Outward foreign direct investment as escape response to home country institutional constraints

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Abstract
In this perspective paper we argue that outward foreign direct investment (OFDI) undertaken as escape response to perceived misalignment between firm needs and home country institutional conditions represents an important but under-explored phenomenon in the international business (IB) literature. We propose that, in advanced industrialized nations, the extent of OFDI as escape is likely to rise with the extent of societal coordination in the political economy. Societal coordination is associated with relatively slower rates of institutional adjustment and thus with relatively greater prevalence of misalignments that may drive OFDI. We illustrate the face validity of our argument and lay out the implications for future research in IB.

Keywords: outward foreign direct investment; institutional change; varieties of capitalism; comparative business systems

Introduction
In this perspective paper we seek to highlight the role of escape from perceived misalignments between firms' needs and home country institutional environments in spurring outward foreign direct investment (OFDI). Escape from the home country through OFDI represents an important but under-explored phenomenon in the international business (IB) literature. We further propose that, in advanced industrialized nations, the relative prevalence of such misalignment, and therefore the extent of OFDI as an escape response, is directly related to the extent of societal coordination in the political economy of the home country. In developing our argument, we draw on insights from a variety of fields, including IB, organization science, comparative political economy, socio-economics, and several strands of institutional theory.

While the literature mentions the possibility of OFDI as an escape response from the home country environment, an extensive literature search suggests that this dynamic has received relatively little systematic exploration in the field of IB. Table 1 summarizes IB research that speaks to the issue of OFDI as escape response from the home country environment, augmented by a number of representative works in related disciplines such as political science and economics. The summary in Table 1 suggests that rigorous conceptual and empirical treatment of OFDI as an escape response from the home country has been relatively sparse in the IB
Table 1: Prior literature conceptualizing OFDI as escape response

<table>
<thead>
<tr>
<th>Source</th>
<th>Mechanism driving escape</th>
<th>Evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Boddewyn and Brewer (1994)</td>
<td>Escape is an expression of avoidance, which constitutes one form of non-bargaining business political behavior</td>
<td>Conceptual treatment</td>
</tr>
<tr>
<td>Caves (1996)</td>
<td>Home country factors such as high tax rates can increase outward FDI</td>
<td>Evidence summarized from prior studies</td>
</tr>
<tr>
<td>Dunning (1996)</td>
<td>‘Some FDI is made to escape restrictive legislation or macro-organizational policies by home governments’ (p: 61)</td>
<td>Anecdotal evidence, one prior unpublished study</td>
</tr>
<tr>
<td>Gordon and Hines (2002)</td>
<td>Firms may relocate their domicile to avoid high home country taxes</td>
<td>Review of prior works on international taxation</td>
</tr>
<tr>
<td>Le and Zak (2006)</td>
<td>Capital flight in developing countries is driven by political instability, economic risk, and policy uncertainty; nonviolent demonstrations and constitutional changes in government attenuate capital flight</td>
<td>Panel regression using data from 45 developing countries</td>
</tr>
<tr>
<td>Narula (2002)</td>
<td>Lack of adaptation of the national innovation system to the R&amp;D requirements of firms may prompt outward FDI to countries with more suitable innovation systems</td>
<td>Interview survey of 35 Norwegian firms</td>
</tr>
<tr>
<td>Rugman and Verbeke (1998)</td>
<td>Conflicual relationship between MNEs and home governments may be linked to opportunistic relocation</td>
<td>Conceptual treatment, brief review of work on regulatory arbitrage in the context of NAFTA</td>
</tr>
<tr>
<td>Schoppa (2006)</td>
<td>Outward FDI is in part an escape response to a burdensome home country institutional environment</td>
<td>Qualitative analysis of aggregate time series data of outward FDI trends in Japan; review of escape responses as conceptualized in political science</td>
</tr>
<tr>
<td>Tallman (1988)</td>
<td>Home country political instability mediates outward FDI to the USA by companies in industrialized economies (Europe, Canada, and Japan)</td>
<td>Pooled time-series cross-sectional regression of FDI investments in the USA from 14 industrialized countries, 1974–1980</td>
</tr>
<tr>
<td>Vernon (1998)</td>
<td>MNEs may relocate headquarters to save on taxes; MNE discontent with government ‘misbehavior’ (p 121) led to voicing of threat of relocation of headquarters</td>
<td>Anecdotal evidence about McDermott Inc.’s relocation to Panama and relocation threat by Volvo</td>
</tr>
</tbody>
</table>

literature, especially in the context of OFDI flows from the advanced industrialized nations.

This relative lack of research on OFDI as an escape response stands in contrast with public and policy debates in many advanced industrialized economies, especially in continental Europe and Japan. For instance, consider the example of Germany, which has experienced a surge in OFDI of about 400% between 1990 and 2003 (standardized for GDP). As early as 1997 the Bundesbank concluded that traditional motivations for FDI such as market- and resource-seeking were insufficient to explain an increasing deficit in the German direct investment balance (Deutsche Bundesbank, 1997). Rather, citing firm-level evidence, the Bundesbank explicitly points to factors specific to Germany, such as taxes and social security contributions, and highlights ‘high regulatory density as well as the manifold rigidities and inflexibilities in the labor market’ (Deutsche Bundesbank, 1997: 76). The Bundesbank finds that these factors were driving German firms to escape the institutional constraints of Germany by investing abroad, as well as deterring foreign firms from investing in Germany. The popular press in Germany reflects this concern. For example, a leading management publication in 2003 surveyed German Mittelstand entrepreneurs about their intended strategic response to the perceived inability of the German business environment to serve the needs of firms. The findings suggest that every seventh entrepreneur was planning to move part of production abroad, every ninth
was contemplating to move all production abroad, and every 13th was considering to relocate head-
quarters abroad (Müller and Student, 2003).

