

## RESEARCH ARTICLE

# Choosing misaligned governance modes when offshoring business functions: A prospect theory perspective

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## Abstract

**Research Summary:** Transaction cost economics (TCE) holds that multinational corporations (MNCs) should select governance modes based on associated transactional hazards. However, MNCs often adopt theoretically misaligned governance modes. Applying a prospect theory (PT) perspective, we use the context of business-process offshoring to explore why firms choose misaligned governance modes. We argue that theoretically misaligned governance modes are regarded as riskier than aligned governance modes, and we suggest that prior experiences of failure in an international context—especially in business functions that are relevant for the internationalization of a firm—prompt decision-makers to choose theoretically misaligned governance modes. We enhance discussions on governance-mode decisions with important behavioral perspectives on how such decisions materialize.

**Managerial Summary:** Experience with underperforming investments provides decision-makers with an important motivation to search for riskier, non-traditional solutions, such as governance modes that do not necessarily comply with conventional logics. We show that such decisions, which have traditionally been conceived as managerial mistakes, are driven by

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behavioral insights found in the fields of human and organizational psychology. While we explore this idea in the context of international governance-mode decisions, we believe such a behavioral perspective on international decision-making is generalizable to other relevant contexts.

#### KEYWORDS

behavioral and prospect theory, business functions offshoring, governance mode, successful and unsuccessful international experience, transaction cost economics

## 1 | INTRODUCTION

When a multinational corporation (MNC) offshores its activities to foreign countries, it needs to choose an appropriate governance mode. It may decide to ensure full control over a subsidiary, have intermediate equity ownership, or acquire inputs from an external supplier. To explain this choice, reasoning derived from traditional organizational economics logics more generally, and transaction cost economics (TCE) more specifically, has emerged as a mainstream framework (see Buckley & Casson, 1976; Hennart, 1982; Williamson, 1975, 1985). This logic suggests that MNCs facing high transactions costs (e.g., due to uncertainty or to the specificity of the assets involved in the internationalization process) typically prefer hierarchical solutions to reduce the risks of a partner engaging in opportunistic behavior (see Zhao, Luo, & Suh, 2004, for a meta-analysis).

However, recent research questions whether managers actually behave according to traditional organizational economics logics regarding foreign governance decisions. For example, Buckley, Devinney, and Louviere (2007) claim that the processes surrounding decisions to enter foreign markets are widely idiosyncratic and do not necessarily match the quasi-rational calculative approaches found in conventional explanations of foreign governance modes (e.g., Buckley & Casson, 1976; Dunning, 1988). Similarly, Maitland and Sammartino (2015) find that decision-makers typically base governance choices on intuition and heuristics instead of rational economic analyses. More recently, Surdu, Greve, and Benito (2021) argue that the overreliance on a few main theories in the field of international business provides an incomplete understanding of the dynamics of firm internationalization. They suggest the use of a behavioral perspective to better understand “increasingly common but neglected internationalization behaviors” (Surdu et al., 2021, p. 1048).

We propose a behavioral framework to unpack sources of heterogeneity in MNCs' governance choices when offshoring. Recent research shows that international experience gives rise to heuristics and cognitive biases that affect governance choices (Elia, Larsen, & Piscitello, 2019) or act as a source of learning about alternative types of governance modes that may have varying effects on firms' growth prospects (Albertoni, Elia, & Piscitello, 2019). In line with this, we use the lens of the prospect theory (PT) to understand whether MNCs' international experiences are associated with decisions to adopt riskier governance modes that do not necessarily comply with TCE-based suggestions. According to PT, decision-makers tend to be more risk-assertive when past performance is below expectations, while they adopt more risk-averse and conservative behaviors when performance exceeds expectations (Kahneman & Tversky, 1979).

We suggest that firms' experiences with over or underperforming offshoring activities influence decision-makers' interpretations and evaluations of the prospect of complying with TCE-based governance-mode suggestions. While TCE predicts that governance choices should reflect the potential for hazards and opportunistic behavior when conducting the activity (e.g., Hennart, 1982), we regard theoretically misaligned governance modes as the outcome of risk-seeking behavior. Accordingly, we hypothesize that MNCs are more likely to choose a riskier governance mode that does not comply with TCE suggestions when they have experienced negative performance in prior international offshoring investments. In such cases, decision-makers will adopt riskier solutions to address the causes of that underperformance and they will, therefore, opt for a non-conventional, theoretically misaligned governance mode.

Moreover, risk-seeking behavior depends not only on past outcomes, but also on the strategic importance of the activity being moved abroad (Fiegenbaum, Hart, & Schendel, 1996; Shoham & Fiegenbaum, 2002). Accordingly, we argue that the effect of past performance is amplified when firms offshore a business function that has been repeatedly internationalized in the past. We find support for our hypotheses in the context of business-functions offshoring in which firms relocate administrative and technical activities abroad and apply internal or external modes of governance (Contractor, Kumar, Kundu, & Pedersen, 2010; Manning, Massini, & Lewin, 2008).

We make three contributions with this article. First, we respond to recent calls to pay more attention to the complex and cognitive aspects of decision-making processes in firms' foreign expansion (see Aharoni, Tihanyi, & Connelly, 2011). We offer a nuanced behavioral perspective based on PT on the governance-mode discussion (Zhao et al., 2004). In so doing, we extend the traditional organizational economics view based on TCE, which looks at past experience mainly as a source of learning, with a boundedly rational behavioral approach by emphasizing the managerial and cognitive consequences of past events (Buckley et al., 2007; Elia et al., 2019; Maitland & Sammartino, 2015; Surdu et al., 2021). Second, while the extant research has highlighted the performance-deteriorating consequences of governance-mode decisions that are misaligned with mainstream theory, we argue that firms may opt for misalignment in order to adopt riskier governance solutions. This approach allows us to alter the conventional view of regarding deviation from theoretical expectations as a managerial mistake to a behavioral perspective based on PT that views governance misalignment as risk-taking behavior triggered by past negative experience (e.g., Buckley, Chen, Clegg, & Voss, 2016; Jiménez, Benito-Osorio, Puck, & Klopff, 2018). Third, we disentangle the roles and effects of different dimensions of a focal firm's previous experiences with offshoring on the heterogeneity in firms' attitudes toward governance modes, thus offering novel insights into *why* and *when* divergences occur in the internationalization process. By combining two research streams—the economic/strategic and the behavioral/process approaches (similar to Buckley et al., 2007), we argue that the governance-mode choice requires a deeper understanding of the underlying complex cognitive mechanisms. Importantly, we argue that our focus on governance misalignment not only allows us not only to better understand the governance choice per se, but also how present governance choices compare to past choices (Putzhammer, Puck, & Lindner, 2020).

## 2 | THEORY AND HYPOTHESES

Prior research emphasizes international experience as an important driver of firms' heterogeneity in governance-mode choices (e.g., Argyres, Felin, Foss, & Zenger, 2012; Argyres & Zenger, 2012; Brouthers & Brouthers, 2001; Delios & Beamish, 1999; Sanchez-Peinado,

Pla-Barber, & Hébert, 2007). International experience reduces the liability of foreignness and risk, which makes a mode offering greater control preferable (Sanchez-Peinado et al., 2007). In addition to uncertainty, international experience has an important impact on the likelihood of initiating a wider search for alternative solutions to spur future performance. For example, Reuer, Zollo, and Singh (2002) find that certain types of experience help firms more effectively design their alliances.

More recent contributions disentangle how different international experiences trigger heterogeneous types of behavior, thereby affecting governance choices. For instance, Clarke, Tamaschke, and Liesch (2013) suggest that the type of knowledge provided by international experience—and the way it affects the governance choice—depends on whether it is location- or non-location bound, and on the length, scope, diversity, and intensity of that experience. Other contributions highlight how firms tend to learn from rare events, develop knowledge useful for identifying other similar events, and unfold that knowledge to manage outcomes (Lampel, Shamsie, & Shapira, 2009; Starbuck, 2009). Relatedly, research shows that firms learn more (or differently) from negative experiences than they do from positive ones. For instance, some firms learn vicariously by observing the errors made by prior entrants and use that learning to reduce the probability of failing in their own investments, although this learning is less effective when there is more heterogeneity in the causes of these failures (Yang, Li, & Delios, 2015). Other firms rely on internal organizational learning from their previous unsuccessful experiences to choose their market re-entry strategies. In fact, past failures have a greater impact than past successes in prompting managers to find a faster path to recovery, search for new potential targets, and re-evaluate previously held assumptions (e.g., Surdu, Mellahi, & Glaister, 2019; Surdu, Mellahi, Glaister, & Nardella, 2018).

