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Cultural Characteristics as Institutional Environment Shift Parameters: A Study of Governance Modes in CBAs

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Recent, influential research in international business has given a new fillip to the institution-based view by proposing that it is evolving from a theoretical lens towards an integrative paradigm for the field (Cantwell, 2016; Meyer & Peng, 2016). The recipients of the 2015 JIBS Decade Award, Klaus Meyer and Mike Peng attribute variations in business context to be of critical importance for the explanation of business phenomena around the world, and propose that the institution-based view integrates perspectives from both developed and emerging economies into its fold. Such research has highlighted the importance of both formal and informal institutions, and their interactions (Ang, Benischke, & Doh, 2015).

Informal institutions often tend to be more persistent than formal institutions, but in different contexts they have been found to substitute, accommodate or even replace the formal institutions (Estrin & Prevezer, 2011); and during economic transitions, they also compete with and undermine the effectiveness of existing formal institutions (Peng, 2003). The bulk of the studies have focused on studying the influence of home country informal institutions or the differences/distance between home and host country institutions (Meyer & Peng, 2016). Little attention has been devoted to the exclusive impact of the host country informal institutions. The few studies that do so, examine it indirectly through phenomena such as social adaptation of MNCs (Zhao, Park, & Zhou, 2014), or as broader studies extending the influence of cultural distance (Beugelsdijk, Slangen, Maseland, & Onrust, 2014; Brouthers 2002, Slangen & Beugelsdijk, 2010). Although recognized as an enduring topic of interest to international business and management (Caprar, Devinney, Kirkman & Caligiuri, 2015), the informal institution of host country national culture in particular has not received adequate attention, either empirically or theoretically (Harzing, 2003; Morschett, Klein & Swoboda, 2010).

We argue that host country cultural characteristics matter independently, as the prevailing national culture can affect the transaction costs of doing business in the host country. This scholarly direction is inspired by Pryor (2007) who has mapped clusters of economic systems to clusters of national culture systems, and further argues how these values have the power to shape the economic systems. Williamson (2000) in taking stock of new institutional economics also lays the foundation at the social embeddedness level, which has a pervasive effect on the long-run character of economies. Beugelsdijk and Maseland (2011) provide a broader treatment of the theory of culture in economics and call for the need to explain how specific cultural dimensions matter within an international economics frame.

The theory we propose is that each of Hofstede's (2001) dimensions of national culture can individually be treated as parametric shifts in the institutional environment across countries in the comparative economic organization framework (Williamson, 1991). The comparative economic organization framework discriminates between market, hybrid and hierarchical governance forms based on the details of transactions on the one hand and the institutional environment context on the other (Henisz, 2000; Henisz & Williamson, 1999; Williamson, 1991). Different institutions have the power to shape the incentives for managerial agents differently, and thereby create variations in the effectiveness of alternative governance structures (Meyer & Peng, 2016). Comparative economic organization has been examined from the transaction cost economics lens for institutional environment shifts in the case of multinational actors (Henisz & Williamson, 1999). Henisz (2000) has focused on the *formal institutions* in terms of the impact of contractual and political hazards determining governance forms. While formal institutions have been the focus of most studies, this paper considers the impact of *informal institutions* (North, 1986), the norms, customs, mores and religion in the environment, some of which operates in the form of national culture (Henisz & Williamson, 1999). In doing so, we connect cultural theorizing with institutional theorizing as recommended by Peterson (2016).

This study attempts several contributions on both theoretical and methodological fronts. First, this attempt study extends the use of the comparative economic organization framework for the analysis of *informal institutions*, thus providing an integrated transaction cost model that encompasses into its fold both cultural and institutional factors rather than treating them as additive extensions (Brouthers, 2002). Second, the study focuses on the influence of host country cultural characteristics, as against home country influences or differences between home and host countries, and host cultural characteristics have received little attention especially in the context of entry mode. An empirical test of the hypotheses is attempted using 69796 cross border deals from the year 1980 to 2015, sourced from *Thomson Financials SDC Platinum* database employing an extensive set of controls from eclectic sources. Our third contribution is a careful multi-level (MLM) analysis of national culture's influence on the firm-level decision, a methodology recently recommended for more precise findings for international business research (Peterson, Arregle & Martin, 2012).

