



# THE INTERNATIONAL BUSINESS CASE FOR DIVERSITY MANAGEMENT

*Programme for the Practice of Diversity Management*

Department of Immigration and Multicultural Affairs in cooperation with the  
Australian Centre for International Business

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## THE INTERNATIONAL BUSINESS CASE FOR DIVERSITY MANAGEMENT

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### PROGRAMME FOR THE PRACTICE OF DIVERSITY MANAGEMENT

The Programme for the Practice of Diversity Management is a collaborative arrangement between the Department of Immigration and Multicultural Affairs (DIMA) and the Australian Centre for International Business (ACIB) funded through DIMA's Productive Diversity Partnership Programme.

The mission of the Programme for the Practice of Diversity Management is to meet the practical needs of business by developing a business case for productive diversity, providing business models for diversity management, and creating toolkits and checklists for assessing diversity.

The Programme invites your firm to become a member of the electronic diversity network, which brings Australian business together to promote good diversity practices.

Join the diversity network on-line at [www.ecom.unimelb.edu.au/diverse/network](http://www.ecom.unimelb.edu.au/diverse/network)

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## THE INTERNATIONAL BUSINESS CASE FOR DIVERSITY MANAGEMENT

### EXECUTIVE SUMMARY

#### 1.0 INTRODUCTION

The relationship between managing workforce diversity and the development of international business capabilities is not well understood. As Australian business ventures overseas, it is faced with the challenges of doing business with people from different backgrounds. These diverse backgrounds include an array of ideologies and institutions, such as different languages, customs, belief systems, social hierarchies and business practices. These factors contribute to the complexity and uncertainty surrounding the international business environment. Organisations operating internationally must develop capabilities to navigate culturally complex environments. The skills that reside within an organisation's culturally diverse workforce are instrumental in developing such capabilities.

#### 2.0 MEASURING CULTURE: INTERNATIONAL BUSINESS IN CULTURALLY-COMPLEX ENVIRONMENTS

The literature on international business operations in culturally complex environments centres on the management of cultural difference across national boundaries. One of the greatest difficulties in assessing the impact of culture on international business is the inability to create accurate and reliable measures of culture and cultural difference. The measures of national culture that have been most widely applied in international business literature have been Hofstede's (1980, 1991, 1993) five dimensions of culture. Hofstede-type measures of culture are both too limited and potentially misleading to provide practical guides for business seeking to internationalise.

##### 2.1 [Applications of Hofstede's dimensions of culture](#)

Hofstede's five dimensions of culture have been widely applied in empirical investigations, including the relationships between culture and joint venture dissolution; levels of societal trust and the way that trust is established; financial performance; the determination of performance maximising compensation; and the appropriateness of establishing internationally standardised business procedures.

##### 2.2 [Limitations of Hofstede's dimensions of culture](#)

Despite the popularity of Hofstede's dimensions of culture, they offer an over-simplified view of national cultures, which may not be particularly useful for firms that are internationalising. Broad definitions of culture allow neither detailed nor accurate definitions of one or more specific cultures, especially where culture is defined at the level of the nation.

#### 3.0 MENTAL MODELS: A NEW THEORETICAL FRAMEWORK FOR CONCEPTUALISING INTERNATIONAL BUSINESS IN CULTURALLY-COMPLEX ENVIRONMENTS

Mental models provide a new tool for business seeking to operate in culturally complex environments. We show that mental models play a crucial role in shaping individual, organisational and inter-organisational behaviour. Harnessing mental models, which are socially learned, educationally reinforced and experientially altered, allow business to interpret the world around them in new ways. Mental models also provide insight into the operation of culturally diverse teams. Shared mental models enhance the ability of diverse group members to coordinate their activities, while divergent mental models increase the scope for conflict.

##### 3.1 [Mental models and communications](#)

Shared mental models facilitate communication between individuals, enhancing the performance of the organisation. In contrast, divergent mental models between parties impose costs on business by creating communication gaps.

### 3.2 Mental models and culture

No two individuals have exactly the same experiences and consequently, each individual has unique perceptions of the world. However, there are many shared mental models amongst people of the same ethnic, religious, linguistic and national groups.

### 3.3 Convergent mental models and the cost of operating in "foreign" markets

Shared mental models can facilitate exchange in international business by reducing uncertainty and lowering the costs of doing business. Using the firm's diverse resources to interact with parties in other countries can be a source of competitive advantage.

### 3.4 Traders, ranchers and hunters: how informal institutions work

There is evidence that informal institutions, such as norms, beliefs and business practices, promote and regulate international exchange. Where formal regulatory institutions (such as legal systems, central banks and stock exchanges) are absent or inefficient, informal mechanisms play an important role in governing business behaviour. Where firms share mental models of both the formal and informal institutional environment with their international trading partners, they are well placed to manage cultural complexity.

### 3.5 Transitional economies, formal institutions, informal rules and dealing with corruption

Australian firms are increasingly seeking business opportunities in transitional economies that lack strong formal economic institutions. Consequently, Australian business needs to understand the importance of informal institutions, including how to access local knowledge and 'decipher' complex host environments. Diversity capabilities play an important role in building such knowledge. For example, diversity capabilities enable firms to understand the complex social and political regimes surrounding "corruption" overseas and to devise strategies to protect themselves from corrupt behaviour.

### 3.6 Diversity implications for building personal relations: insights into "Asian values" and rent seeking

Individuals from particular cultural, linguistic and ethnic backgrounds may possess special capabilities in establishing personal overseas networks. Such networks are ubiquitous in Chinese business and prove particularly useful in rent-seeking economies. Mental models are a key to understanding "Asian values" and Asian business networks.

## 4.0 DIVERSITY AND FIRM INTERNATIONALISATION: HARNESSING DIVERSITY FOR GLOBALISATION

Organisations that employ and manage employees from diverse national backgrounds have a greater propensity to internationalise than organisations with relatively homogeneous workforces. Since homogeneous groups of people are more likely to be insular and domestically focused than nationally/culturally/ethnically diverse teams, organisational homogeneity is a barrier to globalisation.

### 4.1 Diversity and entry mode decisions

Firms that use their diversity to manage internationalisation increase their choices of entry modes into foreign markets, allowing firms to select across exporting, licensing, franchising, alliances, joint ventures and wholly-owned subsidiaries. This reduces the necessity of the firm having to follow fixed stages of international expansion, from exporting, to sales branches, then to production facilities. Diverse organisations also possess cross-cultural capabilities to assess partner selection, location choice and

whether to join local industry associations. Such capabilities enable diverse organisation to make better market entry decisions than homogeneous organisations.

## **5.0 EXPATRIATE MANAGERS IN CULTURALLY-COMPLEX ENVIRONMENTS: SUCCESS AND FAILURE**

Expatriate staff operate international joint ventures, alliances (including franchises and licensing) and wholly-owned subsidiaries. The ability of expatriates to navigate culturally complex environments has a significant effect on the success or failure of offshore business operations. Expatriate failure is a serious problem, which stems from the inability of expatriate managers, and their accompanying families, to understand and adapt to foreign cultures. With yearly costs of maintaining an expatriate manager ranging between \$300000 and \$500000, such failures impose considerable costs on organisations.

### **5.1 [Workforce diversity implications for the management of expatriate assignments](#)**

Effective workforce diversity management reduces the costs of appointing inappropriate expatriate managers, ensuring that expatriates are carefully selected for their cross-cultural capabilities. Such expatriates usually adjust quickly and perform effectively in their assignments.

### **5.2 [Cross-cultural training: a second best solution](#)**

Where organisations lack expatriates who share a national cultural background with host country nationals, cross-cultural training is a second best solution to problems of expatriate failure. While the cost of cross-cultural training can range between \$1500 and \$10000 for a one week course, the provision of such training reduces the chance of expatriate failure. Cross-cultural training is no substitute for using employees from diverse backgrounds.

## **6.0 DIVERSITY IMPLICATIONS FOR SMALL AND MEDIUM SIZED INTERNATIONAL BUSINESSES**

Diversity management is not only an issue for large MNEs, but also for small and medium sized enterprises (SMEs). Many SMEs are unable to afford expensive cross-cultural training programs or consultants to aid their internationalisation processes, which makes the efficient use of culturally diverse employees particularly important.

## **7.0 CONCLUSION**

Diversity management provides organisations with capabilities for managing in culturally-complex environments.

## SECTION 3

# THE INTERNATIONAL BUSINESS CASE FOR DIVERSITY MANAGEMENT

## 1.0 INTRODUCTION

The relationship between managing workforce diversity and the development of international business capabilities is not well understood. As Australian business ventures overseas, it is faced with the challenges of doing business with people from different cultural backgrounds. These diverse backgrounds include an array of ideologies and institutions, such as different languages, customs, belief systems, social hierarchies and business practices. These factors contribute to the complexity and uncertainty surrounding the international business environment. Organisations operating internationally must develop capabilities to navigate culturally complex environments and the skills that reside within an organisation's culturally diverse workforce are instrumental in developing such capabilities.

