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Regional Integration, Multinational Enterprise Strategy and the Impact of Country-level Risk: The Case of the EMU

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The European Monetary Union (EMU) provides a new macro-level, institutional setting for multinational enterprises (MNEs). The authors investigate the impact of regional integration on MNE strategy by analysing Belgian firms' entry-mode choices in foreign markets, both EMU and non-EMU ones, with a focus on what impact remains of country-level risk. They demonstrate that regional integration has altered the impact of country-level institutional risk on MNE entry-mode choices inside the EMU. The conventional predictions of international business theory have been reversed, with higher country-level risk inside the EMU driving a preference for wholly owned subsidiaries. Within the integrated region, insider firms now view higher country-level risk as the equivalent of higher, micro-level contracting risk. Such risk can best be mitigated through full internalization, combined with arm's length contracts, rather than through equity joint ventures.

Introduction

Global foreign direct investment (FDI) stocks have grown strongly throughout the past decades. In parallel with this empirical phenomenon, the scholarly literature has devoted substantial attention to the determinants of multinational enterprise (MNE) internationalization patterns. This has included attention to the impacts of bilateral investment treaties (BIT) (Oh and Fratianni, 2017) and regional integration (Kolk, Lindeque and Buuse, 2014; Oh and Contractor, 2014; Oh and Li, 2015; Rugman and Verbeke, 2004, 2005; Verbeke and Asmussen, 2016; Verbeke and Kano, 2016). Regional elements appear important, in addition to country-level variables, to explain various dimensions of MNE strategy (Arrègle *et al.*, 2013; Blevins *et al.*, 2016; Kim and Aguilera, 2015; Oh and Rugman, 2012; Rugman and Oh,

2013). Regions should therefore be considered systematically when MNE international expansion patterns are investigated. The present study focuses on the impact of a particularly far-reaching case of regional integration, namely that of the European Monetary Union (EMU), on insider MNEs' entry-mode choices.

Regional integration arrangements such as the EMU – with the euro as its common currency and with a common monetary policy – aim to facilitate the free flow of goods, services, capital and labour, and are supposedly instrumental in establishing more efficient markets. Firms from one EMU member can expect to enjoy free(er) economic access to all other member states and to the various benefits from this far-reaching European integration. Such benefits result from the common European framework driving an institutional-level playing field, in this case including monetary

policy (Oxelheim and Ghauri, 2004). However, little is known about whether – and how – insider MNEs consider regional integration in their entry-mode choices, an issue we address in this study.

A large number of prior entry-mode studies have usefully focused on transaction cost economics (TCE) and related internalization theory-based explanations to explain MNE entries. Here, firm-level parameters in the ‘contracting sphere’ (broadly considered) are the most critical in providing guidance to entry-mode selection. However, it has also been argued that micro-level analyses ‘must be qualified by factors stemming from the institutional and cultural context’ (Kogut and Singh, 1988, p. 412; North, 1990). Here, several studies have focused on the potentially important impact of foreign legal and regulatory frameworks on MNE decision-making (Coeurderoy and Murray, 2008; Demirbag, Glaister and Tatoglu, 2007; Holmes *et al.*, 2013).¹ The bulk of past empirical work has focused on host-country-level characteristics, which raises the question of whether the impact of these country-level variables would remain ‘as expected’ in an era of increased regional integration (Verbeke and Asmussen, 2016).

In the present paper, we assess how MNEs from one specific economy might adapt their entry-mode strategies as a function of regional integration, in this case exemplified by the presence of a ‘Single Market’ and the sharing of a common currency. Regional integration, by definition, entails a change in a set of macro-level, institutional shift parameters and the related requirements for resource bundling by MNEs (Rugman and Verbeke, 2004). Our study thereby extends the literature on the implications of regional integration for international business (Banalieva, Jiang and Santoro, 2010; Benito, Grøgaard and Narula, 2003; Rugman and Oh, 2013; Rugman and Verbeke, 2004).

Several prior studies did analyse the effect of European integration on a variety of entry-related phenomena within Europe, such as cross-border mergers and acquisitions (Moschieri, Ragozzino and Campa, 2014), and the number of research

and development (R&D) partnerships being established (Ramsay, Kay and Hennart, 2001). However, these studies did not investigate formally the differential impact on entry-mode choices triggered by regional integration, when expanding within vs. outside the region.

In contrast, the present article offers novel insight into the impact of operating within the EMU core vs. operating outside the EMU. We do consider traditional explanatory variables for entry-mode strategies from TCE/internalization theory, and from studies on institutional context and cultural distance, but we combine these with variables measuring the impact of regional integration between the home and host countries. Specifically, we test the effects of conventional, national institutional risk and cultural distance on entry-mode strategies for expansion within vs. outside the home region.

The next section highlights the most commonly studied variables affecting entry-mode strategies. In the third and fourth sections, we develop our hypotheses and describe the methodology. The fifth section discusses our results, as well as the research and management implications, the limitations and future research directions. The final section concludes.

Theoretical background

Conventional internalization theory suggests that the interplay between firm-specific advantages (FSAs) and country-specific advantages (CSAs) will determine MNE location and entry-mode choices (Rugman and Verbeke, 1992). Firm-specific advantages represent the MNE’s unique resource combinations that allow the additional costs of doing business abroad vis-à-vis relevant rivals operating in host environments to be overcome. Firm-specific advantages can include assets protected by property rights (such as patented knowledge), but also managerial capabilities allowing efficient resource orchestration.

Country-specific advantages determine location choices. Here, performing particular value-added activities in particular host countries allows imperfect markets to be overcome and may thus reduce the MNE’s spatial transaction costs compared with operating out of the home market only (Rugman, 1990). Most importantly, locating value-added activities abroad can be instrumental

¹The institutional environment can be decomposed into formal and informal institutions, with the latter sometimes including ‘culture’ (Holmes *et al.*, 2013). In our paper, however, we adopt the conventional distinction made between the impact of institutions, referring to formal institutions only, and the impact of culture.

for comparatively more efficient ‘asset bundling’ (Hennart, 2009; Verbeke and Hillemann, 2013). Given the MNE’s extant reservoir of FSA and its selection of locations with particular CSAs, the choice to set up a wholly owned subsidiary (WOS, full internalization) vis-à-vis an equity joint venture (EJV), in any particular host country reflects the relative benefits associated with these alternative entry strategies (Buckley and Casson, 1976; Teece, 1986). Rugman and Verbeke (1992) describe how MNEs internalize specific operations because of natural and government-induced market imperfections.

