EXPLAINING THE UTILIZATION OF MANAGERIAL EXPATRIATES FROM THE PERSPECTIVES OF RESOURCE-BASED, AGENCY, AND TRANSACTION-COSTS THEORIES

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ABSTRACT

This paper develops an integrative framework explaining multinational firms' managerial staffing decisions in initial foreign-entry situations from resource-based theory, agency theory, and transaction-costs theory, and it offers a set of theoretically grounded, testable propositions concerning these staffing decisions. In particular, we maintain that managerial staffing decisions are influenced by: (1) the value that managerial expatriates and local hires could potentially add to the firm; and (2) the relative contractual risks associated with the use of managerial expatriates and local managers.

This paper indicates that the use of managerial expatriates can improve contractual efficiencies in at least four ways. First, the use of expatriates helps align the economic incentives between the headquarters and the foreign subsidiaries. Second, the headquarters knows better the characteristics

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of expatriates relative to local hires. The use of expatriates reduces the uncertainty of the headquarters in recruiting managers and mitigates the incomplete contracting problem. Third, expatriates are better equipped with firm-specific capabilities than local hires, reducing contractual (small-numbers) problems. Fourth, expatriates have committed greater sunk cost investments in the multinational firm than local hires. These investments support their cooperative relationships with the firm and mitigate potential bargaining problems in employment contracting. However, although managerial expatriates can potentially improve contractual efficiency and may relieve a firm's concern over its limited control on managers, expatriates may not have adequate abilities in managing local idiosyncrasy.

INTRODUCTION

A multinational firm that enters into a foreign market must decide how it should staff the managerial positions of its foreign operation(s). Specifically, a multinational firm can utilize two types of human resources to manage its foreign subsidiary – expatriates and local hires.[1] Deployment of human resources has an important impact on the effectiveness of strategy implementation in these multinational firms (Edström & Lorange, 1984).

A number of research studies have written about factors underlying the use of managerial expatriates. A premise in these research studies is that the need for information processing, coordination, and control will lead to the utilization of expatriates. Hence, in these research studies, factors that indicate a greater need for coordination and control were used to predict the use of expatriates in foreign operations. For example, Boyacigiller (1990) argues that a high interdependence between the parent firm and the foreign operation requires a greater extent of information processing and thus results in the utilization of greater numbers of expatriates. Harzing (2001) argues that a larger cultural distance between the parent firm and the foreign operation leads to a higher perceived need for control and communication, and hence results in a greater reliance on expatriates.[2]

While these research studies shed light on some factors that influence such staffing decisions, several areas require further research. First, the research studies' premise that the need for information transfer and control leads to the use of expatriates implicitly presumes that the use of expatriates improves information processing, coordination, and control in the multinational firm. However, such a presumption is dubious, as some research studies have shown that managerial expatriates do not always meet multinational firms' expectations, and that the *failure rates* (in terms of expatriates' inability to complete their term

of assignment and their poor performance) of expatriates can be high (Ashmalla, 1998; Black & Gregersen, 1999; Dolins, 1999; Hill, 2000; Shaffer, Harrison & Gilley, 1999; Tung, 1981). Hence, there is a need for replacing this presumption with a more generalized, theoretically grounded explanation of why managerial expatriates are still expected (by multinational firms) to perform in the presence of a high need for coordination and control.

Second, it has been recently commented that virtually all of the research studies exploring staffing decisions have been built on Edström and Galbraith (1977), which is the only English publication that explains theoretically why international transfer of managers occurs (Harzing, 2001, p. 140). In Edström and Galbraith (1977), three major reasons for international managerial transfer have been highlighted, of which facilitating information transfer and control is included. However, these reasons have not been developed in a comparative context. Given that managerial expatriates are one of the options of managerial resource deployment in foreign operations, the theory of international managerial transfer can be more complete if it considers a comparative assessment of alternatives of international human resource deployment. In addition, since the 1980s, there has been substantial development in theories for analyzing comparative governance modes (such as transaction-costs theory) and resource deployment (such as resource-based theory) in the international business and strategic management literature (Anderson & Gatignon, 1986; Buckley & Casson, 1976; Hennart, 1982; Luo, 2001; Rugman, 1981). Nevertheless, researchers have not yet taken advantage of these theoretical developments in explaining staffing decisions of multinational firms.

The current paper attempts to advance the theory of international transfer of managers by addressing these research areas. In particular, we present an integrative framework of strategic managerial staffing decisions in international greenfield entry situations based on resource-based, agency costs, and transaction-costs theories. While a multinational firm can send expatriates for technical assistance purposes, our framework focuses on explaining strategic *managerial* expatriation and provides a comparative analysis of potential benefits and costs of expatriates and local hires as *managers* of foreign operations. Since our framework reflects the calculation of the multinational firm on international managerial staffing decisions, the propositions developed in this paper are based on the assumption of *greenfield* entries.

Our framework considers both potential economic value that managerial expatriates and local managers can add to multinational firms and the relative organizational control that the firms can have over alternative human resources. The perspective of control in our framework extends the international business research literature on control by addressing "specific control" of human resources

within a multinational firm (Luo, Shenkar & Nyaw, 2001). While overall control (i.e. the level of ownership) determines to what extent a multinational firm can influence its *foreign subsidiaries* through payoff structuring and decision-making power allocation (Hennart, 1988; Luo, Shenkar & Nyaw, 2001), human-resource control focuses on influencing the *managers* of the foreign subsidiaries. These two influences may not be entirely equivalent since effective control that a multinational firm has over its foreign operations partially depends on managerial actions and managerial abilities, and could be shaped by managerial self-interest-seeking behavior (Schaan, 1988). The study of human-resource control is therefore warranted.

Our paper contributes to the research literature on human-resource control by addressing how a firm can choose governance for managerial services ex ante to influence the human resource control in the foreign operations. Previous research literature on international human resource control has generally focused on an ex post course of action such as selecting and training expatriates (e.g. Snell, 1992), and ex ante governance considerations have received little attention. The current paper sees expatriates and local hires as two governance modes for providing managerial services (such as control implementation) in foreign subsidiaries, and explores the factors affecting relative contractual costs of these two governance alternatives.

