



# Impact of historical conflict on FDI location and performance: Japanese investment in China

Gerald Yong Gao<sup>1</sup>,  
Danny Tan Wang<sup>2</sup> and Yi Che<sup>3</sup>

<sup>1</sup> Department of Marketing, University of Missouri-St. Louis, St. Louis, MO, USA; <sup>2</sup> Department of Marketing, Hong Kong Baptist University, Kowloon Tong, Hong Kong; <sup>3</sup> Antai College of Economics and Management, Shanghai Jiao Tong University, 1954 Huashan Road, Shanghai 200030, China

**Correspondence:**

Y Che, Antai College of Economics and Management, Shanghai Jiao Tong University, 1954 Huashan Road, Shanghai 200030, China.

Tel: (86)-21-52301594;

e-mail: tccheyi@sjtu.edu.cn

**Abstract**

Historical relations between countries bring important explanatory power for foreign direct investment (FDI) decisions, yet little is known on whether a home–host country relation exhibits heterogeneous effects on FDI across the country’s subnational regions. In this study, we examine the long-term impact of historical conflict on FDI location choices and performance. Using a sample of 8,646 Japanese FDI in China, we show that civilian casualties in different provinces of China during the Second Sino–Japanese War exert deterring effects on Japanese FDI location choices. Furthermore, we demonstrate that civilian casualties negatively affect Japanese FDI performance and political capital accumulation strategies, in the forms of excessive tax payment and local employment, can reduce this negative effect. This study contributes to the discussion on how within-country differences of historical factors affect FDI location decisions and performance. The findings on firms’ political capital accumulation strategies also provide important implications for FDI operation in an environment characterized by historical animosity.

*Journal of International Business Studies* (2018) 49, 1060–1080.

<https://doi.org/10.1057/s41267-016-0048-6>

**Keywords:** FDI; historical conflict; Japanese firms; location; performance; political capital; China

## INTRODUCTION

Foreign direct investment (FDI) is a central motor of economic integration and interdependence among countries in this increasingly globalized world. Its driving forces have attracted extensive attention in the international business field. Prior research has examined the impact of host country specific factors, such as labor cost, infrastructure, and market potential (Dunning, 1998; Narula & Dunning, 2000); industry agglomeration (Chang & Park, 2005; Cheng & Kwan, 2000; Head, Ries, & Swenson, 1995); and institutional environments (Ma & Delios, 2007; Meyer & Nguyen, 2005). Researchers have also adopted a nation-dyadic perspective, using the distance concept to capture differences between home and host countries, including cultural distance (Hofstede, 1980; Kogut & Singh, 1988), economic distance (Tsang & Yip, 2007), geographic distance (Kim, Delios, & Xu, 2010; Nachum & Zaheer, 2005), and institutional distance (Kostova & Zaheer, 1999; Xu & Shenkar,

Received: 31 October 2015

Revised: 26 September 2016

Accepted: 8 October 2016

Online publication date: 31 January 2017



2002). Extending this stream of research, Makino and Tsang (2011) incorporate historically shifting relational factors between countries to demonstrate that historical relations bring enhanced explanatory power for FDI decisions, above and beyond those distance attributes. Thus adopting a historical perspective to *bring history back* into international business research is crucial for generating new insights into existing theoretical frameworks of FDI (Jones & Khanna, 2006). However, given historical relation is a nation-dyadic level construct, little is known whether a home–host country relation exhibits universal or heterogeneous effects across the country's subnational regions.

This oversight is particularly serious in large emerging economies, where substantial diversities and variations in culture, economy, and politics exist across subnational regions (Dow, Cuypers, & Ertug, 2016; Ma, Tong, & Fitza, 2013; Meyer & Nguyen, 2005; Xu, 2011). Because economic and institutional transitions usually introduce changes unevenly across regions in those markets, foreign firms operating there are exposed to differential regulation rules, social norms, and business practices. Therefore it is imperative for researchers to zoom into reveal within-country differences of national-level constructs (Chan, Makino, & Isobe, 2010; Lorenzen & Mudambi, 2013; Ma et al., 2013). In particular, historical relations are path dependent ties between nations, intertwined with cultural, religious, and political traditions, and affected by local conventions and social norms in different geographic locations (Arikan & Shenkar, 2013; Makino & Tsang, 2011). For example, according to a study conducted by Chinese Academy of Social Sciences,<sup>1</sup> although national animosity toward Japan exists in China, people's attitudes vary across regions: strong anti-Japanese sentiment marks central and western provinces like Guangxi, Shanxi, and Hubei, however people in coastal areas such as Shanghai and Guangdong hold less hostile attitudes, and some young generations are even Japanophiles. Therefore national-level relations might not be held in a constant form across subnational regions. To enhance our understanding on how home–host country historical relations affect FDI differentially in various regions within a host country, FDI research should move to the next level of refinement of geographic units.

Examining the impact of home–host country historical relations on FDI performance represents another critical issue, as how to achieve better FDI performance remains a central challenge in the

international business field (Peng, 2004). Traditional perspectives on determinants of FDI performance include resource-based view (Barney, 1991), industry-based view (Porter, 1980), and institution-based view (Peng, Wang, & Jiang, 2008). Past studies have identified ways of reducing the liability of foreignness and developing competitive advantages in foreign markets, such as appropriate entry modes and timing (Chang & Rosenzweig, 2001), exploitation of location-specific advantages (Dunning, 1998; Ma et al., 2013), alliances with partners (Lu & Beamish, 2001), and local experience accumulation (Luo & Peng, 1999). Social, cultural, political, and historical factors also play significant roles in determining economic activities and firm behavior (Dai, Eden, & Beamish, 2013; Martin & Sunley, 1996). However, despite their relevance and salience, scant attention addresses non-economic determinants of FDI performance, largely due to the difficulty of modeling such factors (Jones & Khanna, 2006; Martin, 1999). To date, no research has empirically tested the effect of historical relationships on FDI performance.

To address these research gaps, we examine how historical conflict, as a specific manifestation of historical relations between home and host countries, exerts long-term impact on FDI location choices and performance. We use the eight-year Second Sino–Japanese War (1937–1945) as the context of historical conflict of analysis. A severe historical conflict such as a war between countries can create deep antagonism imprinted in citizens' memories of the country victimized by the war. Through assessing the long-term impact of within-country differences of a single war on FDI location choices and performance, this study provides a more rigorous theory testing because it can rule out multiple country- or conflict-level confounding factors. The war-related civilian casualties in different subnational regions of China varied significantly, so we can examine whether the national-level conflict affects FDI differently across regions. The investigation of the performance effect of historical conflict helps broaden existing theoretical perspectives and generates new insights into FDI performance research. Moreover, based on social capital theory and particularly the political capital literature, we propose three political capital accumulation strategies that can remedy the negative impact of historical conflict: host-country state capital involvement, excessive tax payment, and local employment. We posit that these strategies can effectively signal a focal foreign firm's



trustworthiness and long-term commitment to the host country, thus mitigating the operational difficulties caused by historical conflict.

We test the hypotheses with a sample of 8,646 Japanese FDI in China during 1992–2001. We collected data about civilian casualties in 26 regions<sup>2</sup> (nineteen provinces with Sichuan and Chongqing combined, three municipalities, and four minority autonomous regions) in China as the key independent variable indicating the long-term effect of historical conflict. The findings show that Japanese firms are less likely to invest in Chinese regions that suffered greater civilian casualties during the war. Civilian casualties also negatively affect FDI performance; yet the political capital accumulation strategies in the forms of excessive tax payment and local employment can reduce the negative effect of historical conflict on performance, which provides critical implications for FDI operation in a hostile environment.

## THEORY AND HYPOTHESES

### Historical Conflict

Historical conflicts include economic and political conflicts, which can escalate into serious military confrontation. Political science and international relations literature has studied historical conflict extensively in terms of its origins, evolution, justifications, and consequences for dyads of adversaries (e.g., Benson, 2004; Hewitt, 2003). A critical issue is how perceptions of fairness emerge during a conflict and subsequently affect interactions between nations (Maoz, 2009). Prior research generally suggests that any reconciliation process is likely to be long and tough, because it requires changes in the conflict ethos, together with building of trust, acceptance, cooperation, and consideration of mutual needs (Bar-Tal, 2000). This process is particularly difficult following severe conflicts (Coleman, 2003; Mitchell, 1981). Moreover, negative sentiment from historical conflicts can pass from generation to generation, hindering the development of bilateral trust and cross-border activities (Arikan & Shenkar, 2013; Guiso, Sapienza, & Zingales, 2009).

