Internationalization of Firms: The Role of Institutional Distance on Location and Entry Mode

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INVESTOR IN PEOPLE

To my husband Simone and my children

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List of Abbreviations

ED	Euclidean Distance
FA	Factor Analysis
(O)FDI	(Outward) Foreign Direct Investment
FE	Fixed Effect model
GCR	Global Competitiveness Report
GLOBE	Global Leadership and Organizational Behavior Effectiveness
IB	International Business
ICRG	Institutional Country Risk Guide
ID	Institutional Distance
IMF	International Monetary Fund
JV	Joint Venture
KOF	Konjunkturforschungsstelle (attached to ETH Zurich)
K&S	Kogut and Singh (1988)
KS	Kogut & Singh Distance
LOF	Liability of Foreignness
MD	Mahalanobis Distance
MNE	Multinational Enterprise
OECD	Organization for Economic Co-operation and Development
OLI	Ownership-Location-Internalization framework developed by Dunning (1981)
PCA	Principal Component Analysis
POLS	Pooled Ordinary Least Squares
RE	Random Effect model
SME	Small and Medium Enterprise
SNB	Swiss National Bank

UNCTAD	United Nations Conference on Trade and Development
WCY	World Competitiveness Yearbook
WGI	World Governance Indicators
WOS	Wholly-owned subsidiary

Introduction

STUDY BACKGROUND

As the world becomes more and more globalized, distance separating countries seems to disappear (Cairncross, 1997; Friedman, 2005; O'Brien, 1992). According to the International Monetary Fund (IMF), globalization can be defined as "the increasing integration of economies around the world, particularly through the movement of goods, services, and capital across borders" (IMF, 2008, p. 2). IMF (2008) to add: "globalization implies that information and knowledge is dispersed and shared" (p. 2). Some scholars consider that globalization has led to the *"death of distance"* (Cairncross, 1997) or to the *"end of geography"* (O'Brien, 1992). Friedman (2005), in his book, uses the expression *"the world is flat"* that reflects the erasure of national borders and the full integration of world economies. In opposition to this view, some reputed scholars note that foreign direct investments (FDI) are primarily undertaken in host regions geographically and institutionally closer to the home country (Cantwell, 2009; Rugman & Oh, 2013). It follows that countries are more regionally integrated than globally integrated (Rugman & Verbeke, 2007). In his book "*World 3.0: Global Prosperity and How to Achieve It*," Ghemawat (2011) considers that the world is "semiglobalized": borders, differences, and distances still matter. Ghemawat suggests that the world can be described neither as not integrated nor as fully integrated. In the DHL Global Connectedness Index 2014, Ghemawat and Altman (2014) affirms that "the levels of globalization are much lower than the levels one would expect to see if borders and distance had ceased to matter. They are also significantly lower than most people's intuitions" (p. 13). Thence, distances still matter in the internationalization process of firms.

As noted by Nachum and Zaheer (2005), "distance is fundamental in international business (IB) theory, and implicitly or explicitly occupies a central position in all its subfields" (p. 747). Distance between two countries is a multidimensional concept,

including not only a geographical dimension but also other dimensions related to the culture, the administrative, political, and economic aspects as shown by Ghemawat (2001) and its "CAGE" framework, as well as by Berry, Guillen, and Zhou (2010) and their nine dimensions of cross-national distance. In the last decade, Van Tulder (2010) notes that the research tends to be oriented toward the institutional and governance distance between countries. Many scholars have emphasized the role of institutions in the internationalization process of firms (Cantwell, Dunning, & Lundan, 2010; Dunning & Lundan, 2008; Van Hoorn, & Maseland, 2016). Recent articles in IB analyze institutions as a factor impacting FDI, especially from emerging countries,[1] whereas others focus on the role of institutions in the foreign entry mode choice.[2] Culture, that can be considered as an informal institution, is also widely analyzed in recent IB papers.[3] As discussed, distance and institutions play an important role in IB. Thus, this book focuses more precisely on an aggregation of these two fundamental concepts, namely institutional distance (ID). A concise literature review on ID highlights different research fields in IB (see Table 1). The main research fields focus on the analysis of the relationship between ID and FDI location choice, as well as ID and entry modes. However, these studies report several weaknesses. The diversity of conceptualization and operationalization of ID leads to mixed results. Additionally, the studies in entry mode primarily focus on the ownership mode. Solely few studies investigate the relationship between institutional distance and establishment mode. A majority of studies investigate the effect of ID on location and entry mode choices for the manufacturing sector, neglecting the effect for the services sector, also noted by Morschett, Schramm-Klein, and Swoboda (2010). Moreover, based on a meta-analysis of 72 studies on entry mode choice, Morschett et al. (2010) suggest to "investigate the combined effect of different variables based on a multi-theoretical framework" (p. 72). For example, in a recent paper, Shaver (2013) suggests to investigate more deeply to what extent past entry mode choices can impact present and future entry

