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Journal of Business Research 57 (2004) 35–46

JOURNAL OF BUSINESS RESEARCH

Foreign expansion in service industries Separability and human capital intensity

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Received 2 April 2001; accepted 6 February 2002

Abstract

We investigate the effect of operating in service industries, in which separability and human capital intensity factors influence the choice of foreign entry mode and expatriate staffing decisions. To look into this issue, we compared 14,863 instances of Japanese foreign direct investment (FDI) into manufacturing and three service industries (wholesale trade, retail trade, and financial services). Our theoretical and empirical analyses support the assertion that in situations where required capabilities must be developed through (1) close contacts with end customers and (2) high levels of professional skills, specialized know-how, and customization, wholly owned subsidiaries and expatriate staff are preferred. From our results, we draw implications for the FDI literature and offer a novel perspective on the factors influencing the internationalization of service firms.
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Keywords: Foreign expansion; Service industries; Separability; Human capital intensity

1. Introduction

When expanding internationally, a firm must determine the appropriate mode for entering foreign markets. It must also decide whether to staff foreign subsidiaries with local and/or expatriate managers. Both decisions have important consequences for a firm's competitive advantage in new international markets (Edstrom and Galbraith, 1977; Hill et al., 1990). Indeed, while wholly owned subsidiaries and expatriate staff provide foreign investors with greater control over foreign operations, they also entail substantial resource commitments, such as capital and managerial resources, in the host country that cannot be easily redeployed to alternative locations.

Research on the choice of entry mode and expatriate staffing strategies has expanded considerably for some years, with a traditional focus on manufacturing firms (Anand and Delios, 1997; Li and Guisinger, 1992). However, the increased importance of services in developed economies and the fast growth of foreign investment in the service sector have fueled research on service multinationals (Aharoni and Nachum, 2000; Boddewyn et al.,1986; Dunning, 1989). Still, scholars have debated whether the determinants of foreign entry decisions are the same for service and manufacturing firms. One group suggests that theories of foreign direct investment (FDI) apply to global service firms (Dunning, 1989; Miller and Parkhe, 1998; Yannopoulos, 1983). Another group argues that crucial differences between goods and services make it difficult to generalize FDI theories across industry sectors (Boddewyn et al., 1986; Erramilli, 1992; Gronroos, 1999).

To widen the focus of this debate and enhance our understanding of foreign investment in the service sector, we developed an analytical framework for examining inter-industry differences in entry mode and expatriate staffing strategies among multinational firms that compete in services and manufacturing industries. This framework suggests that wholly owned subsidiaries and expatriate staff are preferred by MNCs competing in industries where required capabilities must be developed through (1) high levels of professional skills, specialized know-how, and customization and (2) close interactions with end customers. Empirical tests using

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0148-2963/$ – see front matter © 2002 Elsevier Science Inc. All rights reserved.
doi:10.1016/S0148-2963(02)00282-5

a sample of 14,863 entries of Japanese multinational firms entering the Asian, North American, and European markets provide supporting evidence.

2. Foreign market entry decisions

Considerable attention has been given to identifying firm- and country-level determinants of foreign market entry decisions (Hill et al., 1990). A large portion of this literature has used internalization theory and transaction cost analysis to explain how companies enter foreign markets (Anderson and Gatignon, 1986; Davis et al., 2000). Various entry modes are available to firms, from export to licensing to ownership-based modes such as joint ventures and wholly owned subsidiaries. Full-control modes, such as greenfield or acquired wholly owned subsidiaries, have been differentiated from shared-control ones, such as a greenfield or partially acquired joint ventures. Full-control modes increase the degree of control that an MNC can exercise over its foreign subsidiaries, but also require greater resource commitments compared to shared-control modes (Anderson and Gatignon, 1986; Nitsch et al., 1996).