This paper makes contributions to the extant research literature on international managerial transfer in at least three ways. First, in the integrative framework, we replace the extant research studies' presumption that managerial expatriates can better achieve information transfer and control by a generalized, theoretically grounded concept – a simultaneous consideration of the potential economic value creation by expatriates and local managers, and the limited control of a firm over expatriates and local managers. In so doing, the current paper offers a deeper understanding of previous posited relationships concerning expatriate utilization and sheds some new light on the factors leading to the use of expatriates and local hires. Second, this framework allows a *comparative analysis* of alternatives to staffing managerial positions in foreign operations of a multinational firm. Third, human resources are one of the more important strategic resources of a multinational firm. However, the discussion of expatriate deployment has been primarily limited to human-resource-management scholars. We maintain that this issue deserves more attention from a wider audience, particularly from international strategy researchers. By presenting the issue of international human-resource deployment in the framework of dominant strategy theories such as resource-based, agency, and transaction-costs theories, it is hoped that our paper will stimulate more diverse efforts in studying this strategic issue, which could potentially enrich the theoretical development of human resource management of multinational firms.

STAFFING DECISIONS IN FOREIGN OPERATIONS

A multinational firm can staff the managerial positions of its foreign operations with expatriates and local hires. Staffing foreign operations requires the multinational firm to consider the potential of expatriates and local managers in creating firm value, and the extent of organizational control that the firm can have over them (Coff, 1997). In this section, we first employ resource-based theory to discuss the potential economic value that expatriates and local managers can bring to the multinational firm. We then consider how the firm's concern over human-resource control impacts its employment decision of foreign operations.

Managerial Staffing Decisions in the Context of Resource-Based Theory

Resource-based theory suggests that a firm is a collection of heterogeneous productive resources/capabilities, and that the characteristics of these resources/capabilities influence how the firm behaves and performs (Penrose, 1959). In particular, a firm whose resources are valuable, rare, and not easily imitable or substitutable is more likely to achieve sustained competitive advantage (Barney, 1991; Lippman & Rumelt, 1982). Because the development of resources/capabilities is often subject to time-compression diseconomies (Dierickx & Cool, 1989), a firm must utilize its resources/capabilities at an efficient rate (Penrose, 1959).

Managerial resources are one of the more important strategic resources of a multinational firm. Managers of foreign operations of a multinational firm potentially contribute to the multinational firm in at least three ways. First, these managers implement the multinational firm's strategies so that the firm can achieve synergies (e.g. economies of scope) and coordination. Second, these managers help the firm to obtain valuable local resources. Third, these managers help the firm to pool and integrate resources and capabilities from different units of the firm into "transnational" capabilities (Bartlett & Ghoshal, 2000). Staffing in foreign operations thus can have important strategic implications for creating economic value and for developing sustained competitive advantages in a multinational firm via revenue drivers, cost drivers, and risk drivers (Castanias & Helfat, 1991; Dyer, 1997; Lado & Wilson, 1994; Zajac & Olsen, 1993).

Making managerial contributions to the multinational firm may require managers of foreign operations to be equipped with multinational firm-specific and local knowledge, as well as intra-firm (multinational network-wide) and local social capital. Specifically, implementing the multinational firm's strategy requires the managers of foreign operations to understand the firm's policies

and the role of foreign operations in the multinational network. Obtaining local resources requires these managers to have local knowledge and local connections. Although, to some extent, a firm could obtain local information from external consultants, a substantial part of local knowledge is tacit and can be best learned through experience (Luo & Peng, 1999). Thus local knowledge cannot be completely bought outside and must be embodied in managers. Finally, building transnational capabilities requires knowledge and capabilities sharing among subunits (including the headquarters), which is more effective when managers of foreign operations actively interact with those of other subunits. Consequently, facilitating development of transnational capabilities requires the managers of foreign operations to be equipped with intra-firm social capital.

Expatriates and local hires are two different types of human resources that a multinational firm can use to staff the managerial positions of its foreign operations. From the perspective of resource-based theory, staffing foreign operations requires the multinational firm to consider the economic value that expatriates and local managers can potentially add to the firm. At the time of the multinational firm's initial entry into a foreign market, expatriates and local managers can be viewed as possessing different managerial capabilities and thus as potentially creating different economic values for the firm. Specifically, since most expatriates are internal transfers rather than new hires, and they have worked and have been socialized within the multinational firm (or the headquarters) for a significant period of time (Greenwald, 1979, 1986; Laing, 1994; Naumann, 1992), expatriates are likely to have accumulated firm-specific knowledge and to have developed specific relationships within the multinational firm (i.e. intra-firm social capital). Expatriates therefore can potentially help the multinational firm in implementing corporate policies and in facilitating resources/capabilities sharing. However, these expatriates may lack local knowledge and connections that could be crucial for the firm's survival and success in the foreign market. In contrast, local hires understand local culture and often have local knowledge and connections to allow the multinational firm to tap into valuable local resources. However, at the time the multinational firm makes an initial entry into the foreign market, local hires in general have not worked for the multinational firm. Therefore, local managers still need to accumulate parent-specific knowledge and intra-firm social capital in order to interact actively with other subunits.

We have now discussed how expatriates and local managers may add to a multinational firm's economic value differently.[3] However, deployment of human resources not only requires the multinational firm to consider the potential of these resources in creating firm value, but also requires the multinational firm to consider the extent of organizational control that the firm can have over these resources, because human resources, unlike physical resources, are under only

limited organizational control (Coff, 1997). For example, employees can leave or threaten to leave the firm; they can shirk on the job and/or withhold critical information. As a consequence, a firm may choose the second best alternative (in terms of economic value creation) when it has serious concerns over whether the most capable managers are willing to do as they are required. It is therefore warranted to explore how such strategic concerns can impact a multinational firm's employment decisions of foreign operations.

