NOTE

INSTITUTIONAL DISTANCE AND THE MULTINATIONAL ENTERPRISE

DEAN XU
Peking University

ODED SHENKAR
The Ohio State University

We draw from the recently developed construct of institutional distance to propose a framework that explains foreign direct investment by the multinational enterprise. We decompose the institutional distance between the host and home countries into distances on the regulative, normative, and cognitive dimensions of institutions, and match these with firm-level attributes to produce propositions regarding host country selection and foreign market entry strategies.

In this note we focus on a newly developed measure of cross-country differences—institutional distance (Kostova, 1999; Kostova & Zaheer, 1999)—to explain multinational enterprise (MNE) behavior. Institutional distance is the extent of similarity or dissimilarity between the regulatory, cognitive, and normative institutions of two countries (Kostova, 1996). It is derived from institutional theory—a nonefficiency perspective in which institutional environment is seen as the key determinant of firm structure and behavior (DiMaggio & Powell, 1983, 1991; Scott, 1995). We focus on the MNE because of the key role it plays in the global economy (e.g., over one-third of international trade consists of transfer among MNE units) and because of its interface with multiple institutional environments. The MNE literature has shown “a growing appreciation of the importance of the institutional context and of the patterns in the way MNEs respond to that context” (Westney, 1993: 60).

This appreciation of institutions was preceded by a dominance of economic theories attributing competitiveness to variables ranging from industry structure (Porter, 1990) to location-specific advantages (Buckley & Casson, 1986; Dunning, 1980; Hennart, 1982; Hill & Kim, 1988). In a departure from economic explanations, Kohut (1991) credited competitiveness to national differences in organizing principles and societal institutions. This coincides with the internationalization process model, in which internationalization is viewed as a series of incremental adjustments to changes in the firm and its environment. The main variable in this model, “psychic distance,” is “the sum of factors preventing the flow of information from and to the market” (Johanson & Vahlne, 1977: 24)—for example, differences in language, education, business practices, culture, and development.

Using Holsteed’s (1980) classification of culture, Kohut and Singh (1988) formed a “cultural distance” index that has become the proxy of choice for national differences (Barkema, Bell, & Pennings, 1996; Brouthers & Brouthers, 2001; Hennart & Larimo, 1998; Li, Lam, & Qian, 2001). This index, however, does not capture the complexity of cross-country differences; in particular, it neglects the critical role of societal institutions in articulating, disseminating, and arbitrating cultural and social cues. Applied to the realm of foreign direct investment (FDI), it fails to yield consistent empirical evidence (Shenkar, 2001).

Institutional distance provides an alternative explanation for MNE behavior. The construct has been linked so far to two aspects of MNE
operations: (1) the establishment of legitimacy in the host country (Kostova & Zaheer, 1999) and (2) the transfer of strategic orientations and organizational practices from the parent firm to the foreign subsidiary (Kostova, 1999). In this paper we extend the treatment of institutional distance to the realm of MNE strategy, focusing on two critical steps in the FDI process: (1) host country selection and (2) foreign entry strategy. These aspects are key ingredients in the FDI decision since they pertain to location and internalization choices (Buckley & Casson, 1976, 1998) and directly impact the external and internal legitimacy of the MNE.

We first decompose the institutional distance construct into three component parts and match each with a set of firm-level attributes to explain MNE country choice strategy. We then discuss the effect of each part on entry and ownership mode in the host country.

INSTITUTIONAL THEORY: A BRIEF REVIEW

Contemporary institutional theory (Scott, 1995) indicates that, in order to survive, organizations must conform to the rules and belief systems prevailing in the environment (DiMaggio & Powell, 1983; Meyer & Rowan, 1977), because institutional isomorphism, both structural and procedural, will earn the organization legitimacy (Dacin, 1997; Deephouse, 1996; Suchman, 1995). The theory has been supported in unitary, domestic environments and with organizations such as public schools (Rowan, 1982) and day care centers (Baum & Oliver, 1992). It has received less support in complex environments with multiple institutional demands (Meyer, Scott, & Strang, 1987) and where strategic choice is vital (Oliver, 1991).

