The effects of institutional distance on FDI inflow: General environmental institutions (GEI) versus minority investor protection institutions (MIP)

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A R T I C L E   I N F O

A B S T R A C T

Existing research suggests that foreign direct investment (FDI) flows into countries with good institutional infrastructure. We distinguish between general environmental institutions (GEI) that promote societal interests at large, and minority investor protection (MIP) institutions that promote the interests of a specific group, and argue that these types of institutions affect international investments differently. We tested this hypothesis by examining the effects of institutional distance on international M&A activities of US firms during 1981–2008. We found that better GEI in the host country attracts inflowing FDI while better MIP may discourage it, because of the perception that it reduces the potential gain an acquiring firm can earn from an international acquisition in that country.

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1. Introduction

International operations produce benefits for a firm because of oligopolistic or resource capabilities that can be deployed to exploit imperfections in the international market. These benefits are derived from reduced transaction costs and the creation of internal markets (Buckley & Casson, 1979; Caves, 1971; Williamson, 1975), or from utilizing and/or acquiring corporate resources and capabilities necessary for international operations (Barney, 1991; Penrose, 1959). Countering these benefits of international operations are the costs of information, monitoring and control as well as trade barriers, which all relate to the concept of "distance." Since international corporate investment involves establishing an operational facility at a distant location – separated not only by geographical distance but also by cultural and institutional distances – it follows that the extent and nature of these distances should influence a firm's incentives for investing abroad, other things being equal.

North (1990, 1994) was among the first to emphasize the importance of institutions, beyond culture, arguing that economic growth and performance are critically dependent on the efficacy of institutions. He defined institutions as formal rules and informal constraints that set the "rules of the game." In Dunning's (1981, 1988) OLI paradigm, a main location (L) variable is institutional distance, which allows for the interdependence between the firm and national institutions on both micro and macro levels. (Dunning & Lundan, 2008a). In international contexts, institutional distance is the extent of institutional dissimilarity between institutions in the home and host countries (Kostova, 1999). Using international firm-level data, La Porta, Lopez-de-Silanes, Shleifer, & Vishny (1997) and La Porta, Lopez-de-Silanes, Shleifer, & Vishny (1998) examined the impact of law on firms' performance, providing evidence that legal tradition and institutions have major impacts on financial development and corporate performance, but not vice versa. This result is consistent with North (1993) who argued that institutions influence economic variables even though the specifics of institutions differ. Xu and Shenkar (2002) presented conceptual ideas about the role of institutional distance in international corporate investments but no empirical evidence.

An increasing amount of literature on global finance and governance recognizes the role of international mergers and acquisitions (M&A) as a vehicle for the international convergence of corporate governance systems.[1] However, legal tradition, and

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[1] See Bris and Cabolis (2008), Chari et al. (2010), Dinc and Erel (2010), Ferreira et al. (2010), Moeller and Schlingemann (2005), and Rossi and Volpin (2004).

social and public institutions are more deeply rooted in a society than corporate governance systems, such as board structure or corporate control. Legal tradition and institutions are now recognized to be a deep, underlying factor that drives the economic performance of nations and firms. Nonetheless, since La Porta et al. (1998), little work has been done on how institutions influence international corporate investment behavior, and whether divergent typologies of legal, social and public institutions affect international corporate investments differently. Multinational corporations (MNC) adjust their strategy and structure based on the "uncertainty and complexity" of the environment, just as they do for institutional quality, which makes the characteristics of countries increasingly important (Cantwell, Dunning, & Lundan, 2010).

In this study, we examined the effect of institutional distance of foreign direct investment (FDI) flowing into a host country by using international M&A data for US firms. We analyzed a vast dataset consisting of 7,492 cases of international M&A by US firms that invested in 38 countries from 1981 through 2008. We began with the idea that two distinct types of institutional distance are relevant for FDI. The first type includes institutions that have impact on the entire society, or on all constituents and all investors equally, such as political institutions, the rule of law, contract enforcement, and similar. We refer to this class of institution as "general environmental institutions (GEI)." The second type of institution protects a specific type or group of investors such as minority shareholders or debt holders rather than the society at large. We refer to this class of institutions as "minority investor protection (MIP)" institutions. Our contention is that the distinction between GEI and MIP is essential for understanding the effect of institutions on FDI. We expected that the institutional distance in GEI would be positively associated with FDI inflow when the host country improves these institutions, while distance in MIP is negatively associated with FDI inflow. We found that the effects of institutional distance on international acquisitions, as measured by the percentage of equity ownership of local firms sought by US firms (FDI inflow to the host country, for improving institutional infrastructure), was positive and significant, but only when GEI variables are included.[2] This is consistent with the finding by Globerman and Shapiro (2003) that countries that fail to achieve a minimum threshold of effective institutional governance are unlikely to receive much FDI inflow. However, when we include MIP institutions, the impact on the FDI inflows is negative and significant. Although this is surprising in light of the popular notion that regards institutional developments, without distinction, as positive, it is consistent with real option theory as applied to institutional development. A high level of local investor protection is indicative of a lower potential for flexibility and profitability for inward international acquisitions by multinational firms. If *domestic* equity investors and creditors are already well protected, the potential gains for an *international* acquirer who introduces superior management and governance in the host country will be smaller. Thus if specific MIP institutional infrastructure is already in place in the host country, it may reduce the attractiveness of that country for international corporate investors. To the extent that the valuation of the host country, prior to committing to investment, is driven by the value of potential growth, this explanation is consistent with the real option perspective as a motive for international investments (Kogut, 1991; Tong, Reuer, & Peng, 2008).