## 2.0 MEASURING CULTURE: INTERNATIONAL BUSINESS IN CULTURALLY-COMPLEX ENVIRONMENTS

The literature surrounding international business operations in culturally complex environments centres on the management of cultural difference across national boundaries. It investigates the different ways in which people from different countries manage organisations and examines the impact of these differences on international business transactions. It evaluates how culture affects international business performance, as it relates to factors such as the degree of success or failure of international joint ventures, strategic alliances, mergers and acquisitions, expatriate assignments, trust building, and parent-subsidiary relations. In general, the international business operation literature suggests that cultural differences can be highly disruptive, but if managed effectively the differences arising from culturally complex environments can be a source of organisation knowledge and learning. Since international firms cannot avoid cultural differences, the development of cross-cultural capabilities is crucial for international business success.

One of the greatest difficulties in assessing the impact of culture on international business is the inability to create accurate and reliable measures of culture and cultural difference. Culture is so dense and complicated that it eludes detailed description. However, several general definitions of culture as a concept have been established. According to Hofstede (1988) culture is "the collective programming of the mind which distinguishes one group or category of people from another." For Hofstede, this category of people is the nation. Doney *et al* (1998) defined culture as "a system of values and norms that are shared among a group of people and that when taken together constitute a design for living." They recognised that culture is not necessarily defined by national boundaries. Culture has also been defined as "a way of life, the sum total of one's philosophy, beliefs, norms, values, morals, habits, customs, art, and literature," (Ariel 1990) and as "the way a group of people solves problems and reconciles dilemmas" (Hickins 1998).

The measures of national cultures that have been most widely applied in international business literature have been Hofstede's (1980, 1991, 1993; Hofstede and Bond 1988; Hofstede *et al* 1991) five dimensions of culture:

1. Power distance - the extent to which societies emphasise differences between individuals' social power and status;
2. Uncertainty avoidance – the degree to which societies tolerate risk and uncertainty;
3. Individualism-collectivism - the relative closeness between societal members and the degree to which people are motivated by individual or societal factors;

4. Masculinity-femininity - the relative societal emphasis on assertiveness versus nurturing; and
5. Long-term/short-term orientation – the length of the time horizons to which societies tend to operate.

### **2.1 Applications of Hofstede's dimensions of culture**

The first four dimensions were derived from a comparative study of the values of managers and employees in 64 national subsidiaries of IBM and the fifth dimension was added following a Hong Kong based study of the values of students in 23 countries (Hofstede 1993). Hofstede's dimensions of culture have been widely applied in empirical investigations, including the relationships between culture and joint venture dissolution (Park and Ungson 1997), (Barkema and Vermeulen 1997); levels of societal trust and the way that trust is established (Doney, Cannon *et al.* 1998), (Strong and Weber 1998); financial performance (Gomez-Mejia and Palich 1997); the determination of performance maximising compensation (Gomez-Mejia and Welbourne 1991); and the appropriateness of establishing internationally standardised business procedures (Griffith, Hu *et al.* 2000).

Park and Ungson (1997) used Hofstede's dimensions of culture to investigate the relationship between cultural distance and joint venture (JV) dissolution involving 186 US and Japanese firms. They selected for study JVs with at least one US partner, which were started between 1979 and 1988 and observed them until September 1995. Contrary to expectations, The study found that cultural distance in general did not have a significant effect on JV dissolution. The results demonstrated that US-Japanese JVs lasted longer than US-US JVs. Park (1997) suggested that this was because prior relationships between international partners appeared to negate some of the difficulties arising from cultural distance.

Barkema and Vermeulen's (1997) study of longitudinal data about 828 foreign entries of 25 Dutch MNEs into 72 foreign countries between 1966-1994 used Hofstede's dimensions of culture to investigate which differences in national cultures are the most disruptive for international joint ventures (IJV). The study found that differences in the level of international partners' uncertainty avoidance and long-term orientation have the most significant negative impact on IJV survival. It posited that these differences also decreased the likelihood that firms would enter a foreign country through an IJV rather than a wholly-owned subsidiary. The study also found that differences in masculinity have a significant negative impact on IJV survival, but that the effect is smaller than the effects of uncertainty avoidance and long-term orientation.

Doney, Cannon *et al* (1998) applied Hofstede's dimensions of culture to consider the relationship between national culture and levels of societal trust. The paper proposed that the ways in which trust was manifested within societies was a product of cultural type. Using Hofstede's individualism/collectivism and power distance measures of culture, Strong and Weber (1998) empirically tested the notion that trust is culturally embedded. The survey findings of the 122 executives in 28 countries studied indicated that trust is not culturally embedded, but rather that it is a learned attribute that emerges with successive transactions.

Gomez-Mejia and Palich's (1997) study of the effects of cultural diversity on organisational performance also applied Hofstede's dimensions to measure culture. Return on assets and market-to-book value were used as measures of performance. The study explored data on 442 Fortune 500 firms at two points in time: January 1985 and January 1990. It found that the entry of firms into culturally distant markets had no significant effect on subsequent accounting and market measures of performance and consequently, "culture may not be as critical of a performance determinant as popular theory suggests". The researchers suggested that the difficulties of operating in culturally complex environments may be only temporary and that firms adapt to these initial difficulties over time.

While recognising that national culture is a crude basis for analysis, Gomez-Mejia and Welbourne (1991) used Hofstede's dimensions of culture to argue that MNEs should take culture into account when

designing compensation strategies. They theorised that the first four dimensions of culture could play a role in developing pay systems, contending that:

1. High power distance cultures require hierarchical compensation policies, whereby compensations is related to the individual's place in the organisational hierarchy;
2. Low power distance cultures require minimal compensation differentiation between hierarchical levels;
3. Individualist cultures will best respond to pay structures that emphasise and reward individual performance and are consistent with pay levels in comparable external firms;
4. Collectivist cultures will best respond to compensation based on group performance, in which intrinsic rewards are emphasised over extrinsic rewards and there is an emphasis on internal equity;
5. High uncertainty avoidance cultures require clearly specified and bureaucratic compensation;
6. Low uncertainty avoidance cultures require compensation that emphasises risk sharing and such compensation must match that of the organisations competitors because employees will be willing to transfer to another employer;
7. Masculine cultures will accept that tradition is an acceptable basis for determining compensation; and
8. Feminine cultures demand compensation that assures equity between the sexes.

By tailoring compensation according to national culture, Gomez-Mejia and Welbourne (1991) asserted that organisations can ensure that compensation packages will effectively motivate optimal performance.

Griffith, Hu *et al.* (2000) used Hofstede's individualist/collectivist and power distance dimensions of culture to test how culture influences the ability of organisations to effectively organise business relations with international partners. The study used survey data from 151 distributors and manufacturers in Chile, Mexico, Canada and the USA. It found that global processes of standardisation of inter- and intra-organisational relations procedures were inappropriate owing to difficulties in directly transferring relationship building and maintenance strategies to culturally distant markets.

## **2.2 Limitations of Hofstede's dimensions of culture**

cultures, which may not necessarily be particularly useful for firms that are internationalising. The credence that has been given to the five dimensions of culture seems excessive for a model purporting to broadly define national cultures that has been largely derived from the managers and employees of a single computer company. The generalisations derived from this model often appear contrary to intuition about different nations. For example, out of 40 countries studied, Australia is categorised as the second most individualistic, after the USA (Hofstede 1980: 222). How then do we account for Australia's relatively high rates of trade union membership, or the substantial charitable donations made each year by US firms? Hofstede's dimensions of culture have been applied to demonstrate both that trust is embedded, to varying degrees, according to national culture (Doney, Cannon *et al.* 1998), and contrarily that there is no significant relationship between national culture and overall societal trust (Strong and Weber 1998).

The inability of the five dimensions of culture to capture cultural complexity, means that they are only of limited use in analysing the impact of cultural complexity on international business. D'Iribarne (1996) argued that Hofstede's dimensions of culture do not represent accurate nor especially useful information. In his comparison between Hofstede's dimensions of culture and an ethnographic study of national workplace culture in France, the USA and Holland, he concluded that ethnography produces more certain and precise understandings of societies. The detailed observation of organisational "life" in ethnographic study encompasses cultural complexities that cannot be captured by survey data. He asserted that the interpretation of Hofstede's (1980) survey data is questionable. For example, the

establishment of the “uncertainty avoidance” index was constructed on the basis of three survey questions:

“Company rules should not be broken - even when the employee thinks it is in the company’s best interests. (a) strongly agree; (b) agree; (c) undecided; (d) disagree, and (e) strongly disagree.”;

“How long do you think you will continue working for this company? (a) two years at most; (b) from two to five years; (c) more than five years (but I will probably leave before I retire, and (d) until I retire.”; and

“How often do you feel nervous or tense at work? (a) I always feel this way; (b) usually; (c) sometimes; (d) seldom, and (e) I never feel this way.”

D'Iribarne (1996) challenged the ability of questions two and three to predict uncertainty avoidance. He noted, “the interpretation of the survey findings must take into account the fact that being tense or, on the contrary, being “cool” is, depending on the country, more or less a social value. A Frenchman may be proud to appear overwhelmed by the weight of his responsibilities whereas an American may take pride in appearing relaxed and a Dutchman in seeming calm”. In addition, feelings of nervousness or tension may be a manifestation of a whole range of factors and not necessarily a product of fear of uncertainty. The expression of intention to remain with the organisation for a period of five years or more (question two) may just as likely reflect the state of the labour market as an employee’s level of uncertainty avoidance. Thus, the reliability of Hofstede’s dimensions in defining national culture is subject to interpretation.

