The effect of political and administrative distance on the choice of market entry mode:
Evidence from multinational enterprises in Algeria

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Abstract:

This study examines the effect of political and administrative distance on the choice of MNEs market entry mode. Drawing on institutional theory, we hypothesize that both political and administrative distance have a negative effect on the choice of FDI. Using a sample of 87 MNEs listed in the 500 Global Fortunes, we find that administrative distance has a negative effect on the choice of FDI. Our findings also show an insignificant relationship between political distance and the choice of market entry mode. These findings enhance our understanding of MNEs choice between exporting and FDI to enter foreign markets and contribute to the development of institutional theory.

Keywords: administrative distance, political distance, multinational enterprise, exporting, FDI, institutional theory; market entry mode.
JEL Classification Codes: O17, G18, F23, D22, M16, L19.

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1. INTRODUCTION

In a world where local and international competition increases, firms search foreign markets to perform their activity. The effect of globalization and international competition made firms curious to discover markets other than their domestic markets. Besides, many other effects of globalization trends such as inter-cultural dialogue, political trends, economic integrations, telecommunication development, international transportation services, international production differences, and technological advances made governments, institutions and firms aim to build different bridges with overseas countries. These three components have made the process of economic integrations, blocks and agreements such as the European Union (EU), the North American Free Trade Agreement, the Euro-Mediterranean partnership, etc., a reality. Wright and Ricks (1994, p. 689) describe the relationship between our study and the introductory above: *"Firm-level business activity that crosses national boundaries or is conducted in a location other than the firm's home country… it is concerned in some way with the interrelationship between the operations of the business firm and international or foreign environments in which the firm operates"*.

The above context leads to focus on an important operation practiced in the field of international business (IB, hereafter), i.e. market entry mode, which is studied from different perspectives, models, and scopes. Regardless external specific factors that determine firms market entry modes, the effect of globalization have made international markets to be in a homogenous dynamism, which creates an international environmental opportunity for the internationalization of firms (Porter, 1990; Porter & van der Linde, 1995).

External environment plays an important role in choosing market entry mode (Brouthers, 2013). The Algerian market was considered as an unattractive market for foreign companies before 1990s. Classifying countries into hot, moderate, and cold countries. Goodnow and Hansz (1972) have classified Algeria in their countries' environmental classification as one of the cold countries. Even they have suggested that it was one of the

warmer countries that tend to be more developed economically but less stable politically. Their classification was based on 59 variables principally including political stability, market opportunity, economic development and performance, cultural unity, legal barrier, physiographic barrier and geo-cultural distance measures.

This research contributes to market entry mode literature. Market entry mode literature focused on the general effect of institutional distance, rather than focusing of specific dimensions of institutional distance (e.g. Arslan & Larimo, 2017; Estrin, Baghdasaryan, & Meyer, 2009; Wu & Deng, 2020). Consequently, there is no agreement on the nature of the effect of the various institutional distance dimensions on the choice of market entry mode. Drawing on institutional theory, we investigate the effect of political and administrative distance on the choice market entry mode. Institutional theory perceives that institutional environment as a key factor in the strategic choices of firms (DiMaggio & Powell, 1983; Scott, 1995). According to Scott (1995), political and administrative distance belong to the regulative dimension of institutional distance. Regulative forces constraint the behavior of firms by the formal institutions in a given country.

Our also study drives motivation from the relevance of the contexts in IB research (Liou & Rao-Nicholson, 2017; Singla & George, 2013; Wang & Chung, 2020; Zhong, Peng, & Liu, 2013). In this research, we shed light on the global fortunes marketing their manufacturing-based products in Algeria. At the early of 1990s, Algerian government has made considerable efforts in liberalizing investment framework by implementing a program of economic reforms, complemented by the "Ordonnance 2001". The privatization of key economic sectors was initiated and has led to the attraction of considerable foreign direct investment (FDI) in several sectors. In 2009, the Algerian government changed the law of investment, by which MNEs had to enter the Algerian market via an international joint venture. Thus, we consider two main equity-based modes, which are exporting and FDI, without distinction between international joint venture and wholly-owned subsidiary.

