DISTANCE MATTERS: LIABILITY OF FOREIGNNESS, INSTITUTIONAL DISTANCE AND OWNERSHIP STRATEGY

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ABSTRACT

The costs of doing business abroad *(CDBA) is a well-known concept in the international business literature, measuring the disadvantages or additional costs borne by multinational enterprises (MNEs) that are not borne by local firms in a host country. Recently, international management scholars have introduced a second concept,* liability of foreignness *(LOF). There is confusion in the two literatures as to the relationship between CBDA and LOF, as evidenced in a recent special issue on liability of foreignness (*Journal of International Management, *2002). We argue that LOF stresses the social costs of doing business abroad, whereas CDBA includes both economic and social costs. The social costs arise from the unfamiliarity, relational, and discriminatory hazards that foreign firms face over and above those faced by local firms in the host country. Because the economic costs are well understood and can be anticipated, LOF becomes the core strategic issue for MNE managers. We argue that the key driver behind LOF is the institutional distance (cognitive, normative, and regulatory) between the home and host countries, and explore the ways in which institutional distance can affect LOF. We operationalize our arguments by showing how*

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institutional distance and liability of foreignness can provide an alternative explanation for the MNE's ownership strategy when going abroad.

> [N]ational firms are likely to have advantages over foreigners . . . National firms have the general advantage of better information about their country: its economy, its language, its law, and its politics. To a foreigner, the cost of acquiring this information may be considerable. But note that it is a fixed cost . . . Of a more permanent nature is the barrier to international operations arising from discrimination by government, by consumers, and by suppliers. It is not the general treatment that is important: this affects the domestic firms as well as the foreign firms, but it does not give one firm an advantage over another. What is important is the fact that in given countries, foreigners and nationals may receive very different treatment. (Hymer, 1960/1976, pp. 34–35)

Stephen Hymer (1960/1976) was the first scholar to theorize that firms experienced *costs of doing business abroad* (CDBA) that were not experienced by local firms. He argued that CDBA should be measured by the advantages national firms have in their home markets relative to foreign-owned firms. Since Hymer's 1960 dissertation, researchers have focused on the types of firm-specific advantages that multinational enterprises (MNEs) need to offset these costs. CDBA has received less attention, serving primarily to motivate research on MNE advantages (Buckley & Casson, 1976; Caves, 1982; Dunning, 1977; Hennart, 1982; Rugman, 1981).

Recently, international management scholars have begun to "open the black box" of the costs of doing business abroad (Eden & Miller, 2001), arguing that MNEs face a *liability of foreignness* in host countries (Kostova & Zaheer, 1999; Zaheer, 1995; Zaheer & Mosakowski, 1997). Zaheer defined liability of foreignness as "the costs of doing business abroad that result in a competitive disadvantage for an MNE subunit . . . broadly defined as all additional costs a firm operating in a market overseas incurs that a local firm would not incur" (1995, pp. 342–343). Zaheer's liability of foreignness list parallels Hymer's CDBA. Both authors focus on additional costs not incurred by local firms in the host country; Hymer speaks of "the stigma of being foreign" (1960/1976, p. 35), and Zaheer (1995) uses the two terms interchangeably.

Are the two concepts interchangeable, or are they different? A recent special issue of the *Journal of Management* (Vol. 8, No. 3, 2002) suggests there is still confusion about the two concepts. Luo and Mezias (2002, p. 218), in their introduction to the special issue, see the two concepts as the same, arguing that CDBA was a "precursor to LOF," but the definitions and use of the two concepts vary from paper to paper. Zaheer (2002, p. 350), in her commentary on the volume, explicitly asks, "Are they [CDBA and LOF] synonymous? Are the liabilities of foreignness a subset of the costs of doing business abroad? Or are they an overarching concept within which the costs of doing business abroad fall?" She answers by noting first that in her early work on LOF, she saw them as the same, but now sees them as different. CDBA is an economic concept consisting primarily of market-driven costs

related to geographic distance; whereas LOF is a sociological concept consisting primarily of structural/relational and legitimacy costs. She concludes with a call for a deeper "understanding of foreignness, and its ramifications" (2002, p. 357).

Our objective herein is to answer Zaheer's call for a deeper understanding of liability of foreignness and its ramifications through an explicit and careful deconstruction of the relationship between CDBA and LOF. Our view of the relationship is close to, but not the same as, Zaheer's; that is, we see LOF as the key component of CDBA. LOF stresses the social costs of doing business abroad. These social costs arise from the unfamiliarity, relational, and discriminatory hazards that foreign firms face and domestic firms do not; such costs are inherently due to uncertainty and are likely to persist over time.

We argue that the key driver behind LOF is the institutional distance (cognitive, normative, and regulatory) between the home and host countries. CDBA, however, is a broader concept that includes LOF but also includes economic activity-based (production, marketing, distribution) costs related to geographic distance. Since these economic costs related to value-adding activities by the MNE can be anticipated and measured, and may well be finite, the core issue for MNE managers remains liability of foreignness. We therefore focus the rest of the paper on LOF. We decompose LOF into three types of hazards (unfamiliarity, relational, and discriminatory hazards) and show how the three pillars of institutional distance (regulatory, normative, and cognitive) can affect each hazard. We operationalize our arguments by showing how institutional distance and liability of foreignness can provide an alternative explanation for the MNE's ownership strategy, that is, the optimal percentage of equity held by the MNE in its foreign operations (where 0% represents exporting and 100% a wholly owned subsidiary), with or without a local partner.

The rest of this work is organized into five parts. The following section briefly reviews key theoretical contributions to the literature on the costs of doing business abroad and liability of foreignness. The third section offers a new deconstruction of the relationship between CDBA and LOF. The fourth section explores the three pillars of institutional distance as drivers of LOF. The fifth section examines some implications for the MNE's ownership strategy. Finally, the sixth section provides conclusions.

LITERATURE REVIEW

The Costs of Doing Business Abroad

The theoretical concept of the costs of doing business abroad was first developed in Hymer's (1960/1976) dissertation. Building on earlier work on the barriers to entry

to new firms, Hymer argued that multinational firms, because they were foreign, faced barriers to entry in a host-country market. MNEs, therefore, needed their own firm-specific advantages to overcome the "home-court" advantages of local firms.[1] Hymer identified four types of foreign firm disadvantages (or domestic firm advantages) that could generate CDBA. First, foreign firms would have less information than domestic firms about the host country and needed to incur start-up costs of acquiring this information. Second, foreign firms could receive differential and worse treatment from the host-country government, buyers, and suppliers compared to domestic firms. Hymer expected this discriminatory treatment to persist over time, even after the firm established operations in the host country. Third, the firm's home government could also generate differential treatment, for example, by prohibiting the firm (both the parent and its foreign affiliates) from engaging in certain activities or by levying more onerous taxes than local firms faced in the host country. Lastly, foreign firms would face foreign exchange risks because receipts and payments of foreign currencies were not synchronized, which local firms would not face.[2]

Hymer's CDBA were over and above the costs faced by domestic firms in the host country. The costs were assumed to be mostly fixed (i.e. non-varying with output); they would decrease over time (but remain positive) the longer the MNE was in the host country. For the same revenue stream, this meant that the MNE would earn smaller profits than an equivalent domestic firm. This is illustrated in Fig. 1, in which the costs of doing business abroad are shown by the MNE's average cost curve lying above that of local firms.[3] Local firms earn profits shown

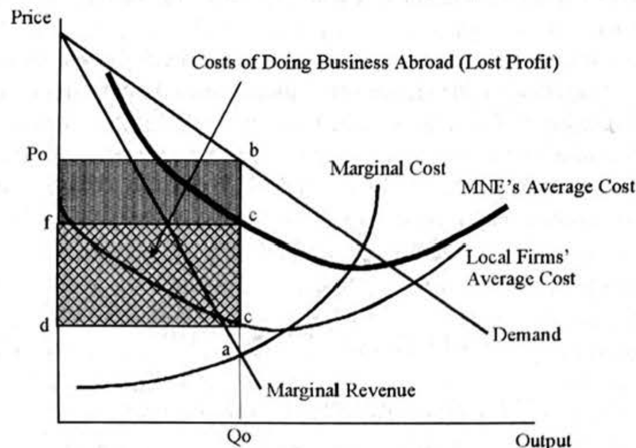

Fig. 1. Costs of Doing Business Abroad.

by the shaded rectangle P_0bcd, whereas the MNE's profits are only P_0bef; thus, the costs of doing business abroad are the rectangle of forgone profits, *fecd*. The MNE therefore needed a firm-specific advantage that either raised revenues (e.g. product patents, brand names) or lowered costs (e.g. economies of scale and scope) or both, to offset CDBA.

