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van Hoorn, Andre; Maseland, Robbert

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RESEARCH NOTE

How institutions matter for international business: Institutional distance effects vs institutional profile effects

André van Hoorn and
Robbert Maseland

University of Groningen, Groningen,
the Netherlands

Correspondence:
A van Hoorn, University of Groningen, PO Box
800, Groningen 9700 AV, the Netherlands.
Tel: +31 503 633 458;
Fax: +31 503 632 341

Abstract

Extant institutional research has failed to make a distinction between the effects of institutional profile and institutional distance on MNEs. The problem stems from the fact that, due to the use of a single reference country, variation in institutional distance between the reference country and partner countries is essentially equal to variation in the institutional profiles of these partner countries, making institutional distance and institutional profile effects indistinguishable. This research begins by demonstrating that the problem of profile – distance conflation is relevant for virtually all possible countries as reference points, and then showing how this problem is mitigated by using more than one country as reference points from which to calculate institutional distance. We conclude that current institutional research in international business is unable to explain *how* institutions matter for MNEs and that a more careful theoretical and empirical distinction between the effects of institutions and institutional distance on cross-border business activities is essential for pushing the institutional perspective in international business studies forward. Multiple reference point research designs are required to achieve this.

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Keywords: institutional theory; institutions and international business; institutional context; institutional distance; institutional profile; institutional environment

INTRODUCTION

The idea that the institutional environment matters for doing business is widely accepted, both within and outside international business studies (North, 1990; Scott, 2008). Exactly how institutions matter for international business is less clear, however. In the literature, two arguments prevail (Jackson & Deeg, 2008). First, resonating with the institutional literature at large, there is a generic argument that *institutional profile* – the institutional environment of a home or host country – matters. Operating in a certain country implies that firms are embedded in and face distinct challenges and opportunities that derive from this country's institutional environment (Dunning & Lundan, 2008; Kostova, 1997; Meyer, Estrin, Bhaumik, & Peng, 2009; Wan, 2005). Second, an argument more specific to international business is that *institutional distance* – the dissimilarity between the institutional

environments of two or more countries in which an MNE is active – matters (Ghemawat, 2001; Xu & Shenkar, 2002; Zaheer, Schomaker, & Nachum, 2012). MNEs operate in multiple institutional environments simultaneously and the dissimilarity between these institutional environments can create all sorts of misunderstandings and legitimacy problems as well as challenges for transfers of knowledge and organizational routines (Eden & Miller, 2004; Zaheer, 1995).

This paper argues that international business research has not adequately distinguished between the two types of institutional effects, neither theoretically or empirically. Using both formal and empirical analysis, we show that the literature's tendency to reason from the perspective of MNEs from a single (developed) country makes it prone to conflate institutional distance effects and institutional profile effects. This conflation, in turn, undermines the validity of most extant institutional research, leaving little solid insights – neither for scholars nor for practitioners – on how institutions and institutional distance in particular matter for international business. On the one hand, extant institutional research is unable to tell whether a particular MNE behavior is a response to the challenges posed by a host-country's institutional profile or to the challenges posed by the dissimilarity between the host-country's institutional environment and the MNE's home-country environment. For MNEs, on the other hand, not distinguishing between profile and distance effects is problematic as well, as the two types of effects require rather different managerial responses (notably efforts to “bridge” the distance between the home and the host country's institutional environments vs reducing exposure to unfavorable host-country institutional environments).

Below, we first analyze exactly how and why distance – profile inflation occurs. The core of the analysis in this section is a mathematical argument showing how the use of a single country as the reference point when assessing institutional distance between MNEs' home countries and their host countries leads to the conflating of institutional distance effects and institutional profile effects. Second, we use large-scale data on countries' institutional profiles to assess the relevance of distance – profile conflation for the practice of institutional research. We propose a set of twin hypotheses that enables us to bring our mathematical insights to data and pay special attention to the designing of empirical institutional research in international business studies to distinguish effectively between distance and profile effects. Finally, we discuss the implications of distance – profile conflation for

extant institutional research and formulate a guideline for future studies of the effects of institutions and institutional distance on MNEs.

