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An Information Cost Perspective of Foreign Ownership Choice

Chiung-Hui Tseng*

*National Cheng Kung University, Tainan, Taiwan**

Abstract: This paper examines investment strategy for a foreign affiliate via an information cost perspective. I*nformation costs* in this study refer to the time and expense consumed by a firm in information gathering, processing, and dissemination for appraising an investment decision under a specific environmental context. Moving beyond the transaction-cost explanations laying emphasis on the costs brought by mankind dishonesty, our information cost model of foreign ownership choice takes account of socio-cultural impact and sheds light on the costs associated with procuring and processing information needed to make investment decisions in host environments. Empirical analyses using binomial logistic regression on a sample of 1,144 foreign entries made by the U.S. companies support our conjecture that a firm prefers wholly-owned subsidiary to joint venture when entering a country with a higher degree of information codification and information diffusion that reflect lower information costs. Moreover, through multiple regression analyses, we found that how an institutional environment expresses and distributes information are tied closely to its national cultural characteristics. Three important theoretical contributions include, first, extending Boisot's cultural space to foreign ownership decisions; second, offering a socio-cultural aspect to complement the transaction-cost rationale; third, lending support to the Uppsala school's 'internationalization theory' that implicitly recognizes information costs.

Keywords: *Foreign Ownership, Entry Mode Choice, Information Cost, Boisot's Cultural Space.*

Introduction

How firms choose between joint ventures (JVs) and wholly-owned subsidiaries (WOSs) for their foreign investment decisions is one of the most critical questions facing both international business scholars and managers. To address this issue, past research has considerably relied on transaction-cost-related explanations which deem cost minimization and efficiency maximization the major concern of formulating an investment strategy (e.g. Anderson and Gatignon, 1986; Buckley and Casson, 1998; Hennart, 1991; Hennart and Larimo, 1998; Morschett et al., 2008). In essence, transaction cost theory proffers that the costs of finding compatible partners, negotiating and drafting agreements, and enforcing and safeguarding the agreements determine firms' ownership choice (Brouthers, 2002; Erramilli and Rao, 1993; Williamson, 1985). Firms are more likely to adopt a shared-control mode when estimation of the transaction costs is low, while tending to prefer a full ownership as the transaction costs increase (Brouthers, 2002; Gatignon and Anderson, 1988).

Despite the popularity of transaction cost theory in entry mode choice literature, scholars (e.g. Lu, 2002; Makino and Neupert, 2000; Roberts and Greenwood, 1997) have noted a major limitation of the theory and argued that, resting on the assumption of opportunism, transaction cost theory owes too much of its predictive content to the potential for 'strategic behaviour' of the human beings involved in a transaction and gives little weight to socio-cultural factors. Moving beyond the emphasis on the costs brought by mankind dishonesty, this study takes account of socio-cultural impact and introduces an information cost perspective on foreign ownership strategy, which sheds light on the costs associated with procuring and processing information needed to make investment decisions in a specific environmental context. Since such costs are contingent on how a host environment tackles and dispenses information, the focus of our information cost view is thus on the socio-cultural setting and on the manner that a society handles information.

Specifically, *information costs* herein refer to the time and expense consumed by a firm in information gathering, processing, and dissemination for appraising an investment decision (Casson, 1999). The relevance of information costs to the choice between JVs and WOSs lies in the fact that such an investment decision is constituted by a process of synthesizing various items of information. The entry strategy formulated hence hinges on the leverage of all the information and, more importantly, all associated costs resulting from that process. In a sense, 'information cost' can be considered a broader concept of 'transaction cost' and most transaction costs pertain to information costs. However, the converse (all information costs are transaction costs) does not hold, and the two theoretical approaches essentially depart from each other in their emphases. For instance, the transaction cost theory centres on the information about potential transacting partners and believes that costs are entailed from *false information* released by collaborative firms. Differently, the information cost perspective focuses on the overall information required for operating under particular environmental circumstances and maintains that costs are yielded by processing *all the information* for the reference of making decisions in the environments where information is embedded and information costs are determined. As such, transaction costs emanate from cooperative partners' misbehaviour, whereas information costs are rooted in environmental conditions not favourable to information flow. Table 1 compares and contrasts the main differences between the two theoretical approaches.