Although the concept of escape as a strategic
response to home country institutional constraints perceived as dysfunctional can be found in
the literature, the extent to which a country’s tendency toward institutional ‘rigidity and inflexibilities,’
to echo the words of the Bundesbank, mediates the
decision of firms to engage in OFDI as an escape
mechanism has not been developed. In this paper,
we draw on the construct of societal coordination
from the varieties of capitalism literature in com-
parative political economy (Hall and Soskice, 2001)
to explore this contingency. Specifically, we argue
that states characterized by higher levels of societal
coordination tend to exhibit relatively slower rates
of institutional change: that is, they tend to display
higher rigidity and inflexibility. In times of rapid
changes in the extra-institutional environment,
this slower rate of adjustment increases the prob-
ability of misalignments between the needs of firms
and the national institutional environment in
which they are embedded. All else equal, this is
likely to increase the propensity of firms to draw on
OFDI as a means of escape to other national
institutional contexts that are perceived to be in
closer alignment with firms’ needs.

We begin by laying out the conceptual linkage
between institutional misalignments and firms’
responses to such misalignments. We argue that
the severity of perceived misalignments increases
with rising turbulence in the extra-institutional
environment that necessitates far-reaching adjust-
ments in national institutional configurations, and
that these adjustment processes are likely to
proceed at slower rates in countries with high levels
of societal coordination in the political economy.
In these latter countries firms may be more likely to
engage in OFDI in order to escape increased
institutional misalignments at home, and the
economic costs they imply. We provide evidence
of the face validity of our argument, and conclude
with implications for future research in IB.

**Firm responses to institutional misalignment**

In this section we develop the construct of institu-
tional misalignment. Based on the notion that such
misalignment is economically costly, we propose a
typology of outcomes flowing from actions taken
by firms in order to reduce this cost. In our view,
OFDI represents a response resulting in ‘legal
escape’ as an outcome.

It is well established in the management literature
that, to survive and thrive, firms must respond to a
multitude of forces in their external environment
(e.g., Arthur, 1994; Gell-Mann, 1994; Kauffman,
1995; Anderson, 1999; Dooley and Van de Ven,
1999; Lewin et al., 1999). For the purpose of this
paper, two sources of such forces are key. First, firms
are assumed to respond to economic pressures emanating from the extra-institutional environment,
such as demographic changes and technological advances (Porter, 1990; Lewin et al., 1999). Second,
firms are assumed to comply with the institutional
constraints placed upon them by the business system
in which they are embedded (Whitley, 1999; Hall
and Soskice, 2001; Redding, 2005). By ‘business
system’ we denote the institutional structure, at the
level of the respective nation-state, that governs
economic activity of firms and employees (Whitley,
1999; Redding, 2005), where ‘institutions’ are
defined as

humanly devised constraints that structure human inter-
action. They are made up of formal constraints (e.g., rules,
laws, constitutions), informal constraints (e.g., norms of
behavior, conventions, self-imposed codes of conduct), and
their enforcement characteristics (North, 1994: 360).

The component parts of business systems include:
at the level of the firm, the institutions of own-
ership, management, and cooperation across firms;
at the level of society, the nature of the state as
well as the institutions of the financial system,
of labor markets, and of social capital; and at
the level of culture, the informal institutions
embodied in rationale, authority, and identity
(Resding, 2005).

Viewed from the perspective of the firm, the
business system would ideally be structured to
support or enhance the ability of firms to respond
to changes in the extra-institutional environment
that affect their ability to compete. For example, a
school system producing highly skilled and versa-
tile workers and scientists can enhance the ability
of firms to use state-of-the-art technology and thus
enhance their competitiveness, as Murmann (2003)
has shown in the context of the German synthetic
dyes industry in the 19th century.

Over time, the extra-institutional environment
changes, and the needs of firms change with it.
In some cases the business system in its existing
form is sufficiently flexible to adjust and accom-
modate these changes, and continues to serve the
interests of firms. In other cases changes in the
extra-institutional environment may be such that
formerly useful elements of the business system lose their utility, or become an obstacle to the ability of firms to respond to the new conditions in the extra-institutional environment: in other words, the needs of firms and the affected element of the business system become misaligned. For example, a vocational training system whose curriculum does not reflect technological advances may train workers who are highly qualified by yesteryear's standards, but need to be retrained by their employers before they can be gainfully employed in the latest systems and processes. Given the complexity of the institutional configuration of any business system, at any point in time some aspects of the business system are likely to be misaligned with some needs of firms embedded in that business system.

Misalignment between the needs of firms to respond to the changes in the extra-institutional environment and the business system in which firms are embedded can inflict economic pain in the form of additional costs, including opportunity costs. For example, firms will experience competitive disadvantage if labor regulations fail to adjust to new realities or if the development and deployment of new kinds of technology, such as genetic engineering, is outlawed in the home country but legal elsewhere.

A number of works have explored the possible strategic options available to firms facing perceived misalignments between firm-level needs and institutional constraints. Hirschman (1970) proposes a dichotomy of exit vs voice. In this view, the construct of 'exit' denotes behavior opting out from the present institutional structure, while the behavioral alternative of 'voice' relates to political pressure mechanisms including collective action (Olson, 1965) designed to obtain either change in adverse conditions or compensation. Actors choose between exit and voice primarily on the basis of cost–benefit expectations. This calculus is mediated by the extent of loyalty of the affected actor to the present arrangement, with higher loyalty implying more voice.

