

National cultural differences and foreign direct investment in emergent countries



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ABSTRACT

The aim of this study is to examine the effects of cultural differences on foreign direct investment performance in a rent-based economy. Regression analysis was used to test the hypotheses in a sample of 121 firms. The findings show that cultural distance, in general, did not have an effect on international foreign direct investment performance, but the hypothesis relating individualism scores of cultures from where foreign investment belongs and the performance of foreign affiliates is verified. The moral engagement of local employees appeared to have a catalytic effect. In contrast, uncertainty avoidance does not have any significant impact on the performance of affiliates. We also find that the performance of a foreign affiliate increases when they invest in the industry in which the host country has a comparative advantage.

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1. Introduction

International companies appear as a place where at least two different cultures coexist. The operations in those companies often generate quarrels and fatal shocks that can lead to their dissolution. This study aims to stress the importance of national cultural in a new area, the Middle East (the rent-based-economy), and to measure its impact on the performance of foreign direct investment (FDI). In the international business literature, Hofstede (1984) defined culture as the collective programming of the mind that distinguishes the members of one group or category from another. Hofstede (1984) built a quantitative model and synthesizes the major differences between cultures in four dimensions:

- Individualism
- Power distance
- Uncertainty avoidance
- Masculinity

In spite of the abundant literature, the effect of culture using the Hofstede model in some areas remains rare. This issue has become relevant in recent years because the integration of some

countries in the Middle East in the world trade organization has accelerated and partners from different cultures have established many projects.

2. Theoretical framework

In the literature on international business, cultural distance (CD) stems from external uncertainty associated with the informal environment of the host country (Delios and Henisz, 2003). Institutional theory argues that environment generates two major constraints. The first one is related to the political and economic system, and the second includes informal constraints and covers culture and ideology (North, 1991). Individualistic countries tend to be innovative and risk-taking (the USA). Collectivist cultures (Japan) tend to emphasize human capital and competitiveness (Hill, 1995). This paper stresses the informal constraints, especially culture, as a determinant of the success of international companies in foreign markets. Porter (1990) considered culture as a resource leading to a competitive advantage through the accumulation of assets and specialized skills and by the commitment of the employee to the company. Dunning and Bansal (1997) claimed that the commitment comes from cultural values and the competitive advantage obtained when culture promotes entrepreneurship and doing business. For example, the advantage of the United States as an individualistic culture lies in its mastery of technology. However, Japan, which is a collectivist culture, benefits in terms of labor organization and the establishment of relationships

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with customers, suppliers and partners. In this perspective, if cultural scores tend to show high levels of collectivism, masculinity and long-term orientation, it will be ranked as a resource. If it shows short-term orientation or high individualism, it will be ranked as an environmental constraint (Henisz and Delios, 2000; Delios and Henisz, 2003; Slangen and Van Tulder, 2009). In the process of the integration of international companies in foreign markets, cultural distance between the home and host countries emerges as a central variable of interest. In the literature on international management culture traditionally deals with the problem related to the choice of entry mode (Gatignon and Anderson, 1988; Kogut and Singh, 1988; Blodgett, 1992; Barkema and Vermeulen, 1997; Leung, 1997; Park and Ungson, 1997; Hennart et al., 1998; Li et al., 2001; Antia et al., 2007; Meschi and Riccio, 2008).

FDI occurs even by sharing the ownership of subsidiaries with other firms (joint venture) or by maintaining full ownership and engaging in contractual relationships as a franchise or license. Kogut and Singh (1988) have shown that cultural distance and the control of uncertainty are positively correlated with joint venture (JV) preference. Dunning and Bansal (1997) studied the effect of culture on firms, including joint ventures. They state that in countries with low levels of individualism, in presence of high transaction costs, companies will prefer the JV as a mode of entry into new markets rather than other forms of investment. In addition Li et al. (1999) argued that from the collectivist culture operating in China prefer labor-intensive industries and low levels of technological investments. On the other hand, firms from countries with individualistic cultures tend to invest in capital-intensive industries.