Previous international economics literature has investigated the impact of historical events on trade between countries. Based on the gravity model of international trade (Tinbergen, 1962), the majority of past studies has focused on determinants such as income, population, contiguity,

and distance in shaping the patterns and directions of international trade. Recent studies started to investigate the long-run impact of historical events on trade flows. For example, Berger, Easterly, Nunn, & Satyanath (2013) found that CIA interventions during the Cold War increased the influence of US over foreign governments, which was used to increase US exports to the intervened countries. Head, Mayer, and Ries (2010) investigated the effect of independence on post-colonial trade, and found that it had little short-run effect but led to a significant long-run decline in trade between colonizers and colonies. Glick and Taylor (2010) found large impact of wars on bilateral trade among belligerent nations and neutrals. Guiso et al. (2009)'s study in Europe showed that lower bilateral trust between countries resulted in less trade, portfolio investment, and direct investment in the long-term, and gave rise to entrenched culture bias among conflictive countries.

### Animosity

Frequent conflicts between countries often create the sentiment of national animosity, defined as “hostility of mind” (Arikan & Shenkar, 2013), or “remnants of antipathy” (Klein, Ettenson, & Morris, 1998), toward a particular country. These sentiments, if not reconciled, persist over time, because negative memories imprinted in people's minds can be easily provoked with new sets of antagonistic nation-to-nation acts. As it can be rendered by the society and enlarged by the media, national animosity affects people's judgments and finally becomes a part of the country's societal beliefs and culture. Depending on its source, Klein et al. (1998) distinguish two types of animosity as economic and war-based. Economic animosity stems from trading practices that one country perceives as unfair, unreliability exhibited by a trading partner, or the economic power of a foreign country. While economic animosity often evolves as trading relationships change, war-based animosity tends to be more country-specific and stable over time. Recent studies generally followed this classification, and further evaluated the two types of animosity's behavioral impact across different eras, source countries, target countries, and product categories (for a comprehensive review, see Riefler and Diamantopoulos, 2007).

The marketing and international business literature on animosity mostly focuses on its impact on consumer behavior, with the fundamental premise that animosity's effect on consumers' purchase is



independent of their product quality judgment, such that “anger can lead consumers to eschew a country’s goods in spite of positive product perceptions” (Klein, 2002: 348). Klein et al. (1998) showed for example that Chinese consumers in Nanjing avoid buying Japanese products, even when the products are comparable or superior to products with other countries of origin. In another study, using the United States and Japan as target countries and the 1997 Asian financial crisis as the backdrop, Leong et al. (2008) discovered that both stable and situational animosity reduce consumers’ willingness to buy products from a country they perceive as hostile. Harmeling, Magnusson, and Singh (2015) examined differential responses of agonistic and retreat emotions from animosity and found that consumer anger is related to negative word of mouth and product avoidance whereas fear leads to product quality judgment and product avoidance. Only recently has the effect of animosity been examined at the firm level. Using panel data on firm-level cross-border alliances between nation pairs, Arikan and Shenkar (2013) found that animosity heavily affects the formation and types of firm-level cross-border alliances. The level of animosity between two nations significantly reduces the number and probability of alliance formation of firms within the nation dyad.

### Historical Conflict Between China and Japan

The Second Sino–Japanese War<sup>3</sup> started in the aftermath of the Marco Polo Bridge Incident. Its significance is reflected in not only the length (1937–1945), but also the huge casualties and losses. Chinese sources list the total number of casualties at 35 million, largely consistent with estimates from the Historical Society of Japan (1967: 213). Among the total casualties, military casualties account for a small part with the lion’s share of losses coming from Chinese civilians (Clodfelter, 2002; Rummel, 1991).

The psychological damage for Chinese people was created by the gross war atrocities and then reinforced by repeated disputes between the two nations regarding Japan’s responsibilities. China and Japan normalized their diplomatic relations in 1972; yet the war remains a point of contention and a stumbling block to their bilateral relationship. War-related issues – including controversies about descriptions in Japanese textbooks, Japan’s denials of war crimes, visits by top Japanese government officials to the Yasukuni Shrine, and recent provocative actions about Diaoyu/Senkaku

Islands – readily stir up Chinese. As a result, roughly 7 out of 10 Chinese people dislike Japan, according to a study conducted by the Pew Research Center.<sup>4</sup>

The Second Sino–Japanese War is an appropriate setting for examining the long-run impact of a significant historical conflict on FDI location and performance. Because of the vast size of China, large variances exist in our focal variables of interest: civilian casualties and FDI activities. China was never occupied entirely during the war, so subnational regions suffered differently. China’s central corridor, from Shanxi and spreading south to Guangxi, passing provinces such as Henan, Hubei, Hunan, and Jiangxi, suffered the most severe attacks because of Japan’s intention to establish a military supply line. The Chinese Armies resisted staunchly, incurring significant military and civilian casualties. Other areas experienced varying degrees of loss, depending on their military importance and the contest between the two sides. Japanese FDI activities also vary greatly across regions in China. Despite their political contentions, Japan ranked third among major source countries of FDI in China during 1992–2002, only behind Hong Kong and the US, accounting for 7.8% of the total volume of FDI (Almanac of China’s Foreign Economic Relations and Trade, 1993–2003 [query 2]). Japanese investments also have not concentrated in mega-cities like Beijing and Shanghai, but instead exhibit a wide geographic distribution. Therefore we can investigate the relationship between historical conflict and FDI in a realistic, subnational setting.

Previous studies have focused on the effects of economic factors on location choices of Japanese FDI in China. Belderbos and Carree (2002) addressed the role of agglomeration and found that Japanese investments tend to follow early entrants from the same industry or industrial groups, highlighting a strong path dependency effect. Cheng and Stough (2006) showed that national policy incentives, agglomeration, labor and land costs are important determinants of the locations of Japanese greenfield manufacturing firms in China. Fung, Iizaka, and Parker (2002) compared FDI from the US and Japan in China. The results showed that while local GDP and policy variables significantly affect the inflow of investment from both countries, labor quality exerts a larger influence on Japanese FDI. Ma and Delios (2007) showed that Japanese firms tend to choose an economic-oriented rather than a political-oriented city as their



investment location, with the consequence of higher survival likelihood in Shanghai than in Beijing. Zhao and Zhu (2000) investigated whether firms with different countries of origin responded dissimilarly to locational factors, and found that Japanese investments favor those areas with low rental costs, abundant human capital, and high export intensity. Zhou, Delios, and Yang (2002) demonstrated an influence of special economic zones and coastal cities on the location choices of Japanese FDI.

While past research has generated important knowledge on the impact of market size, cost of operations, agglomeration, and quality of economic institutions, our study examines the impact of non-economic factors, historical conflict in particular, in accounting for FDI location choices. Dai et al. (2013) examined the effect of contemporary conflict as an important type of non-economic factor. They developed an innovative means of capturing subsidiary static and dynamic exposure to conflict zones and showed that exposure to threats is an important determinant of subsidiary survival. In this study, we extend the investigation on conflict and focus on historical conflict using the Second Sino–Japanese War as the context and link it with FDI location and performance. We demonstrate that repressed war memories can add to distrust and cast a shadow, even after decades-long efforts and bilateral economic cooperation. The particular conflict-induced psychological consequence should only affect foreign investors from the antagonist country.

### Historical Conflict and FDI Location Choices

In this study, we propose that the nation-dyadic level historical conflict exhibits variations in different subnational regions and in turn plays a significant role in determining FDI location choices. In the Japan–China dyad, though the war ended more than half a century ago, people from both nations constantly engage in cognition about its causes and other relevant facts, due to the lack of a consensus between the two national governments. This cognitive process can be painful, especially for Chinese people, who suffered extensive violence on their national soil. Over the years, considerable animosity has accumulated and the hostile emotions intertwined with cognitive activities have formed societal beliefs that can serve motivations for ego defense and national pride (Bar-Tal, 2000). The animosity effect is particularly pronounced in areas that suffered severe civilian

casualties. Killing and wounding violate the moral code of the sanctity of life, marking an enduring scar on people's memories. Without effective post-war reconciliation, people gradually become socialized to a conflictive ethos, believing in a form of antagonism toward the conflict-evoking country (Arikan & Shenkar, 2013). Japanese firms aiming to enter China make location decisions in the context of this Sino–Japan relation and the long-existing animosity.