Broad definitions of culture allow neither detailed nor accurate definitions of one or more specific cultures, especially where culture is defined at the level of the nation. Definitions of culture as Australian, American, Ethiopian or Japanese cannot encompass the intricacies of their subcultures or reveal internal diversity, contradictions and complexities. As a result, the “thick description” of culture that has become popular in the field of anthropology cannot be applied in business research.

Despite the difficulties in defining national cultures and cultural distance, it is widely accepted that both formal and informal institutions, as well as the ideologies according to which people operate, vary across and within national borders and that this variation complicates the international business environment. A culturally complex environment is one in which an individual or group has difficulty deciphering the institutional and ideological frameworks according to which members of a given culture adhere. Thus, a given culture, in and of itself, is not necessarily highly complex, rather it poses challenges to outsiders who are unfamiliar with the ways in which it operates.

It has been asserted that cultural complexity impedes performance by imposing costs on international business transactions (Palich and Gomez-Mejia 1999). While cultural homogeneity allows the standardisation of business processes, cultural diversity renders global processes of standardisation as inappropriate owing to inefficiencies in directly transferring relationship building and maintenance strategies between culturally inconsistent locations (Griffith, Hu *et al.* 2000). Consequently, international business organisations must often go to considerable expense to address cultural complexity, to ensure that business practices are consistent with the diverse cultural environments in which they operate.

### **3.0 MENTAL MODELS: A NEW THEORETICAL FRAMEWORK FOR CONCEPTUALISING INTERNATIONAL BUSINESS IN CULTURALLY-COMPLEX ENVIRONMENTS**

Mental models play a crucial role in shaping individual, organisational and inter-organisational behaviour. They determine the ways in which people understand their environments, governing the type of information they receive and the ways in which they process that information (North 1990). Such models allow individuals to interpret the world around them, acting as software to process data (North 1990; Cannon-Bowers, Salas *et al.* 1993; Eggertsson 1993; Denzau and North 1994). Mental models are the internal representations that individual cognitive systems create to make sense of the external environment. These models are not necessarily stable, but are socially learned, educationally reinforced and experientially altered (Werhane 1999).

Most mental models are so deeply embedded that people do not even realise they are simply models, but believe them to be reality (Senge 1990). Humans devise overlapping sets of incomplete mental models through which they frame, order, organise and interpret the subjective data of their experiences (Werhane 1999). An individual's mental model evolves in response to the development of an architecture or series of categories that provides structure to the information arising from the individual's experiences of the physical environment and from the socio-cultural linguistic environment (Hutchins and Hazlehurst, 1992 as cited in Denzau and North 1994). Clearly, the mental representations of the world, according to which individuals operate, are usually of historical environments rather than current ones (Knight, Pearce *et al.* 1999). These mental models are path dependent, providing historically derived frameworks through which individuals can make sense of present stimuli, which are external to the mind (Starbuck and Miliken 1998).

Mental models can also operate at the group level (Weik and Roberts 1993; Denzau and North 1994; Knight, Pearce *et al.* 1999). Collective mental models are shared cognitions among group members. This refers to agreements or overlap among individual team members' mental models that do not necessarily require a deliberative consensus-seeking process. Collective mental models may emerge from shared experiences that become stored in a group's "social memory" (Ouchi, 1986 cited in Dodgson 1993). The degree to which individual mental models overlap has been termed "strategic consensus" (Knight, Pearce *et al.* 1999). Strategic consensus enhances the ability of group members to coordinate their activities and facilitates collaborative decision-making processes by reducing friction between group members (Cannon-Bowers, Salas *et al.* 1993). Equally, where individual mental models of group members are significantly divergent, there is greater scope for behavioural conflict.

### **3.1 Mental models and communications**

Shared mental models facilitate communication between individuals. Human communication is conducted largely (but not exclusively) through the imperfect tool of formalised language (Appleby, Hunt *et al.* 1994). Communication of an idea from one individual to another requires the first individual to encode the idea in language and transmit it to the second individual, who must then decode the message and form her own perceptions of the original idea. Such communicative accuracy is limited because factors influencing ideas and decisions are often derived from tacit knowledge, which is of a personal nature and is inherently difficult to codify and communicate (Polanyi 1966). Individuals are more likely to be able to encode and decode their internal ideas into a shared language, and are thus more likely to be able to effectively communicate, when they share common features in their mental models (Denzau and North 1994). For example, where two individuals both analyse received information through the application of a radical feminist meta-narrative, the use of the term 'masculine' would contain implicit meanings, such as associations with aggression, dominance, exploitation and patriarchy. When they communicate with a third individual whose mental models were not shaped by radical feminist discourse, the term 'masculine' might hold different meanings, such as strength, bravery and chivalry. In short, efficient communication of meanings can be enhanced by shared mental models and be limited by divergent mental models. This does not mean that effective communication cannot flow between individuals and groups with divergent mental models. Rather, in such cases, communicators must invest greater effort in ensuring that their ideas are transmitted and accurately.

According to Casson (1995), successful business coordination depends on intelligible and reliable flows of information, which requires a common language and compatible communication equipment. The compatibility of communication equipment may be enhanced by convergence of mental models between individuals and groups. Indeed, psychological laboratory experiments indicate that people recall longer lists of words, interpret ambiguous stimuli more accurately and retrieve information about a story they have heard more effectively when these information flows are relevant to pre-existing mental structures (Sedikides and Skowronski, 1993 cited in DiMaggio 1997). In contrast, there is considerable scope for conflict where the internal logics of multiple parties' mental models diverge or clash. An example of incompatible mental models is that of a wife who views her household labour through a

'marketplace' interpretive framework while her husband views the same situation through a mental model of 'family' that emphasises the concept of selfless service (DiMaggio 1997).

Divergent mental models between parties to exchange impose costs on business. Where mental models diverge or clash, firms must invest in infrastructure to address communicative gaps. Such mechanisms monitor communications to avoid misunderstandings and reduce the uncertainties in interactions with foreign nationals. Firms bridge communicative gaps by employing translators, cross-cultural consultants and intermediary bodies. They invest considerable time and resources to make explicit, tacit understandings that exist between parties with convergent mental models.

### ***3.2 Mental models and culture***

Culture plays an important role in shaping individuals' mental models. As Hayek (1979) and Buchanan (1994: 125) have observed "persons may abide by codes of conduct or personal rules of behavior that have emerged over a long period of cultural evolution, a process that is neither understood by those who are affected nor directed by anyone's intent". The primary locus of culture resides within an individual's cognitive schema (Talmy 1995). Culture can be interpreted as a cognitive phenomenon, moving away from, often over-simplistic, latent values concepts (Hofstede 1980), towards more complex interpretations of culture that can account for subtle ontological variations and nuances between individuals within more crudely defined cultural groups (Sullivan and Weaver 2000). No two individuals have exactly the same experiences and consequently, each individual has unique cultural perceptions of the world (Denzau and North 1994). However, when individuals identify with a group, their cognitive culture system directs their attention towards patterns of behaviour exhibited by other group members, which they then emulate (DiMaggio 1997). Consequently, universal cultural patterns emerge as groups of individuals establish overlapping cognitive frameworks or mental models.

Despite the myriad of differences between individuals, there are many shared mental models amongst people of the same ethnic, religious, linguistic and national groups. This is not to suggest that individuals experience an external and fixed culture derived from ethnic, religious, linguistic or national affiliations. The hypothetical wife and husband mentioned above could easily belong to the same religion, nation, and ethnic and linguistic group, yet there remained significant divergence in their mental model of the wife's household labour. Rather, strategic consensus can, but does not necessarily, emerge from common cultural backgrounds of exposure to many of the same ideologies and institutions. Equally, individuals who have been exposed to vastly different ideologies and institutions will form divergent mental models to interpret their environment (Denzau and North 1994).

### ***3.3 Convergent mental models and transaction cost implications: lessons for operating in "foreign" markets***

Shared mental models within cohesive cultures can facilitate exchange in international business by reducing uncertainty and lowering transaction costs. Exchange in business involves the transfer of property rights to goods and services from one individual or organisation to another. Transaction costs are costs of exchanging, monitoring and enforcing the exchange of these property rights. Transaction costs include the costs of obtaining the information necessary to measure the valuable attributes of what is being exchanged and the conditions surrounding the exchange, including the behavioural profiles of all parties. In a given exchange, transaction costs encompass the costs of seeking a partner for exchange, negotiating the terms of exchange and then monitoring and enforcing the exchange.

Institutions, or 'rules of the game', facilitate exchange. Institutions, which may be formal or informal, provide structures for human activity and reduce uncertainty by providing guidelines for human behaviour through defining and limiting the set of choices available to individuals (North 1990). Formal institutions include laws and regulations defining the exchange environment. Culture is an informal institution that determines conventions, norms and codes of behaviour and encompasses taboos,

customs and traditions, providing the 'incentive set' for guiding individual and organisational behaviour. Both formal and informal institutions reflect the evolving mental models of those who create and maintain them (Denzau and North 1994). In a culturally cohesive environment, for example, transaction costs are reduced when convergent mental models between parties facilitate exchange. Given that all parties are familiar with the cultural norms that shape the exchange environment, there is minimal scope for confusion in defining appropriate behaviour. This is particularly important where there is a lack of strong formal institutions, such as a legal or regulatory system, to regulate exchange.

