Chapter 1

Introduction

“Even though there is now a considerable and growing body of research on various aspects of internationalization, there remains limited development and questioning of the basic concepts that underpin internationalization as a process. Indeed, one could argue that we have barely scratched this surface.”

—Liesch and colleagues (2002: 26)

1.1 An introduction to internationalization processes

This book deals with a fundamental issue in International Business studies, namely the processes by which firms develop their international activities. In the field of International Business, this topic was first addressed well over four decades ago; most prominently by a group of Swedish scholars at Uppsala university. Ever since, the contexts in which firms operate have changed tremendously. There have been both anticipated and unanticipated shifts in geopolitical power, and bold steps have been taken toward greater social, political, and economic integration. At the same time, we’ve witnessed a decline in barriers to trade, a worldwide increase in wealth (often combined with rising inequality), and vast technological developments in information technology. Such changes, it has been argued, have forced firms to considerably alter their behaviour in order to survive in today’s global environment (Axinn and Matthyssens, 2002).

What has not changed, however, are the basic challenges faced by firms deciding to cross borders. Inexperienced firms lack an in-depth understanding of the foreign markets they seek to enter, such as of local business and market conditions, and firms are often unacquainted with the local contexts of foreign markets. In addition, newly internationalizing firms lack experience in setting up and organizing their activities abroad, which is far more complex than the day-to-day management of domestic operations.
Internationalization Decisions

The central notion in behavioural models of internationalization processes is that the uncertainty caused by a lack of knowledge and experience must influence the decisions firms take, such as which markets to enter and whether to do so by exporting or perhaps through the establishment of a local subsidiary. The main reasoning of behavioural internationalization scholars is that decision-makers deal with uncertainty both through incremental decision making and by learning ‘on the go’ through experience (e.g. Wiedersheim-Paul, 1972; Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977). This, it is argued, is reflected in the internationalization patterns of firms. In terms of market selection, firms are expected to prefer markets which are relatively similar to the home market, as such markets are more easily understood. In terms of a firm’s involvement in foreign markets, it is argued that firms prefer to ‘test the water’, such as through exporting or a local representative, before gradually increasing their direct involvement in a foreign market.

Yet both empirical and anecdotal evidence suggest that firms often do enter foreign markets through relatively committed modes of entry, such as through the establishment of a local subsidiary. For example, in Brouthers’ sample of 178 foreign market entries (Brouthers, 2002), 61% of the entries were wholly owned subsidiaries and 26% joint ventures, while only 13% consisted of foreign entries through licensing and exporting. Even among inexperienced small and medium sized enterprises (SMEs), the establishment of wholly-owned subsidiaries is not uncommon (Nakos and Brouthers, 2002; Pinho, 2007; Rasheed, 2005). In fact, research has identified a group of SMEs—commonly known as international new ventures or ‘born-globals’—which are characterized by rapid international involvement even at inception (Oviatt and McDougall, 1994; Shrader, Oviatt, and McDougall, 2000).

Similarly, the notion that firms prefer to enter markets that are more similar to the home market has received mixed support. For example, on the one hand both Grosse and Goldberg (1991) and Grosse and Treviño (1996) find that firms originating from culturally more different countries tend to be less directly involved in the United States, in terms of both assets and offices (Grosse and Goldberg, 1991) and foreign investment (Grosse and Treviño, 1996). Yet neither Engwall and Wallenstål (1990), Benito and Gripshrud (1992), Mitra and Golder (2002) nor Ellis (2007) find support for the idea that firms gradually expand into countries which are culturally increasingly more different. At the very least, such conflicting findings should give rise to healthy scepticism regarding the importance attached to country differences in explaining foreign market selection.

