International Business Review 19 (2010) 575–588

Contents lists available at ScienceDirect

International Business Review

journal homepage: www.elsevier.com/locate/ibusrev

External uncertainty and entry mode choice: Cultural distance, political risk and language diversity☆

Cristina López-Duarte [1,*], Marta M. Vidal-Suárez [1]

Universidad de Oviedo, Dpto. de Administración de Empresas., Escuela Jovellanos Gijón, Avda. Luis Moya Blanco, n° 261, 33203 Gijón, Asturias, Spain

A R T I C L E   I N F O

Article history:
Received 27 July 2009
Received in revised form 24 March 2010
Accepted 25 March 2010

Keywords:
Cultural distance
Entry mode
Foreign direct investment
Joint venture
Language
Language barriers
Language diversity
Political risk
Wholly owned subsidiary

A B S T R A C T

This paper aims at analyzing the effect of external uncertainty on the entry mode choice when investing abroad. We consider the effect of uncertainty coming from the formal host country's environment (political risk) and from the informal one (cultural distance). The potential existence of an interaction effect between both of them is also analyzed. In particular, we analyze how language diversity between the home and host countries may condition the influence of this interaction effect on the entry mode choice. In order to empirically test our predictions, a database of foreign direct investments made by Spanish firms is used.

1. Introduction

The analysis of the entry mode choice related to foreign direct investments (FDIs) constitutes a classic topic of study in International Business. This choice implies deciding on the degree of commitment that the investing firm wants to assume in the host market; in this sense, the investing company should decide if it will invest alone maintaining 100% of the equity of the firm located in the host market – that is, investing through a wholly owned subsidiary (WOS) – or if it will share the equity with (at least) another firm – investing through a joint venture (JV).

The entry mode choice has been broadly analyzed in the literature from different theoretical perspectives, being the Transaction Cost Theory (TCT) among the most commonly used frameworks. From TCT perspective the external uncertainty affecting the internationalization process arises as one of the main factors conditioning the entry mode choice. In such a framework, the cultural distance (CD) between the home and the host countries of the FDI (informal environment) and the host country's political risk (PR) (formal environment) become the two main sources of such external uncertainty. Both variables have been widely analyzed in the literature on entry mode choice, although almost always in an isolated way, ignoring, therefore, the existence of potential interaction effects between both of them. Said in other words, the moderating/intensifying effect of one of these variables on the role played by the other one has been ignored (Brouthers & Brouthers,

☆ Financial support from *Spain's* Ministerio de Ciencia y Tecnología (Project: SEC 2009-07786) is gratefully acknowledged. An earlier version of this paper has been published by Fundación de las Cajas de Ahorros (FUNCAS) working paper series #476.

* Corresponding author. Tel.: +34985182179; fax: +34985182161.
E-mail addresses: clduarte@uniovi.es (C. López-Duarte), mmvidal@uniovi.es (M.M. Vidal-Suárez).

[1] Both authors contributed equally to this work.

0969-5931/$ – see front matter
doi:10.1016/j.ibusrev.2010.03.007

2001). One of the purposes of this paper is to contribute empirical evidence on the potential existence of such an interaction effect.

In addition, external uncertainty may be conditioned by a third factor which has traditionally been bundled within the cultural distance concept, thus, ignoring its individual influence on the choice of mode of entry: the language diversity (LD) between the home and host countries. Linguistic distance between the home and host countries is an important component of psychic distance which is likely to influence transaction costs (Demirbag, Tatoglu, & Glaister, 2007), and which is not always captured by cultural distance measures (West & Graham, 2004). The literature analyzing the role of language on internationalization patterns[2] points out to this factor as one of the main sources of conflict in international business administration. In spite of these facts, language has been an almost overlooked factor in entry mode literature; and the very scarce existing literature is far from conclusive about the role played by LD on the entry mode choice. On the one side, some authors argue that language diversity increases the risk perceived by foreign investors and, thus, their tendency to invest through JVs rather than through wholly owned subsidiaries – see, for instance, Demirbag et al. (2007). On the contrary, other researchers have found that the higher the linguistic barrier, the greater the control degree of parent companies over their subsidiaries (Harzing & Feely, 2008).[3] We seek to analyze how language diversity conditions the role played by the above mentioned interaction effect between cultural distance and political risk on the choice of entry mode.