Hymer's argument was widely accepted,[4] and international business research in the 1970s and 1980s focused not on CDBA, but on understanding firm-specific advantages. The costs of doing business abroad languished as a research area.

Liability of Foreignness

Writing 20 years after Hymer, Doz (1980, p. 27) was perhaps the first to realize that the costs of doing business abroad involved two conflicting pressures on the MNE. The "economic imperative" pushed MNEs to integrate and rationalize their operations across countries, while the "political imperative" pushed MNE subsidiaries to tailor their operations to host-country demands. In responding to these conflicting pressures, Doz argued that MNEs could adopt a "worldwide integration strategy" or "national responsiveness" strategy, or could satisfice by choosing an in-between "administrative coordination" strategy.

This integration-responsiveness matrix was subsequently developed in Bartlett and Ghoshal (1989), Doz and Prahalad (1984), and Prahalad and Doz (1987). Viewing the MNE as a network provided a new way to conceptualize CDBA through the integration-responsiveness lens. Ghoshal and Bartlett (1990) argued that in host countries with strong relational ties between suppliers, manufacturers, customers, and government (within-density pressures), MNE subunits would face intense pressures for isomorphism with their local environments. These pressures could cause conflicts in terms of internal legitimacy within the MNE network (across-density pressures). Furthermore, different firm-specific characteristics could be "explained in terms of selected attributes of the external network" in which the MNE subunit is embedded, underscoring differences across host-country environments (1990, p. 610).[5] In a similar vein, Rosenzweig and Singh (1991) examined the costs associated with conflicting pressures to conform to the institutional demands of host countries yet also to coordinate closely with other MNE subsidiaries.

Empirical work on the costs of doing business abroad started with Zaheer's (1995) empirical study of the exit patterns of trading rooms of U.S. and Japanese banks. Treating CDBA and LOF as interchangeable, she organized LOF into four categories that paralleled Hymer (1960/1976): costs due to spatial distance (travel, transport, coordination), unfamiliarity with the local environment, differential treatment by the host country, and costs imposed by the home-country environment.

Combining the global integration-national responsiveness matrix developed by Doz (1980) with an institutional perspective of the MNE (Rosenzweig & Singh, 1991), she argued that MNEs could reduce LOF by either transferring firm-specific advantages from their parents or mimicking the organizational practices of local firms. Zaheer (1995) found that firm-specific advantages were preferable to local isomorphism in terms of reducing exits.

Zaheer and Mosakowski (1997) expanded this analysis to the exit patterns of all currency-trading rooms worldwide over a 20-year period. They found that exit patterns for MNEs were similar to those for domestic firms during the first 2 years and after 16 years of entry; in the middle period MNE exit rates were higher, suggesting that LOF exists but falls with in-country experience and eventually disappears. They concluded that LOF arose "mainly from the foreign firm not being sufficiently embedded in the information networks in the country of location" (1997, p. 445).[6]

Kostova and Zaheer (1999) applied institutional theory to the theory of the multinational enterprise, arguing that MNEs were rewarded for isomorphism with the local environment, receiving increased legitimacy, resources, and survival capabilities, whereas a failure to conform adversely affected their legitimacy. They suggested that host-country institutions lacked information about the MNE and would therefore use stereotypes and impose different criteria to judge MNEs. Moreover, MNEs faced different legitimacy standards compared to domestic firms, and in many instances, they were expected to do more than domestic firms with respect to "building their reputation and goodwill, in supporting local communities, and so on" (1999, p. 74). The costs involved in establishing and maintaining legitimacy placed foreign-owned firms at a competitive disadvantage. When operating in multiple countries, the challenges facing MNEs increased as complexities rose in the legitimating environment, organization, and process of legitimization.

Recent empirical work has tested whether LOF is reflected in poorer performance by MNE subunits (Miller & Parkhe, 2002; Miller & Richards, 2002), high exit rates (Hennart et al., 2002), and increased lawsuits (Mezias, 2002b), compared to local firms. The studies find clear evidence that LOF reduces MNE performance and increases firm exits. However, Mezias (2002a), in his careful research design, points out the difficulties of appropriately testing the links between LOF and firm performance.

In addition to work on LOF and firm performance, some researchers have focused on firm strategies to reduce the liability of foreignness. Buckley (1983, p. 48) noted that local knowledge should give domestic firms advantages, but relative only to first-time foreign investors, not to long-established multinationals. Gray argued that:

> [T]he disadvantage of being foreign wanes with the duration of being established in the host country and is largely eliminated by foreign direct investment (FDI) through acquisition. The Hymer postulate is still relevant for some young firms with ownership advantages that allow them to compete in niche markets, but for the well-established TNCs that now dominate international production in well-defined industries and product lines, it is no longer relevant (1996, pp. 51–52).

Zaheer and Mosakowski (1997, p. 458) agree that Hymer's postulate presents a "rather static picture of both the costs of doing business abroad and of MNE competitive advantage, and is perhaps most useful at understanding the MNE at a point in time, such as at market entry." Zaheer (2002, p. 353) notes that LOF is "inherently a dynamic concept" and that as the MNE subunit becomes more of an insider in the host country, LOF should fall and perhaps disappear.

Petersen and Pedersen (2002), based on a survey of 494 MNEs from Sweden, Denmark, and New Zealand, show that managerial discretion is directly related to unfamiliarity hazards of LOF. MNEs with a global integration strategy (Doz, 1980; Prahalad & Doz, 1987) that discouraged local learning and adaptation remained unfamiliar with the local environment years after entry. Eden and Miller (2001) argued that mode-of-entry selection into the host country could be a way to reduce LOF; for example, selecting a local joint venture partner would reduce unfamiliarity costs and discriminatory treatment by the local government.

Luo et al. (2002) argued that MNE strategies to cope with LOF should be separated into offensive strategies (local networking, resource commitment, legitimacy improvement, and input localization) and defensive strategies (contract protection, parental control, parental service, and output standardization). They examined the effects of local networking and contract protection on production and marketing costs and sales revenues of 92 MNEs in China. Their results showed that contracts reduced costs while local networking raised revenues; together, both reduced LOF and raised MNE profitability in the host country. Eden and Molot (2002) offer support for the effects of offensive and defensive strategies. In their case study of foreign MNEs in the Canadian automotive industry, the authors showed how first movers (the U.S. assemblers) used their firm-specific advantages and relation-building strategies to become insiders, effectively eliminating LOF. Their insider status was used to obstruct the entry and worsen the MNE-state bargains of latecomers (Japanese transplants). And, most recently, Nachum (2003) shows that firm-specific advantages and multinationality enabled foreign firms to outperform local firms in the London financial services industry.

In 2002, Luo and Mezias guest-edited a special issue of the *Journal of International Management* on the liability of foreignness. LOF definitions varied across the papers in the volume. Luo and Mezias (2002, p. 218) argued that CDBA was a "precursor to LOF," seeing the concepts as identical. Sethi and Guisinger

(2002, p. 223), however, expanded LOF to encompass more than CDBA by including "the aggregated effect of the firm's interaction with all elements of the international business environment." In a "middle of the road" approach, Calhoun (2002, p. 305) agreed that LOF could be defined as "all additional costs to a firm related to operating in a distant location" (that is, as CDBA), but argued that these costs should be categorized into two groups. One set of costs is related to geographic distance; these costs can be anticipated and are finite. The second set of costs, Calhoun argued, is related to uncertainty and persists over time. These costs are at "the heart of every discussion of liability of foreignness." Reading between the lines, LOF is therefore a subset of CDBA.

Zaheer, in her commentary on the papers, raised the issue of whether CDBA and LOF were identical concepts. Contrary to her earlier work, she argued that the concepts were not the same; CDBA came from an economic approach to MNE theory, whereas LOF was grounded in socio-institutional analysis. "[W]hile the costs of doing business abroad focus on market-driven economic costs, I see the liability of foreignness as focusing on the more social costs of access and acceptance" (2002, p. 352). LOF, for Zaheer, involves costs associated with the firm's network linkages (or lack thereof) in the host country and institutional distance between the home and host countries.