These examples barely do justice to the vast body of International Business (IB) literature on internationalization, but they are illustrative of the state of play: While our understanding of internationalization processes has greatly improved, for example in terms of our understanding of the different components of experiential internationalization knowledge (Eriksson, Johanson, Majkgård and Sharma, 1997; 2000) or in terms of our understanding of the importance of business networks (e.g. Johanson
and Mattson, 1988; Blankenburg Holm, Eriksson, and Johanson, 1996; Leonidou, Katsikeas, and Hadjimarcou, 2002), empirical studies on the basic drivers of internationalization processes continue to produce conflicting results. Such conflicting findings indicate that despite the steady increase in research on internationalization over the last two decades, the exact factors affecting human decision-making in the context of internationalization are still not fully understood.

What is more, as the quotation at the beginning of this introduction illustrates, theoretical progress has been limited. The dominant theory explaining the processes by which firms internationalize—the learning-based ‘Uppsala’ or ‘Nordic’ model—has remained virtually unchanged. This, to some extent, is testimony to the relative robustness of the model, and to the appeal of the behavioural perspective it adopts to understanding internationalization as a process. Yet while the key assumptions of the Uppsala model correspond closely to early scholarly work on organizational learning and decision-making, such as Cyert and March (1963) and Aharoni (1966), the assumptions of the model have not changed following more recent insight into both organizational learning and human decision-making (Forsgren, 2002). The objective set out here is to improve on the state of play by reconsidering, both theoretically and empirically, some of the basic factors affecting internationalization decisions; in particular the importance of country differences and actual knowledge.

The central thesis of this book is simple: Apart from the attractiveness of foreign markets in terms of factors such as size, distance, entry barriers and market potential, the internationalization process of firms is mainly driven by the extent to which foreign markets are perceived as familiar, which reduces the risk and uncertainty associated with foreign market commitments. This thesis builds on two related assumptions underlying human decision-making, namely that decisions are based on both actual knowledge and the subjective beliefs which decision-makers hold to be true (Simon, 1947; 1991), and that both substantiated knowledge and unsubstantiated beliefs reduce the uncertainty which decision-makers experience. To understand how this thesis advances the explanatory power of internationalization models, some explication of current theories on internationalization—and internationalization process theory in particular—is essential. Hence, apart from providing an outline of the remainder of this book, I will use this chapter to provide a brief introduction to IB theories on internationalization, and to some of the core concepts in this book.

1.2 Theories on internationalization

Theories on internationalization—understood as “the process of increasing involvement in international operations” (Welch and Luostarinen, 1988: 36)—can be divided and classified along several lines. For example, theories on internationalization can be divided into theories which seek to explain the degree of market
commitment of the firm—in terms of the commitment of resources and/or the selected mode of entry—and those which seek to explain the selection of particular foreign markets over other markets. A second division is between theoretical perspectives which are rooted in economics, and behavioural theoretical perspectives on internationalization. Table 1.1 presents a classification of theories on internationalization in International Business along these lines.

**Degree of market commitment**

Over the past two decades, transaction cost theory (TCT) (Williamson, 1975; 1981) has “served as the overriding perspective for theorizing entry mode choice and, accordingly, transaction-cost-related covariates have been recognized as major determinants of entry mode decision” (Zhao, Luo and Suh, 2004: 525). From a transaction cost perspective, entry mode selection is approached as an issue of governance, and entry mode selection is largely treated as a relatively isolated economic decision. Firms are expected to select the entry mode with the lowest transaction costs, given a particular degree of asset specificity, and considering the combined effect of asset specificity and external uncertainty, internal uncertainty, and the potential for free riding by potential business partners (Anderson and Gatignon, 1986). Meta-analysis has established empirical support for the basic predictions of the TCT perspective on entry mode selection (Zhao, Luo and Suh, 2004), in particular when only the crude dichotomous trade-off between markets (such as exporting) and hierarchies (equity-based entry modes) is considered. Yet the TCT perspective is not without limitations (see for example Ghoshal and Moran, 1996) and IB scholars increasingly share the view that “transaction cost thinking […] could be enriched by coopting variables and concepts from other disciplines with a richer tradition of in-depth analysis of organizational functioning” (Verbeke, 2003: 499).