### ***3.4 Traders, ranchers and hunters: how informal institutions work***

The importance of informal institutions is illustrated by Greif's (1989) study of 11<sup>th</sup> century Maghribi traders, which revealed how informal institutions replaced inadequate formal institutions to regulate trading. The Maghribi traders were largely middle class Jewish traders who emigrated from the Abbasid caliphate to North Africa, in the first half of the tenth century. They managed the uncertainty and complexity of trade by operating through an institution of peer organisation known as coalitions. Coalition relations were governed by an implicit contract that each coalition merchant would employ only member agents, at an optimal premium. In addition, coalition merchants agreed never to employ an agent who cheated while operating for a coalition member. Furthermore, if any agent who had been caught cheating were to operate as a merchant, any agent who cheated this individual would not be considered by the coalition to have cheated. Honest trading amongst the Maghribi traders was enforced via a reputation mechanism that determined that the benefits of coalition membership exceeded any incentives to cheat. Consequently, the traders succeeded in minimising transaction costs by reducing the uncertainty as to the behavioural profiles of agents and the necessary wage premium to keep them honest.

Similarly, Ellickson's (1994) theory of norms demonstrated that informal institutions (or norms) can be more important than formal institutions in regulating human interaction. His investigation of the resolution of cattle trespass disputes in Shasta County, California, revealed that the existence or non-existence of legal rules to resolve trespass disputes had no effect on actual dispute outcomes. Rather than relying on the legal system to settle disputes, they were settled according to an informal system of norms. In the event of damage caused to the property of one neighbour by the trespass of cattle of another, the parties resolved the dispute informally, with the offending party offering some form of compensation, such as repairing the damage. This is consistent with the Coase Theorem, developed in Ronald Coase's seminal paper 'The Problem of Social Cost', which posits that dispute resolution can be conducted more economically efficiently through informal arrangements than via external regulations (Coase 1960). Ellickson argued that members of 'close-knit groups' are capable of forming cooperative and cost minimising outcomes to disputes without recourse to external institutions, such as the law. The norms of the region were such that it was important to behave as a 'good neighbour.' There was a sense that those who did not adhere to this norm would face sanctions: they may be ostracised by the community or others may feel justified in sabotaging their property. The threat of these sanctions served as an effective enforcement mechanism to ensure that ranchers adhered to the informal norm of 'good neighbourliness'. This norm was considered more important than legal regulations governing cattle trespass. Indeed, resorting to legal remedies to resolve disputes was considered by ranchers to imply a lack of trust and, hence, inconsistent with the prevailing norms.

Norms can explain what may appear to outsiders to be irrational or inefficient economic behaviour. McManus' (1972) analysis of the fur trade in North America since the late sixteenth century explained the seemingly irrational behaviour of Indians involved in the trade. The Indians, who had exclusive marketing rights to the furs of beavers on their land, allowed the depletion of beaver populations, even though beaver furs were a major source of ongoing income. While the formal institutional arrangements suggested that it would be economically rational for Indians to harvest the furs of some beavers, while conserving the remainder for future returns, the Indians were bound by the informal 'Good Samaritan' constraint. Just as Ellickson's (1994) norm of 'good neighbourliness' governed dispute resolution in Shasta County, the 'Good Samaritan' constraint regulated fur harvesting in regions of Canada. The

'Good Samaritan' constraint meant that Indians could not deny access to their resources to other Indians "in need" of these resources for non-commercial purposes. In an environment in which it was not uncommon for families to starve over the winter months, withholding goods from others would be expensive for individuals who could reasonably expect to find themselves in need in the future. In the absence of formal institutions to ensure a reliable food supply, the 'Good Samaritan' constraint was enforced. During the summer months, hunters would shirk owing to their right under the 'Good Samaritan' constraint to make claims on the resources of others. During the winter months, families were isolated from each other by the harsh weather and the costs of shirking rose; the hunter who shirked would also starve. In addition, the isolation meant that individuals could hunt beavers without fear that their harvest would be appropriated by others in need. This led to rampant harvesting in the winter months, depleting beaver populations and restricting future returns from the fur trade.

McManus' examination of the Indian fur trade, Ellickson's theory of norms and Greif's analysis of Maghribi trader coalitions, reveal the importance of informal institutions to promote and regulate exchange. Where formal regulatory institutions are absent or inefficient relative to informal mechanisms, the informal institutions play a more important role in governing human behaviour. Yet, not all parties to a cross-cultural exchange may be familiar with informal institutions that govern economic relationships. For example, a rancher who has newly arrived in Shasta County may not be acquainted with the norm of 'good neighbourliness' and pursue formal legal proceedings if her property were damaged by the trespass of her neighbour's cattle. The new rancher has a divergent mental model of the situation from the dominant model in the region. She views the situation as a matter for legal resolution, while those belonging to the dominant regional culture have modelled the situation differently. Her unwitting violation of cultural norms may result in excessive costs, not only incurred from the legal process itself, but also through damage to neighbourly relations.

For organisations operating internationally, those in cultural environments similar to dominant cultures in the parent country, will encounter relatively minimal mental model gaps when dealing with host country nationals. The mental models of both parties will have been shaped by many similar cultural experiences. The consequent overlap of mental models will facilitate the process of encoding, transmitting and decoding communications across national boundaries and reduce the level of uncertainty in exchange. Indeed, there is a strong case that organisations manage international business units more efficiently when they operate in countries with similar national cultures (Palich and Gomez-Mejia 1999). In short, transaction costs are minimised within relatively culturally homogeneous environments because the mental models of parties to exchange result in convergent mental models of the institutional environment that determines appropriate behaviour. In addition, where formal institutions are lacking, informal institutions can more easily regulate exchange when parties have relatively convergent mental models of such institutions.

Just as shared mental models derived from cultural proximity can lower international business transaction costs, divergent mental models derived from cultural distance can raise them. Divergent mental models can limit effective communications. When international business involves interactions between persons of diverse cultural and linguistic backgrounds, there is considerable scope for communication gaps. For example, what may be considered culturally acceptable gift giving in one cultural context, may be modelled as bribery in another. Since cultural diversity in international business is unavoidable, parties to exchange must develop mechanisms to bridge such gaps. Such mechanisms involve costs, for example the employment of interpreters and cross-cultural training. Even so, interpreters and cross-cultural training may result in errors or missed opportunities. Language barriers are not necessarily ameliorated via interpreters, given the importance of nuances and idiomatic speech. Cross-cultural training for expatriates will not be a substitute for an upbringing in the host country. The mental models of a national involves a much deeper understanding of cultural norms and mores that cannot be transferred through a short training course or even prolonged periods as an expatriate manager. Values, beliefs and routines that individual internalise during early formative stages of human development significantly influence the way that they will later construct reality (Calori, Lubatkin *et al.* 1997). Clearly, individuals who have had their mental models shaped by the same

formal and informal institutions and experiences as their international business partner have an edge over those who are later trained in cross-cultural skills, language and etiquette.

### ***3.5 Transitional economies, formal institutions, informal rules and dealing with corruption***

Formal institutional weakness, combined with governance by norms, has important ramifications for Australian MNEs. Managers need to understand the importance of informal institutions and access local knowledge to 'decipher' complex host environments. When Australian firms enter new foreign markets, they are disadvantaged relative to domestic companies owing to inferior knowledge of host country political, economic and social institutions and organisations. They face costs of learning 'how things are done' that carry implications for their competitiveness and ability to write enforceable, incomplete contracts in the host country. As an outsider, the Australian firm's participation in local commercial networks may be constrained. The studies of traders, ranchers and hunters already discussed demonstrate the importance of non-legal sanctions within business communities or commercial networks. By identifying and ostracising agents who breach informal 'rules of the game', such networks facilitate incomplete contracting by decreasing the transaction costs for participants (Williamson 1985; Greif 1993). Australian firms need to understand and possess clear mental models of the informal 'rules' if they are to succeed in the 'game' and avoid informally enforced sanctions.

MNEs expand the scope of their activities to new locations because they perceive opportunities to earn rents from firm-specific assets. Increasingly, such opportunities are identified in transitional economies, which often lack strong formal economic institutions. To extract returns, firms must be able to define and enforce their property rights in firm specific assets, an ability that is determined by the institutional environment. When designing contracts, firms seek to protect and maximise the rents on their assets from opportunistic behaviour by agents, whether joint venture partners, subsidiary heads, foreign licensees or the state. As more and more Australian firms enter transitional economies, they are often faced with institutional frameworks that are unstable and ill-defined. Weak economic institutions magnify the difficulties for Australian business of designing appropriate incentive and monitoring devices in contracts between the firm and its agents.

Failure to understand norms in environments with weak formal economic institutions can seriously erode rent streams. The manipulation of property entitlements through the aegis of the state represents one of the greatest threats to rents on firm-specific assets. Subject to international agreements and the constraining influence of reputation, the principle of sovereignty endows the state with many degrees of freedom when defining, allocating and enforcing rights to wealth-creating assets. A wide range of manipulations is available to the state to erode the competitiveness of foreign firms, including tax and tariff rate changes, blocked profit remittance, forced renegotiation of government contracts, and, at the extreme, expropriation. Manipulations of the investment environment also occur through less visible means, such as selective enforcement of environmental and workplace safety regulations, and delays in the issue of expatriate visas and import licenses. The state may re-define or re-allocate a MNE's property rights to fulfil its responsibilities to the greater public good, or through corruption of office, for the private gain of sectional domestic interest groups.

