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Cultural Distance and Corporate Internationalization: Evidence from Emerging Economies

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Abstract

This study investigates the relationship between cultural distance and entry mode choice, where the foreign investor firm and the host country are both from emergent economies. Within this framework, research is limited and the issue is whether companies, regardless of their specific situations, have the same strategy when they meet a high degree of uncertainty in the host environment. In this study, we focused on the influence of informal institutional factors: cultural distance, that has been extensively analyzed in international business, measured by Kogut and Singh index and defined according to Hofstede, Globe Project and Schwartz approaches. The general trend derived from prior research proves that when a company from a developed country is involved; overall more enthusiasm is shown for wholly-owned subsidiaries rather than joint venture. This result still stands validated for corporations from this emergent economy area. Our analysis of a sample of 163 FDI in the Kingdom of Saudi Arabia (KSA) using logistic binary regression model reveals that the foreign firms prefer to establish wholly-owned subsidiaries in the host country over entering into a joint venture with a local firm, taking into consideration the large cultural distance.

Keywords: Cultural Distance, Entry Mode, Emergent Economies

JEL Classification Code: F23, F55, L25, M16, N45

1. Introduction

Culture is defined as a genetic informational basis of society, or a static set of values, habits, practices, knowledge, belief, art, morals, law, and any other capabilities gained by man as a member of society. For anthropologists, it represents a set of symbolic systems (i.e., language, matrimonial rules, economic relations, art, science, and religion). In last decades, Hofstede builds an evolutive model in four dimensions used in many studies to estimate the cultural distance (CD) between the home and host countries (Barkema & Vermeulen, 1997; Brouthers & Brouthers, 2001; Gatignon & Anderson, 1988; Kogut & Singh, 1988; Meschi & Riccio, 2008; Park & Ungson, 1997). Cultural distance is used to respond to some management problems, as entry mode choice decision to be taken is whether to share the ownership of such an affiliate with other firms (JV) or to maintain full ownership (WOS). International business literature analyzes the role that culture plays in this choice and shows an inconclusive determinism (Brouthers & Brouthers, 2001). Our contribution is to analyze the influence of cultural distance in a new context using more than proxy; the study explores an extended literature review of culture and measures the impact on entry mode choices in the unexplored field, emergent countries (Dnishev & Alzhanova, 2016; Dzung, Tuan, & Tinh, 2017; Erum, Hussain, & Yousaf, 2016; Zaabi, 2010).

2. Theory and Hypotheses Development

2.1. Hofstede's Framework

Through an international investigation conducted between 1967 and 1978 in IBM subsidiaries, Hofstede (1984) attempts to describe the behavior patterns of various national groups in four areas

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1. The relation to authority
2. The relationship between the individual and the group
3. The social implications of belonging to a sex category
4. The attitude toward uncertainty and risk

These axes represent the background of Hofstede's cultural dimensions, which are respectively: power distance, individualism vs masculinity, and uncertainty avoidance. By tradition, international management literature has used the theory of cultural distance developed by Hofstede (1984) to measure the dissimilarities between cultures using the index of Kogut and Singh (1988). Hofstede defines culture as a set of collective mental programs shared by members of a group. Culture, therefore, is what distinguishes one group from another. Two extra dimensions, namely, long-term orientation and indulgence versus restraint, have been identified and measured in consecutive studies (Hofstede & Bond, 1988; Hofstede & Minkov, 2010).

2.1.1. Power Distance

Inequalities exist in societies in several areas: physical and mental characteristics, social status, wealth, power, laws, rights, etc. The study will look upon the unequal distribution of power in organizations. This approach will be adopted for cultural differences across nations. According to Hofstede (1984), the unequal distribution of power among employees is the essence of the organization. It is inevitable and functional. It comes from the hierarchical relationship between managers and subordinates. At the organizational level, Hofstede distinguishes two kinds of hierarchical relations: the first, a relationship characterized by objective elements, such as the expertise of both parties and their history at work. The second, a relationship is characterized by subjective elements that depend on the mental program of both parties and the psychological effect that one has on the other (mental program includes values and personality influenced, in turn, by social norms). Hofstede and Bond (1988) argue that inequality in society is endorsed by those in positions of followers, not by leaders. To estimate quantitatively the power distance, Hofstede developed a power distance index (PDI), which represents the arithmetic average of scores of three items in the HERMES questionnaire, namely, the perception of leader's decision-making, the perception of subordinates' anxiety during a disagreement with their superiors, and decisions preferred by employees.

