Impact of Institutional Environment on Entry Mode Choice: A Review of Literature

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Abstract:
International entry mode selection is a crucial decision. This paper has the major purpose of reviewing the literature on the impact of institutional environment on the choice of entry mode in international business. By reviewing various studies, conclusions have been drawn. But the results were found to be very differing amongst the studies.

Keywords: *Entry mode choice, FDI, Institutional environment, International business*

1. Introduction

The choice of entry mode has a great impact on the entrant's performance and success of the foreign operation. These are the different forms of entering a foreign markets. These can be equity or non-equity. The equity modes category includes: joint ventures (JVs) and wholly owned subsidiaries (WOSs). WOSs further include Greenfield investment and acquisitions. The non-equity modes category includes export and contractual agreements. The contractual agreements include licensing, franchising and turnkey projects. These modes differ in terms of risk, return, control and the size of investment.

The choice to decide between these modes depends on many factors like; country related factors, industry to be targeted, market specific factors, and particular firm related factors. Country specific factors include the economic condition, political scenario, legal framework, social factors, institutional environment, etc of home as well as host country. Industry or market specific factors include entry barriers into a target industry, industrial uncertainty and complexity, market potential, level of consolidation, etc. Firm specific resources include international or business experience, size of the subsidiary, diversity of operations, nature of the product, proprietary technology, firm's culture, tacit know-how, specialized assets and reputation, firm's strategic goals, etc.

In our earlier paper (Garg, 2014), we discussed the various modes of entry and factors affecting them in detail. In our current paper we will focus on the institutional environment and its impact on the selection of mode to enter that country. There is no single and universally agreed definition of an 'institution'. Scott asserts that "Institutions are social structures that have attained a high degree of resilience. They are composed of cultural-cognitive, normative, and regulative elements." Institutional environment includes many factors like, culture, language, political risk, corruption, government effectiveness, regulatory quality, rule of law, property rights, etc.

2. Objective

The objective of the study is to review the literature related to the impact of institutional environment on the choice of entry mode in international business.

3. Literature Review

3.1 "The Effect of National Culture on the Choice of Entry Mode"

Kogut and Singh (1988) studied the effect of national culture on choice between equity modes of entry.

The data on 228 entries into the United States market was used. The results were drawn using a multinomial log it model. The dependent variable was the choice between acquisition, wholly owned green fields, and joint venture. The independent variables were: cultural distance between countries & attitudes towards uncertainty avoidance. The measures were derived from the work of Hofstede (1980). Other variables were diversification, country experience, multinational experience, asset size, R&D and advertising and sect oral dummies (manufacturing or services).

The results showed that the entry mode selection is influenced by cultural factors. The effect of Cultural Distance is to increase the probability of choosing a joint venture over an acquisition. The effect of Uncertainty Avoidance is to increase the probability of joint venture and Greenfield.

3.2 "The Effect of Regulative and Normative Distances on MNE Ownership and Expatriate Strategies"

Xu et al. (2004) examined the effect of two measures of institutional differences, regulative and normative distances, on Japanese MNE's ownership and expatriate strategies.

Dependent variable was equity ownership (wholly owned subsidiary, majority ownership, 50% ownership or minority ownership). Regulative and Normative Distances were measured using "management" and "institutions" factors global competitiveness report. Various control variables were incorporated at the country, industry, parent firm, and subsidiary levels, like culture, industry R&D intensity, industry advertising intensity, firm size, experience, etc.

Ordered logistic regression was used to analyze the level of ownership. The results showed that the MNE is less likely to hold a high level of ownership in sub-units located in institutionally distant host countries. Due to regulative and normative distances, it is difficult for the MNE to establish external legitimacy for the sub-unit in institutionally distant host countries. Therefore, the MNE is more likely to yield a large proportion of equity ownership to the local partner in exchange for local legitimacy and a smoother institutional transition. Hierarchical OLS regression results showed that regulative and normative distances are associated with a smaller presence of expatriates.

3.3 "Hofstede, Schwartz, or managerial perceptions? The effects of different cultural distance measures on establishment mode choices by multinational enterprises"

Drogendijk and Slangen (2006) examines the effect of cultural distance measures on the choice by multinational enterprises between expanding abroad through green field or acquisition.