The national culture is the most specific attribute related to the population of a given country and is a potential influencing factor on FDI inflows. In many previous studies, cultural distance had a negative correlation with the performance of international companies and was used in many studies as an external factor to test the instability of strategic alliances (Gomes-Casseres, 1989; Blodgett, 1992; Park and Russo, 1996; Barkema and Vermeulen, 1997; Park and Ungson, 1997; Hennart et al., 1998; Meschi and Riccio, 2008). Hofstede's (1984) cultural dimensions has been used abundantly to analyze how the host country's culture can influence inward FDI for both "Greenfield" and acquisition direct investments.

Barkema et al. (1996) examined how companies can overcome national cultural differences to reduce foreign entry barriers through organizational learning. Firms can learn from a variety of experiences, including previous investment, which can help to reduce the barriers to entry in host countries (Johanson and Vahlne, 1990). Therefore, the strategy of entering foreign markets is the most important focus of research concerning FDI in an unfamiliar environment. In international

management, studies on cultural distance have been developed to choose the appropriate country and the appropriate form of investment (Barkema and Vermeulen, 1997; Hennart et al., 1998; Kogut and Singh, 1988; Li et al., 2001; Schneider and DeMeyer, 1991). However, cultural similarity does not equate to successful ventures. Kessapidou and Versarkelis (2002) argued that foreign firms that come from distant national culture environments benefit more from the mixture. This benefit is transformed into performance. Furthermore, culture cannot be considered as a fundamental determining variable in international business. Twomey (2002) explained that the expansion of FDI inflows in ex-colonies risks minimizing behavior because of the similarity in legal and political traditions between the host and home countries. Finally, from the economic point of view, any serious consideration of the investment in foreign markets must take into account the hypotheses of the eclectic paradigm (Dunning, 1980). International companies must seek three advantages when they decide to invest in foreign markets. The ownership advantages refer to the competitive advantages of the multinational seeking to engage in FDI. Location advantages refer to locational attractions and internalization advantages mean that firms will prefer to engage in foreign production rather than licensing. To attract investment, Dunning and Lundan (2008) proposed another model called the ESP (Environment / Systems / Policies) model. The environment includes the resources, capabilities, intangible assets and the ability of companies to use them to serve domestic or foreign markets. It includes the production factors, market size, infrastructure, communication, networks and relationships with local institutions. The systems refer to the macro-organizational mechanism in which these resources are allocated (the interaction between the role of the state and the market). Finally, policies are related to the country's governmental policies and strategic objectives. ESP and eclectic models focus on the economic background of FDI because the economic logic is more persuasive. Chinese culture is quite different from Western culture. Nevertheless, the volume of FDI in recent decades exceeds thousands of projects. Investors can first move for economic reasons and then look for solutions to the consequences of culture differences. Thus, in summation, we can posit the following hypothesis:

H1: There will be a negative correlation between cultural distance and the performance of international FDI in a rent-based-economy.

2.1. Individualism

The relationship between the individual and the community differs from one nation to another. It depends on social norms and the value system of the dominant group. Thus, it affects the mental program of individuals, the structures and the functioning of institutions, including the family, the education

system, and religious and political institutions. Individualism means that members of society prefer to act as individuals rather than as members of a group. Collectivist societies are traditional in which their members attempt to respect the group's standards and avoid engaging themselves in actions that are unappreciated by other members. Consequently, leaders will be less willing to offend norms and take too many risks. At the organizational level, engaging in risky investments can be seen as a willingness to endanger the existence of the company. Furthermore, the degree of individualism / collectivism in society affects employees' attitudes towards the organization. According to [Etzioni \(1975\)](#), when collectivist values prevail, there is a moral commitment to the organization. However, if the society's culture is individualistic, the calculative involvement dominates.

The degree of individualism depends both on social norms and other factors, such as the level of education of employees, the past of the organization and its size. [Hofstede \(1980b\)](#) attributed the moral commitment to medium-sized companies and the calculative involvement of large ones. Therefore, it is relevant to note that two levels of individualism coexist within the affiliates in developing countries. The first relates to the less developed countries that typically have collectivist cultures, and the second refers to the developed countries that typically have individualistic cultures. In this case, the divergence between employees produces an inconsistent and desynchronization toward the commitment to the achievement of organizational goals. This climate leads to potential conflicts and could have negative consequences on the performance of foreign affiliates.

