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Cultural distance and the choice between wholly owned subsidiaries and joint ventures ☆

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ABSTRACT

Most empirical research on the choice between joint ventures and wholly owned subsidiaries analyzes the role of cultural distance in an isolated way. This study explores the potential influence of some factors related to the diversity among countries that are traditionally associated with cultural distance but not explicitly included in measurements of cultural distance. Different approaches to and measurements of cultural distance are used in this analysis. This study examines the potential existence of a moderating or intensifying effect of third variables on the role played by cultural distance. The results confirm the contingent role of host country risk on the choice between equity joint ventures and wholly owned subsidiaries.

1. Introduction

The cultural distance (CD) between the home and host countries of a foreign investment is a variable traditionally considered in the literature dealing with the choice between joint ventures (JVs) and wholly owned subsidiaries (WOSs), starting with Gatignon and Anderson (1988) and Kogut and Singh (1988). The choice between JVs and WOSs arises once the foreign firm decides to enter the host market through an equity foreign direct investment (FDI), that is, once the firm decides to grow abroad by investing equity and setting up a subsidiary in the target country. A second decision must then be made: whether to share the ownership of such an affiliate with other firms (equity joint venture) or to maintain full ownership (wholly owned subsidiary).

The literature on international business analyzes the role that CD plays in this choice; nevertheless, the empirical evidence is inconclusive. The recent and exhaustive revision of the literature by Dow and Larimo (2009) presents contradictory results—see also Brouthers and Brouthers (2001), Shenkar (2001), Harzing (2003), and Tihanyi, Griffith, and Rusell (2005) for additional reviews.

The study here contributes new empirical evidence by analyzing the influence of some differences between the home and the target in the form of geographical distance and differences dealing with language and economic development. The study explores the potential existence of an interaction effect between CD and third variables, in particular, a variable related to the formal environment of the host country: its political risk (PR). Therefore, the study focuses on the role that the target's formal and informal environment plays on the choice between WOSs and JVs.

The empirical analysis uses a database covering 302 investments made between 1989 and 2003 by listed Spanish companies whose shares are traded on the Madrid Stock Exchange. These investments are located in 27 different countries, endowing the sample with a high degree of diversity related to cultural distance regarding Spain, other forms of distance between countries and host countries' political risk. This diversity, together with the fact that the home country is Spain, constitutes an additional advantage of this paper, as most empirical evidence on the choice of ownership structure tends to show a US bias, in which the US is the home or host country of investments (Brouthers & Brouthers, 2001). As Lau (2003) and Wei, Liu, and Liu (2005) state, patterns of internationalization and entry mode seem to differ depending upon some characteristics of the home and/or host countries.

Following this introduction, Section 2 presents a review of the literature on the choice between WOSs and JVs. This review is based on Transaction Cost Theory (TCT) and focuses on the analysis of the relationship between cultural distance, political risk and investment choice. It reviews the concept and measurement of cultural distance while introducing the analysis of other factors conditioning the

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perceived environmental distance between countries and studying the existence of an interaction effect between CD and PR. Section 3 presents the methodology and data features and Section 4 presents the findings. Section 5 offers conclusions, limitations and suggestions for future research.

2. Literature review

Transaction Cost Theory is a particularly suitable framework to analyze the role that external uncertainty plays in the internationalization process of firms as well as on the choice of the mode of investment—Zhao, Luo, and Suh (2004) and Brouthers and Hennart (2007) show that TCT is effective in explaining investment processes in international contexts that present a high level of external uncertainty.

The cultural distance between two nations reflects existing differences in certain values, norms and behavioral rules between them (Shenkar, 2001). In the case of foreign investments, CD relates to the external uncertainty associated with the *informal environment* of the host country (Delios & Henisz, 2003; Henisz & Delios, 2002; Slangen & Van Tulder, 2009). These differences increase the liability of foreignness or the difficulties that the investing firm must overcome when it seeks to develop its activities in a new country. Although this source of external uncertainty arises as a decisive factor conditioning the choice between JVs and WOSs, the existing literature does not give definitive conclusions (Brouthers & Brouthers, 2001; Harzing, 2003; Shenkar, 2001). One possibility is that the investing firm prefers to invest through a joint venture to gain access to local knowledge and contacts related to the host country's informal environment. Because these are specific assets, the foreign investor may decide to share the project with a local partner who provides access to these specific resources. Among the most recent studies, Chang and Rosenzweig (2001); Yiu and Makino (2002); Tatoglu, Glaister, and Erdal (2003); Pak and Park (2004); Tsang (2005), and Quer, Claver, and Andreu (2007) show a preference for JVs over WOSs in high cultural distant contexts.

