Business Groups in Russia: Internal Organisation and Innovation Strategies

Svetlana Avdasheva[*]

Abstract

This study is based on a series of surveys and interviews of top-managers for approximately 400 Russian industrial enterprises, which was conducted during the years 2001-2003. The main focus of the paper is the scope of business groups in Russia, which are based both on shareholding and alternative forms of coordination; entry into business-group incentives for insider owners (that is to change the right of control on certain gains), innovation strategies of enterprises within business groups and the sources of competitiveness of both enterprises and the business groups as a form of industrial organization in Russia. The survey results show that industrial firms within business groups have different innovation and restructuring strategies in comparison with the firms that remain outside of both formal and informal business groups. Those firms that are controlled by business groups as outside owners are oriented primarily toward restructuring of internal organization and management, introduction of new products and expanding production. At the same time, this group of enterprises spends less effort on withdrawing unprofitable products and marketing restructuring. Results of an in-depth interview demonstrate the division of authority and responsibility within business groups. Goals for the enterprise management within business groups are formulated in terms of quantity of production along specific product lines, but not financial targets. The parent company retains all the detailed financial control over enterprises. This kind of organization provides ambiguous impact on competitiveness of business group enterprises in the short and long run.

Keywords: enterprise, business group, restructuring, innovation
JEL Classification: P23, P31, M20

---

[*] *Svetlana Avdasheva, Higher School of Economics, Moscow, Russia.*

I would like to thank Bruce L. Jaffee, Slavo Radošević, Ivan Teodorović, Maja Vehovec and other participants of the 65th Anniversary Conference of the Institute of Economics, Zagreb for their helpful comments. I also would like to express my gratitude to my colleagues Yevgenij Yasin, Tatiana Dolgopyatova, Boris Kuznetsov, Yuri Simachev, Victoria Golikova, Andrei Yakovlev, Eldar Askerov, Anna Kosygina and other participants of the project "Non-market Sector in Russian Economy" (2001-2003, HSE) and State University – Higher School of Economics for financial support.

1 Introduction

Business groups[1] as a specific form of organization in Russian industry have attracted attention since the beginning of the 1999 economic recovery. Many people in business, academics and government hope that new holding companies could be the driving force of effective modernization of industry. At the same time, a number of questions about the business group's influence on decision-making and performance remain unanswered.

The objective of this article is to analyze the influence of business groups on the innovation strategies of Russian firms, which were established in the Soviet period. The main sources of information are the results of surveys and in-depth interviews of managers and owners of industrial enterprises, conducted within the project "Non-market Sector in Russian Economy" (2001-2004). The alternative theoretical explanation for the persistence of business groups as an organizational form in Russian industry is based on the analysis of data on innovation strategies, corporate governance, and incentives for the owners and managers of enterprises (according to their own estimation) to join a business group.

2 Organization of Russian Industries: General Context of Development of Business Groups

It is obvious that the only way to explain business groups in Russia is to analyze the main tendencies of development of Russian industrial organization since 1992. Thus the problem becomes very complex, taking into account the specifics of Russian transition and the presence of many different and, very often, contradictory explanations of these specifics in the modern literature. Trying to restrict the scope of discussion, it is crucial to mention four aspects of industrial organization in Russia: the model of ownership and

[1] *Speaking about business groups, one can mean fairly different organizational forms. First, it includes the holding companies both "old" (emerged as a result of reorganization associated with privatization) and new (emerged as a result of a wave of mergers and takeovers, especially after 1998). Second, it includes various types of "hybrid" organizational forms, which have become typical of Russian industries, especially in production of homogenous products. Third, it is some kind of network, both informal and formal, that is created with state support (for example, officially registered financial industrial groups – FIG). Any big business in Russia typically includes all these types of links, and that is why there is some kind of common knowledge that the main participants in Russian markets are not "companies", but "business groups". A typical business group is a conglomerate, with a very complicated combination of shareholding, structural and personal relations. From some viewpoints business groups can be considered a type of strategic alliances, specific to Russian industries.*

corporate control, the organizational structure of Russian companies, the mechanism of contract enforcement and the sources and determinants of competitiveness between Russian companies.