For empirical testing of our hypotheses we used a database collecting 334 FDIs carried out between 1989 and 2003 by listed Spanish companies whose shares are traded on the Madrid Stock Exchange. These FDIs are located in 33 different countries, endowing the sample with a high degree of diversity both in cultural distance regarding Spain, and in host countries' political risk. Such a diversity, together with the fact that the home country is Spain, constitutes an additional advantage of this paper, since most empirical evidence on entry mode choice tends to show a US bias (being the US the home or host country of investments), as already pointed out by Brouthers and Brouthers (2001).

The paper has been organized in the following way: in Section 2, we present a literature review on entry mode choice based on TCT. This review is focused on the analysis of the relationship between external uncertainty and entry mode choice. Next, we revise the traditionally established predictions related to external uncertainty by considering the interaction effect between the cultural distance and the political risk; as well as the language diversity between the home and host countries. Our predictions are tested with a sample of FDIs carried out by Spanish firms whose features are presented in Section 3; Section 4 shows empirical evidence and a discussion of our results. Finally, we summarize the main conclusions and managerial implications.

2. Literature review

Basing on the framework provided by TCT, the external uncertainty associated to the FDI constitutes a main factor conditioning the entry mode choice. Such an external uncertainty is related to the uncertainty perceived by the investing company in the formal and informal institutional environment of the host country (Delios & Henisz, 2003b; Henisz & Delios, 2002; Slangen & van Tulder, 2009). In the literature about entry mode, the uncertainty associated to the informal environment of the host country has been traditionally conceptualized and measured through the cultural distance, while that related to the formal aspect of the environment has been linked with the country risk; in particular, the political risk (Zhao, Luo, & Suh, 2004).

Following Hofstede (1980, 2001), *culture* is defined as "collective mental programmes" shared by a group of people; these programmes being different from one group to another. The culture is, thus, what distinguishes one group from another. *National culture* refers to such programmes when the identified group of people share the national environment.[4] The cultural distance between two nations reflects the existent differences in certain values, norms and behaviour rules between them (Shenkar, 2001). These differences increase the liability of foreignness or the difficulties that the investing firm should overcome when it seeks to develop its activities in a new country.

The *country risk* refers to the volatility of the political, economic, and social factors of the target country; while the *political risk* is defined as the likelihood of an unfavourable change in the governmental regime of the country and/or in the policies issued by such a regime (Henisz, 2000). Although such a difference between country and political risk exists, it becomes difficult to isolate the three types of factors that configure the country risk, since political, social and economic causes of risk tend to be highly correlated. The higher the host market volatility, the more difficult for the foreign investor to obtain, interpret and organize the information to successfully carry out a FDI (Delios & Henisz, 2003b).

Although TCT points to the external uncertainty as a decisive factor conditioning the entry mode choice, it is not clear how such uncertainty influences the investing firm's decision. On the contrary, TCT can accommodate opposite predictions related to this issue (Brouthers & Brouthers, 2001; Harzing, 2003; Shenkar, 2001).[5] On the one side, the investing firm may prefer to invest through a joint venture in order to gain access to local knowledge and contacts. Since these are specific assets

[2] See Demirbag et al. (2007) for a review.

[3] The paper by Arora and Fosfuri (2000), relative to the choice between WOSs and licensing agreements in the chemical industry, empirically proves the relevance of language when choosing entry mode.

[4] In the strictest sense, the culture concept is easier to be applied to societies than to nations. Historically, however, many groups of people sharing national contexts have developed collective programmes, which allow a national culture approach.

[5] These papers highlight such double hypothesis based on TCT, but all of them focus on the analysis of external uncertainty derived from cultural distance.