In conclusion, an acquiring firm may prefer a host country that has a general institutional infrastructure, but not the one where a high level of investor protection because of the possibility that it protects existing local investors at the expense of future international corporate investors. We interpret this to be consistent with a real option valuation for investor protection existing in the host country prior to international M&A. This concept of FDI inflow is new, and supports the idea that the attractiveness and pull of incoming FDI depends on the nature of local institutional development, not its level. This contrasts with the general practice in empirical international business research, which assumes institutional distance is a single, homogeneous variable that influences corporate international investments.

The remainder of the paper is organized as follows. Section 2 discusses institutional theory and develops our empirical hypotheses. Section 3 describes the data and methodology, while section 4 presents empirical results. Section 5 discusses the results concludes the paper.

2. Institutional theory and hypotheses

Institutions are "the rules of the game in a society [that] structure incentives in human exchange [and] affect the performance of economies over time" (North, 1990). In contrast to the "old institutionalism" that focused on describing the organization as an economic environment and how the arrangement of power influences control of the economic system (Engerman & Sokoloff, 2008; Samuels, 1984, 1987), the "new institutionalism" is motivated by the neoclassical foundation of rationality, optimization and equilibrium. New institutionalism opens up and expands the theory of the firm in areas like the organization and operation of the corporation (Samuels, 1995). This is an attempt to extend the range of neoclassical theory by accounting for institutional factors such as property rights and governance structures, including the role of nonmarket arrangements in influencing economic, financial and business behavior. However, unlike old institutionalism, new institutionalism is not an attempt to replace standard neoclassical economic theory (Parto, 2005). Rather it views MNCs as a "coordinated system of domestic and cross-border value-added activities" (Dunning & Lundan, 2008a, p. 125) that use FDIs to maximize profits and growth.

North (1990) introduced the notion of institutional "path dependence." Path dependence recognizes that increasing returns to institutions can lead to "lock in" of a particular institutional arrangement that emerged for unique historical reasons (Boettke, Coyne, & Leeson, 2008). Sachs (2000) suggests that the barriers to evolutionary social change are so powerful that a fundamental institutional change can only be the result of an external shock, not internal evolution. If so, institutions that are successful in one country cannot easily be transferred to another country with the same result, implying that institutions are sticky (Boettke, Coyne, Leeson, & Sautet, 2005; Boettke et al., 2008). The conclusion drawn from this literature supports the notion that institutions are important exogenous variables for explaining outcomes in different environments.

The extant literature on the typologies of institutions focuses on formal (e.g., law and regulations) versus informal (e.g. self-imposed codes of conduct) institutions.[3] Formal rules need to map onto the existing informal institutions in order to be successful for economic development (Boettke et al., 2008). According to Greif (2006), the key characteristics of institutions are exogenous to individuals and "reflect intentional or unintentional human actions." It is important to remember that even without direct government involvement, individuals are able to form trading coalitions to enforce certain economic behaviors. For example,

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[2] As a result of a dramatic increase in the last three decades, the international M&As have become a principal form of FDIs (Weber and Tarba, 2010; Gomes et al., 2011).

[3] For a detailed example of formal vs. informal institutions, see Dunning and Lundan (2008b).

common law nations enforce flexible financial contracts beyond the "rules on the book" (Bergman & Nicolaievsky, 2007; La Porta, Lopez-de-Silanes, & Shleifer, 2008; Lerner & Schoar, 2005; Pistor, 2005).

The distinction between GEI and MIP presumes that investors seek to reduce their risk and protect their properties while maximizing returns. This requires functioning GEI that ensure the effective rule of law as well as stable institutional environment necessary for the firm initiating or conducting ongoing businesses. North and Weingast (1989) argued that sound property rights and incentive schemes created by distinctive British institutions enabled Great Britain to be the first country to industrialize. Conversely, North, Summerhill, and Weingast (2000) ascribed economic failures in Latin America to obstruction of institutional development that might have guaranteed property rights and contract enforcement. The type of political regime (e.g. democracy or dictatorship) is also an example of GEI (Acemoglu & Robinson, 2006; Aron, 2000; Boix, 2003; Easterly, 2007; Persson & Tabellini, 1994; Persson & Tabellini, 2005; Persson & Tabellini, 2007; Przeworski, Alvarez, Cheibub, & Limongi, 2000). The legal origin theory of La Porta et al. (1997, 2008) includes additional examples of GEI: procedural formalism, judicial independence, and others. GEI also refers to accounting standards that tend to stimulate acquisitions (Haleblian, Devers, McNamara, Carpenter, & Davison, 2009; Rossi & Volpin, 2004).

