CULTURAL DISTANCE AND FOREIGN DIRECT INVESTMENT: A COMPREHENSIVE MODEL EXPLAINING THE IMPACT OF NATIONAL CULTURAL DIFFERENCES ON ENTRY MODE CHOICE AND SUBSIDIARY PERFORMANCE

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ABSTRACT

Although cultural differences between countries and their consequences have received a lot of attention in the FDI literature, the complex relation between cultural distance (CD), entry mode choice, and subsequent subsidiary performance has not been examined in sufficient detail. This paper fills this void in the literature by developing a comprehensive model of the relationship between these three concepts. By recognizing that both intra-firm interactions with local firms and interactions with external stakeholders embedded in the host-country environment may produce culture-related difficulties, and by simultaneously considering multiple subsidiary characteristics (viz., the desired degree of integration, the subsidiary's establishment mode, and its ownership structure), the model yields more precise predictions regarding the impact of CD on entry mode choice and subsidiary performance. These predictions are expressed in a number of propositions.

Key words: cultural distance, entry modes, subsidiary performance, comprehensive model

INTRODUCTION

Undertaking foreign direct investment (FDI) means confronting alien cultures. As a result, cultural differences between countries and their potentially harmful consequences have received a lot of attention in the FDI literature. However, this literature has not carefully mapped out the complex relation between cultural distance (CD), entry mode choice, and subsidiary performance. This paper will attempt to fill this void in the literature by developing a comprehensive model of the relationship between these three concepts, thus enabling a more precise assessment of the impact of CD on foreign entry mode choice and subsequent subsidiary performance.

We will first review the existing empirical literature dealing with the impact of CD on entry mode choice and affiliate performance. This literature review forms the basis for the model, which is developed in a subsequent section. By recognizing that both intra-firm interactions with local firms and interactions with external stakeholders embedded in the host-country environment may produce culture-related difficulties, and by simultaneously considering multiple subsidiary characteristics, the model results in a typology of foreign subsidiaries that yields more precise predictions regarding the impact of CD on entry mode choice and subsequent subsidiary performance. These predictions are expressed in a number of propositions, which we develop in a next section of the paper. Testing these propositions corresponds to testing the validity of the typology. We finish with the main conclusions and implications of this paper.

LITERATURE REVIEW

Two streams of international management (IM) research in which cultural differences have often been suspected and found to play a role are those dealing with foreign entry mode choice and subsidiary performance, with cultural differences usually being measured through the Kogut and Singh (1988) index of national CD[1].

Studies within the first stream of research can be subdivided into two groups. The first mainly deals with the choice of ownership structure for foreign subsidiaries, viz. joint venture (JV) or wholly-owned subsidiary (WOS)[2]. Within this group of studies, results regarding the impact of CD have been ambiguous. A number of studies (Agarwal, 1994; Barkema and Vermeulen, 1997; Benito, 1994; Brouthers and Brouthers, 2001; Erramilli, 1991; Erramilli and Rao, 1993; Gatignon and Anderson, 1988; Hennart and Larimo, 1998) found that increasing CD made foreign investors prefer JVs over WOSs, presumably because larger national cultural differences increase the amount of uncertainty associated with FDI – uncertainty that can be reduced through a JV with a local firm with better labor management skills and more knowledge of local conditions (Agarwal, 1994; Root, 1998). Larimo (1993), analyzing FDI by Finnish firms, found no impact of CD, while others (Madhok, 1994; Padmanabhan and Cho, 1996; Anand and Delios, 1997) found that a large CD made WOSs more likely, supposedly due to the high costs and uncertainties associated with working with an equity partner from a culturally distant country[3]. Bell (1996), finally, found a curvilinear (U-shaped) relationship, with JVs being preferred over WOSs by Dutch firms when national cultural differences were either small or great. According to Bell (1996), this result suggests that JVs are used for various purposes. In culturally distant countries they are used to get acquainted with the local conditions, while in culturally similar countries they are formed for other reasons, such as joint research or cost reductions.

[1] The Kogut and Singh (1988) index of national CD is based on the differences in scores along each of Hofstede's (1980) four cultural dimensions (i.e., power distance, uncertainty avoidance, masculinity / femininity, and individualism) between the country entered and the investing firm's home country. These differences are corrected for differences in the variances of each dimension and then arithmetically averaged. Algebraically: $CD_j = \Sigma_{i = 1, 2, 3, 4} [(I_{ij} - I_{ih})^2 / V_i] / 4$, where CD_j is the cultural distance between country j and the investing firm's home country, I_{ij} is country j's score on the ith cultural dimension, I_{ih} is the score of the investing firm's home country on this dimension, and V_i is the variance of the score of the dimension.

