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Institutional Distance and Location Choice of Multinational Enterprises

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ABSTRACT

Even though scholars have realized the importance of the impact of the institutional environment on the strategy of MNEs, most of them have overlooked the first and essential step of the FDI decision—location choice. In this paper, we link institutional theory and location choice literature and propose that the difference in the host country and home country's institutional environments - institutional distance - has a negative effect on the FDI's location choice. We also formulate hypotheses about firm specific attributes that may moderate this impact of institutional distance on location choice. Using data on Japanese companies' FDI information and the World Bank Governance indicator, we empirically test these ideas and the results show that the greater institutional distance significantly diminishes the MNE's intention to invest

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1. Introduction

What determines the location choice of Foreign Direct Investment ("FDI")? This is a central question in the international strategic management theory and practice. As FDI brings capital, technology, employment opportunities and leads to great wealth generation in many countries, more and more policy makers are increasingly keen to know more about how to attract FDIs. The importance of this question has been reflected by the presence of a vast body of research. Various frameworks including neoclassical, monetary, transaction cost and eclectic theory have been brought to bear to analyze the determinants of FDI (Bass, McGregor & Walters, 1977; Davidson, 1980; Dunning, 1980; Hideki, 2006; Kobrin, 1991; Loree & Guisinger, 1995). Among these different approaches, the eclectic theory by Dunning (1980), in particular, is viewed as exceptionally flexible and comprehensive (Gastanaga, Nugent & Pashamova, 1998). According to this theory, the location advantage of a country/geographical unit plays a prominent role in determining where FDI will go to. The competitive advantage of a given location has traditionally been viewed in terms of economic factors such as the availability of raw materials, the growth and size of the market, and the cost of labor (Davidson, 1980). This view has its root in neoclassical economic theory which stated that "equilibrium in the economy as well as relevant economic variables such as prices and outcomes, could be explained without reference to institutions" (Mudambi & Navarra, 2002: 636). But gradually researchers became interested to know whether expanding the set of explanatory factors could enhance the understanding of how markets operate. Moreover, unlike the factors of production, which are characterized by a great mobility, institutions represent the major immobile factor in the globalized market (Mudambi & Navarra, 2002; Murtha & Lenway, 1994; North, 1990). Taking institutions into consideration will help complete the

framework of explaining the international attractiveness of a location. Therefore following the seminal work of North (1971) which emphasizes the importance of institutions on how market operate, more and more researchers have argued that it is equally important to study the FDI within the social context and that a country's institutions play an essential role in determining the location advantage of a potential place for FDI to go to (Aldrich & Fiol, 1994; Bevan & Estrin, 2004; Henisz, 2000; Klaus E. Meyer, 2009; Mudambi & Navarra, 2002; Murtha & Lenway, 1994; Xu & Shenkar, 2002).

In this spirit, there has been much research that studies how the different institutional variables such as national policy (Loree & Guisinger, 1995), intellectual property protection (Oxley, 1999), corruption (Mohsin & Leon, 2002; Uhlenbruck, Rodriguez, Doh & Eden, 2006), the extent of privatization (Ramamurti, 2000), the culture and value (Bhardwaj, Dietz & Beamish, 2007) of the host country will affect the MNE's FDI's strategy. In our paper, we will use a recently developed construct in this literature, namely "institutional distance," which measures the difference in numerous aspects of institutional environments between the home and host countries (Kostova, 1999). By using this construct, we will be able to comprehensively study a number of aspects of the institutional environment and capture how differences in these aspects will affect the FDI location choice.

Previous research in institutional distance most notably focuses on how it affects the entry mode and/or the ownership strategy of the FDI (Eden & Miller, 2004; Ferreira, Li & Jang, 2007; Meyer & Nguyen, 2005; Xu & Shenkar, 2002; Yiu & Makino, 2002).

These studies found that the institutional distance significantly affects the ownership strategy of the MNE's entry. For example, Yiu & Makino (2002) found that the greater the institutional distance, the more likely the multinational enterprises will choose a joint venture over a wholly owned subsidiary. However, prior to deciding in what way to enter, the MNEs actually have to decide *where* to invest. To our knowledge, surprisingly little attention has been paid to and no empirical studies have been conducted on how institutional distance will shape the first, and an important, decision of the FDI —location choice. Therefore, in this study we attempt to fill this gap and provide theoretical and empirical insight into the role of institutional distance and its impact on FDI decision.

Our analysis is based on data on Japanese MNE's entry in 63 countries around the world from the year 1980 to 2003. We used the World Bank Governance indicators within this period of time to operationalize the central construct of the paper—institutional distance. We find that institutional distance significantly diminishes the MNE's attempt to invest. Furthermore, we also analyzed how specific company attributes (R&D intensity, prior experience, and social embeddedness) will moderate this effect. The results show that R&D intensity of the firm significantly decreases the effect of institutional distance on the FDI entry. The results provide important implications both for policy makers who are interested in attracting certain kinds of firms as well as for investors who want to overcome the risks brought about by institutional distance.

This paper is structured as follows: Section 2 overviews the relevant literature on institutional theory as it relates to MNEs and location choice. In section 3, we develop a theoretical model of how institutional distance affects the incentive of the investors to

operate a FDI and formulate our main hypothesis according to this model. Furthermore, we discuss how firm specific attributes will moderate the effect of institutional distance on the firm's entry decision. Our sample, sources of data, and variables as well as our methodology are introduced in section 4. We then present our results, following which we discuss the possible implications for research in FDI as well as for the actions of investors and policy makers.

2 Literature Review

2.1 Institutional Distance

Institutions are "the rules of the game in a society" (North 1990: 3) or "the cognitive, normative and regulative structures and activities that provide stability and meaning or social behavior (Scott 1995: 33). Organizations are embedded in the institutional environment and are influenced by this environment to conform to the rules and belief systems of the environment, thus becoming institutionally isomorphic (Dacin, 1997). According to institutional theory, the institutional environment is the key determinant of firm structure and behavior (DiMaggio & Powell, 1983).