[1]See Lu, Liu, Wright, and Filatotchev (2014), Williams and Grégoire (2015), Wu and Chen (2014), Meyer, Ding, Li, and Zhang (2014).

[2]See Chang, Kao, and Kuo (2014), Contractor, Lahiri, Elango, and Kundu (2014), De Villa, Rajwani, and Lawton (2015), Du and Boateng (2015).

[3]See Stahl and Tung (2015), Caprar, Devinney, Kirkman, & Caligiuri (2015), Avloniti and Filippaios (2014), De Jong and Van Houten (2014).

Table 1: Literature Review on ID: Research Fields.

Research fields	Period	Home	Host	Sector	ID Effect	
					Informal	Formal
Legitimacy						
Rottig and Reus (2008)	2000–2005	Various	US	nd	–*	–*
Local isomorphism						
Salomon and Wu (2012)	1978–2006	Various	US	Banks	+*	+*
FDI location choice						
Trevino and Mixon (2004)	1988–1999	Various	Latin America	nd		–*
Du (2009)	1980–2003	Japan	Various	Man-Serv		–*
Seyoum (2009)	2002	Various	Various	nd	–	–*
Wu (2009)	1956–2006	Various	US	Banks	–*	–*
Pogrebnyakov and Maitland (2011)	1995–2007	Various	Various	Serv	–*	+
Aleksynska and Havrylchyk (2013)	1996–2007	Various	Various	nd		–*
Cezar and Escobar (2015)	2004–2009	Various	Various	nd		–*
Kuncic and Jaklic (2013)	1990–2010	Various	Various	nd		–*
Choi, Lee, and Shoham (2016)	1981–2008	Various	US	nd	+*	Mixed
Entry mode choice						
(1) Ownership (partial)						
Yiu and Makino (2002)		Japan	Various	Man	+*	+*
Xu, Pan, and Beamish (2004)	1996	Japan	Various	nd	+*	+*
Demirbag, Glaister, and Tatoglu (2007)	as of 2003	Various	Turkey	Man-Serv	+*	
Kittilaksanawong (2009)	2000–2007	Taiwan	Various	Man	Mixed	Mixed
Arslan and Larimo (2010)	1990–2007	Finland	Various	nd	–*	+
Ando (2012)	2008	Japan	Various	Man	+*	+*

Table 1: (*Continued*)

Research fields	Period	Home	Host	Sector	ID Effect	
					Informal	Formal
Chang, Kao, Kuo, and Chiu (2012)	1999–2008	Japan	Various	Man-Serv	−*	−*
Ilhan Nas (2012)	1995–2003	Various	Turkey	Man-Serv	+*	+*
Elango, Lahiri, and Kundu (2013)	2001–2008	Various	BRIC	nd	+	+*
Owens, Palmer, and Zueva-Owens (2013)		UK	Various	Man	+	+
De Beule, Elia, and Piscitello (2014)	2001–2010	Various	Italy	Man		−*
(2) Establishment (Greenfield)						
Ionascu, Meyer and Erstin (2004)	1990–2000	Emerging countries	Various	Man	−*	+*
Estrin, Baghdasaryan, and Meyer (2009)	1990–2000	Various	Emerging countries	Man-Serv	+*	+*
Arslan and Larimo (2011)	1990–2006	Finland	Emerging countries	Man	+*	−*
(3) Completion of acquisitions						
Dikova, Sahib, and van Witteloostuijn (2010)	1981–2001	Various	Various	Serv	−*	−*
Meyer, Ding, Li, and Zhang (2011)	1982–2009	China	Various	nd		−*
Reis, Ferreira, and Santos (2013)	Conceptual				−	−
Results of FDI						
(1) Integration						
Parkhe (2003)	Conceptual				−	−
Mtar (2010)		France	UK	Man	Mixed	Mixed
Li, Jiang, and Shen (2016)	Survey	China	Various	Man-Serv	+*	+*
(2) Subsidiary performance						
Pattnaik and Choe (2007)		Korea	Various	Man	−*	−*

