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

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**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

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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