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Liability of foreignness to competitive advantage: How multinational enterprises cope with the international business environment

Deepak Sethi*, Stephen Guisinger[1]

University of Texas at Dallas, P.O. Box 830688, Richardson, TX 75083-0688, USA

Abstract

An expanded and holistic conceptualization of the *liability of foreignness* (LOF) is presented that goes beyond the traditional *foreign subsidiary–local firm* dyad in the host country. Taking the *strategy process* perspective, we contend that this liability is the aggregated effect of the firm's interaction with all elements of the international business environment (IBE), not merely in the initial entry mode decisions but throughout its foreign operations. Viewing the antecedents and consequences of this liability holistically, we argue that accurate *reading* of the complex and volatile IBE, formulation of a compatible strategy and its effective implementation together contribute to good performance. As the resource-based perspective suggests the degree to which firms develop such tacit skills, differentially affects their performance. Firms that excel in these environment-*reading* skills and are agile enough to quickly adapt to its changes can transform this liability into a competitive advantage.

Keywords: Liability of foreignness; International business environment; Competitive advantage

1. Introduction

Forty years after the path-breaking contribution by Hymer (1960), the notion of *liability of foreignness* (LOF), though widely acknowledged in scholarly works, still eludes precise theoretical delineation. The fact that a firm, accustomed to functioning in its home country

* Corresponding author. Tel.: +1-972-883-2372; fax: +1-972-883-6164.
E-mail address: deepak@utdallas.edu (D. Sethi).
[1] Deceased.

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environment, incurs costs and disadvantages on venturing abroad can easily be appreciated. Several studies have explored the nature and effect of many of those disadvantages, be they on account of cultural differences, host government policies, political risk or other similar factors. Such attempts, however, represent only isolated snapshots of the phenomenon and have failed to view this liability holistically. Most research has conceived LOF in the constricted dyad of *foreign subsidiary–local firm* operations. Traditionally, all disadvantages incurred by the former in the host country's environment have been loosely clubbed under this "umbrella" term. The traditional conceptualization presents a somewhat static and constricted view that is unable to explain all the *costs of doing business abroad* incurred by multinational enterprises (MNEs), either on an enduring basis or in the context of multicountry operations. Consequently, this narrow focus on only some restricted elements rather than upon a fully delineated whole does not allow a proper perspective of the phenomenon.

The costs arising out of unfamiliarity and discrimination in the host country's environment are not the only costs incurred by an MNE once it ventures abroad. Interaction with the extreme complexity and volatility of the international business environment (IBE) itself imposes many other costs upon MNEs. Such costs arise not only out of *reading* the IBE incorrectly but also from not formulating and implementing a strategy that is compatible with it. Moreover, these costs are incurred not merely at the time of the initial entry into a foreign market but can persist throughout the duration of the firm's foreign operations. This paper uses the term *reading* colloquially to include scanning, interpretation, synthesis and analysis. There is ample evidence of such costs, both empirical and anecdotal. Some recent studies, going beyond the traditional dyads, have presented evidence at the macro level, contending that diversification and globalization cause a reduction in firm value (Denis et al., 2000; Mason and Moore, 1999). Click and Harrison (2000), for instance, followed the financial performance of over 3000 US firms over a 14-year period to provide empirical evidence that an increase in the extent of multinational operations of US corporations actually brought about erosion in their value. Their arguments, however, are based only on an accounting and economics-based perspective and do not take into account the strategic compulsions due to which MNEs might often be constrained to accept such costs in order to follow their rivals into foreign markets due to oligopolistic rivalry. The financial issue of *firm value* thus cannot be divorced from the strategic issue of *foreign market entry*. This paper seeks to examine LOF through the relatively underexplored lens of strategic management, departing from the usual transaction-cost economics perspective, because it enables a more realistic and continuous appraisal of the effect of the IBE on MNE operations.

Anecdotal evidence also abounds about such costs, with even established MNEs often incurring huge losses in their foreign operations. Ricks (1993) and Knight (1995), for instance, provide lucid accounts of blunders in international business. However, do those anecdotes really reinforce the LOF argument? Or, alternatively, are they getting confounded with mistakes that even domestic firms could make in their strategy formulation or operations? It could, however, be argued that if the firm's operations were to remain confined to the domestic arena, it would not get exposed to the extreme complexity and volatility of the IBE, which increases the likelihood of strategic mistakes. The *degree of difficulty* of operations in the IBE increases exponentially, requiring more sophisticated techniques of *reading* the environment, relative to domestic firms. However, as we demonstrate later, the increased propensity for mistakes is not merely due to the erroneous *reading* of the IBE. The failure to formulate a strategy that is compatible with the prevailing IBE further accentuates it, and the problem is compounded even more if *implementation* itself is flawed. Moreover, all these steps have to remain *in sync* throughout the duration of its foreign operations or else performance would suffer. Undoubtedly, this requirement exists even for domestic firms. However, for MNEs, strategy formulation and implementation demand much higher dimensions of stringency due to the extreme complexity, volatility and interdependence of the IBE.

There is a need, therefore, to distinguish LOF (in the traditional dyadic sense) from a so-called liability of foreign operations, which simply are all the *costs of doing business abroad*. While the former is due to spatial distance, unfamiliarity with the environment and discrimination suffered by the subsidiary in the host country, *the latter comprehensively includes all costs incurred by any domestic firm from the moment it undertakes cross-border operations*. However, do we need two terms that make the foregoing distinction or would an expanded conceptualization of the existing term LOF suffice? This paper recommends the latter alternative.