We hypothesize that all else being equal, Japanese firms are less likely to invest in regions that suffered greater casualties during the war, because the impact of regional casualties is non-trivial. The greater animosity associated with casualties may lead to higher transaction costs and exchange hazards for Japanese firms, including uncertainty (Luo, 2007), mistrust (Guiso et al., 2009), and perceptions of the likelihood of opportunism of future business partners (Kastner, 2007). In turn, these firms may need to make greater, more credible commitments *ex ante* to signal their goodwill to stakeholders such as consumers, business partners, and local governments. These credible commitments are irrevocable and not transferrable to other investments, and can lose much of the value when the investment relationship ends. *Ex post* governance of Japanese FDI in heavily affected regions also requires more costs to alleviate the heightened risks and exchange hazards. If behavioral opportunism by local partners is a serious threat, Japanese investors need to spend more on monitoring, socialization, or incentive alignment (Wathne & Heide, 2000). Finally, political tensions at the national level easily provoke antagonistic sentiments in areas that experienced heavy historical civilian casualties. Thus Japanese firms must maintain a relatively high level of flexibility and responsiveness, which further increases operating costs. Taken together, regional casualties during the war should constitute a critical historical factor affecting Japanese FDI location choices. Thus we predict:

**Hypothesis 1:** Japanese firms tend to avoid regions in China that were heavily affected during the Second Sino–Japanese War for FDI locations.

### Historical Conflict and FDI Performance

We also expect that animosity, stemming from civilian casualties in a region, affects not only Japanese FDI location choices but also its



performance. First, the persistent psychological damage of the war suggests that the greater the civilian casualties during the war, the greater the remaining antipathy toward Japan and Japan-related symbols might be. Thus consumers in regions that experienced heavy civilian casualties hold stronger animosity toward Japanese firms and are more reluctant to purchase products made by Japanese companies (Harmeling et al., 2015; Klein et al., 1998). Second, if employees are socialized through their previous education and experience to hold hostile attitudes toward Japan within an organization, Japanese firms will need to exert extra efforts to align their values, build a psychological infrastructure, and develop trust and cooperative attitudes. All these efforts involve considerable administrative burdens and costs. In turn, Japanese FDI in those regions face more hurdles in achieving better performance, compared with operating in other regions that experienced fewer civilian casualties. Third, deeply negative emotions can extend beyond the individual level to influence organizational behavior (Hutzschenreuter, Pedersen, & Volberda, 2007). Trust in local partners usually has a pivotal effect on foreign firms' coordination effectiveness and overall performance (Malhotra & Lumineau, 2011). Perceptions of trustworthiness between business partners from different countries can largely depend on cultural and historical factors (Guiso et al., 2009). If local partners originate from an environment with a strong conflictive ethos, it would be harder for Japanese firms to collaborate with them. Upper echelons theory also suggests that top management's psychological biases greatly affect firms' attitudes and behaviors (Hiller & Hambrick, 2005). Therefore local managers' negative proclivity against Japan might influence their companies' relationships with Japanese firms, causing greater coordination uncertainties and costs.

Despite the fact that local governments usually welcome and support Japanese FDI, we propose that the above operation difficulties pertaining to both individual and organizational levels will cast a negative impact on performance. We thus hypothesize:

**Hypothesis 2:** Civilian casualties during the Second Sino–Japanese War relate negatively to the performance of Japanese FDI in subnational regions in China.

### Political Capital Accumulation Strategies

Firms align their managerial actions with the environmental conditions to improve competitive positions (Child, Chung, & Davies, 2003; Reger, Duhaime, & Stimpert, 1992). Multinational firms in particular can engage in certain strategic responses to the unique business settings in host markets (Regnér & Edman, 2014). In our context, because it is challenging to cope with the hostile environment caused by civilian casualties, Japanese firms can adopt strategies to seek institutional support and enhance their organizational legitimacy. Drawing upon social capital theory, we posit that political capital accumulation strategies can serve such functions. At the firm level, social capital is a collective resource of an organization obtained through network ties, which allow members to access social resources within the network (Burt, 1992; Granovetter, 1985). Political capital of an organization is a specific type of social capital that a firm can acquire through its political affiliations and interactions with dominant political entities (Hillman & Hitt, 1999). It can enhance firms' legitimacy and grant them access to policy information or other valuable resources (Faccio, Masulis, & McConnell, 2006). These benefits may balance the negative effect of historical conflict and make firms less vulnerable to social hostility.

Political capital continues to be a valuable resource for firm operation in emerging economies. Despite the ongoing institutional transition, government influence and intervention remain prevalent. For example, the government still plays a key role in guiding business activities through implementing differential tax, land, and labor policies (Xu, Lu, & Gu, 2014). In other words, the market mechanism and government redistributive mechanism coexist (Li & Zhang, 2007). As long as the government still controls scarce resources including access to finance and key technology, political capital will continue to be a critical resource that firms have high incentives to acquire (Walder, 2002). Furthermore, acquiring political capital helps firms reduce exchange hazard in emerging markets. Business contracts backed by local governments can effectively reduce transaction costs for foreign firms by providing official assurance that the contract terms will be fulfilled in a timely manner (Nee, 1992). Firms can acquire and accumulate political capital with different levels of governments. In the Chinese regulation regime, institutional transition has essentially created a



regionally decentralized authoritarian system characterized by institutional polycentrism (Batjargal et al., 2013; Xu, 2011; Xu, Tihanyi, & Hitt, 2014). The central government formulates main policies, while regional governments also have great influences on economic activities through implementing national policies with direction and establishing regulation rules locally. Therefore we focus on three types of political capital accumulation strategies with both the central and regional governments, namely host-country state capital involvement, excessive tax payment, and local employment.

At the central government level, Japanese FDI can acquire crucial political capital by getting state capital involved. Through collaborating with state capital, Japanese firms will be able to obtain important institutional support in the market and they are more likely to get favorable treatments in the administration system (Cui & Jiang, 2012). Consequently, political capital from the state enables Japanese FDI to overcome regulatory constraints such as bureaucratic and inefficient procedures that are still hindering business operations in the Chinese market. Furthermore, the high level of government affiliation indicates a high status in the business environment that can foster normative legitimacy and trustworthiness of a focal Japanese FDI (Wang, Hong, Kafouros, & Wright, 2012). As a result, the uncertainty, together with the potential bias that customers and business partners may hold toward Japanese FDI, can be alleviated.

Japanese firms can also accumulate important political capital with local governments in subnational regions. In the process of institutional transition in China, the central government has delegated more power including investment approval, land use, and banking to local governments through administrative decentralization (Xu, 2011). Local governments can exercise great discretion initiating changes, coordinating business activities, and enforcing regulation rules regionally (Xu et al. 2014). Given the power of regional governments in influencing economic activities in China, it is critical for foreign firms to engage relationship building with them to acquire political capital. With fiscal decentralization and tax sharing reform started from 1994 in China, tax revenues for the central government have been boosted (Zhang, 2006). Local governments thus face tougher fiscal burden and collecting taxes becomes a top priority (Lin & Liu, 2000). The unique features of the tax

system in China often result in substantial variations in firms' actual tax burden. Local governments can impose different levels of taxes and provide additional incentives and reductions to attract foreign investments. In addition, the enforcement of tax laws and rules differs significantly, largely depending on the connection of firms with the governments. Therefore the effective tax rates can be varied for firms operating in the same industry and region (Cai, Fang, & Xu, 2011). Tax payments of foreign firms can be a major source for local governments to generate fiscal revenues in subnational regions. Therefore those Japanese firms with higher tax payments are more likely to establish better political connection with local governments, and get institutional support as a reward.

Another way to accumulate political capital regionally is to employ more local workers. Boosting employment is a primary objective of local governments in emerging economies (Sun, Mellahi, & Thun, 2010). For example, the unemployment problem became a serious social issue with the restructuring of state-owned enterprises and layoffs of large numbers of workers in China (Fleisher, Li, & Zhao, 2010). Consequently, employment creation becomes one of the most important incentives for local governments to attract FDI. FDI contributes to the host economies with capital and advanced technology injection. Foreign firms usually pay a wage premium for local workers compared with domestic firms in emerging markets, which helps improve living conditions and enhance social stability (Fosfuri, Motta, & Rønde, 2001). Moreover, local employees of foreign firms can also acquire important foreign human capital, such as advance knowledge and skills (Sofka, Preto, & de Faria, 2014). Therefore increasing local employment is consistent with regional governments' interest and represents an effective means of signaling foreign firms' long-term commitment to the local market and fostering their trustworthiness with the governments, business partners, and consumers.

Although Japanese firms suffer from animosity and social bias in regions that were heavily affected during the Second Sino-Japanese War, we posit that they can leverage political capital accumulation strategies with both central and regional governments to obtain government support and enhance their legitimacy. Such strategies should mitigate the negative effect of regional casualties on FDI performance. We hypothesize:



**Hypothesis 3a:** The negative performance effect of civilian casualties is weaker for Japanese FDI with Chinese state capital involvement.

**Hypothesis 3b:** The greater the tax paid, the weaker the negative performance effect of civilian casualties on Japanese FDI.

**Hypothesis 3c:** The more local employment generated, the weaker the negative performance effect of civilian casualties on Japanese FDI.

