

Institutions, Transaction Costs, and Entry Mode Choice in Eastern Europe

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The process of change from a centrally planned system to a market economy generates an institutional framework that is only partially reformed, and therefore inconsistent and unstable. This leads to high transaction costs for economic agents. Multinational enterprises entering transition countries have to adapt their strategies to the local institutions and reduce exposure to

highly imperfect markets. This paper analyzes how the costs of organizing business in transition environments influence entry mode choice. The empirical results show that host country institutions in transition economies, have an impact on the choice of entry modes. Moreover, different mechanisms determine the internalization of managerial and technological knowledge.

INTRODUCTION

That multinational enterprises entering a new market must adapt their strategies to the host country environment has been a hallmark finding in the international business literature. In recent years, increasing attention has been paid to the adaptation of these strategies to the demands of the institutions in the host economies (Oxley, 1999; Peng, 2000). Institutions are important for the functioning of any economy, as they con-

strain or facilitate business. For countries in development or transition, the evolution of institutions appropriate to a market economy is a critical hurdle (e.g. Clague, 1997).

One way to understand business strategies in emerging markets is to analyze the role and effects of institutions in reducing transaction costs (Hoskisson et al., 2000). This requires an investigation of different institutional contexts across countries and their effects on entry strat-

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egies. In this paper, I focus on transition economies, where the institutional framework is unusually unstable during the process of change from central-plan coordination to a market economy (Swaan, 1997). Thus entrants must adapt to an institutional environment that is itself in flux.

The analysis begins with the observation that enterprises organize their cross-border operations either as international trade, through contractual modes of coordination, or with equity investment as joint- or wholly-owned ventures. These entry modes, which provide varying degrees of control over local operations, have been analyzed with the transaction costs approach (e.g. Anderson and Gatignon, 1986; Hennart, 1991) as well broader eclectic frameworks (see Caves, 1996). I argue, and show empirically, that entrants adjust their mode choice to the specific transaction costs in different institutional frameworks.

The next section discusses the evolution of institutions in transition economies, their impact on transaction costs, and consequently on entry mode choice. Section three introduces the methods of empirical analysis. The results are presented and interpreted in the section four. Section five concludes the analysis.

INSTITUTIONS AND TRANSACTION COSTS IN TRANSITION ECONOMIES

The essence of economic transition is the replacement of one coordination mechanism by another. Yet efficient markets depend on supporting institutions that can provide, in North's (1990) terminology, the formal and informal rules of the game of a market economy. Institutions reduce transaction costs by reducing uncertainty and establishing a stable structure to facilitate interactions. However, these rules were not in place when the socialist system disintegrated.

Moreover, the new economic agents lacked (tacit) knowledge of both how to use the market mechanism and of potential partners and competitors. They had to identify potential types of business and the preferences of potential business partners; and they had to learn to assess the composition of demand and supply to set the right prices. This increased the search, negotiation and contracting costs of new business relationships. The lack of knowledge of markets and of the functioning of a market economy thus magnified transaction costs in the transition context (Swaan, 1997; Meyer, 2001).

Gradually, market-based institutions have been established in Eastern Europe (Table 1). This reduces, but does not eliminate, the high transaction costs. Rapidly changing institutions may generate, at any point in time, inconsistency between the requirements of different institutions as well as uncertainty over future institutional changes. Businesses have reacted by relying on inherited systems of personal networks that earlier served to overcome shortages under the central plan. Network-based coordination has thus retained its importance as a coordination mechanism during transition (see e.g. Stark, 1996; Puffer, 1996).

Western businesses entering transition economies also face high transaction costs. They lack information about local partners; they must negotiate with agents inexperienced in business negotiations; and they face unclear regulatory frameworks, inexperienced bureaucracies; underdeveloped court systems, and corruption. Post-entry, investors may be concerned about the weak protection of intellectual property, which as shown by Oxley (1999) increases investor preference for hierarchical modes.

However, an internal mode of organization is also subject to high costs.