Closely related to transaction-cost-based perspectives on internationalization—in that the form of an MNEs involvement in foreign markets is similarly explained by market imperfections—is internalization theory, as developed in the work of Buckley and Casson (1976; 1998) and Rugman (1981). Internalization theory views the MNE as a bundle of resources and activities which can either be internalized and exploited or externalized, depending on costs and the benefits generated by imperfections in external markets. Entry mode selection and international expansion is largely framed as an issue of where to draw the border of the MNE; which is dependent on whether the costs and benefits of exploiting proprietary knowledge and controlling the firm’s activities through firm-based entry modes outweigh the benefits and costs of exporting, or of licensing the firm’s knowledge and activities to local partners.
Table 1.1: Classification of theories on internationalization in International Business

<table>
<thead>
<tr>
<th>Theoretical foundations</th>
<th>Theoretical scope</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Market commitment</td>
</tr>
<tr>
<td><strong>Economics-based theories</strong></td>
<td>Transaction cost theory</td>
</tr>
<tr>
<td></td>
<td>Knowledge-based theory of the MNE</td>
</tr>
<tr>
<td><strong>Behavioural theories</strong></td>
<td>Innovation models</td>
</tr>
</tbody>
</table>

A second related perspective is the knowledge-based evolutionary perspective of the multinational corporation, which views the multinational enterprise (MNE) as the superior vehicle to transfer tacit knowledge across borders (Kogut and Zander, 1993; Tallman, 2003). As such, foreign expansion is explained by the competitive capabilities of a firm to successfully create, replicate, and transfer knowledge abroad (Kogut and Zander, 1993), and firms with a strong technological base and a rich knowledge structure are therefore predicted to expand internationally through startups rather than through acquisitions (Barkema and Vermeulen, 1998). Compared to internalization and transaction cost perspectives on entry and establishment mode selection, Kogut and Zander’s work emphasizes that alternative modes are evaluated in terms of differences in their potential for value creation, rather than in terms of differences in transaction costs.

The various innovation models of internationalization (e.g. Bilkey and Tesar, 1977; Cavusgil, Bilkey and Tesar, 1979; Reid, 1981) present a different view on the degree of foreign involvement, in that the development of export behaviour is represented as an organizational innovation process. The various models describe the early stages of export behaviour in terms of several sequential export stages. For example, Reid (1981) distinguishes between five consecutive stages, ranging from export awareness—in which the need or opportunities for exporting is recognized—to adoption or rejection of exporting. The innovation models are highly intuitive, yet the
various models also suffer from their descriptive nature and possess limited explanatory power. Although most authors at a later stage invested in further explaining why firms move from one stage to the next (Andersen, 1993), these models generally suffer from a “lack of proper theory” (Andersen, 1993: 217). In addition, the question on what basis firms select some foreign markets over others is largely left unanswered.

Location choice

Emphasizing such factors as local demand and transportation costs, factor endowment, and local governance policies, the location of foreign trade and investments has by nature been the domain of international economists. To these explanations, International Business adds factors which explain differences in location-choice between firms, mainly by emphasizing firm-level differences in the attractiveness of foreign markets, and differences in the costs MNEs incur when doing business abroad. These differences have been argued to stem from such characteristics as the country of origin (e.g. Henisz and Delios, 2001; Johanson and Vahlne, 1977; 1990), MNE strategy (Makino, Lau, and Yeh, 2002; Chung and Alcacer, 2002), and MNE experience (e.g. Davidson, 1980; Johanson and Vahlne, 1977; 1990). Apart from internationalization process theory, discussed in the next section, IB scholars have mainly relied on the work of John Dunning and, to a much lesser extent, Raymond Vernon to explain location choice.

