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The effect of the magnitude and direction of institutional distance on the choice of international entry modes

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ABSTRACT

This paper analyzes the relation between institutional regulative distance and the choice of international entry mode. The study contributes to existing literature by considering the relative positions of the origin and destination countries on this relation, examining the possibility that institutional distance may exert an asymmetric effect. The results, using a database of European firms and multilevel analysis techniques, indicate that entry in countries with lower levels of regulatory development than that of the origin is related to modes that require a lower resource commitment. Conversely, entry in countries with higher levels of regulatory development is related to higher resource commitment modes. These findings suggest that the direction of institutional distance is important for the choice of international entry mode.

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1. Introduction

Different studies examine how environmental institutional factors affect the strategic decisions of firms. These studies indicate that institutional factors, along with firms' resource endowments and capacities and the level of competition in the sector, determine corporate strategies such as internationalization (Gao, Murray, Kotabe, & Lu, 2010; Peng, Wang, & Jiang, 2008).

Some of the literature analyzing the impact of institutions on firms' decisions examines the differences between origin and destination countries via institutional distance (Kostova, 1999). As a country's institutional context is composed of regulative, normative and cognitive dimensions (Scott, 2001), some authors indicate the need to avoid oversimplification and concentrate on specific dimensions of institutional distance rather than broad analyses (Zaheer, Schomaker, & Nachum, 2012). In line with this idea, this paper focuses on the regulative dimension, as it has been observed to have a strong impact on internationalization decisions such as the choice of entry mode (Chao & Kumar, 2010; Yiu & Makino, 2002). Regulatory institutions include laws, regulations, and political and social configurations (Dikova & Van Witteloostuijn, 2007) that determine the governance framework for economic, legal and social relations (Globerman & Shapiro, 2003). On the one hand, these institutions define in a coercive manner what is and what is not allowed; firms, then, do not have the option of freely deciding to follow these regulations or not, they are obliged to do so (Eden & Miller, 2004). As Slangen and Beugelsdijk (2010) suggest, this situation may imply that governance imperfections are exogenous hazards that have to be taken as a given by firms. And on the other hand, since any modification to this situation depends on the regulators, a change in the regulations is more rapid and can quickly affect business decisions, in contrast to informal institutions whose change is slower (Estrin, Baghdasaryan, & Meyer, 2009; North, 1990). Lastly, regulatory institutions in distinct countries can be classified via degree of development. Specifically, different authors include with regulative distance the fact that the regulatory development of destination countries may be more or less weak than that of the origin country (Håkanson & Ambos, 2010; Wu, 2013). It is, then, possible to talk of an asymmetric effect of regulative distance (Cuervo-Cazurra & Genc, 2011; Phillips, Tracey, & Karra, 2009; Zaheer et al., 2012), an effect that depends on whether the firm enters countries with better or worse regulatory conditions than those of the origin country. This consideration follows the recommendation posited by Shenkar (2001) about addressing the illusion of symmetry in the analysis of distance. For this reason, then, we need to consider the two directions of distance: negative distance (when a firm enters countries with less developed regulatory conditions than the

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origin country); and positive distance (when a firm enters countries with more developed regulatory conditions than the origin country).

The inclusion of asymmetry in the study of institutional distance is a recent phenomenon. The literature on institutional distance – and specifically regulative distance – has traditionally conducted its analysis in absolute terms, solely considering the magnitude of the distance. This focus has resulted in no distinction being made between firms entering countries with higher or lower levels of regulatory development than the origin country (positive and negative regulative distance). This limitation could explain why studies based on transaction cost economics (considering efficiency criteria) and institutional theory (considering legitimacy criteria) – the two theoretical approaches used to examine the impact of regulative distance on entry mode choice – find contradictory results. Some papers argue that greater regulative distance leads firms to prefer entry forms requiring lower resource commitments (Dow & Larimo, 2009; Xu, Pan, & Beamish, 2004; Xu & Shenkar, 2002); other research, however, suggests the opposite relation (Estrin et al., 2009; Gaur & Lu, 2007). We believe that the analysis of the asymmetric effect of regulative distance requires the inclusion of both criteria in order to reveal how firms tackle the choice of entry mode as they seek efficiency under institutional constraints (Kim & Gray, 2008; Roberts & Greenwood, 1997). Firms, then, are not performing efficiency optimization by only focusing on the costs and risks in their operations, but efficiency maximization as they are subject to institutional influences in order to achieve external legitimacy (Roberts & Greenwood, 1997).