In addition to evaluating transaction costs arising directly from specific business dealings with particular economic actors at the micro level, MNEs also consider each host country’s broader institutional environment (Demirbag, Glaister and Tatoglu, 2007; Driffield, Mickiewicz and Temouri, 2016). Here, formal institutions represent the underlying structure within which business operates, and they define the prevailing regulatory setting in the host country (Davis, Desai and Francis, 2000; Holmes *et al.*, 2013; North, 1990). Transaction cost economics theory suggests that macro-level institutional structures represent a frame within which the MNE’s operations are conducted (North, 1990; Williamson, 1985). The extreme case of macro-level framing is one whereby the ‘optimal’ micro-level choice is simply made impossible: for example, when a host government restricts foreign ownership levels (Gomes-Casseres, 1990; North, 1990). Multinational enterprises are then ‘incentivized’ to select a lower ownership level, as found in an EJV, with low(er) control modes not only meeting public policy preferences, but also increasing the firm’s flexibility (Anderson and Gatignon, 1986).

In the case of high, host-country institutional risk, the complementary resources provided by a local partner, and which cannot be accessed in efficient, external markets, can supposedly mitigate this macro-level risk (Anderson and Gatignon, 1986; Demirbag, Glaister and Tatoglu, 2007). Several scholars have found support for this link in their empirical studies, in particular the negative relationship between political or economic risk and the ownership level in the host-country operation (Kim and Hwang, 1992; Shan, 1991).²

²However, Driffield, Mickiewicz and Temouri (2016) describe an alternative scenario, whereby a foreign firm

Foreign MNEs also face broader institutional hazards that can affect entry-mode strategies. For example, the institutional environment may suffer from weaknesses causing increased business risk for all firms, such as insufficient property rights protection (North and Weingast, 1989). In host countries with weaker property rights, MNEs tend to invest less because of greater transactional risk and less predictable profits (Williamson, 1996). Property rights protection is especially critical for MNEs with an intrinsic preference for equity ownership, because of the nature of their FSAs. Such cases typically arise when the resource bundles being transferred to host countries cannot be transacted in efficient markets, thereby making market contracting (e.g. licensing) problematic. In the case of high institutional hazards, such as those resulting from weak property rights protection, there will be a stronger preference to select an EJV, assuming the local partner can provide resources such as strong relationships with the local regulatory enforcement apparatus, that cannot be transacted either in efficient markets (Hennart, 2009).

Adding macro-level institutional characteristics as parameters in empirical work thus helps to explain the MNE’s differential capacity to deploy, exploit and augment its FSAs across national institutional contexts for each entry mode. The optimal entry-mode strategy will depend on both the desired level of FSA protection (and further FSA enhancement) in the micro-level transactions at hand, and the anticipated exposure to macro-level hazards in the host country’s institutional environment likely to spill over to micro-level contracting behaviour (Anderson and Gatignon, 1986).

Mainstream, internalization theory thinking would thereby suggest that higher national institutional risk in the host country will increase MNE preferences for EJVs compared with WOSs. This prediction is subject to the qualification that

may be better protected against expropriation in a low-institutional-quality environment than the host-country partner. In that case, and in the absence of foreign ownership limits, the host-country partner(s) might actually have a preference for foreign MNE majority ownership to protect against outright expropriation. We think this is an unlikely scenario, but it might have validity in circumstances where the foreign MNE does not bring high levels of proprietary knowledge to the partnership. Driffield, Mickiewicz and Temouri (2014) also suggest that, in instances of high institutional risk, host-country partners may increase their minority equity share because such higher share can alleviate agency problems.

the complementary resources provided by a local partner can mitigate macro-level hazards in the form of institutional risks, and do not trigger new and significant micro-level risks. This prediction is valid across strategic entry motivations, whether market-seeking, resource-seeking, efficiency-seeking and even strategic asset-seeking. In each case, the exact form that will be taken by institutional risk may be different but, across the board, successful entry can best be supported by a local partner who knows how to navigate the risky institutional setting at hand, and who is enlisted to safeguard any knowledge transferred from the MNE home country to local operations.

The broader empirical literature in international business has also consistently demonstrated the impact of higher institutional risk (e.g. in the realm of legal enforceability of agreements) on MNE strategic decision-making (Bucheli and Kim, 2015). For example, Berry (2017) has shown the impact of weak intellectual property rights protection regimes on the internal knowledge protection strategies of US MNEs.

Hypotheses development

Regional integration and institutional risk

Most national governments, including European ones, typically strive to achieve non-discrimination of their home-grown firms when these operate abroad (Esteveordal and Suominen, 2008). They typically attempt to establish closer relationships with strategically important neighbouring countries, and this can take the form of regional integration. The level of regional integration is probably the most advanced in Europe, and this has been achieved through the European Union (EU) and the EMU. The EMU probably represents the highest level of regional integration presently observable in the world economy. Besides a single market, the 19 EMU member states share a single monetary policy that is enriched by the Stability and Growth Pact, i.e. a framework for national fiscal policies in the EU. Hence, the EMU is broader in scope in terms of the number of member states involved and their depth, i.e. the range of policy areas dealt with, than any other regional integration treaty.

With the introduction of a single European currency, the EMU reduced exchange rate instability and uncertainty. More specifically, de Sousa and

Lochard (2011, p. 554) describe how the EMU has had an impact on FDI through a reduction in transaction costs, since it: '(1) removes currency conversion costs; (2) suppresses in-house costs of maintaining separate foreign currency expertise; (3) eases price decisions and comparison of international costs; (4) irrevocably removes intra-eurozone exchange-rate volatility'. In broader economic terms, the EMU has also affected growth, openness, labour markets, productivity and prices (Baldwin *et al.* 2008). It has positively affected the efficiency of capital markets and all other markets for inputs, intermediate outputs and final outputs.

Even more broadly, when signing regional integration agreements, member states typically expect to benefit in political and economic terms (Lamy, 2002). First, by harmonizing the economic structure of member states, regional integration facilitates control of – and coordination with – micro-level economic actors in international transactions (Benito, Grøgaard and Narula, 2003). Second, the more highly integrated input and output markets facilitate – and reduce costs associated with – recruiting, training, deploying and monitoring of employees in foreign operations. Third, increased regional integration typically confers the insider MNE with higher legitimacy and ease of working with a wide range of external, local stakeholders, compared with regional outsider MNEs.

All the above point to requisite inputs and complementary resources becoming more readily accessible in efficiently functioning external markets, and institutional hazards in the form of *ex ante* equity level restrictions and *ex post* expropriation risks declining or being eliminated throughout the region. The infusion into the MNE's decision-making context of a new level of reliable, high-quality regional institutions substituting for national-level (either discriminatory, or otherwise less efficient) ones allows the firm to focus more on managing micro-level risks rather than on safeguarding against national-level risks. Any remaining, national-level institutional risks within the region can now be more easily managed by the firm itself, possibly with the support of local, external contracting parties, and without the need to take on board EJV partners, whose presence would trigger the need for additional, micro-level safeguards to protect the MNE's FSAs.