We argue that firms' international experiences also function as effective reference points for decision-makers' future decisions on foreign governance modes. While prior research has mostly focused on the learning effect of MNCs' international experiences, we offer a PT perspective that seeks to explain why MNCs may opt for riskier governance modes than conventional TCE explanations would suggest.

## 2.1 | A prospect theory perspective on governance-mode choices

When applied to governance-mode choices, TCE predicts that MNCs investing abroad will prefer hierarchical solutions (rather than markets) when transaction costs are high (Brouthers, 2002). Complex transactions with a high degree of specificity, poor structure, and uncertainty are subject to opportunistic behavior in international markets and are, therefore, argued to be most efficiently organized within hierarchies. Related empirical work finds that the foreign governance mode is also associated with such factors as cultural distance and institutional context (e.g., Zhao et al., 2004). For example, the managerial literature has shown that the more politically uncertain a given location is, the greater the need to retain the possibility to quickly divest and opt for modes of governance involving less equity (Henisz & Delios, 2001; Kobrin, 1979). In situations characterized by high uncertainty, firms may require higher degrees of flexibility and real options, resulting in lower-equity modes of entry (Gatignon & Anderson, 1988).

The extant research also shows that firms deviating from these predictions may experience lower technological performance (Leiblein, Reuer, & Dalsace, 2002), worse financial and non-financial outcomes (Brouthers, 2002), and less cost savings and reduced service quality (Elia,

Caniato, Luzzini, & Piscitello, 2014). Hence, a misalignment between TCE's prescriptions and the chosen governance mode is conventionally conceived as a managerial mistake that can have serious negative consequences for the MNC. Nevertheless, the literature also highlights that firms deviating from (or aligning with) theory-based governance modes may not always experience negative (or positive) performance. For example, Albertoni et al. (2019) show that only the alignment with "mindful learning" fosters the future growth of the company, while the alignment with "inertial learning" has an insignificant effect. Relatedly, Elia et al. (2019) suggest that governance misalignment is a behavioral consequence of past negative international experiences. The authors highlight the importance of distinguishing between under- and over-performing firms' international experiences and discuss how governance-mode choice is affected by decision-makers' biases.

We build upon this research and employ PT to argue that decision-makers adopt theoretically misaligned governance choices when the outcomes of past experiences are negative, and that their governance choices are more aligned when the outcomes are positive (Kahneman & Tversky, 1979; see Table 1 for a comparison of TCE and PT). PT suggests that decision-makers tend to be more risk-seeking when past performance is below expectations, while they adopt more risk-averse and conservative behaviors when performance exceeds expectations (Figueira-de-Lemos & Hadjikhani, 2014; Miller & Chen, 2004). More specifically, PT assumes that decision-makers frame the outcomes of their decisions as gains or losses relative to established reference points (Tversky & Kahneman, 1981). These reference points play a crucial role in explaining how decision-makers establish the prospects of a decision's outcomes. As such, they are risk-averse when they experience gains compared to their reference points (as they prefer sure gains to probable gains with greater expected value) and risk-seeking when they experience losses relative to their reference points (as they prefer probabilistic losses to sure losses of less magnitude) (Holmes Jr, Bromiley, Devers, Holcomb, & McGuire, 2011; Levy, 1992).

**TABLE 1** Comparison of TCE and prospect theory

	<b>Transaction cost economics</b>	<b>Prospect theory</b>
Level of analysis	Transactions	Individual/decision-maker
Key logic	Complex transactions with a high degree of specificity, poor structure, and uncertainty are subject to opportunistic behavior in international markets.	Decision-makers frame the outcomes of their decision into gains or losses relative to established reference points. Decision-makers are risk-averse when they experience gains compared to their reference points and risk seeking when they experience losses compared to their reference points.
Implications for governance modes	Foreign governance mode should economize on transaction costs to mitigate potential hazards and opportunistic behavior. MNCs investing abroad prefer hierarchical solutions (rather than markets) whenever transaction costs are high.	Decision-makers experiencing losses will opt for riskier (theoretically misaligned) governance modes. Decision-makers experiencing gains will opt for less risky (theoretically aligned) governance modes.
Representative work	Buckley and Casson (1976), Hennart (1982), Williamson (1975, 1985)	Kahneman and Tversky (1979), Tversky and Kahneman (1981), Fiegenbaum and Thomas (1988)

We propose that theoretically misaligned governance modes are associated with significant risk and uncertainty. Building on the TCE's assumption that the foreign governance mode should economize on transaction costs in order to mitigate potential hazards and opportunistic behavior (e.g., Hennart, 1982), we conceptualize misaligned governance modes as the result of risk-seeking behavior in which decision-makers opt for nontraditional governance modes on the expense of ensuring protection for foreign-asset-specific investments. As such, we adopt PT to better understand the antecedents of such decisions. We argue that international experience stemming from past failures acts as a reference point in which decision-makers experienced a loss, making them more likely to opt for riskier solutions (i.e., theoretically misaligned governance modes).

## 2.2 | Firms' previous unsuccessful international experiences and governance-mode choices

As discussed above, PT-based studies emphasize that experiences with success and failure have important consequences that guide firms' decisions (Baum & Ingram, 1998; Haunschild & Sullivan, 2002; Madsen & Desai, 2010). In particular, failure challenges existing wisdom and structures and motivates firms to adopt riskier attitudes with the aim of overcoming past failures. Accordingly, performance below the reference point induces riskier behavior, as it incentivizes the decision-maker to critically review and update expectations of existing capabilities and the requirements necessary to manage activities in the given environment. Firms experiencing performance below expectations are motivated to reconfigure their resources and activities to increase effectiveness (Moliterno & Wiersema, 2007). Such failures to attain aspiration levels often increase firms' risk profiles (Bromiley, 1991; Kahneman & Tversky, 1979), as decision-makers seek riskier solutions to reduce the gap between current performance and their aspiration levels (Fiegenbaum & Thomas, 1988; Greve, 1998).

We draw on these insights to argue that when prior international activities failed to meet expectations, decision-makers become more likely to search for riskier solutions that can overcome the challenges causing the underperformance. Indeed, underperformance induces a sense of urgency, making the adoption of riskier decisions more likely (Cameron, 1984; March, 1981). Based on the assumption that a misalignment between the governance mode selected by the company and the mode prescribed by TCE is inherently risk-prone and uncertain, we expect firms to be less likely to comply with theoretical prescriptions when prior international activities performed below expectations. Accordingly:

**Hypothesis 1.** *Experience with unsuccessful international investments increases the likelihood of choosing a riskier, theoretically misaligned governance mode.*

## 2.3 | The moderating effect of the business function's international relevance

Furthermore, we argue that the relationship between past negative performance and the choice of a riskier, misaligned governance mode is moderated by the relevance of the focal business function for the company's internationalization process. PT and its more recent evolution within the strategic reference point domain (Fiegenbaum et al., 1996; Shoham & Fiegenbaum, 2002)

suggest that decision-makers emphasize functions that encompass the core capabilities (e.g., cost-reduction, quality, speed, innovation) crucial for achieving a competitive advantage in foreign markets. These functions are considered the firm's *center of gravity* and capture more managerial attention than other activities (Fiegenbaum et al., 1996). Therefore, negative past performance in a relevant function will likely trigger a stronger reaction from the decision-maker, who will then be even more willing to adopt risk-seeking behavior in the form of governance misalignment in order to recover quickly and to re-establish positive performance for their strategic activities.

Much of the literature acknowledges that international experience contributes to the development of firms' core knowledge, capabilities, and know-how (Brouthers, Brouthers, & Werner, 2008; Carlsson, Nordegren, & Sjöholm, 2005; Delios & Beamish, 2001; Eriksson, Johanson, Majkgard, & Sharma, 1997; Evans, Mavondo, & Bridson, 2008; Magnusson, Westjohn, & Boggs, 2009). The extant research also finds a positive link between the intensity of previous international experience (e.g., in terms of number and/or size of related investments) and the development of firm-specific advantages (Clarke et al., 2013). Building on these insights, we propose that the reiteration of the internationalization of a specific function by a company is associated with the accumulation of knowledge and capabilities that make it strategically relevant and that it will, therefore, receive more attention (Ocasio, 1997). For instance, firms that repeatedly offshore R&D functions are expected to rely on the development of innovation capabilities to gain a firm-specific advantage, while firms that repeatedly offshore sales functions are more attentive to how activities influence their marketing capabilities.