## METHOD

### Sample and Variables

We obtained data from the Survey of Foreign-invested Enterprises, conducted by the National Bureau of Statistics of China in 2001, which provides firm-level information about FDI's locations, sales, profits, assets, and employment. The 147,203 foreign-invested enterprises in the survey account for around 75% of all those operating in China, according to the China Statistical Yearbook of 2002. We focused on Japanese firms that invested in China since 1992, the year that FDI in China began to increase substantially, following Deng Xiaoping's South China Tour. After deleting entries with missing values for the key variables, we retained 8,646 Japanese FDI invested in China during 1992–2001.

We employed a conditional logit model to study the location choices of Japanese FDI (McFadden, 1974; Hoffman & Duncan, 1988). The dependent dummy variable indicates the province each Japanese firm chose to enter in a specific year. To match the data form requirement of conditional logit models, we rearranged the data structure into a firm-year format to have 224,796 (8,646 firms for 26 provinces) observations. For firm performance, we used return on assets (ROA) as the indicator (Huang, Jin, & Qian, 2013).

To measure subnational levels of historical conflict, we used the percentage of civilian casualties (including minor or major wounds and death), defined as the ratio of civilian casualties to the pre-war population across provinces, from the Statistical Abstract of the Republic of China (Chi, 1987). Because this measure originates from historical facts, it is less likely to be affected by endogeneity problems, such as omitted variable biases. As a robustness check, we used the number of wars and property losses as alternative proxies (Chi, 1987; Han, 1946).<sup>5</sup> Figure 1 shows the distribution of war

atrocities; darker shading corresponds to greater damage during the Second Sino-Japanese War.

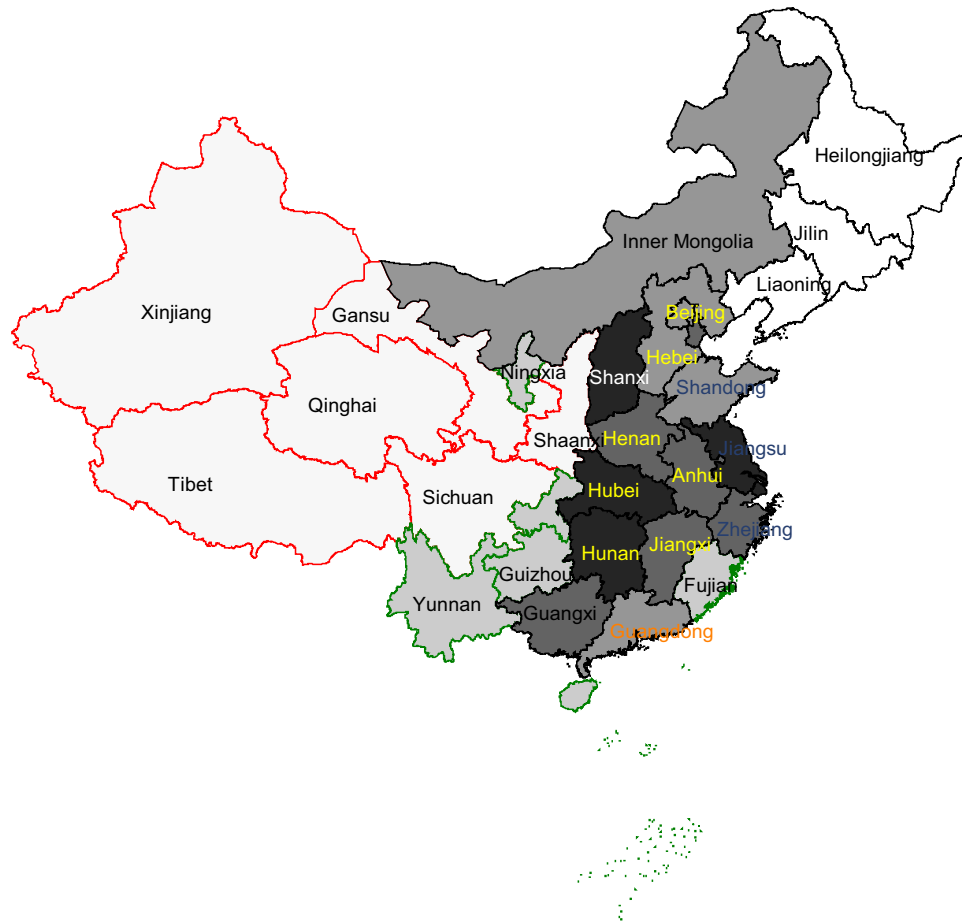
We included a number of controls that may determine FDI location choices. First, to control for the costs of transportation and infrastructure, we included minimum distance of a province to four major seaports in China (Dalian, Hong Kong, Qinhuangdao, and Shanghai) and highway density<sup>6</sup> (Wei & Wu, 2001). Second, we controlled for firm agglomeration in the same industry, which could exert network externalities (Chang & Park, 2005). Third, to capture the political influence of local policies, we included a dummy variable to indicate whether a province contains a special economic zone that may favor FDI, and the average ratio of a firm's extralegal payment to its total revenue in a province, to account for the impact of property rights protection (Johnson, McMillan, & Woodruff, 2002). Fourth, foreign firms typically consider market demand as an important factor of location choices (Helpman, Melitz, & Yeaple, 2004), so we included regional gross domestic product as a proxy. Finally, to capture the effect of skilled labor in the region, we controlled for regional education measured by secondary school enrollment rates as a proxy of human capital (Borensztein, Gregorio, & Lee, 1998; Liu, Lovely, & Ondrich, 2010). Table 1 presents the means, standard deviations, and correlations of all variables.

In examining the effect of civilian casualties on FDI performance, we examined three moderators: state capital involvement, excessive tax payments, and local employment. State capital is a dummy variable, equal to 1 if a focal Japanese FDI contains an investment from the central government of China and 0 otherwise. To measure tax payments, we employed a two-stage estimation method. In the first stage, we investigated the determinants of firm taxes, using the following estimating equation:

$$tax_{fj} = \alpha_j + X'_{fj}\beta + \varepsilon_{fj}, \quad (1)$$

where  $tax_{fj}$  denotes the taxes paid by firm  $f$  in industry  $j$ ;  $\alpha_j$  is a set of industry-fixed effects controlling for time-invariant factors that determine the firm's tax (e.g., industry-specific statutory tax rate);  $X'_{fj}$  is a vector of firm characteristics, including total assets, exporting dummy, annual sales, profits, registered equity, and firm age;  $\beta$  is a vector of their coefficient estimates; and  $\varepsilon_{fj}$  is the error term with  $t$  distributed asymptotically. After fitting





**Figure 1** War atrocity across China. Notes: this figure illustrates the war atrocity index across provinces in China. This index absorbs the variation of civilian casualty, wars, and property losses using Principal Component Analysis Method. Five levels of shades represent varying levels of war atrocity with a darker shade corresponding to greater war atrocity. The figure using civilian casualty alone for illustration generated similar patterns.

**Table 1** Descriptive statistics and correlations

	1	2	3	4	5	6	7	8	9	10	11
1 Civilian casualty	1.00										
2 Wars	0.80***	1.00									
3 Property losses	0.40***	0.50***	1.00								
4 Distance	-0.20***	-0.31***	-0.83***	1.00							
5 Infrastructure	0.24***	0.35***	0.48***	-0.56***	1.00						
6 Agg_domestic	0.04***	0.18***	0.64***	-0.50***	0.45***	1.00					
7 Agg_foreign	-0.03***	0.12***	0.64***	-0.59***	0.47***	0.73***	1.00				
8 SEZ	0.01***	-0.05***	0.34***	-0.40***	0.47***	0.60***	0.57***	1.00			
9 PRP	0.06***	0.06***	0.11***	-0.08***	0.13***	-0.01***	-0.01***	-0.01***	1.00		
10 GDP	0.11***	0.28***	0.47***	-0.21***	0.41***	0.72***	0.51***	0.33***	0.13***	1.00	
11 Education	0.03***	0.16***	0.47***	-0.51***	0.32***	0.45***	0.52***	0.30***	0.07***	0.45***	1.00
Mean	1.77	51.50	1.07	2.84	7.72	0.04	0.03	0.38	0.53	0.73	0.89
SD	1.90	56.39	0.95	0.75	0.88	0.04	0.04	0.49	0.42	0.51	0.08

Notes: N = 224,796; \*p<0.10; \*\*p<0.05; \*\*\*p<0.01.



Eq. (1) with firm-level data from the industrial census of China in 2000, we obtained all coefficient estimates determining a firm's tax and then we predicted firm taxes for Japanese FDI in 2001. Excessive tax payment was calculated as the ratio of actual firm taxes minus the predicted taxes to firms' total assets. Local employment is measured by the ratio of a firm's total employment minus the number of expatriates to total local labor forces.

