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Author(s): Seung-Hyun Lee, Oded Shenkar and Jiatao Li

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RESEARCH NOTES AND COMMENTARIES

CULTURAL DISTANCE, INVESTMENT FLOW, AND CONTROL IN CROSS-BORDER COOPERATION

SEUNG-HYUN LEE¹* ODED SHENKAR,² and JIATAO LI³

¹ School of Management, University of Texas at Dallas, Richardson, Texas, U.S.A.

² Fisher College of Business, The Ohio State University, Columbus, Ohio, U.S.A.

³ Department of Management of Organizations, Hong Kong University of Science and Technology, Clear Water Bay, Hong Kong

Previous research analyzing the impact of cultural distance on joint venture negotiations has often confounded firm and environment effects. To decouple these effects, the cross-border cooperation preferences of small and medium-sized Korean firms were studied, considering simultaneously firms involved in inward and outward investment ventures. While cultural distance showed no significant relationship with the degree of control sought over the cooperative ventures, cultural distance was significantly related with a preference for ventures in domestic or foreign markets. The impact of cultural distance was found to be greater in inward investment than in outward investment. Copyright © 2008 John Wiley & Sons, Ltd.

INTRODUCTION

The extensive literature on foreign direct investment (FDI) often emphasizes cultural distance as a key determinant of a firm's mode of entry into a foreign market, and also of the type of cross-border cooperation, that is, equity or contractual (e.g., Kim and Hwang, 1992; Kogut and Singh, 1988). Most of the prior work on FDI has discussed multinational enterprises (MNEs) investing in foreign markets, rarely considering that firms not only invest overseas but may also invite foreign partners to join them in a cooperative venture

within their own domestic market. The domestic market is the country in which the focal firm is originally established, and where the cooperation is more easily managed. The country in which the foreign partner is operating will be termed a foreign market for the purposes of this discussion. Managing in a foreign country is harder for a focal firm because of its lack of familiarity with the foreign environment. Since past studies focused on a firm that was foreign to the market in which the cooperative venture operates, they confounded two types of challenges: the challenge of working in a foreign environment, and the challenge of working with a foreign partner.

The distinction is important, since a local partner can mitigate the problems that a foreign partner would encounter (Erramilli, 1990). Insisting on this distinction may prove useful in settling a

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*Correspondence to: Seung-Hyun Lee, University of Texas at Dallas, School of Management, Box 830688, SM 43, Richardson, TX 75083-0688, U.S.A. E-mail: lee.1085@utdallas.edu

major theoretical debate and resolving the empirical inconsistency over the impact of cultural distance on entry mode decisions (Shenkar, 2001).

In addition to confounding environment problems with partnership problems, previous studies have often made an unsubstantiated assumption that cultural distance is symmetric. They have assumed that the cultural distance from the focal firm to a foreign country is identical to the reverse cultural distance as seen from the partner's point of view (Shenkar, 2001). The few studies that have looked into foreign investment from the perspective of the local partner, however, suggest that such symmetry is unlikely (e.g., Luo, Shenkar, and Nyaw, 2001; Shenkar and Li, 1999). This potential asymmetry has received little attention.

The present study was designed to compensate for these shortcomings in the literature by simultaneously examining outward and inward cooperation mode preferences in cross-border cooperation, decoupling environment and firm effects on entry mode selection. Outward investment seeks a cooperative relationship in a foreign country in which the partner firm is operating. Cooperative domestic investment, on the other hand, seeks a cooperative relationship in the domestic market in which the focal firm is established.

To control for survival bias, the influence of partners preferences, and bargaining outcomes, this study has followed Tallman and Shenkar (1990) and Shenkar and Li (1999) in measuring investment preferences at the strategic intention stage instead of investments. Small and medium-sized firms from a newly industrialized country were considered, since such firms are as likely to seek cooperation for projects undertaken at home as to seek opportunities in foreign markets.

