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It Takes Two to Tango: Signaling Behavioral Intent in Service Multinationals' Foreign Entry Strategies☆

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ABSTRACT

An unresolved tension exists in the literature on the foreign entry strategies of service multinational corporations (SMNCs). Prior research indicates that SMNCs face higher levels of transaction costs than non-service firms, making them more likely to prefer foreign entry strategies with greater hierarchy and control. Another stream of research suggests that *less* hierarchical entry strategies could increase SMNCs' flexibility and their ability to learn about the local environment, allowing them to adapt products and services to local needs. This suggests that there are important, underappreciated tradeoffs involved with the degree of hierarchy in SMNCs' foreign entry mode. To address this tension in the literature, we build a conceptual approach that integrates TCE with signaling theory to argue that firms' reputation for behavioral intent could have wide-ranging impacts on SMNCs' entry mode strategy and partner selection likelihood. Integrating these theories suggests the need to acknowledge that it takes "two to tango": the attributes and preferences of both the foreign entrant *and* the local partner need to be factored into foreign entry strategies. We develop propositions using this integrative approach in order to contribute to further theoretical development in this important and growing stream of research.

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1. Introduction

Service multinational corporations (SMNCs) are ubiquitous in the global economy. The recent World Investment Report suggests that SMNCs' cross-border activities have been least affected among all sectors in the post-recession economy (UNCTAD, 2013). This has resulted in the service sector having a large and growing importance in economies around the world. Despite these trends, theory building using the unique context of SMNCs has lagged behind (Capar and Kotabe, 2003). This paucity creates a need and an opportunity for further conceptual development—particularly in the area of SMNCs' foreign entry strategies (Kundu and Merchant, 2008; Magnusson et al., 2009).

Traditionally, transaction cost economics (TCE) has been the dominant lens used to analyze the foreign entry strategies of SMNCs, generating a rich body of insights (Blomstermo et al., 2006; Brouthers and Brouthers, 2003; Erramilli, 1991; Erramilli and Rao, 1993; Kundu and Merchant, 2008). Noting that SMNCs are unique in many ways, researchers have argued that SMNCs can face higher levels

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of transaction costs than non-service firms (Dunning, 1989). Specifically, SMNCs are more sensitive to the threat of opportunism from local transaction partners in a host country (Brouthers and Brouthers, 2003). To mitigate this threat, SMNCs are posited to often prefer higher levels of control in their foreign entry strategies, through the use of more 'hierarchical' entry modes (Brouthers et al., 2002)—operating a wholly-owned subsidiary, rather than forming a joint venture with a local firm, for instance. Yet, more hierarchy may entail important tradeoffs, such as higher organizational costs (Williamson, 1985) and less flexibility (Kogut, 1991; Yin and Shanley, 2008). Critically for SMNCs, which often need greater levels of adaptation and interactivity with the local environment (Capar and Kotabe, 2003; Dunning, 1989), more hierarchy may result in missed opportunities to learn from local firms about the host country environment (Inkpen and Beamish, 1997; Makino and Delios, 1996).

This dilemma creates a unique challenge for SMNCs' entry strategy: the greater threat of opportunism suggests a higher level of hierarchy than may be optimal from the perspective of adaptation and interactivity. At the crux of this problem is the information asymmetry between the foreign entrant and a local transaction partner (Williamson, 1985). This asymmetry occurs because the local firm knows how it intends to behave toward the SMNC, whereas the SMNC lacks this information about the local firm's intentions. As a result, even though most firms do *not* usually act opportunistically, firms do not know ahead of time which potential partners will actually behave opportunistically and which will not (Williamson, 1993). This means that SMNCs must adopt more hierarchical entry modes in order to gain greater control, even when it is not otherwise advantageous to do so. Yet, if there *was* a way for a firm to signal its intentions *ex ante*, this would open up the possibility of less hierarchical entry modes that could entail lower costs, greater flexibility, and an increased ability for adaptation to the local context. This raises the question: how might firms—even those that have had no previous interaction with each other—overcome this information asymmetry and signal their behavioral intent?

