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Title:

Cultural Tolerance as a Moderator of the Relationship Between Home-Host Psychic Distance and Firm Performance

Abstract

This paper introduces the concept of Cultural Tolerance (CT) and indicates its role in examinations of multinational companies. CT is the degree of openness toward different cultures and acceptance of diversity in terms of values, beliefs, and behaviours. We argue that CT is a significant determinant of the host country environment and can moderate the impact that Psychic Distance between home and host countries has on firm performance. We develop a framework of CT by incorporating 13 dimensions across the four level of tolerance and we construct a composite index based on 45 reliable indicators. Following confirmation of the internal consistency of CTI, we then test its impact on multinational companies, by focusing on a sample of 718 SMEs with 2,395 foreign subsidiaries across the EU. Our findings confirm the significance of CT in cross-cultural examinations and indicate that in countries where cultural tolerance is deemed to be low (range of 0 to 0.4), the effect of PD on performance is statistically insignificant. Furthermore, the results show that CT positively moderates the impact of home-host PD on performance.

1. Introduction

Over the last couple of decades, European politicians have expressed concerns that immigrants building and maintaining bounded communities based on their ethnic and/or religious identities, pose a threat to national unity (Roberge & Rousseau, 2012). Fears of terrorist attacks, xenophobia, unemployment, and financial crises, and, most crucially, hostility towards immigrants and generally diversified cultural values are the sources, as well as the effects, of this issue (Nyamnjoh, 2010). Even though, there is a growing "fear of the other" in countries with a long history of diversity (Searchlight Educational Trust, 2011), cultural diversity is becoming more prevalent, and it has an impact on not only social and political unity, but also organizational cohesiveness and efficiency.

Within a country, the attitudes, approaches, and behaviours towards diversity can be conceptualised through the concept of Cultural Tolerance (CT). CT indicates the degree of openness toward different cultures, where individuals and groups within a nation allow the existence of practices, beliefs, and values different from their culture without interference (DeMarco & Fox, 2020). CT is defined by Kirchner et al. (2011) as the willingness to tolerate or accept people or groups, as well as their underlying values and conduct, via coexistence, even if they are radically different from one's own. As such, determining the degree of CT in a country can be particularly useful in multiple ways (Das et al., 2008; Weldon, 2006), including cross-cultural research.

Due to their significant and complex role in international expansion and performance, few concepts in IB research have attracted more attention and have been a source of debates over reliability and generalisability than cultural distance and Psychic Distance (PD) (Reus & Rottig, 2009). Researchers in the last couple of decades have been arguing that we are underestimating or overestimating the impact of distance between the home and host countries on the performance and internationalisation of multinational companies (Au, 1997). This is due to the fact that the diversity within nations, in combination with the nationals' attitudes and openness towards different cultural values, although recognized in the literature (Håkanson & Ambos, 2010; O'Grady & Lane, 1996; Shenkar, 2001; Tung & Verbeke, 2010), are not efficiently conceptualised and measured, thus leading to misinterpretations of the impact of distance.

As Beugelsdijk et al. (2013, p.3) argue, "if cultural variation in host countries induces multinationals to target segments that are culturally close, then the customers the firm actually deals with are culturally less distant than the home–host cultural distance suggests". With the same logic, a country's openness towards diversity, can imply the need for less adaptation by multinational companies to match the cultural values of the host country. CT in relation to foreign diversified cultures can moderate the role of distance between the cultures of the home and host countries. Very high levels of CT could imply that the role of PD on multinational companies is altered or weakened.

The main aim of this research is to examine how the level of CT in the host country influences the impact of PD between the home and the host country and, consequently, the performance of SMEs. To do so, we attempt to develop a reliable conceptualisation and operationalisation and of CT in EU countries and create the CT Index (CTI) providing country scores of CT. The index is created by merging a diversity of indicators which capture the four levels of CT: permission, co-existence, appreciation of the value of difference, and respect. By developing and testing the CT index we make significant contributions to cross-cultural research. First, we indicate that CT is an important determinant of the host country environment and a significant factor affecting firm performance. Secondly, we provide evidence that the impact of PD on performance is positive when the host countries are more tolerance towards different cultural values and diversity. The index will be further extended to other countries and regions of the world.

2. Cultural Tolerance in IB

2.1. The concept of CT

CT has been researched as a source of decreasing societal conflicts that arise from discrimination and the restraint of civil liberties (Rapp & Freitag, 2015). It has been further conceptualised as a liberal political thought and as a vital characteristic of a liberal political order. This is when people in the society are tolerant and most likely will be able to cordially resolve conflicts and disagreements regarding the political manner of the society (Muldoon et al., 2012). In the educational and psychology fields, CT is researched with regard to the motives of a culturally tolerant behaviour at an individual level and not just obligatory implemented by the schools and state (Jensen & Meckling, 2008).

Implementing CT in IB research can deliver valuable insights on internationalisation strategies, localization vs standardization approaches and how multinational companies deal with the cultural complexities in the host country institutional environments. Formal institutions, deriving from formal laws, rules, and policies, impact enterprises' strategic decisions by signalling what the government encourages and restricts (Chen et al., 2018; North, 1990). Differences of informal institutions across countries, which relate to culturally transmitted and socially built informal procedures and norms, raise uncertainty, intensify pressures for localization and increase costs (Kogut & Singh, 1988; Delios & Henisz, 2003). In addition to cross-border distance, institutional values are also diversified within national cultures. For instance, different educational systems within countries have epistemological and cultural differences (Maruyama, 1994). As such, multinational companies deal with institutional and cultural differences across and within host countries (Au, 2000).

CT relates to the degree in which a country is inclined to accept cultural diversity within or coming from outside national borders. CT has been explained by Hjerm et al (2019) as a value orientation toward difference and as readiness to live and let live, to tolerate a variety of lifestyles by Crick (1971). According to Walzer (1997), a society may resign to accept difference, or it may be open, curious, or even respectful of difference. High degree of CT would imply acknowledgement and acceptance of the identity and uniqueness of differences and willingness to embrace positive aspects in their own mindset and behaviour. A country with moderate levels of CT would be more sceptical and hesitant towards diversified principles and at extreme levels, a country with very low CT would exclude, ignore, or fight diversity. Participants in a culturally intolerant society have negative views regarding foreign social norms and values, show opposition towards encountering them and perceive them as a source of conflict.

CT is conceptualized by Gasser and Tan (1999) utilizing the concept of social distance. They developed a CT Scale that measures how people feel about certain customs and social norms. They looked at the scale's latent structure and the interrelationships between the three theoretical components of attitude: affect, belief, and intention in the countries of Japan, Honduras, Britain, Thailand, and Saudi Arabia. Additionally, Persel et al. (2001) employed the dimensions of homosexuality and race to indicate the decline in open expressions of intolerance. In their analysis, the authors explain that intolerance is a step towards tolerance, at least to a certain point. The authors argue that open displays of intolerance, regardless of conduct, show a profound contempt of differences. Their research indicates the need for a more generalizable model of CT.

