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The impact of MNE cultural diversity on the internationalization-performance relationship
Theory and evidence from European multinational enterprises

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ABSTRACT

Prior work has established the importance of degree of internationalization for understanding the performance of multinational enterprises. Despite all efforts, however, the relationship between degree of internationalization and firm performance (I-P) is still the subject of ongoing debate following inconclusive findings. We suggest that the international business literature has largely overlooked MNE cultural diversity as an essential determinant of the I-P relationship. We argue that the impact of the degree of internationalization on MNE performance is contingent on MNE cultural diversity. The impact of the degree of internationalization on performance is positive for MNEs that operate in culturally similar countries and negative for MNEs that operate in culturally diverse countries. Our study is among the first to examine the impact of MNE cultural diversity on the I-P relationship with a unique panel dataset from European multinationals. The results provide convincing support for our approach to the study of the degree of internationalization and MNE performance.

1. Introduction

Ever since firms first started foreign operations, the question of whether and how the degree of internationalization fosters company performance has been one of the most important in international business (IB) research (Banalieva & Sarathy, 2011; Banalieva & Robertson, 2010; Buckley & Casson, 1976; Dunning, 1981; Hymer, 1976; Johanson & Vahlne, 1977, 2009; Ruigrok & Wagner, 2003; Stinchcombe, 1965). Despite all efforts, however, the internationalization–performance (I-P) relationship is still the subject of ongoing debate following mixed empirical findings (Hennart, 2007, 2011). In this study we delve deeper into these empirically inconsistent results. We argue that a contingency perspective on the I-P relationship for multinational enterprises (MNEs) is useful to address the prior mixed results. We add to existing research by demonstrating that MNE cultural diversity determines the relationship between the degree of internationalization and firm performance. Degree of internationalization is the same as the degree of geographic diversity or country diversity, that is, how many countries or how widely spread the MNE is. MNE cultural diversity is an assessment of how similar the different countries are.

Assessing the situation, Hennart (2011) and Wiersema and Bowen (2011) conclude that while the volume of the I-P research stream is substantial and theories on internationalization are abundant, the inadequacy of our current conceptualizations and measures of internationalization persist. Hence, the I-P research domain is broad, but it has not yet reached maturity and there is a need to re-examine conventional wisdom about internationalization and performance. We propose that MNE cultural diversity is underexplored in I-P research. One of the most important dimensions of foreign business contexts which can impact on the effect of internationalization on performance is the national culture of host countries vis-à-vis the home country. We add depth to the understanding of the relationship between internationalization and performance and explain one of the complicating factors–MNE cultural diversity. We explain that as a firm's corporate strategy invites greater internal cultural diversity through international expansion, there are higher costs to the firm that sometimes outweigh the benefits of internationalization.

We analyze interaction effects by using product-term regression techniques to support our main conjecture empirically (Baron & Kenny, 1986; Jaccard & Turrisi, 2003). We test our hypothesis concerning the effect of MNE cultural diversity on the I-P relationship on a panel dataset for 2003–2007 that combines headquarters information from the largest European MNEs. Our window of observation and research settings are relevant to this study because in this period many European MNEs expanded their

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international activities drastically (Buckley & Casson, 2009; Rugman & Oh, 2009). Our empirical research enables the study of whether the particular trends of internationalization by European MNEs improve their performance.

The outline of the paper is as follows. We begin by reviewing research in two areas that serve as the foundation for our contingency framework of MNE internationalization: the literature on the I-P relationship and the literature on how cultural diversity determines MNE performance. Next, building on this theoretical background, we formulate our hypothesis about the effect of MNE cultural diversity on the I-P relationship. Then, we introduce this paper's research methodology, addressing issues related to our measures of the variables and estimation methods. Following that, we present our empirical evidence. Finally, we conclude with an appraisal, discussing limitations and offering a reflection on opportunities for future research.

2. Literature review

This section provides background literature for both internationalization and firm performance and cultural diversity. Cultural diversity and internationalization are related but distinct concepts. In this study, internationalization is interpreted as the extent of a firm's present involvement in international operations (Buckly & Ghauri, 1999).[1] Internationalization can consequently be defined as the degree to which an MNE is active in multiple countries via subsidiaries or exports, and thereby implicitly also addresses geographical diversification (Lu & Beamish, 2004). Divergent national cultures imply the notion of cultural distance, which can be regarded as the difference between one national culture and another on the basis of a certain cultural parameter (Mezias et al., 2002; Morosini, Shane, & Singh, 1998; Proff, 2002; Tihanyi, Griffith, & Russell, 2005). MNE cultural diversity is consequently perceived as the aggregate level of cultural heterogeneity with which a firm is brought into contact as a result of its international operations (Gomez-Mejia & Palich, 1997).[2]

2.1. Benefits of internationalization

There have been many empirical studies of the precise relationship between internationalization and firm performance (see Wiersma & Bowen, 2001, Kircka et al., 2011 and Yang & Driffield, 2012 for comprehensive reviews). However, these studies have yielded mixed or even contradictory results. Prior studies report a positive relationship (e.g. Goerzen & Beamish, 2003), a negative relationship (e.g. Hitt, Hoskisson, & Kim, 1997), a U-shaped relationship (e.g. Qian, Li, Li, & Qian, 2008), an inverted U-shaped relationship (e.g. Wang, Chen, & Chang, 2011), an S-shaped relationship (e.g. Ruigrok, Amann, & Wagner, 2007) and even non-significant relationships between the degree of internationalization and firm performance (e.g. Sambharya, 1996).

