University of Macedonia

Department of Balkan Slavic and Oriental Studies

PhD Thesis

Multinational Enterprises, Entry Mode Strategies, and Emerging Economies
An Institutional and Transactional Approach:
The Case of Turkey

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:

η διατριβή αυτή αφιερώνεται

στον άντρα μου, Χατσίκ, για την αμέριστη συμπαραστάση,
στον γιο μου, Άρη, για όλες τις στιγμές που απουσιάσα από διπλα του,
και στον πεθερό μου και πεθερά μου, Άρη και Μαίρη για όλη τη βοήθεια

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Chapter 1: Introduction

International Business literature (IB) defines cross-national distance, which has a robust influence on organizational choice (Yamin and Goleshorki 2009), as the difference between national characteristics of home and host countries. Various authors developed different factors affecting cross-national distance (see indicatively Ghemawat 2001; Berry, F Guillén, and Zhou 2010), the most prominent of which are those of Ghemawat (2001). In his view, countries may be "distant" from each other not only in geographic terms (kilometers), but also because cultural, administrative/political, and other economic differences, as they are described in the CAGE analytical framework, make it harder for firms to cross borders.

Much attention has also been paid to the impact cross-national distance has on to the foreign market entry-mode chosen by Multinational Enterprises (MNEs). A review (Datta, Herrmann and Rasheed 2002, as cited in Harzing 2003) limited to foreign market entry by U.S. firms or entry into the U.S. by non US firms identified nearly 100 studies over the past decade. This is not surprising, since Datta et al. (2002) indicate that foreign market entry mode choice is one of the most important strategic decisions in the internationalization process of a firm.

Foreign market entry mode decisions are commonly segmented into equity-based modes and non-equity based modes (e.g. Pan and Tse 2000). Non-equity based modes involve exports and contractual agreements, whereas the equity-based entry modes involve FDI made by MNEs (Dunning and Lundan 2008) and are considerably inflexible and irreversible in nature (Elango and Sabharya 2004, as cited in Arslan and Larimo 2010, p. 320). Pair-wise analyses have been carried out comparing choices of modalities, such as, a joint venture (JV) vs. a non-equity partnership, or a JV vs. an acquisition/wholly-owned subsidiary (WOS) formation, among others.

Different theoretical approaches have been used including the Transaction Cost Approach (TCA) (Anderson and Gatignon 1986), the Corporate Strategy Perspective (Caves and Mehra 1986), and the Learning Perspective (Barkema and Vermeulen 1998). Although these studies examine the determinants of entry-mode choice from different aspects, and many times have been criticized for inconsistent results, they commonly posit that the entry-mode decision is based on MNEs' deliberate, conscious efforts to enhance their competitiveness, efficiency, and control over critical resources (Yiu and Makino 2002).

Therefore, the foreign market entry mode decision and the cross-national distance concept are

important research topics in the field of IB. “The choice of FDI mode involves detailed analyses of trade-offs between control and investment risk as well as conformance to the institutional requirements of host countries” (Arslan and Larimo 2010, p. 320). So, MNEs face two important decisions when they wish to expand into new foreign markets using the FDI mode: whether to acquire an existing enterprise (acquisition) or build a Greenfield investment, and the level of equity control in a subsidiary firm (formation of wholly owned subsidiary or a joint venture with local partners).

The aim of the present thesis is to reconcile FDI equity mode strategy in Turkey as a function of cultural, institutional, geographic, and economic distance. More specifically, this thesis aims firstly, at the transformation of the CAGE distance framework to CIGE distance framework. Secondly, at the distinction between cultural and institutional concept. Thirdly, at the construction of a model with specific characteristics. Fourthly, at the empirical implementation of the model by specifically analyzing the entry mode choice in a wholly owned subsidiary- the MNE holds 100% of the equity- as opposed to JV subsidiary-MNE holds from 10-90% of the equity- and its different forms– minority, co-ownership and majority JV- through the implementation of the “CAGE (Cultural, Administrative/political, Geographic, and Economic) Distance framework” as developed by Ghemawat (2001).

This is proposed to be achieved by analyzing and comparing how each form of distance affects entry mode choice strategy. This aim is based on the premises that Ghemawat's (2001) conceptual framework is a comprehensive framework which employs a variety of distance determinants (cultural, economic, geographic, etc.) and simultaneously provides the basis for the development of an “envelop” approach.

The first goal of this thesis develops in two steps and focuses on applying some theoretical modifications to CAGE dimensions. The first step aims at the transformation of administrative/political distance by institutional distance, while the rest CAGE dimensions (cultural, geographic, and economic) remain as Ghemawat (2001) suggests. So, the “CAGE distance framework” in this thesis is being transformed into “CIGE distance framework”. The second step aims at approaching the new distance framework through TCA and institutional theory. More specific, economic distance and geographic distance may be approached through TCA, whereas cultural distance and institutional distance may be approached through institutional theory (New Institutional Economics) (see Figure 1). The institutional theory, in turn, may be employed on the basis of Scott's (1995) three institutional pillars: regulative, normative, and cognitive.

Lastly, the second goal of this thesis aims at conducting a clear distinction between cultural and institutional concept. Particularly, this thesis following Redding (2008) and Grief (2006) arguments that

beliefs and norms make up culture, while *rules and organizations make up institutions*, and simultaneously considering Scott's (1995) arguments that the cognitive pillar is connected with beliefs and norms, it makes two assertions. Firstly, it distinguishes cultural from institutional concept, and secondly, it considers the cognitive pillar of Scott's institutional theory equivalent to cultural distance.

The very basic hypothesis this thesis is based on is that foreign equity ownership decisions in an emerging market will be affected by transaction cost considerations, institutional considerations and firm or industry level variables. As Wright, Filatotchev, Hoskisson, and Peng (2005) argue emerging economies provide a new context for understanding relative strengths and weaknesses of these different perspectives. As emerging economies have become significant entities in the new world economy, the evolution and composition of economic institutions in them has inspired a rich literature in the organizational sciences. Among the institutions that have received some attention are the large, diversified conglomerates and networks of closely affiliated businesses (Ramamurti and Singh 2009). From a wide range of emerging economies that exist the present thesis chooses to focus on Turkey. Turkey is worth of inspiring significant questions and future work on this interface in other emerging economies. Similarly, the Turkish business environment shares many common features with highly diversified business environments in other emerging economies (see Chang and Hong 2000; Maman 2002) and also reflects the unique characteristics of Turkish society and its social and political history (Bugra 1994a; Karademir and Danisman 2007).

More specific, the determinants of foreign investors' ownership choice in the case of Turkey can be justified in a number of ways. To begin with, Turkey is considered to be at the crossroads of both the East-West and the North-South axes, creating an efficient and cost effective outlet to major markets (http://www.invest.gov.tr/en-US/investmentguide/Pages/10Reasons.aspx). Its proximity to emerging markets in the Middle East and Central Asia creates unique business opportunities.

Turkey also functions as an important energy terminal and corridor for Europe, which borders to the West and is a major energy consumer, since it is located in close proximity of more than 70 percent of the world’s proven primary energy reserves. This makes the country a linchpin in energy transit and an energy terminal in the region.

Moreover, “Turkey is an EU accession candidate country, a member of the Organization for Economic Cooperation and Development (OECD) the G20, and an increasingly important donor of bilateral Official Development Assistance (ODA)” (World Bank Group Country Partnership Strategy for the Republic of Turkey for the period 2012-2015 2012, pp. 1). Turkey is also one of the largest middle income partners of the World Bank Group (WBG) and the largest economy in SE Europe, and the Middle East.

In 2012 it was also the sixteenth largest economy in the world and the European Union's sixth largest trading partner in terms of GDP at PPP (IMF WEO). Turkey was designated by the U.S. government as one of the Big Emerging Markets, characterized by high economic growth and rapidly growing population (Garten 1996). Its economic growth is outstripping OECD averages, while trade volumes have also robustly been growing reaching US$ 152 billions by the end of 2013, up from US$ 47 billions in 2003. Moreover, for the period 2002-2013 its economy grew with an average annual real GDP growth rate of 5% (http://www.invest.gov.tr/en-US/turkey/factsandfigures/Pages/Economy.aspx).

A sound macroeconomic strategy in combination with prudent fiscal policies has also reined in its public finances; the EU-defined government nominal debt stock fell to 36.3% from 67.7% between 2003 and 2013. Hence Turkey has been meeting the "60 percent EU Maastricht criteria" for public debt stock since 2004. Similarly, during the period 2003- 2013 the budget deficit decreased form more 10% to less than 3%, fulfilling another of the Maastricht criteria. Significant improvements in such a short period of time have registered Turkey on the world economic scale as an exceptional emerging economy, the 16th largest economy in the world and the 6th largest economy when compared with the EU countries, according to GDP figures (at PPP) in 2013.

Half of the 76 million population of the country, is under the age of 30 (TurkStat 2012) making Turkey a much younger society than EU member states. There are approximately 600,000 university graduates from 170 tertiary education institutions (Student Selection and Placement Center-OSYM 2012) and more than 700,000 secondary school leavers (Ministry of National Education 2012) annually. This reflects a dynamic, motivated, and well-educated population, enhancing the labor productivity of the country.

Additionally, the Turkish cultural and institutional context provides an interesting and useful research setting characterized by its attempts to become a more Western style market economy; this is illustrated by the country's ongoing negotiations with the EU, as the first Muslim country ever bidding for EU membership.

Furthermore, since the early 1980s Government policy in Turkey has aimed at developing a free market economy. The country's traditional inward-oriented and therefore, import-substitution policies have been replaced by an export-oriented development strategy. Turkey has recorded a substantial increase in FDI, especially after 2006. This has been the result of the combination of the decisive implementation of a sound economic program and an institutionalized economy fueled by USD 123 billion of FDI in the last decade. Turkey was ranked, according to A.T. Kearney FDI Confidence Index, as the 13th most attractive FDI destination in 2012.

Lastly, the business approach that prevails is based on the fact that business opportunities alone

are not sufficient, unless they are accessible to entrepreneurs. Thus, a comprehensive reform program to improve the business environment has been adopted and implemented. Early results, such as, simplified procedures for setting up a business (average of 6 days to set up a company in Turkey, while the average in other OECD members exceeds 12 days) and new FDI legislation-the second biggest reformer among OECD countries in terms of restrictions on FDI since 1997 (OECD FDI Regulatory Restrictiveness Index 1997-2012)- are strong indicators of the change in business practices.

Between 2002 and 2010 there was a sharp increase in Foreign Direct Investment (FDI) flows into the country from USD 1,082 million to USD 9,084 million (Unctad 2012).There was also a surge in MNE's acquisitions of manufacturing companies from 21% in 1990 to 33% in 2003 (Turkan 2005). Moreover, in the first 9 months of 2011, FDI to Turkey have reached to US$ 10.9 billion (Yased 2011). In 2012 FDI inflows to Turkey have reached $12.4 billion decreased by 23% compared with those of 2011, however, Turkey in 2012, ranked 24th among the countries attracting the most FDI flows in the world, 14th among developing countries, and 1st in the West Asia region. As of 2013, FDI flows fell to $ 12.7 billion, a 4% decline year-on-year. Real estate purchases made in Turkey by foreigners averaged $2 billion annually over the past five years.

Foreign capital has flowed into Turkey from countries all over the world, but the majority of it has its origins in Europe and the USA. In terms of distribution of authorized FDI by country of origin, foreign investment in Turkey is dominated by European countries (72%), followed by the USA (12%), with the remaining mainly shared by countries of the Far East (7%) and the Middle East (3%) (GDFI, 2005, 2013). Recently, Turkey realized that it may progress more quickly if it can attract investments from emerging markets such as those of Asia, Pacific and the Middle East. More than half of investors are planning to expand their current operations in Turkey. Other preferred choices include Joint Ventures, followed by acquisitions and Greenfield investments (Ernst & Young's Attractiveness Survey Turkey 2013: The Shift, the Growth, and the Promise 2013).

Therefore, given the emerging nature of the market and the transitional characteristics of the institutional environment, the Turkish context provides a good case in point to test these dimensions alongside composite indices. In this framework, this thesis presents a number of significant novelties. The first one addresses the choice foreign investors make between full ownership (setting up a wholly-owned subsidiary) or being engaged in partial forms of acquisition (minority, co-ownership or majority-owned subsidiary through a JV) through Ghemawat's (2001) conceptual framework. IB scholars have analyzed so far these FDI decisions of MNEs using different approaches. Some past studies have addressed the ownership mode strategy of MNEs by studying the choice between a JV and full ownership (e.g. Anderson and Gatignon 1986; Luo 2002; Xu et al 2004; Brouthers and Hennart

2007). Other IB scholars have focused on the choice between Greenfield investment and acquisition entry by MNEs (e.g. Hennart and Park 1993; Brouthers and Brouthers 2000).

However, according to Chen and Hennart (2004), the lack of studies differentiating between full and partial acquisition in the past explains the variance in findings of studies addressing establishment and ownership mode strategies of MNEs. Moreover, by putting full and partial acquisitions or JV or wholly owned subsidiary together, important features of different types of acquisitions have been ignored (Chen and Hennart 2004, as cited in Arslam and Larimo 2012, p. 321). So, it is expected this thesis to be one of the first to enrich the IB field by analyzing in detail the choice between full and partial acquisitions by MNEs in foreign markets.

Further, this thesis addresses the issue of entry mode strategy, both theoretically and empirically by combining institutional and transactional perspectives following Meyer's (2001, p. 358) assertion that "efficient markets depend on supporting institutions that provide the rules of the game of a market economy. Institutions reduce transaction costs by reducing uncertainty and establishing a stable structure to facilitate interactions between markets and institutions". So, this thesis provides a comprehensive approach of FDI equity mode strategy by reconciling and analyzing how institutional and transactional approaches, which are rooted in New Institutional Economics, are inter-connected in order to produce a multidimensional aspect of FDI equity mode strategy considering the emerging economy of Turkey.

In addition, another novelty of this thesis is that it approaches entry mode strategy through Ghemawat's (2001) conceptual framework, something which has not been addressed specifically in the IB literature so far. Ghemawat (2001) considers the multiple aspects of distance in the literature (Beckerman 1956; Hymer 1960; Johanson and Vahlne 1973; Dunning, 1977, 1993; Nordstrom and Vahlne 1994; O'Grady and Lane 1996, etc.) and proposes a suitable and effective conceptual framework categorizing distance into four broad forms of distance that are likely to influence the international development of MNEs. In light of this view, Ghemawat's (2001) contribution can be used as an analytical framework for examining the role of distance in international operations in general and for cooperative strategies in particular.

Moreover, institutional context needs particular attention "partially because institutional context uses terms such as "institutions" and "institutional distance" which mask a variety of institutional approaches that are currently used in international business research [and also because] IB research draws on institutional approaches from various disciplines, such as economics, sociology and political economy (Hotho and Pedersen 2012, p. 236). Therefore, considering this view and recognizing that one of the reasons that CAGE was constructed was to identify institutional voids derived from

intermediaries that make institutions work properly (http://www.peoi.org/Courses/Coursessp/intlbus/ch/ch8d.html), this thesis is expected to be one of the first to contribute theoretically to IB literature, by incorporating a transaction-based, institution-based view, and entry mode strategy in Ghemawat's (2001) conceptual framework.

Another contribution of this thesis is that it distinguishes between normative and cognitive institutional aspects/pillars, as suggested by Scott (1995), which has been criticized for overlaps in the boundaries of its institutional dimensions, especially concerning the normative and cognitive pillars (e.g. Peng and Khoury, 2009). Hence, in the choice of entry mode strategy made by MNEs, full ownership (setting up a wholly-owned subsidiary) or being engaged in partial forms of acquisition (minority, co-ownership or majority-owned subsidiary through a JV) is dependent not only on organizational skills, but also on broader economic, social, and cultural requirements represented by the institutional environment.

Lastly, the present thesis through "CIGE Distance framework" integrates Turkish economic and geographic perspectives, analyzing these dimensions on a broader basis: it includes not only GDP differences and kilometric differences, respectively, but also a wider range of characteristics, such as, firm or industry, linguistic, and colonial factors.

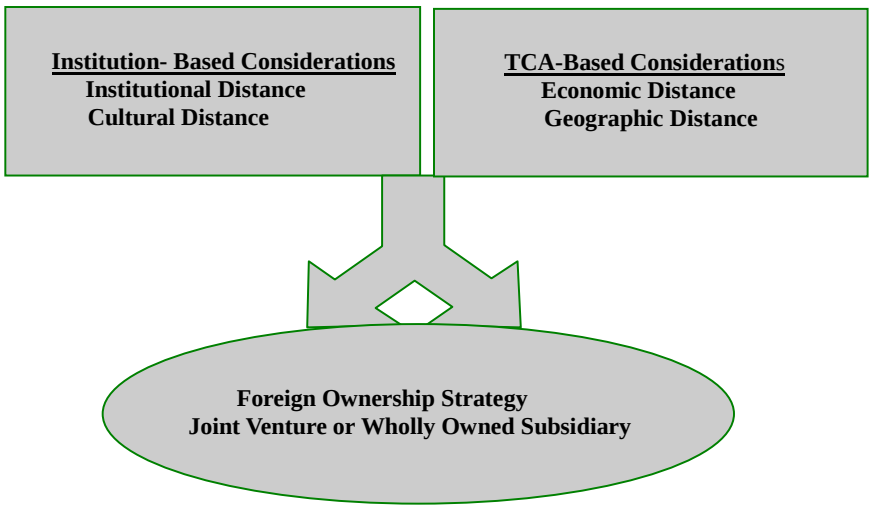
This is accomplished through employing the Factor Analysis (FA) method and the construction of composite indices in order to achieve an even more effective hypothesis testing, by reducing reliance on single item measures of complex constructs. These modifications are employed in a sample of 245 MNEs, coming from 17 European Union (EU) and 21 non EU countries from the dataset of the Republic of Turkey Prime Ministry Investment Support and Promotion Agency (ISPAT) through the Multinomial Logistic Regression (MLR) econometric testing method.

More specifically, this thesis develops the base model into four sub-models dividing them into three steps through hierarchical regression analyses, in order to achieve comprehensive analysis by deciphering whether the inclusion of cultural and institutional variables would significantly affect the incremental explanatory power of entry-mode choice (Yiu and Makino 2002). The **first step** is going to test the **Base Model** incorporating economic and geographic distance; the **second step**, through **Model 1**, is going to test the significance of overall institutional distance in combination with two cultural-cognitive indices (**GLOBE and Hofstede**), economic, and geographic distance. Finally, **the third step**, through **Models 2, 3, and 4**, is going to test the components of institutional distance **(regulative and normative distance)** in combination with two cultural-cognitive indices, i.e., economic distance, and geographic distance.

The rest of the thesis consists of the following sections: Chapter two describes the historical

background of the Turkish FDI environment focusing on the history of FDI from the Ottoman Empire and concluding to the more recent modifications that took place in Turkish FDI Law until 2010. Chapter three analyzes the Turkish FDI structure and performance for the 2002-2010 period focusing on the distributed FDI inflows to Turkey by home country, FDI mode of entry, and conducting a comparative analysis of FDI flows to Turkey in relation to peer countries. Chapter four analyzes the FDI determinants theory starting with a brief presentation of FDI theories and concluding to Dunning's (1977, 1988, 1991, 1993, 2000) holistic theoretical framework (OLI) by stressing the importance of Transaction Cost Approach (TCA) and connecting it with Institutional theory (New Institutional Economics). Chapter five defines the concept of "distance" and presents Ghemawat's (2001) theoretical framework in detail. Further, it defines FDI entry modes and analyzes how TCA, entry mode choice and distance concepts are incorporated. Chapter six develops the model, and hypotheses building. Chapter seven presents the methodology, data, and sources of the sample. Chapter 8 develops empirical results and Chapter 9 concludes.

Fig.1



Source: Peng (2006, pp. 219), Demirbag, Glaister, and Tatoglu, (2007, pp. 421)

Chapter 2: FDI in the Republic of Turkey

In order this analysis examines the evolutionary structure of the FDI environment of Turkey, it is important first to conduct a historical analysis under the lens of the global and domestic motivations as well as to examine the conditions that led to

Turkey's liberalization in the FDI regime.

The starting point of the history of FDI in Turkey is dated back to the Ottoman Empire with the Capitulations. The Capitulations[1] permitted foreign governments, since the 16th century, to exercise extraterritorial jurisdiction over their nationals living in the Ottoman Empire (Hale 1981; Erdilek 2005). They also created a system of extraterritorial privilege and immunity for FDI firms. They accorded foreign traders and businessmen exemptions from direct taxation and the right to have all disputes in which they were involved settled in special courts run by their consular representatives (Grigoriadis and Kamaras 2008).

The Free Trade Agreement of 1838 with the Great Britain restricted the foreign trade policies of the Ottoman Empire. That trade agreement and all the others signed with other nations included the Capitulations, and opened the Ottoman economy to privileged presence and activities of foreigners in both the domestic and international sectors. FDI became concentrated in the services sector, especially in financial services such as banking and insurance, and in public utilities, and infrastructures such as railroads, ports, telephones, electricity, water, and gas. The British also established cotton plantations and acquired large land holdings for farming in western Turkey as the Ottoman legislation allowed foreigners to own land. Under the Capitulations, FDI firms as legal persons possessed extraterritorial rights to operate just like foreign real persons. FDI firms were exempt from corporate income and dividend taxes that had to be paid by national firms. Many such FDI firms could resort to deceptive and dishonest business practices without fear of legal actions by Ottoman authorities. The privileged status of FDI firms caused large segments of the Ottoman economy to fall under foreign domination, resulting in the economic colonization of the empire as was the case in China in the 19th century (Erdilek 2005).

The Ottoman Empire became saddled with increasing foreign indebtedness after 1840, which resulted in insolvency and default in 1875-1876. The Council of the Public Debt was established in 1881 by the European creditor nations to service the Ottoman Empire's defaulted foreign debt. The Council of the Public Debt controlled a significant segment of the national revenues, its powers extending through taxation into every corner of the Ottoman Empire (Erdilek 2005).

The economic life of Turkey in the last four decades of the Ottoman Empire was almost totally controlled by either foreigners or by non-Muslim subjects of the Empire who had benefited from the Capitulations at the expense of the Empire's Muslim majority (Erdilek 2005; Grigoriadis and Kamaras 2008). Foreign capital began to play an important part in the development of the country, especially, in communications and services, but also in agriculture and in the infant manufacturing industries. Most

[1] The Capitulations were harmful and humiliating derogations from national sovereignty that have negatively and deeply influenced Turkish attitudes toward FDI (Erdilek 2005).

of the FDI firms employed foreign managers and skilled workers, and conducted their business correspondence in French until the Ottoman State in 1916 enacted a law requiring Turkish to be used in all business correspondence. Railways, tramways, and ports, gas, electricity, and water, were all operated by foreign concessionaire companies, as were also most of the mines and factories (Erdilek 2005; Quataert 1994).

During 1890-1914, FDI accounted for an increasing share of total foreign capital inflows, reaching half of total foreign indebtedness in 1914. Railroads accounted for two thirds of all FDI in 1914, with the British, French, and Germans having built an extensive railroad network during 1888-1896. FDI in manufacturing and mining accounted for less than 10 percent of total FDI. The Capitulations, resented as a symbol of inferiority and subservience, were annulled by the Ottoman Empire in 1914 as World War I began, ending the privileged status of FDI firms. World War I also led to the nationalization of several British and French FDI firms, including several railroads and shipping yards. The Treaty of Lausanne finally ended the Capitulations in 1924 (Erdilek 2005).

In this period of economic liberalism, with full currency convertibility, the Treaty of Lausanne restricted the Turkish Republic's commercial policies. The Republican regime gave cautious encouragement to FDI in light of the unfavorable experiences during the Ottoman Empire. In his speech to Izmir Economic Congress in 1923, Ataturk was highly critical of the Capitulations and the economic colonization of the Ottoman Empire. Despite this criticism, Ataturk declared that Turkey was open to FDI as long as it respected the country's laws, accepted national treatment without seeking extraterritorial privileges, and yielded mutual gains (Okcun 1981).

Although several FDI firms were nationalized, with fair compensation, during this period, new FDI firms came into existence, benefiting from the Law for the Encouragement of Industry enacted in 1927. The first FDI in the manufacturing sector after the founding of the Turkish Republic was by Nestlé to manufacture chocolate. Ford Motor Company's auto assembly project in 1929 failed to develop due to the onset of the Great Depression in 1930 and was shut down in 1936. The Great Depression also signaled the end of economic liberalism and the rise of Etatism or Statism in Turkey (Frieden 2006).

In 1930, the Law No. 1567 for the Protection of the Value of Turkish Currency, imposing quantitative controls on foreign exchange transactions, ended currency convertibility. Although it was meant initially to stay in effect for only three years, it remained in effect far before receiving several amendments. The Law No. 1567 also marked the end of economic liberalism and the beginning of increasing government intervention in the economy. During 1934-1938, when FDI was neither opposed nor encouraged, several new FDI firms were established. Many existing FDI firms, however, mostly

railroads and municipal public utilities, were nationalized, with fair compensation, during 1930-1939 (Erdilek 2005).

After World War II, which did not allow for FDI activity, Turkey began to ally itself with the West, with significant consequences for FDI. Decree No. 13, issued in 1947, under Law No. 1567, required foreign investors to get permission from the Ministry of Finance in order to transfer funds out of Turkey under restrictive conditions. Law No. 5583 enacted in 1950 was the first law under the Republic to address the issue of FDI. It guaranteed profit transfers, but under very restrictive conditions. Law No. 5821, titled Law to Encourage Foreign Capital Investments, enacted in 1951, replaced Law No. 5583.

It contained fewer restrictive conditions and several needed clarifications about permitted FDI activities but still did not indicate an entirely welcoming attitude toward FDI (Aktar 2003). Neither Law No. 5583 nor Law No. 5821 attracted much FDI. Law No. 6224, titled Law to Encourage Foreign Capital, and prepared with the help of a U.S. expert, was enacted in 1954, without the support of the opposition parties in the Grand National Assembly, to replace Law No. 5821. The Republican People's Party depicted Law No. 6224 as the reintroduction of the infamous Capitulations, pledging itself to revise the law after regaining power. Law No. 6224 lifted all the restrictive conditions contained in Law No. 5821(Aktar 2003).

Although it had the word "Encourage" in its title, Law No. 6224 did not contain any special incentives to attract FDI. In 1954, Law No. 6326 was enacted to attract FDI for petroleum exploration. Under both Law No. 6224 and Law No. 6326, FDI firms were exempt from the foreign exchange regulations imposed by Law No. 1567. However, the enactment of Law No. 6224 coincided with

"the 6–7 September 1955 program, which primarily targeted the Greek minority of Istanbul but also affected Armenians and Jews, resulted in the pillage of non-Muslim properties, while in 1964 12,000 Greeks were expelled. These events, combined with the demographic trends of Turkey's Muslim population, pushed non-Muslims into economic and numerical insignificance. [Simultaneously], [w]orldwide, the slump in commodity prices started to reverse only in the mid- 1950s, while anti-colonialism and all its presumed variants were at their height. [Import Substitution Industrialization (ISI)] was only picking up steam and indeed was to deliver seemingly impressive results in later years, in Turkey and elsewhere" (Grogoriadis and Kamaras 2008, p. 56).

So, ironically the economic and business environment began to worsen for FDI as Law No. 6224 went into effect to attract FDI.

Law No. 6224, which governed FDI until its replacement with Law No. 4875 in 2003, has been described as a "liberal" law but in reality during much of its existence it was not applied "liberally." It did not contain any provisions for nationalization and international arbitration. It also did not specify that performance requirements could be imposed on FDI firms but not on national firms. It specified

the principle of national treatment for FDI firms, but in practice the principle was often violated (Onis 1994). Its vagueness enabled the Turkish bureaucracy to apply it restrictively and arbitrarily during much of its existence, making it more of a discouragement than encouragement of FDI (Erdilek 2005).

Over the years, it also became outdated and failed to reflect the best international practice in FDI legislation. During 1954-1958, the Turkish economy became increasingly unstable and did not attract much FDI. During 1958-1960, under the economic stabilization program designed by the IMF and the OECD, the Turkish economy was still too risky for new FDI. Some existing FDI firms, however, took advantage of the peculiar conditions of the late 1950s, characterized by price controls and shortages of basic goods, to earn extraordinary profits, which fueled the hostility toward FDI in Turkey. At the end of 1960, during which the Turkish military took over the government, the cumulative total FDI (stock) was $17.3 million.

During this period of planned economic development under Five-Year Development Plans, Turkey followed an inward-looking import-substitution strategy. This strategy, which led to recurrent balance of payments crises, as exports could not keep up with imports of intermediate inputs and capital goods, attracted the type of FDI that served primarily the domestic market. Despite exhortations and performance requirements, FDI did not play a significant role in the development of exports. Except for the First Five-Year Development Plan (1963-1967), which extolled the benefits of FDI and underlined the need for the establishment of an Investment Promotion Agency (IPA), the successive Five-Year Development Plans contained increasingly skeptical views about the benefits of FDI (Buğra 1994).

The role of private capital inflows deemphasized, preferring state borrowing, in dealing with Turkey's savings and foreign exchange gaps. **But why did the Turkish bureaucracy and the political establishment over several decades show a strong preference for the injection of foreign capital into the Turkish economy in the form of debt, especially government-to-government and international agency-to-government debt, rather than in the form of FDI?** Foreign debt capital was preferred because it could be imported and used more quickly as cash; used for current expenditures as well as investment; used at the discretion of the bureaucracy in any public or private project; and used in investment projects of the State Economic Enterprises, and thus strengthen the public sector, the bureaucracy, and the political party in power (Bugra 1994).

This preference for foreign debt capital was made feasible by Turkey's strategic importance for the Western world prior to the collapse of the Soviet Union. This preference for foreign debt capital helped Turkey also understand the slow pace of privatization in Turkey until recently in terms of the reluctance of the bureaucracy and the political parties to give up the power that comes from state

ownership of productive activities that could be better carried out by the private sector. As reflected in the Five-Year Development Plans after the first one, and the decrees of FDI firms, the State Planning Organization (SPO)'s opposition to FDI deepened after the mid-1960s. In 1963, Turkey became an associate member of the European Economic Community (EEC) (Erdilek 2005).

In the 1970s, the European Economic Community (EEC) countries, especially Germany, tried unsuccessfully to move Turkey toward a more favorable position on FDI. Turkey was more interested, however, in sending more of its surplus labor to the EEC, and obtaining better conditions of employment for the Turkish workers already there than in receiving higher levels of FDI. Turkish workers' remittances from the EEC became a major source of foreign exchange, preferred to foreign exchange that could be obtained through FDI. The EEC's initiatives to overcome the Turkish reluctance on FDI were regarded with suspicion and resentment, especially after the EEC closed, in the mid-1970s, its doors to new inflows of Turkish workers and sent back a significant number of the ones it had earlier employed (Esfahani 2003).

During much of the 1960s and 1970s, however, Turkey actually lacked the political and economic stability to provide a secure environment for FDI regardless of whether it wanted FDI or not. Until the mid-1960s, several coalition governments and two abortive military coups showed Turkey to be politically unstable in its second experiment with democracy. The relative political stability of second half of the 1960s ended with another military intervention in 1971. After the early 1960s, FDI firms began to be increasingly regimented by firm-specific decrees that dictated what they could and they could not do, and what they should and they should not do, as the performance requirements imposed on them, in violation of national treatment, began to proliferate (Kar and Elveren 2005).

The entry of new FDI firms became exceedingly difficult and time-consuming. A prospective FDI firm could be forced to get as many as 23 signatures from various official authorities in order to receive FDI permission, which could take as long as three years. Before 1962, FDI requiring little or no fixed capital investment was permitted under Law No. 1567. Decree No. 17, issued in 1962, under Law No. 1567, blocked the profit transfers by FDI firms established under this law. In 1967, Law No. 933 amended Law No. 6224, abolishing the Committee to Encourage Foreign Investment, which had private sector representatives, and transferring the FDI authority to the SPO (Erdilek 2005).

The SPO over the years became the nemesis of FDI firms, as it imposed increasingly stringent performance requirements not only on prospective FDI firms but also on existing FDI firms, especially during 1974-1979 (Erdilek 2005). It viewed FDI in the services sector as of no benefit to Turkey, viewing only FDI in manufacturing of any possible benefit. The period 1974-1979 also witnessed rising political instability and widespread violence between political factions and ideologies, which

drastically worsened the environment for FDI. The balance of payments crisis in 1977-1978 was followed by an exodus of FDI from Turkey in 1979, as the number of FDI firms dropped from 106 to 91. Throughout the 1970s, as in the 1960s, the OECD tried to obtain from Turkey a liberal treatment of FDI (Erdilek 2005).

Turkey appeared to go along whenever needed the urgent financial assistance of the OECD countries. Especially in 1978, open diplomatic pressure was exerted on the Turkish government to accept a greater role for FDI in Turkey's development. This was presented as a condition for the international rescue operation without which Turkey could not avoid impending financial insolvency. The government paid lip service to attracting more FDI to placate the OECD but did nothing toward that objective. During this period, FDI inflows totaled $210.8 million, bringing the cumulative total FDI (stock) to $228.1 at the end of 1979 (Unctad 2011).

This period ended with the January 1980 economic reforms that ushered in a new era of globalization based on export-promotion with a great potential for FDI, which unfortunately was not realized. At the beginning of this period, just as in 1954, the government made an exceptional effort to welcome FDI. It invited experts from the United States and the OECD to review and propose changes in Law No. 6224. It used the private sector resources of the Union of Chambers of Commerce, Industry, and Commodity Exchanges of Turkey to promote FDI (Onis and Bakir 2007).

As noted earlier, the First Five-Year Development Plan (1963-1967) contained a strong endorsement of FDI, emphasizing the need for its active promotion by an IPA. This was an auspicious start but for political reasons as well as for the autarkic import-substitution strategy that distorted incentives for FDI, it soon fizzled. In fact, beginning in the mid-1960s, the relationship between the government and foreign investors became increasingly adversarial, bordering on hostility in the late 1970s. This period witnessed Turkey’s second lost chance to establish a mutually beneficial and lasting relationship with FDI (Onis and Bakir 2007).

January 1980 economic reforms, implemented more rigorously after the military took over the government in September 1980, significantly improved the FDI environment at the outset. The Council of Ministers issued in the 1980s, and first half of the 1990s, several decrees and many communiqués aimed at simplifying and clarifying the bureaucratic processes that had “bedeviled” foreign investors earlier, especially in the late 1970s (Erdilek 2005).

Particularly, during 1980-1983 significant steps were taken in the direction of replacing the import-substitution strategy with an outward-oriented regime. Key relative prices determinants including the exchange rate, interest rates, and the product prices of state enterprises were deregulated and import quotas were largely dismantled. However, the major moves toward liberalization of the

economy occurred following the retransition to parliamentary democracy in November 1983 (Loewendahl and Ertugal-Loewendahl 2000).

Significant reductions in the effective rates of protection as well as the removal of restrictions on capital account and the foreign payments regime in December 1983 and January 1984 constituted the immediate measures of the newly elected Motherland Party government (Nas and Odekon 1988; Olgum, Togan and Akder 1988). Parallel to the reforms of the trade and payments regime, specific measures in the direction of liberalizing the FDI regime were introduced during the post-1983 phase. The landmark in the context of FDI reform involved the reorganization of bureaucracy, effectively in 1984, with a single organization, the Foreign Investment Department of the State Planning Organization, assuming responsibility for authorizing applications for foreign investments and for monitoring the subsequent performance of foreign investors.

A highly unified bureaucratic structure emerged, which substantially eliminated the delays and ambiguities associated with the previously highly fragmented structure in the FDI regime contrasted sharply with the fragmented and incoherent nature of policy making that characterized other major spheres of economic policy in the 1980s, such as the administration of export incentives (Onis 1992).

Another major shift in the direction of liberalizing the FDI regime involved the specific legislation on the formation of free trade zones in 1985. The major, objective of this shift was to encourage export-oriented FDI in prespecified regions of the country. These regions of free zones would be exempt from most of the previous provisions applying to FDI activity outside the free zones. The major benefit offered by free zones involved exemption from the Turkish taxes. Moreover, Turkish labor laws were not applicable in the free trade zones for a ten-year period, which meant that the regions would be free from strike activity. All payments in the free trade zones had to be made in Central Bank-designated hard currencies. The first free trade zone was opened in Mersin in January 1987 (Erdilek 1988).

1986 marked the climax of the FDI liberalization process. As a result of the changes introduced, 100 percent foreign ownership became feasible for all foreign investors in all sectors of the economy. Disincentives for foreign ownership in the form of attempts to impose local equity participation were totally eliminated. The minimum export requirements that had been imposed on foreign firms, but not to domestically owned firms, were removed (Yased 1986; Erdilek 1988).

Another fundamental step involved the elimination of fiscal discrimination against foreign investors. The Turkish personal and corporate income tax legislation were modified and became much more favorable to foreign investors. Finally, the scope of the Foreign Investment Department of the State Planning Organization was considerably expanded. The department was empowered to receive

and approve applications up to USD 50 million, even in cases where the application involved 100 percent foreign ownership. Applications exceeding USD 50 million, however, still required approval by the Cabinet (Onis 1994).

The basic principle underlying the government's philosophy toward foreign investment, namely the equal treatment of domestic and foreign firms, became firmly established through the series of steps introduced in 1986. It is important to emphasize that the new Law does not embody any specific measures that involve positive determination in favor of foreign investors, such as tax holidays. In this respect, the Turkish FDI regime differs considerably from FDI regimes of many developing countries, particularly countries in Southeast Asia (Mehmet 1990).

Finally, the FDI regime in Turkey involved a major institutional innovation in the form of the "build-operate-transfer" (BOT) model that has attracted widespread international attention (DPT 1987; Dinc 1989). Many researchers had identified transport communications as the major impediments confronting the Turkish economy during the early 1980s. In fact, public investment has progressively shifted, as part of the structural adjustment program, away from manufacturing into infrastructural activities in order to relieve this constraint. The evidence suggests, however, that infrastructural projects within the public sector are characterized by long gestation lags with a corresponding amplification in costs (Onis and Ozmucur 1991). The BOT model was a direct response to the endemic problems of prolonged investment programs within the public sector. The model was designed to attract foreign investment to the construction of infrastructural facilities and thereby transfer some of the burden imposed on the private sector. The proponents of the BOT model claim that it embodies several distinctive advantages. The consortium of firms undertaking the projects has an obvious built-in incentive to complete the project as rapidly as possible so that it can reap the benefits of operating the project. Significant economies in costs can be established as companies seek to obtain their inputs from the cheapest source possible. Parallel to the gains in efficiency, a major advantage of the scheme is that it constitutes an additional source of finance for priority projects (Onis 1994, pp. 96).

However, these decrees and communiqués were not codified, so that they could become more reliable, by integrating them into Law No. 6224. Therefore, after the mid-1980s, the FID lost its initial drive to boost FDI, becoming the General Directorate of Foreign Investment (GDFI), located first in the SPO, and then in the Undersecretariat of the Treasury, where it is currently. Despite its many achievements, the January 1980 reform program failed to attract sustained and substantial FDI flows as the economy became increasingly unstable, inflation began to rise again, and the feeble privatization efforts failed (Onis 1994).

During 1980-1983, the cumulative total of approved FDI (stock) reached $932 million for 185 FDI firms, benefiting from the use of non-guaranteed trade arrears from the 1970s as FDI capital. FDI inflows began to rise only in the late 1980s, but averaged a mere $168 million annually during the decade (Unctad 2012).

The 1990s has been called the lost decade for Turkey in terms of the failure to establish

economic and political stability:

- Turkey had 9 coalition governments in 10 years, with the average life span of government less than 18 months (Grigoriadis and Kamaras 2008).
- Economic growth was increasingly sporadic, with sharp rises and falls, including a financial crisis in 1994, followed by a severe recession (Grigoriadis and Kamaras 2008).
- Inflation raged on the average at more than 80 percent per year (Grigoriadis and Kamaras 2008).

The Customs Union with the EU, which went into effect in January 1996, could not create a surge in FDI, as the Turkish economy was reaching the precipice in mid-1996, when it seemed to be on a knife-edge between hyperinflation and a government default on spiraling domestic currency debts.
On 6 December 1996, the Financial Times wrote:

Turkey's economy seems to be in a perpetual state of quasi-crisis. Heavy inflation, extortionately high interest rates, and one of the world's most worthless currencies are all symptoms of profound imbalances, themselves caused by unsustainable public finances."

Nevertheless, in the 1990s, FDI inflows averaged $772 million annually, no doubt benefiting from the global FDI boom. The amendment of the Constitution in August 1999 to allow for international arbitration for foreign investors, as well as the acceptance of Turkey as a candidate for full EU membership in December 1999, improved its prospects as a host country for FDI (Unctad 2012).

In January 2000, an economic reform program was launched by the three-party government with the financial support of the IMF and the World Bank. The program collapsed following the back to back economic crises of November 2000 and February 2001 had to be redesigned. Before its full implementation, however, the coalition government collapsed in 2002. Lack of consensus on privatization among the coalition partners during 1999-2002 deprived Turkey of potential FDI inflows (Erdilek 2005).

The first privatization window of opportunity for attracting FDI in the 1990s was missed by Turkey as the former communist countries in Eastern and Central Europe took full advantage of it. During 1980-2002, less than half of the total authorized FDI of about $35 billion was realized, pointing to problems in either the choice of authorized FDI projects or the difficulties faced by foreign investors in implementing their projects. Foreign Investment Advisory Service (FIAS) of the World Bank Group was asked in September 2000 to study the FDI environment and make recommendations for its improvement, as part of the World Bank Group's 2001-2003 Country Assistance Strategy for Turkey, which stressed the importance of FDI repeatedly and underscored the role of FIAS in improving Turkey's FDI environment (Erdilek 2005).

An in-depth review of the IMF documents (Letters of Intent, Staff Reports, Article IV consultations, and Stand-By Arrangement reviews) on Turkey since March 2001 showed that, following its economic crises in November 2000 and February 2001, and in need for IMF and World Bank support, Turkey was constantly encouraged to improve its FDI environment as part of the conditionality for IMF financial assistance (Erdilek 2005). FIAS, with the support of the Turkish government and with cooperation of the private sector, prepared two studies:

- Turkey: A Diagnostic Study of the Direct Foreign Investment Environment in Turkey (February 2001), and
- Turkey: Administrative Barriers to Investment (June 2001).

The first FIAS study put the major blame on political and economic stability, in general, and on policy instability in particular, for Turkey's failure to attract FDI far below its potential, emphasizing that "the mindset' of the nation's civil service has generally not been investor-friendly and has been slow to change…" and that "…investors lack a sufficient degree of reliability and predictability in Turkey to justify serious long-term investment decisions." It also faulted the slow and partial judicial system that had allowed the repeated violations of the national treatment principle. It recommended the establishment of an Investment Promotion Agency (IPA) and the development of a long-term FDI promotion strategy, especially for export-oriented FDI. FIAS noted that most successful IPAs benefit from a strong and direct participation of the private sector and that the General Directorate for Foreign Investment might not be able to function effectively as an IPA by itself (Erdilek 2005).

The second FIAS study, building on the first one, documented and analyzed at length Turkey's administrative barriers to FDI according to different international benchmarks. It is, at 250 pages and with 10 appendices, by far the most exhaustive recent study of the Turkish FDI regime and environment, based on extensive field work consisting of surveys and interviews. It is right on target with its hard hitting charge that the Turkish administration has been fixated on control instead of service and enforcement (Erdilek 2005).

This control, combined with lack of accountability and transparency, and exercise of discretion, has resulted in widespread corruption, according to FIAS. The second FIAS study deals with a long list of issues relating to employment of both foreign and domestic labor, company registration and reporting, location and operation of FDI companies. Among the operational issues are taxation, trade and customs regime, ex-post monitoring and site inspections, intellectual and industrial property rights. The analyses of these issues are followed by specific recommendations for reform. Its conclusions emphasize the need to build the political will required for an action plan with broad support and to monitor improvements as that plan is implemented (Erdilek 2005).

The two FIAS studies have provided the basis of the recent changes in Turkey's FDI environment and policies. Following meetings in March 2001 and September 2001 at the Turkish Treasury to discuss the two FIAS studies, a Reform Program to Improve the Investment Environment in Turkey was announced in November 2001. In January 2002, a Coordination Board for the Improvement the Investment Environment (CBIIE), consisting of government and private sector representatives, was formed to implement the Program to Improve the Investment Environment in Turkey. CBIIE formed several technical committees (13)[2] for in-depth study of individual issues that concern the improvement of the investment environment (Erdilek 2005).

It also formed an Investment Advisory Council (IAC), consisting of the chief executive officers or chairpersons of 20 foreign affiliates. IAC scheduled its first meeting for July 2002, which had to be postponed as the coalition government was falling apart. IAC held its inaugural meeting, chaired by the Prime Minister, in March 2004, identifying 13 key areas on which the government was advised to focus its efforts to improve the FDI environment. After its second meeting, chaired by the Prime Minister, in April 2005, IAC commended the government for its progress in improving the FDI environment, drawing attention to 10 important issues that needed to be worked on (Erdilek 2005).

The AK Party's electoral victory in November 2002 signaled a significant improvement in the FDI environment first by bringing political stability and second by providing a clearly pro-FDI official stance lacking in the past. AK Party's program is clearly pro-FDI and the AK Party government recognized the importance of FDI as an essential factor in the Turkey's economic development. The AK Party government has shown through its actions that its pro-FDI stance is not just rhetoric meant to please the IMF and the World Bank. Soon after taking office, the government reorganized the CBIIE and restated its operational principles. The AK Party government has also provided the much needed economic stability with higher rates of real growth and rapidly falling inflation (Loewendahl and Ertugal-Loewendahl 2000; TÜSIAD and YASED 2004; Hadjit and Moxon-Browne 2005)

The enactment of Law No. 4875 in June 2003 to replace Law No. 6224 was a crucial step forward. Law No. 4875 for Direct Foreign Investments defines the following:

- FDI according to current international practice (TUSIAD and YASED 2004) ,
- replaces the old FDI approval and screening system with a notification and registration system (TUSIAD and YASED 2004),
- bans nationalization without fair compensation (TUSIAD and YASED 2004),

[2] Company registration, Employment, Sectoral licensing, Investment Location, Taxes and Incentives, Foreign Trade and Customs, Industrial and Intellectual Property Rights, Foreign Direct Investments Legislation, Investment Promotion, Small and Medium Sized Enterprises, Corporate Governance, Research and Development (World Trade Organization 2012).

- guarantees national treatment to foreign investors (TUSIAD and YASED 2004),
- does not restrict FDI in any sectors (TUSIAD and YASED 2004),
- does not impose any performance requirements (TUSIAD and YASED 2004),
- eliminates the old minimum capital limit for new FDI projects (TUSIAD and YASED 2004),
- grants foreign investors full convertibility in transferring their capital and earnings (TUSIAD and YASED 2004),
- allows foreign investors to own property without any restrictions (TUSIAD and YASED 2004), and
- recognizes foreign investors' right to international arbitration (TUSIAD and YASED 2004).

During the 18-month period between the enactment of Law No. 4875 in June 2003 and the end of 2004, 2,461 new FDI firms came into existence and 634 national firms became FDI firms, with total FDI inflow of $3.8 billion, 80 percent of which originated from the EU. According to the Istanbul Chamber of Industry (ICI), in 2004, among the largest 500 industrial firms, there were 149 FDI firms, which accounted for 43 percent of the total sales, 51 percent of the total value-added, 44 percent of the total profits, 49 percent of the total exports, and 27 percent of the total employment. According to the ICI, in 2004, among the largest 1,000 industrial firms, there were 223 FDI firms, which accounted for 40 percent of the total sales, 49 percent of the total value-added, 44 percent of the total profits, 44 percent of the total exports, and 27 percent of the total employment (TUSIAD and YASED 2004).

Turkey's accession negotiations with the EU, which started in October 2005, has raised Turkey's profile and potential for FDI. According to UNCTAD estimates in the World Investment Report (WIR) 2005, Turkish inward FDI stock, which was $11,194 million in 1990, rose from $19,209 million in 2000 to $35,188 in 2004 (TUSIAD and YASED 2004).

In 2006 a new Law No. 5523 issued for the incorporation of the investment support and promotion agency. The object of this Law is to set out functions, tasks, powers and organization of the Investment Support and Promotion Agency of Turkey (ISPAT), which is incorporated for determination and implementation of investment support and promotion strategies aimed to encourage and increase a number of investments in Turkey that are required for economic development of the country (Undersecretariat of Treasury General Directorate of Foreign Investment 2006). The Investment Support and Promotion Agency of Turkey is incorporated, in association with Prime Ministry, as a legal entity with administrative and financial autonomy to ensure implementation of this Law, and to undertake the functions vested upon it by this Law. Particularly, the objects of the Agency are the following:

- To coordinate and to support investment and promotion activities carried out at international level by the public institutions and corporations, development agencies and private-sector organizations (Undersecretariat of Treasury General Directorate of Foreign Investment 2006);
- to undertake planning and presentation of information and guidance for investors; to provide, in cooperation with development agencies, information and guidance services that may be required by the investors during pre/current/post investment stages (Undersecretariat of Treasury General Directorate of Foreign Investment 2006);
- to follow up transactions executed before the relevant institutions and corporations, and development agencies as a support to applications made to obtain license and approval for investment projects (Undersecretariat of Treasury General Directorate of Foreign Investment 2006);
- to perform and conclude license and approval formalities before the relevant institutions and corporations, and development agencies investments, which are designated according to the criteria set out, differently or similarly, for domestic capital investments and foreign direct investments, such as type, place, capital amount of investment, or offered job-opportunities (Undersecretariat of Treasury General Directorate of Foreign Investment 2006);
- to predict the impediments and problems likely to be encountered by the investors and to make attempts before the relevant authorities for solution of problems (Undersecretariat of Treasury General Directorate of Foreign Investment 2006);
- to develop or to collect from relevant institutions and corporations all kinds of information and data which will contribute to increase investments in Turkey, and to arrange updating and distribution of such information, and to cooperate with national and international organizations on this subject (Undersecretariat of Treasury General Directorate of Foreign Investment 2006);
- to make attempts before the relevant authorities to provide designation of necessary policies which will higher the level of effectiveness of investment support and promotion activities(Undersecretariat of Treasury General Directorate of Foreign Investment 2006);
- to contribute to reform processes aimed to improvement of investment climate, and to launch offers within this scope (Undersecretariat of Treasury General Directorate of Foreign Investment 2006);
- to provide technical and financial support to national and international conventions, seminars and similar other meetings on the subjects relating to its functions, and to ensure continued participation in such organizations (Undersecretariat of Treasury General Directorate of Foreign

Investment 2006);

- to issue and to support issuance of printed matters and electronic publications in Turkish and other foreign languages providing details on the Agency's tasks (Undersecretariat of Treasury General Directorate of Foreign Investment 2006);
- to perform other duties vested upon it by the laws (Undersecretariat of Treasury General Directorate of Foreign Investment 2006).

In a similar way, the Law on the Amendment of the Income Tax Law and some other Laws entered into force on 4 April 2007, in order to lower the tax burden on the employees by the implementation of the minimum living allowance system. By this amendment, Turkey has moved on 5 steps on the ranking among OECD countries in terms of the tax burden on employees. Particularly, by the provisional Article No. 75 attached to Income Tax Law, firms are enabled to benefit from Research and Development incentives which are provided to individuals. Therefore, investments to be made in line with the new regional, sectoral and project based incentive system have been supported via reduced corporate tax rate (Erdilek 2005).

In 2008, the Law No. 5746 on "Enhancing Research and Development Activities", which involves important incentives towards accelerating research and development activities and innovation, was published on the Official Gazette on 12 March 2008 and came into force in April 2008. Moreover, Prime Ministry Circular No. 2008/7 on The Establishment of Coordination Council for Intellectual and Industrial Property Rights was enacted on 21 May 2008. Finally, a new scheme for government incentives for investment projects incorporating sectoral and regional development priorities was introduced with the Decree on Government Incentives for Investments dated 16 July 2009. This scheme has included a mix of tax and non-tax incentives for investments and exports as well as special provisions on free trade zones, technology parks, research and development, and incentives for less developed regions. While some incentives are provided horizontally across the country, others are provided for companies investing in specific regional economic zones (Undersecretariat of Treasury General Directorate of Foreign Investment 2006, 2007, 2008).

Chapter 3: FDI in the Republic of Turkey: Stylized Facts

3.1 Distribution of FDI Inflows to Turkey by Home Country

For the 2002-2010 period the distribution of FDI inflows to Turkey by country of origin shows that foreign investors in Turkey come from 153 different countries. However, there were 11 countries with annual average FDI outflow over USD 100 million to Turkey.[3] The Netherlands took first place, with an aggregate amount of USD 6,242 million of investment in 2002- 2006 (Undersecretariat of Treasury 2007).

In 2007, it was clear that companies with an EU origin also took the lead, totaling USD 10,148. Of these EU-originating companies Germany (3,125 firms), United Kingdom (1,831 firms) and the Netherlands (1,419 firms) had the highest number of foreign-owned companies in Turkey. Of the total number of 3,702 companies established in 2007, 2,118 originated from the EU, 527 from Near and Middle East Countries and 506 were from other countries around the world (Undersecretariat of Treasury 2007).

In 2008, EU companies exceeded non-EU companies by totaling at 11,626. As for, EU origin companies, Germany (3,600 firms), the United Kingdom (2,021 firms) and the Netherlands (1,673 firms) were again the top three countries with the highest number of foreign capital companies in Turkey. Of the total 3,397 companies established in 2008, of which 1,789 of the EU, 567 were from Near and Middle Eastern countries and 548 were from other countries around the world (Undersecretariat of Treasury 2008).

In 2009 the distribution of the total 23,620 foreign capital companies followed the same pattern as in two previous years. EU companies comprised 12,808 which 4,051 were from Germany, 2,172 from the United Kingdom and 1,766 from the Netherlands; these were the top three EU countries with the highest number of foreign capital companies in Turkey. Of the total of 2,935 companies established in 2009, 1,390 were from the EU, 628 were from Near and Middle East countries and 429 from other European countries. Lastly, in 2010 the distribution of the total 25,948 foreign capital companies was as follows: EU countries obviously took the lead once more with 13,582 companies. Of these the top three were Germany with 4, 326 companies, the United Kingdom with 2,238 companies and the Netherlands with 1,872 companies. Of the total 3,344 companies established in Turkey in 2010 1,343 came from the EU, 942 from Near and Middle East countries, and 513 were from other European

[3] According to the equity capital component of FDI inflow.

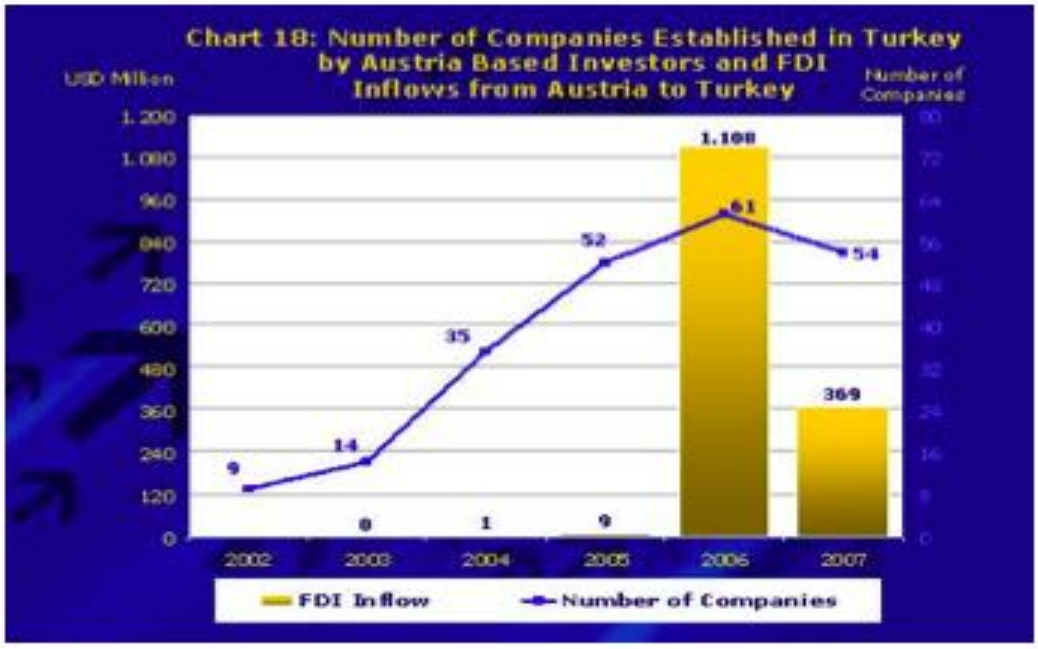
countries (Undersecretariat of Treasury 2009).

As concluded from the above, the main countries investing in the Turkish economy can be distinguished in two groups: On the one hand, there are globally leading investor countries that have large-sums of annual FDI outflow figures, such as France, the UK, Belgium, Italy, Germany, and, the USA. On the other hand, there is a group of countries, consisting of the United Arab Emirates (UAE), Greece, the Russian Federation, and, Austria, which appear in the top investors list in Turkey, as a consequence of large-scale Mergers & Acquisition (M&A) deals. For instance, FDI flows from the UAE exceeding USD 1,5 billion in both 2005 and 2006 were the annual installments for the "Türk Telekom" privatization deal and the considerable amount of FDI inflow from Greece in 2006 was due to the acquisition of Finansbank by the National Bank of Greece (Undersecretariat of Treasury 2010).

The next section is going to present insight about trends of FDI flows through looking at the sectoral and geographical composition of global FDI by major investor country in Turkey.

For 2006 and 2007 **Austrian** investments in Turkey concentrated in the retailing and energy sectors. The acquisition of 34% of Petrol Ofisi by OMV (USD 1,1 billion) in 2006, and the acquisition of 50% of Enerjisa by Verbund (USD 327 million) in 2007 were the biggest Austrian FDI (Undersecretariat of Treasury 2007). (Figure 2)

Fig. 2



Source: Undersecretariat Treasury, 2007

Since 2007 Austria-based FDI has shown increasing annual trends, which amounted to USD

681 million in 2009. This increasing trend reflected an increase of 16% in 2008 (USD 586 million). FDI in the energy sector accounted for 80% and FDI for the manufacturing sector accounted for 15% of the investment stated. The most significant investment for this period was realized by OMV, which acquired 35% of Borasco Elektrik's shares. This transaction accounted for the majority of Austria-based FDI in 2009 (Undersecretariat of Treasury 2008, 2009).

In 2010, Austrian FDI also recorded an upward trend, which amounted to USD 1, 798 million, reflecting an increase of 76% compared to UDS 1,019 million in 2009. A total of 65 companies with Austrian capital began to operate in Turkey either through company establishment, branch office establishments or share transfer methods in 2010 (Undersecretariat of Treasury 2009, 2010).

Generally speaking**, Belgian** investments reached a record level of USD 38,9 billion in 2003 and then declined to USD 33,5 billion in 2004 and to USD 22,9 billion in 2005 (Undersecretariat of Treasury 2007).[4]

Table 1
Distribution of Belgian FDI Outflows by Host Country in 2005 (USD Billion)

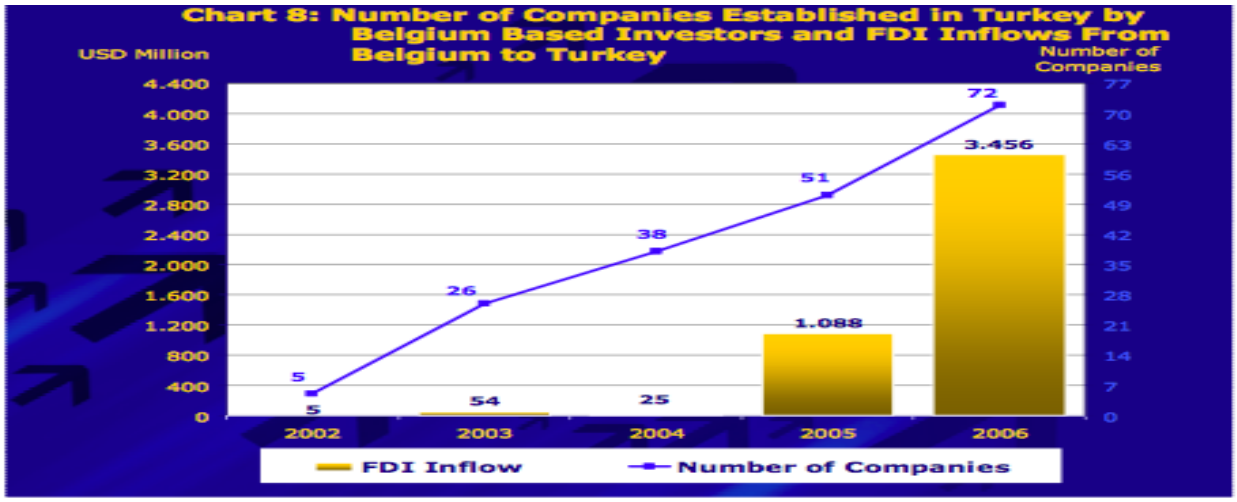
Country	FDI	Percentage Share (%)
Germany	5.2	22.82
France	3.6	15.89
UK	2	8.81
Other	9.9	43.19
Total	22.9	100

Source: Banque de Belgique (www.bnb.be), as cited in Undersecretariat of Treasury 2007.

The Belgian outward investments concentrated in the tertiary (services) sector and, particularly, business activities, finance and transport, storage & communications, while they tended to prefer developed destination countries, such as Germany, Luxemburg, the Netherlands, France and the UK (Table 1).[5] In the first half of 2005, 76% of Belgian FDI outflows were hosted by EU countries, such as Germany, France and the Netherlands (Undersecretariat of Treasury 2008).[6]

[4] Country Fact Sheet: Belgium, World Investment Report 2006, UNCTAD
[5] UNCTAD, WID Country Profile: Belgium National Bank of Belgium, Press Release, Direct Investment in Belgium:Extent and Trend, 11.01.2007.
[6] Banque de Belgique (www.bnb.be), as cited in Undersecretariat of Treasury 2008.

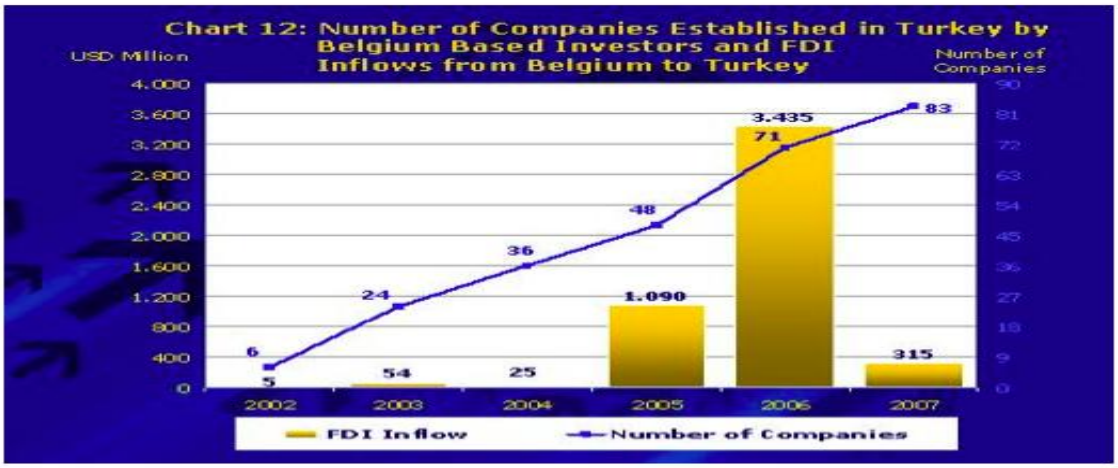
Fig. 3



Source: Undersecretariat of Treasury, Central Bank of the Republic of Turkey

More specifically, considering the case of Turkey, in 2002 the number of companies with Belgian capital established in Turkey increased steadily (Figure 3). At the end of 2006, there were 265 companies with Belgian capital operating in the Turkish economy. Furthermore, Belgian FDI inflows into Turkey exceeded USD 1 billion for 2005 and 2006. Similar to the Greek investments -the large-scale M&A deals between Dişbank and Fortis Bank in 2005 and Denizbank and Dexia Bank in 2006- there were also two major Belgian investments in the Turkish economy (Undersecretariat of Treasury 2007).

Fig. 4



Source: Undersecretariat Treasury, 2007

In 2009, Belgium-based FDI inflows to Turkey amounted to USD 220 million (Figure 4). Of great importance was the Redevco transaction. A real estate company, Redevco, transferred capital to Turkey which accounted for one-third of the total Belgium-based FDI (Undersecretariat of Treasury 2008, 2009).

FDI inflow from **the Czech Republic** to Turkey amounted to USD 386 million in 2009; however, before 2009, there had not been any Czech Republic-based FDI in Turkey. In 2009, a significant investment was the acquisition of 37.4% of Ak Enerji's shares by CEZ (Undersecretariat of Treasury 2009).

French FDI abroad constantly increased between 2002 and 2005, reaching USD 115,7 billion in 2005 from its USD 50,4 billion level in 2002.[7] Outward FDI flows dropped to USD 108 billion in 2006 indicating a downturn.[8] Geographical breakdown of France's direct investments abroad reveals that in 2005 the majority of FDI outflows were directed to European countries and the USA. Among the European countries, Belgium, the Netherlands, Italy and the UK were the most preferred host countries for French investors (Table 2). In 2006, Switzerland also became an important destination for French FDI along with EU member countries and USA (Undersecretariat of Treasury 2007).

Table 2
Distribution of French FDI Outflows by Host Country in 2006 (EUR Billion)

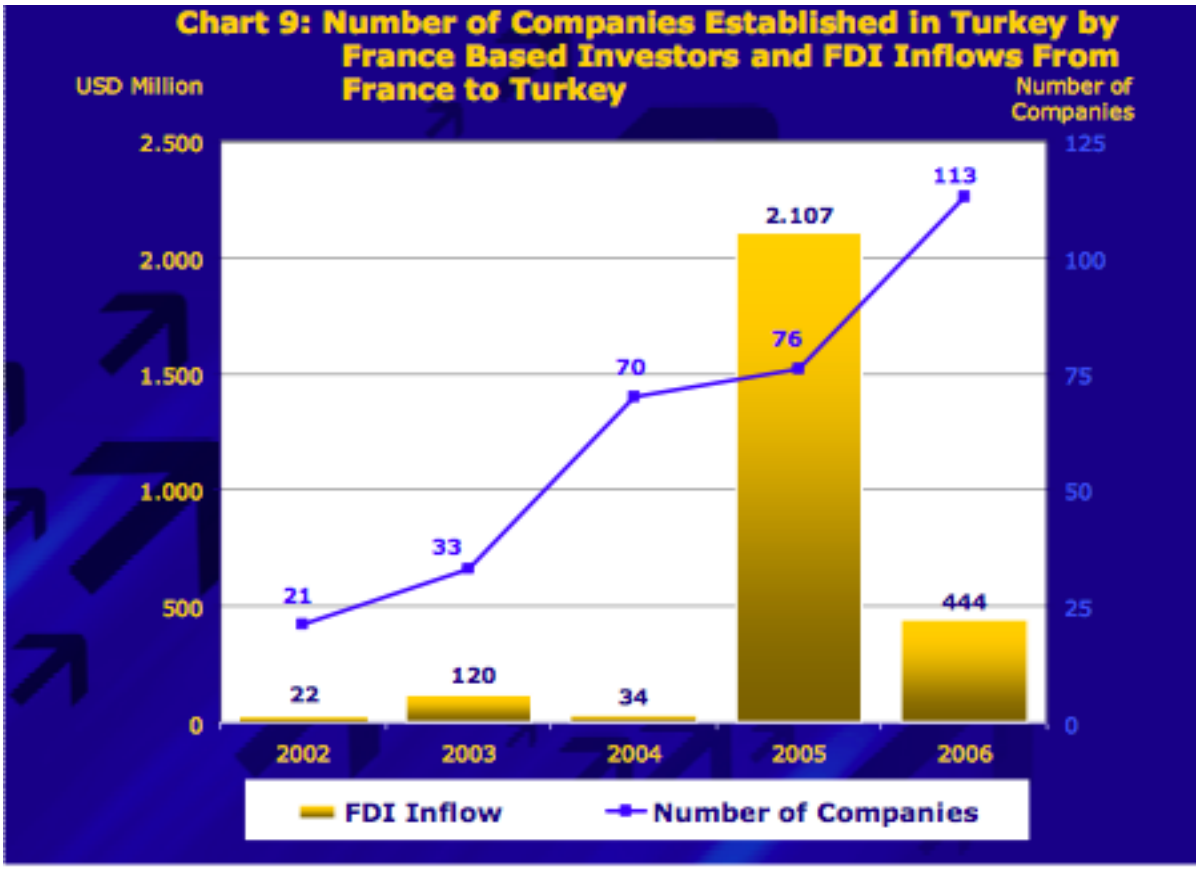
Country	FDI
EU-27	48
USA	15
Switzerland	10.1
Japan	1.3
Brazil	1.1
Other	11.8
Total	86.7

Source: EuroStat News Release, 24.05.2007, as cited in Undersecretariat of Treasury 2007.