The paper looks to contribute to the literature in different ways. First, the focus on the regulative dimension advances our understanding of the asymmetrical effect of this particular dimension on firms' decisions. Although the regulative dimension is central to internationalization decisions, few studies analyze the asymmetric effect of distance. Second, our examination of the direction of the distance by integrating economic and institutional perspectives makes it possible to consider how firms respond to the dual need for legitimacy and efficiency. This enables us to shed light on the contradictory findings of previous studies that limit their focus to the magnitude of institutional distance. Third, and in line with the recommendation by Bruton, Ahlstrom, and Li (2010), this paper also goes beyond most other studies, which are restricted to a single origin or destination country. The richness of the available data (with a sample of European SMEs from more than 30 countries operating in over 100 destination countries around the world and from different manufacturing and service sectors) allows us to perform a multilevel analysis considering factors at the decision, firm, and firm's home country levels.

The paper is organized as follows. The next section addresses the relevant theoretical aspects and research hypotheses, before going on to discuss the methodology. The final sections present an analysis of the results and their implications, concluding with some comments on limitations and future lines of research.

2. Literature review and hypotheses

The impact of institutions – and of institutional distance – on the choice of entry mode has typically been viewed from the perspectives of transaction cost theory and institutional theory (Demirbag, Glaister, & Tatoglu, 2007; Gelbuda, Meyer, & Delios, 2008; Kim & Gray, 2008). The former focuses on efficiency criteria, while the latter examines legitimacy criteria. The studies based on transaction cost economics suggest that firms prefer entry forms requiring lower resource commitments in order to minimize the effect of uncertainty when the regulative distance is great (Dow & Larimo, 2009). This focus on costs and risks, however, has also given rise to contrary arguments. As Gaur and Lu (2007) state, one way of mitigating costs in countries separated by a wide regulative distance is by using entry forms that offer greater control over operations. This argument is based on the belief that greater institutional distance produces uncertainty and unfamiliarity, resulting in higher transaction costs in market operations and thereby favoring entry forms associated with heavier resource commitments (Kim & Gray, 2008; Tihanyi, Griffith, & Russell, 2005).

Of the studies that analyze institutional differences from the institutional theory perspective, some suggest that firms prefer entry modes that require lower resource commitments when distance grows because they allow them greater flexibility and minimize the conflicts between external legitimacy and internal consistency (Xu et al., 2004; Xu & Shenkar, 2002). Other papers, however, argue that entry forms that offer higher levels of control make it possible to manage regulatory differences more easily (Estrin et al., 2009) – an approach that gives priority to internal consistency over the acquisition of external legitimacy (Davis, Desai, & Francis, 2000). The empirical evidence from this approach, though, suggests that it is external legitimacy that is vital for the survival of MNEs (Xu et al., 2004). Moreover, this external legitimacy may be especially important for SMEs, as these firms are more influenced by external forces than are large firms (Cheng & Yu, 2008).

Given that institutions provide the structure for transactions to take place and affect the firm's choice of entry mode, both perspectives seem to be required (Delios & Beamish, 1999). Specifically, we follow the line of those authors who believe that they are complementary, as firms are obliged to manage the needs of legitimacy and efficiency in their decisions (Kim & Gray, 2008; Roberts & Greenwood, 1997). And yet, although these papers make an effort to integrate both approaches, they only analyze the magnitude of the distance. We feel that by including the impact of direction we are able to clarify the relation between regulative distance and entry mode choice. This is the case because the needs of legitimacy and efficiency may exert different effects on firms' decisions depending on the direction of the distance.

Some studies explore asymmetry in the relation between cultural distance and firms' decisions, such as the assignation of expatriates in subsidiaries or the degree of influence of the headquarters over subsidiaries (Brock, Shenkar, Shoham, & Siscovick, 2008; Drogendijk & Holm, 2012). Other research extends the reach of asymmetric effects to other institutional dimensions (Cuervo-Cazurra & Genc, 2011; Phillips et al., 2009). A few studies even focus on the regulatory dimension and point to the influence of institutional distance – depending on whether it is positive or negative – on the success of product innovations (Wu, 2013). Nevertheless, the analysis of regulative distance via the premise of the existence of asymmetry is underdeveloped in the study of entry mode decisions.

Taking this idea of asymmetry as a starting point, our reasoning is based on the argument that the direction component makes it possible to consider institutions as constraints for firms' decisions only in some circumstances. The legitimacy criterion, then, is only a determining factor in certain cases; any assumption that institutions are constraints in all cases would involve presuming symmetrical effects in which the problems of obtaining legitimacy are the same for a firm regardless of whether it operates in a country with a stronger or weaker regulatory environment than its origin. Moreover, equating the existence of institutional distance with a lack of institutional knowledge (Eriksson, Johanson, Majkgard, & Sharma, 1997) implies that greater distance has the same effects on the entry mode decision independently of the relative position of the origin and destination countries because the firm does not possess sufficient complementary resources to comprehend a new institutional environment (Cuervo-Cazurra,

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