Institutional Distances and the Performance of Multinational Subsidiaries in Brazil

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Abstract

Although several studies have addressed the strategies and patterns of multinational companies in Brazil and Latin America, very few studies have discussed the determinants for the performance of multinational subsidiaries. The study's main objective is to investigate the effects of institutional and cultural distances and the mediating effects of experience and industry for the performance of foreign subsidiaries in Brazil. Using quantitative methods, we collected data from 38 foreign subsidiaries operating in Brazil during the period between 2000 and 2014. The tests were performed in a progressive manner employing three sub-models in order to evaluate the implications of formal and informal institutional distances in an aggregate manner and in separate variables for the distances in specific dimensions. The moderating effects of cultural distance to the institutional distance was also verified indicating that the greater the distance in terms of both, formal and informal institutions will have a negative effect to the performance of multinational companies (MNCs) in Brazil. The results indicate that specific dimensions of the formal and informal institutional environments have different and significant effects on the performance of MNCs in Brazil. Finally, the findings concluded that while experience and industry do not matter, the firm's resources were highly significant.

Key words: Institutional distance, cultural distance, subsidiary, performance, Brazil

1 INTRODUCTION

Political reforms and economic stability during the 1990s in Brazil have significantly contributed to positive change in internal context. This is responsible for contributing to a positive business environment, not only for the expansion of domestic firms, but also for the attraction of multinational companies from different regions around the world. Thus, Brazil has emerged as one of the most attractive destinations for direct foreign investment in Latin America. Its participation reached a record of 39% of the total FDI in the region during the period from 2007 to 2010 (UNCTAD, 2010). Its position among the top ten host countries for world FDI pointed to the role and strategic importance of the country in the world economy.

Several studies have addressed the strategies and patterns of multinational companies in Brazil and Latin America. However, very few studies have discussed the determinants of the performance of multinational subsidiaries (Perkins, 2008). Although studies regarding the determinants of the performance of subsidiaries in Latin America, especially in Brazil, are scarce, a review of the literature suggests that cultural and institutional distances between the subsidiary's home country and the host country may significantly influence the performance of these firms in the host market.

Studies in international business have focused primarily on investigating the effects of resources and strategy on the performance of firms. The contribution of the Resource Based View (RBV) approach (Barney, 1991) was considered crucial in the understanding of the internationalization strategies of firms, and their performance in foreign markets (Peng, 2001). Since the contributions of Kostova (1997), and Kostova and Zaheer (1999), studies in international business have started considering the role of the context and distance between the home and host countries in shaping the strategy of foreign subsidiaries, and therefore, their performances.

In earlier studies on international management, authors have approached the topic by using cultural distance (Kogut &Singh, 1988) to evaluate how the differences between home and host countries matter. However, recent studies (Shenkar, Luo & Yeheskel, 2008) have pointed to the limitations of the concept when using it to capture the distance effects, and have suggested the use of the broader concept of institutional distance (Peng, 2001; Shenkar, 2001; Xu & Shenkar, 2002).

In the neo-institutional theory, institutions represent the rules of the game, and are "the humanly devised constraints that structure human interaction" (North, 1990; p.3).They can be divided into formal and informal institutions. Using a similar perspective, Scott (1995, p. 33) suggests that institutions are "regulative, normative, and cognitive structures that provide stability and meaning to social behavior". While, formal institutions can be identified with the regulative pillar, informal institutions refer to the normative and cognitive structures of a society. According to Peng, Wang and Jiang (2008), culture can be seen as a substratum of institutional arrangements, which means that culture is part of the informal institutions in the environment that underpin formal institutions.

Although the institutional impact on the performance of subsidiaries is still controversial, this perspective has introduced new ways to measure and estimate the role of distances on shaping the strategies of multinational companies. Several studies have suggested that the effect of the institutional environment is more likely to determine the mode of entry in foreign markets (Brouthers, 2001 Brouthers & Brouthers, 2000; 2001; Xu, Pan & Beamish, 2004). This means that the performance of subsidiaries is determined by entry mode, eithera wholly owned subsidiary or a joint venture, and the acquisition or Greenfield (Brouthers, Brouthers & Werner, 2008).

In addition, studies have approached the institutional determinants of the performance of subsidiaries by using different indicators (Du, 2009), such as country risk, governance indicators, world competitiveness indicators and cultural distance (Barkema & Vermeulen, 1997; Das & Teng, 2003; Giora, Alistar & Anderson, 2008). However, it seems that the effect of different measurements of the institutional distance pointed to different results, as well as to controversial impacts (Beamish & Lupton, 2009).

In this paper, we suggest that the effects of the various levels of institutions may have different impacts due to the differences in the speed of institutional changes. Countries may create robust and efficient regulatory frameworks for the activities of foreign firms. However, it does not necessarily imply changes in the normative and cognitive-cultural frameworks of the country. There is a lag of institutional change among the Scott´s pillars (1995), as well as in the path dependency effect among the three pillars. On the other hand, besides the pace differences among the different levels of institutional changes, the interaction between them may be more important in shaping the behavior of firms, and thus, their performance.

In the present study, we advance the literature in international business by discussing the relationships between institutions and the performance of foreign firms in an emerging country. Furthermore, by using a panel data model, we will estimate the determinants of the performance using a long-term perspective.

Finally, we will test the mediating role of the resources and industry of the firm. Therefore, the objective of the present study is to address the impacts of formal (quality of regulatory institutions) and informal institutional (cultural) distances between the home and host country to the performance of foreign subsidiaries in Brazil. Additionally, the present study evaluates the moderating effects of cultural distance on the institutional distance.

2 THEORY AND HYPOTHESES

In international business literature, two main models have significantly influenced empirical studies on the internationalization of the firms: the OLI Paradigm (Dunning, 2000) and the Uppsala Model of Internationalization (Johanson & Vahlne, 1977).Dunning (2000) combined the different aspects of the international business theories into one single framework, called the Eclectic Paradigm or OLI Paradigm. The principal hypothesis of the Eclectic Paradigm of International Production is that the level and structure of a firm`s foreign value-adding activities will depend ownership advantages, internalization and location advantages (Dunning & Lundan, 2008).

The Uppsala approach has shifted the debate in international business from previous models to a new consideration for the process of internationalization, which has contributed to new topics in the field.