Table 1: (*Continued*)

Research fields	Period	Home	Host	Sector	ID Effect	
					Informal	Formal
(3) R&D / Product innovations						
Aguilera-Caracuel, Aragón-Correa, Hurtado-Torres, and Rugman (2012)		Various	Various	Man		−*
Anón Higón & Manjón Antolín (2012)	2002−2006	UK	Various		−*	−*
Van Den Waeyenberg and Hens (2012)	Case studies	Holland	Ghana	Man	−	−
Malik (2013)	1994−2005	Various	Various	Man	Mixed	Mixed
Wu (2013)		China	Various	Man	+*	+*

Notes: Sector can be either manufacturing (Man) or services (Serv). "nd" means that no differentiation between sectors has been taken into account. "+" means that the authors find a positive effect of ID, "−" a negative effect and "*" means that the effect is statistically significant at least at 10% level.

mode choices. This study attempts to fill in the gaps found in the literature, notably: to clearly argue the choice of ID measures, to distinguish between determinants of location and entry mode choice in manufacturing and services sectors, to consider the effect of ID on entry mode not only in terms of ownership choice but also in terms of establishment choice, and finally to empirically integrate the effects of variables based on different theoretical streams (especially organizational learning and network/cluster approaches).

The analysis of the location and entry mode choice is not arbitrary. It is based on the REM model developed by Liuhto and Jumpponen (2003) and composed of three elements: R for reason to internationalize, E for environmental choice, and M for modal choice. The three questions underlying these elements are *why*, *where*, and *how* firms internationalize, as shown in Figure 1. As noted by Liuhto and Jumpponen (2003), the REM model is a "simplistic theoretical tool for the analysis of internationalization" (p. 23). In fact, it omits the *what* firms internationalize. This question refers to the value chain activities (i.e., inbound logistics, operations, outbound logistics, marketing and

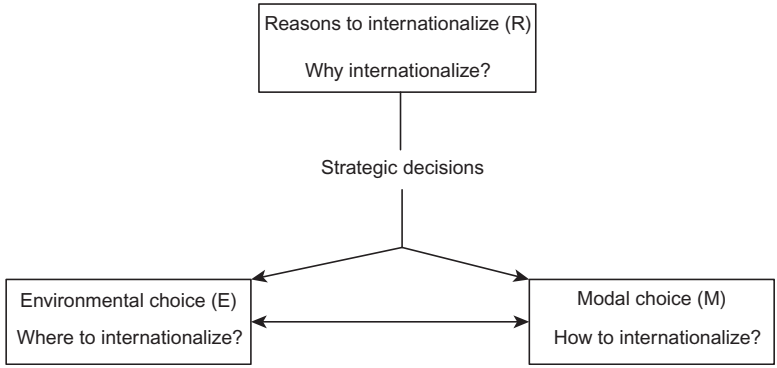

Figure 1. REM Model. *Source*: Based on Liuhto and Jumpponen (2003), p. 24.

sales, and service) (Porter, 2008, p. 75). However, this aspect cannot be explained theoretically by institutional distance, the central variable of this study. Thus, this book will focuses on the impact of institutional distance on the two strategic decisions of location and entry mode, as in Xu and Shenkar (2002) – other determinants (e.g., the reasons to invest abroad) are considered as control variables.

