



Policy uncertainty and the sequence of entry by Japanese firms, 1980–1998

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Abstract

We extend the stages model of internationalization to incorporate a sophisticated consideration of temporal and cross-national variation in the uncertainty of the policy environment. Using a sample of 6465 international expansions of 665 Japanese manufacturing firms in 49 countries, we develop arguments from internationalization and bargaining power perspectives to show how Japanese firms manage policy uncertainty in host country environments through the within-country sequencing of investments. Although a distribution to manufacturing entry sequence tends to prevail in countries with low levels of policy uncertainty, as uncertainty in the policy environment increases, initial entry by distribution is increasingly likely to be eschewed in favor of an initial entry by a joint venture manufacturing plant. We suggest that this change in investment sequence occurs as firms shift from an emphasis on developing knowledge about local markets and consumers in low-hazards markets to an international expansion strategy in uncertain policy environments that places knowledge development of the policy environment at the forefront of a firm's strategy.

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Research on the sequence of within-country corporate expansion into new geographic markets has focused on identifying the firm- and country-level factors that influence a firm's ability to learn about the domestic market environment. In the existing research, firms are presumed to begin an overseas investment sequence with a distribution facility and, as they gain knowledge of the local market, increase the commitment involved in their local operations by forming jointly owned and, eventually, wholly owned manufacturing facilities. This *stages model of internationalization* (Johanson and Vahlne, 1977) is underpinned by the idea that geographic distance and market, linguistic and cultural differences have the strongest influences on a firm's international expansion process.

Although the stages model enjoys a strong heritage and has good face validity, literature reviews consistently highlight empirical irregularities in the observed sequences of international expansion that the model, as generally specified, cannot explain (Barkema *et al.*, 1996). We suggest that the stages model can be improved by incorporating a more complete conceptualization of national institutional environments. We contend that uncertainty in the

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policy environment is an important component of the country-level environment that has been omitted from consideration in previous formulations and empirical tests of the stages model.

In this study, we demonstrate that the incorporation of policy uncertainty into the framework of the stages model yields predictions substantively different from that of the existing literature, and that these differences can help explain the mixed empirical support for the commonly predicted investment sequence, especially in uncertain policy environments. By incorporating consideration of the policy environment, we emphasize an investing firm's need to balance considerations of cultural, market *and* political knowledge in determining the optimal sequence of investment that includes as many as three direct investment types – a distribution facility, a joint venture manufacturing plant, and a wholly owned manufacturing plant.

We put forward the idea that the balance between domestic competitors' perceptions of a foreign entrant as a rival for local market share and the perception of domestic customers and suppliers that a foreign entrant is a partner in the local economy influences policymakers' incentives to discriminate against a foreign entrant. We argue that this balance is likely to be less favorable, and thus more likely to engender an adverse policy response, when an investment sequence begins with a distribution facility. The likelihood that policymakers will act on these incentives is greater in countries where the structure of policymaking allows individual political actors substantial discretion and where domestic competitors are particularly powerful constituencies. The hazard of such adverse policy change can negatively affect the net present value of existing and future subsidiaries in a country. Even with the possibility of gaining market knowledge in a low commitment distribution entry, when policy uncertainty is sufficiently high, the heightened hazards associated with an investment sequence that begins with a distribution entry argue for a reversal in the commonly cited within-country expansion path of distribution facility to manufacturing plant.

Background

International expansion in the stages model is a process rooted in uncertainty reduction and experiential learning (Johanson and Vahlne, 1977). Experiential learning in a market provides important information about consumer preferences, competitors and other aspects of a host country's

business environment. Each investment is a step in which a firm gradually reduces its uncertainty about local habits, consumer tastes and preferences, and market structure (Barkema *et al.*, 1996) and strengthens its network of relationships with customers, suppliers, competitors and policymakers (Forsgren and Johanson, 1992). A firm curtails chances of failure in its entries (Root, 1987) by learning from its foreign investment experience and strengthening its local ties as it moves along an establishment chain of increasing commitment, concomitant with experience gain, from exports, to distribution, to joint venture manufacturing and to wholly owned manufacturing plants (Davidson, 1980).

The implicit assumption in this summary of the stages model is that local market knowledge is the dominant constraint faced by multinationals entering a new market, particularly when a foreign entry is made with a market seeking motivation. This was indeed likely to have been the case when the stages model was first being formulated and tested. At that time, cultural differences and variances in consumer preferences were likely to be the primary sources of investment uncertainty in the often-studied expansions of US firms into Canada or Europe, or the expansions by Nordic firms to other Nordic countries, to other European countries and to North America.

Qualitative research suggests, however, that another constraint, namely uncertainty over the future policy environment, weighs heavily upon the minds of senior management (Kobrin *et al.*, 1980). In defining the political domain, scholars emphasize that the ability of a nation's government to credibly commit to a given set of policies influences the mode of entry (Henisz and Williamson, 1999). In our hypothesis development, we seek to extend research based in the stages model to incorporate insight into how policy uncertainty influences choices about the sequence of establishment of operations in a market.

Hypothesis development

Entry types

The typical stages model approach argues that the within-country sequence of investment begins with a distribution entry. A distribution entry is a platform for experiential learning about a host country's culture (Johanson and Vahlne, 1977) and for relationship development with consumers because the close and complex ties between

consumers and a firm engendered by a distribution entry (Capron and Hullan, 1999) fosters repeated interactions that stimulate information flow. The effectiveness of establishing a local distribution system is reflected in observations that foreign manufacturers tend to find domestic distributors inefficient (Yamawaki, 1991) or opportunistic (Sakakibara and Serwin, 2000), whereas those that invest in local distribution tend to be more successful (Bergsten *et al.*, 1978). After developing an understanding of the local culture and local consumer tastes by a distribution entry, the feasibility of constructing a manufacturing plant increases (Barkema *et al.*, 1996).