The basic assumption of the Model is that the experiential knowledge and the general information available about a market will determine the resource commitment that a firm will make to a particular market, in a incremental way, from export strategy, to production subsidiary. The access to a higher stage of the internationalization´s establishment chain is influenced by the gradual development of knowledge, especially experiential knowledge, in foreign markets, as well as the resources committed. Due to differences between the home and host countries, firms will perform on different levels. Firms with limited resources, as well as restricted knowledge and experiences, will first enter in countries that are geographically or culturally closer to the home market. This suggests that firms will start their internationalization in countries with lower psychic distance. The Uppsala Model introduced the concept of distance as an important factor that drives the path and strategies of firms in foreign markets.

It is important to note that both theoretical frameworks have considered the distance between home and host countries to be a determining factor in the international expansion of firms. Nevertheless, it seems that the contributions of the Institutional Theory have been crucial in integrating the concept of institutional distance into the general framework of international business. Dunning and Lundan (2008), as well as the different studies by Kostova (1997),Kostova and Zaheer (1999), Shenkar (2001), Xu and Shenkar (2002), and Peng (2011) explored the implications of the Institutional Theory for the internationalization.

One of the main contributions of the institutional theory lies in how to overcome the concept of cultural distance (Kogut & Singh, 1988) as the main distance factor used to explain the internationalization strategy and performance of firms in foreign markets. According to Xu and Shenkar (2002), the index of cultural distance "does not capture the complexity of cross-country differences; particular (sic), it neglects the critical role of societal institutions in articulating, disseminating, and arbitrating cultural and social cues".

Cultural distance as a measure of cultural differences between the home and host countries has been used in different areas. Particularly in the FDI literature, the concept was used to explain the location decision of MNE, and especially the sequence of these investments. The second application of the concept of cultural distance has been to predict the choice of mode of entry into foreign markets. A third application of the concept has been to explain the performance of multinational subsidiaries in foreign

markets (Shenkar, 2001). However, empirical studies have shown controversial results in terms of its impacts on the different levels of internationalization strategy.

However, as shown in table 1, empirical studies show controversial results about the impact of cultural and institutional distances on the performance of multinational firms operating in foreign markets.

Table 1: Empirical studies

Variable	Author	Impact on Performance
Cultural Distance and Performance	Peretomode (2012)	Negative (*)
	Beamish and Lupton (2009)	Neutral
	Giora, Alistair and Anderson (2008)	Neutral
	Halkos and Tzeremes (2008)	Positive (*)
	Das e Teng (2003)	Negative (*)
	Barkema and Vermeulen (1997)	Negative (*)
	Gomez-Mejia and Palich (1997)	Neutral
	Zaheer and Mosakowski (1997)	Negative (*)
	Zaheer (1995)	Negative (*)
Institutional Distance and Performance	Aguilera-Caracuel, Fedriani and Delgado-Márquez (2014)	Negative (*)
	Aguilera-Caracuel et al. (2013)	Negative (*)
	Aguilera-Caracuel et al. (2013)	Negative (*)
	Ma, Tong and Fitza (2013)	Negative (*)
	Ramsey and Bahia (2013)	Negative (*)
	Yang, Martins and Driffield (2013)	Negative (*)
	Higón and Antolín (2012)	Negative (*)
	Salomon and Wu (2012)	Negative (*)
	Tang and Rowe (2012)	Negative (*)
	Hilmersson (2009)	Negative (*)
	Du (2009)	Negative (*)
	Mikael Hilmersson (2009)	Negative (*)
Experience and Performance	Pehrsson et al. (2015)	Positive (*)
	Yang, Martins and Driffield (2013)	Positive (*)
	Higón and Antolín (2012)	Ambiguous
	Peretomode (2012)	Negative
	Tang and Rowe (2012)	Positive (*)
	Lee, Cheong-A., et al. (2011)	Positive (*)
	Perkins (2008)	Negative (*)

(*) Statistically significant

Source: Elaborated by the authors.

Although the literature suggests that cultural distance and institutional distance will have negative impacts on the performance of the subsidiaries of multinational companies when operating in a foreign market, there are several empirical studies demonstrating different impacts. For Shenkar (2001), the inconsistent results of the cultural distance are first related to the conceptual properties, which suppose that the distance between the home country and the host country is symmetric, stable, and linear. In terms of methodological properties, the main limitations of the cultural distance concept are related to the assumption of corporate homogeneity. The concept relies on national culture measures and implicitly assumes a lack of corporate culture variance (Shankar, 2001). The concept also supposes a spatial homogeneity, which implies that the CD index assumes uniformity within the national unit. For Shenkar (2001), such properties of the concept have not been supported in the empirical literature.

Despite the methodological and theoretical limitations, the concept of cultural distance, when used, can be supplemented by using either a long-term orientation or other measurements that avoid linearity (Shenkar, 2001). Based on the critiques of the concept, Xu and Shenkar (2002) suggest that institutional distance is an alternative explanation for the behavior of multinational enterprises.

There are several advantages of the concept of institutional distance. First, institutional distance is not assumed to be constant. Institutions change over time. Second, the concept does not suppose a linear impact on investment, entry mode, and performance. The concept has been linked from the beginning to the strategic behavior of multinational enterprises attempting to establish legitimacy in foreign markets, as well as attempting to transfer ownership advantages from the parent firm to the subsidiary. This is used as a strategic orientation to cope with the liability of foreignness (Kostova &Zaheer, 1999; Xu & Shenkar, 2002). Finally, in the broader perspectives of North (1990) and Scott (1995), institutions are formal and informal. This means that cultural distance is part of the institutional distance.

The literature review suggests that cultural distance and institutional distance negatively impact the performance of multinational subsidiaries. More recently, Hernández and Nieto, 2015, Zaheer, Schomaker and Nachum (2012), suggest that the magnitude and the direction of the institutional distance should be considered when employing the construct for analyzing the internationalization process of firms.

The review of empirical studies regarding the topic suggests that there are controversial results concerning how firms manage these differences. The contradictory results from these studies make it even more important to test how the multinational firms operating in Brazil are managing the cultural and institutional distances in order to be competitive in the Brazilian market.

