

One of the most important research themes in the area of international business (IB) has been the study of the internationalization-performance relationship. The recent special issue on this topic in *Management International Review* (3/2007) effectively demonstrates the continued interest of IB scholars in this research theme over the last 40 years. In addition to the special issue, recently published work by Brock, Yaffe and Dembovsky (2006), Chang and Wang (2007), Chari, Devraj and David (2007), Contractor, Kumar and Kundu (2007), Hitt, Bierman, Uhlenbruck and Shimizu (2006), and Thomas (2006) all go on to portray the critical importance of the topic to IB scholars and practitioners.

Our study has been motivated, in part, by the ongoing debate that surrounds the internationalization-performance research, since consensus in theoretical modeling as well as in empirical analyses still remains questionable (Contractor, 2007, Hennart, 2007). Our study derives further motivation from the increasing attention, and hence, increasing importance given to 'contexts' in IB research (Meyer, 2006; Witt and Lewin, 2007). In the particular case of the internationalization-performance research, it is only recently that contextual factors, such as the country of origin, have been considered in the theoretical and empirical frameworks (Elango and Sethi, 2007; Ruigrok, Amann and Wagner, 2007). However, the application of the contextual factors is limited in scope, since scholars have only looked at the context from the perspective of the home country. Scholars have, either, empirically examined firms from contexts other than the typical developed countries like the US, UK and Japan but without any systematic incorporation of context in their studies (e.g. Capar and Kotabe, 2003; Contractor, Kumar and Kundu, 2007; Nachum, 2004; Thomas, 2006), or, included a home country contextual factor in their conceptual and empirical investigation (e.g. Elango and Sethi, 2007; Ruigrok, Amann and Wagner, 2007). This presents a serious gap in research, since the firms under the internationalization-performance investigation are highly international and, as a consequence, present in multiple host countries. The nature of markets, both in host as well as in home countries, are important in determining the scope (geographic and product) of the firm (Peng and Delios, 2006) as well as its long term performance.

Without taking into consideration the context of the host country, particularly the differences between the host and home country contexts, into the internationalization-performance model, conceptualization and thereby findings remain incomplete.

We seek to fill this research gap by building on the application of ‘context’ by incorporating the effect of institutional distance (distance between the home and host country institutional contexts) into the internationalization-performance model. This study brings institutional distance into the conceptual framework as a moderator between internationalization and firm performance. Institutional distance is a newly developed measure of cross-country differences (Kostova and Zaheer, 1999) and refers to “the extent of similarity or dissimilarity between the regulatory, cognitive, and normative institutions of two countries” (Xu and Shenkar, 2002, pp. 608). Institutional theory is the foundation of institutional distance and it perceives institutional environment as the key determinant of firm structure and behavior (DiMaggio and Powell, 1983, 1991; Scott, 1995). Most of the internationalization-performance research is positioned from the perspective of the resource-based theories, transaction cost economics or organizational learning theories. None to our knowledge use an institutional theory approach to understand the internationalization-performance relationship. Our study makes a contribution to existing literature on internationalization-performance research by adopting an institutional theory perspective focusing on how differences in institutions in home and host countries affect performance of internationalizing firms. Our study, in this regards, also contributes to the increasing importance and applicability of institutional theory to explain firm strategy and behavior in the international context. Prior studies have looked into problems in transfer of organizational knowledge and practices due to differences in institutional contexts (Kostova, 1999; Kostova and Roth, 2002), effects of institutional distance on firm strategies pertaining to choice of country, entry mode, ownership (Xu and Shenkar, 2002; Xu, Pan and Beamish, 2004) and on survival of foreign subsidiaries (Gaur and Lu, 2007) as well as on subsidiary staffing policies (Gaur, Delios and Singh, 2007). We extend this body of work by focusing on the role that institutional distance plays in moderating the performance

consequences of internationalization.

Next, we explore an important, yet under-investigated antecedent of firm internationalization, that of home country economic openness. Wan and Hoskisson (2003) demonstrate that home country environments can have a significant impact on firm corporate strategy and on firm performance. However, there is a lack of studies explicitly investigating the effect of home country environments on the corporate strategy pertaining to geographic and/or product diversification (Wan, 2005). Home countries create environments that can facilitate or impede their firms' competitiveness (Porter, 1990). Alternatively, home countries' institutional constraints might force firms to look for escape routes through international expansion (Witt and Lewin, 2007). A better understanding of the interplay between competitive advantages of countries and the firms of that country may offer significant advances to competitive international trade and investment theory (Dunning, 1990, 1993). The conceptual model of our study is presented in Figure 1. The major research questions that we seek to address through this conceptual framework are the following:

- (1) Does an increase in international diversity enhance firm performance?
 - (2) Does home country economic openness matter in firms' adopting international diversity strategy?
- and,
- (3) What is the role of institutional distance (regulative and normative distances) in explaining the relationship between international diversity and firm performance?

(Insert Figure 1 about here)

The rest of the paper is organized in the following manner: First, we provide an overview of the conceptual framework using an institutional theory perspective. Next, we develop hypotheses concerning the three major research questions. Then, we discuss the methodology (data collection, measurement of variables, and research design) adopted for this study. We present the results of our empirical analyses next. Finally, we discuss the implications of our findings for scholars and practitioners and provide limitations of the study along with some future research directions.

Theoretical Background

Institutions and Institutional Contexts

Institutions have been defined generally as the rules of the game in a society, “the formal or informal constraints that shape human interaction” (North, 1990). Scott (1995) introduced the concept of a three-dimensional country institutional context, comprised of regulatory, normative and cognitive dimensions. Regulatory or legal aspects of institutions most commonly take the form of regulations; they guide organizational action by force or threat of legal sanctions. Organizations accede to them so as to avoid the penalty for non-compliance. For example, corporations adopt new pollution control technologies to conform to environmental regulations, and non-profit organizations maintain accounts and hire accountants in order to meet tax law requirements (DiMaggio and Powell, 1983). Normative or social aspects of institutions generally take the form of rules-of thumb, standard operating procedures, occupational standards and educational curricula. The ability for such procedures to guide organizational action stems from their social obligation or professionalism. For example, gift-giving and bribery is a commonly accepted norm in emerging economies like India and China. Cognitive or cultural aspects of institutions embody symbols - words, signs, and gestures as well as cultural rules and frameworks. Organizations usually abide by these rules without conscious thought (Zucker, 1983).