HYPOTHESES

National culture plays an important role in strategy formulation, as strategies are chosen on the basis of assumptions regarding the environment and about relationships among people (Schneider, 1989). Culture has also been identified as a key influence on operational management, where the need to adjust to a different cultural environment and/or to the routines and practices of a foreign partner is a daunting task and an impediment to performance (Agarwal, 1994; Kogut and Singh, 1988; O'Grady and Lane, 1996). The scope and

scale of these differences have been gauged in academic studies using the 'cultural distance' construct (Kogut and Singh, 1988).

To date, the vast majority of studies examining the impact of cultural distance have measured the investment mode preferences of firms undertaking outward investment (e.g., Barkema *et al.*, 1997; Li and Guisinger, 1991). Yet the same choice also applies to inward joint venture investment, where a focal firm is seeking a foreign partner to come into its domestic environment and contribute resources and capabilities that are internally unavailable, or to share business risk (Shenkar and Li, 1999). Further, the two FDI flows, inward and outward, are complementary, since the preferences of prospective foreign and local partners are eventually resolved in a mutual bargaining game.

As noted, a fundamental difference between outward and inward investment in cross-border cooperation is that the former involves dealing with both a foreign environment and a foreign partner, while the latter is limited to adapting to a foreign partner. Embarking on an international cooperative venture (ICV) in a foreign country requires dealing with unfamiliar suppliers, customers, competitors, regulators, unions, as well as more general constituencies (e.g., educational institutions, public opinion). In contrast, cooperating with an inward investor avoids the problems of managing in a different cultural environment. This allows the local firm to benefit from established legitimacy and established institutional support. The distinction would be expected to have an important impact on the relationship between cultural distance, investment direction, and the cooperative mode selected. These impacts will be investigated using cultural familiarity theory.

Cultural familiarity theory

Empirical studies on cultural distance and FDI have shown that culture affects entry mode decisions. Cultural familiarity theory holds that firms are less likely to invest in culturally distant countries, and that they show poorer performance when they do. For this reason, firms are likely to opt for a governance mode associated with less control as a way to alleviate problems in culturally distant locations (Li and Guisinger, 1991; Shenkar, 2001). Here the level of control is defined as the extent of ownership involvement in a cooperative relationship (Erramilli and Rao, 1993). The logic is that

since the different psychological environment of a foreign culture will lead to conflict, it is better to minimize exposure to things foreign by limiting presence in that market (Cartwright and Cooper, 1993).

Cultural familiarity logic thus predicts that firms would choose ICVs over wholly foreign-owned subsidiaries when seeking to reduce cultural exposure in a materially different market. Further, when opting for an ICV, the logic predicts that firms would pursue one involving less control on their part. Kogut and Singh (1988) and Kim and Hwang (1992) have indeed found that low control modes were often selected in situations characterized by high cultural distance. When there is great cultural distance, insufficient knowledge discourages large resource commitments to the ICV (Erramilli, 1990; Erramilli and Rao, 1993), leading firms to reduce the risk of cooperating with culturally different partners by choosing low control investment modes (Davidson, 1982). Thus, based on cultural familiarity theory, we propose that:

Hypothesis 1: Cultural distance will be negatively associated with preferences for higher control modes of cooperation.

Culture is generally understood to serve two critical functions: external adaptation and internal integration (Schneider, 1989). In a business context, outward investment necessitates balancing both functions; inward investment requires mostly internal integration with one partner. As Hofstede *et al.* (1990) have proposed, firms from different countries often differ in fundamental values, whereas firms from the same country differ primarily in their organizational practices. From this perspective, national culture should be of less concern when cooperating with an inward investor. Hence, from a cultural familiarity perspective, local partners will prefer to retain tighter control over their domestically based cooperative ventures. Hence,

Hypothesis 2: Inward investment will be more closely associated with preference for higher control modes of cooperation than outward investment.

Firms investing abroad are likely to incur some liability of foreignness (Knickerbocker, 1973;

Zaheer and Mosakowski, 1997), even if the cultural distance to their target destination is relatively small. This is because any need to change organizational routines and practices to accommodate a different cultural environment can be troublesome, even if the change is relatively minor. For instance, O'Grady and Lane (1996) observed high failure rates for U.S. firms investing in Canada, even though the two countries have highly similar cultures.