Table 2: Theoretical perspectives and determinants of subsidiary performance

	Cultural Distance	Institutional Distance	Experience	Industry
OLI Paradigm	(+) Innovation, identifying opportunities (-) Aligning expectations, communications	(-) Not being familiar with the "rules of the game" (North, 1990)	(+) Learning how to interact with the market	(+) Opportunities to internalize, locate resources in competitive regions (-) Access to resources, foreign markets
Uppsala Model	(-) Psychic distance makes it difficult to communicate with the market	(-) Additional costs when compared to local firms	(+) Reduces the effects of psychic distance	(+) Differentiation (-) Market condition (saturation, competition, etc.)
Institutional Theory	(-) Regulatory, Normative and **COGNITIVE**	(-) **REGULATORY, NORMATIVE** and Cognitive	(+) Reduces the effects of cultural and institutional distances	(-) Instable foreign market conditions increases the risk to commit resources (greater impact on resource intensive industries)

Source: Elaborated by the authors.

Table 2 presents a summary of how the different theories of international business have addressed the impacts of distance on FDI performance. We also report the role attributed to experience and industry in moderating the effects. Table 2 shows that there might be both positive and negative effects regarding the implications of each variable on the performance of the subsidiaries. By analyzing these theories, one could argue that the distances may represent a treat or an opportunity for subsidiaries of multinational companies to perform in a superior manner.

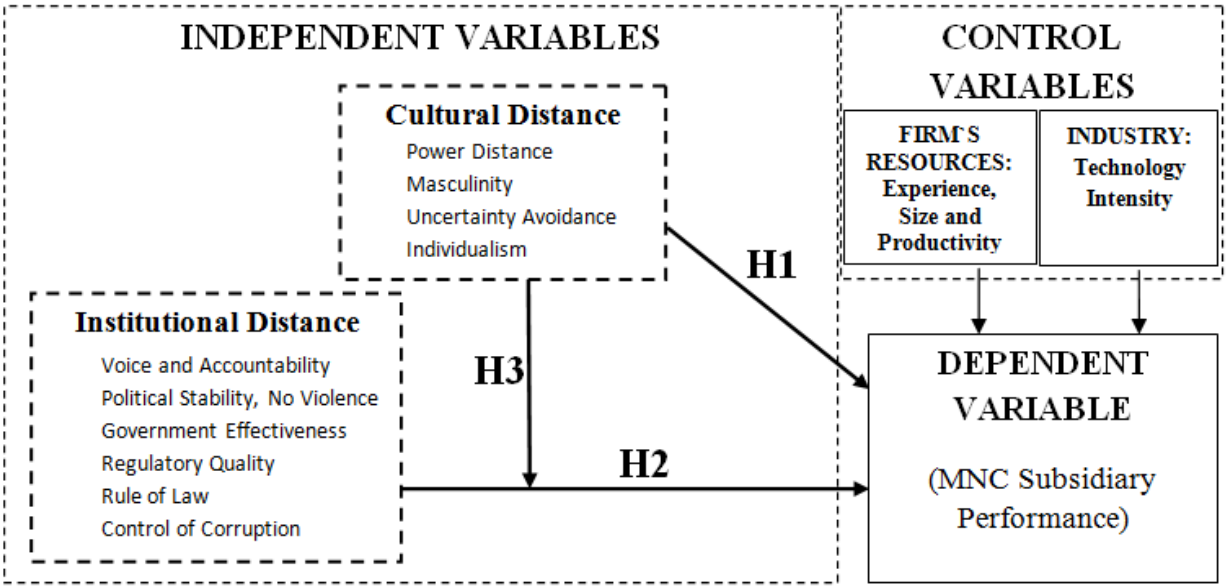
Considering this two-sided nature of the distances and the effects of the variables for the subsidiary's performance, it is particularly important for an organization to evaluate and implement actions that could convert a challenging condition into an opportunity. It is important to note that both theories of international business present similar results regarding the effects of distance on a subsidiary's performance. Furthermore, experience and knowledge can be seen as firm resources that may contribute to the moderation of the effects of distance. However, it seems that such behavior may be different according to the type of industry.

2.1 General Framework and Hypotheses

In order to illustrate the determinants of the performance of multinational subsidiaries, we propose to test the following general framework. In this model, we suggest that the institutional distance and the cultural distance between the multinational firm's home country and Brazil will determine the performance of the multinational company's subsidiaries. In this model, we also suggest that the firm´s

resources and the industry in which the subsidiary of the multinational firm operates will mediate the effects of cultural and institutional distances.

Figure 1: General Framework



Source: Elaborated by the authors.

According to the proposed model, the performance of the multinational company's subsidiaries will be determined by the cultural distance and institutional distance. The model also implies that the firm's resources and industry have mediating effects on the subsidiaries 'performance. Furthermore, we suggest that the interaction between formal and informal institutions affect the subsidiaries' performance. Based on this framework, we draw some hypotheses.

Cultural Distance Hypothesis

In the 1970s, the Nordic school presented a model for the internationalization process of the firm, which became internationally known as the Uppsala Internationalization Model (Johanson & Vahlne, 1977; Johanson & Wiedersheim-Paul, 1975).The model suggests that foreign companies are at a disadvantage when competing with local firms because of the psychic distance between the firm`s home country and the host country. According to the authors, the psychic distance represents the condition in which the foreign firm is unable to communicate with the foreign market because it does not understand the culture and institutional norms presented in this new environment. In order to overcome this condition, the authors suggest that firms need to acquire experience in the new foreign market before they decide to increase the level of commitment to the market. The Uppsala model is known as a behavioral approach, in which the firm will decide to increase its commitment to the market as a consequence of acquiring experience with the market, which will, in turn, reduce the uncertainties created by the psychic distance.

Based on this approach, Kogut and Singh (1988) verified that the cultural distance between the country of origin and targeted foreign market would directly influence the entry mode choices for these companies. Therefore, in order to calculate the cultural distance between the home country and the host market, they developed an index that utilized the dimensions of the national culture (Hofstede, 1980) to compute the cultural distance between two countries.

The following hypothesis was developed to verify the implications of cultural distance on the performance of the subsidiaries operating in Brazil..

H1: The greater the cultural distance between the multinational company`s home country and Brazil the lower the performance of the subsidiaries.

