



Revista Venezolana de Ciencias Sociales

ISSN: 1316-4090

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Revista Venezolana de Ciencias Sociales, vol. 10, núm. 2, julio-diciembre, 2006, pp. 308-322

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Cabimas, Venezuela

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## Institutional Economics of Co-Operation and the Political Economy of Trust

**José G. Vargas-Hernández\***

### ABSTRACT

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The aim of this paper is to analyze the institutional economics of co-operation and the political economy of trust. It is reviewed the transactions costs, the principal-agent theory, market power, increasing-returns theory and value creation, strategic management: competitive forces, resource-based theory, organizational knowledge and learning, strategic choice theory and the collective efficiency theory. Finally, it is explained the political economy of trust.

**Key words:** Co-operation, institutional economics, political economy, trust.

## Economía institucional de cooperación y la economía política de la confianza

### RESUMEN

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El propósito del presente artículo es analizar la economía institucional de la cooperación y la economía política de la confianza. Se revisan los costos de transacción, la teoría del agente-principal, el poder del mercado, la teoría de los retornos crecientes y creación del valor, administración estratégica, fuerzas competitivas, teoría basada en los recursos, conocimiento y aprendizaje organizacional, teoría de la elección estraté-

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Recibido: 08-02-06 / Aceptado: 20-11-06

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gica y la teoría de la eficiencia colectiva. Finalmente, se explica el potencial de la economía de la confianza.

**Palabras clave:** Cooperación, economía organizacional, economía política, confianza.

## **Introduction**

In recent years, a great amount of scholarly attention has been devoted to the political, social, and economic consequences of cooperation. A new instrument for value production in the global economy is the cooperative mode of organization characterized as interdependent, long-term relations among autonomous organizations.

Productive and creative cooperation considered as a potential incentive-related coordination in many spheres and activities among governments and their agencies, firms of the industrial and commercial sectors, cooperation and conflict between firms, between workers and management, and between firms and functions must contribute to a major economic project.

### **I. Institutional economics of co-operation**

Institutions have an important influence on individuals' expectations of the future, locking in the system to a stable long-run structure. Cooperative structures can emerge as an 'institution' defined as an observed regularity in the behavior and/or actions of individuals or groups when they encounter a similar set of circumstances (Witt, 1987:87). Social institutions are sets of rules that structure social interactions in particu-

lar ways. These rules provide information about how people are expected to act in particular situations. They can be recognized by those who are members of the relevant group as the rules to which others conform in these situations, and structure the strategic choices of actors in such a way as to produce equilibrium outcomes (Knight, 1968:54).

The self-organizational perspective sustains that institutionalization of competitive or cooperative behavior results from micro-macro interactions more than coordination costs and asset specificity. The new organizational economics explains theoretically the different modes of vertical relations between firms, suppliers and customers.

Trust may be sustained by appropriate institutions (Levi, 1998: 77-101; Hardin, forthcoming). An institutional account of trust is done by Farrell and Knight (2004). Institutions may exert an independent effect on trustworthiness. The evolution of institutions may be expected to have an impact on trustworthiness, and cooperation among individuals.

Transaction costs, the principal-agent theory, market power, increasing returns theory, strategic management (competitive forces, RBV, organizational knowledge and learning), strategy choice theory and resource dependency theory, offer complementary

explanations of cooperative arrangements. Transaction cost theory focuses on cost minimization; relationship marketing on providing superior customer value; organizational learning on knowledge; and strategic behavior theory on profit maximization, and resource dependency theory on obtaining resources (Figure 1).

#### a. Transaction costs

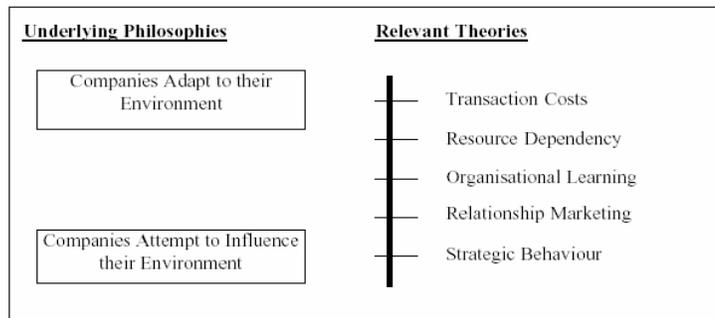
Transaction cost theory rests on the assumption that markets are most efficient for minimizing transaction costs. Transactions are defined as the goods or services being transferred across some boundary (Williamson, 1981). Transaction costs include the planning, monitoring and adapting of transfers under the various governance structure choices available (Mosakowski, 1991).