In this paper we address this question by integrating TCE and signaling theory in order to consider the role of a firm's reputation in SMNCs' entry strategies. Signaling theory (Spence, 1973, 2002), as derived from information economics (Boulding and Kirmani, 1993), is "fundamentally concerned with reducing information asymmetry between two parties" (Connelly et al., 2011). Thus, we suggest that it complements TCE's concerns about the threat of opportunism faced by SMNCs as they enter foreign countries—concerns that the local firm can also have about the SMNC. Signaling theory indicates that a firm's *reputation for behavioral intent* can serve as a signal that it will transact in a trustworthy manner (Connelly et al., 2011). A firm's reputation for behavioral intent refers to perceptions of trustworthiness as a transaction partner based on prior transactions with other firms (Barney and Hansen, 1994; Blois, 1999; Lorenz, 2000; Stevens and Makarius, forthcoming; Wong and Boh, 2010). Reputation is built over many past interactions between itself and other firms, and provides information even for firms that have not transacted with it in the past (Fong et al., 2013; Weigelt and Camerer, 1988). Thus, we argue that it is uniquely qualified to balance opposing factors such as opportunism and forbearance, as well as desires for control versus adaptation and interactivity, to better predict SMNCs' entry strategies.

Responding to the call for more theoretical development on SMNCs (Lahiri et al., 2014), we contribute to the literature on SMNCs' foreign entry strategies in three critical ways. First, we argue that the unique aspects of services—their inseparability, intangibility, heterogeneity, and perishability—result in systematic variance in the transaction hazards and transaction costs faced by SMNCs. In doing so, we go beyond the observation in extant literature that SMNCs face higher transaction costs than non-SMNCs, and instead dig deeper into the differences in the transaction costs faced by different *types* of SMNCs. Second, we incorporate the construct of reputation, which suggests that perceptions of both the foreign SMNC and the local firm matter. This presents an opportunity to view foreign entry as a mutual decision rather than the typical TCE perspective that looks at foreign entry as a unilateral choice made by the multinational entering the foreign country (Hennart, 2009). Thus, we integrate TCE and signaling theory to suggest that it takes "two to tango," as *both* firms signal and receive reputation information that tells them about the other's intentions. This allows each side to see if there is value in doing business together, as well as whether and how a transaction should take place. This also helps to address the dilemma SMNCs face as they seek to balance the need to reduce the threat of opportunism with the need for flexibility and local responsiveness as they enter foreign countries. Finally, we contribute by introducing two new constructs to the literature—reputational credibility and reputational distance. These constructs suggest that it is not only a firm's reputation that matters, but also the extent to which the information provided by that reputation can be believed (credibility), and how similar or dissimilar one firm's reputation is to the reputation of a potential transaction partner (distance).

We start with an overview of the theoretical underpinnings of TCE, and create propositions linking unique attributes of services to the transaction costs SMNCs face when entering foreign countries. Next, we provide an overview of signaling theory, and argue that a firm's reputation for behavioral intent can allow it to signal honest intentions, thereby reducing transaction costs. Acknowledging the underappreciated insight that both SMNCs *and* local firms have concerns about each other's behavior (Brouthers, 2013; Hennart, 2009), we then discuss what integrating TCE and signaling theory means for predicting and explaining SMNCs' foreign entry mode and partner selection strategies. We conclude with a discussion of the contributions of the present study, suggestions for future research, and implications for practitioners.

2. SMNCs, reputation, & foreign entry: integrating TCE & signaling theory

What drives the international success or failure of firms is a question central to the fields of strategy and international business (Peng, 2004). To be successful internationally, SMNCs must carefully craft their foreign entry strategies to optimize performance (Lahiri et al., 2014; Li and Guisinger, 1992). To this end, researchers have paid close attention to two specific facets of entry strategy: entry mode and partner selection (Pan et al., 1999; Stevens and Dykes, 2013). In this paper, we will develop new theory that integrates

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