ANALYSIS OF THE PROBLEM

Differences in Institutional Distance and Institutional Profile Effects

Institutional perspectives in international business studies draw upon both organizational and economic approaches to institutions (North, 1990; Scott, 2008). The institutional tradition in organizational studies stresses the need for actors to conform to their institutional environment. Such isomorphism (DiMaggio & Powell, 1983) is required to achieve legitimacy in an institutional field, which is deemed a precondition for the survival and thriving of organizations (Kostova & Zaheer, 1999; Xu & Shenkar, 2002). The relevant issue for international business studies is that MNEs do not operate in a single institutional field (Roth & Kostova, 2003), but in a complex web of institutional systems that exerts multiple, and sometimes opposing pressures on the MNE and can only be handled through active involvement of MNEs' senior management (Kostova, Roth, & Dacin, 2008). The difficulty of handling these diverse pressures depends on the degree of institutional distance between the various institutional environments in which the MNE operates (Eden & Miller, 2004; Xu & Shenkar, 2002).

Institutionalism in the economic tradition, on the other hand, emphasizes the quality of the institutional environment, stressing the role of formal and informal institutions in this regard (North, 1990). A system of effective formal institutions reduces uncertainty and restrains opportunistic behavior, lowering transaction costs and facilitating the division of labor through anonymous and impersonal exchange (North, 1990). In absence of such a governance system, open markets for resources do not exist, which leads firms to take recourse to informal arrangements and internal markets (Khanna & Palepu, 1997). The concern in international business studies is that the attractiveness of expanding globally and doing business abroad depends on the institutional profiles of the prospective host countries, posing challenges for foreign firms and requiring MNEs either to adapt or to stay away from certain countries (Khanna, Palepu, & Sinha, 2005).

The Conflation of Institutional Distance and Institutional Profile Effects

Why does conflation of institutional distance effects and institutional profile effects occur? Institutional

theorizing in international business studies tends to reason from a developed country perspective, meaning it focuses on the challenges faced by MNEs originating from highly developed institutional environments expanding to institutional environments that are less developed. Empirical institutional research is similarly dominated by studies of MNEs from developed countries that expand toward developing countries. Although literature concerning emerging market MNEs is growing (e.g., Buckley, Clegg, Cross, Liu, Voss, & Zheng, 2007; Luo & Wang, 2012), the majority of distance studies thus focuses on firms from a single or institutionally homogeneous set of countries (see Bae & Salomon, 2010; Beugelsdijk, Maseland, Onrust, van Hoorn, & Slangen, 2015; Kirkman, Lowe, & Gibson, 2006; Tihanyi, Griffith, & Russell, 2005 for surveys).

Reasoning from a single reference point implies that variation in institutional distance between an MNE's home country and its host countries is tantamount to variation in the institutional profile of those host countries. In mathematical terms, we have a constant, namely the institutional profile score of the MNE's home country (in our empirical illustration, the first principal component of the six indicators from the Worldwide Governance Indicators (WGI) project), from which we subtract the institutional profile score of the host countries. As the constant is the same for all possible host countries, the only variation in institutional distance between the MNE's home country and its host countries is the variation in the institutional profiles of these host countries themselves. Given that host countries' institutional profile scores are subtracted from the home country's institutional profile score, a low institutional profile score for the host country thereby goes together with having a high distance to the home country.

Importantly, changing the reference point toward the situation faced by MNEs from institutionally less developed countries does not affect the association between dyadic institutional distance and the institutional profile scores of the partner countries involved. The only difference between the two scenarios is the direction of the correlation between calculated distances and host country institutional profile scores. When taking an institutionally less-developed country as a reference point, institutional distance is calculated by taking host countries' institutional profile scores and repeatedly subtracting the same constant, namely the institutional profile score of the home country. In this case, a high institutional

profile score for the host country thus goes together with high distance to the home country. Accordingly, while the correlation between institutional distance and profile is negative when taking an institutionally well-developed country as a reference point, this correlation is positive when taking an institutionally less-developed country as a reference point.