Countries have idiosyncratic characteristics in their national institutional environment, which is composed of various types of institutions such as policy, regulation, value system, and education systems (Kostova, 1999). According to the institutional theory literature, there is variance across countries in their institutional environments (Kostova & Zaheer, 1999; Meyer & Rowan, 1977). As the MNEs spread their operations in different countries, they need to interface across multiple institutional environments as

well as carry on their operations under diverse institutional pressure and absorb such pressure (Xu & Shenkar, 2002). For example, the institutional environment in emerging markets may typically display the constraints of lack of reliable market information and extensive state intervention in business operations, both of which will bring risks to the MNE performing in those markets (Shige, 2004). Similarly, investors from countries with efficient legal systems may find it exceedingly difficult to lobby properly with the corrupted officials in the host country to secure their contracts. Or some MNEs from developed western countries may encounter great difficulties in promoting products in eastern world.

An illustrative example is the case of Cargill, the multinational giant in the seed sector that encountered great patriotic protest in selling its seed product in India. The Indian people see the production of wheat as the base of their country's economy and therefore view the selling of seed by a Western company as an instance of the Western world's ill-meaning intent to control and "colonize" the country (Kostova, 1999). Even Cargill's commercial for the seed, which advertised that the products are clean because their whole process is mechanized, was attacked by the local press as "insulting Indian women and workers who use their hands to work" (Sharma, 2000). Eventually, Cargill was forced to withdraw the subsidiary in India and report a huge loss. Because of the institutional distance between the US and India, the MNE's routine (mechanized manufacturing) constituted a symbol challenging the identity of the host country (respect of the manual worker); and the company's product was viewed as an attempt to harm the country's independence and therefore was not accepted by the local customers. Obviously, these difficulties were less likely to happen if Cargill had invested in an institutionally adjacent country such as Canada. Cargill's failure in operating an FDI in India as well as many

other MNEs who are suffering from trying to cope with the local institutions such as the legal system, corruption, culture all point to the fact that it is crucial to cope with the differences in institutions between the host country and home country. Thus it is essential to study and understand MNEs through the lens of institutional differences.

Building on Scott's (1995) definition of institutions, Kostova (1996) developed a construct to measure the difference or similarity of the regulative, cognitive, and normative institutions of two countries, labeling this construct institutional distance.

The *regulative* pillar reflects "the existing laws and rules in a particular national environment and promote certain behavior and restrict others" (Kostova,1999: 314). The *normative* pillar refers to "the values and norms held by the individual in a given country" (Kostova,1999: 314) and it is "rooted in societal beliefs and norms and prescribes desirable goals and the appropriate means of attaining them" (Xu & Shenkar,2002:610). For example, evil versus good, or paradoxical versus logical. And the third pillar, the *cognitive,* reflects "the cognitive categories widely shared by the people in the particular country such like schemas, frames, inferential sets and representations affect the way people notice, categorize and interpret stimuli from the environment" (Kostova,1999: 314) or "the social knowledge, national symbols and the way and ability that the people understand and interpreted things in a certain country" (Xu & Shenkar,2002:610). Eden & Miller (2004:16) interpret these three pillars in a relatively straightforward way as follows: "the regulative defines what people are permitted or not to do," the normative pillar defines "what is or is not right to do" and finally the cognitive pillar can be interpreted as "what can or cannot be done".

Here we define the institutional distance as “the difference in the regulative, cognitive, and normative institutions between home country and host country institutions. And we used the World Bank Governance indicators to operationalize the regulative and normative pillar of this construct.And for the cognitive pillar, we group it together with the normative pillar as these two pillars are quite similar to each other (Gaur et al., 2007; Scott, 1995).

2.2 MNEs and Location Choice

Various studies have examined different determinants of the FDI location choice, such as host market size and growth, tariffs, low-cost factors, policy, culture, knowledge available, and institutional embeddedness (Bhardwaj et al., 2007; Chen, Chen & Ku, 2004; Davidson, 1980; Kobrin, 1991; Michael & Howard, 2007; Wilbur & Juan, 2002). In addition to these factors, more and more scholars have realized the importance of the institutional environment in determining the FDI location choice.

As a result of the process of globalization, more and more companies invest in the countries where the institutional environment is different. For example, more and more MNEs from developed countries are investing in developing countries where the institutions are very different from the countries the MNEs themselves come from. (Bevan & Estrin, 2004; Dikova & Witteloostuijn, 2007; Hoskisson, Eden, Lau, & Wright, 2000) In some of the developing countries, a large body of the economic institutions and activity used to be state-owned. Although the governments have already privatized most of the state-owned companies they are still actively involved in the operation of these

markets. (Inonascu, Meyer & Erstin, 2004; Klaus E. Meyer, 2009; Ramamurti, 2000; Uhlenbruck et al., 2006). Therefore the MNEs will face the risks that exist in the legalistic dispute resolution mechanisms and contractual guarantees (Henisz, 2003). Then the possibility of rent generation in these markets will require the MNEs to be good at coping with the local government and local market norms. Another example is that the higher the normative and cognitive distance between the home country and host country, the more likely is the cross-cultural communication between the parent company and the subsidiary or customers to fail. This is because differences in scripts, schemas, norms or values impede information sharing between individuals from different cultures (Inonascu, Meyer, & Erstin, 2004) These risks and costs are all derived from the institutional difference between the home country and host country. Thus it is crucial to study the impact of institutional distance on the FDI strategy

Since Kostova (1996) developed the construct of institutional distance, it has captured the interest of many scholars and a number of studies have been conducted on the effect of institutional distance on the strategy of MNEs. However, most of this research has focused on the effect of institutional distance on the entry mode choice of FDI (Eden & Miller, 2004; Ferreira et al., 2007; Meyer & Nguyen, 2005; Xu & Shenkar, 2002; Yiu & Makino, 2002) or the institutional distance's impact on the subsidiaries' performance and survival (Gaur & Lu, 2007; Pattnaik & Soonkyoo, 2007). Xu & Shenkar (2002) argued that the institutional distance will affect the MNE's choice of country, but also that the choice needs to be matched to firm-level attributes. The authors proposed that the MNE with a global strategy is more likely to enter institutional adjacent markets while the MNE with a multidomestic strategy is more likely to enter institutionally distant markets. Though Xu & Shenkar (2002) discussed how institutional distance might affect the

location strategy of MNEs, they did not provide an empirical test of this suggestion. The location choice is a first and essential decision for the FDI strategy of MNEs. However, there have been few studies that focus on and attempt to explain this important choice. Therefore, we aim to will fill the gap in the literature with this paper by developing a hypothesis of the impact on institutional distance on the location choice of MNEs. We then follow this development by an empirical test of our hypothesis.

