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)

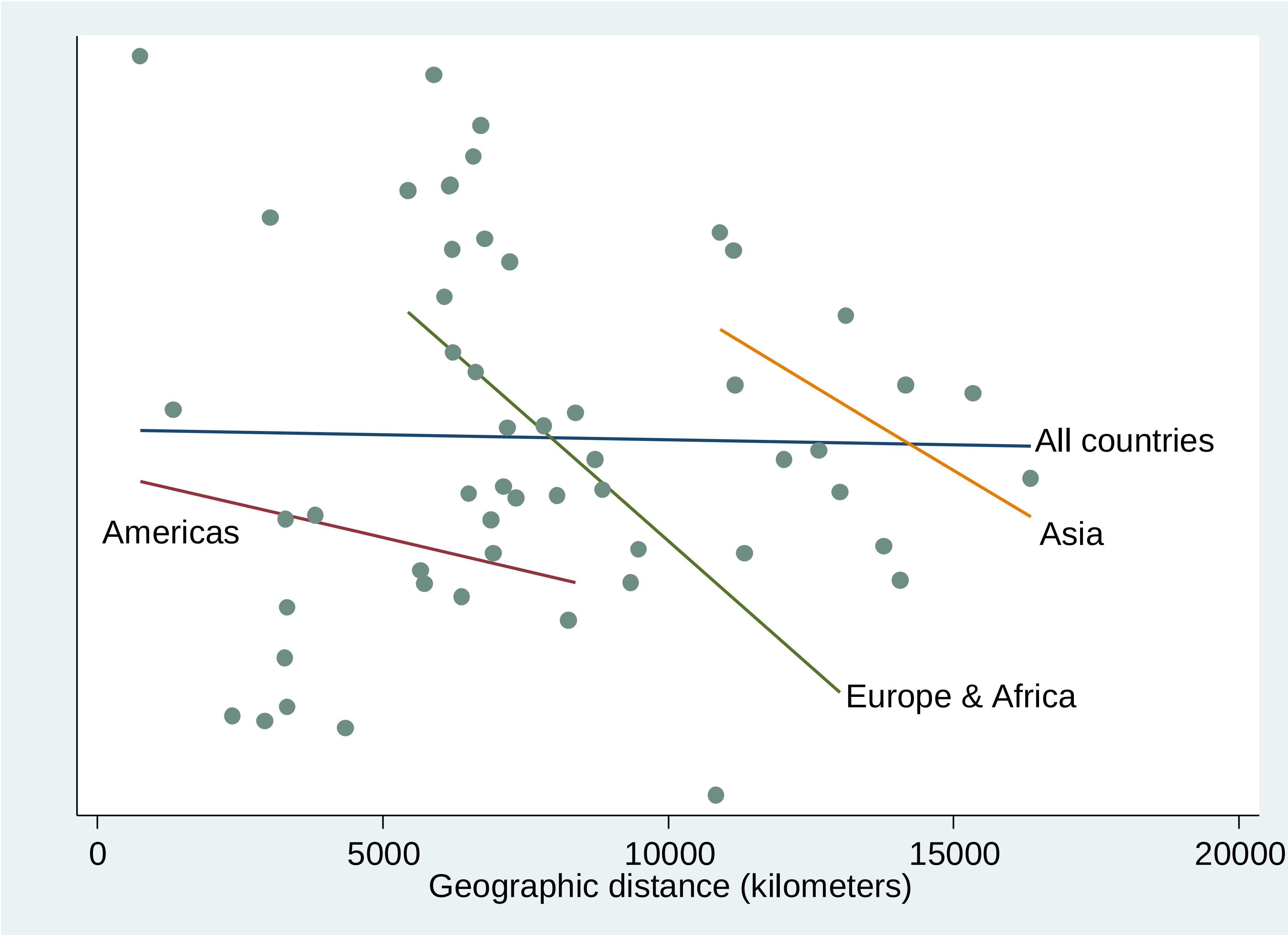
Spatial distance

- **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.

