How overlap in informal institutions affects international economic relations

Abstract:

This paper investigates the effect of differences in informal institutions on economic relations between countries. Starting point is the argument by North (1990) and Williamson (2000) that firms evolve in a symbiotic relationship with their institutional environment. This argument implies that firms are less effective when moving to different institutional contexts that do no fit firms’ knowledge, objectives, and organizational structure. The paper argues that this effect causes firms to opt for FDI in countries with a large degree of overlap in informal institutions. More specifically, the larger the segment of the population in a country that has the same values as people in the firm’s home environment, the more effective firms will be able to operate in that country. To test this proposition, we construct a ‘cultural overlap’ measure on basis of a set of values from the World Values Survey. We show that it has significant effects on MNE location decisions. We conclude that cultural overlap is a theoretically and empirically relevant determinant of international economic relations.

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**Introduction**

What is the effect of institutional differences on the economic relations between countries? Most of the literature in new institutional economics is comparative in nature, viewing the evolution of countries’ institutional setting in isolation. Classic contributions by Acemoglu, Johnson, and Robinson (2001), Greif (1994; 2006; Greif and Tabellini 2010), North (1990; 2005), or Rodrik et al (2004) all have in common that they trace outcomes of countries to their different institutions. Whereas this approach resulted in important insights, this literature generally neglects the potential impact of institutional differences on economic outcomes through their effect on the economic interrelations between countries (Maseland 2011). Lack of economic development in a particular country may have not so much to do with the quality of its institutions itself, as with the fact that its institutions are very different from those in rich countries, cutting a country off from trade and investment flows from rich countries.

New institutional literature offers plenty of reasons to suspect that institutional differences matter for economic relations between countries. Institutions are thought to evolve in symbiosis with firms (North 1990), leading to embeddedness of firm behavior, knowledge and organizational structures in a country’s (informal) institutional setting (Williamson 2000). Informal constraints, such as shared standards of communication and shared norms, values, and codes of conduct help shape firms organizational structure and behavior (North 1990; Very, Lubatkin, Calori, and Veiga 1997). For this reason, organizational behavior that does not match underlying informal institutions will be less effective. By going abroad, however, this is precisely the situation economic agents find themselves in: they enter institutional contexts that do not match their organizational structures and behavioral patterns. This foreignness causes a liability for firms, reducing their performance or discouraging them to enter an institutionally alien market in the first place (Mezias et al 2002).

This paper analyzes the effects of institutional differences on foreign direct investment (FDI) flows between countries, arguing that FDI flows are related to the degree of informal institutional similarity. More specifically, it claims that a larger overlap in informal institutions, measured by the proportion of the population that has values similar to those in the home country of a firm, facilitates entry in a market. We substantiate this claim by an analysis of the location of the 1029 largest affiliates of 37 FDI originating countries. By relating these location choices to data from the World Values Survey about the overlap in qualities respondents mention to be important to teach children, we show that such ‘cultural overlap’ is a significant determinant of FDI flows.

The paper fits within an extensive literature in international business studies arguing that so-called ‘cultural distance’ between multinational enterprise (MNE) home country and candidate host countries negatively affects both the magnitude and level of control of cross-border entry (e.g. Kogut and Singh 1988). It adds to this literature by showing that it is overlap—the proportion of the population sharing values—rather than cultural distance that matters for FDI location choice. Focusing on overlap rather than distance, the paper extends the debate about cultural differences from the exclusive realm of transaction cost theory to the realm of institutionally induced firm-specific advantages (FSA’s). Firms have a certain cultural background, which gives them a competitive edge over other firms when targeting likeminded consumers.

Methodologically, the paper addresses the common criticism that studies of national cultural distance assume away intra-cultural variation (Au 1999; 2000; Au and Cheung 2004; Kogut and Singh 1988, p. 427; Mezias et al 2002; Tung 2008; Tung and Baumann 2009; Tung and Verbeke 2010), while providing an equally attractive alternative. Although the importance of intra-country variation is increasingly appreciated, researchers by and large have balked at the complexity considered to be involved in including such variation (Tung and Verbeke 2010, 1266). By contrast, the concept and measure introduced in this paper is easy to use and readily available.

In the following, we will first review the theory on the role of cultural differences in MNE decision making, focusing on the choice of subsidiary location. We will then introduce cultural overlap as a theoretically plausible concept in dealing with cultural differences against the backdrop of the cultural distance literature. Thirdly, we will provide empirical support for the relevance of cultural overlap for MNE location choice. Finally, several directions for further research on cultural overlap and implications for International Business are discussed.