When hosting inward investment, the cultural adjustment is focused on building a relationship with the foreign firm and does not extend to the broader business environment. This allows a local firm to manage the relationship with a low level of ownership, since it is managing in a familiar environment. At the same time, the culturally distant partner, managing in an unfamiliar territory, will more easily allow its local partner to manage in its own way, even though the partner has a low level of ownership. A culturally close foreign partner, however, would be more comfortable with increasing its ownership since the foreign partner may have fewer problems in dealing with the national culture of the local firm. Therefore

Hypothesis 3: The direction of investment flow will moderate the relationship between cultural distance and preferences for tight control: the negative relationship between cultural distance and control will be stronger for firms seeking inward investment than for those making an investment abroad.

METHODOLOGY

Sample

The sample consisted of 444 small- and medium-sized Korean firms that are listed in the 1999 version of the *Directory of Potential Industrial Partners from Korea* (SMIPC, 1999) because they were seeking to establish a cooperative relationship in Korea with a foreign partner. The directory is compiled by the Small and Medium Industry Promotion Corporation (SMIPC) of South Korea, which keeps track of smaller firms engaged with foreign partners in cooperative ventures outside or inside Korea. The venture types included joint ventures, distributorship agreements, technology licensing

agreements, and mergers and acquisitions (M&A). In the directory, the firms indicated the area of the world they preferred for their activities, the proposed products, and basic firm data, including the industry in which the firm was already primarily engaged. Most of the firms indicated multiple preferences for the location and type of ICV, and each of the 837 firm-preference combinations was considered independently. The SMIPC originally surveyed 15,000 small and medium-sized firms to compile the directory.

Since the SMIPC was offering a free service, the response rate was 100 percent. Nevertheless, to see if the responding firms in 1999 still properly represent small firms in Korea, the sample was compared with the small- and medium-sized firm statistics for 1999 provided by the Korea Federation of Small Business (KFSB).¹ In general, firms with fewer than 50 employees were found to be overrepresented among the 837 cases, while those with more than 50 employees were underrepresented.² Comparatively larger firms may have been in a better position to find foreign partners on their own, while smaller firms needed more assistance from the government (Guillen, 2000). Deleting 125 cases that did not indicate either location or the type of ICV sought, reduced the sample to 712 cases. In addition, nine cases indicating a preference for M&A were excluded, since they were too few to give an adequate statistical result. A lack of cultural distance scores for many countries of preference eliminated more cases, and there were several industries in which all firms only wanted partners for outward investment. These industries were also excluded from the analyses. After all these excisions, a final sample of 386 cases was used in the analyses.³ To see if the deletion of part of the sample had affected its representativeness, a t-test was performed comparing the reduced sample and the original using size and age. The results confirmed that the final sample remained representative of the original in terms of those characteristics.

¹ We would like to thank the SMIPC and KFSB for providing the detailed data.

² This is not surprising in that Guillen (2000) has shown that in Korea, large firms are engaged more in international activities than their smaller counterparts.

³ A separate analysis confirmed that dropping some of the industries made no qualitative difference to the results. See the Appendix.

Measures

Independent variables

Direction of investment (Investment flow). Inward investment was dummy coded as '1' and outward investment as '0' for the analysis.

Cultural distance. Cultural distances from South Korea to other countries were measured with Kogut and Singh's (1988) index based on Hofstede's (1980) aggregate scores. This index has frequently been used in foreign entry studies (Agarwal and Ramaswami, 1992, Barkema *et al.*, 1997) and was applied here to afford comparability with prior work.

Control variables

Firm size. Various studies (Gomes-Casseres, 1985; Stopford and Wells, 1972) have found that firm size correlates with the ownership structure of foreign ventures. Firm size was measured by the number of employees.

Firm age. The liability of newness (Stinchcombe, 1965) suggests that reliability and accountability are favored in the selection process, and that both increase with age. Firm age was measured by the number of years the firm had been in operation.