TABLE 1
PROGRESS OF INSTITUTION BUILDING IN TRANSITION

	CR	HU	PL	RO	R
Large-scale privatization	4	4	3+	3-	3+
Small-scale-privatization	4+	4+	4+	4-	4
Governance and Enterprise Restructuring	3	3+	3	2	2-
Price liberalization	3	3+	3+	3	3-
Trade and foreign exchange system	4+	4+	4+	4	2+
Competition policy	3	3	3	2	2+
Banking reform & interest rate liberalization	3+	4	3+	3-	2-
Securities markets & non-bank financial institutions	3	3+	3+	2	2-
Commercial law (extensiveness & effectiveness)	3	4-	3+	3+	3
Financial regulations (extensiveness & effectiveness)	3	4	4	3-	3-

Countries: CR = Czech Republic, HU = Hungary, PL = Poland, RO = Romania, R = Russia
Code: 4+ = Standards and performance typical of advanced industrial economies, 1 = little progress in establishing the relevant institutions. The classification is based on the EBRD's office of the chief economist.
Source: EBRD 1999.

The central-plan regime was based on an economy-wide hierarchy that established quantitative output targets for firms, with few incentives to provide quality and customer service. Workers and managers have thus developed considerable experience in shirking, and the underlying routines and attitudes persist with the transition.

Moreover, the costs of establishing a wholly-owned operation are high. Until recently, acquisitions were only possible as part of the privatization process, which required complex negotiations with government authorities, management and work councils. After the acquisition, investors need to make considerable investment in restructuring the post-socialist firms, changing corporate strategy, organizational structure and culture (e.g. Newman, 2000) and implementing technological modernization

and environmental clean-up. Moreover, privatization agencies were in many cases reluctant to cede full control, and thus ownership, to foreign investors (Meyer, 2001).

Greenfield projects may be too slow to achieve investors' desired strategic objectives, notably if they pursue first-mover advantages (Meyer and Estrin, 2001). Establishment costs may be considerable as bureaucratic procedures, such as approval of real estate acquisition, are complex and slow. Moreover, greenfield investors may find it harder to integrate into local business networks, which may be vital for business success, because networks are extensively used where formal institutions are weak (Peng, 2000).

Thus the costs of setting up a fully-owned local operation in a transition economy are high. I expect establish-

ment costs and the costs of internal organization to outweigh the transaction costs arising from operating in imperfect markets. Progress in institution building reduces these costs, and facilitates higher degrees of internalization:

Hypothesis 1: Entrants are more likely to establish wholly-owned subsidiaries in economies that have progressed furthest in institutional reform.

Progress in reform brings the institutional framework of East European economies closer that of Western Europe. This convergence of institutions reduces *psychic distance* and thus facilitates international business (Johanson and Vahlne, 1977). Lower psychic distance reduces the need to invest in information, to train local staff and to adapt management processes to the local environment. This affects all forms of business, but to different degrees (e.g. Oxley, 1999). The costs of psychic distance arise at least in part from the institutional setting. Notably, lack of familiarity with institutions increases establishment costs, and thus discourages complex operations and wholly-owned subsidiaries.

The majority of prior studies suggest that the greater the psychic distance, the lower the preference for internal modes (e.g., Gatignon and Anderson 1988; Gomes-Casseres 1989, Kogut and Singh 1988). In our context, psychic distance is lower for home countries closer to Eastern Europe. Germans, for example, have a history of private and business contacts that help businesses to adapt to local institutions.

Hypothesis 2: Entrants originating from countries with lower distance proximity to transition economies are more likely to establish wholly-owned subsidiaries.

Knowledge Transfer

A prime theme of the entry mode choice literature has been the market failure for information due to information asymmetries (Arrow 1971). Consequently, direct investment is frequently associated with the “public good character of knowledge within the firm” (Caves 1971:4), and the transfer of brand names as free-riders may otherwise degrade the quality of products (e.g. Anderson and Gatignon 1986). A different view of why knowledge transfer is internalized is offered by Kogut and Zander (1993), who argue that the costs associated with transferring tacit knowledge favor internal transfer.

In transition economies, the diffusion of knowledge is of particular concern because the institutional framework does not provide for the efficient protection of intellectual property rights. Hence technology-intensive firms would prefer to internalize their transactions in high-tech goods and services. This includes transfer of production know-how, assessment of market opportunities for innovative products, as well as the training of sales and service personnel. In line with earlier research (e.g. Gatignon and Anderson 1988, Hennart 1991) I propose:

Hypothesis 3a: Entrants that transfer technology are more likely to establish a wholly-owned subsidiary.

