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Institutional distance: construct of isomorphism relevant to multinational companies

Ana Krajnović *

Privredna banka Zagreb plc, Zagreb, Croatia

A B S T R A C T

The institutional environment in which multinational companies act is unique and complex. It is unique in the sense that the subsidiaries of multinational companies are facing dual pressures from both the host country and the country of the parent company. Further, the complexity of the environment presumes the need for global integration and the need for the local adaptation. Although some countries are characterized by a more favorable institutional environment for establishing and expanding business, in other countries the institutional environment is a challenge for multinational companies. In this paper, the author will present the current theoretical knowledge and references in already conducted research regarding the institutional distance in the context of multinational companies and its subsidiaries.

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**Corresponding author:*
krajnovicana@gmail.com

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1. INTRODUCTION

The institutional environment in which multinational companies act is unique and complex. It is unique in the sense that the subsidiaries of multinational companies are facing dual pressures from both the host country and the country of the parent company. The institutional environment from the perspective of multinational companies is complex because of the need for global integration and consistency, also because of the need for the local adaptation (Rosenzweig & Singh, 1991). Adaptation to the local environment of the host country is a necessary prerequisite for achieving legitimacy (Kostova, 1999). Often, these needs for adopting and adapting to the local environment and conditions are contradictory, which is further burdened by the imperative to use best practices in all

subsidiary countries in order to easily manage and utilize competencies to achieve efficiency (Taylor, Beechler & Napier, 1996).

Although some countries are characterized by a more favorable institutional environment for establishing and expanding business practices, in other countries the institutional environment is a challenge. Institutional theory theorists suggest that challenges and difficulties from the institutional setting are related to institutional pressures to make companies isomorphic to local conditions and practices to make foreign businesses legitimate (Kostova & Roth, 2002) and on the other hand, the more institutional the distance, the more the transfer of the parent company's business practices to its subsidiaries is difficult.

This review paper will provide insight into the theoretical perspective of institutional distance as a construct inseparable from the operations of multinational enterprises in today's business environment. Additionally, the empirical findings of the conducted research so far in the relevant literature will be presented

2. INSTITUTIONAL DISTANCE: THEORETICAL BACKGROUND

Institutional distance is defined as the relative difference in the quality of institutions of the country of origin and the host country (Gaur & Lu, 2007), and in the conceptualisation of this matter the differences in market, political and social conditions that represent institutional quality are analyzed. The inefficiency or poorly established key institutions in the host country will adversely affect the operations of the subsidiaries operating under such local conditions. The lack of appropriate market mechanisms for information distribution and the lack of transparency increases the cost of identifying and evaluating a multinational subsidiary as a credible business partner for other players in that market. Furthermore, poorly regulated political and legal institutions limits establishing quality business contracts, potentially leading to an inability to build stable and long-term relationships with local suppliers, which will impede the exchange and distribution of goods and services (Pattnaik, Choe & Singh, 2015).

Institutional distance can also be seen as the extent of institutional differences between the country of origin and the host country. Institutional distance is based on the institutional profile of the state, which consists of three dimensions: regulatory, cognitive and normative (Kostova, 1999). Institutional distance provides an explanation for the organizational behavior of multinational sunsidiaries and monitors the operations of subsidiaries in two key aspects: (1) establishing legitimacy in the host country and (2) transferring strategic orientations and organizational practices from the parent company to foreign subsidiary (Kostova & Zaheer, 1999). Edwards and Kuruvilla (2005) imply that the institutional environment of the host country is complex and idiosyncratic and may be an obstacle to the successful transfer of business practices. Hall and Soskice (2001) focused on identifying specific attributes of the institutional setting at the country level, and used the results to explain variations in inter-institutional organizational behaviors and the degree of differences between

institutional environments across countries. Kostova (1999) finally systematized the institutional differences that multinational companies face as institutional distance; the greater the difference between the institutional environment of the host country and the country of origin, the more severe are the difficulties in transferring and establishing organizational business.

Institutional infrastructure is often subject to layering processes (Mahoney & Thelen, 2010), that is, new institutions are added to existing previous institutions and can be potentially revived or used for new purposes. This conclusion offered a perspective on how institutional environments are characterized by a multitude of different institutional logics and interpretations of the environment (Thornton & Ocasio, 2008). When these logics coincide or are ambiguous they can create multinational enterprises a strategic opportunity and a solution for overcoming distances, creating patterns of behavior that have hitherto deviated from the host country's standard business practices (Jackson, 2010).

