Resource Availability And Firm's International Strategy As Key Determinants Of Entry Mode Choice

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November 2016

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Abstract

This study aims to focuses on the relationship between the two main MNE's strategies: multidomestic and global. The choice of entry is examined not only on the basis of Transaction Cost and Resource Based View, but it also incorporates a concept on Integration and Adaptation Cost. Moreover, the paper includes an analysis on brownfield investment and presents it as an alternative investment mode in transition/emerging economies. This paper, examined two strategies that most of MNEs follow: multidomestic and global strategies. Companies following a multidomestic strategy will mostly depend on local firm's resources, such as local technology, local brand name, networking and distribution channels. Their primary aim is to respond to local market demands, which can best be achieved by a locally well-integrated subsidiary. This paper is a purely conceptual literature review, which is based on a substantial number of scientific and conceptual articles. This paper decided to concentrate on the relationship between the resources, strategies and entry modes (including brownfield investment), because this paper discovered a large research/literature gap in this field of interest.

Abstrak

Tulisan ini mencakup analisis investasi brownfield dan menyajikan sebagai modus investasi alternatif dalam transisi / negara berkembang. tulisan ini, meneliti dua strategi yang sebagian besar MNEs pakai: strategi multidomestic dan global. Perusahaan yang mengikuti strategi multidomestic sebagian besar akan tergantung pada sumber daya lokal perusahaan, seperti teknologi lokal, nama merek lokal, jaringan dan saluran distribusi. Tujuan utama mereka adalah untuk merespon tuntutan pasar lokal, yang dapat dicapai oleh anak perusahaan lokal yang terintegrasi dengan baik. Tulisan ini merupakan konseptual tinjauan literatur murni, yang didasarkan pada sejumlah besar artikel ilmiah dan konseptual. Makalah ini memutuskan untuk berkonsentrasi pada hubungan antara sumber daya, strategi dan mode entri (termasuk investasi brownfield), karena tulisan ini menemukan gap penelitian / literatur di bidang ini yang menarik.

Keywords: ***Entry modes, MNE's Strategies, Transaction Cost, Resource Based View, Integration and Adaptation Cost***

INTRODUCTION

Choosing an appropriate mode of entry into new markets is a fundamental decision for multinational enterprises (MNEs) planning to expand internationally. Most literature distinguishes two choices of FDI entry modes: greenfield investment and acquisition. However, in this paper add brownfield investment as a third alternative entry mode for MNEs investing in transition economies. With every investment decision its transaction costs and resource availability should be considered. Therefore, in the first part of this paper, this paper provides theoretical framework on Transaction Cost Theory and Resource-Based View. This paper also incorporates integration and adaptation costs into this framework. Afterwards, this paper provides the reader with a short overview on two main entry mode choices and introduce the concept of brownfield entry. Subsequently, this paper analyzes the "resources needed for strategic objectives" and try to describe their relation to mode choices. In the next part of this paper, define two types of company strategies (multidomestic and global) and try to find the connection between a strategy followed by a company and its entry mode decision. Lastly, this paper combine two approaches (resources and strategies) and introduce some unprecedented relationships between resources and strategies on entry mode choice. During this examination this paper present several propositions regarding brownfield investment in transition economies.

THEORETICAL FRAMEWORK

The investment decision of any MNE is never taken in isolation. Transaction costs, integration and adaptation costs and availability of resources play an essential role in decision-making of any MNE and impact its selection of establishment mode choice. To understand why those concepts are so important this paper should examine two major theoretical theories that might explain MNE's investment behavior; Transaction Cost Theory and Resource-Based View. Following two theories, this paper analyzes three types of "resources required for strategic objectives" and then explain their importance for MNE's investment mode choice in the further section of this paper. Finally, this paper will explain the concept of Integration and Adaptation Costs (I&A) and describe why they should be taken into account when assessing costs and benefits of any specific investment mode choice.

The first theory that this paper will look at is Transaction Cost Theory (TC). Transaction cost variables are concerned with the costs of integrating an operation within the firm as compared with the cost of using an external party to act for a firm in a foreign market.

Transaction Costs Theory maintains that costs of finding, negotiating and monitoring the actions of potential partner's influence entry mode choice (Hill, 1990). Transaction Cost Theory, however, looks at the costs of making an investment as the only determinant of MNE's investment decision. Many researchers argue that it undermines the contextual factors in the choice of foreign investment choice (Dikova, 2007).