However, in Eastern Europe, technology transfer is of secondary importance to the transfer of modern managerial skills. Investors have to engage in management training and education in areas such as marketing, accounting, finance and modern leadership skills (e.g. Child and Czegledy 1996). This transfer is necessary because management skills in the

central plan system were fundamentally different. Yet, it requires the transfer of tacit knowledge (Kogut 1996), which according to Kogut and Zander (1993) cannot be easily achieved across markets, as it requires direct interaction between the person possessing the knowledge and the recipient. I thus propose:

Hypothesis 3b: Entrants that build up local management capabilities are more likely to establish a wholly-owned subsidiary.

METHODOLOGY

Modeling Organizational Modes

Export and import are basic forms of international transactions, since goods leave the sphere of influence of an exporting firm when handed over. International contracts can organize different types of transactions that transfer goods or services to a local partner in exchange for a fee or a share in revenues, e.g. licensing, franchising, subcontracting, and management contracts. Contracts may provide rights to constrain or monitor the partner. Notably, strong foreign partners can gain some degree of control over local partners in less advanced economies if the latter become dependent upon foreign inputs.

A joint-venture (JV) places the local business unit under the joint control of the legally independent local and foreign partners. Through profit sharing, JVs create incentives to support the success of the venture, but they only partly eliminate the incentives to shirk on the partner. JVs are therefore avoided, unless transaction costs in one or more of the markets concerned are very high *and* full internalization is not feasible (Hennart 1988). Finally, the entrant can obtain full control over the local operation by establishing a wholly-owned subsidiary.

This paper analyzes the full range of entry modes: international trade, contractual arrangements, JVs and wholly-owned subsidiaries. The mode of business is a categorical variable defined as follows:

(1) MODE = 3 if the business relationship involves only trade

= 2 if the business relationship involves contracts, but no direct investment

= 1 if the firm has established a joint-venture (JV), but no wholly-owned operation

= 0 if the firm has established a wholly-owned subsidiary.

The different modes are analyzed as alternatives without implicit order. In this, I follow theoretical arguments suggesting that these modes differ by more than one dimension. Buckley and Casson (1996) show that while licensing would be preferable if markets are both highly volatile and large, it is less attractive if patent rights are poorly protected or if the value of the technology is highly uncertain. JVs are less attractive for business across high cultural distance because of coordination problems (Kogut and Singh, 1988). Hence, intermediate forms may be best at minimizing transaction costs because they can effectively deal with specific kinds of transaction costs.

The Enterprise Survey

The data for the analysis were collected through a questionnaire survey of 677 West German and British companies in winter 1994/1995. The questionnaire was sent in German or English to key informants in corporate headquarters to minimize information bias, after it had

been tested in interviews and a pilot study (Meyer 1998). The companies were selected randomly from a database (Amadeus) of all firms in three broadly defined industries: food and beverages, chemicals, and engineering. 269 firms replied (39%) and reported their business with five countries: Czech Republic, Hungary, Poland, Russia, and Rumania. The returned questionnaires include firms without business contacts in the region as it was not known, *ex ante*, whether or not the firms were active in transition economies. The variation across various categories (e.g. size, industry, advertising expenditures) was low, suggesting that the non-response bias is small. From the survey, 656 observations of active business relationships of either mode in any of the five countries were obtained. Of these, 576 were used in the empirical analysis after eliminating observations with missing values, providing a larger database than most empirical international business studies in transition economies.

Variables

The progress of *institution building*, which I expect to encourage wholly-owned operations (H1), is measured by a composite index based on the EBRD transition indices (Table 1), which reflect an expert evaluation of the institutional reforms.¹ The differences in psychic distance (H2) are proxied with a dummy variable *German firms*. Compared with British firms, they are more familiar with transition economies due to more intensive personal and commercial relations.

Knowledge transfer (H3a, H3b) is proxied by both firm and transaction level variables. *R&D* expenditures, as a percentage of turnover, captures the technology intensity of the firm. Mana-

gerial knowledge is proxied by *human capital* intensity, which I measure as personnel costs per employee. Actual incidences of knowledge transfer have been reported in the survey and are introduced as dummy variables for *technology transfer* and *management transfer*, respectively. In addition, I expect that *consumer goods* manufacturers need to transfer more managerial know-how to establish new systems for marketing and distribution. Table 2 summarizes the variables, their measurement and summary statistics.