2. Literature Review
2.1 Internationalization Stage Models

Studies consider the model of Uppsala School (Jan Johanson & Vahlne, 1977, 1990, 2006, 2009; J. Johanson & Wiedersheim-Paul, 1975) the well-known and predominant. The Swedish model, established in 1977, is a development for internationalization process (J. Johanson & Wiedersheim-Paul, 1975): a) no regular export activities, b) export via independent representatives (agents), c) establishment of an overseas sales subsidiary, and d) overseas production and manufacturing units, where the successive stages represent higher degrees of international involvement and commitment. Based on the behavioral theory of the firm (Cyert & March, 1963) as well as the studies of (Penrose, 1959) and (Aharoni, 1966), the original model of Jan Johanson and Vahlne (1977) suggest that a firm that internationalize their activities with successively greater psychic distance including factors related to language, culture, political systems, level of education, and level of industrial development.

The American school of innovation stage models (I-Model) (Bilkey & Tesar, 1977; Cavusgil, 1980; Czinkota, 1982; Reid, 1981) considers internationalization as innovation for the firm. It may therefore be described as a process of innovation (Andersen, 1993) presenting different stages of sequential models for the internationalization process of firms. Influenced as well as by the behavioral theory of the firm (Cyert & March, 1963), the models were derived mainly from empirical studies focused on the development process of American SMEs (Leonidou & Katsikeas, 1996). The four models involve learning and managers as specific factors when studying the behavioral perspective, explaining internationalization of firms. Opportunity recognition and commitment represent an innovation adoption process as far as internationalization issue is concerned (Lim, Sharkey, & Kim, 1991). This point of view is influenced by stages of the adoption process (Rogers, 1962, pp. 81-86), and product life cycle model (Vernon, 1966). All models are almost similar except the models of Bilkey and Tesar (1977) and Cavusgil (1980), which suppose that the firms is not

interested in exporting at the first and partially the second stage, while the models of Czinkota (1982) and Reid (1981) describe firms as a unit more interested and active during the early stages.

2.2 Market Entry Modes

Markets are entered via equity as well as non-equity modes. Y. Pan and Tse (2000) provided a hierarchical model of the choice of market entry mode. Non-equity market entry modes include export and contractual agreements. Export refers to the international marketing of products without passing by production chain operations in the host country. This mode is the step of international engagement by the U-model. Exporting, including direct and indirect, requires minimal financial, human, and other resource commitments as compared to other entry modes. Contractual agreements refer to licensing, R&D contracts, alliances (Y. Pan & Tse, 2000) and franchising.

Equity-based market entry modes are wholly-owned subsidiary and international joint venture. Wholly-owned subsidiary is a market entry mode where a firm holds 100 percent of the subsidiary's ownership. It requires large resources and capabilities. Some governments restrict this mode in some industries. International joint venture equity based cross-border alliances that are formed by two or more legally separate organizations located in different countries (Geringer & Hebert, 1989). Developing countries such as China, India, Russia, and post-communist countries within Central and Eastern Europe are often entered via international joint ventures because of weak property rights protection and centralized political governance. The aim of entering companies from the developed countries to develop their performance, but on the other hand less developed or developing countries attract the latter by their local resources (natural, human, animal, etc.) in order to develop their economies, employ their citizens, and own technology and know-how. For instance, China is one of the countries that are entered via IJVs almost over the last four decades (Child, 2002; Child & Tse, 2001; Luo, 2009; Luo & Park, 2004; Y. G. Pan & Chi, 1999). It is an internationalization mode for firms

that would invest in countries where ownership caps and legal restrictions lead them to setup a type of forced IJV (Puck, Holtbrügge, Mohr, Lee, & Makhija, 2009).

3. Hypotheses Development

Political distance refers the extent of similarities or dissimilarities between two countries in terms of their political stability, democracy, state size, and regional agreements, while administrative distance refers to the extent of similarities of dissimilarities between two countries in terms of their economic freedom and government bureaucracy inefficiency.

Entering developing countries' markets via FDI requires land acquisition and matching regulations related to economic freedom, such as licenses, import of required production tangible and intangible resources. Thus, FDI is associated with higher planting and operating costs, as compared to exporting mode. MNEs facing political and administrative distance suffer the effects of distance. Political and administrative distance lead to uncertainty and MNEs misfit with the developing countries' environment (Coeurderoy & Murray, 2008; Hernández & Nieto, 2015). This situation stems from a lack of knowledge in dealing with the levels of risk (Berry, 2006).