Furthermore, the degree of individualism plays a crucial and decisive role in moderating the propensity for absorbing technological knowledge. According to [Hofstede \(1980a\)](#), there is a strong relationship between an employee's position in the individualism-collectivism continuum and technological assimilation. Indeed, advanced technology based on conceptual knowledge requires an individualistic behavior among entrepreneurs, managers, and employees and a posture synonymous with modernity, wealth and satiety. The introduction of such technologies in less developing countries changes social norms and becomes an instability factor. In addition, the high level of collectivism in traditional societies slows the process of technological transfer ([Hofstede, 1980a;b](#)). [Hofstede \(1980a,b\)](#) suggested that the transfer of intermediate technologies is more possible in the context of collectivist countries. Moreover, many authors argue that technology used in joint subsidiaries has mostly reached the stage of maturity. Furthermore, industrial cooperation is limited to assembly activities as opposed to conception activities typically reserved for partners from developed countries, which requires enormous technological competencies and very highly qualified human resources. In emerging countries, since

individualism encourages innovation and initiative ([Shane, 1992](#)), a company from a highly individualistic society when investing in a collectivistic country introduces technology and business know how, which could provide more advantages for the affiliates. This reinforcement of productivity in turn enhances profitability and the performance. Therefore, we can posit the second hypothesis as follows:

H2: There will be a positive correlation between the individualism scores of foreign investors and the performance of international FDI.

2.2. Uncertainty avoidance

Uncertainty avoidance refers to differences in the perception and management of environmental opportunities and threats ([Schneider and DeMeyer, 1991](#)). People equally face the uncertainty, but they are different in the ways that they face it. Each society has developed different manners to alleviate the anxiety generated by uncertainty, such as technology and laws ([Hofstede, 1994](#)). Technology helps to alleviate the natural uncertainties and laws serve to reduce it against the behavior of others. Generally, societies that accept uncertainty tolerate different behaviors and opinions. In practice, they are limited to minimum rules. However, societies with a high level of uncertainty are phlegmatic and contemplative and the environment does not promote emotion expression ([Hofstede and Bond, 1988](#)).

In business, investors face a double uncertainty. The first concerns the political, economic and financial environment of a given country. The second is associated with the behaviors of those who created it, including their probable reactions, common mental programming or more simply their national culture. Companies in countries characterized by high levels of uncertainty avoidance tend to organize themselves formally and hierarchically ([Hofstede, 1980b](#)). However, in countries where the level of uncertainty avoidance is low, formalization becomes unpleasant and the employees will be attracted by a more flexible structure. [Barkema and Vermeulin \(1997\)](#) stated that the uncertainty avoidance is strongly correlated with the performance of strategic alliances. This dimension is likely to be a determinant of the performance of FDI because it refers to the extent to which firms from different cultures coexist and cooperate with different levels of formalization, how they interpret threats and opportunities in the environment, the degree of risk taking of investors and the proliferation and success of projects. Therefore, we can posit the following hypothesis.

H3: There will be a negative correlation between the uncertainty avoidance scores of foreign investors and the performance of international FDI in the rent-based-economy.

3. Empirical analysis

3.1. Database and methodology

The current study uses a variety of secondary data sources in order to test the impacts of cultural factors on the performance of foreign affiliates using multiple regression analysis. The dependent variable used in the model is the profit ratio (NPROF), which is defined as net income over sales in the period under consideration. The study uses data issued by the FDI Intelligence from The Financial Times, The World Investment Report in 2013 and a local database for the affiliates of foreign firms established in the kingdom of Saudi Arabia and examines their operations between 2003 and 2013. The current study uses Hofstede's (1980a) culture dimensions because they are the most universal and widely accepted ratings and have been used in numerous prior studies. Data on 248 foreign firms were collected. However, due to the lack of individual data for some firms, our final sample consists of 121 foreign firms from both manufacturing and services. Table 1 presents the means, the standard deviations and the partial correlations of the variables used in our analysis.