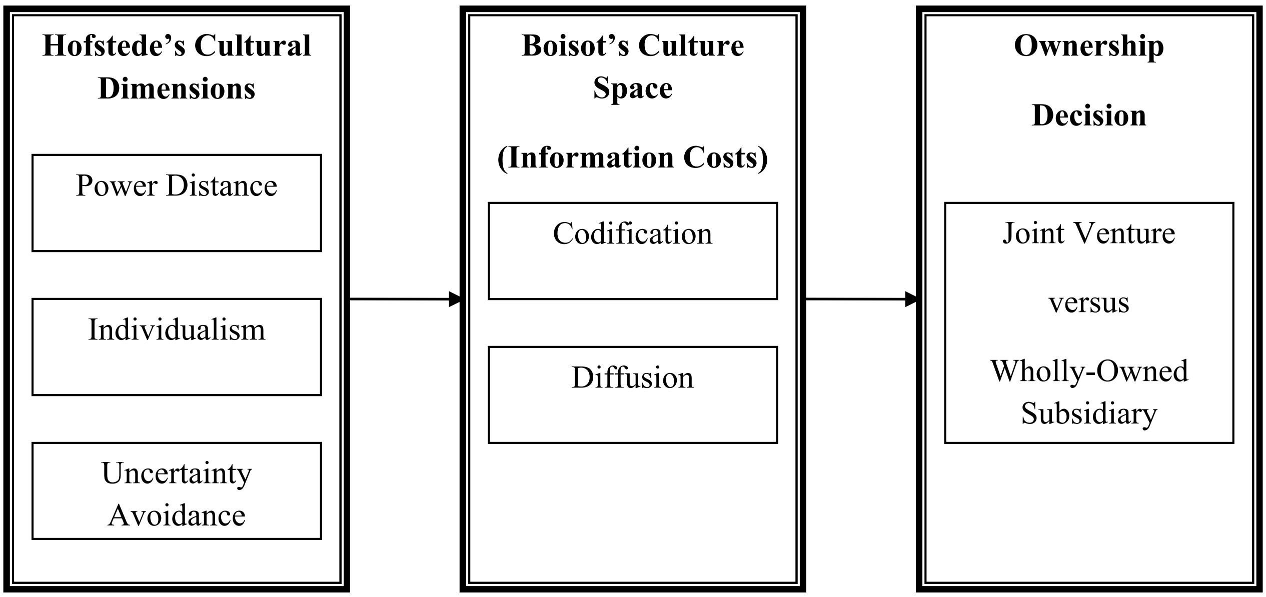
Table 1: Comparison between Transaction Cost Theory and Information Cost Perspective

	Transaction Cost Theory	**Information Cost Perspective**
Definition of Costs	Time and expense of finding partners, negotiating and drafting agreements, and enforcing and safeguarding the agreements	Time and expense consumed in information gathering, processing, and dissemination for appraising an investment decision
Source of Costs	Collaborative partners' misbehaviour	Unfavourable environmental conditions for information flows
Information Considered	False information released by collaborative firms	Information in general required for operating in specific environments
The Role of the Firm	The firm as a nexus of transactions	The firm as a user of information
Objective	Transaction cost minimization	Information cost minimization
Theoretical Reasoning	full control over foreign operations when transaction costs are high	full control over foreign operations when information costs are low

Grounded on the information cost perspective, we suggest that for a multinational firm who confronts 'liability of foreignness' in a host country while possessing certain competitive edges over local rivals, it will be more likely to prefer a WOS to a JV for exploitation of its proprietary capabilities if the host location exhibits a congenial information processing condition, in turn resulting in lower information costs for the firm. The reason why this is so is that such a host environment facilitates the firm to be equipped with knowledge required for local operations, renders the firm more confident, and be willing to commit greater resources to the investment or even pursue a full ownership that avoids inter-firm conflicts, unwanted knowledge leakage, and other opportunistic issues deriving from partnerships as discussed in the transaction cost theory. Our reasoning is consistent with the thesis of the internationalization theory that firms make greater resource commitments to countries where they are better informed of local market knowledge (He et al., 2015; Johanson and Vahlne, 1977).

In sum, this study contributes new insights into the choice between JVs and WOSs by developing an information cost model of foreign ownership choice. To calibrate the information processing condition of a host country, we adopt a two-dimension culture space proposed by Boisot (1987), who viewed culture as manifestation of information structuring (*codification*) and information sharing (*diffusion*) by social groups. Drawing from these two socio-cultural dimensions, this study aims to examine two questions. First, how do levels of codification and diffusion in a host country which determine a firm's information costs of an investment affect its choice between JVs and WOSs? Second, how are the manners that an institutional environment formalizes and shares information among people affected by its cultural characteristics indicated by Hofstede (1980)? Figure 1 illustrates these two research questions as a conceptual framework.