7 Country Fact Sheet: France, World Investment Report 2006, UNCTAD.

8 EuroStat News Release, 24.05.2007, as cited in Undersecretariat Undersecretariat of Treasury, General Directorate of Foreign Investment (2006). *Foreign Direct Investment in Turkey 2006.* Republic of Turkey Prime Ministry Undersecretariat of Treasury.

Fig. 5



Source: Undersecretariat of Treasury, Central Bank of the Republic of Turkey

Since 2002 a considerable number of French companies have been established in Turkey. More specifically, in 2005 French investments recorded a substantial increase, due to the transfer of the USD 1,8 billion paid by the USA-based GE Consumer Finance for the shares of Garanti Bank from France rather than the USA. In early 2006, 313 new establishments and participations took place in Turkey to reach 558 new establishments and participations at the end of 2006 (Figure 5). The amount of USD 268 million paid by Groupama for Başak Insurance &Pension privatized in 2006 was the largest French investment in recent years (Undersecretariat of Treasury 2007).

According to the sectoral breakdown of FDI undertaken by French multinationals, investments in the insurance sector in 2008 attracted most attention. Groupama, the French multinational that won the privatization bid for Başak Sigorta & Emeklilik and entered Turkey in 2006, decided to expand its activities in Turkey and bought all the shares of another domestic insurance company, Güven Sigorta, for around USD 300 million in 2008. Zurich Financial Services acquired 100% of the shares of TEB

Sigorta, a domestic insurance company, and transferred approximately USD 300 million through France. In addition, another French insurance giant, AXA, acquired 50% of the shares of Oyak Sigorta, a domestic insurance company, for USD 525 million and transferred the capital through Spain. Therefore, this transaction was recorded as FDI from Spain in the balance of payments statistics (Undersecretariat of Treasury 2008).

In 2009, the French FDI flows into Turkey amounted to USD 593 million. Transportation, storage & communication sector, manufacturing sector, and wholesale & retail trade sector were the top three sectors, in decreasing order. The most important FDI inflow was transferred by Gas De France, which acquired 90% of İzmit Gaz Dağitim's (İZGAZ) shares by winning the privatization bid with an amount of USD 232 million. Another France-based M&A deal came to USD 20 million, namely the sale of 75% of Coster Aerosol Valf Sanayi's shares to Centragroup Fareva S.A.S (Undersecretariat of Treasury 2009).

In 2010 French FDI into Turkey amounted to USD 600 million, maintaining the level of recent years. Manufacturing is the top sector followed by financial intermediation. The most significant French capital inflow to Turkey in 2010 was made by Legrand France, which acquired 100% of the shares of Inform Elektronik. In total, 88 companies and branch offices were established or participated in other companies with French capital in 2010 in Turkey (Undersecretariat of Treasury 2010).

German economy showed low levels of FDI outflows for both 2003 and 2004, as a result of liquidation of German companies abroad and repayments of intra-company loans to company headquarters. However, in 2005 German FDI outward had an upturn reaching USD 46 billion. The upward trend continued for the following year and an outflow of USD 65 billion was achieved. In 2006, German investments had the largest share (25%) in the USA (Table 3) (Undersecretariat of Treasury 2007).

Table 3

Distribution of German FDI Outflows by Host Country (USD Million)

Country	2004	2005	2006
USA	-8.807	-6.956	16.12
Luxemburg	4.005	2.504	6.164
The United Kingdom	-6.234	7.746	5.648
China	1.352	3.710	3.196
The Russian Federation	-800	-254	2.554
Italy	-24.450	4.394	2.492
Hungary	1.370	1.717	2.291
Spain	-1.380	2.381	2.158
Belgium	-2.590	-4.408	2.062
Austria	1.515	5.712	1.028
Other	37.901	29.106	21.550
Total	1.886	45.652	65.27

Source: Undersecretariat Treasury, 2006.

In 2005, the top three sectors, with respect to outward FDI in Germany, were communications & transportation with USD 14 billion, banking & insurance with USD 7,8 billion and the manufacturing sector with USD 3,8 billion (Table 4) (Undersecretariat of Treasury 2007).

Table 4

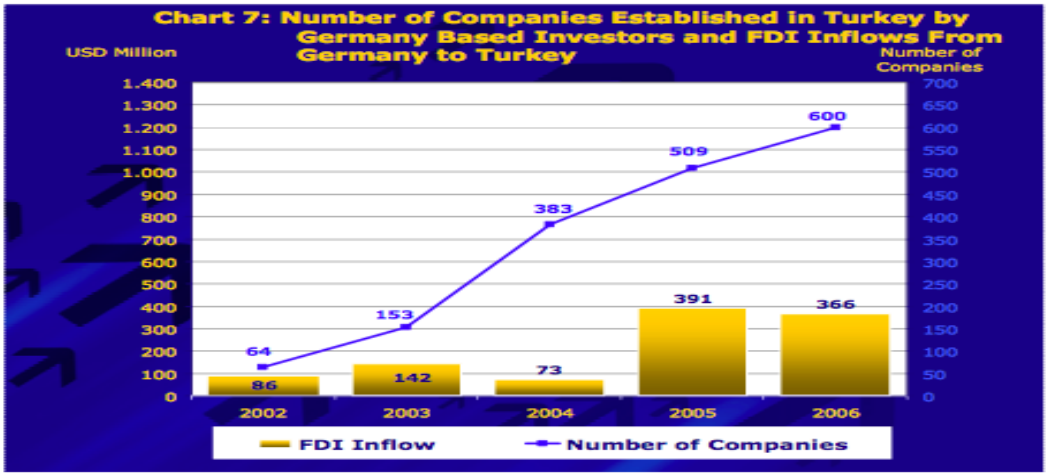
Distribution of German FDI Outflows by Sector (USD Million)

Sectors	2004	2005
Transportation, Communication	1.154	13.912
Banking, Insurance	2.836	7.751
Manufacturing	-1.989	3.746
Leasing, R&D, IT Services	-15.917	3.120
Trade	3	2
Personal Services, Other Services	-667	510
Energy, Water	789	423
Mining	-179	10
Construction	128	-5
Tourism	21	-6
Other	12.196	14.102
Total	1.886	45.652

Source: Undersecretariat Treasury, 2006.

Considering the case of Turkey, the annual number of company establishments and participations with German capital increased from 64 in 2002 to 600 in 2006 (Figure 6). In terms of FDI flows, Turkey accepted USD 280 million from Germany in the 2002-2006 period (Undersecretariat of Treasury 2007).

Fig. 6



Source: Undersecretariat of Treasury, Central Bank of the Republic of Turkey

German investors have been interested in different sectors, such as manufacturing, finance, and energy in recent years. Acquisition of 72.6% of Demirdöküm by Vaillant for USD 324 million, acquisition of the shares of Karbogaz in 2006, acquisition of Birleşik Oksijen Sanayii in 2007 by Linde Gas (USD 177 million in total), and the acquisition of the institutional cross-border custody business of Garanti Bank by Deutsche Bank were the most outstanding German investments of the last years (Undersecretariat of Treasury 2008).

Moreover, in 2008, German MNE Allianz SE acquired Koç Holding's shares in their two joint ventures, Koç Allianz Sigorta A.Ş. and Koç Allianz Hayat ve Emeklilik A.Ş. This deal cost Allianz SE approximately USD 600 million and constituted the largest German FDI. Another substantial direct investment in the insurance sector was the acquisition of 25% of the shares of İsviçre Sigorta by Germany-based Ergo International AG. Following the completion of this deal, İsviçre Sigorta became a wholly-owned subsidiary of Ergo. Lastly, EWE, an energy company seated in Germany, bought an additional 40% of Bursagaz and Kayserigaz in 2008 and transferred approximately USD 400 million through the United States. The remaining part of the deal, around USD 100 million, was transferred through Germany (Undersecretariat of Treasury 2008, 2009).

In 2009, Germany-based FDI inflows amounted to USD 388 million. Of these, 40% were derived from the wholesale and retail trade sector, 20% from the energy sector, and, 10% from the manufacturing sector. More specifically, 50% of Borusan Enerji's shares were acquired by ENBW

Holding for USD 75 million following a partnership decision between Borusan Holding and the German company ENBW AG. This transaction was the top Germany-based investment in the energy sector in 2009. At the beginning of 2009, Germany-based company RWE acquired 70% of total shares of E.ON & Turcas Güney Elektrik A.Ş. and transferred about USD 17 million. Lastly, capital transfers by Media Saturn and Metro AG, which operate in the wholesale and retail trade sector, accounted for about 20% of total Germany-based FDI in 2009 (Undersecretariat of Treasury 2009).

In 2010, German FDI to Turkey increased by 20%, as compared to 2009 and amounted to USD 598 million. Financial intermediation was the top and energy was the second most favored sector among German investors in Turkey. Ströer Group increased its stakes in Ströer Kentvizyon by acquiring 40% of Ströer Kentvizyon's shares for an amount of about USD 70 million and this deal can be considered the most significant Germany-based merger and acquisition deal in 2010. Capital transfer from Germany to Turkey due to the acquisition of Park Diş Tiracet Solutions (USA) and Tremco Illbruck (Germany) can be regarded as another significant deal for that year. Germany was the third largest investor country in the world in 2010. A total of 471 companies with German capital began to operate in Turkey through company establishment, branch office establishment, and share transfer methods. Germany ranked first according to the number of foreign companies with 4,326 companies (Undersecretariat of Treasury 2010).

FDI from **Greece** to Turkey was significant in 2006 and 2007, due to two large M&A deals realized in the banking sector. USD 2.8 billion was transferred from Greece for the acquisition of 46% of Finansbank by the National Bank of Greece in 2006 and USD 2.3 billion was transferred for the additional shares called in the stock exchange following the initial acquisition in 2007. Another important Greek investment in the banking sector in 2007 was the USD 180 million paid by EFG Eurobank for 70% of Tekfenbank (Undersecretariat of Treasury 2006, 2007).

In 2008, FDI inflows from Greece to Turkey totaled USD 779 million and 89% of this amount was transferred to Turkey by means of the acquisition of the additional 9.2% shares of Finansbank by the National Bank of Greece. This transaction made Finansbank a wholly-owned subsidiary of the National Bank of Greece (Undersecretariat of Treasury 2008).

In 2009, FDI from Greece to Turkey decreased to USD 59 million. However, in 2010 there was another increase, which amounted to USD 425 million. Almost all Greece-based FDI in 2010 was in the financial intermediate sector (Undersecretariat of Treasury 2009).

The outward FDI from **Italy** was recorded as EUR 15.5 billion in 2004, EUR 33.6 billion in

2005 and EUR 32.4 billion in 2006.[9] The reason for the 116% growth in the outward FDI figure in 2005 was cross-border M&A transactions undertaken by Italian banks. No significant increase in Italian investments has been observed in sectors other than finance. A decrease has occurred in the energy sector investments. On the other hand, investments in the manufacturing sector have been steady at the level of EUR 6.1 billion (Undersecretariat of Treasury 2006, 2007).[10]

Table 5
Sectoral Distribution of Italian FDI Outflows by Sector (EUR Million)

Sectors	FDI
Agriculture	57
Energy	2.154
Manufacturing	6.142
Construction	128
Commercial Services	5.968
Other	25
Total	14.474*

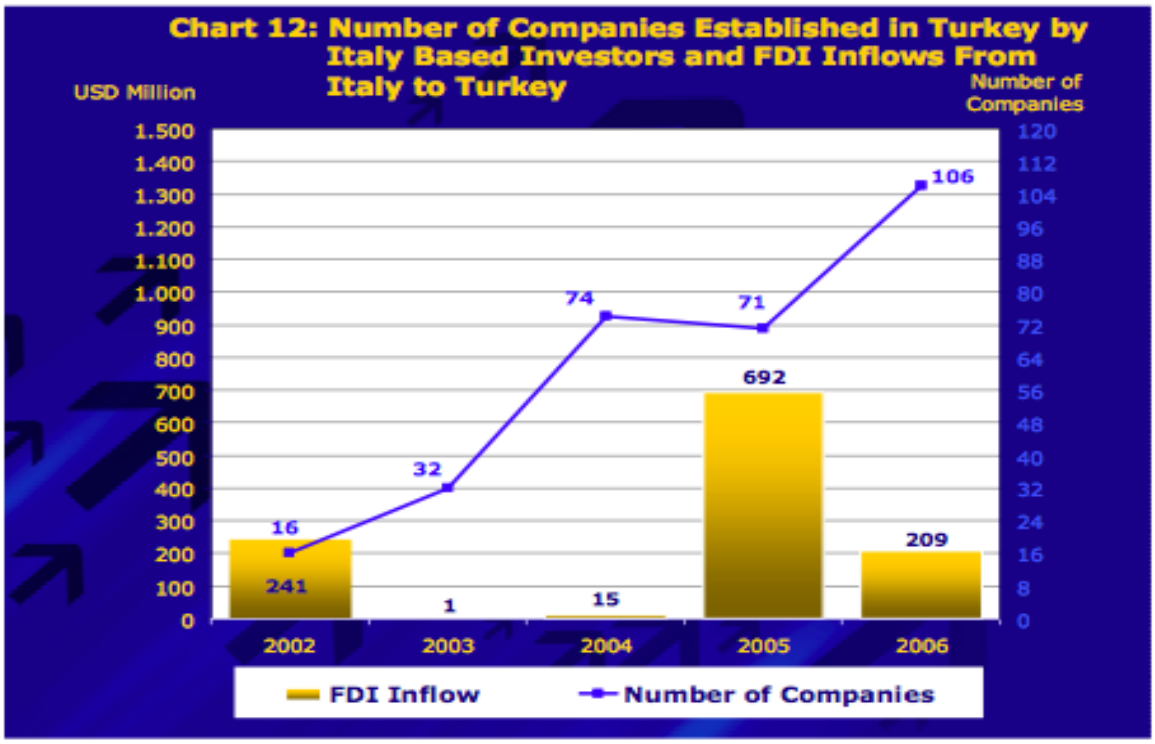
Source: ICE-Instituto Nazionale per il Commercio Estero (www.ice.gov.it), as cited in Undersecretariat of Treasury 2006, 2007. *Total FDI figure does not include investments in real estate and banking sectors.

At the end of 2005, there were 16.832 international companies with Italian shareholders operating in the world economy (Table 5). Geographical breakdown of these companies demonstrates that France, the USA, Germany, the UK and Spain are the top 5 host countries (Undersecretariat of Treasury 2006).[11]

Concerning the case of Italy, in 2006, 106 Italian companies were established in Turkey. The cumulative number of Italian companies reached 513 by the end of 2006. Italian FDI in Turkey was approximately USD 209 million in 2006 (Figure 7) (Undersecretariat of Treasury 2007).

[9] ICE - Istituto nazionale per il Commercio Estero, as cited in Undersecretariat of Treasury 2006.
[10] Banca D'Italia (www.bancaditalia.it), as cited in Undersecretariat of Treasury 2006, 2007.
[11] Business Monitor MA4 / Foreign Direct Investment 2005, February 2007, National Statistics, as cited in Undersecretariat of Treasury 2006, 2007.

Fig. 7



Source: Undersecretariat of Treasury, Central Bank of the Republic of Turkey

More specifically, in 2006, 2,699 new foreign-owned companies and branches were established while 651 foreign capital participations in domestic companies were realized. Out of a total of 14,955 foreign-owned companies in Turkey, 82.2% are new companies and branch establishments and 17.8% foreign capital participations in domestic companies (Undersecretariat of Treasury 2006, 2007).

In 2009, Italy-based FDI inflow to Turkey amounted to USD 289 million (2008 – USD 249 million). About 80% of investments in 2009 were made in the manufacturing industry sector. Considering the M&A deals, the top Italy-based investment was the sale of 99% of Alfacem's shares owned by Çimentaş to an Italian company named Cementir. Çimentaş Group sold 37.2% of its indirect shares through Alfacem in Elaziğ Altinova Çimento Fabrikasi and 39.8% of its direct shares in Kars Çimento Fabrikasi for the amount of EUR 85 million (USD 118.4 million) to the Italian company (Undersecretariat of Treasury 2010).

Despite its limited amount of FDI in recent years, **Japan** was one of the top 10 investors in 2010 in Turkey with USD 347 million. Almost all FDI from Japan was transferred to financial intermediates. Sompo Japan Insurance (NKSJ), which is one of the largest insurance companies in Japan, acquired

93% of Fiba Sigorta. For this deal, USD 338 million was transferred from Japan to Turkey (Undersecretariat of Treasury 2010).

In 2008, **Luxemburg**-based MNEs got more interested in real estate projects in Turkey. However, Moonlight Capital S.A.- a Luxemburg-based company controlled by a British venture capital company (BC Partners)- acquired 50.8% of a large retailer, Migros, and paid USD 1.9 billion for the deal (Undersecretariat of Treasury 2008).

In 2009, FDI inflows from Luxemburg amounted to USD 579 million. The top three sectors which attracted this amount were the wholesale & retail trade sector, health services, and the manufacturing sector, in decreasing order. In the health service sector, acquisition of 40% of Medical Park Sağlik Hizmetleri A.Ş's shares by the USA- based "The Caryle Group" for USD 100 million was one of the most important M&A deals in 2009 (Undersecretariat of Treasury 2008, 2009).[12]

In 2010, FDI flows from Luxemburg decreased to USD 280 million. Construction, manufacturing, wholesale & retail trade were the three most attractive sectors for Luxemburg investments in Turkey (Undersecretariat of Treasury 2010).

Dutch direct investments abroad were EUR 52 billion, on average, between 2000 and 2006. It is observed that outward FDI from the Netherlands has been fluctuating over the years. Consequently, net Dutch outward direct investments which were at a level of EUR 115 billion in 2005, decreased to EUR 18 billion in 2006 (Undersecretariat of Treasury 2006, 2007).[13]

European countries are the most preferred investment destinations for Dutch companies, although their share decreased from 88% in 2005 to 57% in 2006. Italy was the leading destination with an investment of EUR 9 billion among target countries of Dutch investors. In the same year, Switzerland, Russia, Belgium, France, and Asia were also among the most favorite destinations for Dutch investors (Table 6) (Undersecretariat of Treasury 2006, 2007).

[12] Since the amount stated was transferred to Turkey from Luxemburg, Luxemburg seems to be the source country for this deal.

[13] De Nederlandsche Bank (www.dnb.nl)

Table 6

Distribution of Dutch FDI Outflows by Host Country (USD Million)

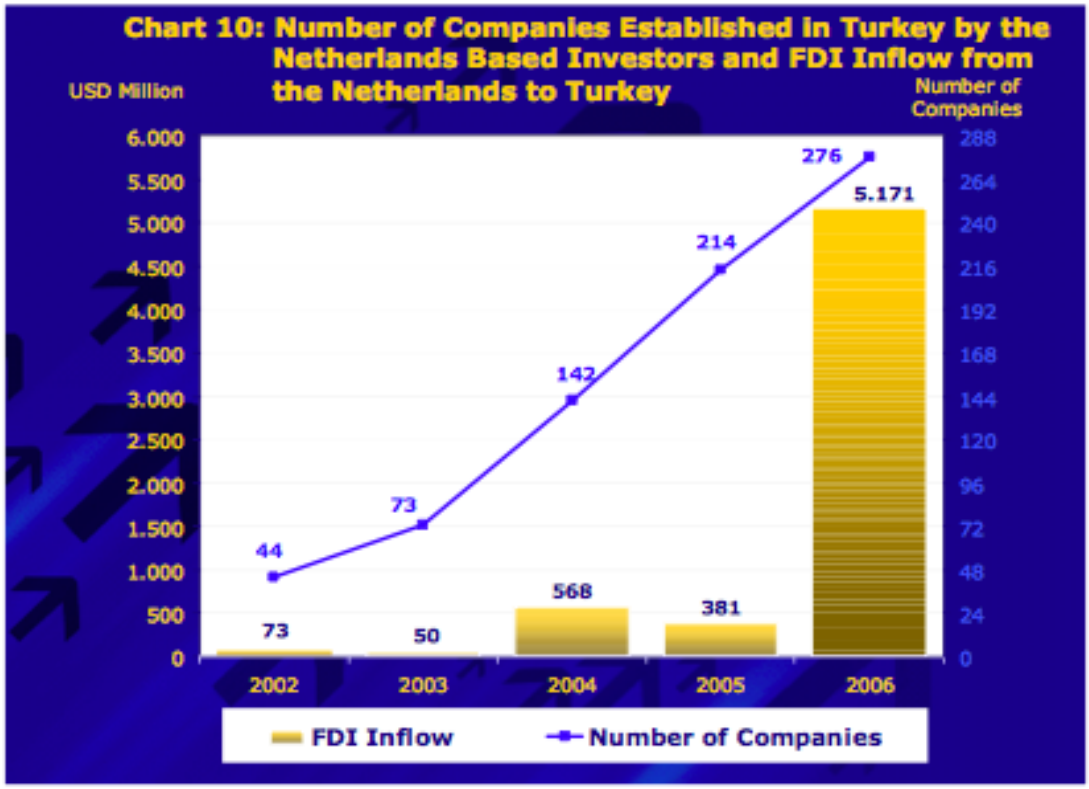
Country	FDI
Italy	9.311
Switzerland	5.203
The Russian Federation	3.516
Belgium	3.273
France	3.105

Source: De Nederlandsche Bank (www.dnb.nl), as cited in Undersecretariat of Treasury 2006, 2007.

Dutch outward investments have been mainly focused on mining, petrochemicals, trade and finance sectors. By the end of 2005, 41% of the outward FDI stock was in the manufacturing sector, 8% in trade, 8% in finance, and 4% in the transportation and telecommunications sector. The breakdown of the outward FDI stock in the manufacturing sector illustrates that, mining & quarrying and manufacture of chemical products were the leading sub-sectors in 2005 and 2004 (Undersecretariat of Treasury 2006, 2007).

Specifically, Dutch outward investments into Turkey in 2006 were 276 companies. With these establishments, the cumulative number of Dutch companies in Turkey had reached 1,189 by the end of 2006. The amount of FDI in Turkey for these establishments and participations equals to USD 5.2 billion in 2006. Approximately USD 4,7 billion of this investment was due to the transfer of capital through the Netherlands for the acquisition of Telsim by British Vodafone (Figure 8) (Undersecretariat of Treasury 2007, 2008).

Fig. 8



Source: Undersecretariat of Treasury, Central Bank of the Republic of Turkey

In 2007, Dutch investments into Turkey were concentrated in the finance sector. The most important acquisitions were those of the complete shares of Oyakbank by ING Bank for USD 2.7 billion, 80% share of Garanti Insurance and 15% share of Garanti Pension by Eureko for a total of USD 623 million and 58.2% of Ray Insurance for USD 85 million. The amount of USD 450 million paid by UK-based Cadbury Schweppes, in exchange for 100% of Intergum, was transferred to Turkey from the Netherlands, and, subsequently, it was reflected in the balance of payments as an investment flow from the Netherlands (Undersecretariat of Treasury 2007, 2008).

In 2008, Dutch FDI inflows to Turkey amounted to USD 1.8 billion. Real estate companies of Dutch origin, such as Multi Turkmall and Redevco, transferred approximately USD 600 million in order to finance their investment projects in the construction sector. The remaining part of the FDI inflows from the Netherlands includes the capital increase of Oyak Bank, which was financed by its Dutch stakeholder, ING (Undersecretariat of Treasury 2008, 2009).

Moreover, the acquisitions of the complete shares of Oyak Emeklilik by ING for USD 139

million, and 51.2% share of Pilsa Plastik by Wawin B.V. for an amount of USD 82 million were the most important M&A deals involving investors of Dutch origin in 2008. Another insurance company, AEGON, seated in the Netherlands acquired 100% shares of Ankara Emeklilik. The transfer, however, was made through the British AEGON, and, therefore, this transaction was recorded as a British one. Lastly, the amount of USD 133 million paid by Greece-based Titan Cement in exchange for 50% of Adocim was transferred to Turkey from the Netherlands and it was presented as an investment flow from the Netherlands in the balance of payments in 2008 (Undersecretariat of Treasury 2008).

In 2009, Dutch FDI inflows to Turkey were negatively affected by the global crisis and amounted to USD 874 million (USD 1.3 billion in 2008), while the amount had been USD 5 billion in 2006 and 2007. Wholesale and retail trade, real estate, construction and manufacturing industry sectors were the top sectors in decreasing order. The most significant FDI inflows were transferred by Multi Turkmall, which is a real estate company of Dutch origin. Moreover, Zentiva N.V. acquired 25% of Eczacibaşi-Zentiva Sağlik Ürünleri and Eczacibaşi-Zentiva Kimyasal Ürünler's total shares for an amount of USD 242.7 million (Undersecretariat of Treasury 2008, 2009).

Furthermore in 2009, Mondi Group acquired a significant part of Tire Kutsan's shares, which is a company manufacturing paper and paper products and TBIH -a Dutch company - bought 10% of Ray Sigorta through Doğan Holding for an amount of USD 20 million (Undersecretariat of Treasury 2009).

However, Dutch FDI investments did not sustain these high volumes in the following years. In 2010 FDI decreased: it amounted to USD 718 million in 2009 and USD 498 millions in 2010. Construction, manufacturing, and financial intermediation were among the leading sectors (Undersecretariat of Treasury 2010).

The most important **Russian** investment for the period 2002-2010 was the USD 1.6 billion paid by Alfa Group for the shares of Turkcell. Moreover, the capital transferred to Turkey due to acquisition of the shares of Atakaş Metallurgy by one of the biggest iron&steel producers of Russia, MMK (Magnitogorsk Iron&Steel Works), was among the biggest inflows in the iron&steel industry (Undersecretariat of Treasury 2010).

FDI inflows from **Saudi Arabia** demonstrated a sudden jump to USD 1.2 billion in 2008 by means of the acquisition of 60% of the shares of Türkiye Finans Katilim Bankasi by The National Commercial Bank (Undersecretariat of Treasury 2009).

In 2008, FDI inflows from **Spain** to Turkey exceeded USD 800 million. However, this relative increase was mostly due to M&A deals of the MNE headquartered in other countries. For instance, French AXA transferred through Spain approximately USD 525 million in order to buy 50% of the shares of Oyak Sigorta, and, Italian MNE Recordati transferred through Spain approximately USD 100

million for the acquisition all the shares of Yeni İlaç through Spain (Undersecretariat of Treasury 2007, 2008).

In 2009, FDI flows from Spain to Turkey were USD 145 million, and in 2010 they amounted to USD 190 million. More than half of these FDI took place in the real estate and construction sectors (Undersecretariat of Treasury 2009).

British outward direct investments reached a record level of GBP 154 billion in 2000. However, since 2004 FDI outflows began to show a declining trend, which continued in 2006 as well. Net outward FDI from the UK, which was GBP 50 billion in 2004, went down to GBP 46 billion in 2005 and GBP 43 billion in 2006 (Undersecretariat of Treasury 2007).[14]

The geographical distribution proves that British investment in America, Asia, and Australia has been shrinking, while it has been expanding in Europe and Africa. France and Luxemburg were the leading European countries where British investments were mainly concentrated. As for Asia, South Korea, Hong Kong, and China were the most preferred investment destinations (Table 7) (Undersecretariat of Treasury 2007).

Table 7
Distribution of UK FDI Outflows by Host Country in 2005 (USD Million)

Country Groups	FDI	Percentage (%)
Europe	13.3	29
USA	22.5	49
Asia	4.1	9
Africa	6	13
Total	46	100

Source: National Statistics (www.statistics.gov.uk).

In 2005, the top five host countries for British outward FDI were the USA, South Africa, France, Luxemburg and Canada (Undersecretariat of Treasury 2007).

Based on the sectoral breakdown of British outward FDI in 2005, approximately 68% of British outward FDI went to the service sector and 32% to the manufacturing sector. Finance has the largest share in the service sector. The leading sub-sectors in manufacturing were chemicals, plastics and

[14] Business Monitor MA4 / Foreign Direct Investment 2005, February 2007, National Statistics.

petroleum products (Table 8) (Undersecretariat of Treasury 2007).

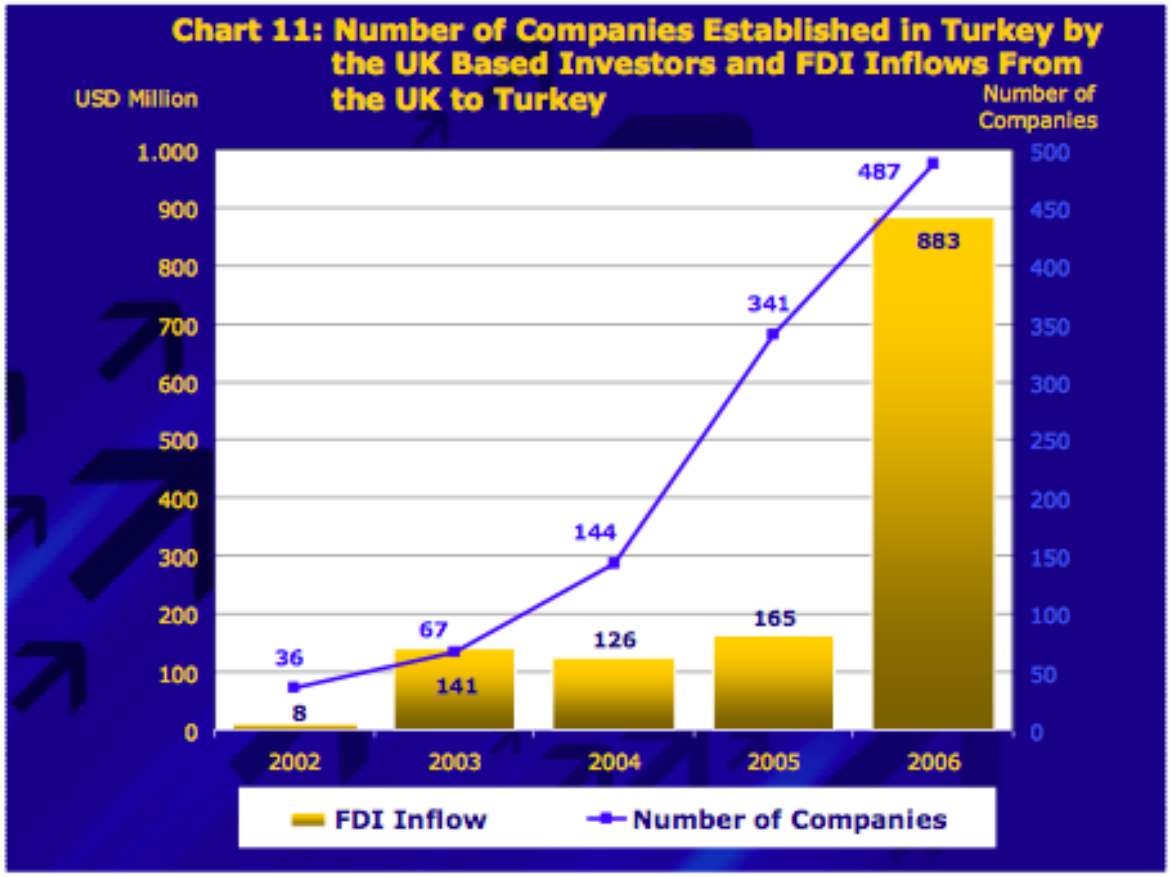
Table 8
Sectoral Distribution of the UK's Outflows FDI in 2005 (USD Million)

Sectors	FDI	Percentage (%)
Financial Intermediation	14	31
Trade	11	23
Chemistry, plastics and Petroleum Products	6	13
Metal and Mechanical Products	5.1	11
Electricity, Gas, Water	4.6	10
Other	5.5	12
Total	46	100

Source: Undersecretariat Treasury, 2006

In 2007, the biggest UK investment took place in the food sector and amounted to USD 450 million paid by Cadbury Schweppes for Intergum. The merger of Aviva and Ak Insurance was also an outstanding development in the insurance sector in 2007 (Undersecretariat of Treasury 2007).

Fig.9



Source: Undersecretariat of Treasury, Central Bank of the Republic of Turkey

In 2008, the United Kingdom took first place in Turkey as a home country with an amount of USD 2.3 billion. This is mostly due to the acquisition of an additional 11.3% shares of Ereğli Demir Çelik (Erdemir) by Arcelor-Mittal in Istanbul Stock Exchange for around USD 1 billion. Moreover, British American Tobacco (BAT) won the privatization bid for the cigarette factories of TEKEL (Turkish State Tobacco Company) for USD 1.8 billion BAT transferred around one-third (USD 611 million) of this amount from the United Kingdom as direct investment. Furthermore, BAT transferred more money to finance the capital expansion. Thus, BAT's direct investment in Turkey reached approximately USD 700 million in 2008 (Figure 9) (Undersecretariat of Treasury 2008).

Similarly, Intergum, a subsidiary of the British multinational Cadbury, increased its paid-up capital and Cadbury transferred USD 241.4 million to participate in the capital expansion. A domestic construction company, Taşyapi İnşaat, and the UK-based Cogentrix established a joint venture, Eti Elektrik A.Ş., for an investment project in constructing power plants in Turkey. As a result of this initiative, Cogentrix transferred USD 140.9 million to Turkey (Undersecretariat of Treasury 2008).

UK-based FDI in Turkey terminated its increasing trend (which started in 2004) falling to USD 333 million in 2009. Transportation, storage and the communications sector became the top sectors attracting one-third of the total UK-based FDI inflow, followed by the wholesale, retail trade and manufacturing sectors. A significant capital inflow of USD 46 million was transferred by HSBC Principal Investments, which acquired 28.3% of Havaş's shares for an amount of USD 76.1 million (Undersecretariat of Treasury 2008).

The downward trend did not change during 2010, since UK originating FDI inflow to Turkey fell to 31% decreasing the total amount to USD 240 million. An amount of USD 50 million was transferred by the UK-based Argus Capital via Luxemburg due to the sale of 40% of the shares of Memorial Health group to Argus Capital and Qatar First Investment Bank for an amount of USD 100 million. Another significant UK-based transfer, due to an M&A deal, was made by a private equity fund called Bancroft, which acquired Kayalar Kimya (Undersecretariat of Treasury 2010).

Annual overseas direct investments by **US** companies was around USD 130 billion, on average, between 2001 and 2003, whereas, in 2004 FDI outflow from the USA jumped to USD 222 billion. Considering American outward FDI flows, 2005 was characterized as a unique year, since the effects of "American Jobs Creation Act of 2004" on MNEs' attitude towards revenue transfer was truly noticeable. The Act encouraged the payment of dividends by foreign affiliates to their U.S. parent companies by offering tax relief for one year (2005)[15]. According to JPMorgan Chase, USA-based companies transferred a total of USD 300 billion revenue to their headquarters.[16] In 2006, FDI outflow from the USA got back on track by reaching USD 169 billion as of the third quarter of the year (Undersecretariat of Treasury 2007).[17]

The sectoral breakdown of the USA's overseas direct investments reveals that the business activities sector which involves legal, financial and technical consultancy services, has the largest share in outward investment followed by the manufacturing sector (chemical industry) (Table 9) (Undersecretariat of Treasury 2007).

[15] Bureau of Economic Analysis (www.bea.gov)

[16] Bringing it home: A study of the incentives surrounding the repatriation of foreign earnings under the American Jobs Creation Act of 2004, Jennifer Blouin, The Wharton School, as cited in Undersecretariat of Treasury 2006.

[17] Bureau of Economic Analysis (www.bea.gov).

Table 9

Sectoral Distribution of the UK's Outflows FDI in 2005 (USD Million)

Sectors	2001-2003 Average	2004	2005	2006
Mining	8.751	14.059	11.378	16.071
Manufacturing	19.785	53.680	38.765	39.058
Chemistry	8.427	11.336	9.078	12.023
Computer and Electronics	1.577	6.108	6.094	5.869
Machinery	892.000	3.426	3.831	3.167
Food	2.806	1.391	2.921	2.822
Metal	448.000	2.298	-393	2.096
Electrical Tools and Components	1.083	941	730	509
Other Manufacturing	11.385	25.869	17.171	10.273
Transportation	3.168	2.313	-667	2.298
Trade	10.333	10.603	17.194	19.180
Communication	-40	-3.526	6.932	5.034
Business Activities	16.812	101.353	-118.634	50.501
Finance and Insurance	20.194	24.086	20.242	23.618
Banks	3.216	-304	-3.941	-353
Professional, Scientific, and Technical Services	1.938	8.389	4.281	4.520
Other	38.736	14.097	11.069	11.038
Total	129.724	222.437	-12.714	168.667

Source: Undersecretariat Treasury, 2006

European countries hosted 50% of the total USD 169 billion of FDI outflow from the USA as of the third quarter of 2006 (Table 10).

Table 10

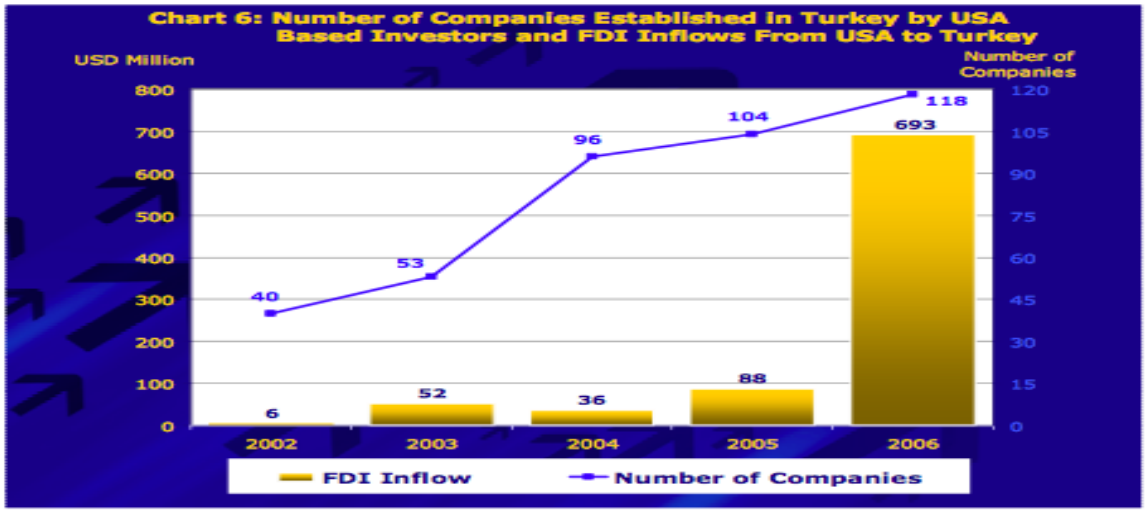
Distribution of USA FDI Outflow by Country and Region (USD Million)

Country/Region	2001-2003 Average	2004	2005	2006
Canada	16.395	23.255	16.789	16.321
Europe	77.527	99.284	-37.488	84.851
Asia - Pacific Region	17.599	78.409	12.999	36.917
Latin America	14.928	18.812	-10.545	25.017
Other	3.275	2.677	5.531	5.561
Total Countries	129.724	222.437	-12.714	168.667

Source: Undersecretariat Treasury, 2006

For the 2002-2006 period, the number of US companies in Turkey increased from 40 to 118, while FDI increased from USD 2 million to USD 693 million. The largest capital transfer from the USA recorded in 2006 concerned the amount paid by Texas Pacific Group for Mey İçki (USD 350 million). As of 2006 year end, 733 US companies represented 4.8% of all foreign-owned companies operating in Turkey (Undersecretariat of Treasury 2007) (Figure 10).[18]

Fig. 10



Source: Undersecretariat of Treasury, Central Bank of the Republic of Turkey

[18] Funds related to direct investments made by US-based companies are generally transferred to Turkey through the Netherlands. Thus, as the origin of transferred funds, the Netherlands is recorded instead of the USA. Therefore, USA's direct investments in Turkey may be officially under-represented (Undersecretariat of Treasury 2007).

In 2007, USA-based investments were diversified in different sectors. The most outstanding USA FDI inflow was that of Citibank, in which USD 3.1 billion was transferred to acquire of the 20% shares of Akbank. Another important USA-based investment in the finance sector was the acquisition of 63.9% of Şeker Insurance by Liberty Mutual. Moreover, of great importance was the acquisition of 97.6% of UN Ro-Ro for approximately USD 1.3 billion by USA- based private equity fund KKR; this has been one of the biggest transactions realized by private equity funds in Turkey. Due to this transaction, an FDI inflow of about USD 527 million was recorded. Lastly, the acquisition of 50% of Beymen and 30% of Boyner by Citigroup, and 51% of İçtaş Energy by AES increased by far the amount that Turkey received from USA-based MNEs when compared to other European and non-European countries (Undersecretariat of Treasury 2008).

In 2008, US-based FDI inflows to Turkey amounted to around USD 900 million. The major part of this amount stemmed from the new M&A deal made between Germany-based EWE and two local natural gas transport companies Bursagaz and Kayserigaz. EWE bought an additional 40% of the shares these companies for a total amount of approximately USD 400 million and completed the transaction by transferring the money through the United States (Undersecretariat of Treasury 2008).

In 2009, US outward investments to Turkey amounted to USD 236 million. The manufacturing industry sector, wholesale & retail trade sector, and real estate sector, in decreasing order ranked top. Important capital transfers were made by USA-based company Bedminster Capital, active in the food & beverage sector. Bedminster Capital acquired of the shares 44.75% share of Ana Gida for USD 32 million (Undersecretariat of Treasury 2009).

In 2010, FDI from the USA to Turkey increased and amounted to USD 320 million (2009; USD 260 million). The energy sector ranked first, followed by transportation, storage & communications sector and manufacturing. In 2010, the most significant acquisition was that of 46% of Airties Kablosuz İletişim's stakes for USD 18 million (Undersecretariat of Treasury 2010).

3. 2 Distribution of FDI Inflows to Turkey by Mode of Entry

Until the early 2000s, in many analyses on FDI to Turkey, the main emphasis was on the annual amount of inflows. As the level of inflows increases with higher amounts of FDI after 2004, the choice of entry mode foreign investors and Greenfield investments used come to the forefront as a new variable for such analyses. The Legislation on Foreign Direct Investments in Turkey provides a basic classification system that identifies minimum requirements equity modes of entry by international

investors. This classification includes new company and branch office establishments and participations in existing businesses. However, the FDI Data System, which records related data in line with the legislation, does not involve a classification criterion to distinguish Greenfield investments from the other types. So, taking into account common aspects of various definitions of Greenfield investments, an experimental approach can be developed by accepting new company and subsidiary establishments as a very crude proxy of Greenfield in all sectors, including services (Undersecretariat Treasury, 2007).

Using such an approach, 1,801 entries with adequate attributes to determine corporate investor behavior were extracted from a total of 9,713 entries in the period 2002-2006 by excluding small investors. This selected group (Figure 10) was used to determine behavior patterns of investors in Turkey in relation to their preferred market entry modes (Undersecretariat of Treasury 2007).

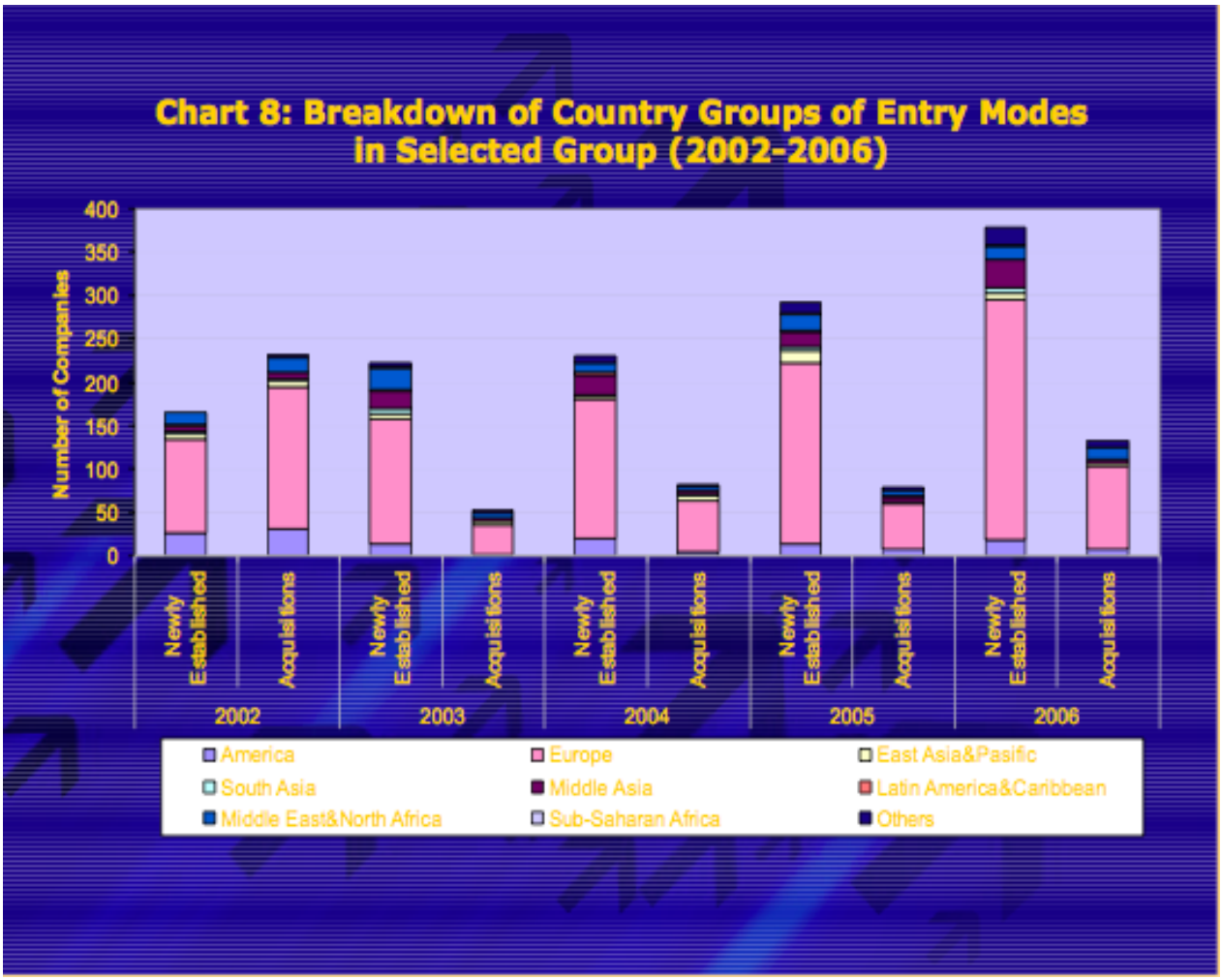
Fig.11

Source: Undersecretariat Treasury, 2007.

In this selected group (Figure 11), the share of the establishment of new companies and subsidiaries, counted as a rough proxy of Greenfield investments, ranged between 74% and 84% in the

time period analyzed (Undersecretariat of Treasury 2007).

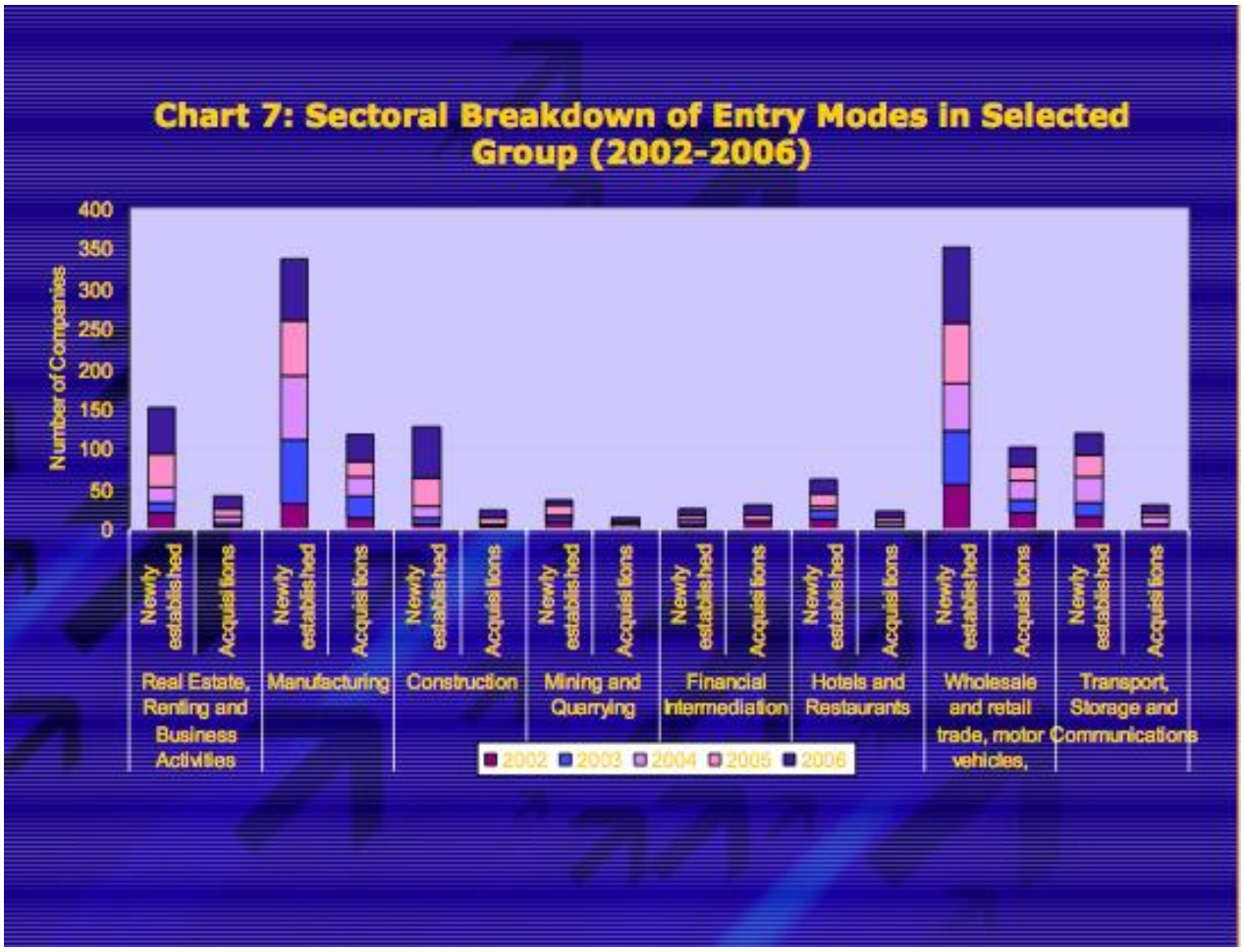
Fig. 12



Source: Undersecretariat Treasury, Central Bank of the Republic of Turkey.

According to the breakdown of country groups (Figure 12), European investors had the most significant share in new company establishments, ranging between 65% and 72% in the 2002-2006 period. It is quite clear that European investors favored establishing new companies by transferring their own assets in order to take advantage of Turkey's geographical proximity to their main headquarters and the fast-growing open markets. In addition, investors that had strong brand power, management experience, know-how and an organizational culture as their critical comparative advantages -especially family- owned and R&D-based companies- seemed to prefer establishing new companies rather than acquisition (Undersecretariat of Treasury 2007).

Fig.13

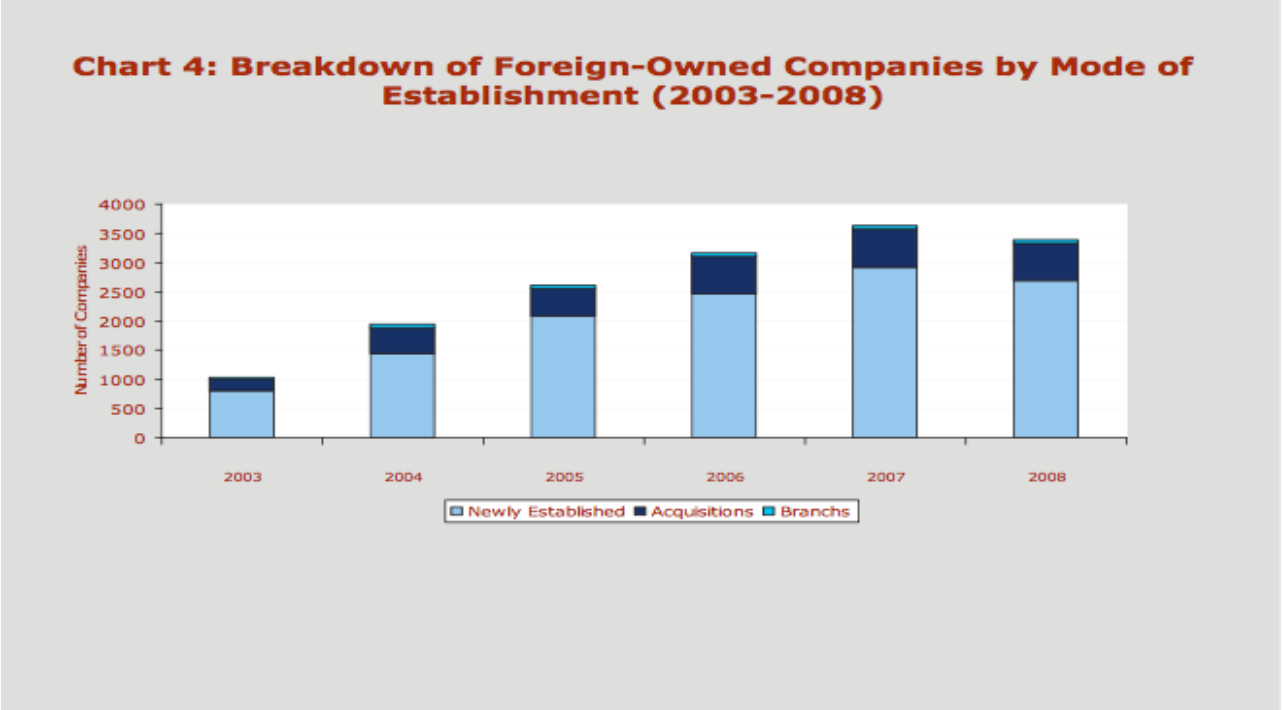


Source: provisional Data, Source: Undersecretariat Treasury, 2008.

Particularly in 2006, 2,699 new foreign-owned companies and branches were established, while 651 foreign capital participations in domestic companies were realized (Figure 13). Out of a total of 14,955 foreign-owned companies in Turkey, 82.2% were new company and branch establishments and 17.8% foreign capital participations in domestic companies (Figure 13) (Undersecretariat of Treasury 2007).

As of the end of 2008, a total of 21,079 companies with foreign capital were in operation in Turkey. Of these 17,160 were companies and branch offices with foreign capital and 3,919 were domestic companies with the participation of foreign capital. Between 2003 and 2008 approximately 80% of the companies with foreign capital were company establishments and branch offices (Figure 14) (Undersecretariat of Treasury 2008).

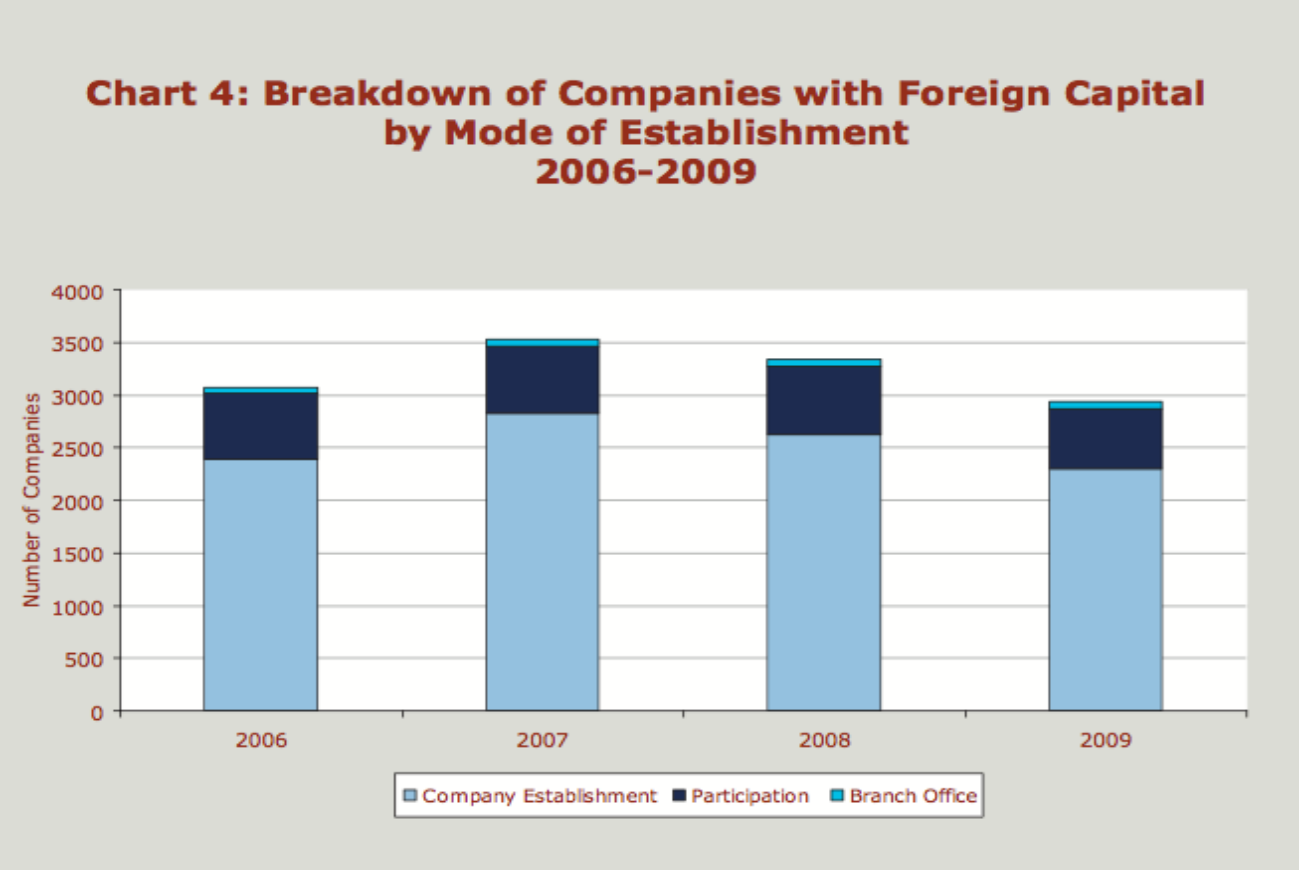
Fig. 14



Source: provisional Data, Source: Undersecretariat Treasury, 2008.

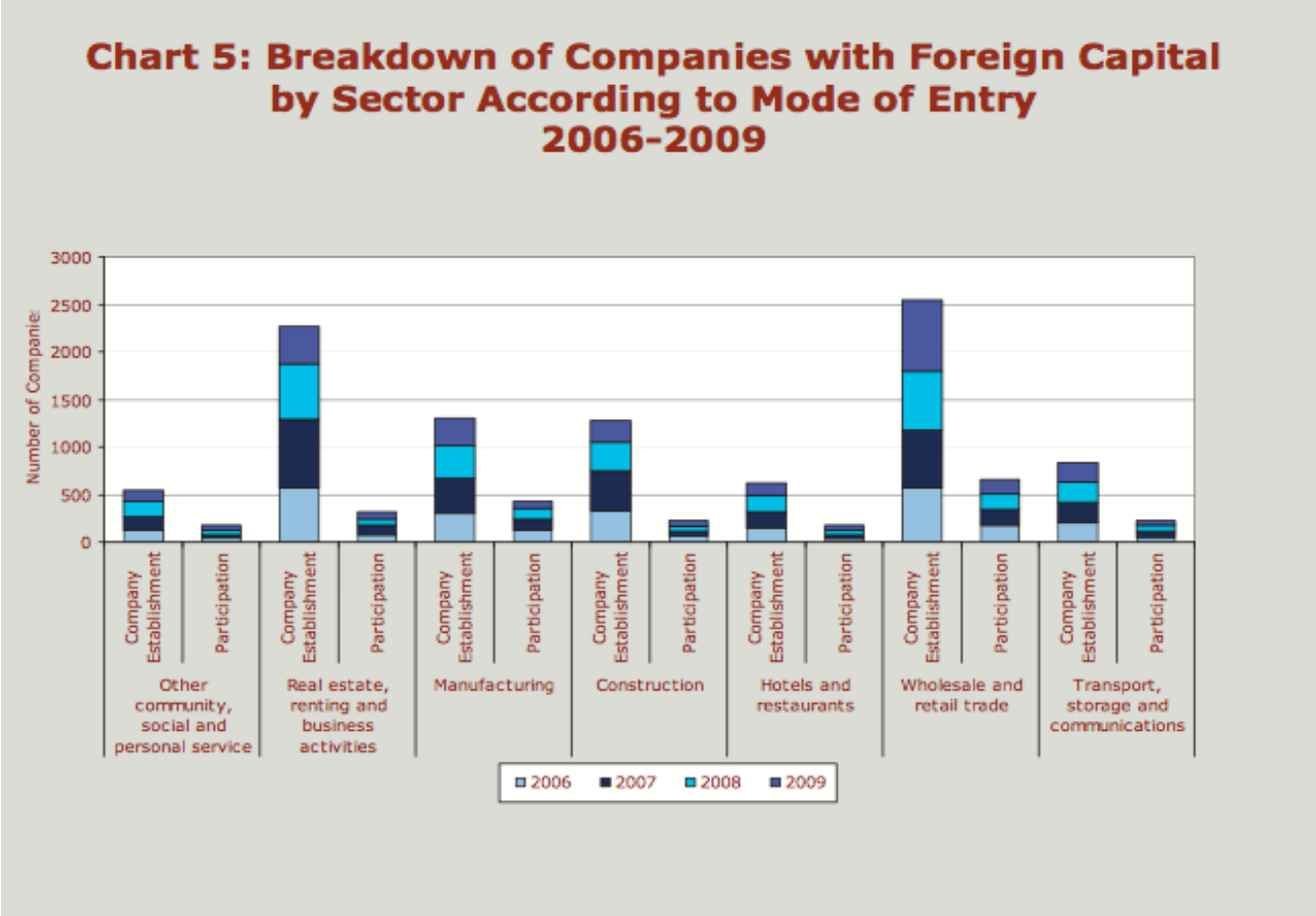
As of the end of 2009, a total of 23,620 companies with foreign capital were in operation in Turkey. Of these, 19,185 were companies and branch offices with foreign capital and 4,435 were domestic companies with the participation of foreign capital (Figure 15). While the number of companies with foreign capital increased by 15% between 2006 and 2007, there was a decrease of approximately 5.5% in 2008 and a decrease of 12% in 2009. Approximately 65% of the companies with foreign capital were company establishments and branch offices (Undersecretariat of Treasury 2009).

Fig. 15



Source: provisional Data, Source: Undersecretariat Treasury, 2008

Fig. 16



Source: provisional Data, Source: Undersecretariat Treasury, 2008

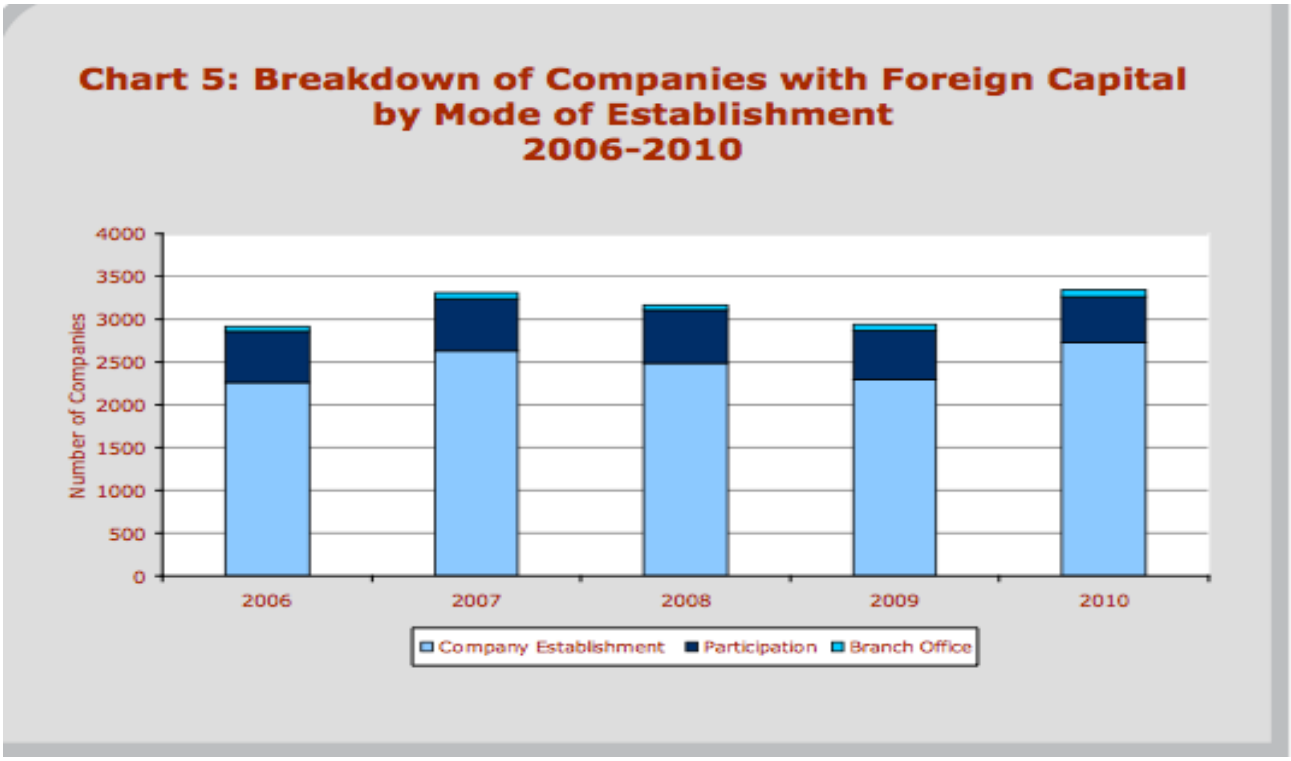
The majority of companies with foreign capital in Turkey are in the wholesale and retail trade business, followed by manufacturing and real estate, renting and business activity sectors (Figure 16) (Undersecretariat of Treasury 2008).

As of the end of 2010, there were 25,948 companies with foreign capital in Turkey. Of these, 21,133 were companies and branch offices with foreign capital and 4,815 were participations of foreign partners in domestic companies. While the number of companies with foreign capital decreased by 4% in 2008 and by 7% in 2009, there was 13% increase in 2010. Moreover, of the total 25,948 companies with foreign capital operating in Turkey, 77% were limited companies, 20.8% were joint-stock companies, and 2.2% were branch offices, "partnership en commandite",[19] collective companies,

[19] A Partnership en Commandite can be formed by two or more shareholders, trading under a company name, and must have its company headquarters in Malta. It is formed by a deed of incorporation, which must then be duly registered.The capital consists of payments made by shareholders, which can be represented by shares. Partnership en Commandite obligations are guaranteed by the unlimited joint and several liability of one or more partners, the general partners. The

ordinary companies, and business associations (Figure 17) (Undersecretariat of Treasury 2008).