3.2. Explanatory variables

The independent variables in this study are the national cultural dimensions. The validity of these dimensions has been empirically confirmed in many studies (Kogut and Singh, 1988; Barkema and Vermeulin, 1997; Hennart et al., 1998; Li et al., 2001; Schneider and Demeyer, 1991). We used two of the dimensions defined by Hofstede (1980b), the individualism index (IDV) and uncertainty avoidance (UA). We also used the national culture distance index (CD). We measured the cultural distance by the difference between the kingdom of Saudi Arabia and the home country in terms of Hofstede's (1980b) cultural dimensions using Kogut and Singh's (1988) formula:

$$CD_j = \sum_{i=1}^4 ((I_{ij} - I_{is})^2 / v_i) / 4$$

where

CD_j is the cultural distance of the jth country from the kingdom of Saudi Arabia

I_{ij} is country j's score on the ith cultural dimension,

I_{is} is the score of the kingdom of Saudi Arabia,

V_i = the variance index of dimension i, and

I_{ij} = the index of cultural dimension i for country j.

3.3. Control variables

The second set of explanatory variables includes the control variables that are firm and industry characteristics, which are widely recognized factors that affect the flow of FDIs received by a country (Yu, 1990). The size of the firm is used as a control variable by assuming that it affects profitability due to economies of scale and is measured as the logarithm of the number of employees at the specified period. As a control variable, the experience (EXP) of the firm is measured as the number of years from the first investment in the host country made by the foreign company until 2013. The longer that the period a firm operates in a market, the more it increases its familiarity with the host country's culture. Therefore, the experience arises as a factor influencing internationalization decisions and profitability (Delios and Beamish, 2001). To control the geographic scope of this experience, we consider a variable (DIV) that reflects the diversity and the engagement of a foreign company in host country (Erramilli, 1991). In addition to these variables, our study includes covariate related to industrial sectors in which the host country is specialized. To capture an industry effect, we use dummy variables (1= sector that host country has comparative advantage, 0= if the host country does not). We expect that companies investing in the petrochemical industry will be more profitable than others.

Table 1: Means, standard deviations and correlations

	M	SD	PROF	INDV	UA	SISE	EXP	ADV	DIV	
PROF	3.7510	1.72109	1							
CD	2.7884	1.40136	-.124	1.000						
INDV	31.2574	24.10297	.073	.185	1.000					
UA	58.7129	21.19355	.149	.221	.240	1.000				
SISE	5.227	1.6555	.275	-.02	.013	.088	1.000			
EXP	8.3366	3.87112	.101	.011	-.006	.066	.093	1.000		
ADV	.3366	.47492	.443	-.003	.045	-.116	.030	.139	1.000	
DIV	.6040	1.72109	-.355	-.046	-.066	.149	-.035	-.213	-.366	1.000

4. Discussion

Table 2 presents the results of two regression models with net profits as the independent variable (NPROF). As Table 2 shows, in the general case, the level of correlation indicates that multicollinearity is not a problem in our study. We used the variance inflation factor (VIF) to assess multicollinearity and found that the VIF scores were well below the

threshold of 10 for two models (Hair et al., 1998). Therefore, multicollinearity does not exist among the independent variables. In addition, the explanatory power of the models is good. Both measures are statistically significant at the p <0.05 level of significance. The two models contain the control variables. Their effects are partially in line with those reported in prior studies. The firms that belong to sectors where the KSA exhibits a comparative advantage are more profitable than the

firms that do not. The variable controlling for the comparative advantage of KSA (ADV) is statistically significant. Petrochemical firms are more likely to realize higher profitability than the service ones. Similarly, the control variables (SISE) used to test the effect of size on the dependent variables is statistically significant at the 10 percent level and the positive sign indicates that a larger foreign affiliate results in higher profitability. This fact may be due to the volume of the petrochemical market, as the KSA represent the top oil producer in the world. Finally, the years of presence in the host country (EXP) and geographic scope (DIV) seem to play no role in the explanation of the performance variation. The effects of control variables are maintained in both models when the independent variables are incorporated. Table 2 shows the results of the regression. As shown, we used two models. Model 1 performs the regression considering the control variables with cultural distance, and Model 2 also includes the control variables and cultural dimensions of home countries.