Chaebol involvement. The South Korean economy is dominated by a group of large conglomerates, which makes it hard for small- and medium-sized firms to survive and sustain competitive advantage. High levels of industry concentration also imply that small competitors might find foreign markets more enticing than their own (Ito, 1997; Mascarenhas, 1986). Thus, the number of *chaebol* firms in each industry was controlled for. The list of *chaebol* firms was obtained from the Korea Fair Trade Commission.

Industry. Depending on which industry a firm is in, there might be differences in the propensity for going abroad or bringing partners to Korea. Lee and Plummer (1992) showed that Korean firms in industries such as textiles and wood products have more outgoing than inward investment, while machinery and chemical product firms show the reverse. That survey had already defined 11 industry classifications. Using this classification, we dummy coded the industries.

R&D intensity. Past research suggests that research and development (R&D) is an important source of competitive advantage (Dierickx and Cool, 1989; Henderson and Cockburn, 1994). In addition, investment in R&D is usually necessary for product innovation (Capon, Farley, and Lehmann, 1992; Hambrick and MacMillan, 1985; Ito, 1997). A reliable Korean firm database, WISEfn, was used to collect firm-level R&D investment data on all listed firms in Korea in 1999. These data were averaged by industry, and the appropriate industry average was attributed to each case in the sample.

Advertising intensity. Advertising is generally considered to increase customer loyalty, generate a reputation premium, and raise entry barriers against prospective competitors (Comanor and Wilson, 1974; Milgrom and Roberts, 1986). Over time, advertising helps firms develop strategic positions that are differentiated from those of their competitors (Fombrun and Shanley, 1990; Rumelt, 1987). Following the same procedure as for R&D intensity, industry averages for advertising intensity were calculated and applied.

Capital intensity. Capital-intensive firms may enjoy economies of scale in both domestic and overseas markets. Following the same procedure as for R&D intensity and advertising intensity, industry average capital intensity was calculated and applied.

Export intensity. International sales provide diversification and help stabilize revenues (Hirsh and Lev, 1971). Exporting firms might have more experience with foreign markets and thus be less concerned about dealing with partners from a culturally distant market. Following the same procedure as for R&D and advertising intensity, industry average export intensity was calculated and applied.

Dependent variable

Extent of control. High control modes were coded as '1' and low control modes as '0.' Outward investment took the form of equity joint ventures or export distributorships. Export distributorship implies handing over most sales rights to a foreign partner, so compared to an equity joint venture it represents less control from the Korean firm's

perspective. In inward investment, import distributorship means retaining more responsibility and control in the hands of the local Korean partner than an equity joint venture would provide. So the high control modes were the equity joint venture in outward investment and import distributorship in inward investment. The low control modes were export distributorship in outward investment and equity joint venture in inward investment.

Analyses and results

Because the dependent variable is dichotomous, we could not use a linear probability model. We therefore used logistic regression to gauge the likelihood of entry mode choice. Initial analyses showed high multicollinearity between the industry dummies and other variables that captured industry characteristics (R&D intensity, advertising intensity, capital intensity, and export intensity), so two separate analyses were conducted. In the first, the industry dummies were used without the variables that capture industry characteristics. In the second, only the variables that capture industry variances were included. The results of the two analyses were not qualitatively different (see the Appendix). Here we will discuss only the results using the industry dummy variables. To further test for the possible presence of multicollinearity, we performed variance inflation factor (VIF) analyses. The VIF scores were all below 10, which is considered acceptable (Neter *et al.*, 1996a).

The hypothesized relationships were tested for using a cross-sectional linear regression methodology, with White's adjustment for heteroskedasticity (STATA 8, 2003).