Figure 1: Conceptual Framework



In the following pages, hypotheses are first developed. Then, research methods are depicted. Next, we report our empirical results. Finally, implications drawn from this study are presented along with suggestions for future research and a brief conclusion.

Literature Review and Hypotheses Development

Information costs and ownership decisions

Information costs have long been recognized by international business researchers, who observed that, compared with indigenous firms that have easier access to local information and knowledge, internationally expanding firms have to initially endure higher information costs arising from their less acquaintance with foreign environments, what Zaheer (1995) named the 'liability of foreignness' (Hymer, 1960, 1976; Kindleberger, 1969; Mezias, 2002; Miller and Parkhe, 2002; Zaheer and Mosakowski, 1997). In their internationalization model, Johanson and Wiedersheim-Paul (1975) also implicitly acknowledged the costs of acquiring foreign market knowledge by proposing that firms only seek familiar markets at their early stage of overseas investment.

To attenuate potential information costs incurred in institutionally different countries, most studies have resorted to such solutions as involving local partners which, nonetheless, would spark transaction costs (Inkpen and Beamish, 1997; Makino and Delios, 1996; Xu et al., 2004), and paid little attention to the sources where liability of foreignness and information costs result from. In fact, identifying their causes and the conditions under which they are expected to be more pronounced has important implications for the understanding of the nature of foreign operations and for the mode choice of foreign operations (Nachum, 2003). Within a national context that market information and knowledge are readily and cost lessly accessed by foreign firms, liability of foreignness can be attenuated without entailing high information costs. This is to say that, under such institutional circumstances, firms need not settle for the choice that obliges them to give up equity ownership to local partners, sacrifice their greatest control over their know-how abroad, and suffer from free-riding, cheating, and dissipation of proprietary knowledge to the partners. Besides, there is less need for firms to experience a lengthy learning process, in the sense of an incremental accumulation of host region knowledge, to compensate for the liability of foreignness.

Countries that brought low information costs to foreign firms usually carry two traits that are conducive to information flow, namely codification and diffusion, which Boisot (1987) and his colleague (Boisot and Child, 1988, 1996, 1999) termed a 'cultural space'. *Codification* refers to the structuring and ordering of information. It is a formalization process through which germane information is compressed into a specific expression, for example, being put into words or set out on paper to make the information less vague and ambiguous, and irrelevant information is eliminated (Boisot and Child, 1988, 1996). Codification is a matter of degree that a society making efforts at codification values well-articulated and scrupulously recorded information (Boisot and Child, 1999). Distinct from but related to codification is diffusion. *Diffusion* reflects the extent of information sharing within a given population. In a society that tends to push towards greater information diffusion, information can be more speedily and more widely disseminated (Boisot, 1987; Boisot and Child, 1988, 1996).

The culture space described by codification and diffusion posits a distinctive information environment for crafting investment strategies. In an institutional context characterized by higher levels of codification and diffusion, firms are exposed extensively to the information needed for decision making and operations, thus leading to lower information costs for mitigating liability of foreignness. Accordingly, firms are less compelled to seek JVs and will be prone to maintain a complete control over foreign subsidiaries. Therefore, we hypothesize that:

Hypothesis 1: *Firms entering countries characterized by higher levels of codification tend to choose WOSs over JVs.*

Hypothesis 2: *Firms entering countries characterized by higher levels of diffusion tend to choose WOSs over JVs.*

From Hofstede's cultural dimensions to Boisot's culture space

Since information structuring and sharing reflect a culture pattern, questions then arise regarding how core beliefs and values of the culture influence and shape its environment in processing information. Drawing from three of Hofstede's (1980) national cultural dimensions which are most pertinent to examining information environments, the following discussion links power distance, individualism, and uncertainty avoidance to codification and diffusion of information.