A moot question, however, arises: If multinational operations incur such liabilities, then why should MNEs still be investing abroad in droves? For instance, while the 20-year period from 1960 to 1980 saw a trebling of aggregate FDI, it jumped from \$500 bn to over \$3000 bn during 1980–1996, a more than sixfold increase in the next 16 years (UNCTAD, 1997). U.S. FDI itself increased from \$60 bn in 1967 to \$ 860 bn in 1997. The phenomenal growth in size and numbers of MNEs bears eloquent testimony to our argument that despite the LOF, firms can and indeed do overcome these disadvantages. In fact, the leading players, by developing appropriate intrafirm processes and skills, often convert this liability into a relative competitive advantage.

This paper, therefore, covers two aspects. It first presents a generic and enhanced conceptualization of the notion of LOF. We argue that LOF is the aggregated effect of the firm’s interaction with all elements of the IBE. Firms incur this liability only as a consequence of their decision to operate abroad, which forces them to interact with the IBE. The second aspect, which is the main theme of this paper, seeks to examine the entire process holistically and focuses upon the antecedents and consequences of this liability. The nature of the IBE (hostile or otherwise), the firm’s *reading* it comprehensively and accurately, the formulation of a strategy that is appropriate for that environment and the adaptation of the firm’s internal processes to ensure effective implementation of that strategy all form an integrated process. Inaccuracies in any of those steps contribute to that liability. Drawing from the resource-based perspective, the paper contends that MNEs can be differentiated on the basis of the degree to which they have developed intrafirm skills and processes for an accurate *reading* of the IBE and then formulating and implementing a strategy that is always compatible with it. The study then provides an illustrative listing of work in existing literature, both strategy and international business, which has dealt with individual facets of the integrated IBE *reading*, strategy formulation and implementation process.

The paper thus seeks to make a contribution both to theory and to practice by providing an enhanced conceptualization of LOF as a metaconstruct and highlighting that firms can, not merely mitigate LOF, but even turn it to a competitive advantage by developing those skills and processes that keep their strategy *in sync* with the IBE, better than rivals.

2. Liability of foreignness

LOF, often characterized as the *costs of doing business abroad*, has been broadly defined in literature as additional costs that a firm operating in a market overseas incurs, which a local firm would not (Hymer, 1976; Kindleberger, 1969). Zaheer (1995) further elaborates that these costs may arise from at least four, not necessarily independent, sources: (1) spatial distance (travel, transportation and coordination costs), (2) unfamiliarity with local environment, (3) discrimination faced by foreign firms and (4) restrictions from the home country. She also contends that though LOF may vary by industry or country, foreign firms, all else being equal, will have lower profitability than local firms and perhaps even a lower probability of survival.

The traditional view of LOF thus is in terms of simple dyadic home–host country pair analyses, which bring out the disadvantages suffered by the MNE subsidiary relative to a local firm. The principal *frame of reference* is the host country's environment. Therefore, different MNE subsidiaries experience varying degrees of LOF in respective host countries. The traditional view also presents a rather static picture that may be more applicable to the initial market entry (Buckley and Casson, 1976; Zaheer and Mosakowski, 1997, p. 458). Such dyadic comparisons neither focus upon the MNE as a whole nor enable a facile consideration of the complexities and interdependencies of the present-day IBE beyond the initial market entry. The effect of the global meta-environment that shapes and affects the host country's policies is also not considered nor is the effect of multilateral trade agreements or regional economic blocks. It is difficult for the dyadic comparison methodology to take account of multiple host country environments in the context of an MNE's globally dispersed operations. The subsidiary's ability to leverage the parent MNE's worldwide strength, experience, R&D and perhaps its *brand equity* also needs to enter the analysis. Moreover, the LOF does not remain constant after the initial entry. While costs due to spatial distance and a relatively stable factor like culture may be fixed, those arising out of factors like government regulations may vary over time. Similarly, longer experience in that environment and development of suitable internal skills to cope with it might also help reduce that liability.

The traditional methodology somewhat lacks the ability to address those issues adequately. However, if the *frame of reference* is shifted to the IBE as a whole and not just to the host country's environment, then a more realistic appraisal is possible. The LOF in this case would still be the *costs of doing business abroad* but more specifically the *additional costs incurred in interacting with all the elements of the IBE once the firm ventures abroad*. Those also include costs incurred in acquiring and developing the skills needed to *read* and deal with the intense complexity and volatility of the IBE. Even domestic firms might incur some of those costs because the prevailing IBE affects all firms, MNE as well as domestic. While it directly affects the MNEs, it also affects domestic firms indirectly, because the domestic business environments exist within an overarching IBE. For instance, a local, purely domestic firm in China would still need to consider the prevailing IBE to formulate an appropriate strategy against its rival—a US subsidiary in China—because the latter's strategy is more directly shaped by the IBE. Moreover, because the Chinese government could be expected to analyze the IBE while evolving its policies and regulations that affect both entities, the local Chinese firm can scarcely ignore it in its analysis. This *frame of reference* and methodology would make analyses realistic and truly reflective of the intricacies of the IBE. More importantly, it would facilitate an effective, real-time and contemporaneous analysis of the dynamically changing IBE.