Problems arise for MNEs when they over emphasise formal institutions and neglect the importance of informal mechanisms. Such failure to understand the critical role of informal institutions, particularly in transitional economies, can produce serious misconceptions of the environment in which MNEs operate. A 1995 survey of Australian companies engaged in markets in India, Indonesia and Vietnam found that managers of Indian investments overestimated the institutional proximity of India and Australia by placing undue emphasis on the formal, rather than informal, 'rules of the game' (Maitland 2000). The study demonstrated that India's British colonial past was a strong attraction for Australian companies; on the surface, India and Australia appeared institutionally similar. As former British colonies, they have inherited bicameral, elected governments, and independent, unbiased and competent High Courts, overseeing the administration of legal frameworks based on the British system

of common law (precedent). In addition, English language facility in India is widespread, particularly as the language of commerce. Under the impression that India 'looked like' Australia, Australian companies relied on legal incentive devices rather than relational norms, encountering a high level of dispute. Australian managers also did not favour JVs, acquisitions and non-equity alliances as methods for investing in India. Critically, negligible host country experience and their reluctance to seek access to the skills of local companies compounded their institutional ignorance. India represented the epitome of state manipulation of the investment environment. The political system, although democratic and sharing structural similarities to Australia's, was subject to extraordinary levels of successful rent-seeking by domestic groups, posing significant barriers to foreign entrants. The design of contracts, assessments of institutional proximity and risk reveal Australian managers were ignorant of the informal norms structuring economic activity in India. The results were poor contract design in India and corresponding disappointment with the performance of contracts.

Diversity capabilities of Australian companies can play a crucial role in building knowledge of informal institutional environments. The political know-how of well informed managers with a host country background, which may range from lobbying capabilities and knowledge of routinised processes for applying political pressure, to highly nuanced knowledge of when a 'word in the right ear' is appropriate, can be effectively exploited by the firm. Such capabilities prevent false mental models of institutional proximity, where easily observable formal institutions exhibit common characteristics with the parent country, but the informal norms diverge. Managers will share with domestic companies in the host country, a similar set of mental models of the formal and informal institutional environment. With a more coherent understanding of the 'rules of the game', foreign 'players' are better placed to devise sound strategic 'game plans'.

Diversity capabilities can also assist firms in understanding corruption in foreign environments. Corrupt behaviour, defined as the abuse of public office for private gain, occurs informally. Corruption is a re-assignment of property rights through the aegis of state sovereignty and involves two types: 'greasing the wheel', including bribes to speed or gain a government permit; and 'theft by stealth', where bribes are paid to re-assign rights to select interests. In Type I corruption ('greasing the wheel'), the individual or organisation paying the bribe 'agrees' to a partial rights transfer to the public official. The bribe represents the transfer of part of the income stream (rent) on the asset or assets the individual seeks to exploit but is prevented from doing so by some aspect of government regulation. Type II corruption ('theft by stealth') is far more insidious, incorporating the payment of bribes to achieve the transfer of full or partial rights from the initial owner *without* their consent. Such rights re-assignment falls into three sub-categories: (a) the transfer of private property rights to new private owner(s); (b) re-assignment from public to private ownership; and (c) from private to 'public' ownership.

Corruption is often a problem where the development of the institutional framework lags the sophistication of the capital stock and where the state is a key holder of ownership rights. These are typical characteristics of transitional economies, in which the system of property rights is not adequately supported by legislation and state enforcement, for example, through institutions such as bankruptcy and intellectual property. In such cases, much of the definition, allocation and enforcement of entitlements within the country are left to administrative and, frequently *ad hoc*, decision-making. Foreign firms may find that they continuously need to 'grease the wheel' to obtain relevant licenses and permits for business operations, eating into their rent streams. Type II corruption can be even more damaging. For example, in articles published four years apart, *The Economist* has twice reported the availability of "neatly-bound" photocopies for foreign firms' business proposals, first in a single bookshop in Hanoi and later, throughout Vietnam (1995; 1999: p48). In such cases, the transfer of rights from the foreign firms is twofold: firstly, having made payment to corrupt official(s) to leak copies of confidential business proposals, the bookseller profits from the sale of the firm's intellectual and, potentially, technological property embodied in the proposals; while, secondly, buyers of the proposals can potentially erode the rent stream on the foreign firm's exploitation of its distinctive resources and capabilities by establishing activities in competition based on the 'revealed' know-how.

Diversity capabilities enable firms to understand the nature of corruption that they might face in a given location. Once firms are aware of how corruption manifests in the business environment, they can implement appropriate strategies to manage corruption. They need to understand the hidden costs of Type I systems and decide whether to 'grease the wheel' or face informal sanctions from public officials, such as delayed processing of permits and excessive red tape. Where firms in Type I environments lack capabilities in 'greasing the wheel', they may select a host country partner that possesses such capabilities. Diversity capabilities can also be employed to gain insights into possible Type II corruption. Culturally-skilled employees may be able to identify the firm's points of vulnerability. For example, in transitional economies that have been historically hostile towards foreign business, Australian firms may risk theft of their intellectual property. Harnessed with such knowledge, firms can take action to protect their property rights. They may limit technology transfers to older technologies and withhold newer innovations; restrict production to the parent, or a third, country and import finished products; or even decide to avoid investing in a given location. Diversity capabilities provide firms with valuable mental models of the possible corruption risks of foreign institutional environments, enabling strategy formulation to protect their property rights.

### ***3.6 Diversity implications for building personal relations: insights into "Asian values" and rent-seeking***

Similarity/attraction theory suggests that convergent mental models may foster the establishment of interpersonal relations. Individuals who share experiences and values have a propensity to like each other because their similarity reinforces their existing attitudes and beliefs, boosting their self-esteem (Hogg and Abrams 1988; Hogg and McGarty 1990). Similar individuals are likely to form favourable impressions of each other, enhancing the potential to establish strong interpersonal relationships. Through consistent and reliable interactions within these relationships, parties establish reputation-based trustworthiness (Parkhe 1998). The establishment of good interpersonal relationships and effective communications has been identified as critical in maintaining the necessary trust between partners to facilitate ongoing exchange (Dodgson 1993; Ashmalla 1998). Diverse organisations are more likely than homogeneous organisations to have members who are similar to foreign clients and partners. These members can be utilised as a resource with special capabilities in establishing trust-based interpersonal relationships. For example, the US company Litton Industries was having problems running its Scottish subsidiary. In 1991, it appointed a Scottish American, George Black, to head the subsidiary. He introduced "textbook American management practices" such as pay-for-knowledge, greater individual accountability and market directed strategies. Litton Industries had tried previously to introduce such practices, but they had been met with local resistance. They believe that Black was successful because he was of Scottish origin and consequently not seen as a "plague from America" (Hickins 1998). Black's cultural similarity to the subsidiary employees, facilitated his foreign assignment.

Individuals from particular cultural, linguistic and ethnic backgrounds may possess special capabilities in establishing personal overseas networks. Personal relations amongst ethnic Han Chinese, known as *guanxi*, play a crucial role in business. While personal connections play a role in business all over the world, the concept of *guanxi* is ubiquitous in Chinese business both in the PRC and abroad (Tsang 1998; Lockett 1987; Yang 1994). It is based on personal bonds between individuals, such as kinship; place of birth, education, and employment; friendship and other ties connecting individuals (Tuan and Ryan 2000). It involves reciprocal obligation to respond to requests for assistance. Through repeated exchange of favours, trust is developed and *guanxi* strengthened. *Guanxi* is mobile and can be transferred between individuals and from individuals to organisations.

It is the role of the firm's HR department to harness the *guanxi* possessed by its members. *Guanxi* is almost an exclusively ethnic-Chinese phenomenon that depends upon a level of competency in Chinese language, which is very difficult for non-native speakers to achieve (Tsang 1998). Even with years of study and travel, it is rarely possible for non-Chinese people to become Chinese. Foreign firms

operating in a Chinese economy may gain favourable outcomes if they can access the *guanxi* of their Chinese employees.

Personal connections, regardless of country of operation or ethnicity, may have positive organisational outcomes for international businesses. Personal connections can be particularly important in rent-seeking economies. In her pioneering study of rent-seeking, Krueger (1974) argued that when quantitative restrictions are imposed on trade, the restricted item becomes a valuable commodity for which organisations will devote resources to obtain. Government restrictions give rise to a variety of rents for which organisations and individuals compete and, in the process, dedicate resources to enhance their competitiveness. Rent-seeking may take a variety of forms, both legal – competitive tendering – and illegal – bribery, corruption and smuggling. The source of rents may be equally diverse, encompassing licenses, permits, special loans and credit facilities, subsidies, discounted privatisations and contracts (Gomez and Jomo 1997). In effect, individuals and organisations may seek to extract rents from any resource that is scarce and valuable. Personal connections may play an important role in an organisation's rent-seeking capabilities. For example, in preparation for the Hong Kong change-over to Chinese sovereignty in 1997, some large Hong Kong companies began to employ the children of senior Chinese officials involved in the hand-over so that they could extract rents under the new ruling regime (Tsang 1998).

