

## THE ROLE OF PSYCHIC DISTANCE ON INTERNATIONALIZATION PROCESS OF SMEs IN TURKEY

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**ABSTRACT.** The purpose of this paper is to investigate the effect of psychic distance factors on internationalization decisions of small and medium-sized enterprises (SMEs). Particularly, this paper offers interesting insights into the literature because of the limited number of academic studies related to psychic distance factors in Turkey and the presence of contradictory findings about the effect of these factors in literature. This study takes into consideration all psychic distance indicators which have been found in earlier studies and indicates how effective those factors are for SMEs in Turkey as an emerging country. The results of the empirical study confirm that psychic distance factors have an impact on the internationalization decisions of companies and the extent of impact of these factors vary considering internationalization degree and number of countries they operate.

**Keywords:** Psychic Distance, Internationalization, Small and Medium-Sized Enterprises

**JEL classification:** M16, L25

### 1. Introduction

In today's fast-paced and aggressive competitive business environment, domestic companies, especially small and medium sized enterprises

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(SMEs) face the fact that it is vital and inevitable to internationalize in order to compete with multinational companies which dominate their home market. However, there are many difficulties of internationalization and SMEs may cope with a more complicated and compelling internationalization process because of having insufficient experience and resources. For Turkey, due to the fact that SMEs constitute 99% of all enterprises and contribute 59% of total export, their internationalization process comes out to be a crucial and critical issue to analyze (TUIK, 2012).

Considering earlier studies carried out, some theories specify internationalization process of companies as a stepwise path, which suggest that companies initially select close markets to internationalize, and then they move forward to more distant ones. Uppsala model is one of the most prominent models, which elaborates this gradual pattern of internationalization (Johanson and Wiedershiem-Paul, 1975). In this model some attributes, named as psychic distance factors, are asserted as disturbing factors affecting understanding of business environment of foreign markets; thus lead companies to select countries which have lower psychic distance at first rather than more distant ones. Yet this suggestion is disaffirmed by some studies arguing that psychic distance factors do not have considerable influence on internationalization decisions (Crick and Jones, 2000; Kontinen and Ojala, 2010; Moen and Servais, 2002). The different and two-sided approaches and findings of current literature and the fact that there is no consensus about the effect of psychic distance factors on internationalization are the motivation to analyze the situation for SMEs in one of the emerging markets, Turkey. The aim of the study is to investigate whether psychic distance factors have any impact on the internationalization decisions at the level of companies; besides if any, it is intended to find whether the extent of impact of these factors vary considering the international experience and internationalization degree of companies.

## **2. Literature Review**

In recent years, companies show a gradually higher propensity to expand into global markets to take advantage of the growth opportunities within a competitive market place. In this case, the most fundamental decision of internationalization process is selection of the right market

(Malhotra et al., 2009). Particularly, the perception of decision makers about the country will be selected may have an important role beyond the realities related to entry decision such as transportation costs or competition in that country. For example, Beckerman (1956), Johanson and Vahlne (1977) revealed that managers/exporters are affected by their perceptions while deciding which foreign market is appropriate to enter. Under this argument, a new concept called psychic distance has emerged.

The term of psychic distance was first used in the literature by Beckerman (1956) in a study about trade flows among European countries and he refers this term to describe that some foreign markets are perceived to be closer than others. Then, the concept was developed and popularized by a group of scholars at Uppsala University to explain internationalization process of a company and identified as a determinant of internationalization behavior (Johanson and Vahlne, 1977; Johanson and Wiedersheim-Paul, 1975). Johanson and Wiedersheim-Paul (1975) define psychic distance as “factors preventing the flow of information between the company and the foreign market (e.g. differences in language, culture, political systems, level of education etc)”. According to Uppsala internationalization model, companies tend to enter foreign markets which are not psychically distant from home country. They start their foreign operations in countries which are less psychically distant and as they gain sufficient knowledge and experience, they subsequently penetrate into the countries which are more psychically distant (Johanson and Wiedersheim-Paul, 1975).