3 Theoretical Underpinnings and Hypotheses

3.1 MNE's Location Choice and Institutional Distance

In the following sub-sections, we develop a theoretical model regarding the relationship between the MNEs location choice and institutional distance between home country and host country. We then generate three hypotheses to empirically test the theoretical model.

Cost of doing business abroad

The differences in the institutional environment is the main driving factor behind the cost of doing business abroad (CDBA) (Eden & Miller, 2004). The CDBA measures all the additional costs faced by a foreign company, relative to the cost faced by a local firm engaged in similar market-based activities (Eden & Miller, 2004). A number of studies have categorized the CDBA into different "hazards".

For example, studies have provided evidence of how the *political hazard* will affect the extra cost and risks that the MNEs need to bear when investing abroad (Delios & Henisz,

2000; 2003; Henisz, 2000). They showed that the policy shifts in taxation or regulation pose threat to MNEs. In an even worse scenario, the host country's government may expropriate the MNE's subsidiary with the motive of transferring revenue and property rights to domestic ownership. Such an eventuality would not only make the MNEs incur the loss in current revenue but also lose any future revenue. Eden & Miller (2004) recognize the CDBA in *unfamiliarity hazards*. They argued that foreign firms would have less information than domestic firms and that the former need to bear the start-up cost of acquiring this information. Meanwhile, Henisz (2000) argued that, the MNEs will face *contractual hazards.* They will be exposed to the risk of loss related to their partner's ex-post opportunistic recontracting. The MNEs may also need to face the hazard of technological leakage and end up losing their core competitive advantage. In addition to these, they may also bear the potential loss related to the hazard of free riding on their brand name and reputation. All these hazards may lead to a huge amount of cost sunk cost and will very likely affect the location choice in the first place.

Xu & Shenkar (2002) argued that the cost of doing business abroad increases when the institutional distance increases. In certain highly uncertain environments, the MNEs may need to face the risks stemming from the hostile local interest groups like the domestic companies and trade unions and they may also face the risk of the host country government's complete appropriation (Kostova & Zaheer, 1999). Therefore, we propose that as the institutional distance between the two countries and the subsequent level of unfamiliarity to the host institutional environment increases, the cost of investing in that host country will also increase, therefore making the MNEs less likely to undertake the FDI entry.

Establishing the legitimacy of the FDI

The central tenet of the institutional perspective is that organizations are greatly influenced by their environment and will be forced to employ similar practices and thus become isomorphic with each other. In fact, only through this isomorphism can the organizations earn and maintain organizational legitimacy and survive (Deephouse, 1996; DiMaggio & Powell, 1983; Kostova & Zaheer, 1999; Meyer & Rowan, 1977). Followed the institutional theory stream, Suchman (1995:574) defined legitimacy as "a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions." She went on to argue that organizations do not simply extract legitimacy from the environment in a feat of cultural strip mining but rather, external institutions construct and interpenetrate the organization in every respect.

One of the critical issues faced by MNEs involves the establishment and maintenance of legitimacy in the multifaceted host environment (Kostova & Zaheer, 1999). The MNEs have operations in more than one country and encounter multi-institutional environments. They are facing the double pressure of building up the internal legitimacy (or global integration) of the new subsidiary within the parent company and other subsidiaries in the other host countries as well as the new subsidiary's external legitimacy (or local responsiveness) in the host country (Xu & Shenkar, 2002). For building up the internal legitimacy, the subsidiaries will need to be more dependent on the parent company's know-how, technology and personnel (Xu & Shenkar, 2002). For example, the HSBC group's vision is to become the world's local bank. It has an aggressive strategy in

localizing all its branches around the world, but as its subsidiaries are spread in very different institutional environments, HSBC reported that there are difficulties for the UK-based management structure to be accepted in other national offices such as Taiwan and Hong Kong and maintain its internal consistency (Whalley, 2005). Thus, to avoid institutional conflict between local norms and its own, the firm will tend to invest in the host country that has a smaller institutional distance to the home country (Xu & Shenkar, 2002)

Aldrich & Fiol (1994) and Kostova & Zaheer (1999) pointed out that the institutional distance will affect the subsidiary's difficulty both of understanding and correctly interpreting local institutional requirements and further affect the external legitimacy of the subunit. Therefore, if the host country and home country are institutionally similar, the new subsidiary will find it easier to be accepted by the local consumers, understand the culture of the host country better, cope better with the local legal system, and more successfully transfer the managerial practices from the parent and interpret them in the new branch. For example, the information about a new product will be much more easily disseminated in a similar language and culture (Davidson, 1980).

Taking the opposite case, the larger the institutional distance, the more difficult it will be for the MNEs to establish the legitimacy in the host country and to transfer the strategic practice within the MNEs own business system (Kostova, 1996; 1999; Kostova & Roth, 2002; Kostova & Zaheer, 1999). For example, it will much more difficult for a US MNE to transfer a HR training program, to Indonesia than to Canada, as the employees may have difficulties to understand or accept the program. (Davidson, 1980) also argued that

it is much more difficult for the investors to transfer the resources and knowledge in marketing, technology, human resource in the different institutional environments. Moreover, according to Ferreira et al. (2007), a larger institutional distance requires MNEs to evaluate, learn, and adapt more extensively to local institutional agents and norms and thus implies that the firm might face greater risks.

Therefore our first hypothesis is

***Hypothesis 1*: A decrease in institutional distance between country X and country Y is associated with an increase in the probability of a market entry in country Y by a firm from country X.**

3.2 Moderators on the Effect of Institutional Distance

According to Xu & Shenkar (2002), the pallette of MNEs' attributes is the main factor that affects their strategic decisions. The location choice of the MNEs, in terms of institutional distance, will need to be matched to firm-level attributes so that the subsidiary can build the legitimacy and the parent company can transfer the knowledge and practice to the established subsidiary. Along this line, Henisz (2003) argued that the company's size, age and interorganizational linkages will make up the MNE's ability to manage institutional idiosyncrasies in the host country. Drawing on arguments and findings from the previous literature, we propose that the firm-level attributes will moderate the institutional distance's impact on the location choice. In the following section, we will discuss three firm-level attributes, namely, the prior experience of the MNE in making FDI, the R&D intensity of the MNE and the network of the MNEs as their effect on the MNEs' location choice.