The prevailing type of ownership in the Russian economy in recent years is the concentrated insider ownership (Dolgopyatova, 2002; Dolgopyatova, 2003). Actually, even in the Soviet period, insiders (managers of the enterprises) had significant property rights (Nureev and Runov, 2001). In this context, privatization in most cases merely formalized and legalized the property rights that had already been acquired. The extremely high enforcement costs of contracts between outsider owners and managers in the transition period were an additional factor, which strengthened the positions of insider owners and contributed to the redistribution of formal ownership to insider managers. Typically the value of minority shareholding to outside owners, who have no additional tools to control decision-making of insider managers in Russia, was negligible during the last decade. The comparative advantages of insiders in Russia became clearer when the factors that decrease efficiency of insider control, such as competition for resources and product markets, have a relatively weak impact on enterprise performance. The legalization of insider property rights took a long time in many cases since in practice privatization resulted initially in dispersed ownership. The concentration of ownership required a long time and in several companies has not been completed even today. During the transition period the non-coincidence of “formal” and “actual” ownerships was typical and that non-coincidence caused further complications in the Russian model of ownership.

Concentrated corporate control was the cause for the specific evolution of the legal form of public corporations in Russia. Today many of these public corporations (open join-stock companies) are de facto closed ones. For most of them obligations linked to their legal status of open JSC create more or less high but useless additional costs (Yakovlev, 2003). In such companies, most traditional instruments of corporate governance actually degenerated. For instance, analysis of decision-making in joint-stock companies in the Ekaterinburg region (Sverdlovsk oblast) (Tkachenko, 2004) showed that the boards of directors function only as an appendage of the decision-making system: boards of directors either legalize the decision of the actual owners or do not make important decisions at all.

The evolution towards “recombinant property” (Stark, 1997) became the pronounced tendency in the development of Russian companies organizational structure during the transition period, when the decision-making and the organization of key transactions were taken outside the formal boundaries of the firm. David Stark, who is the author of the term “recombinant property”, explained these forms by the evolutionary development of enterprises in the transition economy. The related concept in the modern institutional economics is the change of the firm’s boundaries. In Russia various forms of “recombinant property” have been cited and extensively described by different authors (one specific form is tolling or processing arrangements, see Avdasheva, 2002). To define the business unit using this organizational structure the term “dispersed company” is sometimes used. The prevailing explanation for “recombinant property” in Russia were the tax avoidance or tax evasion schemes (Kuznetsov, Gorobets and Fominych, 2002), and the specific forms of receiving income from property (Rozinsky, 2002). According to alternative explanations for “recombinant property”, which are rarely encountered, such organizational forms could be efficient in a specific context even when there is no tax evasion (Avdasheva, 2002). Regardless of the “main” reason for the use of the “recombinant property” model, there is no doubt that this model explains well the different characteristics of industrial organization in a transition economy, including corporate governance, outsiders-insiders relationships and externalization by company management of marketing functions from production functions).

Concerning contract enforcement, it is necessary to stress the extreme importance of personal relations and personal trust as a precondition for completing any contract in Russia. Again, personification of economic links in the transition period was evidently inherited from the Soviet period. Before liberalization, the formal rules of centralized planning were supplemented by informal links between directors and the directorate (administration) on the one hand, and the Communist Party bodies and executive authorities on the other hand. It is possible to argue that the very system of centralized planning was only the outer form for a complex of informal and personified relationships. But, there is no doubt that links between directors played the same role in the Soviet economy that the networks of firms do in the market economy. After the break-up of the former system of central planning, and under the slow development of market-type coordination, the significance of personal relationships in Russian industries grew as never before (Kleiner, 1996). Keeping in mind the high costs of contract enforcement, it seems very natural that personal links and personal trust provide support for formal contracts.

Finally, the determinants of the competitiveness of Russian enterprises are also important for our study. While incentives to innovate or just to restructure the enterprise’s activity are a complicated subject, we can say that they depend on the extent to which more efficient market participants can increase market share and profit. Unfortunately, a number of authors have shown that on the one hand, restructuring of Russian enterprises typically has not significantly increased productivity, and on the other hand, the financial performance of Russian companies varies mostly because of shifts in demand and has no connection with any indicators of productivity (Bhaumik and Estrin, 2003). The analysis of case studies of the restructuring of Russian enterprises often shows that the influence of restructuring on the financial and overall economic performance is almost absent (Linz, 2000). Similar results were obtained in studies performed at the micro-level, and also at the level of industries: total factor productivity (TFP) decreased or stagnated in the export-oriented industries that demonstrated remarkable growth and improvement of financial performance after 1998 (Bessonova et al., 2003).