1.1 THEORY AND HYPOTHESES

1.1.1 Culture in entry mode studies

A few studies have specifically analyzed the impact of the individual cultural characteristics on mode choices, thus attempting to shed light on the paradoxes of the aggregate construct. Kogut and Singh (1988) argued that, in addition to their pioneering construct of cultural distance, home country uncertainty avoidance was an important determinant- the greater the culture of the investing firm is characterized by uncertainty avoidance, the greater the likelihood of choosing a joint venture or wholly owned greenfield over an acquisition. Again, Erramilli (1996) has argued that greater the power distance characterizing the firm's home country culture, or and greater the uncertainty avoidance characterizing the firm's home country culture, greater the likelihood that the firm will seek majority ownership in foreign subsidiaries. Hennart and Larimo (1998) did not find support for Erramilli's (1996) hypothesis. The focus of these studies has been on the influence of the home country dimensions. Barkema and Vermeulen (1997) went one step ahead by considering the differences between the home and the host country dimensions, to hypothesize that differences in uncertainty avoidance and long term orientation, rather than other dimensions, reduces a firm's propensity to set up an intenational joint venture rather than a wholly owned subsidiary. Brouthers and Brouthers (2001) also used differences in individual cultural dimensions to argue that investment risk moderated the relationship between cultural distance and wholly owned forms of entry. The only study that examines host cultural characteristics is Bharadwaj, Dietz and Beamish (2007) but they examine its influence on foreign direct investment location choices.

1.1.2 The Comparative Economic Organization Framework

Williamson (1971, 1991, 2000) is credited with operationalizing the field of transaction cost economics. Williamson's (1991) framework on comparative economic organization is represented in Figure 1. In simple terms, the three forms of governance, market, hybrid and hierarchy, are supported by different contract forms, and incur different relative transaction costs, represented by the three curves in the figure. The costs are a function of the asset specificity k and a vector of shift parameters. For a particular value of k (let us say k*), the optimal form of governance is decided by operating on the envelope of the three curves; when k* is less than k_1, managers use the market form, the hybrid form when k* lies between k_1 and k_2, and hierarchy in cases where k* is greater than k_2. The critical predictive action is that which is located in the neighborhood of k_1 (M to X) and k_2 (X to H).

The tenets of the transaction cost economics paradigm rest on the concepts of asset specificity, uncertainty and frequency of contracting, backed by the assumptions of bounded rationality, incomplete contracts and opportunism (Brouthers & Hennart, 2007). As asset specificity and uncertainty increase, greater levels of control are considered preferable in the relationship between the parties.

In addition, Williamson (1991:287) also brings in the *institutional environment*, as the "set of fundamental political, social and legal ground rules that establishes the basis for production, exchange and distribution". The institutional environment is treated as a set of parameters, changes in which draw out shifts in the comparative costs of governance, i.e. they cause differential shifts in the intercept and/or slope of each governance mode. The intercept reflects the fact that the *bureaucratic costs* of a particular form of organization is high or low because of inferiority or superiority respectively in *autonomous adaptation* respects, which are basically market-like transactions and represented as adaptation (A) (where A denotes Hayek's (1945) notion of 'A'utonomy). Thus the intercept represents the costs when asset specificity is negligible. The slope reflects the *marginal disability of markets* as compared with hierarchies in coordinative adaptation respects as asset specificity, hence bilateral dependency, becomes more consequential, and is represented as adaptation (C) (where C denotes Barnard's (1938) notion of 'C'oordination).

Figure 1 demonstrates the simple shift parameter framework that builds on this model to extend the comparative economic organization framework to *within* and *between* countries with multinational actors (Henisz & Williamson, 1999). The institutional environment is observed to shift across countries and within a country over time, causing one or more of the cost curves to shift. The solid lines represent the case for country A and the dotted lines denote the 'shift' attributable to the institutional environment aspects in country B. The changes are visible as shifts in the intercept, changes to the slope and subsequent variations to the critical values of k at which the optimal form of governance shifts. For instance, as the hierarchy curve intercept hypothetically shifts from H_A up to H_B due to increased bureaucratic costs, assuming the X curves remains unchanged across countries for the moment, the critical value of k_2 shifts to k'_2 or rather, if asset specificity is kept constant, the optimal choice of governance form changes depending on the relative shifts in the governance curves. In the example, at the point of k* shown in Figure 1, the optimal mode shifts from hierarchy to hybrid, for the same value of k*. This also results in a greater propensity of the hybrid form to be adopted in relation to the hierarchical form in country B as compared to country A, as indicated by the increase in the shaded area.