Fig. 17

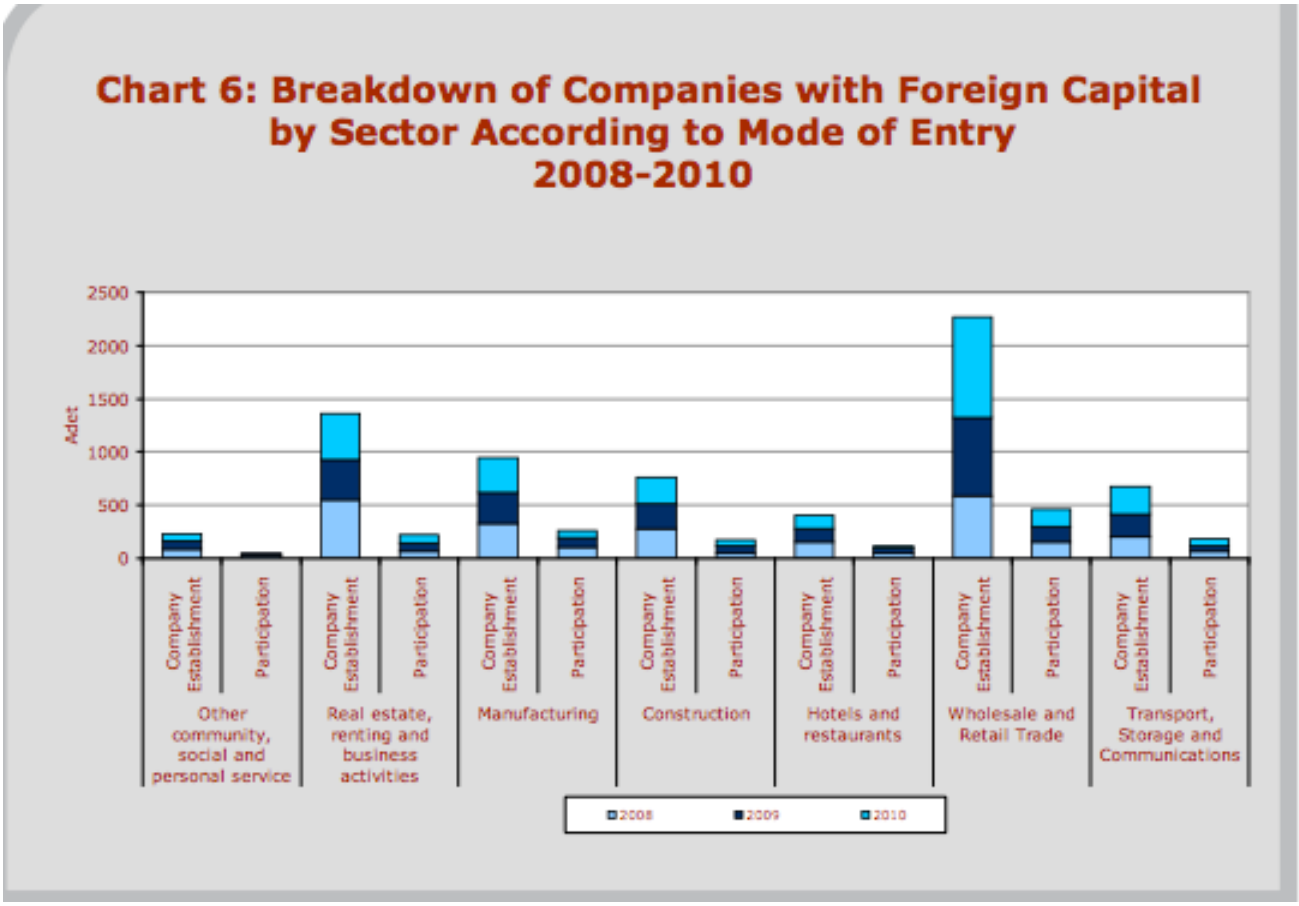


Source: Undersecretariat Treasury, 2010

Between 2006 and 2010, approximately 81% of the companies with foreign capital were company establishments and branch offices (Undersecretariat of Treasury 2010).

other shareholders, the limited partners, are only liable for the share capital they have put into the partnership.The Partnership en Commandite accounts do not need to be audited, unless its capital is represented by shares, in which case auditors need to be appointed and its accounts organized in the same way as for a limited liability company (Undersecretariat of Treasury 2008).

Fig. 18



Source: Undersecretariat Treasury, 2010.

The graph indicates that the majority of the companies with foreign capital in Turkey, operate in the retail and wholesale trade sector, followed by manufacturing, real estate, renting and business activity sectors. In 2009, the number of companies established with foreign capital and branches was 2,370 and there were 566 participations to existing domestic companies. In 2010, 2,801 companies and branches with foreign capital were established in Turkey and there were 543 participations in existing domestic companies. In 2010 while the number of participations in existing companies decreased by 18.2%, the number of participations in existing domestic companies decreased by 4.1% as well compared to the previous year (Figure 18) (Undersecretariat of Treasury 2010).

3. 3 Comparative Analysis of FDI Inflows to Turkey to Peer Countries

Investment indices constructed by several international institutions are used as benchmarking tools for improving investment environment studies for directing investors in their decisions of their appropriate investment location decisions, and for comparing countries as FDI hosts. Considering this view and recognizing that these indices contribute significantly to an effective investors' decision on mobilizing their investments, this section uses the four following indices: Economic Freedom Index, IMD World Competitiveness Yearbook, Business Competitiveness – Ease of Doing Business, Investor Country Index prepared by the Turkish Undersecretariat Treasury, in order to present a comprehensive view of the comparative analysis of Turkish FDI flows in relation to peer countries. However, before this analysis proceeds, it is important to stress that in the case of Turkey, there have been numerous instances when the actual home country transferred the money to Turkey through another country and, therefore, the transaction was listed as investment flow from the 'intermediary' country. For example, in 2008 the insurance firm AEGON, headquartered in the Netherlands, acquired 100% of the shares of Ankara Emeklilik, but the transaction was carried out through the United Kingdom and was recorded as a British investment. Similarly, in 2008, the Greek Titan Cement company acquired 50% of Adocim, but the transaction was carried out through the Netherlands and the investment flow in Turkey was listed as originating from NL (Foreign Direct Investments in Turkey 2008, p. 53).

The index of **Economic Freedom has being published by** Heritage Foundation, since 1995, determines economic freedom using ten factors based on fifty variables. The categories included in this index are the following: business freedom, trade freedom, fiscal freedom, freedom from government, monetary freedom, investment freedom, financial freedom, property rights freedom, freedom from corruption, and, labor freedom. Each of the ten categories (freedoms) is graded on a scale from 0 to 100, with 0 reflecting the least economic free country and 100 reflecting the most economic free country. A country's overall score is derived by averaging these ten categories, with equal weight being given to each one (http://www.heritage.org/index/).

In 2006, Turkey scored 57 points ranking 92nd among 157 countries, while in 2007 Turkey noted a slow progress, since it scored 57.4 points out of 100 ranking 90th. In 2008, Turkey scored 59.9 points out of 100, that is 2.5 points more than the previous year; however it was designated for another year as a mostly unfree country. In 2009, Turkey scored 61.6 points out of 100 in the Economic Freedom Index 2009, 1.6 points more than the previous year's level, and ranked 75th among 185 countries becoming a moderately free country. In 2010, Turkey's economic freedom score was 63.8, making its economy the 67th freest in the 2010 Index. Its score was 2.2 points higher than the previous

year, reflecting improvements, particularly, in investment freedom, freedom from corruption, and fiscal freedom (see Table 11) (http://www.heritage.org/index/).

Overall, according to the Economic Freedom Index, Turkey has undertaken a series of reforms and accelerated its economic restructuring. The economy has recorded annual growth of about 5 percent over the past five years. The state's involvement in the economy remains considerable, but the private sector had grown more vibrant, and its role in the country's economic growth is increasing. The business environment is becoming more streamlined and efficient, albeit at a slow pace (http://www.heritage.org/index/).

Moreover, Turkey's overall economic freedom remains curtailed by lingering institutional weaknesses. Regulation and taxation, despite some improvements, remain burdensome and deter more dynamic entrepreneurial activity. The state still sets some prices and maintains state-owned enterprises. The labor market remains rigid. Property rights are usually enforced, but the judiciary is overburdened and slow. Corruption is perceived as a significant factor in the country's economic development (http://www.heritage.org/index/).

The second index used in this section is referred to World Competitiveness Yearbook. Since 1989, the World Competitiveness Yearbook has been published annually by the Institute for Management Development (IMD), and it is prepared according to assessments based on 323 different criteria compiled under economic performance, government efficiency, business efficiency, and infrastructure. The World Competitiveness Yearbook count for investor surveys as well as statistical data which represents 2/3 in the overall ranking. The overall competitiveness is graded on a 0 to 100 scale, 100 showing the most competitive country (http://www.weforum.org/reports/global-competitiveness-report-2013-2014).

According to the World Competitiveness Yearbook, in 2006 Turkey ranked 58th among 131 countries (see Table 11). However, in 2007 Turkey dropped down five ranks as compared to the previous year score and took the 53rd position out of 137 economies, since it noted 2.48 points below the 2006 score. In 2008, Turkey recorded a substantial upward trend, since it achieved a score of 45.54 points out of 100 taking the 63rd position among 133 countries. In 2009, Turkey, despite being one of the most successful countries in the economic performance field, fell by 2 points and was at the 61st of 133 other countries due to its low scores in the fields of infrastructure and government efficiency. In 2010, in a similar manner, Turkey remained in the same position (61st out of 139 countries), with a score of 51.12 points (http://www.weforum.org/reports/global-competitiveness-report-2013-2014).

When its overall performance is evaluated, according to IMD for the period 2002-2010, Turkey appeared to be facing a lot of difficulties, which affected its overall competitiveness: the fields that had

most problems were government bureaucracy, policy stability, tax regulations, and tax rates (http://www.weforum.org/reports/global-competitiveness-report-2013-2014).

The third index is that of the Business Competitiveness-Ease of Doing Business Report prepared by the International Finance Corporation (IFC). This index is a source for calculating national competitiveness. This kind of index sheds light on how easy or difficult it is for a new or a local entrepreneur to start and run a small to medium-size business when complying with relevant regulations. The index measures and tracks changes in regulations affecting 11 areas in the life cycle of a business: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, resolving insolvency and employing workers. The Doing Business Index does not include any macroeconomic conditions or financial systems; it merely focuses on the business sector so as to recognize the availability of a regulatory environment for business. According to the Ease of Doing Business Report, the above 9 indicators are taken into account in calculating score values of 183 country economies (IFC Ease of Doing Business Report, 2011).

The Doing Business index ranks economies from 1 to 189 on the ease of doing business, first place being the best. For each economy the index is calculated as the ranking on the simple average of its percentile rankings on each of the 10 topics included in the Doing Report Index. The ranking on each topic is the simple average of the percentile rankings of its component indicators (IFC Ease of Doing Business Report, 2011).

In 2006, Turkey ranked 84th position out of 183 countries, while in 2007 it fell by 7 positions, ranking 91st among 175 countries. In 2008, Turkey's position changed to the 57th among 181 countries, while in 2009 it falls behind again, reaching the 63rd position among 183 countries. Finally, in 2010 Turkey ranked 73rd: it had achieved only one positive reform in the field of credit. Moreover, although many reforms took place in the of 2006-2010 period, Turkey still faced many obstacles, particularly in the field of construction permits (ranking 133rd), employing workers (ranking 145th), and closing business (rank 121st); this reflects the underlying need for more effectively enforced and more proactive reforms in the fields described above (see Table 11) (IFC Ease of Doing Business Report, 2011).

Table 11
Ranking of Turkish Investment Profile

	Ranking/ Number of Countries in 2006	Ranking/ Number of Countries in 2007	Ranking/ Number of Countries in 2008	Ranking/ Number of Countries in 2009	Ranking/ Number of Countries in 2010
Economic Freedom Index	**92/157**	**90/157**	**81/162**	**75/183**	**67/183**
World Competitiveness Yearbook (IMD)	**58/131**	**53/137**	**63/133**	**61/133**	**61/139**
Ease of Doing Business Index	**84/175**	**91/175**	**57/181**	**63/183**	**73/183**

Source: Author's Design, 2014.

Last but not least, the fourth index employed in this section (Table 13) is related to the investor country index prepared by the Undersecretariat Treasury only for 2009 and 2010. The factors taken into consideration for ranking investor countries for this index are listed below:

- cumulative number of companies with foreign capital in Turkey (Undersecretariat Treasury 2009);
- the share of companies with foreign capital higher than TL 500,000 among all companies with foreign capital (Undersecretariat Treasury 2009);
- the share of companies with foreign capital lower than TL 500,000 among all companies with foreign capital (Undersecretariat Treasury 2009);
- the number of companies with foreign capital established in 2009 and 2010, respectively (Undersecretariat Treasury 2009);
- FDI flows to Turkey between 2002 and 2009, and, 2002 and 2010, respectively (Undersecretariat Treasury 2009);
- the number of transactions between 2002 and 2009, and, 2002 and 2010, respectively (Undersecretariat Treasury 2010);
- the number of FDI flows in 2009 and 2010, respectively (Undersecretariat Treasury 2010).

Investor country index obtained by weighing the factors above and top ten investors' countries in 2009 and 2010 are presented in Tables (12, 13).

Table 12

Investor Country Index and Breakdown of FDI in 2009 by Home Country

Rank	Country	FDI Index 2009
1	**The Netherlands**	8.74
2	**Austria**	6.81
3	**France**	5.93
4	**Luxemburg**	5.79
5	**Germany**	3.88
6	**The Czech Republic**	3.86
7	**The United Kingdom**	3.33
8	**Italy**	2.89
9	**The United States of America**	2.36
10	**Belgium**	2.2

Source: Undersecretariat Treasury, 2009.

Table 13

Investor Country Index and Breakdown of FDI in 2010 by Home Country

Rank	Country	FDI Index 2010
1	**Austria**	1.79
2	**France**	6
3	**Germany**	5.98
4	**The Netherlands**	4.98
5	**Greece**	4.25
6	**Japan**	3.47
7	**The United States of America**	3.2
8	**Luxemburg**	2.8
9	**The United Kingdom**	2.4
10	**Spain**	1.9

Source: Undersecretariat Treasury, 2010.

It is clear that in both 2009 and 2010, EU countries were the main investors in Turkey. In 2009 the Netherlands ranked first, followed by Austria, France, Luxemburg, Germany, the Czech Republic, the UK, Italy, the USA, and Belgium. In 2010, a similar trend was followed with Austria as the leading investor-country, followed by France, Germany, the Netherlands, Greece, Japan, the USA, Luxemburg, the UK, and Spain.

Chapter 4: Interpreting FDI: Theory

4.1 Theoretical Inefficiencies: The Background

At its most basic, economic exchange across national boundaries has taken place for several centuries. Furthermore, one of the most remarkable aspects of economic life nowadays is the manner in which all countries increasingly find themselves an intrinsic part of the semi-global economy (Auerbach 1996). Such interdependence means that the concept of the semi-global economy is reflection of the fact that the contemporary marketplace is inherently international. Moreover, this new world order with its international competition, economic trading blocs (e.g., Association of South East Asian Nations, North American Free Trade Agreement and the Single European Market) and global emphasis, is forcing firms towards a "new reality" (Lazer, 1993, p. 93) which demands a global marketing imperative. Czinkota et al. (1995) have described this scenario as follows:

> The global imperative is upon us! No longer merely an inspiring exhortation, thinking and acting globally is the key principle for business success. Both the willing and the unwilling are becoming participants in global business affairs. No matter how large or small your business, ready or not, here comes the world (p. 1).

In attempting to explain cross-national commercial activities, the international economics have, over the last three decades, witnessed significant advances. However, such intellectual developments have fostered a diversity in knowledge which is evident from the range of extant theories.

To begin with, the importance of international trade to a nation's economic welfare and development has been heavily documented in the economics literature since Adam Smith's (1776) pioneering inquiry into the nature and causes of the wealth of nations. In a similar manner, Ricardo (1817) much later has supported that the extent to which a country exports and imports relates to its trading pattern with other nations. That is, countries are able to gain if each devotes resources to the generation of goods and services in which they have an economic advantage (Ricardo 1817; Smith 1776). Therefore, classical trade theory describes the scenario where a country generates goods and services in which it has an advantage, for consumption indigenously, and subsequently exports the surplus.

Moreover, Heckscher (1919) & Ohlin (1933) in a traditional model of free trade, has recognized that trade occurs since countries are specialized in the production of goods, in which they have a price advantage, and subsequently, exchange them for goods in which they have a price disadvantage. Following Heckscher-Ohlin (1933) model, Mundell (1957) has analyzed the effects of factor movements using the substitutability of trade and capital flows asserting that an increase in trade

impediments stimulates factor movements, and an increase in impediments to factors stimulates trade. In this framework, Mundell (1957) points at changes in the structure of trade, which are led by an exogenous increase in tariffs, and ultimately, create incentives for capital to move across borders.

While insightful, all the above models remain limited in their capacity to provide a comprehensive analysis of trade and capital flows and their interaction under a rich set of scenarios. For instance, the most important drawback of Mundell (1957) model is that capital mobility in the static two-country, two-factor, two-factor (2x2x2) framework is confined to the allocation of capital across countries, for a fixed level of world capital. A dynamic model in which capital flows are driven by the allocation of savings across countries became relevant and important extension.

All things considered the traditional (classical or neo-classical) models of trade, which were the dominant paradigms in international economics until the 1950s just one issue was addressed: where the production would take place. Questions relating to the ownership and organization of economic activity were ignored. This was because the market for the cross-border exchange of goods and services was to be assumed costless mechanism. Resources were assumed to be immobile across national boundaries, but mobile within national boundaries. Firms were assumed to engage in only a single activity. Entrepreneurs were assumed to be profit maximizers, and finally, management strategy was assumed to be confined to identifying the optimum level of output or a given a cost level minimizing the costs of supplying at certain level of output.

4.2 The Market Imperfections Approach

During the 1960s two influential and path breaking contributions to the theory of MNE and MNE activity have emerged. Each was put forward quite independently of the other, and has approached its subject from a very different perspective. The first contribution is that of **Stephen Hymer** (1960, 1968) who, in his PhD thesis expresses his dissatisfaction with the theory of portfolio capital transfers to explain foreign value-added activities of firms. More specific, he identifies three reasons for his dissatisfaction. The first is that once risk and uncertainty, volatile exchange rates, cost of acquiring information, and making transactions are incorporated into classical portfolio theory, many of its predictions become invalidate. “This is because such market imperfections alter the behavioral parameters affecting the conduct and performance of firms, and in particular, the strategy in servicing the foreign markets” (Dunning 1994, pp. 69).

Secondly, FDI involves the transfer of a package of resources (technology, management, entrepreneurship, etc.) and not just finance capital which portfolio theorists claimed. And thirdly, FDI

involves no change in the ownership of resources transferred, whereas indirect investment, which is transacted through the market, do necessitate a change in ownership characteristics. “In consequence, the organizational modality of both the transaction of the resources (intermediate products) and the value-added activities are linked by these transactions are different” (Dunning 1994, pp. 69).

However, Hymer's work is best known for its application of an industrial economics approach to the theory of foreign production. He firstly addresses the question “**of why foreign owned firms are able to compete with indigenous firms in the host economy, given the innate advantages of indigenous firms”** (Buckley and Casson 1976, pp. 67). In this framework, he asserts that for multinational firms to own and control foreign production they must possess some kind of innovatory abilities, cost, financial or marketing advantages which are sufficient to outweigh the disadvantages they face by competing with indigenous firms in the host country. These advantages, which he assumes to be exclusive to the firm owning them, imply the existence of some kind of structural market failure. Then, Hymer (1960) goes on and identifies four types of foreign firm disadvantages (or, alternatively, domestic firm advantages) that can generate costs in doing business abroad:

- First, foreign firms will have less information than domestic firms about the host country and needed to incur start-up costs of acquiring this information.
- Second, foreign firms can receive differential and worse treatment from the host country government, buyers and suppliers compared to domestic firms. Hymer (1960) expects this discriminatory treatment to persist over time, even after the firm established operations in the host country.
- Third, the firm’s host government can also generate differential treatment, for example, by prohibiting the firm (both the parent and its foreign affiliates) from engaging in certain activities or by levying more onerous taxes than local firms faced in the host country.
- Lastly, foreign firms would face foreign exchange risks because receipts and payments of foreign currencies were not synchronized, which local firms will not face.

In seeking an explanation of these imperfections, Hymer (1960) bases on Bain's (1956) barriers to entry, and argues that firms have to posses some kind of proprietary or monopolistic advantages, which may arise from the ability of firms to improve the allocation of resources or organize transactions more efficiently. These advantages constitute barriers to entry for foreign firms in the host country.

To sum up, the emphasis placed by Hymer is on the organization of economic activity by MNEs, as a means of advancing monopoly power, rather than of reducing costs, improving product quality or

fostering innovations something which lead him to consider the alternatives between FDI and other forms of international involvement options, rather than on the analysis of costs and benefits of these options (Dunning 1994, pp. 70).

However, according to Dunning, Hymer (1968) in a later paper takes a rather different approach to explain international production. In this concept, he tries to consider things from the firm's point of view. In developing his analysis, Hymer draws heavily on the ideas of Coase (1937). He applies the analysis of Coase (1937) to suggest reasons why firms might wish to engage in cross-border vertical integration. Although he does not fully develop his arguments, he appears to acknowledge that MNEs might help "to improve international resource allocation by circumventing market failure. To this extent, at least, his 1968 contribution is a natural point of departure for the rigorous work of the internalization economists in the following decade (Horaguchi and Toynne 1990).

The second stream of work that partially builds upon the factor-endowments tradition is the one that takes into account the role of innovation and the diffusion of knowledge. Posner (1961), Hufbauer (1965), Vernon (1966), Hirsch (1967) and Wells (1972) were probably the most important references, with the product cycle theory, normally associated with Vernon, being the model that better describes the role attributed to MNEs in the interaction between technology, international production and trade.

In a classic paper published in 1966, Vernon applies a microeconomic concept- product cycle- to describe and explain a macroeconomic phenomenon that is, the foreign activities of US MNEs in the post-war period. The argument of his theory is based on the fact that technological development produces changes in the products' factors intensity changing in this way the comparative advantages of countries. However, it is quite possible that any initial competitive advantage which is enjoyed by innovating enterprises might be eroded by the superior competence of firms in other countries. Without explicitly explaining, Vernon (1966) initiates market imperfections into his analysis and then he shifts the unit of analysis to the firm and, particularly, to the location of the production (Vernon 1966).

More specific, he asserts that firstly, the product is produced for the home market, at a later stage of the product cycle, because of a combination of innovation and production advantages the product is exported to foreign countries with similar demand patterns, and much later, when the product becomes matured and standardized, the focus of product cycle is based on its cost efficiency. However, the pressure the firm in order to ensure cost-efficiency brings about many imitations which are initiated in developed countries and, later, in developing countries (Vernon 1966).

Despite its major contribution, the product-cycle model has received a lot of criticism. More specifically, Clegg (1987, pp. 24) has claimed that "[the product cycle] is not, in itself, a complete theory of FDI as it does not explain the ownership of production". Not least because the competitive

advantage of firms is frequently associated with country-specific advantages (Dunning, 1993a). Further, Clegg (1987, pp. 26) has added that "the product cycle is primarily a theory of new FDI, and it has little to say on the extensions of existing investments by a mature foreign-investing nation".

In a similar way, Dunning (1994, pp. 71) has supported that

"this approach [of Vernon] to explaining foreign production was essentially an extension of the neo-classical theory of spatial distribution of factor endowments to embrace intermediate products together with an acknowledgment that strategic factors, arising from an oligopolistic market structure in which MNEs were observed to compete, influenced by the response of firms to these endowments. It did not, however, address organizational issues. Since the competitive advantages of firms were assumed to be country-specific, little attention was paid to the kinds of advantages that arose specifically from the internalization of cross-border markets" (Dunning 1994, pp. 71).

However, Dunning (1994, pp. 71) has noted that despite its deficiencies, the product cycle is the first dynamic attempt to incorporate the determinants of international trade and foreign production.

Other researchers – mainly from a business school tradition, and often from Harvard itself- built on the Vernon approach. Perhaps of greater significance for the development of the theory of foreign production at that time were the finding's of a group of Vernon's students, notably **Knickebocker**. Particularly, Knickerbocker explains that foreign production is not based only on locational variables that determine the spatial distribution of economic activity of firms, but their strategic response to these variables and to the anticipated behavior of their competitors. In other words, Knickerbocker (1973) is based particularly at the behavior of the managers themselves. In that concept he asserts that,

"managers seek prestige and are often empire builders. The subjective motivation of managers may be important motives in the establishment and expansion of foreign subsidiaries. These incentives are important for individuals but will not suffice, if real economic benefits are not simultaneously available. Managers cannot survive if they do not produce profits, and therefore, it is convenient to make the standard assumption that profit maximization is the appropriate criterion (Rugman 1996, p. 570).

Considering this view, Knickebocker (1973) shows that the expansion of American MNEs abroad have been determined by micro level decisions in which foreign subsidiaries are established in response to initial direct investment by rival firms. It is assumed that the relevant market structure is characterized by oligopoly rather by a situation of perfect competition leading to the implication that direct investment has to be explained by market imperfections rather than by differences in real or monetary rates of return. Coupled with the assumption of oligopoly is the hypothesis that American exports follow a product cycle in which product-pioneering American MNEs generate successive advantages in production of goods by innovations in manufacturing, marketing, management, and technology. These markets are specific to the firm, and it is clearly in the firm's own interest to exploit its innovation not only in the domestic market, but also by extending sales abroad through exports

and/or foreign subsidiaries (Knickerbocker 1973; Rugman 1996, p. 571).

Such an argument has been advanced previously by Vernon, Kindlberger, Johnson, Caves, and others. However, Knickebocker extends this argument with his emphasis on oligopolistic reaction. Once one firm is in oligopolistic market situation and is engaged in direct investment, then there is an incentive for rivals to respond in order to defend their market share. Thus, in Knickebocker's view most direct investment is "defensive" in nature, and is governed by the interdependency of firms in such a market structure. Knickebocker does not attempt to identify the motivation of a firm's behavior (which he terms aggressive) to which oligopolistic rivals respond as part of a defensive strategy. Instead, he relies on the product cycle theory, and considers it to be a sufficient reason for aggressive foreign expansion (Knickerbocker 1973; Rugman 1996).

4.3 The Market Internalization Approach

By the mid 1970s it was becoming clear that none of the above theories so far has put forward to explain the foreign activity of MNEs. Of all the explanations, Hymer's (1960) has offered the most promising paradigm asserting that the world is characterized by imperfections in the goods and factor markets, which act as barriers to the free trade of goods and services and inhibit private international financial investment. As a result, neither factor price equalization nor goods price equalization has been observed. Further, there was a large volume of FDI and international production by MNEs, an activity which could not be explained readily by conventional trade theory alone. Therefore, "a large volume of the literature has been developed, in order to offer explicit explanations of the FDI phenomenon and the reasons for international MNE production" (Rugman 1985, pp. 367).

In light of this view, two major attempts were made to offer more holistic explanations of the foreign activities of firms, each of which has attracted widespread attention in the relevant literature. These are TCA through the internalization theory of the MNE, and the eclectic paradigm of international production.

Particularly, internalization theory was first developed by Coase (1937) in a domestic context and by Hymer (1960) in an international dimension. On the one hand, Coase (1937) is the first to note that "the market operation costs something". This cost derives from market imperfections, that is, imperfections that are due to the fact that the neo-classical assumptions of perfect knowledge and perfect enforcement are not realized (Teece 1981; Dunning and Rugman 1985). Therefore, a variety of transaction, contracting, and coordinating costs are generated which frequently lead to vertical integration within the firm and, subsequently, to internal organization of a firm, which can be a more

efficient method of production (Rugman 1980).

According to Coase (1937), these costs are defined as: the brokerage cost of finding a correct price; the cost of defining the obligations of parties in a contract; the risk of scheduling and related input costs; and the taxes paid on exchange transactions in a market. However, these costs can be avoided by the management team of the firm (or entrepreneur in the original Coasian conception) using administrative fiat in order to set internal (transfer) prices. Subsequently, the firm can control the production and marketing of an intermediate product through its vertically integrated structure. To this end, it is more efficient for the firm to set prices internally when there are high transaction costs in using a regular market or when such a market cannot exist.

These fundamental insights of Coase are readily applicable to MNEs, because there are presumably more imperfections and greater transactions costs in international than in domestic markets which give rise to MNEs. In that perspective, MNEs can enjoy worldwide economies of internal organization, which are sufficient to offset the additional costs of operating abroad in unfamiliar political and economic environments. This means that once an MNE is established abroad it will then use its internal organization to defend its market advantage. This advantage may have been generated, for example, in the firm specific use of knowledge, information, management or marketing skills.

Therefore, Coase (1937) best known as the forefather of internalization and transaction cost theory, first foresaw that transaction costs arise when transactions are conducted through **the market imperfections**. The core insight is that decision makers are situated at a boundary where by using a *pareto* efficiency approach, they have to constantly compare the transaction costs of using the market against those of managing exchanges internally. Internalizing the transactions optimizes the relative value of the exchange. In essence, the market price mechanism is replaced by fiat.

On the other hand, the major point of Hymer's seminal thesis of 1960, published by Kindleberger in 1969[20] is that "the MNE has a firm specific advantage, developed in response to one or another market imperfection" (Rugman 1985, pp. 460). He demonstrates that market advantages are achieved whether the MNE can acquire factor inputs at a lower cost than its rivals, whether it has better distribution and marketing facilities, whether it has a monopoly advantage in information, research, knowledge or some other aspect of the production process, or whether it makes a differentiated product. Hymer recognizes that in these situations the firm can create an internal market to substitute for, or supersede, the regular external market. So, the MNE is a response to some sort of externality and it overcomes the externality by internalization.

[20] Hymer's thesis was published by Kindleberger in 1976, due to MIT's refusal to publish a thesis until 1976, by which time the thesis was enjoying "a notoriety and an underground existence" (Kindleberger, 1976, p.xiv).

Despite the influential impacts of Coase (1937) and Hymer (1960, 1969), another most influential treatment of externalities and market imperfections is attributed to Caves (1971). Caves links the imperfect market for knowledge with arguments which suggest that the MNE will respond to such imperfections by engaging in product differentiation and horizontal integration. The MNE tends to operate in oligopolistic markets and these encourage it to differentiate its product, or to utilize scale economies or some other firm specific advantage.

"The "Caves economies" of product differentiation advantages and horizontal integration can be contrasted with the "Coase economies" of information and knowledge advantages which occur under vertical integration. Both types are stressed here since they are the essence of internalization. The MNE is usually both vertically and horizontally integrated, so it is able to maintain its firm specific advantage quite readily" (Rugman 1985, pp. 370-371).

Furthermore, other writers have also focused on the imperfect nature of the knowledge advantage of the MNE, without relating this to internalization theory and TCA (see for example Johnson (1970), Hirsch (1976)). However, Vernon (1966) as discussed above, relates more clearly the product cycle with TCA and internalization on the basis that product cycle model lies in the basic motivation of research and knowledge generation, which promotes a new product. So, Vernon (1966) clearly asserts that the dynamic nature of research generation lies at the heart of the theory of internalization and therefore, the product cycle model is a sub-case of it. Once the motivation of research is explained by internalization then everything else in the product cycle model follows (Rugman 1985, pp. 372).

In addition, Knickerbocker (1973), based on the defensive behavior of MNEs, explains the oligopolistic reaction by MNEs using the theory of internalization. Particularly, he argues that there must exist initial imperfect market, such as an oligopoly with price leadership or some collusion, in order to generate the concern with market shares on a world basis. If this oligopoly structure exists in a domestic industry and a firm engages in FDI to secure its share of a foreign market, then it is clear that this firm attempts to retain its specific advantage, as will any MNE.

However, the first explicit treatment of the relationship between knowledge market imperfections and internalization of markets for intermediate goods was developed independently in two transAtlantic locations, in the UK, by Buckley and Casson (1976) and in the USA, by Williamson (1975). First, the work of Buckley and Casson (1976) at the University of Reading in the UK took place quite independently, and in ignorance of the work of Williamson (1975) on transaction costs and MNE. Buckley and Casson (1976) have written, in ignorance of Williamson (1975), although they were well aware of the fundamental concept of market imperfections in Coase (1937), which they cited, understood and used as a basis for their clear and elegant exposition of the benefits and costs of

internalization (Rugman 1986, pp. 102).

These scholars do not simply complement previous work, they re-center the analysis by building upon the theory of the firm (Coase 1937). Looking at the firm as an alternative institution to markets, their theory "views the MNE as a special case of the multiplant firm" (Buckley and Casson 1976, pp. 36). In this framework, their book demonstrates how seemingly unrelated aspects of multinational operations, such as technology transfer and international trade in semi-processed products, can be understood using a single concept – the internalization of imperfect markets (Buckley and Casson 2009).

Imperfect markets for knowledge is the basis of Buckley and Casson's theory of the multinational enterprise (1976). This means that "a necessary condition for an internal market to be more efficient than an external one is that the external market is imperfect" (Buckley and Casson 1976, pp. 36-37). Using empirical evidence on the global pattern and evolution of FDI including, at the time, relatively novel firm-level regressions, Buckley and Casson (1976) "[combine] the focus of the international business literature [with] country-specific, industry-level, and firm-level determinants of international investment flows (Henisz 2003). They develop their theory on three simple postulates:

- "Firms maximize profits in a world of imperfect markets" (Henisz 2003, pp. 175).
- "When markets in intermediate products are imperfect, there is an incentive to bypass them by creating internal markets. This involves bringing under common ownership and control the activities that are linked by the market" (Henisz 2003, pp. 175).
- "Internalization of markets across national boundaries generates MNEs" (Henisz 2003, pp. 175) (Buckley and Casson, 1976, 33).

So, the internalization theory evolves from the concept of market failure. Some transactions are more efficiently performed inside the firm than in the market. Buckley and Casson (1976, pp. 36) assert "that under certain conditions (such as non-increasing returns to scale), the co-ordination of interdependent activities by a complete set of perfectly competitive markets cannot be improved upon." This means that there is no advantage in replacing a market-a perfect system- by a centrally administered control system, such as the firm. Therefore, the incentive for internal coordination of activities by a firm does not rest on the advantages of centralization *per se*. On the other hand, it rests on the avoidance of market imperfections.

Buckley and Casson (1976) specify five "factors" of market imperfections which generate significant benefits to internalization. Four of them- when the co-ordination of resources over a long period is needed; when the efficient exploitation of market power requires discriminatory pricing; when

bilateral monopoly produces unstable bargaining situations; when the buyer cannot price correctly the (usually intangible) goods on sale, or when public goods are involved- depend mainly on the nature of the product and the structure of the external market. While, the fifth type depends on government interventions in international markets. These interventions create incentives for transfer-pricing, the exploitation of which is a function not only of the nature of product and the structure of the external market, but also of the characteristics of fiscal systems in various regions linked by the market.

The discussion above suggests that there are certain markets in which the incentive to internalize is particularly strong. The strongest case of all concerns the markets for various types of knowledge. More specific, the production of knowledge through R&D, the knowledge which is a "natural monopoly" and is best exploited though a discriminatory pricing, the bargaining conflict between purchasers (monopsonists) and sellers (monopolists), buyer uncertainty especially when the knowledge is a public good, and finally, the difficulty in valuing flows of knowledge.

Moreover, Buckley and Casson (1976, pp. 39) list and other several markets where internalization is very likely to happen: perishable agricultural products, intermediate products in capital-intensive manufacturing processes, and raw-materials geographically concentrated.[21] However, these are secondary in their analysis.

But against the benefits of internalization must be set the costs. Buckley and Casson (1976) list several main types of cost. The first is the resource cost of fragmentation of the market, which depends on the relation between optimal scales of the activities linked by the market. The second and probably of greater importance is the additional communication cost attributable to internalization. This means that the cost is greater, the greater the geographical distance between the regions linked by the market, and the greater the "social distance", i.e. the dissimilarities in language and the social business environment. The third is the cost of political discrimination against foreign-owned firms, which will tend to be greater the more unstable are political relations between the nations concerned. The fourth is the administrative cost of the internal market, which depends largely on the professionalism of the management.

> [Therefore,] the conclusion is that the incentive to internalize depends on the interplay of (i) industry-specific factors, namely the nature of the product, the structure of the external market and the relation between the optimal scales of the activities linked by the market, (ii) region specific factors, namely the geographical and social distance between regions involved, (iii) nation specific factors, namely the political and fiscal relations between the nations involved, and finally, (iv) firm specific factors such as the degree of professionalism of management (Buckley and Casson 1976, pp. 44-45).

[21] Casson (1982, pp. 20) put it in different words: "MNEs will predominate in R&D-intensive industries, in resource-based industries, and when the international division of labor is inhibited by fiscal intervention which can be avoided by transfer-pricing".

To sum up, internalization approach through its main representatives assumes that "internalization can occur in response to any type of externality in the goods or factor markets" (Rugman 1985, pp. 368). A tariff, or other type of distortion in the goods market, will induce FDI and multinational activity. Subsequently, the essence of internalization theory is the explicit recognition of these worldwide market imperfections which in practice prevent the efficient operation of international trade and investment.

Furthermore, the MNE has been an efficient response to non-government market failure in areas of the factor market, such as information and knowledge. Imperfections in this factor market, at an international level, tend to generate the MNE. Of particular interest is the lack of regular markets for intermediate products, such as research, information and knowledge. These markets cannot be found in international trade, because of the risk of loss of the knowledge advantage if direct sales were made in another nation.

Yet in internalization theory there is no simple interaction of supply and demand to set a market price. Instead the MNE is driven to create an internal market of its own in order to overcome the failure of an external market to emerge for the sale of information. This internal market of the MNE is an efficient response to the given exogenous market imperfection in the determination of the price of information. So, internalization allows the MNE to solve the appropriability problem by assigning property rights in knowledge to the MNE organization.

To this end, the creation of an internal market by the MNE permits it to transform an intangible piece of research into a valuable property specific to the firm. The MNE will exploit its advantage in all available markets and will keep the use of information internal to the firm, in order to recoup its initial expenditures on research and knowledge generation. Production by subsidiaries is preferable to licensing or joint ventures, since the latter two arrangements cannot benefit from the internal market of an MNE. Therefore, they would dissipate the information monopoly of the MNE, unless foreign markets were segmented by effective international patent laws or other protective devices.

Despite its insightful contribution, internalization theory has been mostly criticized that it does not provide insight in some aspects of MNE behavior, including FDI-related activities. In this framework, internalization theory is blamed for not explaining all types of FDI nor all aspects of international operations of MNEs. In some instances, the internalization theory, sets out in the Rugman (1985) paper, provides little more than a tautological explanation of certain forms of MNEs operations, since Rugman (1985) does not establish explicitly internalization as a general theory of FDI (Parry 1985, pp. 565).

Further, Dunning has supported that internalization theory is better described (according to Buckley 1990) as a paradigm than a theory, in as much as the kinds of market failure that determine

one form of foreign-added activity may be quite different from that of the another. “For example, in some consumer good or service industries, the inability of the market to ensure a seller of an intermediate product sufficient control over the quality of the final product which may bear the seller's name may be a reason for replacing that market by forward integration. By contrast, backward integration may be motivated by a perceived need to reduce the risk of interrupted suppliers or price hikes, while the common governance of multiple activities in dispersed locations may be prompted by the desire to gain economies external to the activities but internal to the firm” (Dunning 1994, pp. 75).

In light of the above, Dunning (1994, pp. 76) has argued that despite accepting the logic of internalization theory, “[this] is not in itself, sufficient [condition] to explain the level and structure of the production of a country's own firms outside their national boundaries, or of the production of foreign-owned firms in the midst”. To a certain extent, this critic has been accepted by some of the internalization theorists. Particularly, both Buckley (1987) and Casson (1987) have acknowledged the need to integrate location-specific variables in the internalization theory, in order to provide a holistic theory of the MNE activity. In the “static” internalization model these ownership variables are considered to be exogenous. However, viewing the growth of the firm as a dynamic process, doubts are raised about “the legitimacy” of that assumption. Therefore, for a firm's current core competences, such as innovatory skills, organizational skills, marketing strategy, etc. these variables should be assumed as the outcome “of past decisions which, at the time they were taken, were endogenous to the firm” (Dunning 1994, pp. 76).

4.4 The Market Transaction Cost Approach

The modern TCA development is largely attributed to Williamson (1975; 1979; 1981; 1983; 1985; 1991; 1998; 2000; 2010), although the genesis of this theory can be traced to much earlier work by Coase (1937), Commons (1934), Knight (1921), Simon (1955) and, generally, scholars of postwar market failure literature (Williamson 1981).

A set of authors has made significant contributions to our current understanding of TCA. The most contribution is that of Alchian and Demetsz (1972). Alchian and Demetsz (1972) examine team production, information costs, and economic organization – contrasting transaction and production costs. Meanwhile, they tend to disagree with the typical characterization of the hierarchy as a form of authority. More specific, they argue that the employee-employer relationship is not characterized by any more authority or fiat than any other type of relationship. The firm is a contractual structure with joint production, several input owners, one party who is common to all the contracts of the joint inputs,

who has rights to renegotiate any input's contract independently of contracts with other input owners, who holds the residual claim, and who has the right to sell his central contractual residual status (Alchian and Demsetz 1972). Their work is influential to a large degree because of their full explanation of the factors giving rise to different types of organizations.

But the most prominent contribution to our understanding of TCA is fairly attributed to Williamson (1975). He developed a transaction cost theory (which is analyzed in depth below), in a book on market and hierarchies (1975), which was not initially formulated as FDI theory. This has been extended further from a mainly domestic US institutional context to an international dimension in several papers by one of his former students David Teece (1981, 1982, 1985) and by Hennart. Hennart's book based on his 1977 doctoral thesis is a blend of McManus, Chicago's property rights theory, and Williamson; indeed it is one of the earliest applications of Williamson's framework to the MNE.

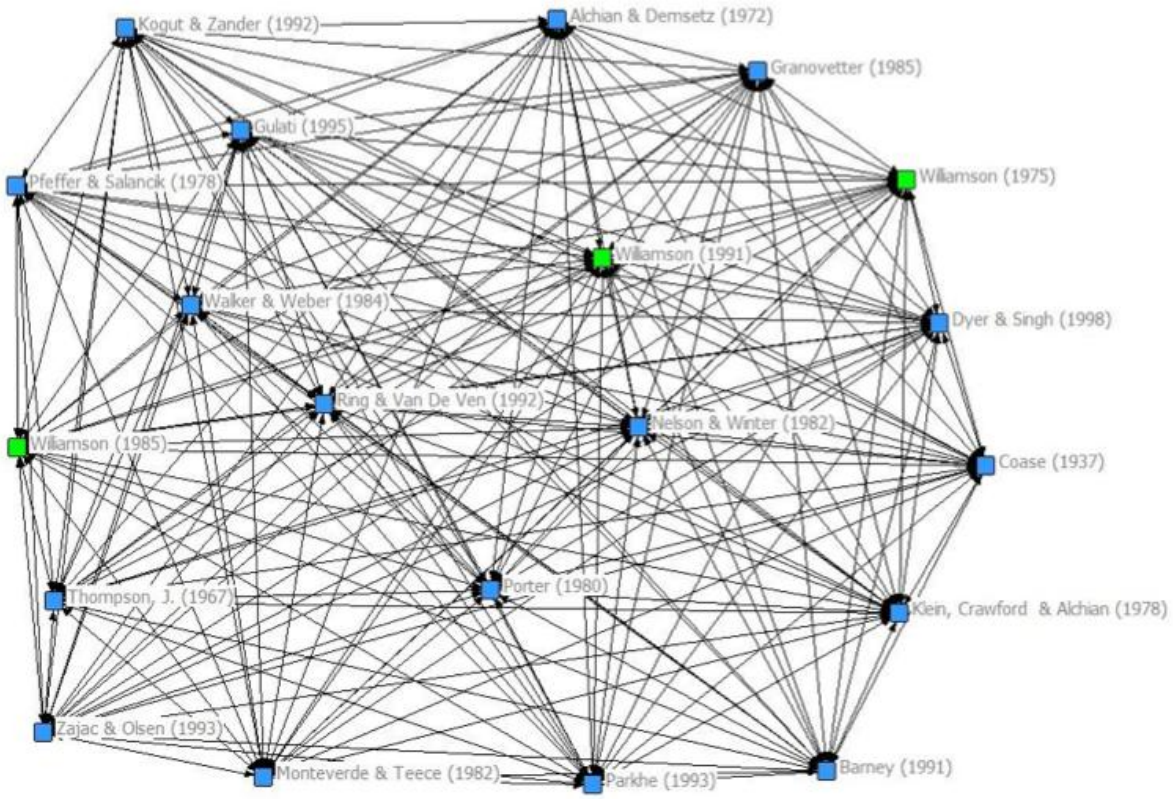
Another representative research on TCA is that of Porter (1980). Porter (1980) uses TCA to compare the relative merits of different theories.

"While Porter may be positioned in the industrial organization group, where the focus is largely on the external environment, be it the industry or the nation (as in his 1990 work on the competitive advantage of nations), the contrast to the focus on the transactions that is postulated by the TCA is clear. In any instance, there is not an evident path linking both streams of research beyond the usual contrasting arguments that characterizes the scholarly debate "(Martins, Seira, Leite Ferreira, and Li 2010, pp. 24).

Further, this section identifies and other fields which are related to TCA and reflect their importance. For example strategic alliances and networks (Ring and Van De Ven 1992; Parkhe 1993; Gulati 1995; Dyer and Singh 1998), transaction costs theory *per se* (Walker and Weber 1984; Williamson 1975, 1985, 1991), resource based view (Barney 1991), industrial organization (Porter 1980), organization theory broadly captured by Thompson 1967; Pfeffer and Salancik 1978; Nelson and Winter 1982; Granovetter 1985 and so forth.

All in all, the most cited works on TCA are Williamson's (1975) paper on "Markets and hierarchies, analysis and antitrust implications' and his 1985 book on "The economic institutions of capitalism" (see Figure 19 for more details). The work of Klein, Crawford and Alchian (1978) is also considered a seminal work on TCA, looking at the possibility of post-contractual opportunistic behavior as a cost of using the market system. Coase (1937) is often cited as the basis for the TCA, as well as Alchian & Demsetz's (1972) paper on the economic organizations.

Fig. 19 TCA Citation Map of the 20 Most Cited Articles



Source: Martins, Serra, Leite, Ferreira, Li (2010)

TCA through the above established theories of FDI poses the main research question: why economic transactions are organized in the way that they are in the modern society (Williamson, 1994). The general conclusion is that activities are internalized inside the firm when there is some form of market failure, and most notably market failure of intermediate inputs. TCA argues that there are costs to conduct transactions through the

market; these transaction costs can be reduced through mechanisms other than markets (Coase, 1937; Williamson, 1975). However, it is observed from 4.1 section that while internalization approach is also realized through market imperfections (vertical integration, transfer pricing and quality control) differs from the theory of TCA. So, it is important first to note that TCA and internalization theory are not exactly the same. Despite the fact that TCA comprises a major part of internalization theory, they face differences and similarities. This is based on the fact that:

On the one hand, both theories perceive the firm as a response to market "failure" and profit-seeking firms internalize operations when, by so doing, the costs of organizing and transacting business

will be lowered (Teece 1986, pp. 23; Madhok 1998). In other words, both internalization theory and TCA are predominantly concerned with the minimization of transaction costs and the conditions underlying market failure.

On the other hand, TCA differs from the internalization theory in many aspects. According to Teece (1986, pp. 23), "these two paradigms diverge, not in spirit, but in emphasis, when it comes to specifics." In a similar way, according to Hennart (2001, pp. 132), "some authors mistakenly believe that the transaction cost approach/internalization of the MNE originated with Williamson (1975)." In fact, TCA was independently developed by Buckley & Casson (1976) and Hennart (1977, 1982). Because these authors developed their theories relatively early, their transaction cost application differ significantly from that by Williamson (1985). Specifically, the concept of asset specificity, which plays a central role in Williamson's theory, is less central to why MNEs expand abroad (Hennart 2001). Put it differently, the primary difference is that the focus of internalization is on the market for knowhow, while that of TCA is on more microlevel transaction characteristics such as asset specificity (Teece 1986).

To this end, the basic idea behind TCA is that the market and the firm offer alternative ways to organize economic activities. The fundamental difference between them lies in their ability to control economic activities. Firm ought to be pure hierarchies, in which the owners should have the complete control over what their subordinates are doing and the competences they possess. Thus, control is an important part of TCA through which transaction costs attributable to bounded rationality and opportunism are supposed to be eliminated, or at least minimized. On the contrary, if the firm does not manage to control transaction costs in that sense, the whole idea behind the increased cost-efficiency collapses.

So, the main focus of TCA is the definition of the determinants of coordination of the transactions through markets or hierarchies (Joskow 1988). In this sense, the boundaries of the firm should be a function of the governance structure (Holmström and Roberts 1998; Williamson, 2002, 2005), especially when it is considered that this governance structure would assure the optimal adaptability of the firm to changes in the conditions of supply and demand. In this framework, TCA interprets and determines transaction costs on a broader basis and involves not only the two extremes of transaction governance (that is, hierarchy vs. market), but also on other hybrid forms and long term contracts.

Considering the above, Williamson develops his theory in a framework that is different from the

orthodox one,22 taking into account the following:

- (i) he examines economic organization through the lens of contract (rather than the orthodox lens of choice);
- (ii) he describes cognition in terms of bounded rationality, on the account of which all complex contracts are incomplete;
- (iii) he makes provision for strategic behavior when an outsourced good or service experiences disturbances for which the stakes are high;
- (iv) he treats adaptation as the main efficiency purpose of an economic organization; and, finally,
- (v) he distinguishes between investments in generic or specific assets, where a bilateral dependency relation between supplier and buyer stages is ascribed to the latter.

  What the argument comes down to is this: efficient intermediate product market exchange is usually well-served by simple market contracting if assets are generic; but the advantage shifts to hierarchy as bilateral dependency (and the resulting risk of costly maladaptations) builds up by reason of asset specificity and outlier disturbances (Williamson 2010).

In fact, the theory on transaction costs aims at the best possible economic organization. Economic organization is influenced by the sum of production costs and transaction costs. Transaction costs are not defined in detail by Williamson, but explained through their relation to the economic organization, and they focus on comparative costs "*by organizing with hierarchies, markets and hybrids*" (Williamson 1991, pp. 282).

Particularly, Williamson (1985, pp. 61) founded his theory on two behavioral prerequisites:

- First, *bounded rationality* is a prerequisite condition that attributes qualities such as the propensity to optimize to a limited number of different alternatives. Bounded rationality assumes more moderate qualities than the neo-classical agent, who is assumed to maximize based on a "superman" ability to assess all available alternatives. Therefore, individuals *do not maximize*, but only *optimize* with the information at their disposal. Indeed, Williamson (1997, pp. 22; 1998, pp. 30) argues that bounded rationality is *"the behavior that is intendedly rational, but only limitedly so"*. Consequently, one of the aim of this prerequisite condition is to consider man as he is in the real world and, ultimately, disregard the rational economic man prerequisite.
- Second, *opportunism* refers to a more sophisticated form of self-interest seeking, namely self-

[22] In his paper *The Vertical Integration of Production (2010): Market Failure Considerations*. American Economic Review, 61(2): 112–23.

interest seeking with guile."*Opportunism suggests calculating behavior",* and further on "*[opportunism] also suggests false or empty, that is, self-disbelieved threats or promises*," cutting corners for undisclosed personal advantage, covering up tracks, and the like (Williamson and Ouchi 1981, pp. 351). In other words, opportunism means the possibility of operators pursuing their own interests and goals "*with guile*", as suggested by Williamson via opportunistic behavior. However, Williamson does not assume that all operators will respond in an opportunistic manner. So, it is impossible to know in advance - *ex ante* – who is an opportunist – and who is not. This, in turn, leads to trust as a necessary means for any business relation.

Additionally, TCA argues that the presence of opportunism in itself is not a problem *per se*; however, the combination of opportunism and bounded rationality creates the need for elaborated contracts. Consequently, the basic idea of TCA is that of a situation in which individuals have the propensity to behave opportunistically and are characterized by bounded rationality. As a result, one of the tasks of this theory is to organize transactions that will economize bounded rationality, while also safeguarding those transactions against opportunism (Williamson and Ouchi 1981).

Consequently, the primary goal is to make enterprises realize that all decisions – both internal and external ones – are subject to consequences of such behavioral prerequisites. Even though Williamson has been criticized for his assumption about opportunism with agents/intermediaries, since not everyone is necessarily equally opportunistic, this does not detract from the true value of the theory, since there will always be some risk of opportunistic behavior.

The two main prerequisites presented above are important contextual factors but they do not themselves imply why MNEs may select vertical integration, because these prerequisites are constant characteristics of any given society. TCA, then, also deals with other important issues besides behavioral prerequisites.

To start with, Williamson, influenced by the theorist Chester Barnard and the economist Friedrich Hayek,[23] considers *adaptation* to be the main purpose of economic organization, but with some differences. Williamson has found little in social sciences ("*The Functions of the Executive*"

[23] Chester Barnard who was an organization theorist rather than an economist, regarded adaptation as the central problem of organization. Barnard featured coordinated adaptation among economic actors working through administration. In his view, the marvel of hierarchy is that coordinated adaptation is accomplished not spontaneously but in a "conscious, deliberate, purposeful" way through administration (1938, p. 4). But while Barnard and Hayek were in agreement on the importance of adaptation, Hayek focused on the adaptations of autonomous economic actors who adjusted spontaneously to changes in the market, mainly as signaled by changes in relative prices. An illustrative recent example is the increase in the demand for fossil fuels that caused gasoline prices to rise sharply in 2008. As a result, automobile firms adapted their strategies to invest in alternative energy vehicles and create new products, which in turn will affect the demand for fuel.

(Barnard 1938) and the "Marvel of the Market" (Hayek 1945, pp. 527)) that informed the study of internal organization (hierarchy) as he has experienced it, and he makes selective provision for each. So, rather than be "trapped" in the old ideological concepts he prefers to divide markets between or hierarchies, formulating a theory, which treats the two, *markets and hierarchies*, as alternative modes of governance, both of which have distinctive roles to play in a soundly-working economy. Thus, a split is suggested for below-management mechanisms relating to business relations and their ever-changing nature: "*Market, trilateral, bilateral, or unified governance"* (Williamson 1985, pp. 79).

Moreover, Williamson moves much further and delimits alternative choices in a contract framework. A contract is not defined as legal rules (with court enforcement); however, a contract is approached as an implementation by private ordering. In particular,

> the major importance of a legal contract is to provide a framework which almost never accurately indicates real working relations, but which affords a rough indication around which such relations vary, an occasional guide in cases of doubt, and a norm of ultimate appeal when relations cease, in fact, to work (Llewellyn 1931, pp. 736–737).

This last condition is important, in that recourse to the courts for purposes of ultimate appeal serves to delimit threat positions. Nevertheless, this more elastic concept of contract as framework supports a (cooperative) exchange relationship over a wider range of contractual disturbances than a strictly legal rule construct would.

Williamson does not, however, restrict himself to mere theoretical meanings, but develops his analysis by integrating its operational dimension, i.e., by operationally defining (1981;1985) the unit of analysis, the modes of governance and how they differ in contract legislation, before presenting their efficient alignment.

The unit of analysis in the transaction cost economics set-up is the transaction - as recommended by Commons (1932) and as is implicit in Coase (1937; 1960). For transaction cost economizing purposes, the critical dimensions of transactions are: *complexity*, *the condition of asset specificity, frequency, and the disturbances* which a transaction is subject to. Williamson (1985; Williamson and Ouchi 1981), however, suggests that the frequency of interaction is also an important factor of transaction costs; but, particularly, in entry mode studies, transactions are considered to be continuous, thus precluding the need for a separate measure of frequency (e.g., Eramilli and Rao 1993; Brouthers and Brouthers 2003). Of these three the attributes of transactions that have been most important to understanding the governance of contractual relations are the conditions of asset specificity and outlier disturbances for which unplanned adaptations are needed, however this thesis is going to define the concept of frequency in order to provide a holistic perspective of TCA.

Particularly, **asset specificity** refers to physical, human, site specific, dedicated, brand name

capital, and episodic (or temporal) forms. What is relevant in this connection is that different types of hazards accrue to different forms of asset specificity and their variations have significant organizational ramifications. Whatever the particulars, the basic regularity associated with transactions supported by investments in specific assets is that these assets cannot be redeployed to alternative uses or to users without loss of productive value (Williamson 1971, 1975, 1976, 1985; Benjamin, Crawford, and Alchian 1978).

Uncertainty is a straightforward assumption and it contrasts with the perfect-information assumption of the neoclassical view. Information about past, current and future states is not perfectly known, for various reasons. Without the existence of bounded rationality and opportunism, uncertainty would be much less of a problem, because general rules would generally prevail (Williamson, 1985). However, given these assumptions uncertainty is especially critical. Uncertainty arises from, for example, not knowing about future states or/and the inability to determine who is more prone to behave opportunistically (Williamson, 1993b). Because it is very difficult to determine *ex ante* who will engage in opportunistic behavior, contracts are not costlessly written and enforced (Williamson, 1993b).

Frequency of transactions. If transactions are infrequent then the costs of alternative governance structures may not be justified. A larger frequency or larger volumes of transactions, however, gives rise to justification for alternative governance structures such as the firm. Therefore, the volume, number, and/or temporal spread of transactions are important to be considered because even given the previous assumptions if they are infrequent alternative governance structures may not be necessary or feasible. The degree of frequency ranges from occasional to recurrent (Williamson 1979, 1985).

In sum, Williamson (1975) identifies three determinants of the transaction costs: (a) agents' bounded rationality, that originates from incomplete contracts, due to the impossibility of foreseeing in the contracting moment, all future situations; (b) opportunism that is originated from one of the partners pursues his own short-term self-interest; and (c) asset specificity, that originates from that the owners of production factors will incur costs if they deviate assets to another use, and this leads to the conclusion that the best use is improved by internalization. So, internalization will be preferred to externalization if three conditions are verified: (1) the degree of the transaction uncertainty is high - that is, if it's difficult to guarantee the execution of the contract - the supplier may have an opportunistic behavior that impairs the customers; (2) if assets involved in the transaction are specific - if just a restricted number of suppliers possess the necessary equipment to the accomplishment of the activity, their bargaining power increases - affect negatively the price of the transaction; (3) if the

transaction is recurrent, that is, if the firm has to buy regularly large quantities of the product to the suppliers, these will be able to demand better conditions.

However, TCA may well be important, but it has received strong criticism. More specifically, critics to TCA have relied on many facets and reasons albeit the relative merits of those critics are arguably. The most common criticism is that the central assumptions of TCA are flawed. For example, the assumption of opportunism has been criticized for ignoring the contextual grounding of human actions, and therefore, presenting an undersocialized view of human motivation and oversocialized view of institutional control (Granovetter 1985). Williamson has responded to such criticisms by re-stating that in his model, opportunism or bounded rationality may differ from person to person much as personality or intelligence do, but when transaction costs change they do so because of changes in the environment, not in the person (Williamson, 1993a,b).

Jones (1998) took an interactionist perspective rather than a dispositional one, to argue that opportunism may be perceived as both a disposition and a psychological state produced by the interaction of personal and situational factors. Alchian and Woodward (1988) offered a refinement of the opportunism assumption in arguing that two types of opportunism should be more clearly identified - moral hazard and holdup - and that this distinction helps the theory better explain organization phenomena.

Moreover, Ghoshal and Moran (1996) have attacked the validity of TCA on the grounds that the opportunism with guile is bad for practice. TCA is normative or prescriptive theory and if opportunism with guile assumption is taken seriously by managers there will be negative consequences for organizations. Application of TCA will increase the occurrence of opportunism rather than decreasing it. Ghoshal and Moran (1996) also have criticized TCA for failing to point out how opportunism is reduced through alternative governance structures. Jones has argued that the problem with TCA is Williamson's description of the determinants of opportunism; and that there is a difference between the propensity to behave opportunistically (a behavioral trait) and the psychological state of opportunism. The same uncertainty condition that may lead some individuals to behave opportunistically it may lead others to trust. Under certain circumstances trust or cooperation may be the most rational and efficient self-interested behavior. The propensity to trust or opportunism as a state is a much more realistic assumption about human behavior given uncertainty (Jones, 1998).

However, Jones (1998) has adopted a positive or entrepreneurial view and argued that bounded rationality and uncertainty are not problems to be managed and overcome, but rather are opportunities to be taken advantage of. Jones (1998: 42) has stated that "[t]he advantages of organizations over markets may lie in leveraging the human ability to take the initiative, to cooperate and to learn; it may

also rely on exploiting the organization's internalized purpose and diversity to enhance both learning and its use in creating innovations and purposive adaptation".

The TCA has been further criticized as only looking into two relative extremes methods of facilitating transactions that do not really exist. The critics argued that the market versus hierarchy dichotomy is somewhat misleading since many transactions are actually carried out through a hybrid governance form (e.g., Hennart, 1993). Refuting, Williamson (1985) has stated that the distributions of transactions would be a "bell-shaped" normal distribution if discrete transaction would be located at the one extreme (market), highly centralized and hierarchical transactions on the other, and hybrid transactions (franchising, joint ventures, and other forms of nonstandard contracting) in between.

In addition, a major critic to TCA is its tautological nature. Eccles (1987) has claimed that Williamson failed to operationalize the measurements of transaction costs and there is a tautological flavor in his arguments. Eccles (1987, pp. 604) has argued that "ex-post arguments can usually be found that any given structure economized on transaction costs by simply defining these costs in a necessary way. When this can not be done, the argument can be made that the existing structure is a "mistake" and will eventually be replaced by one that does economize on these costs". The simple comparison of transaction costs under different governance structure is meaningless, because the governance structure used to manage a transaction changes the nature of a transaction (Dow 1987).

In a similar way, Jones (1998) has also noted that transaction costs appear on both the left and the right hand sides of the causality equation, which is one of the typical attributes of tautologies. Although Williamson has distinguished *ex ante* costs (such as negotiation costs) from *ex post* costs (such as costs associated with contractual failures), it is hard to find any costs that are not transaction costs. Methodologically, case studies have been the prevalent means of assessing TCA because the main variables of interest to TCA researchers, specifically asset specificity, uncertainty, frequency - are difficult to measure consistently across firms and industries (Klein and Shelanski 1994).

Lastly, TCA has been criticized for failing to explain the alternative forms of organization and a lot of other organizational phenomena. However, TCA does not claim itself as panacea for everything; it only attempts to explain a portion of the organizational phenomena: why and under what conditions transactions are organized in certain ways (Coase 1937; Williamson 1979). At best, TCA deals with relative efficiency question. Therefore, while deserving a prominent place among the theories in organization, TCA can and should not be used exclusively to explain organization phenomena.

4.5 The Eclectic Paradigm-"OLI"

The "eclectic" or "OLI" paradigm was developed by John Dunning in a series of publications (1977, 1980, 1981, 1993, 1994, etc.). The goal of this conceptual framework is to study FDI determinants through a "generic" (as Dunning characterized it 1994, p. 265) framework in order

"to offer a general framework for determining the extent and pattern of both foreign-owned production undertaken by a country's own enterprises and also that of domestic production owned by foreign enterprises. Unlike internalization theory, it is not a theory of the MNE *per se*, but rather of the activities of enterprises engaging in cross-border value-adding activities. Neither is it a theory of FDI, in the Aliber sense of the word, as it is concerned with the foreign-owned output of firms rather than the way output is financed" (Dunning 1993, pp. 76).

On the contrary, according to Dunning (1993, pp. 76), the eclectic paradigm describes a conceptual framework for explaining "what is" rather than "what should be" the level and the structure of foreign value activities of enterprises. Particularly, the eclectic framework stands at the intersection between a macro-economic theory of international trade and a micro-economic theory of the firm. In other words, it is an exercise in macro resource allocation and organizational economics.

The basic assumption of the eclectic paradigm is based on two kinds of market **imperfections**, in order to explain the spatial distribution of some kinds of output (which might be termed, according to Dunning 1993, pp. 76, Heckscher-Ohlin-Samuelson output). "The first [one] is that of structural market failure which discriminates between firms (or owners of corporate assets) in their ability to gain and sustain control over property rights or to govern multiple and geographically dispersed value-added activities. And, the second [one] is that of the failure of intermediate product markets transact goods and services at a lower cost than those which a hierarchy might have to incur" (Dunning 1993, pp. 76).

In that way, Dunning (1993, pp. 76) recognizes that the firm is no longer a "black box" neither are markets the sole "arbiters" of transactions. Instead, he asserts that firms differ in organizational forms, systems, innovatory abilities, attitude to commercial risks, etc, and therefore, what is needed to explain firms' attitudes is a holistic approach based on the combination of country and firm specific characteristics.

The principal hypothesis of the eclectic paradigm is based on the premise that the level and structure of a firm's foreign value-adding activities depend on the following three conditions:

(1) The firm possess ownership advantages "O", which indicate who is going to produce abroad (Dunning 1993, pp.142). In this case, "O" advantages take the form of the privileged possession of intangible assets, which are, at least for a period of time exclusive in the firm. Moreover, these advantages arise from the common governance of cross-border value-added activities. So, the extent to

which firm possess these ownership specific advantages *vis-à-vis* firms of other nationalities in the particular market locational determine the extent of the wealth capacity of a firm, and hence, the value of its assets (Dunning 1977, 1994).

Assuming that condition (1) is satisfied, then it must be more beneficial to the enterprise possessing these advantages to use them itself (internal) rather than to sell or lease them in foreign markets, and these advantages are called internalization advantages (I). In other words, this means that is more profitable for the firm to internalize its advantages through an extension of its own activities rather than externalize them through licensing and similar contracts (Dunning 1977, 1994).

And lastly, assuming that conditions (1) and (2) are satisfied, it must be profitable for the enterprise to utilize "O" specific advantages in conjunction with at least some factor inputs, the distribution of which is assumed to be uneven in order to produce locational advantages (L) to the countries possessing them over those who do not (Dunning 1977, 1994). Otherwise, foreign markets would be served entirely by exports and domestic markets by domestic production (Dunning 1977, p. 275).

In other words, the above configuration means that the greater the ownership advantages (Hirsch 1976, as cited in Dunning 1977, pp. 275) a firm has, the more incentive is for the firm to utilize them internal (internalization advantages), and the more incentive is for the firm to exploit them from a foreign location (country) (location advantages). In this framework, the eclectic paradigm suggests that all forms of international production can be explained by reference to the above conditions. It makes no *a priori* prediction about which countries, industries, firms, are most likely to engage in FDI. On the contrary, it hypothesizes that at least, some of the advantages will not evenly spread across countries, industries and enterprises and it accepts that such advantages may change over time (Dunning 1979).

> [Further], [t]he eclectic paradigm asserts that the precise configuration of the OLI parameters facing any particular firm, and the response of the firm to that configuration, is strongly contextual. In particular, it will reflect the economic and political features of the country or region of the investing firms, and of the country or region in which they are seeking to invest; the industry and the nature of the value added activity in which the firms are engaged; the characteristics of the individual investing firms, including their objectives and strategies in pursuing these objectives; and the raison d'être for the FDI (Dunning 2000, pp. 164).

All in all, combining the three above conditions, the conclusion that can be drawn is based specifically on the development of competitive advantages, which are derived from the fact that firms differ in organizational systems, innovatory abilities, their attitude to commercial risks, and finally to their strategic response to these and (other variables) (Dunning 1994, pp. 76). The firm reflects the most important and efficient choice among other alternative choices, such as licensing, international

trade, etc. since firm combines the ability to increase specific ownership advantages, to internalize markets, and lastly, to choose foreign locations according to the extent that enterprise's global interests are served by creating or utilizing its "O" advantages.

Therefore, changes in the position of a country can be interpreted through changes in the kind of the specific advantages of the firm, the nature of the "O" advantages which favor the organization of internal markets, and lastly, through changes in the supply of inputs from foreign countries; both of them are advantages which differ in endowment and country level (Kyrkilis 2002, pp. 82).

However, OLI paradigm has accepted many and various criticisms. "It is accepted that, precisely because of its generality, the eclectic paradigm has only limited power to explain or predict particular kinds of international production; and even less, the behavior of individual enterprises" (Dunning 1988, pp. 1). In a similar way, "a crucial question relates to its applicability to the individual firm. Dunning (1988) argues that the paradigm has little predictive power for individual firms, while Dunning (1995) refers to the individual firm as the unit of analysis" (Pedersen 2003, pp. 10).

Moreover, the paradigm has been criticized for its broad and loose structure. One issue has been whether an approach which lumps evidence for O, L and I-advantages can be operational. O, L and I represent *necessary*, not sufficient conditions for FDI. How many competencies a firm had to possess in order for O to be just "necessary" was unclear, however, as was the level of significance required for I-advantages to warrant an FDI.

Moreover, another criticism is directed toward the three kinds of advantages: are they independent and are they necessary? Rugman (1981) has found that, from an epistemological point of view, the border between O- and I-advantages are severely blurred. Casson (1987) has argued that market failure in intermediate product markets is a necessary as well as sufficient condition for the existence of MNEs. However, Dunning (1988) was unable to entirely refute the argumentation and ends up agreeing in part with Rugman that O- and I-advantages have a tendency to become inseparable.

Later Itaki (1991) took up the point and, after a penetrating and logical tour-de-force, concluded that O-advantages are redundant in the sense that they can logically be classified as internationalization advantages that have (been) developed over time.

Despite the strong criticism, the eclectic paradigm has proved an extremely fruitful way of thinking about MNEs and has inspired a great deal of applied work in economics and IB literature. It provides a helpful framework for categorizing much (though not all) recent analytical and empirical research on FDI and offers a comprehensive framework to investigate the significance of factors influencing both the initial expansion of multinational enterprises (MNEs) by foreign production and the subsequent growth of their activities (Dunning and Robson 1987, pp. 1; Tolentino 2001, pp. 191).

Further, the OLI paradigm facilitates the comparison between different theories by establishing a common ground between various approaches and by clarifying the specific questions theorists have posed, as well as the the different levels of analysis (Cantwell and Narula 2001).

4.6 Transaction Cost Approach as a General Theory

Having reviewed briefly the theory of FDI determinants and having evaluated the merit of each theory separately, this section concludes that TCA through internalization theory and the eclectic paradigm provide the cornerstones for the current theory of the MNE (Verbeke 2009), since these two theories provide the intellectual foundations for the rigorous theoretical and empirical analysis which characterizes research on MNEs at what has become known as the "Reading School" of international business (Rugman 2009). However, between these two prominent theories, this thesis chooses TCA as the appropriate theory able to accommodate FDI equity mode, and specifically, to analyze how entry mode choice (wholly owned subsidiary as opposed to JV subsidiary and its different forms– minority, co-ownership and majority JV) is affected by different forms of distance through the implementation of the "CAGE Distance framework", for the reasons that are listed below.