[2] Some studies (Erramilli, 1991; Erramilli and Rao, 1993; Kim and Hwang, 1992) also consider other options such as licensing, thereby shifting the emphasis from ownership structure to control.

[3] Brouthers and Brouthers (2001) try to reconcile these contradictory findings by arguing that investment risk moderates the relationship between CD and ownership structure. According to these scholars, managers opt for JVs in low-risk countries, but for WOSs in high-risk countries.

The second group of studies within the stream of foreign entry mode research deals with the choice of establishment mode, viz. greenfield investment or acquisition. The number of studies linking cultural differences to this choice is somewhat more limited. A number of studies (Barkema and Vermeulen, 1998; Harzing, 2002; Kogut and Singh, 1988; Larimo, 2002; Vermeulen and Barkema, 2001) found that increasing CD led MNEs to prefer greenfields over acquisitions. According to Kogut and Singh (1988) and Larimo (2002), this is because larger national cultural differences on average result in larger differences in organizational and management practices, making post-acquisition integration more difficult and, hence, acquisitions less attractive in culturally distant countries. Three other studies (Brouthers and Brouthers, 2000; Cho and Padmanabhan, 1995; Padmanabhan and Cho, 1999) found, however, that CD had no impact on establishment mode choice.

The second stream of IM research in which cultural differences have been suspected to play a role deals with foreign affiliate performance, with cultural differences generally being seen as reducing performance by making effective pairwise interactions difficult and by producing feelings of hostility and significant discomfort, leading to a 'cultural clash' between the parties involved (Parkhe, 1991; Shenkar, 2001). This hypothesis has received very mixed empirical support.

Barkema, Shenkar, Vermeulen and Bell (1997) and Barkema and Vermeulen (1997) found that increasing CD made Dutch international joint ventures (IJVs) more likely to fail[4]. Barkema and Vermeulen (1997) also found, however, that this relationship did not hold for all of Hofstede's (1980) cultural dimensions, with differences in uncertainty avoidance, masculinity and long-term orientation having a significantly negative effect on IJV longevity, and differences in power distance and individualism not having any effect. Park and Ungson (1997) unexpectedly found that increasing CD made U.S. IJVs less likely to fail[5] – a result in line with Morosini, Shane and Singh's (1998) finding that national cultural differences enhanced rather than deteriorated the performance of cross-border acquisitions in Italy, supposedly because acquisitions in culturally distant countries provide acquiring firms with

[4] For reasons of comparison, Barkema and Vermeulen (1997) also examined the impact of CD on the longevity of WOSs. No significant effects of CD were found for this type of venture.
[5] For a more extensive overview of the impact of CD on IJV performance, see Larimo (2001).

new sets of routines and repertoires embedded in the national cultures of the acquired units[6]. Datta and Puia (1995), on the other hand, found that wealth effects for shareholders of U.S. acquiring firms were significantly lower for acquisitions in high CD countries than for acquisitions in low CD countries, while Barkema *et al*. (1996) found partial support for a negative relationship between CD and the longevity of Dutch acquisitions abroad.

Besides studies focusing on a single mode of foreign entry, there are also a number of studies that have examined the impact of cultural differences on the performance of foreign subsidiaries in general. Larimo (1993), Benito and Larimo (1995), and Benito (1997) found that CD did not have a significant negative impact on the survival rate of Finnish and Norwegian subsidiaries abroad. Similarly, Hennart, Barkema, Bell, Benito, Larimo, Pedersen, and Zeng (2002) found that U.S. affiliates of Japanese MNEs were no more likely to be sold or liquidated than those of Northern European MNEs, even though national CD to the U.S. is considerably larger for Japan than for Northern Europe (Hofstede, 1980). Hennart *et al*.'s (2002) explanation for this unexpected result is that the impact of CD on longevity may have been offset by that of cultural traits. While Japanese MNEs may in fact have experienced greater problems with their American subsidiaries than their Northern European counterparts, they may have been slower in selling or liquidating them due a higher tolerance for short-term losses in support of a strategy of long-term market share and / or an urge to save face.

Li and Guisinger (1991), Barkema, Bell, and Pennings (1996), and Larimo (1998), on the other hand, found that CD did have a negative effect on the survival rate of foreign ventures[7]. Barkema *et al*. (1996) furthermore suspected that the intensity of this effect would vary across entry modes because they require different amounts of 'acculturation'. Acculturation can be described as the process of contact, conflict, and adaptation that occurs when two national cultures come together (Cartwright and Cooper, 1993). Barkema *et al.* (1996) hypothesized that CD would have a stronger negative effect on the longevity of JVs and acquisitions than on that of WOSs and greenfields, since the former two modes of entry

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[6] It should be noted that this result should be interpreted with care because of the relatively small number of observations (52) compared to the number of variables included in their model (15).