We expected that a higher GEI in the host country will have a *direct* positive impact on inward FDI because of reduced risk due to GEI in the host country. Given the fact that the institutional distance is defined as the difference between institutions in the home country (US) and host country, its effect on FDI inflow in the host country will be negative.

Hypothesis 1. *The FDI inflow in the host country is associated negatively with the institutional distance between the home and host country in GEI.*

The minority investor protection (MIP) institution was the second category in our institutional typology. It consists of those institutions that protect minority shareholders and the company's debt holders from the power and extraction of corporate insiders and controlling shareholders pursuing their private benefit (Shleifer & Vishny, 1997). La Porta et al. (1997, 1998) showed that institutions, in the form of investor protection laws that protect the rights of atomistic minority shareholders and debt holders, vary greatly between countries. Generally, common law countries offer better investor protection than civil law countries. La Porta et al. (2008) also indicated that protection of a financier's property rights is essential for assuring the inflow of capital to the firms.

In the context of the Dunning (1981), Dunning's (1981, 1988) OLI paradigm, an MNC will use its ownership (O) advantages to internalize (I) transactions that result in FDI activity if it finds it in its interest to exploit the O advantages in a specific location (L). Different institutions are the "underpinning" the O and I advantages of the MNC and the L advantages of the location (Dunning & Lundan, 2008a). If local institutions interfere with the maximizing the profit of the multinational, this should have a negative impact on FDI inflow in the host country.

We argue, somewhat counter-intuitively, that the impact of MIP on FDI inflow to the host country in general and on international M&As in particular will be negative, meaning that better investor protection law in the host country will actually reduce FDI inflows to the country. The existence of laws providing a high level of protection for minority investors in the host country could reduce the potential gains of international corporate investors, especially when they provide major equity capital,

Table 1
List of 38 host countries of US M&As in our sample.

Argentina	Japan
Australia	Malaysia
Austria	Mexico
Belgium	Netherlands
Brazil	New Zealand
Canada	Norway
Chile	Peru
Colombia	Portugal
Denmark	Singapore
Egypt	South Africa
Finland	South Korea
France	Spain
Germany	Sweden
Greece	Switzerland
Hong Kong	Taiwan
India	Thailand
Indonesia	Turkey
Israel	United Kingdom
Italy	Uruguay

making the foreign acquirer a controlling shareholder. Thus, in contrast to GEI, the institutions specific to the protection of minority investor rights may discourage FDI inflows. Given that MIP distance is defined as the US minus host country, the effect of the MIP distance on FDI inflow will be positive.

Hypothesis 2. *The FDI inflow in the host country is associated positively with the institutional distance between the home and host country in MIP.*

3. Methodology

3.1. Sample and data collection

To construct our sample, we began with international M&A transactions from 1981 through 2008 obtained from Thompson's SDC database. We then limited our sample to countries for which we could obtain country-level governance and institution data from La Porta et al. (1997) for calculating the two institutional factor scores (GEI and MIP). Our final sample consisted of 7492 observations of international M&A investments made by US firms in 38 host countries during the research period. Table 1 lists the 38 host countries in our final sample. The wide geographical dispersion of the sample gives us the diverse international data suitable for the present study and analyzing the impact of varying, and potentially offsetting, measures of institutional distance. Specifically, FDI inflow was measured by the percentage of equity ownership in local firms sought by US firms at the firm-level. Corporate financial variables were obtained from the Capital IQ dataset by Standard & Poor's. Cultural data for countries were taken from Hofstede, Hofstede, and Minkov (2010). Country-level governance and institution data are from La Porta website (1997) which updates La Porta et al. (1997). The FDI restriction index came from the OECD. Additional data were obtained from the World Bank's World Development Indicators database.

3.2. Institutional variables

We conducted a principal component analysis (a form of exploratory factor analysis) on the 10 institution variables that La Porta et al. (1997) presented and extracted two factors from them.[4]

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[4] The criteria stopped at two factors.

Table 2
Principal component factor analysis of institution variables.

Variable	Factor 1 (GEI)	Factor 2 (MIP)
Rule of law	0.90	
Percentage of share capital to call an extraordinary shareholders' meeting		−0.44
Mandatory dividend	−0.45	
Percentage of secured creditors to approve reorganization		0.59
Anti-director rights		0.45
Creditor rights		0.85
Efficiency of judicial system	0.78	
Contract repudiation by government	0.90	
Risk of expropriation	0.93	
Accounting standards	0.76	

See La Porta et al. (1997) for exact definitions of these variables.

The results in Table 2 show that, of the 10 variables, six load on factor 1, and four load on factor 2. Precise definitions of these variables are in Appendix 1.

Upon closer inspection, we see that five of the variables that loaded positively on factor 1 are GEI variables: *rule of law, efficiency of judicial system, contracts repudiation by government, risk of expropriation*, and *accounting standards*. The only other variable loaded on factor 1 is *mandatory dividend*, which loaded negatively, but this sign should be expected because it is a MPI variable. As discussed in the previous section, we expected that GEI and MIP institutional variables to have opposite signs. The four variables uploaded to factor 2 (*percentage of share capital to call an extraordinary shareholders' meeting, percentage of secured creditors to approve reorganization, anti-director rights*, and *creditor rights*,) are all from the MIP category and all uploaded positively. However, the fifth variable-*percentage of share capital to call an extraordinary shareholders' meeting*, loaded negatively because the lower percentage means more power for the minority shareholders, i.e., the higher MIP distance in favor of the US, or against the host country, decreases FDI inflow in the host country.