Countries vary in terms of the nature of regulatory, normative and cognitive institutions that dominate its context - industry and social arrangements. For example, emerging economy countries are generally heavily regulated economies due to government imposed controls on capital, labor and factor markets. Strict import, inward foreign direct investment restrictions and licensing requirements in many sectors are used to maintain low levels of competition. Khanna and Palepu (1997, 2000a, b) observe that in many emerging economies there is a lack of key institutions necessary for a firm to function profitably. For example, an entrepreneurial firm or an export-house in an emerging economy with no substantial links with government banks or other financing institutions will face extreme difficulty in raising capital to meet foreign investment or export requirement needs. Foreign firms operating in such institutional contexts will also get equally

affected. For example, given the rigid labor laws and absence of proper channels of recruitment in most of the emerging economy countries, a foreign firm's flexibility, similar to that of a domestic firm, in downsizing and/or upsizing is restricted. Countries also vary significantly on cultural dimensions leading to cultural distances between different countries (Kogut and Singh, 1988). For example, certain countries value the collective sense of work, achievement and pride and accept a hierarchical mode of operation, while others value individualism, personal goal achievements and a flatter organizational mode of operation.

The above three dimensions of institutional context are connected, not analytically or operationally distinct and with transitions among the three possible (Hirsch, 1997). Moreover, "the cognitive and normative dimensions of the country institutional context are conceptually close to culture, whereas the regulatory dimension is unique to country institutional context and not captured by culture" (Kostova, 1999, pp. 314). As such the institutional dimensions are a more holistic, and thus better, means to capture effect of cross-country differences on firm strategic behavior (Cho and Padmanabhan, 2005; Shenkar, 2001). Furthermore, there is substantial theoretical overlap between the cognitive and normative institutional dimensions and hence is usually hypothesized as a combined construct (Hoffman, 1999, Gaur and Lu, 2007; Gaur, Delios and Singh, 2007). Our conceptualization of institutions and institutional distance is on similar lines. We test for the moderating effect of regulative and normative institutional distances between a firm's home and host country on the link between international diversity and performance.

International Diversity

International diversity refers to firms' "expansion across the borders of global regions and countries into different geographic locations, or markets" (Hitt, Hoskisson and Kim, 1997, pp. 767), and thus measures the geographical scope of a firm. The degree of a firm's international diversity captures the extent of the firm's presence in different markets outside its home market in different capacities. A firm can be present in a variety of foreign markets in different capacities conducting a range of activities like raw material sourcing (resource-seeking motive of international presence),

performing back-end jobs such as information technology and/or software development (efficiency-seeking motive of international presence), selling their end products and services (market-seeking motive of international presence), and in some cases gaining knowledge from competitors, collaborators, customers and governments (knowledge-seeking motive of international presence). Hence, international diversity plays an important role in a firms', typically a multinational enterprise (MNE), strategic behavior (Hitt, Hoskisson and Ireland, 1994) and has significant impact on firm performance (Hitt, Biermen, Uhlenbruck and Shimizu, 2006).

Scholars in the international business field have extensively explored the relationship between international diversity and firm performance (Li, 2007). Most of them argued that international diversity is vital for firms' growth because it exploits foreign market opportunities and imperfections through internalization (Rugman, 1979; 1981). However, international diversity presents firms with increased competitive challenges from international and local competitors (Hitt, Hoskisson and Kim, 1997) and from operating in unique and varied institutional contexts. A positive relationship (e.g., Buhner, 1987; Grant, 1987; Grant, Jammie and Thomas, 1988; Kim, Hwang and Burgers, 1989; Siddharthan and Lall, 1982), a negative relationship (e.g., Chang and Thomas, 1989; Collins, 1990), an inverted U-shaped relationship (e.g., Daniels and Bracker, 1989; Geringer, Beamish and daCosta, 1989; Hitt, Hoskisson and Kim, 1997; Sullivan, 1994), an S-shaped relationship (e.g., Contractor, Kundu and Hsu, 2003; Lu and Beamish, 2004; Li, 2005; Thomas and Eden, 2004), and even no relationship (e.g., Buckley, Dunning and Pearce, 1978; Haar, 1989; Sambharya 1995), can all be found in prior studies. Surprisingly, none of the above studies incorporate the role of institutional contexts and the consequent differences that exist between different countries, in determining the impact of international diversity on firm performance.

Institutional Contexts, International Diversity and Firm Performance

Unique institutional structure guide firm's strategic activities and affect the nature and amount of innovation and long-term competitive advantage that takes place within a country's

borders (Nelson, 1993). Since firms are embedded in country-specific institutional arrangements, such as access to research and educational institutions, access to sources of financing, and availability of pools of educated labor (Busenitz et. al., 2000), their performance get negatively affected when faced with weak (unfavourable, inadequate and inefficient) institutional context. On the other hand, when faced with a strong (favourable and efficient) institutional context firm performance is likely to improve. The institutional context of a country also determines the complexity and costs of conducting transactions for an individual firm. A lack of institutions or the presence of 'institutional voids' makes transactions more cumbersome and costly (Khanna and Palepu, 2005). This has direct bearing on firms' organizational strategy, for example tendency of firms to be part of a larger network or business groups in many emerging markets, and as a result on firm performance.

In the context of internationalizing firms, a weak host-country institutional context might further increase costs associated with entry and liabilities of foreignness and newness, owing to unclear regulations and weak enforcement of rules. For the same reasons, gaining legitimacy will also be more complex and difficult for the firm in such contexts. On the other hand, a strong institutional context may reduce uncertainties involved with operating in a new and foreign location and enable quick recovery of initial investments. The effect of entry and subsequent operation in a weak or strong institutional context will depend to a large extent on the focal firm's past experiences of operating in other institutional contexts, in particular with the nature of institutional context in its home market. A firm that is based in a weak institutional context is likely to overcome challenges of operating in another country with a weak institutional context much easily than a firm that has had no such experience. As such, the negative effect on performance for this particular firm will be less significant when making entry and operating in the new environment, compared to that for a firm based in a country with strong institutional context. Hence, from the standpoint of a firm, the differences between the institutional contexts where it conducts or plans to conduct business is of key concern since dealing with the differences is what substantially accounts for overall

performance effects. Based on this line of argument, we include institutional distance as a moderating factor in the conceptual and empirical framework of international diversity and firm performance.