Table 1 shows the results using Kogut and Singh's (1998) aggregate measure of cultural distance in examining how cultural distance and direction of investment affect a firm's decision on control over cooperative ventures. Age and size showed no significant relationship for small firms deciding how much control to have. The number of competitors in the industry was also not significant. The number of *chaebol* firms in the industry, however, was significant ($p \leq 0.01$) and negatively associated with high control, except in Model 3. Perhaps strong *chaebol* presence signals a weak position for small firms in the industry, making them less eager to have a controlling interest in their cooperative ventures. Among the industry dummy variables, the electronic products industry

Table 1. Results of regression analyses on the mode of control

Control variables	(1)	(2)	(3)
Machinery	-0.507 (0.91)	-0.396 (0.75)	-0.170 (0.29)
Metal products	-1.466 (1.24)	-1.378 (1.18)	-0.989 (0.81)
Electronic products	-2.707 (3.07)**	-2.504 (2.84)**	-2.183 (2.32)*
Textile and garments	-0.986 (0.88)	-0.924 (0.80)	-0.445 (0.38)
Medical products	0.926 (0.78)	1.462 (1.31)	1.841 (1.62)
Age	0.410 (1.48)	0.446 (1.62)	0.456 (1.56)
Size	-0.205 (0.72)	-0.237 (0.85)	-0.298 (1.05)
No. of competitors	0.007 (0.85)	0.008 (1.04)	0.009 (1.09)
No. of chaebol firms	-0.145 (2.24)*	-0.124 (2.04)*	-0.096 (1.41)
Independent variables			
Cultural distance		0.160 (0.72)	0.420 (1.28)
Direction		1.086 (2.43)*	4.177 (2.67)**
Direction* Cultural distance			-0.919 (2.04)*
Constant	-1.355 (1.46)	-2.417 (2.26)*	-3.469 (2.34)*
Chi-square	19.21**	28.61**	36.73**
Log likelihood	-105.10	-101.10	-98.46
Pseudo r-square	0.10**	0.14**	0.16**
Observations	386	386	386

Robust z statistics in parentheses

* significant at the $\leq 5\%$ ($** \leq 1\%$) level

was the only industry that was significantly different from the other industries.

Cultural distance was not significant and thus Hypotheses 1 was not supported. A possible explanation is that the effect of cultural distance on the choice of entry mode is fundamentally different between inward and outward investments and requires different measures. The direction of investment however showed a significant positive relationship ($p \leq 0.05$ in Model 2 and $p \leq 0.01$ in Model 3). Therefore Hypothesis 2 was supported. This suggests that cultural familiarity theory provides a good explanation for the direction of the investment flow. Simply put, firms may feel more comfortable in their domestic environment and

therefore opt for arrangements giving them a lot of control.

To show the interaction effect, the nonstandardized beta coefficients and constants from the saturated regression model were used to plot the relationship between cultural distance and the level of control in inward and outward investments. The mean cultural distance was first calculated, and then the sample was divided into two to compute their respective means. So the means for low and high cultural distance cases were produced to show the interactions. The interaction between cultural distance and direction of investment was negative and significant at the five percent level. For the interaction terms, the variables were centered to avoid any multicollinearity problems that might arise in using interaction terms with the main variables (Neter *et al.*, 1996b)). Figure 1 shows the interactions among cultural distance, direction of investment and the level of control. Hypothesis 3 was supported.

Firms investing outside of their home country face the liability of foreignness (Knickerbocker, 1973; Zaheer and Mosakowski, 1997) and this applies to all firms investing abroad regardless of how large or small the cultural distance is. In other words, entering an unfamiliar environment by investing abroad involves significant unfamiliarity and uncertainty compared to what is faced by firms seeking inward investments. Therefore, when we compare the impact of cultural differences on the level of control sought over inward and outward investments, the impact of cultural distance is greater in inward investment than in outward investment. So firms welcoming inward investment commit fewer resources because of their unfamiliarity with the partner firm's culture.

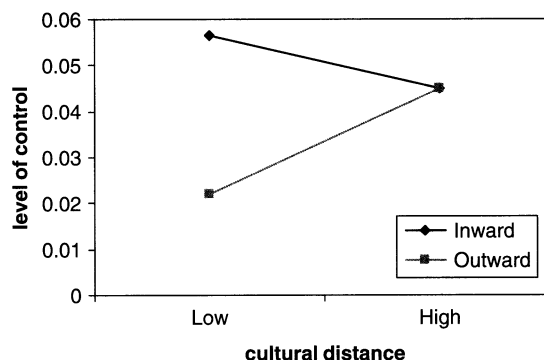


Figure 1. Interaction of cultural distance and direction of investment with the level of control