A manufacturing entry, whether wholly owned or a joint venture, is an expansion in which a subsidiary is formed for the purpose of producing goods for sale domestically or for export. Although a variety of motives exist, foreign firms frequently move productive operations overseas in response to factor cost differentials, to economize on transportation costs and/or to customize production for local tastes and preferences (Caves, 1996). As the levels of resource commitment and market-specific knowledge are higher than for a distribution entry, the stages model posits that manufacturing operations follow direct investments in distribution in markets that are sufficiently large, sufficiently low-cost production sites or sufficiently closed to imports.

Although a distribution entry involves a less significant deployment of physical and non-redeployable assets than jointly and wholly owned manufacturing entries, at an absolute level, the risks faced by a distribution entry are non-trivial. Establishing a distribution system requires a considerable, and non-recoverable, investment in time (Dierickx and Cool, 1989) in which the absolute monetary value of investment can be significant. By 1986, the combined dollar value of investment in distribution by Japanese, German and UK firms in the US exceeded \$60 billion (Yamawaki, 1991). A distribution subsidiary also involves a considerable deployment of expatriate and local staff. As examples, in 1999, Canon's main distribution facility in the US employed 2389 people (188 expatriates), Skylark's in Malaysia had 1860 employees, and Seiko's in Thailand had 1700 employees (Toyo Keizai, 1999).

Given the level of investment, and risk, for distribution as well as jointly and wholly owned manufacturing investments, the decision to enter a country by any of these entry modes is consequen-

tial and can influence the success of a firm's sequence of expansion in a host country. Despite the sequential nature of the investment process, much of the economics-based literature on entry mode choice has examined a firm's investments in isolation from one another, and most frequently with reference to the choice of joint venture or wholly owned entry (Gatignon and Anderson, 1988; Hennart, 1988). Even studies that adopt a sequential perspective fail to consider a market entry strategy starting with distribution facilities (Chang and Rosenzweig, 2001).

As we have discussed, a first entry by distribution can help develop local knowledge and relationships. The independent development of such local resources can serve as a substitute for the knowledge acquisition from a local partner that motivates many joint ventures (Makino and Delios, 1996). Frequent use of a distribution entry as a first entry into a market can thus explain why joint venture manufacturing entries are used infrequently in countries with low policy uncertainty, even among firms inexperienced in manufacturing in a host country (Beamish *et al.*, 1997). Meanwhile, as we develop in our arguments below, in uncertain policy environments initial entry by a distribution facility can carry a cost that may offset the learning and relationship acquisition benefits of the traditional investment sequence. The consideration of a sequential perspective including distribution entries should therefore contribute to both the literatures on the stages model and economics-based studies of entry strategies.

The policy environment

For analyzing the influence of the policy environment (that is, the set of laws, regulations, administrative procedures and policies formally sanctioned by the government that impact on a firm's profitability by altering its costs or revenues) on a firm's choice of investment sequences, there are two time-related considerations. First, a firm is faced with the *ex ante* policy environment under which it negotiates the terms of its entry. Governments can have a set of policy initiatives designed to attract specific types of investment. Areas with specialized economic policies for foreign investors, such as duty-, tariff- or tax-free production zones, or special economic zones as set up in mainland China in the 1980s, are an example of this. A firm can also negotiate a specific set of conditions for its investment, and generate favorable terms, as might be the case when a firm such as Honda is

considering building an automotive assembly facility.

Second, a firm is faced with the *ex post* policy environment in which the terms of investment can be altered by the host country government, in an obsolescing bargaining scenario (Vernon, 1977; Kobrin, 1987). The potential loss to a firm from a change in the policy environment can be particularly high, where *ex ante* bargaining generates uniquely favorable conditions for investment. Firms are therefore likely to expend substantial resources in lobbying or other influence strategies to guard against the overturning, alteration or reinterpretation of *ex ante* policy commitments or even to secure their improvement over time (Boddewyn and Brewer, 1994). When making an investment, a firm therefore needs to be concerned with the *ex ante* policy environment, with its stability across time (Gatignon and Anderson, 1988), and with its ability to influence the *ex post* policy environment.

A firm's ability to understand, react to and ultimately influence the policy environment varies in both its familiarity with the underlying structure of a country's policymaking apparatus and its relative bargaining power (Lecraw, 1984), both of which are influenced by the structure of a firm's 'exchange relationships with customers, suppliers and competitors' (Forsgren and Johanson, 1992). The local knowledge and local network of relationships that a firm develops will have a strong influence on its relationships with a host country government (Fayerweather, 1973). This influence is independent of a firm's own ability to lobby or influence government policy, either directly, or indirectly through its home country government, international or domestic industry associations, consultants, lawyers, media or other channels (Behrman *et al.*, 1975).

The policy environment and choice of entry type

We posit that distribution and manufacturing entries bring a different set of costs and benefits to a host country economy, thereby altering a firm's ability to understand, react to and influence the local policy environment. As a consequence, a firm's investment sequence in a host country will vary with a country's level of policy uncertainty.

Manufacturing entries that exclusively sell their output abroad provide economic benefits in the short term in the form of cross-industry linkages in supply and output markets (Borensztein *et al.*, 1995), stimulation of the efficiency of domestic

firms' production, and improvements in international competitiveness (Chung *et al.*, 2002), particularly if joint ventures are implemented with local firms (Shenkar and Li, 1999). Further, as the managers of the manufacturing plant bargain with governments over the terms of entry, they establish relationships and gain knowledge about the local policymaking apparatus, as the firm has something to offer in return. Distribution facilities that sell foreign or locally produced output are, by contrast, less appealing to host country governments. Although consumers may benefit from lower costs, concentrated producer interests may be harmed by the increase in competition and the lack of off-setting employment, hard currency or tax revenue gains that could cushion this negative impact. In fact, net outflows of currency in the form of profit repatriation and a net loss of jobs in the domestic economy may create substantial economic costs to the host country government (Feenstra and Hanson, 1996).