This expanded conceptualization of LOF will also be applicable to all situations in a generic manner rather than being narrowly confined to the traditional dyadic view. The following examples may help illustrate this point. (1) The LOF is incurred by a US subsidiary operating in Sweden with respect to its local Swedish rival (the traditional LOF view). This LOF might, however, vary over time due to experience gained by the subsidiary or due to changed conditions that affect the two entities differently. (2) The extent of LOF incurred by the same US subsidiary with respect to the same Swedish rival would differ from the previous case, if the US subsidiary has had prior experience of operating in Norway. This is based on an extension of the Uppsala model's argument of experience in a culturally proximate country (Johanson and Vahlne, 1977; Barkema et al., 1996). (3) The extent of the LOF incurred by two US subsidiaries operating in Sweden would be different if one of them has had extensive experience in worldwide operations while the other has had only limited experience. (4) The LOF incurred by two US subsidiaries in Sweden, with identical levels of prior experience, would still be different in case where one of them develops better skills and internal processes for coping with the IBE. (5) The LOF incurred by two US subsidiaries in Sweden that are identical in size and experience would still vary in case where they adopt different entry modes.

This expanded and generic conceptualization of LOF would also obviate the necessity for having two separate terms that distinguish the traditional understanding of LOF from a so-called liability of foreign operations (the additional *costs of doing business abroad*). The paper, hereafter, adopts this enhanced LOF and proceeds to carry out a holistic examination of its antecedents and consequences to see how MNEs might mitigate this LOF through development of appropriate skills and intrafirm *routines*.

2.1. Distinguishing LOF

The LOF is liable to be confounded with the notion of *lack of fit* from mainstream strategy and also with the *liability of newness*. The disadvantages suffered by a firm, when its strategy is not in conformity with the dictates of its environment, are denoted as a *lack of fit* (Andrews, 1971). Ansoff and Sullivan (1993) also stress the need to comprehend environmental complexity and turbulence level and argue that firm profitability is optimized only when its strategic behavior is aligned with its environment. *Lack of fit*, thus, is a broad characterization that is applicable to all firms, domestic or multinational, when firm strategy

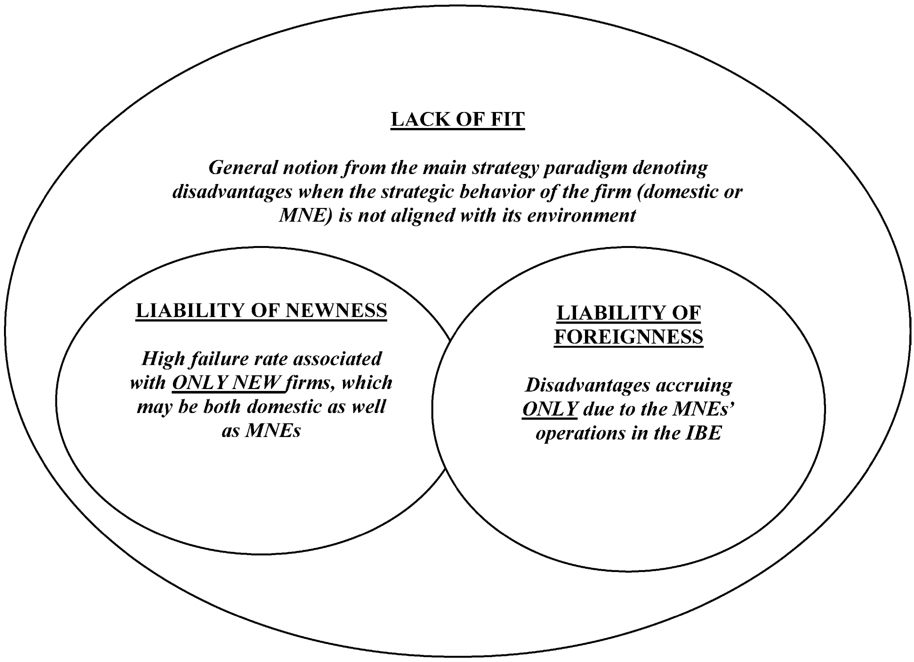

Fig. 1. Distinguishing LOF from lack of fit and liability of newness.

is incompatible with its environment. For the MNE, obviously, that environment is the IBE. The *liability of newness*, on the other hand, is the high failure rate associated with new organizations (Stinchcombe, 1965), which also could be both domestic and multinational. LOF, however, refers only to the disadvantages accruing exclusively from a firm's operations in the IBE. It is neither a general mismatch of firm strategy with its domestic environment (*lack of fit*) nor the infirmity associated with new firms (*liability of newness*). Fig. 1 seeks to depict that distinction.