From the two factors above, we first created two institutional distance variables: "GEI distance for La Porta factor 1" that represents the US-target country gap in GEI, and "MIP distance for La Porta factor 2" that represents the US-host country gap in MIP, obtained by subtracting the score on the factors for each host country from the US score. However, in the multivariate regressions, we use the residual value of each institutional distance measure obtained from the side regression instead of using raw values, in order to circumvent the potential bias due to high correlation between institutional distance and cultural distance.

3.3. Control variables

We used two alternative distance variables as controls: cultural and geographic distance. *Cultural distance* has long been recognized as a major variable affecting FDI. Shenkar (2001) argued that cultural distance influences the costs of managerial coordination, control or monitoring, while Vachani (1991) maintained that cultural distance creates informational frictions that may influence the transfer of informal resources such as knowledge. Ahern, Daminelli, and Fracassi (2012) found that national cultural differences help determine where mergers create gains, and how gains are divided between the parties. Also Tarba and Weber (2011) and Weber, Tarba, and Reichel (2009) found that cultural distance influences the outcome of international M&A.

The data for *cultural distance* is based on national culture because Weber, Tarba, and Reichel (2011) claim that national culture has an impact on M&A. We used the cultural dimensions of Hofstede et al. (2010).[5] Based on Shenkar's (2001) arguments against using an aggregate dimensions for cultural distance, we used uncertainty avoidance and power distance, which Lubatkin, Calori, Very, and Veiga (1998) have proven influences international M&A activity.

Buckley and Casson (1979) argued that geographical distance increases entry barriers, while Portes and Rey (2005) indicated that geographical distance increases informational friction. For this variable, we used the log of the minimum geographical distance between capital cities of the US and the host country (Siegel, Licht, & Schwartz, 2011). *Shared border* is also used for Canada and Mexico, which border with US (Ahern et al., 2012) and are members of the North American Free Trade Association.

Other control variables include *energy production* (equivalent to 1000 kt. of oil and oil equivalents), which is a proxy for natural resources, gathered from the Word Development Indicators by the World Bank. Previous studies identified the importance of natural resources such as energy production for FDIs (Aleksynska & Havrylchyk, 2011; Asiedu, 2006; Poelhekke & Van Der Ploeg, 2010). We include *patent applications per 1000 residents* as a proxy for the attractiveness of the target nation for knowledge-seeking FDIs. We also include annual *GDP*, in one million US dollar and in constant 2000 dollars. We control for GDP as a proxy for the effect of economic masses (Siegel et al., 2011).

Another control variable is *exchange rate stability* of the host country. The literature recognizes the relationship between the real exchange rate risk and FDI flows (Chakrabarti & Scholnick, 2002; Chakrabarti, Gupta-Mukherjee, & Jayaraman, 2009). By implication, the real exchange rate risk may influence FDI location decisions of US firms because exchange rate changes affects the net present value of the investment in dollar terms. We used the annual index of exchange rate stability for each country as calculated the PRS Group, to rank each country on a scale of zero (highest risk) to ten (lowest risk).

The *regulatory restriction index* for FDIs for each country, industry and year is also of interest and affects FDIs. The OCED developed this index in 2003 to measure how restrictive the FDI policy is in OECD countries. However, the OECD data are available only for four reference years (1997, 2003, 2006, and 2010) but our sample covers international M&A investments for 18 years from 1981 to 2008. For practical purposes, we used the closest FDI restrictiveness index for missing years, based on the assumption that FDI policies remained time-invariant between the reference years. For example, if the FDI restriction index is available only for 2003 we will fill in missing cells for 1997 with the 2003 data.[6] For industry classification, because the OECD used sector classifications rather than SIC industry codes, we looked up 2-digit SIC codes for the 22 industrial sectors and manually matched OECD industry sectors with the 2-digit SIC codes for target companies in our dataset. We used a composite total measure of the FDI restriction index across industry.

We also control for the size of US acquiring firms based on the total value of their common equity and include a dummy variable, *same industry*. If the two-digit SIC for target and acquiring firms are the same, the value is one, otherwise zero. Since the M&A activities

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[5] We also used the original Hofstede (1980) variables in lieu of the variables from Hofstede et al. (2010) as a robustness check. The results remain the same.
[6] For test robustness (not reported here for the sake of brevity), instead of filling in for missing years, we re-estimated our models using a subsample of the international M&A investments made only in those 4 reference years. We found that our main results remain robust.

Table 3
Summary statistics.