Table 2: Regressions for the performance of foreign companies

Variables	M1	M2
Constant	1.329 (1.089)	1.212 (1.258)
DC	-.018 (-.158)	
INDV		.207*** (2.020)
UA		.003 (.295)
SISE	.241** (2.761)	.241** (2.773)
EXP	-.011 (-.126)	-.013 (1.42)
ADV	.371*** (3.194)	.373*** (3.234)
DIV	-.130 (-1.100)	-.130 (1.107)
R^2 adjusted	25.4	26.1
F-statistics	5856***	6900***

t-stat in parentheses; *** p <.005; ** p <.01

Hypothesis 1 that stated that distance cultural has a negative effect on the performance of host country affiliates is not supported. National culture distance is not statistically significant in explaining the variation of the performance of foreign affiliates in Saudi Arabia (significance at p <0.05). This goes against the results of previous studies that found that, in most cases, there was a significant correlation with the performance of international companies in emerging countries (Kogut and Singh, 1988; Barkema and Vermeulen, 1997; Leung, 1997; Park and Ungson, 1997; Hennart et al., 1998; Delios and Beamish, 2001; Li et al., 2001; Antia et al., 2007; Meschi and Riccio, 2008; López-Duarte and Vidal-Suárez, 2013; Hancıoğlu et al., 2014). However, the sign of national culture distance is negative. This result confirms the important assumption of the literature that argues that foreign companies from countries with small cultural distances are more successful than firms from countries with large cultural distances (Barkema and Vermeulen, 1997; Feils and Rahman, 2011; Hofstede, 1980b; Park and Ungson, 1997). Furthermore, our analysis concurs with the results of (Kessapidou and Varsakelis, 2002) for the case of Greece. They claim that when foreign affiliate is culturally distant from the Greek

culture, the performance of the affiliate increases. Foreign companies in Greece coming from a distant national cultural environment take advantage of the mixture of the national cultures that makes them better performing. On the other hand, companies from similar national cultures use similar routines and similar operations process. Hence, the advantage of the intercultural interaction is not significant in terms of business performance. Kessapidou and Varsakelis (2002) had a resource-based vision of culture differences (Porter, 1990). Our results can be explained in same way. The KSA is a multicultural country, and this characteristic has become a habit in social life and the practices of companies.

Our findings support H2 that individualism is significant in explaining the variation in the performances of foreign affiliates in Saudi Arabia (significance at p <0.05). Parkhe (1991) proved that diversity in terms of national culture in companies is often perceived as a source of tension and as a cause of failure of international companies (Pothukuchi et al., 2002; Sirmon and Lane, 2004). Some studies considered that cultural differences between developing and developed countries reside essentially in the power distance (Mendonca and Kanungo, 1996) and at the level of uncertainty avoidance (Kogut and Singh, 1988). Our results demonstrate that individualism as a cultural dimension plays a catalytic role and enhances the performance of foreign affiliates. This result contradicts Boudabbous (2005) who claimed that in the context of Euro-Maghreb joint ventures (particularly, those between French and Tunisian companies), there are complications associated with individual values. Our results support (Triandis, 1989) in that; this dimension is particularly relevant to the performance of cross-cultural teams. The degree of individualism / collectivism can affect the attitudes of employees towards the organization. According to (Etzioni, 1975), when collectivist values dominate, the moral implication must settle in the organization. However, when individualistic values dominate, the calculative implication prevails. Therefore, it is relevant to note that within the foreign affiliates, there are two different levels of implication and engagement. The first one is relative to less developed countries that are generally collectivist cultures, and the second one is relative to the developed countries that are individualistic cultures. Hence, employee involvement varies according to the culture from which the employee belongs. Any incoherence in the relationships between employee-employee, employee-leader and leader-leader lead to employees that are uninvolved the objectives of the firm and ultimately affect the profitability of the company. Furthermore, according to (Yan and Luo, 2016), the employee-employee relationship and their mutual expectations differ considerably according to cultural contexts. The degree of individualism depends as much on social norms as on other factors, such as the level of education, the history of the organization and its size. Therefore, differences in social norms can be