3. International business environment

While the firm incurs a LOF when operating in the IBE, the precise contents of the latter are not defined. The IBE is an amorphous aggregate of several elements that differ along geographical, social, political and economic dimensions. Complexly intertwined and often transcending political boundaries, these elements are not static either. Some elements, such as those based on geography, economy or culture, remain relatively stable over time, while others like exchange rates are more volatile. Although there is a quantum jump in the complexity of a domestic firm's operational environment when it moves into cross-border operations, the MNE's business environment is becoming even more complex due to the situation succinctly described by Kobrin (1997) as *complex interdependence*. Until now, the MNE had to contend only with the host country's environment in which its subsidiary was embedded. However, with ever-increasing global integration, the MNE's value chain activities are spread over many more countries and they now have to contend with multiple host country environments. Those are also often subject to complex interactions amongst various IBE elements. This makes the IBE *kaleidoscopic* in nature because any change in a single element in one location can set off different reactions elsewhere. For instance, volatility in exchange rates may cause one government to enact a particular policy, which in turn may trigger a different response in another country. These responses might affect two subsidiaries of the same MNE in those respective countries differently, impelling them to take independent actions. Thus, one of the challenges for MNEs is to constantly adapt to increasing environmental complexity and uncertainty while still exhibiting some degree of consistency amongst its various globally dispersed units (Ghoshal and Westney, 1993; Rosenzweig and Singh, 1991).

Further confounding environmental complexity is the emerging scenario wherein supranational institutions like the WTO, unresolved issues from its predecessor GATT's "Uruguay Round," NGOs and environment groups (like Greenpeace) are all increasingly impacting government policies (Brewer and Young, 2001; Ostry, 2001; Spar, 2001; Kobrin, 2001). Kostova and Zaheer (1999) also highlight this increasing complexity by alluding to the global meta-environment, which all MNEs now have to contend with. The Emergent Interaction (Toyne and Nigh, 1999) and International Economic Involvement paradigms (Gray, 1999) also take a broader, multicomponent view of international business that places MNE activities within an overarching IBE. However, neither these supranational institutions nor geostrategic factors that impact interstate relations directly affect MNE operations. Instead, their effect is felt indirectly through the impact these factors have on the government policies of different countries. Hence, perspicacious MNEs also monitor these factors in order to discern the emerging trends well in time and thus take a lead over their rivals by proactively tailoring their strategies. The IBE is thus *the operational environment of MNEs*, and *it directly impacts*

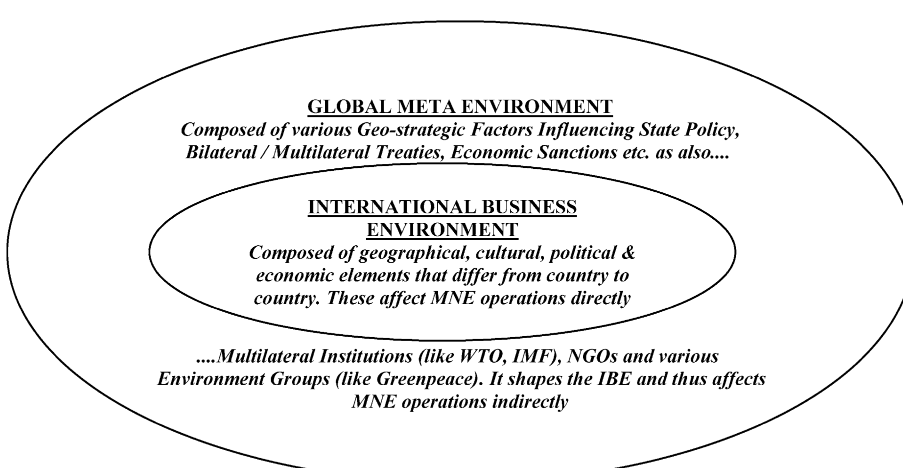

Fig. 2. The IBE within an overarching global meta-environment.

them. It, in turn, exists within an overarching meta-environment, consisting of supranational institutions, geopolitical factors and instruments of state policy like bilateral/multilateral treaties, trade sanctions and so forth. Fig. 2 presents a depiction of the IBE and the meta-environment.

4. LOF and MNE strategy

Because interaction with the IBE is the prime source of LOF, MNEs need to *read* (scan, analyze and interpret) the IBE correctly. However, LOF cannot be overcome merely by a correct *reading* of the IBE. Consideration of all elements in the entire interlinked process is crucial, as the stylized flowchart at Table 1 seeks to highlight. It sets the stage for the discussion of the implications of the LOF on MNE strategy and performance.

The table indicates that even if the IBE were to be scanned and interpreted comprehensively and accurately, optimal performance would still not accrue unless, in addition, a compatible strategy was formulated and the intrafirm processes were suitably adapted to ensure effective implementation. Consequently, *strategy formulation* and *implementation* have also been included within the purview of *mitigation of LOF*, even though those two processes are also applicable to domestic firms and not confined just to MNEs. This may seem to contradict our earlier assertion that LOF is attributable exclusively to interaction with the IBE, whereas *strategy formulation* and *implementation* appropriately form part of the *lack of fit* notion of mainstream strategy. It is, however, emphasized that when a domestic

Table 1
How the holistic process of dynamic *reading* of the IBE, strategy formulation and implementation affects the LOF

