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The Effect of Multinationality and Strategic Choice on Subsidiary and Home-country Firm Performance: The Moderating Role of Cultural Distance

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Abstract: Previous studies have demonstrated the relation between performance and multinationality of the firm either at the home country level or subsidiary level. Drawing from resource-based view and institutional theory, this study aims to find performance implications of international diversification at both domestic and international levels. In attaining the performance, the study explores different strategies that MNCs use and the moderating effect of cultural distance.

Key words: multinationality; strategic choice; cultural distance; firm performance
JEL code: M

1. Introduction

Firms expect to increase performance when they make the decision to go global and internationalize their scope of businesses. International expansion allows the firm to capture economies of scale, or geographic scope (Kogut, 1985). One of the many advantages of international expansion is greater learning or international experience (Kobrin, 1991). Previous studies revealed the impact of international diversification on the performance of the Multinational Corporation (MNC) (Contractor, Kundu, & Hsu, 2003; Ghoshal & Nohria, 1989; Gomes & Ramaswamy, 1999; Wan & Hoskisson, 2003; Zahra, Ireland, & Hitt, 2000). These studies looked at the performance of the MNC either at the home country level or subsidiary level. Drawing from Resource-based view and institutional theory, our study is trying to find the implications of international diversification at more specific levels. Our research objective is to find out the performance outcomes of multinationality and strategic choices on subsidiaries of the MNC and also on its home country firms. The study argues that higher international diversification, depending on the strategic choices and cultural factors, leads to higher subsidiary performance which in turn collaborates with home country firm performance. In attaining the performance, the study explores the effect of cultural distance. Underlying the employment of cultural distance in international business research is the assumption that differences between foreign and home country cultures increase the cost of entry, decrease operational benefits, and hamper the firm's ability to transfer core competencies to foreign markets (Bartlett & Ghoshal, 1989; Palich & Gomez-Mejia, 1999).

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These costs of doing business in international markets could include a number of reasons, such as coordination difficulties, foreignness and unfamiliarity with the local culture market relations, or political boundaries. Therefore, in general, one would expect that a foreign firm would be at a competitive disadvantage relative to local companies in a country — it's so-called "liability of foreignness" — everything else being equal (Zaheer & Mosakowski, 1997). Hence, this study suggests that subsidiaries benefit when they are culturally closer to their home-countries since the difficulties would be less severe and the liability of foreignness would be less in play, at the least, in culturally familiar countries.

This paper is designed in the following way. First, based on the RBV, we demonstrate the linkage between firm resources and the MNC performance. Secondly, we look deeper on how international diversification enhances the subsidiary and home country firm outcomes. Thirdly, we demonstrate the moderating effect of cultural distance between the home and host country of the MNC on the performance at both domestic and foreign levels. Afterwards, we present the different strategic choices in this picture. Finally, the paper closes with conclusion, implications and future directions of the study.

2. Resource-based View

Resource-based view (RBV) presumes that firms within an industry are heterogeneous in the valuable resources they control, and such firm heterogeneity persists over time insofar as those resources are not perfectly mobile across firms (J. Barney, 1991). Strategies are therefore asserted to be based more on firm-specific attributes than on general market structures, and are devised by the firm to identify, protect, and exploit its unique skills and proprietary assets (Tallman, 1991). Consequently, the firm directs its strategy crafting based on resources that it has amassed (J. B. Barney, 1996; Oliver, 1997). Meanwhile, the firm also chooses a strategy that can better utilize the pool of resources (Madhok, 1997).

The two fundamental tenets underlying the RBV — that is, firm heterogeneity and resource immobility — are just as germane to an international context as they are to the domestic milieu (Ekeledo & Sivakumar, 2004; Knight & Cavusgil, 2004; Tan & Mahoney, 2005). To transform a short-run competitive advantage into a sustained competitive advantage requires that these resources are heterogeneous in nature and not perfectly mobile.

Laying these presuppositions on the case of multinational expansion, firms within a single industry exhibit a different level of international growth, mainly due to inherent idiosyncrasy in the resources they own. Further, the resources, which may be transferable across nations within the boundary of a firm, are not perfectly mobile across firms. Indeed, for a multinational firm contemplating an expansion strategy across national boundaries, its existing inventory of resources inevitably will limit the range of strategic possibilities (Tseng, Tansuhaj, Hallagan, & McCullough, 2007). Therefore, MNCs will be more comfortable in the markets similar to the ones where they have been upraised and where it can use its current resources and strategies.