Accordingly, we expect that when negative past performance is associated with a business function that a firm has repeatedly internationalized, its propensity to explore and adopt risk-seeking behaviors—such as governance misalignment—will be higher. In this case, there will be greater urgency to recover from past performance shortcomings, as the function is more likely to receive more attention from decision-makers. Hence, we arrive at our second hypothesis:

**Hypothesis 2.** *The higher the international relevance of a business function for a firm, the greater the probability that prior unsuccessful international experiences increase the likelihood of choosing a riskier, theoretically misaligned governance mode.*

### 3 | DATA AND METHODS

#### 3.1 | Databases

To explore our hypotheses, we focus on the context of business-functions offshoring (i.e., the relocation of business functions abroad in captive and outsourced governance modes; Manning et al., 2008). The primary data source for our empirical analysis is the database developed by the Offshoring Research Network (ORN), a research project that was launched in 2004 by Duke University to study the offshoring of business services (Lewin, Massini, & Peeters, 2009; Lewin & Peeters, 2006). The ORN database is the result of collaboration among 13 partner universities in different countries,<sup>1</sup> and is based on the cooperation of researchers and practitioners in data collection and the development of a better understanding of the offshoring phenomenon. The ORN database builds on six surveys of offshoring companies undertaken between 2005 and 2011. These surveys allowed the collection of detailed data on the drivers, geographical factors, risks, governance mode, and performance implications of global sourcing investments across all business functions. To complement the ORN database, we use additional

information collected from<sup>2</sup>: (i) the World Competitiveness Yearbook; (ii) the World Bank; and (iii) Hofstede (2001).

### 3.2 | Sample and descriptive statistics

Due to missing values in some of the ORN variables employed in the empirical analysis, our final sample includes 560 observations, each corresponding to a single offshoring investment. Table 2 shows that most of the initiatives (65.89%) originate from the United States, followed by the Netherlands (17.14%) and Belgium (10.71%). The main host countries are India (36.43%) and China (10.71%), while the rest of Asia and Western Europe (13.21% each) are the most targeted macro-regions.

Table 3 shows that the most commonly offshored business functions are information technology (IT) and customer contact, involving 21.79% and 16.07% of the investments, respectively. Finally, the same table indicates that software and IT services (27.5%) and manufacturing (20.18%) are the industries responsible for the majority of offshoring investments.

### 3.3 | Methodology

We rely on a two-step methodology that builds on previous literature investigating the relationship between governance modes and performance (Brouthers, 2002; Castañer, Mulotte, Garrette, &

TABLE 2 Home and host countries of the offshoring investments

Home countries	No.	%	Host countries	No.	%
Belgium	60	10.71	Africa <sup>a</sup>	7	1.25
Denmark	1	0.18	Asia (except India and China) <sup>b</sup>	74	13.21
France	3	0.54	Australia and New Zealand <sup>c</sup>	4	0.71
Germany	1	0.18	Central and South America <sup>d</sup>	41	7.32
Netherlands	96	17.14	China	60	10.71
Spain	22	3.93	Eastern Europe <sup>e</sup>	57	10.18
United Kingdom	8	1.43	India	204	36.43
United States	369	65.89	Middle East (Israel)	1	0.18
-	-	-	North America (including Mexico) <sup>f</sup>	38	6.79
-	-	-	Western Europe <sup>g</sup>	74	13.21
Totals	560	100		560	100

<sup>a</sup>Africa includes South Africa (5) and Morocco (2).

<sup>b</sup>Asia includes Philippines (42); Malaysia (9); Indonesia (4); South Korea (4); Japan, Singapore, Taiwan, and Thailand (3 each); Vietnam (2), and Pakistan (1).

<sup>c</sup>Australia has three observations and New Zealand has one.

<sup>d</sup>Central and South America includes Brazil (14); Argentina and Costa Rica (7 each); Colombia and Jamaica (3 each); Ecuador, Peru, and Uruguay (2 each); and El Salvador (1).

<sup>e</sup>Eastern Europe includes Poland (15), Romania (11), Russia (10), Hungary (9), Czech Republic (8), and Slovakia (4).

<sup>f</sup>North America includes Mexico (14) and the United States (10).

<sup>g</sup>Western Europe includes the Netherlands (12); Germany (11); the UK (10); France and Ireland (8 each); Spain (8); Italy and Norway (4 each); Sweden (3); Denmark (2); and Austria, Belgium, Finland, Luxembourg, Portugal, and Switzerland (1 each).



TABLE 3 Business functions and industries of the offshoring investments

Business functions	No.	%	Industry	No.	%
Call center/customer contact	90	16.07	Aerospace and defense	3	0.54
Engineering services	60	10.71	Arts, entertainment, and recreation	2	0.36
Finance/accounting	54	9.64	Automotive	14	2.5
Human resources	15	2.68	Construction	1	0.18
Information technology	122	21.79	Energy, utilities, and mining	5	0.89
Legal services	5	0.89	Finance and insurance	65	11.61
Marketing and sales	46	8.21	Healthcare	2	0.36
Product design	30	5.36	Manufacturing	113	20.18
Research and development	43	7.68	Other	47	8.39
Software development	48	8.57	Pharmaceuticals and life sciences	16	2.86
Supply chain and facilities	47	8.39	Professional services	50	8.93
			Retail and consumer goods	24	4.29
			Software and IT services	154	27.5
			Telecommunications	36	6.43
			Transportation and logistics	28	5
Totals	560	100		560	100

Dussauge, 2014; Elia et al., 2014; Leiblein et al., 2002; Shaver, 1998). In step (I), we estimate the relationship between two governance modes in offshoring (outsourcing versus captive) and a set of explicative and control variables that reflect the drivers of the governance-mode choice based on an “extended” TCE model that includes experience and other control variables capturing, for instance, the cultural and institutional environment (Brothers, 2002; see Equation 1):

$$\text{Outsourcing} = f(\text{international experience, other explicative variables, controls, } \varepsilon). \quad (1)$$

We then compute the misalignment between the governance mode predicted by step (I) and the governance mode selected by the companies in the sample for each offshoring investment. The misalignment reflects the extent to which the governance choice for each foreign venture departs from the governance model predicted in step (I) (i.e., from a model in which the explicative variables comply with the mainstream theory).

In step (II), we focus on the subsample of offshoring investments undertaken by companies with at least one previous experience (a total of 320 observations), as experience is our key explanatory variable. To test Hypothesis 1, we regress the governance misalignment on the variables in step I and on the unsuccessful international experience, as shown in Equation (2):

$$\text{Governance misalignment} = f(\text{unsuccessful international experience, other explicative variables, controls, } \varepsilon). \quad (2)$$

To test Hypothesis 2, we introduce the international relevance of the business function and the interaction term with the previous (unsuccessful) experience, as shown in Equation (3):

$$\text{Governance misalignment} = f(\text{unsuccessful international experience, business function international relevance, unsuccessful international experience} \times \text{business function international relevance, controls, } \varepsilon). \quad (3)$$

### 3.4 | Variables

#### 3.4.1 | Variables in step (I)

##### *Dependent variable*

The dependent variable in Equation (1) in step (I) is *outsourcing*, a dummy variable set equal to 1 when the governance mode selected by the company is outsourcing (i.e., international, local, or a domestic third-party service provider), and 0 when a captive governance mode (i.e., wholly owned subsidiary) is chosen. The variable originates from the following question in the ORN survey: “What is the service delivery model currently used for this offshoring implementation?”. In our sample, the number of outsourcing investments (51.96%) is balanced with the number of captive investments (48.04%).

##### *Explicative variables*

To identify the main explicative variables accounting for the governance-mode choice, we draw on the “extended TCE model” proposed by Brouthers (2002). In addition to the TCE variables, this model controls for the external environment and for the cultural and institutional context. We also include international experience, which is one of the main factors responsible for firms’ heterogeneity in governance choices (e.g., Argyres et al., 2012).