The data included 246 foreign expansions by 157 Dutch MNEs between 1995 and 2003. Logistic regression was used. The dependent variable was the choice between green field and acquisition, the data on which was gathered through questionnaires. The independent variable, cultural distance was measured using data from Hofstede (1980), Schwartz [(1994) and survey-based perceptual measure

After controlling for other factors, it was found that high scores on all cultural distance measures significantly increase the likelihood that MNEs choose green fields, and that the explanatory power of the Hofstede and Schwartz-based measures is comparable, while that of the perceptual one is somewhat lower. It was finally concluded that it may thus be premature to dismiss Hofstede's work as outdated or as inaccurately reflecting national cultures, and to consider Schwartz's framework to be superior.

3.4 "The Impact of Corruption on Entry Strategy: Evidence from Telecommunication Projects in Emerging Economies"

Uhlenbruck et al. (2006) examined how firms adjust their strategy for entering foreign markets in corrupt environments and how different types of corruption affect firms' choices.

The data on 220 telecommunications development projects in 64 emerging economies was used, which was obtained from World Bank's Private Participation in Infrastructure (PPI) Database. It was analysed through multinomial logistic regression analysis. Dependent variable included two equity-mode choices (wholly owned subsidiaries and joint venture) and one non equity mode choice (build-own transfer/turnkey projects). The main independent variables were pervasiveness and arbitrariness of corruption. The measures of both of these dimensions of corruption were drawn from two sets of questions on corruption in the World Business Environment Survey (1998). Several other variables were also included to control for country, industry, project, and firm-level characteristics.

The results showed that, in the presence of corruption, MNEs use non equity and partnering modes as an adaptive strategy to participate in markets. They use short-term contracting and entry into joint ventures to adapt to the pressures of corruption. The significant coefficients for the WTO commitments variable suggested that equity entry via joint ventures is more likely where countries have acceded to a relatively high number of the WTO's openness and investment requirements. The coefficients of the political risk and experience variables suggest that higher political risk and prior participation in telecommunications projects, respectively, increase the likelihood of entry via joint venture with a local partner over entry via wholly owned subsidiary.

3.5 "Formal and informal institutional distance, and international entry strategies"

Estrin et al. (2007) studied the impact of formal and informal institutional distance on entry mode choice.

The data from six emerging economies was used that incorporated multiple host as well as multiple home countries. The econometric analysis was performed using a Logit model in which the dependent variable is mode of entry (Greenfield or otherwise). The independent variable, institutional distance was distinguished between formal and informal aspects. Scott's (1995) three pillars of regulatory (formal) and cognitive and normative (informal) were used to create separate indices for different aspects. The variable "Experience" (affiliate and commercial) was also used to study its interaction effect.

It was found that the probability of a green field investment is positively related to formal (regulatory) institutional distance, but negatively related to informal (normative and cognitive) institutional distance. So, these two have opposite effects on entry mode choice. Regulatory distance primarily increases the costs of cooperating with a local partner, and thus makes green field entry more attractive. Cognitive differences raise the benefits that investors may gain from establishing a JV or acquisition. In particular, the local partner may help enhancing legitimacy with local customers, business partners, and government authorities. It was also found that the effects of informal distance affect especially firms with prior experience in the country, while regulatory distance is not moderated by experience.

3.6 "Perceptions of Institutional Environment and Entry Mode: FDI from an Emerging Country"

Demirbag et al. (2010) analyzed the impact of institutional environment on entry mode choice of FDI coming from emerging countries.

The study was based on the collection of primary data at firm level selected from Turkish companies operating in Central Asian Republics (Azerbaijan, Kazakhstan, Turkmenistan, Uzbekistan and Kyrgyzstan). The dependent variable was entry mode choice (wholly owned subsidiaries and joint ventures). Principal component analysis was used to explore the underlying dimensions of political risk and binomial logistic regression was used to draw the results. The independent variables were ethical uncertainties and arbitrariness, political and economic risk, attitude towards FDI, relation between home and host country, risk of intervention, law and order uncertainties, corruption (bribery index), size of operations, route (sequential method i.e. export first, than equity based modes or direct entry).

The findings indicated that greater ethical and arbitrariness uncertainties, risk of intervention, law and order uncertainties and pervasiveness of corruption increase the likelihood of joint venture compared to wholly owned subsidiary. The better the relationship between the home and host countries of investors, the more likely are foreign investors to choose a wholly owned subsidiary entry mode over a joint venture strategy. Size of operations has a similar impact. Political and economic uncertainties, attitude towards FDI and entry route were found to be insignificant.