The Appendix presents the results of analyses including the industry level variables. The results capture more industry variances. The advertising intensity typical of an industry showed a positive relationship significant at the 10 percent level. R&D intensity was not significant, perhaps because advertising is more location-bound than R&D. Anand and Delios (1997) found that while R&D investments tend to transcend borders, advertising remains bound to the home market. It is possible that the benefits of advertising investment can only be appropriated in a particular location and cannot readily be transferred (Rugman and Verbeke, 1992). Firms that invest more in advertising might thus have more incentive to better use this capability in cooperative ventures by insisting on having more control. Capital intensity was not significant. The export intensity of an industry was significant ($p \leq 0.10$) and negative except in one model. Firms that export more may have less incentive to focus on cooperative ventures and so do not pursue high control.

CONCLUSION

This study applied cultural familiarity theory to develop hypotheses pertaining to the relationships between the direction of investment flow, cultural distance, and control (as reflected in entry mode preferences). To disaggregate the confounded impact of a foreign environment and a foreign partner when seeking cross-border cooperation, inward and outward cooperative preferences of small and medium-sized Korean firms were examined simultaneously. The findings showed no significant impact of cultural distance on control preferences, but they confirmed the relationship between the direction of investment flow and the level of control sought, and also the moderating role of investment direction in the relationship between cultural distance and control preferences. The results provide support for the cultural familiarity theory, reaffirming the importance of culture in FDI decisions. The findings confirm that interacting with a partner is just one facet of the interaction involved in undertaking an ICV. The findings also reaffirm the importance of examining the local partner's perspective in ICVs (Luo *et al.*, 2001) and that of examining a partner's strategic intentions prior to the bargaining game that determines the ICV's control structure (Shenkar and Li, 1999).

Ideally, future research should examine modal preferences simultaneously for foreign and local partners in the same two environments (such as the United States and France) so as to provide a better description of how such preferences are formed, and the extent to which they are influenced by cultural differences between the two locales.

While it is valuable to see that cultural distance asymmetry exists and that it makes a difference in firms' investment preferences, this study was limited to Korea. The results might be Korea-specific. Different findings are certainly possible if the cultural distance asymmetries in other countries are examined. For example, given that Korea is a country with high uncertainty avoidance and high power distance, firms in Korea might be more likely to seek less uncertain partnership choices. Firms from nations characterized by low uncertainty avoidance and low power distance may find it more valuable to seek opportunities abroad.

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APPENDIX: RESULTS OF REGRESSION ANALYSES ON THE MODE OF CONTROL WITH INDUSTRY LEVEL VARIABLES

Control variables	Model (1)	Model (2)	Model (3)
Age	0.383 (1.39)	0.419 (1.52)	0.422 (1.46)
Size	-0.217 (0.84)	-0.249 (0.99)	-0.301 (1.18)
No. of competi- tors	0.007 (0.97)	0.011 (1.40)	0.013 (1.59)
No. of <i>chaebol</i> firms	-0.276 (2.93)**	-0.290 (2.91)**	-0.277 (2.72)**
R&D intensity	-493.300 (0.60)	-842.123 (1.10)	-1,096.901 (1.37)
Advertising intensity	128.229 (1.74)†	149.310 (1.96)†	142.935 (1.87)†
Capital inten- sity	0.994 (0.31)	0.742 (0.24)	0.492 (0.16)
Export intensity	-6.502 (1.74)†	-6.173 (1.68)†	-5.698 (1.53)
Independent variables			
Cultural dis- tance		0.165 (0.75)	0.418 (1.27)
Direction		1.102 (2.53)*	4.012 (2.66)**
Direction* Cul- tural distance			-0.871 (1.99)*
Constant	-0.018 (0.01)	-0.764 (0.56)	-1.451 (0.93)
Chi-square	21.12**	28.44**	34.84**
Log likelihood	-107.26	-103.13	-100.70
Pseudo r-square	0.12**	0.16**	0.18**
Observations	444	444	444

Robust z statistics in parentheses

† significant at 10%; * significant at 5%; ** significant at 1%