Beyond these dimensions, there is an evident lack of consensus both theoretically and empirically about the nature and measurement of CT (Alvesson & Sandberg, 2011). As CT can act as a significant determinant of the host country environment and is useful for multinational companies in obtaining an accurate and deeper level of understanding of the host country environment, the concept of CT needs to be further developed and explored. Furthermore, the degree of a country's CT does not only influence the institutional environment within countries, but also impacts on the extent and significance of distance between nations.

2.2. Distance and Tolerance

Increased population movement and migration activities, whether forced or intended, have resulted in increased exposure to diversity and contact with people from different cultures. Several scholars have argued that there are important aspects related to the role of the cultural variation within countries, which have been overlooked (Au, 1997; Shenkar, 2001), thus affecting the reliability of cross-cultural research. In addition, not acknowledging countries' openness towards diversity (DeMarco and Fox, 2020) entices criticism as it can determine the host country's uncertainty caused by the difference and distance between the home and host countries. The limitation of existing frameworks and measures of distance, such as cultural distance and PD, to capture within country diversity, cultural homogeneity, and peoples' attitudes towards diversity, has been extensively discussed in the literature (Shenkar, 2001; Kim & Gray, 2009; Sousa & Bradley, 2008).

PD focuses on "factors preventing or disturbing the flow of information between firms and the market" (Johanson & Wiedersheim-Paul, 1975) p. 308) including differences in culture, language, religion, education, political systems, and industrial development. Stressing the importance of PD, Zaheer et al. (2012), p.19) state that "*essentially international management is the management of distance*". Uncertainty and PD cause enterprises to fight for adaptation within the host country, seeking acceptance and integration, characteristics which comprise the concept of CT.

Due to PD, acquiring localised knowledge becomes a challenge for multinational companies. The Liability of Foreigners (LOF), defined as 'the costs of doing business abroad' (Zaheer, 1995, p. 342), is highly influenced by PD between the home and host country (Granovetter, 1985). LOF occurs '*mainly from the foreign firm not being sufficiently embedded in the information networks in the country of location*' (Zaheer and Mosakowski, 1997: 445) as the business environment is characterised as a web of relationships and not just a market with many independent stakeholders.

CT can act as a moderator to the relationship of PD and subsidiaries performance, where high CT between the home and host country will enable foreign subsidiaries to familiarise with the local environment, determine adaption degree in the country, and apply intercultural sensitivity. Distance, a concept that has been proven to have a large influence in a variety of international business phenomena ranging from entry modes to international collaboration, is an important component in CT (Shenkar, 2012; Tihanyi et al., 2005), as the two concepts are interrelated.

A high degree of cultural distance between two countries, which implies highly diversified cultural values between them, may decrease the degree of CT that one country has over the values of the other and vice versa. High CT may reduce the degree of cultural distance between two countries. Following this rationale, the impact of home-host distance on multinational companies may be reduced by high levels of CT in the host countries. Therefore, since CT can determine both the degree of distance, but also the impact it has on the multinational companies, it can be a crucial determinant of this relationship and should be considered in research involving cultural differences on MNEs or international SMEs.

2.3. Links with International SMEs

The literature provides abundant findings and evidence on the multiple ways in which home-host distance impacts MNEs' internationalization, strategy, and performance. Fewer insights are available on International SMEs; however, SMEs are increasingly venturing abroad and gaining momentum in the global economy, owing to factors such as lower foreign-market barriers and tougher home conditions, which are seen as important contributors to economic growth and employment (Acs et al., 1997; Chen & Martin, 2001; Reynolds, 1997). SMEs and MNEs differ in important ways, such as experience with foreign environments, ability to withstand host government demands, and level of resources available to manage foreign operations. As such, SMEs face greater challenges when

investing abroad (Vachani, 1998) and although depends on the industry, structure, and competition, may be more sensitive towards pressures for localization and highly influenced by home-host distance.

Bolton (1971) described SMEs as having a personalised style of management devoid of formal structures; with ownership and control solely in the hands of the owner (Spencer, 1999). SMEs have been recognized as a key factor in investment in social capital which can assist in tackling societal challenges, however this is not reflected in their social practice because they are mostly driven by personal moral conviction and not business reason (Habisch, 2004). Considering the nature of SMEs and their vulnerability towards PD, they are a significant and interesting sample to explore the moderating role of CT. Following the arguments presented in this paper, we develop the following hypothesis:

Cultural tolerance positively moderates the impact of PD on the performance of SMEs.

2.4. Conceptualizing and Measuring CT

Walzer (1997) suggests that tolerance can take five different meanings. Firstly, he defines tolerance as a resigned acceptance of difference for the sake of peace. Secondly, he suggests that tolerance is a passive, relaxed, benignity towards indifference. Thirdly, he believes that it is a principled recognition where the 'others' have rights even if they exercise those rights in the same way as locals. Finally, he analyses tolerance as a curiosity; or even respect, a willingness to listen and learn and finally he portrays very high tolerance as an enthusiastic endorsement of difference seen as a condition for humanity to flourish.

Lozano and ESCRICH (2016) have theorized a four-level analysis of CT, including permission, coexistence, appreciation of the value of difference, and respect. We build on the four levels of CT and attempt to develop and incorporate dimensions which will determine nationals' approach towards others (including foreigners, immigrants and same-country nationals with diverse cultural values) for each level (as illustrated in Figure 1).

Permission implies that majorities are showing tolerance to minorities - horizontal tolerance with authoritarian undertones. Fiala (2005) argues that a culturally tolerant society is where participants recognize, understand, and allow foreign values, norms, and knowledge that are different from their own. Permission incorporates aspects of CT towards diversified values in terms of religion and different languages. Religion plays a significant role in the formation of social norms, such as when conservative attitudes are frequently related to strong religious beliefs (Cukur et al., 2004), thus tolerance for diverse religions is considered a dimension towards a more broad-based institutional level. Language is part of the country's identity and generally, the way a person expresses himself, therefore when learning a language people do not just obtain linguistic education rather, they receive the experience of exploring cultural elements such as the behavior of the society (Yallop, 2003) and can increase CT.