**2. Background**

A large literature in IB discusses the effects of cultural differences on MNE behavior. Point of departure in this literature is the idea that c**ultural differences create all kinds of tensions and misunderstandings in intercultural encounters (Hofstede 2001). Such nuisances make that foreign firms are at a disadvantage vis-à-vis locals when operating in culturally distant contexts. Only when the ownership advantages of firms are strong enough to offset this ‘liability of foreignness’ (Hymer 1976; Zaheer 1995), firms may successfully enter a culturally distant market. F**irms therefore tend to select culturally proximate countries for investment, at least in earlier phases of their expansion (Barkema, Bell and Pennings 1996;Flores and Aguilera 2007; Galan et al 2007; Lee, Shenkar and Li 2008; Li and Guisinger, 1991; Shenkar, 2001). **The experience gained by expansion in culturally proximate environments may subsequently be used to venture further** (Barkema, Bell and Pennings 1996)**.**

Problems of overcoming cultural differences are also argued to affect the entry modes chosen. To reduce their exposure to risks generated by cultural differences, firms generally lower the level of long term commitment when operating in culturally distinct countries. Larger cultural differences are therefore associated with lower levels of ownership (Gatignon and Anderson 1988; Lee, Shenkar and Li 2008; Li and Guisinger, 1991; Pla-Barber, Sanchez-Peinado, and Madhok 2010). In addition, firms try to reduce the necessity of cultural adaptation by opting for greenfield investments rather than mergers and acquisitions when entering culturally alien contexts (Chang and Rosenzweig, 2001; Kogut and Singh, 1988; Weitzel and Berns, 2006).

Although the idea that cultural differences affect location and entry modes is widely shared, empirical support for these arguments is not unambiguous. A significant number of studies find no or opposite effects of cultural differences (Benito and Gripsrud 1992; Brouthers and Brouthers 2001; Ellis 2007; Mitra and Golder, 2002; Robertson and Wood, 2001; Terpstra and Yu, 1988). In spite of this, culture is generally considered to be an important determinant of the location and form of FDI.

*Theory: From transaction costs to Firm-Specific Advantages*

What all these arguments have in common is that they see culture mainly as a source of problems and costs. This interpretation of cultural differences as an investment deterrent is by and large inspired by transaction costs theory. The general argument is that cultural differences generate principal-agent problems, uncertainty and lack knowledge about markets, resulting in transaction costs. In response, firms tend to shun culturally distinct environments, or limit their vulnerability by opting for arms-length entry modes.

Cultural differences may not only be interpreted as a source of costs, but also as a source of opportunities (Sarala and Vaara 2010). By generating transaction costs, culturally induced uncertainty and principal-agent issues also tend to shield off a specific environment from competitors from different cultural contexts. The logic of transaction costs implies that firms with a specific cultural background have a special ability to connect to likeminded consumers that other firms lack. A cultural background may thus not only be seen as a liability, but also as an ownership advantage: a set of culture-generated resources and capabilities that competitors (or potential competitors) do not have. Put differently, firms have culturally induced FSA’s in targeting culturally similar segments of the market (cf. location-bound and home-region bound FSA’s (Rugman and Verbeke 2004, 2007).

If firms go abroad in order to exploit their ownership advantages (Hymer 1960, 1976), in the case of culturally induced FSA’s they do so by focusing on those consumers whose values fit those of the firm. They may do so by targeting sizable minorities of likeminded consumers living in otherwise culturally distinct countries. This mechanism is similar to the effect of linguistic ties. A reason why Spanish firms are targeting the U.S., for example, is not that the ‘linguistic distance’ (i.e. the average time it takes a Spanish-speaker to learn English (Chiswick and Miller 2005)) between Spanish and English is small; it is because of the U.S.’s substantial Hispanic market that Spanish-language firms are well-equipped to serve (Davila, 2001: Sunderland et al., 2004). Likewise, foreign firms may actually enjoy an advantage over local firms in targeting segments of the local environment to which their cultural distance is limited relative to that of locals (Javorcik et al 2006; Miller, Thomas, Eden, & Hitt, 2008; Nachum 2010).

Culturally induced FSA’s are likely to be especially relevant in the context of downstream, market seeking FDI (cf. Rugman and Verbeke 2007). Since the success of FDI focused on the upstream side of the value chain largely depends on low costs of production, standard transaction costs arguments are likely to be relatively more important there. When it comes to market seeking investment, though, firms are not so much interested in reducing the degree of cultural differences as in identifying those markets in which the firm has a distinct competitive advantage because it shares consumers’ value orientations. The question is where to find these consumers and the associated opportunities for market expansion. The answer to this question drives the choice of location.

