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# Egalitarianism, Cultural Distance, and Foreign Direct Investment: A New Approach

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This study addresses an apparent impasse in the research on organizations' responses to cultural distance. We posit that cross-country differences in egalitarianism—a cultural orientation manifested in intolerance for abuses of market and political power and support for protection of less powerful actors—affect multinational firms' choices of destinations for foreign direct investment (FDI). Using historically motivated instrumental variables, we observe that egalitarianism distance has a negative causal impact on FDI flows. This effect is robust to a broad set of competing accounts, including the effects of other cultural dimensions, various features of the prevailing legal and regulatory regimes, other features of the institutional environment, economic development, and time-invariant unobserved characteristics of origin and host countries. We further show that egalitarianism correlates in a conceptually compatible way with an array of organizational practices pertinent to firms' interactions with nonfinancial stakeholders, such that national differences in these egalitarianism-related features may affect firms' international expansion decisions.

**Key words:** foreign direct investment (FDI); neoinstitutionalism; global strategy; multinational firm; culture; cultural distance; egalitarianism; regulatory arbitrage; Pollution Haven Hypothesis; entrepreneurship

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## Introduction

For decades, notions such as the liability of foreignness, cultural distance, and psychic distance have been part of the organization theorist's vocabulary. Nevertheless, cultural distance remains more of a myth—a cherished story—than a well-established reality. Notwithstanding scores of studies, mostly reliant on a composite index based on Hofstede (1980), several surveys have largely concluded that the literature faces an impasse.<sup>1</sup> Debate still rages over how to theorize and operationalize culture, how stable culture is, which cultural factors influence organizational decisions, and whether cultural effects are dominated by other institutional factors.<sup>2</sup> This murky state of affairs may hinder organizational scholars from recognizing the importance of culture, and of cultural distance, for organizations.

Seeking to address these issues, we advance a new integrative approach to cultural distance and organizations. We conceptualize culture as a fundamental social institution tightly linked to historical and ecological conditions that render cross-cultural differences quite stable. We focus in particular on egalitarianism, a cultural orientation that induces people to recognize one another as moral equals (S. H. Schwartz 1994, 1999; N. L. Schwartz 2001). Egalitarianism is manifested in intolerance of abuses of market and political

power and support for protecting less powerful actors. Prior research has linked egalitarianism and international investment to key societal institutions, including antitrust law and policy; legal protections for employees, the sick, and the elderly; curbs on corruption; and accounting transparency (Siegel et al. 2011). This research, however, like the literature more generally, fails to specify organizational features that may be affected by egalitarianism. This study is the first to probe beneath the level of such broad institutional factors, examining the organizational level and linking egalitarianism to organizations via a new theoretical account and consistent findings.

Mastering socially appropriate ways of exerting power is of crucial importance for firms. Virtually every interaction between an organization and its stakeholders, broadly defined (Freeman 1984), takes place within a certain power relationship. As an organization emerges in its home institutional environment, it responds to isomorphic pressures (DiMaggio and Powell 1983) and adopts values, norms, and structural features compatible with this environment. Such isomorphic adaptation also characterizes its relations with stakeholders. Organizational theory, however, lacks an agreed-upon model of the factors that distinguish different organizational cultures (Hartnell et al. 2011). Because we are dealing here with organizations' interactions with their institutional

environments—first at home and later abroad—we utilize the Schwartz dimensional framework of cultural orientations with a focus on its egalitarianism orientation (S. H. Schwartz 1994, 1999, 2004). To motivate the analysis, we first present evidence that egalitarianism correlates in a conceptually compatible way with an array of organizational features. In particular, we consider compensation of both top executives and ordinary workers and various interactions with the community. These organizational-level factors do not emanate from legal prescriptions and thus capture informal social norms that organizations adopt and follow. That these norms are linked with egalitarianism anchors the key notion of isomorphism in organizations in culture.

We develop a content-rich account of the link between cultural distance and firms' strategic decisions to enter foreign markets via foreign direct investment (FDI), or a strategic investment that involves control. FDI is a momentous step for an organization: it subjects organically developed organizational features to a "stress test" of sorts in the host market. Specifically, the greater the difference in terms of cultural egalitarianism between the home and host markets, the greater the adjustments the firm will have to make in order to engage effectively with its stakeholders. Our theory thus points to egalitarianism in particular as a theoretically defined and empirically measurable factor that causes organizations to expand to destinations where their interaction with stakeholders is more likely to resemble such interaction at home. This thesis allows us to link prevailing levels of egalitarianism to largely exogenous factors that can serve as instruments to buttress an argument on culture's causal role and to link levels of egalitarianism to specific organizational features. Our theory thus yields a fuller account than has previously been advanced in the literature.

We also consider, more briefly, how egalitarianism fares as an explanatory variable compared with the other cultural dimensions of the Schwartz theory of cultural dimensions, embeddedness/autonomy and harmony/mastery (S. H. Schwartz 1994, 1999, 2004). We find that egalitarianism distance has a strong negative impact on FDI flows in a broad sample of nations using data from different sources and time periods. Prior research failed to relate international investment to the other two cultural dimensions in the Schwartz model, but we find that FDI tends to flow from high-embeddedness to low-embeddedness countries. We link this finding in part to international regulatory arbitrage on environmental protection regimes. We also connect cultural harmony to countries' proclivity for entrepreneurship, such that harmony distance may particularly encourage multinational enterprises (MNEs) to enter less entrepreneurial countries. Taken together, our theory and evidence show that cultural distance is not a myth, when considered in an organizational context, but that the mythology may need to be reconceived.

## Background and Research Hypothesis

### Culture, Cultural Dimensions, and Egalitarianism

The social sciences conceptualize culture as a society's system of shared values, beliefs, norms, and symbols. This framework traces its intellectual roots to iconic figures like Weber (1904–1905) and Durkheim (1915), and it permeates contemporary institutional and organizational theory (e.g., DiMaggio 1994; Meyer and Rowan 1977; Guillén 1994, 2001; Holburn and Zelner 2010). A broad research program in the social sciences suggests how to identify and measure national cultures. The central postulate of this approach is that all societies confront similar basic problems or challenges when they come to regulate human activity (Kluckhohn and Strodtbeck 1961). Societies' responses to these basic challenges constitute their fundamental institutions, and analysis of these challenges points to dimensions on which cultures can be compared.

Dimensional theories of culture identify these key challenges, and we leverage the theory advanced by S. H. Schwartz (1994, 1999, 2004) to derive and test specific hypotheses. Though earlier frameworks remain useful,<sup>3</sup> the Schwartz framework is currently considered the more advanced in cross-cultural psychology (Smith et al. 2006), because it affords a variety of advances: (a) It derives cultural orientations from a priori theorizing. (b) It designates a priori the value items that serve as markers for each orientation. (c) It uses only items tested for cross-cultural equivalence of meaning as measures. (d) It includes a set of items demonstrated to cover the range of values recognized cross-culturally—a step toward ensuring relative comprehensiveness of cultural value dimensions. (e) It specifies how different cultural orientations are organized in a system of related dimensions and has verified this organization. And (f) it demonstrates empirically that the order of national cultures on each of the orientations is robust across different types of samples from each of a large number of nations (S. H. Schwartz 2004).

Our focal cultural orientation is *egalitarianism*, defined as "the belief that all people are of equal worth and should be treated equally in society" (N. L. Schwartz 2001, p. 65). Egalitarianism is a polar position in the egalitarianism/hierarchy dimension of S. H. Schwartz (2004), which specifies a society's orientation with respect to legitimate modes of exerting power. A culture's relative emphasis on egalitarianism is expressed in numerous aspects of life that involve the use (and abuse) of power and authority in the political arena, the marketplace, and organizations. More generally, this dimension addresses the basic societal challenge of guaranteeing that people behave in a responsible manner that preserves the social fabric, performs the productive work necessary to maintain society, and manages their unavoidable interdependencies. Egalitarianism seeks to

induce people to recognize one another as moral equals who share basic interests as human beings: people are socialized to internalize a commitment to cooperate and to feel concern for everyone's welfare. Important values in such cultures include equality, social justice, responsibility, help, and honesty. The polar alternative, *hierarchy*, relies on hierarchical systems of ascribed roles; it defines the unequal distribution of power, roles, and resources as legitimate and even desirable. Social power, authority, humility, and wealth are important values in hierarchical cultures.

Power processes stand at the core of our theory. Power is ubiquitous in social interactions, and the exercise of power is thus a key issue in numerous contexts (e.g., Bourdieu 1973). Neoinstitutionalists thus care about how "legitimate coercion," or the use of an actor's authority, leads others to adopt a practice or behavior (Scott 1987, p. 502; 2001). Informal norms about exercising power are likely to apply to the full gamut of a firm's stakeholders (Freeman 1984). Social actors—both organizations and individuals—draw on these norms for guidance on acceptable modes of behavior vis-à-vis weaker counterparts, including employees, customers, suppliers, and smaller competitors, and vis-à-vis powerful counterparts such as government officials. The ubiquity and, indeed, the diffuse nature of the concept of power led March (1988, p. 6) to assert that power is "a disappointing concept. It tends to become a tautological label for the unexplained variance." Utilizing the theoretically driven and empirically validated concept of egalitarianism allows us to avoid this trap and to deal in a disciplined way with differences in the ways organizations wield power and societies regulate its use.