Variable	Obs.	Mean	Std. dev.	Min	Max
FDI inflow (%)	7492	80.86	32.52	0.1	100
GEP distance (La Porta factor 1), US-Target	7492	0.39	0.70	−0.08	2.99
MIP distance (La Porta factor 2), US-Target	7492	−0.76	1.06	−2.43	1.97
Power distance (Hofstede et al., 2010), US-Target	7482	−4.46	15.70	−64	29
Uncertainty avoidance distance (Hofstede et al., 2010), US-Target	7482	−8.89	20.35	−66	38
Shared border dummy (Mexico, Canada)	7492	0.22	0.41	0	1
Log (Geographical distance)	7480	8.71	0.48	8.02	9.68
Energy production (1000 kt. of oil and oil equivalent)	7372	191.47	126.58	0.00	1655.77
Patent applications (per 1000 residents)	7057	20.06	54.12	0.01	384.20
GDP (one million US$, constant 2000 dollar)	7433	943.34	798.79	18.74	10189.90
Exchange rate stability	7456	9.13	1.26	0	10
Same industry dummy (2-digit SIC)	7492	0.46	0.50	0	1
FDI restriction index	6866	0.11	0.17	0	1
Log (Common equities of acquirer)	6510	7.07	0.35	4.88	10.40

This table presents summary statistics for the variables used in empirical work. The sample contains international M&A data by US Firms from 1981 to 2008. The M&A data are from Thompson's S.D.C. deals database. FDI inflow represents the percentage of equity ownership of local firms sought by US firms. Firm-level financial variable are obtained from Capital International dataset by the Standard & Poor's. Culture data for nations are from Hofstede (1980) and in Hofstede et al. (2010). Country-level governance and institution data are from La Porta website which updates La Porta et al. (1997). FDI restriction index comes from OECD. Additional data are obtained from the World Bank governance database.

might be related to business cycle and other intertemporal macroeconomic changes, we include a year fixed effect.

3.4. Descriptive statistics

Table 3 provides summary statistics for main variables used in the empirical analysis. We note that the dependent variable–the FDI inflow (the percentage of equity ownership of a local firm sought by US firms)—varies widely from 0.1% to 100%, providing sufficient variability. In addition, the positive mean value of gap La Porta factor 1 and a negative mean value of gap La Porta factor 2 shows that host countries, on average, maintain weaker GEI, but stricter MIP than the US.

Table 4 shows that the correlation coefficient matrix between explanatory variables. We observe that La Porta factor 1 gap, which approximates GEI distance, has high correlation (above 0.50) with both measures of cultural distance measures used (power distance and uncertainty avoidance). La Porta factor 2 gap, which approximates MIP distance, also has high correlation with uncertainty avoidance. This suggests that cultural and institutional distance should be used selectively or the correlation between the two should be purged in one of the two distance variables. However, the analysis of variable inflation factors (VIF) in Appendix 2 shows that there is no significant multicollinearity issues which might affect the reliability of the results.[7]

4. Main empirical results

Before proceeding to the main multivariate regression analysis, we needed to orthogonalize the measures of institutional distance and cultural distance given high correlation between them, as reported in Table 4. Although the VIF analysis may not indicate a significant multicollinearity issue in the overall regression, a high correlation between the two measures could make individual coefficients difficult to interpret. We ran a side regression for each distance measure (GEI or MIP) as a function of power distance,

uncertainty avoidance (both shown as a US minus target country) and the constant. The residual value of each institutional distance, which is the actual distance minus the fitted value from the side regression, is then used in the main multivariate regression analysis.[8]

Table 5 presents the results of multivariate regressions where the FDI inflow is regressed on the two measures of institutional distance, together with the selective addition of cultural distance, geographical distance, and control variables in regression models. In all specifications, we used the residual value of each institutional distance measure discussed above to circumvent the effect of correlation between institutional distance and cultural distance.

Our first primary finding was that the coefficients of GEI institutional distance (measured by La Porta factor 1 gap) were statistically significant and negative in all specifications. This supports Hypothesis 1, which predicted that the FDI would be negatively correlated to the gap between the home and host country in GEI. This means that if a country has a lower GEI value than the US, it will have a negative impact on FDI inflows, i.e., a decrease in the acquisition of local firms by US multinationals. Conversely, it also means that a host country with a higher GEI than the US will attract more FDI inflows from the US.

Another primary finding was that the coefficients of MIP institutional distance (measured by La Porta factor 2 gap) were significant and positive across all models. This supports Hypothesis 2 that predicted a positive association between MIP distance and FDI inflow. The La Porta factor 2 gap was the institutional distance in MIP institutions between the US and host countries. Both of these results were robust across all models, even when alternate distance measures, such as cultural distance and geographical distance, and other control variables, were used.

Regarding alternate measures of distance, the coefficients of the cultural distance were significant and positive regardless of whether power distance or uncertainty avoidance was used. That is, both cultural distance and geographical distance do influence international acquisitions by US firms, consistent with expectations from the extant literature. Among the other control variables, it is noteworthy that US multinationals were found to reduce their equity investments in host countries where FDI is highly restricted. More importantly, the basic results on institutional distance

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[7] Additionally, there seems to be a high correlation (0.82) between two control variables, patent application and GDP, which may cause a multicollinearity issue when used simultaneously in multivariate regressions. However, as shown in Appendix 2, the variance inflation factors (VIF) are both within acceptable range (under 10). Indeed, the VIFs of all the explanatory variables are well below 10, suggesting that there were no significant multicollinearity issues among our explanatory variables that might affect the reliability of the results.