*Methodology: Overlap vs. distance*

Traditionally, researchers in international business investigating cultural differences have focused on cultural distance. The most popular measure is the one developed by Kogut and Singh (1988). It is based on the sum of the absolute differences of national scores on the four cultural dimensions identified by Hofstede (1980, 2001). The K-S measure is computed on basis of the following formula:

 (1)

which gives the cultural distance (CD) of the *j*th country from a base country (denoted by subscript *a*). *Iij­­* indicates the national scores of country *j* on the *i*th dimension of Hofstede. The term *Vi* in the denominator represents the variance of cultural dimension *i*.

Its popularity notwithstanding, the K-S measure has attracted significant criticism (see Shenkar, 2001 or Tung and Verbeke, 2010 for overviews). In recent years a number of alternatives have been proposed. Some contributions focus on broadening the distance concept by including additional dimensions, such as institutional, economic, or demographic distance (Berry, Guillen and Zhou 2010; Dow and Karunaratna 2006; Ghemawat 2001; Kang and Kim 2010; Kim and Gray 2009). Others introduce sources of values information other than Hofstede’s (2001) survey (Ng, Lee and Soutar 2006; Sarala and Vaala 2010; Shao, Kwok and Guedhami 2010). The main logic remains the same in all these variants; distance is conceived in one way or the other as the difference between scores at the country level.

Kogut and Singh (1988, p. 427) already recognized that using a national measure of cultural distance to investigate firm behavior is potentially problematic, arguing that information on the firm level was preferable. In the past years, critique about the neglect of intra-country variation in cultural distance measures has grown more vocal (Au 1999; 2000; 2004; Berry et al 2010; Mezias, Chen, Murphy, Biaggio, Chuawanlee, Hui, Okumara, and Starr, 2002; Tung 2008; Tung and Baumann 2009). Mezias et al (2002) show that national level indices are not appropriate measures at the organizational level. Tung and Baumann (2009) argue that distances between ethnic Chinese spread over various countries are often smaller than between ethnic Chinese and their non-Chinese countrymen. These results suggest that firms may target specific ethnic sub-markets when making investment decisions, bypassing national culture (Javorcik et al 2006). All this questions the relevance of national cultural distance measures. However, in spite of the increased recognition of the relevance of intra-country variation, research has generally backed way from taking intra-country variation into account because of the perceived complexity of doing so (Tung and Verbeke 2010, 1265).

The concept of cultural overlap offers a simple way to effectively address intra-country variation. To see the practical difference between the distance and overlap concepts, consider the following numerical example (Table 1). Assume three countries, each containing 100 respondents, who may score 0-4 on a particular cultural dimension. The distribution of scores differs between countries.

*Table 1. Example of inter- and intra-country distribution of cultural values scores*

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | 0 | 1 | 2 | 3 | 4 | *Average score* |
| Country A | 25 | 25 |  | 25 | 25 | *2* |
| Country B |  |  | 100 |  |  | *2* |
| Country C | 50 | 25 |  | 25 |  | *1* |

Between which country pairs would we expect more interactions? Cultural distance concepts (looking at the difference between average culture scores) lead us to expect MNE’s from Country A to prefer doing business in Country B above doing business in Country C. After all, the difference between average scores is 0 between countries A and B, and 1 between A and C.

However, exclusively looking at distance between averages obscures the fact 75% of firms in country A are able to match with a Country C-resident with identical values. By contrast, there are no such matches at all between inhabitants of Country A and B. Looking at cultural overlap—the share of likeminded people in a country— we would therefore expect firms from Country A to select Country C rather than Country B. By focusing on segments of Country C to which they are culturally similar, firms are able to exploit their cultural FSA’s. Firms, after all, do not select countries, they select consumers to serve. If cultural differences matter in this process, that makes that firms minimizing cultural differences select culturally similar partners from within a variety of settings, not select culturally similar settings harboring a variety of partners. For this reason, the share of a population in Country A whose values correspond to those of people in Country B is more relevant to MNE’s than national cultural distance.

Obviously, cultural overlap and cultural distance are related empirically. If cultural overlap is large, this also tends to reduce the difference between average culture scores. Even if cultural overlap is what matters most, this does not contradict the vast empirical literature lending support to the idea that cultural distance affects MNE behavior. If our reasoning is correct, however, the observed effects of cultural distance actually reflect the correlated effects of cultural overlap on cross-cultural firm behavior.