Insert Figure 1 about here

1.1.3 National culture as informal institution

North's (1986: 230) treatise on new institutional economics explains: 'Individuals possess mental models to interpret the world around them. These are in part culturally derived--that is produced by the intergenerational transfer of knowledge, values, and norms which vary radically among different ethnic groups and societies'. The incomplete information and limited mental capacity by which to process information determines the cost of transacting which underlies the formation of institutions. Institutions are formed to reduce uncertainty in human exchange and are the rules of the game of a society or are the humanly-devised constraints that structure human interaction. North (1986: 231) further explains that institutions are composed of ‘formal rules (statute law, common law, regulations), informal constraints (conventions, norms of behavior, and self-imposed codes of conduct), and the enforcement characteristics of both’.

1.1.4 Integrating culture into comparative economic organization

The key variables in transaction cost economics are asset specificity, external and internal uncertainty and frequency of contracting (Brouthers & Hennart, 2007). Primarily, entry mode studies in the transaction cost school have examined each of these three elements for their main effects on the entry mode choice. Brouthers (2002) has extended the transaction cost model to include institutional and cultural context factors, in addition to several controls, where cultural context is treated under a much broader notion of investment risk associated with different host country systems.

We chose to adopt Hofstede’s (2001) conceptualization of national culture for three reasons. (1) Hofstede envisions cultural differences as a ‘problem’, and hence cost, is therefore more suitable to a theoretical frame of transaction cost. Other culture frameworks examine the values or practices of societies, where differences are not necessarily a ‘problem’, (2) a large part of the empirical literature on cultural distance and mode choice employs Hofstede’s dimensions, including very recent international business research that continues the use of these dimensions along with Kogut & Singh’s (1988) cultural distance construct (Choi & Contractor, 2016; Dai and Nahata, 2016; Boubakri, Guedhami, Kwok & Saffar, 2016) (3) Drogendijk and Slangen (2006) in a comparative study of Hofstede’s, Schwartz and perceptual measures contend that it may be “premature to dismiss Hofstede’s work as outdated or as inaccurately reflecting national cultures, and to consider Schwartz’s framework to be superior” (Drogendijk & Slangen, 2006: 362) and report the weaker explanatory power of perceptual measures. In addition to Hofstede (2001) as our primary vehicle, we also propose to extend our theory and empirics to include alternate operationalizations such as GLOBE (House, Hanges, Javidan, Dorfman & Gupta, 2004) and Schwartz (1999).

The approach taken in order to integrate national culture into the comparative economic organization is to investigate the impact of the cultural dimensions; deriving from the explanations in the culture literature, in their impinging onto the fundamental assumptions of the transaction cost economics framework, such as on opportunism, trust, reputation effects, control and the like. This examination is done in a manner in which the dimensions are likely to affect the transaction cost determined mode of governance. We provide below two sample hypotheses:

Masculinity/Femininity. Masculinity represents a preference for achievement, heroism, assertiveness, and material success; as opposed to femininity, which stands for a preference for relationships, modesty, caring for the weak, and the quality of life. Masculinity-femininity is about a stress on ego versus a stress on relationship with others (Hofstede, 2005: 123).

Shane (1994: 628) explains that ‘According to Williamson's (1975) model, opportunism is constant across cultures. However, researchers have argued theoretically and shown empirically that societies differ on the level of opportunism in them. For example, Ouchi (1980) argued that in cultures with strong socialization mechanisms, people's sense of obligation and duty to others keeps them from acting opportunistically toward them’

Doney, Cannon and Mullen (1998: 610) explain ‘Self-serving behavior is unlikely in feminine societies as well, because it is inconsistent with the value system: feminine societies exhibit a pattern of nurture, and there is a tendency to-ward less aggressive, more cooperative behavior. To the extent that feminine societies frown upon opportunistic behavior, the costs associated with such behavior would be quite high. Such is not the case in individualist or masculine societies, where instances of opportunism are frequent and the price paid for opportunistic behavior is likely to be discounted.’