For the FDI performance model, we included a set of covariates that potentially affect firm performance. We controlled for exporting as a dummy indicating whether a firm engaged in exporting activities, capital labor ratio, and debt equity ratio at the firm level. Industry level controls include Herfindahl index to capture the degree of competition and agglomeration of both domestic and foreign firms. For regional controls, we included distance to major seaports, a dummy indicating whether a province has a special economic zone, property rights protection, and education.

## Models

To test Hypothesis 1, we employed a conditional logit model and analyzed the location choices for Japanese FDI in difference provinces in China (Chang & Park, 2005; McFadden, 1974). Specifically, we expressed firm  $f$ 's location choice function as

$$\pi_{fpt} = \alpha + \beta \times \text{casualty}_p + X'_{pt-1}\sigma + \varepsilon_{fpt}, \quad (2)$$

where  $\text{casualty}_p$  denotes civilian casualty in province  $p$ , and  $X'_{pt-1}$  is the vector of control variables that affect FDI location choices. To alleviate concerns of reverse causality, we measured all independent variables at  $t - 1$ .  $\varepsilon_{fpt}$  is the error term that contains variables that cannot be observed.

The probability that Japanese firm  $f$  chooses province  $p$  for its FDI can be expressed as

$$\begin{aligned} p_{fpt} &= \Pr\{\pi_{fpt} > \pi_{fkt}\} \\ &= \Pr\{(\varepsilon_{fpt} - \varepsilon_{fkt}) \geq \beta(\text{casualty}_p - \text{casualty}_k) \\ &\quad + (X'_{kt-1} - X'_{pt-1})\sigma\}, p \\ &\neq k. \end{aligned} \quad (3)$$

Assuming that  $\varepsilon_{fpt}$  follows a Type I extreme distribution,  $p_{fpt}$  can be written as

$$p_{fpt} = \Pr(Y_{ft} = j) = \frac{\exp(\beta \times \text{casualty}_k + X'_{pt-1}\sigma)}{\sum_{k \in J} \exp(\beta \times \text{casualty}_k) + X'_{kt-1}\sigma}, \quad (4)$$

where  $J$  is the set of province choices faced by Japanese firms, and  $Y_{ft}$  is a dummy variable that indicates whether Japanese firm  $f$  in year  $t$  chooses province  $j$ . A negative, significant estimate of  $\beta$  suggests that, holding other factors constant, Japanese firms are less likely to locate in provinces with heavy civilian casualties. In addition, Eq. (4) can be estimated using maximum likelihood estimation. The maximized log-likelihood function is

$$\ln L = \sum_{f=1}^n \sum_{p=1}^J d_{fpt} \ln \Pr(Y_{ft} = j), \quad (5)$$

where  $d_{fpt}$  equals 1 if  $Y_{ft} = j$ , and it equals 0 otherwise. We chose  $\beta$  and  $\sigma$  to maximize the log-likelihood  $\ln L$ .

To test Hypotheses 2 and 3, we used the following estimate:

$$ROA_{fjp} = \alpha + \beta \times \text{Casualty}_p + X'\theta + \varepsilon'_{fjp}, \quad (6)$$

where  $ROA_{fjp}$  represents the return on assets of firm  $f$  in industry  $j$  and province  $p$ ;  $\alpha$  is the constant;  $\varepsilon'_{fjp}$  is the error term; and  $X'$  is a vector of firm-, industry-, and province-level controls.

## Results

Table 2 presents our empirical results testing Hypothesis 1. Column 1 includes only control variables in the conditional logit model. Column 2 shows the full model in which civilian casualty was included in addition to the agglomeration and institutional effects, regional attributes, and other conventional determinants. The results show that civilian casualty has a significant effect ( $\beta = -0.145$ ,  $p < 0.01$ ), suggesting Japanese firms tend to avoid regions with heavy civilian casualty. This estimate indicates that one standard deviation increase of civilian casualty (1.9%) in a province will decrease the probability of being chosen as a location by 28%. Thus Hypothesis 1 is supported. For the effects of control variables, Japanese firms choose provinces with low costs (i.e., distance, infrastructure, and agglomeration) to locate while preferring locations with better institutions (i.e., property rights protection) and more market demand (i.e., GDP) to invest; they also choose provinces with more open policies toward foreign firms (i.e., special economic zones) and better human capital (i.e., education). To further examine sub-regional variations of historical conflict on FDI, we collected information on civilian casualties of Shandong province from The List of Victims in

**Table 2** Conditional logit model of Japanese FDI location in China

	(1)	(2)	(3)	(4)
	Depend variable is a dummy indicating the province that the Japanese firm has chosen			
Civilian casualty		-0.145*** (0.014)		
Wars			-3.742*** (0.405)	
Property losses				-2.014*** (0.388)
Distance	-0.470*** (0.042)	-0.530*** (0.044)	-0.537*** (0.043)	-0.719*** (0.068)
Infrastructure	0.383*** (0.031)	0.364*** (0.028)	0.378*** (0.028)	0.359*** (0.031)
Agg_domestic	0.106*** (0.046)	0.180*** (0.045)	0.128*** (0.045)	0.149*** (0.047)
Agg_foreign	0.948*** (0.031)	1.018*** (0.031)	1.061*** (0.033)	0.989*** (0.032)
Special economic zone	0.409*** (0.035)	0.288*** (0.038)	0.271*** (0.038)	0.364*** (0.036)
Property right protection	-0.309*** (0.036)	-0.231*** (0.038)	-0.232*** (0.037)	-0.291*** (0.037)
GDP	0.412*** (0.041)	0.378*** (0.039)	0.400*** (0.039)	0.511*** (0.045)
Education	3.684*** (0.305)	3.146*** (0.297)	3.314*** (0.303)	3.574*** (0.307)
Pseudo R square	0.26	0.26	0.26	0.26
Log pseudo likelihood	-20,867	-20,800	-20,820	-20,854
Firms	8,646	8,646	8,646	8,646
Location choices	26	26	26	26
Observations	224,796	224,796	224,796	224,796

Notes: \* $p < 0.10$ ; \*\* $p < 0.05$ ; \*\*\* $p < 0.01$ . Standard errors are in parenthesis.

Shandong Provinces during Second Sino–Japanese War,<sup>7</sup> compiled by the Research Department of Communist Party History in Shandong province, 2014. We conducted analysis at two finer geographic unit levels; prefecture and county. The estimation results are highly consistent: the coefficient estimates of civilian casualty at both prefecture and county level are negative and significant, suggesting a deterring effect of historical conflict on the location choices of Japanese FDI at sub-provincial level.

The validity of estimates on  $\beta$  relies on the assumption that Japanese army did not encounter more resistance that caused more casualties in regions with certain cultural characteristics, and the war damage has not affected the post-war development and the pattern of investment opportunities for foreign firms. In other words, some omitted factors may be related to civilian casualty while also affect FDI location choices. This possibility can be assessed by estimating the location choices for FDI from countries other than Japan. In

addition, previous studies suggest that the distance measures between countries, such as culture, economic, geographic, and institutional distances matter for FDI location choices (Makino & Tsang, 2011). To ensure that our results are robust after incorporating these distances, we controlled for these four types of distances in our models with all foreign firms invested in China included. For the measure of cultural distance, we generated provincial culture measures based on World Values Survey following Beugelsdijk, Maseland, and van Hoorn (2015), and calculated the cultural distance value using foreign countries' scores obtained from Berry, Guillen, and Zhou (2010). Economic distance was constructed as the difference between a province's GDP per capita and those of foreign countries (Berry et al., 2010). Geographic distance denotes the distance between province capital cities of and a specific country, constructed using the Great Circle Distance method. Institutional distance was calculated as the difference of institutional quality of provinces and foreign countries, where province

Table 3 Descriptive statistics and correlations of the overall sample

	1	2	3	4	5	6	7	8	9	10	11	12	13
1 Civilian casualty	1.00												
2 Wars	0.81***	1.00											
3 Property losses	0.41***	0.50***	1.00										
4 Geographic distance	-0.01***	-0.03***	-0.09***	1.00									
5 Cultural distance	0.13***	0.05***	0.18***	-0.15***	1.00								
6 Institutional distance	0.07***	0.06***	0.10***	0.02***	-0.07***	1.00							
7 Economic distance	-0.03***	-0.04***	-0.04***	-0.41***	0.32***	0.03***	1.00						
8 Infrastructure	0.24***	0.35***	0.48***	-0.03***	0.05***	0.12***	-0.14***	1.00					
9 Agg_domestic	0.04***	0.18***	0.64***	-0.05***	0.09***	-0.03***	-0.01***	0.45***	1.00				
10 Agg_foreign	-0.01***	0.04***	0.23***	-0.03***	0.06***	-0.02***	-0.02***	0.18***	0.27***	1.00			
11 SEZ	0.01***	-0.05***	0.33***	-0.02***	0.24***	-0.04***	-0.04***	0.46***	0.60***	0.21***	1.00		
12 GDP	0.11***	0.29***	0.47***	-0.01***	0.01***	0.11***	0.04***	0.41***	0.71***	0.18***	0.33***	1.00	
13 Education	0.03***	0.16***	0.46***	-0.05***	0.20***	0.07***	0.02***	0.33***	0.44***	0.19***	0.30***	0.46***	1.00
Mean	1.77	51.50	1.07	8.82	-3.12	10.89	-10.29	7.73	0.04	0.04	0.38	0.74	0.89
SD	1.90	56.39	0.95	0.68	10.14	14.36	4.35	0.88	0.04	0.14	0.49	0.52	0.08

Notes: N = 778,986; \*p<0.10; \*\*p<0.05; \*\*\*p<0.01.

institutions and cross-country institutional quality were extracted from Survey of China's Private Enterprises and Polity IV Project respectively (Acemoglu, Johnson, & Robinson, 2001). Table 3 presents the descriptive statistics and correlations of variables for the sample of FDI from all countries. The estimation results reported in column 1 of Table 4 suggest that with cultural, economic, geographic, and institutional distances included, we still detected a negative and significant impact of civilian casualty on Japanese FDI locational choices, captured by the interaction between civilian casualty and the Japan dummy.