Prior experience as a moderator of the institutional distance

The previous experience of the firm influences the country characteristics' importance in influencing the location choice (Davidson, 1980). The firm's experience in a potential host country yields substantive information about that host country's culture, its process of policy making, the efficiency of the government, the common business practices, and consumers' preference. The host country experience conveys legitimacy to the subsequent consistent behavior of the MNE (DiMaggio & Powell, 1983) and provides the investor with an analogue on which the future investment can be based on. The MNE's experience in the host country market or markets that possess institutional characteristics that are similar to those of the host country will help them diminish the uncertainty (Davidson, 1980; Henisz, 2003; Henisz & Delios, 2001). Moreover, Davidson (1980), Lu & Beamish (2004) and Meyer & Nguyen (2005) argued that experiential learning can help to overcome the liability of newness and foreignness and will increase the firm's propensity to make subsequent investments in the same host country. After such learning is achieved in familiar institutional environments, the firm is more likely to target novel country markets with more unfamiliar institutional features.

In addition to the above, the prior experience in the host country will build up the legitimacy of the organization by establishing a good reputation and making the consumer get more familiar with the brand. This legitimacy of the organization will spillover from the prior subunit to the new subunit (Amburgey & Miner, 1992; Kostova, 1999; Kostova & Zaheer, 1999; Yiu & Makino, 2002).

Therefore our second hypothesis is as follows.

***Hypothesis 2*: The FDI experience of a firm from country X will weaken the negative effect of institutional distance on the likelihood of the firm from country X making an FDI in country Y.**

R&D intensity as a moderator of the institutional distance

According to (Xu, 2001), the transnational transfer of technological capabilities is an important aspect in the operations of the MNEs. This is why R&D intensity, which is a surrogate for technological intensity in general, has been in the focus of numerous studies (Kedia.B, 1988; Michael & Howard, 2007; Vachani, 2005; Wilbur & Juan, 2002). The knowledge-based company will tend to be more influenced by how good the regulation or intellectual property is in the host country. For example, according to Pattnaik & Soonkyoo (2007) in a country with weak intellectual property rights protection, MNCs cannot protect their valuable firms-specific technologies and brands from imitation efforts from local companies. They are weaker in bearing the risk brought about by the lack of regulation.

Therefore our next hypothesis is:

***Hypothesis 3:* The R&D intensity of a firm from country X will weaken the negative effect of institutional distance on the likelihood of the firm from country X making an FDI in country Y.**

The social embeddedness as a vehicle to overcome the Institutional Distance

(1) Imitating and mimicking

According to Marsden (1981), social embeddedness reflects the degree to which economic transactions take place through social relationships and networks of the relationships that use social or noncommercial criteria to govern business dealings. Eden & Miller (2004) pointed out that firms will tend to imitate the organizations that are in the same social context. Similarly, Henisz & Delios (2001) have indicated that the experience of related firms matters much greater for a firm's own decision making than the experience of unrelated firms. Moreover, Haveman (1993) has shown that organizations will follow similar and successful organizations into new markets. Also, according to (Roberts & Royston, 1997), when entering a new institutional environment, the MNEs may form legitimacy by observing the overall performance of other organizations and infer the efficiency of their own organizational designs. In an empirical test of this idea, Martin, Swaminathan & Mitchell (1998) found that Japanese auto firms have indeed followed their buyers, competitors, and non-competing suppliers into the United States and Canada. Similarly, Guillen (2002) provided evidence showing that Korean firms within business groups will affect each other's entry decision in China.

(2) Strengthening the legitimacy

Aldrich & Fiol (1994) and DiMaggio & Powell (1983) have pointed out that the close ties between firms strengthen the legitimization of practices across firms. Moreover, according to Yiu & Makino (2002), when local constituents evaluate the legitimacy of a particular foreign subsidiary, they are very likely to refer to the legitimacy of others that belong to the same cognitive category, for instance, foreign subsidiaries of the same

organizational field or from the same country. This is referred to as external legitimacy spillover (Kostova & Zaheer, 1999). In their study of Taiwanese' MNEs, Chen & Chen (1998) pointed out that the network linkage would drive FDI because investors can gain access to strategic assets in a foreign country via network connections. This linkage or embeddedness would also facilitate the FDI, because, via network linkage, investors can overcome entry barriers to establish themselves in a foreign market and can reduce transaction costs when running cross-country operations.

In sum, the social embeddedness with firms that are already present in the host market will encourage the MNEs to get into institutionally distant environments by mimicking these related companies as their model, since the linkages and connections may help the newly entering firm to set up legitimacy despite the difference in institutions between the host and home country.

Therefore, our fourth and last hypothesis can be split into two distinct sub-hypotheses

***Hypothesis 4a**: With increasing institutional distance, a firm's social embeddedness with the firm's main bank has an increasing impact on location choice.*

***Hypothesis 4b:** With increasing institutional distance, a firm's social embeddedness with the Japanese firm from the same industry has an increasing impact on location choice.*

A summary of our model and hypotheses is depicted below in Figure 1.The predicted effects of our hypotheses are noted in the bracket.

<<<< INSERT FIGURE 1 ABOUT HERE >>>>

4. Methodology

4.1 Data Source and Sample

Japan is one of the most economically active countries in the world and Japanese MNEs have invested in more than 100 countries in the world(Gaur & Lu, 2007). Such a large number of Japanese FDI entries across various countries ensures that we have a healthy range of country-level variance in MNEs FDI decisions, also implying that we will have variance regarding institutional distance.

We collected our data from multiple sources. To look into firm specific attributes, we need information on corporate-level accounting and performance. Accordingly, we collected data on all Japanese firms listed in Tokyo Stock Exchange from the Nikkei NEEDS tapes. The Nikkei NEEDS tapes is an electronic database that provides information on corporate performance and other financial indicators of Japanese firms listed on the first and second sections of the Tokyo stock exchange.