The above allows qualification of the internalization theory prediction that greater institutional risk at the macro level in a host country will

typically have a positive effect on the MNE's likelihood to operate an EJV vis-à-vis a WOS at the micro level. We expect this effect not only to be moderated, but actually to be reversed for MNEs expanding to countries that are part of their home country's regional integration agreements, in this case the EMU. When operating in a regionally integrated market, 'insider' MNEs will tend to view higher national institutional risk as a parameter that can and should be managed by the firm itself, similar to micro-risks that require more rather than less control over how to manage the company's FSAs. The national institutions triggering 'residual' risk inside the integrated region do so largely by 'cascading down' frailties to the micro-level, e.g. increasing the danger of FSA dissipation in cases of equity-based contracting modes with partners, and are treated as if they were micro-level sources of risk. These should be managed directly by the firm through higher internalization, possibly in combination with market contracts (e.g. for specialized legal services): a lower use of EJVs will ensue.

In the EMU (given the absence in almost all sectors of institutional limits imposed on ownership levels and dangers of expropriation), the key institutional problem facing the MNE when tapping into complementary resources provided by local partners is its vulnerability to unwanted knowledge dissipation at the micro level. What matters here are the intricate details of the national-level knowledge appropriability regime in a broad sense, such as the non-discrimination of foreign firms in courts of law and the presence of robust institutional checks and balances, without which the risk of unintended knowledge dissipation without full recourse would prevail. Micro-level equity partners could then build on macro-level frailties of the host country to take advantage of the MNE. Use of an EJV partner would create new, 'inside', micro-level institutional hazards.

The EJV partner de facto gains much easier, privileged access to coveted MNE FSAs than any external actor. In the EMU, stronger macro-level frailties at the national level with the danger of spilling over to micro-level contracting will increase the predicted level of MNE ownership. In these cases, EJV partners who are not needed to accommodate foreign equity-level restrictions or to mitigate risks of expropriation could engage in contract infringement and free-riding that can be avoided through internalization.

In contrast, lower national-level institutional hazards associated with entry into a particular EMU country will reduce the micro-level hazards of unwanted knowledge dissipation and thus, *ceteris paribus*, will support setting up EJVs with local actors. In EMU host countries with lower national-level, institutional risk, MNEs will be able to rely more extensively on macro-level safeguards when engaging in knowledge-sharing and in new resource-recombining with EJV partners, thus also strengthening the opportunity to develop new FSAs to be exploited in the host country and beyond (Verbeke, 2013). Here, lower national-level institutional risk also reduces micro-level contracting hazards.

Thus when internationalizing within regional markets such as the EMU, where limits on equity ownerships levels are absent and the risks of expropriation very low, and a common regional, regulatory regime of high quality prevails, the MNE will try to avoid complicating the entry process in countries with higher institutional risk by internalizing (e.g. through hiring employees responsible, *inter alia*, for the political risk mitigation function) and by contracting for specialized services. Here, an EJV partner would require additional safeguards to avoid intra-EJV FSA dissipation problems. We thus hypothesize:

H1: Home-regional integration will reverse the conventional positive effect of higher, national institutional risk on MNE preferences for EJVs, whereas this effect will remain positive outside the region.

Regional integration and cultural distance

Cultural distance, which could be interpreted as the lack of alignment between informal institutions between two countries, has been the most frequently studied macro-level variable to explain entry-mode choices at the micro level (Morschett, Schramm-Klein and Swoboda, 2010). However, the prior literature has not led to any consensus on predicted effects (Beugelsdijk *et al.*, 2018; Morschett, Schramm-Klein and Swoboda, 2010; Shenkar, 2001; Tihanyi, Griffith and Russell, 2005). Meta-analyses by Beugelsdijk *et al.* (2018), Tihanyi, Griffith and Russell (2005) and Morschett, Schramm-Klein and Swoboda (2010) have shown a non-significant relationship between cultural distance and entry-mode decisions, but we

introduce this parameter as a main, independent variable, in the context of regional integration, so as to allow comparability with prior studies (Hutzschenreuter, Kleindienst and Lange, 2014; Lee, Shenkar and Li, 2008).

The dominant view is that a reduction in cultural-context similarity should be interpreted as the equivalent of an increase in macro-level investment risks affecting host market attractiveness (Agarwal and Ramaswami, 1992; Dunning, 1993). *Ceteris paribus*, MNEs supposedly prefer economies with a similar cultural context and then tend to select wholly owned entry modes in such contexts in order to realize the full profit potential of their FSAs (Erramilli and Rao, 1993; Kim and Hwang, 1992).

Following this perspective, MNEs would – when expanding into host countries with higher cultural distance and therefore higher perceived risks – tend to prefer, again *ceteris paribus*, EJVs, and this for two reasons. First, this entry-mode limits the exposure to such risks by lowering commitments of firm-specific resources (Erramilli and Rao, 1993; Kim and Hwang, 1992). Second, an EJV with a host-country partner allows access to local complementary resources that reduce cultural distance with external actors when these resources cannot be accessed in external markets (Beamish and Banks, 1987; Rugman, 1985). Here, the local EJV partner acts as a bridge between the MNE and the high cultural-distance, external environment.³

In terms of extant empirical research, much work indeed suggests that cultural distance makes shared-control modes comparatively more attractive (Davidson and McPetridge, 1985; Kogut and Singh, 1988), but this result does not appear to hold strongly. Given that cultural-distance effects have been assessed in most extant studies that have analysed MNE entry-mode choices, and have used

macro-level variables (Malhotra, Sivakumar and Zhu, 2011), we do the same in the present study, but focusing on the context of regional integration (for recent reviews on the importance of culture in international business studies, see (Harzing and Pudelko, 2016) and (Stahl and Tung, 2014)).

Cultural distance between regionally integrated countries, though not affected directly by regional integration and thus still present owing to heterogeneous cultures within the region (Blevins *et al.*, 2016), could also become interpreted as a source of micro-level risks, especially in the context of joint ventures, that can be mitigated through use of WOSs, somewhat analogous to the case of institutional risk. The argument is that, within the integrated region, the insider MNE will have much more ample scope to select, train, deploy and monitor the employees who can provide the best dual fit with the firm's culture and the host-country national culture. When expanding into a higher cultural distance country within the region, the best way to overcome such distance is therefore by hiring contracting parties as employees. Here again, EJVs are viewed as bringing unnecessary complexity to foreign operations, with macro-level cultural distance challenges potentially cascading down to the micro level, whereas use of WOSs within the region allows socialization of employees, and strengthening – where efficient – of the importance of corporate culture over national culture. This leads to the following hypothesis in the realm of entry within the home region:

H2: Home–regional integration will reverse the conventional positive effect of higher cultural distance on MNE preferences for EJVs, whereas this effect will remain positive outside the region.