2.1.1 Institutional Distance Hypothesis

Different levels of analysis can be identified in the institutional perspectives of international business: the macro-level and micro-level perspectives. One of the most representative approaches of the macro-institutional approach has been developed by North (1990), which has focused on the investigation into the role of institutions in the economic growth of nations. North (1990) defines institutions as the rules of the game in a society, affirming that they are characterized as limitations that mold the human interaction and the way the society develops over time.

For North, the institutions exist to minimize the uncertainties present in the human actions for those who are subject to them. Therefore, the institutions of a nation take a group of actions and conducts that are socially accepted and desirable in order to produce a certain result for the society. Still, according to the author, when a nation or society assumes a certain institutional environment, it creates more favorable conditions for the development of certain types of activities, as well as organizational structures, to the detriment of other ones.

Within the business literature, firm-level institutional analysis draws on the framework of Scott (1995: 48). According to him, institutions "are multifaceted, durable social structures made up of symbolic elements, social activities, and material resources". This conception is based on the definition that "institutions are comprised if regulative, normative and cultural-cognitive elements that, together with associated activities and resources, provide stability and meaning to social life". The three elements are known as the Three Pillars of Institutions.

The regulative pillar refers to "the processes that involve the capacity to establish rules, inspect others' conformity to them, and, as necessary, manipulate sanctions – rewards or punishments – in an attempt to influence future behavior". (Scott, 1995: 52).The normative pillar exists on the set of beliefs, values and norms that define and constrain social behavior, while also empowering and enabling social actions. The third pillar of the framework is the cultural-cognitive pillar, which can be defined as shared social knowledge and practices.

Scholars of international business have tried to explore the contributions of the Institutional Theory in order to understand the process and strategies of the internationalization of firms. The Uppsala Model suggests that when a MNE enters a foreign market, it starts to explore and experiment how to communicate and operate in this new environment. According to Zaheer (1995), this situation generates additional costs for foreign companies to operate in a new international market. The author named this condition Liability of Foreignness, and suggests that these additional costs may arise from the following situations: (i) Costs directly related to the geographical distance between the parent and the subsidiary, which will result in higher costs related to transportation and activities coordination in remote locations and in different time zones; (ii) Specific costs related to lack of knowledge and network connections in the local market; (iii) Costs related to barriers imposed by the foreign market that favors local businesses; and (iv) Costs imposed by the country of origin that may restrict or impede the company's expansion into the foreign market.

In particular, when considering the lack of knowledge concerning how to interact with the foreign market, MNE are at a disadvantage when compared to domestic firms. The literature suggests that as the firms get more experienced with the host country, the negative effects generated by the firm's lack of familiarity with the culture and institutions found in this new foreign market may be partially or completely eliminated.

The burgeoning of institutional perspectives in the 1990s and 2000s has contributed to the understanding, not only of the different strategies that firms adopt when they go global, but also to the different performances that are registered in different contexts (Peng et al., 2009). One of the significant

contributions in this field is related to the shift of focus from cultural differences among countries, to the broader concept of institutional distance (Kostova, 1999; Kostova & Zaheer, 1999; Xu & Shenkar, 2002). This research perspective has been framed based on the three institutional pillars of Scott (1995): regulative, normative, and cultural-cognitive. The institutional distance can be measured in terms of the distance concerning the three pillars, and estimating their effects on the location and strategies of MNCs entering and creating value in foreign markets.

Shenkar, Luo and Yeheskel (2008) propose a new metaphor for explaining the implications of the differences encountered by MNE entering a foreign market. The authors suggest that distances or differences can occur in terms of technology, geographical, cultural, institutional reasons, and many other elements that can create additional challenges for MNEs operating in foreign markets. Shenkar, Luo and Yeheskel (2008) suggest that the greater the distance between the firm's home country and the host market, the more friction that will occur, making it difficult for the firm to operate in the foreign market.

North (1990) defines institutions "as the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction" (p. 3). The author distinguishes between formal institutions, such as rules that human beings devise, or informal constraints, such as conventions and codes of behavior. Thus, institutional constraints represent the framework within which human interactions take place, and consist of formal written rules as well as unwritten codes of conduct that underlie and supplement the formal rules (North, 1990). Formal rules can complement and increase the effectiveness of informal constraints. They may lower information, monitoring, and enforcement costs, which may influence the performance of subsidiary in foreign markets. Formal rules also may be enacted to modify, revise, or replace informal constraints.

Formal rules include political and judicial rules, economic rules, and contracts (North, 1990). Political rules broadly define the hierarchical structure of the polity, its basic decision structure, and the explicit characteristics of agenda control. Economic rules define property rights, which are the bundle of rights over the use and the income to be derived from the property, as well as the ability to alienate an asset or a resource. Contracts contain the provisions specific to a particular agreement in exchange.

In this formal conception of institutions, there is a hierarchical relationship among its components. The rules, according to North (1990), descend from polities to property rights to individual contracts. However, the relationship between formal rules and economic performance is limited. North (1990) considers that a mixture of informal norms, rules, and enforcement explains economic performance.

In order to test the effect of formal rules, we will use the indicators of world governance (Kaufmann, Kraay, & Mastrazzi, 2009) on the performance of multinational subsidiaries in Brazil. The World Governance Indicators approach has been particularly used to measure the impact of governance on economic development (Kaufman et al., 2009). Other scholars have used it to explain the institutional changes in developing countries, and their effects on attracting FDI from developed countries (Daude & Stein, 2007) More recently, authors have used the concept of governance to estimate the effects of institutions on OFDI, like Globerman and Shapiro (2002) addressing the case of USA-OFDI, and He and Cui (2012), using firm data.

Under governance, Kaufman et al. (1999) understand the following:

> . . . traditions and institutions by which authority in a country is exercised. This includes, (1) the process by which governments are selected, monitored and replaced, (2) the capacity of the government to effectively formulate and implement sound policies, and (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them. (p. 1).

> **H2:** The greater the institutional distance between the multinational company`s home country and Brazil, the lower the performance of the subsidiaries.

Although psychic distance and cultural distance are very broad terms, Xu and Shenkar (2002) consider that in order to fully understand the elements that influence the internationalization process of the firm, more elements should be added to this analysis.