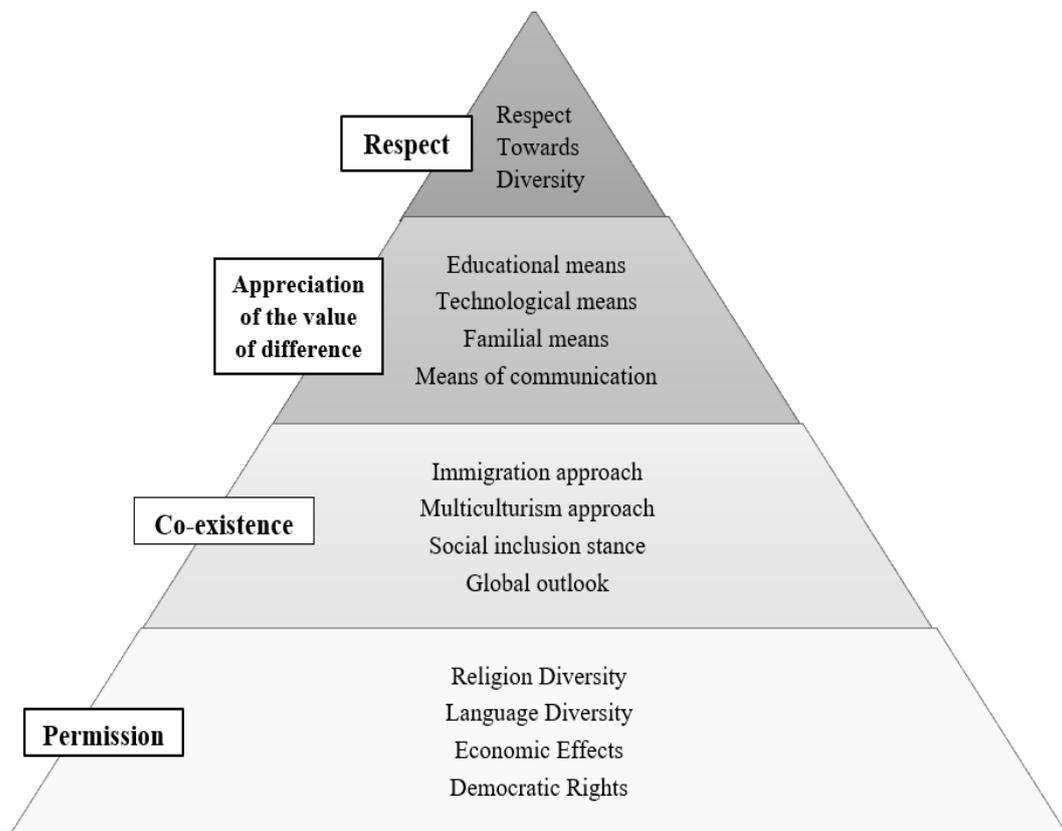
CT can also be determined by democratic and economic circumstances. Political tolerance, is defined as a readiness to respect the civil liberties of individuals with whom one disagrees, is no exception (Avery et al, 1992). High degrees of autocracy and other repressive political forms do not create tolerant attitudes while democracy balances conflict of interest and is regarded crucial in increasing cultural tolerance (Weil 1985). Economic uncertainty, high unemployment, inequality, and immigration can reduce tolerance and is conducive to xenophobia (Inglehart, 1999); therefore, economic circumstances at the national level can significantly influence CT.

Co-existence refers to the use of tolerance to advocate a minimal level of societal harmony, with the goal of achieving "*peaceful coexistence*." Tolerance is associated with a strong cultural identity and well-defined groups, in which peaceful cohabitation is desired without aiming to dilute identities,

persons, or groups. Tolerance is regarded as a personal right that considered in conjunction with the right to liberty.

Social scientists have focused on how people feel and co-exist with ethnic minorities, refugees, and immigrants (Savelkoul et al., 2011) and is important determinant of CT. In relation to migrations, tolerance includes cognitive elements, such as recognition of real discrimination problems; evaluative elements, such as a sense that minorities fit into the host society and contribute positively to it; and political elements, such as a willingness to welcome more immigrants or support minorities. In addition to migration flows, some countries have high degrees of multiculturalism within borders, which in turn affects CT. According to the racial threat theory, as the number of members of a minority group in a community grows, those who are not members of that group will feel increasingly threatened and in competition for resources, leading to greater intolerance for the minority group (Hajnal 2001; Liu 2001). According to the social interaction hypothesis, intolerance arises from a lack of knowledge or understanding among groups, which leads to fear and intolerance.

Figure 1: CT Dimensions



Social inclusion is a subject heavily discussed in recent years and plays a critical role in CT. Rawal (2008) identifies the power of social exclusion as a concept to describe the complex nature of social deprivation, particularly its institutional and cultural dimensions. Social inclusion can include a variety of themes, trends and issues that are relevant or important in different societies, but for the purpose of this research we focus on gender inequality and sexual orientation. We consider that these indicators, in a broader sense, illustrate the degree of CT in current and changing issues of diversity in a country

and across the world. Finally, positive, or negative attitudes towards globalization can also act as determinants of CT. Globalisation entails the coordination and integration of economic activity across national borders and transnational relations are becoming increasingly sensitive to cultural contingencies and cultural coding. CT can therefore be influenced by these relations as well as beliefs over the globalization of societies.

Appreciation of the Value of Difference indicates that individuals in the society, whether migrants or citizens agree in principle that it is a desirable for a society to be diverse in terms of ethnic groups, religions, and cultures. It involves acknowledgement and acceptance of the identity and uniqueness of cultural differences as an enrichment of the social environment without intentions to distort identities, persons, or groups.

Family and education can play a critical role in cultivating an appreciation of the value in diversity. Almond (2010) believes that the view of how toleration is interpreted and applied is something that has been carefully revised and determined to be imposed on children in school as a matter of formal educational policy. Furthermore, education for tolerance is seen as a duty for the family, as well as schools and the larger community, where tolerance is perceived as something 'good' and discrimination as something 'bad' (Almond, 2010). The role of the family in children's education is as a foundation for moral values and life views, part of which is tolerance and acceptance of diversity.

The media and the use of technology are also important determinants of CT. White et al. (2013) highlight the key opportunities for media education, when analysing the interethnic tolerance of the student audience in the context of contemporary educational reform. Due to the ever-increasing interest of youth in media culture (television, the press, cinema, the Internet, etc.), a significant influence of contemporary world mass media on youth priorities and interests. Communication media are therefore a powerful tool of CT and technology is constantly altering and enhancing the magnitude of media. Internet use relates to both attitudinal and behavioural tolerance toward immigrants, social inclusion and diversity. Internet users are more likely to support and befriend more foreigners in their society and online media they have the potential to drastically alter society's structure (Zuboff 1988).