Oliver (1991) reviews empirical findings to identify five general strategic responses to institutional misalignment: acquiescence, compromise, avoidance, defiance, and manipulation. Under this scheme, acquiescence means taking no action. Compromise refers to efforts to reduce the need to conform to institutional pressures. Avoidance involves non-compliance, which can occur through hidden non-conformity, evasion of outside scrutiny, or escape from the institutional field. Defiance refers to active resistance to constraints by ignoring, challenging, or attacking the underlying institutions. Manipulation as a strategy is intended to 'co-opt, influence, or control institutional pressures and evaluations' (Oliver, 1991: 157). Of particular importance in the context of this paper is Oliver's prediction that avoidance responses such as escape become more common as economic efficiency and fitness with the institutional environment decrease, which is to say, as institutional misalignment increases.

Boddewyn and Brewer (1994) explore the political options available to multinational enterprises (MNEs) to distinguish bargaining and non-bargaining forms of business political behavior. Bargaining behavior includes conflict and partnership between firms and governments, while non-bargaining behavior breaks down into compliance, avoidance (including the possibility of escape), and circumvention. Bargaining behaviors aim at inducing institutional change, while 'avoidance and circumvention assume that these firms can operate independently of governmental constraints and incentives' (Boddewyn and Brewer, 1994: 128f.).

Empirical observation and theoretical reasoning suggest these models can be further elaborated. First, it is not clear whether these typologies provide for the possibility that firms may initiate institutional adjustment autonomously, as is generally possible in the context of informal institutions (i.e., those not embedded in statutes). There may be a cost associated with such deviance – for example, in the form of a relative loss of legitimacy (Meyer and Rowan, 1977; DiMaggio and Powell, 1983) – but the choice to deviate is a realistic option. For instance, lifetime employment has been widely practiced by major Japanese firms, although it is not embedded in any statutes. A firm that decides to deviate from this employment practice is likely to experience reputational costs – for example, by becoming less attractive as an employer – but the firm does retain the option to deviate. Second, none of these typologies allows for the possibility that actors may comply with an offending institution but legally seek to circumvent its effects. For instance, some firms may choose to exploit legal loopholes to reduce their tax bills. Third, none of these typologies allows for the possibility that actors may use one part of the institutional environment to self-compensate for the economic costs imposed by another part of the institutional environment. For example, business owners considering the costs of publicly provided utilities
excessive might consider getting back part of their perceived overpayment by cheating on their taxes. We consequently propose a deductive typology of firm responses to the occurrence of a misalignment between their business requirements and the institutional environment. While the various schools of institutionalism offer different conceptualizations of institutions and their effects, they tend to concur that institutional structures that are aligned with the requirements of economic actors lend an economic advantage. This can occur through mechanisms such as giving legitimacy to specific practices (Meyer and Rowan, 1977; DiMaggio and Powell, 1983) or raising or diminishing transaction costs (Keohane, 1984; Williamson, 1985; North, 1990). Conversely, where institutions are not aligned with the business requirements of firms, economic advantage may shrink or disappear, or even become an economic liability. Under conditions of such misalignment, firms incur an economic cost relative to the outcome that would have been attainable if institutions and firms’ requirements were fully aligned.

Building on these considerations, we propose that firms’ responses in the face of this economic cost can result in four general kinds of outcome:

- acceptance of the misalignment and its cost (acquiescence);
- elimination or at least reduction of the misalignment and consequently its cost (abatement);
- reduction of the cost of the misalignment without any change in the misalignment itself (diminution); or
- partial or complete departure from the business system in order to avoid both the misalignment and its cost (escape).

These choices are collectively exhaustive of the possible outcomes. They are not necessarily mutually exclusive, as some responses may lead to outcomes that span categories.

Within these outcomes, we can further distinguish two dimensions. First, abatement and diminution are available either through own action or through the action of others, such as the state. Second, responses can be legal or illegal, as judged by the standards of the extant formal institutional environment. Overall, inaction or action by firms in the face of perceived institutional misalignment can thus lead to seven general outcomes (Table 2): acquiescence, legal and illegal abatement, legal and illegal diminution, and legal and illegal escape. As indicated in the table, one can classify OFDI as a response resulting in ‘legal escape’ as an outcome; we will develop this aspect further in a later section.

In summary, we have suggested that firms can respond to the costs of institutional misalignments

<table>
<thead>
<tr>
<th>Outcomes</th>
<th>Mechanisms</th>
<th>Legal</th>
<th>Illegal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquiescence</td>
<td>Accepting the misalignment and its cost</td>
<td>Compliance</td>
<td>By firm itself: non-compliance</td>
</tr>
<tr>
<td>Abatement</td>
<td>Reducing or eliminating misalignment and thus the cost</td>
<td>By firm itself: autonomous change of informal institution Through others: political action aimed at abolition of law</td>
<td>Through others: illegal political action aimed at abolition of law</td>
</tr>
<tr>
<td>Diminution</td>
<td>Reduction of cost of misalignment while maintaining the misalignment</td>
<td>By firm itself: compliance with offending institutions while circumventing effect Through others: political action aimed at compensation payments</td>
<td>By firm itself: non-compliance with unrelated institution to compensate for cost of the misalignment Through others: illegal political action aimed at compensation payments</td>
</tr>
<tr>
<td>Escape</td>
<td>Avoiding misalignment and associated costs</td>
<td>Shifting of firm activities or assets to another institutional environment, for example, through OFDI</td>
<td>Illegal shifting of firm activities or assets to another institutional environment</td>
</tr>
</tbody>
</table>

Table 2 Possible outcomes of responses by firms to misalignment between their needs and the institutional environment
either by sitting still, or by taking action, and we have proposed a typology of outcomes resulting from these responses.