**3. Hypotheses and Method**

On basis of the discussion so far, we maintain that cultural overlap is a relevant variable for subsidiary location decisions by MNE’s. What is more, it is the variable that actually underlies much of the apparent effects of national cultural distance. This leads us to the following hypotheses:

*Hypothesis 1. Cultural overlap is positively related to the number of cross-border activities by MNE’s, even when controlled for cultural distance.*

*Hypothesis 2a. Any effect of cultural distance on MNE cross-border activities is reduced when including cultural overlap in the explanation.*

A stronger version of this hypothesis is that cultural overlap is the *only* aspect of cultural differences that matters for MNE location decisions, so that national cultural distance does not affect such decisions at all.

*Hypothesis 2b. Any effect of cultural distance on MNE cross-border activities disappears when including cultural overlap in the explanation.*

In the discussion of the theoretical link between cultural differences and location choice, we argued that transactions costs resulting from cultural differences are likely to matter more in cases where MNE’s go abroad for efficiency seeking reasons. When the motivation is market-seeking, however, cultural FSA’s are likely to be of more importance. Our data do not contain direct information about the motivation for FDI. However, they do allow us to distinguish between industrial affiliates and affiliates in the services (financial and otherwise) sector. Since the provision of services is generally more associated with face-to-face contact than production of industrial goods, FDI in the services sector is on average likely to be more market-seeking than in the industrial sector. This brings us to our final hypothesis:

*Hypothesis 3: the effect of cultural overlap relative to that of cultural distance on subsidiary location-selection is stronger in the services sector than in the industrial sector.*

*Data & Method*

In order to test our hypotheses, we estimate the following regression equation:

 (2)

in which  is the number of affiliates in country *j* of firms from country *I,*  is the coefficient showing the effect of cultural overlap,  represents the effect of cultural distance, and  and denote the effects of a set of bilateral and host country-specific control variables.

Our main variable of interest is cultural overlap, which is derived from a set of items from the World Values Survey[[1]](#footnote-1) based on the question:

*Here is a list of qualities that children can be encouraged to learn at home. Which, if any, do you consider to be especially important? Please choose up to five! (Code five mentions at the maximum):*

*V12. Independence*

*V13. Hard work*

*V14. Feeling of responsibility*

*V15. Imagination*

*V16. Tolerance and respect for other people*

*V17. Thrift, saving money and things*

*V18. Determination, perseverance*

*V19. Religious faith*

*V20. Unselfishness*

*V21. Obedience*

We believe the child qualities-items tap basic differences in culturally transmitted ethical beliefs and values. This set of items has been included in the WVS for 87 countries, resulting in 7396 bilateral relations. Our main cultural overlap measure is based on this, and focuses on the number of people in country A mentioning the same qualities as respondents in country B. Cultural overlap between countries is calculated on basis of the following formula:

 (3)

which gives the cultural overlap (*COj*) from country *j* to country *i*.  indicates the proportion of mentioned qualities in country *j* that is quality *q*.  is a weight factor representing the proportion of the world population mentioning quality *q*. This cultural overlap measure represents the chances that one agrees with someone from country B on a quality (cultural distance, by contrast, reflects the expected degree of disagreement with someone from country B). In addition, we use an alternative, more restricted measure of cultural overlap focusing on the chances of meeting someone with the same combination of mentioned qualities:

 (4)

In this formula, *CCO*ji represents the restricted cultural overlap from country *j* to country *i*, *Ccj*denotes the proportion of combinations of three mentioned qualities in country *j* that is combination *c*, and *Tc*is again a weight factor, this time representing the proportion of the world population with combination *c*. Both measures of cultural overlap are compared to the standard Kogut-Singh (1988) cultural distance measure, calculated following Equation 1.

We are interested in the impact of cultural overlap on the location of main MNE affiliates. We investigate this using data about the location of the largest affiliates of MNE’s originating in 37 countries. This data is collected from UNCTAD’s ‘FDI country profiles’ for individual countries, which are freely available from the UNCTAD website. The choice of countries is informed by data availability, as the sample contains all countries for which both the WVS item and information about largest affiliates was available[[2]](#footnote-2). To check whether our results depend on the sample containing both rich and poor countries, we also run the analysis focusing on rich economies only.

In order to isolate the effect of cultural differences, we control for a number of other factors potentially influencing location decisions. Since we are interested in bilateral factors only, we control for country specific effects by including the total number of affiliates in a host country as a measure of its general attractiveness for FDI. Because the size of the potential market for a firm is a function of both the total size of a market and the share of this market with similar values, we include host country GNI (source: [www.worldbank.org](http://www.worldbank.org)) as well. Also, we include a number of bilateral controls, including geographical distance and dummy variables to identify particular links between countries such as a shared colonial past and common languages (taken from [www.cepii.fr](http://www.cepii.fr))[[3]](#footnote-3). Table A1 in the appendix presents descriptive statistics for the included variables.