Another theory, which is commonly used for explaining foreign investment mode choice decision, is Resource-Based View (RBV). It indicates that a firm can gain competitive advantages over competitors by using internal resources and capabilities (Barney, 1986). This is predominantly the case when the exploitation of internal resources and capabilities for competitive advantage is difficult to replace or imitate (Wright, 1992). If a company possesses firm-specific assets in the process of internalization, it can enhance the firm's uniqueness and competitive advantages, enabling it to penetrate foreign markets (Caves, 1982).

There is a gap in the literature when it comes to "resources required for strategic objectives." From what this paper has found, only Meyer and Estrin (2001) and Cheng (2006), who bases his work on Meyer's study, mention the resources and their importance in MNE's investment mode choice. Therefore, base the next sub-section of this paper solely on Meyer's and Estrin's (2001) research. In their paper, the authors consider three types of resources as being crucial determinants of foreign direct investment. They include: resources of the investor, resources of local firms and resources available on the market. Meyer claims that those three types of resources determine MNE's choice between three types of entry modes: greenfields, acquisitions and brownfields. The last concept that is important for any foreign direct investment decision is the idea of Integration and Adaptation Costs. No investment is complete with the acquisition of needed resources. They have to be adapted and integrated to the needs of the new business that has been created and have to be put into efficient use. This, however, may be a problem for a MNE that has just entered the market; the assets have to be adapted to host country's culture and standards, the network relationships in the host market have to be rebuild and people need to be retrained. This may lead to significant integration and adaptation costs.

What Meyers concludes is, that the mode choice has to reflect the costs and the time lags required for integration and adaptation (Meyer, 2001). On the whole, the mode of foreign direct investment chosen by investors is driven by practical considerations of cost and other factors. The three theoretical approaches: TC, RBV, and I&A, provide useful and complementary perspectives on FDI choice strategy.

MODE CHOICE OPTIONS

In order to effectively expand into international markets, it is essential for a firm to take the proper foreign direct investment (FDI) choice. FDI mode strategy can be used to help the firm formulate an effective international operating strategy and to position the firm to be successful in a foreign market, enhancing its international competitiveness (Anderson, 1986). Traditionally, researchers distinguish two major FDI mode choices for MNEs planning to expand abroad. They include: greenfield investment and mergers/acquisitions. In this paper include a brownfield investment as an alternative for MNEs planning to invest in transition economies. In this section, this paper will define and examine advantages and disadvantages of the three mode choice options that are available for MNEs that plan to expand internationally. this paper will start by analyzing two primary modes of foreign direct investment: greenfield and acquisition. Then, this paper will present brownfield, as an alternative option and an attractive compromise between acquisitions and greenfield. Finally, this paper will make an analogy to the previous section and explain the relationship between resource availability and investment mode choice.

A greenfield entry into a foreign market involves the establishment of a new subsidiary from bottom up to enable foreign sale and/or production (Meyer, 2001). Basically, greenfield is an attractive mode of FDI for a firm in the foreign market because it can choose the site that it needs best, start afresh, and acclimate itself to the new business culture at its own pace. Real estate is purchased locally and employees are trained using the investor's know-how and financial resources. When firms grow through greenfield investments they are able to maintain the quality of their recruitment standards and thus integrate local professionals into existing organizational structure (Glückler, 2005). There are several downsides to greenfield investments that the MNE has to take into account when making its investment decision. First of all, the high cost of establishing a new affiliate from scratch. Following that, internal firm organization and recruitment as well as market relationships have to be fully developed from the beginning without local knowledge. This will lead to slow, incremental growth for the venue, which may be just too lengthy to build a competitive position and stay in the market, especially in developed markets (Glückler, 2005).

Another option that MNEs commonly choose in order to expand to a foreign market is an acquisition. It is typically presented as the alternative to Greenfield investment. Acquisitions are "purchases of stock in an already existing company in an amount sufficient to confer control" (Kogut, 1988). There are few major advantages of this mode choice option. First of all, an acquisition facilitates quick entry into a host market. Then, it allows an immediate access to local resources, which may have an enormous effect on firm's competitiveness and position in the new market. On the other hand, acquisitions face few challenges that were not in existence in the previous case of greenfield investment. Researchers often mention knowledge dissolution as one of the main disadvantages of acquisitions. It is difficult to protect firm's specific assets while combining them with local firm's resources. Another important disadvantage of acquisition as an investment choice is the great possibility that a new, acquired firm requires deep restructuring that is needed for achieving organizational fit between two firms (Meyer, 2001). This will result in high integration and adaptation costs. In some situations, especially in transition economies, the restructuring is so immense and reaches the point at which the investment resembles a greenfield mode choice. The term used in literature for that specific type of investment is "brownfield."