A few points about operationalizing egalitarianism deserve notice. First, evidence suggests that cross-national differences in cultural orientation dominate differences at subnational levels, e.g., between religious groups within a country (Inglehart and Baker 2000) and between geographically distant regions in large countries such as the United States and China (S. H. Schwartz 2004). Legal institutions also relate to the national level. This evidence points to countries as the appropriate level of analysis, as well as to populations of MNEs as actors whose FDI patterns should be studied (e.g., Schnepfer and Guillén 2004). Second, emphasis on egalitarianism may vary among societal subgroups. For instance, members of the corporate elite in a given society might endorse hierarchical values more than, say, minimum-wage earners. Using matched samples to assess cross-cultural differences may thus have an advantage over heterogeneous (including representative) samples. As noted, S. H. Schwartz (2004) further confirmed that such differences hold across sample types. Third, the hierarchy pole of the egalitarianism/hierarchy dimension exhibits some overlap with Hofstede's concept of power distance, in that both

dimensions deal with social inequality. However, fundamental differences between the two concepts make power distance unsuitable for our analysis. Power distance refers to acceptance of inequality on the part of less powerful actors. Fear of authority is pivotal to power distance. According to Hofstede (2001, p. 53), "The question 'How frequently are employees afraid to express disagreement with their managers?' was chosen as a central question measuring power distance." This item—and two related questions—constituted the power-distance index. In contrast, the egalitarian/hierarchy dimension addresses a different issue. Hierarchy does not imply fear of authority on the part of ordinary people. Hierarchical systems of ascribed roles derive their legitimacy from their capacity to ensure responsible behavior; egalitarianism emphasizes individuals' willingness to internalize commitments to the welfare of others and to cooperate voluntarily with them. These key elements of egalitarianism are absent from low power distance.<sup>4</sup>

Furthermore, both antecedents and consequences of egalitarianism are conceptually remote from power distance. At least two of the exogenous factors that predict egalitarianism levels—namely, national war experience that may foster an ethos of "equality of sacrifice" (Wilensky 1975, p. 71) and societal fractionalization that may weaken the view of all societal members as moral equals—are conceptually unrelated to power distance. At the organizational level, power distance has been shown to relate to centralized decision making in organizations (Bloom et al. 2012). Egalitarianism, however, does not express a societal aversion to centralized decision making; instead, it calls for mitigating any inequities that centralized or decentralized organizations may engender. Siegel et al. (2011) thus show that higher egalitarianism correlates with the existence of laws providing greater benefits to weaker members of society. As we will show, we consistently find that organizations distribute their product more equally in more egalitarian countries. Moreover, we found egalitarianism—possibly because of its better measurement and its reflection of a societal attitude toward market power—to be economically and statistically significant in explaining FDI flows, whereas power distance is not.

### Causes and Consequences of Egalitarianism

Cultural stances on egalitarianism are largely determined by historical factors dating back a century or more. In our sample of countries, we found approximately half of the variance in egalitarianism to be predicted by exogenous factors. Societal fractionalization, whether consequent to historical divisions in ethnicity, language, or religion, is an ecological variable inimical to cultural egalitarianism. Members of fractionalized societies are less likely to promote others' welfare voluntarily, leading to lower expenditures on public goods (Alesina and



La Ferrara 2005). Among the world's large religious denominations, Catholicism and Protestantism have been associated with political movements that promoted egalitarian values at least since the late 19th century (Irving 1979, Hanley 1994). Christian Democratic parties in both Europe and Latin America endorsed social personalism (Fogarty 1957), whereby the community shares an obligation to protect the individual from the abuses of capitalism. Today, countries whose dominant religion has historically been Catholicism or Protestantism score significantly higher on egalitarianism.

Countries' war histories also influence the development of egalitarianism. Wars, especially those fought during the era of state formation in the 19th century, often required the expansion of rights that promoted national solidarity (e.g., Holsti 1991, Tilly 1993). When the very formation or survival of the state required sacrifice from the lower classes, elites have been persuaded to broaden social and political rights to build a so-called equality of sacrifice (Wilensky 1975). Higher levels of egalitarianism today are associated with the number of wars a country fought during the 19th century, the number of days it spent at war during that century, and the number of military deaths it sustained in wars (Siegel et al. 2011).

Finally, we instrument egalitarianism with a variable for a history of communist rule. Experienced in most countries as an exogenous shock, the adjustment to living conditions under communist totalitarian rule was analogized by Kohak (1992) to long-term prisoners' adaptation to jail: people develop a set of skills and attitudes that enable them to live reasonably under the circumstances. One prominent feature of life under communist regimes is a ubiquitous close surveillance of words and deeds. Compliance is often enforced by informants, diminishing the prevailing level of interpersonal trust (Marody 1988, Nowak 1988). This scenario may in turn undermine egalitarian values that call for voluntary commitment to the welfare of others (S. H. Schwartz et al. 2000). If others cannot be trusted, a commitment to their welfare is foolhardy at best and self-destructive at worst—in direct contradiction to communist principles.

Egalitarianism relates to a broad set of conceptually compatible policy outcomes at the institutional level that curb abuses of economic and political power. Thus egalitarianism is correlated with higher levels of social redistribution to the weak, the unemployed, and the elderly, and with greater legal protections for workers; it also correlates with lower levels of corruption, regulation prescribing greater financial transparency, and more effective anti-monopoly regulation and enforcement (Siegel et al. 2011). At the individual level of analysis, research shows that managers in hierarchical societies tend to believe that status or power differences justify different rules for different people. Such managers more frequently invoke their status, power, or authority as a

means to force concessions from negotiation partners (Brett 2001, Tinsley 2001).

### Organizations and Cultural Egalitarianism

The relationship between cultural egalitarianism and organizational features is more complex. As yet, there is no agreed-upon theory of cultural dimensions for comparing organizations' values. Cameron and Quinn (1999) developed a "competing values framework" to describe four types of organizational cultures, but they did not consider the impacts of the surrounding culture; a meta-analysis has called this theory into question (Hartnell et al. 2011).<sup>5</sup> Organizational practices—e.g., the use of uniforms (Trice and Beyer 1993, see also Kirkland and Shapiro 1997)—have thus been linked to national culture, but in the absence of an underlying theory of cultural dimensions, such practices can support different interpretations. In accordance with the neoinstitutional view of organizations as entities nested within societies—and hence within the institutional environment—cross-cultural psychologists advance similar accounts (e.g., Hofstede and Peterson 2000, Sagiv and Schwartz 2007). Here, we advance an integrated account that theorizes concretely about issues at the organizational level but also looks beyond idiosyncratic examples to address a general strategic challenge that all organizations face—namely, handling their relations with stakeholders.

It stands to reason that organizations in more egalitarian cultures practice greater sharing of resources; doing so reflects a view of all corporate constituencies as moral equals. Resources may be material, such as compensation or benefits; they may be notional, such as information about the firm. In either case, possession of and control over resources makes individuals or organizations more powerful. Of particular interest are organizational practices that result from managerial discretion rather than legal compliance, notably interactions with nonfinancial stakeholders such as labor and the community that are less regulated and thus more amenable to social pressure. For instance, less egalitarian compensation structures are characterized by more payment levels and greater differentials between levels (Grol and Schoch 1998, Milkovich and Newman 2011). Siegel and Larson (2009) showed that Lincoln Electric, the famous Ohio-based maker of arc-welding equipment, faced greater difficulty implementing its successful pay scheme, which relied heavily on piecework and discretionary bonuses, in more egalitarian countries. Regulations in more egalitarian countries directly limit the use of such pay practices, as well as guarantee uniform entitlement to leaves and other benefits regardless of workers' productivity.

To motivate our hypothesis on cultural distance, we first illustrate the relations between home-country

**Table 1** Egalitarianism and Associated Organizational Features

Panel A: Pairwise correlations										
Variable label	Description									[1]
[1]	Egalitarianism (countries' scores on the Schwartz cultural egalitarianism orientation). Source: 2005 release of Schwartz cultural values data set (see the online appendix).									1
[2]	The ratio of (CEO hourly wage/Average production worker hourly wage) (national average for 2006 (21 countries). Source: Fernandes et al. (2011) for CEO compensation; U.S. Bureau of Labor Statistics for worker wage).									−0.63***
[3]	The ratio of (CEO hourly wage/Average production worker hourly wage) (National averages for 1997–2007 (23 countries)). Source: Boardex database for CEO compensation; U.S. Bureau of Labor Statistics for worker wage).									−0.37***
[4]	Severity of controversies related to a firm's executive compensation and governance practices, including involvement in compensation-related legal cases, intrafirm objections, and extrafirm criticism by NGOs or other observers (national average for 2010–2011 (37 countries)). Source: KLD (Socrates).									0.40**
[5]	Company claims to provide flexible working hours or working hours that promote work-life balance (national averages for 2002–2010 (43 countries)). Source: Datastream (ASSET4 database).									0.27***
[6]	ASSET4's social performance score (measure of a company's capacity to generate trust and loyalty with its workforce, customers, and society through best management practices) (national averages for 2002–2010 (43 countries)). Source: Datastream (ASSET4 database).									0.36***
[7]	Number of CSR reports divided by the mean total population in millions (national averages for 1995–2007 (31 countries)). Source: Dhaliwal et al. (2011).									0.39**
[8]	Company reports using or has been shown to use human rights criteria in the selection or monitoring process of its suppliers or sourcing partners (national averages for 2002–2010 (43 countries)). Source: Datastream (ASSET4 database).									0.29***
[9]	Company reports or has been shown to be ready to end a partnership with a sourcing partner if human rights criteria are not met (national averages for 2002–2010 (43 countries)). Source: Datastream (ASSET4 database).									0.34***
[10]	Impact Monitor's Human Rights Management score considers management policies on a company's impact on local communities and freedom of expression (national averages for 2010–2011 (26 countries)). Source: Impact Monitor database.									0.58***