Therefore in more feminine cultures, the degree of opportunism appears to be relatively lesser than that in more masculine cultures. In a culture with high femininity, the adaptation costs (C) of hybrid contracting are reduced, causing a reduction in slope of the cost curve, and therefore effects a rightward shift of k2. Adaptation (A) is also expected to be reduced for transactions with lower asset specificity. The distribution of transactions favors greater reliance on hybrid in relation to hierarchy mode in countries with higher femininity, or equivalently, countries higher on masculinity are likely to prefer hierarchical forms to hybrid forms, for transactions of the same level of asset specificity.

> *Hypothesis 3. The higher the masculinity of the host country, the greater is the propensity of the hierarchical form to be adopted in relation to the hybrid form.*

Uncertainty Avoidance. This dimension measures the degree to which the members of a society feel uncomfortable with uncertainty and ambiguity, which leads them to support beliefs promising certainty and to maintain institutions protecting conformity (Hofstede, 1985). Human societies use technology, law and religion to cope with uncertainty and organizations use technology, rules and rituals (Hofstede, 2001: 147).

Williamson (1991) explains that uncertainty may be characterized as either an increase in the frequency or intensity of environmental disturbances. Countries with higher uncertainty avoidance maintain institutions protecting conformity (Hofstede, 1985) and therefore are likely to experience lesser frequency of disturbances in their environment. Although the efficacy of all forms of governance may be dampened in the face of more frequent disturbances, the hybrid mode is more susceptible because the hybrid form requires mutual consent, that require time, and frequent disturbances can upset adaptation. Therefore, an increase in market and hierarchy and a decrease in hybrid will be associated with an increase in the frequency of disturbances. Again, an increase in the intensity of the disturbances also disfavors the hybrid mode (Williamson, 1991). Higher the uncertainty avoidance (thus lesser the frequency of disturbances), lesser is the slope of the hybrid curve in relation to the hierarchy cost curve, and therefore greater is the distribution of transactions adopting the hybrid mode. Alternatively, countries with lower uncertainty avoidance are likely to prefer hierarchical forms to hybrid forms, for transactions at the same level of asset specificity.

Hypothesis 4. The lower the uncertainty avoidance of the host country, the greater is the propensity of the hierarchical form to be adopted in relation to the hybrid form.