Research has also explored the complementary use of systems and procedures, such as staffing or human resource-based mechanisms (Mayrhofer and Brewster, 1996; Tung, 1982), to control foreign operations (Baliga and Jaeger, 1984). The use of expatriates deals with the limitations of solely using ownership to protect firm-specific assets. While a full-control mode such as a wholly owned subsidiary can help to address opportunism problems (Sohn, 1994) shirking or hold-up by local management remain possible (Alchian and Demsetz, 1972; Alchian and Woodward, 1988). Expatriate managers can reduce risks of opportunism and ensure that company policies are carried out effectively in foreign subsidiaries (Baliga and Jaeger, 1984; Edstrom and Galbraith, 1977; Roth and Nigh, 1992).

In expanding the focus of international research from manufacturing to service firms, scholars have explored whether theories of multinational manufacturing firms apply to multinational service activity (Boddewyn et al.,1986; Dunning, 1989) and the international expansion of service firms (Katrishen and Scordis, 1998; Li and Guisinger, 1992; Miller and Parkhe, 1998). For the entry mode decision, studies have highlighted the tendency of service firms to rely on wholly owned subsidiaries (Erramilli, 1992; Erramilli and Rao, 1993). A notable difference between the internationalization of services and manufacturing firms is that a service firm seldom requires large-scale investments in physical assets such as capital equipment and facilities to establish a presence in foreign markets. The value-creating assets of a service firm rest more on its human capital than on its physical infrastructure (Erramilli and Rao, 1993; Campbell and Verbeke, 1994). Accordingly, international investments in the service sector have been found to rely heavily on "people-transfers; that is, training programs, visits by experts and the *employment of expatriates*" (Grosse, 1996, p. 796 emphasis added).

This stream of research has also suggested that service MNCs face unique challenges when expanding abroad. The distinct nature of a service firm's assets exerts stresses on entry mode choice decisions and the use of expatriate managers. This idea has fueled the debate over the generalization of FDI theories across sectors and the development of service-specific frameworks (Carman and Langeard, 1980; Erramilli, 1992; Gronroos, 1999). Many researchers argue that there are crucial differences in the production and delivery of services and goods. Services differ from manufactured goods along features such as the intangibility of the offering, the separability of production and consumption, and the perishability of inventories (Lovelock and Yip, 1996; Zeithaml et al., 1985).

Among these variables, the "separability" of production and consumption has been deemed of importance for service firms' internationalization (Erramilli and Rao, 1993). Separability characterizes transactions by the level of interaction required between providers and users (Hirsh, 1989). News delivery is an example of a separable service. Like most material goods, information may be designed, manufactured, and stocked for later delivery and consumption. Most other services (e.g., those provided by hotels or restaurants) necessitate the close physical proximity of buyers and sellers (Anand and Delios, 1997; Carman and Langeard, 1980; Zeithaml et al., 1985). Separable products or services can be transferred to overseas markets where they can be sold to a set of foreign consumers. Inseparable ones are *location-bound*. If foreign consumers are to access an inseparable service, the consumer must come to the site at which the service is produced. This feature of inseparable services, in which the product of location-bound resources must be consumed at the same time and location at which it is produced, has important implications for entry decisions in foreign markets (Erramilli and Rao, 1993, p. 35).

The degree of "idiosyncrasy" that characterizes a service is another key factor to consider when discussing the internationalization of service firms (Erramilli and Rao, 1993; Zeithaml et al., 1985). Because many services are *labor-intensive* or people-centered, the marked differences between employees in terms of skills, education, or specialized know-how create considerable variance in performance at service production or delivery. Firms can reduce this risk by substituting physical resources for the human element (as in the case of automated-teller machines) or through extensive education and training of employees. When training is extensive and when employees have a high level of skills when joining a firm, the degree of human capital is greater. According to Erramilli and Rao (1993), the production/delivery of services typically relies on a high intensity of human capital—the skills, talent, and knowledge of a firm's employees that are not easily transferred to different organizational or social contexts. Below, we contend that differences in human capital intensity faced by service firms

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