The resources offered by the institutional context of the host country provide MNCs with the opportunity to use, reinterpret, or adapt behavior to overcome institutional distance and to shape behavior acceptable in the host country. However, over-availability of resources can adversely affect the overcoming of institutional distance precisely because of institutional complexity and the “pluralistic institutional environment” of which Micelotta and associates (2017) wrote, concluding that institutional plurality makes it difficult to assimilate and engage in institutional change.

The formal regulatory component of institutional distance influences the increase in the cost of learning the "rules of the game" in international business and the new environment. Multinational subsidiaries face a liability of foreigness that is likely to act as a source of competitive disadvantage for a multinational enterprise (Eden & Miller, 2006). Although the tendency in some industries is to standardize business practices to reduce the effect of institutional differences across countries (Larsen & Manning, 2015), institutional distance influences important strategic decisions such as business expansion locations (Schwens et al., 2011), ownership issues (Eden and Miller, 2004), and the analysis of business performance of foreign affiliates (Gaur & Lu, 2007).

Gaur and Lu (2007) argue that while there are potentially negative effects on a subsidiary operating in a country with different regulatory institutions, remote regulatory environments provide opportunities for institutional arbitrage. For example, in the United States, many multinational companies with originally weak regulatory contexts in the country of origin set up R&D centers to benefit from well-placed intellectual property protection contracts. However, in cases of perceived high levels of institutional distance, Gaur and Lu (2007) argue that the scope of such arbitrage becomes narrower, resulting in a decrease in competitive advantage. As regulatory institutional distance increases, subsidiaries face an institutional distance where they cannot find an adequate solution and where relational dangers are too high and ultimately adversely affect the performance of the subsidiary.

Differences in formal institutions, such as laws and regulations, and the implementatin, as well as differences in informal institutions such as norms and cognitions that result from cultural differences (Peng et al., 2009) affect the organizational behavior of multinational subsidiaries. Institutional theory assumes that "regulatory" differences between countries will increase the "foreigner" characteristics of subsidiary and increase the cost of learning the "rules of the game" (North, 1991). Differences also arise from the different types and characteristics of business systems between countries that affect the way capital and labor are organized and controlled, managed by economic exchanges and competing interests, and state policies affect economic activities, the financial system and education systems..

3. OVERVIEW OF THE MOST SIGNIFICANT RESEARCH

Recent empirical research has conceptualized institutional distance as a multidimensional construct given the complexity of the institutional environment (Fortwenge, 2016). Researchers have shifted their interest towards defining the dimensions and attributes of the institutional environment that are critical to international business and the behavior of MNCs. Countries differ in the way companies coordinate business activities, and institutions vary in strength, so institutional pressures also appear at different intensities. Furthermore, institutions are different globally and internationally; even geographically close countries often have significantly different institutional environments. The latter is increasingly approached to understand the institutional environment as one that offers a particular source of resources for strategic opportunities and is no longer seen solely as a limiting factor (Dörrenbācher & Geppert, 2017).

The degree of institutional distance is usually calculated by summing the specific values of the cognitive, normative and regulatory dimensions that represent a particular institutional environment (Kostova, 1999): the greater the distance between the two countries, the greater and negative is the effect of the distance (Kostova & Roth, 2002). This perspective of institutional distance has proved significant as it explains the burning problems of international business such as why MNCs have difficulty transferring business practices to subsidiaries (Kostova & Roth, 2002), but does not provide explanation for how and why institutional distance between the two countries is so significant for transfer of practices.

Jackson and Deeg (2008) conclude that institutional distance also affects the difference in terms of coordinating business activities in a particular institutional setting. Ahmadjian (2016) points out that the specifics of countries are characterized by a certain societal logic. Institutional distance is often shown only as the difference between the institutional infrastructures of the two countries. What this perspective lacks is a reflection on how institutions can weaken or more severely restrict organizational behavior, and that institutionalization must necessarily be scaled; the varying degrees of

power of institutions differently affect the behavior of international subsidiary, so context is very important to observe (Faulconbridge & Muzio, 2015).