Brownfield investment is not one of the primary modes of foreign direct investment. Nevertheless, this paper wants to include it in this analysis as an alternative option for MNEs planning to invest in transition and emerging economies. Brownfield investment can be regarded as a hybrid mode between greenfield and acquisitions. It is formally an acquisition but it closely resembles the greenfield in its organization. It is a new operation that entails the purchase of an existing firm by an acquirer headquartered outside the country in an amount significant to confer control (Cheng, 2006). Within a short period of time the investor replaces plant and equipment, labor and even the product line (Estrin et al., 1997). The new operation is build and the primary resources that are used are the ones provided by the investor. After a short transformation period the acquired firm has undergone an extensive restructuring and it closely resembles a greenfield investment (Meyer, 2001). The advantage of brownfield investment may exactly compensate for the downside of greenfield entry. By purchasing a local company, an investor may get a foot into business (local customers, local- firm's distribution channels, established professionals) and achieve a considerable market share, without bearing high costs of setting up a new affiliate from the scratch. Brownfield investments allow faster growth and gain profits right from the start, whereas greenfield investments need time to reach the point of breakeven. There are, however, the trade-offs. Two main disadvantages of brownfield investment are: overpriced target company and post-merger integration failure (Glückler, 2005). The first one relates to the fact that the investor does not have necessary knowledge of the foreign market to accurately assess the fair value of the acquired company (its customers, networks, channels, reputation), so it is easy for a local company to overestimate its value and take advantage of the investor. The second problem deals with integration problems which can be very harmful and might ruin the whole venture if local professionals decide to leave the company and take their knowledge and client base with them (Glückler, 2005).

RESOURCE AVAILABILITY AND MODE CHOICE OPTIONS

In this section of the paper this paper will explain how resource availability may affect establishment mode choice. This paper will also develop some propositions concerning the relationship between resource availability and brownfield investments.

The main distinction between the three mode choice options, described in the previous section, is the origin of the resources used in the new operation.

Resources Owned by Investor

According to the Resource Based View, firm-specific assets are sources of competitive advantage and the firm can create further value by transferring those priceless advantages to the foreign market where local firms lack those resources. However, the concept of Integration and Adaptation costs suggests that it is more difficult for the firms with less post-acquisition restructuring experience to transfer and redistribute its firm-specific assets through acquisition. Therefore, greenfield investment would be the most efficient way to transfer company advantages from specific assets to the foreign markets. Also, as mentioned in Cheng's study (2006), for firms having more foreign post-acquisition restructuring experience, brownfield can be a good compromise between acquisition and greenfield in transferring its specific advantages to the host market, while at the same time preventing high integration costs in the host market. For that reason, this paper look at the brownfield investment as an option that can bring the benefits of greenfield investment while keeping all the advantages of an acquisition. This paper therefore proposes:

Proposition 1: Companies planning to invest in transition/emerging economies, whose firm-specific assets are the sources of competitive advantage should consider a brownfield investment as a way of keeping the benefits of greenfield investment while preventing high transaction costs.

Resources Held by Local Firms

These resources are crucial in MNE's investment mode choice. If the local company possesses valuable assets it may attract acquisition investment. A local company could provide market share, brand name, marketing and distribution networks, as well as technological assets. Therefore, firms tend to buy a foreign firm's equity through acquisition or brownfield rather than greenfield in order to acquire the complementary assets needed in foreign markets and prevent extra transaction costs.

Proposition 2: Companies planning to invest in transition/emerging economies, which see complementary assets of local firms as necessary for their foreign operation should consider a brownfield investment.

Resources Available on the Market

Local markets provide assets required for greenfield investments, such as real estate, business licenses, local skilled-workers, and supply of intermediate goods (Meyer 2001). In emerging and transition economies, however, where the availability of those resources cannot be assured, MNEs would be more likely to expand through acquisitions and brownfields rather than greenfield investments (Meyer, 2001).

Proposition 3: Companies planning to invest in transition/emerging economies where certain resources may be underdeveloped or not available should consider a brownfield investment.