Firstly, in contrast to the eclectic paradigm TCA is mainly applied (see indicative Kogut and Singh 1988; Anderson and Gatignon 1986; Zejan 1990; Hennart 1991; Padmanabhan and Cho 1995; Shelanski and Klein 1995;, Hennart and Reddy 1997; Erramili, Agarwal, and Kim 1997; Delios and Beamish 1999; Brouthers and Brouthers 2000; Meyer 2001; Brouthers 2002; Yiu and Makino 2002; Rugman and Verbeke 2005; Demrbag, Glaister, and Tatoglou 2007; Brouthers and Nakos 2010, etc) to explain the choice of entry mode strategy.

"Using Dunning's own reasoning, it is apparent that there is a close linkage between O and I [which are used specifically in TCA] in that a knowledge-type O advantage needs to be internalized. As will be shown below, this process is best analyzed by transaction cost analysis at the firm level. In contrast, L advantages can be fully explained by country-level analysis (Rugman 2010, pp. 2).

More specific, within internalization theory the MNE can choose to expand abroad either through FDI (retaining knowledge-based firm specific advantages), or it can choose another form of entry, such as licensing, joint ventures, or alliances (all of which lead to potential dissipation of the knowledge of the MNE). The relative costs and benefits of the choice of entry mode will vary over time, potentially leading the MNE to sequence foreign entry through firm specific advantages control mechanisms, such as exporting and FDI, to be followed later by more risky modes, such as alliances, joint ventures, and licensing. In short, internalization theory explores the hazards of doing business abroad across different

entry modes, where the firm specific advantages of the MNE need to be offset against both dissipation risks and the liability of foreignness in entering into risky foreign markets (Rugman and Verbeke 2003).

On the contrary, the treatment of location advantages and the choice of entry mode in the eclectic paradigm is much broader than in TCA. The eclectic paradigm examines the interactions between "O", "L", and "I" at industry level. In this way, it is much closer to conventional international economics than the resource-based view approach of internalization theory. For example, the asset-seeking motive for FDI advanced by Dunning confuses the desire of a home country firm to seek knowledge with the locational availability of such knowledge in a host country. This type of confusion comes from an approach which ignores the critical role of the firm in generating and controlling knowledge. Using the logic of internalization theory, it would be extremely rare for asset-seeking FDI to exist. No firm in the knowledge-intensive country would have an advantage in dissipating its knowledge-based FSA (firm specific advantages) to a potential rival asset-seeking firm (Rugman 2010).This means that,

"home country MNEs (today mainly from emerging economies) go to a host country in the hope of acquiring knowledge-related assets. Of course, such asset-seeking FDI is only half the story. While emerging economy MNEs may want to acquire knowledge, there is no reason to believe that firms in the host countries will want to sell it to them. Therefore, asset-seeking FDI is a weak form of FDI; it is only a partial explanation, since the completion of this strategy lies outside of the control of the home country firm. Even if home country firms attempt non-equity types of FDI, such as joint ventures or collaborative alliances, it is difficult to believe that knowledge is actually being transferred to them in a dynamic sense. For example, Lenovo's acquisition of the IBM PC division, while potentially an asset-seeking FDI, may well not lead to future knowledge generation by Lenovo. Similarly, takeovers of creative service firms are unlikely to lead to ongoing knowledge generation (Rugman and Doh 2008, pp. 235).

Secondly, one of the problems with Dunning's eclectic paradigm is that "it is too eclectic" (Rugman 2010, pp. 2). Indeed, in many ways, each of the three motives for FDI is overdetermined. This is especially true for "O" advantages. According to Dunning (1994), these include not only the firm's intangible assets, such as knowledge, brands, organizational structure, and management skills, but also natural factor endowments; manpower; capital; the cultural, legal and institutional environment; and industry market structure. Obviously, the latter set of O advantages is easier to be analyzed as country factors.

Thirdly, in a similar manner, Dunning and Lundan (2008) have a very broad definition of location (L) advantages, including country specific factors, such as labor force market size, natural resources, market size, aspects of the infrastructure, the education system, governance structures, aspects of political and government activity, and other environmental factors, including culture. This distinction is blurred raising doubts about the specific classification of the above advantages. In that concept and given that firms can influence governments to obtain shelter-type "O" advantages, the distinction

between L and O advantages is difficult to make. For example, when Dunning describes an MNE which has access to natural resources (ownership of an oil well, a forest, or a mine), he first classifies natural resources as host country L advantage, whereas later, without explicit explanation, he classifies them as O advantages.

Fourthly, contrary to the firm-level analysis at the core of TCA, the eclectic paradigm is more of an industry-level analysis. The configuration of O, L, and I advantages serves to explain outward FDI and, although this has firm-level implications, it has been mainly tested at industry level (Dunning 1992). Furthermore, the extension of the eclectic theory to explain economic development in the investment development path offers industry-level analysis to explain the expansion patterns of industries and countries (Dunning and Narula 1996). Therefore, the essence of the eclectic theory is that the O, L, and I advantages interact to produce a rich and holistic (almost co-evolutionary), however only descriptive, explanation of the patterns of overseas FDI at industry level.

On the contrary, TCA has a narrower and more parsimonious focus on the intangible knowledge advantages of MNEs. Particularly, TCA is a firm-level explanation of FDI, which is able to focus on the strategic decision-making of the MNE and also able to demonstrate the heterogeneity of firm-level behavior within any industry, since it connects firm specific characteristics mechanisms with the environmental factor. As a result, Rugman (1981) has argued that the two key determinants of FDI, according to internalization theory, are country-based factors, called country specific advantages (CSAs), and firm-level factors, called firm specific advantages (FSAs).

Fifthly, TCA is also explained by the fact that "any issue arising can be reformulated as a contracting problem and can be usefully examined through the lens of transaction cost economizing perspective" (Williamson 1998). Taking into consideration the above and within the ambit of issues to which transaction cost economics are related, TCA has greater application value in some areas such as entry mode strategy than in others such as development path. Transaction cost economics, therefore, has a place alongside other – partly rival, partly complementary –perspectives on the theory of firm and market organization. Jon Elster's *dictum* that "explanations in the social- economic sciences should be organized around partial *mechanisms* rather than general *theories"* (1994, pp. 74) (emphasis in original) is one to which transaction cost economics subscribe.

And lastly, TCA is explained by the fact that transaction cost analysis is the product of two recent and complementary fields of economic research: "New Economics of Organization and New Institutional Economics" (Williamson 1998, pp. 23).

On the one hand, new economics of organization from its origins as a theoretical construct devised to examine relations within the firm (Moe 1984). Particularly, new economics of organization

"is characterized by three elements: a contractual perspective on organizational relationships, a theoretical focus on hierarchical control, and lastly, a formal analysis via principal-agent models" (Moe 1984, pp. 739). This means that the principal–agent model examines the difficulties that arise from contracting in any setting. Agency relationships are created when one party, the principal, enters into a contractual agreement with a second party, the agent, and delegates to the latter responsibility for carrying out a function or set of tasks on the principal's behalf. The principal can be any individual or organization that delegates responsibility to another in order to economize on transactions costs, pursue goals that would otherwise be too costly, or secure expertise.

This approach "assumes away all organizational considerations, to a theory of economic organizations that can explain why firms, corporations, and other enterprises behave like they do" (Moe 1984, pp. 739). This is a less unified neoclassical theory than a large family of diverse theories related by shared analytical foundations, chief among them: a focus on the individual as a unit of analysis, the assumption of rational, utility-maximizing behavior, a concern for efficiency, and optimality. The origins and basic themes have been shaped most fundamentally by Coase (1937), Simon (1979) and Alchian (1950).

On the other hand, the theory of New Institutional Economics comes in two parts. Part one deals with the institutional environment – the rules of the game – and traces its origins also to Ronald Coase's (1960) paper on "*The Problem of Social Cost*". Part two deals with the institutions of governance – the play of the game – and originates from Coase's (1937) paper on "*The Nature of the Firm*".24 So, the theory of New Institutional Economics focuses mainly on the formal rules and regulations (Williamson 2000) and how these rules and regulations affect the choice of governance arrangements, through how economic activity is organized. Norms and customs are treated largely as givens (Williamson 2000), and individuals are assumed to create and shape institutions relatively independently of cultural preferences (Mayhew 1989). Thus, from the perspective of New Institutional Economics, institutions affect which governance arrangements are most efficient, but they have little impact on how the game is played other than through the establishment of rules and regulations.

So, working on both of these areas, TCA began to take shape in a concerted way in the 1970s and has grown exponentially as a key conceptual move, which aim is to push beyond the theory of the firm as a production function, which perceives the firm from a technological construction, into a theory

[24] Both parts got underway in the early 1970s Davis and North (1971), Williamson (1971), and Alchian and Demsetz (1972) and progressively took shape over the last decade North (1981), Williamson (1975, 1976, 1979), Klein, Crawford, and Alchian (1978). "Exponential growth occurred in the 1980s and has continued ever since. Two Nobel Prizes – one to Ronald Coase in 1991 and the other to Douglass North in 1994 – celebrate its influence" (Williamson 1998, pp. 24).

of the firm as a governance structure, which perceives the firm from an organizational construction.

In that framework, it has been shown that TCA, which is a refinement of the market imperfections approach, transaction costs, environmental factors, institutional environment, and governance structures, may be applied as a general theory (according to Rugman (1985) terminology) for the purposes of the present thesis. TCA is able to examine firms' choices, and namely, those regarding where to set the boundaries of the firms or choices regarding what they do and what they do not. The essence is that it does have the ability to formulate transaction costs, but also the potential to connect firm specific mechanisms with institutional factors, particularly, concerning market selection.

4.7 New Institutional Economics and Transaction Cost Approach: A Synthesis

In light of the above and recognizing the inherent connection between TCA and New Institutional Economics and the necessity to reconcile them; this thesis asserts that from the perspective of New Institutional Economics and TCA, institutions matter because host countries' institutional environment have a significant impact on the costs and uncertainty MNEs face when setting up local operations, and on their access to local resources. Strong and stable host-country institutions lower transaction costs and the level of policy uncertainty (Deliosand Henisz 2003, Henisz 2000, Meyer 2001), and they contribute to efficient markets for local resources (Khanna et al 2005; Meyer et al 2009). Therefore, the quality of the institutional environment affects not only the performance of local investments (Trevino and Mixon 2004; Wan and Hoskisson 2003), but also the appropriateness of alternative governance forms. For example, MNEs are more likely to enter through wholly owned subsidiaries in host countries with developed institutions than in countries with less developed institutions (Henisz 2000; Meyer 2001; Meyer et al 2009). In addition, developed institutions reduce the risks and complexities of acquisitions (Dikova and Van Witteloostuijin 2007), and allow entrants to devote less effort to understanding the policy environment (Delios and Henisz 2003).

International Business scholars' increasing interest in institutions coincides with the rise of several key emerging markets, such as India, Turkey, and China, which offer new opportunities to extend our understanding of how institutions matter (Meyer and Peng 2005) and has "pushed the institution-based view to the cutting edge of strategy research" (Peng et al 2008, 923). The rise of large emerging economies also gives rise to new questions. For instance, an increasing amount of attention is being paid to how firms can overcome the absence of a strong institutional framework and the lack of intermediaries, known as "institutional voids", in emerging economies (e.g. Chakrabarty 2009; Khanna et al 2005; Mair and Marti 2009). Variation in the ability of MNEs to manage such institutional

idiosyncrasies may explain why foreign affiliates' performance in developing market economies varies widely (Henisz 2003; Chan et al 2008).

In addition, a growing stream of literature seeks to explain the internationalization of MNEs from emerging economies, especially the ways in which such MNEs may internationalize despite the disadvantages of coming from countries with weak institutions and inefficient market mechanisms (Aulakh 2007; Child and Rodrigues 2005; Luo and Tung 2007). While these MNEs lack more sophisticated strategic resources, which may necessitate the acquisition of such assets from more mature MNEs (Luo and Tung 2007), their ability to operate in difficult institutional environments also gives emerging-market MNEs a relative advantage when entering other less developed market economies (e.g. Cuervo-Cazurra and Genc 2008).

New Institutional Economics is strongly rooted in microeconomics and its arguments have been widely applied in studies of economic history (e.g. North 1990, 1991), in game theoretic approaches to the formation of, and, changes in macroeconomic institutions (Aoki 2001). New Institutional Economics thought is also evident in the subfields of international business in which the effectiveness of country-level institutions is paramount.

The origins of the theory of New Institutional Economics is based at the beginning of the twentieth century and, in particular, during the interwar period, where a group of economists rebelled against the neoclassical view of the economy as a relatively closed model. The central principle of what became known as Institutional Economics was that because the institutional features of societies (including individual preferences) are interdependent, and, subsequently, analyses should take into account the dynamics of the entire social system (Mydral 1978). As indicated by Veblen's (1909, pp. 626, as cited in Hotho and Pedersen 2012, pp. 239) definition of institutions as “settled habits of thought”, institutional economists recognized that institutions and their interdependencies are closely interviewed with habits and cultures (Hodgson 2006). However, this recognition also severely complicated by their institutional analyses. Such analyses tended to result in “tentative generalizations and mere plausible hypotheses” (Myrdal 1978, pp. 775) which appeared to contribute little to theory formation (Coase 1998). After the Second World War, the role of Institutional Economics was, therefore, largely marginalized in favor of neoclassical economics (Hodgson 2007; Lowndes 1996).

Widespread appreciation for the role of institutions in economics returned in the 1970s and 1980s, most notably through the work of Douglass North (1990, 1991) and Williamson (1975). The renewed interest in institutions was largely a reaction to the neoclassical view of markets as frictionless allocation mechanisms driven by national agents with perfect information (Ménard and Shirley 2005; North 1991). In that framework, New Institutional Economics suggests that the nature of exchange

processes and the amount of "friction" are dependent on the institutional context in which they take place. For example, the extent to which the institutional environment guarantees property rights and facilitates the enforcement of contracts affects the level of transaction costs (Coase 1937; Williamson 1975).

Furthermore, institutionalized rules and regulations "dictate the margins at which organizations operate" (North 1990, pp. 110) or the boundaries of tolerated behavior, particularly with regard to competition, collaboration, and corruption. Rules and regulations, therefore, affect whether the behavior of an organization has negative or beneficial effects on an economy's overall productivity. Subsequently, in New Institutional Economics, the **effectiveness and quality of the institutional** framework is believed to have an direct bearing **(legitimacy)** on the functioning and form of markets and organizations, and on economics performance.

In other words, in New Institutional Economics institutions reflect the rules of the game in a society, or more formally are the devised constraints that shape human interaction (North 1990, 3). In that perspective, the theory of New Institutional Economics focuses mostly on formal rules and regulations (Williamson 2000) and how these rules and regulations affect the choice of governance arrangements through which economic activity is organized. Thus, an important distinction between Old Institutional Economics and New Institutional Economics is that the latter largely view institutions as constraints, rather than conditions of individual choice. Norms and customs are treated largely as givens (Williamson 2000), and individuals are assumed to create and shape institutions relatively independently of cultural preferences (Mayhew 1989). Thus, from the perspective of New Institutional Economics, institutions affect which governance arrangements are most efficient to entail legitimacy to MNE, but they have little impact on how the game is played other than through the establishment of rules and regulations.

In line with the focus of New Institutional Economics on institutional effectiveness and the entailing legitimacy, measures of institutional distance that build on a New Institutional Economics typically capture the quality, strength or level of development the institutional framework. In that framework, the applications of New Institutional Economics in IB research generally conceptualize institutions on the country level (e.g. rules and regulations). Such institutions are believed to affect transaction costs and to constrain the actions of actors in the pursuit of their interests. However, they are assumed to have no or little impact on the interests that actors pursue or in the preferences of actors other than what the rules of the game exclude. For example as Aguilera and Jackson (2003) note, agency approaches to comparative corporate governance tend successfully to characterize different governance mechanisms, but they provide little or no explanation for the observed differences in

governance.

Furthermore, institutions and their effects are implicitly assumed to be relatively unrelated rather than interdependent. This has translated into what Jackson and Deeg (2008b) term a variable-based approach to institutions, in which institutions are conceived of as factors that independently constrain or impact... the cost of IB activity' (Jackson and Deeg 2008b, 542). Recently, fuzzy analyses highlight the danger of this approach. For example, Pajunen (2008) illustrates that the mere presence or absence of a single institutional factor may have little impact on the perceived costs of operation and, hence, on the attractiveness of a location. Similarly, Schneider et al (2010) illustrates that the single institutional characteristics do not sufficiently explain export performance in high-tech industries.

This thesis framing TCA and New Institutional Economics, it goes one step further by applying two innovations. First, it applies New Institutional Economics through Scott's (1995) three institutional aspects- regulative, normative, and cognitive- in order to provide an envelop analysis, and secondly, it sheds light on the overlap between normative and cognitive aspects.This approach draws its theoretical logic on the following reasons:

Firstly, transaction costs and institutional environment theories (New Institutional Economics, New Organizational Institutionalism, and Comparative Institutionalism) of FDI entry modes differ in terms of the logic underlying each approach. While the transaction cost theory focuses on efficiency, the institutional theory uses different conceptions to approach the notion of institutions and their effects. These differ, for instance, in whether institutions are primarily perceived as regulative, normative, or cultural-cognitive systems, as well as in the level of analysis (Scott 1995). Despite the fact that some of the above institutional conceptualizations have attempted to integrate both theories (Williamson 1991), these efforts have remained limited due to the integration of only the regulative environment, while some of the normative and cognitive dimensions of institutional theory have not been used by transaction cost theorists (Yiu and Makino 2002).

Secondly, different markets are endowed with different levels of resources and institutions of varying effectiveness. Particularly, in emerging market economies, institutions and institutional factors are particularly important because institutional immaturity raises transaction costs and risk level (Child, Chung, and Davies 2003; Meyer 2001, 2004; Meyer and Peng 2005; Uhlenbruck 2004). Especially for the case of Turkey, institutions have played a major role in the recent phase of neo-liberal restructuring of Turkey, following the crisis of February 2001. Turkey was a typical paradigm of institutional inefficiency, due to the lack of a planned coordination by officials, for convergence of political and bureaucratic will, as well as due to the lack of domestic societal mobilization for institutional reforms in the direction of strengthening state capacity in Turkey.

In that framework, for the period 1990- 2002, Turkey has faced a "rhetorical" and "institutional crisis" (Onis and Bakir 2007)."Rhetorical transition" refers to the fact that regulatory institutions were set up during this period. However, the emergence of such institutions as legal entities failed to be translated into effective implementation. As a consequence, the Turkish state faced an "institutional crisis" in which the opening up of the economy was not complemented by a parallel development in the state's institutional capacities to undertake effective regulation. So, the Turkish institutional context did not effectively respond to the need for sound institutions, which subsequently facilitated a worse business environment (not facilitating transactions) for the business and organizations alike.

However, for the period 2002-2010 the Turkish institutional environment has benefited significantly from the presence of a double external anchor, with both the International Monetary Fund (IMF) and the European Union (EU) playing significant and complementary roles in the recent transformation process. Especially, the EU has been an important catalyst for change in the political and economic realms. The significance of the EU's influence increased considerably following the decision at the EU's Helsinki Summit in December 1999 to grant Turkey formal candidate status. As a result of the Helsinki decision, the key political and economic actors faced a more powerful set of incentives for change and the implementation of deep-seated institutional reforms.

One of the key steps in this process was the Copenhagen Summit of 2002 which strongly signaled the opening of accession negotiations between the EU and Turkey. The summit was important because it generated strong political will and public support for institutional reforms. This followed other key steps such as the historic decision of the EU Council in December 2004 to initiate accession negotiations and finally the October 2005 decision to actually inaugurate the negotiation process. Hence, a combination of powerful external pressures and a display of political leadership and will at home helped to produce an economic and institutional environment that by late 2005 already sharply differed from the situation in February 2001.

Moreover, after 2001crisis, IMF participated in a number of institutional reforms, which were evident in different areas and notably in the banking sector (Bakır 2006). A new agency, the Bank Regulatory and Supervisory Agency (BRSA) was established in June 1999 following the ratification of the IMF-sponsored Banking Act. This agency took responsibility for banking supervision and regulation from the Treasury and the Central Bank and became operational in September 2000. The BRSA also incorporated Sworn Bank Auditors and Savings Deposit Insurance Fund (SDIF) in 2001. Further, the regulation and supervision of non-bank financial institutions were transferred from the Treasury to the BRSA in 2005. However, in the pre-crisis period, there was no natural constituency pressuring for the establishment of an agency like the BRSA and there was a lack of political and

bureaucratic will as well as fierce resistance from powerful banking lobbies. As a result, the BRSA was unable to perform a proper regulatory role in such a way as to prevent the twin crises. The latter essentially stemmed from the malfunctioning and under-regulation of both the private and the public components of the banking system. Following the February crisis, however, the BRSA was able, with IMF support in the background, to attain partial autonomy from politicians and interest groups and to press ahead with tough regulatory measures with some domestic support (Alper and Onis 2004).

Further, considering the institutional changes in FDI regulations, the enactment of Law No. 4875 in June 2003 to replace Law No. 6224 was a crucial step forward. Particularly, the new Law has defined among others, the following: FDI according to current international practice (TUSIAD and YASED 2004), replacement of the old FDI approval and screening system with a notification and registration system (TUSIAD and YASED 2004), bans nationalization without fair compensation (TUSIAD and YASED 2004), guarantees national treatment to foreign investors (TUSIAD and YASED 2004), no restriction of FDI in any sector (TUSIAD and YASED 2004), no imposition of any performance requirement (TUSIAD and YASED 2004), etc.

Lastly, in 2006 a new Law No. 5523 has issued for the incorporation of the investment support and promotion agency. The object of this Law is to set out functions, tasks, powers and organization of the Investment Support and Promotion Agency of Turkey (ISPAT), which is incorporated for determination and implementation of investment support and promotion strategies aimed to encourage and increase a number of investments in Turkey that are required for economic development of the country (Undersecretariat of Treasury General Directorate of Foreign Investment 2006). The Investment Support and Promotion Agency of Turkey is incorporated, in association with Prime Ministry, as a legal entity with administrative and financial autonomy to ensure implementation of this Law, and to undertake the functions vested upon it by this Law.

The BRSA and FDI regulations are good examples of a major characteristic of the new era, which it is labeled as the "re-regulation" phase (Onis and Bakir 2007). "Re-regulation" refers to the development of regulatory capacities of the state, which involves not only the setting up of new institutions but also a significant increase in their powers of implementation. There is no doubt that effective measures were taken in the direction of stronger financial regulation in Turkey after the 2001 crisis. Turkey is on the way to establishing a regulatory state. However, "a regulatory state, which can adopt a proactive approach in the financial services industry by steering and coordinating policy community still does not exist" in Turkey (Bakır 2006, p. 202). For that reason, significant progress needs to be made in terms of strengthening regulatory institutions as well as developing a strong state capacity.

In light of the above and as suggested by North (1990), institutional theory should be integrated in the Turkish context and interpreted with transaction cost theory. Hence, some scholars have recently begun extending transaction cost-based entry mode theory by incorporating institutional and cultural context variables as well as transaction cost variables (Demirbag and Weir 2006; Tatoglu, Glaister, and Erdal 2003; Brouthers 2002; Brouthers and Brouthers 2000; Delios and Beamish 1999). The combination of TCA and New Institutional Economics under the lens of Scott's three institutional aspects will going to analyze in depth the nature of exchange processes and the amount of "friction" which are dependent on the institutional context in which firm takes place. For example, whether and to what extent the institutional environment guarantees property rights and facilitates the enforcement of contracts, and normative and cognitive aspects dictate the margins at which organizations operate.

Thirdly, when applying these three different aspects of institutional theory another issue has emerged: the overlap between normative and cognitive aspects that is, the cognitive and normative aspects of a country's institutional context are conceptually close to its culture, whereas the regulatory aspect is unique to a country's institutional context and not captured by culture (Kostova 1999, pp. 314).

Kostova (1999) has pointed out that in some cases scholars have emphasized the cognitive nature of culture, while in others cases they have stressed its normative component. Thus, some studies use cultural factors to analyze the cognitive dimension (e.g., Gaur et al. 2007; Pogrebnyakov and Maitland 2011), while others use culture to examine the normative dimension and the effect of cross-country differences on firm strategic behavior (e.g., Busenitz, Gomez, and Spencer 2000; Shenkar 2001; Yiu and Makino 2002) (Herná Ndez, and A Jesu´ S Nieto 2012). In that framework and observing the different empirical studies (Gaur and Lu 2007; Xu et al 2004; Estrin et al 2007; Chao and Kumar 2006, etc.), institutional distance herein is defined using only two of the three aspects of Scott's theoretical framework - regulative (social aspects) and normative aspects (business aspects) - incorporating the cognitive-cultural aspect into the cultural framework.

This distinction is based, primarily, on Redding's (2008) analysis that culture is not necessarily *per se* a dominant determinant of events. However, some times, culture framework is significant and simultaneously different from institutional framework- defining this difference as "societal effect"-and deserves a place in its own right. Providing in that way, a conceptual domain to distinguish between culture and institutions.

All things considered, this thesis by applying a complete institutional theory (regulative, normative, and cognitive) and distinguishing the blurred concept between normative and cognitive aspects addresses the following issues: how various transaction costs that are faced by MNEs, interact

with the specific environmental characteristics of the emerging economy of Turkey; and simultaneously to what extent the three institutional aspects influence firms' mechanisms to choose the appropriate entry mode strategy. So, the rest of this section is going to analyze the theory of New Institutional Economics, to define the three institutional pillars, and lastly, to distinguish institutional and cultural concept.

4.8 Scott's (1995) Institutional Pillars

As previously said, institutions have developed to become similar (showing isomorphism) across organizations, even though the evolved in different ways. DiMaggio & Powell (1983) and Scott (1995) introduce several factors that give rise to isomorphism. Scott (1995), for example, develop the concept of a three-dimensional country institutional context, comprising regulatory-coercive, normative, and cognitive-cultural-mimetic dimensions. "Institutional distance can be different for each institutional aspect" (Yiu and Makino 2002, pp. 670).

In particular, **regulative or coercive aspects**, according to DiMaggio and Powell (1983) come from legal mandates, or from contract law, or financial reporting requirements, or influences from organizations they are dependent upon. Scott (1995) enhances the term involving not only rule-setting, which means, the capacity to establish rules, but also incorporates monitoring-inspect or review other's conformity to them, and sanctioning activities-rewards or punishments in an attempt to influence future behavior.

Similarly, economic historian Douglas North features rule systems and enforcement mechanisms in his conceptualization:

> [institutions] are perfectly analogous to the rules of the game in a competitive team sport. That is, they consist of formal written rules as well as typically unwritten codes of conduct that underlie and supplement formal rules....the rules and informal codes are sometimes violated and punishment is enacted. Therefore, an essential part of the functioning of institutions is the costliness of ascertaining violations and the severity of punishment (North 1990, pp. 4).

Organizations observe these rules so as to avoid the penalty for non-compliance. For example, corporations adopt new pollution control technologies to conform with environmental regulations. Non-profit organizations maintain accounts and hire accountants, in order to meet tax law requirements (DiMaggio and Powell 1983). Also, in transition economies the influence of coercive pressures appear to be strong.

Additionally, Edden and Miller (2004) assert that regulatory dimension-pillar sets out prescriptive "may" and proscriptive "may not" behaviors, applying rewards and sanctions for compliance with these

pre/proscriptions. Also, the authors supplement that regulatory dimension in host countries is perhaps the easiest for foreign firms to observe, understand and correctly interpret because regulatory institutions are codified and formalized in rules and procedures. In terms of multinational strategies, host-country regulatory institutions create pressures for local responsiveness to which MNE affiliates must conform to achieve external legitimacy. Such pressures come at the cost of global integration (Doz 1980; Prahalad and Doz 1987).

Normative or social aspects of institutions generally take the form of rules of thumb, standard operating procedures, occupational standards and educational curricula. In this aspect, emphasis is placed on rules that introduce a perspective, evaluative, and obligatory dimension into business life (Scott, 1995). The capacity of such procedures to guide organizational action stems from social obligation or professionalism. For example, gift-giving and bribery is a commonly accepted norm in emerging economies like India, Turkey, and China.

The same line of thought is followed by DiMaggio and Powell (1983) who refer to normative pressure as norms of professionalism, which set up a cognitive base and legitimize organizations. Normative pressures are established through formal education, for instance, universities and professional networks that filter personnel within the same industry. Highly standardized education systems in former communist countries, for example, create a shared normative basis for local decision making.

Lastly, **cognitive or cultural or mimetic aspects** of institutions embody symbols, such as words, signs, and gestures, as well as, cultural rules and frameworks reflecting cultural alignment, according to Scott (1995). Organizations usually abide by these rules without conscious thought (Zucker 1983) just by *imitating* each other, according to Demirbag, Glastier, and Tatoglu (2007). Therefore, its is observed from the analysis above that regulative and normative distance may account for the cross-national variations in the entry mode choice, whereas the cognitive distance may account for the cross -firm variations in entry mode choice (Yiu and Makino 2002).

The cognitive and normative aspects of a country's institutional context are conceptually close to its culture, whereas the regulatory aspect is unique to a country's institutional context and not captured by culture (Kostova 1999, pp. 314). Consequently, many papers examine the normative and cognitive aspects together via culture (e.g., Kogut and Singh 1988; Jensen and Szulanski 2004; Salomon and Wu 2012). Indeed, culture molds behavior from the values that make up the perceptions of the world and societal norms (Root 1987). Kostova (1999) points out, however, that in some cases scholars emphasize the cognitive nature of culture, while in others they stress its normative component. Thus, some studies use cultural factors to analyze the cognitive dimension (e.g., Gaur et al. 2007; Pogrebnyakov and

Maitland 2011), while others use culture to examine the normative dimension and the effect of cross-country differences on firm strategic behavior (e.g., Busenitz, Gomez, and Spencer 2000; Shenkar 2001; Yiu and Makino 2002) (Hernàndez and Nieto 2012).

In that framework, institutional distance in this thesis is defined using only two of the three aspects of Scott's theoretical framework - regulative (social aspects) and normative aspects (business aspects) - incorporating the cognitive-cultural aspect into the cultural framework.

This distinction is based, primarily, on Redding's (2008) analysis. Redding contends that culture is not necessarily *per se* a dominant determinant of events. However, some times, culture framework is significant and simultaneously different [from institutional framework]- defining this difference as "societal effect"-and deserves a place in its own right. Providing in that way, a conceptual domain to distinguish between culture and institutions.

In accordance with Redding (2008), Grief (2006) also asserts that the distinction between culture and institutions means that *beliefs and norms* make up culture, while *rules and organizations* make up institutions. Cultural distance is a powerful tool to measure and analyze cross-country differences and it is also associated with institutional factors (House, Hanges, Javida, Dorfman, and Gupta 2004).

Moreover following the relevant literature, Gaur and Lu (2007) have applied institutional distance as a contingency factor to explain the relationship between ownership strategies and subsidiary performance. In that concept, the authors have grouped normative and cognitive aspects into one concept, reasoning that they would be quite similar to each other (Scott, 1995). To measure regulative and normative/cognitive distance, Gaur and Lu (2007) have used country-level indicators derived from the *World Competitiveness Yearbook.* They have supplemented with a political risk rating variable obtained from *Country Risk Ratings: Euromoney.* Gaur and Lu (2007) have received empirical support to their hypotheses that foreign ownership positively correlates with subsidiary survival in institutionally distant (both in terms of regulative and normative/cognitive distance) countries.

Xu et al (2004) have distinguished and developed the regulative and normative distance measures and empirically tested them into a sample of Japanese overseas subsidiaries. The measures for regulative and normative distances are constructed on the basis of information provided in *The Global Competitiveness Report*, which documents country differences over various items of institutional environment (Xu et al. 2004). Their empirical analysis has provided support to the hypotheses, i.e. larger regulative and normative distances were associated with a lower level of equity ownership.

A further advancement in the operationalization of the institutional distance construct was made by Estrin et al. (2007), who have equaled the normative distance with the cultural distance index of Kogut and Singh (1988). To measure regulative distance, Estrin et al. (2007) have employed the

Economic Freedom Index published by the Heritage Foundation. Cognitive distance measure was composed by the authors from four items, two of which are associated with educational achievements of a country, and two - with exposure to new technologies in the society. Estrin et al. (2004) have hypothesized concerning entry mode choice that Greenfield investment would be associated with large regulative distance but not associated with large cognitive or normative distance. These hypotheses have found empirical support in the case of regulative and cognitive distances, but not for normative distance. This has led the authors to conclude that all three measures should be used simultaneously to capture the variation in entry mode choice.

Hernàndez and Nieto (2012) have analyzed the relation between normative and cultural-cognitive institutional distance and the international entry forms of Small and Medium Enterprises (SMEs) by separately considering informal institutional dimensions such as normative and cultural-cognitive distances, as well as examining how the regulatory development of the destination may moderate these relations. Additionally, they have focused on the development of the relevant literature on SMEs, both by using the institutional theory to explain the internationalization of these firms and providing a more complete picture of their entry modes. In this light, they have examined the interaction effect of each of the above distances and the regulatory development of the destination on entry mode choice. Their methodology has based on a multilevel analysis of a database of European SMEs containing information on different locations and three entry forms: exports, collaborative modes and direct investment. Their results indicate that greater levels of normative distance increase the likelihood of using collaborative forms in SMEs. Similarly, the findings show that the preference for collaborative forms grows as the cultural-cognitive distance increases. In both cases, the study finds a positive moderating effect of regulative institutions on these relations.

Finally, Chao and Kumar (2006) have argued that there is substantial theoretical overlap between the cognitive/cultural and normative institutional dimensions, which is treated as a higher order factor (Gaur et al. 2007; Gaur and Lu 2007; Hoffman 1999). In that concept, they have investigated the impact of institutional distance on the international diversity–performance relationship. They first discussed the international diversity–performance relationship for large multinational firms and later showed the moderation effect of regulative and normative institutional distance. Based on a sample of Fortune 500 firms, they have found an inverted U-shaped curve. Particularly, regulative institutional distance has a negative moderating effect on the international diversity–performance relationship, while normative institutional distance shows a positive effect.

Therefore observing through the different empirical studies, the theoretical overlap between cognitive and normative distance and the tendency in the relevant literature to distinguish the

regulative, and normative distance from this of cognitive-cultural distance, this thesis pays particular attention to the impact of cultural distance and distinguishes it from that of institutional distance.

Chapter 5: FDI Entry Modes: The Choice of Ownership Structures

5.1 Entry Mode Choice Definition and Classification

After a firm decides to enter a certain foreign market, it must choose a mode of entry i.e., select an institutional arrangement for organizing and conducting international business transactions, such as contractual transfers, joint ventures, and wholly owned operations (Erramilli and Rao 1993). The choice of the correct entry mode for a particular foreign market is one of the most crucial decisions in international business (Terpstra and Sarathy 1991). The choice of the correct mode determines the extent to which a firm gets involved in developing and implementing different programs in the foreign market, the amount of control the firm enjoys over its marketing activities, and the degree to which firm succeeds in foreign markets (Anderson and Gatignon 1986; Erramilli and Rao 1993).

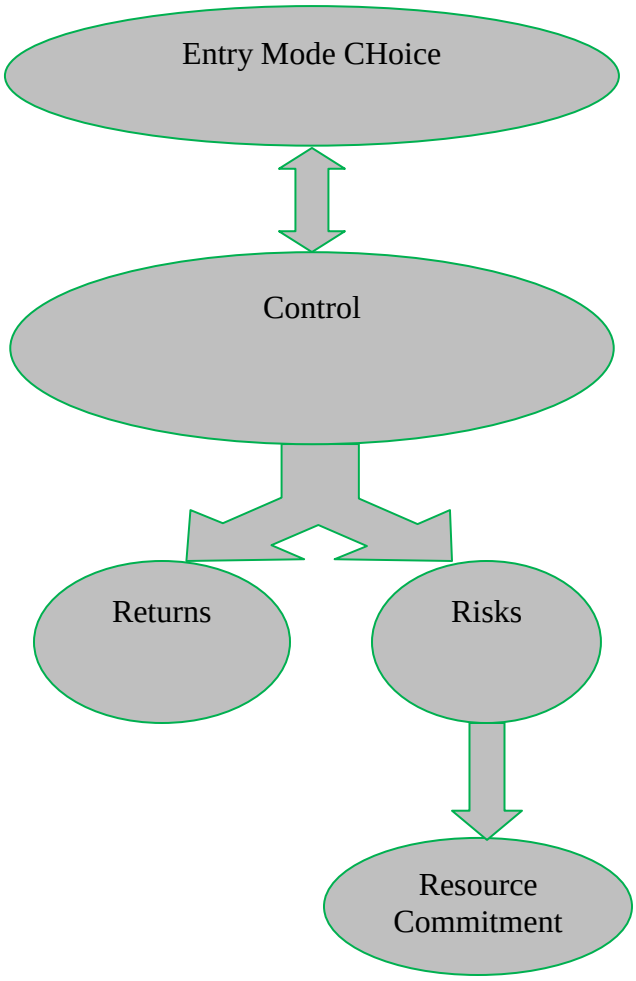
So, entry mode choice emphasizes to what extent a firm chooses to control (to own) a subsidiary in a foreign market. In light of this view, entry mode choice is heavily related to the concept of control. Control means the ability to influence systems, methods, decision criteria and has a critical impact on the future of a foreign enterprise. Without control, a firm finds it more difficult to coordinate actions, carry out strategies, revise strategies, and resolve disputes that invariably arise when two parties to a contract pursue their own interests (Davidson 1982). Further, the entrant can use its control to obtain a larger share of the foreign enterprise's profits. **In short, control is a way to obtain a higher return.**

However, control carries costs (Vernon 1983). To take control, the entrant must assume responsibility for decision-making, responsibility a firm may be unwilling or unable to carry out in an uncertain foreign environment (Anderson and Gatignon 1986). Control also entails commitment of resources, including high overhead. Resource commitment, in turn, increases the firm's exposure, i.e., the possibility of losses due to currency changes (Davidson 1982). Thus, to assume control is also equivalent to assume some forms of risk (see Figure 20).

Control, then, has been and continues to be the focus of the entry mode literature, because it is the single most important determinant of both risk and return. High-control modes can increase return and risk, while low-control modes (e.g., licenses and other contractual agreements) minimize resource commitment (hence risk), but often at the expense of returns. So, firms trade various levels of control for reduction of resource commitment in the hope of reducing some forms of risk while increasing their returns. However, there are various entry modes which represent a different mix of control, a

comprehensive analysis of which is presented in the following section.

Fig. 20



Source: Author's design, 2014.

In principle, any set or network of value-added activities may be organized in a variety of ways (Dunning 1993). Somebody can imagine a spectrum of organizational modes. On the one hand, each activity along the chain may be undertaken by separate firm, which will buy and sell its intermediate products from and to the open market. On the other hand, all activities may be undertaken by the same firm, which means that each or the intermediate product markets is internalized. In the former case, ownership and, subsequently, the right to control the use of the products being bought or sold, is transferred at the point at which the transaction is made. In the latter case, there is no change in

ownership, hence control over the products remains within the jurisdiction of the same firm.

Between these two extreme forms of organization, a firm may engage in a variety of organizational relationships, each of which involves a different combination of resource and capability commitment, risk bearing, and control sharing. For example, more larger MNEs, particularly, those whose organizational structure is diversified, are more likely to be engaged in various and interdependent bilateral relationships, the character of which is likely to affect, and to be affected by, the complex relationships of which it is part.

> A rather different approach (but complementary) to analyzing the organization of business transactions is based on the extent to which economic agents perceive that it is better to compete or cooperate with each other, in order to achieve their objects. Most neo-classical economists view firms as vying with each other for resources, capabilities, and markets. Moreover, while the invisible hand of the market is assumed to serve to organize transactions in such a way as to benefit all parties, it is also presumed that, except at the point of the exchange, the parties have no contact with one another (Dunning 1993, pp. 234).

Specifically, in some cases, many firms may work together to achieve a specific and well articulated goal for a limited period of time. In other cases, firms may form joint ventures or non equity alliances to promote and organize a large number of activities. Some firms also, when faced with a particular market failure, may react by internalizing the market, while others might respond by working to lower the transaction costs of using it.

Even today, most of the literature on MNE activity and international production has concentrated on transactional relationships between firms. Many studies have explored the choice between contracts and equity (franchising contracts vs. company-owned outlet, management contracts vs. production subsidiaries). Other international business text books separate the issue of whether a firm that wishes to invest in a foreign country should do by acquiring or setting up a joint venture or a wholly owned subsidiary (100%), from that of the operational relationships it has both within its ambiance of governance (e.g., selling management services from the parent to one of its foreign affiliates) and between itself and independent firms.

Although there is no complete listing of entry mode structure, the mostly investigated choice is between wholly owned subsidiaries (WOS) and joint ventures (JV). Brouthers and Hennart (2007) have identified 16 different entry modes based on the previous studies. According to their argument, there are two main views on the meaning and the categories of entry mode choice.

The first perspective considers contracts, joint ventures and wholly owned subsidiaries as a continuum of increasing control, commitment and risk. WOS would be chosen, if MNEs exert maximum control, make maximum commitment and take on maximum risks. Contracts would be

selected, when MNEs prefer minimum control, make relatively less commitment and take on minimum risks. Following this line of thought, many scholars have, subsequently, identified various mode structures. For example, Erramilli and Rao (1990) identified 11 types of entry mode, namely, ranging from Greenfield WOS ventures to licensing and franchising; Anderson and Gatignon (1986) listed 17 mode structures ranging from WOSs to small shareholder organizations.

The second perspective is represented by Hennart (1988, 2000), who doesn't agree that JV is a step in the continuum between contracts and WOS; he has categorized entry modes into two types: contracts and equity (JVs and WOSs). According to Hennart (1998, 2000), the main difference between contract and equity is the fact that input suppliers are paid *ex post* from the profits of the venture in equity, while in contracts payments are specified *ex ante*.

Hennart (1998, 2000) further has argued that the former is efficient, when there is difficulty in defining what MNEs must contribute ahead of time and measuring contribution is costly after the cooperation. Hennart (2000 as cited in Yang and Zhao n.d , pp. 2) has also claimed that

> buying production factors locally may sometimes be difficult. Firms with hard-to-transact-assets will integrate into WOS if the assets can be bought on the market; in contrast, if the assets held by the MNE can be easily purchased on the market, a local firm with hard-to-transact assets will contract the technology and establish a domestic WOS.

When both the MNE's and local firm's assets are hard to transact, JV would occur. Thus, Hennart (1988) has argued that JVs are not an intermediate entry mode between market and hierarchy, but rather a solution of the double market failure. He has also claimed that JVs are categorized in the hierarchy/equity category, and "JVs are the any type of setup where input providers are paid for their inputs through a share of the profits of the venture."

Meanwhile, the partial acquisitions and JV Greenfield should be categorized as JVs, something which is not in line with Kogut and Singh (1988), who have argued that the term JV refers to the shared new ventures with separate legal personalities. Brouthers and Hennart (2007) have adapted and adopted Hennart (2000)'s definition of the JVs and differentiate contracts, WOSs, and JVs.

Specifically, Brouthers and Hennart (2007) have adapted Hennart's (2000) model of entry modes, classifying modes of entry into three categories (JV, WOS by local firm and WOS by MNE), and have showed that JV is not an intermediate form between market and hierarchy, but results from joint internalization because of double market failure (Hennart 1998). Moreover, these authors have also distinguished the level of ownership (contracts, JV, WOS) and the establishment mode (Greenfield vs. acquisitions), both of which are used by scholars.

Meyer et al. (2009a) have classified modes of FDI into three types: Greenfield, acquisition, and joint venture. On the one hand, joint ventures partially integrate local resources from a local partner,

acquisitions integrate the local firm *in toto* (totally*)*, and, both of them offer access to resources that are held by local firms. On the other hand, Greenfield doesn't directly approach local firm as organizational resources, but allows the MNE to purchase or contract local resources.

Later on, Kogut and Singh (1988); Chang and Rosenzweig (2001); Elango and Sambharya (2004) have stated that there are two sequential stages in the entry mode choice: the first stage concerns the decision between partial ownership (JV) vs. full ownership (acquisition/Greenfield), and the second stage concerns the decision between acquisition and Greenfield, if wholly owned is preferred by MNE. But in practice, these authors have argued that these two stages are often blurred, since many studies have examined the three entry choices simultaneously.

For the purposes of the current study, this analysis, following Anderson and Gatignon (1988, pp. 314), Hennart (1991), Birkinshaw and Pedersen (2009, pp. 367), and Barkema et al (1996) employs two alternative entry modes: **wholly-owned subsidiary** and **joint venture** -since they are viewed as the two major distinct organizational modes (Li, Yang, and Yue 2007)- applying, subsequently, the four-stage subsidiary typology:

- Wholly-owned subsidiaries (the MNE holds 100% of the equity);
- Dominant partnerships (the MNE holds the dominant share of the equity; that is, owns more equity than any other partner);
- Balanced roughly equally partnerships (the MNE's share is the same as that of the largest partner);
- Minority partnerships (the MNE holds less equity than the largest partner).

Especially, in the context of foreign expansion, the wholly owned subsidiary and joint venture may be subject to different social codes and correspondingly possess differentiated social identities (Yiu and Makino 2002). For instance, several studies have shown that joint ventures established with a hybrid equity structure, are more susceptible to the effects of cultural distance than wholly owned subsidiaries, because the former have to contend with both national and corporate cultures or "double-layered acculturation" (Barkema, Bell, and Pennings 1996).

The wholly owned subsidiary and the joint venture can thus be considered distinct organizational forms featuring different equity structures, under different legal regulations, and implementing different practices (Shenkar and Zeira 1987). Consequently, this thesis analyzes the pattern of foreign firms' choice of a wholly owned subsidiary as compared to a joint venture for the 2002- 2010 period in the case of Turkey.

5.2 Entry Mode Choice and Transaction Cost Approach

Previous studies in areas of international trade, industrial organization, and market imperfections have identified a number of factors that influence the choice of an entry mode for a selected target market. Integrating perspectives from these areas, Dunning (1977, 1980, 1988) has proposed an excellent comprehensive framework, which has stipulated that the choice of an entry mode for a target market is influenced by three types of determinant factors: ownership advantages of a firm, location advantages of a market, and internalization advantages of integrating transactions within the firm (Agarwal and Ramaswami 1992).

In such circumstances, several other empirical studies have attempted to directly or indirectly use the Dunning framework in explaining the choice between joint venture and sole venture (Kogut and Singh 1988), licensing and sole venture (Caves 1982; Davidson and McFetridge 1985), extent of foreign direct investment (Cho 1985; Dunning 1980; Kimura 1989; Sabi 1988; Terpstra and Yu 1988; Yu and Ito 1988), and ratio of acquisition to total subsidiaries (Wilson 1980).While these studies have made substantial contribution to our understanding of entry mode behavior of firms, they have been based on a weak assumption: entry mode decision is made "in isolation" and is driven essentially by efficiency considerations at the level of the individual entrant or subsidiary unit (Kim and Hwang 1992, pp. 29).

So, much later a more comprehensive attempt has been developed by the prominent works of Anderson and Gatignon (1986) and Gatignon and Anderson (1988). These authors have formulated a holistic approach of the determinants of entry mode strategy offering an excellent review and integration of existing entry mode explanations within a transactional theoretical framework, focusing on the central role of environmental and transaction-specific factors in influencing entry mode strategy.

In conceptual and empirical entry mode studies, TCA has been particularly useful in explaining the determination of ownership levels (e.g., Anderson and Gatignon 1986; Gatignon and Anderson 1988; Gomes-Casseres 1989), since Williamson has been the first to pose the dilemma of which organizational structure offers a more efficient solution for the firm. Specifically, Williamson (1985) has suggested that firms tend to adopt an organizational market-structure - (non-equity modes) versus hierarchies (equity modes) - when expanding abroad, basing their decisions on how efficient a structure is when compared to the alternative. In that framework, their choice for TCA has been justified by the fact that TCA "combines elements of industrial organization, organization theory, and contract law to weigh the tradeoffs to be made in vertical integration (and by extension, degree of control) decisions."

In light of this view, a basic parameter in the theory of TCA concerns the entry mode choice. A foreign market entry mode evolves into "an institutional arrangement that makes possible the entry of a company's products, technology, human skills, management or other resources into a foreign country" (Root 1987, pp. 5). Firms can enter foreign markets via exporting (direct or indirect), contractual methods (licensing and franchising) or foreign direct investment (joint ventures and wholly-owned subsidiaries).

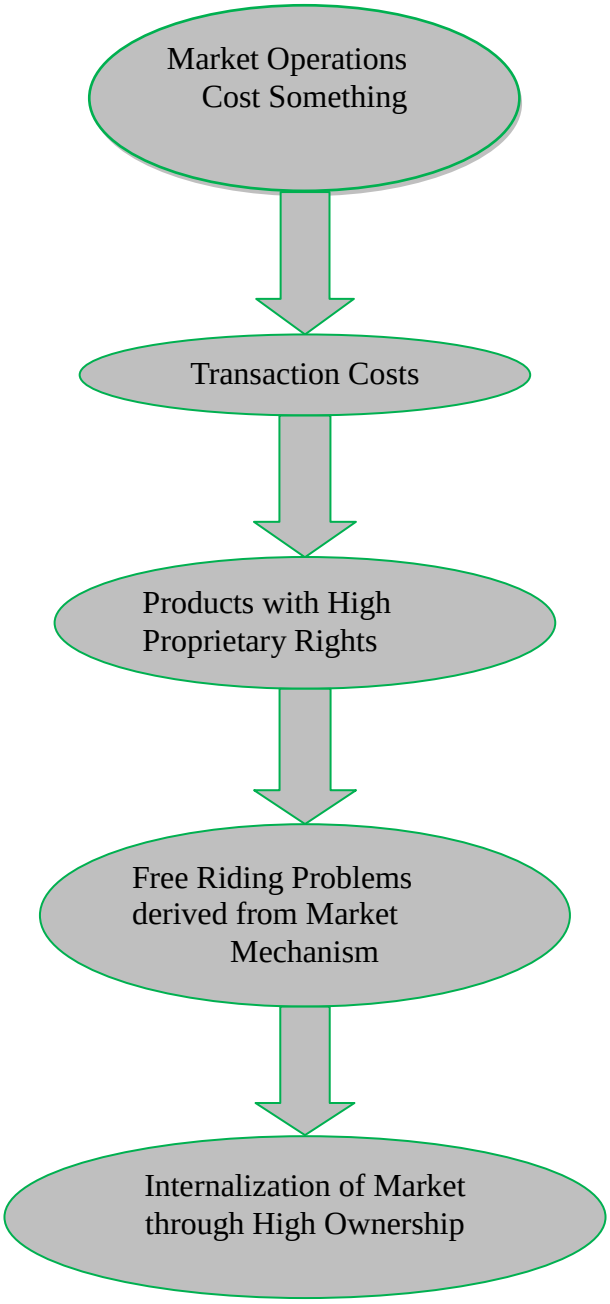
However, entry modes may differ greatly in their mix of advantages and drawbacks. Tradeoffs involved are difficult to evaluate and little understood. Several surveys of how firms actually reach their entry mode decision (reviewed in Robinson 1978) indicate that few companies make a conscious, deliberate cost/benefit analysis of the options available. So, the viewpoint adopted, in this section, is that international entry mode choices are most usefully and tractably viewed as a trade-off between control and transaction costs.

Taking into consideration all the above and following Anderson and Gatignon (1986) that TCA best supplements entry mode choice, this thesis integrates entry mode choice to TCA proposing the following. Market operations involving technological know-specifying the agreement conditions, the likelihood of disclosing key knowledge, the difficulty to codify such knowledge, etc. produce some costs for the firm (Coase 1937). These costs derive from market imperfections, that is, imperfections that are due to the fact that the neo-classical assumptions of perfect knowledge and perfect enforcement are not realized (Teece 1981; Dunning and Rugman 1985). Therefore, a variety of transaction, contracting, and coordinating costs are generated. These transactions costs, in turn, refer to products and services with high proprietary content that may suffer from potential free-riding problems. In other words, these transactions depend on institutional effectiveness that is, market mechanism and the related problems derived from market mechanism, such as opportunistic behavior, bounded rationality, asset specificity, disturbances problems, etc (Williamson 1985, 2010). So these assets are costly to be transferred through an imperfect market, and therefore, the firms will tend to internalize them through choosing the entry mode choice, which is more efficient structure (high ownership) when compared to an alternative one (see Figure 21) (Anderson and Gatignon, 1986; Buckley and Casson, 1976; 1998; Hill and Kim, 1988; Rugman, 1981).

This means that market transactions involving technological know-how imply costs which may constitute a clear incentive for FDI (Teece 1986). Such entry mode proves more efficient when transferring tacit or non-codifiable knowledge enjoying little legal protection (Hennart 1989). Furthermore, to safeguard specific assets from potential opportunism problems, firms may use high

control governance structures, such as WOSs (Tahir and Larimo, 2004). Particularly, Kumar (1984) has argued that firms operating in sectors with a high technological intensity may be expected to use entry modes allowing them a more efficient control of all the tasks to be carried out in the host country. Similarly, Chen and Hu (2002) have observed that WOSs are more likely than contractual JVs when the foreign firm belongs to a high-technology industry.

Fig. 21



Source: Author's design, 2014.

5.3 The Concept of Distance as a Determinant of FDI Entry Mode Choice

The concept of distance occupies a central place in the IB field and has important implications for strategic firm decisions, such as location choice (e.g. Johanson and Vahlne 1977; Dunning 1979), transfer of organizational practices (Kostova and Roth 2002), and entry mode strategy (Kogut and Singh 1988). The first approach of distance has conducted through psychic distance. However, the definition of psychic distance has changed substantially, since its first use in Beckerman's (1956) study as "subjective perceptions of managers on the distribution of international trade". Later, Stephen Hymer (1960) has noted that a key factor shaping the internationalization of the firm is the so-called ''liability of foreignness'', which increases with the distance between the home and host countries. Further, Johanson and Vahlne (1977, pp. 24) have supported that distance refers to ''differences in language, education, business practices, culture, and industrial development'' as relevant dimensions.

Similarly, Nordstrom and Vahlne (1994, pp. 42) have defined psychic distance as "factors preventing or disturbing firm's learning about and understanding a foreign environment". In contrast, O'Grady and Lane (1996, p. 330) have defined psychic distance as "...a firm's degree of uncertainty about a foreign market resulting from cultural differences and other business difficulties that present barriers to learning about the market and operating there." For their part, Barkema, Bell, and Pennings (1996, pp. 153) have developed ''linguistic, institutional, cultural, and political factors'', but they have operationalized them in terms of cultural distance and cultural blocs of countries. Lastly, Hennart and Larimo (1998, pp. 517), who have approached distance from a transaction-cost perspective, have restricted their definition to ''national cultural characteristics of the home and host countries'', basing their measurement on Hofstede's data.

However, the key contribution in this area is attributed mostly to the seminal work of John Dunning (1979, 1993) who has asserted that "the extent to which a country's enterprises serve particular markets or serve them from one location than another will vary according to characteristics of home and host countries and the physical and/or "psychic" and "economic distance" between them".

More specific, Dunning (1979, pp. 284) has asserted that the concept of "psychic" distance.

> "has been particularly developed by the Swedish economists (Hornell and Vahlne 1972) and it refers to circumstances which prevail or restrain the flow of goods and/or payments between business and market". [Distance] depends on differences in the level of development between the home country and foreign market, in their levels of education, language, culture, and customs, and legal and commercial systems. [Later in 1978] some Finnish economists (Luostarinen 1978) have added a third component of distance viz. "economic" distance—the inverse of the economic "pull" of a particular market e.g. as measured in terms of GNP or growth of GNP."

In that way, Dunning (1979) has been the first to formulate a holistic perspective of the determinants of distance and the first "who has looked beyond a country's sales potential as expressed by national wealth or propensity to consume" (Ghemawat 2001, p. 1). So, Dunning (1979, 1993) and Dunning & Lundan (2008) have emphasized, through the eclectic paradigm (OLI), the importance of cross-national distance proposing a multidimensional perspective of ownership, locational and internalization advantages, delimiting distance as the *differences* not only in economic level between host and home country, but also including institutional level (legal and commercial systems) and cultural (education, language, culture, and customs) factors of both countries.

Although, this definition of psychic distance has been quite broad, most subsequent studies have narrowed it and have conceptualized psychic distance as merely cultural distance (see reviews in Shenkar 2001 and in Tihanyi et al 2005). While some of these studies have found evidence that MNEs tend to go to culturally similar countries (Bilkey and Tesar 1977), others have found that cultural distance does not have a significant role in explaining market entry (Benito and Gripsrurd 1992). In a meta-analysis of the literature, Tihanyi et al (2005) have report that results fail to provide evidence of a significant relationship between cultural distance international diversification, or firm performance.

So, many prominent studies have returned to the original broad definition of psychic distance and have proposed various dimensions on which distance can be measured. Particularly, in 2001, Ghemawat has developed the most comprehensive framework. He has developed his concepts on the basis that distance produces "risks and costs", which "result from barriers created by distance" (Ghemawat 2001, p. 3). By this way, Ghemawat's article, "Distance Still Matters: The Hard Reality of Global Expansion" discusses the reasons and rationale that drive companies to over-estimate profit potential in foreign markets. He analyzes the failures of different companies' (News Corp, Tricon Restaurants, etc.) foreign expansion endeavors to determine what these failures have in common, concluding that these failures share one common attribute: a failure to account for **distance**.

Ghemawat (2001) supports that companies erroneously utilize an inadequate and incorrect modality when deciding on foreign expansion: the country portfolio analysis (CPA). The CPA focuses on national GDP, levels of consumer wealth, and people's propensity to consume, but ignores "the costs and risks of doing business in the market." These costs are grouped into a category classified as "distance" which itself is sub-divided into four dimensions: Cultural, Administrative/political, Geographic, and Economic distance (**CAGE)**.

Further, Ghemawat (2001) proceeds his analysis to list factors that influence distance and industries that are affected by the specific dimensions. Particularly, he defines **cultural distance** as the

differences in religious beliefs, race, social norms, and language asserting that all these attributes are capable of creating distance between two countries. **Administrative/political distance** involves historical and political associations between countries (for example, colony-colonizer links can affect the trade between two countries). The integration of European Union (EU) is probably the leading example of deliberate efforts to diminish administrative and political distance among trading partners. But the most common attribute of this kind of distance exists in the barriers that each government raises against the foreign competition: tariffs, trade quotas, restrictions on FDI movement, and preferences for domestic competitors in the form of subsidies and favoritism in regulation and procurement.

Geographic distance is defined not only as a matter of how far away a country is in miles or kilometers, but involves and other attributes, such as the physical size of a country, the average within-country distances to borders, the access to waterways and the ocean, man-made geographic attributes—most notably, a country's transportation and communications infrastructures- and lastly, topography characteristics which create transportation costs. For example, products with low value-to-weight or bulk ratios, such as steel and cement, incur particularly high costs as geographic distance increases. Likewise, costs for transporting fragile or perishable products become significant across large distances.

Lastly, **economic distance** is defined as the difference between two countries' wealth or income. According to Ghemawat (2001) when markets rely on economies of scale, experience, and standardization should aim their efforts on markets with a similar economic profile. The reason for this is that, in order for the company to exploit their competitive advantage, they need to imitate their existing business model and this can be hard to achieve if the cost and quality of resources, and consumer incomes are very different. On the contrary, there are companies who base their advantage on these differentials (arbitrage) i.e. exploit cost and price differentials between markets (Ghemawat 2001).

Despite Ghemawat (2001) has developed a novel and complete methodology regarding the kind of the dimensions, he still misses some important aspects. According to Berry, Guillén, and Zhou (2010, p. 10),

> Ghemawat's theoretical framework does not go far enough in recognizing the complexities of distance given that it does not take into consideration important dimensions, including variables related to finance, politics, demography, knowledge, and global connectedness. In addition, Ghemawat does not offer guidance as to the specific empirical indicators to be used to capture each of the four dimensions that he discusses.

Moreover, Cuervo-Cazura and Genc (2012, p. 221) have formulated that studies of this kind

tend to be “broad” and to “make two major assumptions: distance is an obstacle and distance is symmetric”. Particularly, they have stated that Ghemawat's (2001) theoretical framework examines four categories in order to “identify the true attractiveness of the host country (as opposed to pure economic attractiveness) combining four major disciplines: sociology (cultural distance), political science (administrative), geography and economics”.

In a similar manner, Angué and Mayrhofer (2010, p.7) have adopted Ghemawat's (2001) conceptual framework asserting that “[Ghemawat] [b]y categorizing the different dimensions inherent to the notion of distance, the author's contribution can be used as an analytical framework for examining the role of distance for international operations in general and for cooperative strategies in particular.” However, “Ghemawat (2001) does not provide details about their operationalization”. Further, Angué and Mayrhofer (2010, p. 26) suggest that “[t]heir results support [that] the notion of technological distance, which is absent from Ghemawat's (2001) initial model, thus suggesting that this parameter should be added to CAGE model formulated by the author.”

Under these conditions and recognizing that the CAGE Distance framework lacks some important aspects, this thesis supplements that Ghemawat (2001) does not approach the CAGE dimensions under the lens of a unified theoretical approach, such as Corporate Strategy Perspective, Learning Perspective, TCA, etc. He also fails to label clearly which variables compose each dimension. Instead he employs a general perspective, which aims at including a wide range of factors without stressing on specific characteristics and attributes of each dimension. As a result, a blurred environment is created regarding the capability of each dimension to accommodate specific concepts.

More specific, firstly, **economic distance** as developed by Ghemawat (2001) is not presented explicitly. As a result, a blurred environment is created regarding the capability of this dimension to accommodate variables related to firm and industry specifics, such as Research and Development (R&D) Expenditures, Firm Experience, etc. However, these days MNEs tend to weigh differences between countries not only on a broader basis, but also to include a wide range of particular factors (firm characteristics, institutional characteristics of the country they are going to invest in, industry characteristics, learning procedure, country profiles, etc.).

Secondly, **administrative/political distance** as suggested by Ghemawat (2001) mainly comprises historical and political associations between two countries. For instance, how colonial links may affect the trade between two countries. Additionally, it involves tariffs, trade quotas, restrictions on FDI movement, preferences for domestic competitors, etc. With this end in view, administrative/political distance pays attention to just one aspect of international firm behavior, which

is part of a wider approach, institutional theory.

However, institutional concept, as suggested by this thesis, embraces many different institutional approaches (New Institutional Economics, New Organizational Institutionalism, Comparative Institutionalism) which are largely complementary as they address and explain different facets of international firm behavior. For example, the theory of New Institutional Economics draws attention to the implications of the functioning of effectiveness of home-host country institutions, while the theory of Comparative Institutionalism highlights the implications of differences in the structure and organization of economies of MNEs. Thus, the ways in which institutions matter for international business are to a great extent dependent on how institutions are conceptualized and are measured.

In light of the above, institutional concept through the three approaches gives the chance for researchers to approach international business firm behavior through different notions, and subsequently, to achieve different explanatory results. Thus Aoki (2001, pp. 10) concludes that which definition of an institution to adopt is not an issue of right or wrong; it depends on the purpose of the analysis". Therefore, since IB is a field that draws on several disciplines and is concerned with multiple levels of analysis (Dunning 1989; Toyne and Nigh 1998; Shenkar 2004), then it is only natural that different strands of institutional theory have come to inform IB research. However, because institutional approaches differ in their explanatory potential, it is important to be aware of the differences between them, if we are to improve the understanding of institutions.

Moreover, the use of institutional theory is also important, because it provides researchers the basis for the incorporation of cultural variables, as well. Institutional theory is well-equipped to distinguish regulative from both normative and cognitive-cultural aspects (Scott 1995) and to offer a separate interpretation for each aspect. This approach has recently emerged by re-conciliating transaction cost-based entry mode theory with institutional and cultural context variables as well as transaction cost variables (Delios and Beamish 1999; Brouthers and Brouthers 2000; Brouthers 2002; Tatoglu, Glaister, and Erdal 2003; Demirbag and Weir 2006). In that concept, researchers, such as Roberts and Greenwood (1997), North, (1990), Kogut and Singh, (1988), have suggested that adding both institutional and cultural context variables to TCA enhances international understanding entry mode choices in three ways:

Firstly, according to Brouthers (2002) as well as Delios and Beamish (1999, pp. 917), institutional context variables provide a valuable extension to TCA, because they "refer to conditions that undermine property rights and increase risks in exchange".

Secondly, Brouthers and Brouthers (2000), suggest that cultural context variables need to be

added to transaction cost entry mode models, because they tend to influence managerial cost and uncertainty evaluations in target markets.

Thirdly, the inclusion of institutional and cultural distance, in accordance with transaction distance measures capture the comparative differences in institutional, cultural and economic-transaction level. This combination offers a considerable promise in terms of further enriching our understanding of how the interaction of these three factors affect International Business research.

With this end in view, this thesis seeks to fill the research gap in the literature of FDI entry mode choice determinants by incorporating the impact of institutional distance (distance between the home and host country institutional contexts), and, simultaneously, cultural distance (distance between the home and host country cultural contexts).

Lastly, **geographic distance** as presented by Ghemawat (2001) is perceived as a barrier-trade for countries which often switch to FDI as an alternative way to access target markets. In light of this view, geographic distance is limited to the physical size of the country, average distances within-country, access to waterways, oceans, etc. However, in this thesis, geographic distance, according to TCA, is approached as an uncertainty which entails costs, and, subsequently, affects the MNEs' decision of an appropriate entry-mode choice.

Furthermore, in this thesis geographic distance is approached as a factor which not only includes kilometers and topography related factors, as Ghemawat (2001) suggested, but also embraces linguistic, contingency and colonial factors making it more comprehensive. The logic behind this argument is based on the fact that Turkey's enjoys a favorable geographic position. Particularly, Turkey is bordered by eight countries: Bulgaria to the northwest; Greece to the west; Georgia to the northeast; Armenia, Iran and the Azerbaijan exclave of Nakhchivan to the east; and lastly, Iraq and Syria to the southeast. Moreover, the Mediterranean Sea is to the south, the Sea of Marmara, the Bosporus, and the Dardanelles demarcate the boundary between Thrace and Anatolia; and lastly, Turkey separates the Europe from Asia. Therefore, given its excellent and important geostrategic position, it is important this thesis to include, through geographic distance, variables that capture the interaction between the above countries.

So, this thesis having proposed some amendments to the CAGE Distance framework, it is now important to define how distance is approached, and simultaneously, how it is interrelated to TCA and entry mode choice. More specific, distance is perceived as the differences/dissimilarities between two countries (country A and country B) which is represented through four forms of distance:

- **Cultural distance** which is approached as the extent of dissimilarity/difference between two

countries in cognitive (beliefs and norms) levels. This means that culture molds behavior from the values that make up the perceptions of the world and societal norms (Root 1987).

- **Institutional distance** which is approached as a measure of cross-country differences (Kostova and Zaheer 1999), and refers to the extent of dissimilarity between the regulatory (social aspects), and normative (business aspects) institutions of two countries (Xu and Shenkar 2002, pp. 608).
- **Geographic distance** which is approached as the difference/dissimilarity in language, contingency, colonial and kilometer level between two countries.
- And lastly, **economic distance** which is approached as the differences in technological capability (research and development expenditure, firm size), in competitiveness, in institutional environment (Bilateral Investment Treaties), and, lastly, in development level, all of which significantly affect FDI equity mode decisions and performance.

However, it is hypothesized that each form of distance produces uncertainties, which are resulted in risks (costs) for the investing firm, because of the behavioral and environmental characteristics, on the one hand, and institutional characteristics (since entry mode choice is perceived as an institutional arrangement), on the other hand. The former includes bounded rationality, opportunism, asset specificity, disturbances or "small-numbers bargaining", and frequency (Williamson 1985).While the latter includes considerations for the MNE to gain legitimacy in the appropriate host country' environments under uncertain conditions. This means that for MNEs each new host country represents a different institutional environment, which can influence their choices and strategies substantially. As a result, MNEs entering new international markets are confronted with hurdles from institutional environments (Delios and Henisz 2003). Previous relevant literature mentions that the frequency, motivation, and type of acquisitions are strongly influenced by various institutional characteristics of the national business systems (Hall and Soskice 2001). "In the case of acquisition of local firms by MNEs, institutions in any country can pressurize MNEs by establishing the permissible range of ownership for foreign firms in their local subsidiaries. Therefore, partial acquisitions may emerge as the only option available for the investing MNEs in cases when there are legal restrictions on full ownership of foreign firms" (Arslan and Larimo 2012, pp. 322).

With this end in view, and arguing that TCA assumes that firms will tend to choose the entry mode choice (institutional arrangement) that entails the lowest cost for them. Then, the firm in oder to minimize its costs, and subsequently, to achieve an risk-adjusted return institutional arrangement (entry mode choice) will minimize the costs derived from different forms of distance (cultural, institutional,

geographic, and economic) circumventing the market through internalizing their activities.

Further, the main decision faced by foreign investors is probably between a wholly owned subsidiary (internalization with full hierarchical control) and joint venture (internalization, with only partial control)-which could be majority, wholly owned, equal, or minority partnership. This is because MNEs entering in a foreign market must first choose between accessing local context-specific resources and capabilities in an embedded form or entering alone. Due to high distances (dissimilarities according to Buckley and Casson (1976) terminology) at the cultural, institutional, geographic, and economic level, entrants often need local resources, such as, institutional or market knowledge embedded in existing organizations (Meyer and Estrin 2001; Anand and Delios 2002) and these can be accessed either by forming a joint venture or by taking over a local firm.