We employed civilian casualty at province level to measure war damage because the loss of human lives has a profound impact on individuals' emotions and the subsequent formation of animosity toward Japan. To check the robustness of our proxy for war damage and include other causes of citizen animosity during the Second Sino-Japanese War, we used two alternative measures in our analyses: number of wars (i.e., great wars, moderate wars, and skirmishes) and property losses (i.e., movable property and real estate losses) during the war. Estimation results using these proxies are reported in Table 4. In all cases, the estimate of  $\beta$  is negative and highly significant, suggesting that Japanese firms are less likely to locate in provinces with higher damage during the War. These results imply that our baseline results are robust to alternative proxies for war damage and our selection of civilian casualty as the baseline proxy is not arbitrary.<sup>8</sup> We further estimated the effects of civilian casualty using five major source countries of FDI in China other than Japan, i.e., the US, Germany, France, the UK, and Italy.<sup>9</sup> We did not detect any significant effect of civilian casualty on FDI location choices, which further confirms that civilian casualty only affects FDI from Japan.

Table 5 presents the correlation table of the variables used in the performance model. The number of observations dropped to 8,259 due to missing values. We reported the performance impact of civilian casualty and the potential moderators on the civilian casualty and FDI performance relationship in Table 6. In all columns of Table 6, in addition to the regional controls, we further included firm level controls of exporting, capital labor ratio, debt equity ratio, and industry level controls of Herfindahl index and agglomeration. In column 1, we found a negative and significant effect of civilian casualty on the performance of Japanese FDI ( $\beta = -0.605$ ,  $p < 0.05$ ),

**Table 4** Location choices of FDI from all countries

	(1)	(2)	(3)
Civilian casualty	-0.011 (0.008)		
Civilian casualty × Japan	-0.085*** (0.018)		
Wars		0.070 (0.265)	
Wars × Japan		-3.125*** (0.534)	
Property losses			0.026 (0.183)
Property losses × Japan			-2.022*** (0.357)
Geographic distance	-0.651*** (0.081)	-0.771*** (0.085)	-1.194*** (0.137)
Cultural distance	0.002 (0.002)	0.001 (0.002)	0.002 (0.002)
Institutional distance	-0.005*** (0.001)	-0.005*** (0.001)	-0.004*** (0.001)
Economic distance	-0.009 (0.022)	-0.005 (0.023)	0.010 (0.023)
Infrastructure	0.640*** (0.091)	0.684*** (0.090)	0.685*** (0.091)
Agg_domestic	3.179*** (0.375)	2.983*** (0.372)	3.319*** (0.434)
Agg_foreign	8.398*** (0.058)	8.402*** (0.058)	8.408*** (0.059)
Special economic zone	0.106*** (0.030)	0.109*** (0.031)	0.124*** (0.029)
GDP	0.323*** (0.030)	0.335*** (0.030)	0.339*** (0.030)
Education	2.165*** (0.206)	2.200*** (0.207)	2.128*** (0.214)
Pseudo R square	0.65	0.65	0.65
Log pseudo likelihood	-34,316	-34,313	-34,319
Firms	29,961	29,961	29,961
Location choices	26	26	26
Observations	778,986	778,986	778,986

Notes: \* $p < 0.10$ ; \*\* $p < 0.05$ ; \*\*\* $p < 0.01$ . Standard errors are in parenthesis.

which provides a strong support for Hypothesis 2. We further tested the moderating effects of three political capital accumulation strategies, namely state capital involvement, excessive tax payment, and local employment. We did not detect a significant moderating effect of state capital. Therefore Hypothesis 3a is not supported. The interaction item between excessive tax payment and civilian casualty has a significantly positive effect on FDI performance ( $\beta = 0.020$ ,  $p < 0.01$ ), supporting Hypothesis 3b. Similarly, the interaction between local employment and civilian casualty yields a significantly positive effect on performance ( $\beta = 4.682$ ,  $p < 0.05$ ). Therefore Hypothesis 3c is

also supported. Taken together, the results suggest that if Japanese firms contribute to local government revenue and employment at subnational provinces, which is conducive to local public goods, the negative effect of historical conflict on their performance can be mitigated.

### Additional Analysis

First, we tested the impact of civilian casualty on Japanese FDI location choices across time by using 5-year intervals (1992–1996 and 1997–2001). The results showed a consistently negative long-term effect of civilian casualty over time. Second, it is important to capture the recent development and

Table 5 Descriptive statistics and correlations of variables in the performance model

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
1 ROA	1.00														
2 Civilian casualty	-0.02**	1.00													
3 State capital	0.02*	0.003	1.00												
4 Tax payment	-0.19***	-0.01	0.03***	1.00											
5 Employment	0.07***	-0.01	0.09***	0.03***	1.00										
6 Export	0.12***	0.03***	0.01	0.13***	0.16***	1.00									
7 CLR	0.11***	0.01	0.09***	0.15***	-0.04***	-0.00	1.00								
8 DER	0.03***	0.01	-0.03**	0.01	0.03***	0.07***	0.16***	1.00							
9 Herfindahl Index	0.01	-0.01	0.00	0.00	-0.01	-0.01	0.02	-0.00	1.00						
10 Agg_domestic	0.06***	0.13***	-0.09***	-0.04***	-0.08***	0.05***	-0.08***	0.03***	0.00	1.00					
11 Agg_foreign	0.03***	0.30***	-0.06***	-0.03***	0.02	0.12***	0.03**	0.02**	-0.01	0.43***	1.00				
12 Distance	-0.02**	-0.25***	0.05***	0.01	-0.06***	-0.10***	-0.01	-0.01	0.02*	-0.28***	-0.65***	1.00			
13 SEZ	0.05***	-0.21***	-0.09***	-0.02**	-0.08***	-0.01	-0.15***	-0.01	0.01	0.55***	-0.16***	0.08***	1.00		
14 PRP	-0.02**	0.17***	0.01	0.01	-0.00	-0.06***	0.01	0.01	0.01	-0.29***	-0.13***	0.18***	-0.21***	1.00	
15 Education	0.04***	-0.05***	-0.03***	-0.01	0.02*	0.07***	0.02*	0.01	-0.01	0.43***	0.49***	-0.64***	0.09***	-0.51***	1.00
Mean	-0.04	1.71	0.10	-0.03	0.05	0.39	3.01	0.23	0.27	0.08	0.11	2.16	0.57	0.54	0.98
SD	0.21	0.95	0.30	0.20	0.18	0.49	1.37	0.69	0.17	0.05	0.06	0.49	0.50	0.31	0.02

Notes: N = 8,259; \*p<0.10; \*\*p<0.05; \*\*\*p<0.01.

trend of Japanese FDI in China. We compiled aggregated province level FDI data to 2013 from the Statistical Yearbooks of China and tested the impact of civilian casualty on FDI inflow into different provinces. The findings were consistent with our results, confirming a persistent effect of civilian casualty on Japanese FDI. Third, the validity of estimates of conditional logit models rests upon the independence from irrelevant alternatives assumption (Hausman & McFadden, 1984). We re-estimated our model using two subsamples without firms located in Shanghai and regions with less than 20 entries; we obtained consistent results. We also tested a nested logit model, which partially relaxes the irrelevant alternatives assumption (Greene, 2008). In the nested logit model, a firm's behavior on location choice was modeled in two steps: a Japanese firm chooses a large region for consideration (e.g., coastal provinces) and then a specific province to locate within this large region. By dividing Chinese provinces into five large regions,<sup>10</sup> we estimated the nested logit mode and obtained robust results, suggesting our original models are not distorted by the assumption of irrelevant alternatives.