Our conceptualization of bringing institutional distance into the international diversity – firm performance equation is unique, however, scholars have analyzed the effect of institutional distance on other key international business strategic activities of firms. With increasing institutional distance between the home and host countries, transfer of strategic routines and establishment of legitimacy becomes more challenging (Kostova, 1999; Kostova and Zaheer, 1999). Institutional distance also significantly affects key foreign direct investment decisions, such as country choice and entry strategies (Xu and Shenkar, 2002). Institutional relatedness, a concept similar to institutional distance, affects the scope of the firm in terms of the level of diversification (Peng, Lee and Wang, 2005). All of these studies have stopped short of theorizing the affect of institutional distance on firm performance for an internationalizing firm. In this regards, our study extends the application of institutional theory to analyzing another important international business phenomenon.

Hypotheses Development

Home-country context and international diversity

Understanding the interplay between competitive advantages of countries and the firms of that country offers better explanation of international trade and investment decisions (Dunning, 1990, 1993). We investigate an important aspect of home country context, the home country economic openness, as an antecedent to firms' adopting international diversity strategy.

The home country of a firm is where its strategy is set, its product and process development takes place, and its essential skills reside. The resources and capabilities possessed by the parent firm in the home country can influence how firms attempt to enter and compete in foreign markets (Brouthers, Werner and Matulich, 2000). Daniels and Arpan (1972), in their study, found that international firms from different country of origins exhibited distinct geographic expansion and

ownership preferences in their subsidiary operations in the United States. In a similar study on foreign direct investment activity of industrialized countries into the United States, Tallman (1988) found that home country political risk was a significant factor. Certain industries in certain countries are more competitive than others owing to characteristics of the industry environment present in their broader home institutional environment, and thereby are likely sources of greater exports and investments to other countries (Porter, 1990). In similar vein, Allred and Steensma (2005) supported the argument that home country context has significant direct influence on firm innovation investment. In sum, the home environmental conditions significantly affect a firm's international strategic behavior.

Based on the above, we argue that home country economic openness is positively related to international diversity. Firms in an open-economic environment have more exposure to international opportunities and are better networked with firms in other country environments resulting in greater knowledge and capabilities to initiate and pursue international expansion.

Hypothesis 1: Home country economic openness is positively related to international diversity.

International Diversity and Firm Performance

International diversity is perceived as a critical element in corporate strategy and a means for sustenance and growth. Because of its importance, researchers have dedicated considerable efforts to investigating its performance implication (Contractor, 2007). Corporate performance can be improved by international diversity since international diversity increases sales in foreign markets and hence diversifies the risk of home country economic downturn. International diversity can also lower costs through economies of scale in manufacturing and through economies of scope in business functions like R&D, marketing, and distribution system. Firms can leverage their competitive advantages by expanding their operations globally and better exploiting their core competences (Bartlett and Ghoshal, 1989; Hamel, 1991; Porter, 1990). In other words, firms can use their existing rent-yielding core competences in foreign markets to generate economies of scale and

scope and consequently achieve better firm performance. To summarize, the common rewards of international diversity are from the following four sources: (1) economies of scale and scope; (2) learning; (3) exploiting relationships among business segments and geographic areas; (4) taking advantage of differences in factor markets.

However, international diversity comes with both rewards and risks. Unfamiliarity with foreign markets and the lack of knowledge about foreign cultures and environments leads to liability of foreignness that MNEs suffer from during their international expansion (Zaheer and Mosakowski, 1997). Moreover, if international diversity is adopted because of pure market share perseverance or domestic market saturation, the costs of international expansion may not be covered by the benefits it yields (Shapiro, 1986). In fact, operations in multiple countries with varied institutional contexts is likely to increase transaction costs as well as costs associated with information collection, processing and dissemination, which may even become higher than the benefits derived from international expansion (Hitt, Hoskisson and Ireland, 1994). Similarly, Datta, Rajagopalan, and Rasheed (1991) argued that bureaucratic costs, inefficiency, and managers' limited ability to understand the complicated international environments adequately exert a negative impact on firm performance. The greater the difference between home and host country institutional contexts, the higher are such costs likely to become.

Hence, there are both positive and negative performance effects of international diversity based on the benefits and costs that accrue to firms as they diversify in international markets. There is a whole body of literature looking at the shape (linear positive, linear negative, U-shaped, inverted U-shaped, S-shaped) of the curve depicting the international diversity – firm performance relationship, but with no clear consensus (Hennart, 2007). The S-shaped curve proposed by Contractor, Kundu and Hsu (2003) and by Lu and Beamish (2004) attempts to reconcile conflicting findings by arguing for a more holistic framework. However, recent studies by Ruigrok, Amann and Wagner (2007) and Bausch and Krist (2007) demonstrate the importance of moderating factors in shaping the curve, particularly the institutional contexts of home and host countries. As such, our

approach here is not to argue for a specific shape of the curve depicting the international diversity – firm performance, rather focus more on the moderating effect of institutional distance. We treat the international diversity – firm performance as an empirical issue and make the following two competing hypotheses:

Hypothesis 2a: There is a linear relationship between international diversity and firm performance.

Hypothesis 2b: There is a curvilinear relationship between international diversity and firm performance.

Institutional Distance

Institutional distance refers to the extent of similarity or dissimilarity between home and host countries' institutional contexts (Kostova, 1996). As an MNE continues to internationalize into distant foreign markets, it is faced with larger institutional distances. Such distances reflect the differences in regulative settings, societal beliefs and norms of doing business, between the home and host countries. With increasing differences in the regulative and normative contexts, costs of internationalization increases and is likely to outweigh the benefits that the MNE derives from its international operations. Hence, with increasing institutional distance between home and host countries, the performance of a firm gets negatively affected as the firm continues on its path of international expansion. The major sources of the negative moderating effect emanate from the following factors.