Employment contracts provide the basis of control that a firm can have ex ante over its employees by broadly defining (within a zone of acceptance) what the firm demands from the employees (Williamson, 1975, 1996). Upon its entry into a foreign market, a firm can make managerial employment contracts with its internal managers (i.e. expatriates) and local hires. The costs associated with making these contracts, in addition to the out-of-the-pocket costs (such as salary, home leave, private schools, etc.), also include the economic costs of the firm in specifying, adjusting, and enforcing the employment contracts, and any economic loss that results from incomplete contracting. The greater the contractual costs, the more likely the firm will incur incomplete contracting problems, and the greater the extent to which the multinational firm may expect its control over managers to be limited. To explore the relative contractual costs associated with expatriates and local hires, we first investigate the contractual problems that a multinational firm potentially incurs when selecting managers for its foreign operations.

Managerial Staffing Decisions in the Context of Agency Theory

From the perspective of agency theory, the potential contractual problems that a firm incurs when selecting its managers include *hidden action* and *hidden information* (Arrow, 1985). Specifically, agency theory explores the problems of potential misalignment of economic incentives between a principal and agents. Agency problems occur when the agents, who perform services on the behalf of the principal, do not bear the entire economic loss caused by their decisions, and thus they have the economic incentive to pursue their own economic interests at the expense of the principal's economic interests (Jensen & Meckling, 1976).

The relationship between the headquarters and the managers of its foreign subsidiaries is a type of agency relationship, in which the headquarters is the principal whose economic interests require the efforts of the agents, i.e. the managers of its foreign subsidiaries (O'Donnell, 2000). The managers of its foreign subsidiaries (i.e. the agents) may not fully serve the multinational firm's (i.e. the principal's) economic interests due to *hidden action* and *hidden information*.[4] *Hidden action* arises when it is costly for the principal to monitor the behavior and to measure the

performance of the agents. Although internet technologies have greatly diminished the economic costs of monitoring based on output control across national borders, there may be other types of monitoring such as behavior or social control that a multinational firm would prefer to use (Jaeger, 1983). These types of control may require non-measurable information, which cannot be readily transmitted electronically.[5] Hidden action thus is likely to prevail when output control, which is based on evaluating individual measurable performance, leads to inefficient outcomes, and the headquarters will have to rely on other types of control to monitor effectively its foreign operations (Eisenhardt, 1985; Masters & Miles, 2002; Ouchi, 1979). One such example is when the strategy that is economically optimal for foreign operations does not maximize the economic profitability of the multinational firm as a whole,[6] which leads to an economic incentive misalignment situation between the headquarters and the foreign operations (Hennart, 1991; Kobrin, 1988). For example, the Dutch company Philips developed a VCR format, the V2000 system, and wanted its North American subsidiary to introduce the format, but the subsidiary was reluctant and instead adopted the rival VHS format by Philips' competitor, Matsushita. Here the economic incentives of the headquarters and the foreign subsidiary were clearly misaligned (Hill, 2000).

In addition to the economic incentive misalignment problem between the headquarters and the foreign subsidiary (as a whole), which occurs because the objectives of the headquarters and the foreign subsidiary may be different, there is also an economic incentive misalignment problem between the headquarters and the managers of the foreign subsidiary, which is caused by managerial self-interests seeking behaviors. Managers may pursue sub-goals and may not be motivated to promote fully the economic interests of the foreign subsidiary (Cyert & March, 1963; March & Simon, 1958; Mishra & Gobeli, 1998). *Hidden information* occurs when the agents have information that the principal does not have and the principal finds costly to learn (Akerlof, 1970). One hidden information problem in the context of a multinational firm selecting managers of its foreign operations is that the headquarters may have limited understanding of the (adaptive and other less observable) ability of its managers (and hence the quality of the services that the managers are capable of providing). As a result, the multinational firm may fail to place the right managers for its foreign operations (Rugman & Verbeke, 2001). Thus, even if the managers of the foreign subsidiary are motivated (see March & Simon, 1958) to promote the economic interests of the headquarters, these managers may not have the required skills for implementing the optimal strategies for the headquarters.

Agency theory predicts that to minimize these agency problems, the principal will try to design both *monitoring* mechanisms and agent economic *bonding* mechanisms that minimize total agency costs, which include the time and effort the principal spends in monitoring the agents, the time and effort the agents

spend in setting up an economic bond to assure that they will act in the economic interests of the principal, and the residual economic loss from unsolved economic incentive misalignment.

Expatriates and local managers are two governance choices for managerial services in a foreign subsidiary. The use of expatriates potentially provides a solution for the hidden information and hidden action problems. One distinct characteristic of expatriates is that expatriates typically have been trained, and have worked and socialized within the multinational firm for a significant period of time. During that process, the firm has assigned to them various tasks so that it can assess their skills and loyalty (Bonache & Fernandez, 1999; Liebeskind, 1996; McCleod & Malcolmson, 1988). In addition, since expatriates have been socialized within the firm, they are expected to be more likely to maintain the multinational firm's overall economic interests compared with local personnel (Eisenhardt, 1985; Kobrin, 1988; Ouchi, 1979). Moreover, the headquarters is likely to have greater uncertainty about the quality of the local managers since these managers are new to the firm upon the firm's entry into the foreign market. As a result, the firm can use expatriates to alleviate at least two contractual problems – information asymmetry problems in selecting managers for the overseas operations and economic incentive misalignment problems between the headquarters and the foreign subsidiary.