The Shirodkar and Konara (2017) study comprehensively analyzes the impact of formal institutional distance on the performance of multinational subsidiaries, and is driven by the increasing development and increasing influence that primarily formal institutions have on the institutional distance and multinational affiliate performance. The subsidiary's performance, as the dependent variable, was measured by the return on equity (ROE). The latent variable, formal institutional distance between the host country of the subsidiary and the parent company, was measured by the Dow index, the Kaufmann index, the Hoth index and the indices proposed by the International Country Risk Guide. Ownership was measured using dummy variables that take a value of 1 in case of wholly-owned subsidiary (i.e. 100% ownership) and 0 if the company is partially foreign-owned with at least a 10% interest. Experience in the host country was measured in years that subsidiary was present in the countries observed.

In the first hypothesis, they propose that greater formal institutional distance will negatively affect the performance of subsidiaries of MNCs in emerging markets. The hypothesis was accepted by results from 17 different countries showing that formal institutional distance was significantly negatively correlated with the performance of subsidiaries operating in Central and Eastern Europe. They conclude that new markets create an environment where differences between the regulatory framework of the host country and the country of origin sublimate the characteristics of the foreigner. The results also confirm that new markets represent a unique context in which potential opportunities are arising from differences in institutions, as some authors have argued, are not directly linked to achieving competitive advantage.

The second hypothesis assumes that the negative effect of the formal institutional distance on subsidiary performance may be partially mitigated by a partial subsidiary ownership. They conclude that the negative effect of formal institutional distance on subsidiary performance is stronger for wholly-owned subsidiaries, whereas for partially domestic-owned subsidiaries, this effect is not statistically significant, leading to diametrically opposite conclusions from those studies that use a (too) general context (exploring only one country of origin: Japan) and argued that the full ownership option improved the survival rate of subsidiaries in an institutionally distant context (Gaur & Lu, 2007).

Third hypothesis assumes that the negative effect of formal institutional distance can be mitigated with greater experience of the subsidiary in the host country, and the results supported the hypothesis. Institutional distance has a strong negative impact on the activity of new subsidiaries in the market, and this negative effect diminishes over time and with the longer presence of the subsidiary in the new environment. Although previous studies have theorized that experience decreases with liability of foreigness, these authors were the first to empirically prove it. This is confirmed and

elaborated that with greater experience and knowledge acquired by the subsidiaries they would be perceived as legitimate and would incorporate into the social and political contexts of the host countries, which will ultimately have a positive impact on the affiliates' business performance.

Salomon and Wu (2012) argue that foreign companies from institutionally distant countries use experience to learn more about the institutional environment of the host country and, as a result, do not need to rely on imitation of the firm's domestic strategies in order to reduce foreigner characteristics; specifically they are interested in how two forms of experience, domestic competition and parent company experience, shape the impact of institutional distance on local isomorphism, and select U.S. bank branches from 1978 to 2006 as a sample.

The US banking industry is highly regulated and banks are facing strong pressures to adapt to the institutional environment (Miller & Eden, 2006). Banks are not only influenced by regulatory component of the environment, but they must also be keenly aware of the fact that legitimacy has been attained, so authors Salomon and Wu conclude that this industry offers an appropriate environment for studying isomorphic foreign enterprise strategies. In particular, they argue that foreign firms from institutionally distant countries are more likely to adopt a local isomorphism strategy in order to gain legitimacy and mitigate the liability of foreigness, and the authors apply a multidimensional approach since previous research has focused on looking at only one dimension and its impact on organizational behavior.

They use an isomorphic local strategy as a dependent variable which they measure as similarity between the asset portfolios of a foreign bank and a domestic US bank on an annual basis. Measurements of banks' asset portfolios are categorized by Miller and Eden (2006) based on their distribution into eight categories: commercial loans, real estate loans, consumer credit, other loans and leases, cash, overnight loans, securities and fixed assets. They set the institutional distance as an independent variable and apply a multidimensional measurement approach. Institutional distance is measured through: cultural distance using Hofstede's dimensions of culture; they measured the economic distance by financial market orientation using the ratio of market capitalization to GDP divided by the ratio of bank loans to the private sector and GDP; regulatory distance is measured through bank regulations, banking regulations, competition rules and capital rules, and the authors set their own measure of regulatory distance; they measured political distance as the absolute value of the CHECKS index, which captures the total level of political volatility within the country and measures the number of veto participants, assuming that more veto players will mean more rigorous verifications and controls, which will also affect predictability political environment between the country of origin of the foreign bank and the United States. To measure the ability of foreign bank subsidiaries to gain experience by learning from their home country competitors, the authors create a measure that captures the experience of banks from the same homeland based on the time of competitors' presence in the observed statistical area; they defined competition experience as "the cumulative years of experience that banks from the same homeland have in the same statistical area at