Our view lies between that of Calhoun (2002) and Zaheer (2002); that is, we see LOF as the key component of CDBA. LOF stresses the social costs of doing business abroad, whereas CDBA includes both economic and social costs. These social costs arise from the unfamiliarity, relational, and discriminatory hazards that foreign firms face and domestic firms do not; such costs are inherently due to uncertainty and are likely to persist over time. We argue that the key driver behind LOF is the institutional distance (cognitive, normative, and regulatory) between the home and host countries. CDBA, however, is a broader concept that includes LOF but also includes economic activity-based (production, marketing, distribution) costs related to geographic distance. Since these economic costs related to value-adding activities by the MNE can be anticipated and measured, and may well be finite, the core issue for MNE managers remains liability of foreignness. We explore these arguments below.

DECONSTRUCTING THE COSTS OF DOING BUSINESS ABROAD

In this section, we develop a new perspective on the costs of doing business abroad, one that incorporates liability of foreignness as its key component, but also includes economic-based costs. Our definition remains true to Hymer (1960/1976): CBDA measures all the additional costs faced by a home-country firm connected with its market-based (selling and/or buying) activities in a foreign country, relative to the costs faced by a local firm engaged in similar activities. These activities could be as minimal as exporting into a host-country market (where the local firm also sells in the host market) to the extensive activities involved in extraction and processing raw materials (where the local firm also extracts and processes).[7] To phrase this more broadly: What are the "additional costs incurred by foreign firms in dealing with the same set of issues local firms deal with?" (Zaheer, 2002, p. 355).

Drawing on our review of the CDBA and LOF literatures, we separate CDBA costs into two major categories: economic market-based activity costs and liability of foreignness.

Activity-Based Costs

When a firm goes abroad, its value-adding activities in the host country can range from minimal to extensive. Consider exporting, for example. Assuming that manufacturing costs are the same in both countries (for simplicity), exporting involves higher freight, insurance, communication, and foreign exchange costs and trade barriers (tariffs, entry, and license fees) that are not faced by a local firm in the host country. If the MNE replaces exports with a local manufacturing plant in the host country, some of the distance-related costs are lower, but there are one-time costs of adapting the MNE's technology and production methods to the host country and the additional costs of training local workers to use the MNE's technology.

Zaheer (2002, p. 351) refers to these costs as "market-driven costs"; this term, however, suggests that the motivation for entry is market-seeking. There are other motivations for going abroad including natural resource-seeking or knowledge-seeking where the value-adding activities may involve extraction and foreign purchases for export to the home country, rather than sales in the host country. The new literature on metanationals (Doz et al., 2001) argues that the core activity for MNEs in the 21st century is the sensing of knowledge in host countries, mobilizing the knowledge into innovative products and processes, and operationalizing their production and delivery throughout the MNE network. This suggests that knowledge-seeking activities, rather than market-seeking activities, are fundamental drivers of competitiveness.

To cover the range of motivations for going abroad, we refer to economic costs as activity-based costs; these include transportation and communications costs, trade barriers, and costs associated with foreign exchange transactions. These costs are overwhelmingly economic and driven by geographic distance. As

Calhoun (2002) argues, they can be anticipated and quantified. They have also become less important with the new information technologies and globalization in the 21st century.

Liability of Foreignness

The second and, we argue, more important component of CBDA is liability of foreignness – being a "stranger in a strange land." Following Zaheer (2002), we argue that LOF can be broken down into three hazards that affect foreign firms disproportionately to local firms in the host country.

Unfamiliarity Hazards

Unfamiliarity costs reflect the lack of knowledge of, or experience in, the host country, which places the foreign firm at a disadvantage compared to local firms. As Caves (1971, p. 5) argued:

> The foreign enterprise must pay dearly for what the native either has acquired at no cost to the firm (because it was part of the entrepreneur's general education) or can acquire more cheaply (because, as it were, the native knows where to look).

Zaheer provided a good example of such information asymmetry and its likely impact on the competitiveness of host-country and foreign-owned firms: "German banks in Germany might have a better feel for whether the Bundesbank is going to lower Deutsche Mark interest rates within the next 24 hours than might British banks located in Germany" (1995, p. 344). This liability of foreignness is related not to the age of the MNE, but rather to the longevity of its experience in the host country. Short tenure in the host country causes unfamiliarity hazards, which are measured by the additional costs that the MNE must incur to achieve the same level of host-market knowledge as a local firm.[8] Information can be earned by local production, investment in marketing, previous experiences in similar countries, taking on a local joint venture partner, and so on.

Caves (1971, p. 13) argued that the additional costs of gathering information were fixed; that is, "they do not vary proportionately with the amount of resources that the firm might stake abroad." Unfamiliarity hazards are therefore the type of additional costs shown in Fig. 1; they shift the foreign firm's average cost curve upwards but do not change production levels. These costs of building market knowledge should disappear over time; however, Peterson and Pedersen (2002) show that they can persist in the long run if MNE managers follow a standardized global strategy and do not proactively engage in local learning.

Discrimination Hazards

The second component of liability of foreignness is the discriminatory treatment inflicted on the foreign firm relative to local firms in the host country. Discriminatory treatment can arise from differential treatment by the home or host governments, consumers, or the general public in the host country. These costs may reflect political hazards (Henisz & Williamson, 1999) or consumer ethnocentricity in the host country (Balabanis et al., 2001; Sumner, 1906). Discriminatory costs therefore focus on the challenges of obtaining external legitimacy. We contend that liability of foreignness is a two-way mirror: foreignness needs to be viewed both from the MNE's perspective of the host country (outside-inside) and from the host country's perspective of the MNE (inside-outside).

Kostova and Zaheer (1999) asserted that liability of foreignness was based on the host-country's unfamiliarity with the foreign firm (an inside-outside approach), resulting in stereotypes and higher standards being imposed on foreign firms.[9] The MNE subunit's lack of embeddedness in the host country relative to local firms led to discriminatory treatment by host-country stakeholders. Even if the MNE affiliate were guaranteed full national treatment under host-country laws, informal discriminatory treatment could occur if the affiliate were perceived and treated as an outsider.[10]

Relational Hazards

All firms incur costs of organization (Masten et al., 1991), whether in the form of internal organization costs (intrafirm transactions) or external organization costs (external market transactions). Both sets of costs are expected to be higher for the firm operating in foreign countries; as Caves notes (1971, p. 6): "alien status always imposes some penalty on managerial effectiveness." Anderson and Gatignon (1986) argued that MNEs faced a greater uncertainty than domestic firms, in terms of both external uncertainty (due to the unpredictability of foreign environments) and internal uncertainty (due to the difficulties of managing employees at a distance and from different cultures). These uncertainties create relational hazards in the form of higher administrative costs of managing the relationships between parties involved in doing business abroad (Buckley & Casson, 1998; Henisz & Williamson, 1999).

From the perspective of intra-organizational relations, administrative (or, alternatively, governance) costs must be incurred in managing operations at a distance. Supervision and management of employees is a more difficult and opportunistic behavior (shirking) that is more likely as geographic distance increases (Hennart, 2001). MNEs face conflicting lines of authority and have multiple sources of value when operating in multiple countries (Sundaram & Black, 1992). Hitt et al. (1997, p. 773) argue that international diversification brings both benefits and costs. The

costs (which they call "internal governance costs") are generated by the increased transaction costs and managerial information-processing demands of managing high complex internationally diversified firms. Calhoun (2002) suggests that governance costs also rise with cultural distance because managerial motivations and goals vary across cultures. Parent firms' routines are also likely to have a tacit component that is difficult to transfer to MNE subunits (Kostova, 1999; Kostova & Roth, 2002). Let us call these costs *intra-organizational relational hazards*, or *intra-relational hazards* for short.

From the perspective of inter-organizational relations, additional costs of negotiating, monitoring, and dispute settlement are incurred with arm's length modes (exports, licensing), whereas costs of trust building must be incurred with cooperative modes (joint ventures and alliances). Trust is a valuable contributor to many forms of exchange, reducing transaction costs in more uncertain environments (Doney et al., 1998). These costs are assumed to be ongoing, but decrease over time if the partners develop a trust-based relationship. Trust facilitates long-term relationships between firms (e.g. Ring & Van De Ven, 1992) and is critical to strategic alliance success (e.g. Gulati, 1995; Madhok, 1995). Moreover, interfirm cooperation lowers costs by reducing the incentive for opportunism and the need to protect against it by one or more of the involved parties (Hagen & Choe, 1998). We call these costs *inter-organizational relational hazards*, or *inter-relational hazards* for short.