More specifically, *international experience*, is a dummy set equal to 1 if the company reports at least one previous international activity before the focal offshoring investment, and 0 otherwise. Previous international experience has been acknowledged as playing a role in governance-mode choice because it reduces uncertainty in future investments, as companies learn from their early investments and adapt the modes of their subsequent entries (Benito & Gripsrud, 1992; Chang, 1995; Gao & Pan, 2010; Swoboda, Elsner, & Olejnik, 2015). We expect firms facing uncertainty to prefer outsourcing, as this mode provides greater flexibility and, hence, the possibility to withdraw the investment more quickly and easily if problems arise (Harrigan, 1985). Conversely, firms should be more willing to adopt captive solutions when they can leverage experience acquired from previous investments.

Following Brouthers (2002), we account for asset specificity by introducing the variable *high-value-added function*, a dummy taking a value of 1 when the function is knowledge-intensive, and 0 otherwise (see also Youngdahl, Ramaswamy, & Dash, 2010).<sup>3</sup> In our sample, 133 investments involve high-value-added functions. In line with the TCE approach, we expect these functions to have a higher probability of being offshored through captive solutions than through outsourcing. We also capture the cultural contexts of the home and host countries through the variable *cultural distance*, which we compute by applying Kogut and Singh’s (1988) index to Hofstede’s (2001) items.<sup>4</sup>

We consider the external environment of the host country through four variables: *host political stability*, which reflects the quality of institutional infrastructures; *host market attractiveness*,

TABLE 4 Exploratory factor analysis of the host-country variables

First-order construct	Items	Source	Loading	Alpha
Host political stability	Political stability and absence of violence/terrorism	WGI	0.8783	.97
	Government effectiveness	WGI	0.8556	
	Regulatory quality	WGI	0.9011	
	Rule of law	WGI	0.8859	
	Control of corruption	WGI	0.8544	
Host market attractiveness	Gross domestic product	WCY	0.9864	.794
	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	
Host low cost of labor	Remuneration call center agent	WCY	0.7480	.785
	Remuneration manufacturing worker	WCY	0.7606	
	Remuneration department head	WCY	0.7254	
	Remuneration personal assistant	WCY	0.7622	
Host human resources	Information technology skills	WCY	0.8036	.924
	Qualified engineers	WCY	0.9310	
	Skilled labor	WCY	0.9000	

which accounts for potential economic growth; *host low cost of labor*,<sup>5</sup> which reflects low wages and other labor costs; and *host human resources*, which accounts for the availability of skilled labor. We compute these variables through an exploratory factor analysis based on items found in the World Governance Indicators databases and the World Competitiveness Yearbook, using the average of the data from 2005 to 2011 (the years of the survey). Details on the items and the factor analysis are provided in Table 4. We expect political stability and market attractiveness to reduce environmental uncertainty and increase the business opportunities arising from market growth, thus favoring the adoption of a captive governance mode, as suggested in the managerial literature. Conversely, the availability of low-cost labor encourages firms to outsource their activities to specialized local service providers. Finally, we expect firms to prefer full control over their foreign activities when the availability of skilled labor is high, as captive solutions ensure more effective absorption of the local knowledge embedded in skilled labor.

We also include three variables capturing the main drivers of offshoring: *market-seeking*, *efficiency-seeking*, and *human resource-seeking* (Lewin et al., 2009). These variables arise from the following question in the survey: “What is the importance of each of the following drivers in considering offshoring this function?”. From the list of the possible drivers, we selected the following items: “Access to new markets for products and services,” “Enhancing efficiency through business process redesign,” and “Access to qualified personnel offshore.” All these variables vary on a Likert scale ranging from one to five. Table 5 shows the distribution of the observations across the three offshoring drivers. Notably, the market-seeking driver is hardly considered relevant (i.e., with a level of importance of 1 or 2) in more than half (53%) of the offshoring investments, while the level of importance is higher (i.e., 4 or 5) for the efficiency-

**TABLE 5** Distribution of observations across market-seeking, efficiency-seeking, and human resources-seeking drivers

Likert scale	Market-seeking			Efficiency-seeking			Human resource-seeking		
	Freq.	Percent	Cum.	Freq.	Percent	Cum.	Freq.	Percent	Cum.
1	194	34.64	34.64	77	13.75	13.75	47	8.39	8.39
2	105	18.75	53.39	71	12.68	26.43	55	9.82	18.21
3	119	21.25	74.64	116	20.71	47.14	94	16.79	35.00
4	61	10.89	85.54	173	30.89	78.04	204	36.43	71.43
5	81	14.46	100.00	123	21.96	100.00	160	28.57	100.00
Total	560	100.00		560	100.00		560	100.00	

seeking and human resource-seeking drivers (52.85% and 65% of the offshoring investments, respectively). We expect the market-seeking driver to increase the probability of a captive investment, which provides more rent-appropriation opportunities than outsourcing. The predominance of the efficiency-seeking driver is likely to favor outsourcing solutions, which enable firms to focus on their core businesses. Finally, *human resource-seeking* investments are likely to select captive solutions rather than outsourcing, as full control enables more effective transfers of knowledge from the local skilled labor to the offshoring company.

#### *Control variables*

We employ a set of control variables that might affect the governance-mode choice. First, we control for *company size* using a scale variable ranging from 1 to 3, with 1 assigned to small firms (less than 500 employees), 2 to medium-sized firms (between 500 and 20,000 employees), and 3 to large firms (more than 20,000 employees). Our sample contains 146 small firms (26.07%), 230 medium-sized firms (41.07%), and 184 large firms (32.86%). Second, we control for the time effect through the variable *age of the investment*, which is computed as the difference between the year of the survey and the year of the offshoring investment. Third, due to the large number of observations originating from the United States, we introduce the dummy variable *home US*, which takes a value of 1 if the United States is the home country of the investment, and 0 otherwise. Fourth, given the legal restrictions that some countries (e.g., India and China) apply (or previously applied) to the governance of inward investments, we employed a dummy variable *host India China* to capture offshoring investments in these two markets. Finally, we include seven *dummy industries*, which group the different sectors according to the Eurostat-OECD (2007) classification based on the R&D intensity of the manufacturing industries and on the knowledge intensity of the service sectors.<sup>6</sup>

### 3.4.2 | Variables in step (II)

#### *Dependent variable*

The dependent variable in step (II) is *misaligned governance mode*, which measures the extent to which the selected governance mode departs from the governance mode predicted in step (I). We compute this variable by applying the methodology suggested by Brouthers (2002), Leiblein et al. (2002), and Elia et al. (2014). Specifically, we obtain a continuous variable (ranging from

0 to 1) equal to  $\Phi$  in the case of a captive governance mode and equal to  $1-\Phi$  in the case of outsourcing, where  $\Phi$  is defined as the standard normal cumulative distribution function, as expressed in Equation (4):

$$\text{Prob}(Y_i = 1) = \Phi(\beta'X_i) \quad (4)$$

### *Explicative, moderating, and control variables*

In the second stage, we focus our analysis on the subsample of observations with at least one previous experience (a total of 320 observations), and we employ the same variables adopted in stage (I) apart from *international experience*. We replace this variable with *unsuccessful international experience*, which is the main explicative variable, and which is computed as the proportion of unsuccessful experiences of the company undertaking the focal offshoring investment up to the year of implementation. To assess the extent to which an experience was unsuccessful, we rely on the concept of hidden costs of offshoring (Larsen, 2016; Larsen, Manning, & Pedersen, 2013), which refers to the unforeseen costs that arise after the implementation of an investment due to either external contingencies or factors that are internal to the company. The hidden costs are responsible for extra costs during the offshoring investment. As such, they affect the extent to which the company can achieve the objective of reducing costs. Specifically, following Larsen et al. (2013), we compute the hidden costs as the difference between the expected and achieved savings (these values are provided through the ORN questionnaire as the percentage of savings in the past year). A positive difference means that the expected savings are higher than the achieved savings and, therefore, that the investment can be regarded as unsuccessful. Vice versa, if the difference is negative, the achieved savings are higher than or equal to expected savings, and, therefore, the investment can be considered successful. The variable *unsuccessful international experience* counts the proportion of former investments with hidden costs higher than zero. In line with Hypothesis 1, we expect a positive relationship between this explicative variable and the misaligned governance mode.

The second explicative variable, *business function international relevance*, is the strategic relevance that a business function has for a firm's internationalization. It is measured as the frequency of past international investments involving the same focal function that is being offshored. According to Hypothesis 2, we expect a positive moderation effect on the relationship between previous unsuccessful international experiences and the misaligned governance mode.

As an additional control, we include *host-country experience*, which is computed as the proportion of previous investments undertaken in the same host country as the focal offshoring investment. This variable accounts for the country-specific experience that can affect the governance choice (and, hence, the extent to which a company misaligns with respect to the theory) by reducing the liability of foreignness.