Three streams of research in institutional theory have established the basis for theory development in the realm of MNE strategy. The first is the emerging focus on the interaction of institutional forces and strategic responses. This stream reflects a realization that an organization can only gain legitimacy from some source(s), based on its adopted practices (D'Aunno, Sutton, & Price, 1991), and that its discretion in responding to institutional forces is influenced by such contextual variables as uncertainty (Goodrick & Salancik, 1996). This approach fits well with the MNE's environment of high uncertainty and multiple demands. Response to institutional and competitive forces in this stream balances strategic similarity and differentiation (Deephouse, 1999). It is best represented by Oliver's (1991) model of strategic responses to institutional forces, and has been applied to issues ranging from work-family (Goodstein, 1994; Ingram & Simons, 1993) to MNE strategies (Tsai & Child, 1997).

The second stream is research on industry creation and on firms facing a new institutional environment—conditions that are akin to those of an expanding MNE. Aldrich and Fiol (1994) examined strategies that founders can pursue in seeking sociopolitical legitimacy and reshaping institutional environments. Haveman (1993) tested the hypothesis that organizations will follow similar and successful counterparts into new markets. In an earlier study Singh, Tucker, and House (1986) found that the lack of institutional support experienced by young organizations was found to be an important reason for the "liability of newness"—a metaphor later extended in the MNE literature to include the "liability of foreignness" (Zaheer, 1995).

If we view the MNE as a network of subsidiarities situated in different environments, the third relevant research stream is that involving interorganizational relationships. Most institutional theory studies have been conducted at the industry (Baum & Oliver, 1992; Holm, 1995), line of business (Tsai & Child, 1997), and profession/task (Gupta, Dinsmich, & Fogarty, 1994) levels. However, in one line of research, scholars have conducted their studies at the interorganizational (Galaskiewicz & Wasserman, 1989; Oliver, 1988), state, or national (e.g., Dacin, 1997; Rowan, 1982) levels of analysis. Their work recognizes that a firm may be situated in multiple institutional fields (Hoffman, 1999) and operate under multiple institutional pressures (D'Aunno et al., 1991; Oliver, 1991). Some of these pressures are local in origin; others are national (Rosenzweig & Singh, 1991; Thomas & Meyer, 1984; Zucker, 1987), leading to "collective action" (Meyer & Rowan, 1977: 360) typical of all organizations in a nation. This is critical to the applicability of institutional theory to the MNE, which operates in multiple institutional environments and under diverse institutional pressures (e.g., that of the host and that of the home countries). In turn, it implies that institutional theory may explain one of the fundamental issues for the MNE: the
dual pressures for global integration and local orientation (Westney, 1993).

In recent years institutional theory has been shown to have the potential to make a significant and direct contribution to research on MNEs. Rosenzweig and Singh (1991) proposed that the relative influence of home and host country institutional environments was dependent on a set of contextual, strategic, and structural variables. Some of their propositions were tested in subsequent studies on MNE human resource management (Rosenzweig & Nohria, 1994), organizational practices of international trading rooms (Zaheer, 1995), and MNE entry mode choice (Davis, Desai, & Francis, 2000).

**Institutional Distance and the MNE**

Based on Scott (1995), Kostova (1996) developed a new construct—institutional distance—referring to the extent of dissimilarity between host and home institutions. Kostova and Zaheer (1999) then proposed that the larger the institutional distance, the more difficult it is for the MNE to establish legitimacy in the host country and to transfer strategic routines to foreign subsidiaries (Kostova, 1999). In other words, a large institutional distance triggers the conflicting demands for external legitimacy (or local responsiveness) in the host country and internal consistency (or global integration) within the MNE system. Balancing these conflicting demands has been a key challenge for the MNE (Bartlett & Ghoshal, 1989; Fayerweather, 1969; Prahalad, 1975; Westney, 1993).