A distinction is required between inter-relational hazards and discriminatory hazards. Inter-relational hazards are firm-to-firm costs that affect external and quasi-external, cross-border internal and external transactions within the MNE's buyer-supplier network. Discriminatory hazards affect the MNE's relations with host-country stakeholders (the host-country government, consumers, and other firms). One set of hazards could influence the other; for example, discriminatory treatment by a host government might encourage a domestic licensee or joint-venture partner to become more opportunistic in its dealings with the multinational, so that political hazards encourage inter-organizational relational hazards (Henisz & Williamson, 1999). Nevertheless, we do see these costs as distinct from one another, which is consistent with the separation of public and private expropriation hazards in Delios and Henisz (2000).

In summary, we have argued that the costs of doing business abroad can be split into two groups: economic market-based costs and liability of foreignness. The former costs can be anticipated and measured, and have decreased with globalization. LOF – the unfamiliarity, discriminatory, and relational hazards that create the added costs of being foreign – is the major barrier faced when firms enter host countries. We argue that a key driver behind these hazards is institutional distance between the home and host countries, to which we now turn.

INSTITUTIONAL DISTANCE AND THE LIABILITY OF FOREIGNNESS

Institutions are "the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction" (North, 1990, p. 3). Scott (1995, p. 33) elaborates on this definition by defining institutions as "cognitive, normative, and regulative structures and activities that provide stability and meaning to social behavior." One of the underpinnings of institutional theory is that organizations are influenced by "common understandings of what is appropriate and, fundamentally, meaningful behavior" (Zucker, 1983, p. 105). Organizations are embedded in a broader institutional environment, and institutional theory underscores the ability of institutions to influence organizations to conform to practices, policies, and structures that are consistent with institutional preferences (Meyer & Rowan, 1977). In highly institutionalized environments, the structure of firms is strongly influenced by *coercive isomorphism* (formal pressure from other organizations), *mimetic isomorphism* (imitation of structures by other organizations in response to pressures), and *normative isomorphism* (conformance to normative standards established by external institutions) (DiMaggio & Powell, 1983). Thus, according to this school of thought, organizations subjected to the same environmental conditions are expected to have the similar structures.

Many scholars have recognized the importance of national boundaries in the study of the organization and environment. In an early work, Lawrence and Lorsch (1967) addressed, to a limited degree, the challenges faced by MNEs, recognizing the importance of national boundaries in organizational environments. Meyer and Rowan (1977) indicated that there was variance across countries in their institutional environments. In the international domain, MNE researchers have adapted this "environmentally deterministic" perspective by positing that each foreign subsidiary of a MNE operates in a unique task environment, which constrains and influences the subunit's activities (Rosenzweig & Singh, 1991; Westney, 1993).

Kostova and Zaheer (1999) employed institutional theory to examine organizational legitimacy of MNEs, arguing that firms are rewarded for isomorphism with increased legitimacy, resources, and survival capabilities, whereas a failure to conform adversely affected MNE legitimacy. Their framework focused on the cognitive aspects of the liability of foreignness, arguing that the host-country environment lacked information about the MNE. As a result, the host country's legitimating institutions used stereotypes and imposed different criteria to judge MNEs, which in turn served as targets for the host-country special-interest groups. They contended that "the host country legitimating environment typically has less information with which to judge an MNE entrant, thus could result in delays in legitimization, in continuing suspicion toward the MNE, and in scrutiny of the

MNE to a much greater extent than that of domestic firms" (1999, p. 73). Moreover, MNEs could face different legitimacy standards compared to domestic firms and in many instances, they were expected to do more than domestic firms with respect to "building their reputation and goodwill, in supporting local communities, and so on" (1999, p. 74).

The fact that institutions matter and differ between countries suggests the importance of a theoretical link between institutional distance and MNE strategies. Building on Scott's definition, Kostova (1996) defined institutional distance between two countries as the degree of difference/similarity between the regulatory, cognitive, and normative institutions of two countries. Institutional distance has been used to explain MNE behavior in terms of building organizational legitimacy in host countries (Kostova & Zaheer, 1999), the transfer of organizational practices from the parent to its subsidiaries (Kostova, 1999; Kostova & Roth, 2002), and location decisions and mode-of-entry strategies (Xu & Shenkar, 2002). The larger the institutional distance between home and host countries, the greater the pressures on the MNE for local responsiveness (Doz, 1980; Prahalad & Doz, 1987), but the more difficulty the MNE has building external legitimacy (Kostova & Zaheer, 1999). At the same time, as institutional distance increases, practicing a global integration strategy becomes more problematic because transferring strategic routines between the parent firm and its subsidiaries becomes more difficult (Kostova & Roth, 2002). Thus, as institutional distance increases, the conflicting pressures for local responsiveness and global integration become stronger (Doz, 1980; Prahalad & Doz, 1987).

Institutional distance can be different for each institutional "pillar": regulatory, normative, and cognitive. The regulatory pillar deals with the "setting, monitoring and enforcing of rules" (Xu & Shenkar, 2002, p. 610), and it reflects "existing laws and rules in a particular national environment which promote certain types of behaviors and restrict others" (Kostova, 1997, p. 180). The regulatory pillar therefore sets out prescriptive ("may") and proscriptive ("may not") behaviors, and applies rewards and sanctions for compliance with these pre/proscriptions. The regulatory pillar in host countries is perhaps the easiest for foreign firms to observe, understand, and correctly interpret because regulatory institutions are codified and formalized in rules and procedures. Regulatory institutions create coercive isomorphism pressures for adoption of social patterns (Kostova & Roth, 2002, p. 217). In terms of multinational strategies, host-country regulatory institutions create pressures for local responsiveness to which MNE subunits must conform to achieve external legitimacy. Such pressures come at the cost of global integration (Doz, 1980; Prahalad & Doz, 1987).

The normative institutional pillar consists of "social norms, values, beliefs, and assumptions about human nature and human behavior that are socially shared and

are carried by individuals" (Kostova, 1997, p. 180). The normative pillar is "rooted in societal beliefs and norms" and "prescribes desirable goals and the appropriate means of attaining them" (Xu & Shenkar, 2002, p. 610). The normative pillar specifies how things should or should not be done, reflecting the values and norms of society. Such informal prescriptions and proscriptions are often culturally driven, tacit understandings that are opaque to outsiders. Public sector corruption is an example of an informal normative institution (Calhoun, 2002; El Said & McDonald, 2002). Normative institutions are tacit, "deep structures" of a country that are difficult to sense and interpret, particularly by outsiders (Kostova & Zaheer, 1999). Higher normative institutional distance should therefore be positively related to liability of foreignness, creating normative isomorphic pressures to conform to host-country practices.

The cognitive institutional pillar affects the "schemas, frames, and inferential sets, which people use when selecting and interpreting information ... it reflects the cognitive structures and social knowledge shared by the people in a given country" (Kostova, 1997, p. 180). Cognitive institutions affect "the way people notice, characterize, and interpret stimuli from the environment" (Kostova, 1999, p. 314) in terms of national symbols, stereotypes, key sectors, and so on. As cognitive institutional distance rises, liability of foreignness increases for MNEs, heightening the pressures for national responsiveness by conforming to host-country practices.

We interpret the difference between the regulatory and normative pillars as follows: while the regulatory pillar defines what organizations and individuals "may or may not do" (where "may" implies permission), the normative pillar defines what they "should or should not do." The cognitive pillar defines what "is or is not true" and what "can or cannot be done" (where "can" implies ability). Thus, the three institutional pillars are akin to three verb tenses: may/may not (regulatory), should/should not (normative) and can/cannot (cognitive).

Institutional distance can explain the dual pressures faced by the MNE for global integration and local responsiveness (Xu & Shenkar, 2002). First, consider the pressures for local responsiveness. Kostova and Zaheer (1999) argued that the cognitive pillar lies between the regulatory and normative pillars in terms of tacitness, and that liability of foreignness is more affected by cognitive and normative institutions than by the regulatory institutions. In all three cases, institutional distance increases liability of foreignness and the need for local responsiveness to host-country institutions, creating pressures for local isomorphism. Regulatory institutional distance creates pressures for coercive isomorphism, normative for normative isomorphism, and cognitive for mimetic isomorphism (Kostova & Roth, 2002, p. 217).