The first dimension is a proxy to measure the differences between national cultures. Relations between individuals are characterized by power, and every culture has a specific acceptance. The power distance can be defined as the acceptance of an unequal distribution of power in institutions and organizations. Institutions are the fundamental elements of society, namely, family, school, and the community, and organizations mean the different workplaces. High PDI means that society is very stratified. Besides, decision-making is centralized by autocratic leaders (Hofstede, 1984).

2.1.2. Uncertainty Avoidance

People are similar in recognizing the existence of uncertainty, but different in how they deal with it. Uncertainty is the extent to which individuals feel threatened by uncertain situations. Members of a culture seek to reduce it by imposing rules, technology, law, and systems. For instance, they use technology to reduce the uncertainties caused by nature and they use law, to control individuals' behavior. People need to structure systems to maintain order and coherence in society. The existence of only a small number of rules and procedures indicates a high level of uncertainty avoidance (Hofstede & Bond, 1988).

2.1.3. Individualism vs Collectivism

Behavior vis-a-vis the group varies from one nation to another. Individualism means that members of society are more willing to act as individuals rather than as members of a group. Collectivism, on the contrary, is when people prefer to act in the interest of the group. A high score on the scale of individualism shows that greater value is placed on individual objectives than on looking after the group's interest. Collectivist societies are traditional. In these societies, individuals attempt to respect the group's values and engage themselves in actions that undervalue self-interest and serve the group's interest.

2.1.4. Masculinity vs Femininity

Hofstede and Waquet (1994) distinguish between two types of culture related to gender: male and female culture. In the male-dominated societies, there is a focus on values traditionally associated with the masculine role (e.g., competition, success, wealth, ambition, and performance goal orientation) where the roles of men and women are clearly distinguished, men must be strong, decision-maker and interested in material success, while women are supposed to be modest, tender, and concerned with the quality of life. On the contrary, in female-dominated societies, there exists stress on relationships, life skills, and, in social performance their roles are indistinguishable (Both men and women are expected to be modest, tender, and concerned about the quality of life) (Hofstede & Waquet, 1994). Therefore, the importance placed on materialism and authoritarian style are the measures of masculinity as opposed to interpersonal relationships and general quality of life.

2.1.5. Other Dimensions

Hofstede's studies attribute scores for each dimension of culture in forty countries. In 1983, Hofstede's method was generalized by its application in fifty-three countries. Though Hofstede's research represents the fundamental theoretical background of culture in international business, it remained incomplete. Some authors believe that cultures converge and, therefore, dimensions will not be stable over time (Barkema & Vermeulen, 1997; O'Reilly III, Chatman, & Caldwell, 1991). Hofstede and Bond (1988) tested a questionnaire developed by Chinese sociologists. They discovered another dimension called "Confucian dynamism" that influences uncertainty avoidance, masculinity, power distance, and individualism. This new dimension emerged as a result of the interaction between eastern and western attitudes. The principles of Confucian doctrine are founded by King Fu Se from ethical practices and pragmatic rules of a daily routine without religious content (Hofstede & Bond, 1988). Confucianism synthesizes four items – stability of a society is based on unequal relationships between individuals; family is the perfect model of all social organization; and the relationship between individuals is based on mutual respect. Also, the golden rule is that one should not treat others in a way that one would not like to be treated by others, and the virtue of work is to endeavor to acquire skills and education; and work rigorously, be patient and persevere.

Yeh and Lawrence (1995) believe that the Confucian dynamic and individualism are two sides of the same coin, highly correlated, and explaining the same phenomenon. Hofstede and the Chinese researchers have named the new concept "long-term orientation". The Confucian dimension stands for fostering virtues oriented towards future rewards, particularly perseverance and thrift. On the contrary, short-term orientation stands for the fostering virtues related to the past and present, which expresses the importance that an individual attaches to the future. We distinguish two kinds of subsequent behavior; first, an individual is loyal to tradition and has a static mentality oriented towards the past; second is that of a dynamic person and endowed with a mentality turned to the future (Hofstede & Bond, 1988).