Meanwhile, for the extent to which institutional distance and institutional profile measures will be correlated, it does not matter whether one keeps the home country fixed when calculating institutional distance or whether one allows the home country to vary while keeping the host country fixed. In all cases, for mathematical reasons, the use of a single reference point (home or host country) results in a strong correlation between institutional distance and institutional profile.

Disentangling Institutional Distance and Institutional Profile

How can we disentangle institutional distance and institutional profile? Principally, there are two options. First, rather than taking institutionally highly developed or undeveloped countries as reference points, we may pick a country from the middle of the institutional profile distribution. Since institutional distance is the absolute rather than the normal difference between two institutional profiles, institutional distance to/from such a reference country is associated with both higher and lower institutional profile scores of partner countries. Hence the direct proportionality between distance and profile that characterizes institutional distance calculated to/from highly (lowly) developed countries vanishes.

A second option is to select multiple reference points from both ends of the institutional profile distribution. If one finds that institutional distance to/from countries scoring high on an institutional profile indicator has a positive effect on, say, the likelihood that a firm adopts a particular entry mode, while institutional distance to/from countries scoring low on an institutional profile indicator has a negative effect, one may safely conclude that it is not institutional distance that is responsible for the effect, but that the effect is due to the institutional profiles of the partner countries. Conversely, if one finds that institutional distance has the same effect for firms from both types of reference countries, the effect stems from institutional distance rather than from partner countries' institutional profile.

EMPIRICAL RELEVANCE

Hypotheses and Empirical Approach

The essential proof for our claim that institutional distance and institutional profile are indistinguishable in single reference point studies is mathematical. The question of the relevance of distance – profile conflation for the practice of institutional research in international business studies is an empirical one, however. We summarize the discussion of the previous section in the following set of hypotheses, spelling out the extent of distance – profile conflation and the role of reference point selection therein:

Hypothesis 1a: Moving to reference points located at either end of an institutional profile dimension, the correlation between institutional distance and institutional profile increases rapidly in strength, to the extent that measures of institutional distance and measures of institutional profile are empirically indistinguishable for the majority of reference points.

Hypothesis 1b: Adopting multiple reference points reduces the correlation between institutional distance and institutional profile, to the extent that effects due to institutional distance and effects due to institutional profile can be meaningfully distinguished.

Hypothesis 1a (H1a) thereby captures the essence of our initial mathematical argument, while Hypothesis 1b (H1b) reflects our argument that institutional distance and profile effects can be disentangled by adopting multiple reference points simultaneously.

As our twin hypotheses revolve around the strength of correlations between institutional profile indicators and corresponding measures of institutional distance, we cannot apply probability theory to test them. Rather, we need to assess whether correlations are strong enough to make constructs indistinguishable or weak enough to make constructs meaningfully distinguishable using informed criteria. Our approach is to adapt standard criteria for the assessment of the reliability of multi-scale measurement instruments, specifically Cronbach's α . Cronbach's α is widely used to evaluate the internal consistency of multi-item measurement scales, providing an assessment of the extent to which the individual items measure the same underlying construct. We deem an institutional distance indicator and an institutional profile indicator empirically *indistinguishable* (H1a) if their combination has a

Cronbach's α that is equal to or greater than 0.7, which is the common threshold for acceptable internal consistency of a multi-item measure (George & Mallery, 2003). Similarly, we deem an institutional distance indicator and an institutional profile indicator empirically *distinguishable* (H1b) if their combination has a Cronbach's α that is equal to or below 0.3, which is well below the common 0.5 threshold of unacceptably low internal consistency (George & Mallery, 2003). In terms of correlations, these two cut-off points imply absolute correlations of 0.538 or higher ($\alpha \geq 0.7$) and 0.176 or weaker ($\alpha \leq 0.3$).