Method

Data and sample

The Belfirst database published by Bureau van Dijk provided an initial selection of 121 publicly listed Belgian companies with international subsidiaries. We triangulated this database with financial and other information provided in each of the MNE's annual reports, and through direct correspondence with individual companies. Over the period covering 1999–2014, we identified a total of 1368 foreign entry events from 46 listed

³Two qualifications should be added here. First, some scholars have argued that, in one particular case, a positive relationship between the level of sociocultural distance and the level of ownership may hold, namely 'when there is a substantial advantage to doing business in the entrant's way' (Anderson and Gatignon, 1986, p. 18). Second, and perhaps more importantly, cultural distance does not necessarily translate into objectively higher hazards for the MNE in terms of behavioural dysfunction in micro-level contracting: higher cultural distance at the macro level does not need to spill over to more expected dishonesty or broader unreliability in micro-level contracting.

Belgian, non-financial MNEs.⁴ We collected data on entry decisions after 1999 because the Eurozone was introduced on 1 January 1999. Our sample of 46 MNEs represents over 70% of the total market capitalization of all listed Belgian non-financial MNEs with international subsidiaries at the time of data collection.

Measurement of variables

Dependent variable. The dependent variable in our study is the MNE's entry-mode strategy for each subsidiary. As a binomial dummy, it takes the value of 1 for an observed WOS (full ownership) and 0 for an EJV (shared ownership). We used the conventional 95% cut-off point for defining a WOS, following previous studies (Gomes-Casseres, 1990; Hennart, 1991; Padmanabhan and Cho, 1999; Yui and Makino, 2002). Ownership shares under 5% were excluded, as we considered those to be portfolio investments rather than direct investments.

Independent variables. Institutional risk and cultural differences are examined in our study as the independent variables. To capture the varying levels of institutional risk characterizing host countries, we applied the widely used Worldwide Governance Indicators (WGI) (Kaufmann, Kraay and Mastruzzi, 2010). The WGI are based on 31 underlying data sources and include data on 215 countries over the period between 1996 and 2014, covering six broad dimensions of governance, namely: (1) voice and accountability; (2) political stability and absence of violence; (3) government effectiveness; (4) regulatory quality; (5) rule of law; and (6) control of corruption. Each dimension is measured on a scale between -2.5 and 2.5 , with higher values indicating lower institutional risk. Given the fact that correlations between the six dimensions surpassed 0.5, we followed prior studies (Dikova and Van Witteloostuijn, 2007; Slangen and Van Tulder, 2009) and averaged the scores of the six dimensions into a composite index measuring governance quality in a host country for a given year. We then converted a negative (positive) value to a pos-

itive (negative) value by multiplying by the 'negative one', for ease of interpretation. Thus, a higher value indicates higher institutional risk. For the years 1999 and 2001, we considered the dimension scores of the preceding year (i.e. 1998 and 2000) since data for these years were not available, following extant studies (Dikova and Van Witteloostuijn, 2007; Slangen and Van Tulder, 2009).

In contrast to most prior empirical work, we did not use the traditional Kogut and Singh (1988) index to measure cultural distance. We agree with Shenkar (2001) and Tung and Verbeke (2010) that this index merely creates a false 'illusion of equivalence', because it assumes the equal importance of differences in the scores on Hofstede's (1980) various national cultural dimensions between the host country and the MNE's home country, in this case Belgium. To overcome the shortcomings of the Kogut and Singh (1988) index, we measured cultural distance as the Euclidean distance index, based on the traditional four dimensions of Hofstede (1980): power distance; individualism; masculinity; and uncertainty avoidance.

Interaction variable. We argued above that the effects of institutional risk and cultural distance on entry mode depend on home-regional integration. Thus, regional integration (EMU) is coded as 1 if the subsidiary is located inside an EMU country, 0 otherwise. We used the EMU as a regional integration variable because it has a single, unambiguous introduction date for the participating nations (i.e. 1 January 1999), in contrast to the formation of the EU. This single date also makes the distinction between FDI in an 'intra-EMU' country vs. an 'outside-EMU' country unambiguous. In addition, the EMU is the highest-level form of economic and institutional integration presently observable. We conducted supplemental analyses, using the EU as an alternative variable for measuring regional integration and found similar results.

Control variables. We included a number of control variables that could influence the entry-mode decision: geographic distance; firm size; R&D intensity; marketing intensity; international business experience; host-country experience; and family firm status.

Geographic distance increases entry barriers through the costs of transportation, managerial control and communication links (e.g. Berthelton and Freund, 2008; Buckley and Casson, 1976). Geographic distance was measured 'as the crow flies',

⁴We excluded two large MNEs with available data from the list, because these firms cannot be considered as 'Belgian' in the conventional sense: first, Anheuser-Busch InBev is a Belgian-Brazilian MNE with headquarters in Leuven, Belgium and Sao Paulo, Brazil; second, the controlling shareholder of Telenet is Liberty Global Inc., Colorado, USA.

using the physical distance in kilometres between the capital of the home country considered, in this case Belgium, and the capital of the host country. Because it was positively skewed, the variable was transformed logarithmically.

Several scholars (Agarwal and Ramaswami, 1992; Erramilli and Rao, 1993) have argued that larger firm size increases the likelihood of WOSs, since full control modes require more financial and managerial resources compared with EJVs. However, others (Hennart and Larimo, 1998; Hutzschenreuter and Voll, 2008) have suggested that large MNEs may face increasing difficulties, adding to their already diversified portfolio with additional WOSs. We measured MNE size as the parent's global assets in millions of euros and transformed the variable logarithmically because of its skewed distribution.

Following Yui and Makino's (2002) approach to take into account expected transaction costs associated with various entry modes, we capture the strength of the parent's FSAs. We defined upstream firm-specific knowledge as the parent's R&D intensity and calculated the R&D expenditures as a proportion of total annual sales (Banalieva and Dhanaraj, 2013). We calculated the parent's 'marketing efforts' (marketing advantages) in terms of overall sales, general and administrative (SG&A) expenses as a proportion of total annual sales (Banalieva and Dhanaraj, 2013).

Multinational enterprises with prior experience are expected to have gained skills on how to overcome obstacles in host countries (Agarwal and Ramaswami, 1992; Erramilli, 1991). We measured general international business experience (experience – international) as the number of years since the establishment of the first international subsidiary (Erramilli, 1991). Country-specific experience (experience – country) is defined as the number of years since the establishment of the first subsidiary in a specific host country (Li and Meyer, 2009). Both experience variables are measured in logarithmic terms, as the 'quantity' of experience would add decreasing marginal value to the parent's overall stock of experience (Padmanabhan and Cho, 1999).