3.7 "External uncertainty and entry mode choice: Cultural distance, political risk and language **diversity"**

Lopez-Duarte and Vidal-Suarez (2010) analyzed the effect of political risk and cultural distance on the entry mode choice of Spanish MNEs and the influence of language diversity on the interaction effect of these two factors.

The period of analysis was 1989 to 2003. The sample comprised of 334 FDIs in 34 different host countries by 63 different firms, which was split into Spanish speaking and non-Spanish speaking samples. The results were drawn using Binomial regression model. The dependent variable was mode of entry (joint ventures and wholly owned subsidiaries). The independent variables were Cultural distance (CD), Political risk (PR) and Language diversity.

The findings showed that the external uncertainty coming from PR or CD positively influences the likelihood of choosing WOSs. But the existence of both, high PR & high CD, makes JVs preferable; however, such a preference for takes place only when language barriers do not exist. No empirical evidence was found for a preference towards WOSs when environment is characterized by both sources of external uncertainty and language barriers exist.

3.8 "The Effect of Corruption Distance and Market Orientation on the Ownership Choice of MNEs: Evidence from China"

Duanmu (2011) examined how corruption distance influences the choice between wholly owned subsidiary (WOS) and joint venture (JV) for MNEs operating in China.

The period of analysis was from 1981 to 2005. The data was analysed using random effects logistic regressions. The dependent variable was the choice between wholly owned subsidiaries and joint ventures. The independent variables were Corruption distance (obtained from corruption index from International Country Risk Group) and Market orientation (Horizontal or vertical FDI).

It was found that MNEs from countries which are less corrupt than China prefer WOS over JV; the higher corruption distance it is between these countries and China, the higher probability their MNEs choose WOS over JV. In contrast, MNEs from equally and more corrupt countries do not prefer WOS over JV; nor the corruption distance affect their entry mode decision. Market orientation has a universal and powerful effect on the entry mode choice regardless which group of countries MNEs are from. It also weakens the tendency for MNEs from less corrupt countries to choose WOS over JV.

3.9 "The Effects of Country-level Factors and Company-level Factors on Entry Mode Choice in China"

Larsen et al. (2014) examined how the country and company level factors affect the mode of entry in China.

The analysis was done using empirical data on 351 entries in China from 2002 to 2013. Binary logistic regression analysis was used. The dependent variable was entry mode (joint venture entry - equally split and acquisition/WOS entry - 100% stake increase). The independent variables were country-level factors (cultural distance, institutional distance and economic distance) and company-level factors (international experience, host country experience and firm size).

The statistical results showed that a higher institutional distance increases the likelihood of choosing a wholly owned subsidiary as entry mode, while a higher economic distance increases the likelihood of choosing an equity joint venture. The remaining predictors found no significant relationships.

3.10 "The effect of the magnitude and direction of institutional distance on the choice of international entry modes"

Hernandez and Nieto (2015) analyzed the relation between institutional regulative distance and the choice of international entry mode by European firms.

The results were drawn using multilevel analysis techniques and data on 10,560 observations of 3703 firms from 32 countries. The dependent variable was entry mode (exports, collaboration agreements such as technology transfers and licenses and foreign direct investment). The independent variables were Regulative distance (based on regulative dimension of Governance Matters VIII, compiled by Kaufmann, Kraay, and Mastruzzi), Distance direction (it takes value 1 when regulative distance is greater for destination country than that of the origin country and takes 0 when the opposite is the case) and Interaction between both (Regulative distance X Distance direction).

The results indicated that entry in countries with lower levels of regulatory development than that of the origin is related to modes that require a lower resource commitment. Conversely, entry in countries with higher levels of regulatory development is related to higher resource commitment modes. These findings suggested that the direction of institutional distance is important for the choice of international entry mode.

4. Conclusion

The institutional environment of home and host country and the distance between them is an important parameter for the choice of international entry mode. The study of literature showed that the entry mode selection is influenced by many of such factors but the exact direction of impact has not been established yet.

Some studies conclude that regulatory distance increases the preference for Greenfield investment but other studies contradict by concluding that regulative distances make it difficult for the MNE to establish external legitimacy for the sub-unit so the MNE is more likely to choose joint ventures. Similarly, cultural distance, corruption and political risk variables also have differing results.

So there is a need for comprehensive analysis in this area to establish exact direction of impact. Also, most of the studies which we have undertaken for the review have focused mainly on equity modes of investment and there is relatively less literature which focuses on determinants of non equity modes of entry.

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