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Distance and perceptions of risk in internationalization decisions☆

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ABSTRACT

This study examines top managers' risk perceptions in internationalization decisions. 126 CEOs and top managers responsible for internationalization in companies with headquarters in Germany, Switzerland, or Austria took part in our experiment. Applying random utility theory in a conjoint choice experiment enables the measurement of top managers' preferences for target countries and entry modes. Country-specific measures of geographic, cultural, economic, and political distances serve as covariates to explain country preferences and to quantify the effect on internationalization decisions. Our results show that distance dimensions are the primary drivers of risk assessment, whereas entry-mode choice is secondary. Internationalization may therefore be a hierarchical decision in which managers choose target market (and risk profile) and view entry-mode choice as subordinate to other environmental factors.

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1. Introduction

International business (IB) literature is so replete with studies on location choice and international entry mode that Shaver (2013) questions the value of further research in this field. Although different theoretical streams highlight a variety of explanations for location decisions (Dunning, 1981; Johanson & Vahlne, 1977), the most notable explanation of what drives such decisions is risk perception.

Perceptions of varying risk between countries—mainly in terms of psychic distance (Bouncken, Cesinger, & Kraus, 2014; Johanson & Vahlne, 1977; Kogut & Singh, 1988) and differences in market development (Brouthers, 1995; Whitley, 1992)—affect internationalization and location decisions. Scholars debate and criticize the measurement and unidimensionality of the psychic distance construct (Håkanson & Ambos, 2010; Shenkar, 2001; Zaheer, Schomaker, & Nachum, 2012). The second major driver of risk in internationalization is entry-mode choice because more equity-intensive entry modes usually imply greater risk (Brouthers, 2002; Hennart, 2009). Although distance and entry-mode choice are theoretical representations of the risk in location and entry decisions, little evidence exists on how these combined risk perceptions drive managerial decisions.

Despite considerable research on international location choice, entry modes, and distances, results regarding the risk of internationalizing to a particular country remain inconclusive. These results may reflect the conflicting theoretical assumptions, as well as the limitations inherent in prevailing methodologies, because choice decisions are methodologically complex. Aharoni, Laszlo, and Connelly (2011) call for new methodologies (e.g., experiments) in IB research.

This study examines internationalization decisions in an experimental setting. In the experiment, managers select the riskiest option from a set of internationalization alternatives (i.e., target countries and entry modes). Country-specific covariates (i.e., measures of geographic, cultural, political, and economic distance) explain country preferences and quantify these preferences' effect on the internationalization decision. Empirical results reveal the primary role of distance dimensions in risk perceptions and the secondary role of entry-mode choice.

2. Choice of location and entry mode

Managers address a multitude of variables when considering internationalization (Cesinger, Fink, Madsen, & Kraus, 2012; Mitter, Duller, Feldbauer-Durstmüller, & Kraus, 2014). These managers often make decisions on the basis of conflicting criteria and trade-offs (Brouthers & Brouthers, 2001; Nielsen & Nielsen, 2011). The desire to minimize liabilities of foreignness (Zaheer, 1995), to increase the probability of legitimacy (Kostova, Roth, & Dacin, 2008) and to maximize chances of survival (Delios & Beamish, 2001), drives internationalization decisions. Thus, such decisions aim to maximize international expansion's utility.

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The target country consists of different geographic, demographic, economic, and institutional attributes. Because managers are unequally familiar with these contextual variables, they have to make decisions using imperfect information and considering the relative position of their home market. Cross-national differences influence perceptions of risk. Hence, when modeling internationalization decisions, scholars must consider the multidimensionality of distance (Aharoni et al., 2011; Håkanson & Ambos, 2010).

The other critical aspect of internationalization decisions is market-entry mode, which typically entails considering the amount of resources to invest, the control level, and the risk that internationalization implies. Multinational companies often seek to minimize risks in international expansion by implementing tight control over foreign operations (Brouthers, 2002).

IB literature reflects different schools of thought and theoretical perspectives. These perspectives comprise classical location theory (Vernon, 1966), foreign trade theory (Heckscher, 1919), transaction-cost theory (Teece, 1981), the OLI paradigm (ownership–location–internalization-specific advantages) (Dunning, 1980), the Uppsala model (Johanson & Vahlne, 1977, 1990), institutional theory (Kostova et al., 2008), and real options theory (McGrath, 1999). With the exception of real options theory, which provides a relevant decision-making framework under conditions of uncertainty (Driouchi & Bennett, 2012), all theories explain the location and entry-mode choice as deliberate decisions that depend on differences in factor endowments and environmental characteristics in international markets.

