, 2009). The figure shows how increasing values of *Failure experience intensity* increase the likelihood of governance misalignment when *Out-function experience intensity* is equal to 0 and to 0.5; whereas in case of higher values of *Out-function experience intensity* (i.e., up to 1), growing values of *Failure experience intensity* do not affect the likelihood of misfit, which remains constant.



Graph 6.1 - The interaction effect between *Failure experience intensity* and *Out-function experience intensity*

7 Conclusions

Our thesis investigates the role of experience in companies' offshoring decisions and, in particular, in the governance mode choice. Specifically, we contribute to the literature on offshoring by exploring the dichotomy between captive offshoring and offshore outsourcing in business services and relying on a database finalized by the Offshoring Research Network, one of the most renowned source of data on offshoring practices.

For our purpose, we have adopted an original two-stage approach through which we have first built the theoretical framework (first stage) and then tested our hypotheses of research (second stage). Following Elia et al. (2014), our theoretical framework consists of an extended model that includes several aspects that have a proven effect on the firm's entry mode choice (i.e., factors related to the TCE, the OLI paradigm, the institutional and cultural context and elements specific to the offshore destinations). Our first stage's results confirm the traditional insights that entry mode decisions are dependent upon specific location attributes and Dunning-based factors; particularly, both weak host country institutions (i.e., a situation of political instability) and the perceived importance of access to new markets push companies to implement captive modalities.

As the first stage is performed similarly to previous researches (e.g., Brouthers, 2002), we believe the second phase provides a real innovation. Indeed, we have employed the governance misalignment (i.e., the misalignment between the governance mode predicted by the theoretical framework in the first stage and the one actually implemented by each company) in an atypical manner. It is no more examined as a determinant of firm performance, rather it assumes the role of dependent variable, analyzed in relation to firm experience.

Given that governance misalignment does not necessarily generate negative performance in foreign investments (Elia et al., 2014), we investigated whether increasing the level of experience (i.e., the number of past offshoring initiatives) stimulates companies to experiment unconventional solutions and, thus, deviate from theory's suggestions. Specifically, we claimed that firms with little experience face a condition of limited information and data in the offshoring decision; therefore, they can only rely on conventional theories to choose the entry mode (Hypothesis 1). Conversely, expert firms can count on their history and re-elaborate their strategies to gain better investment outcomes; certainly, depending on the type of experience cumulated, this may lead to entry solutions distant from theory recommendations.

Hence, we disentangled the overall concept of experience along two distinct directions, i.e., the degree of success and the service relatedness, in order to highlight whether they meaningfully influence the misalignment and how they differently make it. First, based on the idea of hidden cost (Larsen et al., 2013), we distinguished between successful and failure experiences. We posited that a collection of past successful initiatives makes managers overconfident about the state of existing organizational knowledge and prompts a naïve continuation of old choices (i.e., the decisions taken initially with little experience), thus a continuous alignment with theory, while failures encourage firms to undertake innovative and untraditional solutions (Hypothesis 2). Second, we considered two offshoring projects related if they involve the same business function; consequently, we derived the classification of out-function and in-function experiences from their relatedness with the initiative of interest. Similarly to the reasoning on success and failure, we suggested that in-function experiences induce the company to persist with old routines (i.e., follow theory advances), since managers tend to perceive a lack of differentiation between offshoring practices within the same business function and imitate what they probably made in the past. On the contrary, out-function experiences bring managers to take a critical approach and search for alternative effective solutions in misalignment with theory (Hypothesis 3).

Additionally, we focused on the interaction between the two aforementioned dimensions of experience (i.e., success/failure and in-function/out-function) to observe, in particular, companies' behavior in situations characterized by higher frequency of past unsuccessful and out-function initiatives. Following our previous hypotheses, the logic would suggest a double pressure toward unconventional solutions; however, we presumed that in such circumstances firms deal with an extreme uncertainty and inevitably return to rely on traditional theories in order to select their governance mode (Hypothesis 4). Indeed, managers not only have historical information about failures, but also they can hardly find out the causes of these failures and learn from them, given that data stems from business functions out of their competence.

The obtained results completely support our hypotheses of research. Firm experience has a positive effect on governance misalignment, thus, inexperienced companies preferably adopt entry modes consistent with the theoretical framework built in the first stage; expert companies tend to distance themselves from theory. Specifically, both failure and out-function experiences, when analyzed separately, confirm their influence in prompting firms to implement innovative solutions (while both success and in-function experiences lead firms to comply with theory). Instead, when they are interacted, results certify that companies' decisions approach again theory suggestions. Finally, contrary to extant literature, our results show that the variables regarding the asset specificity (TCE-related) and the

market attractiveness do not affect the entry mode choice *per se*, rather they push firms to undertake modalities in line with the overall theoretical framework.

Hence, we believe our thesis provides a really interesting contribution to the international business literature. Indeed, on the one hand, we propose an uncommon role for the governance misfit in the research (i.e., by exploring it as an antecedent of performance rather than studying its direct effect on performance); on the other hand, we shed light on the vast theme of experience, which has been often overlooked by past literature. Particularly, our analysis makes a decisive step forward about the learning mechanisms that originate from previous choices and the processes of imitation within a company. Elements that are typically ignored by scholars.

In addition to this contribution, relevant managerial implications arise from our study. It appears that managers correctly behave with regard to failure experience: they challenge the organizational knowledge of the firm by discarding existing models of the reality and looking for divergent models suitable for the business environment in which the company operates. The same can be said concerning the out-function experiences. However, in case of both successful and in-function experiences managers tend to passively replicate past choices, without a clear analysis of the peculiar situation they are going to face in the foreign market. We claim that they should be critical and proactive in all circumstances, also when everything seems to proceed positively. Indeed, offshoring projects are fundamental for companies and a persistent narrow attitude in the decision process (e.g., neglecting trends in the external world) is likely to produce highly negative investment outcomes in the long run.

In conclusion, this thesis opens up opportunities for further investigations and future developments. The two dimensions of experiences can be extended through the addition of significant factors. Specifically, we have based the idea of success on subjective expectations (i.e., the expected savings); integration with objective measures, such as data from the companies' balance sheet, would guarantee a more reliable description of successful experience. As far as the service relatedness, its definition could be enlarged by considering, besides the business function, the industry associated with each initiative. Moreover, a very interesting future research might include a competitors' analysis; do firms learn also from other organizations? Do they learn more from competitors' failures or successes? Do they look at the general competitors' experience or only at the experiences related to the business function of interest? Unfortunately, we have not had the possibility to explore these further opportunities due to the nature of the ORN database, as it basically assigns an ID to each offshoring project, but we have no information on the specific name of the firm implementing the initiative.

Finally, it might be worth strengthening the theoretical framework with further perspectives (e.g., the Resource-based view) in order to build an even more comprehensive model.

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