**DISCUSSION**

Existing research in international business has uncovered the impact of various factors, associated with different economic and policy regimes, on firms' foreign expansion. However, a less understood issue is whether and how historical relations affect FDI activities. In this study, we utilize the context of the Second Sino-Japanese War (1937-1945) to examine the effect of historical conflict on Japanese FDI in China. Using civilian casualties across subnational regions in China, we find that regions that suffered greater damage during the war attract less FDI from Japanese firms. The findings also show that Japanese FDI's located in regions with greater casualties perform worse than those in other regions. Furthermore, we find that political capital accumulation strategies, in the forms of excessive tax payments and local employment, can serve as potential remedies that reduce the negative effect of civilian casualty on performance.

**Contributions**

This study makes several important contributions to the literature. First, we respond to calls for more fine-grained analyses of within-country differences



Table 6 Performance model with moderating effects

	ROA						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Civilian casualty	-0.605** (0.272)	-0.613** (0.272)	-0.614** (0.272)	-0.626** (0.265)	-0.819*** (0.264)	-0.579** (0.272)	-0.472* (0.276)
State capital		1.081 (0.765)	1.085 (0.766)				
State capital × civilian casualty			0.070 (0.748)				
Tax payment				-0.024*** (0.001)	-0.032*** (0.001)		
Tax payment × civilian casualty					0.020*** (0.002)		
Local employment						6.874*** (1.284)	7.092*** (1.287)
Local employment × civilian casualty							4.682** (2.170)
Firm-level controls							
Exporting	5.216*** (0.466)	5.202*** (0.466)	5.202*** (0.466)	6.606*** (0.458)	6.890*** (0.456)	4.823*** (0.471)	4.815*** (0.471)
Capital labor ratio	1.778*** (0.168)	1.758*** (0.169)	1.758*** (0.169)	2.296*** (0.165)	2.297*** (0.164)	1.830*** (0.168)	1.837*** (0.168)
Debt equity ratio	0.050 (0.328)	0.069 (0.328)	0.069 (0.328)	-0.062 (0.319)	-0.081 (0.317)	-0.009 (0.327)	-0.016 (0.327)
Industry-level controls							
Herfindahl index	1.115 (1.289)	1.110 (1.289)	1.109 (1.289)	1.085 (1.254)	1.068 (1.247)	1.135 (1.287)	1.124 (1.286)
Agg_domestic	1.446* (0.801)	1.459* (0.801)	1.460* (0.801)	1.299* (0.779)	1.621** (0.776)	1.662** (0.800)	1.635** (0.800)
Agg_foreign	0.503 (0.551)	0.540 (0.552)	0.543 (0.552)	0.110 (0.536)	0.062 (0.533)	0.538 (0.550)	0.463 (0.551)
Region-level controls							
Distance	-0.060 (0.720)	-0.080 (0.720)	-0.076 (0.721)	-0.125 (0.701)	-0.293 (0.697)	0.126 (0.719)	0.058 (0.720)
Special economic zone	1.989*** (0.668)	2.040*** (0.669)	2.038*** (0.669)	1.995*** (0.650)	1.837*** (0.647)	2.087*** (0.667)	2.167*** (0.668)
Property right protection	0.795 (0.935)	0.817 (0.935)	0.812 (0.937)	0.993 (0.910)	1.238 (0.905)	0.825 (0.933)	0.822 (0.933)
Education	3.003 (15.634)	2.635 (15.634)	2.611 (15.636)	5.446 (15.215)	2.644 (15.128)	2.742 (15.607)	1.557 (15.612)
F Statistics	15.8***	14.69***	13.56***	47.81***	51.14***	18.32***	17.26***
Observations	8,259	8,259	8,259	8,259	8,259	8,259	8,259

Notes: \* $p < 0.10$ ; \*\* $p < 0.05$ ; \*\*\* $p < 0.01$ .

in international business research (Chan et al., 2010; Lorenzen & Mudambi, 2013; Ma et al., 2013). Specifically, we investigate within-country variations of historical conflict, which is traditionally treated as a host-home country construct, and assess its effects on subnational location choices and performance of FDI. Prior literature generally focuses on country-specific factors as determinants of FDI; but even if the “border effects” assumption of abrupt changes at national frontiers can be valid, it is no longer sufficient (Beugelsdijk & Mudambi,

2013). Instead, the subnational context profoundly affects FDI strategies and thus must be recognized, to reveal the more subtle spatial heterogeneity (Chan et al., 2010). Extending the pioneering work by Makino and Tsang (2011) on historical relations and FDI, our study provides strong evidence of subnational differences in the long-term impact of historical conflict on FDI activities. This approach of focusing on within-country differences of country-level constructs thus adds nuance to our understanding of the effects of historical factors on FDI



location decisions and performance. Moreover, our findings demonstrate that political capital accumulation strategies are effective only with local governments, but not with the central government, which provides further evidence that a subnational perspective is critical for investigating firm behavior and strategies in the dynamic environmental conditions in emerging markets.

Second, we extend FDI research by incorporating the influence of historical conflict on FDI performance. Relatively scant attention has been paid to the non-economic determinants of FDI performance (Jones & Khanna, 2006; Martin, 1999). Recent studies start to acknowledge the importance of social, cultural, political, and historical factors. But the ways that history affects international business activities remain unclear (Jones & Khanna, 2006; Makino & Tsang, 2011; Martin, 1999; Martin & Sunley, 1996). We use regional civilian casualties as a proxy for the psychological damage caused by the Second Sino–Japanese War and link it with FDI performance. We demonstrate that repressed war memories can add to distrust and cast a shadow on FDI operation, even after decades-long efforts and continuous economic cooperation. The conflict-induced animosity is persistent, biasing people's judgments and blocking market access of foreign investors from the antagonist country. Our findings reveal the strong influence of local people's post-conflict psychological processes on foreign firms' strategic decisions and performance outcomes.

Third, we examine the capacity of political capital accumulation strategies in weakening the negative impact of historical conflict on FDI performance. Political capital can offer firms notable strategic benefits, including access to policy information, legitimacy, and valuable resources that are helpful in overcoming liabilities of foreignness or information asymmetries in foreign markets (Faccio et al., 2006; Hillman & Hitt, 1999). These benefits are particularly relevant in China's regionally decentralized authoritarian system, in which political authorities at the subnational level have significant control over key resources (Xu, 2011). Although acquiring political capital may heighten operational costs, it enables foreign firms to align with the interests of local governments to obtain institutional support, which in turn curtails the negative influence of past conflicts in the local context. Our study thus provides initial, strategic solutions that foreign firms can utilize to mitigate the deterrence effect of historical conflict. These firm-level remedies are highly relevant, considering that many FDI

destinations in emerging economies are characterized by turbulent contextual variations (Beugelsdijk & Mudambi, 2013). Our findings shed new light on how foreign firms can adjust their strategic choices in accordance with the unique historical, political, and social backgrounds that mark the various regional markets in host countries.

### Implications

Our findings provide important implications for managers and policymakers. In the global arena, we continue to witness constant conflicts among countries. Firms entering countries or regions with known animosity or conflicts may face increased transaction costs and exchange hazards, and perceive higher likelihoods of opportunism. Managers should not underestimate the negative psychological impact, as sentiments of animosity do not fade away easily.

To mitigate the negative effects of animosity due to historical conflict, foreign companies should seek political capital at the subnational level. In emerging economies such as China, the central government formulates strategic industrial policies, but firm-level performance depends heavily on local governments, which aim to maximize their local fiscal revenues and generate employment opportunities (Sun, Mellahi, & Thun, 2010). Tax payments and local employment opportunities can help foreign firms establish solid relations with local governments. Companies that fail to respect the interests of local governments instead may suffer. This lesson is particularly relevant for Japanese multinationals, which have traditionally tended to work closely with Japanese suppliers rather than locally owned companies to protect their independence (Ravenhill, 1999). In China's auto sector for example, Honda preferred to bring a core group of Japanese suppliers with it to Guangzhou, rather than working with the municipal government to develop indigenous local suppliers in late 1990s. This short-sighted strategic choice made Honda fail to accumulate political capital with local governments, and consequently the company lost its preferential treatment. In contrast, Hyundai in Beijing and Volkswagen in Shanghai have enjoyed more institutional support, including local requirements that every new city taxi must be the companies' car models (Sun et al., 2010). Since 2004, the sales of Honda have lagged behind major competitors, despite its first-mover advantage in China.