The choice of a firm's investment sequence alters the relative timing and magnitude of these benefits and costs that a firm offers to customers, suppliers, competitors and, indirectly, to domestic political actors as well. The likelihood that political actors will use discretionary policy instruments, including restrictions on profit repatriation, foreign exchange quotas for capital and other inputs, corporate tax rates and local wage and employment laws, in a manner that enhances or degrades firm performance is a function both of the timing and magnitude of these costs and benefits and of the discretion of the political actors to respond to these incentives. Where political actors possess substantial discretion in their policymaking (that is, where policy uncertainty is high), investment sequences will vary in a manner that increases the short-term benefits to the host country government and minimizes the short-term costs.

As described above, investment sequences that begin with a manufacturing plant and later add a distribution facility front-load the political benefits while postponing and requiring an appropriate discounting of the costs. This sequence thereby minimizes the likelihood of unfavorable policy responses. Particularly when policy uncertainty is high, this minimization of uncertainty from the policy environment can outweigh the costs of unfamiliarity with the local market, culture and political system. Accordingly, we would expect that distribution entries followed by manufacturing entries are the most likely sequence in a country

with low policy uncertainty, but an investment sequence beginning with a manufacturing entry is increasingly likely as policy uncertainty increases.

Hypothesis 1a: The higher the policy uncertainty in a host country, the less likely it is that a firm's investment sequence will begin with a distribution entry.

With a decreasing likelihood of initiating an investment sequence by a distribution entry, there would necessarily come fewer instances of distribution–manufacturing entry sequences, as the number of first entries by distribution declines. In addition to this absolute reduction, we are also concerned with the influence that a prior entry of one type has on an entry of another type: that is, what is the marginal effect on the rate of manufacturing entry when a distribution entry has been made, and how does this vary across countries that differ in their level of policy uncertainty?

Our prior arguments suggest that, as policy uncertainty increases, distribution entries should provide less information and knowledge to facilitate subsequent manufacturing entries. The market or cultural information that is easily absorbed in a distribution facility is of less utility in uncertain policy environments than the knowledge, information and negotiating capabilities developed in a prior manufacturing entry. Hence, in addition to the absolute decline in the number of investment sequences that begin with a distribution facility in countries with high levels of policy uncertainty, we hypothesize that the marginal effect of a given distribution entry on the rate of subsequent entry by manufacturing plants will also decline relative to the marginal effect in countries with low levels of policy uncertainty.

Hypothesis 1b: The higher the policy uncertainty in a host country, the less the positive influence of a prior distribution entry on entry rates for manufacturing plants.

Although, in uncertain policy environments, an investment sequence that begins with a distribution entry faces heightened hazards compared with one that begins with a manufacturing entry, this does not mean the latter is immune from policy uncertainty. Indeed, the perils remain substantive, with the added complication that a manufacturing entrant's assets can be large and difficult to redeploy. In response to these hazards, a firm can take several actions. It can avoid investment if policy uncertainty is sufficiently high (Vernon, 1977), or it can rely on hazard-mitigating capabilities acquired from prior investment experience

(Delios and Henisz, 2000). A third strategy involves structuring the manufacturing subsidiary as a joint venture to involve a local partner.

Joint ventures are particularly valued where there is a specific need for a local firm's contributions to help contend with, for example, cultural differences (Kogut and Singh, 1988) or policy uncertainty (Delios and Henisz, 2000; Henisz, 2000a). Joint ventures can serve as an effective vehicle for acquiring knowledge instrumental to a firm's development of a market position (Inkpen and Beamish, 1997) and its success within a market (Makino and Delios, 1996). A local partner helps reduce asset and capital commitment by a multinational to its subsidiary (Hennart, 1988), and it brings local content and both market and non-market knowledge that reduce a subsidiary's exposure to policy uncertainty. In an uncertain policy environment, a joint venture manufacturing entrant has a formal equity partnership with a local firm that can from the outset of the investment make the case for the net economic and political benefits of the entry.

In countries with low levels of policy uncertainty, a joint venture manufacturing entry can still provide complementary capabilities such as local knowledge of labor markets, markets for a firm's output or the host country culture. Yet distribution entries are also a conduit for experiential learning about host country conditions. Such learning via a distribution entry can obviate the local knowledge-related need for a joint venture manufacturing entry, although other motivations, such as technology sourcing, might lead to future entries by manufacturing joint ventures. Accordingly, we would expect that investment sequences that begin with manufacturing joint ventures are more likely in a country with high policy uncertainty.

Hypothesis 2a: The higher the policy uncertainty in a country, the more likely it is that a firm's investment sequence will begin with a joint venture manufacturing plant.

As with H1b, we are also concerned with how the marginal benefits of an initial joint venture manufacturing plant entry, in the form of the acquisition of the necessary information to facilitate subsequent entry by wholly owned manufacturing plants, vary across countries with different levels of policy uncertainty. Our arguments suggest that joint venture manufacturing plants would provide the greatest host country learning benefits when policy uncertainty is high. Accordingly, we expect

that a joint venture manufacturing plant's stimulus to subsequent entry by a wholly owned manufacturing plant is greater, the higher the level of policy uncertainty in a host country.

Hypothesis 2b: The higher the policy uncertainty in a country, the greater the positive influence of a prior joint venture manufacturing plant entry on entry rates for wholly owned manufacturing plants.

Despite these arguments, firms may still choose to enter uncertain policy environments with an investment sequence that begins with a joint venture distribution facility. A firm's rationale for doing so would not hinge upon its ability to understand, react to and influence the policy environment but rather on product-specific, firm-specific or manager-specific attributes. Given the lower weighting attached to the policy environment in these cases, the role of the policy environment in altering the choice between wholly owned and joint venture distribution facilities may not be sufficiently strong to be observed in the absence of a better understanding of these alternative factors.

Methods

Setting

We test these two pairs of hypotheses using panel data on the international expansion of Japanese firms. Japanese firms' international expansion is a good setting as distribution entries are featured prominently in their international expansion strategies. Further, the majority of investments in this expansion were made in the 1980s and 1990s (UNCTAD, 1997), limiting concerns about left-censoring. Japan has been a leading source of outward FDI, and its country distribution is extensive, thus providing the country-level variance required to test the effects of policy uncertainty, while controlling for other economic influences.