Panel B: Regression analyses											
Dependent variable:		DV: Log(production worker compensation/subsidiary value-added)									
Independent variable:		[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]	[10]
Host country egalitarianism level											
Excluded outliers: (production worker compensation/subsidiary value-added) > 0.25; < 2 production workers		0.208*** [0.068]	0.239*** [0.071]	0.170** [0.082]	0.192** [0.083]						
Excluded outliers: (production worker compensation/subsidiary value-added) > 0.5; < 2 production workers						0.189*** [0.057]	0.232*** [0.059]				
Excluded outliers: (production worker compensation/subsidiary value-added) > 0.75; < 2 production workers								0.214*** [0.056]	0.259*** [0.058]		
Excluded outliers: (production worker compensation/subsidiary value-added) > 1.0; < 2 production workers										0.205*** [0.057]	0.250*** [0.059]
Controlling for log sales, corporate tax rate in the host country, subsidiary's fixed asset intensity, subsidiary's leverage, subsidiary's export intensity, subsidiary's R&D intensity, multinational parent's gross margin, multinational parent's fixed-asset intensity, multinational parent's leverage, and multinational parent's R&D intensity		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Controlling for statutory protection of labor union power and protection for workers during collective disputes (Source: Botero et al. 2004)		No	Yes	No	Yes	No	Yes	No	Yes	No	Yes
Controlling for multinational parent fixed effects		No	No	Yes	Yes	No	No	No	No	No	No
Clustering at the subsidiary level		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
P-value		0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
No. of observations		3.360	3.355	3.360	3.355	5.792	5.786	6.552	6.545	6.834	6.827
R-squared		0.082	0.085	0.115	0.116	0.080	0.085	0.059	0.063	0.041	0.045

Notes. This table presents relations between egalitarianism and associated organizational features. Robust standard errors are in parentheses. CRS, corporate social responsibility; R&D, research and development. \*\*\*Significant at the 1% level; \*\*significant at the 5% level; \*significant at the 10% level.

cultural egalitarianism and firm-level practices vis-à-vis nonfinancial stakeholders. Panel A of Table 1 first explores these relations via a novel set of correlations between egalitarianism and employment practices. The data, described more fully in the Data section, consist of firm-level observations that we aggregated and averaged to create measures of social norms. We find that firms in more egalitarian countries pay their CEOs a lower multiple of the average worker's pay. Such firms are also more likely to face objections and outside criticism on employment issues and to adopt employee-favoring policies, suggesting the existence of mechanisms through which the informal social environment influences organizations to comply with cultural values. Panel A also presents a positive correlation between home-country egalitarianism and the scope of firms' nonfinancial (CSR) disclosure. To isolate the social norm component of disclosure, we separately confirmed that this correlation is robust to an index of social disclosure laws drawn from Dhaliwal et al. (2011). We also present positive correlations between egalitarianism and organizational practices that consider human rights in the process of selecting or terminating suppliers or sourcing partners and that take the general community into consideration more generally, indicating culturally consistent relations with broader stakeholders.

Panel B of Table 1 provides a more in-depth analysis of the link between egalitarianism and organizational pay practices, with examples from an extensive set of regressions of firm-level data on U.S. MNEs' international subsidiaries. Using stringent specifications that control for multiple variables, we find that these subsidiaries pay production workers a greater share of their value-added the more egalitarian the host country.<sup>6</sup> No country to our knowledge regulates the share of firm value-added paid to employees, but legal protections for unionized labor might enable workers to extract a larger share of the value-added. We therefore control for such legal protections and find that the coefficient for egalitarianism only becomes more pronounced. The exploratory findings in panels A and B of Table 1 reinforce one another in supporting the intuition that organizations respond to the surrounding culture in a conceptually consistent way. In tandem, these findings set the stage for our hypotheses by highlighting the question of whether firms that make a strategic expansion abroad can adjust fully to the culture of any destination country.

### Hypothesis

Our hypothesis focuses on differences in cultural egalitarianism as an impediment to a firm's entry into international markets via FDI. To fully leverage its relative advantage in a foreign market, a firm must decipher local institutions and norms pertinent to power relations with stakeholders, many of which are informal. It is unlikely to be enough for the firm to acquaint itself with

local laws and adhere to them. Given their prior cultural embeddedness in their home-country institutional environment, MNEs may find it difficult to adjust to a host country's unwritten, unspoken rules of the game.

Our research hypothesis on egalitarianism distance focuses on sheer distance, whatever the direction of entry on the egalitarianism/hierarchy dimension. This hypothesis is motivated by the view that implementing organizational practices in several national institutional environments is likely to be costly (Kogut 2004, Kostova 1999). Certain costs will stem from the need to adjust firm practices to local regulations, which may entail legal expenses and the like. Such costs become more worrisome, however, to the extent that they restrict the firm's ability to leverage its relative advantage in the destination market. Holburn and Zelner (2010) show that MNEs do not necessarily prefer destination markets characterized by lower policy risk—that is, the risk of unchecked exercise of political power to expropriate value from MNEs. Instead, they prefer markets institutionally similar to those of the firm's home country. Such institutional proximity enables firms to leverage political capabilities developed at home to handle similar challenges abroad (see Habib and Zurawicki 2002). Interestingly, Holburn and Zelner (2010) show that MNEs' ability to capitalize on their homegrown political capabilities to cope with policy risk associates positively with the level of home-country ethnic fractionalization—a finding largely in line with our theory and evidence on societal fractionalization and egalitarianism.<sup>7</sup>

Stated more generally, organizational practices that have been optimized in a home market subject to isomorphic pressures (Zucker 1977, DiMaggio and Powell 1983, Wuthnow et al. 1984) may not be fully transferable to interactions with firm stakeholders abroad, thus blunting the firm's competitive edge. Incompatibility with prevailing institutions may entail vulnerability to the vagaries of the market (Meyer and Rowan 1977) and may lessen the organization's probability of survival because of reduced legitimacy (Zucker 1987, Ingram and Yue 2008). Because institutions are value-laden, organizations may refuse, on principled grounds, to comply with foreign institutions that reflect extremely different values (cf. Simons and Ingram 2003, Freeman and Audia 2006). Since egalitarianism is linked to a broad array of institutions that govern the exercise of power in relations with corporate stakeholders—including employees, financial stakeholders, competitors, and governments—distance on this dimension is likely to be especially burdensome for foreign entry. Hence,

**HYPOTHESIS 1.** *Egalitarianism distance relates negatively to FDI flows.*

Within the vast scholarship on cultural distance, most studies have examined sheer distance; few have looked at institutional settings in home or host countries or at



directional cultural distance (Shenkar 2001, Datta et al. 2002, Harzing 2004). Erramilli (1996) thus argues that firms whose home countries exhibit high power distance prefer foreign-entry modes characterized by higher levels of ownership. Egalitarianism's pervasive effect on numerous aspects of life suggests several theoretical predictions that appear to be equally plausible but may be practically opposite. On the one hand, roots in a more hierarchical culture may equip an entrant with the internal mechanisms and motivation to wield power more boldly and thus to attain a competitive advantage over, if not to overwhelm, its stakeholders. By focusing less on social justice—a central value in egalitarianism—such organizations may be able to gain more economically. On the other hand, roots in a more hierarchical country may make the entrant ill-equipped to play on a more level playing field. More stringent transparency requirements, greater resource sharing with more constituencies, and generally higher expectations for fairness and equality may be cumbersome for entrants accustomed to unquestioning obedience and deference. Thus, though prior commentators have stressed the importance of directional distance, theoretical reasoning can cut both ways. We therefore conduct directional analyses of cultural distance without proposing formal hypotheses.

## Data

### Dependent Variables

We examine the choices of organizational populations (Ingram and Simons 2000, Simons and Ingram 2003) about the scope of their expansion to different international destination markets by looking at their aggregate foreign direct investment decisions. To assess their choices of host countries for FDI, we employ, as a dependent variable, the natural logarithm of FDI flows. Data on FDI flows come from the United Nations Conference on Trade and Development (UNCTAD) and the Organization for Economic Co-operation and Development (OECD); the data cover the years 1970–2004, although the majority of observations originate after 1990. Because UNCTAD and OECD both capture data from governments, their data for the years 1985–2004 are consistent. For the years prior to 1985, our source is UNCTAD. We found cases during 1985–2004 in which one organization collected data from a government while the other did not, and vice versa; we therefore combined the data sources.<sup>8</sup> Because the data are sharply skewed, we rely principally on the natural logarithm of ( $FDI\ flows + 1$ ).