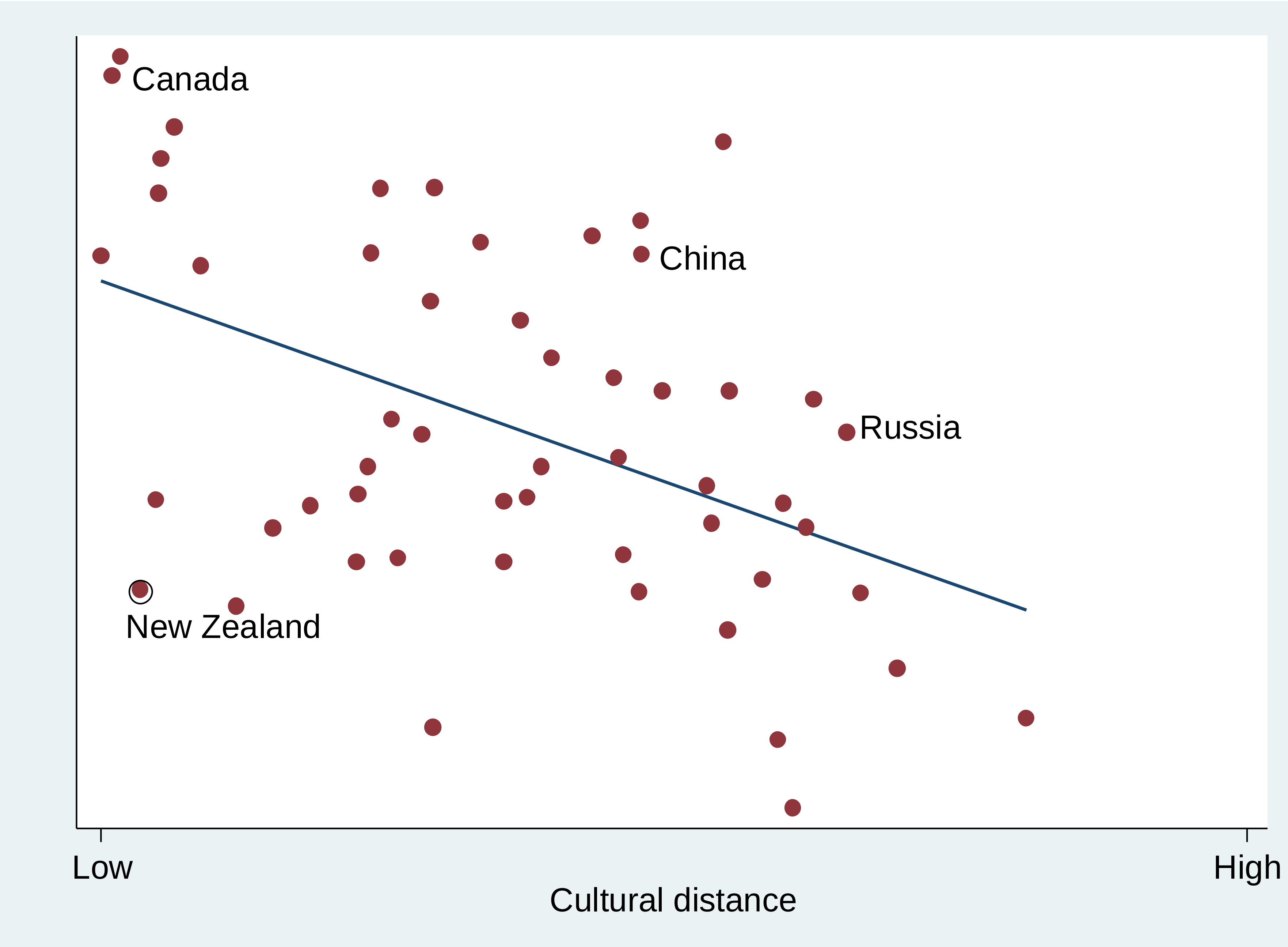
Cultural distance

- **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



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' awarness** about **human rights** and '**pollution havens**' may induce **losses** in **market share** at **home** (e.g. **boycott** campaigns) theguardian

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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**