Given their complexity, internationalization decisions often represent trade-offs between competing alternatives. Because of information asymmetries and uncertainty in internationalization decisions, managers might delay their decisions or decide not to internationalize at all.

3. Development of hypotheses

3.1. Cultural and geographic distance

Typically, IB scholars conceptualize and measure differences in the informal environment by cultural distance (Kogut & Singh, 1988; Shenkar, 2001). Cultural distance refers to the extent to which shared norms and values in one country differ from those in another (Drogendijk & Slangen, 2006). By inducing a lack of understanding regarding cultural norms and values, cultural distance increases misunderstandings, creates difficulties in conforming to informal institutions, and raises risk in managerial decision-making (Slangen & van Tulder, 2009). Furthermore, cultural distance increases the cost of foreign-market entry and hampers the transfer of core competencies to foreign markets (Bartlett & Ghoshal, 1989; Palich & Gomez-Mejia, 1999). As a result, the organization's ability to operate effectively and gain operational benefits decreases.

H1a. Greater cultural distance between the home country and the target country has an association with greater perceived risk in internationalization decisions.

Despite substantial reductions in long-distance communication and transport costs (Cairncross, 2001), geographic distance maintains a powerful role in internationalization decisions (Kraus, Meier, Eggers, Bouncken, & Schuessler, in press; Leamer & Storper, 2001; Nachum & Zaheer, 2005). McCann's (2011) empirical results indicate that space and scale remain important because these cost reductions do not affect overall costs relating to distance. Several empirical studies confirm that geography remains a barrier to trade and foreign direct investment (FDI) (Berthelona & Freund, 2008; Gripsrud & Benito, 2005; van Bergeijk & Brakman, 2010) and that geographic distance increases the perceived risk of a foreign market because of information asymmetries.

H1b. Greater geographic distance between the home country and the target country implies greater perceived risk in internationalization decisions.

3.2. Economic and political distance

Economic distance is likely to induce risk in internationalization because of misunderstandings and problems in accessing foreign stakeholders (Ghemawat, 2001). Economic development is a pull factor in internationalization (Ambos & Ambos, 2011) because internationalization to more economically developed economies is a utility-maximizing opportunity. In contrast, greater volatility in less economically developed and emerging economies increases the perception of risk (Estrin & Meyer, 2004). Another prominent consideration is whether an international market country offers access to a highly qualified labor pool (Manning, Massini, & Lewin, 2008) and yields knowledge spillovers stemming from intense competition in local industry (Almeida, 1996).

H2a. Lower economic development in the target country than in the home country has an association with greater perceived risk in internationalization decisions.

Several studies confirm that political systems with predictable rules minimize the risks of internationalization and increase the likelihood of FDI (Gelbuda, Meyer, & Delios, 2008; MacCarthy & Atthirawong, 2003). Thus, organizations tend to maximize their utility and minimize risk by internationalizing into more politically developed countries.

H2b. Lower political development in the target country than in the home country has an association with greater perceived risk in internationalization decisions.

3.3. Entry-mode choice

Chang and Rosenzweig (2001) and Samiee (2013) classify the extensive literature on entry modes into three broad groups: ownership and control issues, country risk and development levels, and cultural distance. Each of these streams presents entry-mode choice as a means of managing—or as a reflection of—international risk because each entry mode is consistent with different levels of control and resource commitments. Despite the debate about the most suitable entry mode for distant and unfamiliar environments (Brouthers, 2013; Brouthers & Brouthers, 2001), managers perceive more equity-intensive entry as riskier because this entry mode involves greater financial exposure. More equity-intensive entry modes also entail more control mechanisms and mechanisms with greater complexity.

Ahmed, Mohamad, Tan, and Johnson's (2002) research on Malaysian public firms demonstrates that managers opt for entry modes with lower resource commitment and lower control. Moderate international risk relates to joint ventures, and only low international risk leads to foreign direct investments with high control and high resource commitment.

H3. An association exists between more equity-intensive entry modes and greater perceived risk in internationalization decisions.

4. Method

4.1. Random utility theory and conjoint choice experiments

Random utility theory (Manski, 1977; McFadden, 2001) reports that decision-makers (managers m) choose the alternative (internationalization strategy i) that offers the highest utility from a set of options. Utility U is a latent construct that consists of a systematic component V and a random error component ε; that is, $U_{mi} = V_{mi} + \varepsilon_{mi}$.

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