### Cultural Distance

Cultural distance on the Schwartz dimensions is computed using country scores from the Schwartz value survey, which was conducted largely during the 1990s (for a detailed description, see S. H. Schwartz 2004;

for data, see the online appendix tables at <http://dx.doi.org/10.1287/orsc.1120.0776>). For every pair of countries, we constructed a measure of sheer distance as being the square of the difference between the countries' scores on an orientation.<sup>9</sup> We also constructed a measure of signed distance as being the algebraic difference between the score for the investing firm's country of origin minus the score for the host country.

To control for potential endogeneity of egalitarianism, we use social fractionalization, dominant religion, 19th-century war experience, and communist-rule history as instrumental variables. We separately confirmed the validity of the instruments and the robustness of our results. We expand the scope of the cultural distance analysis by running robustness tests with cultural data drawn from Hofstede (2001) and Project GLOBE (House et al. 2004), whose dimensions draw on Hofstede's work. We also use a more recent measure of power distance derived from the World Values Survey by Berry et al. (2010).

### Controlling for Legal Differences

In light of evidence that legal family affiliation is a powerful predictor of financial development—and other policy outcomes (La Porta et al. 2008)—we control for legal family. A dummy is set equal to 1 when home and host countries belong to different legal families. Following Siegel et al. (2011), we began with the data on legal origin reported in La Porta et al. (1999) and then surveyed changes in civil and commercial codes in former socialist countries. We also take into account national differences in the rule of law, which encompasses legality, law and order, protection of property rights, and other dimensions. There are many overlapping measures on the rule of law. We use the index from the World Bank's 1998 governance indicators data set to construct distance measures for this institution (see Kaufmann et al. 2003, Globerman and Shapiro 2005, Antràs et al. 2007).

Among the many laws and regulations that MNEs need to comply with, we focus on environmental regulation—a major bone of contention in policy debates over FDI. MNEs are often accused of engaging in regulatory arbitrage on environmental regulations, thus enriching home-country investors while depleting host countries' resources. Although environmental regulation is not applicable to all industries, substantial FDI is concentrated in potentially polluting manufacturing industries. The "Pollution Haven Hypothesis" postulates that MNEs will flock to jurisdictions whose environmental protection regimes are less stringent and therefore less costly to comply with. The "race to the bottom" thesis refers to the fear that jurisdictions will vie for FDI inflows by weakening their environmental protection to socially suboptimal levels. The evidence on this subject is decidedly mixed (see Jeppessen et al. 2002 for a summary and meta-analysis).



We operationalize differences between countries' environmental regulation regimes using Esty and Porter's (2001) Environmental Regulatory Regime Index (ERRI). The ERRI reflects the stringency of national environmental regulation as perceived by experts. This time-invariant index encompasses the stringency of standards, strictness of enforcement, and the quality of environmental institutions. We also use the 2010 Environmental Performance Index (EPI), a measure of the performance of countries' environmental policies compiled by the Yale Center for Environmental Law and Policy and the Center for International Earth Science Information Network at Columbia University. Its title notwithstanding, this index too is time invariant; it aggregates data from different time points during the 2000s.

### Additional Variables

To demonstrate the relations between egalitarianism and organizational practices, we use national averages of several firm-level variables pertaining to employees and the larger community. We use variables that operationalize hard data as well as scores constructed by experts that cover firms from around the world, such as Boardex, KLD (Socrates), Datastream (ASSET4), and Impact Monitor. From the U.S. Bureau of Labor Statistics, we obtain data on worker wage; from Fernandes et al. (2011), we obtain data on CEO compensation. From the U.S. Bureau of Economic Analysis, we obtain data on production worker compensation and value-added, which conceptually can be viewed as sales minus the cost of purchased inputs, in foreign subsidiaries of U.S.-based MNEs in 1994 and 1999.<sup>10</sup> We use data on CSR reporting from Dhaliwal et al. (2011) and data on statutory protections to unionized labor from Botero et al. (2004).

For the analysis of cultural harmony and entrepreneurship, we control for differences in entrepreneurship between countries using several measures. Alfaro and Charlton (2006) have pointed out the difficulty of starting a business in a country dominated by older and larger firms. Skewness in the firm-age distribution and skewness in the firm-level employment-size distribution are therefore also useful measures, because a country with a higher skewness in firm age or employment size is more heavily dominated by older and/or larger firms. Our main data are based on Alfaro and Charlton (2006), who used the WorldBase data set for 1999. For robustness tests, we use data from the World Bank Group Entrepreneurship survey (Klapper et al. 2010) and from the New Business Activity Index of the Global Entrepreneurship Monitor (GEM) (Minniti et al. 2005). The latter, a survey-based index, reflects the population share of "new owners"—those reporting that they are owner-managers of new firms that have paid wages or salaries for more than 3 months but less than 42 months. To maximize country coverage, we use 2005 data.

We also consider a range of economic, geographic, and institutional variables. To take economic variables into account, we use the log product of origin country gross domestic product (GDP) and host country GDP, as well as the log product of both countries' per-capita GDP. We control for wealth distance and signed wealth distance by taking the squared difference of log GDP per capita for each country-pair-year. Then we take the signed wealth distance by subtracting the log GDP per capita for the host country from the log GDP per capita for the origin country in the same year. Data on GDP and GDP per capita are in 2000 constant U.S. dollars, drawn from the World Development Indicators.

We control for the role of corporate tax rate differences (see Hines 1999, Desai et al. 2007) with data from the World Tax Database of the University of Michigan Office of Tax Policy Research (OTPR). We take the origin country's top corporate statutory tax rate and subtract from it the host country's top corporate statutory tax rate. Because these corporate tax data are available only through 2002, we augment them with corporate tax data for 2003–2004 from the original source of the data, the Center for International Trade and Economics at the Heritage Foundation.

To control for the effect of bilateral treaties designed to avoid double taxation (see Davies 2004), we create a dummy for the existence of a bilateral tax treaty for every country-pair-year observation. We obtain data on bilateral tax treaties from the University of Michigan OTPR. We control for the effect of bilateral investment treaties (BITs) using data from UNCTAD (see UNCTAD 2009). A dummy variable is set to 1 if a BIT was signed or enforced for every country-pair-year observation or 0 otherwise.

To control for instability, we use Henisz's political constraints index (POLCONIII; see Henisz 2000, 2006). This measure estimates the feasibility of policy change as the extent to which a change in the preferences of any single political actor may lead to a change in government policy. Specifically, we take the squared distance between origin-country-year and host-country-year observations. We also test for competing effects of government intervention in the economy using Visser's (2009) measure, which follows Hall and Soskice (2001), and for democracy distance using the distance between each pair of countries on their polity score (Marshall and Jaggers 2009). Finally, we control for countries' heritage with indicator variables for whether two countries share a common colonizer or a common language and for the role of geographic distance by taking the log of minimum geographic distance between all pairs of countries.

### Model

To test our hypotheses, we harness a gravity equation model, which has long been the workhorse in international trade studies; over the last decade, it has

made inroads into FDI studies too. The gravity equation reflects the intuition that bilateral economic flows relate positively to the size of the economies in question and negatively to the distance between them (Kleinert and Toubal 2010). More recent applications of the gravity equation add social measures of distance—language, politics, corruption, and the like—to basic geographical distance, on the assumption that such distance hinders FDI flows (see Zwinkels and Beugelsdijk 2010 for references). In our primary specification, we estimate the following ordinary least squares (OLS) regression for country-pair-years during 1970–2004:

$$\begin{aligned} \text{Log}(\text{FDI flows} + 1)_{ijt} &= \beta_0 + \beta_1 * \text{Egalitarianism distance}_{ijt} \\ &+ \beta_2 * \text{Signed egalitarianism distance}_{ijt} \\ &+ \beta_3 * \text{Harmony distance} \\ &+ \beta_4 * \text{Signed harmony distance} \\ &+ \beta_5 * \text{Embeddedness distance} \\ &+ \beta_6 * \text{Signed embeddedness distance} \\ &+ \beta_7 * \text{Log product of origin–host GDP}_{ijt} \\ &+ \beta_8 * \text{Log product of origin–host GDP per capita}_{ijt} \\ &+ \beta_9 * \text{Signed corporate taxation distance}_{ijt} \\ &+ \beta_{10} * \text{POLCONIII distance}_{ijt} \\ &+ \beta_{11} * \text{Common language}_{ijt} \\ &+ \beta_{12} * \text{Common colonizer}_{ijt} \\ &+ \beta_{13} * \text{Geographic distance}_{ijt} \\ &+ \beta_{14} * \text{Different legal family}_{ijt} \\ &+ \beta_{15} * \text{Rule of law distance}_{ijt} + \varepsilon_{ijt}, \end{aligned}$$

where the log of origin–host pair  $ij$ 's log of ( $\text{FDI flows} + 1$ ) in year  $t$  is determined by egalitarianism distance, signed egalitarianism distance, harmony distance, signed harmony distance, embeddedness distance, signed embeddedness distance, the log product of origin–host GDP, the log product of origin–host GDP per capita, corporate taxation distance, POLCONIII distance, common language, common colonizer, geographic distance, different legal family, and rule of law distance. For all models we cluster the standard errors at the origin–host country pair level.