We also note several important implications for policymakers. War causes massive collateral





damage, including losses of human life and the destruction of physical capital, that are tangible. The psychological and social costs, such as cognitive and emotional damage and the destruction of trusting social relationships, may be more persistent. Policymakers should be aware of the long-run impact of historical conflict when seeking to attract FDI from antagonist countries and accordingly find solutions to reduce this hostility and animosity. For example, during the Asian economic crisis, Japan's initiatives and efforts to absorb imports from struggling Asian nations were applauded by regional and international communities (Leong et al., 2008). Other proactive efforts might include correcting attributions of conflicts, sending aid and trade missions, and encouraging exchange visits by officials, academics, and citizens. Through such efforts, accumulated animosity might be gradually transformed into positive relationships. If China and Japan could turn over a new leaf, their bilateral trade investment might even reach new heights.

### Limitations and Future Research

Our study is subject to several limitations that also suggest a variety of directions for future research. First, our measure of war atrocities at the province level may contain an aggregate bias. Continued research could further zoom into investigate within-country differences at a finer geographic level. The sub-provincial results from Shandong represent some initial efforts. Second, we used a firm-year data structure to examine Japanese FDI location choices. Because the database did not contain information about parent firms, we could not investigate sequential entries of the same parent firm. Future studies can further examine whether experience and learning from past entries help Japanese firms deal with the negative impact of historical conflict. Third, the findings document a strong and persistent effect of historical conflict, but our study does not capture consumers' hostile attitudes directly, nor can it describe their shifting cognitive processes over time. It would be worthwhile to examine whether foreign firms can employ strategies to directly mitigate consumers' animosity in regions with heavy civilian casualties. Rigorous qualitative research might help reveal the underlying mechanisms. Finally, our study focuses on political capital accumulation strategies as potential remedies. Establishing strategic alliances with firms from countries that already have bilateral trust with the host country might be another means through which Japanese firms can navigate

the hostile environment. Additional studies thus should explore alternative strategies that are beneficial to firm operations in regions and countries where animosity sentiments continue to exist.

### ACKNOWLEDGEMENTS

We thank the Editors John Cantwell, Ron Boschma, and three anonymous reviewers for their insightful suggestions. We also appreciate the helpful comments from Ram Mudambi, Shige Makino, Gongming Qian, Xufei Ma, Grazia Santangelo, and participants at the JIBS Special Issue Conference, New Orleans, 2016. Special thanks to Sjoerd Beugelsdijk for the advices on method improvement. The support from Office of International Studies and Programs at University of Missouri-St. Louis and Shanghai Pujiang Program (16PJ048) is gratefully acknowledged.

### NOTES

<sup>1</sup>The details of the 2002 survey by the Chinese Academy of Social Science can be found at <http://qk.cass.cn/rbxk/qkml/2002year/6/201303/P020140425560832665895.pdf> (in Chinese).

<sup>2</sup>We excluded three northeastern provinces, Heilongjiang, Jilin, and Liaoning. They were occupied by the Japanese army in 1931 before the full-scale war and were subject to different colonial strategies. Therefore in the books about losses of China during the war, there was no information about these three regions.

<sup>3</sup>The First Sino-Japanese War was from 1894 to 1895.

<sup>4</sup>See "Publics of Asian Powers Hold Negative Views of One Another", Pew Research Center, September 21, 2006. [www.pewglobal.org/2006/09/21/publics-of-asian-powers-hold-negative-views-of-one-another](http://www.pewglobal.org/2006/09/21/publics-of-asian-powers-hold-negative-views-of-one-another).

<sup>5</sup>Wars were more likely to generate media coverage and property losses can capture the locational damage. Thus the inclusion of these two alternative measures help provide a more complete picture of historical conflict.

<sup>6</sup>Transportation infrastructure is an important engine of regional development and can increase urbanization and promote industrial growth, therefore represents a critical factor for FDI location choices (Faber, 2014; Head & Ries, 1996).

<sup>7</sup>The data only contained information of deaths of each region during the war. Since no reliable population estimates at prefecture and county levels before



the war are available, we normalized civilian deaths by the unit area size following Nunn (2008).

<sup>8</sup>We standardized the three indicators and compared sizes of the coefficients. Civilian casualty has a larger effect than the other two alternative measures.

<sup>9</sup>We obtained similar results by using top 20 China's major source countries of FDI and these results are available upon request.

<sup>10</sup>To specify the nested logit model, we partitioned our sample (i.e., 26 provinces) into five large regions

based on the method of Jin and Qian (1998): coastal provinces (Shandong, Jiangsu, Zhejiang, Fujian, Guangdong, and Hainan), inland provinces (Jiangxi, Nanhui, Hebei, Henan, Shanxi, Hubei, Shaanxi, Sichuan, and Hunan), northwest provinces (Inner Mongolia, Qinghai, Xinjiang, Gansu, and Ningxia), southwest provinces (Yunnan, Guangxi, and Guizhou), and huge cities (Beijing, Tianjin, and Shanghai).

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## APPENDIX: VARIABLE DEFINITIONS AND SOURCES

Variable	Definition	Source
Civilian casualty	Ratio of civilian casualties to total population in 1936	A historical account of the surveys of China's losses during the war with Japan; Statistical Abstract of the Republic of China
Wars	Number of major and moderate wars	A historical account of the surveys of China's losses during the war with Japan
Property losses	Log of movable property and real estate per capita	An estimate of China's losses in the war against Japan
Distance	The minimum Great Circle Distance of the province to four major seaports, plus the distance of these sea ports to Japan or each foreign country (unit: km)	The Great Circle Distance method
Infrastructure	Log of the length of highway per square kilometer in a province	China Statistical Yearbook
Agglomeration	Ratio of the number of firms in the same industry-region cell to the national total in the same industry, with domestic and foreign firms calculated separately	Annual Survey of Industrial Firms (ASIF), conducted by National Bureau of Statistics of China (NBSC)
Special economic zone	A dummy variable indicating whether a province contains any special economic zones	Ministry of Foreign Affairs



Variable	Definition	Source
Property rights protection	Average ratio of a firm's extralegal payment to its total revenue in a province	Survey of China's private enterprises
GDP	Real province gross domestic product with 1992 as the base year	China data online (University of Michigan)
Education	Secondary school enrollment rate at the province level	China Data Online (University of Michigan)
Geographic distance	Log of Great Circle Distance between a Chinese province's capital and a foreign country	The Great Circle Distance method
Cultural distance	Each province culture score minus a foreign country's cultural score	World Values Survey; Mahalanobis Distance (Berry et al., 2010)
Institutional distance	Standardized province measures of institutional quality minus a foreign country's standardized institutional quality score	Survey of China's Private Enterprises; The Polity IV Project
Economic distance	Province GDP per capita minus a foreign country's economic proxy	China Statistical Yearbook; Mahalanobis Distance (Berry et al., 2010)
State capital	A dummy variable indicating whether a Japanese FDI contains investments from the Chinese government	Survey of Foreign-invested Enterprises conducted by NBSC
Tax payment	Ratio of extra tax paid by a firm to its total assets	Survey of Foreign-invested Enterprises conducted by NBSC
Local employment	Ratio of number of local workers employed by a firm to local labor forces	Survey of Foreign-invested Enterprises conducted by NBSC
Exporting	A dummy variable equal to 1 if a firm exports and 0 otherwise	Survey of Foreign-invested Enterprises conducted by NBSC
Debt-to-equity ratio	Ratio of debt to firm equity	Survey of Foreign-invested Enterprises conducted by NBSC
Capital labor ratio	Ratio of capital to total employment	Survey of Foreign-invested Enterprises conducted by NBSC
Herfindahl index	Sum of the square of firm market shares in an industry	ASIF conducted by NBSC
Return on assets	Ratio of firm profit to total assets	Survey of Foreign-invested Enterprises conducted by NBSC

**ABOUT THE AUTHORS**

**Gerald Yong Gao** is Associate Professor of Marketing at College of Business Administration, University of Missouri-St. Louis. He received his PhD in Marketing from The University of Hong Kong. His current research interests include marketing and innovation strategies, export, FDI performance, and strategic orientations. He has published in scholarly journals such as *Administrative Science Quarterly*, *Journal of International Business Studies*, *Journal of the Academy of Marketing Science*, and *Journal of Operations Management*.

**Danny Tan Wang** is Associate Professor in the Department of Marketing at School of Business, Hong Kong Baptist University. He received his PhD from The University of Hong Kong. His research

covers a wide variety of topics including marketing channel strategies, foreign direct investment, and development issues in contemporary China. His research has been published in *Journal of Marketing*, *Journal of Marketing Research*, and *Environment and Planning A*, among others.

**Yi Che** is Assistant Professor of Economics at College of Economics and Management, Shanghai Jiao Tong University. He received his PhD in Strategy and International Business from The University of Hong Kong. His research interests include trade and FDI. He has published in scholarly journals such as *Journal of Comparative Economics*, *Asian Economic Journal*, and *China Agricultural Economic Review*.

Accepted by Ron Boschma, Guest Editor, on 8 October 2016. This article has been with the authors for two revisions.