Table 6 provides the correlation matrix and descriptive statistics for the variables employed in step (I), while Table 7 shows the correlation matrix and the descriptive statistics for the variables adopted in step (II). Given the high correlations between some pairs of variables, such as *business function international relevance* and *host-country experience* in Table 7, we computed the variance inflation factors for Tables 6 and 7. All the values were lower than the threshold of 10 (Hair Jr., Anderson, Tatham, & Black, 1995), which rules out potential multicollinearity problems.

TABLE 6 Correlation matrix and descriptive statistics, step (1)

Variables	1)	2)	3)	4)	5)	6)	7)	8)	9)	10)	11)	12)	13)	14)	15)
1) Outsourcing	1.000														
2) International experience	-0.108	1.000													
3) High-value-added function	-0.035	-0.006	1.000												
4) Cultural distance	0.012	0.110	-0.024	1.000											
5) Host political stability	-0.213	0.094	0.024	-0.214	1.000										
6) Host market attractiveness	-0.056	0.032	0.076	0.105	0.137	1.000									
7) Host low cost of labor	-0.088	0.108	-0.035	-0.014	0.467	-0.028	1.000								
8) Host human resources	0.119	-0.138	-0.057	-0.289	-0.470	-0.263	-0.448	1.000							
9) Market-seeking	-0.255	0.040	0.165	0.028	0.206	0.047	0.182	-0.183	1.000						
10) Efficiency-seeking	-0.094	0.150	-0.054	0.019	0.112	-0.066	0.136	-0.070	0.217	1.000					
11) Human resource-seeking	0.053	-0.095	0.113	-0.083	-0.008	0.086	0.017	-0.006	0.020	0.028	1.000				
12) Company size	0.076	0.146	-0.050	-0.056	-0.238	-0.192	-0.128	0.237	-0.173	0.106	0.032	1.000			
13) Age of the investment	-0.121	-0.174	0.020	-0.045	0.205	-0.082	0.215	-0.028	0.071	0.057	-0.096	-0.009	1.000		
14) Home US	0.213	0.042	0.039	-0.002	-0.358	-0.056	-0.293	0.251	-0.267	-0.094	0.271	0.463	-0.117	1.000	
15) Host India China	0.092	-0.125	0.095	-0.072	-0.544	0.195	-0.663	0.444	-0.130	-0.153	0.059	0.057	-0.156	0.325	1.000
Observations	560	560	560	560	560	560	560	560	560	560	560	560	560	560	560
Mean	0.520	0.584	0.238	2.086	-0.845	0.432	-0.510	0.703	2.518	3.346	3.670	2.068	8.200	0.659	0.471
Std. dev.	0.500	0.493	0.426	1.085	0.984	1.134	0.842	1.368	1.425	1.322	1.223	0.765	4.606	0.474	0.500
Min	0.000	0.000	0.000	0.020	-2.121	-0.685	-1.519	-2.625	1.000	1.000	1.000	1.000	3.000	0.000	0.000
Max	1.000	1.000	1.000	4.835	1.723	6.292	2.738	2.176	5.000	5.000	5.000	3.000	47.000	1.000	1.000

TABLE 7 Correlation matrix and descriptive statistics, step (II)

Variables	1)	2)	3)	4)	5)	6)	7)	8)	9)	10)	11)	12)	13)	14)	15)	16)
1) Misaligned governance mode	1.000															
2) Unsuccessful international experience	0.056	1.000														
3) Business function international relevance	-0.100	-0.042	1.000													
4) Host-country experience	0.137	0.032	-0.520	1.000												
5) High-value-added function	-0.160	0.154	0.001	0.000	1.000											
6) Cultural distance	0.052	0.048	0.115	-0.131	-0.032	1.000										
7) Host political stability	-0.147	-0.076	0.210	-0.360	-0.019	-0.206	1.000									
8) Host market attractiveness	-0.092	0.071	0.000	-0.033	0.121	0.072	0.113	1.000								
9) Host low cost of labor	-0.139	-0.107	0.243	-0.373	-0.064	-0.105	0.433	-0.043	1.000							
10) Host human resources	0.061	0.012	-0.260	0.357	-0.097	-0.256	-0.425	-0.288	-0.399	1.000						
11) Market-seeking	-0.101	-0.097	-0.073	-0.135	0.134	-0.009	0.195	0.043	0.181	-0.155	1.000					
12) Efficiency-seeking	-0.046	0.117	-0.106	-0.134	-0.074	-0.022	0.141	-0.091	0.122	-0.080	0.198	1.000				
13) Human resource-seeking	0.011	0.041	0.096	-0.054	0.123	-0.129	0.031	0.069	0.031	-0.054	-0.080	-0.036	1.000			
14) Company size	-0.001	0.008	-0.152	0.114	-0.015	-0.093	-0.288	-0.194	-0.191	0.291	-0.212	0.038	0.045	1.000		

(Continues)

TABLE 7 (Continued)

Variables	1)	2)	3)	4)	5)	6)	7)	8)	9)	10)	11)	12)	13)	14)	15)	16)
15) Age of the investment	0.010	-0.196	0.109	-0.187	-0.003	0.008	0.196	-0.052	0.166	-0.048	0.153	0.116	-0.162	-0.063	1.000	
Home US	0.143	0.139	-0.092	0.279	0.051	0.030	-0.368	-0.030	-0.336	0.208	-0.395	-0.255	0.315	0.446	-0.274	1.000
Observations	320	320	320	320	320	320	320	320	320	320	320	320	320	320	320	320
Mean	0.402	0.360	0.329	0.249	0.238	2.190	-0.759	0.464	-0.420	0.534	2.588	3.522	3.584	2.178	7.506	0.681
Std. dev.	0.198	0.419	0.377	0.381	0.426	1.146	1.021	1.180	0.870	1.370	1.447	1.259	1.291	0.740	3.569	0.467
Min	0.029	0.000	0.000	0.000	0.000	0.020	-2.121	-0.685	-1.519	-2.625	1.000	1.000	1.000	1.000	3.000	0.000
Max	0.866	1.000	1.000	1.000	1.000	4.835	1.723	6.292	2.672	2.137	5.000	5.000	5.000	3.000	37.000	1.000



For the econometric analysis, we employ a robust Probit model in the first step, with the dependent variable being a dummy. We use a fractional Probit model in the second step, with the dependent variable taking a continuous value ranging from 0 to 1.

## 4 | RESULTS

Table 8 reports the results of the econometric analyses. Model (a) of step (I) confirms that experience plays an important role in the selection of the governance mode, as it is negatively and significantly ( $p < .01$ ) correlated with the dependent variable. The marginal effect shows that firms with at least one previous international experience have a 12.6% lower probability of selecting outsourcing, as expected. We also find that the main control variables explaining the selection of the governance mode are *host political stability* and *market seeking*, both displaying a negative and significant coefficient ( $p < .05$  and  $p < .01$ , respectively). Marginal effects suggest that the probability of choosing outsourcing decreases by approximately 1% when the stability of a country increases by 10%, while it decreases by 0.5% when the propensity to undertake a market-seeking investment increases by 10%. As expected, this indicates that stable political infrastructures and the market-seeking driver are likely to favor the adoption of a captive governance mode (rather than outsourcing). Another result stemming from step (I) is that US firms have a 13% higher likelihood of undertaking outsourcing investments ( $p < .05$ ).

Notably, *high-value-added function*, which accounts for asset specificity, does not seem to affect the selection of a captive versus an outsourcing governance mode in Model (a). Instead, it appears to influence the selection of a misaligned versus an aligned governance mode. Indeed, Model (b) of step (II) shows that *high-value-added function* is negatively correlated with the dependent variable in step II ( $p < .01$ ), which means that when asset specificity is high, firms prefer to comply with the governance mode predicted in step (I). More specifically, the marginal effects show that the probability of misalignment is almost 6% lower when the offshoring involves a high-value-added business function. A similar negative effect arises from *host-market attractiveness*, which is negatively and significantly correlated with the dependent variable ( $p < .01$ ). The marginal effect shows that the probability of misalignment decreases by 0.3% when market attractiveness increases by 10%. Finally, the probability of selecting a misaligned governance mode is 7% higher when the host country is either India or China ( $p < .05$ ). This is likely due to the specific regulations to which firms must adhere when investing in these countries, which decrease the degrees of freedom that firms have in their selection of governance modes.