Data sources and sample

We derived our sample from the 1898 manufacturing firms listed on the first and second sections of the Tokyo Stock Exchange as of 1999, as provided in the Nikkei NEEDS tapes. We matched this list with the foreign subsidiary data found in the 1986, 1989, 1992, 1994, 1997 and 1999 editions of Toyo Keizai's *Japanese Overseas Investment*, to construct a longitudinal profile of foreign entries. An annual edition reputedly contains a complete listing of the

stock of each firm's foreign subsidiaries for that year (Yamawaki, 1991; Henisz and Delios, 2001).

For the sample, we needed to be concerned with host country–firm pairs in which there was left censoring in the subsidiary foundation history. As Japanese subsidiaries tend not to be divested in the first few years of operations (Delios and Beamish, 2001), we set initial subsidiary entry not prior to 1980 as our starting date and removed all host country–firm pairs in which a firm had an entry in the country prior to 1980. After this, we had 3384 unique combinations of host country–firm investment histories, among which we observed 2334 distribution entries, 2339 joint venture manufacturing entries, and 1792 wholly owned manufacturing entries, as undertaken by 665 Japanese manufacturing firms, into 49 countries worldwide.

Measures

Our dependent variable identifies four categories of entry types: no entry, a distribution entry, a joint venture manufacturing plant entry, and a wholly owned manufacturing plant entry. We identified manufacturing and distribution entries by referring to the written description of a subsidiary's industry in *Japanese Overseas Investment*. We defined a manufacturing subsidiary as a joint venture when a local partner had a 5% or greater equity stake.

Policy environment

We examine both the probability of a policy change and the likelihood that any change is likely to be adverse owing to the lobbying efforts of host country competitors. We take our measure of uncertainty in the policy environment, *political hazards*, from Henisz (2000b). It quantifies the extent to which any one institutional actor – for example, the executive or a chamber of the legislature – in a given country is unconstrained in its choice of policies in a given year. The measure takes information regarding the number of independent branches of government (executive, lower and upper legislative chambers, judiciary and sub-federal institutions) with veto power over policy change, the alignment of the political preferences of these branches, and the heterogeneity of within branch preferences from political science databases. A simple spatial model of policy interaction is then used to derive an estimate of the feasibility of policy change given this information. Possible scores for the final measure of *political hazards* range from

zero (least hazardous) to one (most hazardous). The main results of the derivation are that:

- (1) each additional veto point (a branch of government that is both constitutionally effective and controlled by a party different from other branches) provides a negative but diminishing effect on the total level of hazards, and
- (2) homogeneity (heterogeneity) of party preferences within an opposed (aligned) branch of government is negatively correlated with hazards.

This construction means that the measure evaluates policy uncertainty, but does not identify whether existing or future policies will be favorable or unfavorable to a firm (Henisz, 2000b).

As a proxy for the strength of competitors' lobbying and influence efforts, we measure the size of the host country's manufacturing sector as a percentage of GDP (*manufacturing percentage*). Larger manufacturing sectors are likely to be more vocal in their opposition to the arrival of foreign entrants. Comparing two countries with the same level of *political hazards*, the one with the higher *manufacturing percentage* should pose greater hazards to foreign entrants, thereby enhancing the probability that an entry takes the form of a wholly owned or joint venture manufacturing plant rather than a distribution facility. We enter both variables into the specification independently and as part of a multiplicative interaction term.

Prior investment activity

Four time-varying variables measured the type of prior investment activity in a host country by the investing firm: prior wholly owned manufacturing entry, prior joint venture manufacturing entry, prior distribution entry, and prior entry into other industries (for example, entries into mining, banking, insurance, or general services) recorded the number of prior entries made into the respective categories.

International experience

We computed *international experience* as a logarithmic transformation of the number of years of investment history a firm had in all countries other than the host country (Delios and Henisz, 2000).

Country spread¹

Country spread was the number of countries in which a firm had foreign investments at the start of each year. This measure accounts for the potential

for a greater propensity to invest in manufacturing plants in hazardous host countries by firms that have a greater spread of international operations. The greater spread of international operations decreases the cost of exiting a host country, increasing a firm's bargaining power with a host country government, and thereby reducing the probability of a detrimental change in policy.

Cultural distance

For this measure, *cultural block distance* (Barkema *et al.*, 1996), we coded countries into Ronen and Shenkar's (1985) blocks of countries, such as Denmark, Finland, Norway and Sweden, that have a similar cultural background. We then ranked these cultural blocks in distance from Japan. Models yielded similar results if we used a cultural distance measure (Kogut and Singh, 1988), which is not unexpected as both categorizations are derived from Hofstede's (1980) cultural scores (Ronen and Shenkar, 1985).

Other firm-level variables

We measured firm size with *employment*, or the logarithm of parent firm employment computed annually for the 1980–1998 period, and lagged by 1 year. We measured technological and marketing assets, which tend to be positively correlated with rates of foreign entry (Caves, 1996), using *R&D intensity* and *advertising intensity*, defined respectively as the ratio of firm-level expenditures on R&D or advertising to total sales. We measured export activity with *export intensity*. We computed the intensity measures as annual 5-year moving averages, with a lag of 1 year.

Other country-level variables

Ownership restrictions measured the perceived legal barriers to equity ownership by foreign companies using the average response of a panel of executives surveyed for the *World Competitiveness Report* (1992–2000) to the statement 'Foreign investors are free to acquire control in a domestic company.' We used the data in the year of an observation or, where a year was missing, the value from the nearest year. We measured market size with *GDP per capita* and *population* and market potential with *population growth* (annual growth rate of population) and *GDP per capita growth* (annual growth rate of per capita GDP). We measured a country's attractiveness for foreign trade (*trade*, ratio of annual value of exports and imports to GDP) and for foreign investment (*FDI*, ratio of annual flow of FDI to GDP). All

models included annual, region and industry fixed effects.