In this context, the case of Switzerland is particularly relevant to analyze. First, Switzerland is listed in the top 20 home economies by outward FDI flows (UNCTAD, 2015b, p. 8). Its outward FDI stocks in 2014 amount to USD 1130614.7 millions (UNCTAD, 2015a), giving it a leading position compared to other world economies (see Table 2). UNCTAD (2004) proposes to introduce the Outward FDI performance index defined as "the world share of a country's outward FDI as a ratio of its share in world GDP" (p. 16). Over the period 2010–2014, Switzerland reports a mean value of 5.93, listed in the top 20 of the OFDI performance index, just below Singapore (mean value: 6.79).[4] Switzerland exhibits a high OFDI performance compared to other developed countries.

Second, As we can see in Figure 2a, its outward FDI position indicates that Switzerland invested and still invests massively within its home region (i.e., European Union; EU). Its OFDI stocks in EU amount to nearly 50% of its overall OFDI stocks. This percentage has not changed significantly over the period 2005–2014. This study aims to understand whether institutional

[4]Author's calculations based on UNCTAD (2015a) with OFDI stocks data.

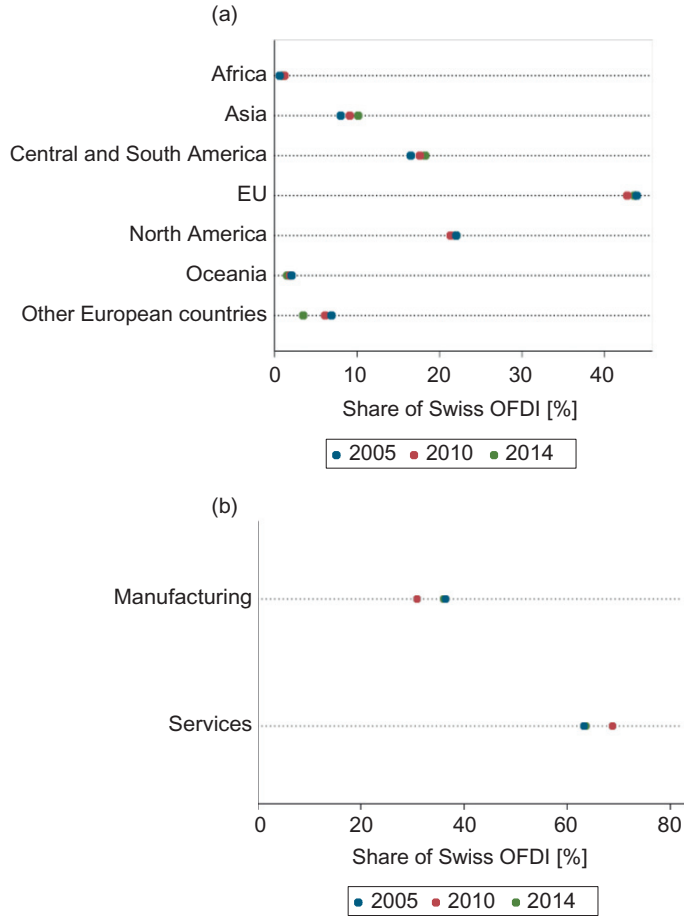

Figure 2. Share of Swiss OFDI Stocks. (a) By World Region. (b) By Sector. *Source*: Author's elaboration based on Swiss National Bank (2016).

distance can be a significant factor explaining the regionalization of Swiss OFDI. Recent studies on Swiss OFDI focus primarily on OLI determinants (i.e., ownership, location, and internalization) to attempt to explain this trend (Arvanitis, Hollenstein, Ley, & Stucki, 2011; Arvanitis, Hollenstein, & Stucki, 2012).

Finally, Switzerland is also singular compared to other developed economies in terms of sectoral composition. In fact, an extensive part of its activities is services-based. This is also reflected in the sectoral composition of its outward FDI stocks (see Figure 2b). Most of the theories on internationalization focus on the determinants affecting the foreign production

Table 2: Top 10 Home Countries by Outward FDI Stocks (2014).