Source:
World Economic Forum

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)*

Figure 6.10 Institutional quality and foreign sales of US multinationals

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 interantionalization

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**

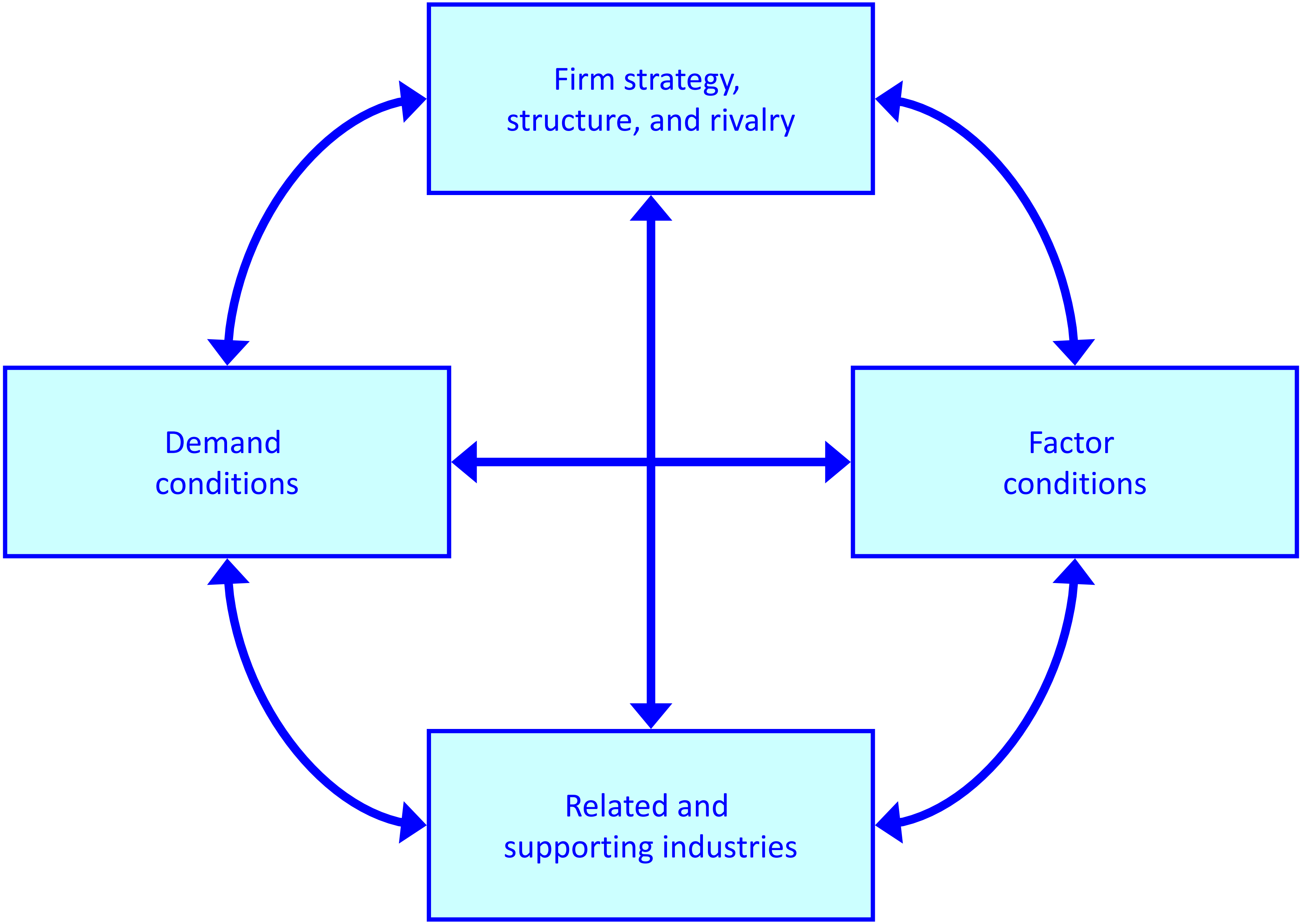
- Foreign products (from specific countries) may have a particulary good **reputation**
  – German beer and cars
  – Italian food and luxury textile

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**

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

- <u>**Clusters!**</u>

- Firms belonging to clusters are **more productive**
  - **Economies of sca**le in the local supply of crucial **intermediate inputs**
  - **Labour pooling** effect
  - **Knowledge spillovers**
  - …