Data and Measures

Data

To bring our mathematical analysis and corresponding hypotheses to data we draw on the well-known WGI (World Bank, 2014). We picked the WGI data because they are oft-used in institutional research, publicly available, and extremely comprehensive, providing scores for over 200 countries. Importantly, though, our results do not depend on the particular institutional indicator considered. We obtain identical results using other indicators, including indicators more closely associated with informal, normative or cognitive institutions or culture (results available on request).

Measures

The WGI project comprises six institutional indicators: Voice and Accountability; Political Stability; Government Effectiveness; Regulatory Quality; Rule of Law; and Control of Corruption. We take averages of countries' scores on these indicators for the period 2004–2013. Scores are available for 203 countries. We use principal components analysis to construct a single measure of regulative institutional profile. This analysis rendered one factor with Eigenvalue > 1 , which accounted for 85.9% of the variation in the six underlying indicators. We calculate regulative institutional distance using a Mahalanobis index (Berry, Guillén, & Zhou, 2010), for which we use the regulative institutional profile factor as input. Tables with summary statistics as well as complete country data are available on request.

Empirical Results

How general is the conflation of distance and profile? We assess H1a by examining the correlations between measured regulative institutional distance and partner country regulative institutional profile factor scores. We consider the strength of

these correlations as a function of the location of the reference country in the institutional distribution, that is, the reference country's score on the regulative institutional profile factor. Figure 1 presents the results, for which we have calculated 203 distance – profile correlations, one for each possible reference country in our sample.

When considering countries scoring low on the regulative institutional profile factor as reference points (e.g., Russia), distance – profile correlations are close to +1, but when considering countries scoring high on the regulative institutional profile factor as reference points (e.g., the US), distance – profile correlations are close to -1. Toward the middle of the institutional profile distribution (Brazil or Romania), the strength of correlations between institutional distance and partner country institutional profile slowly decreases. The overall pattern provides strong support for H1a. Institutional distance and partner country institutional profile scores are empirically indistinguishable (Cronbach's $\alpha \geq 0.7 / |r| \geq 0.538$) for the large majority of potential reference countries, 162 out of 203 to be precise. For only 13 out of 203 potential reference countries, are institutional distance and partner country institutional profile scores meaningfully distinguishable (Cronbach's $\alpha \leq 0.3 / |r| \leq 0.176$).

Do multiple reference points allow distinguishing between institutional distance and institutional profile? H1b concerns the possibility of avoiding mixing up distance and profile by using multiple reference countries from opposing ends of the institutional profile dimension in question. To assess this hypothesis, we have selected two countries that have been used regularly as reference countries in institutional distance research and score oppositely on our regulative institutional profile factor: the US and Russia. The United States is positioned close to the upper end of the institutional profile distribution, scoring 1.40 on the regulative institutional profile factor, while Russia is positioned close to the lower end of the institutional profile distribution, scoring -0.78 on the regulative institutional profile factor.

Panel A in Table 1 presents the distance – profile correlations using the United States, Russia, and the combination of the United States and Russia as respective reference points. Following Figure 1, for the United States separately (Column 1), institutional distance correlates very strongly *negatively* with the institutional profile factor, while this correlation is strongly *positive* for Russia (Column 2). When we use both the United States and Russia as reference countries (Column 3), the strong correlation between institutional distance and partner countries' institutional profile scores disappears,