Vernon’s product life-cycle model (Vernon, 1966) relates shifts in international trade and investment to shifts in local demand, and to shifting factor costs over the course of an industry’s product life cycle. As a product moves through the various stages of its life cycle, gradually moving from product development to product maturity, “concern about production cost […] take[s] the place of concern about product characteristics” (Vernon, 1966: 196). At the same time, Vernon argues, demand for the product may gradually spread to less-advanced economies. This gradually causes the location of production to shift from the country in which the product was developed (in Vernon’s work, the United States) to less-advanced countries with lower production costs, where firms from the home country eventually face competition from local entrepreneurs. Over the course of a product’s life cycle, this gradually turns the country of origin of a particular product from a net exporter into a net importer.

The second and more prominent theoretical perspective in International Business on the location of MNE activity is the eclectic paradigm developed in the work of John Dunning (e.g. Dunning, 1958; 1988). Dunning explains the activity of firms abroad by arguing that foreign investment is a function of the competitive advantages which encourage firms to internationalize (O), of the competitive advantages of some locations over others (L), and of the extent to which a firm
decides to internalise its foreign activities (I). The extent and location of a firm’s activities are largely explained by Williamsonian and International Economics-based arguments respectively. Although more of a theoretical framework than a theory in itself, the eclectic ‘OLI’ paradigm is one of the few IB perspectives on MNE activity which seeks to explain both the extent and the location of foreign investment and international production. However, due to the generality of the eclectic paradigm (Dunning, 1988), and as Dunning’s work focuses primarily on explaining the investment pattern of groups of firms at either the country or industry level (Dunning, 2001), the eclectic paradigm has limited power in explaining the internationalization behaviour of individual firms.

1.3 Internationalization process theory

In contrast to the theoretical perspectives on internationalization discussed above, internationalization process theory is concerned with resource commitment, market selection and sequence. It is less concerned with the question why firms internationalize, and instead focuses on how, where, and when. Originating in the work of Swedish scholars in the 1960s and 70s, (e.g. Carlson, 1966; Wiedersheim-Paul, 1972; Johanson and Wiedersheim-Paul, 1975) internationalization process theory adopts a behavioural approach to internationalization, rooted in the work of Cyert and March (1963), Aharoni (1966) and Penrose (1957). It is assumed that internationalization does not result from the optimal allocation of resources based on a careful comparison of alternative foreign markets and modes of entry. Rather, internationalization process theory relates market selection, market commitment and sequence to the uncertainty and risks internationalizing firms experience due to a lack of information and experiential knowledge, by positing that firms primarily deal with risk and uncertainty through incremental decision-making and by learning about foreign markets and international operations.

Internationalization process theory applies this notion to address two distinct patterns: the degree of market and resource commitment within foreign markets, and foreign market selection. Based on the observation that Swedish firms often develop their operations abroad incrementally rather than treating their foreign operations as one-off investments (e.g., Wiedersheim-Paul, 1972; Johanson and Wiedersheim-Paul, 1975), internationalization process theorists predicted that what initially defers the commitment of resources to a foreign market, is a lack of local-market knowledge. As firms accumulate local-market knowledge through experience, their involvement in the foreign market is expected to increase in terms of both the mode of operation and the commitment of resources (Johanson and Vahlne, 1977, 1990); a process which is labelled the ‘establishment chain’ (Johanson and Wiedersheim-Paul, 1975). In a sense, internationalization process theory thus characterizes the internationalization process
within foreign markets as a gradual 'learning through experience' process (O'Grady and Lane, 1996).

Second, internationalization process theory predicts that in addition to factors such as market size and market potential, firms initially select foreign markets on the basis of their psychological closeness to the home market (Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977). The degree of psychological or 'psychic' distance between the home and the foreign market is strongly related to country differences, such as differences in language, culture, and political system, which are assumed to disturb the flow of information. As similar countries are therefore assumed to be easier to understand, internationalization process theory predicts that firms experience less uncertainty towards these markets, and that firms enter markets which are more similar, before psychically more distant—less similar—markets are entered (Johanson and Vahlne, 1990). As such, the notion of psychic distance is employed as the cognitive link between foreign markets and the uncertainty decision makers experience towards these markets. Taken together, internationalization is characterized by the gradual expansion into psychically more distant markets, combined with a gradually deepening involvement in those markets in which the firm is already active—much, it has been noted, like the rings which appear on the water when throwing a pebble in a pond.