Scenario	Firm process	Issue involved
The overall IBE may either *actually* be hostile or *perceived* to be so	The MNE would need to scan and analyze the IBE	How structured is the process
Even if the IBE is actually *not* hostile	The firm may not scan the IBE comprehensively, both in terms of its contents and the geographical spread	Comprehensiveness of the scanning process
Even if the IBE is scanned comprehensively	The firm may not perceive individual elements of the IBE accurately	Accuracy of the perceptual process
Even if the firm perceives the individual elements accurately	Its collation, synthesis, analysis and interpretation of the overall IBE may not be correct	Correctness of the inferential process
Even if the IBE is analyzed and interpreted correctly	The firm may not formulate a strategy that is compatible with the IBE as then existing	Appropriateness of the formulated strategy
Even if the strategy formulated is appropriate for the IBE	The firm may not adapt its internal processes adequately to ensure effective implementation of the formulated strategy	Effectiveness of strategy implementation
Even if the adaptation of the internal processes is effective initially	The firm may not be flexible enough to modify its strategy, in conformity with the demands of the constantly changing IBE	Agility to remain in sync with the dynamically changing IBE

firm goes multinational, the increase in environmental complexity is of such magnitude that its *strategy formulation* and *implementation* processes demand an entirely different dimension of stringency and rigor. Domestic firms, even large multidivisional ones, seldom face the high degree of complexity that the addition of an international dimension does to its operations. For MNEs, scanning and interpretation of the IBE is inextricably linked with *strategy formulation* and *implementation* processes. This is imperative because of the *kaleidoscopic* nature of the IBE, where a solitary change in any IBE element in one location could trigger *ripples* elsewhere, thereby changing the entire complexion of the situation. Moreover, this has to be done continually, as it is essential for the MNE to constantly reappraise and modify its strategy in order to remain always *in sync* with the rapidly changing IBE. Also, because inaccuracies in the initial steps of Table 1 compound and magnify those of the subsequent stages, the importance of treating the *reading* of the IBE as an integrated prerequisite for *strategy formulation* and *implementation* stages can hardly be overemphasized.

5. Scanning, interpreting and analyzing the IBE

The *environment* presents a paradox. It completely engulfs us, touching every aspect of our existence, yet being somewhat diffuse it defies precise description. Thus, only the beholder specifies a focal viewpoint while defining it. Likewise, the IBE, being a subset of *environment*, is also an abstract conceptualization that is prone to subjective descriptions. Scholars do acknowledge that it vitally affects MNE operations, but the sparse attempts at identifying and analyzing its components imply that its relevance has been somewhat ignored. The paucity of citations to scholarly attempts at defining and analyzing the IBE in any exhaustive review of IBE literature, as in Dunning's (1993) "Multinational Enterprises and the Global Economy," amply bears this out.

Identification of all elements constituting the IBE is thus the prerequisite to its analysis. The early research in IBE focused mostly on home/host country's environmental factors, as affecting the intent to move abroad, and the location of the enterprise. The studies, therefore, analyzed environment indirectly in the context of host government's policies and entry modes (Fagre and Wells, 1982; Encarnation and Vachani, 1985; Anderson and Gatignon, 1986; Gomes-Casseres, 1990). Neither Hymer (1960), who first provided the *market imperfections* based rationale for FDI, nor Vernon (1966), who provided the *product life cycle* based explanation, had explicitly analyzed the environment. The stylized *Porter's diamond* was an analytical framework of the IBE, though indirect (Porter, 1990). However, while facilitating comparative analysis of the competition-nurturing environment in various countries, the framework is not meant for a general or comprehensive analysis of the IBE at any given time.

One of the few early attempts to disaggregate and analyze the IBE was that of Farmer and Richman (1970) who identified several critical environmental constraints, which they classified as *educational-cultural*, *sociological-cultural*, *political and legal* and *economic* variables. Fayerweather (1973) and Sundaram and Black (1992) also allude to the environment, but the identification of its elements in both attempts is not comprehensive enough. An element of the IBE, however, that has received relatively greater attention in the literature is *culture*. Among the more prominent studies on culture is that of Hofstede (1980), who developed a set of four dimensions, viz. *power distance*, *individualism*, *uncertainty avoidance* and *masculinity*, to describe cultural differences.

A systematic attempt to comprehensively identify elements constituting the IBE is that by Guisinger (2001). His taxonomy is based on eight mutually exclusive elements that in their aggregate form the IBE. These elements, which he calls "geovalent components of the environment," are *econography* (a neologism formed from the terms *economic geography* and *demography*), *culture*, *legal systems*, *income levels*, *political risks*, *tax regimes*, *exchange rates* and *restrictions*. Guisinger selected these eight elements based on both deductive analyses, drawing on institutional economics (Williamson, 2000) and inductive reasoning, using the stock of IBE empirical research. This identification facilitates the IBE *reading* process because MNEs can now focus upon specific elements of the environment in their analysis and not just on an abstraction. MNEs' value chain activities are now increasingly spread worldwide. Hence, they need to analyze unique multicountry variations in various IBE elements concurrently. These are best analyzed by segregating different IBE constituents into separate *silos*.

MNEs scan their environment to glean informational inputs from it. Such inputs are the basic raw materials on which organizations operate, and these facilitate establishment of a workable level of certainty. Participants selectively attend to their environments and then, in their interactions together, make collective sense of what is happening (Weick, 1995). However, the *informational inputs* in their raw form are of little use and first have to be converted into *actionable knowledge* through collation and analysis. Amit and Schoemaker (1993) differentiate between *information* and *knowledge* and highlight the process involved in developing the latter as a strategic asset of the firm. Kogut and Zander (1992) also make the distinction between "information" and "know-how," viewing the former as *what* and the latter as *how*. They elaborate that *information* includes facts, axiomatic propositions and symbols that can be transmitted without loss of integrity, *once the syntactical rules for deciphering it are known* (emphasis added). The use of the *geovalent* taxonomy in our analytical framework facilitates comprehensive analysis of the IBE, thus providing sound inputs for formulating firm strategy.