While Kostova and Zaheer stopped short of developing the strategic implications of institutional distance, their approach has a direct bearing on it. If institutional distance affects MNE legitimacy in the host country and the transfer of routines to the subunit, then it should be a key determinant of FDI decisions. To develop this angle, we first decompose institutional distance into its three component parts—regulative, normative, and cognitive distances—and then discuss the implications of the three for two strategic decisions: country choice and entry strategies. Country choice in terms of institutional distance has direct implications for local legitimacy of the MNE. Entry strategy indicates the extent to which the MNE internalizes its foreign subsidiary (Buckley & Casson, 1976, 1998); it pertains to the level of legitimacy resulting from being internally consistent within the MNE system. Thus, country choice and entry strategy channel the external and internal isomorphic pressures exerted on the MNE for conformity and legitimacy.

According to Scott (1995), the three pillars of institutions are distinct—a division that has been validated empirically (Busenitz, Gomez, & Spencer, 2000). The regulative pillar rests on the setting, monitoring, and enforcement of rules. It is based on instrumental logic and uses legal sanctioning as the basis of legitimacy. The normative pillar prescribes desirable goals and the appropriate means of attaining them; legitimacy is rooted in societal beliefs and norms. The cognitive pillar highlights internal representation of the environment by actors; legitimacy is anchored in cultural orthodoxy. We suggest that each of the three pillars produces its own measure of institutional distance and that these measures vary in terms of their implications for MNE behavior. For example, property rights are more sensitive to regulative distance because they are anchored in legal provisions, whereas differentiation strategies are more susceptible to cognitive distance because they might violate national symbols. Finally, normative distance may undermine import of MNE practices that deviate from societal expectations.

**Institutional Distance and Country Choice Strategies**

The MNE literature proposes that FDI strategies are shaped by the resource advantage, strategy, and structure of the parent firm (Collis, 1991; Dunning, 1980; Ghoshal & Nohria, 1989; Hill, Hwang, & Kim, 1990; Rosenzweig & Singh, 1991; Tallman, 1991). These parent firm attributes provide a basis for strategic decisions with respect to a foreign market. We argue that the choice of host country, in terms of institutional distance, must be matched to firm-level attributes such that the legitimacy of the foreign subsidiary in the host country is established and the transfer and sustainability of competitive advantage are ensured. Once a host country has been targeted, entry strategies must be matched with institutional distance to that country in order to enhance competitive advantages resulting either from a small institutional distance or from the ability to mitigate the negative impact of a large distance.
The firm-level variables discussed below, while not an exhaustive list, are representative of those resource, strategic, and structural attributes. The source of competitive advantage is possibly the most important strategic determinant for firms in a competitive market place. Global strategy is the guiding principle for MNEs' global operations and often distinguishes firms with similar competitive advantages. Organizational diversity identifies differences across the firm's constituencies, capturing the firm's interface with the environment (input and output) and in its internal operations.

Source of competitive advantage. Scholars have long argued that the MNE operating overseas incurs special costs (Hymer, 1976; Kindleberger, 1969). It must overcome the "liability of foreignness" (Zaheer, 1995), either by transferring firm-specific competitive advantages to a foreign subsidiary (Dunning, 1981, 1988) or by utilizing the host country-specific advantages of the subsidiary (Kogut, 1991; Porter, 1990). Firm-specific competitive advantages have been presumed embedded in organizational routines (Barney, 1991; Reed & DeFillippi, 1990) or strategic practices (Kostova, 1999). Correspondingly, researchers have discussed host country-based competitive advantage in terms of local practices in human resources management and control, among others (Rosenzweig & Nohria, 1994; Zaheer, 1995). An MNE may gain competitive advantage over local firms via its routines or over other MNEs by conforming to local practices.

Kostova (1999) argues that since organizational practices are shaped by the institutional environment, successful transfer of these practices from the parent firm to the foreign subsidiary depends on the distance between the host and home environments: the larger the distance, the more difficult the transfer. Among the three pillars of institutions, the normative component, which defines organizational goals and objectives as well as the appropriate ways to pursue them, has direct bearing on organizational practices. To the extent that MNEs' routines are not in violation of host country laws and regulations, regulative distance will not have much impact on the MNE whose competitive advantage lies in those routines. While a government may outlaw a certain routine to keep an MNE out (e.g., the attempt to prohibit Avon's direct selling in China), this is not a common occurrence. Similarly, cognitive distance will have little impact on investment by the routine-driven MNE, except where the routines constitute a symbol challenging host country identities. The transfer of MNE routines, therefore, is mainly constrained by the normative distance between the host and home countries.