Respect represents unwillingness to openly voice intolerant opinions and goes beyond acceptance, by integrating the business case with the ethical perspective, thereby having a positive effect to corporate profits, managing diversity in the workplace, and creating a fairer society. Respect is seen as a desirable quality in a variety of multicultural and multi-ethnic civilizations (Nieto 2000). In social interactions, respect is seen as a crucial virtue and relational component (Carter 2013). Respect is also described by De Cremer and Mulder (2007, 443) as "a moral building stone or even gatekeeper for a moral and humanitarian community." Respect as a virtue appears to rely primarily on an individual's or nation's moral conscience, although laws were originally enacted to compel tolerance and penalize or discipline intolerant behaviour (Schirmer et al., 2012).

3. Data, Sources and Methods

3.1. Development of the CT Index (CTI)

We employ a diversity of reliable indicators (refer to Table 1) through which we develop the CTI in EU countries for each CT level as follows:

Permission

For the dimension of *Economic Effects*, we incorporate an indicator for equal opportunity legislation and considered unemployment rates in each country (source: IMD). We further incorporated the economic sentiment indicator which captures above average economic sentiment expressed by consumers and businesses about their finances and the state of the economy (source: Business and

Consumer Survey), and finally, we include the indicator of discrimination in job opportunities is employed to evaluate whether in difficult financial circumstances people are intolerant towards foreign employability (source: WVS). To develop the *Democratic Effects* variable, we employ data involving the degree of equal opportunities in the society, freedom of choice, and trust in legal systems and police (source: ESS) capturing nationals' perspectives towards the significance of these dimensions in the society. We balance these by including dimensions involving people's trust in the legal system, police, and justice (source: IMD), as well as the Freedom Status of the country (source: FH).

In terms of *Religion Diversity*, we consider people's evaluations on the degree of trust in people of a different religion, close interaction with different religions, and acknowledgement and 'acceptance' of other religions (source: WVS). We combine these with the Restrictions on Religions Index and Social Hostilities Index (source: PEW Research Centre – Global Restriction Religion) and thus develop a complete measure representing attitudes towards different religions. For *Language Diversity*, we use the Greenberg diversity index (source: Ethnologue) in relation to the degree of people's interaction with people who speak different languages (source: WVS).

Co-existence

A variety of indicators are used to represent the dimension of *Immigration Approach* such as the indicators of migrants in relation to total country population (source: WB), the immigration permit perceptions and the impact of immigrants on social life and the enrichment of society, (source: ESS, 2022), the immigration laws regarding employment, the degree of foreign labor force and the degree of foreign highly skilled personnel (source: IMD). To capture the *Multiculturalism Approach* we capture people's perceptions towards the significance of traditions, customs and the degree to which they consider foreigners to enrich national culture (source: ESS). *Social Inclusion* is represented by different indicators that portray the degree of inclusion based on the factors of gender inequality (source: UNDP), of sexual orientation (source: WVS) and overall freedom of expression (source: FH). Lastly, *Global Outlook* is measured based on the indicators of the country's attitudes towards benefits of globalization, openness to ideas and contribution to world exports (source: IMD), as well as degree of exposure to new and different things in life (source: ESS).

Acceptance of the Value of Difference

The dimension of *Familial Means* includes indicators of the degree tolerance promoted in the family system and overall family trust (source: WVS) and the quality of child-parent family relationship (source: OECD), all of which indicate the family conditions and values towards tolerance. Similarly to family values, the educational system is critical as a mean for cultivating tolerance. The *Educational Means* dimension is captured by the indicators of the effectiveness of the educational system, government expenditure on education, education level and education mobility in terms of attracting international students (source: IMD). The dimension of *Technological Means* is captured by indicators relating to the availability of digital/technological skills in the country along with internet usage (source: IMD) and the *Means of Mass Communication* dimension, is measured by the indicator of media freedom (source: FI). Combined, the use of technology and the internet with online and traditional media are significant means through which CT towards diversity can be promoted or confined.

Respect

Respect, at the top of the pyramid, represents the highest degree of CT and we employ data of the degree on the significance of respect for people (source: ESS) and human rights (source: WVS) in the society.

Table 1: CTI Dimensions, Indicators, and Sources

CT Level	Dimension	Indicator	Explanation/Measurement	Source
Permission	Economic Effects	Economic development	<i>Equal opportunity legislation in the economy encourages economic development</i>	IMD
		Employment rate	<i>Employment rate as a % of labor force</i>	IMD
		Economic sentiment	<i>Economic sentiment indicator, annual index</i>	BCS
		Discrimination in job opportunities	<i>When Jobs are scarce, employers should not give priority to nationals rather than immigrants (% of population)</i>	WVS
	Democratic Effects	Equal opportunities	<i>Important that people are treated equally and have equal opportunities (% of population)</i>	ESS
		Freedom of choice	<i>Important to make own decisions and be free (% of population)</i>	ESS
		Trust in legal system & police	<i>Trust in the legal system – Index Trust in the police – Index</i>	ESS
		Justice	<i>Justice is fairly administered</i>	IMD
		Political Stability	<i>The risk of political instability is low</i>	IMD
		Freedom House Status	<i>Freedom status: Free, Partly Free or Not Free</i>	FH
		Religion Diversity	Trust people of a different religion	<i>Trust people of another religion (% of population)</i>
	Interaction with different religions		<i>Would not like to have as neighbors people of a different religion (% of population)</i>	WVS
	‘Acceptance’ of other religions		<i>My religion is not the only acceptable religion (% of population)</i>	WVS
	Restrictions on Religions Index		<i>Index of 20 indicators of ways that national and local governments restrict religion, including through coercion and force.</i>	PEW RC
	Social Hostilities Index		<i>Index of 13 indicators of ways in which private individuals and social groups infringe on religious beliefs and practices, including religiously biased crimes, mob violence and efforts to stop particular religious groups from growing or operating.</i>	PEW RC
	Language Diversity	Language Diversity	<i>Greenberg diversity index - The probability that any two people of the country selected at random would have different mother tongues.</i>	Ethn