The value of the behavioural perspective internationalization process theory employs in understanding the dynamics of internationalization is evident. Yet at least two observations support a critical review of the basic assumptions of internationalization process theory—in particular the idea that firms eschew foreign countries that are dissimilar from the home country, and the idea that actual local market-knowledge is the main driver of internationalization decisions. First, empirical support for the basic predictions of the internationalization process model has been mixed. Second, the psychic distance concept, in particular the association of psychic distance with cultural differences, has also been criticized on conceptual grounds.

**Empirical support**

Part of the charm of internationalization process theory is in its intuitive appeal. However, empirical support for some of the basic predictions of internationalization process theory is not undisputed; not even to the sympathetic observer (e.g. Björkman and Forsgren, 2000).¹

For example, while psychic distance is a widely accepted concept in the literature on export behaviour (Stöttinger and Schlegelmilch, 1998), empirical studies on the

---

¹ The studies considered here are empirical studies which were conducted relatively independent of the line of research which lead to the development of the internationalization process model.
effect of psychic distance on export activities are inconclusive. Dow (2000) for example, who uses a panel of experts to develop a psychic distance scale, finds that psychic distance is a highly significant predictor of early export market selection for his sample of Australian manufacturing firms. Yet Stöttinger and Schlegelmilch (1998), using subjective country distance scales, find no effect of psychic distance on the development of export activities of the firms in their sample. A related study by Klein and Roth (1989) on the export channel structure of 900 Canadian exporters instead suggests that the effect of psychic distance is dependent on the extent to which firms make use of specialised assets: While Klein and Roth find that perceived differences have a significant effect on the degree of forward integration of firms with low asset specificity (i.e. firms which make no extensive use of specialised assets), for firms high in asset specificity the coefficient of perceived country differences was not significant. A close look at the results of a study by Dow and Karunaratna (2006) instead raises the question whether all country differences are equally relevant in explaining the export behaviour of firms. Their analysis focuses on the effect of various potential psychic distance ‘stimuli’ on the trade intensity between 38 countries. The results show that while the coefficients for differences in the level of industrial development, the level of education, and religion are both negative and significant, the coefficients for differences in culture and common language, among others, are not significant.

Studies which instead focus on the effect of psychic distance and country differences on the location of foreign investments, tend to make use of absolute country differences such as cultural distance (Kogut and Singh, 1988) rather than subjective distance measures. As with studies on export behaviour, empirical studies on the effect of country differences on investment location are similarly inconclusive. Often cited studies by Davidson (1980) and Grosse and Treviño (1996) for example, appear to support the notion that firms prefer investments into markets which are more similar to the home country. Davidson (1980), focusing on foreign investments by 180 large U.S. firms, finds that internationally inexperienced firms in particular have a preference for investing in more similar foreign markets. Grosse and Treviño (1996) find that a similar pattern appears to hold for firms investing in the United States. In their study, both cultural and geographical distance were negatively related to the amount of foreign direct investment countries invest in the United States. However, a study by Benito and Gripsrud (1992) illustrates that support for the effect of country differences on investment location is not universal. Focusing on investment decisions by Norwegian firms, Benito and Gripsrud (1992) find no support for the idea that the sequence in which foreign investments are made is related to the cultural distance from Norway.

Perhaps the best support for the idea that psychic distance affects location decisions is found in studies which focus on market selection—whether through exporting or otherwise—and the internationalization process of firms. For example, in
his study on the internationalization process of Finnish firms, Luostarinen (1980) finds that the majority of Finnish firms (70%) tend to first enter those countries which are culturally most similar to Finland.\(^2\) Child, Ng, and Wong (2003) instead focus on the effect of psychic distance on the internationalization of Asian firms. The five Hong Kong firms which are the focus of their study initially internationalized into countries in South and Southeast Asia before other—predominantly Anglo-Saxon—countries were considered; thus lending additional support to internationalization process theory. Comparable effects are observed by Erramilli (1991) and Gipsrud and Benito (2005), who find that both U.S. service firms and U.K. retailers tend to only enter culturally more distant countries as international experience increases. Engwall and Wallenstål (1988) however, were unable to confirm a similar pattern—expansion from culturally close to culturally more distant countries—in their analysis of the internationalization process of Swedish banks.