Regarding the key variables concerning experience, our results show that *unsuccessful international experience* exhibits a positive and significant coefficient ( $p < .05$ ), thus providing support for Hypothesis 1. In addition, the marginal effects show that the probability of misalignment increases by 1% when the intensity of unsuccessful experience increases by 10%. In other words, a shift from one to two negative international experiences in a company might increase the probability of misalignment by about 10%.

*Business function international relevance* exhibits a negative but insignificant sign. Conversely, Model (c) shows that, when introducing the interaction term between *unsuccessful international experience* and *business function international relevance*, the coefficient is positive and significant ( $p < .01$ ). Therefore, when negative performance occurs in those functions that are frequently offshored, the probability of selecting a misaligned governance mode increases. This result confirms Hypothesis 2. To further explore the interaction effect, we plotted the

TABLE 8 Results of econometric analysis: Step (I) (outsourcing), step (II) (misaligned governance mode)

Variables	Step I		Step II		Marginal effect	Marginal effect		
	Equation (1)		Equation (2)				Equation (3)	
	Coefficient	Marginal effect	Coefficient	Marginal effect			Coefficient	Marginal effect
International experience	-.317** (.100)	-0.126** (0.039)	.282* (.119)	0.109* (0.046)	.145 (.101)	0.056 (0.039)		
Unsuccessful international experience			-.076 (.110)	-0.029 (0.042)	-.227* (.096)	-0.088* (0.037)		
Business function international relevance			.027 (.107)	0.011 (0.041)	.032 (.094)	0.012 (0.036)		
Host-country experience					.462** (.138)	0.178** (0.053)		
Unsuccessful international experience*			-.160* (.081)	-0.061* (0.030)	-.174* (.084)	-0.066* (0.031)		
Business function international relevance			.005 (.032)	0.002 (0.012)	.008 (.032)	0.003 (0.012)		
High-value-added functions	.085 (.103)	0.034 (0.041)						
Cultural distance	-0.030 (.087)	-0.012 (0.035)						
Host political stability	-.258* (.112)	-0.103* (0.045)	-.039 (.051)	-0.015 (0.020)	-.038 (.050)	-0.015 (0.019)		
Host market attractiveness	-.036 (.051)	-0.014 (0.020)	-.083** (.020)	-0.032** (0.008)	-.085** (.017)	-0.033** (0.007)		
Host low cost of labor	.015 (.107)	0.006 (0.043)	-.000 (.044)	-0.000 (0.017)	-.004 (.043)	-0.002 (0.016)		
Host human resources	-.038 (.069)	-0.015 (0.027)	-.019 (.023)	-0.007 (0.009)	-.026 (.022)	-0.010 (0.008)		

TABLE 8 (Continued)

Variables	Step I		Step II			
	Equation (1)		Equation (2)		Equation (3)	
	Coefficient	Marginal effect	Coefficient	Marginal effect	Coefficient	Marginal effect
Market-seeking	-.144** (.049)	-0.057** (0.019)	-.019 (.023)	-0.007 (0.009)	-.025 (.021)	-0.010 (0.008)
Efficiency-seeking	-.037 (.046)	-0.015 (0.018)	-.007 (.018)	-0.003 (0.007)	-.007 (.017)	-0.003 (0.007)
Human resource-seeking	.002 (.071)	0.001 (0.028)	.021 (.032)	0.008 (0.012)	.025 (.030)	0.010 (0.012)
Company size	-.127 (.130)	-0.050 (0.052)	.075 (.055)	0.029 (0.021)	.076 (.059)	0.029 (0.023)
Age of the investment	-.028 (.027)	-0.011 (0.011)	.005 (.011)	0.002 (0.004)	.005 (.011)	0.002 (0.004)
Home US	.336* (.160)	0.133* (0.063)	-.050 (.083)	-0.019 (0.032)	-.061 (.078)	-0.024 (0.030)
Host India China	-.239 (.207)	-0.095 (0.082)	.180* (.075)	0.069* (0.029)	.183* (.076)	0.071* (0.029)
Constant	.967 <sup>†</sup> (.587)		-.220 (.248)		-.147 (.242)	
Dummy industries	Yes		Yes		Yes	
Observations	560		320		320	
Chi-Square	649.907**		891.112**		900.143**	

Note: Standard values in brackets.

<sup>†</sup>  $p < .10$ , \* $p < .05$ , \*\* $p < .01$ .

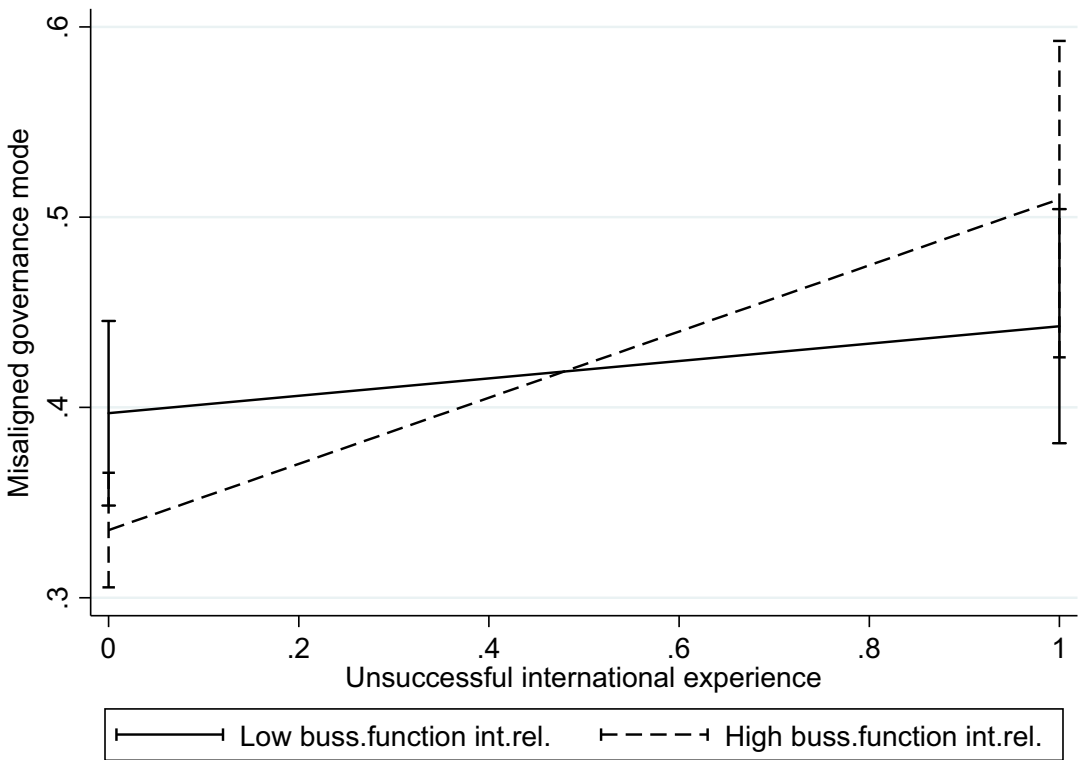


FIGURE 1 Plot of the interaction term of Table 8, Model c

results using the coefficient estimates. Figure 1 confirms that the relationship between *unsuccessful international experience* and *misaligned governance mode* is more positive for high values (i.e., equal to the mean + the standard deviation) of *business function international relevance* than for low values (i.e., equal to the mean – the standard deviation) of the same variable.<sup>7</sup> However, the confidence intervals partially overlap, which means that the probability of adopting a misaligned governance mode in case of previous unsuccessful experience does not strongly differ between business functions with high and low international relevance. To gain further insights, following Karaca-Mandic, Norton, and Dowd (2012), we also compute the cross partial derivatives of the interaction term by comparing the marginal effects of the previous unsuccessful international experiences when the business function's international experiences are extremely high and extremely low. The difference between the two values is .13, which suggests that the change in the predicted conditional probability of adopting a misaligned governance mode because of prior unsuccessful international experience is 13% higher when offshoring a strategic business function that has been repeatedly internationalized than when offshoring a business function for the first time.