Second, consider the pressures for global integration. Normative institutional distance is probably more important than either regulatory or cognitive in

explaining the difficulties of transferring MNE practices from the parent firm to its subunits (or vice versa; Kostova, 1999; Xu & Shenkar, 2002). MNEs should be reluctant to transfer practices that are illegal in the host country (regulatory distance) or where the local employees would have obvious difficulties learning the practice (cognitive distance). However, because of its tacitness, normative distance suggests that MNE practices could appear to be transferable at low cost, whereas, in fact, different cultural assumptions and value systems mean that normative distance is much higher than it appears. Thus, the greater the normative distance between the home and host countries, the greater the difficulty faced by the MNE in implementing and maintaining a global strategy (Xu & Shenkar, 2002).

INSTITUTIONAL DISTANCE, LIABILITY OF FOREIGNNESS, AND OWNERSHIP STRATEGY

We now integrate these theoretical strands explained above and explore the linkages between institutional distance, the costs of doing business abroad (more particularly, the liability of foreignness), and the MNE's ownership strategy. Peng (2002, p. 251) argues that an institution-based view of business strategy can explain "why strategies of firms from different countries and regions differ." We focus our analysis on one of the most important of the MNE's strategies, the mode of entry decision, which we operationalize as the percentage of equity ownership held by the MNE (where 0% represents exporting and 100% a greenfield, wholly owned subsidiary), with or without a local partner.

Perhaps the most comprehensive work linking the economic costs of doing business abroad to the firm's mode of entry decision is Buckley and Casson (1998). They outlined four types of CDBA (although they did not use the term): (1) a net cost of home production relative to foreign production; (2) a one-time cost of learning about the foreign market; (3) transaction costs if the mode of entry is arm's length (costs of monitoring, dispute settlement, opportunistic behavior, etc.) or cooperative (trust-building costs); and (4) a one-time net cost of adapting a foreign production facility to the firm's technology if foreign production involves a local firm. Using basic assumptions regarding these costs and holding the host-country environment constant, Buckley and Casson predicted the most likely modes of entry and analyzed how cost changes could affect the entry choice. Their analysis, however, is primarily a microeconomic approach to the costs of doing business abroad, with less attention paid to socio-institutional factors that affect liability of foreignness considerations.

Some work has been done using an institutional approach to the firm's mode of entry decision. Davis et al. (2000) argue that, in order to achieve legitimacy

in the host country, the MNE must conform to host-country institutional norms. Local adaptation pressures made it difficult for the MNE subunit to achieve parent isomorphism. Thus, tensions between local responsiveness and global integration affect the MNE's mode of entry decision. Based on surveys of U.S.-based firms in the pulp and paper industry, the authors found that wholly owned subsidiaries have a higher parent isomorphism than other entry modes, whereas exporters have a higher host-country isomorphism. When external and internal pressures were both low, the firms used mixed entry modes.

The degree to which countries rely on formal or informal institutions can also affect market entry strategies. El Said and McDonald (2002) hypothesize that OECD countries have impersonal exchange systems with strong third-party enforcement mechanisms (regulatory institutions); transition and emerging market economies, however, tend to have weak formal institutions and therefore rely more heavily on informal institutional enforcement procedures (e.g. networks, trust, hostages). Where informal constraints were more important than formal constraints, the authors hypothesized that firms were more likely to take a local partner (equity joint venture or subcontracts to intermediaries), and their interviews with foreign managers in Jordan supported this hypothesis.

Most recently, Xu and Shenkar (2002) applied the concept of institutional distance and its three pillars to the MNE's location and mode-of-entry strategies. In terms of mode of entry, they argue that the higher institutional distance, in general, the lower the preferred level of equity control and commitment because of the twin difficulties of obtaining external legitimacy in the host country and transferring managerial practices to the MNE subunit.

To this point, we have not addressed the linkages between institutional distance and the MNE's choice between acquisition and greenfield investment. Studies have concluded that MNEs tend to prefer greenfield investments over acquiring local firms when institutional differences between countries are pronounced (e.g. Kogut & Singh, 1988) because acquisitions accentuate these differences (Barkema & Vermeulen, 1997). For example, when normative institutional distance is high, it is more difficult to transfer organizational practices to an acquired local subsidiary, especially when the practices of local firms are institutionalized in the host-country environment. In contrast, local employees in a greenfield subsidiary should be more receptive to adopting the MNE parent's practices. Moreover, when the cognitive institutional distance is high, acquisitions are viewed as "takeovers" and a "blow to national sovereignty" from the local market's perspective (Xu & Shenkar, 2002, p. 613), discouraging acquisition in favor of greenfield entry. When the institutional distance is low, both acquisition and greenfield investment become more attractive (Xu & Shenkar, 2002). The choice, in such situations, therefore turns on other factors. For example, Zejan (1990) found that when

market growth was high, foreign firms prefer greenfield investment. In addition, industry concentration has been shown to increase the likelihood of greenfield investment (Hennart & Park, 1993; Shaver, 1998).[11]

Institutional Distance and Ownership Strategy

We turn now to integrating these ideas into a model linking institutional distance, liability of foreignness and the MNE's ownership strategy. We start from the premise that, holding revenues constant, the multinational enterprise should select the ownership strategy (i.e. the percentage of equity ownership) that minimizes the additional costs of doing business abroad; that is, the sum of activity-based costs, unfamiliarity hazards, discriminatory hazards, and intra- and inter-relational hazards. As we argued above, economic activity-based costs are affected primarily by geographic distance and choice of production location. They can be measured and anticipated. Therefore, it is the costs associated with avoiding unfamiliarity, discriminatory, and relational hazards that principally drive the MNE's ownership strategy. These costs are the components of liability of foreignness. We have argued above that LOF is driven by institutional distance; thus, *LOF mediates the relationship between institutional distance and the MNE's ownership strategy*. The greater the institutional distance, the greater the liability of foreignness and the more likely the MNE is to select an intermediate ownership strategy.[12] Our model of these relationships is illustrated in Fig. 2, and these relationships are explored below.

We start with a basic proposition linking overall institutional distance, through its effects on liability of foreignness, to the MNE's ownership strategy. Xu and

Fig. 2. Institutional Distance, Costs of Doing Business Abroad, and Ownership Strategy.

Shenkar (2002) argue that the higher institutional distance, the lower the preferred level of equity because of the difficulties of obtaining external legitimacy in the host country and transferring managerial practices to the MNE subunit. MNEs that enter distant markets typically choose lower levels of commitment and resources (Anderson & Gatignon, 1986), preferring joint ventures to wholly owned subsidiaries as an entry mode. Where perceived institutional distance is higher, MNEs favor entry modes with low resource commitments (Hill et al., 1990). Therefore,

Proposition 1. As institutional distance increases between the home and host countries, the MNE is more likely to choose a low ownership strategy, *ceteris paribus*.

Regulatory Distance and Ownership Strategy

Regulatory distance measures the difference between home and host countries in terms of the setting, monitoring and enforcement of rules. Within developed countries, regulatory frameworks have become more homogeneous due to globalization pressures, regional integration schemes, and international institutions such as the World Trade Organization and the OECD. Even in developing countries, the ability of governments to force capricious, unilateral policy changes on MNEs has been substantially curtailed by the web of bilateral investment and double tax treaties, membership in international organizations, and structural adjustment constraints imposed by the World Bank and International Monetary Fund (Ramamurti, 2001). In addition, almost all national policy changes affecting MNEs since 1990 have been liberalizing (UNCTAD, 2003). Only in key sectors where local cognitive symbolism is high (e.g. petroleum in Mexico) are there still regulations restricting foreign equity ownership.

However, government regulations can also indirectly affect ownership strategy. For example, lack of intellectual property rights protection heightens inter-relational hazards of opportunistic behavior by local partners, thereby discouraging intermediate equity modes in favor of either exporting or wholly owned subsidiaries (Xu & Shenkar, 2002). Missing property rights also encourage corruption in the form of counterfeiting and intellectual piracy. MNEs are therefore more likely to choose either arm's length contracts or 100% equity ownership (where there is no regulatory ceiling on equity share) to protect their property rights. Therefore,

Proposition 2. As regulatory institutional distance rises between the home and host countries, the MNE is likely to avoid intermediate ownership strategies in favor of either a low (contractual) ownership or high (100%) ownership, except where high ownership is prohibited by host-country regulations, *ceteris paribus*.