**4. Results**

First, we compare our cultural overlap measures to the standard cultural distance measure developed by Kogut and Singh (1988). Table 2 provides correlations between the alternative concepts of cultural differences.

*Table 2. Correlations between alternative concepts of cultural difference*

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Cultural overlap** | **Cultural Overlap**  **(combinations measure)** | **Cultural Distance** |
| **Cultural Overlap** | 1.000 | .888\*\* | -.151\*\* |
| **Cultural Overlap**  **(combinations measure)** | .888\*\* | 1.000 | -.117\*\* |
| **Cultural Distance** | -.151\*\* | -.117\*\* | 1.000 |

*Notes: \*\* indicates correlation is significant at the 0.01 level (2-tailed).*

We see that although cultural distance and cultural overlap are significantly correlated (as we would expect), the correlation is not very high (-.151 for our main measure of cultural overlap). This assures us that they capture different aspects of cultural differences between societies.

Next, we focus on the effect of cultural overlap and distance on the location of MNE affiliates. Table 3 presents the main results. Model 1 gives the baseline model, including all relevant bilateral and host country-specific control variables. As expected, affiliate location is by geographical distance, colonial ties and common language. GNI has no significant effect, but otherwise unspecified general attractiveness of a location (given by the total number of affiliates in a host country) does. Including cultural overlap or cultural distance measures (Models 2 and 3) also gives expected results: cultural overlap is positively related to the number of affiliates in host economies, while cultural distance is negatively related to the location of affiliates.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| *Table 3. Number of bilateral affiliates* | | | | |
|  | **Model 1** | **Model 2** | **Model 3** | **Model 4** |
| **(Constant)** | .423\*\*  (4.397) | -1.599\*  (-2.515) | .736\*\*  (5.131) | -1.683  (-1.418) |
| **Geographical distance** | -6.202E-5\*\*  (-6.438) | -5.704E-5\*\*  (-5.051) | -6.605E-5\*\*  (-5.918) | -6.186E-5\*\*  (-4.428) |
| **Colonial ties** | 1.129\*\*  (4.195) | .965\*\*  (3.240) | .599  (1.819) | .266  (.688) |
| **Common Language** | .575\*\*  (4.170) | .470\*\*  (2.922) | .644\*\*  (3.477) | .611\*\*  (2.576) |
| **GNI host country** | 3.626E-14  (1.274) | 4.927E-14  (1.582) | 6.623E-14  (1.927) | 8.763E-14\*  (2.185) |
| **Total affiliates in host** | .024\*\*  (13.112) | .022\*\*  (11.260) | .026\*\*  (11.761) | .024\*\*  (9.545) |
| **Cultural Overlap** |  | .024\*\*  (3.181) |  | .028\*  (2.052) |
| **Cultural Distance** |  |  | -.118\*\*  (-3.201) | -.094  (-1.897) |
| ***N*** | *1774* | *1475* | *1254* | *955* |
| ***R2 (Adjusted)*** | *.255* | *.250* | *.295* | *.288* |
| Notes: \* indicates significance at .05 level; \*\* indicates significance at .01 level. T-values in parentheses. | | | | |

In order to test to what extent the apparent effect of cultural distance in Model 3 is actually driven by the effect of cultural overlap, we include both variables in Model 4. Doing so, we find that cultural overlap remains positively related to location choice (though now only at the 5% level), while the effect of cultural distance is no longer significant. These results are in line with Hypotheses 1, 2a and 2b, indicating that cultural overlap is the variable that matters more to firms choosing affiliate locations.