[7] A later study by Vermeulen and Barkema (2001), which incorporated CD as a control variable in their survival analyses, came to similar findings.

require the investing firm to interact with both a variety of local stakeholders embedded in the host-country environment and a local firm ('double-layered acculturation'), while the latter two entry modes require interaction with local stakeholders only ('single-layered acculturation'). Although their results were not fully supportive, their argument makes clear that both *internal* socio-cultural interactions (with a JV partner or an acquired unit) and *external* socio-cultural interactions (with a variety of local stakeholders, such as suppliers, buyers, government agencies, and unions) may affect the performance of foreign ventures – an observation that has not been incorporated in any other large-scale empirical study[8].

Notwithstanding this contribution, Barkema *et al.*'s (1996) hypothesis is based on two implicit assumptions, whose validity can be called into question. First of all, they assume that the negative impact of CD on venture performance is the same for all greenfields, while it stands to reason that the intensity of this effect varies with the ownership structure of the subsidiary (JV or WOS). When a foreign investor establishes a wholly-owned greenfield (WOGF), it needs to interact with all kinds of local agents embedded in the host-country environment who have no affinity at all with the foreign venture, and are therefore likely to be a source of culture-related difficulties. When the investor establishes a partially-owned greenfield (POGF) together with a local partner on the other hand, this partner can provide valuable help in dealing with local stakeholders and other issues related to the foreign environment (Agarwal, 1994; Root, 1998; Stopford and Wells, 1972). In the words of Curt Nicolin, the former CEO and chairman of the Swedish company ASEA:

> Don't ever buy 100 percent of any company in China, because you don't understand the Chinese. You must have somebody who is involved in the business, whom you can trust and who can tell you what you can do and not do in China, and he must be part owner (Morosini, 1998, p. 182).

The fact that the local partner has an equity stake in the venture ensures that it will really provide this help (Hennart and Larimo, 1998; Neal, 1998). This releases the investing firm

[8] It should be noted, however, that there have been a number of earlier studies that already recognized this point. For an enumeration of these studies, see Neal (1998, p. 70).

from having to interact with the foreign environment and local stakeholders, but it now has to deal with a foreign partner, which may also cause cultural conflict and harm performance. The local partner's equity stake has a mitigating effect, however, because the partner will at least be partially motivated to act in the venture's best interest (Hennart, 1988) and will therefore try to avoid cultural conflict as much as possible, or solve it as soon as it arises. Hence, we would expect the negative impact of CD on venture performance to be less strong for POGFs than for WOGFs[9].

Second, Barkema and colleagues (1996) also assume that the negative impact of CD on venture performance is the same for all acquisitions. However, "how different one culture is from another has little meaning until those cultures are brought into contact with one another" (Shenkar, 2001, pp. 527-528). In other words, cultural differences are not a problem – in the sense that they do not lead to cultural conflict and poor performance – as long as the amount of interaction between the cultures involved is low (Neal, 1998). By arguing that all foreign acquisitions involve double-layered acculturation, Barkema *et al*. (1996) implicitly assume that all international mergers and acquisitions (M&As) are alike in terms of the amount of cultural interaction that takes place. However, this amount varies within the population of international M&As (Olie, 1996; Shenkar, 2001)[10]. The prime determinant of the amount of cultural interaction is the degree of post-acquisition integration desired by the acquiring firm (Buono and Bowditch, 1989; Elsass and Veiga, 1994), which reflects how closely the investing firm wants the other system to be positioned vis-à-vis its own (Shenkar, 2001). When an acquired unit is tightly integrated into the acquirer's operations, there is a large amount of interaction between the acquirer on the one hand, and the acquired unit and – possibly – its environment on the other[11] (Neal, 1998). As a result, acculturation will be

[9] A disadvantage of shared ownership is that it may lead to a conflict of interest between the partners, which may reduce venture performance. Although such a conflict is strategy related rather than culture related, its effect should nevertheless be controlled for.
[10] This also holds for domestic M&As (Chatterjee, Lubatkin, Schweiger, and Weber, 1992).
[11] Whether the acquirer has to interact with the environment in which the acquired unit is embedded again depends on the ownership structure of the venture (JV or WOS). In case of a partial acquisition, the local partner can still provide valuable help in dealing with local stakeholders, but in case of a full acquisition the acquirer will have to manage on its own.

extensive and performance will decline (cf. Barkema *et al.*, 1996)[12]. When an acquired subsidiary is treated as a quasi-autonomous unit, on the other hand, there is no or only limited interaction with the acquired unit and its environment (Olie, 1996), which makes the scope for culture-related difficulties small and performance consequences negligible (Hofstede, 2001; Neal, 1998). Since Barkema *et al*. (1996) did not consider this second possibility, this may explain why their results did not fully corroborate their hypothesis.