Normative Distance and Ownership Strategy

Normative institutional distance reduces the MNE parent's ability to transfer practices effectively to the MNE subunit, which raises the intra-relational costs of managing operations at a distance. In addition, normative institutional distance reduces the ability of a foreign entrant to understand host-country institutional guidelines (Kostova & Zaheer, 1999), and so unfamiliarity hazards should be higher across all modes of entry. Normative distance increases the challenges for the MNE subunit to establish and maintain external legitimacy, thus increasing the probability of discriminatory treatment (Kostova & Zaheer, 1999). Therefore, we expect unfamiliarity, discriminatory, and inter- and intra-relational hazards all to increase with normative institutional distance. These hazards favor lower equity modes, in particular, sharing equity with a local partner.

> **Proposition 3.** As normative institutional distance rises between the home and host countries, the MNE is more likely to choose an intermediate ownership strategy, *ceteris paribus*.

Cognitive Distance and Ownership Strategy

Cognitive institutions represent "the way people notice, characterize, and interpret stimuli from the environment" in terms of national symbols and stereotypes (Kostova, 1999, p. 314). Cognitive institutional distance facing the MNE should therefore come primarily in the form of national symbols and stereotypes. Kostova and Zaheer (1999) suggested that foreign firms could incur stereotyping by host-country institutions due to their unfamiliarity with outsiders. Cognitive institutions are affected by the way domestic firms and consumers interact and how they view foreigners. We provide four examples.

Consumer Ethnocentrism

We argue that the degree of stereotyping by host-country institutions should depend on the level of ethnocentrism in the host country (Balabanis et al., 2001). Ethnocentrism reflects an unfavorable perception of outsiders and favorable perception of insiders (Sumner, 1906). Balabanis et al. (2001, p. 60) suggested that the consequences of this bias range from maintaining and forming stereotypes to "genetic superiority."

We infer that high levels of ethnocentrism result in stronger, more intense stereotyping against outsiders or favoritism of insiders. We contend that higher levels of ethnocentrism are associated with higher discriminatory hazards for all

modes of entry. As a result, the MNE should be more likely to want a local partner in order to attenuate anti-foreign sentiments. As ethnocentrism increases in the host country, inter-relational hazards may also increase because of challenges associated with establishing trust with local entities (Williams, 2001). The issue for the MNE is to find a suitable local partner that does not share this ethnocentrism, but still engenders the respect and support of other locals. For MNEs that choose to operate in countries with high consumer ethnocentrism, more than likely, the firm will need to use an exporting strategy for a foreign subsidiary rather than a local market strategy. In this scenario, we anticipate that the benefits of having a local partner should offset the greater relational hazard.

The size of the MNE may be important here. Firm size provides advantages such as financial strength, market power, and a strong reputation that should lower discriminatory hazards and encourage the MNE to opt for a wholly owned subsidiary. With size, however, comes increased visibility and a higher probability of being targeted by special interest groups, making it more difficult for the MNE to maintain external legitimacy (Kostova & Zaheer, 1999). In high ethnocentric countries, the likelihood of consumer reaction increases, raising the liability of foreignness and the need for a local partner. Therefore:

> **Proposition 4.** The higher the level of consumer ethnocentrism in the host country, the greater the cognitive institutional distance and the more likely the MNE is to choose an intermediate ownership strategy, *ceteris paribus*.

Country-of-Origin Effects

In some environments, being perceived as foreign may be an advantage, not a disadvantage (Bilkey & Nes, 1982; Nagashima, 1977). French wine and Swiss watches are common examples of products that have country-of-origin advantages. These advantages may disappear if the MNE sets up a joint venture and moves production to the host country. For example, Miller (a U.S. beer producer) had the rights to distribute Lowenbrau in the U.S. Because demand outstripped supply, Miller renegotiated its contract with Lowenbrau and began to brew the beer in Texas. However, sales decreased once production shifted to the U.S. because the beer lost its image as a premium import from Germany (Griffin & Pustay, 1999). In such cases, licensing is preferable to a joint venture because it avoids local production (retaining the cachet of foreignness) while assisting with transfer of local-market knowledge to the MNE (reducing unfamiliarity and discriminatory hazards). Therefore:

> **Proposition 5.** Where country-of-origin effects are strong and viewed positively by host-country consumers, the MNE benefits from foreignness; thus, the

greater the cognitive institutional distance based on country-of-origin, the more likely the MNE is to use a low ownership strategy, *ceteris paribus*.

Social Embeddedness of Local Firms

We argue that embedded social networks of firms in host countries increase the cognitive institutional distance for foreign firms. Social embeddedness reflects the degree to which economic transactions take place through social relationships and networks of relationships that use social and non-commercial criteria to govern business dealings (Marsden, 1981). The importance of "in-group" association that leads to differences in the treatment and perception of outsiders relative to insiders is fundamental to this perspective (Tajfel & Billig, 1974). Research suggests that embeddedness becomes more of an issue for foreigners that enter relationship-driven markets (Bhappu, 2000; Uzzi, 1997). Bower (1987) concluded that Japanese firms forged strong ties that led to high entry barriers. Similarly, Granovetter (1973) found that tight relationship linkages between host-country insiders led to exclusion of organizations that were unable to establish comparable ties. High embeddedness of local firms increases the distinction between insiders and outsiders, raising cognitive institutional distance, and increasing discriminatory hazards. Local embeddedness can also be a barrier to the sharing of information, increasing unfamiliarity hazards for foreign firms. Thus, external legitimacy is likely to be problematic for an MNE subunit unless it has a local partner; however, building trust with firms that are already embedded in another set of relationships should also be difficult. Therefore:

Proposition 6a. The higher the social embeddedness of local firms, the greater the cognitive institutional distance and the more likely the MNE is to choose an intermediate ownership strategy, *ceteris paribus*.

Scholars have suggested that trust in cross-border business relationships is especially prevalent in Oriental cultures, which tend to exhibit a high collectivism and long-term orientation that, in turn, is integrated into managerial decision-making and affects the country's business environment (Hofstede, 1980). As a result, social embedded ties between organizations are quite common (Egelhoff, 1984; Ouchi, 1980). These ties, which are based on "strong mutual monitoring and sanctioning" (Yamagishi, 1988, p. 217), or what some scholars have deemed deterrent-based trust (Gulati, 1995), reduce costs and risk, facilitate communication, ensure trust and reliability (e.g. Gerlach, 1992), and consequently reduce the need for control. Researchers have concluded that the Japanese interorganizational system can be transplanted effectively to other countries (Hagen & Choe, 1998; Nishiguchi,

1994). An MNE accustomed to building trust in business relationships at home is inclined to better understand information sharing and operate more effectively abroad. Empirical studies have concluded that firms with home-country socially embedded ties are inclined to use less equity ownership in different host-country environments (Sohn, 1994). Therefore:

Proposition 6b. If local firms in both the home and host countries exhibit a high local social embeddedness, the MNE is more likely to choose a lower ownership strategy compared to the case where only host-country firms exhibit high social embeddedness, *ceteris paribus*.

Proportion of Foreign to Local Firms

The mix of foreign to local firms in the host country can also affect cognitive institutional distance. Anderson and Gatignon argued that the presence of foreign MNEs encouraged local workers to "obtain a business education abroad, which in turn, can reduce problems associated with sociocultural distance and reduce the level of ethnocentrism in the host country" (1986, p. 200). As the number of foreign firms in a host country increases, the host country has more information by which to evaluate new entrants so unfamiliarity and discriminatory hazards, from the host-country perspective, should be lower. Zaheer and Mosakowski (1997) found that as the balance of foreign to local trading rooms increased in a host country, the liability of foreignness declined, and the longevity of both domestic and foreign firms increased. This suggests that the MNE should be willing to take on a higher equity mode the greater the ratio of foreign to local firms in the host country.

However, as the proportion of foreign to domestic firms rises in a politically salient industry (e.g. petroleum, autos, banking), further entry can cause a backlash against foreign firms because of the perceived violation of national symbols. This backlash is likely to harm new entrants the most because of their lack of external legitimacy. Thus, the relationship between the ratio of foreign to local firms and cognitive institutional distance may be U-shaped, falling initially as early entrants ease the way for latecomers, but eventually rising as host-country residents become concerned about the proportion of national assets held by outsiders. Therefore:

Proposition 7. As the proportion of foreign to domestic firms rises in the host country, cognitive institutional distance decreases, making the MNE more likely to choose a high ownership strategy; however, this effect is weaker for nationally sensitive industries and weakens (and could reverse) as the percentage of foreign to domestic firms continues to increase, *ceteris paribus*.