For organisations operating in culturally-complex international environments, a diverse workforce increases the likelihood both of convergent mental models and personal connections between organisation members and overseas partners, customers, suppliers and regulatory bodies. In venturing overseas, a firm leveraging the diverse mental models of its workforce is well placed to build international relations and facilitate cross-cultural exchange.

#### 4.0 DIVERSITY AND FIRM INTERNATIONALISATION: HARNESSING DIVERSITY FOR GLOBALISATION

Organisations that employ and manage employees from diverse national backgrounds have a greater propensity to internationalise than organisations with relatively homogeneous workforces. When firms seek to expand internationally, they usually created top management teams to consider market choice and entry mode. There is evidence that diverse teams identify a greater number of solutions to problems and these solutions are more creative than those of homogeneous teams (Palich and Gomez-Mejia 1999; Cox and Blake 1991; Robinson and Dechant 1997). A 1999 Canadian study of 152 undergraduate and MBA students of international business explored the relationship between national diversity and international expansion decisions (Punnett and Clemens 1999). The students were formed into 15 nationally diverse and 23 nationally homogeneous teams of four members each, with Canadian or non-Canadian nationality being loosely defined by place of birth, number of years spent in Canada, language spoken at home, and self-identification. With the exception of one US team, all the other nationally homogeneous teams were comprised of Canadians. The teams were presented with a case study of a company seeking new markets. The study found that diverse teams, while they took longer to reach decisions, were more likely to prioritise internationalisation than the homogeneous teams, which tended to prioritise domestic expansion. In addition, diverse teams considered a greater range of international expansion options than the homogeneous teams. The study concluded that nationally diverse teams are more likely to be internationally oriented than homogeneous teams.

Since homogeneous groups of people are more likely to be insular and domestically focused than nationally/culturally/ethnically diverse teams, organisational homogeneity may result in missed opportunities to globalise. Diverse organisations are more likely than their homogeneous counterparts to realise that business does not stop at national borders. They are better positioned to exploit new emerging markets overseas. Even when homogeneous organisations do venture overseas, they often prioritise entry into countries perceived to be culturally similar. For homogeneous firms, culturally distant markets are seen as having high degrees of uncertainty (Davidson 1980; Erramilli 1991). The uncertainty of overseas markets is consistent with what Vernon (1966) called the "gradual fanning out from geographically and culturally familiar to the geographically and culturally remote areas of the

world". This uncertainty can be ameliorated by productively exploiting the firm's diversity capabilities. When organisations employ, promote and value the skills of people from diverse national backgrounds, overseas environments become less uncertain and more familiar, offering organisations a greater choice of internationalisation destinations.

#### *4.1 Diversity and entry mode decisions*

Organisational diversity also impacts upon the range of potential entry choices. Internationalising organisations enter foreign markets via a variety of entry forms that include exporting, intermediate arrangements (such as licensing and franchising) and equity forms (including wholly owned subsidiaries and IJVs). Equity form options also include mergers and acquisitions and greenfield investments. When organisations internationalise, they consider the costs of pursuing each of these options, with varying degrees of management responsibility and control. Eramilli (1991) found that while US service firms displayed a preference for full control methods, such as wholly-owned subsidiaries, this preference declined with perceptions of cultural distance. Without the know-how to operate in culturally distant markets, the firms sought out partners, relinquishing some management control.

Kogut and Singh (1988), Davidson (1980) and Gatignon and Anderson (1988) found similar results for manufacturing firms. Gatignon and Anderson (1988) discovered that US MNEs preferred wholly owned subsidiaries over shared ownership when the firm was more experienced, R&D and advertising intensive and faced low country risk. Cultural distance was a central obstacle to entering new markets, forcing firms to select IJVs over wholly-owned subsidiaries. Kogut and Singh (1988), investigated Wilson's (1980) finding that nationality of MNE mattered in the choice of entry into foreign markets. Combining Hofstede's four original dimensions into a uni-dimensional index of culture distances, Kogut and Singh (1988) measured the effect of cultural distance between the home and host country on the entry choices of IJVs, M&A and greenfield investments. Using US Department of Commerce data on 506 entry modes into the US for 1976-1983, Kogut and Singh (1988), found that cultural distance and national attitudes to uncertainty influenced the choice of mode, while controlling for industry and firm effects. IJVs were selected when cultural distance was perceived to be large. Kogut and Singh (1988), related cultural distance to the high management costs of integrating different work practices, which favoured IJVs over acquisitions.

Using data on Japanese subsidiaries in the US, Hennart (1991) (see also Hennart and Reddy 1993; Hennart and Park 1993) undertook a number of empirical tests of explicit country entry models. Hennart (1991) concluded that Japanese MNEs were driven by the same general factors as their American counterparts in their investment strategies, including cultural distance. Using longitudinal data on 828 IJVs and wholly-owned subsidiaries of 25 Dutch MNEs between 1966 and 1994, Barkema and Vermeulen (1997) tested the impact of cultural distance on mode choice. Confirming much of the research by Erramilli (1991), Kogut and Singh (1988), and Gatignon and Anderson (1988), Barkema and Vermeulen (1997) found that IJVs increased with cultural distance, but that transaction costs, industry factors and firm-specific factors (such as size and level of technology) also impacted on mode choice.

In a rational choice model, Benito and Grisprud (1992) played down the importance of national culture in their study of Norwegian firms. In an analysis of a database of 201 cases representing investments undertaken by 93 Norwegian companies from 1910 to 1982, they found that Norwegian firms did not make initial investments in foreign markets close to Norway and at a later stage spread to more distant markets. Rational choice, not culture, was the dominant explanation for the choice of entry mode. While Benito and Grisprud (1992) found no general pattern of cultural learning, they did speculate that industry type was an important variable. If firms sought cheap labour markets, then there were no countries "culturally" close to Norway in which to invest. They concluded that culture was not unimportant in the investment decision, but that other factors dominated. Jemison and Sitkin (1986) were more sceptical of the rational choice model. They noted the high failure rates of M&As, and identified impediments to the successful integration of acquirer and acquired. These impediments were related to cultural factors,

where highly sporadic M&As confronting senior managers with ambiguities and subtleties for which rational decision-making made them unprepared. Managing cultural diversity at home provides experience required to integrate M&As overseas.

International experience and learning variables are important in the stages model, which provides the earliest conceptualisation of motivations for the timing of market entry. Johanson and Vahlne (1977) and Luostarinen (1977) initiated the stages approach, identifying sequential step models of overseas involvement. Based on case study evidence from Swedish steel, engineering, and pulp and paper companies, Johanson and Vahlne (1977) explained the internationalisation of MNEs in terms of incremental increases in market-specific knowledge and experience, and increased resource commitment to foreign markets. Archival work has uncovered similar patterns. For example, pre-1939 British MNEs switched from agency contracts to sales branches as foreign location information and market sales volumes grew (Nicholas 1983; Wilkins 1974).

There is contradictory evidence on whether MNEs routinely pass sequentially through the stages from exporting to production plants (Newbould, P. *et al.* 1978; Bureau of Industry Economics 1984; Millington and Bayliss 1990; Kwon and Hu 1995). For example, Hedlund and Kverneland (Hedlund and A. 1985) found that 44% of Swedish firms investing in Japan went from agents to production, without passing through intermediate stages. In a study of 38 Canadian firms, with 121 form changes, Calof and Beamish (Calof and Beamish 1995) found that only 52% were single-step incremental stages.

Recently, Andersson, Johanson, and Vahlne (1997) placed acquisition within the stages model. Acquisition behaviour was described as organic, building on the knowledge and relationships of previous involvement in an incremental fashion. Key variables in the acquisition process included the experiences shared between acquirer and acquired, and the acquirer's psychic distance, measured as the scope and depth of the acquirer's international experience. Andersson and Svensson's (1994) results were consistent with Caves and Mehra's (1986) argument that experience in routinised processes of expanding internationally encouraged acquisitions.

The effective management of diversity can increase the choices of viable entry modes into foreign markets and reduce dependence on a stages model of international expansion. Well managed diverse organisations may possess capabilities in coping with difference that their relatively homogeneous counterparts lack (Fujimoto, Hartel *et al.* 2000). They may perceive overseas destinations as 'less foreign' than do homogeneous organisations. Consequently, they may not believe that IJVs are their only viable choice of equity based entry mode into overseas markets that are perceived as 'different'. With the necessary know-how for working in culturally diverse environments, such organisations may be better positioned to choose to enter new markets via modes that offer greater management control, such as wholly owned subsidiaries.

Diverse organisations can also make better entry mode decisions than homogeneous organisations. Poor entry mode decisions are a significant cause of foreign venture failure (Lane and Beamish 1990). The use of managers with knowledge of culturally distant markets reduces the costs of evaluating, entering and operating in unfamiliar environments. It may also facilitate a greater depth of knowledge and understanding of the implications of selecting any given entry mode. Cross-cultural capabilities that emerge from well managed productive diversity will enable management teams to better assess the problems they face in the internationalisation process, such as problems in partner selection, location selection and whether to join local industry associations. The solutions will also be more innovative. Equally, the creative decision making that can emerge from productive diversity facilitates decisions about the nature of the products/services that organisations are going to market overseas.