If a large normative distance makes the transfer of organizational routines difficult, the MNE with strong, firm-specific, routine-based competitive advantages will invest in host countries with a normative institutional environment similar to its own. MNEs that invest in normatively distant markets are more likely to lack strong, routine-based competitive advantages but instead for their subunits to imitate local practices (Rosenzweig & Nohria, 1994; Zaheer, 1995). The latter firms are less constrained by normative distance when making FDI but may purposefully choose to enter normatively distant markets where their freedom to adapt will confer a competitive advantage over MNEs from the same home country that will not adapt.

**Proposition 1:** Other things being equal, the MNE with routine-based competitive advantages is more likely to enter markets that are normatively adjacent, whereas the MNE with host country-based competitive advantages is more likely to enter markets at a greater normative distance.

Global strategy. MNE strategies have often been encapsulated as ranging from "global" to "multidomestic" (Ghoshal & Westney, 1993; Porter, 1986), or from high to low integration. Global strategy (or high integration) implies that the MNE concentrates production and management in one location to reap scale economies and exercise control. Multidomestic strategy (or low integration) implies that foreign subsidiaries focus on local markets, carry out production and marketing locally, and exercise significant autonomy (Ghoshal & Westney, 1993). Rosenzweig and Singh (1991) argue that foreign subsidiaries in multidomestic industries are more dependent on local resources and, hence, have a greater need to gain legitimacy locally. In contrast, MNE affiliates in global industries are more dependent upon other MNE units for know-how, technology, capital, and personnel and, hence, are more subject to institutional pressures from the parent firm.
An important theme in the strategy literature is that firms will seek out market niches that match their strategic thrust (Miller, 1988; Porter, 1980). In the case of the MNE, the level of global integration is determined by the structural characteristics of its industry (Kobrin, 1991; Porter, 1986), as well as home country characteristics (Dyvers & Hagedoom, 2001); the adopted strategy, in turn, will influence the choice of host market (Ohmae, 1985). A logical extension of the above arguments is that MNEs with a global strategy will invest in host countries where institutional distance is small; otherwise, they will encounter difficulties in parent-subsidiary cooperation. In contrast, MNEs with a multidomestic strategy have the latitude of investing in institutionally distant markets, since they do not rely as heavily on parent-subsidiary coordination and are less concerned with institutional conflict within the MNE. They may, however, enjoy a competitive advantage over their competitors, who cannot make similar adjustments, in countries where institutional distance is large.

The key distance between institutional environments here is that pertaining to prescribed behavior—namely, normative. Cognitive distance will also have some impact where global strategy is perceived to be a symbolic challenge to local orthodoxy (e.g., cultural industries in France). Differences in the regulative environment, in contrast, will not have much impact on market choice, because such differences are codified and built into the MNE’s routines. The one exception may be where regulative requirements are perceived to undermine core strategy—for example, where the host country rules require mandatory technology transfer that conflicts with the MNE’s proprietary strategy.

Proposition 2: Other things being equal, the MNE with a global strategy is more likely to enter markets that are adjacent normatively and cognitively, whereas the MNE with a multidomestic strategy is more likely to enter markets that are institutionally distant on the same dimensions.

Organizational diversity. Organizational diversity may be defined as the degree of difference across key organizational inputs (e.g., shareholders and employees), outputs (e.g., product lines), and internal operations (e.g., corporate culture and decision making). Diversity means an organization is not dependent on a single resource source (Pfeffer & Salancik, 1978) and is open to influences by multiple stakeholders (Evan & Freeman, 1988) and institutional constituents (Oliver, 1991). It also implies that the organization is open to diverse operational modes. Kondra and Hinings (1998) suggest that organizations within an institutional field are likely to apply institutional pressure on deviants. We propose that diversity in the institutional field will reduce isomorphic pressure on deviant members. Thus, Miller and Chen (1995) found that the diversity of a firm’s social context (such as its product market) leads to nonconformity to norms. Similarly, DiMaggio and Powell (1983) argued that the extent to which an organizational field is dependent on a single source of resources influences the level of isomorphism in the field.