First, one of the main sources of competitive advantage, and thereby superior performance, of MNEs over domestic firms, lie in their ability to internalize knowledge in different host country locations (Caves, 1982; Hymer, 1976; Teece, 1976) and then transfer it back home and to other locations (Doz, Santos and Williamson, 2001). However, if the foreign markets are institutionally very distant, transferring strategic resources to and from those foreign subsidiaries becomes an arduous task (Kostova, 1999). This can have two implications for the firm under consideration. 1) The firm may decide to invest significant resources in overcoming the challenges of transfer, or 2) the firm may decide not to integrate the particular foreign subsidiary located in the very distant host

country with rest of the organization. In the first situation, costs of operating in the foreign market will be very high and lead to lower performance, at least for sometime. In the second situation, the firm will not be able to benefit from its foreign operation to its full potential. As such, even if performance does not decrease, it will not improve in any way.

Second, besides assimilation, internalization and transfer of knowledge, MNEs constantly strive to balance global integration with local responsiveness (Bartlett and Ghoshal, 1989). Global integration subjects the MNE operations in foreign locations to gain internal legitimacy within the firm, while the need for local responsiveness forces the MNE to gain external legitimacy in the host country. Research suggests that the local isomorphic pressures are stronger than internal pressures of conforming to corporate culture and practices (Rosenzweig and Nohria, 1994). Thus, for MNEs, gaining external legitimacy becomes more critical and pressing than gaining internal legitimacy (Xu, Pan and Beamish, 2004). The problem lies in responding to local isomorphic pressures and achieving external legitimacy in host country locations that have very different regulatory systems and business norms. As the regulative and normative distance becomes larger, establishing legitimacy in host countries becomes more difficult (Kostova and Zaheer, 1999). Lack of requisite legitimacy leads to lower performance levels for the overall MNE. The issue of gaining legitimacy becomes more problematic as the MNE continues to diversify into a number of foreign markets. The conflicting pressures to accede to local requirements as well as simultaneously integrate globally becomes extremely complicated (Xu and Shenkar, 2002) resulting in increased costs of control, coordination and overall governance.

Third, in order to achieve the objectives of efficient knowledge management along with increased control and coordination while expanding into international locations, MNEs increasingly use parent country nationals or expatriates (Boyacigiller, 1990; Gong, 2003; Gupta and Govindarajan, 2000; Harzing, 2001). Parent country nationals are more likely to act in the interest of the MNE, and are also more familiar with the organizational practices and other tacit knowledge residing in the home country operations that are to be transferred to the foreign locations. However,

parent country nationals are usually costly in monetary terms, can lead to legitimacy losses in the host country (Harzing, 2001) and at times also not available for certain expatriate assignments (Beamish and Inkpen 1998). With increasing institutional distance between the home and host country operations of an MNE, there is a higher likelihood of more number of parent country nationals assigned at important positions in the host country operation (Gaur, Delios and Singh, 2007). We argue that such high numbers of expatriate positions is a major source of increase in the cost structure of the firm, not only in supporting them monetarily, but also in searching, negotiating with, and monitoring relevant managers from the MNE home country operations.

Finally, MNEs are always faced with agency costs attributable to opportunistic behavior on part of managers and other local partners who are based in distant locations from the home country of the MNE (Buckley and Casson, 1998; Henisz and Williamson, 1999). Such costs are likely to magnify when MNEs enter and commence operations in host countries marked by very different regulative and normative institutional contexts (Eden and Miller, 2004; Xu and Shenkar, 2002). Gaur and Lu (2007) in their study on ownership strategies and survival rates of Japanese firms' subsidiary operations in a host of institutionally different countries found that with increasing institutional distance firms increased their level of equity ownership or entered and operated through the most costly route of wholly owned subsidiary. Such firm strategies are intended for greater control of the host country operation, but also will serve as important source of increased cost for the firm. The performance of the firm, as a consequence of such high cost entry and operation methods, at least in the short run, is likely to negatively affect overall firm performance.

From the above arguments, we conclude that the costs of international diversity will exceed the benefits from international diversity when the institutional distance between the various host countries and the home country is larger. We test the effect of regulative and normative distances separately and hence make the following two hypotheses:

Hypothesis 3a: The relationship between international diversity and firm performance will be negatively affected when the regulative distance between home and host countries increases;

Hypothesis 3b: The relationship between international diversity and firm performance will be negatively affected when the normative distance between home and host countries increases.

METHODOLOGY

Sample

To be included in our sample, a firm had to be ranked on the *Fortune Magazine's* Global 500 company list in Year 2004. All these 500 companies have to publish their financial data and report figures partially or wholly to a government agency. We relied on two major data sources, Hoover's (a D&B Company) and Mergent Online (formerly Moody's), for all firm level information required for our empirical analyses. For unavailable data points, a firm's financial annual report obtained from Mergent Online provided supplementary information. Data collected are for the fiscal years between Year 2002 and Year 2004. For country level data on regulative and normative distances we used *The Global Competitiveness Report*, published by the World Economic Forum in Geneva.

Table 1 represents the distribution of these 500 companies' home countries. United States was the home country for the largest number of companies (175 companies; 35 percent), followed by Japan (81 companies; 16.2 percent). France (39 companies; 7.8 percent), Germany (37 companies; 7.4 percent), and United Kingdom (37 companies; 7.4 percent) were the next three countries that were home to more than 30 companies ranked in the list. In total, 31 countries were represented.

(Insert Table 1 about here)

Previous studies on international diversity – performance have used similar datasets from different contexts. For example, Lu and Beamish (2001, 2004) used the Nikkei NEEDS tapes for corporate information on Japanese firms and Capar and Kotabe (2003) as well as Ruigrok and Wagner (2003) used *The Largest 500 German Companies List* (Die Welt Zeitung Information Services: <http://www.welt.de/wirtschaft/ranglisten/>) for their study on German firm's international diversity – performance relationship. Xu, Pan and Beamish (2004), Gaur and Lu (2007) as well as Gaur, Delios and Singh (2007) have used the scores on institutional distances from the *The Global Competitiveness Report*.