Despite the existence of relevant evidence (e.g., Anderson and Gatignon 1986; Anderson and Coughlan 1987; Gatignon and Anderson 1988; Hennart 1991; Eramilli and Rao, 1993; Delios and Beamish 1999; Brouthers and Brouthers 2003; Brouthers and Nakos 2004; Demirbag, Glaister, and Tatoglu 2007), the literature does not diverge on how firms should weigh tradeoffs to arrive at a choice that maximizes risk-adjusted return on investment. So, this thesis, having connected TCA, entry-mode choice and different forms of distance, proceeds to analyze in depth the framework of each form of distance which affects entry mode choice under the lens of the TCA unified theoretical framework.

5.4 A Framework Analysis of Cultural Distance

A cultural orientation describes the attitudes of most people most of the time, never of all the people all of the time (Adler 2002: 22)

When first analyzing the cultural framework many researchers seem to have used and continue to use the terms “cultural” and “psychic” distance interchangeably (e.g., Leamer 1974; Davidson 1980; Kogut and Singh 1988; Shoham and Albaum 1995; Bakerma and Bell 1996; Stöttinger and Schlegelmilch 1998; Child, Ng, and Wong 2002; Dow and Karunaratna 2006; Sousa and Bradley 2006; Ojala and Tyrväinen 2007), which reflects the lack of consensus. Similarly, the issue of measuring psychic distance has puzzled various authors (e.g., Johanson and Wiedersheim-Paul 1975; Swift 1999; Conway and Swift 2000; Evans and Mavondo 2002; Dow and Karunaratna 2006; Ellis 2008; Avloniti and Filippaios 2012) who have suggested different factors that may influence psychic distance. Additional, these factors seem to be difficult to measure using statistics publicly available.

For these reasons, many authors (e.g., Benito and Gripsrud 1992; Gomez-Mejia, and Palich 1997;

Morosini et al. 1998; Steensma et al. 2000) have only focused on measuring cultural distance, even though it is only one of the dimensions of psychic distance, as highlighted by Dow and Karunaratna (2006), Harzing (2003), and Evans and Mavondo (2002), respectively. For instance, Evans and Mavondo (2002) have presented a psychic distance summary construct which contains cultural distance and business distance. In their study, the measurement of organizational performance considering these two dimensions has approximately the same explanatory power as the single dimension of psychic distance. If both these dimensions are disaggregated into five individual factors for regression analysis, the resulting model of ten dimensions is of much higher explanatory power.

In the same line, Sousa and Bradley (2008) have argued against the coincidence of cultural and psychic distance. The authors posit that, while psychic distance exists at an individual level, cultural distance should be applied at a national level.

For the purpose of this section, focusing on national level distances, our discussion will be confined to cultural distance.

When talking about culture, one quickly notices that many different understandings and definitions have derived from different methodological assumptions exist (Kluckhohn 1951; Kluckhohn and Strodtbeck 1961; Rokeach 1973; Hofstede 1980; Hofstede and Bond 1988; Triandis 1994; Hofstede 2001; Schwartz 1992, 1999; Adler 2002; House et al. 2004). Culture is hard to grasp in concepts, let alone, to define in precise terms. Although many scholars in different disciplines have tried to come up with an all-inclusive and universal definition of what culture actually is, to this day a universally agreed-upon definition of culture is lacking (e.g., Magala 2005). **What, then, is meant when the term "cultural" is used ?** A number of relevant definitions include the following:

- **Kluckhohn** (1951, pp. 86) quotes culture as a consensus of anthropological definitions, particularly, says that:

culture consists in patterned ways of thinking, feeling, and reacting, acquired and transmitted mainly by symbols, constituting the distinctive achievements of human groups, including their embodiments in artifacts; the essential core of culture consists of traditional (e.g., historically derived and selected) ideas and especially their attached values.

- **Hofstede** (2001) defines culture as "collective programming of the mind that distinguishes the members of one group or category of people to another." (Hofstede 2001, pp.13) This meaning derives from social anthropology, but in the past decades it has entered common parlance. It refers to the way people think, feel, and act, distinguishing the members of one group or category of people from another. The word "category" can refer to nations, regions within or across nations, ethnicities, religions, occupations, organizations, or the genders. A simpler definition according to Hofstede is also "the unwritten rules of the social game" (http://geert-

hofstede.com/countries.html).

- According to **Adler** (2002) culture is a way of life of a group of people, the configuration of all the more or less stereotyped patterns of learned behavior which are handed down from one generation to the next through means of language and imitations.
- **GLOBE** (2004) which is the acronym for the Global Leadership and Organizational Behavior Effectiveness Research Program, defines culture as

"shared motives, values, beliefs, identities, and interpretations or meanings of significant events that result from common experiences of members of collectives and are transmitted across age generations." This definition can apply for both societies and organizations, and may be investigated at the societal and organizational level of analysis (GLOBE 2004, pp. 57).

- **Oxford Advanced Learner's Dictionary of Current English** (2010, pp. 370) defines culture as "1. the customs and beliefs, art, way of life social organization of a particular country or group. 2. a country or a group, with its own beliefs, etc. Also, defines culture as" beliefs and attitudes about something that people in a particular group (country) or organization share."

It is, therefore, clear that culture is not easy to define. Kroeber and Kluckhohn (1952) identified 164 definitions 60 years ago, and Taras, Rowney, and Steel (2009) highlight a multitude of conceptualizations with different focus. This section follows a general consensus which indicates that

culture broadly describes the human-made part of the environment (Herskovits, 1955), or a "group's characteristic way of perceiving its social environment" (Triandis, 1972, pp. 3). It can also entail the "shoulds" and "oughts" of life that guide "the meaning we attach to aspects of the world around us." (Earley, 2006, pp. 925) More specifically, culture provides people within a society with a common system of communication (Hall, 1976) and a common definition of identity (Camilleri, 1989) (Wilken, Jacob, and Prime, 2013, pp. 700).

This section covers the most basic studies, that define cross-national cultural differences, and shows how the latter impact a firm's behavior in general. The aim is to explain foreign ownership decisions, focusing on the **nature** of the cultural dimensions used assessing the relative merits of the two cultural frameworks formulated by **Hofstede and GLOBE**. The inclusion of GLOBE framework enhances the current debate on the relative merits of this cultural dimensional framework, as an alternative to Hofstede's index; it also addresses concerns expressed in relevant literature around the assumption of the stability of cultural dimensions over time.

This will be illustrated below by presenting a short exposition on the definition of national culture, reflecting the general understanding of the basic frameworks national cultures lead to. More specifically, these frameworks include the studies of Hofstede (1980, 2001), Schwartz (1992, 1999), Trompenaars (1997), and House et al. (2004). Furthermore, different levels (e.g., values, beliefs, and behaviors) and layers (e.g., individual, organizational, and occupational cultures) are deployed. Finally,

an explanation is given why this study focuses only on Hofstede's and GLOBE frameworks.

Having examined the values held by over 116,000 workers employed in a multinational company IBM with branches located in 72 countries, between 1967 and 1973, **Hofstede** (1980) has developed four country cultural dimensions: power distance, individualism–collectivism, uncertainty avoidance, and masculinity–femininity. A fifth dimension, i.e. time orientation (also referred to as Confucian Dynamism) has added in a subsequent study of Chinese Value Surveys (CCC 1987; Hofstede 2001).

In summary, the five cultural dimensions of Hofstede are described as follows (based on Hofstede 1997, 2001):

- *Power Distance Index (PDI):* is a measure of the interpersonal power or influence between two groups, for example B and S as perceived by the least powerful of the two, S.25 This means the extent to which the less powerful members of organizations and institutions accept and expect that power is distributed unequally. The basic problem involved is the degree of human inequality that underlies the functioning of each particular society (http://geert-hofstede.com/countries.html).
- *Uncertainty Avoidance Index (UAI):* expresses the degree to which the members of a society feel uncomfortable with uncertainty and ambiguity26. The fundamental issue here is how a society deals with the fact that the future can never be known: should we try to control the future or just let it happen? Countries exhibiting strong UAI maintain rigid codes of belief and behavior and are intolerant of unorthodox behavior and ideas. Weak UAI societies maintain a more relaxed attitude in which practice counts more than principles (http://geert-hofstede.com/countries.html).
- *Individualism* versus *Collectivism (IDV):* the high side of this dimension, called *Individualism*, and can be defined as a preference for a loosely-knit social framework in which individuals are expected to take care of themselves and their immediate families only. Its opposite, *Collectivism*, represents a preference for a tightly-knit framework in society in

[25] The term “power distance” is taken from the work of Mulder (1976, 1977). Mulder's theory is based on a long series of laboratory and field experiments with simple social structures. Mulder defines “power” as the “the potential to determine or direct (to a certain extent) the behavior of another person/persons more so than the other way round” and “power distance” as the degree of inequality in power between a less powerful Individual (I) and a more powerful Other (O), in which I and O belong to the same social system” Mulder (1977, pp. 90).

[26] According to Hofstede (1980, pp.111) a basic fact of life is that time only goes one way, put it another way, “we are living with uncertainty and we are conscious of it. Extreme uncertainty creates intolerable anxiety and human society has developed ways to cope with the inherent uncertainty of our living on the brink of an uncertain future. These ways belong to the domains of technology, law, and religion.
Different societies have adapted to uncertainty in different ways. These ways not only differ between traditional and modern societies, but even among modern societies. Ways of coping with uncertainty belong to the cultural heritage of societies and they are transferred through basic institutions, like the family, the school, and the state.

which individuals can expect their relatives or members of a particular in-group to look after them in exchange for unquestioning loyalty. A society's position on this dimension is reflected on whether people's self-image is defined in terms of "I" or "we" (http://geert-hofstede.com/countries.html).

- *Masculinity (MAS):* this dimension represents a preference in society for achievement, heroism, assertiveness, and material reward for success. Society at large is more competitive. Its opposite, femininity, stands for a preference for cooperation, modesty, caring for the weak and quality of life. Society at large is more consensus-oriented. (http://geert-hofstede.com/countries.html).
- *Long term versus Short term orientation (LOT):* the long-term orientation dimension can be interpreted as dealing with society's search for virtue. Societies with a short-term orientation generally have a strong concern with establishing the absolute Truth. They are normative in their thinking. They exhibit great respect for traditions, a relatively small propensity to save for the future, and a focus on achieving quick results. In societies with a long-term orientation, people believe that truth depends very much on situation, context and time. They show an ability to adapt traditions to changed conditions, a strong propensity to save and invest, thriftiness, and perseverance in achieving results (http://geert-hofstede.com/countries.html).

Nevertheless, this extensive and frequent application has also been subject to criticism (e.g., Banai 1982; Korman 1985; McSweeney 2002; Baskerville 2003, 2005; Javidan et al. 2006a; Bertsch and Girard 2011) for various reasons, including the lack of comprehensiveness, inattention to the conceptual equivalence of question items across cultures, the single-company focus, and outdated data (Chow 1994; Schwartz 1994).

Particularly, the most recurrent criticism has found in the relevant literature is based on the fact that Hofstede's data are focused on single firm, IBM. Therefore, while the number of respondents is considered to be particularly high, the fact that is based on one firm contradicts the extensiveness and generalizability of his findings (McSweeney 2002).

Additional criticisms have pointed out that the dimensions were constructed more than 30 years ago; However, Hofstede (2007) has claimed that they are still appropriate and applicable in the current cultural settings.

Something which is also important is that according to Harzing (2003, pp. 13) that

Hofstede's cultural index tends use equal scores for set of countries that differ on completely different aspects of culture.

This is problematic, since we could expect different dimensions of culture to have a differential impact on entry mode choice. Hofstede (2001) has argued, for instance, that Power Distance (PD) and Uncertainty Avoidance (UA) are practically relevant for the functioning of organizations.

Despite these criticisms of Hofstede's dimensions of national culture, most of his dimensions would still appear to be relevant and valid in present-day organizations (Hofstede 2007; Newman and Nollen 1996). In the same manner, Avloniti and Filippaios (2014, pp. 3) supplement that "Hofstede's work is undeniably one of the most prominent and extensive in the cultural Distance literature. It has gained extensive support and vast implementation". Moreover, Avloniti and Filippaios (2014, pp. 3) add that "Hofstede's work appears in approximately 1400 published articles in different journals, while 140 replications have been produced between the beginning of 2000 and the end of 2005; hence his contribution to the cultural literature is reflected in the fact that is almost impossible for someone not to mention his work in discussions involving culture and cultural diversity." This may be due to the fact that his dimensions have developed from values deeply established in a culture. Values are found to remain relatively divergent across cultures despite increasing globalization of markets, as opposed to more superficial manifestations of culture (e.g., symbols, rituals, and heroes) that have been changing ("converging") over time (Hofstede 2006).

By employing an alternative conceptual and operational approach (Kim and Gray 2009), **Schwartz** (1994) has developed a theory of value dimensions on which national cultures can be compared. Schwartz (1994) has identified ten individual-level value dimensions from data spanning 41 cultural groups in 38 nations; later he has extended his study to include 63 nations (2003). Unlike Hofstede, Schwartz links individual and national-level approaches by developing parallel sets of concepts applicable to both levels of analysis (Smith 2004, pp. 10). Through this approach, Schwartz develops seven country-level value types (conservation, hierarchy, intellectual autonomy, affective autonomy competency, harmony, egalitarian compromise) with three bipolar dimensions: Conservatism versus Intellectual and Affective Autonomy;27 Hierarchy versus Egalitarianism;28 and Mastery versus Harmony.29

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[27] Conservatism (or Embeddedness) versus (Intellectual and Affective) Autonomy, close to the individualism - collectivism dimension as cited in Hofstede 1984; Kagitçibasi and Berry 1989; Schwartz and Ros 1996; Triandis 1994. The principle that organizes this bipolar dimension is the opposition between pursuing values that especially benefit the individual, those of self-promotion, as opposed to achieving values that mostly benefit the collective, those of self-transcendence (Gouveia and Ros 2000).

[28] Hierarchy versus Egalitarianism (power difference versus societal basis), this dilemma deals with the issue of how to guarantee responsible behavior that will preserve the social fabric. To manage the unavoidable social interdependencies some sort of hierarchy is considered necessary.

[29] Mastery versus Harmony addresses the issue of humankind to the natural and social world. Do people in the society generally tend to believe they can actively master and change the world and get ahead through active self-assertion and ambition? Or do people generally accept the world as it is, and rather try to fit in harmoniously rather than to change or

Schwartz based on his cultural value priorities, asserts that

nations are arrayed in a two-dimensional space, revealing meaningful groupings of culturally related nations. The appropriate unit of analysis [for Schwartz] for assessing the validity of culture-level dimensions is the society or cultural group, [and] not the individual person (Hofstede 1980, 1990; Schwartz 1994b).

Schwartz defines values as conceptions of the desirable that guide the way social actors (e.g. organizational leaders, policy-makers, individual persons) select actions, evaluate people and events, and explain their actions and evaluations (cf. Kluckhohn 1951; Rokeach 1973; Schwartz 1992). In this view, values are trans-situational criteria or goals (e.g. security, hedonism), ordered by importance as guiding principles in life.

Cultural values represent the implicitly or explicitly shared abstract ideas about what is good, right, and desirable in a society (Williams 1970). These cultural values (e.g. freedom, prosperity, security) are the bases for the specificnorms that tell people what is appropriate in various situations. The ways that societal institutions (e.g., the family, education, economic, political, religious systems) function, their goals and their modes of operation, express cultural value priorities.

Schwartz's framework represents a large-scale and innovative study, in many respects. Schwartz distinguishes between individual and cultural levels. Apart from this, Schwartz distinguishes between value “types”30 and value “directions”.

Furthermore, the most important characteristic of Schwartz's framework is that he studies both the content and the structure of human values (Yeganeh and Su 2011) focusing not only on outcomes, but on preferences that guide one's life. This approach is supposed to produce results that are more succinct and accurate, minimizing the effects of situational factors. The Schwartz conceptual framework refers as novel in analyzing cultural traits; however its applicability in cross-cultural management research is very restricted.

Trompenaars and his colleagues (1993) developed a framework for cultural analysis based on a broad, 10- year survey involving approximately 15,000 questionnaires among 28 countries.31 His framework approaches cultural distance as the way in which a group of people solves problems. This process of problem solving is concerned with three important issues: relationship with the others, time and the environment.

Consequently, he proposes a model of seven fundamental dimensions of (national) culture for

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exploit it?

30 Value type is a group of values that can be conceptually combined into one meaningful description.

31 The model is based on data collected from managers in different countries of the world. More specific, Trompernaar's and Hampden Turner's questionnaires ask respondents for a preferred behavior in a number of both work and leisure situations.

understanding cultural diversity in business (pp. 8). The first five factors describe relationships with other people: universalism versus particularism, individualism versus collectivism, neutral versus emotional, specific versus diffuse, and achievement versus ascription. The remaining two dimensions are: orientation in time and attitudes towards the environment (Hofstede 1996).

Particularly, Universalism is related to a belief what is good. In that view, true can be discovered and applied universally, whereas particularism is a belief that unique circumnstances are the determinant (Thomas and Mueller 2000). Individualism and Collectivism are related to the extent to which importance is given to individual versus group interests. The third orientation is related to the importance of reason and emotion among people. In neutral cultures, people control their feelings and their emotions, but in affective cultures people tend to be demonstrative. Diffuse and Specific Cultures are contrasted in their attitude toward space and communication. In specific culture, people separate their private part of their lives from the public, while in Diffuse cultures these aspects may overlap (Thomas and Mueller 2000).

The fifth dimension is related to orientation of people to achievement and ascription. Attitude to time can be related to the past, present, or future orientations or to the extent to which time is regarded as linear or holistic. Attitude to environment is a major cultural factor and societies can have two main directions concerning environment: controlling nature through imposing their will upon it or living as a part of it.

Despite the comprehensiveness of this theory and its similarity with that of Hofstede's (1980), the present conceptual framework has many shortcomings, which detracts from its applicability. For example, it does not consider cultural dimensions, unlike Hofstede (1980), creating an overlap and blurring borders in relevant literature. What is more, this model measures the **intensity** of cultural values, excluding the relative values - a valuable tool for empirical research. Considering all the above, this model cannot be applied to empirical research and, therefore, restricts its applicability.

In an attempt to move beyond Hofstede's approach**, GLOBE (House et al. 2004)** designs constructs and scales that are more "comprehensive, cross-culturally developed, theoretically sound, and empirically verifiable" (Javidan et al. 2006 pp. 899). By applying these constructs to data collected from a total of 17,370 middle managers of 951 organizations in three industries (i.e. food processing, finance, and telecommunications) in 62 nations, nine country-level dimensions are identified:

- *Future Orientation:* is the degree to which individuals in an organization or society engage in future-oriented behaviors such as planning, investing in future, and delaying individual or collective gratification (GLOBE 2004, pp. 12).

- *Gender Egalitarianism:* is the degree to which members of an organization or society minimizes gender role differences while promoting gender equality (GLOBE 2004, pp. 12).
- *Assertiveness:* is the degree to which individuals in an organization or society are assertive, confrontational, and aggressive in social relationships (GLOBE 2004, pp. 12).
- *Institutional Collectivism or Collectivism I:* is the degree to which organizational and societal institutional practices encourage and reward collective distribution of resources and collective action (GLOBE 2004, pp. 12).
- *In-group collectivism or Collectivism II:* is the degree to which individuals express pride, loyalty, and cohesiveness in their organizations and their families (GLOBE, 2004, pp. 12).
- *Power Distance:* is the degree to which members of an organization or society expect and agree that power should be stratified and concentrated at higher levels of an organization or government (GLOBE 2004, pp. 12).
- *Uncertainty Avoidance:* is the extent to which members of an organization or society strive to avoid uncertainty by relying on established social norms, rituals, and bureaucratic practices. People in high uncertainty avoidance cultures actively seek to decrease the probability of unpredictable future events that could adversely affect affect the operation of an organization or society and remedy the success of each adverse effects (GLOBE 2004, pp. 11).
- *Performance Orientation:* is the degree to which an organization or society encourages and rewards group members for performance improvement and excellence (GLOBE 2004, pp. 13).
- *Human Orientation:* is the degree to which individuals and organizations or societies encourage and reward individuals foe being fair, generous, caring, and kind to others (GLOBE 2004, pp. 13).

Moreover, a distinction between **values and practices32** is conducted**.** This distinction is based on the view that a national culture can be broadly defined as "values, beliefs, norms, and behavioral patterns of a national group" (Javidan et al. 2006, pp. 899). Anchored in theory and empiricism, the recent GLOBE dimensions warrant further empirical assessment.

GLOBE methodological measures33 are based on various research methodologies both

[32] Practices are measures of "What is,..." or "What are,..." common behaviors, institutional practices, proscriptions, and prescriptions. Values are expressed as "What should be,...". As each respondent was to respond on both the practices and values, the values measured are referred to as "contextualized values", which means that the questionnaire items were designed to yield current societal and organizational practices and respondents' values with respect to these practices.

[33] Questionnaires items are developed on the basis of the work of prior scholars (e.g., Hofstede, Triandis, Kluckhohn and Strodtbeck), interviews and focus groups are conducted in several cultures, extant organizational and culture theory, and two pilot studies among middle managers (House et al. 2004, pp. 21).

qualitative and quantitative (2004, pp. 91). Hanges (2004, pp. 92) concludes that

> the constructs measured by the GLOBE scales generalize beyond the sample from which the data are obtained, the method used to collect these data, and the "sets of operations" applied on these data [and thus that] [t]he findings reflect the broader societal and organizational cultures under study." However, comparing project GLOBE with the earlier cultural studies, one must also acknowledge that "each has inherent errors, and neither can be considered as providing the one best way to denote national culture, as cited in Smith (2006, pp. 915).

Besides, many terms are conceptually simplistic about the nature of culture and neglect its depth, richness, and complexity to some extent. Methodologically, as also acknowledged by Kogut and Singh (1988) national-level data obtained in these frameworks are frequently used to predict individual or organizational behavior despite the lack of any guarantee that an individual or organization will act in the way his/her national culture dictates. The problem of this fallacy may result in potential systematic bias, thus distorting relationships between variables.

Despite the flaws discussed, this framework enables us to put "theories and explanations into a clarifying perspective" as cited in Sondergaard 1994; Sivakumar and Nakata 2001 and to "deconstruct culture into a set of universal "ethic" dimensions (Schwartz 1994, pp. 116– 117). Following, also, Javidan et al.'s conclusion on the 2006 exchange between Hofstede and House et al. (2006b, pp. 899) it is argued that:

> [I]t is time to move beyond Hofstede's approach and to design constructs and scales that are more comprehensive, cross-culturally developed, theoretically sound, and empirically verifiable." This last remark is particularly true after recent waves of empirical criticism of Hofstede (e.g., by Brendan McSweeney as cited earlier).

The first complexity in understanding culture is related to the different levels of depth of cultures. With the "onion assumption", Hofstede (1980, 2001) explains that values drive practices (behaviors) in a positive way, i.e., when people value something, they act alike (Bik 2010).

However, the notion that values and beliefs drive behavior has recently been questioned by House et al. (2004, as cited in Javidan et al. 2006b, pp. 902) and these notions show the opposite:

> people may hold views of what should be (e.g., [contextualized] values) based on what they observe in action (e.g., practices)". One explanation is that people generally desire more of something they do not have. Another explanation can be found in the questionnaire design aimed at measuring "contextualized values". House et al. (2004) concludes that Hofstede's "onion assumption" is too simplistic and additional research is needed to explain such a complex relationship (Javidan et al. 2006b, pp. 901) (Bik 2010, pp. 87).

Cultural practices should be considered to be more robust indicators or explanatory factors of actual behavioral differences compared to cultural values. For example, Smith et al. (2006, pp.49) states that "the 'as is' ratings comprise the most extensive [cultural] survey to date that has focused on the description of behaviors."

Having recognized the importance of "practices" and "values" (as proposed by GLOBE) and the distinction between them led to their incorporation and use in this section in the following manner: Firstly, a model is constructed which incorporates only the relative "values" of GLOBE and Hofstede's indices. Then a second model incorporates the "practices" of GLOBE index and the relative "values" of Hofstede's index. Lastly, a third model incorporates both "practices" and "values" of the GLOBE index and compares them with the relative "values" of Hofstede's index. This approach helps formulate an accurate and spherical construct of foreign ownership decisions comparing the relative merits of these two alternative cultural frameworks in various ways (Hofstede 1980; GLOBE 2004).

Generally, three **layers** of cultural analysis are considered to interact or interfere in the relationship between societal culture and the professional behavior of auditors functioning in that culture: **the individual level, the organizational level, and the occupational level**.

Are all individuals within a defined culture the same? The answer, of course, is no. Individuals all have their own characteristics, values, and beliefs. Nevertheless, in a given culture all these individual values and beliefs are summed up to the level of some common denominator or assumed homogeneity. This is considered the case with national cultures: in a country, certain values and practices will be dominant over others. Cultural dimensions used in this study refer to "the value culture of the dominant, majority group" (Schwartz 1999, pp. 25).

Several scholars have studied the interaction between cultural values at the individual level and those at the societal level (e.g., Smith and Schwartz 1997).34 This is important as much of the data used to study cultures is collected from individuals within those cultures, e.g. through questionnaires distributed to individual participants. When comparing cultures at the societal level, "the results obtained are characterizations of cultures but not of individuals." (Van de Vijver and Leung 1997, pp. 124) This is generally referred to as the "ecological fallacy" (e.g., Hofstede 2001, pp.16), confusing individual-level data within cultures with societal-level data between cultures.

The "reversed ecological fallacy", on the other hand, refers to the assumption that individual-level data is also valid at the societal level and, therefore, the assumption that cultures are "king-sized individuals." (House et al. 2004, pp. 99) These cross-level inferences "can be fallacious because of a difference in meaning of constructs at the individual and cultural levels" (Van de Vijver and Leung 1997, pp. 125).

[34] These cultural dimensions are the dimensions on the basis of which countries differentiate themselves. This, however, does not say anything about the absolute cultural value of a country; only that one country is higher on a certain dimension than another country. For example, all countries are collectivist to a certain extent, but one country is generally more collectivist than the other.

Hofstede supposes that in IBM35 there is a singular, uniform and monopolistic organizational culture (cf. Risberg 1999; Parker 2000). The principal flaw of this characterization is not to have claimed that there is a single world - wide IBM organizational culture – albeit that is contestable, and not self-evident as he suggests – but to treat that culture as the only organizational culture in IBM (McSweeney 2002).

However, about 10 years after the initial publication of his analysis of the IBM survey data, Hofstede began to belatedly acknowledge that there is cultural variety within and between units of the same organization (e.g., 1991, pp. 193; 1998a, pp. 11).36 In that way, Hofstede redefines his initial "organizational culture" leaving his national culture identification claims undisturbed. **How does he do that?**

He states that "national cultures and organizational cultures are phenomena of a different order" (Hofstede 1991, pp.182). Whilst, national cultures are characterized, he says,

by core [phenomenological] values – which his questionnaire analysis sought to identify – "the core of an organization's culture", he states, is not shared "values", but, "shared perceptions of daily practices" (1991, pp. 182–3). Thus, he concludes that the cultural heterogeneity within IBM does not affect his cross-subsidiary comparison of values, as organizational culture does not contain/reflect values (1999, pp. 38) (McSweeney 2002, pp. 97).

On the contrary, House et al. (2004, pp. 77) not clearly explain organizational level. With this end in view, the GLOBE project tries to explain organizational level through the mechanisms of the institutional theory, and more specifically, through isomorphism - which is the basic principle of institutional theory. Illustrated the interaction among industrial, organizational, and societal characteristics with national culture. These theories propound that organizational cultures become "isomorphic" with the societal cultures in which they are embedded, indicating that organizational cultures pass on the interacting effect of societal cultures on professional behavior (Bik 2010, pp. 88).

Hofstede asserts that "within the occupational level, there is a certain degree of values and convictions that people hold with respect to the national and organizations cultures they are part of. The culture of management as an occupation has components from national and organizational cultures. This is an important distinction from the organizational level" (Wikipedia 2013) (http://en.wikipedia.org/wiki/Hofstede's_cultural_dimensions_theory).

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35 The Enterprise in which Hofstede conducted his research.

36 Research projects which he directs on organizational cultures reveals, he states, "considerable differences" (1991, pp. 182). An inevitable implication of this changed characterization of organizational culture is that during the IBM survey periods there are cultural differences both within each IBM national unit and between them (1991, pp. 253) and not cultural uniformity as Hofstede had originally claimed and trumpeted as a distinctive virtue of his research. An acknowledgement that organizations possibly have multiple cultures and not a single culture might seem to contradict a crucial part of his first assumption and thus undermine Hofstede's national culture mapping claims.

However, this assumption according to McSweeney (2002, pp. 98) wrongly implies that:

(a) members of each organizational occupation regardless of country will have attended the same type of courses – yet someone in, say, marketing in IBM was just as likely to have studied zoology, or anthropology, or French, as "marketing" itself; (b) the fundamental contents of the pertinent third-level courses are the same, regardless of country, and yet we are all aware that even within single countries there is not uniformity of course content; (c) occupational "socialization" only occurs pre-work: at "school or university (1991: 182)."

An important study in this respect, is that of Soeters and Schreuder (1988): occupational culture also interacts with the impact of national culture although national cultures still "shine through" distinctively. Some effect of occupational or industry culture should be expected (e.g., Merrit (2000) in the aviation industry). However, no universally consistent effect has been found so far (e.g., House et al. 2004, pp. 664).

In short, and following Bik (2010) it is argued "that employees maintain or enhance their culturally specific ways of working even when employed by multinational or global organizations." (Adler 2002, pp. 69) In other words, there is a general consensus that organizational or occupational practices or cultures do not (significantly) eliminate the impact of societal cultural differences on the behavior of professionals functioning in those societies. House et al. (2004), concurs by concluding that "one of the major findings of the GLOBE research program is that organizational and managerial practices tend to reflect the societal orientation in which they function. (…). In this section, it is supposed that organizational cultures reflect the societies in which they are embedded" (2004, pp. 6, 37). Hence, societal cultural differences are expected to influence the behavior of businessmen within that society, irrespective of the organizational or occupational culture.

When deploying and assessing such conceptual frameworks, the conclusion is that there are many reasons why this project will focus theoretically and then empirically only on Hofstede and GLOBE frameworks excluding Schwartz, and Trompenaars, framework:

To start with, Hofstede's and GLOBE frameworks are very close to Redding's distinction, that is, culture generally reflects how systems, e.g., legal systems and institutions (political institutions) of a nation work.

Moreover, these frameworks provide a quantitative measurement for said meanings.

Furthermore, the publication of GLOBE's study has witnessed the resurgence of scholarly debate on the relative merits of these two dimensional cultural frameworks, Hofstede's and GLOBE in particular. Hofstede (2006) claims that GLOBE project is an expansion and replication of his five dimensions, yet this has been vigorously refuted by Javidan et al. (2006) in their re-analysis of the relationships between GLOBE's and Hofstede's dimensions (Kim and Gray 2007). It is argued that the

relatively weak correlations between the dimensions show that GLOBE moves beyond Hofstede's with the nine dimensions showing strong construct validity. However, albeit a bit scattered, we can still find some meaningful associations between some of these dimensions, especially for power distance, individualism/collectivism, and uncertainty avoidance (Hofstede 2006; Javidan et al. 2006).

Another significant reason is that, while Schwartz's (1994)37 cultural value dimensions are distinct from Hofstede's, there exist significant conceptual similarities and empirical associations between the two sets of dimensions (Hofstede 2001; Steenkamp 2001). For example, conceptually Schwartz's autonomy/embeddedness dimension and Hofstede's individualism/collectivism continuum overlap as "both autonomy and individualism are associated with the notion of optimistic, responsible enjoyment, while embeddedness and collectivism reflect the broader concept of fulfilling one's duty with the existing social order" (Ahn 2005).

Additionally, this conceptual similarity between Schwartz's and Hofstede's frameworks, is further supported by strong empirical associations (Schwartz 1994). Schwartz's dimensions are an improvement on Hofstede's in that he used an exhaustive set of universal conceptual dimensions ("etic") and gave particular attention to issues like the effect of sample size, historical change, distinction between culture-level and individual-level dimensions, meanings that are far from the defined conceptual framework followed in this project.

Finally, despite its numerous merits, the Schwartz's and Trompenaars' models have not been applied as extensively as the Hofstede's and GLOBE frameworks in IB. This lack of empirical testing may be due to the nonorthogonal nature of value dimensions, which makes it difficult to use multivariate statistical techniques (Steenkamp 2001). Nevertheless, these theoretical frameworks are soundly founded and rigorously measured, while offering useful theoretical insight potential for further studying MNEs behavior.

Cultural distance is widely used to explain the behavior of MNEs in a vast array of areas including entry mode choice, foreign market selection, sequential investment, MNE performance, level of control, and the transfer of parent systems (e.g., Kogut and Singh 1988; Rosenzweig and Nohria 1994; Shenkar 2001; Brouthers 2002; Harzing 2003; Tihanyi et al. 2005). In particular, it has been extensively used to explain the foreign entry mode choice of MNEs. The most recent hypothesis proposes a curvilinear relationship between cultural distance and the mode of entry choice, whereby

[37] Schwartz (1994) identifies ten individual-level value dimensions from data spanning 41 cultural groups in 38 nations, which was later extended to 63 nations (2003). Schwartz links individual and national-level approaches by developing parallel sets of concepts applicable to both levels of analysis (Smith, 2004: 10). Through this approach, Schwartz develops seven country-level value types with three bipolar dimensions: autonomy (intellectual/affective)–embeddedness; egalitarianism–hierarchy; and harmony–mastery (refer to Schwartz 1994 for further details).

low and high cultural distance would lead to a wholly owned mode preference, while a moderate level of cultural distance will favor a cooperative mode (Wang and Schaan 2008).

The majority of the studies have examined the relationship of cultural distance to FDI entry modes, i.e. ownership (joint ventures vs. wholly owned subsidiaries) and establishment mode (Greenfield, acquisition or joint venture), except for a few studies involving non-FDI modes (e.g. Erramilli 1991; Shane 1993, 1994; Contractor and Kundu 1998; Arora and Fosfuri 2000; Chen and Hu 2002). Theoretically, the effect of cultural distance on ownership strategies is ambiguous: in distant locations, an investor may be more in need of a partner, yet it is also more difficult to manage the inter-cultural interface with a partner. This makes the impact of cultural distance an interesting question for empirical study.

Mixed empirical results have been presented in relevant literature. Kogut and Singh (1988) examined 228 foreign ventures in the U.S., and found that the greater the cultural distance between the home country and the USA, the greater the probability of choosing a joint venture over a Greenfield operation or acquisition. This positive relationship to shared control mode of entry has been supported in subsequent studies (e.g. Erramilli and Rao 1993; Agarwal 1994; Pan 1996; Hennart and Larimo 1998; Brouthers and Brouthers 2001; Meyer 2001; Pak and Park 2004). The MNE's preference for sharing the equity of its host country affiliate with a local partner may be due to the cost and uncertainty constraints associated with entering culturally distant markets. The costs of controlling and coordinating a wholly owned subsidiary are perceived to be greater than the transaction costs incurred to manage a joint venture.

In contrast, an exactly opposite relationship has also been supported in the literature (e.g., Padmanabhan and Cho 1996; Erramilli, Agarwal, and Kim 1997; Chen and Hu 2002). For example, Chen and Hu (2002) found that foreign MNEs select a wholly owned subsidiary in China when the cultural distance is large. This finding is in line with that of Padmanabhan and Cho (1996) who finds that large cultural distance between Japan and the host country of Japanese MNEs is significantly related to their choice of a high control mode (i.e. wholly owned subsidiaries). Interestingly, from a survey of Singaporean MNEs where cultural distance is based on primary data, not on Hofstede's dimensions, Rajan and Pangarkar (2000) found that cultural distance has varying effects on ownership mode choice. While cultural distance has a bearing on the choice between minority joint ventures and wholly owned subsidiaries, it does not differentiate between majority joint ventures and wholly owned subsidiaries. Finally, no significant relationship is found in Erramilli (1996), which was further supported in Tihanyi et al. (2005) recent meta-analyses of data from 66 independent samples previously

used in prior studies. Tihanyi et al. (2005) did not any obtain evidence of a significant relationship between cultural distance and entry mode.

5.5 A Framework Analysis of Institutional Distance

A recurring question in International Business (IB) research is how institutions matter for IB activity (Henisz and Swaminathan 2008; Eden 2010). Through the 2000s, institutional approaches have been particularly influential amongst comparative studies of business. What institutional approaches suggest is that embedded social cultures and rules mould and remoulded by the choices made by firms. In practice, this means that within specific national contexts, there will emerge a dominant way of doing things, which may have the beneficial effects of imparting predictability and lowering transaction costs (Geoffrey and Dermibag 2012).

In this project, it is taken as assumption that firm's strategy and structure is shaped by the national institutional context in which the firm exists (Morgan 2012). In other words, this analysis supports that "the institutional perspective emphasizes the importance of the influence of both institutional forces embedded in national environments and decision makers' cognitive constraints on the founding conditions of new ventures" (Yiu and Makino 2002, 667). **But what happens when a firm internationalizes in the sense of locating offices, branches, subsidiaries, production facilities, in other countries, which means that enters a different institutional context?**

Kostova (1999) describes this a situation of institutional duality (see also Morgan and Kristene 2006). The MNE subsidiary in the locality creates co-presence of two institutional logics. The first is conformity to the rules of its home context and the second is conformity to the host context. This gives rise to two research themes. The first is primarily concerned with adaptations and learning which the multinational undergoes in a specific institutional context. **Does it structure the subsidiary in accordance with its home-based practices or the practices of its host context? How does this affect the whole strategy and structure of multinational?** This is increasingly described in terms of micro-politics of the MNEs and its subsidiaries. The second considers how MNEs relate to and affected by the host institutional context and this can be labelled as the macro-politics of the MNEs. This section will pay attention to both of them.

When posing these questions, another important issue emerges: **which institutional theory is appropriate to accommodate and give answers to these queries**. This is partially because terms such as "institutions," "institutional distance," and "institutional theory" mask the wide variety of

institutional approaches that are currently used in IB research (Hotho and Pedersen 2012). Different and various conceptualizations, terms, and levels of analysis make it difficult to refer to institutions in a more general sense. For example, institutions may differ on a regulative, normative, and, cognitive basis. Aoki (2001, pp. 10), however, concludes that "which definition of an institution to adopt is not an issue of right or wrong; it depends on the purpose of the analysis". Thus, this section cites the three dominant institutional approaches in IB research (without analyzing them except for New Institutional Economics, which is used as a theoretical framework in the present section): New Institutional Economics, Organizational Institutionalism, and Comparative Institutionalism.

Peng (2002) argues that an institution-based view of business strategy can explain **"why strategies of firms from different countries and regions differ"**. The analysis in this section focuses on one of the most important MNE strategies, namely the mode of entry decision, which is operationalized as the percentage of equity ownership held by the MNEs (where zero percent represents exporting and 100 percent a greenfield or wholly owned subsidiary) with or without a local partner.

Alternative modes of entry provide foreign investors with different means of managing the dual challenges of institutional distance: gaining legitimacy and transferring practices. For example, greenfield investors or wholly owned subsidiaries establish a new organization by recruiting and training staff individually, and creating an organizational structure that matches MNE global structures (Brooke and Remmers 1970; Bartlett and Ghoshal 1989. Investors can, therefore, create an organizational culture that is similar to the parent, which reduces the frictions between parent and subsidiaries, and facilitates the transfer of practices. Consequently, MNEs are more likely to choose a Greenfield investment in situations where transmitting their own practices to their affiliates is of greater concern than earning and maintaining legitimacy (Ionascu, Meyer, and Estrin 2004).

However, Greenfield projects have, at least initially, only very limited legitimacy in the local environment, while cooperation with a local partner, in the form of a joint venture or an acquisition enables the foreign investor to benefit from the partner's local status. Cooperative entry allows thus, MNEs appear less foreign than entry via Greenfield projects (Kostova and Zaheer 1999), even though the process of internal accommodation may not always be smooth (Xu and Shenkar 2002). Therefore, the choice of a joint venture or a local acquisition is more appropriate in MNE's for which the attainment of local legitimacy is of greater concern than transferring practices to affiliates. But, such cooperation implies that the local organization is more strongly influenced by local practices, which implies that the interactions with other units of the foreign parent MNE may be less smooth. Thus,

Greenfield projects facilitate transfer of organizational practices, while joint ventures and acquisitions are more useful to build local legitimacy.

This differential exposure to local institutions makes it natural to apply institutional theory to analyze the link between differences in business environments and MNEs' entry modes (Davis, Desai, and Francis 2000; Lu 2002; Xu and Shenkar 2002; Harzing 2003).

5.6 A Framework of Analysis of Geographic Distance

The international business literature has devoted a great deal of attention to firms' entry decisions, focusing on an array of institutional perspectives (e.g., Yiu and Makino 2002), learning-based perspectives (e.g., Kogut 1988; Barkema and Vermeulen 1998), transaction cost economic theory (e.g., Anderson and Gatignon 1986, Erramilli and Rao 1993), and country-level considerations (see above for details) to identify the determinants of firms' governance decisions in overseas market. Indeed, these frameworks have been very useful at improving our understanding of the determinants of firms' international expansion strategies. However, with few exceptions, little attention has been paid to geographic distance as a potential driver of firms' modes of entry, although this variable has often been considered either as a proxy for cultural or psychic distance (Johanson and Vahlne 1977), or in terms of the accounting and transportation costs inherent in investments situated at more distant locations (e.g., Hennart and Park 1994; Caves 1996).

Admittedly, geographic distance is an important factor for the choice between FDI and other forms of entry mode (Harzing 2004). Geographic distance might lead to a preference for more control through high-control entry modes (joint venture or Greenfield), since control through direct personal interaction is less easy to achieve in distant countries. And although geographic distance and cultural distance are highly correlated for some country pairs, they are completely unrelated for others.

For example, Australia is culturally similar to the U.S./Canada and the U.K., but geographically very distant. Countries within Europe are geographically very close but culturally very different. The problem with most of the studies discussed above is that they usually only include countries where geographic and cultural distance are highly correlated, by using the U.S. as home/host country and Europe and/or Japan as home/host countries. If cultural distance is found to influence entry-mode choice, would this relationship still be valid for countries that are culturally very distant but geographically very close e.g. Turkey as host country and Greece, Germany, U.K., the Netherlands, etc. as home countries?

This section focuses on a theoretical approach to the relationship between entry mode and geographic distance investigating the impact of geographic distance on the degree of ownership purchased by firms in specific foreign target-countries. Studies of geographic distance have gained momentum in a number of business areas, such as mergers and acquisitions (e.g., Chakrabarti and Mitchell 2005; Grote and Umber 2006; Grote and Rücker 2007), entrepreneurship (e.g., Jaffe, Trajtenberg, and Henderson 1993; Lerner 1995; Audretsch and Feldman 1996; Audretsch and Stephan 1996), and financial economics (e.g., Coval and Moskowitz 1999; Garmaise and Moskowitz 2004; Bae, Stulz, and Tan 2005; Pirinsky and Wang 2006). This research is built upon and explores how geographic distance can be isolated as an independent variable capable of shifting firms' cross-border entry-mode strategies.

Amongst the country-level variables that have been investigated in the literature, geographic distance has received comparatively less attention from scholars. Although this variable has been accounted for in previous research on FDI and entry mode literature (e.g., Kinoshita and Campos 2003; Pusterla and Resmini 2007), in most cases it has served either as a control or as a proxy for cultural or psychic distance (Strivastava and Green 1986; Kogut and Singh 1989; Groose and Goldberg 1991; Martin and Velasquez 1997). Few exceptions exist that approach geographic distance as an independent factor that affects entry mode and investigates the determinants of FDI (e.g., Grosse and Trevino 1996; Bevan, Estrin, and Meyer 2004). Consequently, the work outlined above does not give specific answers to the twofold question **"why and how geographic distance might affect FDI patterns?"** on the

other hand, it does open an opportunity to tackle this question formally. Therefore, the literature of geographic distance in this section is analyzed into five parts (see below), so that its role and impact on the entry mode literature may be understood.

Beckerman (1956) was the first one to introduce "the special problem" of psychic distance; he distinguishes the behavioral component - which influences the ways by which suppliers in a given country would see their customers as being "closer" - from the actual geographic or economic distance. In that way, geographic distance defined as a unique and valuable factor capable of influencing psychic distance (Ellis 2008; Figueiredo da Rocha, Ferreira da Silva, and Carneiro n.d.; Evans and Mavodo 2002a).

Later, the original proponents of the Uppsala model have also used this distinction between psychic and geographic distance, providing a theoretical rationale for the use of geographic distance. In their view, geographic distance can be used as a surrogate for psychic distance because distance limits the access and thus the ability to learn about other markets (Johanson and Wiedersheim-Paul 1975).

Additionally, Dow and Karunaratna (2006) use time zones as a proxy for geographic distance, including geographic distance as a control variable in their measurement model of psychic distance; they conclude that "geographic distance is still the single most influential "trade inhibitor". Similarly it is argued in Dow and Karunaratna's (2006, pp. 593) paper, that

> geographic distance accounts for almost twice as much total variance explained as all the other psychic distance stimuli combined; and this is for a set of industries (Conlon 1985) explicitly identified as having low transportation costs!" This is consistent with Leamer and Storper (2001) findings that the importance of geographic distance has not declined substantially.

Furthermore, Stöttinger and Schlegelmilch (1998) provide an interesting measure of psychic distance by combining magnitude scaling and geographic distance. Child, Ng, and Wong (2002) also recognize the importance of geographic distance through the lens of psychic distance. Geographic distance in their empirical work is approached to as temporal and climatic differences. Another variable of the geographic distance is proposed by Souza and Bradley (2005, 2006), who suggest the use of the individual perception of differences in climatic conditions as a measure of psychic distance.

On the other hand, Clark and Pugh (2001) (also Luostarinen 1979) do not consider geographic distance as a dimension of the psychic distance construct, but as a different, although *relevant,* concept impacting foreign market entry. Dow (2000, pp. 54) supplements that progress in telecommunications and transportation "dramatically reduces the impact of geographic distance" and therefore its use should be "severely thrown into doubt". After testing the two constructs, he concludes that "they represent largely distinct relationships" (pp. 58). Also, suggests that low geographic distance is viewed

favorably in the country selection of Australian SMEs because of lower transportation costs. Similarly, Chetty (1999) finds that managers of New Zealand SMEs favor Australian market in their market entry decision due to a familiar business environment and low operation costs.

Yet, Beckerman (1956, pp. 32) considers economic distance in a different construct. For him, economic distance includes "the cost of transversing distance rather than the actual mileage involved", which can be measured differently depending on whether one would consider the closest points between the two countries, the geometric centers of the countries, or even their centers of gravity (based on some sort of weighting mechanisms). Lastly, Klein and Roth (1990, pp. 29) consider physical distance as a "hard" dimension and psychic distance as a "soft" dimension of the same phenomenon (the "gap between buyers and sellers").

Another strand of literature examines geographic distance in the base of cultural distance. For example, Shenkar (2001) proposes that geographic distance should be used as a moderator or a mediator of the impact of cultural distance.

In a theoretical base, Ghemawat (2001) in a comprehensive and innovative attempt tries to broaden the study of cross-national distance delimiting four kinds of distance including: geographic distance. In that framework Ghemawat (2001) defines geographic distance with the following way:

> [geographic distance is] not only a matter of how far away the country is in miles or kilometers. Other attributes that must be considered include the physical size of the country, average within-country distances to borders, access to waterways and the ocean, and topography. Man-made geographic attributes also must be taken into account—most notably, a country's transportation and communication infrastructures. [Subsequently,] companies that find geography a barrier to trade are often expected to switch to direct investment in local plant and equipment as an alternative way to access target markets. But current research suggests that this approach may be flawed: Geographic distance has a dampening effect, overall, on investment flows as well as on trade flows. In short, it is important to keep both information networks and transportation infrastructures in mind when assessing the geographic influences on cross-border economic activity" (Ghemawat 2001, pp.7).

In the same line, Houtum (2000) focuses on a theoretical base considering borders and border regions. More specifically, illustrates and categorizes the various strands that are developed in the relevant literature, as an effort to assess and understand how borders function and, mostly, how delimit the interaction between peoples and countries within European area. According to Houtum (2000) three different theoretical strands have been discerned from the rich geographic literature on borders and border regions. These three strands are labelled as:

- Flow Approach,[38]

[38] This strand of study follows the classic European economic geographers, such as Zotti (1982), and Clark (1994). In this strand, physical distance became one of the key words in the spatial economics. The physical position of the borders are

- Cross Border Cooperation,39
- and People Approach.40

This section will not focus on these strands, although they are of great significance.

Many other scholars have tried to approach geographic distance using gravity models (Wolf and Weinschrott 1973; Hamilton and Winters 1992; Krishna 2003; Fratianni and Oh 2009). Gravity models in international economics literature consider how geographic distance between two countries affects

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measured, mostly, in terms of physical distance. As a result, borders are seen as peripheral in the national context.
In particularly, the basic idea of this approach is that space can be seen as a homogeneous physical abstraction in which artificial obstacles prevent a natural continuity in the flow of activities. Thus, state borders, such as *discontinuities* increase the marginal cost of interaction (Nijkamp, Rietveld, and Salomon 1990).
It ensues that an important subject of analysis using the flow approach is the density and missing links with infrastructure. The analysis of the link between regional accessibility and regional economic potential became particularly important subject of study. Due to the dominance of the flow approach in regional economic science, borders become a synonym for barriers, just as they had in the sphere of economics.

[39] Another stream of studies have emerged since the early of 1990s. Cross-Border Cooperation Approach is clearly linked to a more general in integration and cooperation in economic geography. Terms and concepts, such as clusters, districts, networks, transaction costs, trust, learning, embeddedness, cooperation, alliances, language, and so on have become very popular in geography. Consequently, this stream of literature takes into account, national and international integration, as takes place in the environment where globalization and Europeanization play basic role in the economy.
The underlying assumption in many of the policy-oriented studies using this approach is that borders can be overcome, and what is more, it should be overcome in the seemingly borderless space of the world. Within these studies, borders can be seen as barriers but not as physical barriers but as barriers to succeed a prosperous integration and harmonization process.
The view of human against borders changed from that dominated in flow approach. While human approach assumes that man functions in cost-minimizing concept, in Cross-Border Cooperation Approach man functions in a different concept and faces borders as a means of succeeding in his economic goals, and generally satisfying his own needs.
The dominant view of borders and regions also changes in this approach. More specific, it argues that borders and regions could profit heavily from the benefits of integration and cooperation. The national being changed into a more dynamic concept by opening its border. The formation of economic relationships across borders can, thus lead to a more cost-effective and efficient spatial division of labor as cited in Anderson 1982; Martinos and Caspara 1990; Nijkamp 1993.
As a result border regions are no longer seen as buffer, and protection zones, but they are seen as active spaces and key areas for cross border policy development. Fitting the image of border regions many studies within the Cross-Border Cooperation compares economic, cultural, political, and social social characteristics among countries. Particularly, studies in the field of administrative and political dissimilarities chiefly focus on the distance between neighboring nations as an obstacle to integration as cited in Anserdon 1982; Duchacek, Latouche, and Stevenson 1988; Verberk 1991; Scott 1999; Church and Reid 1999. The measurement of this distance is chiefly on the national level which then can be compared.
Along with the social distance "objective" differences between characteristics of the population are included on either side of the border. These differences are evolved in language, territory, education, population density, if they experience of the same colonization, etc as cited in Cramer, Logie, and Mergaerts 1984; Grosse and Trevino 1996; Shenkar 2001; Kwon and Konopa 1992; Arora and Fosfuri 2000.

[40] Emphasis in this strand has been put to mental creation and symbolic shaping and reshaping of borders by human beings. This strand centers its attention to human behaviors without ignoring the said two. Studies using this strand of analysis make use of different kind of disciplines within geography - including political and social geography, anthropology, and psychology- to grasp the basic elements of human spatial behavior. Borders are interpreted as necessary constituents of social and individual life, and, therefore, studied in terms of relevance rather than as an impediment or barrier effect.
This strand also focus on emotional reactions, actions, origins of individuals, and groups are confronted with the economic and political ambitions of an integration. This strand distinguishes between sociological people approaches and "sociopsychological" people approaches which are out of the attention of this research.

bilateral trade flows (Berry, F Guillèn, and Zhou 2010). Different methods are used to examine geographic distance between pairs of countries. For example, Chen (2004) calculates geographic distance according to the latitude and longitude of the main city in each region or country, and finds that geographic distance decreases international trade between pairs of countries. In the same line, Krishna (2003) uses the direct line distance through a gravity model to measure geographic distance.

Grosse and Trevino (1996) approach geographic distance as independent factor that affects entry mode and investigates the determinants of FDI into the United States. They find that there is a negative relationship between geographic distance and the amount of investment undertaken by foreign investors. One empirical limitation of this paper is that it defines geographic distance as the distance from the foreign firm's country capital to the closest of either New York, San Francisco, or Houston (Ragozzino 2009). Thus, a New York-based firm investing in Toronto is regarded as a transaction of equal distance to another involving the same firm and a partner in Vancouver, whereas the spatial dispersion between the two deals is clearly not the same (Ragozzino 2009).

Finally, another significant illustration of a recent paper that has accounted for the role of geographic distance in FDI as an independent factor is that of Bevan, Estrin, and Meyer (2004). The authors study institutional variables in the location choice of foreign entrants in Eastern European transition economies. In their model, geographic distance is merely a control variable measured as both the distance between the source and the host country, as well as a dummy variable assuming a value of one if the two countries share a border and zero otherwise. Interestingly, both of these controls turn out to be very significant explanators of FDI inflows in the countries they consider. Comparable findings have also been reported in other related papers (e.g., Resmini 2000; Kinoshita and Campos 2003; Bevan and Estrin 2004).

5.7 A Framework Analysis of Economic Distance

As the globalization trend continues, FDI remains one of the most extensively researched topics in IB literature. Within this stream of research, many studies have focused on how differences in national cultures or the cultural distance between the home country and the host country affect foreign market selection, entry mode choice, and the subsequent performance and survival of MNEs (see Harzing 2004 for a comprehensive review). Although the issue of cultural distance has been well-studied, management scholars seem to have neglected another important variable, namely economic distance (as Ghemawat (2001) labeled it) or, in other words, the level of economic development of the

host country relative to that of the home country.

However, the level of economic development in a globalized world is not only confined to macroeconomic characteristics of both host and home countries, but also tends to include other corporate and institutional characteristics. In this context, economic distance reflects differences in technological capability (research and development expenditure, firm size and other asset specificities), in competitiveness, in institutional environment (Bilateral Investment Treaties), and, lastly, in development level, all of which significantly affect FDI decisions and performance. Thus, economic distance is a valuable measure, which can potentially to enhance the understanding of FDI. To address this gap of knowledge, this section investigates the impact of economic distance on entry mode choices made by MNEs.

As already said, when a firm expands into a foreign market through direct investment, it has to decide whether to establish a wholly owned subsidiary (internalization with full hierarchical control) or a joint venture (internalization, with only partial control). This section following Aoki's argument (2001), concludes that "the entry mode adopted is not an issue of right or wrong; it depends on the purpose of the investment". To put it differently, the success of an MNE's operations in the host country partially depends on whether they have chosen entry modes that fit the opportunities presented by the countries concerned. Therefore, wholly-owned subsidiary and joint ventures are both suitable for exploitation[41] and exploration, respectively. Thus, the research question in this framework is the following: **How does the mode of entry choice affect economic distance?**

[41] One of the key-issues in International Business Research is how MNEs exploit their existing resources (exploitation) and explore (exploration) for new resources in host countries through FDI (Makino, Lau, and Yeh 2002).

Chapter 6: The Model and Hypotheses Building

6.1 Model

Having built on an "envelop" theory by connecting TCA, entry mode choice, and distance, it is now important to formulate a model appropriate to accommodate the relationship between them. Particularly, a model able to express how and to what extent the different forms of entry mode choice i.e., wholly owned subsidiary versus joint venture through minority, co-ownership, and majority joint ventures, which lead to internalization of the market, are affected by the specific forms of distance (cultural, institutional, geographic, and economic). So, this chapter proceeds the analysis firstly, by describing the dependent and independent variables in order to conclude to the algebraic formula of the function, secondly, by developing hypotheses, thirdly, by developing the method of construction of indices and the econometric method, and lastly, by introducing the sample, its characteristics, and the dataset is based on.

The 10% and 90% cut-off points are used in this thesis to capture the alternative ownership structures. The investments with foreign ownership of less than 10% are considered to be portfolio investments and are excluded from the sample.[42] A venture is defined as a JV (internalization with only partial control) when foreign equity ownership ranges from 10% to 90%, while a venture with foreign equity shareholding of over 90% is considered to be a WOS (internalization with full hierarchical control) (Verbeke and Hillemann 2013). This range is consistent with the definition of a JV used by the U.S. Department of Commerce. Also, Park and Ungson (1997), Hladik (1985), Demirbag, Glaister, and Tatoglu (2007), Li, Yang, and Yue (2007) follow the same definitions. In this thesis, joint ventures are further classified into three categories: minority foreign-owned (10–49%), co-ownership (50– 50%), and majority foreign-owned (51–90%).

6.1.1 Cultural Distance Variable

Having defined in chapter 5 "culture" as the way "that provides people within a society with a common system of communication" (Hall 1976) and "a common definition of identity" (Camilleri 1989, as cited in Wilken, Jacob, and Prime 2013, pp. 700), and "cultural distance" as the extent of dissimilarity/difference between two countries in cognitive (beliefs and norms) levels. This section

[42] Although 5% and 95% cut-off points were also tested, no significant differences were detected; therefore this section focuses only on 10% and 90% cut-off points.

continues firstly, by analyzing the most prominent empirical studies concerning cultural distance through Hofstede and GLOBE models, in order to stress the ambiguous results of this variable, secondly, by illustrating the different ways that each model is constructed, and thirdly, by describing data, source, and measure used in this thesis for each cultural model.

Cultural distance frequently used to explain the behavior of MNEs in a vast array of areas including entry mode choice, foreign market selection, sequential investment, MNE performance, level of control, and the transfer of parent systems (Kogut and Singh 1988; Rosenzweig and Nohria 1994; Shenkar 2001; Brouthers 2002; Harzing 2003; Tihanyi et al 2005). In particular, it has been extensively used to explain the foreign entry mode choice of MNEs. The majority of these studies have examined the relationship of cultural distance to FDI entry modes, i.e. ownership (JVs vs. WOS) and establishment mode (Greenfield, acquisition, and JV), except for a few studies involving non-FDI modes (e.g. Erramilli 1991; Shane 1993, 1994; Contractor and Kundu1998; Arora and Fosfuri 2000; Chen and Hu 2002).

However, mixed empirical results have been found in the relevant literature. Kogut and Singh (1988) have examined 228 foreign ventures in the U.S., and have found that the greater the cultural distance between the home country and the USA, the greater the probability of choosing a JV over a Greenfield operation or acquisition. This positive relationship to shared control mode of entry has been further supported in subsequent studies (e.g., Erramilli and Rao 1993; Agarwal 1994; Pan 1996; Hennart and Larimo 1998; Brouthers and Brouthers 2001; Meyer 2001; Pak and Park 2004). The MNE's preference for sharing the equity of its host country affiliate with a local partner may be due to the cost and uncertainty constraints associated with entering culturally distant markets. The costs of controlling and coordinating a WOS are perceived to be greater than the transaction costs incurred to manage a JV.

In contrast, an exactly opposite relationship has also been supported in the literature (e.g., Padmanabhan and Cho 1996; Erramilli, Agarwal, and Kim 1997; Chen and Hu 2002). For example, Chen and Hu (2002) have found that foreign MNEs select a WOS in China when the cultural distance is large. This finding is in line with that of Padmanabhan and Cho (1996) who have found that large cultural distance between Japan and the host country of Japanese MNEs is significantly related to their choice of a high control mode (i.e. WOS).

Interestingly, from a survey of Singaporean MNEs where cultural distance has based on primary data, not on Hofstede's dimensions, Rajan and Pangarkar (2000) have found that cultural distance has varying effects on ownership mode choice. While cultural distance has a bearing on the choice between

minority JVs and WOS, however, it does not differentiate between majority JVs and WOS. Finally, no significant relationship has found in Erramilli (1996), which is further supported in Tihanyi et al's (2005) recent meta-analyses of data from 66 independent samples previously used in prior studies. Tihanyi et al. (2005) have failed to obtain evidence of a significant relationship between cultural distance and entry mode.

Various reasons have been proposed to explain these inconclusive results. On the one hand, the inconsistencies have been attributed to the failure of Hofstede's (1980) cultural dimensions to capture the complexities and intricacies of national culture (Shenkar 2001; Harzing and Noorderhaven 2006). While a tangible and convenient tool, Kogut and Singh's (1988) reductionist construct of cultural distance based on Hofstede's values dimensions has been subsequently subjected to further discussion and debate. For instance, in her in-depth discussion of prior studies in the area, Harzing (2003) has identified common flaws in studies focusing on the role of cultural distance in entry mode choice, one of which is the dependence on a simplistic cultural distance measure.

More importantly, there has been an increasing call for a need to incorporate a variety of distance factors, such as differences in language, institutions, industry norms, religion, and family structure (Mezias et al 2002; Harzing 2003; Tihanyi et al 2005). So, new approaches to studying cultural differences have been suggested, such as the use of constructs like "friction" or "cultural intelligence". It is argued that the "scale and essence of interface between interacting cultures" ("friction" in Shenkar 2001, pp. 527) or an individual's or organization's "capabilities to adapt in a cultural setting" ("cultural intelligence" in Earley 2006, pp. 929) are a more critical driver of behavior in MNEs than cultural distance *per se*. On the other hand, proponents of dimensional approaches have generally agreed upon the central importance of dimensions in measuring culture and cultural distance, but have been divided on the substance of the dimensions (Smith 2006). Specifically, despite the extensive application in international business studies, the Hofstede (1980) dimensional framework has been frequently criticized and has led to the emergence of various other cultural frameworks, including perhaps most importantly, Schwartz (1994, 2003) and GLOBE (2004), as discussed in chapter 5.

So, a quite recent body of literature has attempted to fill the literature gap. In this framework, some papers have focused on methodological issues by using cultural distance measurements different from the traditional Hofstede model or proposing different empirical relationships between the cultural distance and the entry mode —for instance, Kim & Gray (2009) and Morschett, Schramm-Klein, & Swoboda (2008) have measured the cultural distance based on the Schwartz or GLOBE projects, while Wang and Schaan (2008) have found an inverted U-shape relationship between cultural distance and

the choice of JVs. A second group of papers has enhanced the literature by considering additional factors related to the distance between countries such as, for instance, language, religion, and degree of economic development —among others, the papers by Davis, Desai, and Francis (2000), Delios and Beamish (1999), Demirbag, Tatoglu and Glaister (2007, 2009), Dow and Kuranaratna (2006), Lu (2002), Meyer (2001), and Tatoglu, Glaister and Erdal (2003).

However, the most recent stream of literature has focused on the analysis of moderators and interaction effects; that is, on the existence of third variables which may influence the role played by the cultural distance in the choice of entry mode. Among these variables are the target's country risk (Brouthers and Brouthers 2001; López-Duarte and Vidal-Suárez 2012), the host country's governance quality (Chang, Kao, Kuo and Chiu 2012), the foreign investor's experience (Cho and Padmanabhan 2005), and the subsidiary's age (Wilkinson, Peng, Brouthers and Beamish 2008). In a similar way, Schwens, Eiche, and Kabst (2011) have found that the cultural distance moderates the role played by the foreign investor's international experience and proprietary know-how in the choice of entry mode.

While some of these studies have extensively contributed to explain the initial literature gap, others just have fed a paradox situation showing ambiguous results. Therefore and recognizing the inexplicit effect of cultural distance on ownership strategies, this thesis focuses on the two important and prominent cultural indices (Hofstede and GLOBE), in order to distinguish them in terms of nature and to shed light on the different aspects frame each one.

To begin with, until recently several models have been developed, such as the Hofstede's (Hofstede 2001, Hofstede and Hofstede 2005; Hofstede 2007), the Schwartz and Bilsky's (1987), the Trompenaars' (1993), and the GLOBE model (House et al. 2004), in order to understand cultural differences between nations. Hofstede's model (Mooij and Hofstede 2010) -the one most frequently applied- as well as the much more recent GLOBE model by House et al. (2004) have provided scholars with much-needed insights into the structure of national cultures. However, ever since the publication of House et al.'s GLOBE model in 2004, there has been a non-stop debate between Hofstede and the GLOBE team; it has culminated in 2010 as reflected in the special issue on "Culture in International Business Research" in Journal of International Business Studies.

While Hofstede's work is not the first systematic study on Cross-Cultural Research (CCR), his cultural dimensions has succeed in putting CCR at the forefront of IB research; his influence in the fields of IB and management has remained undeniable despite criticisms voiced against his study over a long time. Besides, the GLOBE cultural dimension model has emerged from one of the most recent studies (Chhokar, Brodbeck, and House 2007) on organizational values and cultures (Pramila 2009).

GLOBE study is less criticized than Hofstede's work, not because it contains fewer controversial issues, but perhaps because it is much more recent, and, therefore, researchers have not yet fully analyzed or tested it.

For these reasons, cultural distance in this thesis is measured using Hofstede's and GLOBE models, but before the measurements of each model, it is important to observe the differences in data collection and countries participating in each one. Table 13 presents the basic differences between the two cultural dimensions and Table 14 lists the Countries (and Regions) participating in the studies of the two models.

Table 13 shows that the two models are quite different. Firstly, there is a significantly long time period separating the two surveys. It is obvious that the twenty-seven year difference explains the new advanced methods (i.e., more comprehensive questionnaires) employed by the GLOBE, which are capable of accommodating new social aspects. Secondly, Hofstede's model has employed MNE as a type of organization (IBM), while the GLOBE has limited its analysis to corporations headquartered in the host cultures and has defined (2004, pp. 97) that it purposefully

> excludes from its sample foreign Multinational Enterprises, because their members would be from multiple cultures and their responses would not be indicative of the societal culture in which these organizations function. The Globe model specifies this sample requirement because respondents from these organizations would most likely, with very [few] exceptions, be almost completely from the societal culture in which these organizations function.

Thirdly, a significant difference between the two models lies in the type of industries included in the survey. The GLOBE model (2004, pp. 97-98) specifically has stated that

> it limits organizations [chosen] to three industries (food processing, financial and telecommunication services), because after polling the CCIs involved in the initial phases of the project, [it] determines that these industries are present in all countries of the world. Further, these industries are chosen because they systematically differ from one another and these differences have important implications for organizational culture. In particular, food processing industry is a relatively stable industry whereas telecommunications and financial industries may be stable or unstable depending on [each] country and economic conditions.

Fourthly, according to Hofstede (2006, pp. 884),

> the analysis of the GLOBE [model] data was a team effort, although closely coordinated by its designer Robert House. [On the other hand,] his [own] analysis was a one-person effort.

Fifthly, the respondents in the GLOBE model have been managers. The respondents in Hofstede's (1980) model have been matched groups of employees in seven occupational categories, two managerial and five non-managerial.

Sixthly, according to Venaik and Brewer (2008, pp. 6), there are some basic differences between the two studies in the way the concept of national culture is measured:

For example, Hofstede's masculinity dimension is measured with the two dimensions of gender egalitarianism and assertiveness in the GLOBE study. (…) [Additionally,] whereas Hofstede's long-term orientation is similar to GLOBE's future orientation, there are two additional dimensions of culture in GLOBE -[namely] performance orientation and humane orientation- that are measured by Hofstede. Besides differences in the number of dimensions, another key-difference is that the GLOBE study measures two distinct aspects of national culture -practices and values- for each of the nine dimensions. Thus, there are eighteen culture scores for each country in the GLOBE study [as opposed to] five in Hofstede.

Lastly, according to Hofstede (2006, pp. 884),

the development and analysis of the GLOBE questionnaire was theory-driven, based on the existing literature, including [his] 1980 book, and on statistical pretests. [On the other hand,] [t]he IBM attitude survey questionnaires had been designed as a management tool and developed through open-ended pilot interviews with personnel in nine countries. The surveys were action-driven and dealt with issues that IBM employees from different categories and/or their management considered relevant in their work situation. There was immediate feedback to management and to employees (Klein et al. 1971). [Hofstede's] cross-national analysis came years later and developed its concepts from the database on file.

As for the countries (and regions) presented in Table 14, it is evident that sample countries are categorized to the six continents in both models. In the cases of Australia and North America, both models have classified the same countries. But in the cases of Africa and South America, some countries and regions differ. In Hofstede's model, East Africa, which contains four countries, is given the same score. The same goes for West Africa, which contains three countries. In the GLOBE model, South Africa is divided into two groups and different scores are given according to the races that have the most prevalent cultural influence. Egypt, Namibia, Nigeria, Zambia, and Zimbabwe are included in the GLOBE model and not in Hofstede's, due to the most recent economic growth of these countries. As for South America, Hofstede's model includes a wider range of countries, since it includes Jamaica, Panama, Peru, Surinam, Trinidad, and Uruguay, not included in the GLOBE model (Shi and Wang 2011).