transposed within the enterprise and can represent a serious threat to survival of international entities. In our sample, Saudi affiliates operate in a highly collectivistic climate as indicated in Hofstede's (1980a) taxonomy, and foreign companies generally have a great respect for the local system value. Therefore, the moral involvement of Saudi employees provides reasons for members to comply with the organization's requirements. In the context of the Chinese and Australian Joint ventures, Yan and Luo (2001) stressed the straightforward respect of norms, standards and social expectations. Underestimating ignoring them could create serious problems for management. They mention the example of the 13th month that the employees used to receive before the Chinese New Year holiday. The refusal of the Australian joint venture led to a general strike throughout the whole period of the holiday. Having said that, individualism as a factor of disagreement in interpersonal relationships can be understood from the definition of culture (Schein, 1985). He defines culture as a system of shared values and serves to solve the problems of external adaptation and internal integration. External adaptation refers to the definition of the organization's goals and strategies and how it responds to the environmental opportunities and threats. This reaction is related to uncertainty avoidance and long-term orientation dimensions (Schneider and Demeyer, 1991). In contrast, internal integration is associated with the interpersonal relationships in the organization that are related to individualism, power distance, and masculinity dimensions (Schneider and Demeyer, 1991). Thus, individualism refers to the problems of internal integration and falls under human resources practices. To avoid friction, Hofstede (1991) stated that human resource management in international companies is commonly left to the local partner. The same policy is taken by US multinationals in their German subsidiaries (Soeters and Schreuder, 1988).

Contrary to our hypothesis, uncertainty avoidance does not have a significant effect on the performance of international affiliates. This result is not in line with previous research. Kogut and Singh (1988) considered that cultural differences reside essentially at the level of uncertainty avoidance. Barkema and Vermeulin (1997) stated that uncertainty avoidance is negatively correlated with the performance of joint ventures. Knowing that uncertainty avoidance refers to differences in the perception and management of environmental opportunities and threats (Barkema and Vermeulin 1997, Schneider and Demeyer, 1991), one possible reason for our results may be the local partner's perception of the opportunity that represents the engagement in FDI. Investments in the KSA are mainly franchises and licenses, and there is no real and direct engagement in business. In fact, cultures with high levels of uncertainty avoidance such as the KSA prefer structure and predictability. Members of these cultures tend to takeover an existing business with existing products, market share and an

established organization (e.g., franchises and licenses). Another possible explanation in societies with low uncertainty avoidance such as Singapore is that there is a preference for unstructured situations and ambiguity, which favors risk taking and those, willing to start new businesses and promote innovation. Finally, the luck of common projects and a favorable environment may be an alternative explanation. Hymer (1976) claimed that a higher degree of liability of foreignness in high uncertainty avoidance nations may put foreign firms at a greater disadvantage relative to local firms, and therefore deters the performance of FDI.

5. Conclusion

The aim of our work was to validate whether the general tendency of the literature about the negative impact of national culture distance on the performance of international FDI still exists in the case of a rent-based economy. We used a sample of 121 foreign firms that operate in Saudi Arabia to test three hypotheses relating national culture to the performance. The first hypothesis stipulates that there is a negative correlation between the culture and performance of the foreign affiliates in KSA. Our analysis does not verify H1 and thus does not support most studies that claim that cultural distance aggravates performance since the cultural interaction creates unstable corporate management practices. Our analysis verifies the second hypothesis of the paper that claims that individualism in an emerging country has a positive effect on the performance of international FDI. The degree of individualism/collectivism can affect the attitudes of employees toward the organization. The employees' moral involvement in the collectivistic society insures the rich goals of international affiliates. Finally, the last hypotheses claimed that uncertainty avoidance in an emerging country has a negative effect on the performance of international FDI. The relationship is not verified. The discussion notes that considering that UA is the most influential cultural dimension in determining cross-cultural variation in technology acceptance (Geert and Jan, 1991; House et al., 2004), our result may be explained by the domination of franchises and licenses and the luck of industries that require high technology investments. Our paper can be expanded to test the impact of culture using the GLOBE project (House et al., 2004) and the Schwartz framework.

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