Since FDI information is essential for this study, we matched the list of Japanese firms to the list of parent firms in the Kaigai Shinshutsu Kigyou Souran-Kuni Betsu (Japanese Overseas Investments – by Country). This directory of Japanese foreign investment is

published annually by Toyo Keizai Inc. Its coverage is close to the population of overseas subsidiaries of major listed and non-listed Japanese firms. This directory reports the information on the subsidiary's date of establishment, industry and sales. We supplemented this information from Kaigai Shinshutsu Kigyou Souran-Kuni Betsu with data from Osiris database, which is a comprehensive database of listed corporate, banks and insurance companies around the world. In addition to the income statement, balance sheet, cash flow and ratios, it contains information on ownership, ratings, earning estimates and stock data

4.2 Variables

Dependent Variable

We use the Japanese MNE's FDI entry in other countries as the dependent variable to indicate the location choice of the Japanese MNE. We coded entry=1 when the MNEs makes an FDI in a given country and year. For example, we will code the entry=1 if the firm make a FDI in U.S in year 1999, with the subsequent years being coded 0. Our dataset includes Japanese MNE's investment activities in 63 countries around the world, thus capturing the differences in the institutions in different countries. As the majority of Japanese investments were made after the 1980s, we develop a panel-specific database of Japanese FDI from the year 1980 until 2003. Our sample comprises 13626 Japanese MNEs and their entry actions in any of these 63 countries from the year 1980 until the year 2003.

Independent Variables

Institutional distance

Our measure of the central construct of our paper—institutional distance is constructed as follows: By using the World Bank governance indicators which aggregate the views of a large number of enterprise, citizens and expert survey respondents in industrial and developing countries. The individual data sources underlying the aggregate indicators are drawn from a diverse variety of survey institutes, think tanks, non-governmental organizations, and international organizations. (World Bank , 2007)

We measured institutional distance between Japan and host countries using the World Bank governance indicators from 1991 until 2003[1].We used "government effectiveness", "regulatory quality" and "rule of law" to operationalize the regulative pillar of institutional distance; we used "voice and accountability", "quality political stability and absence of violence" and "control of corruption" to operationalize the normative and cognitive pillar of the institutional distance. For the subsidiaries that entered the host countries before 1991, we used the World Bank governance indicators for the year 1991.

<<< INSERT TABLE 1 ABOUT HERE >>>

We then use an Euclidean distance calculation**,** similar to that used in Kogut and Singh (1988), to calculate the institutional distance using the following formula:

$$RD_k / ND_k = \sum_{i=1}^{n} \left[(I_k - I_j)^2 V_I \right] / n$$

Where I_k refers to the institutional indicator *(I)* for country *k*, I_j refers to the institutional indicator (*I*) for Japan (*j*), and V_I is the variance of indicator *I*. RD_k and ND_k are regulative and normative distances of country *k* from Japan. The symbol *n* refers to number of indicators for a particular measure. RD_k comprises first three indicators whereas ND_k comprises the rest.

Using this Euclidean distance calculation, we reduce the sensitivity of our measures to differences in any one indicator. The larger the values of regulative distance and normative distance, the greater are the differences between host country and home country in the regulative and normative aspects (Gaur & Lu, 2007)

FDI Experience

We used the cumulative number of prior FDIs of the Japanese parent company around the world to indicate the experience of that MNE. For example, the observation of 10 in *experience* indicates that up to year t, that Japanese MNE has set up 10 subsidiaries around the world. We use this variable to test whether an increase in the FDI experience leads to FDI in countries with higher institutional distance

R&D intensity

We source R&D expenditures and sales of the parent Japanese companies from the Nikkei NEEDS tapes. The larger the R&D intensity, the more the firm might be motivated to invest in building up competitive advantage in technology and therefore

might be more sensitive to the intellectual property protection policy of the different potential host countries.

Social Embeddedness

We used two variables to operationalize the construct of social embeddedness that the MNE possessed at the time of making an FDI decision

The presence of the firms from the same industry

As firms in the same industries are mostly involved in the relationships of being competitors, suppliers or clients with each other, we construct a variable which captures the presence of the firms from the same industry in the potential host country. This is a dummy variable with its value equal to 1 when there is at least one Japanese firm from the same industry that is present in country i, during timet

Main bank-presence

The Japanese main bank will most probably be present only when there are Japanese companies in that host country. Moreover, the main banks will provide the new subsidiary with information on local market; help the new subsidiary to build relationships with local partners; as well as providing financial advisory or aids. Therefore the presence of the main bank is likely to indicate the presence of the firms from the home country in the host country as well indicating the availability of resources (relational and financial)

Control variables

We use a number of variables to control for country, industry and time effects.

At the country-level, we control for the conventional macro economic variables —market size, growth and attractiveness. Following the measurement of (Gastanaga et al., 1998) we use the GDP growth to capture market growth, GDP per capita to capture the market size of the host country and the FDI inflow that the country has received to control for the market attractiveness. The 63 countries‘ annual data for the period of 1980 to 2003 are included.

At the firm level, we use sales to control for the firm size.

Also we include the year dummies in the model to pick up the effect of changes in other time-related variations that our variables might not have captured.

4.3 Model

In order to empirically test Hypotheses (1) to (4), we formulated the following model:

$$FDIentry_{ijt} = \beta_0 + \beta_1\, Dis\_instituion_{ijt} + \beta_2 Experience_{ijt} + \beta_3\, Experience_{ijt}{*}Dis\_institution_{ijt} + \beta_4\, R\&D\ intensity_{ijt} + \beta_5\, R\&D\ intensity_{ijt}{*}\, Dis\_insitution_{ijt} + \beta_6\, Network_{ijt} + \beta_7\, Network_{ijt}{*}Dis\_insitution_{ijt} + \beta_8\, Mainbankpresence_{ijt} + \beta_9\, Mainbankpresence_{ijt}{*}Dis\_insitution_{ijt} + \sum_{x=1}^{5}\beta_{9+x}\, Controls_{ijt}$$

Our dependent variable, *FDIentry*, is a binary variable which is set to 1 when the firm *i* make an investment in country *j*, at year *t*.

We balanced the panel data by dropping the observations with missing values, we obtain a balanced panel data structure.