Measures

Dependent variable

Firm performance as measured by Return on Assets (ROA) was used as the dependent variable. We collected information on ROA for each firm in the sample for a period of 3 years from 2002 to 2004. We also collected the Return on Equity (ROE) and Return on Investment (ROI) figures for each firm for the 3 year period, for purposes of supplementary analyses. All the financial information was available in the Mergent Online data source. Usage of ROA as a measure for firm performance is in line with previous studies in this area (e.g. Capar and Kotabe, 2003; Contractor, Kumar and Kundu, 2007). Some other studies in this area have also used Return on Sales (ROS) as a firm performance measure. However, ROA and ROS have a very high correlation ($r = 0.91$) and have generated very similar findings in extant research (Hitt, Hoskisson and Kim, 1997). Hence, using either ROA or ROS is sufficient for reliability of results.

Independent variables

International Diversity

We created a two item measure, consisting of number of foreign subsidiaries and the number of countries in which the firm's foreign subsidiaries operate, to measure international diversity in our study. The number of foreign or non-home-country subsidiaries captures an important aspect, the scale of international operations and exposure, of international diversity (Errunza and Senbet, 1984; Sambharya, 1995, pp. 208). The second item, the number of foreign countries in which a firm operates, captures the scope of international operations for a particular firm. According to Tallman and Li (1996, p. 188), "as most discussions of competitive advantage derived from the scope of international operations address tax, currency, economic, and political arbitrage, and as various firms structure their country operations differently, a country count seems to address scope issues better and less arbitrarily than a subsidiary count". Since, we were able to find information on both, foreign subsidiary count and foreign country count, from Mergent Online, we created a composite index to measure international diversity. Extant literature has used such a composite measure of

international diversity, thus validating its reliability (e.g. Tallman and Li, 1996; Ramaswamy, 1993)

Furthermore, by using a multi-dimensional measure, this study addresses the limitations attached with using a uni-dimensional measure of international diversity (Sullivan, 1994). For analytical purposes, the two measurement items were integrated into a composite index following established procedures (Sanders and Carpenter 1998). First, the two count measures were divided by the maximum number of foreign subsidiaries or the maximum number of countries in the sample, respectively, to change them from counts to ratios. Second, the average of these two ratios was calculated. After these calculations, the final measure of international diversity ranges from 0 to 1, with 1 representing the highest level of international diversity for a firm in our sample. Our composite index of international diversity is in some regards a more holistic measure compared to the most commonly used '*foreign sales to total sales*' measure (e.g. Capar and Kotabe, 2003; Geringer, Beamish and daCosta, 1989; Grant, 1987; Habib and Victor, 1991; Ruigrok and Wagner, 2003; Sambharya, 1995). The '*foreign sales to total sales*' measure does not address the breadth or scope of foreign operations and focuses more on the overall strategic importance of the foreign operations to the firm (Tallman and Li, 1996, pp. 184).

Institutional Distance

We adopt the measures for regulative and normative institutional distances that Xu, Pan, and Beamish (2004) used in their study. These measures were developed based on information provided in *The Global Competitiveness Report*, published annually by the World Economic Forum, Geneva. The report documents country differences over 170 items that can be categorized into eight factors: openness, government, finance, infrastructure, technology, management, labor, and institutions. The factors of 'institutions' and 'management' were used to measure the constructs of 'regulative' and 'normative' institutional distance, respectively (Xu, Pan and Beamish, 2004). The 'institutions' factor in the *Global Competitiveness Report* includes 19 survey items that describe a country's civil systems and the 'management' factor includes 18 survey items that describe managerial practices in a country. The regulative measure includes 6 out of 19 'institutions' items that describe the legal and

regulative aspects of a country's environment and normative measure includes 7 out of 18 'management' items that suggest managerial attitudes and norms.

The simple numerical average of 6 items (7 items) for each country was taken as the country's score on its regulative dimension (normative dimension). The regulative and normative distances were then calculated as the absolute difference between the two countries' (home and host) scores on respective dimensions. Since almost every company in the sample had subsidiary operations in more than one host country, several absolute-difference numbers were calculated for both regulative and normative distances. In this study, every regulative or normative distance was weighted. In other words, each absolute-difference number was weighted based on how many subsidiaries the company had in that specific host country. Then, all weighted absolute-difference numbers were added up and became that company's regulative distance or normative distance.

For example, if there is a company from the United States having 2 subsidiaries in Japan, 4 subsidiaries in Germany, and 4 subsidiaries in France. Normative distance of this company will be calculated in the following formula (This formula also applies to regulative distance):

$$\text{Normative distance} = [(5.49-4.88)] \times 2/10 + [(5.49-4.71)] \times 4/10 + [(5.49-4.49)] \times 4/10$$

In this formula, 5.49 represents United States' normative score; 4.88 represents Japan's normative score; 4.71 represents Germany's normative score; 4.49 represents France's normative score. The information of each country's regulative and normative scores can be found in Xu, Pan, and Beamish's (2004, pp. 285-307).

Home Country Economic Openness

Home country economic openness was extracted through factor analyses from three variables (balance of trade, trade to GDP ratio, and tourism receipts) in *The World Competitiveness Yearbook* (Year 2002, 2003, and 2004 editions). This Yearbook is published annually by the International Institute for Management Development in Lausanne, Switzerland. Before running factor analyses, information on four variables in the yearbook were collected. These variables are: balance of trade, trade to GDP ratio, tourism receipts, and integration into regional trade blocks.

Balance of trade (item 1.2.04 in the Year 2002 edition of *The World Competitiveness Yearbook*) is trade's percentage of GDP. Ireland, 30.91%, ranked number one in the list and Estonia, -14.54%, ranked last; the item 1.2.18 is trade to GDP ratio (i.e., $(\text{Exports} + \text{Imports}) / (2 \times \text{GDP})$). Singapore, 172.88, ranked number one and Japan, 10.94, ranked last in the sample; the item 1.2.20 is tourism receipts (i.e., tourism receipts from abroad as a percentage of GDP). In this item, Estonia, 10.01%, ranked number one in the list and Japan, 0.07%, ranked last again; item 2.4.01 is integration into regional trade blocks, which is about whether home country's integration into regional trade blocks provide enough access to foreign markets. Austria, 9.35, was number one and Argentina, 3.28, was last in the sample. After factor analyses, balance of trade, trade to GDP ratio, and tourism receipts were found to load onto the same factor, while integration into regional trade blocks did not and hence was left out of the 'home country economic openness' variable.