Thus, a third factor that should be considered when examining the impact of CD on subsidiary performance – besides the subsidiary's establishment mode and its ownership structure – is the desired degree of integration between the subsidiary and the parent; another point that previous research has not considered.

In the next section we will develop a comprehensive model that incorporates these neglected issues and that enables a more precise assessment of the impact of CD on both foreign entry mode choice and subsequent subsidiary performance.

CONCEPTUAL MODEL

The previous section has made clear that in order to properly assess the impact of CD on entry mode choice and subsequent subsidiary performance, the existing literature should be extended in two ways. First, the observation that culture-related difficulties may arise from both intra-firm interactions and interactions with external stakeholders should be taken into account (cf. Barkema *et al*., 1996). Second, three subsidiary characteristics should be considered, viz. the desired degree of integration, the subsidiary's establishment mode, and its ownership structure. This leads to the conceptual model depicted in figure 1.

< Insert figure 1 about here >

[12] It should be noted that a firm faced with cultural conflicts may give up on its attempts to integrate the subsidiary, but the reduced *ex post* level of integration that results will in turn reduce performance.

According to this model, cultural differences may produce conflicts both internally and externally, which, in turn, reduces subsidiary performance. The extent to which this will be the case depends on three factors: the desired degree of integration between the subsidiary and the investing firm, the subsidiary's establishment mode, and its ownership structure. The model furthermore shows that cultural differences may also influence a firm's *ex ante* choice of establishment mode and ownership structure, but that this does not apply to the desired degree of subsidiary integration. This is because the latter factor is exogenous, as will be explained below.

The impact of CD on *ex post* subsidiary performance should be strongest during the first few years following the expansion (Buono and Bowditch, 1989). This is because cross-cultural issues may eventually be overcome, as firms can be expected to gradually learn how to deal with cultural differences (cf. Barkema *et al.*, 1996; Parkhe, 1991), which should reduce their harmful impact on performance. Meschi (1997) found that increasing IJV longevity reduced the extent of cultural differences between the IJV partners as perceived by their managers, suggesting that firms over time indeed learn how to deal with their respective cultures. Accordingly, cultural differences can be seen as being part of the so-called 'liability of newness' (Stinchcombe, 1965)[13].

Combining the three factors mediating the relationship between CD and performance produces a typology of foreign subsidiaries as depicted in figure 2. The figure shows that both firms seeking a high and those seeking a low degree of subsidiary integration can choose between four subsidiary types, viz. partially-owned greenfield (POGF), wholly-owned greenfield (WOGF), partial acquisition (PACQ), and full acquisition (FACQ).

< Insert figure 2 about here >

[13] According to some observers (see Buono and Bowditch, 1989, p. 194), it takes about five to seven years before employees feel truly assimilated into a new firm and before inter-group tensions and mutual distrust between members of acquiring and acquired firms have subsided. However, cases where cross-cultural issues persisted for as long as several decades have also been reported (Olie, 1996, p. 19). This suggests that the negative impact of cultural differences on performance may be long lived. This negative impact should nevertheless be particularly strong during the early years of the subsidiary.

According to transaction cost scholars (e.g., Hennart, 1982, 2000), firms expand abroad to internalize transactions that are too costly to accomplish through market exchange. This will be the case when the assets to be exchanged – which may be tangible, such as raw materials and components, or intangible, such as knowledge and goodwill – are poorly defined and difficult to measure. In this case, the price system fails to provide the right information and, thus, cannot enforce transactions (Hennart, 1991). Internalizing these transactions through FDI may be an efficient solution to this problem.

The first factor influencing the extent to which FDI produces culture-related difficulties and reduces subsidiary performance is the degree to which the investing firm wants to integrate the subsidiary into its network, which, in turn, mainly depends on the extent of interdependencies between the subsidiary and other units, either headquarters or other subsidiaries. When these interdependencies are low, the degree of subsidiary integration will usually be low as well. This is for example the case for firms pursuing multidomestic strategies, which require a high degree of local responsiveness (Bartlett and Ghoshal, 1989; Harzing, 2002). Letting local managers free to maximize the subsidiary's profits, and rewarding them as a function of these profits, rather than tightly controlling them through a high degree of integration is more efficient in this case. This relieves the investing firm's management from having to learn how to operate locally and economizes on the amount of information sent to and received from the subsidiary (Hennart, 1991). Integration is limited to the incorporation of the subsidiary in the firm's strategic planning system, which involves providing the subsidiary with broad guidelines for its role in the corporate portfolio and its goals. The subsidiary is expected to develop and propose its own strategic plans to achieve these goals, while headquarters evaluates these plans and, when approved, allocates resources for their implementation. Integration at the operational level does not take place. In case of an acquisition, most of the acquired unit's production, R&D, and marketing operations continue as they did before the acquisition (Shrivastava, 1986). Such a decentralized control system, which has a close resemblance to a market, is frequently employed by firms, especially by the larger ones (Buckley and Casson, 1991).