Given the empirical challenges of our data, we use the xtlogit command in STATA to run the logit regression on the panel data to estimate the effect of the independent variables on the probability of the MNEs to make the entry decision.

4.4 Results

Tables 1 and 2 contain descriptive statistics of our final sample as well as pair-wise correlation.

<<< INSERT TABLE 2 ABOUT HERE >>>

<<< INSERT TABLE 3 ABOUT HERE >>>

Descriptive statistics

Looking at our descriptive statistics, we see that only 0.2% of our country/year observations involve an entry by a Japanese MNE in a foreign country. This figure confirms that it is important to find out more about the factors, such as institutional distance, that determine such entry, since it is rare but valuable.

The main independent variable, institutional distance, ranges from 0.03 to 10.3, which reflects the variation of countries in our sample.

We see that the average GDP per capita in our dataset is $10787.63, while the minimum is $44.64 and the maximum is $46501.21. These figures align well with what we would expect to see given worldwide figures and the characteristics of our dataset. For example, according to CIA World Fact Book, worldwide GDP per capita in 2003, adjusted for purchasing power parity, was $8200. Our higher average across the years suggests that Japanese MNE's were more likely to invest in already large and growing economies, compared to the worldwide average. As for the lowest and the highest GDP per capita figures, the estimated GDP per capita figures for Somalia in 1980, the first year of our observation period, vary between $40 and $90, while the USA GDP per capita for the year 2003 was $37800, with only Luxemburg ranked above, at $55100. Considering that our data cover a range of 63 countries and 24 years, our maximum and minimum GDP per capita figures align well with these estimated figures, giving us confidence in our data.

The descriptive statistics of GDP growth confirms that Japanese MNEs tend to invest in relatively fast growing countries with a median of 3.2%

Our correlation table shows that the moderators are not correlated and therefore we are able to empirically test for the effect of different moderators on the relationships between institutional distance and investment decisions without facing any serious problem of high multicollinearity among these theoretically important moderator variables.

<<< INSERT TABLE 4 ABOUT HERE >>>

Next in table 4, wet proceeded to a stepwise regression of our econometric model formulated above. Specification 1 shows the baseline model that includes only the control variables. We controlled for the conventional economic variables that measure the market size and market growth factor (GDP growth, GDP per capita, FDI inflows). We also controlled for the industry difference and time effects by including the industry code and entering in the time dummies. Finally we control for an important company-specific attribute-firm size by including the firm sales in the model.

The results show that the GDP per capita of the host country as well as GDP growth have positive and significant coefficients. These suggest that MNEs are more likely to make investments in large and growing markets. Neither of these results are surprising and they attest to the representativeness and validity of our data. Likewise, the sales of the firm has a positive effect suggesting that larger MNEs, or MNEs that have more slack resources, are more likely to make investments other countries in general. As before, this effect of the control variable is intuitive and allows us to have greater confidence in our data.

Now we proceed to test our main hypothesis H1. In specification 2, we add the critical variable - institutional distance - to the baseline model. The result shows that the institutional distance is negatively and significantly ($p < .005$) related to the firm's probability of entering the country. Therefore Hypothesis 1 is strongly supported, suggesting that a decrease in institutional distance between country X and country Y is associated with an increase in the probability of a market entry in country X by a firm from country Y. All the controls variables retain the same sign as in the baseline model.

In specification 3, we use the cumulative presence of the firm across the world to indicate the prior experience of the firm. After adding the experience variable and the interaction term with the institutional distance, the results of model 4 show that this experience does not have a significant effect on the institutional distance, suggesting that a company's experience in doing FDI will not necessarily diminish the effect of institutional distance; therefore, hypothesis 3 is not supported

In specification 4, we add R&D intensity and the interaction term which is R&D intensity times the institutional distance. The result shows that FDIs by firms with high R&D intensity are more influenced by institutional distance than by firms with low R&D intensity, therefore, Hypothesis 2 is strongly supported.

In specification 5 and specification 6, we use the presence of the firms in the same industry (eg: supplier, competitor) and the presence of main bank from Japan to indicate the social embeddedness of the firm, we also add in the interaction terms with the institutional distance of these two variables. The results show an insignificant interaction effect. Therefore, hypotheses 4a and 4b are not supported.

It is somewhat puzzling that H2 is not supported by the results. We expected to find that a firm's cumulative experience in other countries would weaken the negative effect of institutional distance on the probability of making an investment in the host country. Our results do not provide support for this prediction. One possibility might be that

experience in different countries does not have the same effect in diminishing the effect of institutional distance on MNEs' investment decisions. In other words, experience in countries that are more similar (or closer) to the host country might be more likely to weaken the effect of distance on the probability of investing in that host country while experience in countries that are not at all like the host country have very little or no effect. Our measure does not take this possibility into account and this might be one reason why we failed to find support for the idea using our data and variables. Another reason that H2 was not supported may be that as the MNE makes more and more FDI in different countries, a greater level of the resources of the company are committed to those investments and therefore there may be less abundant resources left for subsequent new investments. (Tan, Erramilli, & Tan, 2001)

H4a and H4b are not supported by our results either. So the presence of other firms in the host country from same industry does not improve the probability of a firm's entering that country and neither does the presence of the main Japanese bank, by having a branch in the host country. For the latter, it might be that the presence of only the main bank is not enough to make a significant impact on the MNEs' investment decision and the presence of other financial (or other facilitating) organizations is necessary for us to observe a significant moderating effect on the probability of making an investment in the host country. For the lack of the former effect, it might be possible that the presence of certain firms from the same industry actually acts as a deterrent while the presence of other firms might act to signal the availability of a market and hospitable institutional conditions. Our aggregate measure conflates these two possibilities and perhaps with a finer grained measure there will be support for our prediction.

We used cook's *d* to check whether the outliers in our dataset unduly influence these results and the results suggest that there is no need to exclude any potential outliers from our sample

5. Conclusion and Discussion

MNEs have their operations in different countries with markedly different institutional environments and therefore are subject to multiple institutional pressures. Moreover, as the institutional environments comprise the social context in which all the transactions of the MNEs take place, it is important to study how the differences in institutional environments will affect the strategy of MNEs. In this paper, our focus was on the location choice of the FDI. Drawing from the theoretical model we developed for the relationship between the possibility of entry and the institutional distance, we argued that the institutional distance diminishes the MNE's intention to invest in the institutional distant countries. We then used the Japanese FDI data set and World Bank Governance indicators to test the hypothesis and our main hypothesis is strongly supported.