Considering the case of Europe, Hofstede has measured Germany twice. Firstly, he has measured Germany as a single country and, secondly, he has divided Germany into East Germany (former GDR) and West Germany (former FRG). Switzerland has also measured in two parts, namely the German-speaking and the French speaking part, to include “Language” as an important element defining cultural clusters (Tang and Koveos 2008). On the other hand, the GLOBE model has not included Bulgaria, Estonia, Luxemburg, Malta, Norway, and Romania. Considering Asia, Kazakhstan, Kuwait, and Qatar are included in the GLOBE, while the Arab World (Egypt, Iraq, Kuwait, Lebanon, Libya, Saudi Arabia, and the United Arab Emirates), Bangladesh, Pakistan, and Vietnam are not. Therefore, the sample countries and regions in Asia are more widely chosen by Hofstede, while the GLOBE model includes a wider range of European countries and regions (Shi and Wang 2011).

Table 13

Differences between Hofstede's Model and the GLOBE Model

Differences	Hofstede	GLOBE
Time Period	1967-1973	1994-1997
Researchers Involved	1	170
Quality of Respondents	Managers and Non-Managers	Middle Managers
Type of Organizations	Multinational Enterprise (IBM)	Non- Multinational Enterprise
Type of Industries	Information Technology	Food processing, Financial and Telecommunication services
Number of Societies Surveyed	79	62
Type of Analysis	Individual Effort	Team Effort
Number of Cultural Dimensions	5	9

Source: Shi and Wang 2011.

Table 14

Participating Countries (and Regions) in Hofstede's Model and the GLOBE Model

Hofstede Model		GLOBE Model	
Africa (9)	East Africa (Ethiopia, Kenya, Tanzania, Zambia) Morocco, South Africa,West Africa (Ghana, Nigeria, Sierra Leone)	Africa (8)	Egypt, Morocco, Namibia, Nigeria, South Africa (Black Sample), South Africa (White Sample) Zambia, Zimbabwe
Asia (24)	The Arab World (Egypt, Iraq, Kuwait, Lebanon, Libya, Saudi Arabia, the United Arab Emirates), Bangladesh, China, Hong Kong, India, Indonesia, Iran, Israel, Japan, Malaysia, Pakistan, Philippines, Singapore, Korea, Taiwan, Thailand, the Republic of Turkey, Vietnam	Asia (18)	The Republic of China, Georgia, Hong Kong, India, Indonesia, Iran, Israel, Japan, Kazakhstan, Kuwait, Malaysia, Philippines, Qatar, Singapore,S. Korea, Taiwan Thailand, the Republic of Turkey
Australia (2)	Australia, New Zealand	Australia (2)	Australia, New Zealand
Europe (26)	Austria, Belgium, Bulgaria, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxemburg, Malta, the Netherlands, Norway, Poland, Portugal, Romania, the Russian Federation, Slovakia, Spain,	Europe (22)	Albania, Austria, Czech Republic, Denmark, England, Finland, France, Greece, Germany-East (former GDR), Germany-West (former FRG), Hungary, Ireland, Italy, the Netherlands, Poland, Portugal, the Russian Federation, Slovenia, Spain, Sweden, Switzerland (German speaking),

	Sweden, Switzerland, the United Kingdom		Switzerland (French speaking)
North America (3)	Canada, Mexico, the United States of America	North America (3)	Canada (English speaking), Mexico the United States of America
South America (15)	Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Jamaica, Panama, Peru, Surinam, Trinidad, Uruguay, Venezuela	South America (9)	Argentina, Bolivia, Brazil, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Venezuela

Source: Shi and Wang 2011.

Hofstede's model measurement has been developed by Kogut and Singh (1988) based on Hofstede's (1980) measures of four dimensions of national culture: Power Distance, Uncertainty Avoidance, Masculinity/Femininity, and Individualism. Hofstede's "Cultures and Organizations", a revised and popularized version of Culture's Consequences was published in 1991 (Fang, 2003). A vital feature of his new book was the inclusion of "Confucian Dynamism" (also known as "Long-term Orientation or LTO) as a fifth dimension of national cultural variance.

According to Hofstede (1991), the fifth dimension deals with time orientation and consists of two contrasting poles: long term orientation[43] and short- term orientation.[44]

Hofstede's initial four dimensions have generated enormous numbers of replications, citations and discussions (Smith 1996; Søndergaard 1994; Triandis 1982); they have also attracted criticism (Lowe 2001; McSweeney 2002a; McSweeney 2002b; Roberts and Boyacigiller 1984; Tayeb 1988, 1994, 2000, 2001; Yeh and Lawrence 1995) and, in some cases, further refinements (Schwartz 1992). However, the fifth dimension does not seem to have been received enthusiastically by the cross-cultural research community. A few studies (e.g., Ralston et al 1992, 1993; Read 1993) have adopted the fifth dimension as a research instrument. These works, however, share the feature of starting by

[43] Long term orientation (Hofstede 1991, as cited in Fang 2003, pp. 348) refers to a positive, dynamic, and future oriented culture linked with four positive Confucian values: persistence or perseverance, ordering relationships by status and observing this order, thrift, and having a sense of shame.

[44] Short term orientation (Hofstede 1991, as cited in Fang 2003, pp. 348) represents a negative static and traditional and past-oriented culture associated with four negative Confucian values: personal steadiness and stability, protecting your face, respect for tradition, and reciprocation of greetings, favors, and gifts.

unquestioningly accepting the notion of Confucian dynamism as a major theoretical platform. Such an approach to cross cultural research is believed to be problematic. In the words of Jackson and Aycan (2001, pp. 7),

> instead, cross-cultural research starts with deep questioning of whether or not the key concepts and measurement tools are relevant and appropriate in different cultural contexts. If not, researchers must develop comparable constructs and tools to capture both the "emic" and as well as the "pan cultural/ etic" aspects of the management phenomenon.

Furthermore, many researchers (Punnett 1990; Triandis 1993; Gudykunst et al 1996) who refer extensively to Hofestede's work avoid engaging in discussions about the fifth dimension. Particularly in Triandis's (1993) review of Hofstede's "Cultures and Organizations", the fifth dimension is not mentioned at all. Also, Gudykunst et al. 1996 and Punnett (1990) in their turn do not include the fifth dimension.

Lastly, many researchers have reported problems in their attempt to operationalize the fifth dimension in their analyses. For instance, Newman and Nollen (1996, pp. 776) have written the following: "long-term orientation is the most difficult [orientation] because it is the newest of the dimensions and the least familiar to Western researchers". Similarly, Redpath and Nielsen (1997, pp. 329) also have commented [that] "this dimension is probably the least relevant to our analysis. It was the most difficult to apply, because distinctions between the two ends of the spectrum are unclear and often seem contradictory". Kalé (1996, pp. 22) also has remarked: "Since this book [Hofstede 1980] was published, Hofstede has added a fifth dimension; however, conceptual and empirical support for this dimension is not very exhaustive (Hofstede 1991)." For these reasons, this section does not include the fifth dimension.

Drawing on Kogut and Singh (1988, pp. 422), the aggregate cultural distance index (CD_j) is calculated based on each dimension deviation of each home country from the Turkish index, as shown in the equation below. Data for Turkey and each home country scores have been derived from Harzing's database (www.harzing.com/download/hgindices.xls). Deviations are adjusted for differences in the variance of each dimension and then arithmetically averaged:

$$\mathbf{HCdj=}\sum_{i=1}^{4}\mathbf{[(Iij\ -Iik)2/Vi]/4}$$

where,

- Cd_j is the aggregate cultural distance;

- I_{ij} is the index value for cultural dimension *i* of home country j;
- V_i is the variance of the index for dimension *i*;
- and *K* represents host country; the Republic of Turkey.

The nine dimensions of the GLOBE (2004) are used to compute another four composite indices of the GLOBE cultural distance: two based on values and two on practices. Distance indices based on **values** (absolute and relative difference) are computed by applying Kogut and Singh's formula (1988, as cited in Kim and Gray 2007, pp. 64) to the value scores of these dimensions. Specifically,

$$\mathbf{GCd}_j = \sum_{i=1}^{9} [(I_{ij} - I_{ik})^2 / V_i] / 9$$

$$\mathbf{GCd}_{ij} = \sum_{i=1}^{9} [\{(I_{ij} - I_{ik}) / (I_{ij} + I_{ik})/2\}^2 / V_i] / 9$$

Similarly, the nine **practice** scores are used to generate two distance indices, based on absolute and relative differences between home and host countries (Kim and Gray 2007). Data for Turkey and each home country scores have been derived from Harzing's database (www.harzing.com/download/hgindices.xls).

Table 15

Items Measuring Hofstede and GLOBE Models

Hofstede Cultural Distance (four items)

1. Power Distance: is a measure of the interpersonal power or influence between two groups, for example B and S as perceived by the least powerful of the two, S. This means the extent to which the less powerful members of organizations and institutions accept and expect that power is distributed unequally. The basic problem involved is the degree of human inequality that underlies the functioning of each particular society (Hofstede 1982).

2. Uncertainty Avoidance: expresses the degree to which the members of a society feel uncomfortable with uncertainty and ambiguity45. The fundamental issue here is how a society deals with the fact that the future can never be known: should we try to control the future or just let it happen? Countries exhibiting strong UAI maintain rigid codes of belief and behavior and are intolerant of unorthodox behavior and ideas. Weak UAI societies maintain a more relaxed attitude in which practice counts more than principles (Hofstede 1982).

3. Masculinity/Femininity: this dimension represents a preference in society for achievement, heroism, assertiveness, and material reward for success. Society at large is more competitive. Its opposite, femininity, stands for a preference for cooperation, modesty, caring for the weak and quality of life. Society at large is more consensus-oriented (Hofstede 1982).

4. Individualism: the high side of this dimension, called *Individualism*, and can be defined as a preference for a loosely-knit social framework in which individuals are expected to take care of themselves and their immediate families only. Its opposite, *Collectivism*, represents a preference for a tightly-knit framework in society in which individuals can expect their relatives or members of a particular in-group to look after them in exchange for unquestioning loyalty. A society's position on this dimension is reflected on whether people's self-image is defined in terms of "I" or "we" (Hofstede 1982).

GLOBE Distance (nine items)

1. Uncertainty Avoidance: is the extent to which members of a society strive to avoid uncertainty by relying on established norms, rituals, and bureaucratic practices (Culture, Leadership, and Organizations: The GLOBE study of 62 Societies by House et al (2004).

2. Power Distance: is the degree to which members of a society expect and agree that power should be stratified and concentrated at higher levels of an organization or government (Culture, Leadership, and Organizations: The

[45] According to Hofstede (1980, pp.111) a basic fact of life is that time only goes one way, put it another way, "we are living with uncertainty and we are conscious of it. Extreme uncertainty creates intolerable anxiety and human society has developed ways to cope with the inherent uncertainty of our living on the brink of an uncertain future. These ways belong to the domains of technology, law, and religion.
Different societies have adapted to uncertainty in different ways. These ways not only differ between traditional and modern societies, but even among modern societies. Ways of coping with uncertainty belong to the cultural heritage of societies and they are transferred through basic institutions, like the family, the school, and the state.

GLOBE study of 62 Societies by House et al (2004).

3. Institutional Collectivism: is the degree to which societal and organizational practices encourage and reward collective distribution of resources and collective action (Culture, Leadership, and Organizations: The GLOBE study of 62 Societies by House et al (2004).

4. In-Group Collectivism: is the degree to which individuals express pride, loyalty, and cohesiveness in their organizations or families (Culture, Leadership, and Organizations: The GLOBE study of 62 Societies by House et al (2004).

5. Gender Egalitarianism:is the degree to which an organization or a society minimizes gender role differences while promoting gender equality (Culture, Leadership, and Organizations: The GLOBE study of 62 Societies by House et al (2004).

6. Assertiveness: is the degree to which individuals in organizations are assertive confrontational, and aggressive in social relationships (Culture, Leadership, and Organizations: The GLOBE study of 62 Societies by House et al (2004).

7. Future Orientation: is the degree to which individuals in organizations or societies engage in future-oriented behaviors such as planning, investing in the future, and delaying individual or collective gratification (Culture, Leadership, and Organizations: The GLOBE study of 62 Societies by House et al (2004).

8. Performance Orientation: is the degree to which an organization or society encourages and rewards group members for performance improvement and excellence (Culture, Leadership, and Organizations: The GLOBE study of 62 Societies by House et al (2004).

9. Humane Orientation: is the degree to which individuals in an organization or societies encourage and reward individuals fro being altruistic, friendly, generous, caring and kind to others (Culture, Leadership, and Organizations: The GLOBE study of 62 Societies by House et al (2004).

Source: Author's Design, 2014.

6.1.2 Institutional Distance Variable

In this thesis, institutional distance between the home country of an MNE and the host country of its subsidiary is approached using the sub-dimensions of regulative distance and normative distance (Gaur, Delios, and Singh 2007). Particularly, it is suggested that each of the two aspects (regulative and normative) produces its own approach of institutional distance and that these approaches vary in terms of their implications for MNE behavior. For example, property rights are more sensitive to regulative distance because they are anchored in legal provisions, whereas normative distance may undermine import of MNE practices that deviate from societal expectations in the host country (Xu and Shenkar

2002). So, this sub-section proceeds analyzing the relevant empirical results and then concludes presenting items compose regulative and normative distance, respectively, and the source of data used for each institutional distance.

The construct of institutional distance was first extensively discussed in the context of foreign entry strategies by Xu and Shenkar (2002), who have proposed that firms would prefer acquisitions where normative and cognitive distances are small, whereas Greenfield investment when normative and cognitive distances are large. Moreover, these authors have proposed that entry mode strategy would more likely take place via a WOS or majority joint venture where regulative distance is small and via a minority joint venture where regulative distance is large. Further, high equity control modes would be preferred where normative distance is small and low equity control where normative distance is large. However, Xu and Shenkar (2002) have not developed concrete measures to test their propositions empirically. This has done in part by Xu et al (2004), who have developed the regulative and normative distance measures and empirically have tested them into a sample of Japanese overseas subsidiaries. The measures for regulative and normative distances have constructed on the basis of information provided in *The Global Competitiveness Report*, which documents country differences over various items of institutional environment (Xu et al 2004). Their empirical analyses have provided support to the hypotheses, i.e., larger regulative and normative distances are associated with a lower level of equity ownership.

Delios and Beamish (1999) have compared the effects of transactional, institutional, and experience influences on the ownership strategies of Japanese investors. Their theoretical development has suggested that the equity position of a foreign investor should increase as the specificity of the assets transferred to the foreign affiliate increases, but a lower equity position should be assumed when the foreign investor requires complementary assets to establish a foreign entry. International experience and a strong institutional environment also should lead to increases in the equity position of the foreign investor. These relationships are tested with data on more than 1000 Japanese investments in nine countries of East and South-East Asia. The results have demonstrated that experience and institutional factors are the most important influences on the ownership position taken in the foreign investment, while transactional factors have a much less important and a more ambiguous role.

A further advancement in the operationalization of the institutional distance construct has been made by Estrin et al (2007), who have equaled the normative distance with the cultural distance index of Kogut and Singh (1988). To measure regulative distance, Estrin et al (2007) have employed the Economic Freedom Index published by the Heritage Foundation. Cognitive distance measure has

composed by the authors from four items, two of which are associated with educational achievements of a country, and two - with exposure to new technologies in the society. Estrin et al (2004) have hypothesized concerning entry mode choice that Greenfield investment would be associated with large regulative distance but not associated with large cognitive or normative distance. The hypotheses have found empirical support in the case of regulative and cognitive distances, but not for normative distance. This has led the authors to conclude that all three measures should be used simultaneously to capture the variation in entry mode choice.

For their part, Ionascu, Meyer and Estrin (2004) have shown how the broader theoretical concept of institutional distance, which incorporates normative, regulatory and cognitive aspects, affects entry mode strategies. Specifically, their theoretical arguments have suggested that the impact of distance varies with different aspects of the concept of institutional distance, and that this impact interacts with both the investor's experience and with the relative importance of the pertinent operation for the investing MNE. Using a unique dataset of foreign direct investment in emerging economies that incorporates multi-host as well as multi-home countries, they have found empirical support for their propositions, and they have provided an explanation for apparently inconsistent results in the previous literature.

Eden and Miller in a paper in 2004 have combined the *costs of doing business abroad* (CDBA), which is a well-known concept in the international business literature, measuring the disadvantages or additional costs borne by multinational enterprises (MNEs) that are not borne by local firms in a host country with a second concept, *liability of foreignness* (LOF). Due to the confusion in the above two literatures as to the relationship between CBDA and LOF, as evidenced in a recent special issue on liability of foreignness (*Journal of International Management* 2002), they have argued that LOF stresses the social costs of doing business abroad, whereas CDBA includes both economic and social costs. The social costs arise from the unfamiliarity, relational and discriminatory hazards that foreign firms face over and above those faced by local firms in the host country. Because the economic costs are well understood and can be anticipated, LOF becomes the core strategic issue for MNE managers. They have argued that the key driver behind LOF is the institutional distance (cognitive, normative and regulatory) between the home and host countries, and they have explored the ways in which institutional distance can affect LOF. In that framework, they have operationalized their arguments by showing how institutional distance and liability of foreignness can provide an alternative explanation for the MNE's ownership strategy when going abroad.

Moreover, Chao and Kumar (2006) have investigated the impact of institutional distance on the

international diversity–performance relationship. They have first discussed the international diversity–performance relationship for large multinational firms and later they have showed the moderation effect of regulative and normative institutional distance. Based on a sample of Fortune 500 firms, they have found an inverted U-shaped curve. Particularly, they have claimed that regulative institutional distance has a negative moderating effect on the international diversity–performance relationship, while normative institutional distance shows a positive effect.

The most recent application of the concept of institutional distance has been made by Gaur and Lu (2007), who have applied it as a contingency factor to explain the relationship between ownership strategies and subsidiary performance. In contrast to Estrin et al. (2007), the authors have grouped normative and cognitive aspects into one concept, reasoning that they would be quite similar to each other (Scott, 1995). To measure regulative and normative/cognitive distance, Gaur and Lu (2007) have used country-level indicators derived from the *World Competitiveness Yearbook.* They were supplemented with a political risk rating variable obtained from *Country Risk Ratings: Euromoney.* Gaur and Lu (2007) have received empirical support to their hypotheses that foreign ownership positively correlates with subsidiary survival in institutionally distant (both in terms of regulative and normative/cognitive distance) countries.

Lastly, Hernàndez and Nieto (2012) have analyzed the relation between normative and cultural-cognitive institutional distance and the international entry forms of Small and Medium Enterprises (SMEs) by separately considering informal institutional dimensions such as normative and cultural-cognitive distances, as well as examining how the regulatory development of the destination may moderate these relations. Additionally, they have focused on the development of the relevant literature on SMEs, both by using the institutional theory to explain the internationalization of these firms and providing a more complete picture of their entry modes. In this light, they have examined the interaction effect of each of the above distances and the regulatory development of the destination on entry mode choice. Their methodology has been based on a multilevel analysis of a database of European SMEs containing information on different locations and three entry forms: exports, collaborative modes, and FDI. Their results indicate that greater levels of normative distance increase the likelihood of using collaborative forms in SMEs. Similarly, the findings also show that the preference for collaborative forms grows as the cultural-cognitive distance increases. In both cases, the study finds a positive moderating effect of regulative institutions on these relations.

Observing the relevant literature, it is concluded that items that constitute each dimension are not explained on a theoretical basis. On the contrary, many studies (Ionascu, Meyer, and Estrin 2004;

Eden Miller 2004; Chao and Kumar 2006; Gaur, Delios and Singh 2007) tend to involve them, basing their choice on the availability of data. Therefore, in this thesis the choice of items involved in regulative and normative distance, respectively, is based on two criteria, namely, relevant literature and prior research. So, this analysis relies on the following studies in order to compose each dimension: Hernàndez and Nieto, 2012; Chao and Kumar 2010; Gaur, Delios, and Singh 2007; Xu et al. 2004; Wan and Hoskisson 2003; Delios and Beamish 1999.

In light of this view, for this thesis regulative and normative distance items are selected from the 2012 edition of the World Competitiveness Yearbook (WCY 2012)[46](Delios and Beamish 1999; Gaur and Lu 2007; Wan and Hoskisson 2003). Generally speaking, regulative processes include rule setting, monitoring, and sanctioning activities, whereas norms define legitimate means to pursue valued ends (Scott 1995: 37). In this section, nine indicators have been compiled in relation to regulative and normative aspects of institutional environments. The values used from the 2012 edition of WCY, which provide sufficient lag to the institutional distance variable. The 321 different items across 59 countries in the WCY are drawn from archival sources.

The factors of "institutions" and "government" are used to measure constructs of "regulative" and "normative" institutional distance, respectively (Xu et al. 2004). The "institutions" factor in the Global Competitiveness Report includes nineteen survey items that describe a country's civil systems and the "government" factor includes eighteen survey items that describe managerial practices in a country. The regulative measure in this section includes three out of nineteen "institutions" items that describe the legal and regulative aspects of a country's environment and the normative measure includes six out of eighteen "government" items that indicate government attitudes and norms. Details of these three regulative and six normative measurement items are listed in Table 16 (Chao and Krumar 2010).

[46] Studies based on New Institutional Economics typically consider the quality, development and effectiveness of institutions in a country. These can be measured in many different ways using a range of variables. As a result, a myriad of different indices exist that measure the overall quality, development, and effectiveness of institutions in a given country, such as World Bank Governance Indicators, the Polcon Index, the Freedom House of Indices, Vitold Henisz's website for a brief overview of different indices and resources (seehttp://www.nsd.uib.no/macrodataguide/set.html?id=29&sub= 1).

Table 16 **Items Measuring Regulative and Normative Distance**
Regulative Distance (three items)
1. Anti-trust Laws: Competition legislation is efficient in preventing unfair competition (Updated: MAY 2012, IMD WCY executive survey based on an index from 0 to 10). 2. Intellectual Property Protection: Intellectual property rights are adequately enforced (Updated: MAY 2012, IMD WCY executive survey based on an index from 0 to 10). 3. Legal System: Justice is fairly administered (Updated: MAY 2012, IMD WCY executive survey based on an index from 0 to 10).
Normative Distance (six items)
1. Adaptability of Government Policy: Adaptability of government policy to changes in the economy is high (Updated: MAY 2012, IMD WCY executive survey based on an index from 0 to 10). 2. Bribe and Bureaucratic Corruption: Bribing and Corruption do not exist (Updated: MAY 2012, IMD WCY executive survey based on an index from 0 to 10). 3. Independence of Local Authorities: The legal and regulatory framework encourages the competitiveness of enterprises (Updated: MAY 2012, IMD WCY executive survey based on an index from 0 to 10). 4. Government Effectiveness: Government Decisions are effectively implemented (Updated: MAY 2012, IMD WCY executive survey based on an index from 0 to 10). 5. Risk of Political Stability: The risk of political instability is very low (Updated: MAY 2012, IMD WCY executive survey based on an index from 0 to 10). 6. Transparency: Transparency of government policy is satisfactory (Updated: MAY 2012, IMD WCY executive survey based on an index from 0 to 10).

Source: Author's design, 2014.

6.1.3 Geographic Distance Variable

Geographic location may affect entry mode choice in a number of ways, through its influence on flows of goods, factors of production, and ideas. However, in this thesis geographic distance is perceived as uncertainty which entails costs and, subsequently, affects the MNEs' decision of an appropriate entry-mode choice. In this respect, geographic distance is concentrated on two mechanisms. One is the actual distance (kilometer) between two markets, and the other is distance in

terms of contingency, linguistic, and colonial factors. Other costs or barriers, such as transport and communication are assumed to exist, however, they are not included herein, due to lack of the relevant data concerning these kinds of costs. Therefore, in light of this view and in order to frame the context of geographic distance an analysis of empirical studies follows.

Studies of geographic distance have gained momentum in number of business areas, such as financial economics (Coval and Moskowitz 1999; Garmaise and Moskowitz 2004; Bae, Stulz and Tan 2005; Pirinsky and Wang 2006), entrepreneurship (i.e., Jaffe, Trajtenberg, and Henderson 1993; Lerner 1995, etc.), however, the most prominent area is that of entry mode choice, and particularly, between mergers and acquisitions (i.e., Chakrabarti ans Mitchell 2006; Grote and Umber 2006; Grote and Rucker 2007). Although this variable has been accounted for in previous research on FDI (Kinoshita and Campos 2003; Pusterla and Resmini 2007), in most cases it has served either as a control variable or as a proxy for cultural or psychic distance. (e.g., Srivastava and Green 1986; Kogut and Singh 1989; Martin and Velasquez 1997). A few notable exceptions exist: Grosse and Trevino (1996) have investigated the determinants of FDI into the United States and they have found that there is a negative relationship between geographic distance and the amount of investment undertaken by foreign investors. One empirical limitation of this paper is that the authors have defined geographic distance as the distance from the foreign's firm's country capital to the closet of either New York, San Francisco, or Houston. Thus, a New York-based firm investing in Toronto is regarded as a transaction equal distance to another involving the same firm and a partner in Vancouver, whereas the spatial dispersion between the two deals is clearly not the same.

As another illustration of an excellent paper that has accounted for the role of geographic distance in FDI, Bevan Estrin and Meyer (2004) study institutional variables in the location choice of foreign entrants in Eastern European transition economies. In their model, geographic distance is not merely a control variable as both the distance between the source and the host country, as well as a dummy variable assuming a value of one if the two countries share a border and zero otherwise. Interestingly, both of these variables turn out to be significant explanators of FDI inflows in the countries they consider.

Further, Ragozzino (2007) has highlighted the role of geographic distance for foreign market entry decisions. He has argued that proximity is likely to reduce information asymmetry and he has explained that companies located close to their target markets may possibly access information directly or indirectly or stakeholders, thus reducing uncertainty about the host country's environment. Therefore, a high physical distance should increase the likelihood of choosing cooperative entry modes.

Using this hypothesis as a starting point, Ragozzino (2009) in a later paper has underscored the role of geographic distance for foreign market entry decisions. Particularly, Ragozzino has examined cross-border mergers and acquisitions undertaken by U.S. companies, in order to determine whether geographic distance affects these firms' governance decisions. Simultaneously, he has investigated the moderating effect of geographic distance on cultural distance and political risk. His findings illustrate firstly that U.S. firms tend to acquire higher stakes in geographic proximate targets than in remote ones. And secondly, since the hazards of cultural distance and political risk increase, acquires would tend to prefer shared ownership for proximate deals, and full ownership for acquisitions of geographic distant targets. These results indicate that the previously-reported effects of cultural and political risk on FDI are not absolute, but they are moderated by geographic distance.

In addition, Berry, F Guillén, and Zhou (2010) have examined cross national distance not in terms of dyadic cultural distance as many scholars have done, in contrast they have conceptualized cross-national distance proposing a set of multidimensional measures, including economic, financial, political, administrative, cultural, demographic, knowledge, and global connectedness as well as geographic distance. These authors have grounded their analysis and choice of empirical dimensions on institutional theories of national business, governance, and innovation systems. Further, in order to overcome the methodological limitations of the Euclidean approach, they have calculated dyadic distances using the Mahalanobis method, which is scale-invariant and takes into consideration the variance–covariance matrix. They empirically have analyzed four different foreign expansion choices of US companies to illustrate the importance of disaggregating the distance construct and the usefulness of their distance calculations. In this framework, they have approached geographic distance as a kind of distance that increases the transportation and communication costs and they have calculated it applying the great circle method.[47] However, geographic distance dimensions has not provided support to their hypotheses.

Moreover, scholars who have used gravity models in the international business and international trade literatures have long recognized the important role of geographic distance (Fratianni and Oh 2009; Hamilton and Winters 1992; Wolf and Weinschrott 1973). Different methods have been used to examine geographic distance between pairs of countries. For example, Chen (2004) has calculated geographic distance according to the latitude and longitude of the main city in each region or country, and has found that geographic distance decreases international trade between pairs of countries, while Krishna (2003) has used only the direct line distance to measure geographic distance. In a similar

[47] See at http://lauder.wharton.upenn .edu/ciber/faculty_research.asp for more information about calculating Euclidean and Mahalanobis distances, as cited in Berry, H.J., F. Guillén, and Zhou, N. (2010).

manner, Dow and Karunaratna (2006) have defined geographic distance as the kilometer distance that separates the country of origin form the host country explaining that travel-time and coordination costs create uncertainty relating to the capacity for rapid communication in order, for example to resolve an urgent problem (Ambos and Ambos 2009).

Considering the above description of empirical studies, data for geographic distance in this section have been derived from the Geo Dist dataset. Other datasets have also been proposed and provide geographic and distance data, notably those developed by Jon Haveman, Vernon Henderson and Andrew Rose. However, the Geo Dist dataset incorporates country-specific geographical variables for 225 countries in the world, including the geographical coordinates of their capital cities, the languages spoken in the country under different definitions, a variable indicating whether the country is landlocked, their colonial links, etc.; this makes the exhaustive set of gravity variables developed in Mayer and Zignago (2005) available and analyzes market access difficulties in global and regional trade flows. Furthermore, Geo Dist provides useful online data (http://www.cepii.fr/anglaisgraph/bdd/distances.htm) for empirical economic research including geographical elements and variables.

Trade economists regularly have used these files in their calculations of gravity equations describing bilateral patterns of trade flows. Co-variates such as bilateral distance, contiguity, or colonial historical links, have been used extensively in the fields of international trade for the study of bilateral flows of FDI; they have also been used by researchers interested in explaining migration patterns, international flows of tourists, telephone traffic, etc.

Geo Dist is divided into two parts. **The first part** of the dataset geo_cepii, incorporates country-specific geographical variables for 225 countries of the world, **while the second part** (or The Bilateral Files: DIST_CEPII.XLS AND DIST_CEPII.DTA) (dist_cepii), which is used in this section, is dyadic, and includes variables valid for pairs of countries. Distance is the most common example of such a variable, and the file includes different measures of bilateral distances (in kilometers) available for most countries across the world.

In particular, the dist_cepii files provide the following bilateral data: the different distance measures and dummy variables indicating whether two countries are contiguous, share a common language or a colonial relationship.

There are two kinds of distance measures employed in this section:

- Simple distances (*dist and distcap*), which are calculated following the great circle formula. This formula uses latitudes and longitudes of the most important cities/agglomerations (in terms of

population) for the *dist* variable and the geographic coordinates of the capital cities for the *distcap* variable. These two variables incorporate internal distances based on areas and also provided in the geo_cepii.xls file.

- Weighted distance measures (*distw and distwces*). The two weighted distance measures use city-level data to assess the geographic distribution of population inside each nation. The idea is to calculate distance between two countries based on bilateral distance between the largest cities of those two countries, those inter-city distances being weighted by the share of the city in the overall country's population.The general formula developed by Head and Mayer (2002) and used for calculating distances between country *i* and *j* is:

$$\mathbf{D_{ij}= [\sum_{\iota}^{k} (pop_k/ pop_i)* \sum_{j}^{l} (pop_l/ pop_j) d^{\theta}_{kl}]^{1/\theta}}$$

where,

pop_k designates the population of agglomeration *k* belonging to country *i*;

parameter θ measures the sensitivity of trade flows to bilateral distance d*k*. For the distw calculation, θ is set equal to 1. The *distwces* calculation sets θ equal to -1, which corresponds to the usual coefficient calculated from gravity models of bilateral trade flows.

In this section, the following variables are used when measuring kilometer distance between Turkey and other sample countries:

- **dist: implies distances in km, for which only one city is necessary to calculate international distances**
- **distwes: weighted distances in km, for which data on principal cities in each country are needed**

Finally the dist_cepii.xls file provides dummy variables indicating whether the two countries are contiguous (contig), share a common language, have had a common colonizer after 1945 (comcol), have ever had a colonial link (colony), have had a colonial relationship after 1945 (col45), are currently in a colonial relationship (curcol 14) or were/are the same country (smctry). From the above, the following variables are used in this section.

- **contiguous: dummy variable indicating whether the two countries are contiguous (contig)**
- **common language: dummy variable focused on the fact that the two countries share a common official language**
- **colony: dummy variable indicating whether the two countries have had a colonial relationship after 1945**

So, the total number of the variables compromising geographic distance and their respective sources are as follow in Table 17

Table 17 **Items Measuring Geographic Distance**
1. dist: implies distances in km, for which only one city is necessary to calculate international distances (http://www.cepii.fr/anglaisgraph/bdd/distances.htm**)**
2. distwes: weighted distances in km, for which data on principal cities in each country are needed (http://www.cepii.fr/anglaisgraph/bdd/distances.htm**)**
3. contiguous: dummy variable indicating whether the two countries are contiguous (contig) (http://www.cepii.fr/anglaisgraph/bdd/distances.htm**)**
4. common language: dummy variable focused on the fact that the two countries share a common official language (http://www.cepii.fr/anglaisgraph/bdd/distances.htm**)**
5. colony: dummy variable indicating whether the two countries have had a colonial relationship after 1945 (http://www.cepii.fr/anglaisgraph/bdd/distances.htm**)**

Source: Author's Design, 2014.

6.1.4 Economic Distance Variable

Economic distance between two countries often reflects differences in factor costs (such as wages) and in technological capabilities (proprietary knowledge), both important factors affecting FDI decisions and performance. Thus, economic distance is a variable that has the potential to enhance understanding of FDIs (Tsang and Yip 2007). In this concept, economic distance in this thesis is perceived as a measure which reflects the differences between two countries' technological capabilities, competitiveness, Bilateral Investment Treaties, and the level of growth/development, etc. But before analyze in depth the items compose economic distance herein, it is important first to present the relevant empirical studies, in order to illustrate the different aspects under which the economic distance

is perceived and finally how it is going to be analyzed in this section.

Many empirical studies have shown that economic distance is closely related to entry mode choice. However, there are many different aspects under which economic distance is approached to. Particularly, one basic strand of the relevant literature refers to how proprietary knowledge is connected to entry mode choice. In this concept, previous research pertaining to firm-level FDI equity mode patterns has revealed a positive correlation between research and development expenditures and the proportion of subsidiaries organized as sole ventures rather than joint ventures (Stopfordand Wells 1972). According to Hymer (1960), "sole ventures" are desired, in order to appropriate fully the returns on certain skills and ability. Kindleberger (1984) has added that high-tech firms choose "sole ventures" in order to squeeze out the maximum rent possible from their technologies. Additionally, concerns about loss of proprietary knowledge drive firms developing path-breaking innovations to keep their proprietary assets intact (Kindleberger 1984).

Moreover, in a study involving 1267 FDI decisions by 180 of the largest U.S. multinationals during the period between 1960 and 1975, Gatignon and Anderson (1988) have found strong support for their hypothesis that the probability of establishing WOS increases with R&D intensity, a surrogate for technological intensity. Davidson and McFetridge (1985) also have found that U.S. firms characterized by high technological intensities tend to reserve their proprietary knowledge for higher-equity modes.

Hennart and Park (1993) have argued that Greenfield investments are the most efficient way for MNEs to exploit firm-specific advantages (R&D intensity) that are difficult to separate form a firm itself and that are deeply embedded in its labor force. However, Kogut and Singh (1998) have found a similar relationship to JVs. Additionally, Yoshida (1987, pp. 61) in a study of R&D intensive Japanese subsidiaries in the United States has shown that Japanese subsidiaries would prefer Greenfield acquisition to acquisitions because they could transfer or devise their own management systems with freshly hired U.S. Employees".

Lastly, another team of researchers have argued that in new industrialized countries (NIC) MNEs do not have significant advantages in technologically intensive industries in relation to the MNEs from advanced countries (Jo1981; Kumar and Kim 1984; Tallman and Shenkar 1990). Jun (1995) has arrived at the same general conclusion in particular reference to the Korean electronics industry. In spite of the impressive accomplishments of NIC MNEs in many high-technology sectors recently, technology represents a weak source of firm-specific advantage to NIC multinationals relative to firms in more advanced countries.

Further, another basic strand of the relevant literature which connects economic distance and entry mode choice refers to international competitiveness. International competitiveness ultimately depends upon the linkages between a firm's unique, idiosyncratic capabilities (firm-specific advantages, FSAs) and its home country assets (country- specific advantages, CSAs). In this sense, international competitiveness is a subject that draws upon perspectives from international business, strategy, international economics, as well as international marketing. So, several empirical studies have tried to accommodate competitiveness through economic distance.

Particularly, Rugman, Oh, and Lim (2011) in their paper present a modified FSA/CSA matrix building upon the FSA/CSA matrix (Rugman 1981). These authors relate this matrix to the diamond framework for national competitiveness (Porter 1990), and the double diamond model (Rugman and D'Cruz 1993), providing empirical evidence to demonstrate the merits and usefulness of the modified FSA/CSA matrix using the Fortune Global 500 firms. They examine the FSAs based on the geographic scope of sales and CSAs that can lead to national, home region, and global competitiveness. Their empirical analysis suggests that the world's largest 500 firms have increased their firm-level international competitiveness. However, much of this is still being achieved within their home region. In other words, international competitiveness is a regional not a global phenomenon.

In a Chinese context, Child and Rodrigues (2005) point out, contrary to the mainstream FDI theory (Caves 1971; Dunning 2001), that Chinese firms invest overseas not to exploit existing competitive advantages, but to redress competitive disadvantages. This is because the ownership advantages enjoyed by Chinese firms are mainly network based (Buckley et al 2007; Morck et al 2008) or home country based (Rugman and Li 2007; Rui and Yip 2008). In short, this strategy supports their overseas expansion intra-regionally, but not globally (Rugman and Li 2007). Beyond regional expansion, Chinese firms are not driven by their ownership advantage but by their need to build sustainable global competitiveness (Child and Rodrigues 2005; Deng 2004), especially by acquiring strategic assets overseas (Rui and Yip 2008).

Rugman and Li (2007) have argued that the competitive advantages of Chinese firms lie in scale economies that are based on China's country-specific advantages in terms of cheap labor and resources. Accordingly, Chinese firms are more likely to successfully compete in labor intensive industries and in industries where they can utilize their low-cost resource supply (Rugman and Li 2007; UNCTAD 2006), primarily in other emerging economies (Luo and Tung 2007; Rui and Yip 2008; Wright et al 2005). Chinese firms also enjoy low-cost advantages in maturing and cost-sensitive industries of developed economies, where manufacturing quality and rigorous cost control have become the key to

competitiveness (Morck et al 2008).

Further in a similar context, Cui and Jiang (2009) have investigated the determinants of FDI entry mode choice between a WOS and a JV by Chinese firms that invest overseas. They have argued that the FDI entry mode choice of a Chinese firm is primarily influenced by the variables related to the firm's strategic fit in host industry and its strategic intent of conducting FDI (competitive advantage). Using survey data of a sample of 138 Chinese firms, the results suggest that a Chinese firm prefers WOS entry mode when it adopts a global strategy, faces severe host industry competition, and emphasizes assets seeking purposes in its FDI. A joint venture is preferred when the firm is investing in a high growth host market.

Lastly, Bell (1996) indicates that foreign investing firms in highly competitive host industries prefer to focus on their firm-specific competitiveness through a solo operation (i.e. through a WOS entry mode). Generally speaking, Chinese firms have competitive advantages in quality control and cost control in manufacturing operations (Rui and Yip 2008). Magnifying these advantages means tightening the control over the operation process and integrating the upstream supply chain for low-cost production input. It is well established in FDI entry mode literatures that WOS is the preferred entry mode for a high level of control and intra-firm integration (Hill, Hwang, and Kim 1990). Accordingly, to overcome host industry competition threat, Chinese firms prefer a WOS entry mode in their FDI.

However besides the contemporary approaches of economic distance through R&D expenditures and international competitiveness, there is also an increasing trend of researches, who tend to connect bilateral investment treaties (BITs) with economic distance and examine the economic effect of such treaties on FDI. This school of thought is based mainly on the fact that especially during the 1990s, the number of BITs quintupled, rising from 385 at the end of the 1980s to 1,857 at the end of the 1990s (UNCTAD 2000). Moreover, the number of BITs between developing countries, between developing countries and countries in Central and Eastern Europe, and between Central and Eastern European Countries have increased from 63 at the end of the 1980s to 833 by the end of the 1990s.

Therefore, within a general context many studies have approached the relationship between FDI and BITs. More specific, the study by Hallward-Driemeier (2003) have looked at the bilateral flow of FDI from 20 OECD countries to 31 developing countries over the period from 1980 to 2000 and have not found any statistically significant effect. This research design is dyadic, consisting of up to 537 country pairs. The study uses fixed-effects estimates and has found that the existence of a BIT between two countries does not increase the flow of FDI from the developed to the developing signatory.

In the same manner, Tobin and Rose-Ackerman (2005) have found a negative effect at high levels

of risk and a positive effect only at low levels of risk, with the majority of developing countries falling into the high-risk category. Particularly, this study analyzes the impact of BITs on general non-dyadic FDI inflows, also in a panel from 1980 to 2000, but with data averaged over five-year periods, covering 63 countries. In a fixed-effects model, Tobin and Rose-Ackerman found that a higher number of BITs either in total or signed with a high-income country lowers the FDI a country receives as a share of global FDI flows at high levels of risk and raises the FDI only at low levels of risk.

While both studies above draw upon data provided by the International Country Risk Guide (ICRG), Hallward-Driemeier (2003) have used individual institutional components, whereas Tobin and Rose-Ackerman (2004) have used the aggregate political risk measure, which included many more components than institutional quality, including some that were not directly related to political risk (such as, among others, religious and ethnic tensions, armed conflict and socio-economic conditions such as unemployment and poverty).

On the other hand, Salacuse and Sullivan have (2004) provided three cross-sectional analyses of FDI inflows to up to 99 developing countries in the years 1998, 1999 and 2000, respectively, as well as a fixed-effects calculation of the bilateral flow of FDI from the United States to 31 developing countries over the period from 1991 to 2000. The authors have found that a BIT with the United States has been associated with higher FDI inflows in both types of calculations, whereas the number of BITs with other OECD countries was statistically insignificant.

For their part, Neumayer and Spess (2005) have conducted a rigorous study based on a much larger panel sample from 1970 to 2001, covering up to 119 countries. Importantly, this study has found a positive effect of BITs on FDI inflows that is consistent and robust across various model specifications. Moreover, Trevino et al (2002), in an investigation of market reform and FDI in Latin America, found a significant positive relationship between the number of host country BITs and inward FDI. Lastly, in a related study, Heinrich and Konan (2001) found that preferential trade areas with low individual trade costs attract increased investment due to a more integrated market.

Grosse and Trevino (2009) have demonstrated that institutions matter in the context of FDI in the transitional economies of Central and Eastern Europe (CEE). These authors employ the New Institutional Economics as a theoretical foundation and apply related concepts, such as BITs in an examination of FDI activity that may respond to institutional development in CEE. Within this context, FDI is expected to respond to country-level macroeconomic, microeconomic, and institutional changes, especially institutional factors that reduce (increase) uncertainty and/or costs related to long-term capital investments. This approach follows Rumelt, Schendel, and Teece (1991) in utilizing tools from

both economics and strategic management to facilitate understanding of FDI decision-making.

However, very few studies have focused on the specific relationship between entry mode choice and BITs. Asiedu and Esfahani (2001, pp. 655) have asserted that governments of host countries have a major role on FDI-related transaction costs. In particular, governments can influence the choice of MNEs between JVs and WOS in several ways. The "reliability of institutions" can be regarded as an important country-specific factor in this context. This should imply that WOS are more likely in host countries with stronger institutions, less political discretion, and a more stable and less risky FDI climate. Transaction costs could be reduced if the government tied its hand credibly through bilateral agreements such as BITs or double taxation treaties (DTTs). And the conclusion of BITs could render WOS more likely if the host country agreed to effective dispute settlement and independent arbitration.

Lastly, Nunnenkamp and Andrés (2013) using count data on Indian JVs and WOS, they have presented an empirical analysis of FDI-related ownership choices and their relation with host country characteristics and indicators of transaction costs. Their negative binomial regression models offer only weak support for the bargaining perspective, according to which JVs should be more likely if the host countries were particularly attractive in terms of market access or resource endowments. Geographical and cultural distance has ambiguous effects on the choice between JVs and WOS. The composition of FDI projects tends to shift toward WOS where investment risks are contained by BITs and better control of corruption.

Finally, the major part of the relevant literature approaches economic distance under the lens of the host's country economic development. To begin with, Cho and Padmanabhan' (1995) study of Japanese manufacturing firms and Zejan's (1990) study of Swedish firms have indicated that the level of a host's country economic development is a key determinant of the choice between Greenfield and acquisition. Both studies have shown that acquisitions are more likely to be established in developed host countries.

Tsang and Yip (2007) taking a theoretical perspective of contrasting resource exploitation with resource exploration, they have argued that FDI hazard rates are lower in countries that are either more or less developed than a home country than are FDIs' hazard rates in countries of similar economic development. They have obtained strong supporting evidence in a sample of FDIs made by Singapore firms. Further, using the reasoning of strategic co-alignment, they have argued that acquisitions have lower hazard rates than Greenfield investments in more developed countries and *vice versa* in less developed countries. They have found supporting evidence for the former argument but not for the latter.

Berry, F Guillén and Zhou (2010) in a cross-national distance analysis, they have disaggregated the construct of distance by proposing a set of multidimensional measures, including economic, financial, political, administrative, cultural, demographic, knowledge, and global connectedness as well as geographic distance. Within this framework, the authors have defined economic distance applying the Whitley's (1992a, pp. 10) argument that national business systems are ‘‘particular arrangements of hierarchy-market relations becoming institutionalized and relatively successful in particular contexts”. Countries differ to varying degrees in terms of the characteristics of their business systems, specifically their economic, financial, and administrative practices. Whitley (1992a, pp. 231) has argued that such differences originate in demographic, geographic, cultural, and political institutions, which make some countries more different, or distant, than others from a given focal country, a characteristic that affects managerial decisions.

Moreover, Ghemawat (2001) in an excellent paper has asserted that the world is not so globalized as many researchers have asserted. On the contrary, he has supported that cross-border differences still matter in the world economy, and these difference are reflected as “distances” in his paper. However, he has not confined himself in this concept, but he has proceeded his analysis by dividing the concept of “distance” into four sub-distances: cultural, administrative/political, geographic, and economic. Within this framework, he has defined economic distance as the differences in wealth or income of consumers through recognizing the necessity to include it in his model, in order to achieve a holistic approach. However, Ghemawat (2001) does not provide any empirical test of his arguments.

Numerous other studies in international business have examined the impact of economic distance on the choice of foreign market, and of entry mode (e.g., Iyer 1997; Yeung 1997; Zaheer and Zaheer 1997). Researchers have also developed ad hoc measures of economic distance, such as Campa and Guillén’s (1999) competitor development index, based on the income per capita of the country in which the focal firm’s most important competitors are located. However, it is important to note that despite the vast number of empirical studies in the relevant literature, the international business literature has tended to focus on three specific indicators of economic differences across countries (for a review see Caves 1996). Countries differ in terms of their income level (GDP per capita), prevailing inflation rates, and intensity of trade with the rest of the world (exports plus imports as a proportion of GDP). These indicators are important, because they are correlated with consumer purchasing power and preferences, macroeconomic stability, and the openness of the economy to external influences. These factors have been found to influence, for instance, foreign market entry mode, firm survival and

performance, among other variables.

Therefore and considering all the above literature review, the items chosen to compose economic distance are the following.

Proprietary knowledge is an important type of specialized asset considered to be a main ingredient, that, in turn, defines public and private sector efforts to obtain a competitive advantage in science and technology (http://data.worldbank.org/indicator/NY.GDP.PCAP.KD). In this context, the measure of proprietary knowledge is a key indicator for such analysis aiming at constructing an economic distance index.

Early entry mode studies by internalization theorists (Buckley and Casson 1976; Rugman 1982; Hennart 1982) are the first who concentrated on the importance of the proprietary knowledge. These studies have stressed that higher ownership levels function as being a response to the need to protect firm-specific knowledge (essentially technological and R&D expenditures) from unwanted dissemination. Hence, internalization theory states that full ownership and control would be observed when a firm transfers unique, firm-specific knowledge to the host country when making its foreign investment (Beamish and Delios 1999).

The ideas of internalization theorists run parallel to the precepts of TCA (Williamson, 1975; 1985). TCA relative to proprietary knowledge predicts the conditions under which the overseas exploitation of the firm's proprietary technologies is conducted internally (through foreign direct investment), or externally through licensing contracts with local firms (e.g., Caves 1995; Belderbos and Sleuwaegen 1996). If the transfer of technology requires specific investments (e.g., R&D which generates proprietary knowledge) to adopt and adapt technologies to overseas conditions, then hold-up risks increase the cost of arm's-length transactions. Asymmetric information concerning the characteristics and value of the technology between the licensor and licensee further reduces the return on external transfers and makes intrafirm transfers to foreign affiliates preferable (Belderbos 2003).

The extent to which proprietary knowledge is transferred to overseas affiliates has been shown to increase over time as transfer costs decrease due to improved codification and standardization of technology and reduced tacitness of knowledge content (Teece 1977). However, when a firm decides on the internal transfer of proprietary assets abroad, it does not only take into account direct costs and benefits in comparison with arm's-length transactions; it also considers that internal transfer and exploitation lead to the accumulation of critical organizational know-how and resources in the form of transfer management skills and expertise concerning the management of technology applications (Kogut and Zander 1993, 1996). Therefore, MNEs that have built up the skills and routines required are

more likely to transfer and adapt proprietary technologies to their foreign affiliates (Belderbos 2003).

The importance of proprietary knowledge is also stressed in many scholars. For example, Delios and Beamish (1999, pp. 917) claim that

> one critical locally based asset is [proprietary] knowledge of the host country environment. Deficiencies in knowledge of the local environment constitute a significant competitive disadvantage for the foreign firm (Hymer 1976), and the accumulation of host country experience alleviates the foreign firm's local knowledge disadvantages (Johanson and Wiedersheim-Paul 1975; Johanson and Vahlne 1977).

In addition, Cantwell (1989, as cited in Tsang and Yip 2007, pp. 1157), has asserted that

> since the technological level of a country is related to economic distance the technology differs across countries, because technology depends on location-specific factors, such as past innovations, education systems, research and development expenditures (R&D), and links between institutions and firms.

Moreover, Calvet (1981, as cited in Anderson and Gatignon 1986, pp. 10) has defined the importance of proprietary knowledge on the basis of its devaluation:

> proprietary knowledge, such as R&D expenditures (which generate proprietary knowledge), is subject to hazards of transmission and valuation. Such knowledge is often ill codified and difficult to transmit across organizational boundaries. Thus, the classic problem of valuation of information arises: the buyer cannot know what the knowledge is worth (what bid to make) unless the knowledge is disclosed, at which point the acquirer need not pay for it. This obliges information-holders to exploit it themselves, resulting in high levels of ownership, and hence control, of a foreign business entity (Williamson, 1981b).

This section observing the standard operationalization in the relevant literature (e.g., Anderson and Gatignon 1986; Caves and Mehra 1986; Gatignon and Anderson 1988; Kogut and Singh 1988; Gomes and Casseres 1989; Hennart and Park 1993; Andersson and Svensson 1994; Padmanabhan and Cho 1995; Delios and Beamish 1999; Brouthers and Brouthers 2000) measures the specificity or proprietary nature of the MNEs asset's which invest in Turkey employing one industry-level variable: the gross domestic expenditure on R&D expenditure (GERD) which express R&D expenditures as the share of GDP.

In this analysis, GERD indicator is derived from the World Bank database (http://data.worldbank.org/indicator/GB.XPD.RSDV.GD.ZS) and is expressed in annual periodicity and uses as aggregation method the weighted average. Particularly, the World Bank (2014) delimits GERD indicator as follows:

> expenditures for research and development are current and capital expenditures (both public and private) on creative work undertaken systematically to increase knowledge, including knowledge of humanity, culture, and society, and the use of knowledge for new applications. R&D covers basic research which includes the experimental or theoretical work undertaken primarily to acquire new knowledge of the underlying foundation of phenomena and observable facts, without any particular application or use in view, applied research which includes original investigation undertaken in order to

acquire new knowledge; it is, however, directed primarily towards a specific practical aim or objective, and lastly experimental development which includes systematic work, drawing on existing knowledge gained from research and/or practical experience, which is directed to producing new materials, products or devices, to installing new processes, systems and services, or to improving substantially those already produced or installed.

However, this indicator excludes R&D expenditures financed by domestic firms but performed abroad.

In today's globalized world, **competitiveness** has become a milestone of both advanced and developing countries. Because of pressures introduced by this globalization, it is important to have a framework for analyzing a country's competitive position in the international market rather than simply focusing on measures of internal productivity. It is common knowledge that the marketplace is no longer restricted to a particular geographic location. A business can thus expect competition from neighboring entities, and/or from similar operations within its region. The marketplace is now global, and even the smallest of organizations compete on an international level. [Therefore,] [i]n order to provide firms the necessary opportunities to assess economic distance and realize global competitive advantage, it is essential to define the *relative competitive position of their home country* [through economic distance] (Önsel, Ülengin, Ulusoy, Aktaş, Kabakc, Topcuc 2008, pp. 221-222).

But the importance of inclusion of this factor doesn't answer only to the need of firms to face a more globalized world. It does also represent the capability of firms to survive and to have a competitive advantage in global markets in terms of education, health and communication infrastructures, as well as on the nation's political and economical stability. Therefore, the study of a combined micro- and macroeconomic characteristics of an economy determine in depth the level of economic distance between two nations (Onsel et al. 2008).

Porter's (1990) work on the competitive advantage of nations has stimulated a debate on the linkages between firm specific assets (FSAs) and country specific assets (CSAs). Particularly, Porter (1990) through the "single diamond" model has raised the basic question of international competitiveness: Why do some nations succeed and others fail in international competition?" arguing that home country location advantages are the key source of FSAs, which determine international competitiveness. As he has suggested in his book, nations are most likely to succeed in industries or industry segments where the national "diamond" is the most favorable. The diamond has four interrelated components: (1) factor conditions, (2) demand conditions, (3) related and supporting industries, and (4) firm strategy, structure, and rivalry, and two exogenous parameters (1) governance and (2) chance. Hence, only in the case of a strong "diamond" domestic companies can be expected to develop the non-location-bound FSAs needed to expand abroad (Verbeke and Hilleman 2013).

Interestingly, the model integrates the important variables determining a nation's competitiveness into one model. Most other models have been designed for this purpose, which

represent subsets of Porter's model (1990). However, substantial ambiguity remains regarding the signs of relationships and the predictive power of the model. This is because Porter fails to incorporate the effects of multinational activities in his model. To solve this problem Dunning (1992) treats, for example, multinational activities as a third exogenous variable which should be added to Porter's model. In today's global business, however, multinational activities reflect much more than just an exogenous variable. Therefore, Porter's (1990) original model has been extended to the generalized double diamond model whereby multinational activities, which include inbound and outbound FDI, are formally incorporated into this model (Moon, Rugman, & Verbeke, 1998). In this sense, firms also "absorb" location advantages from other markets than the home market as the basis for augmenting their own FSAs.

Observing the double diamond, it is obvious that there is a clear linkage between the double diamond framework and Hennart's (2009) arguments for entry mode choice. This is explained by the fact that Hennart (2009) addresses the transactional characteristics of complementary assets in the host country and their potential for bundling with the MNE's FSAs. These complementary assets co-determine the MNE's initial entry mode choice and its subsequent evolution. Hennart (2009) describes this view as asset bundling approach.

The main contribution of Hennart's (2009) article is that his analysis underlies a 2 x 2 matrix that represents the various possible combinations of an MNE's resources and a local owner's complementary assets. A combination of both, in the form of asset bundling, is necessary to develop successfully value-adding activities in a particular host country. Extant knowledge is the key FSA the MNE seeks to exploit and various local assets constitute the key CSAs to be accessed as complementary resources.

Three markets provide the MNE with various options to exploit its extant knowledge and to access requisite CSAs. First, the MNE could make its own knowledge accessible in the market for asset services, by licensing this knowledge to a host country manufacturer, who will then engage himself in local production. Second, the MNE could purchase complementary local resources in the market for assets (e.g. in the labour market or the market for natural resources) and bundle these with its own FSAs, in order to enhance goods and services produced abroad. Third, the MNE could offer itself or parts of itself for sale, or acquire (or merge with) foreign companies, in which case it would be active in the market for firms. So, Hennart (2009) and Verbeke (2013) characterize these CSAs as indispensable parameters in international expansion, while Porter ignores the relevance of host country CSAs.

Therefore, the linkage is that the relative strengths of those CSAs (whether CSAs are described as location advantages, as in Verbeke (2013) or as complementary local assets (Hennart, 2009) matters little) and their accessibility determine a host country's attractiveness and ultimately affect the MNE's decision on whether to expand to this host country and if so, how to serve this market (entry mode decision). As discussed in chapter 5, an entry mode choice decision is a complex strategic challenge involving a "process of linking existing knowledge bundles with new knowledge in host countries and regions" (Verbeke 2009, pp. 112). Here, the recombination of the MNE's FSAs with the requisite complementary assets of local owners is crucial to the MNE's overall success in the host country.

Competitiveness at the firm level is clear, that is, companies compete for markets, and it is measured by looking at market shares or profitability. Competitiveness at the country level has been assumed to be almost similar. However, market shares fail to give insights into countries' balance of trade and economic strength through their failure to consider imports (Krugman and Hatsopoulus 1987). Also, market shares ignore sales arising from foreign affiliates and foreign licensed sales, since only exports are considered. For these reasons, competitiveness at the country level cannot be measured the same way as that at the firm level (Kao, Wu, Hsieh, Wang, Lin, Chen 2007).

Interestingly, although there are different criteria (e.g., IMF, OECD, Buckley 1988; Porter 1990; Boltho 1996; Fagerberg 1996) to determine a country's national competitiveness, competitiveness, in many cases, is related with the productivity growth of the country at both the macro and micro levels. However, there seems to be no agreed on definition of national competitiveness (Krugman 1996). Scholars of different disciplines usually look at the problem from different points of view (Buckley et al. 1988). **What, then, is meant when the term "national competitiveness" is used?**

Hickman (1992) in his book[48] defines as competitiveness

> the ability to sustain, in a global economy, an acceptable growth in the real standard of living of the population with an acceptably fair distribution, while efficiently providing employment for substantially all who can and wish to work and doing so without reducing the growth potential in the standards of living of future generations (pp. 6)

Similarly, Stanovnik & Kovačič[49](2000, as cited in Arslan and Tatlıdil 2012, pp. 33) have focused on international competitiveness with respect to the definitions given by IMD and OECD. Particularly they have defined that**,**

> in line with the definition of IMD, competitiveness is viewed as [the ability] "to create added value and thus increase national wealth by managing assets and processes, attractiveness and aggressiveness, globality and proximity and by integrating these relationships into an economic and social model", whereas OECD defines international competitiveness

[48] Hickman, B. G. (1992). *International Productivity and Competitiveness. N*ew York: Oxford, Oxford University Press.
[49] Stanovnik, P., and Kovačič, A. (2000). *Measuring Competitiveness of National Economies with Emphasis on Slovenia*. Institute for Economic Research, Working Paper 6, 1-26.

as “at which level a country can, under free and fair market conditions, produce goods and services which meet the test of international markets while simultaneously maintaining and expanding the real incomes of its people over the long term”.

Moreover, Scott and Lodge (1985, pp. 10) have defined national competitiveness as “the catchphrase in the global world” and refers to a country’s ability to create, produce, distribute and service products in the international trade while earning rising returns on its resources. Finally, the definition from the World Economic Forum (WEF 2003) involves ‘‘the set of institutions and economic policies supportive of high rates of economic growth in the medium term’’ (Kao et al. 2007).

While these definitions are not exactly the same, they share a common spirit, that is, **creation of an environment conducive to improving the prosperity of a country**. So, in this thesis, a nation's competitiveness is perceived as a nation's ability to increase the welfare and real income levels by producing goods and services under fair international market conditions, (Duzgun 2007, pp. 422-424) and simultaneously can compare itself to other nations of similar economic development (Onsel et al. 2008, pp. 222).

There are three prominent indices that measure national competitiveness. One is prepared by the IMD and appears in the World Competitiveness Yearbook; the second is contained in the Global Competitiveness Report of the WEF, and the third is referred to in Business Competitiveness - Ease of Doing Business Report prepared by International Finance Corporation (IFC). Because of the different definitions and data sources used, competitiveness rankings of a country vary. For example, Turkey is at the 39th position according to the World Competitiveness Yearbook by IMD, at the 59th rank according to the Global Competitiveness Yearbook by WEF, and at the 65th position according to Business Competitiveness - Ease of Doing Business Report by IFC. Therefore, it is necessary to analyze, albeit superficially, how and why these indices are generated before determining the source of competitiveness for this section.

To begin with, WEF’s annually published Global Competitiveness Report carries out respective computations of the competitiveness index by different indicators. Global Competitiveness Report focuses on economic welfare and increasing standards of living while making computations and rankings of the countries. Hence, indicators used in this yearbook are strongly regarded as the factors which are crucial for achieving high growth levels. In WEF’s Global competitiveness Report (GCR) 2011-2012, 116 lowest level variables are used for 142 countries and then these 116 variables are grouped into 12[50] pillars, which are then further grouped into 3 stages according to the stages of

[50] Institutions, Infrastructure, Macroeconomic Environment, Health and primary Education, Higher education and training, Goods Market Efficiency, Labor Market Efficiency, Financial Market Development, Technological Readiness, Market Size, Business Sophistication, Innovation. WEF’s Global Competitiveness Index 2011-2012, page 15, retrieved from

development (WEF, GCR, 2011, pp. 4-10).

WEF uses a different weighting scheme in the Global Competitiveness Report. Every sub-factor and variable is assigned a different weight depending on the development levels of the country, which is determined by the GDP per capita level of each country.

Secondly, the structure of IMD index is based on the following path: it divides the variables used for the computing the national competitiveness into four groups[51] and then these four groups are sub-divided into 5 sub-factors. These sub-factors are once again divided into several indicators which are totally 341 indicators for 59 economies (IMD, World Competitiveness Yearbook, 2011). IMD, in contrast to WEF, gives equal weights to 20 sub-factors in the computation of the scores and the ranking of the countries. The primary goal of IMD is that it compares economies which are under the same level of development.

Lastly, Business Competitiveness - Ease of Doing Business Report prepared by International Finance Corporation (IFC) is also a source of computing the national competitiveness. According to Ease of Doing Business Report, 9 indicators[52] are taken into account in the computation of the score values of the countries for 183 economies (IFC Ease of Doing Business Report, 2011).

Doing Business Report focuses on the business sector and evaluates the economies in the view of how difficult or easy for a business to run when complying with the regulations. This publication doesn't include any macroeconomic conditions or financial systems while computing the score values; it just focuses on the business sector to understand the availability of regulatory environment for business.

In the light of what has been mentioned above, these three indices are somewhat different in the scope of their purpose. At the onset, it should be said that the Ease of Doing Business Report (IFC) is slightly unlike the others, since it does not take into account the macroeconomic and financial environment of a country. Therefore, it is reasonable to compare the World Competitiveness Yearbook (IMD) and Global Competitiveness Report (WEF) when considering the reliability of indices. According to these three indices, rankings of Turkey and 11 of its potential rival countries are presented in Table 18. The source of the table below was chosen because its analysis is based on sound

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(http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2010-11.pdf)

[51] Economic Performance, Government Efficiency, Business Efficiency, and Infrastructure. IMD's The World Competitiveness Scoreboard 2011 retrieved from (http://www.imd.org/research/publications/wcy/upload/scoreboard.pdf)

[52] Starting a Business, Dealing with Construction Permits, Registering Property, Getting Credit, Protecting Investors, Paying Taxes, Trading Across Borders, Enforcing Contracts, and Closing a Business. IFC's Ease of Doing Business Report 2011, page 4, retrieved from (http://wwwdoingbusiness.org/~/media/FPDKM/Doing%20Business/Documents/Annual-Reports/English/DB11-FullReport.pdf)

arguments. The criteria used include regional, population, cultural, and institutional aspects.

Table 18

Rank and Score Values of Turkey and other 11 countries

Countries	Global Competitiveness Report (WEF) 2011-2012		World Competitiveness Report (IMD) 2011-2012		Ease of Doing Business Report (IFC) 2011-2012
	Rank	Score	Rank	Score	Rank
Brazil	53	4.32	44	61.04	127
China	26	4.90	19	81.10	79
Colombia	68	4.20	46	59.77	34
Egypt	94	3.88	53(*)	50.55 (*)	94
India	56	4.30	32	70.65	134
Indonesia	46	4.38	37	64.61	121
Korea	24	5.02	22	78.5	16
Malaysia	21	5.08	16	84.12	21
Russia	46	4.21	49	58.38	123
South Africa	50	4.34	52	56.86	39
Turkey	59	4.28	39	63.79	65
Vietnam	65	4.24	36(*)	65.36 (*)	78

Source: As cited in Arslan and Tatlıdil, 2012, pp. 39. The World Competitiveness Yearbook 2011, Ease of Doing Business Report 2011 and the Global Competitiveness Yearbook 2011-2012. * denotes that these values are not given in IMD's Global Competitiveness Yearbook, they are estimated by using missing value obtaining techniques by the authors.

It is obvious from the Table 18 that the ranking of each country is not the same for each index, due to the different variables used for the indices and the weighing scheme assigned to each variable. Firstly, IMD and WEF do not use the same variables; for example, WEF uses 116 variables in its computation of national competitiveness, whereas IMD uses 341 variables in its computation and these variables change over time. Secondly, while WEF assigns specific and unequal weights to each indicator, IMD assigns equal weights to all variables. However, these differences are not sufficient to

determine which index is more reliable and accurate for this study. **So, what criteria can be used to decide which index is more appropriate for this analysis?** The methods employed in this analysis are two: (1) calculations of correlations between IMD, WEF and Ease Doing Business indices, and (2) critical comparison.

On the basis of calculated rank correlations, it can be deduced that the correlation between

- WEF's Global Competitiveness Index and Doing Business Report is 0.5820,
- IMD's World Competitiveness Yearbook and Doing Business Report is 0.5263
- and WEF's Global Competitiveness Index and IMD's World Competitiveness Yearbook is 0.8955.

While the calculated score correlation between WEF's Global Competitiveness Index and IMD's World Competitiveness Yearbook is 0.7443.

Therefore, it is obvious that the weakest association is between IMD's World Competitiveness Yearbook and Doing Business Report, whereas the strongest association is between WEF's Global Competitiveness Index and IMD World Competitiveness Yearbook. In particular, the 0.8955 score means that, the two indices are using approximately similar variables or proxies related to the variables in their calculations. However, the variables used in these two indices are not identical because there are some differences in country characteristics.

Turning to the second method, WEF's Global Competitiveness Index and IMD's World Competitiveness Yearbook are critically compared, since Doing Business Report show the least correlation with both WEF's Global Competitiveness Index and IMD's World Competitiveness Yearbook. IMD's World Competitiveness Report, despite its weaknesses,[53] is useful for different communities since it uses more variables than WEF. Furthermore, IMD compares economies with similar characteristics and the same level of development.

In addition, WEF index, despite its advantages,[54] has two basic weaknesses. The first one lies in

[53] IMD gives equal weights to the variables while computing the index. Also, IMD measure is simple to interpret and determine a country's competitiveness, this means that it is lacking in its ability to encompass the relationships amongst the set of 248 *correlated* variables. Any developed measure that represent countries' competitiveness should be "optimal", in the sense that the indices be weighted averages with the weights determined by incorporating the inter-relationships among the 248 variables.
Moreover, IMD concentrates on more developed economies. For example, in World Competitiveness Year book there is a criterion of the number of Nobel prize winners, in which is almost impossible for underdeveloped countries to score above zero. Moreover, the complexity of the reports makes it hard to generate the model for those countries not selected (Oral and Chabchoub 1996; Lall 2001).

[54] WEF is clearly concerned with dynamic comparative advantage, and places technological dynamism at the core of building such advantage: there is now "a multi- speed world economy divided by technological dynamism" (WEF 2000, pp. 19). The ability to sustain incomes and growth depends, in a globalizing world, on each country's ability to innovate or import and use technologies created elsewhere. This approach opens the way, in economic terms, to the analysis of

its underlying assumption, namely, that markets are considered to be efficient, which implies that economies are substantially "market friendly"; however, it leaves out a significant set of issues, particularly in developing countries, where market failures call for selective responses (Lall 2001).

The second weakness refers to

problems with the model specification, the choice of variables, the identification of causal relations and the use of data. "Current competitiveness," which should be explained by stock variables, is measured almost wholly by flow or rather, perceptions of flow) variables. Causal relations between independent and explanatory variables are confused or theoretically unwarranted. Many nonlinear or controversial relationships are left unexplored. The plethora of explanatory often repetitive) variables does not add to the explanatory power of the index. The use of econometrics to demonstrate the statistical power of the analysis and to derive detailed conclusions may be misleading. The empirical base is too weak and fragile to support such exercises (Lall 2001, pp. 1520).