Recently, Hofstede found a sixth dimension related to indulgence and restraint behavior. Indulgence represents a tendency to allow the relatively free gratification of basic and natural human desires associated with enjoying life and having fun. Restraint reflects the belief that such gratification must be regulated by strict social standards.

2.2. GLOBE's Project Approach

The GLOBE project (House et al., 2004) analyzes cultural differences, considering the differences that exist between groups in the same country. Every region may have its own language, values, religion, and traditions. Based on an investigation conducted in 61 countries, the GLOBE project studies, in particular, the role of leadership in organizations and societies. In the same way, like Hofstede's studies, the GLOBE project measures nine attributes or cultural dimensions of both societal and organizational cultures, namely, assertiveness, institutional collectivism, in-group collectivism, future orientation, gender egalitarianism, humane orientation, performance orientation, power distance, and uncertainty avoidance.

– Power Distance: The degree to which the people of a culture accept the unequal distribution of power by group members.
– In-Group Collectivism: The degree to which individuals express loyalty and cohesion with their organizations or families.
– Institutional Collectivism: It refers to institutions' practices that aim to encourage collective rewards, collective distribution of rewards, and collective action. Individual interest does not prevail over collective interest.
– Uncertainty Avoidance: The degree to which a group relies on social norms, laws, and rules to face unknown situations.
– Gender Egalitarianism: It refers to the degree of minimization of gender inequalities.
– Assertiveness: It is the degree to which societies promote competitiveness among individuals, a high level of assertiveness in individuals reflects an aggressive attitude in their relationships with others.
– Humane Orientation: The degree to which group encourages generosity, kindness, attention, and fairness towards others.
– Performance Orientation: The degree to which groups encourage and reward members for performance improvement and excellence.
– Future Orientation: It reflects the degree of commitment of individuals to future-oriented behaviors.

2.3. Schwartz's Approach

Schwartz (1999) analyzed three main issues or values shared by all societies: the individual-group relationship, individuals' responsible social behavior, and the relationship between humankind and the natural and social worlds. Based on these typologies, Schwartz identifies, just as Hofstede and the GLOBE project did, three bipolar dimensions, namely, embeddedness/autonomy, hierarchy/egalitarianism, and mastery/harmony.

2.3.1. Embeddedness versus Autonomy

The embeddedness/autonomy dimension concerns the relationship between the individual and the group. It draws the border between the individual and the group. The first pole of this dimension, embeddedness, perceives the individual as an entity integrated into the group, and shares the group's way of life. On the other side, autonomy represents a cultural emphasis on the individual's independence and highlights the value of autonomy and personal uniqueness.

2.3.2. Hierarchy versus Egalitarian Engagement

The hierarchy/egalitarianism dimension refers to the extent of guarantee of responsible behavior of individuals to bring about social coherency. Hierarchy is a system of unequal distribution of power and ascribes roles to individuals. This system supports social power, authority, humility, and obedience. Egalitarian cultures encourage recognition of the other as an equal sharing the same basic interests as all human beings, a system that encourages individuals to voluntarily cooperate with others and recognize them as moral equals. This system supports equality, social justice, responsibility, and honesty.

The mastery/harmony dimension concerns the relationship between humanity and the natural and social world. The culture of harmony refers to individuals' interest in accepting the world as it is and the extent to which people try to accept the system rather than change it. In contrast, harmony refers to individuals' interest in accepting the world as it is and their desire to fit in the natural and social environment, rather than changing or exploiting it.

3. Joint Venture and Culture Differences in Literature

Franko (1971) studied the key factors influencing JV performance. He examined a set of variables, including cultural differences. Subsequent research examined almost the same variables: country risk (Meschi & Riccio, 2008); intangible assets, experience in local markets, size and ages of JVs (Delios & Beamish, 2001); experience in foreign markets, the position of the JV activity compared to the parent and parent size (Hennart et al., 1998); cultural differences and culture dimensions (Barkema & Vermeulin, 1997); sales, horizontal or vertical integration and growth rate (Leung, 1997); competition between partners, the difference in activity between the parent company and the JV, and technology transfer (Ungson et al., 1997); competitiveness (Park & Russo, 1996); relations with other partners, suppliers, JV and licenses, research and development, production, marketing, and industry growth (Kogut, 1989). JVs considered in each of these studies were with corporations based in developed countries however studies concerning JVs between entities from two developing countries are rare. Meschi, (2004) and Leung (1997) examined in this context respectively the effect of country risk and the longevity between JV and acquisitions. Culture remains a fundamental subject of research either context because there are as many cultures as nations, even more, if we count subcultures in the same country. In the context of foreign investment in emerging markets, the emphasis seems likely to be on business environment, particularly cultural differences (Meschi, 2002). We hypothesize that when cultural distance is large, foreign company will choose WOS over JV.