*Sector-specific results*

Is cultural overlap equally relevant for all types of FDI? Theoretically, we have argued that cultural distance is more closely linked to transaction costs, while cultural overlap fits the idea of culture-related FSA’s better. From this, we deduct that in industrial sectors, which are relatively dominated by efficiency seeking FDI, cultural distance carries more weight than in service sectors, where market-seeking motives are relatively more important. To test this, Table 4 provides the results per sector.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| *Table 4. Number of bilateral affiliates per sector* | | | | |
|  | **Model 5** | **Model 6** | **Model 7** | **Model 8** |
| **Constant** | .106  (.203) | -1.016  (-1.827) | -.692\*  (-2.108) | -1.753\*  (-2.291) |
| **Cultural Overlap** | .003  (.421) | .015\*  (2.381) | .009\*  (2.415) | .025\*\*  (2.835) |
| **Cultural Distance** | -.051\*  (-2.311) | -.033  (-1.413) | -.010  (-.712) | -.043  (-1.326) |
| **Geographical distance** | -2.572E-5\*\*  (-4.172) | -2.600E-5\*\*  (-3.958) | -9.645E-6\*  (-2.508) | -3.596E-5\*\*  (-3.989) |
| **Colonial ties** | -.169  (-.991) | -.017  (-.092) | .449\*\*  (4.201) | .435  (1.740) |
| **Common language** | .198  (1.888) | .252\*  (2.268) | .152\*  (2.326) | (.407)\*\*  2.662 |
| **GNI host country** | 8.380E-15  (.484) | 4.749E-14\*  (2.508) | 2.140E-14\*  (2.042) | 7.544E-14\*\*  (2.917) |
| **Total industrial affiliates** | .028\*\*  (9.247) |  |  |  |
| **Total tertiary affiliates** |  | .023\*\*  (9.159) |  |  |
| **Total financial affiliates** |  |  | .024\*\*  (6.639) |  |
| **Total service affiliates** |  |  |  | .022\*\*  (8.945) |
| ***N*** | *955* | *955* | *955* | *955* |
| ***Adjusted R2*** | *.215* | *.277* | *.192* | *.290* |
| Notes: \* indicates significance at .05 level; \*\* indicates significance at .01 level. T-values in parentheses. | | | | |

Results indicate that the relative effects of cultural overlap and cultural distance indeed differ strongly between sectors. In fact, industrial affiliates appear to be located on basis of cultural distance rather than overlap (Model 5), which supports the thesis that transaction costs are more relevant in industrial sector-FDI. Models 6-8 show that in the tertiary, financial and service (i.e. financial and tertiary combined) sectors only cultural overlap has a significant effect on affiliate location. Cultural distance has no significant effect. Apparently, cultural overlap is more important in the services sector, while distance is the more relevant concept in the industrial sector. This confirms our third hypothesis.

*Robustness*

To what extent are these results robust for changes in measures or in sample? If we focus on OECD economies only, results remain by and large unchanged (Table A2 in the Appendix). Looking at all sectors combined, cultural overlap still enters significantly (5% level), while cultural distance has no longer a statistically significant impact. In the industrial sector, we now find that neither distance nor overlap is significant. In the tertiary, financial and combined services sector cultural overlap is shown to affect location. Our overall conclusions slightly gain strength from these results.

If we replace our standard cultural overlap measure by the alternative, more restricted version, we see that results change slightly in favor of cultural distance, though again many of the results remain unchanged (Table 5). Looking at all sectors together, cultural distance now has a significant negative effect on location choice. Cultural overlap no longer has a significant effect, at least not at the 5% level. Results per sector, however, are still in line with our initial findings. Location of industrial affiliates appears to be primarily driven by cultural distance. For the tertiary, financial and service sectors, cultural overlap is more important. This suggests that cultural overlap is at least a relevant complement to standard cultural distance measures, which is especially important to MNE’s operating in the services sector.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| *Table 5. Number of bilateral affiliates total and per sector, alternative measure* | | | | | |
|  | **Model 9** | **Model 10** | **Model 11** | **Model 12** | **Model 13** |
| **Constant** | -.089  (-.183) | .241  (1.129) | -.134  (-.589) | -.186  (-1.389) | -.331  (-1.057) |
| **Cultural Overlap (restricted version)** | .012  (1.808) | .001  (.420) | .006\*  (2.018) | .004\*  (2.234) | .011\*  (2.486) |
| **Cultural Distance** | -.104\*  (-2.127) | -.051\*  (-2.379) | -.039  (-1.685) | -.013  (-.937) | -.051  (-1.626) |
| **Geographical distance** | -6.369E-5\*\*  (-4.546) | -2.590E-5\*\*  (-4.193) | -2.696E-5\*\*  (-4.092) | -1.029E-5\*\*  (-2.670) | -3.760E-5\*\*  (-4.158) |
| **Colonial ties** | .306  (.789) | -.165  (-.966) | .004  (.022) | .463\*\*  (4.324) | .470  (1.877) |
| **Common language** | .607\*  (2.535) | .196  (1.854) | .253\*  (2.250) | .149\*  (2.260) | .405\*\*  (2.619) |
| **GNI host country** | 8.221E-14\*  (2.067) | 7.960E-15  (.465) | 4.457E-14\*  (2.370) | 2.020E-14  (1.940) | 7.107E-14\*\*  (2.765) |
| **Total affiliates** | .024\*\*  (9.698) |  |  |  |  |
| **Total industrial affiliates** |  | .028\*\*  (9.345) |  |  |  |
| **Total tertiary affiliates** |  |  | .023\*\*  (9.299) |  |  |
| **Total financial affiliates** |  |  |  | .024\*\*  (6.722) |  |
| **Total service affiliates** |  |  |  |  | .023\*\*  (9.089) |
| ***N*** | *955* | *955* | *955* | *955* | *955* |
| ***Adjusted R2*** | *.287* | *.215* | *.271* | *.191* | *.289* |
| Notes: \* indicates significance at .05 level; \*\* indicates significance at .01 level. T-values in parentheses. | | | | | |