Control Variables

Firm International Experience, Firm Size, Firm Leverage Ability, and Industry Profitability

Firm international experience is the simple count of the number of years a company had international operations; the logarithm of total employees worldwide was used as a proxy for firm size; debt to equity ratio was the proxy for firm leverage ability. All three control variables have often been used in the extant literature. Because of the nature of the sample (the cross-sectional industry data), the performance information (ROA) of each investigated industry was obtained. Industry ROE information was also collected for supplementary purpose.

Statistical model

Multiple Regressions

In order to test for the abovementioned three hypotheses, multiple regression models using cross-sectional and time-series data for the Year 2002, 2003, and 2004 were used. Since the research framework of this study is similar to a triangular system (Christen, Iyer and Soberman, 2006), we followed Lahiri and Schmidt (1978) and estimated this triangular system in the manner of seemingly unrelated regression models. Hence, the simultaneity issue was ignored with maximum

likelihood estimation method. In Model 1 international diversity was regressed on the home country economic openness. This tested for hypothesis 1 pertaining to the antecedent's effect on international diversity.

In Model 2, we include the four control variables: industry profitability, firm international experience, firm size, and firm leverage ability. The purpose of Model 2 is to see how these control variables might influence the regression results in the latter models with the relevant independent variables included. Moreover, Model 2 served as the basis model to check for increase in explanatory power with additions of new independent variables.

In order to test for the linear relationship between international diversity and firm performance (Hypothesis 2a), Model 3 was run with firm performance regressed on international diversity and control variables (hereafter, control variables were always included in the regression model). Since the relationship between international diversity and firm performance is also hypothesized as one being depicted by a curvilinear shape, firm performance was also regressed on the square term of international diversity, in Model 4, to test for Hypothesis 2b. Institutional distance in this study was decomposed into two different variables: regulative distance and normative distance. In Model 5, these two variables were added with control variables to see whether they have their direct, primary impacts on the dependent variable, firm performance. In Models 6 and 7, the moderating effect of regulative distance on the international diversity- firm performance link was tested (Hypotheses 3a). Hypotheses 3b was tested by Models 8 and 9 to investigate normative distance's moderating effect.

Results

Descriptive statistics and correlations are provided in Table 2. Regulative distance and normative distance were significantly correlated ($r = -.64$; $p\text{-value} = .000$). However, analyses on variance inflation factors (VIF) show that multicollinearity was not a concern, since all VIF values were substantially lower than the cut-off point of 10 recommended by Neter, Wasserman, and Kutner (1990).

(Insert Table 2 around here)

Model 1 indicates that home country economic openness ($\beta = .160$; $p\text{-value} = .000$) was significant and positively related to firms' adopting international diversity strategy (see Table 3). Thus, Hypothesis 1 was supported. However, this model explained only about 2.4% ($F\text{-value} = 13.152$; $p\text{-value} = .000$) of the variance. One thing worthy to be mentioned is that the beta values used in this study are 'standardized coefficients'.

(Insert Tables 3, 4, 5, 6, 7 and 8 around here)

Results for Model 2, with only the control variables, indicate that there were significant relationships between industry profitability and firm performance, between firm international experience and firm performance, and between firm leverage ability and firm performance. These findings are consistent with prior studies (Li, 2007) and provide support for controlling them in the main models.

Results from the hierarchical regression models 3 and 4 support hypothesis 2a that international diversity is positively related to firm performance. The curvilinear relationship between international diversity and firm performance was not supported (hypothesis 2b). Using the incremental F value as a statistical test to determine if the additional variables in Model 3 (i.e., international diversity) and in Model 4 (i.e., the square term of international diversity) add value in explaining the variance, based on the recommendations of Jaccard, Turrisi, and Wan (1990), Model 3 was tested over Basis Model (incremental F value = 3.684; $p\text{-value} = .056$). However, Model 4 was not superior to Model 3 (incremental F value = .806; $p\text{-value} = .370$), which furthers supports the non-existence of the curvilinear relationship between international diversity and firm performance. Results of Model 5 indicate that there was no direct, primary effect of either regulative distance or normative distance on firm performance. In addition, Model 5 was not a better model than the Basis Model since the incremental F value (1.921) was not significant ($p\text{-value} = .336$). These results validate our next step to test for the moderating effects of these two institutional-distance variables. Two regressions were run to test for Hypotheses 3a. Models 6 and 7 indicate that regulative distance is significant and negatively moderates the relationship between international diversity and firm

performance (Hypothesis 3a was supported). We did not test for regulative distance's moderating effect on the square term of international diversity- firm performance link since there was no support for the curvilinear hypothesis

Results in Models 8 and 9 indicate that normative distance significantly but positively moderated the relationship between international diversity and firm performance (Hypothesis 3b was not supported). Model 9 explained 16.5% (F value= 15.109; p-value= .000) of the variance and was tested over Model 8 (incremental F value= 4.939; p-value= .027).

Discussion and Conclusion

The curvilinear (inverted-U) relationship between international diversity and firm performance was not found in this study. Instead, a positive, linear relationship was found with the sample of Fortune 500 companies. On average, companies in this study had around 33 years of prior international experience, so one of the reasons for this finding could be similar to Tallman and Li's (1996) argument: "losses due to overexpansion should be mitigated by the typical gradualism of internationalization and by highly developed skills at managing international subsidiaries in a sample of multinational firms" (p. 185). Without necessary experience and knowledge, managers could still anticipate a curvilinear relationship between international diversity and firm performance. Moreover, our result of a positive linear relationship is in line with recent findings with different contextual approaches. Hitt et. al. (2006) hypothesize and find a positive linear relationship for US legal service firms, so do Ruigrok and Wagner (2005) in their meta-analytic study of the multinationality-performance research literature.

