Journal of Business Research 65 (2012) 1160–1170

Contents lists available at ScienceDirect

Journal of Business Research

How cultural distance influences entry mode choice: The contingent role of host country's governance quality

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ARTICLE INFO

Article history:
Received 1 December 2010
Received in revised form 1 July 2011
Accepted 1 July 2011
Available online 27 August 2011

Keywords:
Cultural distance
Governance quality
Entry mode
Joint venture
Wholly owned subsidiary

ABSTRACT

When entering a culturally distant host country, whether MNEs prefer JVs or WOSs has long been a paradox. The current study aims to explain the paradox by examining the effect of the host country's governance quality. This study hypothesizes that governance quality plays a contingent role. When MNEs enter a culturally distant country with poor governance quality, the risks of collaborating with local partners soar. MNEs thus prefer WOSs. However, if governance quality is satisfactory, the local partners' opportunistic behavior will be restricted, and MNEs thus prefer JVs. An analysis of 2451 entries by Taiwanese MNEs into 13 countries supports the hypotheses.

1. Introduction

Cultural distance, as many international business researchers report, influences the entry mode decision of multinational enterprises (MNEs) (Morschett, Schramm-Klein, & Swoboda, 2010; Tihanyi, Griffith, & Russell, 2005; Zhao, Luo, & Suh, 2004). Fundamental differences in norms and values between the home country of MNEs and the host country of their foreign operations often create operational difficulties and increase the efforts required to enter a foreign country. This forces MNEs to scrutinize their degrees of control and resource commitment when they endeavor to establish overseas operations (Gatignon & Anderson, 1988; Kogut & Singh, 1988).

However, prior research provides conflicting empirical results regarding the influence of cultural distance on entry mode choice (Brouthers & Brouthers, 2001; Shenkar, 2001; Tihanyi et al., 2005). Some studies indicate that high levels of cultural distance were associated with the adoption of joint ventures (JVs), a collaborative mode of entry (e.g. Chang & Rosenzweig, 2001; Erramilli & Rao, 1993), while others find greater cultural distance to relate to the selection of wholly owned subsidiaries (WOSs), a full control entry mode (e.g. Agarwal, 1994; Anand & Delios, 1997). Prior research seldom reconciles this paradox. Only a few endeavors exist such as Brouthers and Brouthers (2001) and Cho and Padmanabhan (2005). However, scholars are still unable to depict a clear picture of the relationship of MNEs' entry mode preference with cultural distance.

Such a cultural distance paradox has roots in the “dual logics” that prior research implies. The “collaboration” rationale contends that collaboration with partners from culturally distant countries can utilize partners' local knowledge to bridge cultural gaps (Kim & Hwang, 1992) and thus lower the management cost of overseas operations (Gatignon & Anderson, 1988). Hence, MNEs prefer JVs when entering a country with a different culture (Brouthers & Brouthers, 2001; Slangen & van Tulder, 2009).

On the other hand, the “control” viewpoint argues that full equity ownership of the overseas subsidiary grants MNEs the power to avoid potential opportunistic behavior of the partner and reduce the cost of contracting. Therefore, MNEs tend to choose WOSs when cultural distance is great (López-Duarte & Vidal-Suárez, 2010; Zhao et al., 2004).

Each of these rationales builds on solid ground, but what factors prioritize or balance the need to collaborate with the need to control remains unanswered. This is very likely the cause of the cultural distance paradox. Therefore, when examining the effect of cultural distance on entry mode choice, accommodating factors that affect both the considerations of collaboration and the considerations of control is imperative.

This study aims to explain the paradox by examining the effect of the host country's “governance quality”, that is, soundness of the

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doi:10.1016/j.jbusres.2011.07.033

overall "public institutions and policies created by governments as a framework for economic, legal, and social relations" (Globerman & Shapiro, 2003, p.20). The current study hypothesizes that the host country's governance quality plays a contingent role on the influence of cultural distance by mitigating the necessity to exert control. When entering a target country with poor governance quality (e.g. the host country has a dysfunctional legal system or serious corruption issues), MNEs prefers WOSs as their mode of entry. However, if governance quality of the host country is satisfactory (e.g. the local law fully protects foreign investors from being exploited), the local partners' opportunistic behavior will be restricted, and full control of the subsidiary will not be necessary. The benefits of collaboration thus dominate, motivating MNEs to choose JVs. An analysis of 2451 entries by Taiwanese MNEs into 13 countries (including industrialized countries such as the U.S., Japan, and Germany, and emerging countries such as India, Brazil, and Vietnam) offers solid empirical support for the hypotheses.

This research makes several contributions to the literature on cultural distance and entry mode research. First, this study finds a contingent effect of governance quality on the relationship between cultural distance and entry mode choice, providing a possible explanation for the "cultural distance paradox", along with parent firms' perceived investment risk (Brouthers & Brouthers, 2001) and their international experience (Cho & Padmanabhan, 2005). However, unlike previous studies, which focus mainly on parent-firm factors, the study examines the influence of an institutional factor—the governance quality of the host country. This perspective provides an institutional explanation for the cultural distance paradox. Second, this study shows that cultural distance does not exclusively influence MNEs' entry mode choice. Governance quality, the formal aspect of institutional environment, interacts within cultural distance, and the two factors jointly affect entry mode choice.