The concept of power distance refers to the degree of inequality among people. Large power distance implies high centralization of authority among a few people while small power distance implies more decentralization of power. Accordingly to Hofstede (1980), people in large power-distance cultures prefer to be managed in an autocratic and directive manner, whereas those in low power-distance countries prefer a participative style and expect to be rewarded for showing initiatives in their work. It is thus salient that in a large power-distance society, people are accustomed to autocratic leaderships such that critical information is mostly controlled by a few people and information is less required to be codified for the public. Thus, we propose that:

Hypothesis 3: *Countries characterized by greater power distance will exhibit lower levels of codification.*

Hypothesis 4: *Countries characterized by greater power distance will exhibit lower levels of diffusion.*

Individualism refers to a social structure that reflects individuals' tendency to look after themselves or their immediate family only and neglect the needs of society. A society high on individualism highlights individual initiatives, opinions, and achievements and believes that people should not emotionally depend on organizations or groups. In such a society, appraisal emphasis will be performance-based, and laws and rules are supposed to be the same for all, which requires information to be fully codified and disclosed for the public. Nevertheless, such a societal context is not conducive to information diffusion because people in the society carry less concern for other individuals within groups and are not motivated to disseminate the information to individuals in need.

On the other hand, a collectivist society believes that one's identity is based on its group membership, group decision making is the best, and groups protect individuals in exchange for their loyalty to the groups. In other words, people in collectivist societies are comfortable with tight social frameworks, are emotionally dependent on or belonging to the groups, and have a strong belief in group decisions. Gomez-Mejia et al. (1998) and Getz and Volkema (2001) asserted that affiliations with groups create connections or networks that often lead to corruption or illegal transactions, which in turn endanger the transparency of information flow and cause lower levels of information codification. Nonetheless, due to the connected ties, information is more likely to be shared and spread, leading to higher levels of diffusion. Accordingly, we posit that:

Hypothesis 5: *Countries characterized by higher individualism will exhibit higher levels of codification.*

Hypothesis 6: *Countries characterized by higher individualism will exhibit lower levels of diffusion.*

Uncertainty avoidance concerns how people deal with the unknown and reflects the extent to which individuals fell threatened by and attempt to avoid uncertain and unknown situations. People in a culture with high uncertainty avoidance feel comfortable with the existence of many formal and informal laws and rules that control their work process, satisfy their emotional need for structure and order, and prevent uncertainty and ambiguity in the environment. Accordingly, such an institutional context will have most information nicely codified and widely diffused in order to meet people's desire for minimum ambiguity and uncertainty in their behaviors. In contrast, people in a culture with low uncertainty avoidance are inclined to be more tolerant of unstructured and changeable environments where codes of behaviors are less rigid and practices count more than principles (Brouthers, 2002). In all, we suggest that:

Hypothesis 7: *Countries characterized by greater uncertainty avoidance will exhibit higher levels of codification.*

Hypothesis 8: *Countries characterized by greater uncertainty avoidance will exhibit higher levels of diffusion.*

Methods

Sample

The sample comprised foreign investments made by the U.S. firms during 2000 and 2009. These firms operated in manufacturing sectors ranging from Standard Industrial Classification (SIC) 3000 to 3999. This sampling frame is selected for three reasons. First, using only U.S. firms ensures that multinational expansion would not be subject to variations in national laws and regulations in different home countries (Shrader et al., 2000). Second, SIC 3000-3999 has been employed as the sample based on prior studies (e.g., Tseng and Lee, 2010) because a large proportion of firms operating within this SIC range are major players in the international business community. Third, the ten-year period between 2000 and 2009 is a duration when the U.S. firms launched foreign direct investment substantially (UNCTAD, 2012).

We identified a list of the sample from the Wall Street journal, one of the most reliable and comprehensive sources of publicly available information on the activities of U.S. firms. In total, we compiled 1,144 investment announcements of the U.S. firms within 42 countries in the Wall Street Journal during the ten-year period, of which 677 are JVs and 467 are WOSs. Following the 95 percent cutoff which has been the rule of thumb in previous studies of partial and full ownership (Gatignon and Anderson, 1988; Hennart, 1991; Padmanabhan and Cho, 1999; Pak and Park, 2004), an investment is considered a WOS if a U.S. firm owns 95 percent or more of equity and a JV if it owns less than 95 percent but five percent or more of equity.