		Interaction with different languages	<i>Would not like to have as neighbors people who speak a different language (% of population)</i>	WVS
Co- existence	Immigration	Migrant population	<i>International migrant stock – Percentage of population</i>	WB
		Effects of Immigration	<i>Immigrants make country worse or better place to live – Index</i>	ESS
		Immigration permit	<i>Allow many/few immigrants of different race/ethnic group from majority (% of population)</i>	ESS
		Immigration Laws	<i>Immigration laws do not prevent your company from employing foreign labor</i>	IMD
		Immigration Labor	<i>Foreign labor force (% of total labor force)</i>	IMD
		High-skilled migration flows	<i>Foreign highly skilled personnel are attracted to your country's business environment</i>	IMD
		Interaction with immigrants	<i>Would not like to have as neighbors, immigrants/foreign workers (% of population)</i>	WVS
	Multiculturalism	Culture enriched via immigration	<i>Country's cultural life undermined or enriched by immigrants - Index</i>	ESS
		Traditions and customs	<i>Important to follow traditions and customs - Index</i>	ESS
	Social Inclusion	Gender inequality	<i>Gender inequality index</i>	UNDP
		Sexual Orientation	<i>Would not like to have as neighbors, homosexuals (% total population)</i>	WVS
		Freedom of expression	<i>Civil liberties questions on freedom of expression and beliefs</i>	FH
	Global outlook	Openness to ideas	<i>National culture is open to foreign ideas</i>	IMD
		Globalization attitudes	<i>Attitudes toward globalization are positive in society</i>	IMD
		Exposure to new things	<i>Important to try new and different things in life</i>	ESS
		Trade openness	<i>Contribution to World exports (%)</i>	IMD
Appreciation of the value of Difference	Familial Means	Tolerance in family	<i>Tolerance for other people is considered an important child quality (% of population)</i>	WVS
		Family trust	<i>Trust: Your family (% of population)</i>	WVS
		Child-parent family relationship	<i>Children who report finding it easy to talk to their parents (%)</i>	OECD CWBP
	Educational Means	Education expenditure	<i>Government expenditure on education</i>	IMD
		Educational system	<i>The educational system meets the needs of a competitive economy</i>	IMD
		Education level	<i>% of population that has attained education (for persons 25-34)</i>	IMD
		Education mobility	<i>Foreign students per 1000 inhabitants</i>	IMD

	Technological Means	Digital/ Technological skills	<i>Digital/Technological skills are readily available</i>	IMD
		Internet use	<i>Internet users: Number of internet users per 1000 people/ Source: Computer Industry Almanac</i>	IMD
	Means of Mass Communication	Media freedom	<i>Freedom of the Press Index</i>	FI
Respect	Respect Towards Diversity	Respect for people and rights	<i>Respect for individual human rights nowadays is important (% of population)</i>	WVS
		Respect in society	<i>Important to get respect from others (% of population)</i>	ESS

Sources: BCS: Business Consumer Surveys; Ethn: Ethnologue; ESS: European Social Survey; FH: Freedom House; FI: Fraser Institute (Quality of Government data); IMD: IMD Competitiveness; OECD-CWBP: OECD Child Well-Being Portal; PEW RC: PEW Research Centre – Global Restriction Religion; UNDP: United Nations Development Program; WVS: World Value Survey.

The CTI is an average between the different levels of CT (permission, co-existence, appreciation of the value of difference, and respect). Each level is measured through several different indicators, all of which have an equal weight towards their respective level and towards the index.

The CTI has been standardised to range between 0 and 1, where higher values denote higher cultural tolerance. Each of the indicators included in the index have been rescaled if necessary to adhere to the scaling of the CTI (for example, the gender inequality index has been rescaled so that higher values denote higher gender equality).

$$CTI_{i,t} = \frac{1}{J} \sum_{j=1}^J permission_{j,i,t} + \frac{1}{K} \sum_{k=1}^K co - existence_{k,i,t} + \frac{1}{L} \sum_{l=1}^L appreciation_{l,i,t} + \frac{1}{M} \sum_{m=1}^M respect_{m,i,t}$$

- for country i, and year t
- J number of indicators capturing permission
- K number of indicators capturing co-existence
- L number of indicators capturing appreciation of value of difference
- M number of indicators capturing respect

3.2. SMEs Data and Variables

This research paper focuses on International Listed SMEs in countries across the globe which have EU subsidiaries. We focus on listed SMEs as listed companies can more easily expand as they access equity funding to carry out new investment initiatives (Pagano et al., 2002). Therefore, this type of companies typically involves significant levels of investment, growth, and leverage. Additionally, even if the firm has no need to finance new investment, present shareholders may desire to sell, and a foreign investment might boost the value of their stock. To measure SME performance and obtain the rest of the company information needed for this research, we use company data from Osiris. Osiris is a database published by BvD which incorporates detailed data for approximately 80,000 Listed companies across the globe. Adjusted templates are employed by Osiris to illustrated accounts in the accurate formats depending on company type and the country of operation (Osiris, 2023).

The sampling strategy of this research is based on the following criteria. First, we incorporate International SMEs which have at least one Foreign Subsidiary in an EU country. Secondly, we focus on SMEs with Wholly Owned Foreign Subsidiaries (WOFSSs). We focus on WOFSSs because research shows they are more sensitive to the impact of PD (and CT) in relation to other entry modes, such as JVs (Kobrin, 1980; White et al., 2014) and we eliminate same country WOS from our sample to control for the international activities of the SMEs. Data involving the year in which the WOFSSs was created by the SME parent were not readily available by Osiris and we combined this with data from other BvD databases, such as FAME and Orbis, as well as a manual collection of data based on their identification numbers, such as their Legal Identity Identifier. This allowed us to develop a database consisting of 718 SMEs with 2,395 WOFSSs across five years (2015-2019).

3.2.1. Variables and Methods

The dependent variable of our research is SMEs performance measured by Tobin's Q, which is the ratio between the market value of the firm's assets and the replacement value of its assets. This method is frequently used in literature, as according to Famá and Barros (2000), the Tobin's q has been established as a variable with evident sufficiency in a variety of applications, including theoretical works and empirical tests. The application of Tobin's q in international business enables SMEs to examine historical performance of the companies as well as growth potential in accordance with the value of q for future performance (Sauaia & Castro, 2002).

To calculate home-host distance, as the independent variable of this research, we focus on PD by implementing Dow and Karunaratna's (2006) PD stimuli. The PD stimuli incorporates the distance across the dimensions of language, religion, education, political systems, and industrial development. Furthermore, the PD stimuli accounts for variation within countries in terms of language and religion by considering both the dominant language/s and religion/s as well as within country diversity of these two dimensions. As such, by incorporating the PD stimuli, which includes within-country diversity, and testing its relationship with CTI, which captures attitudes and perceptions towards diversity, enables us to deliver a more comprehensive and consistent examination and analysis.

To test the moderating effect of CT on PD and performance, we use the below model to be estimated using Ordinary Least Squares (OLS):

$$\begin{aligned} \log(\text{Performance})_{ijt} &= \log(PD)_j + CTI_{jt} + \log(PD) \times CTI_{jt} + \log(\text{SME Size})_{ijt} \\ &+ \log(\text{SME firm leverage})_{ijt} + \log(\text{International experience})_{ijt} \\ &+ \text{Same Region Dummy}_j + \text{Parent Sector}_{ij} + \kappa_t + e_{ijt} \end{aligned}$$

- For subsidiary i operating in country j, and in year t
- κ_t : year dummies

The moderating role of CT is estimated on performance by calculating the conditional effects of PD on performance. These effects are then plotted against CTI and the standard errors of these conditional effects are computed using the Delta method (Oehlert, 1992).