## Results

After a discussion of some preliminary tests, the first subsection presents the results for egalitarianism distance and FDI flows and discusses the robustness of egalitarianism distance to possible effects from a variety of other institutions, including legal and cultural dimensions. The second subsection then discusses in detail the impact of distance along the cultural dimensions.

### Egalitarianism Distance

Summary statistics and a correlation matrix appear in Tables 2 and 3. There is little likelihood that collinearity is a problem for our primary variable of interest, egalitarianism distance. There is more collinearity between other control variables (e.g., common language and common colonizer) and other cultural distance measures. In any event, we confirm that the results for egalitarianism distance are substantively similar with and without the inclusion of all of these control variables.

Table 4 presents the main egalitarianism results. Egalitarianism distance is negatively associated with FDI flows, in line with Hypothesis 1. This variable is highly significant statistically across a wide range of specifications. Predicted egalitarianism distance (that is, based on

**Table 2 Summary Statistics**

Variable	Descriptive statistics				
	Mean	Std. dev.	Min	Max	No. of obs.
[1] Log( $\text{FDI flows} + 1$ )	1.152	2.105	0.000	11.595	42,783
[2] <i>Egalitarianism distance</i>	0.171	0.212	0.000	1.297	42,783
[3] <i>Signed egalitarianism distance</i>	−0.008	0.413	−1.139	1.139	42,783
[4] <i>Harmony distance</i>	0.272	0.343	0.000	2.411	42,783
[5] <i>Signed harmony distance</i>	−0.004	0.521	−1.553	1.553	42,783
[6] <i>Embeddedness distance</i>	0.295	0.383	0.000	2.720	42,783
[7] <i>Signed embeddedness distance</i>	0.006	0.543	−1.649	1.649	42,783
[8] <i>Log product of origin–host GDP</i>	51.338	2.368	43.708	59.234	42,783
[9] <i>Log product of origin–host GDP per capita</i>	17.636	1.754	11.078	21.133	42,783
[10] <i>Signed corporate taxation distance</i>	0.099	11.497	−53.000	53.000	42,783
[11] <i>POLCONIII distance</i>	0.060	0.086	0.000	0.476	42,783
[12] <i>Common language</i>	0.080	0.271	0.000	1.000	42,783
[13] <i>Common colonizer</i>	0.120	0.325	0.000	1.000	42,783
[14] <i>Geographic distance</i>	8.637	0.960	4.127	9.895	42,783
[15] <i>Different legal family</i>	0.720	0.449	0.000	1.000	42,783
[16] <i>Rule of law distance</i>	2.099	2.380	0.000	9.710	42,783

Table 3 Pairwise Correlation Matrix

Variable	[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]	[10]	[11]	[12]	[13]	[14]	[15]
[1] Log(FDI flows + 1)	1														
[2] Egalitarianism distance	−0.097***	1													
[3] Signed egalitarianism distance	0.098***	−0.014***	1												
[4] Harmony distance	−0.039***	0.268***	0.010**	1											
[5] Signed harmony distance	0.027***	0.001	0.560***	−0.010	1										
[6] Embeddedness distance	−0.084***	0.142***	0.008	0.079***	0.006	1									
[7] Signed embeddedness distance	−0.158***	0.006	−0.562***	−0.005	−0.496***	0.005	1								
[8] Log product of origin–host GDP	0.495***	0.029***	0.022***	−0.030***	0.023***	−0.099***	−0.007	1							
[9] Log product of origin–host GDP per capita	0.394***	−0.151***	0.034***	−0.027***	0.026***	−0.083***	−0.036***	0.482***	1						
[10] Signed corporate taxation distance	0.001	0.005	−0.020***	−0.002	−0.077***	−0.005	−0.020***	−0.011**	−0.029***	1					
[11] POLCON111 distance	−0.087***	0.176***	−0.006	0.086***	−0.003	0.195***	−0.004	−0.056***	−0.215***	0.006	1				
[12] Common language	0.057***	−0.101***	0.007	−0.093***	0.000	−0.112***	−0.006	0.003	−0.064***	−0.006	−0.040***	1			
[13] Common colonizer	0.036***	−0.109***	0.005	−0.142***	0.000	−0.037***	−0.001	−0.060***	−0.056***	−0.006	−0.005	0.627***	1		
[14] Geographic distance	−0.274***	0.098***	−0.015***	0.091***	0.005	0.019***	0.005	−0.011**	−0.225***	0.008	0.154***	0.057***	0.071***	1	
[15] Different legal family	−0.058***	0.056***	0.006	0.156***	−0.008*	0.010**	−0.008*	0.014***	0.109***	0.002	0.018***	−0.378***	−0.506***	0.054***	1
[16] Rule of law distance	−0.120***	0.144***	0.014***	−0.048***	0.009*	0.326***	−0.022***	−0.048***	−0.194***	−0.010**	0.194***	0.015***	−0.056***	0.184***	0.113***

\*\*\*Significant at the 0.01 level; \*\*significant at the 0.05 level; \*significant at the 0.10 level.

**Table 4** Egalitarianism and FDI Flows

Independent variable	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
<i>Egalitarianism distance</i>	−0.611*** [0.111]	−0.402*** [0.115]			−0.112*** [0.027]	−0.216*** [0.048]	−2.222*** [0.827]	−2.111*** [0.789]
<i>Signed egalitarianism distance</i>	0.162** [0.074]				−0.070* [0.038]	−0.118** [0.056]	0.626 [0.409]	0.347 [0.412]
<i>Predicted egalitarianism distance</i>			−0.931*** [0.188]	−1.175*** [0.423]				
<i>Boardex CEO-to-average-worker-pay distance</i>								−2.93e-06 [3.53e-06]
<i>Signed boardex CEO-to-average-worker-pay distance</i>								−0.005*** [0.001]
<i>Harmony distance</i>	0.161** [0.069]	0.130* [0.076]	0.112 [0.075]	−0.461* [0.26]	0.078** [0.033]	0.141** [0.064]	−0.416*** [0.158]	−0.425*** [0.160]
<i>Signed harmony distance</i>	−0.376*** [0.056]				−0.159*** [0.035]	−0.041 [0.061]	−0.757*** [0.178]	−0.640*** [0.181]
<i>Embeddedness distance</i>	−0.052 [0.060]	−0.409*** [0.069]	−0.358*** [0.071]	0.088 [0.228]	0.010 [0.025]	0.337*** [0.093]	1.665*** [0.398]	1.690*** [0.394]
<i>Signed embeddedness distance</i>	−0.688*** [0.052]				−0.155*** [0.043]	−0.225** [0.093]	−0.959*** [0.239]	−0.786*** [0.249]
<i>Log product of origin–host GDP</i>	0.389*** [0.015]	−1.962*** [0.174]	−2.011*** [0.173]	0.695 [0.650]	1.157*** [0.046]	1.619*** [0.080]	1.121*** [0.046]	1.123*** [0.046]
<i>Log product of origin–host GDP per capita</i>	0.147*** [0.016]	2.557*** [0.168]	2.566*** [0.168]	0.786 [0.655]	0.319*** [0.042]	0.357*** [0.136]	−0.070 [0.188]	−0.099 [0.199]
<i>Signed corporate taxation distance</i>	3.359E-04 [0.002]	0.003** [0.001]	0.003** [0.001]	0.008*** [0.003]	0.027 [0.025]	−0.083* [0.043]	−0.037*** [0.010]	−0.034*** [0.010]
<i>POLCON/III distance</i>	0.397* [0.232]	0.090 [0.244]	0.120 [0.238]	−1.532** [0.748]	0.047* [0.024]	0.114 [0.105]	2.303 [1.750]	2.275 [1.749]
<i>Common language</i>	0.249* [0.136]	0.257** [0.113]	0.253** [0.112]	0.307 [0.363]	0.030 [0.036]	0.052 [0.092]	−0.192 [0.450]	−0.176 [0.448]
<i>Common colonizer</i>	0.298*** [0.109]	0.065 [0.090]	0.069 [0.090]	−0.154 [0.322]	0.129*** [0.036]	0.341*** [0.092]	1.157** [0.451]	1.170*** [0.452]
<i>Geographic distance</i>	−0.526*** [0.029]	−0.570*** [0.036]	−0.565*** [0.035]	−0.891*** [0.076]	−0.542*** [0.032]	−0.700*** [0.043]	−0.971*** [0.084]	−0.978*** [0.084]
<i>Different legal family</i>	−0.141** [0.062]	−0.152*** [0.047]	−0.133*** [0.048]	−0.275*** [0.096]	−0.089*** [0.030]	−0.053 [0.057]	0.020 [0.282]	0.033 [0.283]