During the ongoing debate on psychic distance, scholars began to revise their psychic distance definitions. For example, in the study of Nordstrom and Vahlne (1994, p.42), they define psychic distance as “factors preventing or disturbing companies’ learning about and understanding a foreign environment”. Their focus on companies’ comprehension and learning refer that consideration of individuals within the company is particularly important when measuring psychic distance due to the fact that individuals’ decisions hold great significance to learn companies’ internationalization behavior. In this context, the term of psychic distance is required to change from an information flow perspective which is based on the differences in national level to a perception-based perspective which shows the importance of how individuals affect their companies’ internationalization process. Thus, the concept of perception has been added to many subsequent studies (Lee, 1998; Stottinger and

Schlegelmilch, 1998; Swift, 1999; Evan and Mavondo, 2002; Evans and Bridson, 2005). Therefore, psychic distance can be redefined as the individual's perceived differences between the home and host country (Sousa and Bradley, 2006). Taking into account that individuals' perceived differences between home and host country becomes especially remarkable for SMEs due to the fact that they are dependent on owners/top managers' decisions in their internationalization process; the concept of psychic distance takes an important place for market entry decisions in earlier stages of internationalization of SMEs (Cicic, Patterson and Shoham, 1999).

When conducted studies are considered, contradictory findings regarding the impact of psychic factors on internationalization decisions of companies appear. For instance, there are some other empirical findings related to insignificance of the psychic distance factors in the internationalization process of companies. Moen and Servais (2002) found that psychic distance has no impact on the export market decisions of internationalizing companies. Besides, according to Crick and Jones's study (2000), growth opportunities, niche markets are more exploratory compared to psychic distance factors in terms of market choice. However, Dow (2005) found that psychic distance perception has an effect on born-global companies rather than global companies in terms of their selection of psychically close markets at first. Hashai and Almor (2004) also claimed that born-global companies follow a gradual internationalization process with regard to entering psychically closer countries rather than distant ones. Moreover, Chetty and Champell (2004) investigated traditional and rapidly internationalizing companies of New Zealand and their findings support that companies behave according to psychic distance logic by following a stepwise path and investing psychically similar countries initially.

Liesch and Knight (1999) mention that the more psychically distant the market, the greater the uncertainty confronting the new entrant. This idea is derived from studies of Johanson and Wiedersheim (1975) and Johanson and Vahlne (1977) which reveal that market knowledge and market experience are important for companies regarding resource commitment and further investment. It was argued that when the companies have sufficient experience related to a particular market and get accustomed to business activities in this market; their level of commitment to that market increase due to decreased perceived risk and uncertainty level through learning. The smaller amount of perceived

risk and uncertainty reduces psychic distance between home and host country. In other words, when companies start to be more familiar with a specific country through the gained international experience, they are encouraged to enter new markets that are psychically more distant. In this context, the following hypotheses were proposed to explain that the impact of psychic distance factors differs through international experience which is a function of both the time and diversity of operations.

*H<sub>1a</sub>: The impact of psychic distance differs through the number of countries operated*

*H<sub>1b</sub>: The impact of psychic distance factors differs through the internationalization age*

According to Papadopoulos and Martin (2010), internationalization degree shows the firm's concentration to foreign markets in terms of export intensity. Additionally, Olejnik and Swoboda (2012) supported this view by identifying that the firms' internationalization degree is related to their knowledge and understanding gained from foreign markets. By considering this relationship and taking into account abovementioned link between international experience and psychic distance factors; one can expect that there is an association between internationalization degree and psychic distance factors.

*H<sub>2</sub>: The impact of psychic distance factors differs through internationalization degree of companies*

### **3. Research Methodology**

In this study, it is preferred to conduct a survey to test mentioned hypotheses above. The survey comprises of two parts. In the first part, it was aimed to measure to what extent psychic distance factors effect SMEs' internationalization decisions. The literature of psychic distance factors was searched and we reached a wide variety of scales and indices about the operationalization of the construct in order to form a questionnaire measuring psychic distance factors (Bello et al., 2003; Boyacıgiller, 1990; Brewer, 2007; Child et al., 2009; Dow and Karunaratna, 2006; Evans and Mavondo, 2002; Hakanson and Ambos, 2010; Johanson and Wiedersheim-Paul, 1975; Katsikeas et al., 2009; Klein and Roth,