[8] The coefficients of both independent variables are statistically significant at one percent in both GEI and MIP regressions. The results are available from the authors.

Table 4
Correlations among independent variables.

		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
(1)	FDI inflow (%)	1.00***													
(2)	GEP distance	−0.23***	1.00***												
(3)	MIP distance	0.02**	0.17***	1.00											
(4)	Power distance	0.21***	−0.62***	−0.37***	1.00										
(5)	Uncertainty avoidance distance	0.12***	−0.57***	−0.61***	0.44***	1.00									
(6)	Shared border dummy	0.05***	−0.07***	0.27***	0.01	0.07***	1.00								
(7)	Log (Geographical distance)	−0.19***	0.20***	−0.23***	−0.17***	−0.09***	−0.75***	1.00							
(8)	Energy production	0.09***	−0.31***	−0.10***	0.16***	0.41***	0.64***	−0.56***	1.00						
(9)	Patent applications	−0.08***	−0.10***	−0.11***	−0.05***	−0.29***	−0.17***	0.22***	−0.13***	1.00					
(10)	GDP	0.06***	−0.29***	−0.11***	0.05***	−0.13***	−0.18***	−0.02	0.10***	0.82***	1.00				
(11)	Exchange rate stability	0.07***	−0.25***	−0.14***	0.13***	0.19***	0.19***	−0.16***	0.26***	0.08***	0.14***	1.00			
(12)	Same industry dummy	0.10***	0.01	0.03**	0.02	−0.01	0.01	−0.03**	0.01	−0.04***	−0.03**	0.00	1.00		
(13)	FDI restriction index	−0.15	0.08***	0.05***	−0.09***	0.07***	0.39***	−0.10***	0.29***	−0.11***	−0.24***	0.05***	0.00	1.00	
(14)	Log (Common equities of acquirer)	−0.02*	−0.03**	0.02	0.02	−0.01	−0.03*	−0.02	−0.05***	0.03*	0.04***	−0.05***	0.03**	−0.01	1.00

* Denote two-tailed significance at the 10% level.
** Denote two-tailed significance at the 5% level.
*** Denote two-tailed significance at the 1% level.

Table 5
FDI inflow on institutional distance by institution type (GEI and MIP).

	(1)	(2)	(3)	(4)	(5)
	FDI inflow				
Residual GEP distance (La Porta factor 1), US-Target	−4.838*** (−5.178)	−4.088*** (−4.505)	−6.982*** (−4.997)	−7.466*** (−5.309)	−4.560*** (−3.470)
Residual MIP distance (La Porta factor 2), US-Target	4.856*** (9.048)	4.067*** (7.412)	1.976** (2.479)	2.281*** (2.837)	3.504*** (4.612)
Power distance (Hofstede et al., 2010), US-Target		0.319*** (10.29)	0.238*** (5.312)	0.264*** (5.907)	0.298*** (6.811)
Uncertainty avoidance (Hofstede et al., 2010), US-Target		0.0775*** (3.485)	0.194*** (4.569)	0.152*** (3.699)	0.132*** (3.286)
Same border		−15.56*** (−11.27)	3.624 (1.011)	−6.177** (−2.317)	−8.370*** (−3.213)
Log (Geographical distance)		−17.93*** (−13.65)	−7.728*** (−3.362)	−13.53*** (−7.246)	−15.36*** (−8.645)
Energy production			−0.0323*** (−3.607)	−0.0101 (−1.416)	−0.00811 (−1.144)
Patent applications			−0.113*** (−5.156)	−0.0305** (−2.544)	
GDP			0.00670*** (4.475)		−0.000351 (−0.430)
Exchange rate stability			−0.292 (−0.587)	−0.453 (−0.909)	−0.305 (−0.668)
Same industry (2-digit SIC)			5.370*** (6.877)	5.335*** (6.818)	5.384*** (6.975)
FDI restriction index			−18.70*** (−5.875)	−19.90*** (−6.295)	−19.43*** (−6.318)
Log (Common equities of acquirer)			−2.608** (−2.151)	−2.490** (−2.050)	−2.204* (−1.821)
Constant	96.23*** (329.6)	255.9*** (22.02)	182.2*** (7.181)	230.9*** (10.35)	243.1*** (11.20)
Year fixed effect	YES	YES	YES	YES	YES
Observations	7482	7470	5598	5598	5869
R-squared	0.040	0.116	0.143	0.139	0.141
Adjusted R-squared	0.0359	0.112	0.137	0.134	0.136

See Table 2 and Appendix 1 for the definition of variables. Robust t-statistics in parentheses.
* $p < 0.1$.
** $p < 0.05$.
*** $p < 0.01$.