The positive effects emphasize the potential sources of competitive advantage that MNEs can achieve through internationalization that are unavailable to firms operating purely domestically (Click & Harrison, 2000; Denis, Denis, & Yost, 2002; Dunning, 1981; Goerzen & Beamish, 2003; Thomas & Eden, 2004). There are production-related efficiencies, such as economies of scale and scope, realizable in internationally diversified operations that go beyond product diversification: these allow a firm to achieve above-normal returns if it is successful in exploiting its domestic competitive advantage in international markets (Buckley & Ghauri, 1999; Caves, 1996). More production-related efficiencies result from a Hekscher-Ohlin-type view, which stresses that due to imperfections in world markets, differing factor costs in individual countries permit MNEs to minimize their production costs by shifting activities to their lowest-cost location, reducing transaction costs, labour costs or material costs (Ruigrok et al., 2007). Market-related efficiencies result from differences in demand and income levels across countries, allowing MNEs to shift sales from low-income, low-margin markets to high-income, higher-margin markets (Thomas & Eden, 2004).

Internationalization can also lead to a reduction in risk, as market diversification leads to a more stable revenue stream and is less vulnerable to country-specific shocks (Hitt et al., 1997). A well-diversified firm runs a lower risk of aggressive moves by competitors as it has multiple bases from which to retaliate (Kim, Hwang, & Burgers, 1989, 1993). Various studies confirm the positive impact of the degree of internationalization on firm performance. Riahi-Belkaoui (1996), for example, reports that the performance of French MNEs is positively related to both related and unrelated international diversification. These findings are consistent with those reported in Errunza and Senbet (1981, 1984), Grant, Jammine, and Thomas (1988), and Tallman and Li (1996). Nevertheless, the positive linear model is theoretically limited (see, for instance, Cardinal, Miller, & Palich, 2011; Wiersema & Bowen, 2011; Yang & Driffield, 2012). The model assumes that there are unlimited international opportunities and that firms can absorb any new international activity ad infinitum. Both assumptions are unlikely, since firms do not have unlimited managerial capacity for handling increasing international complexity.

Non-significant findings for the hypothesized performance-enhancing effect of the degree of internationalization have also been reported (see Buckley, Dunning, & Pearce 1978, 1984; Shaked, 1986; or Sambharya, 1996). Following the insignificant findings, I-P studies called attention to the negative effects of the degree of internationalization on firm performance (Geringer, Tallman, & Olsen, 2000; Gomes & Ramaswamy, 1999; Hitt et al., 1997; Michel & Shaked, 1986). The negative effects are typically defined as the extra costs and complexities in the early stages of internationalization that arise as a result of the liabilities of foreignness (LOF) (Zaheer, 1995) and the increased complexities involved with high levels of internationalization.[3] LOF can be expressed as the extra costs a foreign firm incurs that are not carried by domestic firms because of differences in local knowledge and experience (Barkema & Vermeulen, 1998; Lu & Beamish, 2004; Zaheer, 1995). LOF costs are distinct from other costs, such as costs due to liabilities of newness, size or age (Mezias, 2002; Sethi & Guisinger, 2002). Although different categorizations of LOF costs exist (Hennart, Roehl, & Zeng, 2002), the key sources of additional costs for foreign firms operating abroad include costs associated with spatial distance, unfamiliarity with host-country environments, a lack of legitimacy in the host country, political and economic regulation, and cultural differences.

[1] The IB literature uses concepts such as degree of internationalization, multinationality, geographic diversification, and international expansion interchangeably to refer to the same phenomenon: international diversification or internationalization for short (Hitt et al., 1997, 2006). The definitions show that MNE cultural diversity and internationalization are conceptually different, which is confirmed by empirical studies in the IB literature focusing on each of the two. Additionally, our empirical study shows that the measures for the two concepts meet the standard statistical criteria to warrant their inclusion as separate variables in the multivariate analysis.

[2] To illustrate the difference between degree of internationalization and MNE cultural diversity, consider the following simple numerical example: Two MNEs, A and B, operate abroad. MNE A is in ten countries – all in Central or South America. MNE B is in five countries – Mexico, Canada, United States, China and India. MNE A has a higher degree of internationalization than MNE B, but a much lower degree of cultural diversity.

[3] The study of LOF is an important research theme in IB. A special issue on this topic in the *Journal of International Management* offers an excellent review of achievements over the last sixty years (Luo & Mezias, 2002).