Firms internalize transaction costs through ownership when exceed the benefits of non ownership (Williamson, 1991). Transaction costs deals with en-

vironmental factors: Asset specificity, technological uncertainty and small numbers bargaining, which may lead to more control and to provide incentives to look for other arrangements such as quasi-hierarchies or vertical integration to internalize the transaction (Hennart, 1988; Osborn & Baughn, 1990; Pisano, 1990; Williamson, 1987). There is a positive correlation between level of integration and degree of control.

Transaction costs economics explains the economic rationale behind the choice of different modes of cooperation or transaction coordination mechanisms. The three basic mechanisms are markets, hierarchies or firms and hybrid modes, including interfirm cooperation agreements. The minimization of transaction costs is the basic principle in selecting institutional forms for different kinds of activities. A strategic integration continuum (Sparling and Cook, 1999) of organizational forms ranging from market through network to vertically integrated firms (William-

**FIGURE 1**  
*Positioning the underlying philosophies and theories relevant to strategic alliance formation*



Source: Hynes, Niki and Mollenkopf, Diane A., 1998.



tions of incomplete information and uncertainty, which characterize most business settings, two agency problems arise: adverse selection and moral hazard. Adverse selection is the condition under which the principal cannot ascertain if the agent accurately represents his ability to do the work for which he is being paid. Any cooperation agreement between legally independent entities often creates a moral hazard problem. Moral hazard is the condition under which the principal cannot be sure if the agent has put forth maximal effort (Eisenhardt, 1989).

#### **c. Market power**

A cooperative strategy may enable collaborating firms to increase their position within market.

#### **d. Increasing-returns theory and value creation (Source: adapted from Gomes-Casseres, 2003)**

Some factors shaping a firm's claim on value created by its constellation are:

- Value-Added Perspective: What is the bargaining power of the firm within the group?
- The firm controls scarce, valued, and well-protected assets
- Competition among the firm's suppliers of complements
- Lack of competition between the firm and its partners
- Structural Perspective: What is the position of the firm within the network of allies?
- Centrality of the firm's position
- The firm occupies structural holes

- The firm participates in multiple constellations.

To sustain successful co-operation, partners need to learn in five key areas: the environment in which the alliance will operate, the tasks to be performed, the process of collaboration, the partners' skills, and their intended and emerging goals. Thus, the strategic, operational and economic scope plays a very important role in the alliance management and value creation logic's (Molevicius, Algis).

Collaboration is bound to be difficult if partner fail to understand the goals of each other. A joint effort at learning about the competitive, technological and market environment develop mutual trust, share understanding and reduces the risks. The value creation logic's and alliance management is show in Figure 3.

#### **e. Strategic management: competitive forces, resource-based theory, organizational knowledge and learning**

Competitive forces intend to maximize profits through improving a firm's competitive position against rivals.

A few authors have shown the way forward in the search for a theory of regulation of interfirm cooperation. The emergence of resource-based approaches to strategy has provided broader bases upon which to build a theory of inter firm cooperation. Resource-based view (RBV) seeks to bridge the gap between theories of in-

**FIGURE 3**  
*Value creation logic's and alliance management*

ELEMENTS OF VALUE CREATION LOGICS	LEARNING/INTERNALISATION
<b>Assessing Contribution</b>	<ul style="list-style-type: none"> <li>• Recent skill leadership</li> <li>• Pace of skill improvement</li> <li>• Access to copractice of key skills</li> </ul>
<b>Agreeing on Alliance Scope</b>	<ul style="list-style-type: none"> <li>• Focus on operational scope as learning ground</li> </ul>
<b>Understanding Joint Task Demands</b>	<ul style="list-style-type: none"> <li>• Ability to copractice." apprentice to master" relationship</li> <li>• Codiscovery and development of new skill</li> </ul>
<b>Defining and Measuring Process</b>	<ul style="list-style-type: none"> <li>• New or enhanced skills</li> <li>• Leveraging opportunities of using the skills</li> </ul>
<b>Keeping Time</b>	<ul style="list-style-type: none"> <li>• Learning cycle of the "apprentice partner(s)" with regard to the skills contributed by other partners, and renewal rate of the skills contributed to the alliance by each partner</li> </ul>
<b>Anticipating Points of Tension</b>	<ul style="list-style-type: none"> <li>• Symmetry and balance in learning</li> <li>• Potential versus actual learning</li> <li>• Competence replenishment versus competence transfer</li> </ul>