Table 2: Variables

Variable	Definition and Measure
Dependent Firm Performance	Return on Assets and Tobin's Q
Independent PD	PD stimuli (Dow's research webpage)
Moderator CTI	Cultural Tolerance Index (indicators & sources available in Table 1)
Control International Experience	No. of years since start of international expansion
SME size	No. of employees
Firm Leverage	Total Debt / Shareholder's Equity
Regional Location	If subsidiary is in the same region with parent
SME sector	Distinguished between primary, secondary, and tertiary SMEs

The control variables of this research are indicated in table 2. *International Experience* measures the no. of years since the SMEs started its international expansion and is a significant control variable because companies with many years of international experience have acquired knowledge and capabilities in dealing with host-country institutional challenges. *Firm leverage* is the debt of a company to its creditors (banks or other financial institutions) (Sulong et al., 2013) and significantly influences SME performance (Krishnan & Moyer, 1997) as an indicator of financial resources. *Company size* can be captured through different indicators; however, we focus on the total number of employees since it has been incorporated by various researchers in the literature (Capar & Kotabe, 2003). Furthermore, we control for the *SMEs sector*, separating the companies into primary, manufacturing and services, as their sensitivity towards PD and CT is different (Ghemawat, 2001); e.g., some services tend to be more closely linked to cultural values due to the intangible and human interaction intensity. Lastly, *Regional location* indicates if the parent and the subsidiary are in the same region (i.e., EU).

4. Results and analysis

4.1. The EU CTI

To test the reliability of our index and measure internal consistency, we used Cronbach's alpha. The results are presented in Table 4 and indicate that the CTI is internally reliable ($\alpha = 0.8850$).

Table 3: Internal Consistency of CTI

Average interitem covariance	0.013
Number of items in the scale	5
Scale reliability coefficient	0.885

The CT for each EU country, along with the 5 dimensions which comprise CT, for a period of 11 years are presented in Table 4. As expected, the difference between the CT values between EU countries are not high, considering that the EU has been putting forward policies with cultural components via education, research, digital technologies, regional development strategies and external relations, along with collaborations on cultures between governments and international organisations (EU, 2023). The country with the lowest CT is Romania, while the country with the highest is Sweden. Greece has the lowest score in the aspect of Permission, which may be due to the economic crises, in combination with a low score in co-existence since Greece is considered the first country of arrival in Europe by irregular immigrants, refugees and asylum seekers before heading west or north (European Commission, 2013).

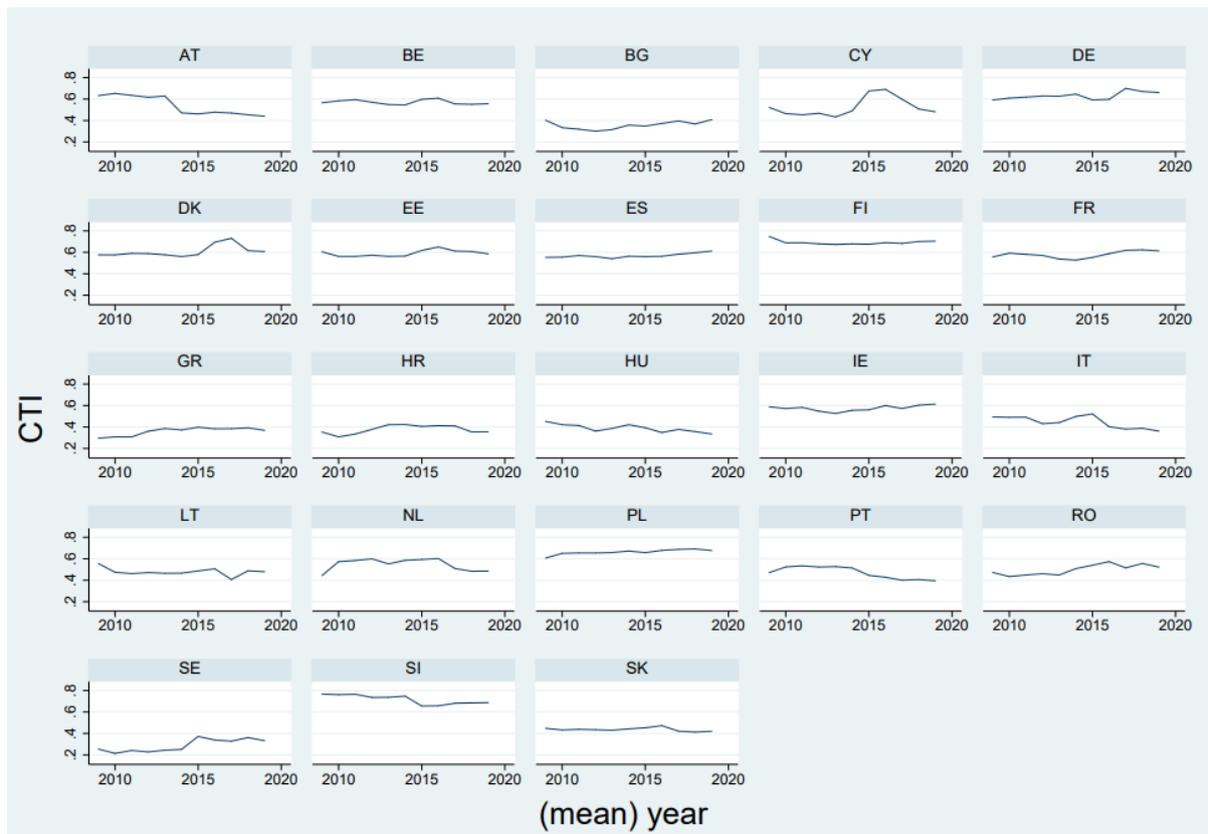
In the dimension of Co-existence, Sweden appears to have the highest score reflecting on its successful policies in social inclusion (e.g., gender equality) and multiculturalism leading to an egalitarian society (SGI, 2022). The Netherlands, Finland, Denmark, and Sweden score the highest in the Appreciation of difference value, partly due to the effectively promoting tolerance of diversity via the educational and family systems and technological means. Finally, in the dimension of respect most countries score considerably lower than in other dimensions. The country with the highest value in respect is France deriving from the country's pledge to prevent violations and secure respect for all human rights via a variety of organisations, bodies, councils, and mechanisms (Ministry of European Affairs, 2022).