Previous studies (e.g. Gallo and Sveen, 1991; Pukall and Calabrò, 2014) have argued that the internationalization processes of family firms differ from their non-family counterparts. We controlled for the family effect by creating a dummy variable family firm, coded as 1 if the MNE is a

family firm, 0 otherwise. Following previous studies (e.g. Gallo and Sveen, 1991), we defined family firms as one where a family member serves as senior executive or director with an equity ownership stake. All the independent and control variables were grand-mean centred, as suggested by Hofmann and Gavin (1998).

Statistical analysis

Since our entry-mode choice data have a hierarchical structure, we used a multilevel mixed-effects logistic regression analysis, using the *melogit* command in STATA. Here, a conventional binary logistic regression approach was not appropriate, because our sample violates the assumptions of constant error variance and independence of errors. Since a single parent firm can have multiple EJVs or WOSs, entry-mode decisions are not independent of each other and the observed operations may share common attributes due to their belonging to the same parent firm (Arrègle, Hébert and Beamish, 2006; Nielsen and Nielsen, 2011). In our study, the entry-mode data are nested with the parent firm level; the subsidiary's entry-mode variables (e.g. WOSs vs. EJVs) are level-1 variables, and parent firm-level variables (e.g. firm size) are level-2 variables.

In order to examine the degree of within-group homogeneity (i.e. how each foreign affiliate is similar in each MNE), we examined the ICC (intra-class correlation), which measures the proportion of variance explained by the MNE headquarters. The ICC based on the full model was 0.41, suggesting that approximately 41% of the variance of entry-mode choice is explained by between-MNEs variability. The multilevel, mixed-effects logistic regression analysis is therefore appropriate for our analysis. Furthermore, our sample consists of MNEs only, i.e. firms with international subsidiaries using WOSs and/or EJVs modes. Domestic firms, i.e. firms without any international operations, and internationally operating companies with other operating modes (e.g. exports, licensing) were excluded. In order to correct for this bias from non-random sampling, we adopted a two-stage Heckman selection model (Heckman, 1979). As a first step,⁵ we used all Belgian listed firms, except firms active in financial industries, to estimate

⁵The first stage probit model took the following form: Probability (MNEs have either a WOS or EJV) = $\alpha + \beta 1$

Table 1. Descriptive statistics: means, standard deviations and correlations

	Mean	SD	1	2	3	4	5	6	7	8	9	10	11
1. Entry mode	0.77	0.42											
2. Geographic distance	7.02	1.45	-0.08										
3. Firm size	14.23	2.01	-0.10	0.26									
4. Marketing advantages	0.19	0.17	0.01	-0.03	-0.05								
5. R&D intensity	0.06	0.17	0.05	0.03	-0.01	0.58							
6. Experience – international	60.40	49.39	-0.09	0.34	0.83	-0.04	0.02						
7. Experience – country	21.35	30.31	0.00	-0.11	0.51	0.00	0.02	0.59					
8. Family firm	0.51	0.50	-0.03	-0.06	-0.14	-0.32	-0.19	0.01	0.05				
9. Institutional risk	-1.29	0.83	-0.16	0.55	0.14	-0.10	-0.04	0.20	-0.15	0.03			
10. Cultural distance	2.26	0.97	-0.03	0.35	0.17	0.03	0.10	0.17	-0.09	-0.03	0.05		
11. Regional integration (EMU)	0.47	0.50	0.04	-0.69	-0.15	0.03	-0.08	-0.21	0.15	0.10	-0.41	-0.47	
12. Inverse Mills Ratio	0.56	0.19	0.07	-0.04	-0.16	0.18	0.23	-0.12	-0.06	-0.07	-0.04	-0.03	0.07

Correlations greater than $|0.06|$ are significant at $p \leq 0.05$ and those greater than $|0.09|$ are significant at $p \leq 0.01$. Two-tailed coefficient test ($N = 1,368$).

the probability that a firm has a WOS or an EJV operating mode, which generated an Inverse Mills Ratio. The Inverse Mills Ratio was included as an additional control variable in the second stage of our mixed-effects logistic regression. The inclusion of the Inverse Mills Ratio in the statistical analysis controls for sample selection bias that might be due to non-random sampling (Heckman, 1979).

In addition, in order to test for the existence of multicollinearity, we examined the variance inflation factor (VIF), including the interaction terms, after all variables were grand-mean centred. The mean of the VIFs is 2.45, with a range varying from 1.11 to 4.45, suggesting that the VIF of each variable is below the conventional threshold ($VIF > 10$), and thus our data do not raise multicollinearity concerns (Myers, 1990; Neter, Kutner and Wasserman, 1990).

Results

Table 1 shows the descriptive statistics. In our sample, 319 (23.3%) affiliates are EJVs, and 1049 (76.7%) affiliates are WOSs. The 46 Belgian MNEs had entries in 66 different countries.⁶

Table 2 shows the results of our hypotheses testing to predict the likelihood of WOSs. Model 1

(firm age) + β_2 (industry dummies) + β_3 (region dummies in Belgium) + ϵ . The first-stage model is statistically significant ($\chi^2 = 22.13, p < 0.05$)

⁶More specifically, 505 WOSs and 139 EJVs were located in EMU countries, 167 WOSs and 29 EJVs in other EU countries (non-EMU), and 377 WOSs and 151 EJVs in host countries outside the EU.

includes only control variables, and Model 2 shows the main effects of institutional risk and cultural distance. Models 3 and 4 examine the interaction effects of regional integration, and Model 5 is the fully specified model.

The conventional international business literature suggested that higher levels of institutional risk and (albeit more controversial) cultural distance would decrease MNE preferences for WOSs. In Model 2, both institutional risk and cultural distance are indeed negatively associated with WOSs, even though the effect of cultural distance is statistically significant only at $p = 0.10$ level.

In our Hypothesis 1, we suggested an interactive effect of national institutional risk and regional integration on entry modes. The results from Model 3 support this hypothesis ($\beta = 1.06, p < 0.01$), indicating that MNEs prefer WOSs (over EJVs) when there is a high level of national, institutional risk for their subsidiaries located in EMU countries. However, the conventional argument from the international business literature is confirmed for subsidiaries in non-EMU countries such that higher levels of institutional risk would increase MNE preferences for EJVs.⁷

We also predicted an interactive effect of regional integration on the relationship between

⁷Marginal effects of institutional change are $dy/dx = 0.073$ ($p \leq 0.10$) for foreign affiliates inside the EMU, and $dy/dx = -0.053$ ($p \leq 0.001$) for foreign affiliates outside the EMU. The contrasts of average marginal effects are also statistically significant ($Chi-square = 6.53, p \leq 0.01$), suggesting that there is a significant difference in terms of entry-mode choices between entering inside vs. outside the EMU.