According to Ghemawat (2001) and Shenkar (2001), besides the cultural distance, there are other elements that affect the performance of multinational companies in foreign markets. Multinational companies, when entering foreign markets, have to learn how to operate in a different cultural and institutional environment. The company's ability to act and adapt to the different cultural and institutional environment is a key element in ensuring the company's competitiveness in international markets. To capture the effects of formal institutional distance combined with the cultural distance, we propose hypothesis 3.

Shenkar, Luo and Yeheskel (2008) suggest that distances or differences can occur in terms of technological, geographical, cultural, and institutional issues, as well as many other elements that create additional challenges for multinational enterprises operating in foreign markets. Shenkar, Luo and Yeheskel (2008) suggest that this distance creates friction between the company and the foreign market. In order to test this condition, hypothesis 3 intends to verify if the combination of several distances, meaning that the company`s home country is not different in only one aspect, but in several aspects will cause hurt this companies performance.

In order to represent and test this condition, for this paper, we consider introducing a variable that measures the interaction between formal and informal institutional distance into the framework. This variable will allow us to test whether companies from countries that have greater differences in terms of both cultural and institutional aspects will perform lower as compared to firms from more similar environments.

This assumption is based on the formal conception of institutions, which supposes that there is a hierarchical relationship among its components. The rules, according to North (1990), descend from polities to property rights to individual contracts. It means that the institutional changes are not linear and not uniform when they occur, and that changes in the regulatory pillar do not mean necessarily the same path of changes in the other dimensions of institutional environment. Therefore, the interaction between formal and informal institutions may explain the performance of a multinational subsidiary in a foreign market. In other words, this is the mixture between formal rules and informal and cultural norms that explain the behavior of firms. We suggest testing the following hypothesis:

> H3: Cultural distance has a positive moderating effect on the relationship between institutional distance and the performance of MNCs` subsidiaries in Brazil.

2.1.2 Control Variables

Experience effect

Experience in the Brazilian market was measured according to the number of years that the company has been operating in Brazil. This data was collected from the company websites regarding the beginning of the company's operation within the Brazilian market. Regarding the implications of experience for the performance of the multinational company in a foreign market, Johanson and Vahlne (1977) and Johanson and Wiedersheim-Paul (1975) suggested that the lack of knowledge about the foreign market would reduce the performance of the multinational company`s operation in foreign market. In assessing the implication of experience to the process of the internationalization of organizations, Johanson and Vahlne (1977) and Johanson and Wiedersheim-Paul (1975), suggested that the accumulation of experience, even when it occurs in different international markets, could serve as an accelerator for the firm to acquire knowledge and understand the dynamics of a new market. According to Johanson and Vahlne (1977) and Johanson and Wiedersheim-Paul (1975), the company's experience may help the company to skip steps in the establishment chain.

Industry effect

According to Johanson and Vahlne (1977) and Johanson and Wiedersheim-Paul (1975), the psychic distance between the company`s home country and the host market will be detrimental on the performance of the organization, regardless of the sector in which the company operates. Johanson and Vahlne (1977) and Johanson and Wiedersheim-Paul (1975) suggested that the psychic distance makes it difficult to interact with the foreign market.

2.2 Description of the Variables

The following table summarizes the variables, as well as the expected behaviors and impacts on the performance of multinational subsidiaries in foreign markets. For the present study, the dependent variable is measured using an objective indicator for evaluating the performance of the subsidiaries operating in Brazil. The criterion selected for measuring the subsidiary`s performance was the net profit. This indicator, like in other studies (Chang, Gong & Peng, 2012), was selected for evaluating the firm's performance because it helps with objectively verifying the capacity of the firm to employ and manage its resources in a competitive manner.

The institutional variables are measured by formal institutional distance (World Governance Indicators), and cultural distance. In order to capture the effect of firm resources, we included several variables, like the assets, size, revenue per employees (productivity), and experience. We also controlled by industry, using a dummy variable.

Table 3: Variables, expected signs and sources

Variables	Expected Sign	Sources
Net Profit	**Dependent Variable**	Annual Report: *Exame*
Independent Variables		
Institutional Distance	-	World Bank
Cultural Distance	-	Hofstede website
Control variables (firm resources)	+	Annual Report: *Exame*
Total Equity (Size)	+	Annual Report: *Exame*
Employees (Size)	+	Annual Report: *Exame*
Experience	+	Annual Report: *Exame*
Productivity	+	Annual Report: *Exame*
Industry Dummy	Neutral	OCDE
Interaction Variable		
ID * CD	-	

Source: Elaborated by the authors.

3 METHOD AND MODEL ESTIMATES

3.1 Sample and Procedure

The objective of the paper is to address the effects of cultural and institutional distances on the performance of the MNES subsidiaries. Using data from 38 foreign subsidiaries operating in Brazil

during the period between 2000 and 2014, we will test such effects using a long-term perspective, with the application of a panel data model. One limit of this study is the sample size. Since our main objective was to analyze the determinants of subsidiary performance on a long term perspective, we could only gather firm data for a limited number of foreign firms. Our sample of foreign subsidiaries is composed mainly of MNEs from developed countries.

Data used in the present study was obtained from various sources. Data about the foreign subsidiaries were collected in the annual publication of the Brazilian magazine, *Exame,* from 2000 to 2014. The annual report presents data for approximately 500 of the largest companies operating in the country, ranked according to the criteria of total sale in the domestic market. The report also presents the evolution of profit, number of employees, total assets, origin of the subsidiary, and international transactions. The institutional distance was calculated based on the data of the World Governance Indicators from the World Bank (Kaufman et al., 2009).

Similar to the formula proposed by Kogut and Singh (1988), we hypothesized that the greater the distance between the home country and the host country (Brazil), the lower the performance of the subsidiary. Using the dimensions of governance determined by Kaufmann et al (2009), a composite index was formed based on the deviation of each home country from Brazil, according to each of the six dimensions of governance. The deviations were corrected for the differences in the variances of each dimension and then arithmetically averaged. Thus, in algebraic form, like Kogut and Singh (1988), we proposed the following index to test the effect of institutional distance on the performance of foreign subsidiaries in Brazil:

$$ID_j = \sum_{i=1}^{6} \left\{ \left(WGI_{ij} - WGI_{iu} \right)^2 / V_j \right\} / 6$$

In this equation, WGIij, stands for the ith governance dimensions and jth country, Vi is the variance of the index of the ith dimensions, u indicates the host country of OFDI (Brazil), and IDj is the measurement of Institutional Distance of jth (home country) from Brazil.