Algeria has a lower institutional development level, as compared to the institutional development level of the countries of MNEs listed in Global Fortunes. Countries with political and administrative unpredictability demonstrate instability of governments and their policies, as well as changes in laws. MNEs. Consequently, a poor understanding of weak political and administrative environments makes dealing with these environments difficult. MNEs, thus, tend to take higher engagement when they understand the political and administrative environment of the host country, and *vice versa*. In other words, a higher institutional distance leads MNEs to enter host country with lower commitment (Cuervo-Cazurra & Genc, 2008). Hence, we hypothesize that both political and administrative distance have a negative effect of a market entry mode that requires a higher commitment.

Hypothesis 1: The higher the political distance, the more likely the MNE to choose exporting over FDI.

Hypothesis 2: The higher the administrative distance, the more likely the MNE to choose exporting over FDI.

4. Methodology

4.1 Sample and Data

We established a dataset from the Global 500 fortune. The dataset consists of MNE marketing their manufacturing-based products in Algeria during 2019 and 2020. We gathered data on MNEs presence in Algeria from their official websites, annual reports, financial statements and online search. We excluded primary and tertiary sector-based products, since we did not find MNEs entering the Algerian market via exporting mode in these two sectors. We found 89 MNEs out of the Fortune Global 500 list that market their products in Algeria.

In the second step, we gathered data on MNEs market entry mode from the same sources offering information about their presence in Algeria and from their distribution companies' website where MNEs were using exporting as a market entry mode. We excluded an observation, since the MNE was using licensing. We also excluded another observation due to the lack of information about MNE market entry mode. Consequently, our sample consists of 87 MNEs using either exporting or FDI as a market entry mode.

In the third step, we collected data on political and administrative distance between MNEs home country and Algeria. We gathered data on political distance using political constraint index (for data on policy-making uncertainty), Freedom House (for data on democracy scores), World Development Indicators of the World Bank (for data on the size of states), and World Trade Organization (for data on the regional trade agreements). We collected data on administrative distance from Heritage Foundation (for data on economic freedom) and the World Bank (for data on Inefficient Government Bureaucracy).

Finally, we collected data on control variables. We collected data on

MNEs assets from their latest annual report. In order to calculate cultural distance, we gathered data on cultural dimensions from Hofstede Insights. To calculate geographical distance between MNEs home country and Algeria, we gathered data on the latitude and the longitude of the capital cities from the CIA Factbook.

The leading three countries having MNEs that market their products in Algeria were the United States with 18 MNEs (20.69%), Japan with 16 MNEs (18.39%), and Germany with 12 MNEs (13.79%) (Table 1).

Table 1. Breakdown of Global Fortunes' countries

Country	Number of MNEs	Percentage
USA	18	20,69
Japan	16	18,39
Germany	12	13,79
China	11	12,64
France	11	12,64
South Korea	5	5,75
Switzerland	3	3,45
UK	3	3,45
Netherlands	2	2,30
Spain	2	2,30
Finland	1	1,15
India	1	1,15
Indonesia	1	1,15
Sweden	1	1,15

4.2 Measures

We used a dichotomous measure for our dependent variable, i.e. market entry mode. We coded 1 for FDI and 0 for exporting. We measured political and administrative distance using the Euclidean distance between MNEs home country and Algeria. Mathematically:

$$ED = \sqrt{\sum_{i=1}^{n} (I_h - I_a)^2}$$

Where ED is the Euclidean distance, I_h is the dimension i of the MNE home country, and I_a is the dimension i of Algeria (See Table 2).

Table 2. Distance between MNEs home country and Algeria

MNE home country	Political distance	Administrative distance
China	1.89	2.76
Finland	3.78	3.63
France	3.49	2.56
Germany	4.24	3.57
India	2.21	3.49
Indonesia	2.47	2.26
Japan	2.17	4.22
Netherlands	3.78	3.15
South Korea	3.28	3.18
Spain	3.42	2.21
Sweden	4.02	4.02
Switzerland	3.40	3.55
UK	2.21	3.84
USA	2.38	4.29

We also included control variables showing to have effects on the choice of market entry mode. Prior studies showed that MNEs size is positively associated with higher resource commitment (e.g. Cohen & Klepper, 1996; Majocchi, Bacchiocchi, & Mayrhofer, 2005; Osborne, 1996). In line with Y. Pan, Li, and Tse (1999), we measured size using MNEs assets. Scholars also highlighted that cultural distance affects the choice of market entry mode (e.g. Ha, Binh, & Dang, 2020; Kogut & Singh, 1988; Pak & Park, 2004). Following prior studies (e.g. Brouthers & Brouthers, 2001; Chang & Rosenzweig, 2001; Slangen & van Tulder, 2009), we

measured cultural distance using the Euclidean distance between MNEs home country and Algeria. We also controlled for geographic distance, since it may affect the choice of market entry mode (e.g. Choi & Contractor, 2016; Ragozzino, 2009). We measured geographic distance using Haversine formula. In other words, we measured the great circle distance between the capital city of MNEs home country's capital city and Algiers.