Measures

The dependent variable, *ownership choice*, is measured by a dummy variable that equals one if an overseas entry is a JV and zero if it is a WOS. The data for assessing information codification and diffusion in host countries come from the World Competitiveness Yearbook, a survey-data report on how a national environment is propitious to the competitiveness of business operations. The series of this report is published by the International Institute for Management Development. *Codification* is evaluated by seven items that manifest the extent to which the institutional framework of a country fosters structuring and ordering of information, including economic literacy rate, likelihood of the occurrence of insider trading in the stock market, effectiveness of implementation of government decisions, frequency of bribing and corruption, governmental transparency, independence of public services from political interference, and levels of hindrance by bureaucracy to business activities. *Diffusion* is assessed by five items that evaluate whether the institutional environment is armed with attitudes towards and infrastructures for information dissemination. They are the extent to which education in finance meet the needs of enterprises, availability of information technology skills, openness to foreign ideas, degree of flexibility and adaptability to new challenges, and development of financial institutions' transparency. Table 2 shows the results of factor analysis and measure validation for the two variables. Both measures of codification and diffusion demonstrate acceptable unidimensionality and reliability. The three national cultural factors (*power distance*, *individualism*, and *uncertainty avoidance*) are gauged using Hofstede's (1980) indices.

*Table 2***:** *Factor Loadings and Reliabilities for Codification and Diffusion*

Items	**Rotated Factor Loadings**		α
	Factor 1	**Factor 2**	
Codification			0.918
Economic Literacy	0.660		
Insider Trading	0.689		
Government Decisions	0.919		
Bribing and Corruption	0.860		
Governmental Transparency	0.703		
Public Service	0.902		
Bureaucracy	0.802		
Diffusion			0.881
Education in Finance		0.808	
Information Technology Skills		0.832	
Openness to Foreign Ideas		0.637	
Flexibility and Adaptability		0.886	
Financial Institutions' Transparency		0.695	

Note: the cumulative sums of total variable explained is 75.058%

In examining the relationships between information costs and ownership decisions, we also control for three variables that are likely to affect a firm's entry strategy. Following previous research on foreign investment strategy (e.g., Brouthers, 2002; Erramilli and Rao, 1993), we control firm size, firm age, and industry segment in which the firm participates. *Firm size* is measured by employee count in the year of a specific foreign entry. *Firm age* is calculated by firms' existence period since founded year to the year of a specific entry. *Industry* effects are controlled for by using nine dummy variables, representing ten industrial subsectors (I_1=SIC 30, I_2=SIC 31, I_3=SIC 32, I_4=SIC 33, I_5=SIC 34, I_6=SIC 35, I_7=SIC 36, I_8=SIC 37, I_9=SIC 38). The sector SIC 39 is the residual dummy variable that signifies when all I's=0.

Results

Table 3 presents the correlations among variables included in the analyses. Results for the analysis of the effects of information costs on the choice between JVs and WOSs are shown in Table 4. We found that in a country characterized by higher levels of information codification, a firm inclines to choose a full-control mode of entry, bearing out Hypothesis 1. Likewise, in a country with higher levels of information diffusions, a firm also tends to prefer a WOS, supporting Hypothesis 2. Regarding the three control variables (firm age, firm size, and industry effect), all of them show no significant impact on the ownership choice.

Table 3: Correlation Matrix

Variables	1	2	3	4	5	6
1. PD						
2. Ind.	-.813**					
3. UA	.212**	-.233**				
4. Codification	-.609**	.478**	-.329**			
5. Diffusion	-.299**	.358**	-.104**	.000		
6. Firm Size	.188**	-.209**	.154**	-.198**	-.089*	
7. Firm Age	.122**	-.065	.092*	-.171**	-.002	.272**

† $p < .10$; * $p < .05$; ** $p < .01$; *** $p < .005$ (all two-tailed tests).

Results for the analysis of the relationships between Hofstede's national cultural factors and Boisot's information processing characteristics are presented in Table 5. The general models are supported, as indicated by significant *F* values. The results show that there is a significant, negative relationship between the degree of power distance and information codification in an institutional environment, supporting Hypothesis 3. Hypothesis 4 posits that the level of power distance is negatively related to the degree of information diffusion. The negative tendency of the relationship is shown but not statistically significant. Hence, Hypothesis 4 is not supported.

Hypothesis 5 predicts a positive relationship between the degree of individualism and codification of information. The estimate is in the same direction as predicted and is statistically significant, thus providing support for Hypothesis 5. The result shows no support for Hypothesis 6, which assumes a negative relationship between the degree of individualism and information diffusion. Finally, the results for both Hypothesis 7 and Hypothesis 8 are in the opposite from what we postulated, providing no support for both hypotheses.