1990; Lee, 1998; Madsen, 1989; Shoam and Albaum, 1995, Sousa and Bradley, 2005). Subsequently, the scales which are used in measurement of psychic distance were examined and all items were integrated by eliminating repetitive and resembling items. Consequently, a questionnaire with 32 items using a 7-point scale (from completely ineffective to completely effective) was formed. Cronbach's alpha of this scale is 0.93 which means a high internal consistency. In the second part, the questions about internationalization degree, international experience and demographic profile were presented to respondents. Internationalization degree was measured with the question of foreign sales ratio. Two questions were asked to assess the level of international experience: the year when companies have begun their international activities (internationalization age) and the total number of countries they operate. The questionnaire was firstly designed in English and then translated into Turkish through back-translation procedure.

In sampling process, list of SMEs engaged in international activities in Izmir have constituted sampling frame. A company list was taken from Aegean Exporters Association and convenience sampling method was used to select subjects. In survey implementation, several surveys applied via e-mails and company visits were made for several others to increase response rate. Totally 123 valid questionnaires were collected.

Studies and revisions about the definition of psychic distance give rise to the alteration of the unit of analysis in the process of measuring psychic distance (Smith et al., 2011). Even though the appropriate unit of analysis for measuring psychic distance consists of individuals, the concept comprises both national and individual determinants (Dow and Karunaratna, 2006; Smith et al., 2011). This study applied to export managers/general managers/owners of the companies.

#### **4. Results**

The questionnaire was filled by decision makers of internationalization process and as a result about 85% of the participants were general managers, export managers or owners of the companies which increases the accuracy/precision of the answers. The sample structure considering aspects such as title of respondents, firm age, product type, internationalization age, total number of countries operated is presented in Table 1.

**Table 1. Respondent Profile**

		%
<i>Title of respondents</i>	Owner/Shareholder	40.7
	President/Vice president	5.7
	Export manager	39.0
	Others	14.6
<i>Firm age</i>	0-3 years	7.3
	4-10 years	23.6
	11-25 years	47.2
	26 +	22.0
<i>Product type</i>	Industrial products	66.7
	Consumer products	33.3
<i>Internationalization age</i>	0-3 years	18.7
	4-10 years	36.6
	11-25 years	37.4
	26-50 years	6.5
<i>Total number of countries operated</i>	1-5 countries	35.0
	6-10 countries	32.5
	10 +	31.7
<i>Foreign sales ratio</i>	1-10 %	13.8
	11-25 %	17.9
	26-50 %	25.2
	51-100 %	42.3

Data analysis was conducted in three stages. At first stage, the mean rating method was used. In this context, Table 2 shows the effect of 32 psychic distance factors on internationalization decisions in descending order. According to this ranking, among all items, having trade agreement ( $\mu=5.22$ ), having similar approaches in the framework of trade ethics ( $\mu=4.99$ ) and conveniently to reach secondary information ( $\mu=4.99$ ) have the highest impact on internationalization decision. It should be noted that the mean score of overall scale was 3.56 and 15 items were under 3.56. Additionally, the respondents rated their interest in sporting activities of host country as the least effective item in their internationalization decisions ( $\mu=1.49$ ). Even though proxy cultural ties such as common language, religion are described as an important determinant of bilateral trade volumes (Felbermayr and Toubal, 2010), cultural similarities have seen among least effective factors in this study; for instance, having similar religion ( $\mu=1.87$ ) was evaluated as one of the least effective psychic distance factors. Due to almost 70% of

respondent companies are producing industrial products which means they are not dealing with end user directly in the operated country, cultural similarities may be perceived as relatively less prevailing.