**Cross-national variation in institutional misalignments**

In this section we propose a contingency in the extent to which national business systems experience institutional misalignments. We introduce the construct of *societal coordination* from the comparative business systems literature. We then apply findings from organizational theory and political science to argue that higher degrees of societal coordination tend to be associated with slower rates of institutional adjustment in response to changes in the extra-institutional environment. The likely result is a higher prevalence of institutional misalignments in nations with high levels of societal coordination, and thus an increased propensity of firms to engage in responses suitable for avoiding the costs of misalignment.

Over the past 15 years a confluence of major changes in the extra-institutional environment has exerted intense pressure on economies all over the world to adapt their institutional structures. There is wide consensus that the world economy is currently in the midst of its transition into the information technology age (Lewin and Stephens, 1993; Lewin et al., 1999; Perez, 2002; Yamamura, 2003), which is taken to have started with the advent of the Intel 4004 microprocessor in 1971 (Perez, 2002) and is likely to involve radical changes in the structure of the business system. Uncertainty and competition in the international economy have increased (Yamamura, 2003) in response to trade and financial liberalization, especially following the demise of the Soviet Union and the attendant removal of the threat of socialism that had induced Western nations to keep market forces in check (Ruggie, 1982). The entry into the world economy of China, India, and the Soviet Union alone is estimated to have effectively doubled the size of the global labor force (*Economist*, 2005), exerting downward pressure on wages in the advanced industrialized nations and prompting the development of new organizational forms such as web-based organizations (Fulk and DeSanctis, 1995) and the growing practice of offshoring (Lewin and Peeters, 2006). Societal ageing (Vernon, 1998) in most of the advanced industrialized nations implies a need to restructure large parts of the social welfare infrastructure, necessitating concomitant institutional adjustments in the business system such as reforms in employment statutes, education and national innovation systems, financial markets, and corporate governance systems.

The cumulative effect of these shifts in the extra-institutional environment has placed very considerable pressure on nations to adjust their institutional structures to match the new realities. Even taken in isolation, each of these developments represents a considerable adjustment challenge to national business systems. The confluence of these macro changes, however, could amount to a 'perfect storm' in the social, political, and economic environment of countries and their business systems.

We argue that the adaptive responses of national business systems to these changes in the extra-institutional environment vary systematically across the advanced industrialized nations. To develop this argument, we draw on a stream of research in political science, socioeconomics, and business variously known as 'comparative business systems' (e.g., Whitley, 1999; Redding, 2005), 'varieties of capitalism' (Hall and Soskice, 2001; Thelen, 2004), and 'co-evolution' (Lewin et al., 1999; Lewin and Volberda, 1999; Lewin and Kim, 2004). The core tenet of this literature is that different societies have evolved structurally distinct forms of capitalism, as expressed in variation in the institutional configuration within which firms and industries are embedded.

A primary concern of this literature has been to establish the main dimensions along which the institutional features of different national business systems vary. The construct of 'societal coordination' has emerged as a central dimension of variation across different varieties of capitalism (Hall and Soskice, 2001; Hall and Gingerich, 2004), and although it is not the only dimension along which different types of capitalism vary (e.g., Boyer, 1997; Orrù et al., 1997; Whitley, 1999; Schmidt, 2002; Amable, 2003; Redding, 2005), the evidence suggests it is a key one (Albert, 1993; Dore, 2000; Hall and Gingerich, 2004).

Hall and Soskice (2001) differentiate between two broad types of coordination: strategic coordination and market coordination. Since the term 'strategic' suggests careful goal-oriented design, which is not necessarily present in these processes, we deviate from Hall and Soskice's nomenclature and refer to it as 'societal coordination'. Market coordination achieves order in the political economy through market forces, especially the price mechanism (cf. Hayek, 1945). Societal coordination, by contrast, draws on formal and informal non-market
interaction and cooperation of actors (Hall and Soskice, 2001; Streeck and Yamamura, 2003) to bring order to economic activity and to build economic institutions. In line with the usage proposed by Hall and Soskice (2001), we replace the term 'market economies exhibiting relatively high levels of societal coordination' with the label 'coordinated market economies' (CMEs), and 'market economies exhibiting relatively high levels of market coordination' with the label 'liberal market economies' (LMEs).

We propose that the rate at which national business systems adjust to the aforementioned changes in the extra-institutional environment is at least partially contingent on the degree of societal coordination in the respective national context – in other words, adjustment processes in the institutional configuration of CMEs are likely to require relatively more time than in the institutional configuration of LMEs. A key distinction between CMEs and LMEs is that the former rely more on societal coordination in adjustment processes while the latter allow for more autonomous adjustment (Hall and Soskice, 2001). Societal coordinated adjustment entails collaboration of organizational actors in effecting changes to the business system. The change process involves aggregate-level bargaining and cooperation among organizational actors with recognized standing that represent the interests of micro-level actors such as firms, workers, and other constituents on a broad basis, such as industries, sectors, regions, or professions (Hall and Soskice, 2001). Typical examples of such organizational actors are labor unions, employer associations, non-government organizations and other interest groups, and government agencies. The results of societal coordinated adjustment processes are commonly agreed-to institutional innovations that are collectively implemented.

Autonomous adjustment occurs when micro-level actors, whose degree of aggregation does not exceed that of the individual organization, undertake institutional innovations without engaging in active societal coordination with external actors. In many cases, this process involves non-conformity with the extant informal institutional structure. These institutional innovations diffuse through the business system through isomorphic and evolutionary mechanisms (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Williamson, 1985; Greenwood et al., 2002).

‘Active’ and ‘external’ take on special relevance in the definition of autonomous adjustment. We stress the absence of active coordination because social embeddedness means that a certain degree of coordination is always present, even if it is not purposefully pursued (Granovetter, 1985). We emphasize the absence of external coordination and bargaining because we recognize that organizations internally tend to exhibit coordination through their own social and political dynamics, with shifting coalitions and actors of varying interests (e.g., Cyert and March, 1963; Greenwood and Hinings, 1996).