## 5.0 EXPATRIATE MANAGERS IN CULTURALLY-COMPLEX ENVIRONMENTS: SUCCESS AND FAILURE

Expatriate staff operate IJVs, alliances (including franchises and licensing) and wholly-owned subsidiaries. Managers, with and without cross-cultural know-how, control and monitor expatriate staff

and form teams to oversee international operations. Differences in national cultures and managers' perceptions of these differences will be important variables in the management of international alliances and ventures. The operation of overseas activities in all countries, but especially developing and transitional economies, require the preparation of executives who understand and can effectively function in multicultural environments and multicultural subsidiaries and alliances. Given the high incidence of Australian investment in Asia, cultural differences between Australia and emerging economies pose special challenges to Australian business. The recruitment, selection, compensation and training of expatriate staff is an important field in international human resource management. Much of the focus is on the ability of expatriate staff to adapt and function effectively in another culture. While many senior managers will not be posted overseas, they will operate in multicultural teams, particularly in IJVs and international strategic partnerships and monitor culturally diverse subsidiaries and employees. They will also deal with governments, politicians and institutions that operate differently from those in Australia.

The ability of managers to navigate culturally complex environments can have significant effects on the success or failure of offshore business operations. The international business literature shows that the inability of expatriate managers and their accompanying families to understand and adapt to foreign cultures is a major cause of international strategic alliance and joint venture failure (Hickins 1998; Fish and Wood 1994; Lake 1995; Lane, 1995; Tung 1982). According to Lane (1995: 100), "a successful joint venture relationship is a stable, healthy, and profitable business relationship based on cooperation and two-way communication that meets the needs of both partners over the long term". The establishment and maintenance of this relationship is largely a role for expatriate and host country managers.

The maintenance of expatriates overseas can pose considerable costs for organisations. Gomez-Mejia (1991) contended that in 1991, the cost of maintaining a expatriate exceeded US\$250000 per year. In 1992, Wederspahn (1992) stated that for a US expatriate with a salary of US\$100000, additional costs of housing, home leave, a company car, air fares, moving allowances, foreign service premiums, and schooling can easily total over US\$300000 per year for relocation to a London assignment. A rough rule of thumb for calculating the yearly cost of an expatriate manager, is expatriate salary multiplied by four. In addition, there are indirect costs.

The indirect costs include a period of reduced productivity while the expatriate adjusts to foreign surroundings. In a study of 409, mostly North American, expatriates who had worked in Europe, Australia, New Zealand, East and Southeast Asia, the Middle East, North America, Latin America, South America and Africa, Tung (1988) found that 22.3 percent took one to three months to feel comfortable in their foreign postings; 25.3 percent took four to six months; 33.7 percent took six to twelve months; and 5.2 percent never felt comfortable. Clearly, it is desirable for expatriates to adjust to their new environments as quickly as possible and consequently, the international business literature on expatriates calls on MNEs to invest in cross-cultural training to address this issue (Ashmalla 1998; Canen 1999; Fish and Wood 1994; Hickins 1998; Lake 1995; Lane and Beamish 1990). The inability of 5.2 percent of expatriates in Tung's (1998) study to ever feel comfortable should be of considerable concern for MNEs. Discomfort with a foreign environment is likely to lower the work performance of expatriates, helping to explain assignment failure (Selmer 1998). According to 80 percent of respondents to a US survey of 52 MNEs, an expatriate's inability to adjust to a foreign cultural environment was a key reason for failure in an international assignment (Lake 1995).

Estimations of expatriate failure rates vary widely, and reliable data are difficult to find. Failure rates are usually measured as a percentage of expatriates prematurely recalled from their overseas assignment, based on the assumption that parent companies recall poorly performing expatriates. This measure of failure is not without its problems. Premature recall does not necessarily indicate expatriate failure, but may reflect early completion of set tasks, failure of an international venture owing to external political circumstances, a deterioration in the health of an expatriate, or other failures external to the individual performance of the expatriate. In addition, parent companies may not be able to access reliable information on expatriate performance. Distance complicates performance assessment, and good or

bad performance may not be evident until the expatriate has completed her/his assignment. Consequently, poor performers may remain in the host country for the full duration of their assignment. As an alternative to premature recall, expatriate success and failure has been measured according to the self-assessment of individual expatriates. Expatriate managers are asked to indicate whether they feel if they have failed or succeeded according to a five point scale (Tung 1998). This measure is only as reliable as the ability of individuals to make accurate and objective observations about their own performance. The self assessment measure has revealed lower levels of failure than the recall measure. It has demonstrated that the vast majority of expatriates perceive themselves to be successful in attaining corporate goals (Tung 1998).

There is much disparity in expatriate failure rates. A 1998 survey of 337 US human resources professionals revealed that 75 percent of respondents report at least some failed expatriate assignments in their organisation and the greatest proportion of respondents (28 percent) indicated a failure rate between 10 and 19 percent (Halcrow 1999). A US study, now twenty years old, based on a sample of 80 US, 29 West European and 35 Japanese MNEs with subsidiaries in Western and Eastern Europe, Canada, the Middle East, South America, East Asia, Africa and the USA, revealed that 69 percent of US firms had failure rates between 10 and 20 percent. Failure rates were lower for European and Japanese expatriate managers, with 59 percent of European and 76 percent of Japanese firms having failure rates below five percent (Tung 1982: 68). Smaller-scale European studies have indicated that failure rates around five percent (Brewster 1988; Hamill 1989; Scullion 1991, all cited in Harzing 1995). No studies of Australian MNEs' expatriate failure rates have been found.

Expatriate failure rates of five to ten percent can be extremely costly. A 1995 survey of 52 US MNEs revealed that the estimated direct costs of a failed expatriate assignment ranges from US\$200,000 to US\$1.2 million (Lake 1995). Indirect costs, such as damaged relations with foreign partners, customers, suppliers, government officials and employees, as well as the financial and emotional costs faced by the failed expatriate and his/her family, are not included in this estimate. In addition, there are the costs of securing a replacement expatriate. A single failure can be highly costly, which warns firms to take every precaution when making expatriate assignments.

### ***5.1 Workforce diversity implications for the management of expatriate assignments***

With expatriate assignments posing considerable real and potential costs for firms, expatriates should be carefully selected for their cross-cultural capabilities. Effective workforce diversity management should attenuate the potential costs of appointing expatriate managers. The selection of expatriates who share the national cultural background of the country to which they are assigned means that they have significantly less difficulty adjusting to the norms of the host country's culture than a non-national. While expatriates from the host country culture still must adjust to the organisational culture of their new assignment, this process will be easier than for expatriates who are unfamiliar with local languages, customs and ways of operating. Selecting national expatriate managers translates into increased productivity, reduced time adjusting to national cultural norms and the ability to more quickly focus on organisational tasks.

Expatriates who are familiar with the national culture of the host country possess valuable capabilities for establishing new foreign ventures. This could be especially important in the initiation stage. In their study of 46 North American executives involved with 66 international joint ventures in LDCs, Lane and Beamish (1990: 96-97) claimed that "partner problems" are the greatest source of international joint venture problems and suggested that parent organisations should use teams with a balance of technical, financial and cross-cultural skill in the search for an international partner. They asserted that too often, organisations rely on poorly informed second-hand information available in diplomatic and expatriate communities in their search for a foreign partner. Expatriates living in relatively isolated expatriate communities may be insulated from current events in the host country and hold inaccurate perceptions of the local people and conditions (Lane and Beamish 1990). Balanced teams should

involve executives who know how to navigate local business networks and seek out prospective partner information in the language of the host country.

### **5.2 Cross-cultural training: a second best solution**

An alternative to selecting expatriates who share a national cultural background with host country nationals is cross-cultural training. Cross-cultural training reduces expatriate and international alliance failure (Ashmalla 1998; Canen 1999; Fish and Wood 1994; Hickins 1998; Lake 1995; Lane and Beamish 1990). However cross-cultural training on its own is not sufficient to ensure expatriate success; firms must first select the most appropriate individual for the job and then commence training. According to Tung (1988: 25), where an assignment requires a high degree of interaction with local communities and the degree of similarity between parent and host countries is characterised as “highly diverse”, organisations should emphasise “relational abilities” and “family situation” (the ability of expatriates’ immediate family to adapt to a foreign cultural environment) when selecting expatriates. She contends that potential expatriates should then be subjected to highly rigorous training programmes to maximise their chances of success.

Cross-cultural training is costly. In 1986, a five day briefing course by the Center for International Briefing (UK) cost AUS\$1500 per participant (Tung 1988: 28). This did not include language training, occupational training or project briefings. In 1982, the Institute for International Studies and Training (IIST) (Japan) was offering 34 week intensive educational programs for expatriates that included intensive training in English (540 hours in the first 8 weeks) and either one other foreign language or advanced English, international management and economics, area studies, Japanese studies and four weeks’ study in an overseas educational institution for AUS\$100000. A three month course including 230 hours of English language training, as well as inter-cultural communication skill development and practical international business training cost AUS\$13000 (Tung 1988: 36-39). In 1991, the cost of a three day cross-cultural training session for an expatriate and her/his family at the Business Council for International Understanding, a cross-cultural training institute affiliated with the American University in Washington DC. (USA), ran as high as US\$10000 (Caudron 1991). While cross-cultural training can be expensive, it helps organisations avoid even more costly expatriate assignment failures. According to manager of foreign service employee programmes at SC Johnson Wax (USA), Jodi Zurawski, “even if you spend \$3000 to train a person who decides after the training that he doesn’t want to go, you’ve still saved at least \$300000 – the combined cost of wages, taxes, rent, moving and other expenses - by finding that out ahead of time” (Caudron 1991). Zurawski attributes her company’s low (for a US firm) expatriate failure rate of less than two percent to the cross-cultural training that they provide.