Some researches have tried to explain why production efficiency does not matter in Russia. One such explanation that initiated broad discussions in Russia was presented in the report of the McKinsey consulting company “Unlocking economic growth in Russia” (McKinsey & Co., 1999). Authors of this report argued that the unequal conditions of competition in the broad sense (including fairly different cost of inputs and different tax regimes for various groups of agents) neutralized the cost advantages of more efficient producers almost completely. That is why the incentives to invest in order to raise productivity (or equivalently to decrease cost) are relatively weak. In this context the question of incentives to innovate (especially for the different types of innovation) at the level of the enterprise or the business group is left unaddressed.

How can we explain the development of business groups in Russian industries within the transition economy? Initially business groups emerged because of the break-down of the former system of coordination, which included planning and contract enforcement. In the new economic conditions the boundaries of firms (as economic items) coincide with the legal boundaries of the Soviet enterprise, but evidently these exogenous boundaries could not be efficient. Disorganization (Blanchard and Kremer, 1997) increased the transaction costs sharply and created incentives to restructure the firm’s boundaries. The typical Russian privatized enterprise could only survive by revising its “make or buy” decisions in the new environment after liberalization.

In most cases, the efficient restructuring of the firm’s boundaries required both the elimination of old units from the organizational structure and the inclusion of new ones. In the early 1990s the process of eliminating the unwanted structures (including sales of assets, split-offs etc.) was more active (Dolgopyatova, 1995), and the second type of restructuring (including takeovers and emergence of business groups) has become more intensive under the economic recovery since 1999 (Pappe, 2000, 2002a and 2002b).

Besides economizing on transaction costs, business groups in Russian industries extract other sources of profits (Dolgopyatova, 2003). Additional coordination tools allow them to decrease losses in efficiency when there are bilateral monopolies. There is scope to escape the “double marginalization” problem in vertical relation of agents which have substantial market power. Horizontal mergers and alliances can create scale economies. The substantial inefficiencies in organization of markets in Russia during the transition period created the potential to capture all these gains.

Researchers of transition economies are still puzzled by the very low rate of restructuring of existing firms boundaries (Murrell, 2004). Similar results – relatively stable legal boundaries of enterprises - were documented for Russian industries too (Lazareva, 2004). It is possible that the development of business groups based both on shareholding and tools of coordination not related to ownership instruments (Avdasheva, 2002) can provide at least one explanation for this paradox: the business groups can be considered as means for changing the actual boundaries of the firm under given boundaries of legal entities.

According to many authors, extensively developed business groups, characterized by a specific system of coordination and contract enforcement, have come about as a result of inefficiency of legislation and its enforcement in transitional countries. Combined with a long tradition of extra-legal conflict resolution under the Soviet period, this fact increases the comparative advantages of different forms of networking. In this context, the underdevelopment of legal regulations should be offset by the development of personalized networks (Ledeneva, 2001). Many authors believe relational contract development to be the explanation for the increase in investments within business groups (Volchkova, 2001; Frye, 2003).

It is quite natural that these relational contracts, especially in the first years of transition, were primarily associated with links inherited from Soviet times. It is also empirically confirmed that during the 1990s the greatest returns were extracted from networks which had emerged before liberalization and privatization (Moers, 2000). The development and use of such networks was sometimes considered as an alternative to market-oriented restructuring of enterprises (Gaddy and Ickes, 1998).

These suppositions are, however, not supported by the results of empirical research on contract enforcement and conflict resolution in Russia and other transition countries (Murrell, 2004). Russian enterprises relatively seldom rely on the help of “third parties” to resolve their conflicts, as opposed to mutual relationships and legal rules (Hendley, Ickes, Murrell and Ryterman, 1997). Similar results were also obtained in other transition countries, for instance, for Romanian firms (Hendley and Murrell, 2003).

Returning to empirical studies of the evidence for the use of networks as an instrument to build trust between agents, even in these studies it has been demonstrated that informal structures within networks are imperfect substitutes for the formal ones; the use of informal structures reduces the decline in production. There can be no doubt, however, that economic growth requires more developed formal structures (Moers, 2000).