The differentiation of societal coordinated and autonomous adjustment is distinct from that of centralization and decentralization, which is commonly used in the organization theory literature (for an extensive review see Volberda, 1998). While highly decentralized national systems, such as the United States, are also relatively low on societal coordination, highly centralized national systems, such as France, exhibit only medium levels of societal coordination. By contrast, highly societal coordinated national systems, such as Austria and Germany, show only medium levels of centralization. While institutional change in highly centralized states tends to occur within a relatively isolated policy elite, states high on societal coordination undertake institutional change within an encompassing decision-making process that involves not only the state elite, but also other aggregate-level organizational actors such as unions and associations. A highly societal coordinated decision-making structure thus resembles a network of multiple alliances of organizations rather than a single hierarchy.

Variation in the relative prevalence of societal coordinated adjustment vs autonomous adjustment affects the characteristics of the institutional adjustment process. This is visible on at least three dimensions: universality of outcomes, riskiness, and rate of adjustment. While our key concern in the context of this paper is the rate of adjustment, the close interrelation among these dimensions makes it necessary and germane to discuss all three.

LMEs tend to exhibit high variety (low universality) in initial adjustment outcomes (Kitschelt, 2003), while CMEs tend to seek and implement system-wide universal solutions. Since the autonomous adjustment common in LMEs occurs at the level of the individual organization, each actor has the scope and latitude to arrive at its own social construction and interpretation of changes in the extra-institutional environment, and to devise a solution congruent with its interpretation. Over
time some solutions emerge and are recognized as achieving greater adaptive fitness. Isomorphic and evolutionary mechanisms will subsequently tend to reduce high initial variety, leading to convergence on a dominant adjustment solution or a small set of competing solutions (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Williamson, 1985). By contrast, the process of devising a universal, system-wide solution is the very essence of the aggregate-level societal coordinated adjustment process in CMEs. Since the bargaining and cooperation requisite of societal coordinated adjustment entail high transaction costs for the involved parties, actors would have limited incentive to undergo the process if they were not bound by its outcome.

A second dimension of variation in adjustment characteristics relates to the riskiness of adjustment decisions. Autonomous adjustment in LMEs implies that the risk of inadequate adjustment responses is borne at the level of each individual actor. This risk tends to increase with the extent of the uncertainty associated with a specific adjustment response and the complexity of the issue, as each actor is likely to have only partial information and possibly insufficient analytical capabilities for devising an optimal solution. However, this risk may be mitigated by the freedom that each actor has for engaging in problemistic search (Cyert and March, 1963) processes until an adequate solution emerges. While the burden and risk of autonomous adjustment rest at the micro level, from the perspective of the nation as a whole the proliferation of solutions constitutes a hedge against the uncertainty associated with inappropriate institutional adjustment responses to changes in the extra-institutional environment. The initial variety of institutional innovations represents a population of experiments that over time evolve more concrete information about their feasibility and consequences.

In CMEs, by contrast, the propensity for universal, system-wide solutions tends to preclude experimental evolution of institutional structures. Getting the initial response wrong could have an adverse impact on the entire institutional structure, and the error may be difficult to correct because actors may be reluctant to engage in renegotiations for fear of loss of political credibility or face. It is therefore crucial for decision-makers in societal coordinated adjustment processes to secure reliable and robust information about institutional misalignments, and to interpret this information correctly. Both aspects are fraught with potential obstacles. First, information flow from the micro level, where institutional misalignments tend to be experienced first, to policy-making actors is subject to numerous pathologies (Hayek, 1945; March and Simon, 1958; Hedberg and Jönsson, 1978; Weick, 1979; Kingdon, 1984; Johnson, 1988; Barr and Huff, 1997; Barr, 1998) that may only partially be mitigated through the existence of multiple parallel communications channels present in some highly coordinated CMEs (Schmitter and Lehmann, 1979; Berger, 1981). Second, cognitive limitations and group dynamics such as Groupthink (Janis, 1982) may affect decision-making adversely, especially when the decision process involves small and cohesive groups of decision-makers (Simon, 1947; Janis, 1982; March and Olsen, 1989; Hall and Taylor, 1996).

A third dimension of variation involves the rate of institutional change. All else equal, CMEs can be expected to require more time than LMEs, first in becoming aware of a given misalignment, and second in devising an initial adjustment response. In the LMEs, actors are in the position of Hayek's famous 'man on the spot' (Hayek, 1945: 524), recognizing the presence of misalignment through its adverse consequences and making their decisions based on their knowledge of the 'particular circumstances of time and place' (Hayek, 1945: 522). Adjustment responses by the individual actor can thus be relatively prompt; however, a considerable period of time may elapse before a dominant system-wide solution, or set of solutions, emerges through isomorphic and evolutionary mechanisms.

The unitary and consensual nature of the adjustment process in CMEs allows for the possibility of relatively quick system-wide implementation of institutional adjustment, once decided upon. However, reaching consensus on institutional adjustment decisions in CMEs, especially those involving major or radical institutional change, tends to take considerable time and political skills. Often such processes are deadlocked without a solution. At least four factors tend to contribute to the relatively slow rate of adjustment. First, aggregate-level decision-makers need to obtain information about the existence and consequences of institutional misalignment from the micro level. This is not only subject to the difficulties associated with information flow already discussed; it is also less time-efficient, as communication takes time. Additional delays in communications may result from issues such as collective action problems (Olson, 1965) and the
Second, the decision-making process itself tends to be relatively more complex and time-intensive in CMEs. As specified before, societal coordinated adjustment typical of CMEs involves a multitude of actors such as the state and representative organizations, with the number of participating organizations tending to increase with the degree of societal coordination. All else equal, the larger the number of actors involved in decision-making, the more complex and time-intensive the process of finding a collectively acceptable agreement (Olson, 1965; Tsebelis, 1995), especially where decision-making requires consensus.