The MNE system has been regarded as an institutional field that exerts institutional pressures on its subunits (Kostova & Zaheer, 1999; Rosenzweig & Singh, 1991; Westney, 1993). One can argue that high diversity across the MNE system reduces the level of institutional pressure that the MNE, as an institutional field, can impose on a foreign subsidiary. In other words, high diversity raises the MNE’s tolerance toward different institutional rules and norms exhibited in the foreign subsidiary. The subsidiaries of a less diversified MNE, in contrast, will show strong conformist tendencies. To avoid institutional conflict between local norms and its own, therefore, the firm with lower diversity will tend to invest where the institutional rules and norms are similar to those of the home country—that is, where institutional distance is small. Evidence shows that cross-national expansion is negatively related to performance in nondiversified firms (but positively related in highly diversified firms), because, among other factors, such firms lack an organizational structure appropriate for the information-processing demands of very different environments (Hitt, Hoskisson, & Kim, 1997).

Kondra and Hinings (1998) note that within an institutional field, response to deviations of other organizations takes a coercive or a mimetic form, which is associated with the regulative or cognitive pillar, respectively. We suggest, however, that the two become relevant at different phases. Regulative distance is the
most relevant in the input phase, because it
determines the "rules of the game," which, once
established, constrain the resources that can be
deployed in the subsidiary (e.g., limits on expat-
riates). In the output phase, cognitive distance
is the most applicable, since it is associated
with symbols that are most likely linked to the
identity of a finished product. Further, in the
transformational phase, the normative pillar be-
comes relevant, because social norms influence
the legitimacy of the organizational practices
employed.

Proposition 3: Other things being
equal, the MNE with low diversity is
more likely to enter institutionally ad-
jacent markets than the MNE with
high diversity.

Institutional Distance and Foreign
Entry Strategies

Entry mode: acquisition versus greenfield in-
vestment. Most studies on foreign entry strategy
have followed a transaction cost approach (Hen-
nart & Park, 1993; Hennart & Reddy, 1997) or
learning approach (Barkema et al., 1996;
Barkema & Vermeulen, 1998). Typically, entry
strategy is related to the extent to which the
MNE internalizes its overseas operations (Buck-
ley & Casson, 1976) and, hence, the level of in-
ternal control and consistency (Gatignon &
Anderson, 1988; Hill et al., 1990). Meanwhile,
country differences are viewed as a barrier to
obtaining local knowledge, making it difficult
for the MNE to manage its foreign subsidiaries
on its own or to enlist the help of a local partner
efficiently (Hennart & Larimo, 1998). With re-
spect to the choice between acquisition and green-
field investment, empirical evidence indicates
that MNEs tend to set up new ventures rather
than acquire existing firms when country dif-
ferences are substantial (Cho & Padmanabhan,
1995; Kagut & Singh, 1988), since these differ-
ences magnify implementation problems in ac-
quislitions (Barkema & Vermeulen, 1998).

Kostova (1999) suggests that large institu-
tional distances constitute a barrier to trans-
rating organizational practices from the parent
firm to the foreign subsidiary. Implicitly, such
transfer, as well as the resulting internal con-
sistency, will be more difficult to achieve if the
subsidiary is a locally acquired firm. Local firms
that have been institutionalized in the host
country environment will have difficulty obtain-
ing legitimacy within the MNE when the two
institutional environments are materially differ-
ent. In contrast, a newly established subsidiary
may be viewed as the MNE's descendant. Com-
pared to locally acquired subsidiaries, start-up
ventures may also be more receptive to the par-
et's routines. The MNE, therefore, will tend to
enter institutionally distant markets via green-
field investment in order to avoid intraorganiza-
tional conflict and difficulty in integrating the
foreign subsidiary.