On the other hand , firms can be conceptualized as bundles of resources that those resources are heterogeneously distributed across firms, and that resource differences persist over time from a RBV perspective (Amit & Schoemaker, 1993; Wernerfelt, 1984). Dynamic capabilities are considered as a type of resource, which are the antecedent organizational and strategic routines by which managers alter their resource base-acquire and shed resources, integrate them together, and recombine them-to generate new value-creating strategies (Grant, 1996; Pisano, 1994). In addition, dynamic capabilities are best conceptualized as tools that manipulate resource configuration, and they viewed dynamic capabilities as necessary, but not sufficient, conditions for competitive advantage (Eisenhardt & Martin, 2000).

In investigating the factors driving multinationality empirically; Tseng et al. (2007) distinguished between the effects of knowledge-based and property-based resources, and demonstrated that both categories of resources significantly impact on international growth, although the knowledge-based resources have more instant and longer-lasting influences than the property-based ones. Accumulated knowledge-based as well as property-based resources rooted in the internationalization help the MNC in growth and performance. As these tangible and intangible resources of the firm are stored in the dynamic capabilities, MNCs will demonstrate better performance at both home and host country levels. International diversification improves the knowledge and capability inventory enhancing resources of the firm. Therefore, the higher the degree of internationalization, the better the MNC will perform in both the subsidiary firm and home-country firm level.

3. International Diversification and Performance

In this study, we investigate the effects of multinatinality to performance in two different levels both at the subsidiary and home country firm level. International diversification refers to the share of foreign operations (sales, assets, subsidiaries, or profit) within the MNC's business portfolio, thus capturing the firm's level of international involvement. It has been theorized that through diversifying internationally MNCs can obtain new resources and transfer their core competencies to new markets (Bartlett & Ghoshal, 1989). These benefits may lead to higher MNC performance and risk-adjusted returns (Gomes & Ramaswamy, 1999; Kim, Hwang, & Burgers, 1993). MNC performance is the aggregate of both the subsidiaries and the home country firms. Hence, this study argues that international diversification would improve MNC's performance in the host country level as well as in the home country level. Therefore, we offer the following propositions:

Proposition 1: Multinational Corporations with higher internationalization diversification exhibit better subsidiary performance.

Proposition 2: Multinational Corporations with higher internationalization diversification exhibit better home country firm performance.

International expansion can promote organizational learning (Barkema & Vermeulen, 1998; Ghoshal, 1987). International experience as well as learning from global transactions adds to intellectual property of the MNC, improves both headquarter and subsidiary processes, and effect strategic decisions. Such expansion allows [MNC's] to achieve growth and positive returns by capitalizing on their unique resources and capabilities (Zahra et al., 2000).

Vernon (1971) affirmed a positive relationship between performance indicators such as return on investment (ROI) or return on sales (ROS) and the extent of multinationality of the firm. With the experience and increased knowledge in the headquarters, it is expected that the better an MNC's performance in global markets, the better it would do in its home market. Therefore, this study argues that higher performance at the subsidiary level will interact with a higher performance in their home country firm level. Therefore, we offer the following proposition:

Proposition 3: Performance at the subsidiary firm level is associated with the performance at the home-country firm level.

4. Moderating Role of Cultural Distance and Institutional Theory

Cultural distance represents the cumulative difference of cultural norms between two countries (Kogut & Singh, 1988). Cultural distance is a construct that denotes differences between a host and home country in basic aspects of culture, including core values, beliefs, customs, and rituals, as well as legal, political, and economic systems (Adler & Gundersen, 2007; Hofstede, 1980). In other words, drawing from institutional theory, these differences reveal themselves in both normative and formative traits. Institutional theory asserts that in order to survive, organizations must conform to the rules and belief systems prevailing in the environment, because institutional isomorphism, both structural and procedural, will earn the organization legitimacy (Scott, 1987). A multinational corporation operating in different countries with varying institutional environments will face diverse pressures. These pressures are higher in less familiar culturally distant environments.