The economic incentive misalignment problem between the headquarters and the foreign subsidiary is likely to predominate when the firm employs a global strategy to configure its activities (Bartlett & Ghoshal, 1989). Specifically, firms using a global strategy typically concentrate their production, marketing, and R&D activities in a few favorable locations in order to respond to cost pressures. Decision-making in these firms is usually centralized, and operations are typically integrated (Harzing, 2000). The process of coordination and rationalization is likely to create conflicts of objectives between the headquarters and the foreign subsidiaries (Kobrin, 1988), leading to an economic incentive misalignment problem between them. For example, in responding to rising economic costs in a particular host country, a firm may decide to shut down a particular operation and to shift its production facilities to a new location. The use of expatriates provides a solution for this economic incentive misalignment problem between the headquarters and the foreign subsidiary because expatriates have been socialized within the firm, and are expected to have a far less biased understanding of individual subsidiaries' roles in the multinational firm (Kuemmerle, 1997). In addition, since implementing global strategy requires the managers to understand the firm's policy, expatriates, whose comparative advantage is firm-specific knowledge and experience, are likely to contribute more economic value to the firms than local hires, whose comparative advantage is their local knowledge and connections. In summary, when a multinational firm employs a global strategy

to configure its worldwide activities, the use of expatriates can potentially create more economic value and also reduce potential economic incentive misalignment problems between the firm and its foreign operations.

In contrast, a firm pursuing a multi-domestic strategy to organize its international activities is less likely to incur serious economic incentive misalignment problems (Bartlett & Ghoshal, 1989). Firms that adopt a multi-domestic strategy tend to locate their production, marketing, and R&D activity in each country in which they do business. These firms typically develop decentralized federations in which each foreign subsidiary is independent of headquarters and other subsidiaries (Harzing, 2000), and it typically functions as an autonomous profit center (Hill, 2000). Since there is little interdependence among the subsidiaries of a firm that follows multi-domestic strategy, the firm can use output control to monitor its subsidiaries' performance effectively (Ouchi, 1979), reducing potential economic incentive misalignment problems between the headquarters and the foreign subsidiaries. In addition, firms that adopt a multi-domestic strategy usually are under great pressure to be locally responsive, and thus tend to value local knowledge and connections. In contrast, since there is little need for coordination, parent-specific knowledge and experience are not particularly useful for managing foreign operations in these firms. Besides, local idiosyncrasy may further inhibit the applicability of parent knowledge. As a result, expatriates are likely to contribute less economic value to the firms than local hires. In summary, when a multinational firm employs a multi-domestic strategy to organize its foreign operations, the use of local managers does not lead to potential economic incentive misalignment problems between the firm and the foreign operations, and can potentially create more economic value for the multinational firm.

Firms that follow transnational strategies attempt to achieve both global integration and local responsiveness. In such firms, decision-making partitions are made in a way that headquarters can better use subsidiaries' knowledge and capabilities, and subsidiaries can better act in the interests of the headquarters (Bartlett & Ghoshal, 2000). Obtaining local information and maintaining fluent information flow between subunits are important as the firm attempts to gain and diffuse knowledge and capabilities in the organization. We expect that the reliance of expatriates in transnational firms is likely to be higher than that in multi-domestic firms because managers of foreign operations in transnational firms need to understand headquarters' global needs and to interact actively with other units of the firm, and expatriates should have comparative advantages for these managerial tasks relative to local managers. We also expect that the reliance of expatriates should be lower for transnational firms than for global firms because transnational firms place more value on local knowledge and connections, and hence local managers can provide greater contributions in transnational firms.

Based on the above discussion, we expect that,

Proposition 1. Other things being equal, the percentage of expatriates in the top management team of the foreign subsidiary, at the time of the subsidiary's initial establishment, is likely to be *highest* for firms employing a global strategy, followed by firms employing a transnational strategy, and this percentage is likely to be *lowest* for firms employing a multi-domestic strategy.

Managerial Staffing Decisions in the Context of Transaction Costs Theory

From the perspective of transaction-costs theory, a multinational firm selecting its managers potentially faces ex ante and ex post contractual problems. Specifically, transaction-costs theory explores the relative efficiencies of governance choices in organizing economic activities (Williamson, 1985, 1996). In the current paper's international business context, expatriates and local hires are two imperfect governance choices for providing managerial services in foreign operations. Contractual problems occur because it is difficult to consider every contingency in the employment contract, and to renegotiate and enforce the employment contract. This incomplete contracting leaves room for managers to behave opportunistically (Hart, 1995; Kim & Mahoney, 2002).

One ex ante contractual incompleteness problem arises from the difficulty in specifying a set of exhaustive criteria for recruiting, identifying, and assigning the right persons for tasks. Such an incomplete contract is likely to prevail in the presence of high uncertainty. High uncertainty may arise externally (environment uncertainty) or internally (task complexity) (Boyacigiller, 1990; Richards, 2001). Both types of high uncertainty lead to the difficulty to link managers' behavior to their performance (Eisenhardt, 1985; Ouchi, 1979) and thus make it difficult for the headquarters to foresee the required abilities for its managers and to specify all the qualifications that its managers should be equipped with prior to employing them. Managers thus may be required to adapt to tasks that the headquarters does not anticipate prior to their assignments. In this case, the firm may prefer using managers who have the ability and willingness to adapt to various contingencies (e.g. restructuring) as they arise (Pearce, 1997). As a result, the *loyalty to the multinational company* and *adapting capabilities* may become the important criteria for a multinational firm in selecting managers in changing and complex environments (Miller, 1977; Tung, 1981). These two individual characteristics, however, are not perfectly observable, and they need to be unveiled in various tasks over time (Miller, 1992; Prescott & Visscher, 1980).

As mentioned earlier, expatriates have established track records in the multinational firm, and the headquarters is expected to have greater knowledge about

their loyalty and their ability of adapting to internal uncertainty relative to the knowledge the headquarters possesses about local hires. The use of expatriates therefore may provide a solution to the ex ante contractual incompleteness problem that arises from internal uncertainty.

> **Proposition 2.** Other things being equal, the greater the internal uncertainty/task complexity, the *higher* the percentage of expatriates in the top management team of the foreign subsidiary at the time of the subsidiary's initial establishment.

However, upon its entry into a foreign market, the multinational firm is not likely to have assessed its expatriates' ability of adapting to the specific local environment. In addition, adapting to contingencies that arise from local environmental uncertainty may require local knowledge and connections (Miller, 1992), for which local hires may have a greater comparative advantage. Therefore, we expect that,

> **Proposition 3.** Other things being equal, the greater the local environmental uncertainty, the *lower* the percentage of expatriates in the top management team of the foreign subsidiary at the time of the subsidiary's initial establishment.