**5. Conclusion**

In this paper, we have argued that cultural distance is not the only relevant or even the most relevant conceptualization of cultural difference for MNE’s. Rather than focusing on the degree of differences between aggregate cultures, MNE’s are likely to focus on the likelihood of individual similarity when deciding to go abroad. An analysis of the location of the largest affiliates of MNE’s from 37 countries supports this thesis. We find that cultural overlap overall is a better predictor of location choice than cultural distance, the industrial sector excepted. We interpret this distinction as indication that cultural distance is a more related to culture-based transaction costs, which are especially relevant for efficiency-seeking FDI. Cultural overlap, by contrast, is more important to firms entering foreign countries for market-seeking reasons. We conclude that cultural overlap is indicative of the MNE’s ability to exploit its culture-based FSA’s.

Our main conclusion is that cultural overlap captures an important complementing aspect of cultural differences, which theoretically and empirically appears to be distinct and perhaps more relevant to MNE activity than standard distance measures. It is therefore a useful concept that may be applied as an alternative to cultural distance in studies of MNE behavior.

Obviously, the concept of cultural overlap and the way in which it is operationalized in this paper are not entirely unproblematic either. What is more, it is not immediately clear whether the superior relevance of cultural overlap extends beyond location choice. More theoretical and empirical work is required in these areas. However, the implication of this paper is not that we should all immediately replace cultural distance measures by cultural overlap indicators in our research. Rather, what this project highlights is the fact that cultural distance is but one way to conceptualize cultural differences. Cultural overlap is one alternative; there may be others. None is likely to be the most relevant one for all purposes. For location decisions, it is theoretically plausible that the actual number of potential customers whose cultural preferences are linked to a firm are important. In other cases, transaction costs generated by differences between higher-order cultural contexts may play a larger role. The more general insight of this study, therefore, is that our conceptualization of cultural differences should follow the topic and question at hand.

That being said, the results of this research project add weight to the case for paying more attention to intra-country variation (e.g. Au 1999; 2000; 2004; Tung 2008). In fact, the near-exclusive focus on the national level when studying culture may be seen as something of an anomaly in international business studies, which is otherwise almost defined by a focus on the firm level. One explanation for this state of affairs is that researchers, while generally aware of the problem of intra-country variation, have stuck with national level cultural distance measures because alternatives are deemed impractically complex. The construction of the cultural overlap measure, however, shows that with generally available data we are able to address intra-country variation in an easy and straightforward way.

Finally, the results of this paper suggest that it may be worthwhile to approach cultural differences not only as a source of problems and costs for firms, but also as a potential source of ownership advantages. A shared culture gives one a specific ability to reach out to fellow culture-members, resulting in privileged access to markets and pools of labor. Firms seeking to exploit this advantage need to address culture not just as a problem, but as an opportunity.

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**Appendix A1**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| *Table A1. Descriptive statistics main variables* | | | | | |
|  | **N** | **Min.** | **Max.** | **Mean** | **Std. Deviation** |
| **Number of bilateral industrial affiliates** | 3510 | 0 | 13 | .11 | .663 |
| **Number of bilateral tertiary affiliates** | 3510 | 0 | 18 | .12 | .778 |
| **Number of bilateral finance affiliates** | 3510 | 0 | 10 | .06 | .440 |
| **Number of bilateral affiliates** | 3510 | 0 | 36 | .29 | 1.617 |
| **Cultural overlap** | 7330 | 53.16 | 98.71 | 82.092 | 6.466 |
| **Cultural overlap (restricted)** | 7220 | 21.83 | 96.10 | 64.396 | 12.108 |
| **Cultural distance** | 4692 | .02 | 10.16 | 2.000 | 1.448 |
| **GNI PPP current international dollars 2008** | 7986 | 3441770495 | 1.E13 | 7.66E11 | 1.877E12 |
| **Geographical distance** | 8584 | 55 | 19650 | 7155.85 | 4601.168 |
| **Common language** | 8584 | 0 | 1 | .11 | .310 |
| **Colonial ties** | 8584 | 0 | 1 | .02 | .139 |
| **Total affiliates in host** | 8943 | .00 | 232.00 | 10.789 | 29.174 |
| **Total industrial affiliates in host** | 8943 | .00 | 81.00 | 4.010 | 10.492 |
| **Total tertiary affiliates in host** | 8943 | .00 | 111.00 | 4.511 | 13.774 |
| **Total finance affiliates in host** | 8943 | .00 | 40.00 | 2.269 | 5.484 |
| **Total services affiliates in host** | 8943 | .00 | 151.00 | 6.780 | 18.927 |