Rank	Country	OFDI Stocks (USDmio)
1.	United States	6318640
2.	United Kingdom	1584146.64
3.	Germany	1583279.407
4.	China, Hong Kong SAR	1459947.392
5.	France	1279089.348
6.	Japan	1193136.605
7.	Switzerland	1130614.7
8.	Netherlands	985255.6277
9.	China	729584.67
10.	Canada	714554.703

Source: Author's calculations based on UNCTADStat database (UNCTAD, 2015a).

(i.e., primarily the industry/manufacturing sector). It would be interesting to analyze to what extent these determinants can explain OFDI in the services sector. Moreover, as reported by the Swiss Statistics Office in 2012, 66.1% of the total number of enterprises are microenterprises (fewer than 2 employees), 32.3% have from 2 to 49 employees, 1.3% have from 50 to 249 employees, and the rest (more or less 0.3%) have more than 250 employees and are considered as big firms. Big firms with a high level of internationalization (e.g., Nestle, ABB) contribute to a large extent to the Swiss OFDI stocks. However, small and medium enterprises (SMEs) are also involved in the internationalization process. Theoretically, the firm size differences can also impact the strategic behavior of internationalization. It would be interesting to test it empirically using the Swiss case.

This book contributes to the controversial debate about globalization and full integration of the world economies, giving evidence that institutional distance is still a new topic and matters in the internationalization process of Swiss firms. The structure of the book will be described in the next section.

BOOK STRUCTURE

The book is divided in four main chapters. In the following, the purpose and the conclusions of each chapter will be discussed to

give the reader an overview of the contents. The thread throughout the book is "institutional distance." The book has as its main objectives to answer the following questions:

- *How can we define and measure "institutional distance"?*
- *How can "institutional distance" impact FDI location and entry mode choices?* – Set of general theoretical hypotheses
- *Is "institutional distance" relevant in FDI location and entry mode choices of Swiss firms?* – Empirical analysis specific to Switzerland

Chapter 1 presents a review of the different conceptualizations and measurements of ID used in previous IB studies. To avoid overlaps, this book will be based on North's conceptualization between informal and formal ID (North, 1990). It also aims to calculate ID using different methods and compare their statistical properties. Based on these calculations, the institutional distance of Switzerland with others countries is illustrated. With respect to the informal ID, Switzerland is relatively similar to developed countries (i.e., European Union, North America, Australia, New Zealand, Japan) and relatively dissimilar to developing countries (i.e., Russia, China, India), as expected. With respect to the formal ID, Switzerland is very similar to developed countries (i.e., small formal ID) and very dissimilar to developing countries (i.e., large formal ID). Differences on informal and formal ID between Switzerland and other countries can potentially be relevant in FDI location and entry mode choices.[5]

Chapter 2 posits the theoretical foundations of the relation between the institutional distance and the internationalization strategies of firms in terms of location and entry mode, primarily based on the concept of "liability of foreignness" (LOF) developed by Zaheer (1995). Due to the costs of entry in a foreign country, firms can be reluctant to undertake FDI in this specific foreign country (Kostova, 1997). ID, considered as one of the major causes of these costs, can impede FDI in particular locations (Eden & Miller, 2004; Gaur, Kumar, & Sarathy, 2011). However, institutional quality of the host country and firm-specific advantages of investing firms can reduce the negative impact of ID on FDI (Globerman & Shapiro, 2002;

[5]The Mahalanobis distance will be considered as our baseline method of ID calculation, other methods of calculation will be used for the sensitivity analysis.

Ramachandran & Pant, 2010). We consider experience and network/cluster embeddedness as determinant firm-specific advantages that enhance learning in a firm. Based on these theoretical considerations, we posit a set of hypotheses tested in Chapters 3 and 4.

Chapter 3 tests the impact of the institutional distance on Swiss FDI location at a country-level using aggregate data from the Swiss National Bank (SNB) over the period 2007–2012. We consider a log-linear version of a gravity model estimated through fixed effect model (FE), random effect model (RE), and pooled ordinary least squares (OLS). The gravity model is estimated for the total sample and for two sectoral subsamples (i.e., manufacturing and services) to account for possible differences in strategic behaviors between manufacturing and services firms. For the total sample, the results indicate that informal ID impacts negatively and significantly the Swiss FDI location choice, whereas the coefficient for formal ID is negative but not statistically different from zero. For the services sample, informal and formal ID have a negative and significant impact on Swiss FDI location choice, institutional quality offsetting the negative formal ID effect. For the manufacturing sample, neither informal ID nor formal ID seem to have an effect on the Swiss FDI location choice, but institutional quality impacts positively and significantly the location choice. Irrespective to the sample considered, the findings show some significantly determinant control variables in the Swiss FDI location choice: the gross domestic product (GDP) of the home and host countries, the geographical distance, and the host country openness to FDI.