Table 2. Results of multilevel mixed-effects logistic regression (dependent variable: likelihood of wholly owned subsidiary)

	Model 1		Model 2		Model 3		Model 4		Model 5	
	β	SE	β	SE	β	SE	β	SE	β	SE
Constant	2.00*	(0.90)	1.35	(0.93)	1.83 [†]	(0.96)	1.38	(0.94)	1.83 [†]	(0.96)
<i>Controls</i>										
Geographic distance	-0.10	(0.07)	0.02	(0.08)	-0.04	(0.08)	0.01	(0.08)	-0.04	(0.08)
Firm size	-0.36*	(0.17)	-0.37*	(0.17)	-0.36*	(0.18)	-0.38*	(0.18)	-0.36*	(0.18)
Marketing advantages	-0.69	(0.80)	-0.70	(0.80)	-0.73	(0.80)	-0.66	(0.81)	-0.73	(0.80)
R&D intensity	0.10	(0.69)	0.09	(0.70)	0.14	(0.71)	0.09	(0.71)	0.14	(0.71)
Experience – international	0.02	(0.01)	0.02 [†]	(0.01)	0.02 [†]	(0.01)	0.02 [†]	(0.01)	0.02 [†]	(0.01)
Experience – country	0.01*	(0.00)	0.00	(0.00)	0.00	(0.00)	0.00	(0.00)	0.00	(0.00)
Family firm	0.56	(0.58)	0.61	(0.58)	0.58	(0.59)	0.59	(0.59)	0.58	(0.59)
Inverse Mills Ratio	0.53	(0.96)	0.57	(0.97)	0.55	(0.98)	0.55	(0.99)	0.54	(0.98)
<i>Moderators</i>										
Regional integration (EMU)	-0.30	(0.22)	-0.47*	(0.23)	-0.11	(0.27)	-0.49**	(0.23)	-0.12	(0.28)
<i>Main effects</i>										
Institutional risk			-0.39***	(0.10)	-0.46***	(0.10)	-0.41***	(0.10)	-0.46***	(0.11)
Cultural distance			-0.17 [†]	(0.09)	-0.05	(0.10)	-0.06	(0.12)	-0.04	(0.12)
<i>Moderating effects</i>										
Institutional risk × regional integration					1.06**	(0.37)			1.03*	(0.42)
Cultural distance × regional integration										
Wald-Chi Square (d.f.)	17.79(9)*	33.73(11)***	41.28(12)***	35.21(12)**	41.27(13)***				-0.25	(0.18)
Δ Chi-square Statistics (d.f.)		16.05(2)***	24.19(3)***	17.95(3)***	24.22(4)***					

*** $p \leq 0.001$, ** $p \leq 0.01$, * $p \leq 0.05$, [†] $p \leq 0.10$. Two-tailed coefficient test ($N = 1368$). Δ Chi-square statistics represents changes in Chi-square values over the baseline models with only control variables (Model 1).

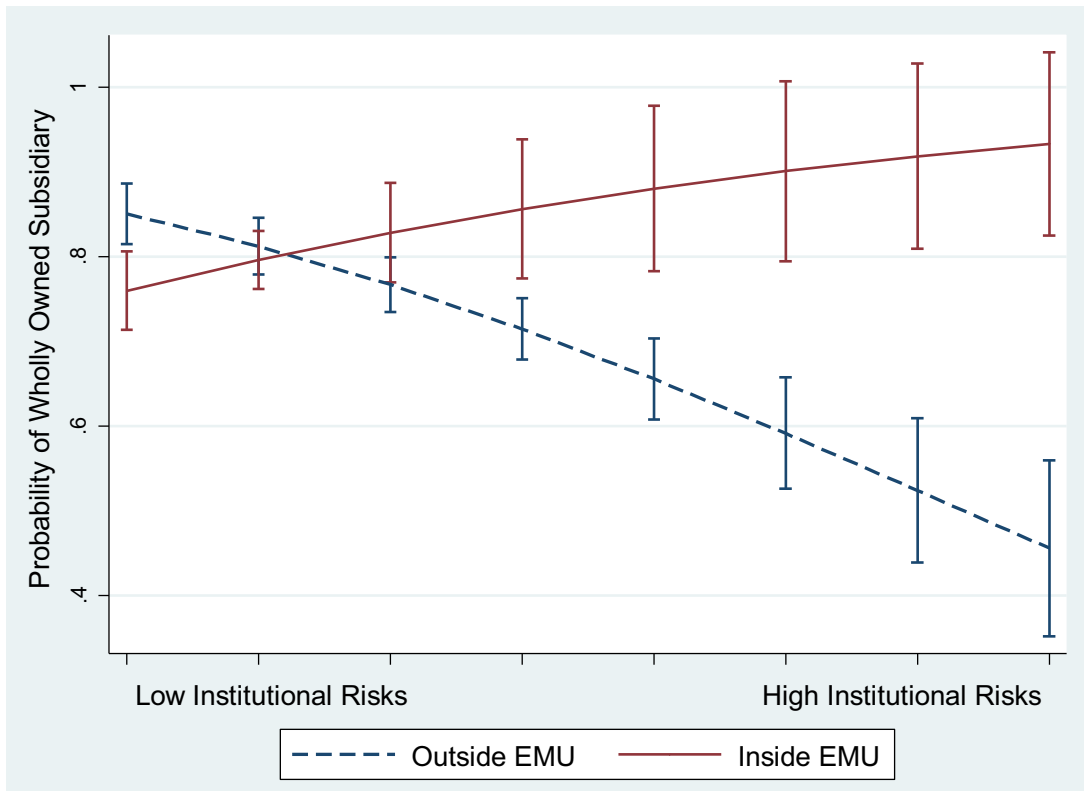


Figure 1. Relationship between institutional risks and probability of wholly owned subsidiary [Colour figure can be viewed at wileyonlinelibrary.com]

cultural distance and entry-mode choice in Hypothesis 2, in the sense that the expected impact of higher cultural distance on the preference for EJVs would be reversed within the EMU. However, the predicted interactive effect of cultural distance and regional integration on the observed entry mode was not statistically significant in Model 4 or Model 5. Thus, Hypothesis 2 was not supported.