When large interdependencies between units are present, on the other hand, firms will usually strive for a high degree of integration. This is for example the case for firms pursuing global strategies. Global strategies are characterized by a focus on economies of scale and scope (Bartlett and Ghoshal, 1989; Harzing, 2002), which requires careful coordination of the activities of the different subsidiaries, as well as the exchange of goods and services between subsidiaries. This, in turn, requires a high degree of subsidiary integration. Firms seeking a high degree of integration typically rely heavily on behavior control, as opposed to price or output control, which is a more dominant control mechanism in firms that desire a low degree of integration for their subsidiaries (Hennart, 1991).

Firms striving for economies of scale and / or scope are in many cases forced to do so because of competitive pressures that cannot be ignored. As a result, firms can be expected not to compromise on the degree of integration they desire for a subsidiary, not even when CD is considerable[14]. This does not mean that firms have to put up with cultural differences, however, because they can influence the potential for cultural conflict associated with an expansion by strategically choosing the subsidiary's establishment mode and ownership structure, as will be shown below[15].

Let us first look at a foreign investor seeking a high degree of subsidiary integration. As stated earlier, such an investor can choose among four subsidiary types, viz. WOGF, POGF, FACQ, and PACQ. When the investor opts for a WOGF, it has to deal with all kinds of local stakeholders embedded in the foreign environment, which is likely to cause culture-related difficulties. When it decides to establish a POGF together with a local partner, the presence of the partner relieves the investor from having to deal with these local stakeholders, but now it has to deal with the partner instead, which may also produce cultural conflict. However, since the JV partner is a co-owner in the venture, this partner will at least be partially motivated to act in the venture's best interest, which should make the scope for cultural conflict somewhat smaller than in case of a WOGF.

[14] Although CD does not affect the degree of subsidiary integration sought, it does (negatively) affect the probability that the desired degree of integration will actually be realized. This is because increasing CD makes intra-firm cultural conflict, which usually hinders integration efforts, more likely.

[15] The other option is of course not to invest at all, which should occur when the expected costs of culture-related difficulties outweigh the expected net benefits from the expansion.

An investor seeking a high degree of subsidiary integration can also expand abroad through full and partial acquisitions. In case of a FACQ, acculturation will be double layered: the investor is exposed to an alien national culture through both interactions with the acquired unit and contacts with local stakeholders embedded in the foreign environment. This is because foreign investors tend to install managers from their respective home countries when they seek a high degree of integration (Buono and Bowditch, 1989; Danis and Parkhe, 2002; Edström and Lorange, 1984; Harzing, 1999; Hofstede, 2001; Neal, 1998; Olie, 1996) – managers who are often not familiar with the national culture of the host country involved. When the investor opts for a PACQ, the scope for cultural conflict will be smaller, because in this case part of the decision-making power remains within the local firm – decision-making power that is primarily manifested by the presence of local managers in the subsidiary's management team (cf. Konopaske, Werner, and Neupert, 2002). As a result, the investing firm is relieved from having to deal with all kinds of indigenous stakeholders embedded in the host-country environment. Moreover, because the local partner has an equity stake in the venture, it should at least be partially willing to act in the venture's best interest, which further reduces the likelihood that culture-related difficulties will arise[16]. Thus, when a foreign investor seeks a high degree of subsidiary integration, the scope for cultural conflict is considerably smaller for PACQs than for FACQs.

When the foreign investor seeks a low degree of subsidiary integration – for example because it pursues a multidomestic strategy – it has the same four subsidiary types to its disposal, i.e. WOGF, POGF, FACQ and PACQ. In case the investor decides to undertake a WOGF or POGF, matters are similar to the high integration case, with a WOGF requiring interaction with various local stakeholders embedded in the foreign environment, and a POGF requiring interaction with a local equity partner. Although the firm may experience culture-related difficulties in both cases, they should be less of a problem in case of a POGF due to the local partner's equity stake. The situation is completely different for the two acquisition types, however. Both FACQs and PACQs do not involve any acculturation, since acquired units that

[16] However, a firm seeking a high degree of integration is not very likely to choose this subsidiary type, as will be argued below.

are not or only limitedly integrated into the acquirer's operations are usually allowed to operate quasi independently, as stated earlier, with local managers running the venture. As a result, there is low or only limited interaction between the investing firm on the one hand, and the acquired unit and its environment on the other, which makes culture-related difficulties unlikely to arise.