**Table 4 (cont'd)**

Independent variable	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
<i>Rule of law distance</i>	−0.017 [0.010]	−0.034*** [0.010]	−0.038*** [0.010]	−0.141*** [0.047]	0.105*** [0.038]	0.261 [0.222]	−0.446*** [0.145]	−0.448*** [0.143]
<i>Visser government intervention distance</i>						−0.264*** [0.034]		
<i>Bilateral investment treaty in effect</i>					−0.0119 [0.019]	−0.032 [0.038]		
<i>Bilateral tax treaty in effect</i>					0.071*** [0.025]	0.051 [0.039]		
<i>Log GDP per-capita distance</i>					−0.094** [0.045]	−0.095 [0.259]		
<i>Signed log GDP per-capita distance</i>					0.199*** [0.062]	0.703*** [0.146]		
<i>Environmental Regulatory Regime Index distance</i>					−0.115*** [0.038]	−0.273*** [0.081]		
<i>Signed Environmental Regulatory Regime Index distance</i>					0.256*** [0.041]	0.198** [0.081]		
No. of observations	42,783	42,783	42,783	13,210	33,786	12,490	1,690	1,690
P-value	0.000	0.0000	0.000	0.000	0.000	0.000	0.000	0.000
R-squared	0.371	0.532	0.533	0.548	0.406	0.438	0.441	0.446

Notes. Presented are the results of OLS regressions in which  $\text{Log}(\text{FDI flows} + 1)$  serves as the dependent variable. Model 1 is the baseline model. Model 2 includes a robustness check that introduces fixed effects for origin and host countries as well as year dummies. Model 3 includes a robustness check with predicted egalitarianism distance and fixed effects for origin and host countries as well as year dummies. Model 4 is the same as Model 3, but it includes the use of fixed effects for origin and host countries, with Visser government intervention distance added. Model 5 includes a robustness check that standardizes all variables and adds embeddedness mechanisms. Model 6 includes a robustness check that controls for Visser government intervention distance. Model 7 is where the sample is restricted to country-year observations with Boardex CEO-to-average-worker-pay distance data available. Model 8 is the same as Model 7, but it includes Boardex data-based distance measures. Robust standard errors corrected for clustering at the origin–host country pair level appear below the coefficients in brackets.

\*\*\*Significant at the 1% level; \*\*significant at the 5% level; \*significant at the 10% level.

our instrumental variables) similarly exhibits a significant negative sign (Models 3 and 4) and thus confirms the causal role of egalitarianism distance in channeling FDI. This central finding is robust to a set of variables that control for additional mechanisms as detailed in the tables. Whereas the results for egalitarianism distance are robust (even in specifications with fixed effects),<sup>11</sup> the results for signed egalitarianism distance are not. This finding is noteworthy because of the importance ascribed to directional distance (Shenkar 2001) and because of the significant relations between FDI and other directional distances, as detailed below.

Egalitarianism distance is also economically meaningful in affecting FDI flows. In a stringent specification that utilizes instrumental variables to predict egalitarianism and that incorporates origin and host country fixed effects along with year dummies (Model 3), we compared the economic impact of distance on several institutional factors. Specifically, we looked at the percentage change in the dependent variable (DV) for a one-standard-deviation increase in egalitarianism distance and other institutional variables. We thus find that a one-standard-deviation increase in predicted egalitarianism distance is associated with a meaningful, but also realistic,  $-11.76\%$  change in mean log FDI flows when converted to millions of dollars. At the level of (mean DV + one standard deviation in DV), this effect reflects a decrease from \$194.54 million to \$171.67 million.<sup>12</sup> The economic significance is naturally greater when looking at egalitarianism distance without fixed effects. In comparison, one-standard-deviation increases in rule of law distance, common language, and different legal family are associated with changes in log FDI flows of  $-8.71\%$ ,  $7.11\%$ , and  $-5.78\%$ , respectively.

Among the legal distance factors, a different legal family affiliation is a negative factor for FDI. This variable may be capturing a broad effect of multiple facets of difference between the legal systems of the home and host countries, above and beyond the costs of complying with particular rules. In contrast, bilateral investment treaties fail to show a significant link. This result may be surprising in that these treaties are designed to foster FDI, but it is not out of line with the current literature, which is indeed in flux (see UNCTAD 2009). Bilateral treaties on double taxation do show an expected positive (though not always stable) sign. Corporate taxation distance does not have a robust effect, perhaps because bilateral tax treaties serve to reduce the effect of taxation distance.

There are interesting effects for environmental regulation distance. Both sheer and signed distances show a negative sign, but the latter is far more economically important. Sheer differences in environmental regulation may hinder FDI because firms' technologies and organizational structures may be calibrated to certain

modes of regulation. More importantly, however, FDI flows from countries with strict environmental controls to countries with lax environmental controls even after accounting for country wealth and rule of law effects. Similar results are obtained with environmental regulation variables from the Global Competitiveness Reports for 2000–2005 and the 2010 Environmental Performance Index. Indeed, this is strong evidence in support of the Pollution Haven Hypothesis.

Finally, the size of the economies, economic development, and geographic distance all exhibit signs as expected in a standard gravity equation setting. Similarity of colonial heritage and a common language tend to be positive factors but are not significant in all models. In terms of the political environment, the distance on political stability is not a stable factor, and the variable for government intervention distance shows a negative sign (albeit in a reduced sample). In any event, the focal egalitarianism distance factor retains its robustness to these factors.<sup>13</sup>

The findings in Table 1 motivate an inquiry into whether the effect of egalitarianism distance on FDI flows is robust to differences in pay practices. One may also wonder whether differences in pay practices are absorbed by egalitarianism distance in the regressions. We report sample results of this inquiry in Models 7 and 8 of Table 4, where we enter distance and signed distance measures of CEO-to-average-worker-pay ratios, respectively, using Boardex data. Strikingly, not only do we confirm that egalitarianism distance remains robust, we also find that signed pay ratio distance is negatively and significantly related to FDI flows. (In a separate set of tests, we confirmed that egalitarianism distance is robust to distance measures of other factors mentioned in panel A of Table 1.) Narrowly interpreted, this finding supports the view that top executives in MNEs may prefer to expand to destinations where their counterparts would earn a higher multiple of ordinary workers' pay. More broadly, this result is consistent with the notion that the degree of egalitarianism in the organizational compensation schemes prevailing in different countries may channel FDI flows to countries with less egalitarian schemes. Taken together, these findings point to the all-encompassing nature of egalitarianism as a fundamental social institution and to the multifaceted effect it may exert on organizations via specific norms.

### Cultural Distance on Additional Dimensions

In addition to the egalitarianism/hierarchy dimension, on which we have focused thus far, the model of S. H. Schwartz (1994, 1999, 2004) distinguishes two cultural dimensions: embeddedness/autonomy and mastery/harmony. The antecedents of egalitarianism that we have identified enable us to hypothesize about the consequences of egalitarianism for FDI based on a full chain of factors, from exogenous antecedents, to culture, to

norms, and to firms' strategic decisions. The literature does not yet offer a similar theory that would ground a causal analysis of how cultural distance on the other two dimensions might affect FDI. Nonetheless, several arguments support the consideration of cultural distance on these dimensions in this study. These two dimensions are on an equal footing with egalitarianism in the theoretical model, but they differ in the substantive societal issues they address. Such differences in content meaning imply that cultural dimensions affect different societal features than organizations may deem important for international expansion. We should therefore determine (1) that egalitarianism distance is robust to the effect of distance on these cultural dimensions, (2) how such compatible, specific factors relate to FDI, and (3) whether such factors exhaust the effect of distance in the general dimension.

The embeddedness/autonomy dimension concerns the desirable relationship between the individual and the group. Embeddedness signifies cultural expectations to restrain actions or inclinations that might disrupt the traditional order or the solidary group in which people are embedded. The opposite pole, autonomy, characterizes cultures in which the person is viewed as an autonomous, bounded entity who is expected to cultivate and find meaning in his or her own uniqueness. We separately found that embeddedness associates more closely with the ERRI measure of environmental regulation, its components, and other environmental regulation variables than with any other cultural dimension. One explanation may be that in-groups in high-embeddedness societies pay relatively less attention, in the course of pursuing their own economic and other goals, to encroachments on the integrity of others' property or on the physical environment.

The mastery/harmony dimension refers to the relation of humankind to the natural and social world. Mastery signifies an emphasis on venturing and getting ahead via active self-assertion to master, change, and exploit the natural and social environment. Harmony represents an emphasis on fitting pacifically into the environment. Prior literature has noted cultural harmony's inverse conceptual link to entrepreneurship as a socially sensitive activity (Sørensen 2007). Cultural harmony is also associated with a societal deemphasis of such entrepreneurial values as daring, ambition, success, and choosing one's own goals (S. H. Schwartz and Ros 1995). These values are compatible with an entrepreneurial spirit that reflects creative destruction and new combinations à la Schumpeter (1934) and Kirzner (1973), among others, and are thus less compatible with cultural harmony (see Licht and Siegel 2006 for a survey).

Table 4 confirms that the effect of egalitarianism distance on FDI flows is robust to controlling for distance on the other two cultural dimensions of the Schwartz model. Thus, countries' cultural profiles are represented by entering one orientation from each dimension.

(Recall that these dimensions are operationalized using the same methodology.<sup>14</sup>) Having established causality in connection with egalitarianism distance, we may feel more confident that observed correlations with distance on other dimensions probably reflect causal effects as well.