Before the *informational inputs* can be used for decision-making, these have to be successively *collated*, *interpreted*, *synthesized* (with other inputs) and *analyzed* before being *disseminated* within the firm. Unless these processes are executed, the informational inputs would be neither intelligible nor actionable. Whether the processes are executed in a formal or informal manner, routinely or selectively and at which particular level of the firm would vary according to the nature of the input and the *routines* established within the firm. As each firm has its own set of routines, the difference in their quality affects their respective outcomes and performance. Environments, therefore, directly influence outcomes whether correctly perceived or not (Pfeffer and Salancik, 1978). Perceiving them entails construction of a blueprint—an image of the environment that attempts to capture and reflect its salient complexity (Scott, 1998). Perception is however affected by the attention structure of the participants and the *bounded rationality* of managers (Simon, 1960; March, 1994). Hence, while some MNEs may form either a simple or an incomplete picture of the IBE, others may be able to fully capture and codify its complexity. This differential in *sense making* (Weick, 1995) about the environment obviously affects the quality of decision-making. The holistic model described later places in the correct perspective the vital importance of a comprehensive and accurate analysis of the IBE for forming better cognitive maps, thus making better decisions and formulating better strategy than rivals.

6. Competitive advantage

Drawing from the resource-based perspective, we contend that MNEs with better skills at *reading* the IBE reduce their LOF and instead enjoy a competitive advantage over rival MNEs and even local firms. While the local firms might enjoy certain inherent advantages, being on their home turf, MNEs can offset those by leveraging their global links through better skills in exploiting the IBE. Such skills are socially embedded in the MNEs' employees and assimilated into firm *routines*. The extent of development of such tacit knowledge, which is a combination of individual skills and firm capability (Nelson and Winter, 1982), varies from firm to firm, and these differential efficiencies constitute the firm's relative competitive advantage. Such skills take time to build up, cannot be easily imitated and are imperfectly mobile (Teece, 1982; Dierickx and Cool, 1989; Barney, 1991). While limited project or country-specific information about the IBE may be procured through consultancy contracts, any enduring capability of this aspect would need to be developed in-house. Because IBE *reading* skills are intimately connected to *strategy formulation* and *implementation*, an in-house development has obvious advantages. It is true that development of a proactive IBE *reading* capability would incur costs too. However, far outweighing those costs are the benefits accruing from the IBE *reading* capability, as it leads to formulation and implementation of firm strategies that are more compatible with the IBE. MNEs might also employ several other means to mitigate LOF, like joint ventures, networks, localization and demanding matching resource commitments. The idea in all these is to better *read* and tackle the host countries' environment through such linkages.

Firm competitive advantage can also be differentiated between *passive receptors* and *proactive acquirers*. Firms in the latter category could be expected to make vigorous, proactive and perhaps even surreptitious efforts to obtain the required information to remove uncertainty. These latter firms, subject to all other cognitive, interpretative and decision-making skills being equal, would assess environmental differences and anticipate changes better than their rivals. Firms with exceptional skills as proactive acquirers could better anticipate even a Schumpeterian "revolution," involving drastic changes in technology or other elements of the environment and be better prepared to "compete for the future," virtually on their own terms (Hamel and Prahalad, 1994). Leading firms therefore resort to techniques like *scenario building* to be able to envision the emerging environment more accurately and faster than others (Schoemaker, 1995).

We would, however, like to emphasize that better *IBE-reading*, by itself, does not provide the competitive edge. The quality of the firm's *core competence* obviously would be crucial in this regard. The other essential aspects are flexible routines and adaptability of its organizational culture. These provide the firm with the agility to quickly respond to the dynamically changing IBE by modifying strategy whenever required. Hence, a real-time, information management-based IBE-*reading* capability could be termed as the firm's *complementary competence* that all firms, across the board, must possess. However, firms in fast-paced and highly volatile sectors, and where technological innovation and obsolescence is rapid, need it in a much greater degree. For some MNEs, it may even be their *core competence* rather than merely a *complementary competence*. For instance, the success of many large MNEs, like Proctor & Gamble, is attributable to the development of precisely such tacit skills that enable them to successfully negotiate the environmental complexities of operations in all countries of the world. It is these managerial skills at negotiating the IBE anywhere rather than possession of any cutting-edge technology that contributes to their high performance. The competitive advantage of such MNEs lies in converting the LOF into a so-called asset of foreignness, which primarily is their ability to exploit the IBE globally, better than any of their local and multinational competitors.