We found that home country economic openness was positively related to international diversity in this study. This has serious implications for policy makers and government officials. Greater effort should be spent on increasing the openness of their home country economic environment since international diversity indirectly influences home country economic performance by facilitating their firms' performance. With regard to institutional distance, regulative distance was found to be the most impeding factor for firms' operations in foreign countries and, surprisingly,

normative distance turned out to be a positive moderator. The results probably mean that managers now should do their homework about not only host countries' 'cultures' but also host countries' 'regulatory institutions'. An explanation of the positive moderating impact of normative distance could lie in the nature of the study's sample (highly globalized set of companies).

Our study contributes to existing literature on international diversity and performance by adopting an institutional theory perspective and investigating the moderating role of institutional distance on the proposed relationship. In this regards our study is unique and novel. However, there are some limitations, which future researchers can build on for further development of this area of research. First, this study used the number of foreign subsidiaries and number of countries as measurement items of international diversity. However, international diversity could be treated further, beyond just the scale and scope dimensions, incorporating the aspect of complexity of activities with which different subsidiaries in different countries are linked. For instance, an MNE can have subsidiary offices in a number of diverse institutional contexts, but all performing very simple roles. On the other hand, an MNE could be spread into institutionally diverse contexts and be performing a range of complex roles. Future researchers can argue that the international diversity of the MNE in the latter case is higher and as such the consequent relationship with firm performance and the moderating roles of regulative and normative distances might also be different. Second, other than home country economic openness, more home country environmental variables can have their impacts on firms' strategic behaviors such as international diversity. Finally, the empirical findings of this study implicitly indicate the possibility that regulatory institutions have become a most impeding influence on international business than the normative institutions. Researchers in the future should focus on this issue since it could potentially bring the new paradigm into the international business studies.

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Figure 1: The Conceptual Framework of this Study

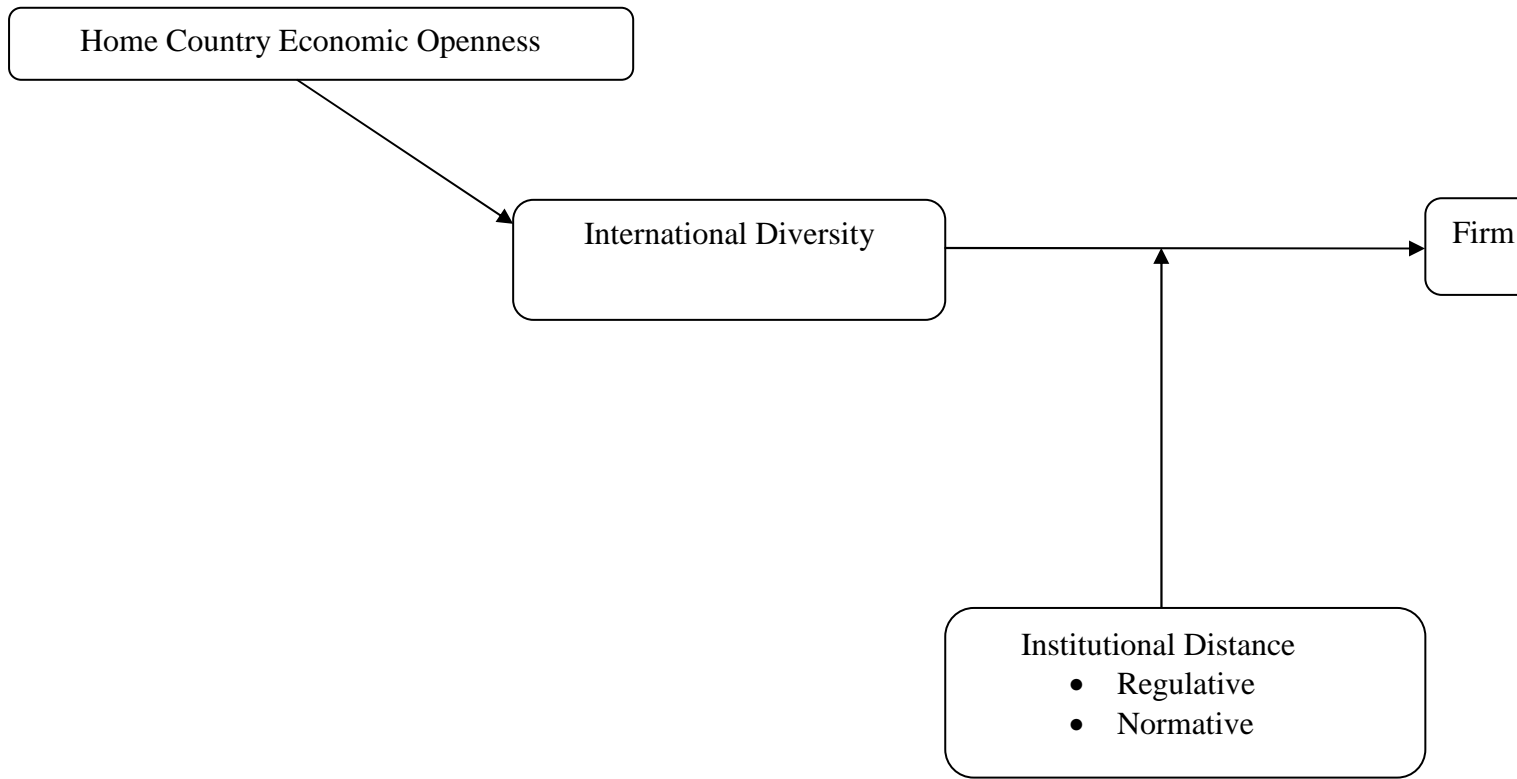


Table 1: Distribution of *Fortune Magazine* Global 500 Companies' (Year 2004's Ranking) Home Countries

Country	Frequency	Percent	Cumulative Percent
Australia	10	2.0	2.0
Belgium	3	.6	2.6
Brazil	3	.6	3.2
Canada	13	2.6	5.8
China	15	3.0	8.8
Denmark	2	.4	9.2
Finland	3	.6	9.8
France	39	7.8	17.6
Germany	37	7.4	25.0
Hong Kong	1	.2	25.2
India	5	1.0	26.2
Ireland	1	.2	26.4
Italy	8	1.6	28.0
Japan	81	16.2	44.2
Luxembourg	1	.2	44.4