**Table 2. Psychic Distance Items**

	<b>Mean</b>	<b>Std. Deviation</b>
Having trade agreements between home and host country	5.22	1.952
Having similar trade ethics between home and host country	4.99	1.931
Having trade representation offices and secondary information availability about host country	4.88	1.840
Presence of aid programs for the host country	4.84	1.985
Having high degree of foreign investments in host country	4.67	2.059
Existence of similar legal system between home and host country	4.50	1.939
Having similar trade regulations between home and host country	4.41	1.886
Having similar consumer preferences between home and host country	4.35	2.045
Knowing the language of the country operated	4.24	2.270
Having similar accepted business practices between home and host country	4.21	1.839
Having similar marketing infrastructure between home and host country	4.07	1.902
Having similar economic climate between home and host country	4.07	1.957
Having similar purchasing power of customers between home and host country	4.06	2.058
Presence of low level of corruption in host country	4.04	2.208
Existence of developed communication infrastructure in host country	3.98	1.952
Having low geographic proximity between home and host country	3.93	2.246
Having similar level of economic development between home and host country	3.70	1.996
Having similar level of education between home and host country	3.47	1.972
Existence of political rivalry between home and host country	3.31	1.988
Travelling frequently to the host country	3.29	2.052
Existence of similar political system between home and host country	3.16	1.926
Having high level of technical development in host country	3.15	1.731
Having similar conventions of personal relationships between home and host country	3.06	1.830
Having cultural similarities between home and host country	2.79	1.955
Having similar life style between home and host country	2.78	1.831



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Existence of previous trading channels between home and host country	2.54	1.956
Having similar climatic conditions between home and host country	2.41	1.801
Existence of Turkish immigrants in host country	2.40	1.782
Having historical ties between home and host country	2.36	1.574
Having small time zone differences between home and host country	2.20	1.651
Having similar religion between home and host country	1.87	1.465
Being interested in sporting activities of host country	1.49	1.011
1= Completely Ineffective ; 7= Completely Effective		

At second stage, an exploratory factor analysis was conducted in order to reduce the number of variables for a subsequent analysis of variance (ANOVA) identifying response variation based on number of countries operated, internationalization age and internationalization degree. As mentioned above, the questionnaire was made up of 32 items, all of which were gathered through scales and indices previously developed. In order to assess the items which have been perceived as more prominent, the items whose mean score are below 3.56 and which are perceived as irrelevant were deleted and not considered for the further analyses. As a result totally 17 items were put into the exploratory factor analysis. However, beforehand Kaiser Meyer Olkin (KMO) value of these 17 items was checked to ensure the suitability and wellness of data for factor analysis. KMO value was found 0.869 and Barlett's Test of Sphericity value was seen as significant (.000), promoting the factorability of correlation matrix. Examination of the rotated factor loadings using varimax rotation yielded four factors with an eigenvalue greater than one, all of which explain 66.12% of the variance. Two items with loading factors less than 0.50 were removed from the analysis (Hair, 1998). The pattern suggested that items included in first factor were corresponding marketing attributes and labeled as "marketing and related items" (6 items,  $\alpha=0.848$ ). Items in the second factor were related to trade characteristics of markets and named as "trade relations" (4 items,  $\alpha=0.798$ ). Third factor was regarded as "business ethics" (3 items,  $\alpha=0.609$ ) and fourth factor was related to "financial incentives" (2 items,  $\alpha=0.751$ ) Subsequently Cronbach's alpha was calculated and item-total statistics were examined for each factor. At least acceptable reliability ratios varying from 0.6 to 0.8 obtained implying that none of the items were needed to be removed due to diminishing total reliability level of factors.

**Table 3. Factor Analysis of Psychic Distance Construct**

Factor items	Factor loading	Cumulative variance explained
<b>Marketing and Related Items (Alpha=.848)</b>		21.98
Consumer preferences	0.829	
Economic climate	0.784	
Purchasing power	0.682	
Economic development	0.646	
Marketing infrastructure	0.585	
Trade regulations	0.539	
<b>Trade Relations (Alpha= .798)</b>		39.67
Trade agreements	0.757	
Foreign direct investment	0.740	
Language	0.642	
Communication infrastructure	0.635	
<b>Business Ethics (Alpha= .609)</b>		53.25
Business ethics	0.720	
Corruption	0.708	
Business practices	0.548	
<b>Financial Incentives (Alpha= .751)</b>		66.12
Aid programs	0.836	
Representation office	0.783	

At third stage, series of ANOVA were conducted to test the hypotheses (Table 4-5). Significant difference of impact for “marketing, trade relations and business ethics based psychic distance factors” were found according to internationalization degree, number of countries operated and internationalization age.

