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The impact of home–host cultural distance on foreign affiliate sales: The moderating role of cultural variation within host countries

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ABSTRACT

Research on how multinational firms deal with home–host cultural differences argues that cultural differences are minimized and assumes that foreign cultures are homogenous. In this paper we relax the cultural homogeneity assumption. In the presence of cultural variation in host countries the minimization of cultural differences leads existing mean-based indices of cultural differences to overestimate the actual cultural differences these firms have to deal with. We test this argument in a 25-year panel analysis of total US multinationals' foreign sales in 54 host countries. At the sample average of cultural variation, the use of mean cultural difference indices yields a 74% overestimate of the actual cultural difference effect. This suggests that home–host cultural differences are a substantially smaller barrier to multinational sales than hitherto assumed. The assumption of cultural homogeneity leads to conclusions in which a too large role is attributed to cultural differences.

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1. Introduction

Cultural differences affect the foreign operations of multinational enterprises (MNEs). A greater cultural distance lowers the performance of MNEs' foreign affiliates (e.g. Barkema, Bell, & Pennings, 1996; Benito, 1997; Craig, Greene, & Douglas, 2005; Li & Guisinger, 1991), the likelihood that they establish such affiliates (e.g. Flores & Aguilera, 2007; Li & Guisinger, 1992), and the amount they invest in them (e.g. Loree & Guisinger, 1995; Sethi, Guisinger, Phelan, & Berg, 2003). The international business (IB) literature therefore considers cultural distance an important source of challenges and costs for firms operating outside their home country. The mainstream view is that home–host cultural distance has a limiting effect on multinationals' foreign activities, both by hurting foreign affiliates' performance *ex post* and by yielding more conservative foreign investment decisions *ex ante* (Tung & Verbeke, 2010).

The cultural distance concept generally referred to is that of the difference in mean values between home and host countries' respective populations. However, an expanding literature in marketing shows that firms do not target host countries' entire populations, but segments of individuals that are most promising to them (e.g. Broderick, Greenley, & Mueller, 2007; Kamakura, Novak, Steenkamp, & Verhallen, 1993; Ter Hofstede, Steenkamp, & Wedel, 1999; Wedel, Ter Hofstede, & Steenkamp, 1998). As cultural distance is generally a liability to firms, individual firms are likely to limit this distance by targeting those segments of host-country customers that are culturally closer to them than the average customer is (Beugelsdijk & Mudambi, 2013). As a result, the actual cultural distance experienced by firms is generally not the distance to the host population's mean values, but is instead the substantially smaller distance to the targeted segment's mean values.

Thus combining international management theory on the minimization of cultural distance with marketing theory on segmentation, we argue that greater cultural variation within host countries offers increased opportunities for firms to target host-country customer segments that are culturally relatively nearby. Greater variation implies that these segments are further removed from the host country cultural mean, i.e. closer to the cultural profile of the internationalizing firm. Therefore, the higher the degree of cultural variation within a host country, the less relevant the home–host cultural distance becomes. We hypothesize that, as intra-host cultural variation increases, the overestimation of the negative effect of cultural distance on multinationals' foreign affiliate sales also increases.

Analyzing US foreign affiliate sales to unaffiliated local customers, we find that, at the sample average of intra-host cultural variation, the most popular index of home–host cultural distance yields a 74% overestimate of the actual detrimental effect of cultural differences. At the world average of intra-host cultural variation, the actual cultural difference effect even becomes insignificant. This implies that – depending on the composition of the sample of host countries – the assumption of cultural homogeneity may lead to a type I error in research on how home–host cultural differences affect multinational firms. Our results

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prove robust to the use of GLOBE and World Value Survey (WVS)-based measures of cultural distance, alternative measures of cultural variation and foreign affiliate sales, and to time and host-country splits of our sample.

Our paper complements the growing number of papers criticizing the cultural distance literature for assuming cultural homogeneity within countries (Engelen & Brettel, 2011; Shenkar, 2001, 2012). We go one important step further by arguing and showing that intra-host cultural variation causes traditional cultural distance measures to yield biased cultural difference effects. Our findings imply that home–host cultural differences are a substantially smaller barrier to multinational firms than hitherto thought. The relaxation of the homogeneity assumption in culture research sheds new light on the role of cultural differences. It forces us to fundamentally revise the dominant view of how national cultural differences affect multinational firms. To assess more accurately how such differences influence multinationals' foreign affiliate sales and international business activity in general, we recommend that future studies pay closer attention to the idea that intra-host cultural variation enables multinationals to target culturally-nearby customer segments abroad.

2. Theory and hypothesis

Firms operate in an institutional context, which influences their operations and strategies. In order to survive and be successful, a firm's organizational structure and culture need to be consistent with isomorphic pressures from its institutional environment (DiMaggio & Powell, 1983; Xu & Shenkar, 2002), especially a society's normative structures: shared norms, values, and beliefs that make up the culture of the country (Hofstede, 1980; Scott, 1995). When going abroad, a firm is confronted with new cultural settings, which bring new isomorphic pressures. In order to gain legitimacy and operate effectively in the new setting, firms' foreign affiliates have to adapt to these pressures.