It should be noted that while Propositions 2 and 3 both concern uncertainties, they yield opposite predictions about the use of expatriates. In new foreign-market entry situations, both internal and local environmental uncertainties are likely to coexist. In this case, the top managerial positions of foreign operations are likely to consist of both expatriates and local managers, and the percentages of expatriates vs. local managers are likely to reflect headquarters' concern about the relative levels (as well as importance) of internal vs. local environmental uncertainties. For example, in emerging economies where political and institutional uncertainties are predominant, the concern for local environmental uncertainty is likely to outweigh the concern for internal uncertainty, and the multinational firm may place a higher percentage of local managers in the top managerial positions of its foreign operations.

The level of uncertainty of a multinational firm about the characteristics of local hires should be higher when the foreign operations are located at culturally distant locations. Specifically, cultural distance may make it difficult for a firm to assess correctly the abilities and characteristics of local hires through physical and verbal contacts as people of different countries have different "silent language" (Hall, 1959), causing potential misunderstanding or even conflict. Consequently, a firm may find it difficult to evaluate both observable and unobservable characteristics of local hires. Such difficulty is likely to increase the propensity of a multinational firm in using expatriates. However, as we will discuss later in this section, culture distance may also increase the "out of pocket" costs of expatriates (e.g. salary and

other compensation), which could be a substantial burden for firms with limited resources. Hence, the benefits of mitigating the ex ante contractual incompleteness problem by using expatriates are likely to be attenuated by the resource constraint for smaller firms with limited resources.

It should be noted that a multinational firm is likely to require more local knowledge and connections to succeed in culturally distant locations, and that local hires might potentially create greater economic value for the firm than expatriates in this situation. However, contractual concerns (i.e. the uncertainty) about local hires may cause the firm to over-rely on expatriates. The finding of several empirical studies (Boyacigiller, 1990; Harzing, 2001) that firms tend to use expatriates for culturally distant subsidiaries seems to be consistent with such a conjecture. Therefore,

Proposition 4. Other things being equal, the greater the cultural distance between home and host countries, the higher the percentage of expatriates in the top management team of the foreign subsidiary of large multinational firms at the time of the subsidiary's initial establishment.

Another ex ante contractual problem arises from a small-numbers condition, which occurs when qualified managerial talent is scarce. Such a condition could happen to the internal managerial labor market (i.e. market for expatriates) in a firm that has few managers who are equipped with international experience and multi-lingual abilities. In this case, the multinational firm is expected to rely more on local hires for providing managerial services in foreign markets.

A firm with higher multinational diversity is likely to be less subject to this small-numbers problem (Barkema & Vermeulen, 1998). Specifically, some crucial local knowledge and skills are often tacit and need to be learned through experience (Eriksson, Johanson, Majkgard & Sharma, 1997; Luo & Peng, 1999). A firm that operates in a variety of countries can provide diverse learning opportunities for its managers (Hitt, Hoskisson & Kim, 1997). The managers can therefore develop multilingual abilities and accumulate location-specific knowledge (Zahra, Ireland & Hitt, 2000). In addition, managers' experience in other countries may also enhance their absorptive capacity to adapt to local conditions (Cohen & Levinthal, 1990). Hence, firms with a greater multinational diversity should have more qualified potential candidates for managerial positions in foreign operations. We therefore expect that,

Proposition 5. Other things being equal, the percentage of expatriates in the top management team of the foreign subsidiary, at the time of the subsidiary's initial establishment, is likely to be *higher* for firms with greater multinational diversity.

The small-numbers condition can also occur in markets for local hires. For example, in emerging markets, local managerial candidates may lack sufficient managerial and/or other professional skills (Hoskisson, Eden, Lau & Wright, 2000). Thus, the firm may have to fill the managerial positions of its foreign operation with expatriates (Edström & Galbraith, 1977; Scullion, 1991). However, the ex ante small-numbers problem may still occur, even in the presence of abundant local talent due to human capital asset specificity (Masters & Miles, 2002). Asset specificity is "the degree to which an asset can be redeployed to alternative uses and by alternative users without sacrifice of productive value" (Williamson, 1996, p. 59). In the current context, asset specificity refers to the degree of firm- (headquarters-) specificity in the capabilities for providing effective managerial services for the headquarters. Because firm-specific capabilities must be accumulated within the multinational firm through the process of learning-by-doing (McKendrick, 2001; Murtha, Lenway & Bagozzi, 1998; Williamson, 1985), the multinational firm is likely to have difficulties in finding local hires with firm-specific capabilities upon its entry into the foreign market. Moreover, expatriates have typically been working in the multinational firm and are expected to be equipped with firm-specific capabilities. The use of expatriates thus provides a solution for this ex ante small-numbers problem.

One task that typically requires firm-specific capabilities is transferring tacit knowledge. Specifically, tacit knowledge cannot be perfectly made explicit. Its transfer requires the transferor to demonstrate the knowledge on the job and to give comments on the errors made by the transferee (Athanassiou & Nigh, 2000; Hitt, Bierman, Shimizu & Kochhar, 2001; Zander & Kogut, 1995). Since tacit knowledge transfer demands a high level of interactions between the transferor and the transferee (Winter, 1987), to facilitate the interaction, the units within the multinational firm (including headquarters and subsidiaries) may have to share similar languages and understanding, and to build informal social links with other units (Cohen & Levinthal, 1990; Lane & Lubatkin, 1998). Such common understanding and intra-firm relationships are firm-specific capabilities that can only be developed through experiences within the multinational firm (Peterson, Peng & Smith, 1999). Therefore, the greater volume of tacit knowledge transfer within the firm (be it from the headquarters to the subsidiaries or from the subsidiaries to the headquarters), the greater the likelihood that the firm will send managerial expatriates to the foreign operations to facilitate knowledge sharing and diffusion.

