Liability of foreignness

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References for this lecture

- BBGV Ch 6
  - Paragraphs 6.5, 6.6
Liability of foreignness

• Definition
  – Total sum of additional costs (of any kind) of doing business abroad
  – Costs that domestic firms do not have

• Firms that want to ‘go multinational’ need to consider these additional costs

• The presence of these costs induces selection
Liability of foreignness: taxonomy of costs

• Costs due to the **spatial distance**
• Costs due to the **unfamiliarity** of the firm with the **local environment** (firm-specific)
• Costs resulting from the **host country environment**
• Costs from the **home-country environment** (e.g. restriction to de-localization)
Spatial distance

• **Transportation costs**
  – Export ➔ transportation of the final product
  – FDI ➔ transportation of intermediate and final goods
    • From headquarter to the subsidiary
    • From the subsidiary to the headquarter

• **Costs of communication**
  – Not so relevant today (VOIP)
  – International telephone calls were very expensive up to the 90s

• **Dealing with different time zones**
  – Workshifts in the headquarter and the subsidiary
Spatial distance

• Which kind of *geographical distance?*
  – Simple distance between closest *border?*
  – Simple distance between *capital cities?*
  – Distance ‘weighted’ by *means of trasportation?*
    • Account for *natural obstacles* (mountains)
    • Account for transport *infrastructure* (highways, high-speed trains, distance from ports)
Figure 6.8 Geographic distance and foreign sales of US multinationals
Cultural distance

- **Differences** in the **culture** between the home and host country may induce a variety of additional costs to multinational firms.
- Culture → **norms, beliefs, values**
  - Differences in culture imply that ‘informal’ rules of the game differ.
  - Failing to adapt to the context of the host country may generate substantial costs for the multinational firm.
Cultural distance

• Different cultures also influence consumers’ preferences
• It is difficult for firms to enter markets that are characterized by preferences that differ from the ones of domestic consumers
• Risk of lower than expected penetration rates
Example: Starbucks in Italy

- Starbucks is trying to enter the Italian market
- The first shop is planned to be opened in Milan in 2018
- Typical ‘bar’ in Italy has very little to do with a Starbucks shop...
  - Organization of spaces
  - Prices
  - Things to do in a ‘bar’

- Starbucks planted palm and banana trees in the Piazza Duomo in Milan (February 2017) to promote the forthcoming opening (200k euro investment)
Locals deride 'kitsch'
Starbucks-sponsored palm
trees planted in Milan's
cathedral square

The “invasion” has alarmed many Italians, who regard American coffee as horribly bland and deeply inferior to their espressos, cappuccinos and café macchiatos. Starbucks offered to plant the exotic trees after winning a bid to renovate some of the city’s open spaces.
Cultural distance

• Language
  – Different language generate costs for organizing production abroad and for exporting goods (labelling)

• People’s behaviour
  – Different ways of solving conflicts
  – Different ways of interacting
Cultural distance

• The **measurement** of cultural distance is (obviously) difficult

• Main **issues**
  – Values and beliefs **change over time** ➞ illusion of stability
  – **Distance is not symmetric** ➞ culture ‘A’ is easily compatible with culture ‘B’ while the opposite is not true
  – Cultural distance may be **firm- or sector- specific**
  – **Intra-country differences** cannot be ignored ➞ Starbucks may have some change in Milan but very little chance in Urbino...
Figure 6.9 Cultural distance and foreign sales of US multinationals

- Canada
- New Zealand
- China
- Russia

Foreign sales of US multinationals (2008)

Cultural distance

Low

High
Institutional distance

• Differences in **formal rules and regulations**
• These differences are tightly connected with historical roots
  – Former **colonies** often maintained the **same legal framework** of their colonizers ➔ English legacy in India
  – Past **occupation** by foreign armies, even for short time periods, may have created **similar institutional frameworks** ➔ the **Italian civil law** (Codice Civile) is almost identical to the **French** one, drafted under the **Napoleon era**
Institutional distance

• Adapting to different rules and regulations may be very costly
  – Organizational routines need to be changed to comply with host country’s rules
    • Workplace conditions
    • Environmental regulation
  – Experts need to be hired to screen host country’s regulation
Institutional distance

- **Institutional differences** may also represent an **opportunity** for multinational firms
  - **Lower protection of workers** in the host country (in comparison of the home country) may **reduce** labour **cost**
  - Less stringent **environmental standards** in the host country may **reduce** the **costs of compliance** for pollution-intensive production activities

- **Race-to-the-bottom**
Institutional distance

• The exploitation of comparative advantages related to differences in the institutional setting across countries by multinational firms may be risky

• Consumers’ awareness about human rights and ‘pollution havens’ may induce losses in market share at home (e.g. boycott campaigns)
How activism forced Nike to change its ethical game

Twenty years of campaigning for workers' rights changed the corporate culture of one of the world's biggest brands - and the sportswear industry

It's worth remembering that in the 1990s the global boycott campaign of Nike was so successful that it has now become an object lesson in how giant corporations can be brought to account by ordinary consumers.