To visualize the interaction effect for international operations established in the post-EMU period, we plotted the effects of institutional risk on entry-mode strategies at different conditions of regional integration. Figure 1 indicates that MNEs show different decision patterns, depending on whether operations are located in the EMU (i.e. a ‘disordinal’ interaction pattern). For entry decisions in EMU countries, MNEs prefer WOSs as national institutional risk increases. In contrast, for operations in non-EMU countries, MNEs follow the more conventional logic, and prefer EJVs as the level of institutional risk increases.

Supplemental analyses

We conducted a number of supplemental analyses to assess the robustness of our findings. Given that the distinction made between an EJV vs. a WOS has not always been clear-cut in the past, we also adopted 90% and 100% (instead of 95%) equity cutoff rates. We also used the percentage of ownership level as a dependent variable. These results were consistent with the initial outcomes, but with slightly different levels of significance. In addition, we used the EU instead of the EMU as a variable for regional integration. The EU and the EMU are highly correlated ($r = 0.75$, $p < 0.001$) and the results are similar to the reported ones. We also included industry (i.e. NACE-BEL industry classification) and year dummy variables to control for the industry effects and time effects. Our results are similar when industry and year dummy variables are included. Lastly, while the euro was introduced as ‘book money’ in January 1999, the actual physical notes and coins were distributed as of January 2002. Therefore, we examined the

sample period covering only the years 2002–2014 ($N = 1,143$), when the euro notes and coins were physically used. The results are similar to Table 2. We assessed whether the effect of regional integration might simply result from geographic proximity. Thus, we conducted additional analyses using geographic distance as an interaction variable. We did not find any interaction effects of geographic distance on the entry-mode choice, suggesting that what matters to the MNE's entry-mode decision is actually the institutional features of regional integration, not just geographic proximity.

Finally, we conducted a subgroup analysis, and the results confirm our findings. For entry decisions in EMU countries ($N = 644$), MNEs prefer WOSs as national institutional risk increases ($\beta = 0.67$, $p < 0.05$). However, for entry decisions outside EMU countries ($N = 724$), MNEs are less likely to use WOSs as institutional risk increases ($\beta = -0.50$, $p < 0.001$).

Discussion

This study focuses on the effects of regional integration (EMU), institutional risk and cultural distance on MNE entry-mode strategies. Our findings suggest that regional integration is a critical factor in internationalization decisions. We also do provide support for mainstream international business theory suggesting that higher, national institutional risk positively affects the likelihood of EJVs as the MNE's preferred entry mode outside the EMU. However, in the case of far-reaching regional integration, in this case the EMU, we empirically show that higher institutional risk actually tends to reverse the conventional effect: it increases rather than decreases MNE preferences for WOSs in host countries inside the EMU, since insider MNEs 'prefer the control to "do it their way"' (Anderson and Gatignon, 1986, p. 18).

Multinational enterprises appear to have a high level of confidence in their ability to manage national institutional risk themselves, possibly because of the presence of overarching, high-quality regional institutions, with which they are familiar, but also because requisite complementary assets can now more easily be accessed in efficient external markets, thus vitiating the need for EJV partners. National institutional risk – rather than remaining an exogenous parameter, to be managed through the complementary resources from a

local EJV partner – becomes a variable on which the MNE may want to exercise more control through establishing WOSs, especially where such national risk is supposedly higher.

This approach becomes similar to the management of micro-level contracting risk, whereby the MNE decides to forego complementary resources provided by potential EJV partners in order to keep full control over the use of its own resources reservoir, while accessing complementary resources in efficient external markets. With harmonized economic, fiscal and monetary policies in the home and the host country, insider firms focus on the full exploitation of their distinctive advantages without having to worry about possible dysfunctional spillover effects from the macro level to the micro level of contracting when EJVs are used.

The UK referendum that ended in favour of Brexit has given a high visibility to the ongoing public debate about the desirability of differential integration levels, especially through the presence of euro-insiders and euro-outsiders, i.e. a 'two-speed' Europe. For example, euro-outsiders must address the trade-off between increased formal interdependence with the EU vs. more state-based sovereignty, with Brexit-like scenario's representing one extreme option (Adler-Nissen, 2016). As our results show, these macro-level political uncertainties do also affect business and can lead to differential considerations by firms on the impact of institutional risk, irrespective of whether the host country is an EMU insider or other EU country. In likely scenarios whereby populist movements in both EMU insider countries and other EU countries will increase national institutional risk for foreign MNEs (e.g. in countries such as Austria and Poland), but will remain short of forcing an exit scenario, our prediction is that regional insider MNEs will increasingly try to avoid EJVs and will exhibit a stronger preference for WOSs, so as to prevent macro-level frailties from spilling over to the micro level. The likelihood of such negative spillovers from the macro level to the micro level is actually rather high. Meyer (2017) compellingly argued that the benefits of higher globalization (which would actually include deeper regional integration as a stepping stone) outweigh any negative side effects. He explained that recent populist movements against globalization are not rooted in globalization concerns per se, but have arisen from failings of domestic policies (Kobrin, 2017, p. 169). This observation is important, because it

suggests a sociological rationale for the predicted, added micro-level challenges when engaging with local EJV partners in high-institutional-risk countries. If foreign MNEs are viewed negatively as ‘agents of globalization’, the self-imposed barriers against contract breaches by local EJV partners (often called forbearance in the EJV context) are likely to weaken, thus making WOSs more attractive for the foreign MNEs.

Our overall results reveal that, in the period between 1999 and 2014, cultural distance did not have a statistically significant effect on MNE internationalization (see also Beugelsdijk *et al.*, 2018). When assessing the interaction effect of regional integration, this interaction term was not statistically significant either, meaning that MNEs do not perceive cultural distance as a critical variable to entry-mode strategy (Shore, 2000). The reason, in our view, is that cultural distance does not necessarily translate into objectively higher hazards for the MNE in terms of behavioural dysfunction in micro-level contracting: higher cultural distance at the macro level does not need to spill over to more expected dishonesty or broader unreliability in micro-level contracting. This observation is in line with the view that a clear distinction must be made between, on the one hand, cultural values and related distances at the societal level and, on the other hand, the personal values of individuals. Here, the intra-country variation in values can be much larger than cross-country variation (see e.g. Fischer and Schwartz, 2011; Verbeke, Yuan and Kano, 2018). This statement holds true especially for host countries that share extensive common ground in cultural terms with a firm’s home country. In our paper, we explain what far-reaching, regional integration means, i.e. to a large extent national institutions being replaced by business-friendly, high-quality, non-discriminatory, reliable institutions. This is of course the essence of the Single Market, the common EMU monetary policy and the single currency.