Source: Molevicius, Algis

ternal organizational capabilities and external competitive strategy theories.

The RBV suggests that differences in firms' performance are related to the variances in firms' resources. Firms are bundles of resources and that inter firm relationships provide access to obtain or retain resources and enable exploitation of learning capabilities that will allow reduce risks to enter into new competence areas. Performance risk is attributable to the alliance's interaction with its environment. The RBV suggests that a company with strong internal capabilities can enjoy an enduring competitive advantage and achieve superior performance (Dierickx & Cool, 1989).

Resource dependency theory (Pfeffer & Salancik, 1978) suggests that in order to survive, organizations must

constantly interact with its environment either to exchange resources and its products. Organizations seek to gain control over the uncertainty of their external environment through cooperative arrangements to guarantee stable flows of resources (Pfeffer & Salancik, 1978; Galaskiewicz, 1985; Miner, Amberguey & Stearns, 1990; Stearns, Hoffman & Heide, 1987). Complexity and dynamism are closely related to environment uncertainty.

Dess and Beard (1984) identified three dimensions of task environments: munificence, complexity, and dynamism. Since complexity and dynamism are usually thought of as determinants of environmental uncertainty (Thompson, 1967). Co-operation is seen as a mechanism to understand and cope

with uncertainty (Spekman *et al.*, 1998). Environment can be conceptualized by two categories: uncertainty and munificence (Beydoun, Abdul and Yang, Haibin, 2003). A conceptual framework of resource development and environment is shown in Figure 4.

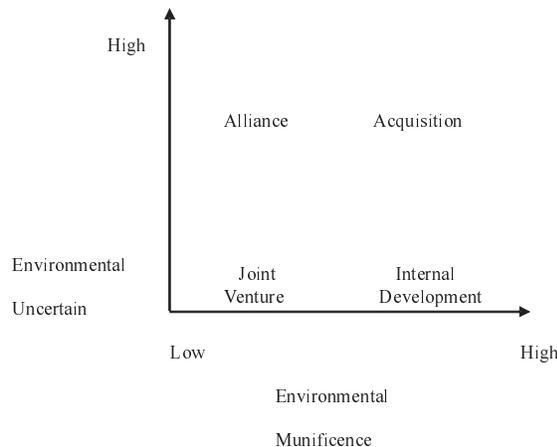
Organizational knowledge and learning explains that tacit knowledge can be transferred under cooperative strategies. The transfer of know-how, product of complex organizational routines can be severely impaired unless the organization is itself replicated (Kogut, 1988: 323).

The management of a portfolio of multiple cooperative agreements raises new questions about the cooperative capabilities of firms. In managing a portfolio of alliances, there may be systematic differences in the cooperative capabilities that firms build up. Having more experience and learning with alliances

may affect the relative success of those firms with alliances (Lyles, 1988).

Research has 'neglected concepts/measures that focus on alliance management' (Spekman *et al.*, 1998) as an explanatory variable for alliance success. Challenges of increasing complexity and conflicting objectives from different alliance partners confronts the management experience of a firm who seeks out ties with partners who could help them manage such strategic interdependencies. Firms have to focus on a series of organizational and strategic issues when is at the center of an alliance network. "Networks can be thought of as a higher stage of alliances, for in the strategic center there is a conscious desire to influence and shape the strategies of the partners, and to obtain from partners ideas and influences in return" (Lorenzoni and Baden-Fuller, 1995: 157). The critical dimensions of a cen-

FIGURE 4  
A Conceptual Framework of Resource Development and Environment



Source: Beydoun, Abdul and Yang, Haibin (2003).

ter are to create value for its partners, to act as a leader, rule setter and capability builder, to structure and set up the network strategy.