While the provision of cross-cultural training for expatriate managers may reduce the chance of expatriate failure, it is not a substitute for using employees from diverse backgrounds. The international business literature on culture is riddled with examples of disastrous *faux pas* that could have been avoided through basic training and a little cultural sensitivity (Aviel 1990). Stories, such as serving ham to an Israeli delegation or offering alcohol as a gift to a Saudi Arabian business partner, have become the stuff of urban(e) legends in international business studies. However, cross-cultural skills go beyond a basic awareness of such local traditions, customs and practices. It takes more than a broad knowledge of local etiquette, imparted to managers in short training courses, to develop a deep and intimate understanding of complex cultural environments. The goal of developing expatriate cross-cultural skills should not be merely to avoid offending host nationals through inappropriate behaviour; it should constitute a core capability that contributes to improving the attainment of organisational goals.

Expatriates who have a background in the host national cultural environment are better positioned to ‘read’, understand and predict the behaviour of host nationals than those who have only received cross-cultural training. Through managing the cross-cultural skills of a culturally diverse workforce, firms can select expatriates who are well positioned to be effective communicators and managers in culturally-complex environments. The advantages of leveraging workforce diversity capabilities have been recognised by the international product-development division of the Encyclopedia Britannica,

which selects expatriates who have a strong connection to the host national culture. The US based company prioritises those employees who originate from the target country or, alternatively, have already lived in or studied there. They send Korean Americans to Korea, Russian Americans to Russia and Japanese Americans to Japan. For example, owing to her cross-cultural skills (in addition to her technical skills), Japanese American project coordinator for Japanese products, Fukiko Ogisy, proved herself to be an especially highly valued member of both the Chicago and Tokyo offices of Encyclopedia Britannica. She has frequently been brought into meetings as an agent to bridge cultural gaps between her (US)American and Japanese colleagues (Soloman 1994).

Despite the Encyclopedia Britannica's enthusiasm for managing employee diversity to facilitate international business activities, most organisations do not prioritise cross-cultural skills when selecting expatriates. According to a 2000 survey conducted by the Australian Centre for International Business, less than 20 percent of CEOs surveyed used their firm's diversity factors/resources "always", while most CEOs used their managers and workers diversity skills only "sometimes", with multi-linguistic skill being viewed as the most important diversity skill for transferring employees overseas. A 1999 survey of over 300 US human resources practitioners revealed that an overwhelming majority of respondents cited technical skills as the "most important" or a "very important" criteria for expatriate selection, while giving a much lower priority to an employee's personality traits, such as adaptability and flexibility, with 11 percent of respondents saying it was of little or no importance (Halcrow 1999). This finding is consistent with Tung's (1982) study of 80 US, 35 Japanese and 29 West European MNEs that concluded that few companies pursue rigorous methods for assessing and developing the relational abilities of their expatriates (Tung 1982)p67.

Where expatriate managers with a sound grounding in the host national culture are not available, organisations with generally diverse managerial workforces may still be better positioned to navigate foreign environments than homogeneous organisations. Managers who are accustomed to working with people of diverse cultural and linguistic backgrounds are likely to have developed a relatively high degree of "openness to perceived dissimilarity" (Fujimoto *et al*, 2000). This means that such managers are generally open to difference and consequently, they will cope better in different/foreign environments than managers who have little experience of diversity. They are reasonably comfortable in "different" environments and, with appropriate cross-cultural and location training, will adapt to their overseas environment better than managers from homogeneous organisations who may be less open to diversity.

## 6.0 DIVERSITY IMPLICATIONS FOR SMALL AND MEDIUM SIZED INTERNATIONAL BUSINESSES

The effective management of workforce productive diversity is not only an issue for large MNEs with major expatriate expenses. It is also important for small and medium sized enterprises (SMEs) that want to internationalise. While little empirical research into the role of productive workforce diversity in internationalisation has been conducted, there is anecdotal evidence to suggest that organisations with diverse workforces may have distinct capabilities for expanding overseas. Internationalisation by SMEs usually begins by establishing basic import-export ties with foreign suppliers or buyers. Many SMEs are unable to afford expensive cross-cultural training programs or consultants to aid their internationalisation processes, which makes the efficient use of culturally diverse employees particularly important.

Language diversity is a highly valuable skill for internationalising businesses. A 1990 report to the Australian Government disputed the widespread assumption that, as the *lingua franca*, English proficiency was sufficient for international trade (Stanley, Ingram *et al*. 1990). It contended that fluency in LOTE (languages other than English) could provide business with distinct capabilities including:

1. An ability to read relevant trade journals;
2. Access to overseas social networks;
3. Understanding of foreign negotiating styles;

4. Knowledge of how to conduct market research;
5. An ability to quickly contact suppliers, distributors and buyers by telephone/e-mail/fax in their preferred language.

The report emphasised the importance of LOTE skills in export success, citing that the average finalist in the 1987 Australian Export Awards employed four times as many multi-lingual people than the average non-finalist. This suggests that firms that manage their linguistic diversity have an edge over those who lack multi-linguistic diversity.

For example, in 1988, Sydney-based rubber products company, Vulcanite, was ready to expand through exports to Asia. The first major foreign contract that it was awarded was to supply components for the Hong Kong Tramways. Vulcanite was awarded the contract over its Swedish competitor owing to the superior packaging and labelling of its products. While the Swedish firm labelled its products only in English, Vulcanite harnessed the productive language-diversity of one of its ethnic Chinese workers and labelled its products both in English and Chinese. The effort of translating the packaging was viewed favourably by the Hong Kong buyer and was a positive factor in building a rapport that facilitated in future negotiations for contracts in Hong Kong (AGB Australia 1993).

Gateway Pharmaceuticals Australia provides another example of how the effective management of productive diversity can provide international business opportunities for SMEs. Gateway was created by Lebanese born trader Louie Sukari and David Bokeyar who is an Australian born pharmacist of Lebanese descent (Wilkinson 1999). Gateway used its links with Lebanon and the Middle East to facilitate exports to this region.

Gateway Pharmaceuticals developed a major international business operation in Vietnam, including a majority owned international joint venture with the Vietnamese Ministry of Health, that led to the establishment of manufacturing operations in Vietnam. Gateway's Vietnamese connection began in 1985 when Bokeyar noticed that ethnic Vietnamese customers who came to his pharmacy in Cabramatta, Sydney, made bulk purchases of basic pharmaceuticals to send back to family and friends in Vietnam. Realising that there was a market for Australian made pharmaceuticals in Vietnam, Bokeyar and Sukari sought to target this market. In addition to Bokeyar's frequent travel to Vietnam to build relations with buyers, links with Sydney's Vietnamese community proved instrumental in Gateway's business success. Bokeyar employed a young Vietnamese Australian woman, Amanda, as an administrator, who was also highly valued for her cross-cultural skills. Business ideas would be discussed with Amanda and her family for their perceptions of their suitability for the Vietnamese market. Amanda also helped Sukari and Bokeyar understand Vietnamese customs. The business, which began in Bokeyar's garage, now has its head office in Sydney as well as two offices in Ho Chi Minh City and two offices in Hanoi that employ over 60 people. The Vietnamese offices are staffed and run almost exclusively by Vietnamese nationals and Vietnamese Australians are often sent by head office to conduct business in Vietnam. Gateway serves as a positive example of how the utilisation of productive diversity can provide significant international business opportunities.

The cases of Vulcanite and Gateway demonstrate that managing productive diversity can constitute core capabilities that aid in the internationalisation process for SMEs. Such firms may not be able to afford to build foreign language and cross-cultural skills through expensive training and consultancy programmes that may still be an inferior substitute for diversity related skills.

## 7.0 CONCLUSION

While the literature linking productive diversity management and its internationalisation implications is sparse, the application of a mental models theoretical framework suggests that workforce diversity facilitates cross-cultural business interactions. Organisations with culturally diverse workforces have a greater likelihood of having managers who share mental models with international business partners than do organisations with relatively homogeneous workforces. They may be better positioned for

developing special capabilities for operating in culturally complex environments and establishing personal relations with overseas business people. Such organisations may be able to reduce the transaction costs of exchange through clearer communications systems and adeptness in navigating both the formal and informal institutions of foreign environments.

Managing workforce diversity may prove especially valuable for securing the success of expatriate assignments. Organisations that effectively harness their internal cultural diversity may be able to make considerable cost savings when it comes to expatriate training while simultaneously benefiting from cross-cultural understandings that go beyond that which can be acquired in a limited training course. Organisations that select expatriates who share the national cultural background and language of the host country will not only be sending expatriates with deep understandings of the host cultural environment, they also will not require costly intensive cross-cultural training (they will, however, still need host organisation and project orientation). In such cases, organisations benefit both from the advantage of selecting an expatriate with strong cross-cultural skills and from the cost savings of reduced educational expenses.

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