Control Variables

Prior research has pointed to the importance of organizational capabilities determining the (opportunity) costs of internalization, which I control for in the analysis. Large and experienced firms can share their resources to realize economies of scale and scope across operations, thus lowering the marginal costs of an additional entry. *Firm size* and *global experience* thus facilitate wholly-owned ventures (Gatignon and Anderson 1988, Kogut and Singh 1988). Similarly, entry is facilitated by capabilities that are specific to the country or region of entry, such as knowledge of the institutional framework and contacts with local partners and government authorities. Therefore, *regional experience* enhances firms' capability to manage internalized business (Gomes-Casseres 1989, Hennart 1991).

Furthermore, different types of local operations create distinct cross-border interfaces that vary in their sensitivity to transaction costs.² Therefore, dummies are included for the types of transactions. Downstream, market-oriented business is used as base case, and dummies are added for *upstream* business and for business with both *up- and*

TABLE 2
VARIABLES

<i>Variables</i>	<i>Definition</i>	<i>Mean (St.Dev.)</i>
<i>Institution building</i>	Unweighted average of ten EBRD indices (see table 1)	3.365 (.359)
<i>German firm</i>	Dummy: 1 for German firms, 0 for UK firm	.571 (.495)
<i>R&D</i>	Percentage of research and development expenditures in turnover	4.24 (3.97)
<i>Technology transfer</i>	Dummy: 1 if the respondent indicated transfer of patented and/or unprotected technological know-how, 0 otherwise.	.156 (.363)
<i>Human capital</i>	Ratio of personnel expenditures in £ over employment	28,385 (9,836)
<i>Consumer goods</i>	Dummy: 1 for consumer goods manufacturers, 0 otherwise.	.335 (.472)
<i>Management transfer</i>	Dummy: 1 if the respondent indicated transfer of managerial and or marketing know-how, 0 otherwise.	.410 (.492)
<i>Firm size</i>	Number of employees of the firm, divided by 10 ⁵ .	.147 (.211)
<i>Global experience</i>	Percentage share of employment outside the home country in firms' total employment	.350 (.284)
<i>Regional experience</i>	Percentage share of turnover in CEE in firms' total turnover.	.026 (.026)
<i>Pharmaceutical</i>	Control dummy	.123 (.329)
<i>Non-European</i>	Control dummy	.139 (.346)
<i>Final and other goods</i>	Control dummy	.135 (.342)
<i>Final goods</i>	Control dummy	.594 (.492)
<i>Knowledge only</i>	Control dummy	.078 (.269)
<i>Upstream</i>	Control dummy	.286 (.452)
<i>Up & downstream</i>	Control dummy	.260 (.439)

downstream operations. The different kinds of goods transferred are controlled for with dummies for *final goods* only, *final and other goods* and for market-seeking business with *only knowledge* transfer. Furthermore, I control for firms affiliated with *non-European* parents and for the *pharmaceutical* industry.

RESULTS

Table 3 presents the regression results. Wholly-owned subsidiaries are

chosen as base case, such that the coefficients report the preferences for other modes relative to wholly owned subsidiaries. The results are most stark for trade. Many of the coefficients are significant and the likelihood is significantly higher compared to those of the other equations. It is common that the results for intermediate control are either more complex or insignificant (see Gatignon and Anderson, 1988, for example).

TABLE 3
MULTINOMIAL MODEL

	<i>Joint-venture</i>	<i>Contracts</i>	<i>Trade</i>
<i>Institution building</i>	-2.650 (0.675)***	-2.036 (0.578)***	-2.692 (0.521)***
<i>German firm</i>	-1.150 (0.638)	-2.899 (0.540)***	-0.847 (0.504)
<i>R&D</i>	-0.059 (0.082)	-0.045 (0.056)	-0.123 (0.490)*
<i>Technology transfer</i>	0.704 (0.468)	0.074 (0.456)	-1.630 (0.506)***
<i>Human capital</i>	-0.012 (0.027)	-0.011 (0.024)	-0.035 (0.018)
<i>Consumer goods</i>	-0.139 (0.473)	-0.395 (0.431)	-0.746 (0.384)
<i>Management transfer</i>	0.034 (0.500)	-2.091 (0.410)***	-3.222 (0.387)***
<i>Firm size</i>	-1.017 (1.088)	-2.051 (0.946)*	-1.166 (0.885)
<i>Global experience</i>	-2.728 (0.890)***	-2.324 (0.733)***	-2.850 (0.685)***
<i>Regional experience</i>	-11.064 (8.874)	-7.168 (7.15)	-9.634 (6.232)
<i>Pharmaceutical</i>	0.241 (1.019)	1.369 (0.790)	2.994 (0.688)***
<i>Non-European</i>	-1.801 (0.885)*	-1.157 (0.601)	0.634 (0.524)
<i>Final and other goods</i>	-2.510 (0.623)***	-1.549 (0.552)**	-1.283 (0.524)*
<i>Final goods</i>	-2.558 (0.723)***	-2.703 (0.707)***	-2.731 (0.673)***
<i>Knowledge only</i>	-1.305 (0.710)	-2.330 (0.784)***	-3.995 (0.865)***
<i>Upstream</i>	0.324 (1.581)	1.248 (1.352)	1.776 (1.296)
<i>Up & downstream</i>	0.686 (1.585)	-0.871 (1.383)	-3.803 (1.333)***
Constant	12.150 (2.706)***	12.422 (2.378)***	17.024 (2.185)***
model χ^2	536.16 (51)	correct predictions	73.78%
log-likelihood	-403.775	p-statistic	39.90%
restr. log-likel.	-671.855	χ^2 -test of IIA	24,199 (54)
Base case: wholly-owned subsidiary			
Levels of significance: * = 5%, ** = 1%, *** = 0,5%			