6.1. Holistic model of MNE strategy and performance

A holistic depiction of the entire process linking MNE strategy and performance is provided in Fig. 3. In their interaction with the IBE, various units of the MNE have to routinely process numerous informational inputs. In addition, MNEs also proactively scan

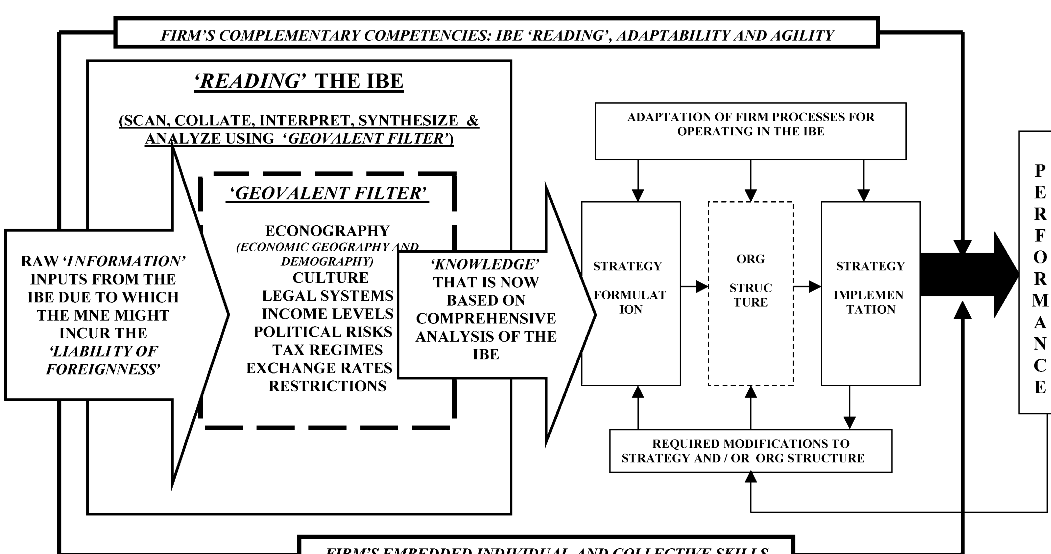

Fig. 3. A holistic model of environmental analysis, strategy formulation, strategy implementation and performance.

the IBE for additional information and competitive business intelligence. Correct analysis of these inputs, though extremely vital, is very difficult given the complexity of the IBE in a multicountry context. To facilitate a comprehensive analysis of the IBE, all informational inputs can be put through a stylized so-called geovalent filter. The effect of each IBE element on the inputs is thus assessed separately as well as interactively. For instance, various IBE elements may often warrant different, often conflicting, options. These then need to be reconciled through appropriate trade-offs to ensure formulation of a sound, coherent and optimal strategy. In the absence of a suitable analytical tool (e.g. *geovalent filter*), some of the inputs from the IBE may either not be picked up at all or be incorrectly analyzed. The environmentally sensitized inputs are thus collated, synthesized and interpreted and hence contribute to better strategy. Based on the steps outline in Table 1, the model also suggests how intrafirm processes should be *adapted* to the prevailing IBE for optimality, thus contributing to effective *strategy implementation*. Because the IBE keeps changing all the time, periodic review and modification of the formulated strategy is necessary to ensure full compatibility always. The periodicity of such reviews would vary by firms and industries. For instance, in stable industry environments, the frequency of reviews may be further apart compared to firms operating in more volatile environments. Ultimately, it is the repertoire of such embedded skills, along with those of quick responses and adaptability, that provide the firm with the competitive advantage and lead to better performance relative to their rivals.

7. The LOF construct

Though the notion of LOF is easy to comprehend, defining this construct precisely for further empirical investigation has been more challenging. The lack of a comprehensive identification of various IBE elements, its *kaleidoscopic* nature and the absence of a holistic model depicting all those interactions between *environment*, *strategy* and *performance* have confounded that difficulty. The construct obviously includes variables that measure the disadvantages of a foreign subsidiary against its local, host country rival due to spatial distance, lack of familiarity and discrimination, as in the traditional notion of LOF. It should also include factors based on the *enhanced* conceptualization of LOF. These are all the additional *costs of doing business abroad* arising out of the MNE's interaction with all elements of the IBE. As argued earlier, the phenomenal increase in complexity and volatility of the IBE necessitates that *environment scanning*, *strategy formulation* and *implementation* processes are treated as part of an integrated process. Consequently, sub-optimal performance by the MNE in any of the functions outlined in Table 1 would result in aggravating the LOF faced by it. Hence, all of the specified functions need to be incorporated into the holistic model.

The LOF construct should therefore include disadvantages caused by the MNE's interaction with (1) the aggregation of all the elements constituting the IBE, including those of the meta-environment through it, (2) the increased complexity of the interactions due to both the larger number of elements in the IBE and the vast geographical spread in the multicountry, global integration context, (3) the complexity due to the dynamically changing