Model

We estimated entry rates using an exponential event history model in which no age parametric dependence is specified in its functional form. This technique models the transition rate from an origin state (no entry) to a destination state (an entry type) as a function of the prescribed covariates. Its general form is

$$r_{jk} = \exp(\alpha_{jk0} + A_{jk1}\alpha_{jk1} + A_{jk2}\alpha_{jk2} + \dots),$$

where r_{jk} is the transition rate from the origin state j to the destination state k , with the observed covariate vector A_{jk} , parameters to be estimated α_{jk} , and constant α_{jk0} . The duration of an event is described by an exponential distribution, where it is possible for more than one destination state to be reached from an origin state. The relationship between the covariates and the transition rate is specified as log-linear to ensure that transition rate estimates are not negative, and estimation uses the maximum likelihood method (Blossfeld and Rohwer, 1995). In each year of observation, we treated a firm of being at simultaneous risk for one of three destinations:

- (1) a distribution entry;
- (2) a joint venture manufacturing entry;
- (3) a wholly owned manufacturing entry.

To estimate this model, we took the sample of 3384 firm–country pairs and expanded it into multiple spells, to capture the 1873 cases of multiple entries by a firm in a country and to include time-varying covariates. In each spell, a firm was at risk of entering with one of the three investment types. Each spell was treated as right-censored unless an entry occurred. The spells included all firm–country–year combinations in which an investment could be made. We retained each

firm–country pair until 1998, or until a firm had both manufacturing and distribution entries in a country. We thus had 71,939 observations.

Results

Table 1 reports first entry types by three categories of *political hazards*. In the low *political hazards* category 59.8% of first entries were made by a distribution facility, whereas just 14.2% were by a joint venture manufacturing plant. In the moderate *political hazards* category the percentage of first entries by a distribution facility declined to 44.3%, whereas those by joint venture manufacturing plant more than doubled to 30.4%. In the high *political hazards* category the percentage of first entries by a distribution facility fell to 23.3%, and those by joint venture manufacturing plant rose to 50.4%. Meanwhile, in each of the three *political hazards* categories, 25–26% of first entries were by wholly owned manufacturing plant. These numbers are consistent with Hypotheses 1a and 2a.

We describe the multivariate tests of our hypotheses in Table 2. The baseline for the multivariate tests of the hypotheses is given in model 1 of Table 3, which presents the exponential event history model estimation of entry rates into distribution (column one of model 1), joint venture manufacturing (column two) and wholly owned manufacturing (column three). The coefficient estimates in each column correspond to the estimated influence that a covariate has on the given entry type. Model 2, which includes the interaction terms between *political hazards* and prior entry by joint venture manufacturing plant and distribution facility, is used to test the hypotheses.

In discussing these models, we first describe individual results for covariates of interest, before turning to the empirical tests of our hypotheses. In both models there is a negative coefficient estimate on *political hazards* in the joint venture and wholly

Table 1 Entry types used for first entry by political hazards^a

Political hazards	Entry type used for first entry in a country			Total
	Distribution facility	Joint venture manufacturing plant	Wholly owned manufacturing plant	
Low (0.10–0.23)	685 (59.8)	163 (14.2)	297 (25.9)	1145 (100)
Moderate (0.24–0.59)	485 (44.3)	333 (30.4)	276 (25.2)	1094 (100)
High (0.60–1.00)	267 (23.3)	577 (50.4)	301 (26.3)	1145 (100)
Total	1437 (42.5)	1073 (31.7)	874 (25.8)	3384 (100)

^aFirst number in a cell is a count, the second is a row percentage.

Table 2 Empirical tests of hypotheses

<i>Hypothesis</i>	<i>Coefficient estimates used to test hypothesis</i>	<i>Calculation to determine effects</i>
H1a H2a	<i>Focal variables for testing hypotheses:</i> Political hazards Political hazards $\times$ manufacturing percentage <i>Prior entry variables:</i> All constrained to equal zero because hypotheses concern first entry <i>All other variables:</i> Constrained to mean values	Determine entry rates for distribution entry and joint venture manufacturing entry at different levels of political hazards Use coefficient estimates from respective columns in Model 2 to determine entry rates for each type of entry Results of calculations displayed in Figure 1
H1b H2b	<i>Focal variables for testing hypotheses:</i> Political hazards Political hazards $\times$ manufacturing percentage Prior distribution entry Prior joint venture manufacturing entry Prior distribution entry $\times$ political hazards Prior joint venture manufacturing entry $\times$ political hazards <i>Other prior entry variables:</i> Constrained to equal zero as hypotheses concern entry rates given prior entry of a specific type. <i>All other variables:</i> Constrained to mean values	Determine entry rates for wholly owned manufacturing entry at different levels of political hazards, given different types of prior entry Use coefficient estimates from wholly owned manufacturing entry column in Model 2 to determine entry rates for each type of entry Results of calculations displayed in Figure 2

owned manufacturing entry columns. For wholly owned manufacturing entries the strength of the local manufacturing sector does not influence entry rates, whereas strong local manufacturing sectors enhance the entry rates for joint ventures in uncertain policy environments. Meanwhile, *political hazards* is not independently significant in the distribution entry column. The influence of the policy environment on distribution entry, however, is given by the positive coefficient estimate on manufacturing percentage and the negative coefficient estimate on the interaction term between manufacturing percentage and *political hazards*.

This set of coefficient estimates indicates that entry rates decline when *political hazards* increase, regardless of the strength of the manufacturing sector. When the manufacturing percentage is one standard deviation below its mean, entry rates in a country with high *political hazards* are one-third of that in a country with low *political hazards*. When the manufacturing percentage is one standard deviation above its mean, the difference is greater, with entry rates in a country with low *political*

hazards eight times that in a country with high *political hazards*. Hence entry rates are lowest in uncertain policy environments in which the manufacturing sector has a strong voice, but highest when policy uncertainty is low and the manufacturing sector has a strong voice.