Mixed-Distance Effects on Ownership Strategy

Some phenomena include more than one type of institutional distance and therefore should have more complex effects on the MNE's ownership strategy. We propose two examples: cultural distance and corruption distance. Cultural distance primarily involved normative and cognitive institutional distance (informal constraints). Corruption distance, however, involves regulatory and normative distance; that is, a mix of formal and informal constraints. We discuss each briefly below.

Cultural (Cognitive and Normative) Distance

Cultural distance is closely related to the two institutional pillars: normative and cognitive. Culture has a cognitive aspect, "the collective programming of the mind that distinguishes the members of one category of people from those of another category" (Hofstede & Bond, 1988, p. 6). Culture also has a normative aspect because society's values and attitudes are part of a culture's characteristics. Cultural distance can therefore be closely proxied by an increase in normative and cognitive institutional distance.

As cultural distance increases, we expect the primary effect to be increased unfamiliarity, in terms of the MNE's knowledge of the host country and vice versa. Discriminatory hazards may also rise, but we anticipate that the primary impact of cultural distance will be to heighten unfamiliarity hazards, therefore increasing the need for a partner that understands the local environment. If the tacit component of the normative and cognitive pillars is low (that is, cognitive frames and social values can be learned), unfamiliarity hazards should decrease with time and, once the MNE has incurred the one-time costs of learning about the host-country environment from its partner, we expect the MNE to acquire the local partner. Thus, an equity joint venture should be the preferred – but short-term – ownership strategy when the cultural distance is high. In the long term, the MNE should prefer to acquire the local partner's share of the equity joint venture.

Barkema et al. (1996) pointed out that equity joint ventures incur double-layered acculturation, requiring adaptation not only to the local environment but also to the culture of the partner. They suggested that culture distance should make alliances shorter-lived. However, empirical evidence suggests that they are preferred to wholly owned subsidiaries for entering countries that are culturally distant (Barkema & Vermeulen, 1997; Kogut & Singh, 1988). We can resolve this paradox once we recognize that cultural distance raises unfamiliarity hazards, which typically are temporary. Thus, an equity alliance with a local partner is an optimal, but short-run, solution to increased cultural distance.

There are, however, exceptions. Kostova and Zaheer (1999) argue that the normative pillar is more tacit in nature than the cognitive pillar. This suggests that where cultural distance is primarily driven by differences in normative systems, unfamiliarity hazards do not necessarily diminish with experience in the host country so that a local partner may continue to have value for the MNE. However, where cultural distance is primarily driven by differences in cognitive institutions, joint ventures will be short-lived. Therefore:

Proposition 8a. Where cultural distance is driven primarily by differences in cognitive institutions between the home and host countries, the greater the cultural distance, the more likely the MNE is to choose an intermediate ownership strategy; however, this choice is expected to be short term in nature with the MNE later acquiring the local partner's share, *ceteris paribus*.

Proposition 8b. Where cultural distance is driven primarily by differences in normative institutions between the home and host countries, the greater the cultural distance, the more likely the MNE is to choose an intermediate ownership strategy, in the short- and long term, *ceteris paribus*.

Our analysis runs contrary to Xu and Shenkar (2002, p. 2002) who argue that "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." If cultural distance is a mixture of normative and cognitive distance, the inconsistent results may be caused by the reverse effect, that cultural distance is too broad a construct, not too narrow. As our argument shows, ownership strategy depends on whether cultural distance is primarily driven by normative or cognitive institutional distance.

Corruption (Regulatory and Normative) Distance

Public sector corruption is another example of how institutional distance can affect liability of foreignness and the MNE's entry-mode choice. Rodriguez et al. (in press) and Doh et al. (2003) argue that corruption has two key characteristics. The first characteristic, pervasiveness, is the probability of a firm's encountering corruption in its interactions with government officials and policy-makers. In a country with highly pervasive corruption (China, Mexico, or Nigeria, for example), bribery extortion is regular, predictable, effective and akin to a tax. There are few regulatory institutions to deter corruption, and corrupt behavior pervades societal norms and values (Calhoun, 2002). The second characteristic, arbitrariness, is the degree of ambiguity or uncertainty associated with corrupt transactions, which makes them less transparent and less predictable in terms of payments and outcomes. In a country with highly arbitrary corruption (Hungary, Malaysia, or Namibia, for example), firms face enormous uncertainties and complexities, in terms of the incidence, predictability, and outcomes of corruption.

In many transition and emerging market economies, corruption is both pervasive and arbitrary, as, for example, in India, Indonesia, or Russia.

Firms are likely to comply with pervasive corruption, Oliver argues, because "[w]hen institutional rules or norms are broadly diffused and supported, organizations will be predicted to acquiesce to the pressures because their social validity is largely unquestioned" (1991, p. 169). Pervasive corruption is an informal institutional constraint where bribery is socially acceptable. In order to achieve organizational legitimacy in the host country, the MNE must comply with the state's pressures to pay bribes and is likely to do so unless the home country prohibits such practices by its MNEs and their subsidiaries. The Foreign Corrupt Practices Act in the U.S. has severely restricted the ability of U.S. multinationals to pay bribes to corrupt foreign governments. However, until their governments signed the new OECD Anti-Bribery Convention, U.K. and German MNEs were free to pay bribes and, in fact, could deduct them as a cost of doing business abroad against their home-country income tax.

In terms of the mode-of-entry decision, Rodriguez et al. (in press) argue that pervasive corruption does not encourage taking on a local partner because a local partner can neither reduce the required bribes nor increase the MNE subunit's external legitimacy. Once the MNE overcomes the short-term unfamiliarity hazards of operating in a pervasively corrupt economy, the authors argue that bribe payments become routine and anticipated; as a result, the MNE can choose a wholly owned subsidiary for an entry mode without adversely affecting external legitimacy. Only where arbitrariness of corruption is high does a local partner become valuable as a method for reducing the unpredictability of corruption. As both dimensions of corruption increase, the MNE should rely more heavily on local firms for insider knowledge and legitimacy. The exception to this case occurs where home regulations prohibit offering bribes. In such situations, Rodriguez et al. (in press) argue that MNEs are more likely to use low equity modes or arm's length intermediaries in the host country to avoid home-country penalties.

We define corruption distance as the difference in the pervasiveness and arbitrariness of public-sector corruption between the home and host countries. Corruption distance could be high on either pervasive or arbitrary dimensions or both. In terms of the pervasiveness dimension, corruption distance depends on differences in both normative institutions and regulatory institutions. Pervasive corruption is based on strong informal institutions where societal norms and values have a high tacit component. In addition, regulatory institutions to monitor and punish corruption should be weak or missing in pervasively corrupt societies. Offsetting the weak regulatory institutions in host countries is the fact that home country regulations against bribery in host countries were also missing for most countries, other than the U.S., until recently.[13] This suggests that pervasive corruption is driven more by differences in the normative than the regulatory institutional pillar for MNEs from most countries. In this case, the tacitness of pervasive corruption does not dissipate with longevity in the host country, and the value of taking on a local partner to reduce unfamiliarity and discriminatory hazards increases. This case was not considered by Rodriguez et al. (in press). We therefore modify their result as follows:

Proposition 9a. Where pervasive corruption distance is driven primarily by differences in regulatory institutions, the higher the pervasive corruption distance, the more likely the MNE is to choose a high ownership strategy, except where high ownership is prohibited by host-country regulations, *ceteris paribus*.

Proposition 9b. Where pervasive corruption distance is driven primarily by differences in normative institutions between the host and home countries, the higher the pervasive corruption distance, the more likely the MNE is to choose an intermediate ownership strategy, *ceteris paribus*.