Chapter 4 is based on a survey on internationalization of Swiss firms undertaken at the end of 2014 in collaboration with KOF Institute, Zurich. Questionnaires were sent to 545 firms and 187 filled-out questionnaires were received (response rate: 34.31%). The purpose of this survey was to determine at a firm-level the motivations of location and entry mode choice and assess the role of experience and network/cluster embeddedness. The chapter is divided into two parts. The first part includes a descriptive analysis of the responses illustrating the general trends observed on Swiss firms' internationalization. The second part deepens the analysis at an econometric level. The responses are transformed into variables and used as independent variables to explain the entry mode choice in terms of establishment and ownership. The equations are estimated through logit and probit models. For establishment choice, the findings indicate that

Table 3: Definition of Key Terms.

Key Term	Definition
FDI	Foreign Direct Investment (FDI) are defined by OECD as: "a category of cross-border investment made by a resident entity in one economy (the direct investor) with the objective of establishing a lasting interest in an enterprise (the direct investment enterprise) that is resident in an economy other than that of the direct investor" (OECD, 2008b, p. 22). As underlined by the OECD report (2008), the main motivation behind this type of investments is primarily to obtain a significant influence over the direct investment enterprise, particularly over its management. Hence, (OECD, 2008b, p. 23) considers as a "direct investor an entity that owns at least 10% of the voting power of the enterprise, reflecting the investor's influence over the management of the direct investment enterprise." However, this threshold is defined arbitrarily and it does not mean that 10% ownership always carries significant influence or, conversely, that less than 10% ownership implies no control in the invested firm.
MNE	"A multinational enterprise (MNE) is an enterprise that engages in FDI and owns or, in some way, controls value-added activities in more than one country" (Dunning & Lundan, 2008, p. 3).
ID	Institutional distance (ID) is defined as "the similarity or dissimilarity between two countries in terms of institutions" (Kostova, 1996).
LOF	Liability of foreignness (LOF) is defined as "the costs of doing business abroad that result in a competitive disadvantage for an MNE subunit"(Zaheer, 1995, p. 342).
Organizational legitimacy	Organizational Legitimacy can be defined as "the acceptance of the organization by its environment" (Kostova, 1999, p. 64).
Location choice	Location choice reflects the strategic choice of firms: WHERE to undertake FDI?
Entry mode choice	Entry mode choice reflects the strategic choice of firms: HOW to enter in a host country? This choice can be divided in two subchoices: establishment (i.e., new firm or acquiring existing firm) and ownership (i.e., the degree of capital participation).
Establishment mode	*Based on Padmanabhan and Cho (1999) and Brouthers and Hennart (2007)*
Greenfield	Greenfield investment consists of building a new entity (subsidiary) belonging to the parent firm.

Table 3: (*Continued*)

Key Term	Definition
Acquisition	Acquisition represents the transfer and absorption of assets of the acquired firm by the acquiring firm, giving it an absolute control of the acquired firm.
Ownership mode	*Based on Hennart and Larimo (1998)*
Full ownership	Capital participation: more than 95%.
Partial ownership	Capital participation: 10–95%.

formal ID decreases the probability to invest through greenfields and informal ID has no significant impact. For ownership choice, the results show that formal ID decreases the probability to invest through partial ownership, whereas informal ID increases this probability. The motivations, related to the seeking of specific intangible or tangible assets, increase the probability to invest through acquisitions and partial ownership.

DEFINITION OF KEY TERMS

This section provides a definition of the essential terms necessary to clearly understand the analysis. Table 3 lists these terms and gives a definition based on reliable sources.