Table 1 summarizes the above arguments. Since the desired degree of subsidiary integration is primarily dependent on the investing firm's strategy and, hence, not subject to variations, we distinguish between firms seeking a high and those seeking a low degree of integration.

< Insert table 1 about here >

PROPOSITIONS

As stated earlier, CD is expected to affect the choice between the various subsidiary types, as well as their subsequent performance. The choice between the subsidiary types depends on the scope for culture-related difficulties associated with them, which, in turn, depends on the amount of socio-cultural interaction involved. In general, the larger the scope for cultural conflict associated with a subsidiary type, the less likely that subsidiary type will be chosen, since rational managers should try to avoid culture-related difficulties as much as possible. However, managers are not *perfectly* rational. Otherwise, they would always perfectly anticipate the negative performance effects of cultural conflict and raise the expected rate of return required from an expansion to be carried out accordingly, and we would not observe variations in subsidiary performance in spite of differences in CD between expansions.

This explains why CD should also affect the *ex post* performance of the various subsidiary types, at least in the short run. The extent to which this will be the case again depends on the amount of socio-cultural interaction involved. Subsidiary types involving higher amounts of socio-cultural interaction will generally experience more culture-related difficulties and will therefore suffer more severe performance consequences than subsidiary types involving lower amounts of socio-cultural interaction.

Based on these observations, a number of propositions can be formulated. Since the degree of subsidiary integration sought by the investing firm is assumed to be exogenous, separate propositions are formulated for firms seeking a high degree of subsidiary integration and for those seeking only a limited amount of integration.

Propositions when the desired degree of subsidiary integration is high

Table 1a indicated that when the investing firm seeks a high degree of subsidiary integration, the scope for culture-related difficulties is small to medium for POGFs and PACQs, medium for WOGFs, and large for FACQs. Since firms should prefer subsidiary types that are less likely to suffer from cultural conflict over subsidiary types that are more likely to do so, and since they should be indifferent between subsidiary types for which the scope for cultural conflict is the same, the following propositions can be formulated:

<u>Proposition 1a:</u> CD does not significantly influence a firm's choice between a POGF and a PACQ, *ceteris paribus*.

<u>Proposition 1b:</u> The larger CD, the more likely a firm will choose a WOGF over a FACQ, *ceteris paribus.*

<u>Proposition 1c:</u> The larger CD, the more likely a firm will choose a JV (greenfield and acquisition) over a WOS (greenfield and acquisition), *ceteris paribus*.

When the investing firm seeks a high degree of subsidiary integration, all four subsidiary types are likely to suffer from culture-related difficulties, as shown in table 1a. Increasing CD should therefore lower the performance of all subsidiary types, at least during their early years. Formally:

Proposition 2a: The larger CD, the lower the initial performance of all subsidiary types, *ceteris paribus*.

However, since the scope for cultural conflict differs across the subsidiary types, we would expect subsidiary performance to vary accordingly. More in particular:

Proposition 2b: The negative impact of CD on initial subsidiary performance will be stronger for FACQs than for WOGFs, *ceteris paribus*.

Proposition 2c: The negative impact of CD on initial subsidiary performance will be stronger for WOSs (greenfields and acquisitions) than for JVs (greenfields and acquisitions), *ceteris paribus*.

Propositions when the desired degree of subsidiary integration is low

A number of propositions can also be formulated for firms that seek a low degree of integration for their foreign subsidiaries. Table 1b showed that when the desired degree of subsidiary integration is low, the scope for culture-related difficulties is small to medium for POGFs, medium for WOGFs, and negligible for PACQs and FACQs. Again, we assume that firms prefer subsidiary types that are less likely to suffer from cultural conflict over subsidiary types that are more likely to do so, and that they are indifferent between subsidiary types for which the scope for cultural conflict is the same. This leads to the following propositions:

Proposition 3a: The larger CD, the more likely a firm will choose a POGF over a WOGF, *ceteris paribus*.

Proposition 3b: CD does not significantly influence a firm's choice between a PACQ and a FACQ, *ceteris paribus.*

Proposition 3c: The larger CD, the more likely a firm will choose an ACQ (partial and full) over a GF (partially owned and wholly owned), *ceteris paribus*.