Yet, adaptation is costly and necessarily imperfect, if only because affiliates also face isomorphic pressures from their MNE parent's organizational structure and home country culture. If an affiliate strays too much from the structures and values of its parent's organization and home culture, the affiliate will not be integrated sufficiently well in its parent's corporate network, impeding the transfer of organizational practices and tacit knowledge (Kostova & Roth, 2002). Because this 'institutional duality' and the associated conflicting conformity pressures prevent complete adaptation to the local context, foreign-owned affiliates virtually always face a lack of legitimacy and effectiveness relative to their local counterparts (Xu & Shenkar, 2002). This implies that firms expanding abroad tend to face a so-called 'liability of foreignness' (Nachum, 2003; Zaheer, 1995).

The degree of liability of foreignness experienced by firms is a function of the degree of difference, or the distance, between home and host cultures. Firms entering culturally more distant countries will face greater difficulty in attaining local legitimacy and transferring their work practices (Kostova, 1999; Kostova & Zaheer, 1999). Consequently, internationalizing firms generally aim to limit the cultural differences that they need to overcome abroad. This has been confirmed by many studies of the sensitivity of multinationals' foreign activities to the difference in culture between home and host countries, the so-called national cultural distance (for a review, see e.g., Kirkman, Lowe, & Gibson, 2006).

Cultural distance affects multinationals' foreign operations because multinationals have to market their products to local customers, adapt products and marketing tactics to local preferences, negotiate with local labor unions, deal with local suppliers, and organize and manage a local workforce. Accordingly, cultural distance has been argued to increase transaction and communication costs (Albuquerque, Bronnenberg, & Corbett, 2007; Anderson & Gatignon, 1986; Giannetti & Yafeh, 2012), impede learning and acculturation (Barkema et al., 1996; Ojala & Tyrväinen, 2007; Weber, Shenkar, & Raveh, 1996), and – more generally – raise the costs of doing business abroad (Nachum, 2003; Zaheer, 1995). Cultural distance eventually affects firms' foreign affiliate sales in a negative way (Slangen & Beugelsdijk, 2010).

When discussing the institutional and cultural environment a firm operates in, international management scholars usually focus on the country environment (Kostova, 1999). Accordingly, cultural distance is generally conceptualized as the difference in values between a given home and host country (Kogut & Singh, 1988; Xu & Shenkar, 2002). Empirically, cultural distance is therefore measured by home and host countries' scores on Hofstede's (1980) survey-based value dimensions, often by transforming these scores into a composite index, using a Euclidean distance formula or a variant thereof (Engelen & Brettel, 2011; Kogut & Singh, 1988). Because Hofstede's work has been criticized (Javidan, House, Dorfman, Hanges, & de Luque, 2006; Steenkamp, 2001), scholars have recently started measuring cultural distance through countries' scores on alternative cultural dimensions, notably those derived from the GLOBE study and the World Values Survey (WVS) (Berry, Guillen, & Zhou, 2010; Estrin, Baghdasaryan, & Meyer, 2009; Giannetti & Yafeh, 2012; Reus & Lamont, 2009). All these measures share the characteristic that they are based on the mean of the responses provided by the people surveyed in each country.

Yet in reality countries are far from homogenous and the context in which a firm operates is not entirely determined by country-level culture and structures (Engelen & Brettel, 2011; Shenkar, 2001, 2012). The local cultural setting in which a foreign-owned affiliate operates may therefore deviate from the average culture of the host country, sometimes quite substantially so (Beugelsdijk & Mudambi, 2013). The neglect of this within-country variation in much of the IB literature on cultural distance has been criticized by several authors (Au, 1999; Shenkar, 2001, 2012; Tung & Verbeke, 2010). However, little work has been done on the consequences of intra-country cultural heterogeneity for the effects of home–host cultural distance.

While international management theory argues that firms generally aim to limit their exposure to home–host cultural distance, the field of marketing contains insights into how firms can realize this aim through their sales strategy. Within the marketing field, segmentation theory proposes that firms selling abroad target groups of individuals, called 'segments'. Market segments are "homogeneous groups of customers who can be targeted in the same manner" because the group members share specific characteristics (Wedel & Kamakura, 2002: 181). Customer segments may be identified on a wide variety of bases, ranging from shared perceptions of product features (e.g., Moskovitz & Rabino, 1994) to such aspects as shared customer attitudes and lifestyles (e.g. Boote, 1983; Verhage, Dahringer, & Cundiff, 1989).

Shared values have been considered particularly useful for segmentation purposes (Hassan & Katsanis, 1994; Brangule-Vlagsma, Pieters, & Wedel, 2002; Yavas, Verhage, & Green, 1992) since values are closely related to motivations and behavior (Kamakura et al., 1993; Wedel et al., 1998), central to cognition (Rokeach, 1973; Schwartz, 1992; Steenkamp, Ter Hofstede, & Wedel, 1999), and because value dimensions are universal (Ter Hofstede et al., 1999). When using shared values as the basis for segmentation, customer segments can be considered subcultures, i.e. subgroups of people holding similar values (Lenartowicz & Roth, 2001). Cultural variation then refers to the presence of subcultures within a country's population, shown to exist in several national populations (Lenartowicz & Roth, 2001; Lenartowicz, Johnson, & White, 2003; Valencia, 1989).

Firms tend to target similar groups of consumers in different countries, a phenomenon referred to as 'segment simultaneity' (Levitt, 1983). In emerging economies, for example, Western multinationals like Starbucks mainly target customers with Western-like values and lifestyles, while Jollibee, the largest food chain in the Philippines, mainly targets Filipinos abroad (Verbeke, 2009). In a similar vein, Latin American banks are overrepresented in Miami, Florida due to the city's large and fast growing Hispanic community "with unique demands and needs" (Miller, Thomas, Eden, & Hitt, 2008: 651).

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