Third, the magnitude of perceived risk associated with a given institutional adjustment is inversely related to the speed of decision-making. In LMEs, the variety of initial adjustment responses acts as a hedge against system-wide adjustment failure, and serves as an important source of information about feasibility of individual solutions. By contrast, societal adjustment in CMEs requires decision-makers to negotiate uncertainty and attendant risk through deliberation, discussion, and thought experiments. These processes take time.

Fourth, CMEs have to contend with the delaying tactics of vested interests in the decision-making process. In many cases the organizations involved in societal coordinated adjustment are the same that were involved in the creation of the extant institutional structures. Since institutional configurations have distributional consequences that favor their originators (Knight, 1992), these organizations tend to have a vested interest in maintaining the present shape of the system. The resistance of vested interests may be overcome through compensating side-payments from those parties gaining from institutional adjustment to those losing from it. The long-term nature of coordination in CMEs should, in principle, be an ideal environment for credible side-payment commitments (Axelrod, 1984). However, under conditions that require radical institutional adjustments (as in the present era), the mechanism of compensation through side-payments is breaking down as the winners of adjustment conflicts – typically firms, financiers, and highly qualified personnel – are increasingly unable or unwilling to share their gains with the losers – typically labor. The likelihood for delay and deadlock can be expected to increase.

In summary, we have argued that institutional adjustment in nations with relatively high levels of societal coordination – the CMEs – tends to be associated with higher levels of universality, greater riskiness, and slower rates of institutional adjustment.

### Implications for OFDI and face validity

**Implications of cross-national variation in institutional misalignments for OFDI**

In this section we point to the implications of the previous section for firms' responses to institutional misalignments. We argue that as a consequence of the adjustment dynamics we have discussed, and all else equal, firms in CMEs are likely to exhibit higher levels of escape through OFDI than their counterparts in LMEs. While in-depth empirical validation is beyond the scope of this paper, we undertake to illustrate the face validity of our argument.

As we have seen in the previous section, greater societal coordination implies a relatively slower rate of institutional adjustment and thus a relatively higher prevalence of institutional misalignments. Following the argument introduced earlier, these misalignments are economically costly. As the slower rate of institutional adaptation becomes manifest and the costs of misalignment accumulate, the inducement–contribution balance (March and Simon, 1958) for a growing number of firms will increasingly turn negative. Firms will thus begin considering taking action to reduce or eliminate these costs. Unlike in LMEs, firms in CMEs usually do not have recourse to autonomous adjustment, which would allow firms to produce legal abatement through their own action (Table 2). With this option unavailable, firms in CMEs are, all else equal, relatively more likely than their LME counterparts to engage in action leading to the other kinds of outcomes shown in Table 2: acquiescence, legal abatement through others, illegal abatement, legal and illegal diminution, and legal and illegal escape.

The possible range of concrete tactics and strategies is virtually endless, and the decision of which kind(s) of outcome to pursue in which concrete way is likely to be subject to multiple contingencies that we cannot pursue in this paper. For our purposes the key point is that OFDI is one of the available responses, as it may represent a legal2 form of escape from institutional misalignments in a given national context (cf. Boddewyn and Brewer, 1994). The territorial limitation of many institutions, especially formal ones such as laws and regulations, creates opportunities for
in institutional arbitrage (cf. Hall and Soskice, 2001) across national boundaries when a firm perceives the institutional environment in a potential host country to be more closely aligned with its strategic needs than the home country institutional environment. All else equal, under these circumstances firms may have an incentive to engage in institutional arbitrage by shifting their affected functional areas or business units from the home country to the potential host country.

Once individual firms begin to undertake OFDI to escape institutional misalignments, a number of mechanisms are likely to contribute to the diffusion of OFDI as an escape response through the business system. First, once a firm establishes that escape through OFDI is a successful strategy, the firm is likely to replicate it for other functions or processes (Nelson and Winter, 1982). Second, positive feedback loops (cf. Baumgartner and Jones, 2002) can lead to a snowballing of escape and other responses across the population of firms within and across sectors. Actions such as OFDI may impose economic pain on other actors in the system, at least in the short term. For example, as more firms escape, overall demand in the economy may decrease, unemployment may rise, and tax revenues can be expected to fall. As a consequence, the inducement–contribution balance (March and Simon, 1958) of other remaining firms in the home country may shift toward action, giving rise to a vicious circle with the potential of shifting the inducement–contribution balance of ever more firms to opt for escape-type actions. This vicious circle will tend to be further reinforced through social learning processes (Bandura, 1977), which may occur informally but may also be mediated by specialized agents such as management consultants or lawyers (cf. Abrahamson, 1996; Abrahamson and Fairchild, 1999). In addition, as escape responses become increasingly common, mimetic and normative isomorphic processes (DiMaggio and Powell, 1983) can be expected to accelerate the diffusion of these escape strategies through institutionalization and legitimation.

**Face validity**

It is beyond the scope of this perspective paper to undertake an in-depth empirical exploration of these dynamics; indeed, it is one of the key objectives of this perspective paper to spur further empirical exploration of our arguments. Nonetheless, we would like to underline the plausibility of our argument of OFDI as an escape response contingent on the extent of societal coordination. In addition to the Bundesbank policy study that supports the idea of escape (Deutsche Bundesbank, 1997), we would like to highlight empirical facts that are, at least *prima facie*, consistent with our argument.