Recent empirical studies focusing on ‘near-market’ effects challenge the importance attached to the degree of similarity between the home country and foreign markets. Mitra and Golder (2002) and Ellis (2007) for example, focusing on firms with a variety of Western origins and Chinese exporters respectively, find no support that the firms in their samples gradually expand into culturally more distant countries. In addition, Ellis (2007), using a panel of experts similar to Dow (2000) to construct psychic distance scales, found no direct effect of psychic distance on internationalization sequence. Instead, both studies suggest that firms tend to enter markets that are similar to previously entered markets, rather than to the home market; a notion which builds on the idea that the probability of entering a foreign market is affected by a firm’s knowledge of previously entered markets (Mitra and Golder, 2002).

Empirical support is similarly mixed for the notion of an establishment chain; or the idea that a firm’s involvement in a foreign country develops incrementally due to a lack of local knowledge and experience. Support for this notion has mainly come from Nordic scholars.\(^3\) For example, while Engwall and Wallenstål (1988) found no support for the idea that Swedish banks gradually internationalize into culturally more distant countries, they did find that local international commitments by the banks in their sample tended to gradually increase over time. Pedersen and Petersen (1998), analyzing the foreign resource commitments of 165 Danish firms, also found support for the idea of gradually increasing foreign resource commitments. In addition, they argue that the internationalization of any firm occurs incrementally, and that it is

---

\(^2\) In Luostarinen (1980), cultural distance consists of a combination of the level of economic development and education, and common language. Luostarinen also demonstrates that Finnish firms tend to enter foreign markets more committedly—such as through investment-based production and marketing operations—if the foreign country shares a common language. Due to issues of multicollinearity however, the level of education and economic development were not considered in this analysis (Luostarinen, 1980: 155-156).

\(^3\) For an overview of research by Nordic scholars on the validity of the internationalization model, see for example Björkman and Forsgren (2000).
merely a matter of the *pace* at which firms internationalize, rather than a question of whether internationalization occurs gradually or instantaneously. Support for the notion of gradually increasing commitments to foreign markets is not restricted to Nordic research. For example, in his earlier-mentioned study on foreign investment location by U.S. firms, Davidson (1980) also found support for the idea that local experience tends to increase the propensity of firms for further investments in a particular country.

However, the notion that firms abstain from foreign market commitments in the absence of local knowledge and actual experience with local markets has also been challenged. Focusing on Japanese market entries by Swedish firms, Hedlund and Kverneland (1985) for example found that at least half of the firms in their sample adopted a more direct approach to expansion of their Japanese activities than would be expected. Similarly, Turnbull (1987) found that the international expansion of the U.K. firms in his sample did not follow an evolutionary path. Studies by Sullivan and Bauerschmidt (1990), Millington and Bayliss (1990), Erramilli and Rao (1990), and Björkman and Eklund (1996) were also unable to confirm the incremental pattern of increasing market involvement predicted by internationalization process theory. Furthermore, as noted earlier, the notion of incrementalism also runs counter to the common empirical observation that firms in fact regularly enter foreign markets through relatively committed modes of entry, such as through wholly-owned subsidiaries (see e.g. Brouthers, 2002). And criticism of the idea of incremental internationalization has only intensified with the notion of rapidly internationalizing ‘born-globals’ or international new ventures and the advent of the ‘new economy’ (e.g., Oviatt and McDougall, 1994; Shrader, Oviatt, and McDougall, 2000; Oviatt and McDougall, 2005). In all, in a review of Nordic studies on the internationalization process of firms, Björkman and Forsgren (2000) describe empirical support for the establishment chain as “considerable, although not undisputed” (2000: 11).