The choice between acquisition and green-
field investment is seldom influenced by legal
issues; laws and regulations rarely distinguish
between these two types of investment. The ex-
ternal legitimacy problem arises, however, at
the normative level, where an acquisition in-
volves a change from current practices that cre-
ates a conflict with host institutions. An acqui-
sition is especially acute at the cognitive level,
because a takeover of existing operations is of-
ten viewed as a blow to national sovereignty
and is a painful reminder of the loss of competi-
tiveness. Acquisitions are often questioned in
terms of their contribution to the national well-
being, given the sometimes lack of new capital
injection and downsizing of ongoing operations
with adverse consequences on employment (see
GM's takeover of Daewoo, for instance).

Proposition 4: Other things being
equal, an MNE is more likely to enter a
foreign market via acquisition where
normative and cognitive distances are
small and via greenfield investment
where normative and cognitive dis-
tances are large.

Ownership strategies. In the literature schol-
ars have extensively discussed ownership mode
(joint venture versus wholly owned subsidiary)
and equity share in a joint venture as control
mechanisms (Gatignon & Anderson, 1988;
Makino & Beamish, 1998). Greater control is as-
associated with enhanced resource commitment
and higher risk (Delios & Beamish, 1999). Higher
levels of intercountry differences, such as a
large cultural distance, require higher levels of
cooperation in the form of equity involvement by
local partners (Contractor & Kundu, 1998; Kim &
From an institutional perspective, firms will refrain from investing in markets that are institutionally distant, because business activities in those markets require conformity to institutional rules and norms that conflict with those of the home country. When they do enter distant markets, firms will choose the lower levels of control and resource commitment commonly associated with a joint venture (Agarwal & Ramaswami, 1992; Anderson & Gatignon, 1986; Hill et al., 1990) so as to lower the risk of institutional conflicts. Given a large institutional distance, the MNE will encounter difficulties in obtaining legitimacy in the host country (Kostova & Zaheer, 1999) and in transferring routine-based competitive advantages (Kostova, 1999). Equity involvement by local partners may partially compensate for those difficulties by mobilizing local legitimacy and by enabling the MNE to rely more on host country–based competitive advantages as a substitute for transferring MNE practices internally (Makino & Delios, 1996; Shan & Hamilton, 1991). Research suggests that external legitimacy is more important to the MNE than internal consistency in countries with very different institutional environments (Rosenzweig & Nohria, 1994; Zaheer, 1995).

The most regulated aspect of FDI is that of whole or majority versus minority control. Even in today’s liberalized investment environment, many nations block whole or majority foreign ownership in “strategic” industries. Normative and cognitive elements also impact the legitimacy of equity arrangements. For instance, joint control may be considered less of a “sell-off” and brings in a local mediator of foreign institutional pressures. However, such institutional concerns tend to be already embedded within the regulative sphere or may indicate risk to the MNE in terms of future legal and regulative changes.

**Proposition 5a:** Other things being equal, an MNE is more likely to enter a foreign market via a wholly owned subsidiary or majority joint venture where regulative distance is small and via a minority joint venture where regulative distance is large.

When it comes to level of control within the same ownership category (majority or minority), regulative distance becomes less important. Legal and regulatory systems are more likely to limit foreign majority ownership than to distinguish, say, between a 51 percent and 90 percent stake. Nor is it likely that the two levels of investment will be perceived differently at a cognitive, symbolic level. The higher level of control will probably be translated, however, into further imposition of MNE routines and practices in a tacit fashion, as the bargaining power of the local partner declines (Yan & Gray, 1994).

**Proposition 5b:** Other things being equal, and within the same ownership category, an MNE is more likely to pursue high equity control over a joint venture where normative distance is small and low equity control where normative distance is large.

**DISCUSSION AND CONCLUSIONS**

In line with recent attempts to develop institutional theory in the international arena (Brouthers & Brouthers, 2000; Davis et al., 2000; Hoskisson, Eden, Lau, & Wright, 2000; Lu, 2002), we extend, in this note, the “strategic responses” perspective of the theory (Oliver, 1991) to the MNE. In international business research, institutions have been regarded as part of the country-level environment. Scholars have emphasized the effects of local isomorphism (Rosenzweig & Nohria, 1994), foreignness (Zaheer, 1995), and institutional distance (Kostova, 1996) on firm survival and success. However, firms’ responses to different institutional pressures have not been studied systematically—a gap we seek to fill here. Further, the decomposition of institutional distance into component parts serves other institutional theory applications—for example, the legitimacy of new firms and organizational forms (Singh et al., 1986) that encounter different challenges at the regulative, normative, and cognitive levels.