A key requirement for empirically investigating the mediating effect of societal coordination on firm-level strategic escape response is the availability of a suitable metric of the extent of societal coordination in the economy. Hall and Gingerich (2004) have developed such an index of societal coordination for 20 OECD countries. The index is standardized to vary between 0 for the country with the relatively smallest reliance on societal coordination and 1 for the country with the relatively highest reliance. As Table 3 illustrates, countries that have been referred to as LMEs show an index value of less than 0.50, while those we have labeled CMEs exhibit values of 0.50 or higher.

Figure 1 plots the societal coordination index values against changes in OFDI stock from 1990 through 2003. We operationalize the change in OFDI stock as the ratio of 2003 outward stock, standardized by 2003 home country GDP, to 1990 OFDI stock, standardized by 1990 home country GDP. The standardized data are obtained from

<table>
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<tr>
<th>Country</th>
<th>Societal coordination index</th>
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<tbody>
<tr>
<td>Australia</td>
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</tr>
<tr>
<td>Austria</td>
<td>1.00</td>
</tr>
<tr>
<td>Belgium</td>
<td>0.74</td>
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<tr>
<td>Canada</td>
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<tr>
<td>Denmark</td>
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<td>United Kingdom</td>
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<tr>
<td>United States</td>
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OFDI as escape response to home country institutional constraints

Michael A Witt and Arie Y Lewin

Figure 1 Societal coordination and increase in outward FDI position, 1990–2003. Time-series FDI data not available for Belgium. Sources: Hall and Gingerich (2004); UNCTAD.

UNCTAD, with 1990 data unavailable for Belgium. The correlation coefficient of societal coordination index values and ratio of OFDI stock is +0.35 (Figure 1). Portugal and Spain are outlier points that show very high increases in OFDI stock. The IB literature on these two countries points to a number of factors that may have confounded the effect of coordination in these two countries, including: late internationalization consistent with Dunning’s investment development path theory (Dunning, 1981; Buckley and Castro, 1998); competitive pressure following accession to the European Union and the completion of the European Common Market in 1993 (Salmon, 2001; Casanova, 2004; Guillén, 2005); home country market saturation and deregulation (Salmon, 2001; Casanova, 2004; Guillén, 2005); and the desire to counter takeover threats from larger European rivals (Casanova, 2004). Excluding Portugal and Spain raises the correlation coefficient to +0.52.

Further empirical work is needed to substantiate the proposed relationship, which is likely to be subject to multiple causalities. For example, variation in starting points as well as EU integration may have a confounding impact on the observed relationship. However, possible catch-up efforts by CME firms that may have been motivated by lower starting points in 1990 (average ratio of OFDI stock over GDP in CMEs: 0.113, in LMEs: 0.162) do not explain why CMEs by 2003 showed considerably higher levels of internationalization than LMEs (CMEs: 0.447, LMEs: 0.333). Similarly, the observed positive relationship between societal coordination and OFDI stock increases still holds when the analysis is limited to the EU nations in the sample. While not conclusive, this suggests that a closer look at the effects of societal coordination and institutional adjustment on OFDI may be warranted.

Implications for IB research and the field of IB

In this paper we have built on and extended prior research to argue that escape to avoid misalignment between firms’ strategic needs and home country institutional constraints represents an additional explanatory factor for OFDI and for the observed variations in the levels of OFDI among advanced industrialized countries. The extent of societal coordination in the political economy affects the rate of change in the institutional environment, and acts as a contingency for the relative prevalence of such misalignment. We have illustrated the face validity of our argument by highlighting data showing that increases in the level of OFDI for advanced industrialized nations, standardized by GDP, from 1990 through 2003 are positively correlated with the measure of societal coordination developed by Hall and Gingerich (2004). Our argument relates to home country liabilities, such as slow rates of institutional adjustment, that may
motivate firms to escape. It does not relate to firms exiting (escaping) host countries because of liability of foreignness (Zaheer and Mosakowski, 1997; Hennart et al., 2002).

Our arguments open up considerable room for further exploration of the origins of OFDI. First, the arguments presented in this paper require empirical testing. If our argument is correct, then incorporating a measure of societal coordination should increase the explanatory leverage of models of FDI flows.

Second, it seems likely that OFDI will exhibit different characteristics depending on whether the motivation behind firm strategy is framed in the minds of the decision-makers in terms of seeking to capitalize on improved conditions abroad or in terms of avoiding deteriorating conditions at home. Prospect theory research (Kahneman and Tversky, 1979; Kahneman et al., 1982; Thaler, 1991; Thaler, 1992; Gilovich et al., 2002), for which Daniel Kahneman received the 2002 Nobel Prize in Economics, has demonstrated that individuals tend to respond differently to objectively identical decision problems depending on whether the issue is framed in terms of gains or losses. Framing in terms of gains tends to induce risk-averse behavior, while framing in terms of losses tends to lead to risk-seeking responses. So while purely mathematical logic would suggest there to be equivalence between a scenario in which conditions deteriorate at home and stay constant in the potential host country and another scenario in which conditions stay constant at home and improve in the potential host country, cognitive psychology suggests otherwise. In the former case, firms are likely to construe of investments abroad as an opportunity to compensate for losses incurred at home. In the latter case firms are likely to view overseas investments as opportunities for additional gains. The foreign direct investment behavior elicited by escape responses may thus vary in quantity and quality from that seen in response to OFDI seeking to capitalize on improving opportunities abroad. To the extent this is the case, it may be possible to extend our understanding of MNEs and FDI by exploring escape responses.

Third, future research on FDI and MNEs could explore whether there is a linkage between the levels of home and host country coordination. One possibility is that investors may seek out opposites. Firms from CMEs may seek to invest in LMEs in order to capitalize on the institutional adaptability of LMEs, for instance, by engaging in business activities not (yet) enabled by their home country institutional environments. Conversely, the relatively slower rates of adjustment of CMEs may prove appealing to LME micro-level actors such as hedge funds or private equity firms seeking to invest in turn-around opportunities. To the extent that CMEs are open to foreign investment, slower adjustment may thus not only induce internal responses but may also attract an additional set of actors from the outside that could help speed up the adaptation process.