METHODS

Sample

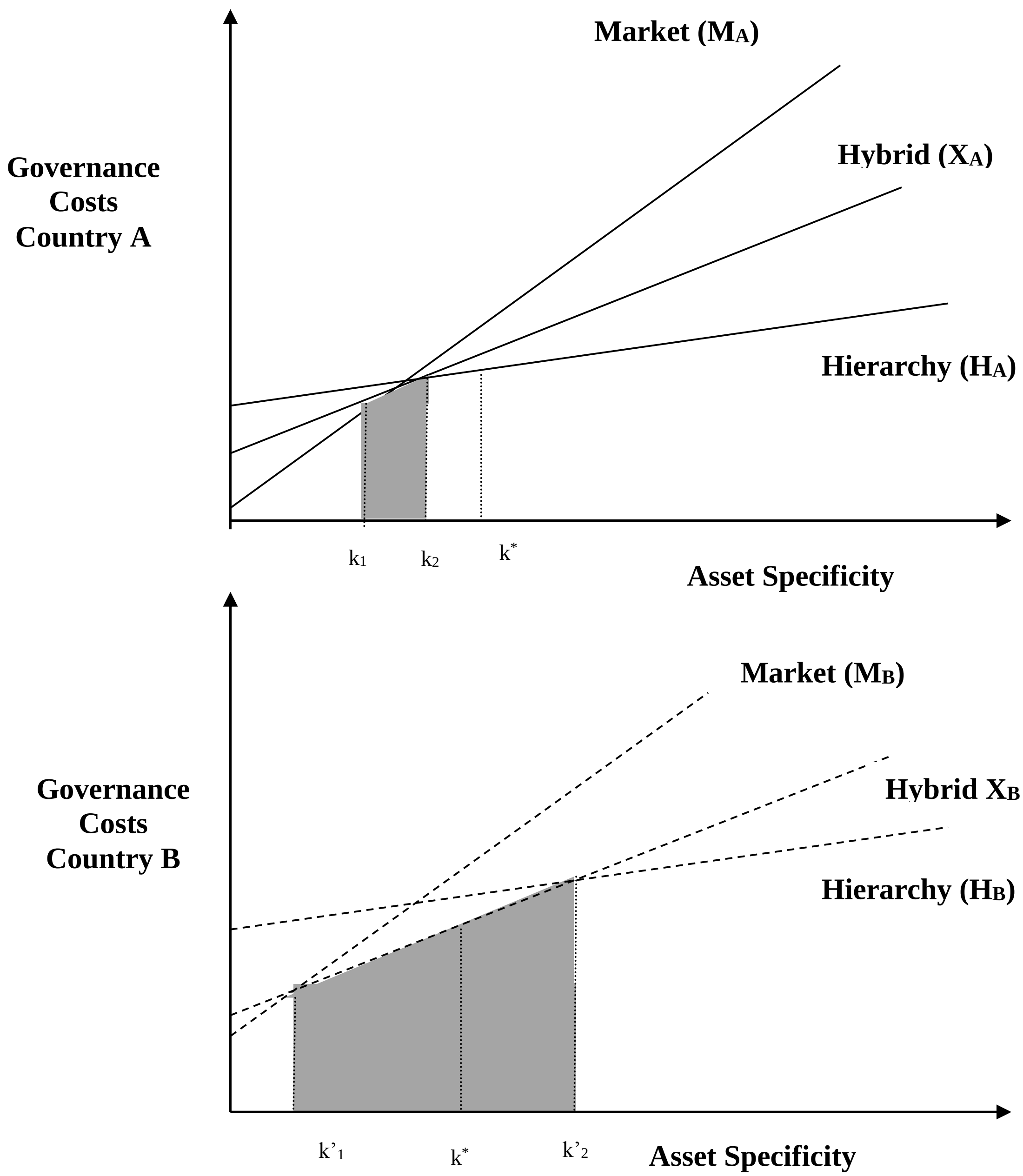
We obtained the data of all partial and full acquisitions with çompleted' status made by US and non-US public companies across all home and host countries between 1980-2015 from the *SDC Platinum Mergers and Acquisitions Thomson Financials* database. We excluded any records which had the joint venture flag set, and the type of acquirer was "corporate" and not "financial" as we considered cultural considerations would be less relevant for purely financial purchases. We retained those records that had values available for our dependent variables of interest": percentage of equity owned" and "percentage of equity sought". This resulted in 69796 transactions spanning 100+ home countries and 100+ host countries. Our explanatory variables for culture were obtained from Hofstede (2001), Hofstede, Hofstede & Minkov (2010) and House et al. (2007).

Multi-Level Analysis Considerations

In multi-level research, accounting for the nesting structure of the data in an accurate fashion is extremely important. We build our model carefully by following the guidelines as below for multi-level studies in international business (Andersson, Cuervo-Cazurra & Nielsen, 2014; Peterson, Arregle & Martin, 2012). We choose the focal unit of the study as the firm-level decision between the acquirer and target. The entry mode phenomenon is nested in the context of the acquirer's as well as the target's national context; hence, ours is a case of cross-nesting between two national levels. Peterson et al. (2012) specify that it may not be necessary to model effects at all levels as certain research problems simply require to control for level effects that are not central to the study, so we include industry dummies. We model our theory as "cross-level direct effects" where a higher-level variable directly influences the dependent variable at a lower level, and analyse in-group variance in intercepts, while incorporating the year of transaction. We propose to choose relevant control variables from theories at each level of nesting based on the extant literature. We rule out the possibility of any effect in the reverse direction of our hypotheses as cultural change is generally a very slow process (Hofstede, 2001).

FIGURE 1
Comparative Economic Organization: The Simple Shift Parameter Framework

(Adapted from Henisz and Williamson, 1999)



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