4. Variable of the Study

The dependent variable is the entry mode choice of foreign investors, from developing countries or as mentioned in the title from countries belonging to the south economic area, in KSA. This is a dummy variable that takes a value of 1 if foreign investors establish JV and 0 for WOS. Table 1 presents the means, the standard deviations and the partial correlations of the variables used in our analysis.

4.1. Dependent Variable

The dependent variable is the entry mode choice of foreign investors, from developing countries or as mentioned in the title from countries belonging to the south economic area, in KSA. This is a dummy variable that takes the value of 1 if foreign investors establish JV and 0 for WOS. Table 1 presents the arithmetic means, the standard deviations, and the partial correlations of the variables used in our analysis.

4.2. Independent Variables

Cultural distance: The current study uses the Hofstede's model (Hofstede & Minkov, 2010) because they are universally accepted ratings and have been used in various previous studies. This variable was operationalized by Kogut and Singh (1988) index, which has been extensively used in research (Barkema, Shenkar, Vermeulen, & Bell, 1997; Barkema & Vermeulen, 1997; Brouthers & Brouthers, 2001; Elmoez, 2018; Hennart & Zeng, 2002; Kogut & Singh, 1988; Makino, Chan, Isobe, & Beamish, 2007; Meschi & Riccio, 2008; Park & Ungson, 1997). A high score on this measurement means a greater cultural distance between the partners.

$$\mathrm{CD}_j = \sum \left\{ \left(I_{ij} - I_{iv} \right) 2V_i \right\} / (6)$$

Where:

CD_j: is the cultural distance of the j$^{\text{th}}$ country from the KSA

I_{ij}: is country j's score on the ith cultural dimension,

I_{is}: is the score of the KSA V_i : variance index of dimension i

I_{ij}: index of cultural dimension i for country j

Table 1: Sample of JVs by Country Between 2007 and January 2017 in KSA

N	Country of Origin of the Overseas Investor	No: of firms	Cultural Distance Hofstede	Cultural Distance GLOBE Project-Practice	Cultural Distance GLOBE Project-Value	Cultural Distance
1	India	31	3.50	1.56	0.85	3.27
2	Russia	6	4.13	2.60	3.467	3.23
3	Indonesia	10	2.37	0.83	0.42	1.11
4	China	36	3.61	2.23	0.61	5.38
5	Turkey	7	2.58	2.84	2.58	5.07
6	Egypt	41	4.21	0.23	0.16	0.19
7	Brazil	5	2.63	3.39	2.52	4.19
9	Philippines	11	1.29	2.15	2.173	1.02
10	Malaysia	16	0.93	1.06	1.38	0.92
Total		163				

4.3. Control Variables

The duration (Dur): The foreign firm's pre-entry experience in terms of the number of years the foreign company has operated in the KSA is considered as the duration. The effect of the cultural distance seems to be limited and diminished by time. Firm learns about the functioning of the foreign market, culture, habits, network behavior, and overcome the handicap of newness as a liability. It can be expected that when the investment duration is long, the likelihood of investors will choosing WOS over forming JV increases (Kuo et al., 2012).

Size (size): An empirical estimation assumes that size affects the profitability and the performance of the firm so it can normally be used as a control variable (Barkema & Vermeulen, 1997; Brouthers & Bamossy, 2006; Luo, 2007). In this research, size is measured as the logarithm of the capital invested in the JVs.

Sector (sec): Literature normally uses the sector as a control variable. The main sectors in which FDI is made in the KSA are services and manufacturing. We employ a dummy variable that takes the value 1 for the JV in the service sector and 0 for the JV in the manufacturing sector.