Malaysia	1	.2	44.6
Mexico	2	.4	45.0
Netherlands	15	3.0	48.0
Norway	2	.4	48.4
Russia	3	.6	49.0
Saudi Arabia	1	.2	49.2
Singapore	1	.2	49.4
South Korea	11	2.2	51.6
Spain	8	1.6	53.2
Sweden	7	1.4	54.6
Switzerland	11	2.2	56.8
Taiwan	2	.4	57.2
Thailand	1	.2	57.4
Turkey	1	.2	57.6
UK	37	7.4	65.0
US	175	35.0	100.0
Total	500	100.0	

Table 2: Descriptive Statistics and Correlations

	Mean	Standard Deviation	1	2	3	4	5	6	7	8	9
1. Industry profitability (ROA)	.0473	.03012	1								
2. Firm international experience	32.9527	26.70988	0.026	1							
3. Firm size (log of employees)	10.7848	1.23083	0.001	0.138**	1						
4. Firm leverage ability (D/E ratio)	1.7188	4.65862	-0.058	0.078	-0.011	1					
5. Home country economic openness	.0000	.9979398	-0.004	-0.088*	0.036	-0.004	1				
6. International diversity	.1016	.12510	0.07	0.086	0.168***	0.046	0.182***	1			
7. Firm performance (ROA)	.4507	.19320	0.095*	0.074	0.112*	0.022	0.173***	0.169***	1		
8. Regulative distance	.0000	1.0000	-0.01	-0.012	-0.049	0.064	0.08	-0.132**	0.064	1	
9. Normative distance	.6387	.25521	0.022	-0.013	0.102*	-0.066	-0.158***	0.12**	-0.062	-0.64***	1

*** = $p < .001$; ** = $p < .01$; * = $p < .05$; † = $p < .10$

Table 3: Regression Results

(Home Country Economic Openness and International Diversity)

DEPENDENT VARIABLE: International diversity	MODEL 1 (n= 500)
INDEPENDENT VARIABLE	
Home country economic openness	.160***
	(4.262)
Adjusted R Square	.024
F Value	13.152***

*** = $p < .001$; ** = $p < .01$; * = $p < .05$; † = $p < .10$

Values in the parentheses are standard errors

Table 4: Regression Results
(Control Variables and Firm Performance)

DEPENDENT VARIABLE: Firm performance	MODEL 2 (n= 500)
CONTROL VARIABLES	
Industry profitability	.379***
	(1.370)
Firm international experience	.072†
	(.002)
Firm size	-.019
	(.000)
Firm leverage ability	-.092*
	(.009)
Adjusted R Square	.155
F Value	23.848***

*** = $p < .001$; ** = $p < .01$; * = $p < .05$; † = $p < .10$

Values in the parentheses are standard errors

Table 5: Regression Results**(International Diversity and Firm Performance)**

DEPENDENT VARIABLE: Firm performance	BASIS MODEL (n= 500)	MODEL 3 (n= 500)	MODEL 4 (n= 500)
CONTROL VARIABLES			
Industry profitability	.379***	.378***	.378***
Firm international experience	.072†	.071†	.068†
Firm size	-.019	-.023	-.023
Firm leverage ability	-.092*	-.092*	-.094*
INDEPENDENT VARIABLES			
International diversity		.079*	.138†
		(.000)	(.001)
International diversity (square term)			-.069
			(.000)
Adjusted R Square	.155	.159	.159
F Value	23.848***	19.918***	16.727***
Incremental R Square		.006	.001
Incremental F Value		3.684†	.806

*** = $p < .001$; ** = $p < .01$; * = $p < .05$; † = $p < .10$

Values in the parentheses are standard errors

Table 6: Regression Results**(Regulative Distance, Normative Distance, and Firm Performance)**

	BASIS MODEL (n= 500)	MODEL 5 (n= 500)
DEPENDENT VARIABLE: Firm performance		
CONTROL VARIABLES		
Industry profitability	.379***	.379***
	(1.370)	(1.370)
Firm international experience	.072†	.071†
	(.002)	(.002)
Firm size	-.019	-.017
	(.000)	(.000)
Firm leverage ability	-.092*	-.088*
	(.009)	(.009)
MODERATORS		
Regulative distance		-.061
		(.054)
Normative distance		-.001
		(.211)
Adjusted R Square	.155	.155
F Value	23.848***	16.269***
Incremental R Square		.004
Incremental F Value		1.921

*** = $p < .001$; ** = $p < .01$; * = $p < .05$; † = $p < .10$

Values in the parentheses are standard errors

Table 7: Regression Results**(International Diversity, Firm Performance, and Regulative Distance)**

DEPENDENT VARIABLE: Firm performance	MODEL 6 (n= 500)	MODEL 7 (n= 500)
CONTROL VARIABLES		
Industry profitability	.378***	.375***
Firm international experience	.070†	.069†
Firm size	-.022	-.023
Firm leverage ability	-.089*	-.089*
INDEPENDENT VARIABLES		
International diversity	.074†	.061
	(.000)	(.000)
MODERATORS		
Regulative distance	-.054	-.067
	(.041)	(.044)
Regulative distance x International diversity		-.040†
		(.001)
Adjusted R Square	.161	.160
F Value	16.907***	14.591***
Incremental R Square	.009	.001
Incremental F Value	2.697†	.749†

*** = $p < .001$; ** = $p < .01$; * = $p < .05$; † = $p < .10$

Values in the parentheses are standard errors

Table 8: Regression Results**(International Diversity, Firm Performance, and Normative Distance)**

DEPENDENT VARIABLE: Firm performance	MODEL 8 (n= 500)	MODEL 9 (n= 500)
CONTROL VARIABLES		
Industry profitability	.378***	.371***
Firm international experience	.072†	.063
Firm size	-.025	-.022
Firm leverage ability	-.090*	-.095*
INDEPENDENT VARIABLES		
International diversity	.075†	.039
	(.000)	(.000)
MODERATORS		
Normative distance	.030	.044
	(.163)	(.164)
Normative distance x International diversity		.099*
		(.002)
Adjusted R Square	.159	.165
F Value	16.671***	15.109***
Incremental R Square	.007	.008
Incremental F Value	2.104†	4.939*

*** = $p < .001$; ** = $p < .01$; * = $p < .05$; † = $p < .10$

Values in the parentheses are standard error