In addition, tacit knowledge is often the source of a firm's competitive advantage (Itami & Roehl, 1987) and needs to be kept proprietary (Luo, 2001). As we explain below, because the mutual economic interest to maintain a long-term relationship is stronger between the firm and its expatriates than between the

firm and local hires, the use of expatriates is expected to better protect this tacit knowledge than the use of local hires. Therefore,

> **Proposition 6.** Other things being equal, the percentage of expatriates in the top management team of the foreign subsidiary, at the time of the subsidiary's initial establishment, is likely to be *higher*, the greater volume of tacit knowledge transferred within the multinational firm.

In addition to these ex ante contractual problems, a firm selecting managers for its foreign operations should also consider an important ex post contractual problem. A firm has only limited control over its managers, as managers may renegotiate the terms of the contract (such as attempting to renegotiate compensation, benefits, and position) in their favor, and these managers may threaten to leave for other firms. Employers may then be forced to accept worsening terms of the employment contract (Milgrom & Roberts, 1992).

One condition in which managers may have greater bargaining power is when the firm employing them has made substantial irreversible investments specific to them, because if the managers leave the firm, the firm will lose these irreversible investments that it has made in them. Such investments may take the form of recruiting and training costs that have been spent on the managers and that the firm cannot recover once these managers leave.

The training that a firm implements for its managers can be firm- or non-firm-specific. Firm-specific training is the training that is particular to the firm. Its content may include the process of socialization of employees, unique (firm-specific) manufacturing processes or managerial practices, and the knowledge about the interdependencies among the sub-units within the multinational firm. Such training could be implemented through on-the-job training (through interaction with and guidance by experienced managers) and through various development programs designed by experienced managers. Non-firm specific training includes all of the training that a firm provides for its employees/managers that increases their productivity not only within the firm but also outside the firm (e.g. foreign language and computer training).

Training represents a significant investment made by the firm because it diverts the resources and time of experienced managers away from other potentially productive activities (Penrose, 1959). However, as long as the training is only valuable within the multinational firm, a firm's risk of having a lower bargaining power than managers should be small, because the manager' skills will not be as valuable in other firms (Becker, 1964; Williamson, 1975). Specifically, the firm is not the only party who may lose its investments if the managers leave. For managers, their experience, knowledge, and relationships that have accumulated over time within the firm are irreversible investments that they commit to the

Table 1. Ex Post Hold-Up Problems of the Multinational's Governance Choice for Managerial Services in Foreign Operations.

Governance choice	Risk to Firm	Risk to Manager
Expatriate manager	Loss of investments made in training the expatriate manager	Loss of firm-specific investments made by the expatriate manager is *high*
Local manager	Loss of investments made in training the local manager	Loss of firm-specific investments made by the local manager is *low*

firm. These investments, if particular to the firm, improve their productivity in the firm but not everywhere else. Firm-specific training thus increases the switching costs of the managers in the sense that they may lose a significant part of their economic value if they leave for other firms.

However, firm-specific managerial skills are only one type of skill that managers should be equipped with. Managers may also receive training that improves their abilities that can be transferred across businesses or firms. Since this training can be useful to other firms, it increases the managers' bargaining power with their employer (Coff, 1997). As described in Table 1, such ex post contractual risk can occur for *both* governance choices for managerial services of foreign operations – expatriates and local managers. For example, before expatriates are sent abroad, they often receive local culture and language training from the multinational firm (Hill, 2000; Tung, 1981). The multinational firm loses the investment once the expatriates leave the firm (Allen & Alvarez, 1998; Black, Gregersen & Mendenhall, 1991). The multinational firm could also give non-firm-specific training to local hires such as technical or practical training (Fey & Björkman, 2001; Ronen, 1986) that can be useful for local competitors. When local personnel leave the firm, the firm not only loses the investments it has made in them but also runs the risk that the training could benefit its competitors.

Although the bargaining problems may occur for both expatriates and local managers, the economic contractual hazards of using local hires are likely to be greater than those of using expatriates. Upon a multinational firm's entry into a foreign market, expatriates have spent more time within the multinational firm. While this working experience allows them to gain the abilities to solve problems, develop leadership skills, and develop other skills that can be useful to other firms, they may also obtain a good deal of knowledge and relationships that are specific only to the firm. Thus, their skills and knowledge are tailored to the firm to a greater extent than local managers'. In other words, expatriates have more to lose once their employment relationship with the multinational

firm is terminated (Liebeskind, 1996), and thus they face a higher risk than local hires.

In fact, we expect that mutual economic interests for maintaining a long-term relationship are stronger between the firm and expatriates than between the firm and local hires. Specifically, the mutual economic interest to maintain a long-term relationship can be promoted by mutual sunk costs investments (Williamson, 1996). In the current context, the economic loss that the multinational firm incurs if the managers leave (investments specific to the managers), along with the economic loss that the managers have if they leave (the firm-specific investments they made in the firm), is the basis of mutual sunk costs investments between the firm and the managers. Since, upon the firm's entry into a foreign market, expatriates have been with the firm for a longer period than local hires, expatriates have made more firm-specific investments in the firm, and the firm has made more irreversible investments in expatriates. In other words, expatriates have made more credible commitments in supporting their cooperative relationships with the firm than local hires.[7] Hence, the multinational firm may mitigate the potential bargaining problems by using expatriates to manage its foreign subsidiaries.

