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Cultural distance and the pattern of equity ownership structure in international joint ventures

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ABSTRACT

This paper develops and tests hypotheses linking cultural distant to the ownership distribution of equity capital across the partners in international joint ventures (IJVs). The paper's underpinnings are linked to the role of equity shares in providing performance guarantees in joint ventures (JVs). It argues that for IJVs based in the home country of one of the partners, the vulnerability of the foreign partner to expropriation of partnership rents increases with its cultural distance from the home partner. We argue this implies the foreign partner is likely to own a smaller equity share of the IJV. Similar hypotheses are formulated with respect to whether the IJV partners are from the same or different triad regions, and cultural clusters. The hypotheses are tested with data on 442 UK-based joint ventures. Our empirical results demonstrate a significant impact of cultural distance on the pattern of equity ownership in IJVs.

1. Introduction

Extant literature indicates that culture and cultural distance, defined as the difference between the national cultural characteristics of the home and of the host countries, has a robust influence on organisational choice. This literature has carried out pair-wise analyses comparing the choices between modalities; for example a joint venture (JV) versus a non-equity partnership, or JVs versus acquisition/wholly owned subsidiary formation (Brouthers, 2002; Hennart & Larimo, 1998; Kogut & Singh, 1988; Slangen & Hennart, 2008; Slangen & Van Tulder, 2009). The literatures also contain studies showing that firms based in countries where the dominant cultural traits are high power distance and low uncertainty avoidance may have an inherent preference for full ownership of their foreign affiliates (Erramilli, 1996). Other studies argue that cultural distance may make it difficult for MNEs to manage their foreign affiliates, making it efficient to enlist the help of a local partner (Stopford & Wells, 1972).

Our contribution is to extend this literature by examining how cultural distance influences the governance mechanism *within* a particular modality. We focus our analysis on equity ownership structure in international joint ventures (IJVs), an important issue that prior literature has not considered explicitly (Barkema, Bell, & Pennings, 1996; Pennings, Barkema, & Douma, 1994). Existing studies in this area have mainly focused on partner asset characteristics as the main indicator of relative equity ownership patterns (Bowe & Golesorkhi, 2007, 2008). However, no previous study considers the direct

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influence of cultural distance on equity shares in IJVs. In this paper we address this issue by examining how cultural distance *per se*, operating independently of the characteristics of the assets contributed by the IJV partners, may help to define a structure of partner vulnerability and hence influence the equity share in IJVs. We acknowledge the influence of cultural distance in two distinct contexts. In one context, culture differences operate within a specific frame of the 'liability of foreignness' for one of the partners. However, there is a more general, second context, where an IJV may be based in a third country and thus neither party is operating domestically. Our study specifically focuses on the former context (i.e. 'home–foreign' IJVs) and develops hypotheses relating to the impact of cultural distance on the relative vulnerability of the 'foreign' partner in IJVs and the provision of a guarantee by the 'home' partner in the form of a higher equity ownership of the IJV.

This paper is organised as follows. In Section 2 we briefly state the conceptual framework based on extant insights from the economics of organisation. This highlights the guarantee function of equity capital in IJVs, although the insights are equally applicable to any JV. Building on this, we develop hypotheses positing the relevance of cultural distance between the foreign and 'home' partners as an influence on partner equity shares in the IJV. Based on similar arguments additional hypotheses relating to the influence of the regional and cultural grouping of the home and foreign partners are developed. Section 3 sets out our empirical methodology, our data sample and discusses the empirical proxies used to measure cultural distance and the other firm-level factors that may influence equity ownership patterns in IJVs. The empirical results are presented and discussed in Section 4, and Section 5 concludes.

2. Theoretical framework

2.1. Theoretical background: partner vulnerability and the guarantee function of equity in JVs

One major governance issue in JVs stems from the fact that on the one hand each party in the JV has an inalienable *de facto* right to pursue their own interest at the expense of others.[2] On the other hand, the two parties need to achieve a degree of cooperation if the (presumed) mutually beneficial outcomes of the JV are to be realised (Buckley & Casson, 1988). Agency theory considers how *ex ante* contracting may best govern the relationship between parties (Jensen & Meckling, 1976). While this logic is also applicable in the context of inter-firm collaboration, considerations of bounded rationality and asymmetric information imply that contracts are invariably incomplete as it is not possible to specify in advance all possible future contingencies (Hart, 1995; Williamson, 1979). In the JV context, one relevant factor is the vulnerability each party perceives as arising from its dependence on the other party for the achievement of the objectives of the JV (Golesorkhi, 2006). Such vulnerability is a function of the level of costly monitoring and enforcement that each party may anticipate as being necessary, vis-à-vis the other party's adherence to contractual obligations, in the operation of the JV (Alchian & Demsetz, 1972; Barzel, 1997; Barzel & Suen, 1992). The anticipated level of monitoring/enforcement costs reflects the degree to which the assets, information set and context of the partner may be expected to give rise to relatively greater variability in the future performance of the JV.

From this perspective, the literature suggests that the negotiated equity shareholding in collaborative ventures may be a significant governance instrument. By choosing to collaborate through a JV, each partner effectively receives a financial return that is proportional to its ownership share of the JV's equity capital. As equity in a JV is a residual claim the rights to which are foregone if the JV fails to attain profitability it acts as collateral, guaranteeing the value enhancing contribution of the JV partner. As such, specifying a higher equity share in the JV partnership *ex ante* reduces the need to incur monitoring and enforcement costs ex post (Barzel, 1982, 2005; Grossman & Hart, 1986; Teece, 1992). As such, the partner in the JV whose contribution and subsequent behaviour has a greater impact on the variability of the joint performance will, by owning the larger share of the equity capital, provide a measure of performance guarantee to the other party. Effectively, by contracting *ex ante* to make a greater portion of his/her income dependent on the residual payoff from the venture, the incentives of this partner are aligned with that of the JV to a greater extent than would otherwise have been the case.

2.2. Cultural distance and partner vulnerability in IJVs

Recent evidence suggests that due to cultural distance, IJVs are particularly difficult to manage (Kaufmann & O'Neill, 2007) and that consequently cultural distance between the partners negatively affects the survival rate of IJVs (Meschi & Riccio, 2008). This suggests that partners in IJVs encounter relatively higher levels of monitoring and enforcement costs. However as Kaufmann and O'Neill (2007) point out, managers understand and anticipate the difficulties associated with cultural distance, and thus may take steps *ex ante* to minimize these problems by choosing less complex and demanding 'types' of IJVs which would require high levels of inter-partner interactions.[3] The argument regarding the guarantee function of the choice of equity share inherently depends on the same logic. Given the anticipated problems of managing across

[2] The theoretical discussion in this section applies to both domestic and international JVs, which is why we use JV rather than IJV in the notation.

[3] For example when cultural distance is high, IJVs are more likely to be of the 'unilateral' type (buyer–seller IJVs). On the other hand, culturally distance partners are unlikely to form 'bilateral' types of JVs where the required level of inter-partner interaction will be high.