The first hypothesis (H<sub>1a</sub>) proposed that the impact level of psychic distance factors for marketing, trade relations and business ethics differs through the total number of countries operated (F = 5.461, p = 0.005; F = 4.052, p = 0.020; F = 6.864, p = 0.002). Therefore, the H<sub>1a</sub> was accepted through the significant result of ANOVA (Table 4). It has been found that as the number of countries operated increases, the impact of psychic distance factors for marketing, trade relations and business ethics decreases. For marketing factor, while companies operating in between 1-5 countries think that psychic distance factors have an effective role on their internationalization decisions ( $\mu = 4.60$ ), companies operating in more

than 10 countries do not find them as much as effective they found ( $\mu = 3.54$ ). Likewise, trade relations and business ethics factors show also decreasing trend effect on internationalization decisions of companies as number of countries they operate increases.

**Table 4. ANOVA for Total Number of Countries Operated**

<b>Number of Countries Operated</b>	<b>Mean* (Std. Dev.)</b>	<b>F</b>	<b>Sig</b>
<i>Marketing and Related Items based</i>			
<i>Psychic Distance Factor</i>			
1-5 countries	4.60 (1.39)	5.461	.005
6-10 countries	4.12 (1.40)		
10 + countries	3.54 (1.53)		
<i>Trade Relations based</i>			
<i>Psychic Distance Factor</i>			
1-5 countries	4.68 (1.44)	4.052	.020
6-10 countries	4.89 (1.54)		
10 + countries	3.92 (1.74)		
<i>Business Ethics based</i>			
<i>Psychic Distance Factor</i>			
1-5 countries	4.96 (1.35)	6.864	.002
6-10 countries	4.44 (1.32)		
10 + countries	3.79 (1.61)		

\*1= completely ineffective; 7= completely effective

For  $H_{1b}$ , according to the results obtained from ANOVA test, significance level of all four factors; marketing, trade relations, business ethics and financial incentives are found greater than 0.05, which means the perceived impact level of psychic distance does not differ significantly through internationalization age ( $F = 1.078, p = 0.361$ ;  $F = 1.688, p = 0.173$ ;  $F = 0.754, p = 0.522$ ;  $F = 2.553, p = 0.059$ ). Therefore,  $H_{1b}$  was not confirmed.

Regarding the  $H_2$ , the ANOVA revealed that the impact level of psychic distance factors on internationalization decisions differs through internationalization degree of companies. Results obtained reveal that two factors; impact of trade relations and business ethics based psychic distance factors on internationalization decisions have significant difference ( $F = 3.410, p = .020$ ;  $F = 4.357, p = .006$ ). Thus, the  $H_2$  is accepted for psychic distance factors related to trade relations and

business ethics (Table 5). Indeed, perceived impact level of psychic distance for business ethics factor decreases as companies' foreign sales ratio increases. While companies had foreign sales ratio in between 1-10% found it more important ( $\mu = 5.19$ ) than companies had foreign sales ratio in between 26-50% ( $\mu = 376$ ).

**Table 5. ANOVA for Internationalization Degree**

		<b>Mean*</b> <b>(Std. Dev.)</b>	<b>F</b>	<b>Sig</b>
<i>Trade Relations based</i>				
<i>Psychic Distance Factor</i>				
<b>Internationalization Degree**</b>	1-10 %	4.98 (1.91)	3.410	.020
	11-25 %	4.55 (1.57)		
	26-50 %	4.01 (1.50)		
	51-100 %	5.01 (1.51)		
<i>Business Ethics based</i>				
<i>Psychic Distance Factor</i>				
<b>Internationalization Degree</b>	1-10 %	5.19 (1.49)	4.357	.006
	11-25 %	4.18 (1.71)		
	26-50 %	3.76 (1.36)		
	51-100 %	4.63 (1.34)		