The cultural distance is measured by using the index of Kogut and Singh (1988), based on differences in scores for each of Hofstede's four cultural dimensions: Power Distance (PDI); Individualism versus Collectivism (IDV); Masculinity versus Femininity (MAS); Uncertainty Avoidance (UAI)(Hofstede, 1980; Hofstede`s website, 2012). Cultural distance between the country of origin of the subsidiary and the host country (Brazil) can be measured according to the following equation:

$$CD_j = \sum_{i=1}^{4} \left\{ \left(I_{ij} - I_{iu} \right)^2 / V_j \right\} / 4$$

In this equation, I is the index for one of the four dimensions (i) for the home country of the subsidiary (j) and (u) is for the host country (Brazil). V stands for the variance of each dimension of the index. Thus, CD shows the cultural difference or distance between Brazil and the host country of Brazilian FDI. The higher the score is, the higher the cultural differences between the two countries.

This index is calculated by subtracting the scores of the home country and host country (Brazil) in each of the four dimensions. The square of the resulting difference is then divided by the variance of the scores for each dimension. Finally, the resulting values in each dimension are summed and divided by four. The scores were taken from the updated Hofstede`s website (www.geert-hofstede.com).

Additionally, for the present study, we intend to test the effects of the different distances in an independent manner for the variables included in the institutional and cultural dimensions.

The subsidiary performance is obtained using the objective indicator, Net Profit, for the fiscal years between 2000 and 2014. Theoretically, the lower the institutional distance between home and host countries, the lower the costs of doing business, and the higher the profit derived from the value-added activities of the subsidiary in the host country.

Panel data method:

The first analysis performed in this study employed the panel data model, which, according to Raj and Baltagi (1992), combines cross-sections with time series. This method permits one to evaluate the relationship between several variables by following the same individuals over a particular period of time.

For the present study, this method was used to analyze the relationship between the performance of multinational subsidiaries in Brazil and the institutional and cultural distances between the home and host countries for a sample of 38 subsidiaries of multinational companies over a period of 15 years. The advantage of the method is that it allows a level of specification that helps with the identification of the long-term general model that may offer a tighter control over individual heterogeneity. On the other hand, in reducing the effects of collinearity among the independent variables, the panel technique enhances the estimator's efficiency.

In order to test the hypothesis, three sub-models were created to verify the interaction between the variables in a linear and progressive manner, with the addition of variables in incremental steps. The equation for the determinants of performance for the subsidiaries of multinational companies operating in Brazil using the panel data model is presented below.

$$PERF_i^t = \beta_0 + \beta_1 LCD_{it} + \beta_2 LID_{it} + \beta_3 EQUITY_{it} + \beta_4 LEXP_{it} + \beta_5 EMP_{it}$$
$$+\beta_6 LPRODT_{it} + \beta_7 IND_{it} + \beta_8 INTER_{it} + \varepsilon_{it}$$

The equation presents the determinants of the performance for the subsidiaries of multinational companies operating in Brazil by combining the following elements. The dependent variable of the equation is the Net Profit, which represents the performance of subsidiary *i* in year *t*. *LCD*i is the cultural distance between the subsidiary's home country *i* and Brazil. It should be noticed that this variable, as the literature suggests (HOFSTEDE, 1980), remains constant over the observed period. The variable *LID* represents the distance between the institutional environment of the subsidiary's home country and Brazil for the company *i* in period *t*. The variable *EQUITY* represents the Total Equity of subsidiary *i* in period *t* and is employed as an alternative to capture size. The variable *EMP* represents the number of employees from the subsidiary of the company *i* in period *t* and along with *EQUITY* intends to provide an alternative measure for subsidiary size. The variable *LEXP* represents the experience, measured in years of operation, of the subsidiary of the company *i* in Brazil for the year *t*. The variable *LPROD* represents the productivity measured in terms of Return on Equity *i* for the period *t* which indicates how productive is the firm in employing the total equity to generate profit. The variable *INTER* represents the interaction of cultural distance with the institutional distance between the home country of the subsidiary *i* and Brazil for the year *t*. The Industry Dummy identified by the variable *IND* represents the technology segment intensity in which the subsidiary operates. It was attributed 1 for high intensity and 0 for low intensity segments. The equation also considers the residual error for the model.

3.2 Model Estimates and Results

The model specified above presented the general framework for the determinants of the performance of multinational subsidiaries in Brazil. Before presenting and discussing the results of the model estimation, some preliminary issues must be understood. First, regarding the risk of regressor endogeneity, it is assumed that the institutional variables are known (formal institutions) and are consequently exogenous.

In order to check for multi-collinearity, we ran a correlation matrix for the variables. The results of the matrix correlation are presented in Table 4, which shows that the risk of multi-collinearity is relatively high between the interaction variable and cultural distance. The use of the composite index for formal institutional distance and cultural distance has significantly reduced the risk of multi-collinearity among the variables.

Table 4: Correlation Matrix, Means and Standard Deviation

IND	1	-0.25	-0.30	0.02	0.10	-0.16	-0.09	0.24	-0.06	-0.12	-0.01	-0.05	-0.14	0.27	0.12	0.26	0.17	0.22	0.20
LCD		1.00	0.43	-0.11	-0.18	0.09	-0.19	0.61	0.90	0.68	0.58	0.55	0.73	0.41	0.37	0.40	0.52	0.46	0.34
EXP			1.00	-0.02	-0.06	0.09	0.13	0.13	0.35	0.29	0.22	0.26	0.26	0.01	0.05	0.02	0.22	0.04	0.06
PROFIT				1.00	0.42	0.13	0.16	-0.16	-0.14	-0.03	-0.22	-0.20	-0.11	-0.20	-0.20	-0.08	-0.07	-0.06	-0.05
EQUITY					1.00	0.06	0.31	-0.20	-0.18	-0.08	-0.35	-0.34	-0.09	-0.23	-0.16	-0.08	-0.16	-0.13	-0.06
PROD						1.00	0.02	0.04	0.07	0.21	-0.04	-0.03	0.09	0.01	0.05	-0.03	0.12	-0.02	0.00
EMP							1.00	-0.20	-0.16	-0.38	-0.20	-0.11	-0.30	-0.23	-0.11	-0.09	-0.21	-0.12	-0.04
LID								1.00	0.86	0.47	0.36	0.31	0.51	0.83	0.54	0.84	0.77	0.83	0.70
INTER									1.00	0.63	0.51	0.47	0.69	0.67	0.47	0.63	0.69	0.67	0.54
POWDIST										1.00	0.26	0.22	0.69	0.32	0.21	0.18	0.46	0.26	0.17
INDIVID											1.00	0.98	0.12	0.35	0.19	0.18	0.44	0.20	0.08
MASC												1.00	0.05	0.30	0.17	0.15	0.40	0.16	0.07
UNCEAVOID													1.00	0.35	0.52	0.17	0.28	0.25	0.13
VOICEACCT														1.00	0.42	0.69	0.55	0.71	0.63
POLSTAB															1.00	0.31	0.27	0.31	0.23
GOVEFFECT																1.00	0.66	0.90	0.83
REGQUAL																	1.00	0.66	0.57
RULEOFLAW																		1.00	0.89
CONTCORR																			1.00