Turning to the prior entry count variables, the main effect of these variables is consistent with the proposed sequence of the traditional stages model. The coefficient estimates for prior wholly owned manufacturing entry are negative in the distribution entry column and the joint venture manufacturing entry column, but positive in the wholly owned manufacturing entry column. This set of results indicates that distribution and joint venture manufacturing entry rates are highest when there have been no previous wholly owned manufacturing entries. The coefficient estimate for prior joint venture manufacturing entry in the distribution entry column is negative (model 2), marking that distribution entry rates are highest when there has not been a prior joint venture manufacturing entry.

Table 3 Exponential estimation of entry rates within countries by type of entry^a

Variables	Model 1			Model 2		
	Distribution	JV mfg	WOS mfg	Distribution	JV mfg	WOS mfg
Political hazards	0.047 (0.428)	−1.808*** (0.437)	−1.238** (0.488)	0.310 (0.432)	−1.759*** (0.440)	−1.099* (0.487)
Manufacturing percentage × political hazards	−0.067*** (0.016)	0.071*** (0.018)	0.021 (0.019)	−0.080*** (0.017)	0.068*** (0.018)	0.012 (0.019)
Prior joint venture manufacturing entry	−0.077 (0.049)	0.201*** (0.013)	−0.088* (0.035)	−0.426*** (0.094)	0.172*** (0.038)	−0.311*** (0.069)
Prior distribution entry	−0.076* (0.032)	−0.553*** (0.085)	0.246*** (0.053)	0.002 (0.047)	−0.518*** (0.127)	0.120* (0.062)
Prior joint venture manufacturing entry × political hazards				0.570*** (0.114)	0.035 (0.041)	0.344*** (0.085)
Prior distribution entry × political hazards				−0.368* (0.157)	−0.121 (0.299)	−0.595* (0.295)
Prior wholly owned manufacturing entry	−0.361*** (0.055)	−0.067* (0.033)	0.335*** (0.022)	−0.361*** (0.055)	−0.064* (0.033)	0.339*** (0.022)
Prior entry into other industries	−0.122** (0.046)	0.007 (0.041)	−0.118** (0.043)	−0.126** (0.046)	0.008 (0.041)	−0.114** (0.043)
FDI	5.537*** (0.978)	5.968*** (1.819)	8.132*** (1.482)	5.848*** (0.980)	6.018*** (1.823)	8.402*** (1.482)
Trade	0.734*** (0.080)	−0.620*** (0.130)	−0.404*** (0.115)	0.753*** (0.080)	−0.617*** (0.130)	−0.382*** (0.115)
Population ^b	0.241*** (0.031)	0.230*** (0.041)	0.144*** (0.036)	0.245*** (0.031)	0.230*** (0.041)	0.147*** (0.036)
Population growth	−21.551** (6.582)	−26.109*** (6.782)	12.824 (7.686)	−22.454*** (6.604)	−26.304*** (6.788)	13.281 (7.720)
GDP per capita ^b	0.035** (0.011)	0.317*** (0.047)	0.111*** (0.025)	0.037*** (0.011)	0.317*** (0.046)	0.113*** (0.025)
GDP per capita growth	−0.305 (0.759)	5.633*** (0.551)	6.368*** (0.675)	−0.334 (0.762)	5.616*** (0.552)	6.397*** (0.678)
Cultural block distance	−0.051*** (0.012)	−0.041* (0.021)	−0.036* (0.017)	−0.051*** (0.012)	−0.041* (0.021)	−0.038* (0.017)
Manufacturing percentage	0.038*** (0.010)	−0.002 (0.014)	0.000 (0.013)	0.042*** (0.010)	0.001 (0.014)	0.004 (0.013)
Ownership restrictions	−0.034 (0.023)	0.055 (0.030)	−0.089** (0.030)	−0.030 (0.023)	0.054 (0.030)	−0.090** (0.030)
R&D intensity	8.747*** (0.867)	7.779*** (1.020)	5.164*** (1.147)	8.652*** (0.866)	7.788*** (1.020)	5.125*** (1.147)
Advertising intensity	1.339 (1.289)	5.181*** (0.936)	1.307 (1.192)	1.282 (1.288)	5.186*** (0.935)	1.580 (1.194)
Export intensity	1.143*** (0.118)	−0.147 (0.156)	0.473** (0.155)	1.128*** (0.118)	−0.143 (0.156)	0.457** (0.155)
Employment ^b	0.269*** (0.019)	0.279*** (0.020)	0.290*** (0.022)	0.266*** (0.019)	0.279*** (0.020)	0.287*** (0.022)
International experience ^b	0.066** (0.023)	0.117*** (0.023)	0.155*** (0.026)	0.068** (0.023)	0.118*** (0.023)	0.159*** (0.026)
Country spread	−0.009 (0.006)	−0.018** (0.006)	−0.029*** (0.007)	−0.009 (0.006)	−0.019** (0.006)	−0.030*** (0.007)
<i>Model indices</i>						
Log likelihood		−28,570			−28,543	
Chi-square		6310***			6364***	
Change in Chi-square		34			54	
		(vs main effects only model)			(vs model 1)	
Number of episodes		71,939			71,939	
Wholly owned mfg. entries		1792			1792	
Joint venture manufacturing entries		2339			2339	
Number of distribution entries		2334			2334	

*** $P < 0.001$; ** $P < 0.01$; * $P < 0.05$.

^aRegion, industry and annual fixed effects included in models 1 and 2, but not reported in Table 2.

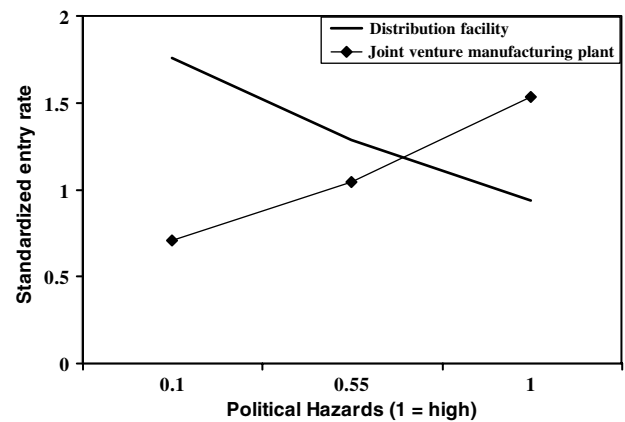
^bVariable is a logarithm.