Table 4: CTI for EU

<i>Country</i>	<i>Country code</i>	<i>Permission</i>	<i>Co-existence</i>	<i>Appreciation</i>	<i>Respect</i>	<i>CTI</i>
<i>Austria</i>	(AT)	0.565	0.615	0.637	0.104	0.54
<i>Belgium</i>	(BE)	0.721	0.675	0.694	0.194	0.571
<i>Bulgaria</i>	(BG)	0.357	0.343	0.409	0.29	0.357
<i>Croatia</i>	(HR)	0.44	0.388	0.369	0.204	0.378
<i>Cyprus</i>	(CY)	0.531	0.494	0.652	0.371	0.526
<i>Denmark</i>	(DK)	0.578	0.687	0.814	0.276	0.609
<i>Estonia</i>	(EE)	0.575	0.559	0.632	0.599	0.591
<i>Finland</i>	(FI)	0.641	0.717	0.817	0.593	0.692
<i>France</i>	(FR)	0.473	0.601	0.624	0.615	0.578
<i>Germany</i>	(DE)	0.62	0.707	0.593	0.605	0.631
<i>Greece</i>	(GR)	0.313	0.44	0.392	0.222	0.36
<i>Hungary</i>	(HU)	0.426	0.391	0.455	0.281	0.388
<i>Ireland</i>	(IE)	0.577	0.739	0.691	0.292	0.575
<i>Italy</i>	(IT)	0.52	0.551	0.418	0.174	0.446
<i>Latvia</i>	(LVA)	0.634	0.51	0.55	0.271	0.546
<i>Lithuania</i>	(LT)	0.529	0.505	0.621	0.229	0.478
<i>Netherlands</i>	(NL)	0.673	0.779	0.803	0.395	0.662
<i>Poland</i>	(PL)	0.455	0.523	0.571	0.33	0.47
<i>Portugal</i>	(PT)	0.465	0.658	0.624	0.247	0.498
<i>Romania</i>	(RO)	0.391	0.329	0.313	0.065	0.288
<i>Slovenia</i>	(SI)	0.498	0.499	0.6	0.151	0.437
<i>Spain</i>	(ES)	0.55	0.673	0.538	0.515	0.569
<i>Sweden</i>	(SE)	0.709	0.823	0.821	0.513	0.717

Average of years 2009-2019, per dimension for each country

Figure 2: CTI by Country



In terms of fluctuations in CT across the years, there are no major shifts, except for Cyprus where we notice an increase in CT in 2015, primarily in the dimension of permission. This increase may be due to a growth in economic circumstances following a shock in the economy in 2013 as well as the fact that in 2015 the parliament passed the law on civil union (Civil Registry and Migration Department – Cyprus, 2015) allowing cohabitation for couples irrespective of gender and sexual orientation.

4.2. Descriptive Statistics

We provide a brief description of our sample to highlight some important characteristics regarding the SMEs examined. From the SMEs in our sample, 44 are in the primary sector, 268 in the secondary and 406 in the tertiary. Furthermore, on average, SMEs have expanded into 3 countries and half of the WOFSS are engaged in the same primary business activity as the parent SMEs, indicating horizontal integration in their internationalisation. In terms of international experience, there is a range of 0.5 to 155 years with an average of 26 years, a relatively high number for SMEs.

Table 6 shows the home countries of parents and the host countries of the foreign subsidiaries. The highest number of SMEs were born in the USA and UK, countries which have a long history in international entrepreneurship and international expansion (Kirby & Whitworth, 2011; Hung & Mascaro, 2004). Sweden is the only European country that has such a high number of SMEs (100 SMEs) expanding into other European foreign countries. In our CTI, Sweden has a high score in the global outlook indicator (under Appreciation of the Value of Difference), which may explain the higher degree of internationalisation in relation to other EU countries.

Table 5: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Performance	3,251	1.237	1.319	0.17	5.344
PD	3,251	6.221	2.143	0.498	14.001
SME size	3,251	143.573	8.629	20	250
Firm Leverage	3,251	11.334	54.635	-0.779	9.028
Regional location	3,251	0.209	0.406	0	1
International experience	3,251	26.11618	26.95236	0.5	155

Table 6: Home and Host Countries

Parent SME - Home Country				WOFSSs – Host Countries			
Country	No. of SMEs	Country	No. of SMEs	Country	No. of WOFSSs	Country	No. of WOFSSs
Australia	4	India	18	Austria	62	Portugal	51
Belgium	18	Italy	21	Belgium	77	Romania	49
Canada	4	Japan	15	Bulgaria	22	Sweden	100
Switzerland	16	Lithuania	1	Cyprus	84	Slovenia	6
China	2	Luxembourg	4	Germany	369	Slovakia	25
Cyprus	2	Netherlands	18	Denmark	93		
Germany	38	Norway	22	Estonia	17		
Denmark	16	Poland	16	Spain	122		
Estonia	2	Portugal	1	Finland	193		
Spain	12	Romania	4	France	184		
Finland	25	Sweden	100	Greece	11		
France	48	Singapore	1	Croatia	14		
Greece	13	Slovenia	1	Hungary	62		
Hong Kong	2	Slovakia	2	Ireland	166		
Croatia	3	Turkey	3	Italy	138		
Hungary	1	UK	119	Lithuania	16		
Ireland	8	USA	131	Netherlands	394		
Israel	25	South Africa	3	Poland	140		

While Greece and Croatia have the lowest number of WOFSSs, the Netherlands and Germany attract the highest number of foreign subsidiaries. The Netherlands' significant tax benefits enable the country to lead the way in setting up European Headquarters (Heimann 2001), while dynamic of growing economic and political integration, along with high scores in social inclusion and diversity has benefited companies expanding in the country. Germany draws foreign SMEs due to its "upper league" production model and talent pool (Fuchs et al., 2021). Many of these international companies already uphold excellent standards in terms of product quality, workplace safety, and other areas, making other SMEs interesting in expanding in Germany.

4.3. The Moderating Role of CTI

Our results confirm the significance of CTI, when examining multinational companies. In Model 1, PD does not show a statistically significant impact on performance. This may be due to the fact that the SMEs have lower levels of internationalisation in relation to MNEs, and therefore face less challenges in relation to managing WOFSSs in many countries simultaneously, while they appear to have many

years of international experience. In addition, the nature of SMEs being small and flexible can allow them to implement localisation practices and find themselves to adapt to the foreign culture more easily (Taneja et al., 2016).

The CTI is included in Model 2, where PD becomes statistically significant. A critical implication of this finding is that PD is relevant and significant when combined with CT, which indicates that PD and CT align well together. When used together, both PD and CTI positively affect SME performance. This result is in accordance with the arguments presented in this research. Country nationals with high CT, may have positive perceptions towards diversity, e.g., in terms of language and religion. Openness to different values and new ideas, may mean openness to try new products and services that may be different to the ones offered by local companies; thus, providing a competitive advantage to international companies operating in the country (Polites, 1973).