#### 4.1 | Robustness checks and additional evidence

We performed a variety of tests to verify the robustness of our results and provide additional evidence. First, we employed two alternative models—an OLS and a Tobit econometric

**TABLE 9** Results of econometric analysis for outsourcing-misaligned governance mode and captive-misaligned governance mode (Step II)

Variables	Outsourcing-misaligned governance mode		Captive-misaligned governance mode	
	Model (a)	Model (b)	Model (a)	Model (b)
	Coefficient	Coefficient	Coefficient	Coefficient
Unsuccessful international experience	.397*	.215	-.017	.001
	(.164)	(.162)	(.207)	(.163)
Business function international relevance	.089	-.113	-.183	-.163
	(.178)	(.223)	(.163)	(.195)
Host-country experience	-.235	-.233	.286*	.284*
	(.170)	(.168)	(.133)	(.133)
Unsuccessful international experience*		.567*		-.070
Business function international relevance		(.282)		(.394)
High-value-added function	-.080	-.098	-.142	-.141
	(.150)	(.152)	(.122)	(.124)
Cultural distance	-.017	-.015	.033	.033
	(.064)	(.063)	(.043)	(.043)
Host political stability	-.069	-.072	.029	.029
	(.093)	(.092)	(.062)	(.062)
Host market attractiveness	-.103	-.106	-.028	-.028
	(.073)	(.067)	(.029)	(.028)
Host low cost of labor	-.013	-.020	.020	.020
	(.099)	(.098)	(.073)	(.073)
Host human resources	.010	.000	-.042	-.041
	(.063)	(.062)	(.041)	(.040)
Market-seeking	-.017	-.024	-.013	-.012
	(.046)	(.045)	(.039)	(.036)
Efficiency-seeking	.049	.050	-.053	-.053
	(.056)	(.053)	(.041)	(.040)
Human resource-seeking	.039	.045	-.014	-.015
	(.068)	(.067)	(.043)	(.042)
Company size	.065	.063	.050	.050
	(.119)	(.120)	(.092)	(.092)
Age of the investment	.022	.022	-.018	-.018
	(.019)	(.020)	(.024)	(.024)
Home US	.012	.008	-.055	-.053
	(.211)	(.204)	(.176)	(.178)
Host India China	.130	.131	.139	.139
	(.181)	(.176)	(.134)	(.134)

(Continues)

TABLE 9 (Continued)

Variables	Outsourcing-misaligned governance mode		Captive-misaligned governance mode	
	Model (a)	Model (b)	Model (a)	Model (b)
	Coefficient	Coefficient	Coefficient	Coefficient
Constant	-1.422** (.469)	-1.328** (.465)	-.296 (.361)	-.306 (.344)
Dummy industries	Yes	Yes	Yes	Yes
Observations	320	320	320	320
Chi-Square	170.992**	192.437**	577.746**	569.221**

Note: Standard values in brackets.

<sup>†</sup> $p < .10$ , \* $p < .05$ , \*\* $p < .01$ .

model—in the second step. The results, which are available upon request, fully confirm our hypotheses.

Second, given the legal restrictions constraining the ways in which firms can enter China and India, we ran a robustness check that excluded observations from these two countries to ensure that our results were not biased by regulatory environments. The results,<sup>8</sup> which are available upon request, confirm both of our hypotheses, although the interaction effect becomes weaker, as the significance of the coefficient is just above the threshold of 10% ( $p < .102$ ) and the marginal effect's significance is 10%.

Third, we computed two variables for misalignment in the second step: *captive-misaligned governance*, which captures the deviation from a captive governance mode; and *outsourcing-misaligned governance mode*, which captures the deviation from an outsourcing governance mode.<sup>9</sup> The results, which are illustrated in Table 9, show that our hypotheses are fully confirmed when using *outsourcing-misaligned governance mode* as the dependent variable, but cannot be verified when using *captive-misaligned governance mode*. In other words, previous unsuccessful experience increases the probability of deviating when the firm should select an outsourcing governance mode, especially when the negative outcome occurred in the business function that is repeatedly offshored. Conversely, when the firm should select a captive governance mode, previous unsuccessful experience does not seem to increase its risk propensity and, hence, the choice of a governance misalignment. Notably, one factor that may be relevant for the probability of misaligning from a captive governance mode is host-country experience, which displays a positive and significant coefficient ( $p < .05$ ).

Finally, we tested the effect of the misaligned governance mode on five measures of performance associated with the focal offshoring investment (all measured on a Likert scale ranging from 1 to 5; source: ORN database): increased productivity/efficiency, better access to new markets, firm growth, product innovation, and overall competitiveness. Specifically, in line with Heckman (1979), we employed a traditional approach in which the governance misalignment arising from the first step was used as an explicative variable in the second step assessing the impact on performance.<sup>10</sup> The results, which are available upon request, show that the effect of the misaligned governance mode is either positively or not significantly correlated with the different performance measures. The only exception is *product innovation*, for which firms report a negative performance effect when deviating from a captive governance mode. Hence, the

governance misalignment does not seem to necessarily be the result of a managerial mistake. Instead, it seems to be a consequence of the accumulation of previous experience, which is likely to prompt either a rational learning process or a behavioral reaction (e.g., a higher risk propensity), for which the effect on performance is not necessarily negative (apart from *product innovation*). In fact, it may even be positive in some cases.

## 5 | DISCUSSION AND CONCLUSION

While the TCE literature classifies the selection of misaligned governance modes as suboptimal and negative for performance, we offer a behavioral perspective on why many MNCs opt for governance modes that deviate from conventional theoretical predictions. To accomplish this, we adopt a PT perspective to explore the role of unsuccessful international experiences in the choice of governance mode. We argue that past failures are more likely to prompt decision-makers to challenge existing wisdom and structures, and thus engage in a search for riskier solutions. As theoretically aligned governance modes can be perceived as a *modus operandi* for firms' international behavior, we argue that theoretically misaligned governance modes can be seen as outcomes that break with existing practices. In addition, we propose that the effect of previous unsuccessful international experience on the probability of choosing misaligned governance modes is amplified when the offshored business function is strategically relevant to the company's internationalization.

Our empirical analyses, which focus on the misaligned governance-mode decisions in the context of business-functions offshoring, confirm our expectations. However, the way in which experience contributes to the governance choice (and misalignment) differs between governance modes. Our additional analyses demonstrate that past unsuccessful international experience only prompts a misalignment from the outsourcing solution—it has no effect when the theoretical prescription is a captive governance mode. One explanation may be that the equity-based governance choice entails substantial upfront investments, making it riskier than outsourcing. In other words, equity-based governance modes are subject to deeper, more articulated considerations, which make them less sensitive to the effects of past failures.

In addition, on the one hand, activities that entail higher transactions costs and, hence, require a captive governance mode are likely to be subject to hold-up and opportunistic behavior if established through (deviating) market solutions. On the other hand, activities associated with lower transaction costs that can be accommodated through outsourcing are likely to incur cost inefficiencies if established through a (deviating) captive solution (Elia et al., 2019). Therefore, decision-makers may, on average, be more concerned about the potential loss of intellectual property that may occur when deviating from captive solutions than about the potential loss of efficiency that may occur when deviating from outsourcing. Consequently, managers are likely to be less motivated to deviate when the predicted governance mode is captive than when the predicted governance mode is outsourcing. More generally, this may suggest that decision-makers suffer from a “loss-aversion bias” that prompts them to avoid risks of potential losses rather than to search for potential gains (Tversky & Kahneman, 1981). When the predicted governance mode is hierarchy, the higher risk propensity arising from past negative experiences is offset by the stronger loss-aversion bias associated with a deviation from a captive governance mode. Our additional analyses indicate that

the probability of misalignment from a captive governance mode increases with host-country experience. One explanation may be that decision-makers are more confident in adopting riskier behavior when offshoring through captive solutions if they have gained knowledge about the local environment. Future studies could investigate the dynamics associated with the equity-based and non-equity-based solutions (including partnerships) to better understand the role of experience in explaining the choice of adopting several types of governance-mode misalignments as well as the interplay with other behavioral aspects associated with each governance mode (e.g., the loss-aversion bias that arises in captive solutions).

## 5.1 | Theoretical contributions

With this research, we claim three main contributions to the extant literature on governance modes. First, we suggest that besides the conventionally held antecedents of governance modes embedded in traditional organizational economics logics (such as TCE), past performance may explain why some firms are more inclined to select international governance modes that confirm the theoretical expectations. As such, we offer a behavioral perspective on the consequences of prior experience (e.g., Buckley et al., 2007; Maitland & Sammartino, 2015; Surdu et al., 2021) by showing that unsuccessful experience triggers misaligned governance-mode choices, especially when those experiences occur in business functions that are crucial for a firm's internationalization. In so doing, we complement the quasi-rational economic approach that has traditionally been employed in the international business literature to explain strategic decisions (Maitland & Sammartino, 2015; Surdu et al., 2021). We adopt a managerial-cognition perspective that views the decision-maker as boundedly rational and, hence, responsible for the heterogeneity that we observe in firm-level internationalization.