5. Statistic Method

As described before, we use the logistic binary regression model to examine the effects of cultural distance between the KSA and investing countries on the entry mode selection by FDI firms. The logit model seems to be an appropriate statistical technique for analyzing dichotomous data. These analyses and all the tests are carried out using the statistics software SPSS 15.

6. Results and Discussion

Table 2 shows the correlation matrix for all the variables selected in the model. Therefore, our sample ($N = 163$) does not cover all variable modalities. Only the 4-dimension model of Hofstede was taken into consideration. The correlation matrix presents a weak correlation between variables ($r < 0.7$). However, a relatively strong correlation is observed between the Schwartz framework and the practical version of the GLOBE project (0.830); the two models reflect similar aspects of national culture and will be tested separately in different models.

Table 3 presents the different analyses of logistic regressions carried out on several models to examine the impact of national culture on the entry mode choice. Different models corresponding to each cultural framework considered in our research are tested. The first model relates to the cultural framework of Hofstede, the second and the third corresponds to the practical and value versions of the GLOBE project and, finally, the fourth model correspond with the cultural framework of Schwartz.

In terms of the effect of control variables, as shown in Table 2, the coefficient of duration variable is positive and significant at level 1% with the entry mode choice in all models. This leads us to conclude that foreign investors would be more likely to choose JV over WOS. This result can be explained by the characteristics of business environment in developing countries. The investor needs support to overcome myopia and to bring solutions to problems related to commercial disputes between investors and their public or private opponents, bureaucracy, insufficiency of information and data, and marketing facilities. Therefore, opting for JV signifies a fundamental need for a local partner. Also, the local partner interacts more intensively and extensively with the domestic environment, which can help to reduce the risks related to changes in the domestic business environment and explore the business potential. However, when the project is export-oriented, the contributions of local companies will become less important, so the foreign company will choose WOS over JV. In the future research, putting in the accounting the integration process of the KSA to WTO as a control variable would be interesting. Hazard related to the business environment will be reduced by new local regulations and international agreements, especially with the setting of the new vision 20–30. The KSA has great socio-economic achievements and creates a favorable business environment for domestic and foreign investors. Favorable changes in the investment environment may make the foreign investors feel more secure and select WOS over JV.

Our fundamental hypothesis concerning foreign investment in the context of south-south relations or cooperation between a partner from one of the emerging countries is that the foreign investors is more likely to choose WOS than JV as the entry mode. As Table 3 shows, all coefficients of cultural distance are negative and significant for all cultural frameworks. In models M2, M3 and M4, the framework of GLOBE with two versions and Schwarz framework, the relation is significant at level 5% ($p < 0.05$), whereas it is significant at level 10% ($p < 0.05$) for Hofstede framework. Therefore, our hypothesis that when cultural differences increase the probability of selecting WOS increases, too, for all culture frames is supported.

Table 2: Mean, Standard Deviation, and Correlation (n = 163)

			Matrix of Correlations							
	M	**SD**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**
CDH	1.9035	0.5546	1							
CDG-p	1.4810	0.9102	0.047	1						
CDG-V	0.96298	0.86309	–0.086	0.682**	1					
CDSH	2.5821	2.0558	0.324**	0.830**	0.224**	1				
Dur	6.7505	2.7975	0.235**	–0.243**	–0.481**	0.032	1			
Size	13.8567	1.5304	–0.124	0.088	0.146	–0.027	–0.175*	1		
Sector	0.1288	0.3360	0.151	–0.115	–0.069	–0.108	0.112	0.359**	1	
Entry	0.6135	0.4884	–0.079	–0.316**	–0.396**	–0.196*	0.423**	–0.074	0.080	1

Table 3: The Effect of Cultural Distance on the Entry Mode Choice of Foreign Firms Investing the KSA (Logistic Regressions)

	M1	**M2**	**M3**	**M4**
CDH	–0.974*			
CDGP		–0.677**		
CDGV			–0.698**	
CDSH				–0.286**
Size	–0.089	–0.001	0.005	–0.031
Dur	0.400***	0.321***	0.255***	0.380***
Sector	–0.700	–0.070	–0.208	–0.075
N	163	163	163	163
Wald chi–square (Prob. > chi–square)	178.747	176.638	178.078	177.122
Khi–square	38.746	40.810	39.414	40,321
Prob	0.000	0.000	0.000	0.000
%correct	74.2	72.4	72.4	69,3

*p ≤ 0,1 **p ≤ 0, 05 ***p ≤ 0, 01.