GLOBAL AND MULTIDOMESTIC STRATEGY

There are a number of reasons for categorizing MNE's strategies. Firstly, a useful typology helps to identify the main characteristics of a certain strategy and therefore reduces the complexity as well as the vast number of determinants influencing an MNE's performance. All the latter is combined into a limited amount of criteria. These main criteria can then support researchers and managers with identifying missing variables and giving managerial advice in a predictive manner. Furthermore, these typologies allow a methodological comparison of different MNEs, which in turn might enable one to draw helpful conclusions concerning future management of a firm (Harzing, 2000). Bartlett and Goshal (1989) probably developed the most extensive typology of MNE's strategies, which has been used by many following researchers and authors. Subsidiaries of companies following a global strategy are mainly used for providing headquarters with market and consumer information. A multidomestic MNE's main focus is on building strong local presence through sensitivity and responsiveness to national differences. Two crucial aspects which differ between the two types of strategies are the level of headquarters control over the subsidiaries and the level of local responsiveness. As a result of their need to adapt products and policies to local market demands, multidomestic MNEs favor a high level of local responsiveness. Their products are supposed to be highly diversified, which can easier be obtained by locally well-integrated and autonomous subsidiaries. This in turn forces headquarters to allow its subsidiaries autonomy of decision and freedom for creativity. Therefore, these MNEs prefer a low level of headquarters control over their subsidiaries. Contrary to this, global MNEs are bound to producing standardized products which can be sold worldwide. Hence, their need for locally well-integrated subsidiaries is comparatively low, leading to a generally low level of local responsiveness. In addition, headquarters are very likely to favor a high level of control in order to maintain the precise production requirements which are essential for producing globally standardized products in a cost-efficient way (Harzing, 2000; Harzing, 2002).

In addition to the level of headquarters' control and the level of local responsiveness, institutional theorists focus on the influence of institutions on organizational structures. They try to provide explanations for homogenous organizational forms, behaviors and practices for different kinds of companies: “Organizations tend to model themselves after similar organizations in their field that they perceive to be more legitimate or successful (DiMaggio and Powell, 1983, p. 152).” The process of homogenization is called isomorphism and can be divided into external and internal isomorphism. External isomorphism means that a company has to be well-integrated into the external environment and cooperate excellent with external institutions, such as the state and additional stakeholders (e.g. suppliers) in order to operate effectively. Moreover, subsidiaries of MNEs are exposed to institutional pressures from within the organization. Hence, they are forced to become internally isomorphic towards headquarters. MNE’s subsidiaries therefore have to adapt to external (environment of the host country) and internal (headquarters procedures and structures) sources of isomorphism (Rosenzweig and Singh, 1991). Multidomestic MNEs strive for a high level of external isomorphism and a low level of internal isomorphism, due to the fact that their subsidiaries have to be well-integrated into the local environment while simultaneously being given a high level of autonomy from headquarters. However, global MNEs tend to prefer a low level of external isomorphism and a high level of internal isomorphism, owing to little necessity for intensive local integration and the increased need for internal structural homogenization within the firm.

RELATIONSHIP BETWEEN STRATEGY AND MODE CHOICE

In this paragraph this paper will try to establish a connection between an MNE’s strategy and its entry mode choice. Linking MNE’s strategies, levels of responsiveness and control to isomorphism theories and to the three different entry modes discussed in this paper, one can come up with the following implications. Since acquisitions are usually well integrated into the local environment, they can quickly react to local market needs. However, a lot of restructuring is necessary to integrate them well into corporate structures. Since this paper learned that multidomestic MNEs favor subsidiaries that can perform a high level of local responsiveness while acting relatively autonomous from headquarters, acquisitions tend to be favored by multidomestic MNEs. Furthermore, this paper know that global MNEs prefer subsidiaries with a low level of local responsiveness, but a high level of headquarters control being executed. This in turn can easier be achieved via greenfield investment, given that greenfield can be build according to headquarters needs, but are typically not well-integrated into the local environment at first. Hence, this paper believe that global MNEs choose greenfield investment as their preferred entry mode. A new entry mode that was added into the discussion was the brownfield investment. This hybrid entry mode, which is formally an acquisition, but resembles greenfields in substance, since the acquired firm is comprehensively restructured with the majority of resources being provided by the MNE, seems to be an attractive alternative entry mode (Cheng, 2006, p. 203). Therefore, the following question remains: Is a brownfield investment more suitable for multidomestic or global MNEs? At this point of this analysis, this paper believe that a brownfield investment is a suitable option for global MNEs, because in certain cases this entry mode is more cost-efficient than a greenfield investment. Moreover, the acquirer can restructure a brownfield until it suits all his requirements regarding internal isomorphism and headquarters control. In this next section, by combining resource availability and strategy, this paper will try to indicate that a brownfield investment is also a suitable option for multidomestic companies.

Proposition 4: Companies following a global strategy, which plan to invest in transition/emerging economies should consider a brownfield investment as a way of preventing high transaction costs associated with setting up a new subsidiary.

IMPACT OF RESOURCE AVAILABILITY AND STRATEGY ON INVESTMENT MODE CHOICE

Within this paragraph this paper will try to describe how much the relationship between the three groups of resources and the strategic type in respect to control/responsiveness needs could predict which mode is suitable for global and multidomestic MNEs.