Since the scope for culture-related difficulties is small to medium for greenfield entry and negligible for entry through acquisition, greenfield entry should generally lead to lower performance than entry through acquisition. More specifically, increasing CD should lower the initial performance of greenfields, but not that of acquisitions. In addition, since the scope for cultural conflict differs across the two greenfield subsidiary types, we would also expect performance differences between these subsidiary types. That is:

Proposition 4a: The impact of CD on initial subsidiary performance will be different for greenfields (partially owned and wholly owned) and acquisitions (partial and full), *ceteris paribus*.

Proposition 4b: The larger CD, the lower the performance of greenfields (partially owned and wholly owned), *ceteris paribus*.

Proposition 4c: CD does not significantly influence the performance of acquisitions (partial and full), *ceteris paribus*.

Proposition 4d: The negative impact of CD on initial subsidiary performance will be stronger for WOGFs than for POGFs, *ceteris paribus*.

Additional propositions

A number of additional propositions can be derived from the typology as well. These propositions refer to differences between the two groups of firms (i.e., those seeking a high and those seeking a low degree of integration) with respect to their preference for a particular establishment mode (greenfield or acquisition) and ownership structure (JV or WOS).

It can first of all be argued that firms seeking a low degree of subsidiary integration will prefer acquisitions over greenfields, since these firms can be expected to pursue a multidomestic strategy requiring a high degree of local responsiveness. In order to be locally responsive, firms need to be well aware of the local market conditions and will therefore be more likely to acquire an existing firm with a knowledgeable workforce and connections in the local market than to set up a new subsidiary from scratch (Harzing, 2002). This does not imply, however, that firms seeking a high degree of integration will prefer greenfields over acquisitions, since these firms generally seek to exploit some type of firm-specific advantage, which can be done through both greenfield investments and acquisitions, depending on the type of advantage involved (Hennart and Park, 1993)[17]. This leads to the following proposition:

Proposition 5: The higher the degree of subsidiary integration, the more likely a firm will choose a greenfield over an acquisition, *ceteris paribus*.

It can also be argued that firms seeking a high degree of subsidiary integration will prefer WOSs over JVs, because a high degree of integration is easier to accomplish when the investing firm obtains full rather than partial ownership of the capital stock of its subsidiary (Hennart, 1982). The reason is that the absence of a partner in a wholly-owned venture facilitates integration, since a partnering firm may (consciously or unconsciously) hinder integration efforts of the foreign investor by delaying the decision-making process or by simply not cooperating. Firms seeking a high degree of subsidiary integration will therefore be likely to establish wholly-owned operations or make full acquisitions in order to facilitate and speed up the integration process, while those seeking a low degree of integration will generally have less need to have full control. Moreover, the latter type of firms may have a

[17] Proprietary process technology, for example, is generally more compatible with greenfields, while superior marketing skills are generally more compatible with acquisitions.

clear preference for shared control, because such firms often pursue a multidomestic strategy, which requires high amounts of knowledge of local circumstances – knowledge that can be obtained through JVs with local firms (e.g., Stopford and Wells, 1972). This leads to the following proposition:

Proposition 6: The higher the degree of subsidiary integration, the more likely a firm will choose a WOS over a JV, *ceteris paribus*.

CONCLUSIONS AND IMPLICATIONS

Although many IM studies have examined the impact of national cultural differences on foreign entry mode choice and subsidiary performance, we have argued in this paper that a more detailed examination is needed. In particular, we have developed a comprehensive model that incorporates a number of relevant issues that have not been addressed in previous research. By simultaneously considering multiple subsidiary characteristics (viz., the desired degree of integration, the subsidiary's establishment mode, and its ownership structure) and by explicitly taking into account that both intra-firm interactions and interactions with local stakeholders embedded in the host-country environment may produce culture-related difficulties, this fine-grained model overcomes many of the limitations of previous research on the impact of cultural differences on mode choice and performance. Future empirical research should test the validity of the typology of foreign subsidiaries derived from the model by testing the propositions developed in this paper. This should tell us whether managers of internationalizing firms actually consider cultural differences when making entry mode decisions and, perhaps even more important from a practical point of view, whether failure to do so results in lower performance.