Differences in national culture systems or the relative cultural distance between countries have been an important topic in the study of global companies (Tihanyi, Griffith, & Russell, 2005). Essentially, cultural distance represents the sum of factors creating on the one hand a need for knowledge, and on the other hand barriers to knowledge flow and hence other flows between the home and target countries (Brouthers & Brouthers, 2001). Accordingly, as the cultural differences between a global company's home and a host country market increase, the underlying ability of the company to operate effectively in the host market decreases (Gomez-Mejia & Palich, 1997). Increased operational difficulties resulting from cultural distance are, in general, derived from the lack of understanding of the norms, values, and institutions that afford social exchange across markets. In addition, cultural distance is often associated with higher levels of complexity and uncertainty, which hamper managerial decision making in distant markets (Tihanyi et al., 2005).

As the national cultural distance between MNCs home-countries and their subsidiaries increases, the underlying gap in the norms, values and institutions that govern exchange between the parties increase. Increased national cultural distance increases the complexity of operations and reduces communication effectiveness (Cui, Griffith, Cavusgil, & Dabic, 2006).

In cases where cultural distance is high between home country and host country of the MNC, learning, acculturation and transfer of home-based management become more difficult, subsequently managing foreign subsidiaries becomes more difficult. As a result, foreign subsidiaries are more likely to perform poorly. When cultural distance is low, the negative effects such as learning difficulties may not be huge and the benefits may be greater than the negative effects. Therefore, cultural distance may benefit performance of the subsidiary. Furthermore, when the home country and host country are culturally distant, some of the parent firm's competencies may not be applicable in the host country environment (Johanson & Vahlne, 1977). This situation may require the parent firm to build new locally relevant organizational capabilities. During this process, the learning between a parent firm and its subsidiary is difficult and time consuming which would result in high transaction costs and in turn would aggravate the poor performance of the subsidiary.

In the context of performance implications, we propose that home-host country cultural closeness strengthens the direct effects of normative and formative institutions. Therefore, the effects of heightened uncertainty and risk due to high cultural distance should diminish the performance. Cultural difference, in this sense, exaggerates the relationship between the effects of multinationality on performance and the subsidiary performance. Therefore, we offer the following propositions:

Proposition 4: Cultural distance between the home-country of an MNC and the host country where the *subsidiary firm is located moderates the relationship between international diversification and subsidiary performance.*

Proposition 5: Cultural distance between the home-country of an MNC and the host country where the subsidiary is located moderates the relationship between subsidiary firm performance and home-country firm performance.

Proposition 6: Average cultural distance between the home-country of an MNC and the host countries where the subsidiary firms are located moderates the relationship between international diversification and home-country firm performance.

5. Strategic Choices

In their seminal book, Bartlett and Ghoshal (1989) examines the local responsiveness and global integration of the MNCs and develop a typology based on a matrix of four strategies: international, multi-domestic, global and transnational. Knowledge flows and the internal coordination complexity of the four types of strategy differ from each other (Wolf & Egelhoff, 2002). First, international strategies involve little explicit exploitation of either global integrating advantages or local adaptation advantages, and thus has limited ongoing exchange of knowledge; secondly, global strategies integrate strategic decisions and centralize core operations; knowledge flows thus are primarily top down, and control is tight; thirdly, multi-domestic strategies assign subsidiaries a specific scope with respect to local markets, and allow more local adaptation; and finally, transnational strategies create the most complex coordination challenges by involving extensive intra-organizational trade, strategic coordination and knowledge exchange not only between headquarters and subsidiaries, but across subsidiaries in different countries (Meyer & Su, 2015).

Examining these strategies as organizational typologies, Leong and Tan (1993) found that executives perceived their companies to vary in international organization types and multi-domestic corporations dominated the typologies, followed by the international and global forms while the transnational form was found to be the least evident structure.

In global strategy, priority is given to global integration while less attention is allocated to local responsiveness. Global companies tend to focus on low cost advantages and non-location bound advantages, such as knowledge based assets (Meyer & Su, 2015)**.** Global strategy integrates the MNC's organizational processes to a higher degree and therefore takes advantage of economies of scale and scope as well as accumulated learning across the MNC. A multi-domestic strategy gives priority to local responsiveness while sacrificing possible economies of scale. A typical multi-domestic strategy may be marketing locally adapted products in each market.