*The conceptualization of psychic distance*

The key concept of psychic distance has also been the frequent subject of conceptual discussions. Following the widespread acceptance of psychic distance as a construct related to “differences in language, education, business practices, culture, and industrial development” (Johanson and Vahlne, 1977: 24), early studies on the effect of psychic distance focused primarily on cultural differences. The association of psychic distance with country differences was strengthened both by the growing conviction that cultural and psychic distance are closely related concepts (Harzing,

---

4 For an overview of environmental changes which pose a challenge to traditional internationalization theories, see Axinn and Matthyssens (2002); and, for a response to similar concerns, see Vahlne and Johanson (2002).
2003), and by the availability of simple measures of cultural distance. For example, in their seminal paper on the mechanism of internationalization, Johanson and Vahlne (1990) explain that the internationalization model “predicts, taking only psychic distance into account, that firms will start by invading “neighbouring” (in the cultural sense) markets” (1990: 17). Similarly, in their study on the influence of cultural distance on entry modes, Kogut and Singh (1988: 430) claim that “[c]ultural distance is, in most respects, similar to the “psychic distance” used by the Uppsala school”. Their study popularized the use of a simple measure of cultural distance based on the Hofstede indices (Hofstede, 1980), which facilitated the interchangeable use of cultural and psychic distance.

In response to growing convergence between psychic and cultural distance, from the mid-1990s onwards several authors suggested to broaden the measurement of psychic distance. Some suggested to include other factors relating to country differences, such as differences in language, and legal and administrative differences (Harzing, 2003), or differences in industry structure and the competitive environment (O’Grady and Lane, 1996). In a recent study, Brewer (2007) instead proposes to extend the measurement of psychic distance with indicators other than country differences alone. Others argue for psychic distance measures which measure perceived country differences (O’Grady and Lane, 1996; Evans et al., 2000; Dow, 2000; Harzing, 2003). This has resulted in psychic distance measures based on expert panels (Nordström, 1991; Dow, 2000), psychographic instruments (O’Grady and Lane, 1996), and large-scale questionnaires (Stöttinger and Schlegelmilch, 1998).

Yet despite much debate over how psychic distance is to be operationalized, actual theoretical development of the psychic distance construct has been surprisingly limited (Liesch et al., 2002; Dow and Karunaratna, 2006). This is problematic, as the lack of consistent empirical support for the psychic distance construct, noted in the previous section, may well result from a misconception about what causes decision makers to perceive some countries as psychologically more distant than others.

1.4 Outline

The issues raised above provide strong motivation for a critical assessment of two key assumptions on which internationalization process theory builds, namely the idea that firms eschew foreign countries that are dissimilar from the home country, and the idea that actual local-market knowledge is the main driver of internationalization decisions. In this book the validity of these assumptions is contested conceptually (Chapter 2), and assessed both through a quantitative analysis of the location of foreign investment (Chapter 4) and through an in-depth case study of the internationalization process of a German publishing house (Chapter 5). These studies are strongly complementary. Chapter 4 assesses the effects of familiarity perceptions on internationalization decisions through objective measures by focusing on bundles of
internationalization decisions, namely the location of foreign direct investment. Chapter 5 instead examines the effects of subjective accounts of familiarity perceptions on internationalization decisions at the firm level. Taken together, the chapters in this book develop the notion that the perception of familiarity is an important yet much overlooked driver of internationalization decisions; a notion which, though simple, may help explain the observed heterogeneity in internationalization patterns. Below I provide a brief outline of the content of each chapter.