Cultural distance may still be important when studying a variety of other international business phenomena (e.g. the effectiveness of cross-cultural teams; the adoption of established managerial practices by host-country operations; the magnitude of reverse knowledge transfers), or differences within countries (see Taras, Steel and Kirkman (2016) for a recent contribution related to this last point). But our study contributes to the growing body of literature suggesting that broad cultural

distance indices may not be particularly useful in studies of MNE entry-mode choices. Beugelsdijk, Ambos and Nell (2018) in their methodological overview of the most important cultural distance indices used in international business research, make the important point that these cultural indices are useful to measure distance in general, but typically do not perform well in terms of their explanatory power when specific, theory-based research questions need to be answered, in this instance related to actual business risks associated with human frailty.

Managerial relevance

Our study has two key managerial implications. First, in a situation of far-reaching regional integration, our research provides support for the increasing relevance of the region as a determining context of entry-mode strategies for ‘insider’ MNEs. A sole focus on widely accepted, national-level explanatory variables appears insufficient to understand the impact of locational context. Further research on the subject matter is needed, especially in terms of studying MNEs from several other EMU countries, but the insight gained from our work is that MNE managers are unlikely to see higher national institutional risk as a trigger for moving from WOSs to EJVs in the home region, driven by the notion that a local EJV partner would provide the resources required to address such risk effectively. On the contrary, higher national institutional risk within a strongly integrated region becomes a parameter that the firm may want to manage itself at the micro level via setting up WOSs, just as it manages conventional micro-economic contracting risks in the realm of knowledge dissipation. Country-level risks that were conventionally viewed as requiring complementary resources from a local partner are now considered risks that can best be managed through a stronger emphasis on internalization. In the presence of common regional institutions favourable to business, managing national institutional risk through internalization becomes the preferred option. Internalization of host-country operations can be combined with accessing requisite complementary resources in more efficient external markets. This external resource acquisition process should not be made more complex by adding a partner who could take advantage of frail national institutions.

Second, given the observed reversal of institutional risk effects inside the home region, it would appear likely that managers will move away from focusing mainly on low-institutional-risk countries as investment targets, and will instead pay more attention to each country within the region as a potential target for future operations as a function of its economic potential, with less overall attention devoted to the challenges of managing frailties. Regional integration *de facto* makes the national borders of host countries permeable and alters the MNE's decision-making frame when selecting entry modes.

Limitations and future research directions

Our analysis has two main limitations. First, our sample included only MNEs with a corporate head office in Belgium and listed on the Belgian stock exchange, so that the results may not be fully applicable to privately held firms or firms from other EMU/EU home countries. In 1957, Belgium was one of the six nations signing the Treaty of Rome, and it is located in the region's geographic centre. Hence, Belgian firms may have a 'time advantage' over companies located in countries that are more recent signatories of European regional integration treaties, even if these are now also EMU participants. Whether our results will be confirmed for firms originating from more recent, and more geographically peripheral, treaty signatories is uncertain at this point. Future studies should therefore include firms from other MNE home countries inside the EMU and the EU. Here, it may be important to distinguish between early and more recent treaty signatories and to take into account their location, i.e. central vs. peripheral countries within the EMU, and differences at the subnational level (Castellani, Meliciani and Mirra, 2016). Moreover, follow-up research could examine the impact of 'weaker regional integration' agreements such as ASEAN and NAFTA or BIT (e.g. Oh and Fratianni, 2017), to assess whether the EMU results of our study continue to hold.

Second, the present study's data analysis has focused on initial entry-mode choices for a 15-year period (1999–2014), and not on the evolution of the operating mode after the initial entry. We acknowledge that there could be differences in the likelihood of termination between WOSs and EJVs, and according to the host country considered (Makino and Neupert, 2000). For example,

the conflict potential between partners may drive MNEs to transform EJVs into WOSs over time (Hennart, 1991). The question could also be raised whether some MNEs might actually have exited a host country after an initial entry, thereby building on an existing knowledge pool inside the firm for any subsequent entry in the same country within our timeframe. However, this is not a concern in our study: Our archival analysis of entries for each individual firm in our database did not lead us to identify any such cases.

Future research could benefit from the use of data on entry-mode structures for multiple home countries simultaneously, and include alternative constructs/approaches to address the effects of formal and informal institutions, e.g. by adding the interrelationships between institutions (Holmes *et al.*, 2013), or the direction of distance (Hernandez and Nieto, 2015). In addition, survey-based data could be considered that would include financial, strategic or managerial risk preferences. This type of study could extend our insight into regional integration impacts by adding more micro-level parameters.

Conclusion

In this study, we have considered the impact of home–regional integration on two conventionally assumed drivers of MNE entry-mode choices, namely institutional risk and cultural distance between countries. More specifically, we have investigated the EMU's impact on MNE entry-mode choices. Building on a sample of 1368 foreign market entries of Belgian MNEs, our study has extended prior research on entry-mode choices by differentiating between investments inside and outside the EMU. Cultural distance does not appear to be relevant for strategic decision-making, in terms of entry-mode choice, either as a main effect or when linked with regional integration as an interaction variable. This is a result that merits reporting, because a large prior literature did predict a positive main effect on MNE preferences for EJVs. The main reason is probably that the mechanisms through which cultural distance in general could supposedly influence entry-mode choices can be varied. In our case, the contextualization is also critical: It is one where a change in formal institutional arrangements at the macro level supposedly influences micro-level hazards.

We did formulate a hypothesis whereby higher cultural distance would, in parallel, exacerbate frailties at the micro level when using EJVs. But higher cultural differences at the macro level do not necessarily translate at all into new micro-level frailties. Here, it is probably fair to state that most extant studies measuring the impact of cultural distance were under-contextualized.

Importantly, our results demonstrate that, inside the home region, the conventional positive impact of national institutional risk on preferences for EJVs is reversed because of regional integration: In the presence of a reliable, regional regulatory regime, higher national institutional risk is viewed as a frailty that could cascade down to micro-level relationships with EJV partners, and that can more easily be managed within the context of a WOS. At the same time, the conventional international business theory prediction of a positive impact of institutional risk on the preference for EJVs outside the integrated home region remains valid.

As a final point, the present populist movements observed throughout the world in favour of stronger national sovereignty imply higher institutional risk associated with foreign entries in the countries where these movements can actually influence policy. Within an integrated region such as the EMU, with well-functioning regional institutions, this might imply an even stronger preference for WOSs (e.g. investments from EMU firms into Greece), because of the regional institutional reliability, combined with the fear that frailties at the national level may spill over to micro-level contracting with EJV partners. For investments outside the region in a country with new protectionist tendencies (such as investments by EMU firms in the USA), we predict a stronger preference for EJVs to navigate more effectively the new institutional uncertainties. Here, 'regional outsider' MNEs cannot rely on the same regional layer of high-quality institutions benefiting insider MNEs.

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