A similar result can be found in the negative coefficient estimate for prior joint venture manufacturing entry in the wholly owned manufacturing entry column. When considered alongside the positive coefficient estimate on the interaction term between prior joint venture manufacturing entry and *political hazards*, these results indicate that wholly owned manufacturing entry is highest when there has not been a prior distribution entry. Finally, prior distribution entry takes a positive coefficient estimate in the wholly owned manufacturing entry column, showing that the rate of wholly owned manufacturing entry is greater when there has been a prior distribution entry. This last set of results shows that, in countries with low levels of policy uncertainty, wholly owned manufacturing entry tends to immediately follow a prior distribution entry, while skipping the step of a joint venture manufacturing entry. This result, although inconsistent with the stages model, is consistent with our conjecture that a joint venture manufacturing entry can be redundant in less uncertain policy environments, when a prior distribution entry has been made.

Our hypotheses involve differential effects of various coefficients on different types of entry in countries with different levels of *political hazards*. Such effects involve multiple coefficient estimates whose impact on entry rates differs in the level of other independent variables. We therefore examine support for our hypotheses using two figures that indicate the initial entry rate by type in countries with various levels of *political hazards* (Figure 1) and the entry rate for wholly owned manufacturing plants for firms with different prior entry profiles in countries with various levels of *political hazards* (Figure 2).

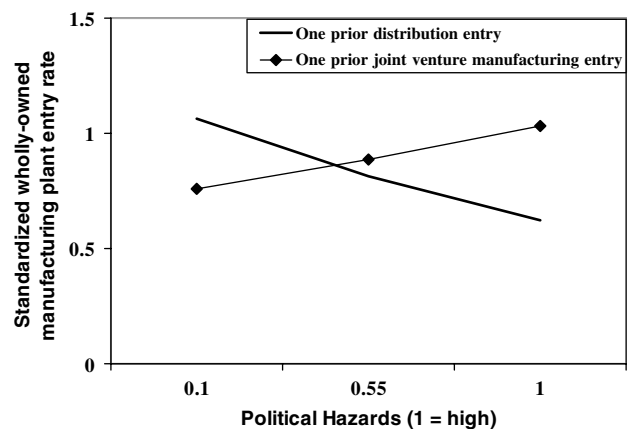
Figure 1 shows how the initial type of entry selected for a country varies by a country's level of *political hazards*. Figure 2 illustrates how the rate of wholly owned manufacturing entry varies by a country's level of *political hazards*, once a specific type of prior entry has been made. Hence the figures show the initial step in entering a market, and the subsequent development of operations once a country has been entered. These figures extend from a tabular assessment of the results as shown in Table 2, which indicates how the sets of covariate estimates on the *political hazards* and prior entry variables are combined to test the hypotheses.

Hypothesis 1a predicted that the likelihood that a firm's investment sequence would begin with a



^aEntry rate standardized by entry rate for a manufacturing facility at the corresponding level of political hazard

Figure 1 Entry rates by type of entry for a firm's first entry in a country.



^aEntry rate standardized by entry rate with no prior entries at the corresponding level of political hazards.

Figure 2 Wholly owned manufacturing entry rates by type of prior entry.

distribution entry would be higher the lower the level of policy uncertainty. H1b predicted that the impact of a prior distribution entry on subsequent entry rates by manufacturing plants would be decreasing in the level of policy uncertainty. We find support for H1a in Figure 1 in the rapid decline in initial entry by distribution facilities relative to joint venture or wholly owned manufacturing plants as *political hazards* increase. When *political hazards* is at its minimum and there are no prior entries, the rate of entry for distribution facilities is 2.48 (1.76) times greater than that for joint venture (wholly owned) manufacturing plants. By contrast, when *political hazards* is at its maximum and there

are no prior entries, the rate of entry by distribution facilities falls to only 0.61 (0.94) times the rate of entry for joint venture (wholly owned) manufacturing plants.

Consistent with H1b, Figure 2 shows that the wholly owned manufacturing plant entry rate is at its highest in a low *political hazards* setting when a firm has made a prior distribution entry, whereas in a high *political hazards* setting a prior distribution entry has a much smaller impact on subsequent entry by a wholly owned manufacturing plant.

Hypothesis 2a predicted that the likelihood that a firm's investment sequence would begin with a joint venture manufacturing entry would be higher, the higher the level of policy uncertainty. Support for this hypothesis is depicted in Figure 1: as *political hazards* increase, entry rates for joint venture manufacturing plants increase above those for distribution facilities or wholly owned manufacturing plants. When *political hazards* is at its maximum, the entry rate by joint venture manufacturing plants is 1.63 (1.53) times greater than that for distribution facilities (wholly owned manufacturing plants). These ratios are greater than the 0.40 (0.71) recorded when *political hazards* is at its minimum.

Hypothesis 2b predicted that the positive impact of such initial joint venture manufacturing entries on subsequent wholly owned manufacturing entries would be higher, the higher the level of policy uncertainty. Consistent with H2b, Figure 2 shows that the wholly owned manufacturing plant entry rate is at its highest in a high *political hazards* setting when a firm has made a prior joint venture manufacturing entry, whereas in a low *political hazards* setting such a prior entry has its smallest impact on subsequent entry by a wholly owned manufacturing plant.

Two alternative explanations for these observed expansion sequences are that they are a function of cultural differences or income differences across host countries, rather than policy uncertainty. To examine these alternative explanations, we constructed models similar to those in model 2, but added interactions between prior distribution entry and prior joint venture manufacturing entry and our measures of cultural distance and GDP per capita. These modifications did not significantly alter the results. We also tested models that examined the interactions between the strength of the host country manufacturing sector and prior entry counts as well as models that combined the *political hazards* and strength of the host country

manufacturing sector variables into a single construct. The qualitative support for our hypotheses was similar in these alternative specifications. Additional details are available from the authors upon request.