This paper believe that local firm's resources are essential for MNEs following a multidomestic strategy. Since responding to local market needs is the primary concern of these companies gaining access to resources like local brands, market knowledge, distribution channels and network relationships is of high importance. Resources of the local firm attract acquisitions because they can help MNEs gain instantaneous market share in a local market and allow them to be responsive to the local market demands. Additionally, some resources of the investor, such as managerial capabilities will be combined with local firm's resources, however, they will not have to be protected by high control modes, such as greenfields. Therefore, this paper believe that those companies will either choose acquisition or brownfield investment mode. In transition economies a more suitable option would be brownfield investment, since most of the companies lack specific technological assets and the only valuable asset they possess is their local brand name. This brand name will be crucial for MNEs following a multidomestic strategy to establish local market presence. Also, most of the restructuring will be done with the resources of the investor. Hence, this paper proposes:

Proposition 5: Companies following a multidomestic strategy, which plan to invest in transition/emerging economies should consider a brownfield investment as their mode choice and use local firm’s resources, such as local brand name, for gaining local market presence.

This paper believe that global companies do not depend on local firm resources to the same extent as multidomestic companies, because of their low need for local responsiveness. In addition, global companies usually strive for a high level of control. Thus, they will choose greenfield or brownfield investment in order to meet their precise standards and ensure their level of control.

Proposition 6: Companies owning significant investor resources while following a global strategy, which plan to invest in transition/emerging economies should consider a brownfield investment as their mode choice, in order to overcome the problems of insufficient/unavailable market resources.

DISCUSSION AND CONCLUSIONS

Companies expand into foreign markets by combining three types of resources: resources of the local firm, resources of the investor and resources available on the market. They combine these resources in order to gain a competitive advantage, as indicated by the Resource-Based View. Bringing together resources held by different companies incurs high transaction costs, due to searching for targets, negotiating and monitoring. Therefore, company’s entry mode choice should analyze resource allocation and the transaction costs arising from merging the necessary resources. Another important element that should be taken into consideration is a company’s strategy. Different strategies will imply the need for specific resources and influence MNE’s entry mode decision. Conventionally many previous researchers referred to greenfield investment and acquisition as two alternative FDI mode choices. However, this paper included brownfield investment as a third entry mode option, which this paper believe, can compensate for disadvantages of the latter selections. For instance, a greenfield investment incurs high transaction costs of setting up a new affiliate. Additionally, it does not allow for an instantaneous local market penetration. On the other hand, the main disadvantage of acquisitions is the dissolution of knowledge which may lead to MNE's loss of competitive advantage. The brownfield investment can be seen as an attractive option for MNEs planning to enter a transition economy. This mode choice is associated with lower transaction costs than a greenfield investment while offering a higher level of control, which leads to an effective protection of internal knowledge.

In the final part of this paper, examined two strategies that most of MNEs follow: multidomestic and global strategies. Companies following a multidomestic strategy will mostly depend on local firm's resources, such as local technology, local brand name, networking and distribution channels. Their primary aim is to respond to local market demands, which can best be achieved by a locally well-integrated subsidiary. Therefore, these MNEs will usually choose acquisitions. But, this paper proposed that a brownfield investment may also be an interesting option for multidomestic MNEs planning to invest in transition economies, even though their only valuable asset is the local brand name. This will allow them to gain instantaneous local market share. Companies following a global strategy will depend on their own resources, such as technology, financial assets and managerial as well as technological knowledge. In order to protect their valuable assets, they will choose a high control entry mode. Hence, the most preferred option will be a greenfield investment. What this paper discovered was that a brownfield investment may also be an alternative for global companies planning to enter transition economies, since deep restructuring will allow a standardization of the structures of the acquired firm as expected by headquarters. Also, it will enable the firm to ensure its high level of control. What this paper found out was, that a determining factor between greenfield and brownfield investments will be the availability of resources in the market. If those are available, the global company will choose greenfield to avoid integration and adaptation costs. In transitional economies, however, when the availability of market resources cannot be granted, the global companies will enter via brownfield.

SUGGESTION

This paper is a purely conceptual literature review, which is based on a substantial number of scientific and conceptual articles. This paper decided to concentrate on the relationship between the resources, strategies and entry modes (including brownfield investment), because this paper discovered a large research/literature gap in this field of interest. This paper suggests a few propositions regarding brownfield investments and see a strong need for future research focusing on empirically testing them. It may provide useful information for companies facing a foreign direct investment decision, both in developed and transition economies.

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