We draw from institutional theory in building our arguments and the theoretical framework about how the MNEs will react to the institutional environment of the host country. Our study sheds light on both the MNEs strategy literature and the institutional theory by linking the location strategy and institutional distance together. Previous literature on institutional distance has mainly focused on the ownership strategy of the MNEs and argued that, for example, the setting up of joint ventures can be the

mechanism to overcome the risks brought about by institutional distance. However in our research, our main focus was on how firm-specific attributes such as previous experience will diminish the impact of the institutional distance on MNEs' location choice.

Our arguments and the empirical results that support them provide implications for managers seeking to expand their operations beyond their home countries. It is important to take institutional distance into account when making a choice about the location of FDI.

For example, Time Warner's AOL tried to crack the Chinese market twice, and was forced to withdraw for the second time on March 2009. It reported difficulties in competing with the local internet companies as the foreign companies are restricted to have a Chinese domain and foreign companies are also not allowed to be in the media business. (ChinaTechNews, 2009). Moreover, Social networking sites Facebook and News Corp.-owned MySpace have also struggled to get some market share in China. And analysts say the reasons are due to a combination of cultural differences, legal issues and Chinese competition. Daniel Harris, a lawyer who represents US companies in China, claimed that US Internet companies "go in thinking they know what they are doing and they go in as though it's the US but end up in big trouble and come running to us, but nine times out of ten it is too late" (Levine, 2009) Some Indian Software companies also reported problems in communicating with the employees in China and Japan because of the culture barrier. (Liu, 2003) Those MNEs might've had less trouble at an institutionally closer country. Like in Canada where the web domain are not restricted as China and the fact that, unlike in China, the AOL Canada is facing smaller institutional distance in regulatory pillar and the fact is that the AOL Canada is doing a good business now.

Our study also provides policy makers designing the institutions with ideas on how to attract FDI, especially through the effect of the regulative pillar. For example, according to our results, R&D intensive companies will be more motivated by institutional distance. Therefore, in order to attract this kind of companies, there will be a need for the government to make changes in the institutional design. Our findings and suggestion also align well with the World Development Report 2005 (World Bank, 2005). This report indicates that China unleashed growth and attracted investment through what appeared to be fairly modest initial reforms, which were to begin and develop a rudimentary system of property rights that created new incentives for a substantial part of the economy.

Moreover, our results show that institutional distance will affect the MNE's perception of the country as a potential investment target. Therefore it is important for the host country government to set up a good image of their institutions (more complete legal system, friendlier investment environment). For example, Friedman (2000) described an interesting phenomenon, which was that Canada's Parliament and media paid more attention to the visit of Moody team than to the visit of Clinton in February 1995, since a downgrading of its triple-A credit rating would make it difficult to attract investment or borrow in the global market. We suggest that future research can focus more on what kinds of institutional design and changes will allow a smaller institutional distance and therefore attract more FDI.

On the firm level, it is vital for the MNEs to be aware of the fact that there are ways to overcome the effects of institutional distance, such as learning from prior experience or following similar companies from the same industry to successfully establish themselves in institutionally distant environments. It will be crucial for the FDI decision makers to

match firm-specific characteristics to their location choice. Interestingly, Gaur & Lu (2007) argued that as the home institutional environment is not necessarily most favorable for all kinds of activities, the institutional distance may actually present opportunities for institutional arbitrage for the MNEs. As the institutional distance between the home and the host country increases, the differences between resources in the home and host country will become more substantial, presenting more potential benefits from institutional arbitrage. For example, it is common for many MNEs to set up their research and development centers in the United States because of a more advanced regulatory regime for copyright protection in the United States and greater emphasis on technology and innovation among U.S. firms (Gaur & Lu, 2007).

For the local firms in the host country, in order to cooperate better with the investors from abroad, it is crucial for the local managers to understand the workings of institutional distance, especially normative (cultural) institutional distance. Marcoulides & Heck (1993) and Buckley, Clegg, & Tan (2006) pointed out that the cross cultural awareness and understanding of the task environment, including the surrounding society's values and mindsets, contribute to a more efficient knowledge transfer and the performance of the subsidiary. For example, Alcatel Bell's tried to diminish the cultural difference and built better understanding with Chinese partners by receiving large number of visitors (Buckley, Clegg, & Tan, 2006). Thus, in order to attract and have a better cooperation with the MNEs, the local companies need to look for way to cope with the institutional distance.

Naturally, our study has its limitations. We have mainly discussed the regulative and normative pillars of institutional distance. Regarding the third pillar of institutional distance, namely cognitive distance, our method to measure it is to group it together with the normative aspect as these two pillars are quite similar to each other (Gaur & Lu, 2007; Scott, 1995). However, other scholars have tried different ways to operationalize cognitive distance. For example Pattnaik & Soonkyoo (2007) used cultural distance, while Inonascu et al.(2004)used the educational system, while Yiu & Makino (2002) used mimicry behavior to operationalize cognitive distance. As can be seen from these examples, while scholar have used various ways to measure cognitive distance, there is still no consistence, or agreed upon way, of how to measure the cognitive profile of the host country and here may benefit from future research that seeks to provide us with a unified and consistent way to measure this cognitive profile.

In conclusion, this study aims at closing an important gap in the FDI location choice literature. Our arguments and findings on how institutional distance has a negative effect on the host country attractiveness on location choice of MNEs provide important implications for corporate managers as well as political decision makers.