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FIGURE 1: CONCEPTUAL MODEL

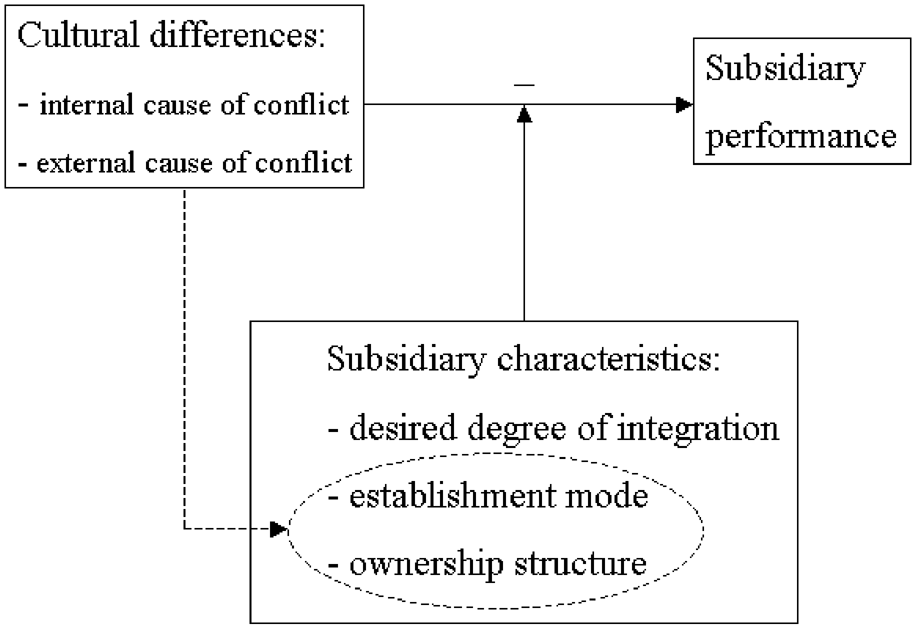
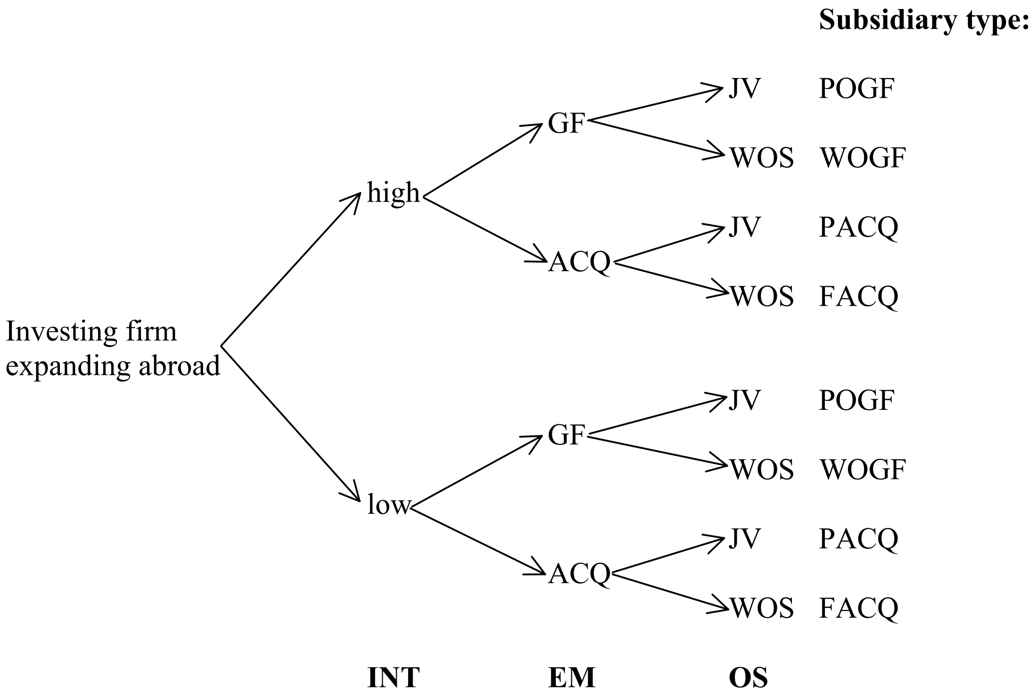


FIGURE 2: A TYPOLOGY OF FOREIGN SUBSIDIARIES



INT: desired degree of subsidiary integration
EM: establishment mode of subsidiary
OS: ownership structure of subsidiary

GF: greenfield
ACQ: acquisition
JV: joint venture
WOS: wholly-owned subsidiary

POGF: partially-owned greenfield
WOGF: wholly-owned greenfield
PACQ: partial acquisition
FACQ: full acquisition

TABLE 1: SUBSIDIARY TYPES AND SCOPE FOR CULTURAL CONFLICT

Table 1a: Scope for cultural conflict when the desired degree of integration is high

Subsidiary type:	Investing firm has to deal with:	Scope for cultural conflict:
POGF	local partner	small – medium
WOGF	foreign environment	medium
PACQ	local partner	small – medium
FACQ	foreign environment and acquired unit	large

Table 1b: Scope for cultural conflict when the desired degree of integration is low

Subsidiary type:	Investing firm has to deal with:	Scope for cultural conflict:
POGF	local partner	small – medium
WOGF	foreign environment	medium
PACQ	neither	negligible
FACQ	neither	negligible