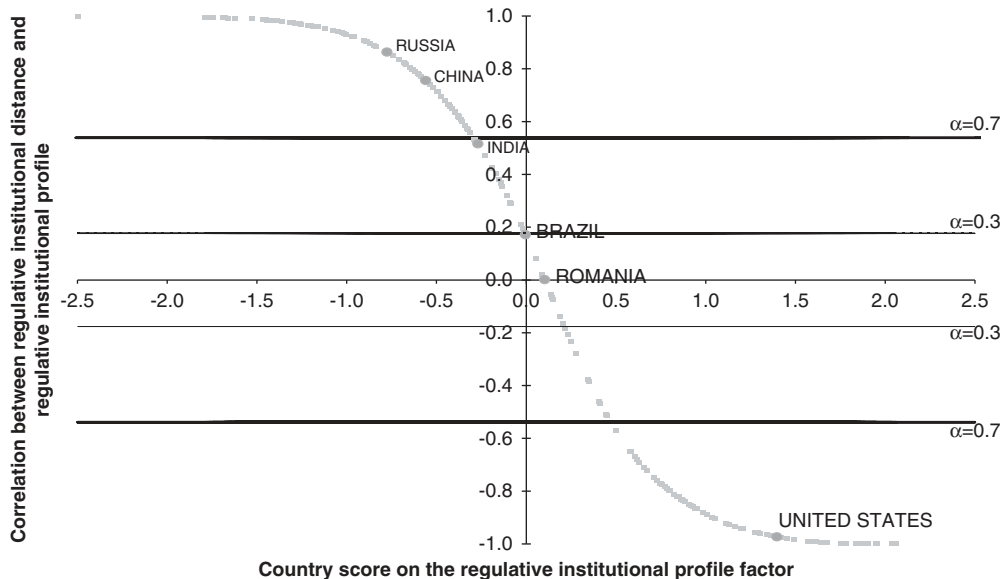


Figure 1 Correlations between institutional distance and partner countries' scores on the institutional profile factor for all reference points. Notes: This figure depicts the correlations between regulative institutional distance and partner countries' regulative institutional profiles, as a function of the reference country score on the regulative institutional profile factor. Correlations are zero at the point where the average distance to partner countries scoring higher on the institutional profile factor than the reference country equals the average distance toward partner countries scoring lower on the institutional profile factor (close to the position of Romania). Detailed results for each reference country are available on request.

Table 1 Can institutional distance and institutional profile be distinguished? Moving from single to multiple reference points

	Panel A: United States and Russia	Panel B: Japan and Nigeria	Panel C: Germany and Bangladesh	Panel D: Combining countries from Panels A-C
Country or set of countries used as reference country/reference countries	1 United States	2 Russia	3 United States and Russia	4 Japan
	5 Nigeria	6 Japan and Nigeria	7 Germany	8 Bangladesh
	9 Germany and Bangladesh	10 US, Japan & Germany	11 Russia, Nigeria and Bangladesh	12 US, Japan, Germany, Russia, Nigeria and Bangladesh
Distance – profile correlation	-0.97 [202]	0.86 [202]	-0.11 [404]	-0.97 [202]
	0.86 [202]	-0.97 [202]	-0.11 [404]	-0.97 [202]
	0.97 [202]	0.02 [404]	-0.99 [202]	-0.07 [404]
	0.93 [202]	0.93 [202]	-0.99 [202]	-0.97 [606]
	0.91 [606]	0.91 [606]	-0.97 [606]	-0.05 [1212]

Notes: Number of observations in square brackets. Scores on the institutional profile factor for the four countries not mentioned in the main text are as follows: Japan scores 1.34, Nigeria scores -1.22, Germany scores 1.62, and Bangladesh scores -1.00.

dropping to -0.11, which is equal to a Cronbach's α of approximately 0.20 and well below our criterion of Cronbach's $\alpha \leq 0.3$. Considering other combinations of reference countries or a combination of sets of reference countries renders similar results (Panels B and C and Panel D in Table 1).¹ Hence the empirical evidence demonstrates very clearly that the relatively easy step of including multiple reference countries, even only two of them, sampled from across the distribution of institutional profiles substantially mitigates the mixing up of institutional distance and institutional profile.

DISCUSSION AND CONCLUSION

This research addresses a vital, hitherto neglected problem in the way institutions and institutional distance have been studied in international business research, which is the conflation of institutional distance effects and institutional profile effects. The problem stems from the fact that the majority of institutional profile or institutional distance studies focuses on firms from a single or institutionally homogenous set of countries. If one considers institutional distance to/from a single reference point only, by mathematical necessity, institutional distance between the reference country and partner countries and the institutional profile of these partner countries correlate strongly. Distinguishing between the effects of institutional distance and the effects of partner country institutional profile on the MNE becomes impossible.