The current study also contributes to the institution-based view of international business strategy (e.g. Ingram & Silverman, 2002; Peng, Wang, & Jiang, 2008), which emphasizes that "strategic choices are not only driven by industry conditions and firm capabilities, but are also a reflection of the formal and informal constraints of a particular institutional framework that managers confront" (Peng et al., 2008; pp.923). By considering both the "formal" and "informal" aspects of the institutional environment, this study provides a complete institution-based view on MNE's entry mode choice. So far scholars have yet to address these two institutional aspects simultaneously, let alone their interactions. This study fills this gap, revealing that the formal institutional hazards (caused by poor governance quality) mitigate the effect of informal institutional hazards (caused by high cultural distance) and jointly influence MNE's entry mode choice.

2. Theory development and hypotheses

2.1. To collaborate or to go solo: the entry mode choice between JVs and WOSs

When entering a foreign country with equity investment, MNEs must make an entry mode choice—either JV or WOS. They will either form a joint venture to collaborate with local partners, or establish a wholly owned subsidiary to fully control their foreign operations. Each entry mode brings different benefits, but MNEs cannot select them simultaneously. Therefore, MNEs have to balance the need to collaborate and the need to control when choosing their entry mode. Among various theories addressing the pros and cons of each choice, the transaction cost economics (TCE) is one of the most congenial (e.g. Hennart, 1988, 1993).

Based on the behavioral assumptions of bounded rationality and opportunism, the TCE perspective considers the emergence of "institutions of capitalism" (Williamson, 1985) to solve problems of opportunism. To economize on bounded rationality and simultaneously safeguard transactions against opportunism calls for an appropriate governance structure (Williamson, 1985). International business scholars apply the TCE perspective to weigh pros and cons of JVs against those of WOSs (e.g. Brouthers & Brouthers, 2001; Hennart, 1988; Kim & Hwang, 1992). International operation incurs significant administrative costs, they assert. When MNEs enter an unfamiliar foreign country, the costs of monitoring, dispute settling, and reward refining are especially high (Hennart, 1988), making the management of foreign subsidiaries costly. Collaborating with local partners via the JV arrangement (typically with a formal contractual agreement) allows foreign MNEs to leverage partners' local knowledge and thus reduces such costs (Teece, 1981; Hennart, 1988).

However, the JV choice is not without cost. Foreign partners may behave opportunistically if given the chance (Hennart, 1988). Since human being is subject to bounded rationality, acquiring sufficient information to foresee partners' behaviors and safeguard against partners' potential opportunism is unlikely. Under this circumstance, the shared equity arrangement of JV bears the *ex ante* transaction costs of discovering a proper partner, drafting an agreement, and bonding contractual arrangements, as well as the *ex post* transaction costs of haggling, adaptation, monitoring, enforcement, termination, and the residual loss of cheating and shirking (Williamson, 1985).

In contrast, the WOS solution offers the benefits of full control over local operations. Within its own organization, an MNE has full control and makes decisions at its discretion, without worrying about the partners' potential opportunistic behavior. As a result, the wholly owned mode of entry is preferred when the costs of arranging, monitoring and enforcing a collaborative agreement are high (Brouthers & Brouthers, 2001; Kim & Hwang, 1992). When entering a cultural distant foreign country, the effect of cultural distance further complicated the considerations.

2.2. Cultural distance and entry mode

Cultural distance in international business research generally refers to the fundamental differences in norms and values between the home country of MNEs and the host country of their foreign operations (Kogut & Singh, 1988; Tihanyi et al., 2005). Based on the framework developed by Hofstede (1980), which categorizes national work-related cultural issues into five different dimensions—power distance, individualism/collectivism, uncertainty avoidance, masculinity/femininity, long-term/short-term orientation, Kogut and Singh (1988) develop a measurement for cultural distance. Scholars accept their measurement, and widely use this measurement in their studies (see Shenkar, 2001; Tihanyi et al., 2005 for a review).

Past studies generally find that cultural distance between the home country and host country increases management costs because it creates knowledge barriers and hampers the transfer of knowledge and core competence to foreign markets (e.g. Anand & Delios, 1997). On the other hand, cultural distance also impedes acquiring and interpreting information about foreign partners' behavior and thus creates tremendous challenges for MNEs to safeguard against partners' potential opportunism (e.g. Gomez-Mejia & Balkin, 1992). The entry mode decision thus becomes complicated (Bartlett & Ghoshal, 1989; Gomez-Mejia & Palich, 1997; Hennart & Larimo, 1998), making it even more difficult for MNEs to choose between JVs and WOSs. In the following sections, we will elaborate the need to collaborate and the need to control respectively, with the presence of cultural distance.

2.2.1. The need to collaborate

When entering a culturally distant country, different norms, values, and beliefs often post considerable challenges in the process of communication and management. Employees from the host country may have difficulties comprehending or accepting the culture of the MNE's home country. Their expectations are consequently more diverse, making conflicts more likely. As a result, organizational and