Therefore, the method used in these indices show that IMD focuses on variables which are more suitable for this study despite their weakness. Lastly, IMD index has not accepted so strong criticism and most important tends to take into account the specific characteristics of each country comparing economies which are under the same level of development.

Developing countries have signed bilateral **investment treaties (BITs)** in order to attract more FDI. In recent decades BITs have become "the most important international legal mechanism for the encouragement and governance" of FDI (Elkins, Guzman, and Simmons 2004, pp. 0). The preambles of the thousands of existing BITs have stated that the purpose of BITs is to promote, to protect, and to facilitate foreign investment reducing the risks that the investor faces, and that such risk reductions, all things being equal, encourage investment. In this light, BITs are viewed by many developing governments as a useful tool, which encourage and finally increases FDI amounts in their respective countries (Neumayer and Spess 2005).

Besides, the burgeoning number of BITs also reflects the changing nature of inbound foreign investment flows, and the locational decisions of MNEs. This means, that whereas, in the past, sitings of FDI were primarily determined by resource endowments and the size and structure of local and adjacent markets, today's locational decisions are far more complex. Government policies and institutions have become increasingly important as regards the traditional economic fundamentals, especially for FDI from and to the advanced industrialized countries. For this reason, host economies seeking to attract inbound MNE activity are increasingly focusing their attention on improving their investment environment (institutional environment) by adopting domestic institutions and policies that favor FDI, concluding international investment agreements, guaranteeing certain standards of

how technology generation, import, absorption and adaptation take place and, for competitiveness analysis, the market failures affecting the process (Lall 2001 pp. 1505). Also, WEF uses a different weighting scheme in its computations.

protection, and providing favorable tax treatment for foreign investors (Dunning 2009).

Therefore, BITs and FDI are strongly affiliated, both theoretically and practically; they are also principal international investment agreements (IIAs), that is, instruments which, in a significant manner, address investment issues (Sauvant and Sachs 2009). It is, therefore, important that this analysis should incorporate BITs as an indicator of Economic Distance.

But why are BITs studied in this sub-section under the lens of Economic Distance? This happens for three reasons: firstly, BITs may facilitate international investment. Secondly, international investment may facilitate economic prosperity. Thirdly, as mentioned in chapter 4 (Theoretical Framework) of this analysis, TCA is a theoretical framework, which is not only based on an organizational theory (New Economics of Organization), but also founded on an institutional framework (New Institutional Economics). The latter, in turn, also provides a basis for analysis and entails the cultural-cognitive dimension from an anthropological perspective, the normative dimension from a sociological perspective, and the regulatory dimension from an economic perspective (see Institutional Distance for more details). Although each of these three dimensions of institutional theory provides a basis for analysis, this thesis focuses on the regulatory environment-economic perspective and the use of NIE, so as to incorporate and justify the inclusion of BITs in Economic Distance, following Grosse and Trevino's (2009, pp. 276) argument that

> while the new institutional economics is not a unified theory, [however] it does provide the basis for theoretical constructs to demonstrate that "institutions matter." [Grosse and Trevino] have identified five constructs—corruption, regulation, [bilateral] investment treaties, privatization, and political risk—that demonstrate that governmental institutions matter in FDI decisions. Evidence that supports these measures of institutional dimensions as affecting FDI decisions will thus support the broader proposition that the new institutional economics offers a useful framework for understanding these decisions, beyond the traditional economic, political, and financial dimensions.

In this context, NIE focuses on the intersection of institutional environments and firms resulting from market imperfections (Harris, Hunter, and Lewis 1995). North (1990) has posited that institutions provide the rules of the game that structure interactions in societies and that organizational action is bound by these rules. A central focus of NIE is the reduction of costs associated with transactions - in this case those related to FDI decision-making and implementation. This perspective emphasizes that firms incur costs when they undertake business transactions, such as the cost of obtaining information and writing and enforcing contracts (in this case BITs).

So, according to NIE, firms are a particular form of organization for administering transactions between one party and another, and firms exist because they may be able to reduce the costs of negotiating and enforcing terms and conditions of exchange relative to market transacting (Coase

1937). Under the managerial-choice approach of NIE (Williamson 1975, 1985; Walker and Weber 1984), managers employ a transaction-cost-economizing estimation when making contracting decisions.[55]

In the case of MNE and FDI decision making, presumably the better the institutional environment is able to approximate zero transaction costs for the foreign investor, the more likely the country is to receive inward FDI flows, *ceteris paribu*s. Thus, one way to understand the intersection of MNE investment strategy and the institutional environment in emerging economies, such as Turkey, is to analyze the ability of institutions to reduce transaction costs associated with FDI-BITs in this analysis-that result from uncertain environments (Hoskisson et al. 2000).

In particular, the adoption of BITs, in this thesis, can be considered as one of the elements of institutional reform that has helped to foster the perception that emerging economies are moving toward market-based economies. Since World War II, many BITs, under the auspices of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank), have been enacted in order to provide protection for foreign investors. In this context, BITs generally offer investors additional and higher standards of legal protection and guarantees for foreign investments beyond those offered under national legislation. In fact, BITs often include provisions for the avoidance of double taxation of income and capital. Thus, from the perspective of the NIE, a BIT may serve as a signal of a favorable investment climate.

Therefore, this thesis concludes that BITs may act as an economic instrument for the international protection of foreign investments, thereby reducing uncertainty and FDI-related costs, while at the same time signaling to foreign investors that the host country has undertaken institutional reforms toward building a market economy. This may imply that BITs play an increasingly important role in the proliferation of international investment, and, thus, are incorporated in economic distance.

The main purposes of Turkey's BITs are to increase the bilateral flows of capital and technology, and to protect investments by international investors in the framework of the legal system of the host contracting state. In line with these principals, BITs are signed with countries that are already major investors in Turkey or could potentially become investors (http://www.economy.gov.tr/index.cfm?sayfa=tradeagreements&bolum=bilateral).

Considering this view, BITs have been signed by Turkey are important tools to protect

[55] Supportive of this view is the argument of Hoekman and Saggi (2000, as cited in Egger and Pfaffermayr 2004, pp. 789), which defines that, due to some differences in national rules, BITs may be the source of higher transaction costs and uncertainty from a firm's perspective. Although this point would support an argument for a harmonized global BIT, i.e., a multilateral investment treaty, these authors concede that differences in cultural, political, and general business climate characteristics are also important determinants of the transaction costs associated with FDI.

investments made by Turkish entrepreneurs all around the world. Turkey, despite having one of the most liberal FDI regimes in its region, still considers its wide web of BITs as an important tool to attract foreign investors. Turkey has signed its first BIT with Germany in 1962. This has followed by the BIT with the U.S. in 1986 and, so far, Turkey has signed 82[56] BITs with developed as well as developing countries; it is also planning to launch negotiations with Algeria and Uganda (YOIKK Secretariat 2011, pp. 8).

Turkey has its own BIT Model text, and updates it regularly to meet international standards as well as to reflect the experience it has gained from international arbitration cases. Turkey has recently updated its BIT text at the end of 2009 in close collaboration with the UNCTAD and the International Institute for Sustainable Development (IISD) (YOIKK Secretariat 2011, pp. 9).

The main principles of Turkey's BIT model are based on the following characteristics:

- designation of the program for the promotion of long-term, productive investments (FDI) (YOIKK Secretariat 2011, pp. 10);
- "fair and equitable treatment" of and "full protection and security" for investments (YOIKK Secretariat 2011, pp. 10);
- most favored nation and national treatment for investments (YOIKK Secretariat 2011, pp. 10);
- protection against expropriation (YOIKK Secretariat 2011, pp. 10);
- compensation for losses (YOIKK Secretariat 2011, pp. 10);
- guarantee for transfer of returns and profits (YOIKK Secretariat 2011, pp. 10);
- access to international arbitration for foreign investors (ICSID, *Ad hoc* Arbitration, or other venues) (YOIKK Secretariat 2011, pp. 10).

Data for BITs between Turkey and other sample countries are derived from a list published by the Ministry of Economy of the Republic of Turkey (http://www.economy.gov.tr/index.cfm?sayfa=tradeagreements&bolum=bilateral). The Turkish Ministry of Economy documents the parties to every bilateral investment treaty with the Republic of Turkey, the date of signature, and the treaty's date of entry into force. In this section, BITs are viewed as a dummy variable which is coded 1 after the date of signing and 0 before it.

[56] Afghanistan, Albania, Argentina, Australia, Austria, Azerbaijan, Bangladesh, Belarus, Belgium-Luxemburg, Bosnia and Herzegovina, Bulgaria, China, Croatia, Cuba, Czech Republic, Denmark, Egypt, England, Estonia, Ethiopia, Finland, France, Georgia, Germany, Greece, Hungary, India, Indonesia, Iran, Israel, Italy, Japan, Jordan, Kazakhstan, Kingdom of Saudi Arabia, Kyrgyzstan, Kuwait, Latvia, Lebanon, Libya, Lithuania, Malaysia, Malta, Moldova, Mongolia, Morocco, Oman, Pakistan, Philippines, Poland, Portugal, Qatar, Romania, Russian Federation, Serbia, Singapore, Slovakia, Slovenia, South Korea, Spain, Sweden, Switzerland, Syria, Tajikistan, Thailand, Republic of Macedonia, The Netherlands, Tunisia, Turkmenistan, United Arab Emirates, Ukraine, USA, Uzbekistan, Yemen.

Several authors, including Buckley (1990), Casson (1987) and Dunning (1980, 1988a), have stressed that a multinational's firm-specific advantages should be considered in relation to competing enterprises or in relation to the competitive environment in host countries. More specifically, this means that a given MNE's characteristic or resource may be an advantage in the context of a particular host location. For example, a technologically-intensive U.S. MNE may conceivably enjoy a greater advantage over firms in less-developed countries than in developed countries.

In this context, firms from newly industrializing countries (NICs), face two types of host locations: those more **developed and those are less developed** than their country of origin. These firms may find that the firm-specific advantages necessary to operate in less developed countries are different from those required in more developed countries.

The fact that developed and developing countries represent different external environments poses different levels of complexity for foreign investors (Beamish 1985), something which is of particular significance to globally operating MNCs from developing countries, including NICs. This happens because MNEs have to replicate their existing business model to exploit their competitive advantage, which is hard to pull off in a country where customer incomes are very different. Wal-Mart in India, for instance, would be a very different business from Wal-Mart in the United States, while Wal-Mart in Canada is virtually a carbon copy (Ghemawat 2001, pp.8).

Therefore, the host country level of development becomes especially important in studies dealing with FDI and entry mode choice, since the different configuration of host country factor endowments, demand conditions and competition can either strengthen a firm's advantages or render them redundant (Dunning 1995; Itaki 1991). (Eramilli, Agarwal, and Kim 1997).

Considering this conceptual framework, Zejan (1990) has stressed the importance of host country level of development through GDP per capita, by including host country market characteristics in an analysis of Swedish MNEs' expansion into 35 countries. Zejan (1990) has analyzed the influence of market size, market growth and the host country's level of development on the MNE's entry decisions. Also, Agarwal and Ramaswami (1992), Padmanabhan and Cho (1995) have focused on the host's country level of development through market potential. Particularly, Agarwal and Ramaswami (1992, pp. 5) have defined that

> firms interested in servicing foreign markets are expected to use a selective strategy and favor entry into attractive markets. This is because their chances of obtaining higher returns are better in such markets. The attractiveness of a market has been characterized in terms of its market potential and investment risk.

Furthermore, according to Ghemawat (2001, pp. 8), the wealth or income of consumers is the most important economic attribute that creates distance between countries; and it has a marked effect

on the levels of trade and the types of partners a country trades with (Ghemawat 2001, pp. 8). In a similar manner, Berry, F Guillèn and Zhou (2010, pp. 5) have stressed that

> the international business literature has tended to focus on three specific indicators of economic differences across countries. Countries differ in terms of their income level (GDP per capita), prevailing inflation rates, and intensity of trade with the rest of the world (exports plus imports as a proportion of GDP). These indicators and, especially income level, are important, because they are correlated with consumer purchasing power and preferences, macroeconomic stability, and the openness of the economy to external influences. These factors have been found to influence, for instance, foreign market entry mode, firm survival and performance, among other variables (for a review of the evidence see Caves 1996).

Lastly, Cuervo-Cazurra and Genc (2012) have developed a theoretical framework in which the host country's level of development occupies a central place. They have classified a country's environment into three dimensions: obligating, pressuring, and supporting, and they have determined how each dimension affects the development of firm resources at home, and the value of such resources abroad. In other words, they have categorized distances based on the following criteria: whether countries can be ranked in terms of level of development along each dimension;[57] and if so, whether the dimension supports the operations of the firm or pressures it to be more competitive.

In conclusion, the level of a country's development is a significant variable, worthy of being included in the construction of economic distance, when attempting to decipher why MNEs coming from countries with high or low level of development may or not prefer specific countries with lower or higher level of development to invest in.

Considering the above, this section employs GDP per Capita as a measure of economic distance. The data for this variable are in constant prices of 2005 U.S. dollars and derived from the World Bank. According to World Bank National Accounts Data, and OECD National Accounts data files (http://data.worldbank.org/indicator/NY.GDP.PCAP.KD), this section defines GDP per Capita as the gross domestic product divided by midyear population. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. The variables and their sources comprising economic distance are presented in Table 19.

[57] For example, considering the supporting dimensions (many of these dimensions are what economists consider public goods provided by the government to help the country's development, such as a good public education system, a well-developed transportation infrastructure and a high quality regulatory system), MNEs suffer a disadvantage when they move from more to less developed countries, and they gain an advantage when they move in the opposite direction. When MNEs move to less developed country they suffer from a disadvantage, because they do not have the supporting resources they took for granted in their home country. On the other hand, if MNEs move into a more developed country in these dimensions, they achieve an advantage compared to their home operations, because they gain access to more sophisticated resources to support their operations, and do not have to invest in developing them (Cuervo-Cazurra and Genc 2012).

Table 19 **Items Measuring Economic Distance**
1. Research & Development Expenditures (World Bank, (http://data.worldbank.org/indicator/GB.XPD.RSDV.GD.ZS))
2. National Competitiveness (IMD, World Competitiveness Yearbook, 2012)
3. Bilateral Investment Treaties (the Republic of Turkey Ministry of Economy (http://www.economy.gov.tr/index.cfm?sayfa=tradeagreements&bolum=bilateral))
4. Gross Domestic Product per Capita (World Bank National Accounts Data, and OECD National Accounts data files (http://data.worldbank.org/indicator/NY.GDP.PCAP.KD))

Source: Author's Design, 2013.

The entry mode choice of wholly owned subsidiary versus joint venture and alternatives within joint venture are modeled as a qualitative choice problem (Demirbag, Glaister, and Tatoglu, 2007). Four entry modes are considered in this section, which include

- wholly owned subsidiary (WOS),
- minority joint venture (MNJV),
- co- ownership joint venture (COJV),
- and majority joint venture (MJJV).

The nature of the dependent variables allows this thesis to use the multinomial logit approach to calculate the effect of the explanatory variables on the probability that each of the four equity ownership is chosen.[58] "The multinomial logit analysis allows the explanatory variables to affect different odds of choosing one alternative relative to the other" (Kogut and Singh 1988, pp. 422). So, the probability that the *i*th firm will choose the *j*th entry mode (P_{ij}) is given in the following model:

$$\mathbf{P_{ij} = Pr(R_{ij} > R_{ik}),} \qquad \mathbf{for\ } k \neq j, \ \mathbf{j= 0,1, 2, 3\ where,}$$

where R_{ij} is the maximum utility for firm *i* if the firm chooses the entry mode *j:*

[58] For an introduction to multinomial logit models, see Green (2008, pp. 843-845), Hosmer Jr. and Lemeshow (2000, 260-287), Long (1997, chap. 6), and Treiman (2009, pp. 336-341). For a description emphasizing the difference in assumptions and data requirements for conditional and multinomial logit, see Davidson and MacKinnon (1993).

$$\mathbf{P_{ij} = \exp(x_{ij}\beta_j) / \sum_{i=1}^{I} \exp(x_{ij}\beta_j)\ where,}$$

P_{ij} is the probability of choosing alternative j and β_j is the vector of coefficients to the independent variables, and x is the vector of independent variables. The parameters (β's) are calculated by maximizing a log likelihood function.

Klein, Frazier, and Roth (1990, as cited in Demirbag, Glaister, and Tatoglu 2007, pp. 427) have stated that "when the multinomial logit model is calculated, one option has to be used as base mode. Because once j -1 alternative probabilities are known, the jth is determined." Therefore, three (j-1= 3) different logit equations are calculated, since wholly owned subsidiaries (WOS) option is used as the basis for comparison. Under this condition the specification model is reduced to:

$$\mathbf{P_{ij} = \exp(x_{ij}\beta_j)/1 + \sum_{i=1}^{I} \exp(x_{ij}\beta_j),}$$

with the baseline alternative specified as

$$\mathbf{P_{ij} = 1/1 + \sum_{i=1}^{I} \exp(x_{ij}\beta_j)}$$

So considering the above, the algebraic forms of the above variables of the function will be as following.

- **WOS vs MNJV= CD + ID + GD + ED,**
- **WOS vs COJV= CD + ID + GD + ED,**
- **WOS vs MJJV= CD+ ID + GD + ED,**

where,

CD = cultural distance equals to cognitive distance as measured by Hofstede and GLOBE indices

ID = institutional distance equals to regulative distance: anti-trust laws, intellectual property rights and legal system and normative distance: adaptability of government policy, bribe and bureaucratic corruption, independence of local authorities, government effectiveness, risk of political stability, and

transparency

GD = geographic distance equals to kilometer distance, weighted distances in Km, contingency, common language, colonial relationship

ED = economic distance equals to R&D expenditures, Competitiveness, BITs, GDP per capita.

6.2 Hypotheses Building

Adopting successful practices of their parents and earning legitimacy are of vital importance for MNEs' affiliates. Due to unfamiliarity with the local environment, costs steaming, for instance, from geographic distance and restrictions on foreign investors, foreign firms are bound to have lower profitability than their local competitors. Consequently, it is crucial for MNEs to transfer their organizational practices that constitute an important source of competitive advantage to their affiliates in order to overcome their liability of foreigners (Kogut 1991). In addition, local firms develop organizational structures and cultures that are consistent with isomorphic pressures in their local environment as developed above. They are thus adapted to local institutional structures. Foreign affiliates, however, should accommodate these pressures and earn legitimacy in order to insure their survival and their success in the new context. Having to gain legitimacy with both the local environment and with the worldwide organization of the MNE, subsidiaries are, therefore, subject to institutional dualism.

In that framework, distances in the three institutional pillars as suggested by Scott (1995) put different strains on the tension stemming from local and corporate institutional pressures. Thus, Kostova (1995) has argued that a high normative, cognitive, and regulative distance between the host and home country impedes the transfer of strategic organizational practices from a parent company to a recipient one. If a practice is inconvenient with existing local regulations, norms, or cognitive aspects, then employees may be reluctant to implement it, or might face problems in understanding and learning it.

More specific, it is especially cognitive distance between an acquired business unit and the parent organization that inhibits MNEs' ability to attain legitimacy within the local context (Kostova and Zahheer 1999). The degree to which one or the other reason prevails is often practice-dependent (Zaheer 1995) and is sensitive to specific contextual variables (Resenweig and Nohria 1994). So, a high **cognitive-cultural** distance has a negative impact on both practice adaptation and affiliates' ability to gain legitimacy. In that framework, two ambiguous options have emerged: on the one hand, obstacles to practice adaptation in existing organizations would encourage WOS. On the other hand, obstacles to

gaining legitimacy would encourage JV.

In light of this view and considering Kogut & Singh (1988) and Anderson & Gatignon (1986) arguments that JV serves frequently the purpose of assigning management tasks to local partners, who are better able to manage the local labor force, and the relationships with the suppliers. A joint venture resolves the foreign partner's problems ensuing from cultural factors. However, JV may be troubled not only by the cultural distance of the partners, but also due to concerns over sharing proprietary assets. On the contrary, WOS avoids both the costs of integration and conflict over sharing proprietary assets by imposing the management style of the investing firm on the start-up, while preserving full ownership (Kogut and Singh 1988). Further, high control is perhaps more efficient when the entrant's methods confer a transaction-specific advantage that cannot be easily imitated by other firms. "On occasion, operation methods that do not fit local culture will constitute the necessary advantage that enable foreigners to compete with locals on their home ground." Therefore, it is hypothesized that

Hypothesis 1a: considering Hofstede's cultural index, the greater the cultural distance between home and host country, MNEs will tend to choose WOS to JV, ceteris paribus.

Hypothesis 1b: considering the GLOBE cultural index, the greater the cultural distance between home and host country, MNEs will tend to choose WOS to JV, ceteris paribus.

Peng (2002) suggests that the strategic choices firms make are not only driven by industry conditions and firm resources, but also reflect the **institutional context** in which the firm is embedded. That is, the firm strategic choices, such as whether and the extent to which to internationalize, reflect the regulative, normative, and cognitive-cultural constraints of national institutional context that firm managers confront; and these contexts should be considered, in addition to firm resources and industry conditions, in understanding how firm strategies are shaped and how these shape the contexts in which they are embedded. Peng et al. (2008) emphasize this view when they argue that international dimension of business strategies is inherently driven by the local and global institutional, industry and resource considerations that internationalizing firms face, as do Yang et al. (2009), who suggest that this framework is useful in explaining the differences and similarities of international expansion of economic actors embedded in diverse institutional, market and resource settings.

Considering the above view, several studies have related institutional concept to entry mode choice. El Said and McDonald (2002) have hypothesized that on the one hand, OECD countries have

impersonal exchange systems with strong third-party enforcement mechanisms (regulatory institutions). Transition and emerging market economies, on the other hand, tend to have weak formal institutions and, therefore, rely more heavily on informal institutional enforcement procedures (e.g., networks, trust, hostages). Where informal constraints are more important than formal ones. So, authors have hypothesized that firms are more likely to take a local partner (equity joint venture or subcontracts to intermediaries); their interviews with foreign managers in Jordan support this hypothesis.

In a similar manner, most recently, Xu and Shenkar (2002, pp. 614) have applied the concept of institutional distance and its three pillars to the MNE's location and mode of entry strategies proposing that:

"[firms] will refrain from investing in markets that are institutionally distant, because business activities in those markets require conformity to institutional rules and norms that conflict with those of the home country. And when they do enter distant markets, firms will choose the lower levels of control and resource commitment commonly associated with a joint venture (Agarwal and Ramaswami 1992; Anderson and Gatignon 1986; Hill et al. 1990), so as to lower the risk of institutional conflicts." In terms of mode of entry, they argue, the higher the institutional distance, in general, the lower the preferred level of equity control and commitment commonly associated with a joint venture (Anderson and Gatignon 1986; Hill et al. 1990; Agarwal and Ramaswami 1992) so as to lower the risk of institutional conflicts."

However, another school of thought (Peng 2003; Estrin et al 2009) has supported that normative and cognitive-cultural aspects of institutions are often tacit in nature and understanding them requires intensive cross-cultural communication by the foreign firm, therefore the management of partial acquisition my prove difficult for MNEs, especially if the MNEs seek to transfer organizational practices to the subsidiary. In this case, full acquisition can be a good option, if there are no legal restrictions imposed by the host-government.

Therefore, the choice between WOS and JV by the MNE has not been addressed specifically in the IB literature so far. So, for the purposes of this section, hypotheses are formulated starting with a basic proposition linking overall institutional distance and then institutional distance is distinguished into a regulative and a normative distance hypothesis.

To begin with, this thesis following Xu and Shenkar (2002) who have argued that the higher institutional distance, the lower the preferred level of equity, because of the difficulties of obtaining external legitimacy in the host country and transferring managerial practices to the MNE subunit; and also following Anderson & Gatignon (1986) and Hill, Hwang, & Kim (1990) that MNEs which enter distant markets typically choose lower levels of commitment and resources preferring joint ventures to wholly owned subsidiaries as an entry mode. Therefore, it is hypothesized that,

Hypothesis 2a: As institutional distance between home and host countries increases, MNEs are more likely to choose a low ownership strategy, ceteris paribus.

Regulative distance measures the difference between home and host countries in terms of the setting, monitoring and enforcement of rules. Within developed countries, regulatory frameworks have become more homogeneous due to globalization pressures, regional integration schemes and international institutions, such as, the World Trade Organization, and the OECD. Even in developing countries, the ability of governments to force capricious, unilateral policy changes on MNEs has been substantially curtailed by the web of BITs and DTTs, membership in international organizations, and structural adjustment constraints imposed by the World Bank and International Monetary Fund (Ramamurti 2001). In addition, almost all national policy changes affecting MNEs since 1990 have been liberalizing (UNCTAD 2003). Only in key sectors where local cognitive symbolism is high (e.g., petroleum in Mexico) there are still regulations restricting foreign equity ownership.

However, government regulations can also indirectly affect ownership strategy. For example, lack of intellectual property rights protection heightens inter-relational hazards of opportunistic behavior by local partners, thereby discouraging intermediate equity modes (joint ventures) in favor of wholly owned subsidiaries (Xu and Shenkar 2002). Missing property rights also encourage corruption in the form of counterfeiting and intellectual piracy. MNEs are, therefore, more likely to choose wholly owned subsidiary (where there is no regulatory ceiling on equity share) in order to protect their property rights. Therefore,

Hypothesis 2b: As regulatory institutional distance rises between home and host countries, MNEs are likely to avoid joint venture ownership strategies in favor of wholly owned subsidiary, ceteris paribus.

Similar to Ionascu, Meyer, and Estrin (2004) it can be agued that MNEs can more easily adopt behaviors and practices *within* businesses where they have some understanding of the underlying technologies and markets than they can with respect to, for example, supply chains, purchases of inputs, ability to market outputs and dealing with local rules and regulations which entail attaining local legitimacy (regulative distance). Thus, when **normative distance** is high, interaction with the local environment will be particularly important, because it increases the importance of creating links with local peers. This leads us to hypothesize that, in these circumstances; the need to gain local legitimacy

and to access local business networks will outweigh other considerations. Hence, normative distance will encourage joint venture rather than wholly owned subsidiary. Therefore,

Hypothesis 2c: MNEs are less likely to choose wholly owned subsidiary to joint venture, when the normative distance between home and host countries is great, ceteris paribus.

The main aspect of this hypothesis is developed on the basis of TCA's fundamental assumptions, namely that **geographic distance** affects an MNE's decision of the appropriate entry mode. For example, it seems plausible that the costs of monitoring partners rise when share-owned solutions are preferred to full acquisitions, because greater amounts of ownership confer a proportional degree of control over the investment, and raise the ability by acquirers to implement decisions and resolve disputes that could arise *ex post* (e.g., Anderson and Gatignon 1986; Grossman and Hart 1986). In contrast, partial ownership may leave partners with differing incentives and opportunities that can not be accounted for in the due diligence stages of deal. Additional evidence come from a working paper by Chakrabarti and Mitchell (2006) who have studied effects of distance on firms' acquisition behavior in the chemical industry, and have found that acquirers tend to prefer proximate investments over remote ones, when the integration and monitoring requirements of the target firm are high.

Therefore, the main body of relevant literature suggests that, on the one hand, MNEs tend to favor target countries within a low geographical distance, and, on the other, when geographic distance increases, they tend to choose a higher form of entry mode. Therefore, it is hypothesized that

Hypothesis 3: the greater the geographic distance between home and host country, MNEs will tend to choose higher form of entry mode wholly owned subsidiary to Joint venture, ceteris paribus.

In order to construct the developing hypotheses of **economic distance** this analysis is based on the contingency theory of organization proposed in Lawrence and Lorsch's (1967) classic work, TCA, and the characteristics of the Turkish business environment.

Particularly, the choice for contingency theory is based on the argument that the basic strategic "co-alignment"[59] proposition is that the fit between a strategy and its context, such as its external

[59] According to Fry and Smith (1987), there are many terms to describe "congruence" in organization theory, such as "follows" (Chandler 1962), "consistent" (Galbraith and Nathanson 1978; Nadler and Tushman 1980), "fit" (Egelhoff 1982), and "co-alignment", "matches", and "nexus" (Thompson 1967). This section follows Tsang and Yip (2007)

environment or an organizational structure, has significant implications for the choice of the appropriate entry mode. Venkatraman and Prescott (1990) distinguish between reductionistic and holistic perspectives on co-alignment.

On the one hand, the reductionistic perspective is developed on the assumption that the co-alignment of two constructs, such as the environment and strategy, can be perceived in terms of pairwise alignment of individual dimensions of the two constructs. In this light, researchers tend to focus on certain characteristics of the environment and strategy so as to investigate the performance of the pairwise alignment. On the other hand, the holistic perspective assumption assesses environment-strategy co-alignment holistically (Tsang and Yip 2007). Researchers adopting the holistic perspective employ a multivariate specification of co-alignment, while also investigating a large number of variables that collectively define a construct.

Both perspectives have their strengths and weaknesses. However, this thesis adopts the reductionistic perspective, because this perspective is based on the assumption that the co-alignment of two constructs, such as the environment and strategy, can be perceived in terms of pairwise alignment of individual dimensions of the two constructs. In this light, researchers tend to focus on certain characteristics of the environment and strategy so as to investigate the performance of the pairwise alignment and can examine performance implications of the co-alignment between economic distance and entry mode choice.

In this respect, when MNEs expand into a foreign market, they have to choose between a wholly-owned subsidiary or a joint venture. MNEs often set up a wholly-owned subsidiary to host countries by sending expatriates familiar with local corporate cultures and routines, so that some of their management systems can be replicated there. These expatriates, in turn, recruit employees from the local population and gradually develop the business alone or with another firm, such as a local partner knowledgeable about local business practices and with good relationships with the host government. However, the corporate culture and routines of a joint venture firm may be very different from those of an outward-investing MNE. Such differences will become a barrier to capitalizing on the MNE's competence in the host country and, hence, will increase the risk of failure.

In this framework, Hennart and Park (1993) have argued that a wholly-owned subsidiary is the most efficient way to exploit firm-specific advantages difficult to separate from a firm itself. In a similar manner, Padmanabhan and Chot (1995) have maintained that establishing a wholly-owned subsidiary allows the installation of the parent's organizational routines at a lower cost than that of

terminology which adopts the term "co-alignment" to describe that "matches were made that would maximize the effectiveness of the organization."

setting up a joint venture.

Another study of R&D intensity of Japanese subsidiaries in the United States has showed that investors tend to prefer wholly-owned subsidiaries to joint ventures, "because they can transfer or device their own management systems with freshly hired U.S. Employees" (Yoshida 1987). Therefore, a wholly owned subsidiary has a better chance of succeeding in the long-term than joint ventures do.

On the contrary, joint ventures appear to be more consistent with resource exploration. For instance, Dunning (1998) has argued that the growth of strategic asset-seeking FDI in recent years is best demonstrated by the increasing role of mergers and joint ventures of FDI, particularly in North America, Europe and Japan. Although a firm's strategic assets may grow through internal asset-enhancing investments over time, firms may also develop assets through external joint ventures. In spite of various implementation problems, joint ventures represent an efficient way of gaining access to strategic assets.

Moreover, Padmanabhan and Chot's (1995) study of Japanese manufacturing firms and Zejan's (1990) study of Swedish firms have indicated that the level of a host country's economic development is a key determinant of the choice between a wholly-owned subsidiary and a joint venture. In fact, both studies have suggested that joint ventures are more likely to be established in developed countries.

To summarize, the above empirical studies have indicated a clear pattern of matching between entry mode and investment motive. For example, Hennart and Park's (1993) study of Japanese firms with strong advantages has considered wholly-owned subsidiaries as more effective than joint ventures so as to transfer their advantages to the United States. On the other hand, in a broader sense, Padmanabhan and Chot (1995) have found that investors tend to acquire local firms when the industrial sector in which the foreign firm is investing in the host country is technologically superior than in the same sector in the home country.

So, applying the concept of strategic co-alignment and while also considering Whitley's (1999) typology, which includes a wider variety of systems, the Turkish business system could be classified as a state organized business system, where the business environment is typically old-fashioned, particularly, in terms of its historical development and early institutional elements. In essence, Turkey has had a state-dependent business system characterized by a strong state, actively coordinating and controlling economic activities (Onis, 1995; Bugra, 1994). Family–owned and –controlled business groups emerge as the dominant economic actors in the Turkish context (Amsden and Hikino, 1994; Guillén, 2000). In addition, Heper (1991) and Bugra (1994) suggest that state intervention in business relations has also contributed to the formation of an unstable business environment in the country. This

unstable relationship between the state and firms encouraged the business groups to invest in wholly-owned subsidiaries. In a similar manner, Onis and Turem (2001) and Onis (2002) stress that many entrepreneurs are encouraged to invest in wholly owned subsidiaries. MNEs engaging in wholly-owned subsidiaries have the chance to transfer their own business systems and to adapt them the local needs (ISO 2008; Demirbag et al. 2007).

Additionally, TCA proposes that firms will choose the entry mode that entails the lowest cost for them. In this prospect, MNEs investing in Turkey will tend to choose wholly-owned subsidiaries to joint ventures in terms of the economic distance, since state intervention in business relations will increase costs entailed. So, a unified control of a wholly-owned subsidiary will give MNEs the ability to implement their own strategies at a lower cost than that of setting up a joint venture.

Therefore, this section, considering the contingency theory, the characteristics of the Turkish business environment and TCA premises proposes that the subsidiary will have a higher chance to operate in Turkey through a WOS rather than a joint venture. The following are, therefore, proposed:

Hypothesis 4: When MNEs invest in Turkey, they tend to use wholly-owned subsidiaries rather than joint ventures, ceteris paribus.

Chapter 7: Methodology, Data, and Sources

As already mentioned, the purpose of this analysis is to measure the influence of particular kinds of distance (cultural, institutional, geographic, and economic) which affect the entry mode choice of MNEs investing in the Republic of Turkey. The measure strategy is used by researchers to date has largely consisted of using single-item measures that are themselves proxy variables (e.g., R&D expenditures to indicate the construct "extent of proprietary information"). This approach, which is in light of the difficulty of obtaining international data, has yielded promising results.

However, hypothesis testing will be even more effective if composite indices are used, thus reducing reliance on single-item measures of complex constructs. The basic advantage of this strategy is that the interpretability of findings will be greatly enhanced by using a variety of proxy variables embedded in one composite index. Therefore, in this light, the procedure of this analysis is based on the following path: the first step is to construct a single index (through factor analysis) for each distance, and the second step is to apply an econometric method capable of soundly accommodating the characteristics of the variables.

7.1 Construction of Indices through Factor Analysis

Having decided on the variables above -economic, institutional, cultural, and geographic distance- and before analyzing the modeling procedure, one basic question arises: which method is appropriate to accommodate the indices at hand? According to relevant literature, the choice is between Exploratory Factor Analysis and Principal Components Analysis. However, in order to reach an explicit answer it is important to first answer two sub-questions: (a) What are principal components analysis (PCA) and exploratory factor analysis (EFA)? (b) How do these differ and how do researchers decide which one to use?

According to Park et al. (2002, pp. 563)

> the goal of EFA is to find a latent structure of observed variables by uncovering common factors that influence the measured variables, whereas the goal of PCA is to reduce the measured variables to a smaller set of composite components that capture as much information as possible in the measured variables with as few components as possible.

Principal components analysis (PCA) and exploratory factor analysis (EFA) are often referred to collectively as factor analysis (FA). On the one hand, the general notion of FA includes "a variety of statistical techniques whose common objective is to represent a set of variables in terms of a smaller number of hypothetical variables" (Kim and Mueller 1978, pp. 9). A more elaborate definition is

provided by Tabachnick and Fidell (2007, pp. 607)

> ...[are] statistical techniques applied to a single set of variables when the researcher is interested in discovering which variables in the set form coherent subsets that are relatively independent of one another. Variables that are correlated with one another but largely independent of other subsets of variables are combined into factors.

On the other hand, PCA is a mathematical procedure that transforms a number of (possibly) correlated variables into a (smaller) number of uncorrelated variables called principal components (Introduction to Principal Components and Factor Analysis, pp. 3).

Calculations for both PCA and EFA involve matrix algebra as well as matrices of Eigenvectors[60] and Eigenvalues.[61] Both PCA and EFA depend on calculating and using matrices of Eigenvectors and values in conjunction with a matrix of the correlation coefficients all of which are based on the variables being studied.

The main difference between PCA and EFA in mathematical terms is found in the values that are put in the diagonal of the correlation matrix. In PCA, 1.00s are put in the diagonal meaning that all of the variance in the matrix is to be accounted for (including variance unique to each variable, variance common among variables, and error variance). That would, therefore, by definition, include all of the variance in the variables.

In contrast, in EFA, the commonalities are put in the diagonal meaning that only the variance shared with other variables is to be accounted for (excluding variance unique to each variable and error variance). That would, therefore, by definition, include only variance that is common among the variables.

In other words, the difference between PCA and EFA is based on the way that two variables analyze the variation in the measured variables (Park et al. 2002). PCA analyzes **variance** and does not distinguish between common and unique variances, because it focuses only on the total variation among the variables. On the other hand, EFA analyzes **covariance** (Tabachnick and Fidell 2007, pp. 635) and separates common variance from unique variance.

In order to make the methodological distinction between EFA and PCA more clearer, algebraic equations are shown below as presented in Dillon and Goldstein (1984).

[60] Eigenvectors are the weights in a linear transformation when computing principal component scores (Suhr n.d.)
[61] Eigenvalues indicate the amount of variance explained by each principal component or each factor (Suhr n.d.)

Principal Components Analysis

$PC_1 = w_{(1)1}X_1 + w_{(1)2}X_2 + w_{(1)p}X_p$

$PC_2 = w_{(2)1}X_1 + w_{(2)2}X_2 + w_{(2)p}X_p$

..

..

$PC_m = w_{(m)1}X_1 + w_{(m)2}X_2 + w_{(m)p}X_{p,}$

where,

- m: the number of principal components
- p: the number of measured variables
- X: measured variable
- PC: principal components
- $w_{(i)j}$: the weight chosen for the *j*th measured variable to maximize the ratio of PC to the total variation

Exploratory Factor Analysis

$X_1 = u_{1(1)}CF_{(1)} + u_{1(2)}CF_{(2)} + \ldots\ldots\ldots + u_{1(m)}CF_{(m)} + e_1$

$X_2 = u_{2(1)}CF_{(1)} + u_{12(2)}CF_{(2)} + \ldots\ldots\ldots + u_{2(m)}CF_{(m)} + e_2$

..

..

$X_p = u_{p(1)}CF_{(1)} + u_{2(2)}CF_{(2)} + \ldots\ldots\ldots + u_{2(m)}CF_{(m)} + e_m$

where,

- CF: common factor
- $u_{(i)j}$: the weight of the ith common factor associated with the j^{th} measured variable
- *i*= 1, 2, …..m= 1, 2, ….....p
- e_j= unique factor, *j*= 1, 2, ……p

The equations above clearly show the two major differences between PCA and EFA. Firstly, EFA

calculates errors (i.e., unique variance), while PCA does not. This indicates that PCA assumes that there are no errors in the measurements. Secondly, in EFA, variables measured are a function of factors, while in PCA, components are functions of variables measured. Lastly, EFA attempts to quantitatively and qualitatively explain correlations between variables, while PCA attempts to account for the variation of variables in a way that will retain as much information as possible from the original measurements (Fabrigar et al. 1999).

Thus, Brown (2009a, 2009b, 2000c, pp. 28) concluded that

> when researchers want to analyze only the variance that is accounted for in an analysis (as in situations where they have a theory drawn from previous research about the relationships among the variables), they should probably use EFA to exclude unique and error variances, in order to see what is going on in the covariance, or common variance. When researchers are just exploring without a theory to see what patterns emerge in their data, it makes more sense to perform PCA (and thereby include unique and error variances), just to see what patterns emerge in all of the variances.

Taking the aforementioned into account, this section applies EFA instead of PCA, because in EFA employs a structured model and is based on specific assumptions. In this respect, EFA is a statistical technique while PCA is often described as a purely mathematical transformation. Furthermore, EFA has traditionally been used to explore the possible underlying factor structure of a set of measured variables without imposing any preconceived structure on the outcome (Child 1990).

The calculation of **regulative and normative distance** in this section is based on two methods. The first method is based on the Factor Analysis, whereas the second method is based on Chao and Krumar's (2010) method. The reason for this choice is based on the following arguments:

- firstly, to compare which of the methods produces the best scores for the measurement of each distance
- and secondly, to achieve a more comprehensive measure of regulative and normative distance.

To begin with, the first part of this subsection performs a factor analysis (principal components factors analysis) with varimax rotation, for regulative and normative distance, respectively. When considering **the regulative distance**, this analysis yields one distinct factor, the eigenvalue of which is greater than 1 (see Table 20). To obtain the one-factor solution, this analysis drops two items (antitrust laws and intellectual property protection) that lack clear loadings in their initial analysis. The loading for the retained item on the corresponding factor exceeds 0.65. Thus, regulative distance consists of one item. In the same vein, when considering **the normative distance**, this analysis employs also one distinct factor, the eigenvalue of which is greater than 1 (see Table 27). So, this analysis drops three items (adaptability of government policy, independence of local authorities, and transparency) lack clear loadings in their initial analysis, while the loadings for retrained items exceeds 0.65.

The second part of this subsection uses the factor scores obtained from the principal components analysis to develop the measure of regulative and normative distance between different countries. The corresponding difference is the factor score for Turkey minus the factor score for each host country.

Finally, this subsection measures the reliability of the two distance scores using item-to-total correlations and Cronbach's alpha. Cronbach's alphas are 0.9653 and 0.9616 for regulative and normative distance, respectively. The item-to-total correlations are also higher than the minimum cutoff point of 0.60, providing strong support for the reliability of the distance measure.

Part One

Table 20
Factor Analysis/ Correlations

Method: Principal Factors

Rotation:Unrotated

Number of Obs: 342

Retained Factors: 1

Number of params: 3

Factor	Eigenvalue	Difference	Proportion	Cumulative
Factor 1	2.69683	2.731	1.030	1.030
Factor 2	-0.03440	0.011	-0.013	1.017
Factor 3	-0.04520	0.000	-0.017	1.000

LR test: independent vs. saturated $chi^2(3)= 1311.67$ Prob>$chi^2= 0.000$

Source: Stata 11, Results.

Table 21

Factor Loadings (pattern matrix) and Unique Variances

Variable	Factor 1	Uniqueness
Legal System	0.9453	0.3951
Antitrust Laws	0.9392	0.1179
Intellectual Property Protection	0.9598	0.0789

Source: Stata 11, Results.

Table 22

Factor Analysis/ Correlations

Method: Principal Factors

Rotation: Orthogonal Varimax (Kaiser off)

Number of Obs: 342

Retained Factors: 1

Number of params: 3

Factor	Eigenvalue	Difference	Proportion	Cumulative
Factor 1	2.69683	_	1.0304	1.0304

LR test: independent vs. saturated $chi^2(3)= 1311.67$ Prob>$chi^2= 0.000$

Source: Sata 11, Results.

Table 23

Rotated Factor Loadings (pattern matrix) and Unique Variances

Variable	Factor 1	Uniqueness
Legal System	0.9453	0.3951
Antitrust Laws	0.9392	0.1179
Intellectual Property Protection	0.9598	0.0789

Source: Stata11, Results.

Table 24

Factor Rotation Matrix Results

	Factor 1
Factor 1	1.000

Source: Stata 11, Results.

Part Two

Table 25

Scoring Coefficients

Method: Regression; based on Varimax Rotated Factors

Variable	Factor 1
Legal System	0.3058
Antitrust Laws	0.2741
Intellectual Property Protection	0.4264

Source: Stata 11, Results.

Table 26 Alpha-Cronbach Test	
Test Scale	mean (unstandarized items)
Average Interitem Covariance	4870.96
Number of Items in the Scale	3
Scale Reliability Coefficient	0.9653

Source: Stata 11, Results.

Normative Distance

Part One

Table 27 Factor Analysis/ Correlations				
Method: Principal Factors				
Rotation: Unrotated				
Number of Obs: 333				
Retained Factors: 3				
Number of params: 15				
Factor	**Eigenvalue**	**Difference**	**Proportion**	**Cumulative**
Factor 1	4.8764	4.5435	0.9584	0.9580
Factor 2	0.3329	0.3087	0.0654	1.0239
Factor 3	0.0242	0.0529	0.0048	1.0286
Factor 4	-0.0287	0.0059	-0.0056	1.0230
Factor 5	-0.0346	0.0479	-0.0068	1.0162
Factor 6	-0.0824	_	-0.0162	1.0000

LR test: independent vs. saturated $chi^2(3)= 2626.77$ Prob>$chi^2= 0.000$

Source: Stata 11, Results.

Table 28

Factor Loadings (pattern matrix) and Unique Variances

Variable	Factor 1	Factor 2	Factor 3	Uniqueness
Risk of Political Stability	0.8701	-0.2194	-0.0480	0.1925
Government Effectiveness	0.9466	0.0851	-0.0899	0.08877
Bribe and Bureaucratic Corruption	0.8834	-0.3280	0.0262	0.1113
Adaptability of Government Policy	0.3364	0.8635	-0.0001	0.1413
Independence of Local Authorities	0.5884	0.6962	0.1265	0.1531
Transparency	0.7174	0.6364	0.0271	0.0795

Source: Stata 11, Results.

Table 29

Factor Analysis/ Correlation

Method: Principal Factors

Rotation: Orthogonal Varimax (Kaiser off)

Number of Obs: 333

Retained Factors: 3

Number of params: 15

Factor	Eigenvalue	Difference	Proportion	Cumulative
Factor 1	2.7405	0.2772	0.5386	0.5386
Factor 2	2.4678	2.4426	0.4850	1.0239
Factor 3	0.0242	0.0000	0.0050	1.0286

LR test: independent vs. saturated $chi^2(3)= 2626.77$ Prob>$chi^2= 0.000$

Source: Stata 11, Results.

Table 30

Rotated Factor Loadings (pattern matrix) and Unique Variances

Variable	Factor 1	Factor 2	Factor 3	Uniqueness
Risk of Political Stability	0.79	0.44	-0.0480	0.1925
Government Effectiveness	0.63	0.71	-0.0899	0.08877
Bribe and Bureaucratic Corruption	0.87	0.37	0.0262	0.1113
Adaptability of Government Policy	0.3364	0.8635	-0.0001	0.1413
Independence of Local Authorities	0.5884	0.6962	0.1265	0.1531
Transparency	0.7174	0.6364	0.0271	0.0795

Source: Stata 11, Results.

Table 31

Factor Rotation Matrix Results

	Factor 1	Factor 2	Factor 3
Factor 1	0.7279	0.6855	0.0143
Factor 2	-0.6856	0.7280	0.0052
Factor 3	-0.0069	-0.0136	0.9999

Source: Stata 11, Results.

Part Two

Table 32 **Scoring Coefficients** **Method: Regression; based on Varimax Rotated Factors**			
Variable	**Factor 1**	**Factor 2**	**Factor 3**
Risk of Political Stability	0.2000	-0.1555	-0.1847
Government Effectiveness	-0.0115	0.3915	-0.7383
Bribe and Bureaucratic Corruption	0.6862	-0.4919	0.1894
Adaptability of Government Policy	-0.3972	0.5956	0.0508
Independence of Local Authorities	-0.0727	0.2809	0.5504
Transparency	0.2748	0.1179	0.1672

Source: Stata 11, Results.

Table 33 **Alpha-Cronbach Test**	
Test Scale	mean (unstandarized items)
Average Interitem Covariance	4272.33
Number of Items in the Scale	6
Scale Reliability Coefficient	0.9616

Source: Stata 11, Results.

The second method is constructed following Chao and Kumar's (2010, pp. 98-99) methodology:

[They calculated] [t]he simple numerical average of 3 items (6 items) for each country was taken as the country's score on its regulative dimension (normative dimension). The regulative and normative distances were then calculated as the absolute difference between the two countries' (home and host) scores on respective dimensions. Since almost every company in the sample had subsidiary operations in [Turkey], several absolute-difference numbers were calculated for both regulative and normative distances. In this study, every regulative or normative distance was weighted. In other words, each absolute-difference number was weighted based on how many subsidiaries the company had in that specific host country. Then, all weighted absolute-difference numbers were added up and became that company's regulative distance or normative distance.

If, for example, there was a company from the United States having 2 subsidiaries in Turkey, the normative distance of this company was calculated in the following formula (this formula also applies to regulative distance):

$$\textbf{Normative distance}_{\text{T-USA}} = [\,(3.48 - 5.81)\,]\ 2/245$$

In this formula, 3.48 represents Turkey's normative score; 5.81 represents USA normative score. The information of each country's regulative and normative scores is presented in Table 34.

Table 34

Country Scores on the Regulative and Normative Distance

Countries	Scores of Normative Distance	Countries	Scores of Regulative Distance
Austria	6.52	**Austria**	6.52
Azerbaijan	-0.46	**Azerbaijan**	-0.52
Bahrain	0.13	**Bahrain**	-0.85
Belgium	5.16	**Belgium**	4.75
Brazil	3.27	**Brazil**	4.06
Canada	6.22	**Canada**	6.64
China	4.83	**China**	4.73
Czech Republic	5.07	**Czech Republic**	4
Denmark	6.69	**Denmark**	5.39
France	5.39	**France**	5.13
Germany	6.3	**Germany**	5.47
Greece	4.04	**Greece**	4.11
Hungary	4.46	**Hungary**	4.27
Iceland	5.51	**Iceland**	6.25
Israel	5.27	**Israel**	5.07
Italy	3.6	**Italy**	3.51
Japan	5.38	**Japan**	4.58

Jordan	3.36	**Jordan**	3.89
Kazakhstan	0.97	**Kazakhstan**	1.46
Korea	3.7	**Korea**	4.07
Kuwait	0.17	**Kuwait**	0.57
Luxemburg	7.1	**Luxemburg**	7.03
Netherlands	5.93	**Netherlands**	6.39
Norway	5.67	**Norway**	6.45
Poland	3.17	**Poland**	3.04
Portugal	3.76	**Portugal**	4.42
Qatar	1.94	**Qatar**	2.18
Romania	2.06	**Romania**	2.45
Russia	2.03	**Russia**	3.09
S. Arabia	-0.44	**S. Arabia**	0.1
South Africa	4.68	**South Africa**	4.44
Spain	4.39	**Spain**	5.05
Sweden	6.2	**Sweden**	6.73
Switzerland	6.3	**Switzerland**	6.94
Turkey	3.48	**Turkey**	4.27
UAE	0.6	**UAE**	0.39
UK	5.61	**UK**	5.62
USA	5.81	**USA**	6.13

Source: Author's Design, 2014.

By comparing the scores from each method, it is concluded that Factor Analysis is more appropriate for the construction of regulative and normative distance indices. This is justified by the fact that it is more prudent for this subsection to employ the same method of constructing indices as the other subsections. In this manner, the analysis will be consistent with the other indices. Moreover, scores produced by the Chao and Kumar method are based on a rule of thumb, rather than a scientific

method, like the one used by Factor analysis. Lastly, scores produced by Factor analysis are proved to be more comprehensive, and, therefore, more appropriate tools for the measurement of regulative and normative distance in this analysis.

The geographic distance index yields two distinct factors with eigenvalues greater than 1 (see Table 35). To obtain the two-factor solution, this analysis drops one item (common language) that did not have clear loadings. The loadings for all retained items on the corresponding factors are greater than 0.65. Thus, this analysis has four items measuring the Geographic Distance.

The second part of this method uses the factor scores, which are obtained from the principal components analysis to develop the measure of geographic distance between different countries. The respective difference was the factor score for Turkey less the factor score for the host country. Cronbach's alphas for the geographic distance items are 0.7955. The item-to-total correlations are also higher than the minimum cutoff of .60, providing strong support for the reliability of the distance measure.

Part One

Table 35
Factor Analysis/ Correlations

Method: Principal Factors

Rotation: Unrotated

Number of Obs: 333

Retained Factors: 2

Number of params: 6

Factor	Eigenvalue	Difference	Proportion	Cumulative
Factor 1	2.13906	1.08544	0.715500	0.716
Factor 2	1.05363	1.05377	0.352400	1.068
Factor 3	-0.00015	0.20281	0.000000	1.068
Factor 4	-0.20296	_	-0.067900	1.000

LR test: independent vs. saturated $chi^2(6)= 2923.00$ Prob>$chi^2= 0.000$

Source: Stata 11, Results.

Table 36

Factor Loadings (pattern matrix) and Unique Variances

Variable	Factor 1	Factor 2	Uniqueness
Contiguous	-0.3886	0.6737	0.3951
Colony	-0.3507	0.6820	0.4118
Distw	0.9652	0.2612	0.0002
Distwes	0.9662	0.2576	0.0002

Source: Stata 11, Results.

Table 37

Factor Analysis/ Correlations

Method: Principal Factors

Rotation: Orthogonal Varimax (kaiser off)

Number of Obs: 333

Retained Factors: 2

Number of params: 6

Factor	Eigenvalue	Difference	Proportion	Cumulative
Factor 1	2.1116	0.8296	0.6727	0.6727
Factor 2	1.0536	0.0000	0.3952	1.0680

LR test: independent vs. saturated $chi^2(6)= 2923.00$ Prob>$chi^2= 0.000$

Source: Stata 11, Results.

Table 38

Rotated Factor Loadings (pattern matrix) and Unique Variances

Variable	Factor 1	Factor 2	Uniqueness
Contiguous	-0.1337	0.7661	0.3951
Colony	-0.0953	0.7610	0.4118
Distw	0.9962	-0.0860	0.0002
Distwes	0.9959	-0.0897	0.0002

Source: Stata 11, Results.

Table 39

Factor Rotation Matrix Results

	Factor 1	Factor 2
Factor 1	0.9392	-0.3433
Factor 2	0.3433	0.9392

Source: Stata 11, Results.

Part Two

Table 40

Alpha-Cronbach Test

Test Scale	mean (unstandarized items)
Reversed Items	Contiguous and Colony
Average Interitem Covariance	1580437
Number of Items in the Scale	4
Scale Reliability Coefficient	0.7955

Source: Stata 11, Results.

The first part of this subsection performs a factor analysis (principal components factors analysis)

with varimax rotation, using Stata 11 software for **economic distance**. Therefore, this analysis yields three distinct factors, the eigenvalue of which is not greater than 1 (see Table 41). To obtain the three-factor solution, this analysis drops one item (overall competitiveness) that lack clear loadings in their initial analysis. The loadings for the retained items on the corresponding factor are very close to 0.65.

The second part of this subsection uses the factor scores obtained from the principal components analysis to develop the measure of economic distance between different countries. The corresponding difference is the factor score for Turkey minus the factor score for each host country. Finally, this subsection measures the reliability of the two distance scores using item-to-total correlations and Cronbach's alpha.

Part One

Table 41

Factor Analysis/ Correlation

Method: Principal Factors

Rotation: Unrotated

Number of Obs: 342

Retained Factors: 3

Number of params: 6

Factor	Eigenvalue	Difference	Proportion	Cumulative
Factor 1	0.3455	0.0534	0.8184	0.8184
Factor 2	0.2920	0.1526	0.6919	1.5103
Factor 3	0.1399	0.4942	0.3303	1.8405
Factor 4	-0.3548	_	-0.8405	1.0000

LR test: independent vs. saturated $chi^2(3)= 67.39$ Prob>$chi^2= 0.0000$

Source: Stata 11, Results.

Table 42

Factor Loadings (pattern matrix) and Unique Variances

Variable	Factor 1	Factor 2	Factor 3	Uniqueness
R&D	0.3791	0.2858	0.0496	0.7721
BITs	0.3678	-0.1973	0.1736	0.7956
GDP per Capita	-0.1516	0.3971	0.1379	0.8003
Overall Competitiveness	-0.2084	-0.1171	0.2963	0.8551

Source: Stata 11, Results.

Table 43

Factor Analysis/ Correlation

Method: Principal Factors

Rotation: Orthogonal Varimax (Kaiser)

Number of Obs: 342

Retained Factors: 3

Number of params: 6

Factor	Variance	Difference	Proportion	Cumulative
Factor 1	0.3129	0.0024	0.7412	0.7400
Factor 2	0.3100	0.1569	0.7736	1.4767
Factor 3	0.1536	0.0000	0.3639	1.8405

LR test: independent vs. saturated $chi^2(3)= 67.39$ Prob>$chi^2= 0.0000$

Source: Stata 11, Results.

Table 44

Rotated Factor Loadings (pattern matrix) and Unique Variances

Variable	Factor 1	Factor 2	Factor 3	Uniqueness
R&D	0.4703	0.0076	-0.0814	0.7721
BITs	0.2203	-0.3787	0.1115	0.7956
GDP per Capita	0.1460	0.4080	0.1091	0.8003
Overall Competitiveness	-0.1476	0.0228	0.3502	0.8551

Source: Stata 11, Results.

Table 45

Factor Rotation Matrix Results

	Factor 1	Factor 2	Factor 3
Factor 1	0.7758	-0.5876	-0.2298
Factor 2	0.5692	0.8089	-0.1471
Factor 3	0.2723	-0.0167	0.9621

Source: Stata 11, Results.

Part Two

Table 46 **Scoring Coefficients** **Method: Regression; based on Varimax Rotated Factors**			
Variable	**Factor 1**	**Factor 2**	**Factor 3**
R&D	0.3970	0.0150	-0.0639
BITs	0.1798	-0.3138	0.1210
GDP per Capita	0.1230	0.3408	0.1101
Overall Competitiveness	-0.1031	0.0140	0.3174

Source: Stata 11, Results.

Table 47 **Alpha-Cronbach Test**	
Test Scale	mean (unstandarized items)
Average Interitem Covariance	27289.08
Number of Items in the Scale	2
Scale Reliability Coefficient	0.0002

Source: Stata 11, Results

7.2 The Econometric Modeling

Regression models implicitly assume that the dependent variable, perhaps after logarithmic or some other transformation, can take any value on the real line. Although this assumption is never strictly true with economic data, it is often reasonable enough. However, it is not an acceptable assumption when the dependent variable can take any specific value with probability substantially greater than zero. Economists frequently have to deal with such cases (Davidson and Mackinnon 1993).

Therefore, if someone wishes to explain economic variables like these econometric models, should take into account their discrete nature. Such models are called qualitative response models. There are two types of qualitative models: binary choice models (the dependent variables coded as 0 and 1) and models that can take on three or more different values, which fall into two categories: (1) those designed to deal with ordered responses and (2) those designed to deal with unordered responses.

There are two ways to deal with the latter models: (1) to use an ordered probit model (deal with ordered responses) and (2) to use a multinomial logit model (deal with unordered responses). (Davidson and Mackinnon 1993).

According to Starkweather and Moske 2011, pp. 0

Multinomial logistic regression is used to predict categorical placement in or the probability of category membership on a dependent variable based on multiple independent variables. The independent variables can be either dichotomous (i.e., binary) or continuous (i.e., interval or ratio in scale). Multinomial logistic regression is a simple extension of binary logistic regression that allows for more than two categories of the dependent or outcome variable. Like binary logistic regression, multinomial logistic regression uses maximum likelihood estimation to evaluate the probability of categorical membership.

Multinomial logistic regression does necessitate careful consideration of the sample size and examination for outlying cases. Like other data analysis procedures, initial data analysis, in logistic regression, should be thorough and include careful univariate, bivariate, and multivariate assessment. Specifically, multicollinearity should be evaluated with simple correlations among the independent variables. Also, multivariate diagnostics (i.e. standard multiple regression) can be used to assess for multivariate outliers and for the exclusion of outliers or influential cases. Sample size guidelines for multinomial logistic regression indicate a minimum of 10 cases per independent variable (Schwab 2002).

Multinomial logistic regression is often considered to be an attractive analysis, because it does not assume normality, linearity, or homoscedasticity. A more powerful alternative to multinomial logistic regression is a discriminant function analysis which requires that these assumptions be made. Indeed, multinomial logistic regression is used more frequently than discriminant function analysis because multinomial logistic regression does not have such assumptions. Additionally, multinomial logistic regression also assumes non-perfect separation. If the groups of the outcome variable are perfectly separated by the predictor(s), then unrealistic coefficients will be calculated and effect sizes will be substantially exaggerated.

Tabachnick et al. (2001, as cited in Bayaga 2010, pp. 290), presents totally the major advantages of the multinomial logistic regression:

- it is more robust to violations of assumptions of multivariate normality and equal variance-

covariance matrices across groups;

- it is similar to linear regression, but it uses more easily interpretable diagnostic statistics;
- multinomial logistic regression does not assume a linear relationship between the dependent and independent variables;
- independent variables need not to be interval;
- multinomial logistic regression does not require that the independents be unbounded;
- and lastly, normally distributed error terms are not assumed.

But for all the potential, multinomial logistic regression has a basic detractor. Koppelman and Wen (2000 pp. 76) define it as

> [multinomial logistic regression] imposes the constraint that the relative probabilities of each pair of alternatives are independent of the presence or characteristics of all other alternatives. This property, widely known as the Independence of Irrelevant Alternatives (IIA), follows directly from the constraint that random error terms are independently (no correlation) and identically (same variance) distributed. This property implies that the introduction or improvement of any alternative will have the same proportional impact on the probability of all other alternatives. This representation of choice behavior will result in biased estimates and incorrect predictions in cases that violate these conditions.

However, weighing the advantages and disadvantages of the method, and following the relevant literature (Kogut and Singh 1988; Agarwal and Ramaswami 1992; Eramilli and Rao 1993; Chang and Rosenzweig 2001; Chen and Hu 2002; Brown, Dev, and Zhou 2003; Wei, Liu, and Liu 2005; Filatotchev, Strange, Piesse, and Lien 2007), this study recognizes the significance of the multinomial logistic regression and, therefore, uses it.

7.3 Data Sampling

To test the hypotheses said in the previous section, a sample of 17 European Union (EU) (Austria, Belgium, Czech Republic, Denmark, France, Germany, Greece, Hungary, Italy, Luxemburg, the Netherlands, Poland, Portugal, Romania, Spain, Sweden, and the UK) and 21 non European MNEs (Azerbaijan, Bahrain, Brazil, Canada, China, Iceland, Israel, Japan, Jordan, Kazakhstan, South Korea, Kuwait, Lebanon, Norway, the Federation of Russia, Qatar, Saudi Arabia, South Africa, Switzerland, the United Arab Emirates, and the USA) are selected by the dataset of the Republic of Turkey Prime Ministry Investment Support and Promotion Agency (ISPAT).

ISPAT is the official organization of promoting Turkey's investment opportunities to the global business community and providing assistance to investors before, during, and after their entry into Turkey. Active on global scale, ISPAT operates with a network of local consultants in Canada, China,

France, India, Japan, Saudi Arabia, Spain, the Russian Federation, the UK, the USA, and South Korea offering an extensive range of services to investors through a one-stop-shop approach, and assists them in obtaining optimum results from Turkey.

The dataset of ISPAT comprises a significant part of foreign equity investments in Turkey and, as of 2002, it includes 256 foreign equity investments, of which 245 are included in this analysis. This dataset incorporates data from national authorities and other relevant sources and provides information about the country of origin, the mode of entry, the sector of operation, the amount of capital, and its distribution among foreign and local partners, the total number and the composition of foreign and local partners, the entry date and the location of the investment.

The distribution of the dataset in terms of foreign investors' ownership choice is as follows: minority foreign-owned: 23.67%; co-ownership: 13.47%; majority foreign-owned: 24.9%; full ownership: 37.96%; and the distribution of the data set in terms of the sector of operation is as follows: primary: 7.35%; manufacturing: 46.94%; services: 45.71%. Within each specific the manufacturing sector, chemicals and related industries constitute: 2.45%; machinery: 6.12%; environmental technologies: 4.49%; food and beverages: 8.98%; automotive and related: 8.57%; and energy industries: 16.33% of all FDI firms. Within the services sector, real estate comprises: 8.57%; hotels and tourist resorts: 3.27%; transportation: 3.67%; banking and insurance (Financial Services): 12.24%; health: 9.8%; and other services: 8.16% of all FDI firms.

The characteristics of the sample firms on the basis of the key dimensions of the data source are summarized in Table 48.

Table 48
Categorization by Origin of Country, by Sector, and by Equity Mode

	No	**%**
Germanic Europe		
Austria	8	3.26
Germany	23	9.3
NL	18	7.34
Switzerland	2	0.82
Total	**51**	**22.04**

Anglo		
Australia	_	0
Canada	4	1.63
Ireland	_	0
S. Africa(White Sample)	1	0.41
UK	16	6.94
USA	31	13.47
Total	**52**	**22.45**
Eastern Europe		
Albania	_	0
Georgia	_	0
Greece	7	2.86
Hungary	2	0.82
Kazakhstan	1	0.41
Poland	1	0.41
Russia	10	4.08
Total	**21**	**8.57**
Latin Europe		
Israel	3	1.22
Italy	9	3.67
France	9	3.67
Portugal	1	0.41
Spain	3	1.22
Total	**25**	**10.2**
Middle East		
Egypt	_	0

Kuwait	3	1.22
Morocco	_	0
Qatar	1	0.41
Turkey	48	20
Total	**52**	**21.22**
Confucian Asia		
China	1	0.41
Japan	7	2.86
S. Korea	1	0.41
Total	**9**	
Latin America		
Brazil	1	0.41
Total	**1**	**0.41**
Nordic Europe		
Denmark	2	0.82
Finland	_	0
Sweden	1	0.41
Total	**3**	
Others		
Azerbaijan	1	0.41
Bahrain	1	0.41
Belgium	2	0.82
Bermuda	1	0.41
Cz. Republic	6	2.44
Dubai	_	0
Iceland	2	0.82
Jordan	1	0.41

Lebanon	1	0.41
Luxemburg	4	1.63
Norway	3	1.22
Romania	1	0.41
S. Arabia	5	2.04
UAE	3	1.22
Total	**34**	**13.88**
Total	**245**	**100**
Broad Sector Categorization		
Agriculture & Mining	18	7.35
Manufacturing	115	46.94
Services	112	45.71
Total	**245**	**100**
Foreign Equity Shareholding		
Joint Venture (10-90%)	152	62.04
Minority JV(10-49%)	58	23.67
Co-Ownership (50-50%)	33	13.47
MajorityJV (51-90%)	61	24.9
WOS	93	37.96
Total	245	100

Source: Author's Design, 2014

Table 49

Correlation Matrix

(N=108)

	Equity	Normative	Regulative	Institutional	GLOBE	Hofstede	Geographic	Economic
Equity	1.0000							
Normative	-0.0355	1.0000						
Regulative	0.03	0.1000	1.0000					
Institutional	-0.0007	0.7081**	0.7723**	1.0000				
GLOBE Cultural Index	-0.0689	-0.3670	-0.2181	-0.3890	1.0000			
Hofstede Cultural Index	0.1278*	-0.0576	0.3365**	0.2019**	0.1831*	1.0000		
Geographic	-0.1430	-0.0725	-0.5861	0.4621**	0.4590*	-0.4349	1.0000	
Economi	0.0127	-0.0700	-0.5193	-0.4152	0.5786*	-0.4083	0.5593***	1.0000

Source: Author's design, 2014.

Prior to running the regression, a correlation matrix (Table 49) has been prepared. Numerous statistically significant correlations between the independent variables have been observed; however,

none of the relationships have been strong enough to warrant concern about possible multicollinearity (Hair et al 1995; Aczel 1996). Moreover, this analysis has applied Wald tests for linear hypotheses to identify variables and interaction terms that provide the best fit for the entry mode regression and has used the results to construct more parsimonious models.

This section shows the results of the multinomial logistic regression analysis explaining the output in terms of multinomial log-odds (logits). The data have concerned 256 foreign equity investments in Turkey and have taken from ISPAT; 245 of these investments are included in the sample at hand. The estimated coefficients shown in Table 50 should be interpreted as representing the marginal utility of choosing a joint venture or a lower equity mode over a WOS. Therefore, a negative coefficient signifies lower likelihood of the venture being chosen as a JV or a lower equity mode over a WOS. The fit of the Models looks good, as model chi-squares have been significant at the $p < 0.01$ level. The outcome measure is **equity** -minority (1), cooporation (2), majority (3), and, wholly-owned subsidiary (4)- from which this analysis is going to test what relationships exist with institutional -which in turn is analyzed to regulative and normative distance- cultural distance, as measured by **Hofstede** index, cultural distance, as measured by the **GLOBE** index, economic distance, and geographic distance. The response variable, **equity**, is treated as a categorical variable under the assumption that the levels of **equity** status have *no* natural ordering and allows Stata 11 to choose a referent group, which is the wholly-owned subsidiary (WOS).

In this framework, this section is going to develop the base model into four sub-models through hierarchical regression analyses, in order to achieve a comprehensive analysis by deciphering whether the inclusion of cultural and institutional variables would significantly affect the incremental explanatory power of entry-mode choice (Yiu and Makino 2002). Specifically, the modeling procedure will be divided into three steps. The **first step** is going to test the **Base Model** incorporating economic and geographic distance; the **second step**, through **Model 1**, is going to test the significance of overall institutional distance in combination with two cultural-cognitive indices (GLOBE and Hofstede), economic, and geographic distance. Finally, **the third step**, through **Models 2, 3, and 4**, is going to test the components of institutional distance (regulative and normative distance) in combination with two cultural-cognitive indices, i.e., economic distance, and geographic distance.