An international strategy has low focus on both global integration and local responsiveness. Therefore, international strategy cannot take advantage of either economies of scale or localization to domestic consumers, and thus can be regarded as a weak strategy. The literature has paid limited attention to international strategy, noting mainly that it would normally be inferior because it neither exploits advantages of responsiveness to local markets, nor advantages of integration and hence knowledge sharing and scale economies (Meyer & Su, 2015).

Transnational strategy, on the other hand, intends to link the benefits of global scale and learning with the benefits of locally adapted products and processes. However, this strategy and the accompanying matrix organizational structure has been criticized as being excessively ambitious, generating complex intra-organizational processes that results in conflicts of interest, creating counterproductive organizational politics, and weaken incentives for individual business units (Chen, Chen, & Ku, 2012; Devinney, Midgley, & Venaik, 2000; Mudambi, Pedersen, & Andersson, 2014; Venaik, Midgley, & Devinney, 2005). Due to above mentioned shortcomings of international and transnational strategies; our study only uses multi-domestic and global strategies in proposition developments.

In regards to culture of the countries that MNCs are operating, MNCs' using global strategy would be more prone to cultural distance effects since they do not adopt their strategies for each different location and try to gain non-location bound advantages created centrally and exploited throughout the organization. On the other hand, the benefits of global strategies such as knowledge based-assets accumulation, economies of scale and economies scope may be more exploited by the home-country firms since they are closest to the head-quarters where global operations are coordinated with spillovers being more accessible. Furthermore, when the cultural distance between the home-country and host locations are closer, home-country firms would benefit even more from these advantages since they would be easier to carry over to home location due to similarities. Therefore, we offer the following propositions:

Proposition 7: MNCs implementing global strategies have better performance <u>at the home-country firm level</u> than MNCs implementing multi-domestic strategies.

Proposition 8: Average cultural distance moderates the relationship between global strategy and performance <u>at the home-country firm level.</u> As the average cultural distance decreases, the positive impact of global strategy increases while as the average cultural distance increases, the positive impact of global strategy decreases.

MNCs competing to a large extend on the basis of location bound advantages that they combine at each location with the global, non-location bound advantages use multi-domestic strategies and adopt their strategies to each country environment and should be more aware of the cultural distance effects in implementation. Furthermore, the benefits of multi-domestic strategies such as gaining the local market attention may be better exploited by the subsidiary firms since they would be more focused to native needs and react rapidly to the changes in the host market. Additionally, when the cultural distance between the home-country and host locations are farther, the importance of implementing multi-domestic strategy would be felt more dramatically since these markets would need a unique approach rather than a typical approach an MNC may use. Therefore, we offer the following propositions:

Proposition 9: MNCs implementing multi-domestic strategies perform better <u>at the subsidiary firm level</u> than MNCs implementing global strategies.

Proposition 10: Cultural distance moderates the relationship between the multi-domestic strategy and performance <u>at the subsidiary level.</u> As the cultural distance increases, the positive impact of multi-domestic strategy on performance increases while as the cultural distance decreases, the positive impact of multi-domestic strategy on performance decreases.

6. Control Variables

This study proposes several control variables on both the subsidiary level and the home country firm level. On the subsidiary level, we offer to control for size, age and ownership which all may cause performance imbalances for the MNCs. Previous studies (Anderson & Gatignon, 1986; Gomes-Casseres, 1989; Hennart, 1991; Padmanabhan & Cho, 1996) have adopted a 95% equity ownership as the cutoff point to differentiate between a wholly owned subsidiary and a joint venture. Thus, this study suggests using this percentage in controlling for the ownership effects.

On the home country firm level, we propose to control for size, age, R&D intensity and advertising intensity. Previous studies have suggested that the scale of an MNC's marketing function, usually operationalized by advertising intensity; helps explain a firm's international involvement (Capon, Farley, & Hoenig, 1990; Caves, 1996; Keown, Synodinos, Jacobs, & Worthley, 1989). Advertising intensity has some performance improvement indications for the firm. In addition, research and development activities themselves predict the rise of MNCs (Caves, 1996). R&D Intensity is a principal means of gaining market share in global competition (Franko, 1989), thus R&D activities would enhance performance of the MNC. Therefore, this study suggests advertising intensity and R&D intensity as control variables in the home country firm level.