The framework endorsed in this paper is clearly distinct from current theoretical streams outside institutional theory and can be helpful in complementing these approaches. For instance, Gatignon and Anderson (1988) acknowledge that transaction cost theory accommodates contrasting predictions regarding the impact of high cultural distance on entry mode: the firm will relinquish control in the face of low knowledge and high uncertainty, or it will internalize in the face of agents whose intentions and ac-
tions are poorly understood. By introducing the concept of regulative distance, the approach we propose here predicts when each of these choices will occur. The MNE will choose low control when the host environment presents a regulative system very different from the one in its home environment, but it will opt for full ownership when the host system is more similar. This explains, for instance, the gradual shift in U.S. investments in China from cooperative ventures to wholly owned subsidiaries, as China’s legal system incrementally adds U.S.-like provisions.

Further development of our framework, therefore, can make theoretical contributions by calling attention to the dynamic nature of firms (Penrose, 1959; Schumpeter, 1950) and institutions (North, 1990; Oliver, 1992). This approach fits well with recent work on MNE subsidiary evolution (Barkinshaw & Hood, 1998), but it goes beyond in recognizing the duality of changes of both firms and institutional environments. Indeed, because cultural distance has been taken to be a static measure (Shenkar, 2001), institutional distance can help us better understand changing national differences and the role of dynamic firm capabilities in dealing with those changes.

As hinted above, however, we propose that institutional distance complements, rather than replaces, the cultural distance construct. Neither construct captures the full spectrum of national differences with relevance to MNE foreign investment behavior. The inconsistent results reported for cultural distance’s impact on foreign investment launch, entry mode, and performance show that it may be too narrow a construct to capture the decisions of firm-level actors, but they do not compromise its underlying role in those decisions (Shenkar, 2001). National institutions add to the context that shapes “national character” and influences investment decisions (Hennart & Larimo, 1998). It is, hence, the combination of both cultural and institutional distance that offers the best hope for a comprehensive assessment of the tacit portion of the environment.

Future research based on the present framework can be extended to other international business areas—for example, sequence and performance of foreign entry, expatriate adjustment and performance, and receptivity toward foreign brands. Regardless of application, measurement challenges must be met. Institutional distance has only recently been operationalized (Busenitz et al., 2000; Kostova, 1996). Kostova (1997) argues that a country institutional profile is issue and country specific, which discounts the necessity for eventual comparison. Here we suggest learning from the “early mover”—the cultural distance literature—which has grappled with those issues for over a decade. This literature shows, for instance, that cultural distance may be asymmetric (Shenkar, 2001), which suggests the need to distinguish between home and host country specifics across institutional environments as well.

Finally, while institutional distance constitutes one more challenge in obtaining legitimacy and transferring strategic practices, it also introduces a new dimension on which the MNE competes globally. From this perspective, the MNE’s advantage is rooted in its ability to link institutional distance to its resources, strategy, and structure, as well as to its FDI decisions and processes. Because these links are firm specific, they constitute a competitive advantage that is difficult to imitate. This is in line with Oliver’s (1996, 1997) argument that the institutional context and process of resource selection influence the firm’s heterogeneity, with competitive advantage derived from the ability to exploit the uneven distribution of resources and institutional capital. For the MNE, asymmetrically embedded in its host and home environments, developing the capabilities to bridge institutional distances is key to obtaining sustainable competitive advantage.

REFERENCES


Haveman, H. A. 1993. Follow the leader: Mimetic isomor-


Dean Xu is an assistant professor of strategic and international management at Guanghua School of Management, Peking University, China. He received his Ph.D. in strategy from Schulich School of Business, York University, Canada. His current research interests include entry mode, diversification, and growth strategy in transition economies.

Oded Shenkar is the Ford Motor Company Chair in Global Business Management and professor of management and human resources at the Fisher College of Business, The Ohio State University. He received his Ph.D. from Columbia University. His research interests cover comparative and international management, including methodological issues and the management of international alliances.