Table 5 shows (as do other tables) that sheer embeddedness distance is not a significant factor in FDI flows, and directional embeddedness distance exhibits a negative sign. The latter result indicates a broad preference for lower-embeddedness cultural environments. Although embeddedness has been linked to a lower rule of law (Licht et al. 2007), it is important to note that we control specifically for rule of law distance as well as wealth differences. As Model 3 in Table 5 shows, the effects of both distance and directional distance on ERRI are significant while the coefficient for signed embeddedness distance weakens. This finding suggests one important channel through which cultural distance exerts its influence on FDI. That is, because the environmental regulation measures capture more than legal compliance, this finding may reflect regulatory arbitrage on substantive environmental policy.

Table 6 reports that, though sheer harmony distance is not significant, signed harmony distance is negatively and significantly associated with FDI flows, indicating that MNEs prefer to expand to markets where the culture is higher on harmony. We examine whether signed harmony distance is robust to differences in countries' proclivity toward entrepreneurship and find that it is. Concurrently, entrepreneurial activity distance is itself a positive and statistically significant determinant of FDI flows. We also note a decrease in signed harmony distance, possibly as a result of this relation. The results are consistent regardless of whether we use the skewness measures for firm age or the firm-level employment size. These measures have the advantage of being fact based, yet we find largely similar results with survey-based measures.<sup>15</sup> To our knowledge, this is the first empirical evidence that distance in societal proclivity toward entrepreneurship is actually positive in influencing the direction of FDI flows. Further research is needed to test the limits of this finding, but we are encouraged that it is robust to the inclusion of entrepreneurial activity measures from different sources and using different methodologies.

## Discussion and Conclusions

This study advances the literature on the multinational firm on two fronts, substantive and methodological. First, we provide robust evidence for the hypothesis that cultural distance affects FDI decisions. We identify and theorize about the importance of egalitarianism distance in channeling the direction of foreign

**Table 5 Embeddedness Distance and Associated Mechanisms**

	Model 1	Model 2	Model 3
<i>Egalitarianism distance</i>	−0.119*** [0.027]	−0.098*** [0.026]	−0.112*** [0.027]
<i>Signed egalitarianism distance</i>	0.016 [0.036]	−0.100*** [0.037]	−0.070* [0.038]
<i>Harmony distance</i>	0.074** [0.033]	0.077** [0.033]	0.078** [0.033]
<i>Signed harmony distance</i>	−0.209*** [0.037]	−0.175*** [0.036]	−0.159*** [0.035]
<i>Embeddedness distance</i>	−0.006 [0.026]	0.009 [0.025]	0.010 [0.025]
<i>Signed embeddedness distance</i>	−0.425*** [0.036]	−0.201*** [0.043]	−0.155*** [0.043]
<i>Log product of origin–host GDP</i>	1.150*** [0.049]	1.173*** [0.047]	1.157*** [0.046]
<i>Log product of origin–host GDP per capita</i>	0.325*** [0.040]	0.288*** [0.041]	0.319*** [0.042]
<i>Signed corporate taxation distance</i>	0.004 [0.025]	0.010 [0.025]	0.027 [0.025]
<i>POLCONIII distance</i>	0.051* [0.026]	0.053** [0.024]	0.047* [0.024]
<i>Common language</i>	0.033 [0.038]	0.036 [0.036]	0.030 [0.036]
<i>Common colonizer</i>	0.116*** [0.038]	0.131*** [0.037]	0.129*** [0.036]
<i>Geographic distance</i>	−0.533*** [0.033]	−0.541*** [0.032]	−0.542*** [0.032]
<i>Different legal family</i>	−0.101*** [0.032]	−0.088*** [0.031]	−0.089*** [0.030]
<i>Rule of law distance</i>	−0.022 [0.026]	0.027 [0.028]	0.105*** [0.038]
<i>Bilateral investment treaty in effect</i>	−0.016 [0.020]	−0.017 [0.019]	−0.012 [0.019]
<i>Bilateral tax treaty in effect</i>	0.062** [0.026]	0.065*** [0.025]	0.071*** [0.025]
<i>Log GDP per-capita distance</i>		−0.124*** [0.044]	−0.094** [0.045]
<i>Signed log GDP per-capita distance</i>		0.422*** [0.049]	0.199*** [0.062]
<i>Environmental Regulatory Regime Index distance</i>			−0.115*** [0.038]
<i>Signed Environmental Regulatory Regime Index distance</i>			0.256*** [0.041]
No. of observations	33,786	33,786	33,786
P-value	0.000	0.000	0.000
R-squared	0.386	0.400	0.406

Notes. Presented are the results of OLS regressions in which  $\text{Log}(FDI \text{ flows} + 1)$  serves as the dependent variable. Model 1: without GDP per-capita distance or Environmental Regulatory Regime Index distance. Model 2 adds in GDP per-capita distance, and Model 3 adds in GDP per-capita distance and Environmental Regulatory Regime Index distance. All variables are standardized for each model. Robust standard errors corrected for clustering at the origin–host country pair level appear below the coefficients in brackets.

\*\*\*Significant at the 1% level; \*\*significant at the 5% level; \*significant at the 10% level.

direct-investment activity. We find that egalitarianism distance exerts a negative and economically significant influence on foreign direct-investment flows by multinationals. Second, we advance first evidence on consistent relations between cultural egalitarianism and organizational features, and we suggest organizational channels through which egalitarianism may exert its

influence. Third, we observe that FDI is also more likely to travel from low-embeddedness to high-embeddedness countries. The related finding that FDI tends to flow to jurisdictions with more lax environmental protection regulation supports the Pollution Haven Hypothesis. Fourth, we present novel evidence that sheer differences in countries' proclivity to entrepreneurship may affect



**Table 6** Harmony Distance and Associated Mechanisms

	Model 1	Model 2	Model 3	Model 4
<i>Egalitarianism distance</i>	−0.149*** [0.028]	−0.148*** [0.028]	−0.147*** [0.028]	−0.147*** [0.028]
<i>Signed egalitarianism distance</i>	−0.055 [0.039]	−0.082** [0.040]	−0.056 [0.038]	−0.122*** [0.038]
<i>Harmony distance</i>	0.017 [0.034]	0.010 [0.033]	0.014 [0.035]	0.025 [0.034]
<i>Signed harmony distance</i>	−0.131*** [0.036]	−0.077* [0.041]	−0.128*** [0.036]	−0.065* [0.037]
<i>Skewness in firm-age distance</i>		0.134*** [0.028]		
<i>Signed skewness in firm-age distance</i>		−0.148*** [0.033]		
<i>Skewness in firm-level employment-size distance</i>				0.164*** [0.030]
<i>Signed skewness in firm-level employment-size distance</i>				0.198*** [0.036]
<i>Embeddedness distance</i>	0.021 [0.027]	0.027 [0.026]	0.021 [0.027]	0.014 [0.027]
<i>Signed embeddedness distance</i>	−0.124*** [0.044]	−0.119*** [0.044]	−0.128*** [0.045]	−0.074* [0.044]
<i>Log product of origin–host GDP</i>	1.240*** [0.049]	1.280*** [0.051]	1.247*** [0.049]	1.222*** [0.050]
<i>Log product of origin–host GDP per capita</i>	0.317*** [0.045]	0.316*** [0.045]	0.326*** [0.045]	0.295*** [0.045]
<i>Signed corporate taxation distance</i>	0.017 [0.025]	0.010 [0.025]	0.005 [0.025]	−0.033 [0.025]
<i>POLCONIII distance</i>	0.048* [0.027]	0.053** [0.026]	0.045* [0.027]	0.052** [0.026]
<i>Common language</i>	0.021 [0.037]	0.022 [0.037]	0.020 [0.038]	0.024 [0.037]
<i>Common colonizer</i>	0.123*** [0.037]	0.131*** [0.037]	0.131*** [0.040]	0.135*** [0.039]
<i>Geographic distance</i>	−0.549*** [0.033]	−0.542*** [0.032]	−0.538*** [0.032]	−0.528*** [0.032]
<i>Different legal family</i>	−0.102*** [0.031]	−0.107*** [0.031]	−0.100*** [0.032]	−0.087*** [0.030]
<i>Rule of law distance</i>	0.130*** [0.041]	0.129*** [0.041]	0.132*** [0.041]	0.137*** [0.040]
<i>Bilateral investment treaty in effect</i>	−0.001 [0.019]	−0.008 [0.019]	0.005 [0.020]	−0.009 [0.019]

FDI flows positively, although FDI tends to flow to countries higher on cultural harmony.

This study also makes methodological advances. We heed calls to distinguish among cultural dimensions and between sheer and directional cultural distance, and we show that their roles may indeed be different. In tandem with the cultural account, we consider additional institutional accounts including differences in legal and political institutions, and we make first steps toward accounting for organizational features. Furthermore, we do not simply assume cultural stability but implement an instrumental variable approach to egalitarianism that allows us to make causal inferences about its role as based solely on exogenous factors in channeling

FDI. The analyses utilize an advanced cultural dimensional framework drawn from S. H. Schwartz (2004) that provides a different vantage point than Hofstede's. Finally, we perform an especially extensive set of robustness checks, including showing that our results are robust to the use of origin and host country fixed effects.