Callahan (1999), outlines the components of the role of the alliance manager in the first order control model.

#### **f. Strategy choice theory**

Strategic choice theory support alliances as complementary to the new core competence allowing organizations for a strategy of choice for a governance structure to capitalize on functional expertise and contract for other needed functions (Fagre & Wells, 1982; Kogut, 1988; Porter, 1980). Specifying performance and control is required and taking into consideration flexibility of non-equity contractual arrangements in such a way that the closer the alliance is to the strategy of the new venture, the more likely that it would choose an equity structure.

McGee, Dowling and Megginson (1994) support the strategic choice theory by finding a relationship between business strategy and use of alliances. Strategy for cooperative arrangements between firms is an important variable in the effectiveness of a strategic alliance. The use of cooperative arrangements is growing and have a positive impact on firm performance when the alliance was chosen in a functional area that the firm's management team had prior experience (McGee, Dowling, & Megginson, 1995; Wisnieski & Dowling, (1997). Organizations have to choose the right cooperative strategy to realize their objectives through cooperation with other organizations rather than in

competition with them (Child and Faulkner, 1998).

#### **g. Collective efficiency**

Collective efficiency has two aspects to it: external economies (the passive dimension) that clustered agents accrue by virtue of their location, and joint action (the active dimension) benefits that arise from deliberate and active cooperation between local agents to obtain external gains. For example, under the allocate efficiency principle, some allied nations cooperate to integrate collectives of highly mobile peacekeeping forces to maintain security with diminished resources.

A cluster is a concentrated grouping together of firms and institutions, which have horizontal and vertical relationships, and linkages based on cooperation to achieve synergy. Marshall used the term "constructive cooperation" to describe the economies of scale and scope gained from cooperation.

Partnerships must be inclusive and involve the active participation of many members, which involve a balancing of the power differentials that exist within the partnership (Sampson et al, 1989, p.491). Regard therefore has to be given to group dynamics, to the symbolic importance of including and excluding particular interests and individuals and to showing proper respect for the joint activity and all the partners involved in it, e.g. by avoiding an 'inner core' of the 'senior' parties (Webb, 1991: 239).

In horizontal partnerships firms endowed with specific skills, typically compete in the market, linked with an-

other company of complementary core competencies, cooperate in product development, basic research, cross-transfer of new technologies and manufacturing capabilities. Horizontal partnerships enable firms to serve new markets, sharing risks and learning.

However, there are some 'externalities of joint action' (Nadvi, 1999) such as the reputation basis created by local standard regulation. An example of environmental externality occurs when cooperation between firms in one line of activity affects other lines of activity, such as the case when R&D affects pricing.

Collective efficiency involves social and technological innovation. Social innovation transforms a non-cooperative behavior into a cooperative minded setting increases the propensity to cooperate in technological innovation.

Minimizing transaction costs and reducing principal-agent problems can be achieved through arrangements of relational contracting and long-term networks based on mutual trust. Cooperative behavior is further enhanced by direct communication between actors and agents and stabilized through the mechanisms of rules and trust, which can overcome opportunistic behaviors and rivalry.

## **2. The political economy of trust**

Farrell and Knight (2004: 8) define trust as "a set of expectations held by one party that another party or parties will behave in an appropriate manner with regard to a specific issue.

Promoting trust and cooperation between firms, institutions and local government can achieve economic gains. "What is needed is sufficient trust to initiate cooperation and a sufficiently successful outcome to reinforce trusting attitudes and underpin more substantial, and risky, collaborative behavior (...). Virtuous spirals of trust and effective collaboration need to be established" (Webb, 1991:237).

Harmonious relationships between firms, communities and government are built upon trust and mutuality "Social trust in complex modern settings can arise from two related sources - norms of reciprocity and networks of civic engagement" (Putnam 2003; 171). Reciprocity characteristics of networks enhances cooperation because: (1) it increases the costs of defection, (2) it fosters robust norms of reciprocity, (3) it facilitates communication and improve information flows, and (4) it embodies past success at collaboration and provides a blueprint for future cooperation (Putnam, 2003: 172). Empirical studies on the evolution of cooperative network relationships that focus on the inter-organizational relationships (Human and Provan, 2000).