Discussion

We have considered the influence of *political hazards* on the within-country sequence of international expansion, as we extended the stages model to include cross-national and temporal variation in uncertainty in the policy environment. Our results show that the probability that a Japanese firm would initially enter a country via a distribution facility was decreasing in the level of policy uncertainty whereas the probability of initial entry via a joint venture manufacturing plant was increasing in the level of policy uncertainty. Furthermore, the marginal benefits of an initial entry in terms of facilitating subsequent entry by a wholly owned manufacturing plant are largest for distribution entries in settings with low levels of policy uncertainty, but largest for joint venture manufacturing plants in settings with high levels of policy uncertainty. The contribution of this research in identifying these differences in entry sequences is to emphasize the important idea of considering the political costs and benefits of a firm's local network of operations as developed through its sequential entries to a foreign market.

This consideration of the relationship between the political environment and firm strategy is not new (Vernon, 1977; Boddewyn, 1988). Prior research has discussed the strategies that a firm can use post-entry to minimize the likelihood that a government will change the conditions under which an investment was made (Behrman *et al.*, 1975; Boddewyn and Brewer, 1994). Our study contributes to this research by first identifying how the policy environment varies in its levels of uncertainty across nations, and then identifying specific strategies for entry into countries that vary in levels of policy uncertainty. Our research points to the idea that choices about sequences of entry impart different development paths for building relationships and knowledge across a firm's consumer and political constituents.

We observe evidence for this in the varying strategies that Japanese firms used for types of entry sequence across countries that varied in their levels of policy uncertainty. Investment sequences that begin with a distribution entry, which is followed by a wholly owned manufacturing entry,

prevail in countries with low levels of policy uncertainty. Investment sequences that begin with a joint venture manufacturing entry, which is followed by a wholly owned manufacturing entry, prevail in countries with high levels of policy uncertainty.

The strategy to initially enter a country by establishing a distribution presence is common in countries with low levels of policy uncertainty, because a firm can use a distribution entry to build knowledge about, and relationships with, consumers. As policy uncertainty increases, however, initial entry by distribution is eschewed by a firm's managers. In its place, managers in firms contend with uncertainty from the policy environment by using an entry sequence that begins with a joint venture manufacturing plant. Policy uncertainty may be countered by building relationships with a local partner and local suppliers in a joint venture manufacturing plant entry. Meanwhile, in less uncertain policy environments, a joint venture manufacturing plant entry is less likely because uncertainty about markets and culture can be countered by a distribution entry, thus obviating the need for a joint venture. By contextualizing the choice of joint venture in relation to policy uncertainty and the sequence of investments, this finding provides a complement to existing research that views the choice of joint ventures as dependent on a firm's general experience levels (Barkema *et al.*, 1996), or as a result of considerations related to transaction costs (Oxley, 1999; Henisz, 2000a).

Entry mode research, which has focused on ownership issues in manufacturing entries, should consider how accounting for distribution entries can help explain observed entry sequences. Research on entry mode choice highlights the idea that a firm will seek to enter by a joint venture when complementary capabilities such as host country knowledge are required (Hennart, 1988). Unless investment histories that account for prior entry by distribution are considered when looking at a firm's investment sequence, a seemingly contradictory observation will be made that an inexperienced firm typically chooses to enter countries with lower levels of policy uncertainty by a wholly owned manufacturing plant, without the use of a prior joint venture manufacturing entry.

The stages model approach can also gain by considering features other than market and cultural uncertainty such as the policy environment, or transactional-related considerations that concern

the sourcing of technological or other forms of knowledge that can also drive the choice to use joint ventures even in the latter stages of a firm's host country expansion sequence (Chang and Rosenzweig, 2001). An expansion of a stages model or sequential entry framework could include consideration of non-equity modes of foreign entry, such as licensing or exporting with a local distributor, although this would involve considerable data challenges and perhaps necessitate a survey instrument.

The results from this study also help to reform considerations about how to examine the influence of national institutional environments on international expansion strategies. The intriguing issue emerging from this study when contrasted with existing studies of the internationalization process is that we observed a weak, almost non-existent influence of the cultural dimension, yet a strong and consistent influence of the political dimension. One reason for this might be the Japanese context. As Japan lacks close cultural counterparts (Ronen and Shenkar, 1985), policy uncertainty is likely to be a dominant consideration for Japanese firms' expansions, compared with the cultural differences that might have been a more immediate concern in previous empirical tests of the stages model that involved Nordic firms.

The lesson we derive from our research for studies of international expansion is that both cultural and policy environments are important, and that inclusion of the latter can help resolve empirical irregularities for the former, particularly with respect to the influence of culture on entry mode choice (Brouthers and Brouthers, 2001). We have expanded on the dimension of uncertainty to show how including measurement of the policy environment in a stages model can improve the predictive validity of the model. A similar effort could be made for other parts of the institutional environment, such as the cultural environment, where research could not just begin to explore variance in national cultures, but perhaps begin to look for cohesion across national cultures when examining cultural influences on international expansion. The cultural blocks measure we employed is a step in that direction.

Conclusion

This study extended ideas based in a stages model of international expansion to incorporate a sophisticated perspective on the impact of uncertainty in a country's policy environment. It highlighted the

differential sensitivity of a firm's sequence of entry in a country by a nation's level of policy uncertainty, to set forth an important modification to the stages model's arguments with respect to the sequence of within-country expansion. We argued and observed that firms exhibited a differential preference for making an initial entry by a distribution facility or by a joint venture manufacturing plant depending on the level of policy uncertainty in a host country. The implication from a theoretical perspective is that sequential investment strategies reflect experiential learning of not only market and cultural environments but also over the policy environment. We thereby bring entry mode studies and the stages model of internationalization into closer concordance with the large body of empirical research emphasizing the importance of

political change and political processes for international expansions strategies across time.

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Notes

¹We thank Bernard Yeung for suggesting the inclusion of this variable.

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