Managers who have followed the literature on cultural distance might have concluded that this concept is useless for guiding business strategy, in light of the mixed findings about its impact on FDI. Corporate leaders thus might concentrate on the operational aspects of FDI projects and at most team up with local partners to gain familiarity with the destination market. This study shows that such an approach may be wrongheaded. Cultural

Table 6 (cont'd)

	Model 1	Model 2	Model 3	Model 4
<i>Bilateral tax treaty in effect</i>	0.074*** [0.026]	0.077*** [0.026]	0.077*** [0.025]	0.071*** [0.025]
<i>Log GDP per-capita distance</i>	−0.106** [0.048]	−0.112** [0.047]	−0.092* [0.048]	−0.104** [0.046]
<i>Signed log GDP per-capita distance</i>	0.242*** [0.064]	0.201*** [0.063]	0.251*** [0.064]	0.289*** [0.061]
<i>Environmental Regulatory Regime Index distance</i>	−0.135*** [0.040]	−0.123*** [0.040]	−0.139*** [0.040]	−0.161*** [0.038]
<i>Signed Environmental Regulatory Regime Index distance</i>	0.258*** [0.042]	0.312*** [0.043]	0.251*** [0.042]	0.166*** [0.042]
No. of observations	31,687	31,687	31,835	31,835
P-value	0.000	0.000	0.000	0.000
R-squared	0.412	0.416	0.408	0.418

Notes. Presented are the results of OLS regressions in which  $\text{Log}(\text{FDI flows} + 1)$  serves as the dependent variable. Model 1: Sample temporarily restricted to countries with skewness in firm-age data; Model 2 adds skewness in firm-age distance. Model 3: Sample temporarily restricted to countries with skewness in firm-level employment-size data; Model 4 adds skewness in firm-level employment-size distance. All variables are standardized for each model. Robust standard errors corrected for clustering at the origin–host country pair level appear below the coefficients in brackets.

\*\*\*Significant at the 1% level; \*\*significant at the 5% level; \*significant at the 10% level.

distance is pervasive and ubiquitous; it manifests itself in fundamental, societal structure and in innumerable specific contexts. Distance on egalitarianism in particular could hinder effective implementation of strategies vis-à-vis all of the firm's stakeholders. Worse yet, there is probably no quick fix for cultural distance. The findings on egalitarianism and organizational social norms suggest that foreign entrants may find it particularly difficult to identify and adjust to such informal norms. At the same time, corporate leaders who are aware of these issues may be able to exploit cultural distance to their benefit once it ceases to be a nebulous idea and can be given concrete and practical meanings. Firms that contemplate foreign entry might thus be well advised to assess the effect of cultural distance on each cultural dimension for the country and the project in question.

Nearly two decades have passed since researchers began to harness Hofstede's (1980) pioneering framework to improve our understanding of cultural distance. Following Ghoshal and Westney's (2005) call for integrating organization theory and international management, this study shows that egalitarianism distance is indeed a fundamental factor in determining FDI flows. The present analyses are inevitably limited and suggest directions for further research. One avenue of research is to seek appropriate instrumental variables for other cultural dimensions, comparable to what we have done here for egalitarianism versus hierarchy. Another is to examine more closely the role of directional distance. Progress in this direction will improve researchers' ability to identify the causal mechanisms linking culture and policy outcomes. Another avenue of inquiry is to identify more specifically the social institutions through which cultural orientations exert their influence on organizations. In-depth inquiries into the causal role of

organizational practices and other features appear to be a fruitful field for further research. The more such mechanisms are identified, the richer both organizational theory and our understanding of the multinational organization will become.

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### Supplemental Material

Supplemental material to this paper is available at <http://dx.doi.org/10.1287/orsc.1120.0776>.

### Endnotes

<sup>1</sup>See Shenkar (2001), Datta et al. (2002), Harzing (2004), Tihanyi et al. (2005), Kirkman et al. (2006), and Berry et al. (2010).

<sup>2</sup>Ghoshal and Westney (2005, p. 1) thus call for "build[ing] a bridge between two fields that had not developed a particularly close relationship: organization theory and international management." Numerous authors have called for additional research on how multinational firms are challenged by multiple, potentially conflicting institutional pressures across the markets in which they operate (Rosenzweig and Singh 1991, Ghoshal and Westney 1993/2005, Zaheer 1995, Westney 2005).

<sup>3</sup>Hofstede's (1980) theory may retain its vitality in several contexts, but operationalizing cultural distance with Kogut and Singh's (1988) aggregated construct, based on Hofstede's dimensions, has reached an impasse. See S. H. Schwartz (2004) for a comparative analysis of the Hofstede and Schwartz models.

<sup>4</sup>Empirically, S. H. Schwartz (2004) shows that across 57 nations, power distance correlated 0.30 with hierarchy,  $-0.46$  with egalitarianism, and  $-0.40$  with the egalitarianism/hierarchy dimension. Thus the dimensions are related as expected but still distinct. For example, China is very high on power distance (ninth) and very low on egalitarianism/hierarchy (last).

<sup>5</sup>See Schein (1985–2005) for another organizational-level theory. House et al. (2004) (a report on the GLOBE project) and Brickson (2005) adapt societal-level value dimensions to organizational-level features.

<sup>6</sup>We consider the ratio of production worker compensation to subsidiary value-added as defined by the U.S. Bureau of Economic Analysis (BEA), and to obtain meaningful results, we restrict the analysis to instances of positive value-added. Note that the general thrust of this paper suggests a potential selection issue in that U.S. MNEs may prefer to hold subsidiaries in markets closer on egalitarianism to the United States. Such a potential bias would stack the deck, however, against finding significant signs in our regressions. We are grateful to an anonymous referee for pointing this out.

<sup>7</sup>In line with studies in economics, Holburn and Zelner (2010) also link such political capabilities to the prevailing level of economic inequality. Empirically, however, we do not observe a significant correlation between egalitarianism and economic inequality using Gini coefficient data for the year 2000 or close to it. This may be the case, *inter alia*, because cultures vary in the legitimacy they ascribe to unequal distribution of economic resources.

<sup>8</sup>Our background research indicates that the data captured from the inward host government is likely to be the most comprehensive. There are cases, however, in which only the outward origin government has reported data. Thus we rely on inward FDI observations but incorporate outward observations if the former are missing. Because governments tended to take several years to release final comprehensive data to these two organizations, the sample ends in 2004. A tiny percentage of observations represent the selling off of foreign direct investments rather than new investments; we treat those cases as zeroes but also confirm, via a robustness check that temporarily excludes them, that they are not influential.

<sup>9</sup>Taking the absolute value of the difference between countries' egalitarianism scores yields similar results.

<sup>10</sup>Specifically, using data collected in its surveys of foreign subsidiary operations, BEA computes the value-added of foreign subsidiaries from the factor income side as the sum of costs incurred (except inputs) and profits in production. The two post-1990 benchmark survey years are 1994 and 1999, when the relevant questions were put to a comprehensive set of U.S.-headquartered multinationals.

<sup>11</sup>Fixed effects models may seem to provide powerful robustness tests, but here, they raise thorny issues. As Table 3 shows, egalitarianism distance variables are robust to origin and host country fixed effects with time dummies. However, such models do not control for unobserved time-varying heterogeneity. As a time-invariant linear combination of countries' cultures, furthermore, a fixed effects model cannot identify the role of signed cultural

distance, as the latter are linear combinations of country terms, and thus it gets absorbed into the fixed effects.

<sup>12</sup>We observe a similar role for egalitarianism distance when we experiment with a dependent variable constructed by subtracting merger and acquisition flows from FDI flows for every country-pair-year (see Online Appendix Table 7). Although this measure is not based on disaggregated data, which are necessary for such an analysis, one may consider this finding a first glimpse of egalitarianism's effect on greenfield and joint-venture FDI flows.

<sup>13</sup>We confirmed the robustness of the egalitarianism distance result in several additional checks. These tests include Tobit estimation (though the postestimation diagnostic "tobcm" in STATA showed that not all Tobit conditions are met, indicating that it should not be relied on), quadratic assignment procedure, and Cochrane–Orcutt instead of OLS regression. Using the Levin–Lin–Chu and Harris–Tzavalis unit root and Breitung tests, we find strong evidence that the panels do not contain unit roots. This result is also robust in alternative samples, including an exclusive focus on the 1990s (when many of the cultural measurements were taken), the use of OECD FDI data alone, and the use of log product of origin–host national population instead of, or in addition to, the size of the economies. These tests are available in online appendices and from the authors upon request.

<sup>14</sup>We have also confirmed that the results are robust to the inclusion of cultural data from Hofstede (2001) and of cultural data from Project GLOBE (House et al. 2004), whose dimensions draw on Hofstede (1980). In addition, we have confirmed that the results are robust to the inclusion of power distance as measured by Berry et al. (2010) using World Values Survey (WVS) data. See Online Appendix Tables 5 and 6.

<sup>15</sup>In robustness checks not reported in the tables, we find consistent results using the GEM measure. Because this measure comes from the end of our sample period, we experimented with limiting the analysis to post-1979, post-1989, and post-1994. We also find similar results using alternative measures of entrepreneurial activity distance based on data from the World Bank Group Entrepreneurship Survey.

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