Alternatively, it is possible that firms seek similarly coordinated environments. Rugman and Verbeke (2004) have suggested that regional firms are much more common than truly global firms. One possible explanation may be that firms, instinctively or consciously, seek out what they perceive as congruent institutional contexts, and thus relatively close institutional distance (Kostova, 1999; Eden and Miller, 2004), to support their FDI strategies. Culturally and geographically, but probably also from the perspective of institutions and institutional adjustment, the search for compatibility could favor a regional strategy. For instance, firms from societal coordinated continental Europe would probably feel most 'at home' in other continental European states or Japan.

Fourth, one might inquire whether there is a linkage between degree of coordination and form of FDI. For instance, are CME firms creating labor-intensive or knowledge-intensive jobs abroad? Both are plausible: the former because the coordinated structure, and especially relations with unions, may steer firms toward investment that preserves high-value-added jobs at home by helping maintain price competitiveness; the latter because knowledge-intensive activities necessary in the new industrial age may be easier and more fruitful to undertake abroad. Similar lines of inquiry are possible for linkages between FDI and other institutional characteristics of the business system, such as corporate governance patterns (Aguilera and Jackson, 2003).

In addition to underlining the importance of escape responses, this paper may contribute to the study of political risk in IB. The focus of the literature has been on institutional change as a source of host country risk for foreign investment (Vernon, 1971; Kobrin, 1982; Berg and Guisinger, 2001; Henisz, 2002). Underlying this approach is the notion that an investment that seemed favorable under the conditions when the investment was made may turn out to be unprofitable if political processes ex post result in changes in policies and institutions. Perhaps the best-known measure in IB
of this risk of change is Henisz's POLCON index, which builds on structural modeling combining institutional and political analysis (Henisz, 2002).

By contrast, this paper suggests the need to also explore the risk of slowness in institutional adjustment. This is relevant for both foreign and domestic investors: both need to consider at least implicitly the possibility that institutional adjustment will fall behind environmental changes, with concomitant implications for economic performance and political dynamics. To the extent that firm capabilities co-evolve with the institutional environment, domestic firms further face the risk that slow institutional adjustment in their home market will erode their competitiveness in international markets and reduce their options for developing requisite capabilities in the emerging new economy.

Consideration of the degree of societal coordination of an economy may provide the first measure for judging this risk of slowness in adjustment among the advanced industrialized economies. POLCON index values were not intended to provide insight into this question. The main source of variation in POLCON values for the advanced industrialized nations is the presence of a federal system, as these countries otherwise possess similar democratic structures with limited alignment across veto points. One counterfactual consequence is that a highly adaptable country such as the United States receives about the same POLCON score as sluggish Germany, and higher scores than Japan and France. At least for the advanced industrialized economies, the degree of coordination may provide a better measure of speed of adjustment, and thus of the risk slowness in adjustment. For studies of FDI among advanced industrialized nations, using societal coordination index scores alongside, or instead of, POLCON may thus potentially increase explanatory leverage.

Our analysis also contributes to the growing literature on comparative business systems, and thus the understanding of the business context in IB, by exploring how system-level characteristics mediate the dynamics of institutional adjustment. The first Annual JIBS Conference on Emerging Research Frontiers in International Business highlighted the importance of integrating context in IB research. JIBS has responded by enhancing its scope to include publications in the area of comparative business systems. For example, Redding (2005) introduces a nuanced framework for the analysis of differences across different varieties of capitalism. This paper augments the picture presented by Redding (2005) by linking system characteristics to variation in adjustment dynamics and their implications for OFDI flows. Our discussion suggests that nations with higher levels of societal coordination may be, at least during the present transitional phase, at a competitive disadvantage because their adjustment processes are slower. To the extent that this is true, this implies lower economic performance in times of heightened adjustment needs and greater political friction within CMEs than in LMEs for the foreseeable future, as well as increasing pressure on CME firms to devise strategies allowing them to span the divide between CME institutions and their strategic need to develop requisite capabilities for the new industrial age.

Future research might push further our understanding of institutional adjustment processes. One avenue is to search for additional sources of variance in adaptive characteristics across business systems. We have suggested that the degree of societal coordination is likely to be a primary divide with considerable explanatory power, but there is sufficient unexplained variance to warrant further work in this vein. The literature on comparative business systems (e.g., Albert, 1993; Berger and Dore, 1996; Whitley, 1999; Dore, 2000; Hall and Soskice, 2001; Streeck, 2001; Amable, 2003; Streeck and Yamamura, 2003; Thelen, 2004; Redding, 2005) may provide a useful starting point for identifying further relevant dimensions of variation across countries.

A second direction would be to explore the impact of interaction among business systems as well as interaction between business systems and the international system. Although we have not considered these dynamics in this paper, the international environment does affect domestic institutional adjustment through processes such as international bargaining and institutions (Ruggie, 1982; Putnam, 1988), social comparison processes (Festinger, 1954) across boundaries, the transmission of ideology and learning (Hall, 1993; Redding, 2005), or trade (Rogowski, 1989). A closer understanding of these interdependencies is likely to yield further valuable insights for the field of IB.

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Notes
1 These distributional consequences are partially related to market opening attendant to globalization, which tends to result in gains for mobile production factors and losses for immobile production factors (Frieden, 1991).
2 In the advanced industrialized nations there are normally no restrictions on OFDI. Where such restrictions exist, OFDI could of course be illegal, and might be labeled as ‘capital flight’.

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