Where corruption distance is high on the arbitrariness dimension, the tacitness and opacity of corruption reflect a high degree of uncertainty and unpredictability. In such cases, belonging to a local supplier-buyer network can be an important buffer against random, arbitrary treatment by government officials and other firms. Relation-based contracting with groups or networks that have shared values and informal enforcement mechanisms can shield firms from arbitrary corruption (El Said & McDonald, 2002). In transition economies with weak or missing regulatory institutions, relation-based contracting can overcome institutional uncertainties (Peng, 2003). This suggests the MNE has a strong need for a local partner to penetrate local networks and lessen the risk of random, discriminatory treatment from arbitrary corruption, but at the same time, inter-organizational relational hazards should also be high. Despite these inter-relational hazards, a local partner should be the preferred ownership strategy when local embeddedness is high. Moreover, where embeddedness of local networks is an ongoing phenomenon, the MNE should be less inclined to acquire its local partner for fear of increased discriminatory hazards following the acquisition. Therefore,

Proposition 10. The higher the arbitrary corruption distance between home and host countries, the more likely the MNE is to choose an intermediate ownership strategy, in the short- and long term, *ceteris paribus*.

DISCUSSION AND CONCLUSION

The concept of the costs of doing business abroad (CDBA) is well known in the international business literature, measuring the disadvantages or additional costs borne by multinational enterprises that are not borne by host-country local firms. Recently, international management scholars introduced a second concept, liability of foreignness (LOF). There has been confusion in the two literatures about the relationship between CBDA and LOF, as evidenced in a recent special issue on liability of foreignness (*Journal of International Management*, 2002). In this paper, we have tried to sort out the differences by arguing that LOF stresses the social costs of doing business abroad, whereas CDBA includes both economic and social costs. These social costs arise from the unfamiliarity, relational, and discriminatory hazards that foreign firms encounter over and above those faced by local firms in the host country. CDBA, however, is a broader concept that includes LOF but also includes economic activity-based costs related to geographic distance. Because these market-related costs are well understood, finite, and can be anticipated, LOF becomes the core strategic issue for MNE managers. We argued that the key driver behind LOF was institutional distance and its three pillars (cognitive, normative, and regulatory) between the home and host countries. We explored the ways in which institutional distance could affect liability of foreignness. We then operationalized our arguments by showing how institutional distance and liability of foreignness could provide an alternative explanation for the MNE's ownership strategy.

Our paper contributes to the growing literature on institutional distance, liability of foreignness, and strategies of multinational enterprises. We carefully explored the differences between the costs of doing business abroad and the liability of foreignness, arguing that LOF was the core (but not the only) component of CDBA. We showed how the three institutional pillars (regulatory, normative, and cognitive) could be conceptualized as forms of institutional distance and explored the impact of each type of distance on the liability of foreignness and the MNE's ownership strategy choice. We also examined two mixed forms of institutional distance: cultural distance (which, we argued, could be broken down into normative and cognitive institutional distance) and corruption distance (which could be broken down into regulatory and normative institutional distance). We linked our analysis to the pressures for global integration and local responsiveness in the international strategy literature. Our analysis supports the argument that liability of foreignness is driven mostly by normative and cognitive institutional distance and that, because of their tacitness, MNEs may continue to need local partners to achieve external legitimacy in host countries. We explored some implications of our analysis for MNEs entering transition and emerging market economies.

At this stage of theory development, it may be premature to discuss the managerial consequences of our model. Nevertheless, we highlight a few issues. First, in this conceptual framework, we assumed that an MNE can achieve external legitimacy, at some cost. However, MNE managers need to recognize that in some institutional environments, outsiders can approach, but may never achieve, legitimacy in the environment. Francis (1991) argued that being isomorphic did not necessarily translate into gaining acceptance. Adapting to local practices could be based on the faulty assumption that "what works for locals will work for foreigners," a perspective destined to fail if local residents view foreigners as outsiders, regardless of their behavior. The same differentiation holds true for foreign firms operating in the host country. They may gain some degree of legitimacy but never achieve insider status. Second, access to local knowledge is an important reason why MNEs choose a local equity partner over a wholly owned subsidiary. It is important to note that the rate of knowledge acquisition is in the firm's control and is a necessary condition to shift from a joint venture to a wholly owned subsidiary (Inkpen & Beamish, 1997; Petersen & Pedersen, 2002).

Another issue is that there can be substantial variation across countries with respect to institutional distance between home and host countries. Our hypotheses tend to reflect the ownership strategies of MNEs from industrialized countries. For example, market structures in OECD countries have impersonal exchange systems and strong third-party enforcement mechanisms (laws, courts, regulatory agencies), and therefore have strong, formalized institutional structures. Transition economies and many emerging market economies, however, with missing or weak formal regulatory institutions, rely on informal institutions to facilitate exchange (El Said & McDonald, 2002; Hoskisson et al., 2000; Peng, 2002). In this paper, we have focused on institutional distance in an absolute value sense, ignoring whether the home or host country has stronger institutions and how this might affect liability of foreignness and the MNE's ownership strategy. We leave this to future research.

Lastly, our research should be extended to empirical analysis. The propositions developed in this paper are testable. Entry-mode choice can be captured with a dichotomous variable, or by percentage of equity ownership. Measures for the three institutional pillars can be constructed. Shimp and Sharma (1987) have developed scales to measure consumer ethnocentrism. Chao's (1993) questionnaire can be used to measure country-of-origin effects. Embeddedness of local firms can be operationalized by adapting Dodwell Marketing Consultants' (1994) indicator of "tie strength" in Japanese industrial groups or a Herfindahl index, which Baker (1994) showed can be used to measure the mix of different types of ties in a firm's network. Rodriguez et al. (in press) set out a framework for measuring pervasive and arbitrary corruption, from which corruption distance could be calculated.

In conclusion, we have deconstructed and reconstructed the twin concepts of the costs of doing business abroad and liability of foreignness. We hope that international business and international management scholars will find our framework and propositions useful in their own research on the multinational enterprise.

NOTES

1. The CDBA concept, therefore, was a foil for the real subject matter of the dissertation: the monopolistic advantages of MNEs relative to national firms.

2. Hennart noted that, "operation in a foreign country will usually entail higher costs, everything else being equal, than operation at home" (1982, p. 2). MNEs incur costs associated with travel, long-distance communication, time lost in communicating decisions and information, and foreign exchange. In addition, firms incur costs associated with unfamiliarity with host country consumer tastes, legal and institutional frameworks of business, and local business customs.

3. If the MNE's average cost curve were above point b in Fig. 1, the firm would incur losses, which would deter entry or hasten exit. If part of CBDA were on a per-unit basis, both the marginal and average cost curves would shift upwards, causing the profit-maximizing output level to fall in addition to the reduction in profits.

4. For example, writing in the late 1970s, Buckley and Casson's list of the costs of doing business abroad is similar to Hymer's: increased communication costs within the MNE network, higher resource costs when economies of scale differed between stages of production, political discrimination costs (e.g. host governments favored local firms or threatened expropriation), and pure governance costs (associated with organizing internal markets across countries and dealing with multiple plants and multicurrency accounting) (Buckley & Casson, 1976, pp. 42–22).

5. Recent work by Zaheer (2000) supported this argument, suggesting that the interorganizational network can be a source of competitive advantage for some MNEs.

6. Embeddedness refers to as the degree to which economic transactions take place through social relationships and networks of relationships that use social and non-commercial criteria to govern business dealings (Marsden, 1981).

7. Note that in some cases there may be no local firm engaged in the same activities as the MNE; in such cases, CDBA measures the additional costs over and those that would be incurred by a hypothetical local firm engaged in the same market-based activities.

8. We refrain from using the term liability of newness (Stinchcombe, 1965), which is related to the age of the MNE, rather to the longevity of its experience in the host country.

9. Kostova and Zaheer referred to the MNE's outside-inside perspective in the context of spillover effects, indicating that "the subsidiary lacks knowledge about the institutional environment... and, thus, is limited in its ability to achieve legitimacy" (1999, p. 76). However, they did not make this link to liability of foreignness.

10. National treatment means that foreign investments and investors receive the same treatment inside a country as do local investors and investments. Chapter 11 of the North American Free Trade Agreement (NAFTA), for example, guarantees national treatment to investors and investments within North America.

11. Since our paper focuses on institutional distance, we leave the effects of market growth and industry concentration on the MNE's ownership strategy for later work.

12. We assume an intermediate ownership strategy (e.g., an equity joint venture) always involves a local partner, not a foreign partner.

13. For example, in terms of investing in China in the 1980s and early 1990s, corruption distance would have been higher for U.S. MNEs than for German and U.K. MNEs, all other things being equal, because the U.S. was the only country enforcing anti-bribery regulations.

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THEORIES OF THE MULTINATIONAL ENTERPRISE: DIVERSITY, COMPLEXITY AND RELEVANCE

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