Source: Elaborated by the authors.

To improve the characteristics of the model estimation, the correct specification of how to deal with unobserved effects is required. These effects can be eliminated when the estimation is carried out with fixed effects. Another technique is to estimate via random effects, which implies that the unobserved effects are not correlated with all independent variables. The choice between fixed or random effects estimation depends on a formal test, the Hausman test. The main idea is that the model must be estimated with random effects, unless the Hausman test rejects it. However, considering that cultural distance is constant over the period of the panel, we estimated our model using random effects.

Panel Data Analysis:

In order to test the above-described hypotheses, we employed the panel data analysis using three sub-models. First, in sub-model 1, we tested the effects of the aggregated indexes for Cultural and Institutional Distances. In sub-model 2, we separated the variables included in the cultural and institutional distances into separate distances for each dimension. In sub-model 3, we included the moderating effect (interaction) of cultural distance and institutional distance to the performance of MNCs in Brazil.

Table 5: Panel data results for the 3 sub-models.

VARIABLES	Sub-model 1 Culture and	Sub-model 2 Cultural and	Sub-model 3 Moderating

		Institutional	Institutional Dimensions	Effects
Control Variables (Firm Resources and Industry tech intensity)	const	126.26***	−3162.09**	166.47***
	Number of Employees (Size)	0.0019	−0.0008	0.0025
	Total Equity (Size)	0.091***	0.091***	0.095***
	Productivity	0.562***	0.597***	0.57***
	Experience	0.44	−0.19	0.42
	Industry	9.93	87.4	12.92
MODERATING EFFCTS OF CULTURAL ON INSTITUTIONAL DISTANCE				−20.83*
CULTURAL DISTANCE (CD)		−142.37		
Cultural Dimensions	Dist. Power Distance		−17.23	
	Dist. Individualism		−2135.24**	
	Dist. Masculinity		947.55*	
	Dist. Uncertainty Avoidance		118.86	
INSTITUTIONAL DISTANCE (ID)		−60.80		
Formal Institutional Dimensions	Dist. Voice and Acct.		−317.28*	
	Dist. Political Stability		−143.63***	
	Dist. Govern. Effectiveness		−336.55*	
	Dist. Reg. Quality		152.43	
	Dist. Rule of Law		881.11***	
	Dist. Control of Corruption		−170.96*	
Number of observations		539	539	539
R-squared		0.19	0.24	0.18
p-value		***	***	***

*p≤0.10; **p≤0.05; ***p≤0.01
Source: Elaborated by the authors.

The findings of the different arrangements of the proposed model show that the performance of a multinational subsidiary in Brazil is sensitive to the differences in the institutional environment between the home and host countries. The results indicate that both formal, as well as informal (cultural distance), affect the performance of foreign firms. Although several studies have employed an aggregate index in order to represent the differences between home and host countries, the results from Table 5 indicate that in order to have a better understanding regarding the implications of the distances it is important to analyze the implications of specific dimensions included in the formal and informal institutional distances.

In that sense, when testing hypothesis 1, although not statistically significant, the results from sub-model 1 indicate that cultural distance have a negative impact to the performance of MNCs in Brazil. This result is in line with several empirical studies (Barkema et al, 1997; Das & Teng, 2003; Li & Guisinger, 1991; Zaheer and Mosakowski, 1997; Zaheer, 1995; Peretomode, 2012) that have pointed the negative effects of cultural differences on the performance and survival of the firms in foreign countries.

In order to further analyze the implications of cultural distance to the performance of MNCs in Brazil, in sub-model 2 we decomposed the Cultural Distance index into separate distances related the each of the four cultural dimensions. By reducing the level of aggregation, we found interesting results which partially support hypothesis 1 in a sense that the greater distance in terms of Individualism, have a negative impact statistically significant at 5% to the performance of foreign MNCs in Brazil. Brazilian Culture scores high in collectivism, indicating that companies that come from more individualistic cultures may be in disadvantage when operating in Brazil.

Additionally, when considering the implications of the cultural distance in terms of Masculinity, the results indicate that the higher the distance, the better the performance. These results may reveal important implications of the cultural dimensions to the performance of MNCs in Brazil as there is large proportion of companies coming from the United States, United Kingdom, Japan, Germany which are characterized by highly individualistic and with high scores for masculinity. In that sense, the results indicate that there are characteristics in home and host countries that could facilitate or compromise the expansion into different foreign markets.

When evaluating hypothesis 2, the results indicate that, although the aggregate index employed to measure the formal institutional distance did not proved to have a statistically significant impact to the performance of MNCs in Brazil, the results from sub-model 2 presented significant implications of formal institutional distances. As predicted by the literature regarding the negatives effects of the institutional distance, the results from sub-model 2 indicate that the distances in terms of voice and accountability, political stability, government effectiveness and control of corruption have a negative impact to the performance of MNCs in Brazil. Once again, it is important to relate these findings to the fact that in general, for the present study, it represents a distance from a more developed country and Brazil. Therefore as predicted by Shenkar, Luo and Yeheskel (2008), the precarious institutions in Brazil creates additional challenges (friction) to MNCs from developed countries when compared to companies from more similar institutional environments.