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Appendix

FIGURE 1

Theoretical Model for the Effect of Institutional Distance on FDI Location Choice

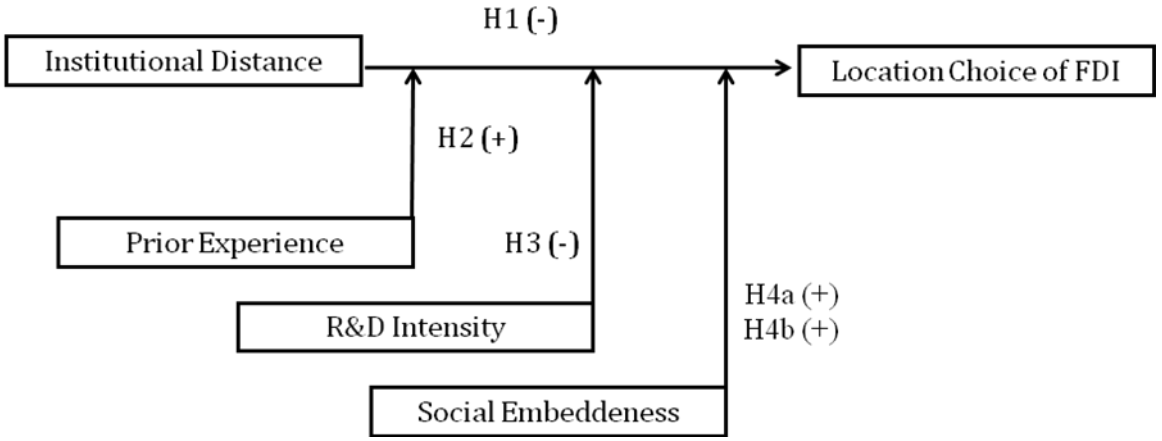

TABLE 1.

Using World Bank Governance Data to Measure Institutional Distance (Adapted from Daniel et al, 2008).

	Name of the WGI	**Definition**	**Component of Institutional Distance**
(1)	Government Effectiveness	The quality of public services, the capacity of the civil service and its independence from political pressures; and the quality of policy formulation.	Regulative
(2)	Regulatory Quality	the ability of the government to provide sound policies and regulations that enable and promote private sector development.	Regulative
(3)	Rule of Law	the extent to which agents have confidence in and abide by the rules of society, including the quality of contract enforcement and property rights, the police, and the courts, as well as the likelihood of crime and violence.	Regulative
(4)	Voice and Accountability	the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.	Normative
(5)	Quality Political Stability and Absence of Violence	The likelihood that the government will be destabilized by unconstitutional or violent means, including terrorism.	Normative
(6)	Control of Corruption	The extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.	Normative

TABLE 2

Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Entry	3433730	.0021635	.0464635	0	1
Dis_institution	3111270	1.474078	1.725986	.035063	10.308
Experience	3433730	3.258625	13.15777	0	565
R&Dintensity	1086050	.0130507	.0223256	0	.2526197
Network	3433730	.550721	.4974215	0	1
Mainbankpresence	3433730	.0287038	.1669727	0	1
gdp_growth	2977259	3.227128	5.594774	-51.03086	106.2798
gdp_per_capita	2988614	10787.63	9988.559	44.6371	46501.21
fdiinflow	2675216	3.21878	21.2865	-82.8921	614.0178
sales	1086050	205515.3	822996	127	2.06e+07

TABLE 3[2]

Correlations

	Entry	Institutional distance	Prior Experience	R&D intensity	Network	Main bank presence	Sales	GDP growth	GDP per capita	FDI inflows
Entry	1.0000									
Dis_institution	0.0275	1.0000								
Experience	0.0276	0.0152	1.0000							
R&D intensity	0.0175	0.0081	0.1071	1.0000						
Network	0.0221	-0.0005	0.1289	0.0870	1.0000					
Main bank presence	-0.0030	-0.0175	0.0027	0.0151	0.0209	1.0000				
Sales	0.0306	0.4432	-0.0394	0.0007	-0.0969	-0.0084	1.0000			
GDP growth	0.0310	0.4504	-0.0348	0.0030	-0.0898	-0.0652	0.9700	1.0000		
GDP per capita	-0.0011	-0.1602	0.0562	0.0319	0.2035	0.2839	0.0464	-0.0421	1.0000	
FDI inflows	-0.0103	-0.0000	-0.0407	-0.0852	0.0258	-0.0082	0.0000	0.0000	- 0.0000	1.0000

[2] n=1086050. Correlations greater than |.045| are significant at $p<.001$

TABLE 4

Result for Panel Specific Data Logistic Regression

Variables	Model1	Model 2	Model 3	Model 4	Model 5	Model 6
Dis_insitution		-0.3549892**** (0.0213459)	-0.328842 **** (0.0230461)	-0.3547816 **** (0.0217262)	-0.4612492 **** (0.0302676)	-0.3552413 **** (0.0216935)
R&D intensity			10.06044**** (0.7296889)			
R&D intensity*Dis_institution			-0.20375** (0.004)			
Experience				0.0037906 **** (0.0006577)		
Experience*Dis_institution				-0.00000159 (1.56e-06)		
Network					1.180735 **** (0.0484569)	
Network* Dis_insitution					0.0000352 (0.000107)	
Mainbankpresence						0.9091718**** (0.0950539)
Mainbankpresence*Dis_institution						-0.000986** (.0003994)
GDP per Capita	4.54e-06** (1.95e-06)	-2.19e-05**** (2.51e-06)	-2.20e-5**** (-2.51e-6)	-2.18e-05**** (2.52e-06)	-2.58e-05**** (2.54e-06)	-2.5e-5**** (2.60e-06)
GDP growth	0.0307326**** (0.00124132)	0.0442714**** (0.0032045)	0.0442425 **** (0.0032031)	0.0443932**** (0.0032072)	0.0313885**** (0.0033461)	0.0463755 **** (0.0034406)
FDI inflows	-0.0003425 (0.002944)	0.0073131* (0.0037954)	-0.0072061* (-0.0037947)	0.0073716 (0.0037955)	0.0031054 **** (0.0037172)	-0.0016343 * (0.0042133)
Sales	1.76e-07**** (6.09e-09)	1.77e-07**** (6.26e-09)	1.87e-07**** (6.34e-09)	1.14e-07**** (1.27e-08)	1.56e-07**** (6.58e-09)	1.78e-07**** (6.29e-09)
Year Dummy	Included	Included	Included	Included	Included	Included
Chi-square	1749.08****	1857.15****	2082.98****	1906.54****	3352.93****	2078.39****
n	818136	792430	792430	792430	792430	792430

Note: Standard errors in parentheses, *=10%, **=5%, ***=1%, ****=0.05%