Empirical research shows interesting evidence on the sources and causes of trust in relations between firms, where the level of prepayment in advance of delivery is considered as an indicator of trust (Raiser, Rousso and Steves, 2003). It revealed that “trust” as measured by the level of prepayment increased in networks which were based both on family relationships and friendship as well as inside business associations. At the same time, there has been no evidence of higher trust within holding companies. This evidence, among others, raises doubts about the ability of informal structural relations within business groups to serve as a viable alternative to the enforcement of laws (contracts), although this view is widely expressed by Russian observers.

But even if membership within a business group does not provide contract enforcement within the group, the weakness of contract enforcement outside the group creates incentives for expansion of hierarchical control and emergence of business groups. The weak protection of legal property rights increases incentives to invest in assets under direct control by the investor. Investors fairly estimate the additional rights of control as equivalent to an increase of expected returns of the given asset. That is why the development of business groups replaces the imperfectly developed financial market in Russia. This has been demonstrated by empirical evidence since the middle of the 1990s (Perotti and Gelfer, 1998). This evidence can explain the rapid growth of business groups since 1999, especially the experience of companies in the oil and gas sector, and the ferrous and non-ferrous metals sectors (Dolgopyatova, 2003). In this context the additional inflows of funds would most likely lead to increased investments inside business groups, if we remember that the avenues for capital outflows have been restricted. As mentioned in many studies, there are more incentives to invest and a correspondingly higher share of invested profits within business groups as compared with the economy as a whole because of better contract protection within business groups due to the use of relational contracts (Volchkova, 2001).

To sum it up, there is a number of both complementary and conflicting explanations for the rapid development of business groups in Russian industry. At the same time, it seems that the existing explanations for the development of business groups contain some paradoxes which remain to be explained. How does the expansion of business groups co-exist with the prevalence of insider control? If there are high transaction costs that create incentives to replace market control for hierarchic or hybrid-type control, why should we think that the cost to enforce interfirm contracts is lower? There are some reasons for sharing the opposite assumption: whether we must associate enforcement of interfirm contracts in the transition economy with an underdeveloped legal system and unsettled moral norms which impose very high costs. In the context of business groups development, the wide authority of insider owners creates a threat to the very survival of any business group, especially taking into account the very complicated structural and ownership relations within typical groups.

From another perspective, if business groups are the heritage of the collectivist Soviet tradition and they rely mostly on relational contracts, how does that coincide with the rapidly increasing proportion of business groups based on partial shareholding, which are trying to re-organize themselves as more or less "classical" conglomerates? At first glance, informal relations can be significantly independent from the allocation of legally assigned property rights.

Another set of questions is connected with industry and size specificities of organization, which are almost absent in Russian business groups. Why do we observe common features in the business groups of the biggest companies in oil and gas sectors and in those groups created by the fairly small firms in retailing?

Again, why is the organizational form of business groups in Russia consistently reproduced in spite of instability of many business groups? If we take a look at the list of the biggest business groups (associated with the richest "oligarchs") at the end of the 20th century (Pappe, 2000), we find that a significant part of them no longer exist and the existing ones have lost control over many enterprises. Nevertheless, business groups still exist and continue to emerge in Russian industry and make significant impact on the innovation strategies of the firms within the group.

This paper attempts to answer at least part of these questions on the nature of Russian business groups, the incentives for insider owners to give up part of decision rights in favor of business groups, the specific distribution of decision rights between insider manager and outsider owner within business groups. Some conclusions are drawn about the innovation strategies of business groups as compared with “stand alone” enterprises.

3 Russian Business Groups in Surveys and In-depth Interviews: 2001-2003

This section is based on the results of surveys of industrial enterprises. The sample was developed within the research project “The Non-market Sector in the Russian Economy” in order to answer a broad set of questions. As for business groups, the general purpose was to explain the prevalence and the stability of business group as an organizational form in the context of prevalence of insider control and the high enforcement costs in the contracts between outsider owners and insider managers. In order to answer these issues we compared the economic performance, innovation (restructuring) strategies, and mechanism of decision making of the respondents within business groups and “stand alone” ones.

3.1 Surveys and In-depth Interviews: Sample Characteristics

Questions about the relationships between firms and business groups were put in two surveys organized in 2001 and 2002 (“Survey 2001” and “Survey 2002”). The samples for these two surveys were not the same, but they overlapped substantially. The questions about business groups and innovations at the level of the firm differed slightly in these two surveys.