The most consistent finding is the highly significant coefficients on *institution building*. These results support the first hypothesis that institutional progress increases investors' preference for internalization, making full ownership more likely. Differences between the other modes are small. Thus, slow institutional development inhibits in particular foreign investment with sole foreign ownership, which requires negotiations with privatization agencies, restructuring former state-owned enterprises, and operational management in the 'post-socialist' culture. Our results are opposite to Oxley's (1999) findings if, as one would expect, progress in transi-

tion and protection of intellectual property rights are positively related. A possible explanation is that the high transaction costs of establishing (rather than operating) a wholly-owned subsidiary are crucial here. This may be explored in greater detail in future research by including a range of institutional factors in the analysis.

German firms are more likely to choose wholly-owned subsidiaries and have, relative to British firms, a particular aversion to contracts. This supports H2, that wholly-owned operations are more feasible in nearby locations. Proximity and familiarity facilitate German entry into Eastern Europe without reli-

ance on a local partner. However, German and British firms differ by more than distance to the transition economies, such that other country-specific effects may have also influenced this result.

The internalization incentives arising from control over know-how are partially supported as wholly-owned subsidiaries are preferred over trade. Yet apart from managerial knowledge, it appears not to affect other choices. In contrast to H3a, all forms other than trade appear suitable for *technology transfer*, despite their different control mechanisms. Yet *management transfer* is more likely to occur, as predicted in H3b, in wholly-owned subsidiaries and JVs, but not with contracts and trade.

The differences between technological and managerial knowledge transfer point to an issue of major theoretical concern. They correspond with results by Ghemawar and Kennedy (1999) who found that *relative to imports*, foreign investment into Poland is high in advertising intensive industries, but low in R&D intensive industries. This seems to reflect the absorptive capacity of local management: Eastern Europe has a solid basis in technological skills, but its human capital is weak in terms of managerial skills (e.g. Swaan 1997). Managerial knowledge transfer often involves tacit knowledge, which is more costly to transfer than the mature technologies typically transferred to emerging markets. It is therefore preferably internalized, which supports Kogut and Zander's (1993) contention that the costs of transferring tacit knowledge, rather than uncontrolled diffusion of knowledge, induce internalization of knowledge transfer.

CONCLUSIONS

The institutions of an economy determine the pattern of transaction costs.

Businesses thus select, and develop, coordination mechanisms that fit the environment. This is particularly evident in transition economies, where firms use, e.g., network-based strategies and barter. Foreign entrants too have to adjust to local conditions to accommodate high transaction costs arising with volatile and inconsistent institutional frameworks. The results of this paper point to the effects of a broad set of institutions that influence transaction costs. For instance, institutional development affects entry mode choice as underdeveloped institutions drive up the costs of establishing wholly-owned ventures. Moreover, I found indications that the type of knowledge transferred has major implications for its internalization.

NOTES

1. I use 1997 data for the empirical analysis as these are equally detailed but closer to the date of our survey than those reported in Table 1. The composite is the unweighted average of the 10 indices.

2. Conventional analysis of transaction costs at the firm level implicitly assumes that all firms engage in the same kind of transaction. I thank Mark Casson for pointing out that proper testing of transaction cost theory therefore requires controlling for different types of business undertaken by these firms.

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