time t". Since a bank may open banking institutes before establishing a branch, it is possible that experience prior to establishing a branch may help in opening the first branch. In addition, as the measure of the firm's own business experience varies over time, it covers additional banking institutions established by the bank after opening a branch, since a bank with more institutes can use its understanding of the local market to change its business strategy.

The authors hypothesize that the difficulties of doing business in the host country are likely to increase with the institutional distance between the host and the country of origin, and as a result, are more likely to opt for local isomorphism as a mitigating strategy to gain legitimacy. In line with this hypothesis, they conclude that the foreign bank strategy adopted is similar to that of local US banks, as cultural, economic and regulatory distances between the country of origin and specifically the United States of America increase. But they cannot conclude the same for a measure of political distance, citing as a possible reason that foreign firms do not use local isomorphism to mitigate the influence of political distance. Nevertheless, the results generally support the assumption that institutional distance influences the chosen business strategy of foreign firms. They further hypothesize that applying the experience of foreign firms from institutionally distant countries (domestic competitors and their own enterprise operations) will benefit more than those firms of institutionally similar countries that enjoy the privilege of less reliance on isomorphic local strategies. Empirical results neither systematically supported these hypotheses, nor that the experience of institutionally distant countries would direct or influence local isomorphism.

This suggests that the strategies used by foreign companies are relatively sustainable and resilient; in the long run, institutional distance influences strategic commitment given that companies are faced with initial strategic commitments that must be fulfilled. However, it has been empirically confirmed that the experience of owning a business has an impact on cultural distance, implying that companies can blend in with the local cultural environment, as accumulating experience and increasing understanding of the local environment provides some breadth in strategy selection.

The research of Solomon and Wu (2012) is a multiple contributor to the institutional literature: the research proves that there is significant heterogeneity in isomorphic strategies, and the results suggest that local isomorphism strategies do not suit all firms equally; foreign companies from more remote institutional environments will find it useful to imitate local competitors. Furthermore, this research examines the impact of institutional distance on the specific operational decisions that companies make in the host country; research to date has examined the impact of institutional distance on site selection or market entry strategy, however, this is the first study to directly contrast institutional distance and local institutional isomorphism. Finally, with this research, institutional distance was analyzed as a multidimensional construct, while the research to date has largely examined one dimension: the cultural, economic or political dimension separately.

Finally, the results of this research suggest that institutional distance influences the final

choice of a foreign firms' strategy and that in the future, institutional distance should be viewed as a multidimensional construct. More precisely, research indicates that while a local isomorphism strategy may help firms (especially managers) from institutionally distant countries to quickly establish legitimacy, managers must be aware that such a commitment potentially imposes a specific strategic direction on future business, since adopting a local isomorphism strategy in the short term may limit the ability enterprises in further progress.

4. CONCLUSION

Looking at multinational companies from an organizational structure perspective, management is a complex task. Geographic distribution contributes to difficult coordination. Since multinational companies operate in at least two markets, they must comply with each of the regulatory requirements, legal frameworks, and each country's legal system is unique and specific. Geographical distribution implies a significant difference in legal systems and non-market institutions. The structures and practices of corporate governance can therefore vary considerably. The complexity of the international environment is also compounded by the fact that the international legal relationship is not clearly defined especially in the segments of jurisdiction, extraterritoriality, protection of intellectual property and in the segment of bribery and corruption.

Institutional distance is a key concept in international business and research since it can be argued that international management is indeed distance management. The interest in institutional distance does not diminish despite sensitization and a stronger interest in managing sociocultural differences, which undoubtedly means that distance will continue to be an important construct when managing and studying multinational affiliates.

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