Table 7: Regression Analysis

Variables	Model (1)	Model (2)	Model (3)
PD	0.057 (0.042)	0.096** (0.043)	-0.276* (0.163)
CTI		0.528*** (0.122)	-0.688 (0.522)
CTI_moderation			0.702** (0.303)
International Experience	-0.119*** (0.016)	-0.119*** (0.016)	-0.118*** (0.016)
SME size	-0.044** (0.021)	-0.042** (0.021)	-0.042** (0.021)
Firm Leverage	-0.203*** (0.013)	-0.202*** (0.013)	-0.202*** (0.013)
SME Sector=secondary	0.615*** (0.079)	0.609*** (0.078)	0.599*** (0.078)
SME Sector=tertiary	0.195** (0.077)	0.189** (0.076)	0.177** (0.076)
Regional Location	0.187*** (0.040)	0.187*** (0.040)	0.174*** (0.040)
R2	0.205	0.209	0.210
F-test	66.272	63.726	59.348
N	3251	3251	3251
Year dummies included	Yes	Yes	Yes

*Standard errors in parentheses. * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$*

This argument is further reinforced in Model 3, where the moderating role of CT is explored. CT indicates a positive moderating impact on SME performance. CT acts as a moderator to the relationship between PD and SME performance, where high CT from the host country will enable WOFSs to easier adapt to the country and familiarise themselves with the local environment. These positive effects will eliminate the PD among countries and consider the effects not detrimental. The negative effects of PD are expected to exist and affect SMEs subsidiaries; however, we argue that CT can minimise the effects of PD.

Figure 3: Conditional Effects: PD & CTI

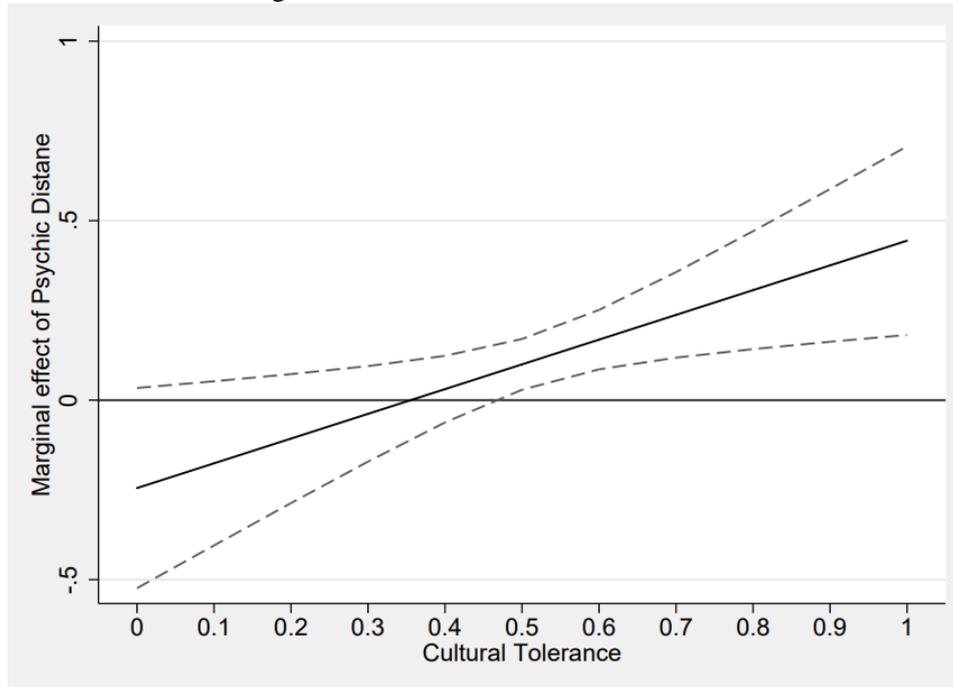


Figure 3 shows the conditional effect of PD at the range of different values for CT based on the estimated regression model (3) of Table 7. It can be seen that the conditional effect of PD depends on the index of CT. The effect of PD on performance is positive and statistically significant when the countries where the subsidiaries operate are considered to be more tolerant to different cultures (CTI range of 0.5 to 1). It can be seen from the figure that as CT increases, the effect of PD on performance also increases. Alternatively, in countries where cultural tolerance is deemed to be low (CTI range of 0 to 0.4), the effect of PD on performance is statistically insignificant.

The control variables in our research present some interesting effects. The firm leverage ratio appears to be negative in relation to performance which is expected given that leverage is most detrimental for small-sized firms than large MNEs (Ibhagui and Olokoyo, 2018) and illustrates the challenges of SMEs when operating in an international environment. Results in international experience may indicate that SMEs that have more recently internationalised adopt more appropriate strategies of localisation while the positive effect of regional location indicates that SME parents outside the EU are more effective in establishing WOFSS within EU countries despite the policies in promoting international cooperation within the region. Finally, the negative impact of MNE size on performance may explain the importance of flexibility in an easier adaptation to the local environment.

5. Conclusion

The role of distance between nations is undeniable in IB. Despite its prominence, numerous researchers have argued the importance of considering diversity within host nations (Au, 2000) as well as the institutional values which make a country open and receptive towards diversity. As Earley (2006) explains, we have a diversity of measures of distance available, thus the next step is to improve how we conceive and approach the impact of distance on companies. Following these arguments and to contribute to this issue, we present and establish the role of CT. We develop an internally reliable index based on a variety of reliable sources and provide the CTI scores for EU countries. It is our intention to extend country coverage to other regions as we acknowledge that EU countries may not present high

variation in terms of their openness towards diversity in relation to other countries outside EU which may present values of hostility across some dimensions of CT, while it would be interesting to explore CT in times of rapid changes, such as the impact of COVID-19.

The results obtained from this research have their limitations, particularly with regards to data availability. Our index of cultural tolerance is constructed for 11 years (2009 – 2019) and the estimated models focus on a sample of 5 years (2015 – 2019). As previously discussed, the index is based on several indicators capturing different dimensions and there is a heavy reliance on survey data (ESS, WVS, IMD, BCS etc.). Survey data are subjective as they involve opinions and perceptions of respondents, thus making the index vulnerable to measurement error and bias. Nevertheless, capturing perceptions and opinions in this case is equally important as the respondents of countries act based on these perceptions and opinions. Furthermore, it would be useful to test the impact the index and obtain a clearer understanding of its role in IB research by focusing on MNEs and employ a larger diversity of variables relevant to internationalisation and firm performance.

Overall, our findings confirm that CT is has a significant role in cross-cultural research, as it acts as a moderator of the PD effect on business performance and a significant determinant of the host country environment. The results confirm that CD and PD align well together, which can contribute to establishing a more valid interpretation of the impact of distance to avoid overestimations or underestimations of the impact cultural distance and PD has on international companies. A potential next step is examining the different levels or dimensions of cultural tolerance in an attempt to understand the source of this identified moderating effect of cultural tolerance and PD on firms' performance. With further development and improvement, we expect that the CTI can continue to make significant contributions in determining these complex relationships.

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