"Nike was targeted by campaigners because it was the world's best-selling brand and because initially it denied responsibility for any malpractice that may be taking place in its sub-contractor factories," explains Rob Harrison, editor of Ethical Consumer.
Institutional distance

• While *multinational* firms may, to some extent, *exploit* the ‘*low*’ *institutional quality* of the host country to gain efficiency, *overall institutional quality* is *important* to ‘do business’ abroad.

• *Enforcement* of law and efficiency of the *judicial system* are *crucial* for doing business abroad.

• The presence of *corruption* in the host country generate substantial *costs*. 
1.01 Property rights, 1-7 (best)
1.02 Intellectual property protection, 1-7 (best)
1.03 Diversion of public funds, 1-7 (best)
1.04 Public trust in politicians, 1-7 (best)
1.05 Irregular payments and bribes, 1-7 (best)
1.06 Judicial independence, 1-7 (best)
1.07 Favoritism in decisions of government officials, 1-7 (best)
1.08 Wastefulness of government spending, 1-7 (best)
1.09 Burden of government regulation, 1-7 (best)
1.10 Efficiency of legal framework in settling disputes, 1-7 (best)
1.11 Efficiency of legal framework in challenging regs., 1-7 (best)
1.12 Transparency of government policymaking, 1-7 (best)
1.13 Business costs of terrorism, 1-7 (best)
1.14 Business costs of crime and violence, 1-7 (best)
1.15 Organized crime, 1-7 (best)
1.16 Reliability of police services, 1-7 (best)
1.17 Ethical behavior of firms, 1-7 (best)
1.18 Strength of auditing and reporting standards, 1-7 (best)
1.19 Efficacy of corporate boards, 1-7 (best)
1.20 Protection of minority shareholders’ interests, 1-7 (best)
1.21 Strength of investor protection, 0–10 (best)*

Source: World Economic Forum
Figure 6.10 Institutional quality and foreign sales of US multinationals

Institutional quality of host country

- Venezuela
- Nigeria
- Russia
- China
- Switzerland
- Sweden
- Finland

Foreign sales of US multinationals (2008)

- Low
- High

Institutional quality of host country
Economic distance

• Difference in welfare, economic development and wealth distribution (i.e. inequality) between the home and host country

• Different economic ‘fundamentals’ result in different preferences of consumers

• Event with identical preferences, consumers in the host country can generally afford different goods than consumers in the home country
Liability of foreignness

• Cultural, institutional and economic distance generate additional costs for firms that decide to become ‘internationally active’
  – Export
  – Vertical multinational activity
  – Horizontal multinational activity

• The liability of foreignness implies different costs for different choices of internationalization
Liability of foreignness: export

- Geographic distance induces transportation costs
- Cultural distance implies that products need to be taylorized to the cultural characteristics of the host country
- Products need to comply with standards (e.g. safety, toxicity) in the destination country
Liability of foreignness: vertical multinational activity

• The management of foreign operations entails substantial costs
  – Dealing with foreign workers, capital markets, public administrations ➔ cultural distance
  – Dealing with time zones
• Transportation costs of products made abroad back to the home country

• As the (pure) vertical multinational firms serve home consumers by producing in the host (foreign) country, there is no need to adapt the product
Liability of foreignness: horizontal multinational activity

• **Horizontal** multinational activity combines the **costs of producing abroad** (same as vertical multinational activity) with the **costs of serving foreign consumers** (same as export)

• **Liability of foreignness** is the **highest** for **horizontal** multinational activity (e.g. Starbucks in Milan!)
Benefits of foreignness (?)

• Being a foreign actor may also give rise to a **premium** for the **fact of being foreign**

• Foreign products (from specific countries) may have a particularly good **reputation**
  – German beer and cars
  – Italian food and luxury textile
Porter’s diamod (1980)

• Theory of national competitive advantage based on cases study of firms
  – How firms can be competitive in global markets?
  – Could government play a role driving development?

• Four interrelated dimensions
  – Factor conditions
  – Demand conditions
  – Firm strategy, structure and rivalry
  – Related and supporting industries
Firm strategy, structure, and rivalry

Demand conditions

Factor conditions

Related and supporting industries

Figure 6.12 Porter’s diamond model
Porter’s diamod (1980)

• Production factors
  – Endowment of specific production factors (in the vein of the HOS model of trade)

• Demand conditions (home market)
  – Market size
  – ‘Quality’ of the demand → induce continuous improvements in product’s quality and in developing new products
Porter’s diamond (1980)

• Related and supporting industries
  – The presence of specialized suppliers in the home market is a pre-requisite for the existence and the development of a competitive domestic industry

• Firm strategy, structure and rivalry
  – How firms are created, organized and managed

• The government may influence all the four dimensions to improve domestic competitiveness

• Limitation of the Porter’s approach ➔ completely ‘home-country’ driven!
From the diamond to the cluster

• It is **not enough** that the four **dimensions** of the Porter’s diamond are in ‘good shape’ at the **country** level

• **Geographical proximity** of firms in the same **city, metro-area, province, region** may enhance the **competitiveness** of all firms

• **Clusters!**

• Firms belonging to clusters are **more productive**
  – **Economies of scale** in the local supply of crucial **intermediate inputs**
  – **Labour pooling** effect
  – **Knowledge spillovers**
  – ...