Finally, Table 51 presents the results of variance components analyses of the parent equity ownership. Results in the left column of Table 51 indicate that 41.1% of the total variance in Turkish equity ownership is explained by country effects, and 1.8% by MNE's effects. Almost similar results have been obtained for the sample of different industrial sectors. These results provide preliminary

support to our assertion that country-specific effects explain a significant portion of MNEs' ownership decisions.

Table 50
Results of Multinomial Logistic Regressions: WOS compared to JV

Step 1				
Variables		**Prob(Y)= Minority JV**	**Prob(Y)= Co-ownership JV**	**Prob(Y)= Majority JV**
	Base Model			
Economic D		-0.6764531 (0.6316789)	-2.2542865* (0.9375543)	-0.8864532 (0.6416918)
Geographic D		-0.7397452† (0.4157512)	-1.3787529 ** (0.4730317)	-0.9765310* (0.4162491)
Constant		-.6336149 (.4008508)	-1.653103 (0.5871161)	-.7131155 (.4096957)
Number of obs = 127, Standard errors in parentheses, LR chi2(12) = 12.34, Prob > chi2 = 0.0459, Log likelihood =-158.44561, Pseudo R2 = 0.0400 †p < 0.1 * p < 0.05, ** p < 0.01, *** p < 0.001				
Step 2				
	Model 1			
Economic D		-1.153967 (.8350914)	-3.058397* (1.199186)	-.8670386 (.86271)
Institutional D		.2878264 (.3078703)	.1468577 (.4466422)	.7033653* (.3244395)
Regulative D		_	_	_
Normative D		_	_	_
Cult-Cogn D (Hof)		-2.59e-11 (2.91e-11)	-7.86e-11 (5.76e-11)	-3.54e-11 (3.32e-11)
Cult-Cogn D (Globe)		-4.08e-11 (6.71e-11)	-1.21e-10 (9.92e-11)	-2.36e-11 (7.09e-11)

Geographic D		-.9001999[ł] (.5280675)	-1.231157[*](.5843436)	-1.144587[*](.5418357)
Constant		-1.052172	-2.336931	-2.780687
Number of obs = 108, Standard errors in parentheses, LR chi2(12) = 20.41, Prob > chi2 = 0.0155, Log likelihood =-131.17008, Pseudo R2 = 0.0722 [ł] p < 0.1 [*] p < 0.05, [**] p < 0.01, [***] p < 0.001				
Step 3				
	Model 2			
Economic D		-1.220076 (.9301869)	-3.86347[**] (1.320667)	-.9210991 (.9487944)
Institutional D		_	_	_
Regulative D		.2466133 (.505917)	-1.085742 (.83454)	.6819502 (.5105536)
Normative D		.3104497 (.4281158)	1.070901 (.752056)	.6971108 (.480707)
Cult-Cogn D (Hof)		-2.69e-11 (2.96e-11)	-5.94e-11 (4.82e-11)	-3.82e-11 (3.45e-11)
Cult-Cogn D (Globe)		-4.09e-11 (7.49e-11)	- 2.26e-10[ł] (1.18e-10)	-1.87e-11 (7.99e-11)
Geographic D		-.9243119[ł] (.5520784)	-.8128713 (.6236762)	-1.183564[*] (.5654641)
Constant		-1.459278	-2.246688	-3.105509
Number of obs = 108, Standard errors in parentheses, LR chi2(12) = 24.36, Prob > chi2 = 0.0182, Log likelihood = **-129.1972**, Pseudo R2 = 0.0862. [ł] p < 0.1 [*] p < 0.05, [**] p < 0.01, [***] p < 0.001				
	Model 3			
Economic D		-1.220076 (.9301869)	-3.86347[**] (1.320667)	-.9210992 (.9487945)
Institutional D		.3104498 (.4281157)	1.070901 (.752056)	.6971108 (.480707)
Regulative D		-.0638365 (.7034156)	-2.156643[ł] (1.248088)	-.0151606 (.7537586)
Normative D		_	_	_
Cult-Cogn D (Hof)		-2.69e-11 (2.96e-11)	-5.94e-11 (4.82e-11)	-3.82e-11 (3.45e-11)

Cult-Cogn D (Globe)		-4.09e-11 (7.49e-11)	-2.26e-10[ł] (1.18e-10)	-1.87e-11 (7.99e-11)
Geographic D		- .9243119[ł] (.5520784)	- .8128713 (.6236762)	-1.183564[*] (.5654641)
Constant		-1.459278	-2.246688	-3.105509
Number of obs = 108, LR chi2(12) = 24.36, Standard errors in parentheses, Prob > chi2 = 0.0182, Pseudo R2 = 0.0862, Log likelihood = -129.1972 [ł] p < 0.1 [*] p < 0.05, [**] p < 0.01, [***] p < 0.001				
	Model 4			
Economic D		-1.220076 (.9301869)	-3.86347[**] (1.320667)	-.9210992 (.9487945)
Institutional D		.2466133 (.4281157)	-1.085742 (.752056)	.6819503 (.480707)
Regulative D		_	_	_
Normative D		0.06384 (0.7034157)	2.156643[ł] (1.248088)	0.0151604 (0.7537586)
Cult-Cogn D (Hof)		-2.69e-11 (2.96e-11)	-5.94e-11 (4.82e-11)	-3.82e-110. (3.45e-11)
Cult-Cogn D (Globe)		-4.09e-11(7.49e-11)	-2.26e-10[ł] (1.18e-10)	-1.87e-11 (7.99e-11)
Geographic D		- .9243119[ł] (.5520784)	- .8128713 (.6236762)	-1.183564[*] (.5654641)
Constant		-1.459278	-2.246688	-3.105509
Number of obs = 108, LR chi2(12) = 24.36, Standard errors in parentheses, Prob > chi2 = 0.0182, Pseudo R2 = 0.0862, Log likelihood = -129.1972 [ł] p < 0.1 [*] p < 0.05, [**] p < 0.01, [***] p < 0.001				

Source: Author's design, 2014.

Table 51 **Percent of Total Variance (%)**				
		Agriculture	**Manufacturing**	**Services**
	Total **(N= 245)**	**Total** **(N=18)**	**Total** **(N=117)**	**Total** **(N=114)**
Country	41.1	30	45.7	40
Country Covariance	-0.4	-7	-1.8	-1
MNE	1.8	11.1	0.7	2.1
Model	42.5	31.6	47	41.2
Error	57.5	68.4	53	58.8
Total Variance	100	100	100	100

Source: Author's design, 2014.

Step 1

Base Model

On the one hand, the coefficient of **economic distance**, *ceteris paribus*, in the Base Model, when minority and majority are compared to WOS, has a negative and insignificant impact on the dependent variable. On the other hand, when co-ownership is compared to WOS, economic distance has the expected sign, and also a significant impact on the dependent variable. This implies two things: firstly, that MNEs would tend to take into account economic distance only in the case where co-ownership is compared to WOS, since the co-ownership's z test statistics equals -2.34 with an associated p-value of 0.019, allowing the null hypothesis to be rejected and the regression coefficient

for economic distance to be statistically different from zero. Secondly, the negative coefficient shows that MNEs in the sample would tend to prefer WOS to JVs, and, subsequently, *Hypothesis 4 is* moderately supported by the Base Model.

Geographic distance has a negative and significant impact on all three cases compared toWOS on the dependent variable, *ceteris paribus*. This implies that in all cases, geographic distance affects MNEs' decision to choose WOS over minority, co-ownership, and majority joint venture. So, *Hypothesis 3* is strongly supported by the Base Model.

Step 2

Model 1

The coefficient of **economic distance**, *ceteris paribus*, in minority and majority entry modes when compared to WOS, has a negative and insignificant impact on the dependent variable. However, when co-ownership is compared to WOS, economic distance also has a negative, but significant impact on the equity mode. This implies that MNEs would tend to take into account economic distance only in cases when co-ownership is compared to WOS, since co-ownership's z test statistics equals -2.55 with an associated p-value of 0.011 and allows the null hypothesis to be rejected and the regression coefficient for economic distance to be found statistically different from zero. Furthermore, the negative coefficient shows that MNEs would tend to prefer WOS to JVs, and, subsequently, *Hypothesis 4* is moderately supported by Model 1.

The coefficient of **institutional distance**, *ceteris paribus*, is significant only in the case when majority equity mode is compared to WOS, while in cases of minority and co-ownership being compared to WOS, institutional distance has no significant effect on the dependent variable. This illustrates that the MNEs that intend to invest in Turkey would take into account institutional distance between home country and Turkey, only in cases of majority entry mode and, ultimately, they opt for lower levels of control commonly associated with JVs rather than WOS, thus providing moderate support to *Hypothesis 2a.*

As for the coefficient of **cultural distance** measured by **Hofstede's** index, it is not significant in any of the three cases of entry modes, when compared to WOS, *ceteris paribus*. This implies that MNEs would not consider cultural distance and provides no support to *Hypothesis 1a*. Similarly, cultural distance as measured by **GLOBE,** *ceteris paribus*, has a insignificant impact on the three equity modes when compared to WOS, and, therefore, *Hypothesis 1b* is not supported, either.

Geographic distance in Model 1, similarly to the Base Model exerts a negative and significant

impact on all three cases, when compared to WOS, on the dependent variable, *ceteris paribus*. This implies that in all cases, geographic distance affects MNEs' decision to choose WOS when compared to minority, co-ownership, and majority joint ventures. So, *Hypothesis 3* is strongly supported.

Step 3

Model 2

By analyzing the institutional distance into its components, the coefficient of **economic distance**, *ceteris paribus*, once again shows consistent results with the previous three Models. Subsequently, MNEs would tend to consider economic distance only in the case where co-ownership joint venture is compared to WOS, and, ultimately, they would tend to choose WOS rather than co-ownership joint ventures, as *Hypothesis 4* supports.

Regulative distance is not significantly different from zero in none of the three cases (minority, co-ownership, and majority), when compared to WOS, *ceteris paribus*. This is explained by the fact that z test statistics for the predictor regulative distance equals 0.49, -1.30, 1.34, with an associated p-value of 0.626, 0.193, 0.182, respectively, which would fail to reject the null hypothesis. So, foreign investors would not consider regulative distance, when investing in Turkey, and, subsequently, *Hypothesis 2b* is not supported at all in the Model at hand.

Normative distance also follows the same pattern of behavior as regulative distance, since it is not significantly different from zero in any one of the three cases, when compared to WOS, *ceteris paribus*. Therefore, both **regulative** and **normative distances** have no impact on MNEs' decisions, and, *hypotheses 2b* and *2c* are not supported by Model 2.

Cultural distance as measured by **Globe** has a negative and significant effect -z, equal to -1.92, and related p-value, equal to 0.055- only in the case where co-ownership is compared to WOS, *ceteris paribus*, whereas in the cases when minority and majority are compared to WOS, the coefficients of cultural distance are insignificant. This implies that only in the case of co-ownership, MNEs would strongly consider the cultural distance and they would, ultimately, tend to prefer WOS to JVs, providing moderate support to *Hypothesis 1b*.

On the other hand, **cultural distance** as measured by **Hofstede,** has no significant impact on the dependent variable, *ceteris paribus*, since in none of the three equity modes, when compared to WOS, the z test (-0.91, -1.23, -1.11) and the related p-values (0.362, 0.217, 0.268) are statistically different from zero. Subsequently, the MNEs in the sample would not tend to consider cultural

differences (as **measured by Hofstede**) between Turkey and their home country, and, so, *hypothesis 1a is* not supported by this Model.

When analyzing institutional distance into its components, moderate support is provided to *Hypothesis 3*, since **geographic distance** in such a Model is not significantly different in any of the three equity modes, when compared to WOS, *ceteris paribus*. In other words, only in the cases when minority equity mode and majority equity mode are compared to WOS, is geographic distance significantly different from zero (with z equal to 1.67 and a related p-value of 0.094 for minority, and z equal to 2.09 and a related p-value of 0.036 for majority). So, MNEs consider comparison with WOS only in minority and majority equity modes.

Model 3

In the Model at hand and Model 4, this analysis incorporates all variables; however, because the Wald test excludes normative and regulative distances, due to high multicollinearity, these two variables are not concurrently incorporated in the same Model. So, in Model 3, all variables are included except for normative distance, and in Model 4, all variables are included except for regulative distance.

So, in Model 3 the coefficient of **economic distance,** *ceteris paribus,* is significant only when co-ownership is compared to WOS and MNEs would tend to prefer a WOS rather than a co-ownership joint venture.

Institutional distance in Model 3 is insignificant in all three cases, when compared to WOS, *ceteris paribus*. In minority equity mode, when compared to WOS, the z test statistics for the predictor institutional distance equals 0.73 with an associated p-value of 0.468. So, if alpha is set at 0.05 level, the null hypothesis would fail to be rejected and it is concluded that for minority, when compared to WOS, the regression coefficient is not statistically different from zero. Subsequently, MNEs do not consider institutional distance when they decide to invest in Turkey operating either in a minority or in a WOS mode. The same goes for co-ownership and majority joint venture, as well, since they both have insignificant z (1.42, 1.45) and related p-values (0.154 and 0.147), respectively. Therefore, *Hypothesis 2a* is not supported by this Model.

The coefficient of **regulative distance** is statistically different from zero, only when co-ownership joint venture is compared to WOS, *ceteris paribus,* since both z test statistics (-1.73) and related p-value (0.084) are significant. So, MNEs that invest in Turkey would take into account the

regulative distance only when co-ownership is compared to WOS, and, they would, ultimately, choose WOS to co-ownership joint ventures, as *Hypothesis 2b* supports.

The increase of one unit of the coefficient of **cultural distance,** as measured by **Hofstede**, is not going to affect an MNE's decision to invest in Turkey, in any of the three cases, *ceteris paribus*. On the contrary, the cultural index, as measured by **GLOBE,** emerges as an important variable when co-ownership is compared to WOS with the sign expected, *ceteris paribus*. Therefore, MNEs investing in Turkey would consider cultural distance only in the case of co-ownership compared to WOS and, they would, ultimately, choose WOS to JV, providing moderate support to *Hypothesis 1b.*

Geographic distance in this Model has a negative and significant coefficient only when minority and majority are compared to WOS, *ceteris paribus*. For minority compared to WOS, z test statistics (-1.67) and the related p-value (0.094) are statistically different from zero, and, subsequently, the null hypothesis is rejected. For majority equity mode, when compared to WOS, z test statistics (-2.09) and the related p-value (0.036) are also statistically different from zero and, once again, the null hypothesis is rejected. Therefore, in both cases, MNEs are inclined to prefer WOS to JVs and *Hypothesis 3* is moderately supported.

Model 4

Lastly, in Model 4, all variables are included except for regulative distance; the results are the following:

Once again, the increase of **economic distance,** *ceteris paribus*, does not seem to affect the MNE's decision to invest in Turkey, in cases where minority joint venture and majority joint venture are compared to WOS. The dilemma is significant only when co-ownership is compared to WOS and MNEs tend to prefer WOS to co-ownership joint venture, providing moderate support to *Hypothesis 4.*

Institutional distance in Model 4 is not statistically different from zero in none of the three cases (minority compared to WOS, co-ownership compared to WOS, and majority compared to WOS), *ceteris paribus.* So, MNEs in this Model would not take into account institutional distance when invest in Turkey. While, **normative distance** in Model 4 is significant (with sign expected) in the case where co-ownership is compared to WOS.

Cultural distance measured by **GLOBE** in Model 4 is statistically different and negative in the case of co-ownership compared to WOS and in this case MNEs would prefer WOS to JV. However, **cultural distance** measured by **Hofstede** is not statistically different in any of the three cases of

comparing minority, co-ownership, and majority to WOS. Therefore, the MNEs investing in Turkey would not take into account any increase or decrease in cultural distance.

Geographic distance in Model 4 is negative and significant in the cases when minority and majority are compared to WOS, *ceteris paribus*. This means that MNEs would choose WOS rather than JV in the two aforementioned cases, whereas, in the case of co-ownership compared to WOS MNEs would tend not consider geographic distance as an important factor when they decide to invest in Turkey and they do not compare co-ownership with WOS.

Overall, the behavior of economic distance is consistent in all five Models and *Hypothesis 4* is moderately supported. This consistency shows that, essentially, economic distance and, namely, the differences in competitiveness, BITs, GDP per capita, and R&D expenditures, are considered as important only in case when a co-ownership joint venture is compared to WOS.

This consistency shows that, essentially, economic distance and, namely, the differences in competitiveness, BITs, GDP per capita, and R&D expenditures, are considered as important factors to encourage sample -MNEs to choose WOS. In that case, sample-MNEs consider that their position in the international market place (competitiveness) and their economic development (GDP per capita) when compared to Turkey's, will allow them not only to survive, but also to achieve a competitive advantage in the Turkish market setting up a WOS. Similarly, in BIT terms, this means that sample-MNEs would consider whether a BIT exists between Turkey and the home country, which will protect them from unfair and inequitable treatment (i.e., shield against expropriation, guarantee transfer of returns and profits, compensation for losses, among others) (Akpinar, 2011, p. 10) and encourage them to set up a WOS. Lastly, sample-MNEs would consider that the protection of specialized assets from dissemination of knowledge and other opportunistic behavior will encourage them to choose a WOS.

Considering the behavior of institutional distance, it is observed that it is significant (with the sign expected) in Model 1, where it is not analyzed in its components, particularly, in the case where majority JV is compared to WOS. However, in Models 3 and 4, where institutional distance is tested with its components, it is insignificant in all cases and, therefore, *Hypothesis 2a* is not supported at all. In this framework, in most Models, sample-MNEs will not opt for lower levels of control associated with a JV in order to lower the risk of institutional conflicts.

For its part, regulative distance only in Model 3 in the case where co-ownership is compared to WOS, has a negative (as expected) and statistically different coefficient from zero providing moderate support to *Hypothesis 2b*. So, MNEs in Turkey would consider the comparison only in the case when co-ownership is compared to WOS and they would opt for WOS over JVs.

One potential explanation is that regulative distance -which measures the difference between home and host countries in terms of setting, monitoring and enforcing of rules- has become more homogenous due to globalization pressures, regional integration schemes, and international institutions as hypothesized in chapter 6. There are many emerging countries, such as Turkey, who participate in organizations, such as, the World Trade Organization, and the OECD, which pose as prerequisite that their participants stabilize their regulative framework, in order to justify a fair entrance-position.

Moreover, the same pattern of behavior is observed and by developing countries. The ability of governments to force capricious, unilateral policy changes on MNEs has been substantially curtailed by a web of bilateral investment and double tax treaties, membership in international organizations, and structural adjustment constraints imposed by the World Bank and the International Monetary Fund (Ramamurti 2001).

Furthermore, almost all national policy changes affecting MNEs since 1990 have been liberalizing (UNCTAD 2003). Only in key-sectors where local cognitive symbolism is high (e.g., petroleum in Mexico) there are still regulations restricting foreign equity ownership. Therefore, MNEs tend not to pay too much attention to the regulative environment, since a governments' task is to construct a stable and secure regulative framework through a series of generalized modifications, which will facilitate hosting MNEs in a well-organized and proactive regulative environment.

An important example of such a construct is that of the World Trade Organization (WTO), an organization for governments to negotiate trade arrangements and trade disputes: since at WTO's heart lie agreements negotiated and signed by the bulk of the world's trading nations. These documents provide the legal ground rules (regulative framework) for international trade, especially for emerging countries, which face many transitional characteristics in regard to regulative systems. In this light, such documents by WTO and other similar organizations are, essentially, contracts, binding governments to keep their trade policies within agreed limits.

Therefore, the goal of these agreements is to help producers of goods and services, exporters, and importers conduct their business, while allowing governments to tackle social and environmental issues. In other words, the WTO's purpose is to help trade flow as freely as possible; this means that governments should not only know the rules of the game, but also develop a framework for transparent and predictable rules (http://www.wto.org/english/thewto_e/whatis_e/who_we_are_e.htm).

There is, however, a case (Model 3) that regulative distance emerges as a significant variable when the comparison between co-ownership and WOS takes place. This is may be explained when MNEs have to develop close collaboration and sharing of specific knowledge and experience, such as

property rights, with local partners. In this case, MNEs often come up against an opportunistic behavior (according to TCA) by local partners, which is discouraging for the development of intermediate equity modes (co-ownerships) by investors in favor of wholly owned subsidiaries. This happens because missing property rights encourage corruption in the form of counterfeiting and intellectual piracy (Xu and Shenkar 2002). MNEs are, therefore, more likely to choose wholly owned subsidiaries (when there is no regulatory ceiling on equity share) in order to protect their property rights.

Normative distance is insignificant in all the Models included, except for Model 4, -where normative distance is tested simultaneously with ID; it is significant (with sign expected) in the case where co-ownership is compared to WOS. This result is translated as follows: whether the adaptability of Turkish government policy to changes in the economy is high or low, whether bribery and corruption exist or not, whether the legal and regulatory framework encourages competitiveness of enterprises or not, whether government decisions are effectively implemented or not, whether the risk of political instability is low or high, or whether the transparency of Turkish government policy is satisfactory or not are not issues that would affect the MNE's decision, in most Models tested.

This may be explained by the fact that normative institutional pressures are less codifiable and take more time to be recognized, unlike regulative institutional forces, codified as formal legal restrictions, and, sanctions, cognitive institutional forces that are easily reflected in industry or organizational historical patterns. Therefore, when MNEs make their entry-mode decision, market legitimacy and cognitive legitimacy may be the most immediate legitimacy that they need to attain, while normative legitimacy takes a longer time to be established in the value systems of host-country nationals (Yiu and Makino 2002).

Generally speaking, the total picture obtained by the measurement of cultural distance (GLOBE and Hofstede) is not uniform. More specifically, the Hofstede index is insignificant in all Models and, therefore *Hypothesis 1a* is not supported at all. However, the GLOBE index emerges as a significant variable and with the sign expected in Models 2, 3, and 4 in cases where co-ownership is compared to WOS, and, therefore, *Hypothesis 1b* receives moderate support, *ceteris paribus.* It seems, therefore, that MNEs in Turkey tend to favor WOS over JV, the greater the CD.

The significance of the GLOBE index can be attributed to the fact that this research project, developed by House et al. (2004), incorporated data from 17,370 middle managers from 951 different organizations in 62 different countries, were engaged in three different industries: food, finance, and telecommunications, it is wider than Hofstede's. Supportive to this view, is that GLOBE is considered to be the largest-scale IB research project ever developed (Avloniti & Fillipaios, 2013), since GLOBE

authors implemented two types of measurements practices “as is” and values “as should be”, as opposed to Hofstede, who has implemented just one and has claimed that values drive practices. Moreover, the authors of GLOBE have claimed that by incorporating both these aspects in their measures they could also examine how they correlate to each other. In that framework, GLOBE dimensions turned out to be more comprehensive, cross-culturally developed, theoretically sound, and empirically verified, as advocated by House et al. (2004).

However, **cultural distance** as measured by **Hofstede** is insignificant in all forms of equity compared to WOS. **Hofstede's** index has many weaknesses despite its undeniable prominence. A range of authors (Banai 1982, Bertsch and Girard 2011, Korman 1985, Triandis 1993, as cited in Avloniti, A., and Fillipaios, F. 2013) have advocated probable errors and limitations regarding conceptualization, data collection methods, and results. In general, criticism focused on inconclusiveness, inattention to conceptual correspondence of issues under examination across cultural settings, the single-firm concentration, and, last but not least, outdated data.

This thesis points out that the most striking disadvantages of Hofstede's index are the following: “illusion of symmetry” and “illusion of stability”, as Shenkar (2001) has stressed. Particularly, the word “distance”, as used by **Hofstede,** assumes that the space from point A to point B is identical to the space from B to A. However, it is not the same for a Turkish MNE to enter an Italian market and for an Italian MNE to enter the Turkish market. The symmetry of distance between two entities is not applicable for the cultural distance between them. In that framework, Shenkar (2001) has suggested that numerous studies have shown the importance of investors' culture in predicting investment, entry mode and performance (e.g., Pan 1996, Kogut and Singh 1988, Tallman 1988). Other studies have shown a role for the host culture. However, there are no studies showing symmetry between the two, nor is there a reason to assume such symmetry. On the contrary, home and host country effects are different in nature, the former being embedded in the firm and the latter in national environment.

Similarly, according to the “illusion of stability”, Shenkar (2001) has supported that cultural distance measured at a specific point in time is assumed to become constant. However, cultures change over time. The culture measured at market entry time may have changed by the time when performance is measured.

Lastly, considering the overall picture of geographic distance one easily can conclude that is not uniform. Geographic distance in Base Model and Model 1-where institutional distance is not analyzed into its components- is significant in all cases compared to WOS, and the sign expected,

providing strong support to *Hypothesis 4.* Whereas in Models 2, 3, and 4 geographic distance- where institutional distance analyzed in its components- is significant only when minority and majority equity modes are compared to WOS and has the sign expected, providing moderate support to *Hypothesis 4*.

When interpreting geographic distance, this means that when MNEs invest in Turkey and perceive that there is great km distance between Turkey and the home country, that Turkey is not contiguous to the home country, that Turkey has not had colonial relations with the home country, and that Turkey is not similar in terms of religion, legal systems, and language with the host country, so they tend to choose WOS. This is consistent with prior findings that costs for monitoring partners rise when share-owned solutions are preferred to full acquisitions (wholly owned subsidiaries), because greater amounts of ownership confer a proportional degree of control over the investment, and raise the ability of acquirers to implement decisions and resolve disputes that could arise *ex post* (e.g., Anderson and Gatignon 1986; Grossman and Hart 1986). In contrast, partial ownership may leave partners with differing incentives and opportunities that can not be accounted for in the due diligence stages of a deal. Supportive evidence comes from a paper by Chakrabarti and Mitchell (2006) who study the effects of distance on firms' acquisition behavior in the chemical industry, and find that acquirers tend to prefer proximate investments over remote ones, when integration and monitoring requirements of the target firm are high.

Chapter 9: Conclusions

This thesis adopts both institutional and transaction cost perspectives to interpret equity ownership patterns of MNEs, entering an emerging market economy. A large database of MNEs' subsidiaries has allowed this thesis to test rigorously a set of hypotheses based on the arguments of institutional and transaction cost theories.

The very basic hypothesis this thesis is based on is that foreign equity ownership decisions in an emerging market will be affected by transaction cost considerations, institutional considerations and firm or industry level variables. As Wright, Filatotchev, Hoskisson, & Peng (2005) and Karademir & Yaprak (2012) have argued emerging economies provide a new context for understanding relative strengths and weaknesses of these different perspectives. As emerging economies have become significant entities in the new world economy, the evolution and composition of economic institutions in them has inspired a rich literature in the organizational sciences. Among the institutions that have received some attention are the large, diversified conglomerates and networks of closely affiliated businesses (Ramamurti and Singh 2009). From a wide range of emerging economies that exist the present thesis chooses to focus on Turkey. Turkey is worth of inspiring significant questions and future work on this interface in other emerging economies. Similarly, the Turkish business and institutional environment shares many common features with highly diversified business environments in other emerging economies (see Chang and Hong 2000; Maman 2002) and also reflects the unique characteristics of Turkish society and its social and political history (Bugra 1994a; Karademir and Danisman 2007).

To this end of view, the aim of this thesis is to reconcile FDI equity mode strategy in Turkey as a function of cultural, institutional, geographic, and economic distance by specifically analyzing the FDI entry mode choice in a wholly owned subsidiary- the MNE holds 100% of the equity- as opposed to JV subsidiary-MNE holds from 10-90% of the equity- and its different forms– minority, co-ownership and majority JV- through the implementation of the "CAGE (Cultural, Administrative/political, Geographic, and Economic) Distance framework" as developed by Ghemawat (2001). This aim is based on the premises that Ghemawat's (2001) conceptual framework is a comprehensive framework which employs a variety of distance determinants (cultural, economic, geographic, etc.) and simultaneously provides the basis for the development of an "envelop" approach.

More specifically, the goals of this thesis are developed as following. The first aim involves the

transformation of the "CAGE Distance framework" to "CIGE Distance framework". This goal is developed in **two steps** and focuses on applying some theoretical modifications to CAGE dimensions. **Firstly**, the administrative/political distance is substituted by institutional distance, while the rest CAGE dimensions (cultural, geographic, and economic) remain as Ghemawat (2001) suggests. The **second step** is developed on approaching the new distance framework "CIGE" through TCA and institutional theory. More specific, economic distance and geographic distance are approached through TCA, whereas cultural distance and institutional distance are approached through institutional theory (New Institutional Economics). The institutional theory is, in turn, employed on the basis of Scott's (1995) three institutional pillars: regulative, normative, and cognitive.

The thesis is constructed in the following way: **Chapter 1** introduces the aim and the basic hypothesis of this thesis and develops how the Turkish cultural, institutional, geographic, and economic characteristics function as appropriate background able to accommodate the Transactional and Instituional Theory**. Chapter 2** presents the historical background of the Turkish FDI regulations beginning from the Ottoman Empire until 2010. **Chapter 3** presents the Turkish FDI structure, paying particular attention to the distribution of FDI inflows to Turkey by home country, by mode of entry, and lastly, by conducting a comparative analysis of FDI flows to peer countries. **Chapter 4** presents a brief FDI literature review, focusing on the interpretation of FDI through market imperfections and the theory of industrial organization, concerning Hymer (1960, 1969), Product Cycle Model by Vernon (1966), and Knickerbocker (1973). The interpretation of FDI through the Internalization theory and the TCA, and finally, the interpretation of FDI by the prominent eclectic paradigm, "OLI". Moreover, this chapter presents how the thesis at hand adopts TCA as a general theory able to accommodate and connect it with the theory of New Institutional Economics. Lastly, incorporates Scott's (1995) three institutional aspects into New Institutional Economics, and it sheds light on the overlap between normative and cognitive distance. **Chapter 5** connects the concept of entry mode choice, TCA, and distance and presents the framework analysis of each form of distance. **Chapter 6** formulates an econometric model appropriate to accommodate the relationship between entry mode choice and the different forms of distance, describing the dependent and independent variables and developing hypotheses. **Chapter 7** constructs the indices for each form of distance, and finally, describes the characteristics of the dataset and the source. In **Chapter 8** the empirical results of the multinomial logistic regression are analyzed, particularly, explaining the output in terms of multinomial log-odds (logits), and finally, **Chapter 9** presents the conclusions.

More specific, **Chapter 2** begins with a brief description of the historical background of the Turkish FDI regulations divided in two distinct periods: 1) history of FDI in the Ottoman Empire and 2) history of FDI in the Republic of Turkey, particularly concerning the sub-periods of **1923-1929**, **1930-1945**, **1946-1953**, **1954-1960**, **1961-1979**, **1980-2002**, and **2003-2010.**

Chapter 3 proceeds with the analysis of FDI structure and performance in Turkey for the 2002-2010 period, particularly concerning, the distribution of FDI inflows to Turkey by home country, by mode of entry, and lastly, by conducting a comparative analysis of FDI flows to peer countries.

Chapter 4 continues with a brief FDI literature review, focusing on the interpretation of FDI through market imperfections and the theory of industrial organization, concerning Hymer (1960, 1969), Product Cycle Model by Vernon (1966), and Knickerbocker (1973). The interpretation of FDI through the Internalization theory and the TCA, and finally, the interpretation of FDI by the prominent eclectic paradigm, OLI.

In that concept, this chapter concludes that TCA and the eclectic paradigm, OLI, provide the cornerstones for the state of the art theory of the MNE (Verbeke 2009), since these two theories provide the intellectual foundations for the rigorous theoretical and empirical analysis which characterizes research on MNEs at what has become known as the "Reading School" of international business (Rugman 2009).

However, between these two prominent theories, this thesis adopts TCA as the appropriate theory able to accommodate FDI equity mode, and specifically, to analyze how entry mode choice (wholly owned subsidiary as opposed to JV subsidiary and its different forms– minority, co-ownership and majority JV) is affected by different forms of distance through the implementation of the "CIGE Distance framework", for the reasons that are listed below.

Firstly, in contrast to the eclectic paradigm, TCA is mainly applied to explain the choice of entry mode strategy. Internalization theory explores the hazards of doing business abroad across different entry modes, where the firm specific advantages of the MNE need to be offset against both dissipation risks and the liability of foreignness in entering into risky foreign markets (Rugman and Verbeke 2003). Therefore, since TCA connects firm specific characteristics mechanisms with environmental factors has a narrower and more parsimonious focus on the intangible knowledge advantages of MNEs, and subsequently, is able to demonstrate the heterogeneity of firm-level behavior within any industry.

On the contrary, the treatment of location advantages and the choice of entry mode in the eclectic

paradigm is much broader than in TCA. In this way, OLI is much closer to conventional international economics than the resource-based view approach of internalization theory. For example, in the eclectic theory aspects of the L variable (such as ownership of natural resources or government controlled businesses) are transformed into O advantages. Further, the eclectic paradigm is more of an industry-level analysis.

Secondly, TCA is explained by the fact that transaction cost analysis is the product of two recent and complementary fields of economic research: "New Economics of Organization and New Institutional Economics" (Williamson 1998, pp. 23). Subsequently, TCA is explained by the fact that "any issue arising can be reformulated as a contracting problem, through New Institutional Economics, and can be usefully examined through the lens of transaction cost economizing perspective" (Williamson 1998). Taking into consideration the above, and within the ambit of issues to which transaction cost economics are related, it is believed that TCA has greater application value in some areas such as entry mode strategy than in others such as development path.

However, this thesis taking into account its inherent connection with New Institutional Economics goes one step further and reconciles TCA with New Institutional Economics by applying two innovations. First, it enhances New Institutional Economics through the implementation of Scott's (1995) three institutional aspects- regulative, normative, and cognitive- in order to provide an envelop analysis, and secondly, it sheds light on the overlap between normative and cognitive aspects. This approach has drawn its theoretical logic on the following reasons:

Firstly, transaction costs and institutional environment theories (New Institutional Economics, New Organizational Institutionalism, and Comparative Institutionalism) of FDI entry modes differ in terms of the logic underlying each approach. While the transaction cost theory focuses on efficiency, the institutional theory uses different conceptions to approach the notion of institutions and their effects. These differ, for instance, in whether institutions are primarily perceived as regulative, normative, or cultural-cognitive systems, as well as in the level of analysis (Scott 1995).

Secondly, different markets are endowed with different levels of resources and institutions of varying effectiveness. Particularly, in emerging market economies, institutions and institutional factors are particularly important because institutional immaturity raises transaction costs and risk level (Child, Chung, and Davies 2003; Meyer 2001, 2004; Meyer and Peng 2005; Uhlenbruck 2004). Especially for the case of Turkey, institutions have played a major role in the recent phase of neo-liberal restructuring of Turkey, following the crisis of February 2001. Turkey was a typical paradigm of institutional

inefficiency, due to the lack of a planned coordination by officials, for convergence of political and bureaucratic will, as well as due to the lack of domestic societal mobilization for institutional reforms in the direction of strengthening state capacity in Turkey.

In this sense, for the period 1990-2004, Turkey has faced a "rhetorical transition" and "institutional crisis" (Onis and Bakir 2007). "Rhetorical transition" refers to the fact that regulatory institutions were set up during this period. However, the emergence of such institutions as legal entities failed to be translated into effective implementation. As a consequence, the Turkish state faced an "institutional crisis" in which the opening up of the economy was not complemented by a parallel development in the state's institutional capacities to undertake effective regulation. So, the Turkish institutional context did not effectively respond to the need for sound institutions, which subsequently facilitated a worse business environment (not facilitating transactions) for the business and organizations alike.

However, after 2004 the Turkish institutional environment has benefited significantly from the presence of a double external anchor, with both the International Monetary Fund (IMF) and the European Union (EU) playing significant and complementary roles in the recent transformation process. Especially, IMF has implemented, after 2001 crisis, a number of institutional reforms evident in different areas and most notably in the banking sector (Bakır 2006). For instance, a new agency, the Bank Regulatory and Supervisory Agency (BRSA) was established in June 1999 following the ratification of the IMF-sponsored Banking Act. This agency took responsibility for banking supervision and regulation from the Treasury and the Central Bank and became operational in September 2000. The BRSA also incorporated Sworn Bank Auditors and Savings Deposit Insurance Fund (SDIF) in 2001.

Further, the regulation and supervision of non-bank financial institutions were transferred from the Treasury to the BRSA in 2005. However, in the pre-crisis period, there was no natural constituency pressuring for the establishment of an agency like the BRSA and there was a lack of political and bureaucratic will as well as fierce resistance from powerful banking lobbies. As a result, the BRSA was unable to perform a proper regulatory role in such a way as to prevent the twin crises. The latter essentially stemmed from the malfunctioning and under-regulation of both the private and the public components of the banking system. Following the February crisis, however, the BRSA was able, with IMF support in the background, to attain partial autonomy from politicians and interest groups and to press ahead with tough regulatory measures with some domestic support (Alper and Onis 2004).

Further, considering the institutional changes in FDI regulations, the enactment of Law No.

4875 in June 2003 to replace Law No. 6224 was a crucial step forward. Particularly, the new Law defines among others, the following: FDI according to current international practice (TUSIAD and YASED 2004), replacement of the old FDI approval and screening system with a notification and registration system (TUSIAD and YASED 2004), bans nationalization without fair compensation (TUSIAD and YASED 2004), guarantees national treatment to foreign investors (TUSIAD and YASED 2004), no restriction of FDI in any sector (TUSIAD and YASED 2004), no imposition of any performance requirement (TUSIAD and YASED 2004), etc.

Lastly, in 2006 a new Law No. 5523 issued for the incorporation of the investment support and promotion agency. The object of this Law is to set out functions, tasks, powers and organization of the Investment Support and Promotion Agency of Turkey (ISPAT), which is incorporated for determination and implementation of investment support and promotion strategies aimed to encourage and increase a number of investments in Turkey that are required for economic development of the country (Undersecretariat of Treasury General Directorate of Foreign Investment 2006). The Investment Support and Promotion Agency of Turkey is incorporated, in association with Prime Ministry, as a legal entity with administrative and financial autonomy to ensure implementation of this Law, and to undertake the functions vested upon it by this Law.

So, considering both the gradual development of Turkish institutional forces and its subsequent inefficiencies and also considering North's (1990) argument that the different aspects of institutional theory should be integrated and interpreted with transaction cost theory, this thesis extends transaction cost-based entry mode theory by incorporating institutional aspects and cultural context variables as well as transaction cost variables in order to provide an in-depth analysis of the nature of exchange processes and the amount of “friction” which are dependent on the institutional context in which firm takes place (Demirbag and Weir 2006; Tatoglu, Glaister, and Erdal 2003; Brouthers 2002; Brouthers and Brouthers 2000; Delios and Beamish 1999).

But when applying these three different aspects of institutional theory another issue has emerged: the overlap between normative and cognitive aspects that is, the cognitive and normative aspects of a country's institutional context are conceptually close to its culture, whereas the regulatory aspect is unique to a country's institutional context and not captured by culture (Kostova 1999, pp. 314).

Kostova (1999) has pointed out that in some cases scholars have emphasized the cognitive nature of culture, while in other cases they have stressed its normative component. Thus, some studies

use cultural factors to analyze the cognitive dimension (e.g., Gaur et al. 2007; Pogrebnyakov and Maitland 2011), while others use culture to examine the normative dimension and the effect of cross-country differences on firm strategic behavior (e.g., Busenitz, Gomez, and Spencer 2000; Shenkar 2001; Yiu and Makino 2002) (Hernández and Nieto 2012). In that framework and observing the different empirical studies (Gaur and Lu 2007; Xu et al 2004; Estrin et al 2007; Chao and Kumar 2006, etc.), institutional distance in this thesis is defined using only two of the three aspects of Scott's theoretical framework - regulative (social aspects) and normative aspects (business aspects) - incorporating the cognitive-cultural aspect into the cultural framework.

This distinction is based, primarily, on Redding's (2008) analysis that culture is not necessarily *per se* a dominant determinant of events. However, some times, culture framework is significant and simultaneously different from institutional framework- defining this difference as "societal effect"-and deserves a place in its own right. Providing in that way, a conceptual domain to distinguish between culture and institutions.

So, having analyzed TCA as a general theory for the purposes of the present thesis, the necessity to combine it with New Institutional Economics through Scott's (1995) three institutional aspects, and finally, to shed light on the overlap between normative and cognitive distance, this thesis proceeds in **chapter 5,** connecting the concept of entry mode choice, TCA, and distance.

On the one hand, entry mode choice is defined on the basis of control which entails both returns and risks. Many studies (Dunning 1977, 1980, 1988; Anderson and Gatignon 1986; Gatignon and Anderson 1988; Caves 1982; Davidson and McFetridge 1985; Cho 1985; Kimura 1989; Sabi 1988; Terpstra and Yu 1988; Yu and Ito 1988, etc.) have identified a number of factors that influence the choice of an entry mode for a selected target market. However, the most prominent works belong to Anderson and Gatignon (1986) and Gatignon and Anderson (1988), who have formulated a holistic approach of the determinants of entry mode strategy, asserting that international entry mode choices are most usefully and tractably viewed as a trade-off between control and transaction costs.

In conceptual and empirical entry mode studies, TCA has been particularly useful in explaining the determination of ownership levels (e.g., Anderson and Gatignon 1986; Gatignon and Anderson 1988; Gomes-Casseres 1989), since first Williamson (1985) has suggested that firms tend to adopt an organizational market-structure - (non-equity modes) versus hierarchies (equity modes) - when expanding abroad, basing their decisions on how efficient a structure is when compared to the alternative. In light of this view, a basic parameter in the theory of TCA concerns the entry mode

choice.

Taking into consideration all the above and following Anderson and Gatignon (1986) that TCA best supplements entry mode choice, this thesis integrates entry mode choice to TCA proposing the following. Market transactions involving technological know-how imply costs which may constitute a clear incentive for FDI (Teece, 1986). Such entry mode proves more efficient when transferring tacit or non-codifiable knowledge enjoying little legal protection (Hennart 1989). Furthermore, to safeguard specific assets from potential opportunism problems, firms may use high control governance structures, such as WOSs (Tahir and Larimo 2004).

On the other hand, the concept of distance distance occupies a central place in the IB field and has important implications for strategic firm decisions, such as location choice (e.g. Johanson and Vahlne 1973; Dunning 1979), transfer of organizational practices (Kostova and Roth 2002), and entry mode strategy (Kogut and Singh 1988). Among the different approaches of distance (Beckerman 1956; Stephen Hymer 1960; Johanson and Vahlne 1977; Nordstrom and Vahlne 1994; O'Grady and Lane 1996; Hennart and Larimo 1998; Dunning 1979) the most prominent is mostly attributed to Ghemawat (2001).

Ghemawat (2001) supports that companies erroneously utilize an inadequate and incorrect modality when deciding on foreign expansion: the country portfolio analysis (CPA). The CPA focuses on national GDP, levels of consumer wealth, and people's propensity to consume, but ignores "the costs and risks of doing business in the market." These costs are grouped into a category classified as "distance" which itself is sub-divided into four dimensions: Cultural, Administrative/political, Geographic, and Economic distance (**CAGE)**. Despite Ghemawat (2001) has developed a novel and complete methodology regarding the kind of the proposed dimensions, this thesis recognizes that he still misses some important aspects.

More specific, firstly, **administrative/political distance** as suggested by Ghemawat (2001) mainly comprises historical and political associations between two countries. For instance, how colonial links may affect the trade between two countries. With this end in view, administrative/political distance pays attention to just one aspect (administrative) of international firm behavior, which is part of a wider approach, institutional theory.

However, institutional concept, as suggested by this thesis, embraces many different institutional approaches (New Institutional Economics, New Organizational Institutionalism, Comparative Institutionalism) which are largely complementary as they address and explain different

facets of international firm behavior. For example, the theory of New Institutional Economics draws attention to the implications of the functioning of effectiveness of home-host country institutions, while the theory of Comparative Institutionalism highlights the implications of differences in the structure and organization of economies of MNEs. Thus, the ways in which institutions matter for international business are to a great extent dependent on how institutions are conceptualized and are measured.

In light of this view, institutional concept through the above three different approaches gives the chance for researchers to approach international business firm behavior through different notions, and subsequently, to achieve different explanatory results. Therefore, since IB is a field that draws on several disciplines and is concerned with multiple levels of analysis (Dunning 1989; Toyne and Nigh 1998; Shenkar 2004), then it is only natural that different strands of institutional theory have come to inform IB research.

Moreover, the substitution of administrative/political distance with institutional theory is also important in this thesis, because it provides researchers the basis for the incorporation of cultural variables, as well. Institutional theory is well-equipped to distinguish regulative from both normative and cognitive-cultural aspects (Scott 1995) and to offer a separate interpretation for each aspect. This approach has recently emerged by re-conciliating transaction cost-based entry mode theory with institutional and cultural context variables as well as transaction cost variables (Delios and Beamish 1999; Brouthers and Brouthers 2000; Brouthers 2002; Tatoglu, Glaister, and Erdal 2003; Demirbag and Weir 2006).

With this end in view, this thesis fills the research gap in the literature of FDI entry mode choice determinants by incorporating the impact of institutional distance, instead of applying administrative distance as suggested by Ghemawat (2001), and finally, transforming the "CAGE" into "CIGE" distance framework.

Secondly, **economic distance** as developed by Ghemawat (2001) is not presented explicitly. As a result, a blurred environment is created regarding the capability of this dimension to accommodate variables related to firm and industry specifics, such as Research and Development (R&D) Expenditures, Firm Experience, etc. However, these days MNEs tend to weigh differences between countries not only on a broader basis, but also to include a wide range of particular factors (firm characteristics, institutional characteristics of the country they are going to invest in, industry characteristics, learning procedure, country profiles, etc.). So, economic distance herein is approached under the lens of TCA, since on the one hand, it functions as a general theory for the purposes of this

thesis, and since on the other hand, it is connected with the concept of entry mode choice, in terms of risks and returns, and the concept of distance, in terms of risks and costs, as well (Ghemawat 2001). In light of this view, economic distance is best explained under TCA, as it transformed as variable able to represent risks and costs that are related to strategic assets, such as R&D expenditures and etc.

Lastly, **geographic distance** as presented by Ghemawat (2001) is perceived as a barrier-trade for countries which often switch to FDI as an alternative way to access target markets. In light of this view, geographic distance is limited to the physical size of the country, average distances within-country, access to waterways, oceans, etc. However, herein geographic distance, according to TCA, is approached as an uncertainty which entails costs, and, subsequently, affects the MNEs' decision of an appropriate entry-mode choice.

Furthermore, geographic distance is also approached as a factor which embraces linguistic, contingency and colonial factors making it more comprehensive. The logic behind this argument is based on the fact that Turkey's enjoys a favorable geographic position. Particularly, Turkey is bordered by eight countries: Bulgaria to the northwest; Greece to the west; Georgia to the northeast; Armenia, Iran and the Azerbaijan exclave of Nakhchivan to the east; and lastly, Iraq and Syria to the southeast. Moreover, the Mediterranean sea is to the south, the sea of Marmara, the Bosporus, and the Dardanelles demarcate the boundary between Thrace and Anatolia; and lastly, Turkey separates the Europe from Asia. Therefore, given its excellent and important geostrategic position, it is important this thesis to include, through geographic distance, variables that capture the interaction between the above countries.

In this concept, this thesis defines overall the concept of distance and simultaneously, how it is interrelated to TCA and entry mode choice. More specific, distance is perceived as the differences/dissimilarities between two countries (country A and country B) which is represented through four forms of distance:

- **Cultural distance** which is approached as the extent of dissimilarity/difference between two countries in cognitive (beliefs and norms) levels. This means that culture molds behavior from the values that make up the perceptions of the world and societal norms (Root 1987).
- **Institutional distance** which is approached as a measure of cross-country differences (Kostova and Zaheer 1999), and refers to the extent of dissimilarity between the regulatory (social aspects), and normative (business aspects) institutions of two countries (Xu and Shenkar 2002, pp. 608).

- **Geographic distance** which is approached as the difference/dissimilarity in language, contingency, colonial and kilometer level between two countries.
- And lastly, **economic distance** which is approached as the differences in technological capability (research and development expenditure, firm size), in competitiveness, in institutional environment (Bilateral Investment Treaties), and, lastly, in development level, all of which significantly affect FDI equity mode decisions and performance.

However, it is hypothesized that each form of distance produces uncertainties, which are resulted in risks (costs) for the investing firm, because of the behavioral and environmental characteristics, on the one hand, and institutional characteristics (since entry mode choice is perceived as an institutional arrangement), on the other hand. The former includes bounded rationality, opportunism, asset specificity, disturbances or "small-numbers bargaining", and frequency (Williamson 1985), while the latter includes considerations for the MNE to gain legitimacy in the appropriate host country' environments under uncertain conditions.

This means that for MNEs each new host country represents a different institutional environment, which can influence their choices and strategies substantially. As a result, MNEs entering new international markets are confronted with hurdles from institutional environments (Delios and Henisz 2003). Previous relevant literature mentions that the frequency, motivation, and type of acquisitions are strongly influenced by various institutional characteristics of the national business systems (Hall and Soskice 2001).

With this end in view, and arguing that TCA assumes that firms will tend to choose the entry mode choice (institutional arrangement) that entails the lowest cost for them. Then, the firm in oder to minimize its costs, and subsequently, to achieve a risk-adjusted return institutional arrangement (entry mode choice) will minimize the costs derived from different forms of distance (cultural, institutional, geographic, and economic) circumventing the market through internalizing their activities.

So, having built on an "envelop" theory by connecting TCA, entry mode choice, and distance, this thesis in **chapter 6** formulates a model appropriate to accommodate the relationship between them.

This is achieved, in the **first** section, by proceeding the analysis describing the dependent and independent variables. The dependent variable for the purposes of the current study employs two alternative entry modes: **wholly-owned subsidiary** and **joint venture** -since they are viewed as the two major distinct organizational modes (Li, Yang, and Yue 2007)- applying, subsequently, the four-stage subsidiary typology:

- Wholly-owned subsidiaries (the MNE holds 100% of the equity);
- Majority Joint Ventures (the MNE holds the dominant share of the equity; that is, owns more equity than any other partner);
- Co-ownership Joint Venture (the MNE's share is the same as that of the largest partner);
- Minority partnerships (the MNE holds less equity than the largest partner).

Moreover, the independent variables i.e., cultural, institutional, geographic and economic, are examined through the analysis of the most prominent empirical studies, illustrating the method of construction, data collection, source, and measure. Finally, it is formulated the algebraic formula of the function as follows.

- **WOS vs MNJV= CD + ID + GD + ED,**
- **WOS vs COJV= CD + ID + GD + ED,**
- **WOS vs MJJV= CD+ ID + GD + ED,**

where,

CD = cultural distance equals to cognitive distance as measured by Hofstede and GLOBE indices;
ID = institutional distance equals to regulative distance: anti-trust laws, intellectual property rights and legal system and normative distance: adaptability of government policy, bribe and bureaucratic corruption, independence of local authorities, government effectiveness, risk of political stability, and transparency;
GD = geographic distance equals to kilometer distance, weighted distances in Km, contingency, common language, colonial relationship;
ED = economic distance equals to R&D expenditures, Competitiveness, BITs, GDP per capita.

In the **second** section of this chapter, hypotheses are developed and most of them have been supported. Particularly, *Hypothesis 1a* considering Hofstede's cultural index, hypothesizes that the greater the cultural distance between home and host country, then MNEs will tend to choose WOS to JV, *ceteris paribus*, something which is not supported anywhere. *Hypothesis 1b* considering the GLOBE cultural index, hypothesizes that the greater the cultural distance between home and host country, then MNEs will tend to choose WOS to JV, *ceteris paribus*, something which is supported in Models 2, 3, and 4.

Considering institutional distance, *Hypothesis 2a* asserts that as institutional distance overall

between home and host countries increases, then MNEs are more likely to choose a low ownership strategy, *ceteris paribus*, something which is supported only in Model 1.

Hypothesis 2b asserts that as regulatory institutional distance rises between home and host countries, MNEs are likely to avoid JV ownership strategies in favor of WOS, *ceteris paribus*, something which is supported in Model 3. Whereas, *Hypothesis 2c* asserts that MNEs are less likely to choose WOS to JV, when the normative distance between home and host countries is great, *ceteris paribus*, something which is supported in Model 4.

Hypothesis 3 asserts that the greater the geographic distance between home and host country, then MNEs will tend to choose higher form of entry mode wholly owned subsidiary to JV, *ceteris paribus*, something which is supported in all models. Lastly, *Hypothesis 4* asserts that when MNEs invest in Turkey, they tend to use wholly-owned subsidiaries rather than joint ventures, *ceteris paribus*, something which is supported in all Models, as well.

In **chapter 7**, the construction of indices, the econometric modeling, and the data sampling are presented. Particularly considering the construction of indices, this thesis constructs a single index for each distance, in order hypothesis testing to be even more effective, reducing in that way the reliance on single-item measures of complex constructs. In that concept, one basic question has arisen: which method is appropriate to accommodate the indices at hand? According to relevant literature, the choice is between Exploratory Factor Analysis (EFA) and Principal Components Analysis (PCA). This thesis adopts, however, EFA for three reasons: 1) this method employs a structured model and is based on specific assumptions, 2) EFA is a statistical technique, while PCA is often described as a purely mathematical transformation and 3) EFA has traditionally been used to explore the possible underlying factor structure of a set of measured variables without imposing any preconceived structure on the outcome (Child 1990).

In the **second** section, it is described the chosen econometric method that is multinomial logistic approach. The nature of the dependent variables allows this thesis to use the multinomial logit approach to estimate the effect of the explanatory variables on the probability that each of the four equity ownership is chosen, since multinomial logistic regression is used to predict categorical placement in or the probability of category membership on a dependent variable based on multiple independent variables.

Finally, in the **third** section the dataset, source, and characteristics of the data are developed. Particularly, a sample of **17 European Union (EU)** (Austria, Belgium, Czech Republic, Denmark,

France, Germany, Greece, Hungary, Italy, Luxemburg, the Netherlands, Poland, Portugal, Romania, Spain, Sweden, and the UK) **and 21 non European MNEs** (Azerbaijan, Bahrain, Brazil, Canada, China, Iceland, Israel, Japan, Jordan, Kazakhstan, South Korea, Kuwait, Lebanon, Norway, the Federation of Russia, Qatar, Saudi Arabia, South Africa, Switzerland, the United Arab Emirates, and the USA) are selected by the dataset of the Republic of Turkey Prime Ministry Investment Support and Promotion Agency (ISPAT). The dataset of ISPAT comprises a significant part of foreign equity investments in Turkey and, as of 2002, it includes 256 foreign equity investments, of which 245 are included in this analysis.

Considering the characteristics of the sample minority foreign-owned consists the 23.67% of the sample; co-ownership consists the 13.47%; majority foreign-owned consists the 24.9%; full ownership consists the 37.96%; and the distribution of the data set in terms of the sector of operation is as follows: primary: 7.35%; manufacturing: 46.94%; services: 45.71%. Within each specific the manufacturing sector, chemicals and related industries constitute: 2.45%; machinery: 6.12%; environmental technologies: 4.49%; food and beverages: 8.98%; automotive and related: 8.57%; and energy industries: 16.33% of all FDI firms. Within the services sector, real estate comprises: 8.57%; hotels and tourist resorts: 3.27%; transportation: 3.67%; banking and insurance (Financial Services): 12.24%; health: 9.8%; and other services: 8.16% of all FDI firms.

In **chapter 8** empirical results of the multinomial logistic regression are analyzed, particularly, explaining the output in terms of multinomial log-odds (logits). The outcome measure is **equity** - minority (1), cooporation (2), majority (3), and, wholly-owned subsidiary (4)- from which this analysis tests what relationships exist with institutional -which in turn is analyzed to regulative and normative distance- cultural distance, as measured by **Hofstede** index, cultural distance, as measured by the **GLOBE** index, economic distance, and geographic distance. The response variable, **equity**, is treated as a categorical variable under the assumption that the levels of **equity** status have *no* natural ordering and allows Stata 11 to choose a referent group, which is the wholly-owned subsidiary (WOS).

Prior to running the regression, a correlation matrix has prepared. Numerous statistically significant correlations between the independent variables have been observed; however, none of the relationships have been strong enough to warrant concern about possible multicollinearity (Hair et al 1995; Aczel 1996). Wald tests also have been applied to identify variables and interaction terms that provide the best fit for the entry mode regression.

Further, the results of variance components analyses of the parent equity ownership are

presented. These illustrate that 41.1% of the total variance in Turkish equity ownership is explained by country effects, and 1.8% by MNE's effects. Almost similar results have been obtained for the sample of different industrial sectors. These results provide preliminary support to our assertion that country-specific effects explain a significant portion of MNEs' ownership decisions.

In this framework, the modeling procedure is divided into three steps. The **first step** tests the **Base Model** incorporating economic and geographic distance; the **second step**, through **Model 1**, tests the significance of overall institutional distance in combination with two cultural-cognitive indices (GLOBE and Hofstede), economic, and geographic distance. Finally, **the third step**, through **Models 2, 3, and 4**, tests the components of institutional distance (regulative and normative distance) in combination with two cultural-cognitive indices, i.e., economic distance, and geographic distance.

The results of the multinomial logistic regression illustrate that both transaction and institutional factors are significant determinants of FDI in the case of Turkey. Since economic distance and geographic distance, which are approached under the lens of TCA, emerge as significant factors in all Models, but in different cases, and institutional factors also have a considerable contribution towards explaining entry-mode choice decisions. While most previous studies have used transaction-cost theory as a conceptual basis for hypothesis development and testing, this thesis suggests that models that only consider transaction-cost variables may be underspecified and institutional factors have a significant and incremental contribution in explaining entry-mode strategies.

But, before analyzing the explanatory power of each variable separate, it is important first to illustrate the overall pattern of behavior of entry mode choice. Generally speaking, the most preferred entry mode choice by foreign investors is WOS, something which is also verified by the observation of the characteristics of the sample. WOS represents the 37.96% of the preferred choices, majority foreign-owned represents the 24.9%, minority foreign-owned represents the 23.67%, and lastly, co-ownership represents the 13.47%.

More specific, when investors tend to consider economic distance the main dilemma is lying between co-ownership and WOS entry mode choice and investors, finally, tend to choose WOS. Considering cultural distance, Hofstede model is never significant providing no explanatory power to the current results. On the contrary, cultural distance, through GLOBE model, it is obvious that it follows the same pattern of behavior as economic distance. Foreign investors are between co-ownership and WOS, and finally, they tend to choose WOS.

Nevertheless, when foreign investors consider geographic distance they tend to consider all the

possible alternative choices at hand. For instance, in Model 1 geographic distance is significant in all three cases compared to WOS, despite the fact that investors, finally, choose WOS. Whereas, in Models 2, 3, and 4 the choices of investors are confined in two alternative options: minority JV vs WOS and majority JV vs WOS, concluding again in WOS.

For its part, institutional distance when is considered overall in Model 1 is developed on the choice between majority JV and WOS, and investors, finally, tend to choose majority JV. However, when institutional distance is analyzed in its components, regulative and normative, then the empirical results show that for both distances the sample investors are between co-ownership and WOS, however, in the former case foreign investors tend to prefer WOS, while in the latter they tend to prefer co-ownership.

This pattern of behavior partly may be explained by the fact that in the Turkish context state intervention plays a significant role in business relations, something which has considerably contributed to the formation of an unstable business environment, and consequently, to many transaction costs for the investors. Consequently, MNEs in order to avoid state intervention and the ensuing inefficiencies, they are mostly engaged in WOS, with the aim to transfer their business systems and to adjust them to local needs through an effective and efficient way (Bugra 1994; Önis 2002), something which is consistent with the Demirbag et al's (2010, pp. 458) empirical results. These authors have argued that their

"results tend to differentiate better between WOS and JVs than between different categories of JV. This may be partly explained by the existence of a hierarchical process in entry mode decision-making (Pan & Tse, 2000). Foreign investors have a tendency first to decide whether to choose either full ownership or shared ownership in their affiliates. Then, they decide the extent of ownership in their shared equity investments".

In terms of determinants of equity ownership in foreign subsidiaries, most of the hypotheses are supported. Particularly, the present results indicate that economic distance between Turkey and the sample countries has a significant effect only in the case where co-ownership is compared to WOS, and MNEs tend to prefer WOS. So, this finding supports that economic distance in the case of Turkey does matter: FDI equity mode is achieved through WOS. Something which is consistent with previous research arguments that WOS represent a more efficient way than JV to get access to strategic assets.

In that framework, economic distance has important managerial implications. For example, when firms invest abroad, they need to pay attention to factors related to the level of economic development of host countries, in addition to cultural and institutional factors. In fact, the influence of the economic distance may be more permanent than cultural and institutional. Barkema et al's (1996)

study has indicated the existence of various cultural learning effects. For instance, firms benefit more from previous experience with expansions into other countries of the cultural block. Similarly, Tsang's (2002) study of Sino-foreign JV has indicated that through learning by doing, firms are more able to improve their skill in acquiring useful knowledge about the institutional and cultural environment of their FDI. On the contrary, the issues associated with economic distance are more permanent. For instance the stage of economic development and other macroeconomic factors affect the difference in general wage level between a home and host countries, and it is beyond any MNEs' ability to manipulate or control this difference.

Considering now the total picture obtained by the measurement of cultural distance (GLOBE and Hofstede) is not uniform. More specifically, the Hofstede index is insignificant in all Models and, therefore *Hypothesis 1a* is not supported at all. However, the GLOBE index emerges as a significant variable and with the expected sign in Models 2, 3, and 4 in cases where co-ownership is compared to WOS, and, therefore, *Hypothesis 1b* receives moderate support. It seems, therefore, that MNEs in Turkey tend to favor WOS over JV, the greater the cultural distance. This consistently positive relationship to high- control mode supports the argument that the costs of direct control through an internal organizational structure (i.e. WOS) are likely to be smaller than those of finding a local partner(s), and negotiating and enforcing a JV agreement under Turkish's relatively less sophisticated inward FDI regime.

Further, the significance of the GLOBE index in this thesis can be attributed to the fact that this research project, developed by House et al. (2004), incorporated data from 17,370 middle managers from 951 different organizations in 62 different countries, were engaged in three different industries: food, finance, and telecommunications, it is wider than Hofstede's. Supportive to this view, is that GLOBE is considered to be the largest-scale IB research project ever developed (Avloniti and Fillipaios 2013), since GLOBE authors implemented two types of measurements practices “as is” and values “as should be”, as opposed to Hofstede, who has implemented just one and has claimed that values drive practices. Moreover, the authors of GLOBE have claimed that by incorporating both these aspects in their measures they could also examine how they correlate to each other. In that framework, GLOBE dimensions turned out to be more comprehensive, cross-culturally developed, theoretically sound, and empirically verified, as advocated by House et al. (2004).

When interpreting geographic distance, this means that when MNEs invest in Turkey and perceive that there is great geographic distance between Turkey and other sample-home country, then it

is possible that sample-foreign investors to choose WOS. This is consistent with prior findings that perceive that costs for monitoring partners rise when share-owned solutions are preferred to full acquisitions (wholly owned subsidiaries), because greater amounts of ownership confer a proportional degree of control over the investment, and raise the ability of acquirers to implement decisions and resolve disputes that could arise *ex post* (e.g., Anderson and Gatignon 1986; Grossman and Hart 1986).

In contrast, partial ownership may leave partners with differing incentives and opportunities that can not be accounted for in the due diligence stages of a deal. Supportive evidence comes from a paper by Chakrabarti and Mitchell (2006) who have studied the effects of distance on firms' acquisition behavior in the chemical industry, and have found that acquirers tend to prefer proximate investments over remote ones, when integration and monitoring requirements of the target firm are high.

Lastly, the present findings have one major implication regarding the institutional perspective of foreign entry-mode choice. Institutional forces may influence the choice of foreign entry-mode at different magnitudes. This means that the form of institutional distance (whether analyzed in its components or not) affects the other variables in the sample i.e., cultural distance and geographic distance, except for economic distance, which follows the same pattern of behavior independently of the behavior of institutional distance.

Particularly, when **institutional distance is tested overall** (Model 1) without analyzed in its components, then it is significant and foreign investors would tend to prefer majority JV to WOS. Cultural distance (Hofstede and GLOBE) is never significant, however, geographic distance is significant in all cases compared to WOS.

Whereas, when institutional distance is analyzed into its components, and more specific, into regulative and normative distance at the same time (Model 2), then neither normative nor cognitive distance is significant. Cultural distance as measured by GLOBE emerges as an important variable, while cultural distance as measured by Hofstede is still insignificant, and lastly, geographic distance is significant in the cases where minority and majority JVs are compared to WOS.

When institutional distance is analyzed in its **regulative aspect** (Model 3), then regulative distance emerges as significant variable in the case where co-ownership is compared to WOS and high regulative aspects result in WOS. Cultural distance, as measured by GLOBE, emerges as significant variable, as well, while cultural distance measured by Hofstede is still insignificant, and geographic distance is significant in the cases where minority and majority are compared to WOS.

This can be explained by referring to previous IB studies that have addressed the problems of

working with a partner form a different regulative environment (Estrin et al 2009). It is important to mention that for MNEs, it can be difficult to work with partners in a partial JV that come from a very different institutional background, as they typically have different formal structures (e.g. Kogut and Singh 1988) and subsequently, this implies different normative styles (such as communication and management). Previous IB literature also mentions the important role of the regulative powers of state authorities in the choice of partial JVs by MNEs, as they permit only partial JVs or WOS in some industries during the privatization by foreign MNEs (Brouthers 2002; Yiu and Makino 2002).

Finally, when institutional distance is analyzed in its normative aspects (Model 4), then normative distance is significant in the case where co-ownership is compared to WOS, and high normative pressures result in co-ownership JV. Between the two measures of cultural-cognitive aspects, only cultural-cognitive distance as measured by GLOBE is significant, and geographic distance is significant in the cases where minority and majority JV are compared to WOS.

The significance of this choice can be explained by referring to the specific characteristics of the Turkish institutional environment, and particularly, by the gradual opening up of the Turkish economy by other sample countries. Meyer (2002) has found that partial JV may be a means to align the interests of an investing MNE and the host government in JVs related to the privatization of state enterprises. Government agencies often have indirect means to influence the prosperity of a business. As the privatization of state-owned enterprises was one key economic characteristics for markets such as Turkey, especially, for 1980-2004 period, the choice for co-ownership offered foreign investors an opportunity to align their interests with those of the Turkish host-country government. This helped them to gain a foothold in new host-emerging countries such as Turkey, with institutions in the process of development, in order to reduce the likelihood of surprise adverse interference by state authorities.

Therefore, overall analyzing the behavior of institutional distance, it is obvious that foreign investors in Turkey tend not to take into account regulative and normative aspects together. On the contrary, they tend to stress just one aspect the time. One possible explanation for this is that regulative institutional forces that are codified in formal legal restrictions and sanctions, might be more easily identified. Moreover, when making entry-mode decision, regulative legitimacy may be the most immediate legitimacy that MNE need to attain.

Unlike, normative institutional pressures are less codifiable and take more time to be recognized, as suggested in chapter 5. Normative institutional pressures might not be easily identified before local operations start. So, foreign investors first incline to underline regulative distance (formal

rules), in order to achieve, initially, an alignment with the host country in terms of rules and regulations. Then sample investors tend to focus on norms that define appropriate and acceptable forms of behavior by organizations (informal aspects), in order to achieve an alignment with the host's country normative background.

Considering all the above, from a managerial point of view, the Turkish context tends to host WOS or full ownership entry mode strategies. This has been witnessed not only in the inward JVs of large Turkish conglomerates such as the Sabanci Group, which is used its inward JVs with DuPont as a "springboard" for its outward JVs, which recently became its WOS (Erdilek 2008), but also in the outward JVs. MNEs investing in the Turkish environment through higher equity mode try to secure preferential treatment offered by the Turkish emerging country governments and also to bypass trade barriers into developed country markets. However, investors in the Turkish background should ensure that they concentrate on the factors that are most relevant to their own situation.

Overall, it is evident that the choice of a particular ownership mode for inward FDI is one of the most important decisions that managers of many MNEs have to make. In terms of explaining MNEs behavior that invest in the emerging economy of Turkey, the empirical results of the present thesis provide support for both conventional, such as TCA, and more recent theoretical views, such as institutional theory. Therefore, it is concluded that institutional, economic, geographic, and cultural variables may have a crucial influence on explaining the strategic behavior of MNEs who invest in Turkey and subsequently, may also affect their global competitiveness, and hence their long-term survival.

Further research would extend the investigation in several directions. First, research analyzing changes over time in ownership patterns would enhance our understanding of the impact of institutional changes on equity compositions of subsidiaries. Second, the classification of investing countries in developed and emerging would enhance our understanding of the preferences of MNEs to invest either in a country with the same development level or in a more developed country. Third, comparison studies of countries with a similar development level to that of Turkey and diverse culture dimensions would provide an in-depth insight into the role of the institutional environment and organizational factors in ownership structures of subsidiaries in emerging market economies. Fourth, future studies could examine whether and when the same results are obtained in different economic and institutional contexts. Further, the present thesis could be extended to other contexts in terms of industry level in which the parent firms operate (e.g., non manufacturing, manufacturing, electronics, and automobiles

sectors), and other modes of foreign entry (acquisition and capital participation).

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