Not only do expatriates' investments in building firm-specific knowledge and relationships alleviate the ex post bargaining problem (hence lowering the costs of adjusting employment contracts), but these strategic investments can be seen as an economic bond that expatriates have posted with the firm, reducing the need of the firm for monitoring the expatriates (hence lowering the economic costs of enforcing employment contracts).[8] Specifically, to reduce managers' sub-goal pursuing behavior, a firm can typically employ output control or a profit-center organizational structure to promote their economic incentives (Eisenhardt, 1985). However, such a type of control cannot be effective in the presence of high (non-priceable) interdependencies among its foreign subsidiaries, and the headquarters may tend to implement behavior and/or cultural control on its managers instead (Gencturk & Aulakh, 1995; Snell, 1992). However, geographical and/or cultural distance between the headquarters and the foreign subsidiaries might make it costly for the headquarters to monitor its foreign operations by using behavior or culture control (Eisenhardt, 1985; Ouchi, 1979). The use of expatriates potentially economizes on the efforts of the headquarters to detect and to monitor the behaviors of the managers of the foreign operations because: (1) expatriates have been socialized within the multinational firm for a substantial period of time; and (2) their stake is higher if fired by the headquarters. In other words, enforcing employment contracts should be at a lower cost with expatriates than with local hires for a multinational firm that implements behavior and/or cultural control on its foreign operations.[9]

Managerial Staffing Decisions over Time

We have now explained how a multinational firm's concern about its limited control over managers affects initial staffing decisions by examining the contractual problems that the firm potentially faces when selecting managers for its foreign operations, which could explain why a multinational firm tends to rely (or over-rely) on expatriates, even when expatriates may fall short of expectations. In the above analysis, expatriates and local hires are considered as having different characteristics in terms of abilities, accumulated firm experience, track records, and so on, and therefore are expected to create different values and produce different contractual risks from the perspective of the multinational firm. Over time, expatriates may develop local knowledge and connections, and senior local hires may build a track record with the firm and develop their parent-specific knowledge and intra-firm relationships. As a result, the characteristics of expatriates and local hires could converge so that relative economic value contributions and contractual risks of using local hires and expatriates could become more similar over time (Langlois, 1992). We expect that as the gap gets smaller between the economic value-creation potentials and contractual risks associated with expatriates and local hires, a firm's propensity of using expatriates is likely to decrease.

The main reason for this expectation is that expatriate utilization is often expensive. First of all, direct costs of expatriates may be several times the domestic salary plus relocation expenses (Chen, Choi & Chi, 2002; Harvey, 1983; Reynolds, 1997), especially in countries where living standards are high. Second, the firm may have to develop training and assistance programs for expatriates and their families (Pucik & Saba, 1998). Such programs are costly and may be even more so for assignments to culturally distant host countries. In addition, these programs may divert a firm's resources away from its core activities, especially for firms with limited financial and managerial resources (Penrose, 1959). Third, repatriation also requires careful planning, or it could create problems for both the (returned) expatriates and the headquarters, such as high turnover rates relative to domestic turnover rates. Finally, over-reliance on expatriates may discourage local employees, and may lead to the turnover of local talents, who may perceive little chance of getting promotions (Zeira & Harari, 1979). Because expatriate utilization can be expensive, a firm is likely to reduce its reliance on expatriates as the contractual risks of local hires decrease over time.

However, it is worth noting that the potential changes concerning local hires should not be taken for granted and might not necessarily lower local hires' contractual risks perceived by the headquarters. For example, these local hires might not accumulate much parent-specific knowledge because there is no training program offered, and therefore the small-numbers problem arising from

the requirement of firm-specific managerial capabilities could still prevail in the labor markets for local managers. In addition, the headquarters might still have difficulty in assessing local hires' characteristics if there is no effective information system that collects and transmits such information. As a result, the ex ante contractual problem due to hidden information could still concern the headquarters when selecting managers for existing foreign operations.

In summary, the propensity of a multinational firm using expatriates is likely to decrease as the characteristics of expatriates and local managers converge over time, alleviating the potential control concerns about local managers. Since such control concerns can be better resolved for multinational firms that invest in local training programs and/or information systems, we expect that,

Proposition 7a. Over time, firms are likely to increase their propensity of deploying local hires in managerial positions of foreign operations. Such a propensity should be stronger for transnational firms who invest in training programs for local hires at the subsidiary level.

Proposition 7b. Over time, firms are likely to increase their propensity of deploying local hires in managerial positions of foreign operations. Such a propensity should be stronger for transnational firms who develop information systems to collect the human resource information at the subsidiary level.

CONCLUSIONS

In this paper, we develop an integrative framework explaining multinational firms' managerial staffing decisions of foreign operations in initial entry situations based on resource-based, agency, and transaction-costs theories. We posit that the staffing decision is influenced by: (1) the economic value that expatriates and local managers could potentially add to the firm; and (2) the firm's limited control over expatriates and local managers. We illustrate potential economic values that expatriates and local managers can bring to the firm and the sources of contractual concerns that a multinational firm has over international employment contracts, and we develop a set of theoretically grounded, testable propositions concerning managerial staffing decisions. In particular, the current paper indicates that sending managerial expatriates to the foreign subsidiary can improve contractual efficiencies relative to hiring local managers, in at least four ways.

First, the use of expatriates helps align the economic incentives between the headquarters and its foreign subsidiaries. Second, the headquarters knows the characteristics of expatriates better than those of local hires. The use of expatriates reduces the uncertainty of the headquarters in recruiting managers and thus

reduces the incomplete contracting problem. Third, expatriates are better equipped with firm (headquarters)-specific capabilities than local hires, thereby reducing contractual (small-numbers) problems. Fourth, expatriates have committed greater sunk cost investments in the multinational firm than local hires. These investments support their cooperative relationships with the firm and mitigate bargaining problems that potentially occur in renegotiating employment contracts. Although expatriates can potentially improve contractual efficiency and may relieve a firm's concern over its limited control on managers, expatriates may not have adequate abilities in managing local idiosyncrasy. In addition, the expatriate utilization can be expensive. The current paper has identified the conditions under which the propensity of a firm in deploying local hires in top managerial positions is likely to be higher.

Although the current paper deals with managerial staffing decisions in foreign-market entry situations, the concerns that we discussed in this paper, such as relative contributions and contractual risks of expatriates and local hires, should still be relevant to the multinational firm's selection criteria in sequential employment decisions of foreign operations. We provide important conditions under which, over time, the relative potential contributions and contractual risks of local hires and expatriates change, leading to the likelihood of the change of governance for managerial services in foreign operations.

The current paper makes several contributions to the international business and strategic management research literature. First, this paper advances the theory of international transfer of managers. Specifically, the extant research literature has presumed that expatriates can better achieve information transfer and control, and has used the factors that explain the need of information transfer and control to predict the use of expatriates. Such a presumption is dubious as expatriation is not always successful and can be very costly. The current paper replaces this presumption with more generalized, theoretically grounded concepts such as potential economic values and contractual concerns that managers bring to multinational firms. In so doing, this paper provides a missing piece to the puzzle of the theory of international managerial transfer.