4.3 Technique of Analysis

Our independent variables do not follow a normal distribution. In addition, market entry mode is a binary outcome, while independent variables are continuous. Therefore, the suitable technique of analysis for testing our hypotheses is logistic regression model. We use STATA/IC 14 program to perform our analyses.

5. Results

Table 3 and 4, respectively, present descriptive statistics and correlation matrix of our variables. Variation inflation factors (VIF) are below 3, which indicates the absence of multicollinearity problem among independent variables.

Table 3. Descriptive statistics

Variable	Mean	Std. Dev.	Min	Max
Market entry mode	0.43	0.50	0	1
Political distance	2.85	0.82	1.89	4.24
Administrative distance	3.53	0.69	2.21	4.29
Size (assets) [a]	114 962.80	117 813.70	9 599.50	601 899.90
Cultural distance	81.17	13.58	41.45	95.51
Geographic distance [b]	6 954.60	3 853.35	1 468	12 220

[a] Assets in USD Million.

[b] In kilometers.

As shown in Table 3, 50 out of 87 MNEs (57.47%) were adopting exporting, while 37 out of 87 MNEs (42.53%) were adopting FDI as a market entry mode. The minimum political distance from the Algerian political environment was that of China ($ED_P = 1.89$), while the highly distant environment was that of Germany ($ED_P = 4.24$). The minimum

administrative distance from the Algerian political environment was that of Spain (ED$_A$ = 2.21), while the highly distant administrative environment was that of the United States (ED$_A$ = 4.29). The minimum administrative distance from the Algerian political environment was that of Spain (ED$_A$ = 2.21), while the highly distant administrative environment was that of the United States (ED$_A$ = 4.29). In terms of control variables, the minimum cultural distance from the Algerian cultural environment was that of Spain (ED$_A$ = 95.51), while the highly distant administrative environment was that of the Sweden (ED$_A$ = 95.51). In terms of geographical distance, the least distant country from Algeria was France (GD = 2 024 km), while the most distant country was Indonesia (GD = 12 220 km).

Table 4. Correlation matrix

Variable	1	2	3	4	5	6
Market entry mode	1.00					
Political distance	0.27 (0.011)	1.00				
Administrative distance	-0.40 (0.000)	-0.21 (0.053)	1.00			
Size (assets) [a]	0.33 (0.002)	0.11 (0.314)	0.06 (0.601)	1.00		
Cultural distance	-0.19 (0.071)	-0.18 (0.103)	0.615 (0.000)	0.03 (0.792)	1.00	
Geographic distance [a]	-0.38 (0.000)	-0.76 (0.000)	0.42 (0.000)	-0.11 (0.325)	0.37 (0.000)	1.00

[a] Logarithmically transformed. Values reported between parentheses are significance levels.

Table 5 presents logistic regression models. Model 1 shows the results of the effect of our control variables on the choice of market entry mode. Model 2 demonstrates the effects of both political and administrative distance on our dependent variable. Model 1 as well as Model 2 demonstrate a significant predictive power (p = 0.000). The results of Model 1 show that size, measured in assets, has a positive effect on the

choice of FDI ($\beta = 0.950$, $p = 0.003$). In addition, they show a negative effect of geographic distance on the choice of FDI ($\beta = -1.163$, $p = 0.003$). The results in Model 2 demonstrate insignificant effect of political distance on the choice of market entry mode ($\beta = -0.150$, $p = 0.761$). In contrast, they show significantly negative effect of administrative distance on the choice of FDI ($\beta = -1.776$, $p = 0.007$).

Table 5. Logistic regressions

Variables	Model 1		Model 2	
	β_j	$P > |z|$	β_j	$P > |z|$
Political distance			-0.150 (0.492)	0.761
Administrative distance			-1.776 (0.656)	0.007
Size (assets)[a]	0.950 (0.317)	0.003	1.080 (0.356)	0.002
Cultural distance	-0.017 (0.021)	0.403	0.045 (0.032)	0.162
Geographic distance [a]	-1.163 (0.397)	0.003	-1.132 (0.619)	0.067
Constant term	0.361 (4.230)	0.932	0.197 (6.772)	0.977
Log-likelihood	-46.97		-42.483	
Log-rank Chi-squared	24.71		33.69	
$P > $ Chi-squared	0.000		0.000	
Pseudo R^2	0.208		0.284	
N	87		87	

[a] Logarithmically transformed. Values reported between parentheses are standard errors.