\*1= completely ineffective; 7= completely effective

\*\*Foreign Sales/Total Sales

## 5. Conclusions

Overall, the results of this study suggest that the effect of psychic distance factors on internationalization decisions varies through companies' international experience and internationalization degree, as hypothesized. According to the results obtained, it was found that as companies gain experience, they give less importance to psychic distance factors during their internationalization decisions. The influence of psychic distance factors based on marketing and related items, trade relations and business ethics on internationalization decisions decreases through gained international experience. Hence, it can be mentioned that impact of psychic distance becomes to be neglected as the number of countries they operate increases. When the companies increase the number of markets they operate, they gain more experience about foreign markets, which

results in upslope of the learning curve. Since they get higher market knowledge about host country, their perceived risk of investing abroad decreases and the psychic distance factors get lower attention.

Participant companies have different perceptions about trade relations and business ethics based psychic distance factors according to internationalization degree. Companies with low internationalization degree mentioned that trade relations based psychic distance factors are more effective on their internationalization decisions compared to companies with higher internationalization degree. This result points out how SMEs at the bottom rung of the internationalization ladder are more influenced about the presence of trade agreement between home and host countries, high degree of foreign investments, and familiarity with language of host country. However, for the companies with highest internationalization degree, the perceived impacts of trade relations based factors have higher mean value. This surprising outcome can be interpreted as highly internationalized companies are more concerned about trade relations based on psychic distance factors due to the fact that their resources stability and permanence are more dependent to international trade revenues and returns. Especially, the presence of trade agreements with host country and high degree of foreign investments to host country makes the process easier for more internationalized companies to intensify their operations and guarantee their earnings by enhancing general trade interaction between two countries.

It should be noted that psychic distance factors do not have broad impact on companies' internationalization decisions. Particularly, the psychic distance factors related to similarities about trade regulations, business ethics, legal systems, business practices were found as relatively more effective factors on internationalization process compared to socio-cultural factors such as historical ties, similar lifestyle and religion. For example, 15 psychic distance items which includes socio-cultural factors have been identified as they had poor impact on internationalization decision. The reasons behind this finding can be SMEs' inadequate awareness about psychic distance factors based on socio-cultural aspects. It can be attributed to two dynamics, first of which is the type of customer targeted and second of which can be defined as operation mode. For instance, most of the companies are producing industrial product, which means SMEs do not deal with end user directly in the operated country. Beside, almost all of the examined companies are internationalized

through export mode and do not deal with further resource investment such as foreign direct investment (FDI). Mentioned issues can be preventive or hindering points that restrain SMEs to deal with the market entirely or completely; hence, reducing the impact of psychic distance or awareness of these factors. Together with the statements above, another explanation which can be drawn from the company visits is that Turkish SMEs mostly take financial opportunities into consideration rather than psychological factors. Those opportunities which have been overemphasized during the interviews consist of cost advantages such as advance payment or money back guarantee. "Financial incentives" was also found as one of the highest rated psychic distance factors and this finding is also in accordance with previous explanation.

Finally, a number of limitations need to be considered. First, the generalization of findings is limited because of the convenience sampling method used. Second, measurement of dependent variable is based on the perceptions of managers. Third, the elimination of items whose mean scores are under 3.56 could damage the validity. Fourth, in the company visits it was reported that companies generally have a tendency to find new markets or customers through references or testimonials by previous customers; hence companies do not become concerned about the environment or characteristics of new markets in the internationalization process. This way of market selection can be noted as a limitation, since it diminishes companies' consciousness about psychic distance factors or the amount of importance devoted to those factors.

As with any study, there are some research limitations that lead to further studies. Our sample does not focus on specific industry and the results may differ from industry to industry. Therefore, it would be recommended to make the comparative analysis among different industries and between SMEs and large companies. Also, the results of this study cannot be generalized for all of the countries, since it has been conducted to the firms operated in Izmir, Turkey.

When discussing managerial implications of this study, managers' perception of psychic distance is crucial for firms in terms of selection of the right market. Therefore, being aware of the effect of psychic distance factors on their internationalization decisions provides more comprehensive understanding of market entry decisions and accordingly, managers may handle distant-creating factors more effectively and efficiently when entering psychically distant markets.

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