Table 4: Results of Binomial Logistic Regression Analysis for Information Costs and Ownership Decisions (Joint Venture = 1)

Variables (Hypothesis Tested)	Model 1	Model 2
Intercept	1.529	1.347
Codification (H1, －)	-.136†	-.135
Diffusion (H2, －)	-.243**	-.194*
Firm Size		.001
Firm Age		.001
Industry Dummy		.001
Sample Size	1,144	711
Model Chi-square	13.133***	8.475
% Of Correct Prediction	81.8%	81.2%

† $p < .10$; * $p < .05$; ** $p < .01$; *** $p < .005$

Table 5: Results of Multiple Regression Analysis for Hofstede's Cultural Dimensions and Boisot's Culture Space

Independent Variables (Hypothesis Tested)	Dependent Variables	
	Codification	Diffusion
Power Distance (H3, － ; H4, －)	-.636**	-.021
Individualism (H5, ＋ ; H6, －)	.089†	.336**
Uncertainty Avoidance (H7, ＋ ; H8, ＋)	-.215**	-.021
Adjusted R^2	.415	.129
F-statistic	167.264***	34.833***

† $p < .10$; * $p < .05$; ** $p < .01$; *** $p < .005$

Discussion and Conclusion

The findings in general support our conjectures that 'information costs' play a prominent role in determining firms' entry mode choice and firms are more likely to pursue full control modes rather than share-equity modes when entering countries characterized by higher levels of information codification and diffusion, which signal lower information costs. Moreover, we found that how an institutional environment tackles information is significantly influenced by its national cultural characteristics despite that some effects of cultural factors are not in the same direction as predicted.

This study provides significant insights into the research on international entry strategy and contributes to the strain of literature in the following aspects. First, our research expands beyond the transaction cost theory that has paid scant attention to the social embeddedness of transaction decisions by laying emphasis on the socio-cultural aspect shaping information costs, which the viewpoint has in reality long been acknowledged by international business researchers yet still received few investigations (Lu, 2002; Makino and Neupert, 2000).

Second, our conceptual ideas and empirical findings lends support to the Uppsala school's 'internationalization theory' hypothesis that alludes to information costs by suggesting that firms would initially go for familiar foreign markets (He et al., 2015; Johanson and Vahlne, 1977). Nevertheless, our results demonstrate that incremental accumulation of local knowledge may not be requisite if costs of acquiring the knowledge are low at the outset of investments.

Third, the current study not only responds to the call for a need to incorporate socio-cultural factors into considerations of entry mode choice but, to our knowledge, is also the first attempt to examine the impact of Boisot's cultural space featuring the information processing condition of a country on ownership decisions. Our endeavor has enriched the theoretical bases for probing the research topic on one hand, and provided complementary explanations for why a firm may choose WOSs on the other hand.

Fourth, this study is one of the firsts to investigate the linkage between the culture values indicated by Hofstede (1980) and the institutional nature concerning information processing. We bridge two streams of thoughts on cultural patterns and found that they are closely connected. It is hoped that this study serves as a starting point and future research will deliver more attention to this important issue.

Our study is not without its limitations which may provide niches for future research. Although the concepts of codification and diffusion of information have been well articulated in a series of Boisot and his colleagues' publications (Boisot, 1987, 1995; Boisot and Child, 1988, 1996, 1999), the two constructs heretofore have not been methodologically measured. In this study, we first developed items drawing from secondary survey data to gauge these two concepts. More tests implemented in other samples are encouraged to strengthen the legitimacy of our measures.

In addition, to control for the country-of-origin effect, the current research is restricted to the investigations of investment strategy by U.S. firms. Future research can be carried out to examine the effects of information costs on foreign investment choice made by firms from other countries to validate the generalizability of our theoretical framework. Lastly, as we made in interesting comparison between the information cost perspective and transaction cost theory earlier, an intriguing question that researchers can further examine is to take a closer look at the two theories together in an empirical context and probe which theoretical perspective can better predict entry mode choice.

In conclusion, we attempted to answer two questions: "how do information costs affect the choice between JVs and WOSs?" and "how are they determined by cultural characteristics?". Empirical results obtained from a sample of 1,144 foreign entries made by U.S. manufacturing companies, show that the lower the information costs in host countries, the more likely a firm will prefer a WOS to a JV. Meanwhile, it should be noted that national cultural factors play a vital role in determining the information costs.

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