**Appendix A2**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| *Table A2. Number of bilateral affiliates total (A1-A5) and per sector (A5-A8) OECD only* | | | | | | | | |
|  | **Model A1** | **Model A2** | **Model A3** | **Model A4** | **Model A5** | **Model A6** | **Model A7** | **Model A8** |
| **Constant** | .534\*\*  (4.337) | -1.752  (-1.795) | .771\*\*  (4.374) | -2.428  (-1.556) | -.072  (-.106) | -1.211  (-1.736) | -1.047\*  (-2.285) | -2.323\*  (-2.330) |
| **Cultural Overlap** |  | .028\*  (2.398) |  | .037\*  (2.055) | .004  (.471) | .019\*  (2.329) | .013\*  (2.496) | .033\*\*  (2.859) |
| **Cultural Distance** |  |  | -.091  (-1.910) | -.034  (-.514) | -.008  (-.266) | -.034  (-1.156) | .011  (.563) | -.026  (-.610) |
| **Geographical distance** | -7.756E-5\*\*  (-6.165) | -7.505E-5\*\*  (-4.805) | -7.809E-5\*\*  (-5.794) | -7.557E-5\*\*  (-4.398) | -3.214E-5\*\*  (-4.322) | -3.027E-5\*\*  (-3.924) | -1.359E-5\*\*  (-2.696) | -4.375E-5\*\*  (-3.976) |
| **Colonial ties** | .129  (.363) | -.334  (-.818) | .161  (.405) | -.349  (-.740) | -.476\*  (-2.327) | -.125  (-.592) | .254  (1.834) | .129  (.427) |
| **Common language** | 1.329\*\*  (5.932) | 1.409\*\*  (5.063) | 1.354\*\*  (5.334) | 1.506\*\*  (4.538) | .639\*\*  (4.445) | .429\*\*  (2.885) | .435\*\*  (4.463) | .868\*\*  (4.088) |
| **GNI host country** | 2.917E-14  (.703) | 5.026E-14  (1.048) | 3.757E-14  (.861) | 6.082E-14  (1.168) | 2.008E-14  (.911) | 1.786E-14  (.762) | 1.711E-14  (1.180) | 4.229E-14  (1.270) |
| **Total affiliates** | .032\*\*  (12.076) | .030  (9.778) | .030\*\*  (10.836) | .029\*\*  (8.787) |  |  |  |  |
| **Total industrial affiliates** |  |  |  |  | .035\*\*  (9.029) |  |  |  |
| **Total tertiary affiliates** |  |  |  |  |  | .024\*\*  (7.709) |  |  |
| **Total financial affiliates** |  |  |  |  |  | . | .033\*\*  (6.467) |  |
| **Total service affiliates** |  |  |  |  |  |  |  | .025\*\*  (7.826) |
| ***N*** | *649* | *649* | *649* | *649* | *649* | *649* | *649* | *649* |
| ***Adjusted R2*** | *.326* | *.327* | *.326* | *.323* | *.294* | *.253* | *.296* | *.289* |
| Notes: \* indicates significance at .05 level; \*\* indicates significance at .01 level. T-values in parentheses. | | | | | | | | |

1. Wave 1-5. Data freely downloadable from www.worldvaluessurvey.org. [↑](#footnote-ref-1)
2. Sample consists of Argentina, Armenia, Brazil, Canada, Chile, Colombia, Denmark, Dominican Republic, Egypt, El Salvador, Ethiopia, Finland, France, Germany, Ghana, Guatemala, Ireland, Italy, Japan, Mexico, Morocco, Netherlands, New Zealand, Nigeria, Norway, Peru, South Africa, Spain, Sweden, Switzerland, Tanzania, United Kingdom, United States, Uruguay, Venezuela, Zambia and Zimbabwe. [↑](#footnote-ref-2)
3. More specifically, we use the distance between two countries’ biggest cities weighted by the share of the city in the overall country’s population, following the formula , where *popk* denotes the population of agglomeration *k* (*l*) in country *i* (*j*). We prefer this measure over other measures of geographical distance, since it incorporates the internal distribution of population and thus reflects the spirit of our cultural overlap indicator. [↑](#footnote-ref-3)