Additionally, differently than what we expected, the results indicate that the greater distance in terms of rule of law will contribute for the superior performance of MNCs in Brazil. When considering the results for this dimension combined with the results for distance in terms of regulatory quality which was the only dimension that did not present an statistically significant relation to the performance we could suggest that regulatory quality does not affect the performance of these companies in Brazil because the rules are not being enforced. This condition is supported by the low scores attributed to both dimensions, and considering that the great majority of companies included in the sample are from developed countries, the results indicate that the precarious laws in Brazil do not affect the performance of NMCs as long as these rules are not applied.

In that sense, the results seem to confirm what Hernández and Nieto, 2015, Zaheer, Schomaker and Nachum (2012) indicate regarding the implications of analyzing not only the magnitude but also the direction of the institutional distance. This recommendation seems to be valid not only when considering the implications of formal, but also for the informal institutions.

Finally, the interaction variable employed to test the moderating effects of cultural distance on the institutional distance was found to be statistically significant at 10%, and negatively correlated with the performance of foreign firms in the Brazil which confirms hypothesis 3. The results indicate that companies from countries that are more distant in terms of both culture and institutions would perform lower when compared to companies from more similar cultures and institutions. This condition supports what Shenkar, Luo and Yeheskel (2008) indicate in a sense that the greater the distances in terms of institutional and cultural environments create friction which is detrimental to the performance of firms.

The results also indicate that size in terms of total equity and productivity were found to be positively correlated with the performance and statistically significant (1%) in all of the arrangement

models. Additionally, the results indicate that experience, industry and the number of employees do not contribute for the performance of foreign subsidiaries in Brazil.

Table 6 presents a result summary for each of the hypotheses comparing the expected and actual behavior for the variables tested, as well as their statistical significance. The results column presents the sign and magnitude for the aggregated index and for the specific dimensions included in each of the dimensions.

Table 6: Summary of the results

Hypotheses	Variable	Expected sign	Main Authors	Results (Sign and significance)
H1: The greater the cultural distance between the multinational company`s home country and Brazil the lower the performance of the subsidiaries.	Cultural distance	(-)	Peretomode (2012); Das e Teng (2003); Barkema and Vermeulen (1997); Zaheer and Mosakowski (1997);Zaheer (1995)	**Aggregated Index (-)** Power Distance (-) Individualism (-)** Masculinity (+)* Uncertainty Avoidance (+)
H2 The greater the institutional distance between the multinational company`s home country and Brazil, the lower the performance of the subsidiaries.	Institutional distance	(-)	Aguilera-Caracuel, Fedriani and Delgado-Márquez (2014); Aguilera-Caracuel et al. (2013); Aguilera-Caracuel et al. (2013); Ma, Tong and Fitza (2013); Ramsey and Bahia (2013); Yang, Martins and Driffield (2013); Higón and Antolín (2012); Salomon and Wu (2012); Tang and Rowe (2012); Hilmersson (2009); Du (2009); Mikael Hilmersson (2009)	**Aggregated Index (-)** Voice and Acct. (-)* Political Stability (-)*** Govern. Effectiveness (-)* Reg. Quality(+) Rule of Law (+)*** Control of Corruption (-)*
H3: Cultural distance has a positive moderating effect on the relationship between institutional distance and the performance of MNCs` subsidiaries in Brazil.	Moderating Effects of Cultural Distance on Institutional Distance	(-)	Shenkar, Luo and Yeheskel (2008); Ghemawat (2001) and Shenkar (2001) ;Xu and Shenkar (2002); Zaheer (1995)	Moderating Effect (-)*

Source: Elaborated by the authors.

Although the results partially confirm what the literature suggests regarding the negative impact of the distances to the performance of MNCs, the findings from the present study brings interesting insights related to specific dimensions of the distances which indicate that some distances may actually contribute for the performance of these organizations. The results clearly highlight the limitations of employing aggregated indexes to measure the distances in a sense that it reduces the possibility of analyzing the implications of specific dimensions.

4 CONCLUSION

In the present paper, we investigated the relationships between institutions and the performance of multinational subsidiaries in Brazil. We argued that the concept of cultural distance presents different limitations, both conceptual and methodological, which may result in some inconsistencies on the empirical level. To avoid these limitations, we supplemented the model of performance determinants with the concept of institutional distance. Based on North´s (1990) approach to institutions, we distinguished between formal and informal institutions. In addition, in line with Scott (1995) and Peng (2011), we considered that cultural distance is part of the informal institutions. To investigate the formal institutions, we used the indicators discussed by Kaufmann et al (2009) that establish the governance as a general approach to capture the quality of regulatory institutions. The results of the model estimation showed important behavior regarding the variables.

Although the literature indicates that cultural distance has a negative effect on the performance of subsidiaries, the results using an aggregated index were not statistically significant. The results could be improved by separating the index into different variables which allowed a deeper analysis regarding the implications of the distances for each dimension to the performance of MNCs in Brazil. In that sense, when considering the results for specific dimensions of the formal and informal institutional distances, it could be concluded that not only the statistical significance, but also the direction of the distance could be an important consideration which could further improve the analysis of the implications of the distance to the performance of MNCs. This condition is in line with Hernández and Nieto, 2015, Zaheer, Schomaker and Nachum (2012) which suggest that the magnitude and the direction of the institutional distance should be considered in order to fully capture the implications of the distances to the internationalization process of firms.

The results also indicate that separating the variables into different dimensions allow a more comprehensive analysis in a sense that the implications of one dimension can be complemented by the results obtained from the other dimensions. This condition could be verified in the results for the variables that measure the distance in terms of regulatory quality and rule of law which did not behave in the manner predicted by the literature. Although these results did not contribute for validating hypothesis 2, it indicates important implications related to how MNCs from more developed countries find ways to take advantages of institutional voids in developing countries.

The results also confirm the moderating effects of cultural distance on institutional distance to the performance of MNCs in Brazil. These findings confirm what Shenkar, Luo and Yeheskel (2008) indicate in a sense that the distances create friction which has a negative effect on the performance of MNCs.

In that sense, we consider that the findings from the present study could be further explored by including specific characteristics of home and host country which could provide a better and more adequate explanation for the implications of each dimension to the performance of foreign MNCs subsidiaries in Brazil.

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