6. Discussion

Our study is motivated by the important effect of regulatory institutional distance on the choice of market entry mode. In addition, it is motivated by the lack of studies that explain the choice of market entry mode based on political and administrative distance between MNEs home country and Algeria. Drawing on institutional theory, our research explains

the negative effect of political and administrative distance on the choice of a market entry mode that requires a higher commitment, i.e. FDI over exporting.

Our first hypothesis suggests that MNEs are more likely to choose exporting over FDI when political distance is larger. We did not find empirical support for our first hypothesis. A possible explanation is that MNEs may not focus on many political dimensions, such as democracy, state size and regional agreements, as far as their focus on economic freedom and bureaucratic practices.

Our second hypothesis suggests that MNEs are more likely to choose exporting over FDI when administrative distance is larger. Grounded in institutional theory, we argue that MNEs find higher administrative dissimilarities inhibiting to understand the host countries' environment. MNEs face a problem of mismatch between their business practices in their home countries and those in the host country. Therefore, they are more likely to choose a market entry mode that does not require a higher commitment, i.e. exporting. The results of our analysis confirm our arguments.

Our findings related to the second hypothesis corroborate with those of Hernández and Nieto (2015), who showed that firms are more likely to choose a market entry mode requiring a lower level of resource commitment when the negative regulatory distance increases. In our context, we use negative distance, which implies that MNEs countries' political and administrative development level is higher than that of Algeria.

Our findings also complements those of Wu and Deng (2020), who found a negative effect of institutional distance (differences in political and legal systems and government regulations) on the choice of a market entry mode requiring higher resource commitment. Our findings also complement those of Zhang (2015), who found that MNEs are less likely to engage with a higher ownership level in their focal subsidiaries when administrative distance in high. Our findings corroborate with those of Schwens, Eiche, and Kabst (2011), suggesting that firms understanding institutional

differences are in a better position to take a market entry mode decision.

7. Conclusion

7.1 Contributions

Focusing on the choice between exporting and FDI, we contribute to the literature on the choice market entry mode, by examining the effect of political and administrative distance on the choice between exporting and FDI. A systematic evidence on the effect of political and administrative distance on MNEs choice between exporting and FDI is lacking far. We believe that our study contributes to the literature, since it demonstrates the effect of the distance of two regulatory dimensions on the choice of market entry mode, rather than taking into account regulatory distance in whole (e.g. Wu & Deng, 2020). We show that administrative distance is the regulatory dimension which determines the choice between exporting and FDI. We also provided an empirical contribution by using the setting of Global Fortunes in Algeria.

7.2 Managerial and policy implications

Our study has practical implications for firms as well as for institutional policy makers. Firms should pay attention to the administrative environment. They should understand and assess host countries' administrative environment before engaging in a specific choice of market entry mode. A better understanding of the administrative differences leads MNEs to become more adaptable with FDI in the host country. Formal institutional policy makers also should be cognizant to their administrative environment. Host countries' policy-makers interested in attracting FDI should develop their administrative environment by promoting economic freedom and reducing inefficient bureaucratic practices, in order to reduce the administrative distance between their countries and MNEs' home countries.

7.3 Limitations and future research

This study has some limitations that may serve as promising futures research opportunities. First, we used a sample MNEs listed in Global Fortune 500 present in Algeria. Therefore, MNEs from many countries are

not included in our sample. Future studies may consider a larger sample by considering the list of Global 2000, consisting of the world largest public companies. Second, we did not consider the dimension of external trade associations in measuring political distance (e.g. Berry, Guillén, & Zhou, 2010; Brewer, 2007), since all MNEs countries in our sample are members in the World Trade Organization while Algeria has the status of observer. Future studies may consider this dimension to obtain more accurate results. Moreover, we measured administrative distance using economic freedom and government bureaucracy inefficiency. Future studies may consider other dimensions, such as sharing a common legal system (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998), and having colonial links (Bröcker & Rohweder, 1990). Third, we used Euclidean distance formula to calculate both political as well as administrative distance. Future studies may Using differences, Kogut and Singh's (1988) distance formula, or Mahalanobis distance formula may provide dissimilar results. Despite these limitations, we believe that our study provides robust results, and fills an important gap in the literature.

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