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Table 6
Estimating FDI inflow on each individual institutional distance measure.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
	FDI inflow									
Rule of law, US-Target	−2.920*** (−8.805)									
Percentage of share capital to call an extraordinary shareholders' meeting, US-Target		14.43 (1.359)								
Mandatory dividend, US-Target			22.41*** (3.810)							
Percentage of secured creditors to approve reorganization, US-Target				0.0834*** (4.500)						
Anti-director rights, US-Target					1.110*** (2.651)					
Creditor rights, US-Target						3.708*** (6.967)				
Efficiency of judicial system, US-Target							−3.031*** (−4.686)			
Contract repudiation by government, US-Target								−5.479*** (−8.029)		
Risk of expropriation, US-Target									−6.171*** (−7.936)	
Accounting standards, US-Target										−0.531*** (−6.934)
Power distance, US-Target	0.131*** (2.868)	0.220*** (4.173)	0.223*** (4.903)	0.251*** (5.665)	0.264*** (5.988)	0.343*** (7.546)	0.0948* (1.745)	0.0801 (1.636)	0.0940* (1.938)	0.207*** (4.726)
Uncertainty avoidance, US-Target	0.118*** (2.982)	0.173*** (3.976)	0.139*** (3.443)	0.234*** (5.455)	0.169*** (4.090)	0.242*** (5.815)	0.0999** (2.374)	0.109*** (2.751)	0.146*** (3.676)	0.0295 (0.656)
Same border (Canada, Mexico)	0.0548 (0.0164)	6.390* (1.912)	3.783 (1.131)	6.044* (1.811)	3.715 (1.076)	−4.214 (−1.159)	7.659** (2.266)	8.747*** (2.609)	7.596** (2.277)	4.579 (1.386)
Log (Geographical distance)	−9.209*** (−4.105)	−8.324*** (−3.618)	−8.978*** (−3.941)	−8.240*** (−3.605)	−8.993*** (−3.874)	−10.94*** (−4.736)	−7.989*** (−3.503)	−3.934* (−1.678)	−5.007** (−2.158)	−8.409*** (−3.719)
Constant	193.3*** (7.741)	181.7*** (7.128)	192.0*** (7.522)	183.5*** (7.214)	186.1*** (7.329)	206.6*** (8.139)	182.2*** (7.189)	145.6*** (5.646)	158.9*** (6.229)	183.3*** (7.274)
Controls	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Year fixed effect	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Observations	5598	5598	5598	5598	5598	5598	5598	5598	5598	5598
R-squared	0.143	0.128	0.130	0.130	0.128	0.137	0.131	0.141	0.140	0.135
Adjusted R-squared	0.138	0.122	0.125	0.125	0.123	0.132	0.126	0.136	0.135	0.130

Robust *t*-statistics in parentheses.
* $p < 0.1$.
** $p < 0.05$.
*** $p < 0.01$.

remained unchanged and confirm Hypotheses 1 and 2 regarding GEI distance and MIP distance. That is, while an improvement in GEI in a host country induces FDI inflow, improvement in a specific MIP institution in a host country may discourage FDI inflow.

To further clarify whether a multicollinearity issue between the two control variables (patent application and GDP) influenced the primary results, we re-estimated model 3 by dropping each of these two variables individually. As shown in models 4 and 5 of Table 5, the coefficients of the two qualitative institutional distance measures remained the same, lending further support to our Hypotheses 1 and 2. In Table 6, we replaced the GEP and MIP factor scores with institutional gap for each of the 10 variables used in the principal component factor analysis. The gap for each institutional La Porta variable represents the US-target country distance, which was obtained by subtracting host country's value from the US value of each variable. The results show that the coefficients for each GEI institutional distance were significant and negative. Moreover, the coefficients for MIP institutional distance were all positive; in four out of the five cases they were statistically significant. These results provide additional evidence to support Hypotheses 1 and 2.

5. Conclusion

Previous empirical analyses in international business used a single measure of institutional distance as if the effect of institutional infrastructure is homogeneous. Our typology of institutions suggests that there is a significant qualitative difference between general environmental institutions (GEI) and minority investor protection institutions (MIP). GEI institutions aim at serving the general societal interests by promoting a better general environment for all investors. These include the rule of law, efficacy of judicial system, contract enforcement, accounting standards and the like. On the other hand, MIP institutions promote and protect the interests of specific investors at the expense of other corporate or overall societal interests, and include provisions concerning minority shareholder rights, creditor rights, and the like. We find that the two categories of institutions not only load on two different factors in principal component analysis, but also have different impacts on FDI inflows in relation to the distance between home and host country. Improvement in the GEI of a country leads to an increase in FDI inflows from the US while improved MIP may discourage FDI inflows. As the institutional gap increases in MPI in favor of further protecting local minority investors in a country, US MNCs may be less willing to acquire local firms in that country because the potential for flexibility and profitability t achievable by international acquisitions might decrease. This contrasts with the tendency of most empirical studies that include institutional distance as a single homogeneous variable.

Our study has a number of managerial implications. First, companies and managers seeking foreign investment should be aware of the negative impact that MIP could have on FDI. This is especially important for companies located in an environment with strong institutions that protect a specific type or group of investors, such as minority shareholders or debt holders. Understanding this obstacle could help managers adopt proactive strategies to overcome the problem before approaching foreign investors. For example: seeking investors from countries with higher or similar MIP scores. An another strategy could be selling a minority stake in the company or selling 100% of the company to minimize the negative effect of the MPI. In addition, investors, managers, and companies from low MPI countries should demand a lower price or other benefits for their capital, to compensate for the expected reduction in flexibility and profitability.