Economic cooperation is impacted by trust. Trust is a key element and decisive factor in the cooperation relationship, which allows real commitment and confidence among the partners to develop a vision for the long run. A seriously flawed cooperative working relationship will doom any agreement to failure, although a flawed written agreement can always be modified. Interdependent decisions to cooperate

are influenced by the degree of cooperation already present in the organizations and may lead to an equilibrium in which cooperative alliances prevail.

In the more socialized version of trust, it has been observed that norms of fairness may enter into transactions between parties and firms. Often in relational contracting, norms of conflict resolution within the relation develop (Macneil, 1978). Trust is an interdependent action of social cooperation for mutual benefit (Coleman, 1990: 306-310).

Rational choice theory explains that trust is a factor in social interactions characterized by risk, as Coleman (1990: 91) has put it "They are situations in which the risk one takes depends on the performance of the other actor." There is a positive relationship between trust and social capital, on the one hand, and political and economic success. researchers attempt to document the various ways in which trust and social capital can improve the performance of political and economic systems. Putnam (1993, 2000) pretends to demonstrate that the political and economic success of large social communities is linked to generalized trust and cooperation, through.

Luhmann (2000) distinguishes between person- and system-trust according to the recipient of trust. Person-trust is aimed at individuals and system-trust refers to the trust in abstract systems of relationships (Krause 1996) such as organizations. Thus, trust can exist towards the representative and at the same time towards the partner organization.

Rational choice theory of institutions explains why individual actors come to trust each other and provides explanation of the forms of cooperation and to understand the differences in cooperation. The encapsulated interest account of trust combined with institutional theory provides the basis for comparative analysis of trust in explaining cooperation (Farrell, 2000). The "encapsulated interest" account of trust specifies the relationship between institutions and trust predicated as trustworthiness in a three party relationship (Hardin, forthcoming) which goes personal and their own self interest among the involved.

Farrell and Knight specify this relationship between trust and social institutions, in a middle ground between Hardin (Forthcoming) and the broader conception of social trust (Putnam, 1993). On the account of Farrell and Knight (2004: 8) "the existence of institutions in common social settings can affect the trustworthiness of the actors in those situations in such a way as to create ongoing relationships of trust among those actors." The authors suggest a model of the relationship between institutions and trust among actors. Insofar as institutions give actors an incentive to behave in a trustworthy or untrustworthy manner and/or affect social beliefs about the trustworthiness or untrustworthiness of actors thorough their dissemination of information about the expected behavior of others.

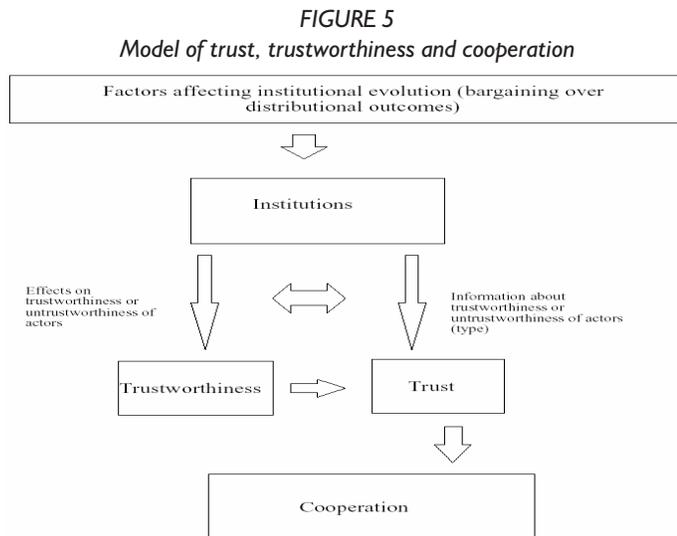
Trust and trustworthiness become relevant when the social cooperation cannot be reduced to simple institutional compliance Cooperation inher-

ent in institutional compliance is different that cooperation through the use of the concepts of trust and trustworthiness. Thus, in any relationship among institutions, trust and social cooperation are relevant. "Cooperation through compliance with institutional rules in particular social settings affects an actor's beliefs about the propensity of others to cooperate (their level of trustworthiness) in similar settings which affects that actor's willingness to cooperate at some subsequent point in time in that same social setting" (Farrell and Knight, 2004: 10-11). Changes in trustworthiness and in trust between actors lead to changes in the extent and form of cooperation. The model the authors set out specifies a set of causal relationships, which may plausibly affect trust and cooperation between actors (Farrell and Knight, 2004: 15).