Our findings suggest that the cultural distance between the home country and the emergent host country or a country from the southern economic zone is an important factor to consider. The business environment in this context embodies a high level of uncertainty, the same result is found in the context of foreign investment in developing countries. Uncertainty, as a component of the informal environment in the institutional theory, has the same impact on developing and developed countries even in north-south or south-south context. It makes companies seem to be less committed and opting for a more flexible method of reconciliation. Consistent with the logic of minimizing uncertainty, our results confirm that a negative relationship between national cultures and level of participation and the choice of the entry mode (Brouthers & Brouthers, 2001; Majocchi et al., 2013). The finding is consistent also with transaction cost theory, which emphasizes that the mode of entry selected by a foreign investor is affected by a desire to minimize the transaction costs (Anderson & Gatignon, 1986). These transaction costs include the cost of drafting contracts, negotiating with business partners, and monitoring the partner (Luo, 2007). When the transaction costs are high, firms are more likely to select WOS as an entry mode because it enables them to operate independently and avoid opportunistic behavior by their local partners.

In the context of FDI in the KSA, it is shown that a strong national culture is more positively associated with the choice of WOS as the entry mode rather than with JV. JV is too risky an arrangement and has many disadvantages, such as lack of flexibility and many companies in JVs end up in litigation. Besides, prior studies identify, as we pointed out earlier, the problem of joint management since JV is formed between partners of diverse cultural backgrounds. Culturally distant partners incur a higher level of management complexity (Barkema & Vermeulen, 1997; Makino & Beamish, 1998; Parkhe, 1991) at the corporate level. Cultural distance creates a divergence in various organizational systems and processes such as communication, trust, formal vs informal control mechanisms, power-sharing, and decision making. Besides, culture could also be a determinant of the risk-bearing propensity of the partners. Thus, cultural asymmetries could lead to divergence in operational and managerial processes and cause instability. Likewise, differences could arise from asymmetries in size, scope, and experience of the JV partners. The more such asymmetries, the more imbalances in power and control would emerge and create instability. Studies have proposed and tested that differences in the cultural backgrounds of the partners and how they affect the performance negatively (Barkema & Vermeulen, 1997; Kogut & Singh, 1988; Shenkar & Zeira, 1992)

To conclude, the findings in our research contribute to a general understanding of the entry mode selection in the case of bilateral relations between companies from the same economic area. Cultural distance is a threat that manager must consider. Prior studies in the context of north-north and north-south partnerships have produced conflicting results (Brouthers & Brouthers, 2001). A possible reason could be how large the cultural distance is and other such circumstances as the size of the foreign investor, the size of the investment, the confidence that the foreign investor has in the ability to handle the selected entry mode and the economics of each mode, etc. The entry mode decisions appear to be influenced by cultural distance only if the target market is risky). Our results are in line with some prior investigations that reported a traditional negative impact of cultural distance, but without interaction with other variables such economic, financial and political risks (Brouthers & Brouthers, 2001; Meschi, 2004). Further studies may enrich the concept of cultural distance and inquire, which components of national culture are critical for determining the strategic decision of entry mode as Barkema and Vermeulen (1997) did when they empirically demonstrate that uncertainty avoidance and long-term orientation negatively affect survival, whereas power distance and individualism do not.

7. Conclusion

In this study, we focused on the influence of informal institutional factors that have been extensively analyzed in international business – cultural distance. As reported above, the general trend derived from prior research is that when a company from a developed-country is involved, it shows more enthusiasm for WOS rather than JV. This result still stands validated for corporations from emergent economy area. Accurately, cultural distance discourages FDI to be mobilized from and between emerging countries. Finally, for more generalizability, future studies should replicate our analysis with a dataset involving other FDI flows, considering other variables specific to the environment and the firm, and refine the concept of cultural distance to deepen our understanding of whether a firm from an emergent economy would show the same behavior when facing a high level of cultural distance in foreign countries as that from a developed economy. This topic is yet to be explored.

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