As such, our results are in line with PT research in which low-performing firms tend to adopt discontinuous behaviors and be more risk-assertive, while high-performing firms tend to align with the standard internationalization models and be more risk-averse (Aharoni, 2010; Fiegenbaum et al., 1996; Kahneman & Tversky, 1979; Shoham & Fiegenbaum, 2002). Our approach, which emphasizes the relationship between previous experience and risk propensity in the governance-mode choice, is complementary to other recent contributions showing that governance experience can be a source of multiple types of learning (Albertoni et al., 2019) or cognitive bias (Elia et al., 2019) that affect governance- (or entry-) mode misalignment. Therefore, future research could investigate how various types of experiences prompt decision-makers to search for new solutions when making governance-mode decisions, including intermediate equity ownership and joint ventures. Simultaneously, it would be worthwhile to investigate other drivers, as our results suggest that some transaction-cost variables (e.g., the high value-added of the offshored function) affect the decision of whether to adopt a misaligned governance mode.

Second, while the extant research pinpoints the performance-deteriorating consequences of misaligned decisions, we contribute by arguing that firms may select such modes of governance in order to break with existing practices and routines. We acknowledge that much of the extant research shows that misaligned governance modes are associated with suboptimal performance (Brouthers, 2002). However, our additional analyses indicate that misaligned governance modes are not always associated with a decrease of performance, which allows us to suggest that the relationship between firms' prior experience and the choice of a theoretically aligned



governance mode is not straightforward. A failure to account for this influence may affect interpretations of subsequent performance effects. More specifically, by showing that several types of experience can trigger different risk-taking approaches to the governance-mode choice, we contribute to the literature that explains how the multifaceted nature of experience affects international business strategies by shaping risk attitudes (e.g., Buckley et al., 2016; Jiménez et al., 2018). In addition, our PT perspective on the governance-mode choice complements the TCE approach, which predominantly emphasizes the role of experience as a source of information and learning that decreases uncertainty and opportunism (e.g., Brouthers et al., 2003; Walker & Weber, 1984). We invite future research to study additional contingencies and behavioral facets of the relationship between experience and theoretically misaligned governance modes, and to further investigate their performance implications.

Third, as shown by Buckley et al. (2007) for location choices, we provide evidence that the governance-mode choice may be a result of decision-making procedures arising from the combination of the traditional “calculative and economics-based” with the “behavioral- and managerial-based” models. More specifically, we show that the latter does not necessarily serve as a substitute for the former when firms gain experience, as the governance mode can fit the theoretical predictions even when firms benefit from learning and acculturation processes arising from previous offshoring investments, as in the case of successful experiences. As such, we contribute by emphasizing that not only location choice, but also governance-mode choice requires a deeper understanding of the complex (rational and less rational) mechanisms that decision-makers employ. In this sense, our results offer some insights into post-entry changes in foreign operation modes, which are examined in two main research streams—the economic/strategic and the behavioral/process approaches (Putzhammer et al., 2020). While the former considers changes in the governance mode as a result of substantial alterations in the external or internal environment compared with the initial situation for a single operation, the latter emphasizes the role of constructs such as experience and risk perception and their evolution during a longitudinal internationalization process. We believe that a mixed approach can help us understand not only the choice of governance mode, but also the changes in that mode. To the best of our knowledge, no empirical study has analyzed this topic from both an economic and a process point of view, although a compelling theoretical framework for analyzing this phenomenon from these two perspectives has been provided by Petersen, Welch, and Benito (2010).

## 5.2 | Practical implications

Our study also has important managerial implications. While we have shown that governance misalignment is not always associated with a decrease in performance, other studies emphasize this risk. Therefore, we encourage managers who have faced prior negative outcomes to carefully consider their decision to misalign before implementing a governance-mode choice. This is particularly important when the transaction costs are high—that is, when the firms should adopt a captive governance mode—as a deviation from this prescribed choice might imply a loss of core knowledge and strategic intellectual property that could erode the firm’s competitive advantage and, hence, its long-term financial performance. Overall, we show that managers should be aware that their decision-making processes can be affected by their behavioral reactions to past negative experiences.

### 5.3 | Limitations and future research

Our paper is not exempt from limitations, which represent additional opportunities for future research. First, our sample includes a limited number of home countries and includes India and China as host countries. In addition, our sample refers to the offshoring of business functions, while it excludes manufacturing initiatives. Although we control for industry, function, and home- and host-country fixed effects, and although our main results are also confirmed after removing ventures from India and China, we invite future studies to extend our analysis by including other countries and industries, and by better disentangling their contingent effects. Second, our ex-post analyses on the performance effects of governance misalignment rely on subjective measures. Future studies could consider more objective measures of performance in order to confirm our finding that, on average, governance misalignment is not associated with performance-deteriorating consequences. Third, our analyses use dummies to account for the transaction costs associated with the governance mode. We invite future studies to introduce more fine-grained constructs to increase the robustness of the measure that we adopted to capture the misalignment from a governance mode based on TCE. Finally, future studies could complement our firm-level perspective with an individual-level analysis to investigate the interplay between the experiences of the managers and of the organization in determining the risk propensity of the decision makers and, hence, the probability of opting for governance-mode misalignment.

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#### ENDNOTES

- <sup>1</sup> The countries involved in the ORN network are Australia, Belgium, Brazil, China, Denmark, Germany, France, Italy, Japan, Korea, the Netherlands, Spain, and the United Kingdom. Each partner was responsible for collecting data on the offshoring of business functions in their own country and for sharing that data with the other members of the network, thus contributing to the ORN database.
- <sup>2</sup> The combination of the ORN survey with external databases allow us to limit common method bias (see Chang, van Witteloostuijn, & Eden, 2010).
- <sup>3</sup> In line with this classification, we identified engineering services, product design, and R&D as high-value-added functions.
- <sup>4</sup> These items are masculinity, individualism, collectivism, and uncertainty avoidance.
- <sup>5</sup> The original items of this variable display high values when labor costs are high. Therefore, we reverse-coded the items before the factor analysis by giving the scores a negative sign. Therefore, the resulting *low cost of labor* variable associates high values with countries with low labor costs.
- <sup>6</sup> The Eurostat-OECD (2007) classification identifies the following categories: knowledge intensive high-tech services, knowledge intensive market services, knowledge intensive financial services, other knowledge intensive services, less knowledge intensive market services, other less knowledge intensive services, high tech manufacturing industries, medium-high tech industries, medium-low tech manufacturing industries, and low-tech manufacturing industries. We used the dummy accounting for high-tech manufacturing industries as the benchmark, while we dropped the dummies accounting for other less-knowledge-intensive services and for low-tech manufacturing industries due to collinearity.
- <sup>7</sup> The mean + standard deviation corresponded to about 0.7, which means that we considered the case in which the business function was offshored in at least 70% of past cases. Conversely, the mean – standard deviation corresponded to about 0.0, which means that we considered the case in which the business function was offshored for the first time.

- <sup>8</sup> The numbers of available observations after excluding the offshoring initiatives occurring in China and India were 296 in the first step and 188 in the second step. The dummy *host India China* was not included in these regressions.
- <sup>9</sup> In line with Elia et al. (2014), we computed captive-governance misalignment as a continuous variable (ranging from 0 to 1) equal to  $\Phi$  when the selected governance mode was captive and 0 when it was outsourcing. Conversely, the outsourcing governance misalignment was computed as  $1 - \Phi$  when the selected governance mode was outsourcing, and 0 when it was captive (where  $\Phi$  is defined as the standard normal cumulative distribution function).
- <sup>10</sup> In the second step, we employed the same control variables as in the first step except for experience. While this variable was employed as a dummy in the first step (thus capturing firms having or not having experience), we used a count variable capturing the total amount of previous international experiences in the second step. Thus, we employed the dummy variable accounting for experienced firms as an exclusion restriction in the first step, while we introduced a variable counting the number of previous experiences in the second step. In line with Leiblein et al. (2002), in the second step we divided the observations of the first step in two subsamples—those reflecting the choice of a captive governance mode and those reflecting the choice of an outsourcing governance mode—and we assessed the effect of misalignment on each performance measure across the two subsamples.

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