The model of trust, trustworthiness and cooperation appears "to provide a good account both of cooperation between actors, and the evolution of this cooperation over time, in relations between economic actors" (Farrell and Knight, 2004:38). In Figure 5 it is shown a model of trust, trustworthiness and cooperation.

Trust and confidence in the partner can rise unrealistically during the partner search and selection stages only to drop as difficulties arise (Doz, 1996) A simple contracting scheme in order to differentiate transactions and corresponding governance structures can be shown.

Hirsch and Meyer explain the scheme in the following terms: Good or a service can be supplied either (1) by a general-purpose technology or (2) by a special purpose technology. The latter



Source: Farrell and Knight (2004).

has the advantage that it is more efficient for servicing steady-state demands (e.g. for a cooperation partner), but it requires greater investments in transaction specific durable assets. The variable  $k$  is used to measure the extent of transaction-specific assets. An investment in the general-purpose technology can be described by  $k=0$  and respectively  $k>0$  when there have been transaction-specific investments. According to Williamson (1989/1999: 62-63), classical market contracting suffices for the first kind, while for the latter type, unassisted market governance poses hazards. The question is whether individuals should trust each other. The authors call this the trust problem in co-operations. Game theory, and more specifically, the prisoner's dilemma models this kind of trust decisions as shown below.

The trust engendered in the partner will result in behavior, which is of benefit to the firm in the alliance. The political economy of trust in clusters of small firms geographically concentrated relay on cooperation to prosper.

### Concluding remarks

Power has distribution aspects (Knight 1992). Power affects cooperation based on trustworthiness as a relational concept. Any agreement puts in place relationships of power and prescribes roles of action for the partners. Relationships of partnerships include the distribution of power and may not be based on equality and equity. In the case of indigenous groups real partner-

ship must involve equitable cooperation. Power over relevant decisions can be shared but not necessarily equal power. No always there is consensus on decisions and the degree of influence exerted by partners may not be equal. Thus, any asymmetries in power affect the trusting relationship of cooperation. There is a widespread perception of alliances as "weapons of power" instead of being "tools of management" (Schroeder, 1976).

Firms frequently exercise their power over other firms to solicit compliance. Schroeder (1976) argues that alliances work, to a certain extent, as *pacta de contrahendo*, constraining and controlling the actions of the allies. To achieve a genuine relationships based on trust it is necessary to establish an appropriate culture linked to reputation sanctions (Kreps, 1990) or to subject behaviors to external organizational forms or institutions which provide actors with a technology to limit abilities to use power (Levi, 1998). Cultural and legal backgrounds of partners give rise to communication and coordination information asymmetry.

Explaining the relationship between trust, distrust and power in sub-contracting relations among firms, Farrell and Knight (forthcoming), Farrell (2001) and Farrell (2004) have suggested that asymmetries of power are incompatible with trust up to a certain level, and even when trust and its outcomes are asymmetric, trust may be possible. Disparities of power prevent trust of arising and distrust is the likely outcome. Firms may prefer to exploit

their power instead of nurturing complex relationships of cooperation (Helper, 1993).

The level of confidence required by a partner is not static. To increase the level of trust not necessarily lead to a reduction in control exerted by partners "the trust level and the control level jointly and independently contribute to the level of confidence in partner cooperation" (Das and Teng, 1998: 496). These authors negate any relationship between trust and control suggesting that both high level of control and trust are necessary in international joint ventures compared to other forms of inter organizational cooperation. In a joint venture, a new corporate entity is formed. Thus, trust and control seem to be independent, but other contin-

gencies should be included in the analyses of the relationship between trust and control in different forms of inter organizational cooperation, such as the impact that cultural factors have on these variables.

As a means of both enhancing cooperative behavior and mitigating competitive conflicts, relational capital based on mutual trust and interaction at the individual level between alliance partners creates a basis for learning and know-how transfer across the exchange interfaces (Kale, Singh and Perlmutter, 2000). For example, Canadian companies currently in Mexico concur and overwhelmingly view establishing trust as very important to doing business with Mexicans (Dennis and Beamish, 1993).

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