We empirically demonstrate that this problem of distance – profile conflation applies to the majority of countries used as potential reference point, including (especially) the United States. Hence this problem has great relevance for institutional research in international business studies. A key implication is that the large amount of institutional (distance) studies in international business research that have adopted a single reference point research design are potentially invalid. Whatever the results found in such work, the attribution of effects either to the institutional profile of the partner country or to the institutional distance to the partner country is unfounded. Most extant research simply does not enable us to tell whether MNEs behave in a particular way in a market because of the institutional characteristics of that market or because of the dissimilarity of that market to the MNE's home country. The mechanisms behind any observed effects of institutions on MNE behavior are unclear. This lack of clarity, in turn, matters not only for theory, but also for managerial practice. Efforts to



overcome institutional distance effects such as investing in knowledge about the local environment or cultural sensitivity training of managers are largely pointless if the actual challenge facing the firm is one of low institutional quality rather than unfamiliarity with the institutional surroundings. No amount of cross-cultural competences or insights about the local institutional environment take away the problem that a market may be, say, too corrupt to do business profitably.

A second key implication is that future studies should take the distinction between institutional profile and institutional distance seriously and adapt their research designs accordingly. Theoretically, we may need to reevaluate arguments about the effects of institutional distance carefully and check whether they actually relate to effects of institutional profile, and vice versa. Empirically, our results indicate that distinguishing between distance and profile effects is achieved effectively by using multiple reference points. Therefore, the simple recommendation for analyses of institutions and institutional distance effects is to make sure that the sample of reference countries and partner countries is sufficiently institutionally diverse.² As a rule-of-thumb, we suggest a minimum of seven reference countries as well as seven partner countries (Franke & Richey, 2010), where reference countries should rank both below and above partner countries on the institutional indicator of interest. If this requirement cannot be met due to data limitations, at the very least, any analysis of institutional distance should also include the corresponding measures of institutional profile, and vice versa. By estimating distance effects and profile effects simultaneously, we get results on the effect of the one construct conditional on the effect of the other construct, which allows us to separate distance and profile effects.

Following this simple guideline, we will be better able to study the effects of institutional distance and institutional profile as separate but related phenomena. The rapidly growing literature on emerging markets provides an excellent opportunity to do so. Increased data availability on countries that are institutionally relatively different

from developed markets offers great opportunities for moving beyond single reference point analyses. The danger, however, is that old mistakes are repeated by simply conducting institutional analyses with only emerging economies as reference countries. For getting a clear grasp of how institutions and institutional distance affect MNEs, it is critical that we move beyond partial perspectives and use only diverse, multiple reference points research designs.

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NOTES

¹The countries covered by Table 1 are all examples that we use to demonstrate empirically the point that a diverse set of reference countries helps researchers disentangle institutional distance and institutional profile effects. Results are similar for yet other combinations of (sets of) reference countries that are similarly institutionally diverse as the combinations depicted in Table 1.

²As the conflation of institutional distance and institutional profile is independent of the phenomenon studied, be it *ex ante* location or entry mode choice or *ex post* outcomes such as subsidiary performance, this recommendation is independent of the phenomenon studied.

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ABOUT THE AUTHORS

André van Hoorn (PhD Radboud University, the Netherlands) is an Assistant Professor at the University of Groningen. A main theme in André's research concerns differences in cultural values and formal institutions and their implications for business and other economic activities. His work has appeared in such journals as the *Global Strategy Journal*, *Journal of Cross-Cultural Psychology*, *Journal of Business Ethics* and *Journal of International Business Studies*. He was born in the Netherlands and is a Dutch citizen.

Robbert Maseland (PhD Radboud University, the Netherlands) is an Associate Professor in International Economics and Business at the University of Groningen. His research interests include the impact of cultural and institutional diversity on economic development and international business. His research has appeared in a wide range of journals such as the *Journal of Economic Growth*, *Global Strategy Journal*, *Journal of International Business Studies*, and *Nature*, and he has published a monograph on culture and economics with Cambridge University Press.

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