Following our propositions and control variables, we suggest the following conceptual model:

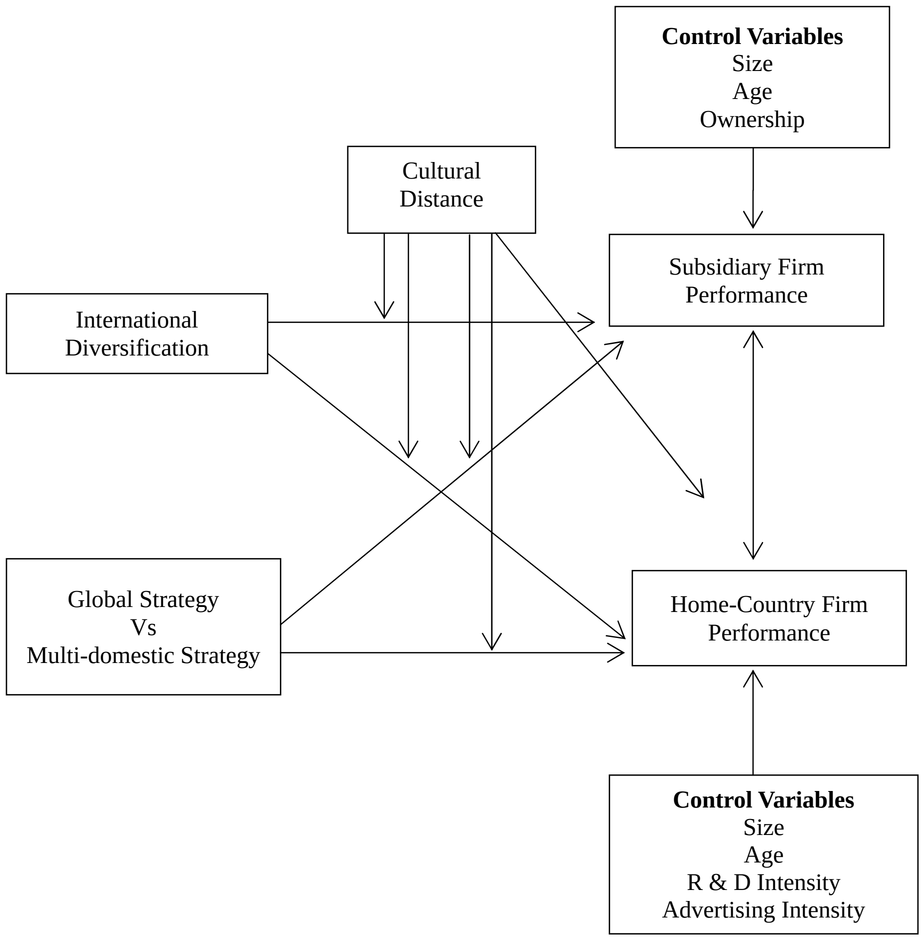

Figure 1 Conceptual Model

7. Conclusion, Implications and Future Directions

The study has some implications for MNCs. First, it demonstrates the importance of international diversification on performance of the MNC at both the home-country firm level and the subsidiary firm level. Secondly, it shows that how the cultural contexts of the foreign countries would enhance or limit the performance of the MNC in global markets and that liability of foreignness firms face abroad is bounded to the cultural and institutional distances of the home and the host countries. Thirdly, the study illustrates how different strategic choices, namely the multi-domestic and global strategies, have different inferences for subsidiary and home-country firm contingent on the moderation effects. This study guides MNCs in choosing new international markets in order to gain better performance outcomes by showing the impact of cultural distance in international diversification and importance of strategic choice in determining which market to internationalize. Additionally, it also validates the interaction of subsidiary firm performance with the home-country firm performance.

In regards to future direction, this study and the propositions presented should be tested using empirical data. MNCs head-quartered in the United States could be used in the testing the model. Secondary data can be obtained for the degree of international diversification, subsidiary and home-country firm performances and control variables from Hoover or Bloomberg business resources. Cultural distance data between host countries and the United States can be obtained from the GLOBE study (House, Hanges, Javidan, Dorfman, & Gupta, 2004). Strategic choices of the MNCs may be obtained using content analysis of the firm web sites or alternatively via mail surveys to firm executives.

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