Second, the existing theory of international managerial transfer, beginning with Edström and Galbraith (1977), has not yet developed a comparative context. The current paper presents an integrative framework that allows a *comparative* assessment of alternatives of human resource deployment in foreign operations.

Third, in addition to providing a richer understanding of previously posited relationships concerning expatriation, the current paper sheds new light on the factors leading to the use of expatriates and local hires. In particular, to our knowledge, our research paper is the first that introduces multinational diversity, the degree of tacit knowledge, and the time dimension as predictors of the use of expatriates.

Fourth, the current paper contributes to the research literature on control within a multinational firm by addressing how a firm can make better governance choices for managerial services *ex ante* to influence the human resource control in the foreign operations. Such a research focus has received relatively little attention in the extant research literature on human resource control.

Fifth, the current paper also sheds light on improving the efficiency of human-resource deployment. Specifically, we submit that the comparative contractual risks of expatriates and local hires may cause a multinational firm to over-rely on expatriates, even when expatriates may fall short of expectations. In line with this thesis, if the multinational firm is able to reduce the contractual costs of utilizing local hires, it can improve efficiency in human-resource utilization. Our research paper provides a detailed discussion of the sources of contractual concerns over international employment contracts. Such a discussion could serve as a starting platform for exploring how to develop mechanisms to reduce contractual concerns.

Finally, the current paper makes use of recent theoretical developments in international business and strategic management literatures – including agency theory, transaction-costs theory, and resource-based theory – to provide an integrative approach explaining a multinational firm's international staffing decisions. Such an approach will hopefully stimulate more diverse conversations about this issue, which could potentially enrich the theoretically development of human-resource management of multinational firms.

It should be noted that while the current paper provides a well-grounded analysis of the governance choice between managerial expatriates and local managers from the perspective of economic efficiency, a firm's managerial staffing decision does not depend solely on economic efficiency. Non-economic factors, such as institutional impediments, may also influence or even dominate the essences of this governance choice. Having made this boundary condition limit to applicability clear, the current paper has, nonetheless, further developed the efficiency perspective in explaining a multinational firm's international staffing decision.

The current paper has presented an integrated framework concerning international managerial transfer and has developed a set of theoretically grounded propositions that are empirically testable (i.e. that are empirically refutable). Future empirical studies can build on this framework and develop further propositions, and collect available data and test hypotheses derived from the theoretical propositions offered here. In addition, this paper has argued that the use of expatriates helps reduce the contractual problems that a multinational firm potentially faces in selecting managers for its foreign subsidiaries. However, the turnover rates of expatriates who have completed their international assignments are often high relative to domestic turnover rates. We consider the turnover

of expatriates a significant economic loss for both the multinational firm and expatriate. The concept of *mutual sunk cost commitments* developed in the current paper provides some theoretical foundations for considering how to provide better economic incentives to retain expatriates from agency and transaction-costs perspectives. We emphasize that the wise manager should both give and receive credible commitments to support economic exchange.

In terms of practitioner prescriptions, we submit that managers, following our integrative framework, are well advised to undertake a *comparative* analysis of the contractual costs and potential contributions of expatriates and local managers. Managers making such a comparative assessment should examine, among other things:

- potential economic incentive misalignment situations between the headquarters and its foreign operations;
- incomplete contracting problems;
- small-numbers conditions; and
- relative mutual sunk cost commitments.

Once again, we advise the wise manager to both *give* and *receive* credible commitments. Finally, managers evaluating the relative potential value-added contribution of expatriates and local talent should also focus on parent- and local-specific knowledge in foreign operations and the ease of obtaining this knowledge through consultants or other market mechanisms.

NOTES

1. Expatriates are non-citizens, including home country nationals (i.e. citizens of the home country of the parent company), and third-country nationals (Daniels & Radebaugh, 2001). Local hires are citizens of the countries in which they are working.

2. A number of other research studies, which do not directly deal with factors leading to the use of expatriates, have also shared the same premise (e.g. Egelhoff, 1984, 1991; Gupta & Govindarajan, 1991; Mascarenhas, 1984) in their theoretical development on issues such as control and knowledge flows in multinational firms.

3. Since our framework simultaneously considers the impact of economic value creation and organizational control on the employment decision of a multinational firm, we hold back developing propositions at this point, and we will do so later when the perspective of organizational control is introduced.

4. Hidden information can also be referred to as information asymmetry. It is a form of ex ante opportunism, while hidden action is a form of ex post opportunism. In the insurance literature, the hidden-information problem is often referred to as the adverse-selection problem (Arrow, 1985), and the hidden-action problem is often referred to as the moral-hazard problem (Holmstrom, 1979).

5. In particular, the strategic hires that we focus on in the current paper are highly likely to be involved in ill-structured strategic decisions that are not readily reduced to codifiable algorithms to be disseminated by computer systems.

6. A dramatic example would be when it is in the headquarters' interest to shut down a foreign subsidiary for rationalization (i.e. economic profitability) reasons.

7. Research has shown that many expatriates leave their firms within a few years after their return to the headquarters (Hill, 2000). We maintain that typically both multinational firms and expatriates consider the turnover a loss of their investments in the mutual relationship. The economic cost of losing a repatriated employee has been estimated to be $1.2 million (Black, Gregersen & Mendenhall, 1991).

8. It should be noted that in addition to expatriates' investments in firm-specific human capital, there might be other economic bonding mechanisms that align the economic incentives of expatriates and the headquarters. For example, expatriates could own stock or stock options of the parent firm, and could receive compensation contingent on parent performance. These economic bonding mechanisms are less likely to exist for local hires, at least upon the initial entry of a firm into a foreign market.

9. A number of authors have conjectured that the propensity of using expatriates is higher when a firm implements behavior and cultural control. Our paper provides a theoretically grounded explanation for this argument.

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