However, greater cultural distance leads to higher transaction costs when cooperating with a local partner; thus, foreign investors may prefer to invest through a WOS to avoid these costs. Following Hennart (1988) and Erramilli and Rao (1993), the costs derived from negotiating a JV contract increase as cultural distance does: differences related to values, norms and behavioral rules make it more difficult to search for potential partners and complicate the negotiation process and the later enforcement of contracts. Investing through a WOS makes it unnecessary to cooperate with a partner whose decision and behavioral rules are not well known or understood by the foreign investor. Fisher and Ranasinghe (2001), Chen and Hu (2002), Tsang (2005) and Kim and Gray (2009) have recently presented empirical evidence supporting the foreign investors' preference for WOSs when investing in highly culturally distant host countries.

Finally, Rajan and Pangarkar (2000), Luo (2001) and Demirbag, Tatoglu, and Glaister (2009) conclude that the CD between the two countries does not significantly affect this choice, while other papers show different results depending on the type of cooperative ventures (López-Duarte & García-Canal, 2002).

Two main factors underlie the contradiction in the results: (I) existing studies on the choice between JVs and WOSs do not pay attention to some factors having to do with the diversity among countries that are associated with CD but are not explicitly included in its measurements (Demirbag, Tatoglu, & Glaister, 2007, 2009; Demirbag et al., 2009; Harzing, 2003); (II) most empirical studies analyze the effect of cultural distance on the investment mode choice in an isolated way, thus ignoring the moderating/intensifying effect of third variables on the role played by CD (Brouthers & Brouthers, 2001; Brouthers & Hennart, 2007; Cho & Padmanabhan, 2005).

2.1. Cultural distance: traditional and recent approaches

2.1.1. Hofstede's approach

The international business literature has traditionally used the cultural distance concept by Hofstede (1980, 2001) and the index by Kogut and Singh (1988) to measure the extent to which different cultures are similar or different.

Hofstede (1980, 2001) defines *culture* as a set of "collective mental programs" shared by a group of people, with these programs differing from one group to another. Culture is thus what distinguishes one group from another. *National culture* refers to programs in which the identified group of people shares the same national environment. The studies by Hofstede (1980, 2001) identify and measure four main cultural dimensions: power distance, uncertainty avoidance, individualism and masculinity. Two new dimensions have been identified and measured in subsequent studies (Hofstede & Bond, 1988; Hofstede, Hofstede, & Minkov, 2010): long-term orientation and indulgence versus restraint.

Power distance is the extent to which the less powerful members of institutions and organizations within a country expect and accept that power is unequally distributed. The power distance dimension thus refers to how a specific society handles inequalities.

Uncertainty avoidance is the extent to which the members of a culture feel threatened by uncertain or unknown situations. When uncertainty avoidance is high, people seek to reduce uncertainty and limit risk by imposing rules and systems to bring about order and coherence; in other words, they have a need for structure.

Individualism refers to people's behavior towards the group. Individualism pertains to societies in which the ties between individuals are loose—everyone is expected to look after him or herself. Collectivism, as its opposite, pertains to societies in which people need to belong to a group and have loyalty to the group. A high value in the individualism dimension implies that individual objectives and personal autonomy are more highly valued than socialization or commitment to collective activities.

Masculinity pertains to societies in which social gender roles are clearly distinct; femininity pertains to societies in which social gender roles overlap. In a masculine society, there exists a stress on values traditionally associated with the masculine role (e.g., competition, success, wealth, ambition and performance goal orientation), whereas in a feminine society, there exists a stress on relationships, life skills and social performance.

Long-term orientation (the Confucian dimension) stands for the fostering of virtues oriented towards future rewards, particularly perseverance and thrift. On the contrary, short-term orientation stands for the fostering of virtues related to the past and present.

Indulgence versus restraint: Indulgence stands for a tendency to enable the relatively free gratification of basic and natural human desires associated with enjoying life and having fun. Restraint reflects a conviction that such gratification needs to be regulated by strict social norms.

The Kogut and Singh index is based on deviation along these cultural dimensions:

$$\mathrm{CD_j} = \sum_{i=1}^{i=n} \left[\left(\mathrm{I_{ij}} - \mathrm{I_{is}} \right) / \mathrm{V_i} \right] / n$$

where CD_j is the cultural distance of the jth country from the home country; I_{ij} represents the index of the ith cultural dimension and the jth country; s represents the home country and V_i represents the variance of the index of the ith dimension; and n is the number of cultural dimensions.

2.1.2. Schwartz's approach

Schwartz (1994, 1999) and Siegel, Licht, and Schwartz (2008) analyze different types of values by considering three issues faced by