Table 2
Survey of literature on individual elements of the model

Firm process	Scholarly work on related ideas	Author(s)
Environment scanning	Environment scanning in Korean firms	Ghoshal (1988)
	Organizational structure and internal processes	Bartlett and Ghoshal (1987)
	Competitive intelligence	Simon (1999), Freeman (1999)
	Scenario planning for likely future environment	Schoemaker (1995)
	Competing for the future	Hamel and Prahalad (1994)
Information management	Transmission of organizational information	Buckley (1967)
	Information and knowledge; syntactical rules	Kogut and Zander (1992)
	Perception of the environment	Pfeffer and Salancik (1978)
	Sense making	Weick (1995)
	Construction of a blue print of the environment	Scott (1998)
	Bounded rationality of managers	Simon (1960), March (1994)
	Heuristics to tackle environmental uncertainty	Amit and Schoemaker (1993)
	Information and organization	Casson (1997)
	Cognition in strategic decision-making	
	Information management in global enterprises	Peppard (1999)
	Firm routines, skills and tacit knowledge	Nelson and Winter (1982)
IBE	Constituents of the IBE	Farmer and Richman (1970)
	Elements of the IBE	Fayerweather (1973)
	Host government policies and entry modes	Fagre and Wells (1982)
	Host government restrictions	Gomes-Casseres (1990)
	Hostility of the investment environment	Vernon (1973)
	Industrial organization perspective of FDI	Hymer (1960), Caves (1971)
	Eclectic paradigm of international production	Dunning (1988)
	Competitive advantage of nations	Porter (1990)
	Influence of national cultural differences	Hofstede (1980)
	Measures of transborder trade restrictions	Guisinger and Bond (1985)
	Effects of misreading the IBE on MNE performance	Ricks (1993)
	Influence of multilateral institutions	Brewer and Young (2001)
	Transnational integration; interdependence	Kobrin (1997)
	Global metaenvironment	Kostova and Zaheer (1999)
	More expansive view of the IBE	Toyne and Nigh (1999)
	Identification of the elements of the IBE	Guisinger (2001)
Strategy formulation	Firm strategy and environment; SWOT analysis	Andrews (1971)
	Environmental turbulence and strategy	Ansoff (1993)
	Isolating mechanisms and interfirm differences	Rumelt (1984)
	Oligopolistic reaction and MNEs	Knickerbocker (1973)
	Strategic fit with the environment	
Strategy implementation	Adapting to environmental jolts	
	Emergent strategies	Mintzberg (1994)
	Environment, strategy, process and people	
	Dynamic theory of strategy	Porter (1991)
	Environmental adaptation paradigm	Guisinger (2001)
Competitive advantage	Firm resources and sustained competitive advantage	Barney (1991)
	Resource-based view of the firm	Wernerfelt (1984), Conner (1991), Peteraf (1993)

Table 2 (*continued*)

Firm process	Scholarly work on related ideas	Author(s)
Competitive advantage	Building inimitable competencies for sustained competitive advantage	Dierickx and Cool (1989)
	Core competence of the corporation	Prahalad and Hamel (1990)

and *kaleidoscopic* nature of the IBE, (4) the relatively greater difficulty in evolving an optimal strategy that has a good "fit" with the IBE compared with domestic firms, (5) the complexity involved in adapting all internal processes to the dictates of the IBE for more effective implementation of that strategy and (6) the greater need for agility and flexibility of internal processes to remain *in sync* with the rapidly changing IBE.

While Dunning's ownership-location-internalization framework explains the rationale for foreign production by firms exploiting their specific ownership advantages at a suitable foreign location, our model goes one logical step further. With the intent to go abroad having been established, the model integrates the process of the MNE's interaction with the IBE, its formulating a compatible strategy and then adapting its internal processes to ensure effective implementation of that strategy. The model is applicable not just for the initial market entry decision but thereafter as well. Viewing the IBE *reading*, *strategy formulation* and *implementation* process through the model holistically can help explain firm performance on a continuing basis.

8. Survey of literature on individual elements of the model

We now *map the terrain* to list selected scholarly work that has examined individual facets of the holistic model proposed by us. The listing is not exhaustive and is intended merely to be illustrative of the traditional visualization of LOF in dyadic country pair terms. More importantly, it highlights the narrow focus in the literature on LOF elements piecemeal and thus underscores that in the absence of an integrated model a realistic view of the entire phenomenon has not been possible. This paper is an effort to propose such a holistic and enhanced conceptualization of LOF (Table 2).

9. Conclusion and implications

The LOF arises primarily due to the MNE's interaction with the IBE, something that domestic firms are not confronted with. Scholars, presumably, had not previously attempted a holistic model of that interaction because individual components of the IBE itself had not been identified comprehensively. This paper has presented an integrated model of the entire MNE–IBE interaction process, which includes strategy formulation and its implementation as well, though the latter two aspects also apply to domestic firms. However, as we have argued, the complexity, volatility and interdependence of various elements of the IBE is far greater in magnitude than anything that even the largest domestic firm would ever have to encounter. This makes it imperative that *environment reading*, *strategy formulation* and *implementation* processes be viewed as an integrated whole in the context of MNEs.

The model envisions all informational inputs from the IBE being systematically and comprehensively screened through any environment-analyzing analytical tool, such as the *geovalent* filter and then collated, interpreted, synthesized with all other information and analyzed. Such environmentally sensitized information would enable formulation of a strategy that is better compatible with the IBE. More importantly, the dynamic monitoring of the IBE enables reappraisal of MNE strategy, on an ongoing basis, in tandem with environmental changes. The alacrity of the firm in detecting those changes and its agility in adapting its internal procedures to quickly modify its strategy ensure that it is rarely *out of sync* with the environment. MNEs that consistently excel in these tacit skills embedded in their personnel and internal routines would enjoy a competitive advantage over their rivals. This integrated model should open up promising areas for further research in terms of operationalization and measurement of various elements of the LOF construct and assessing their impact on MNE performance. It would also be very useful for practice, as it enables MNE managers to better understand the intricacies of the IBE in order to devise appropriate intrafirm skills to deal with it.

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