The central thesis of this book largely builds on the same behavioural foundations as internationalization process theory, but present a different explanation of what drives internationalization decisions. The purpose of Chapter 2 is to clarify the underlying reasons for this difference. To that end, Chapter 2 presents a conceptual critique of the two assumptions of internationalization process theory discussed above. It is argued that internationalization process theory overemphasizes the importance of knowledge in internationalization decisions, that the proposed link between country differences and uncertainty is underdeveloped and unconvincing, and that internationalization process theory is inconsistent in what is at the source of the uncertainty associated with internationalization decisions. Building on two suggestions from the literature on organizational decision-making, the notion of familiarity perceptions is then proposed as a central concept in understanding internationalization decisions, and several lines of research are developed which are addressed in the subsequent chapters.

In anticipation of the empirical study in Chapter 4, which focuses on the effects of historical ties and country differences on the location of foreign investment, Chapter 3 addresses the lack of an indicator of intrinsic institutional country differences. Recently, much progress has been made in the operationalization of potential country level psychic distance stimuli (Dow and Karunaratna, 2006; Brewer, 2007), such as differences in industrial development, political ideology and religion. What has been missing from most analyses however is a consideration of the effect of institutional differences. This, it is argued in Chapter 3, can be attributed to the lack of an appropriate institutional distance indicator. Existing indicators of institutional differences either capture differences in institutional quality and effectiveness (for examples see Delios and Beamish, 1999; Meyer, 2001; Wan and Hoskisson, 2003), or differences in the regulative, normative and cultural-cognitive elements which affect organizational behaviour in a particular setting (Kostova, 1997; Busenitz et al., 2000; Kostova and Roth, 2002). What is still lacking however is an indicator of intrinsic institutional country differences; or, in other words, an indicator which captures the type of differences in socio-economic organization which can be found between, for example, the advanced economies of Sweden, the United States, and the Netherlands.

In Chapter 3 this issue is addressed through the development and validation of an institutional distance indicator which builds on comparative institutional thought;
in particular the work of Richard Whitley on comparative business systems (Whitley, 1992; 1998; 1999). As such, the study in Chapter 3 also presents an opportunity to empirically assess whether there is any quantitative support for the distinctiveness of the business system types that make up the business systems framework. While the business systems typology proposed by Whitley is applied widely to characterize capitalist market economies, Whitley’s typology emerged from detailed but relatively particularistic socio-economic accounts and comparisons of both Asian and European market economies. The cluster analysis in Chapter 3 offers the first systematic analysis of whether similar coherent socio-economic configurations emerge when a wider set of countries is considered.

The measure of comparative institutional distance developed in Chapter 3 is subsequently applied in Chapter 4, in which the effect of the perception of familiarity on location decisions is explored. To that aim, Chapter 4 examines the extent to which both country differences and historical ties—a variable associated with the perception of familiarity—affect the location of foreign direct investment originating from the United Kingdom, France, the Netherlands, and Germany between 1984 and 2003. Building on the idea that the perceived understanding of foreign markets depends both on actual knowledge and market information as well as on the unsubstantiated beliefs, assumptions, and generalizations that are held to be true, the perception of foreign market familiarity is put forward as an important yet overlooked dimension of psychic distance perceptions.

While the quantitative study in Chapter 4 explores the effect of familiarity perceptions on location choice, in Chapter 5 an embedded case study is employed to explore the effect of familiarity perceptions on the development of local market commitments. The internationalization process of the German publishing house which is the subject of the case study in Chapter 5 is characterized by a string of high-commitment entries into the markets of Central Eastern Europe. It therefore is a typical case where a firm’s involvement in new foreign markets does not progress as gradually as predicted by internationalization process theory. In addition, the firm experienced negative cultural learning processes in several markets. The organizational responses differed widely, from attempted withdrawal to the persistence of high-commitment entry-modes. Chapter 5 focuses on the reasons behind these alternative responses.

The final chapter of this book provides a brief overview of the findings, and ties together the conclusions that can be drawn from the separate studies. The concluding chapter highlights that the notion of foreign market familiarity may have important implications for behavioural explanations of internationalization processes. More specifically, it is implied that incorporating the notion of familiarity perceptions into internationalization models has implications for the internationalization patterns which can be expected from a behavioural standpoint. This provides fertile ground for future research, for which several interesting directions are suggested.