Policymakers at the national level should also consider the price of a better institutional environment that protects specific type or group of investors such as minority shareholders or debt holders. This will help them find the optimal level of regulation for protecting minority investors.

Our sample includes only MNCs for whom the US is their home country. We suggest that future researchers test the influence MPI distance between home and host countries for a sample including different home countries. In addition, future research should study the impact of countries' MPI institutions in terms of absolute value, not only as an outcome of distance.

Appendix A. Definitions of the institution variables.

Variable	Description
Rule of law	Assessment of the law and order tradition in the country produced by the country-risk rating agency *International Country Risk* (ICR). Average of the months of April and October of the monthly index between 1982 and 1995. Scale from zero to 10, with lower scores for less tradition of law and order.
Percentage of share capital to call an extraordinary shareholders' meeting	It is the minimum percentage of ownership of share capital that entitles a shareholder to call for an Extraordinary Shareholders' Meeting. It ranges from 1% to 33%.
Mandatory dividend	Equals the percentage of net income that the Company Law or Commercial Code requires firms to distribute as dividends among ordinary stockholders. It takes a value of zero for countries without such restriction.
Percentage of secured creditors to approve reorganization	Minimum percentage of secured creditors in value to approve for the plan of reorganization.
Anti-director rights	An index aggregating the shareholder rights which we labeled as "anti-director rights." The index is formed by adding 1 when: (1) the country allows shareholders to mail their proxy vote to the firm; (2) shareholders are not required to deposit their shares prior to the General Shareholders' Meeting; (3) cumulative voting or proportional representation of minorities in the board of directors is allowed; (4) an oppressed minorities mechanism is in place; (5) the minimum percentage of share capital that entitles a shareholder to call for an Extraordinary Shareholders' Meeting is less than or equal to 10% (the sample median); or (6) shareholders have preemptive rights that can only be waived by a shareholders' vote. The index ranges from 0 to 6.
Creditor rights	An index aggregating different creditor rights. The index is formed by adding 1 when: (1) the country imposes restrictions, such as creditors' consent or minimum dividends to file for reorganization; (2) secured creditors are able to gain possession of their security once the reorganization petition has been approved (no automatic stay); (3) Secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm; and (4) the debtor does not retain the administration of its property pending the resolution of the reorganization. The index ranges from 0 to 4.
Efficiency of judicial system	Assessment of the "efficiency and integrity of the legal environment as it affects business, particularly foreign firms produced by the country-risk rating agency *Business International Corporation*. It "may be taken to represent investors' assessments of conditions in the country in question". Average between 1980 and 1983. Scale from 0 to 10, with lower scores for lower efficiency levels.

Appendix A (Continued)

Variable	Description
Repudiation of contracts by government	ICR's assessment of the "risk of a modification in a contract taking the form of a repudiation, postponement, or scaling down" due to "budget cutbacks, indigenization pressure, a change in government, or a change in government economic and social priorities." Average of the months of April and October of the monthly index between 1982 and 1995. Scale from 0 to 10, with lower scores for higher risks.
Risk of expropriation	ICR's assessment of the risk of "outright confiscation" or "forced nationalization". Average of the months of April and October of the monthly index between 1982 and 1995. Scale from zero to 10, with lower scores for higher risks
Accounting standards	Index created by examining and rating companies' 1990 annual reports on their inclusion or omission of 90 items. These items fall into seven categories (general information, income statements, balance sheets, funds flow statement, accounting standards, stock data and special items). A minimum of three companies in each country were studied. The companies represent a cross-section of various industry groups where industrial companies numbered 70 percent while financial companies represented the remaining 30%.

Source: La Porta et al. (1997).

Appendix B. Variance Inflation Factor (VIF) Test

	(1)		(2)		(3)	
	VIF	Tolerance (1/VIF)	VIF	Tolerance (1/VIF)	VIF	Tolerance (1/VIF)
Residual GEP distance (La Porta factor 1), US-Target	1.20	0.833535	1.22	0.819075	1.91	0.522927
Residual MIP distance (La Porta factor 2), US-Target	1.19	0.837486	1.44	0.692681	2.10	0.476031
Power distance (Hofstede, 2010), US-Target			1.32	0.758089	1.35	0.741926
Uncertainty avoidance (Hofstede, 2010), US-Target			1.26	0.795604	1.88	0.530673
Same border (Canada, Mexico)			2.51	0.398981	7.13	0.14019
Log (Geographical distance)			2.54	0.393018	4.49	0.222531
[Controls]						
Energy production					3.76	0.265669
Patent applications, per 1000 residents					7.96	0.125583
GDP (constant 2000, one million US$)					8.72	0.114628
Exchange rate stability					1.55	0.645414
Same industry (2-digit SIC)					1.01	0.987252
Log (Common equities of acquirer)					1.17	0.857655

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