For a part of the firms in the sample we had data from official statistical reports. In addition, the role of business groups in making important decisions at the firm level was explored through a series of in-depth interviews organized in the autumn of 2003. It is important to stress that the firms in the sample surveys and in-depth interviews are primarily medium-sized. This can be considered as an advantage of the sample, keeping in mind that our goal is to reveal some features of the “median” business group consisting of “typical” firms. Moreover, the development of big business in Russia is characterized in many papers.

The next very important feature of the sample is that it consists of firms that were organized in the Soviet period and later privatized in the 1990s. There are few start-up enterprises in in-depth interviews, but generally the scope of the research is medium-scale privatized firms in machine building, in the light industry, and the food processing industry.

According to the results of these surveys, a substantial part of Russian firms enter into business groups or associations of various types. In the “Survey 2001” 63% of the 431 respondents said that they represent stand alone enterprises, 13% identified their firms as entering into an informal business group, 11% said they were included in a legally identified group which determines strategic development of their firm (as opposed to executive management), and 13% - as entering into a legally identified group where the group performs executive management at the enterprise level. In “Survey 2002” the distribution of answers differs slightly: 68% of the 484 respondents are stand alone enterprises, 15% are members of an informal group and 17% are members of a legally identified group.

As one could expect, the bigger the firm is the higher is the probability that it is part of a business group. Industrial differences are present but they are not very significant: the highest proportion of enterprises united by business groups is in the machine building industry (a third), and the lowest proportion (about a fifth) exists in the construction materials industry.

There were 30 participants of the in-depth interviews who represented enterprises and firms. All the respondents were CEOs of their firms: 14 were general directors, 11 were deputy directors. The companies were mostly established in the Soviet period and then privatized (60% are open JSC and 30% are closed JSC): 37% of respondents were in the light industry, 30% in the food industry, and 33% in the machine building industry. As was already mentioned, interviews were conducted in mostly medium-size companies: 13 companies had 100 to 500 employees, 12 had 501 to 1000 employees, and only 5 had more than 1000 employees. The typical firm in the sample is characterized by relatively stable financial performance, while there were some firms in bankruptcy, including those which were under external management at the time of the interview. Most of the firms demonstrated a huge increase of output since 1998.

Out of the total of 30 firms where interviews were conducted, 16 were part of different business groups, which were owned by outsider owners. Only one respondent said that his enterprise entered into a business group which had no share in the ownership but which actually performed the functions of executive management. Several firms in the textile industry operate under stable processing contracts.

Out of 26 respondents who were able to assess the degree of ownership concentration in the firm only two said that their shares distribution was still widely dispersed or at least allowed for further future concentration[2]. For the rest of the sample, ownership is definitely concentrated. In only three companies there are state shares, though in none of them does the state retain control rights.

3.2 Competitive Advantages and Innovation Strategies of Firms Inside Business Groups (Survey)

The first question was: did firms inside business groups demonstrate a greater increase in output during the period of recovery since 1999. Though it is impossible to answer this question precisely (considering significant variations in output growth for both groups of firms – see Table 1), on average firms inside business groups grew faster during the period 1999-2002 than did the "stand alone" enterprises. If some advantages did exist for the first group of firms, they became apparent only after 1999 but not in the period since 1997 (Table 1). It was only in the recovery period since 1999, and not the period of economic decline (covered from 1997 for the sample) that the firms in business groups obtained some advantages which fostered increased output.

The survey data give clear explanations about the causes for faster growth demonstrated by the firms which are part of business groups. These are connected with the higher demand that led to the higher indicators of orders from the relevant firms. Analyzing the answers to the survey question about the length of the firm's production time needed to complete the received orders, we can see (Table 2) that among the firms in business groups ("Survey 2002") the share of those whose production times were less than a month is three times lower in comparison with stand alone enterprises. Correspondingly, for the firms in business groups the share of those who have orders for a year or more is two times higher. For the "Survey 2001" the demand advantages for the firms in business

[2] *Some respondents spoke about ownership concentration in spite of the fact that their companies were organized as partnerships. We think that we can consider these estimations keeping in mind the clear economic sense (control rights concentration).*

groups were even higher. Consequently, this group of respondents had higher capacity utilization ratios and higher estimates of economic and financial performance.

Table 1. **Output and employment of enterprises inside and outside business groups: 1997-2002***				
	Increase of output (times)		**Increase of number of employees (times)**	
	1997-2002	**1999-2002**	**1997-2002**	**1999-2002**
"Stand-alone" enterprises	243 6.56 (69.85) 0.83	244 4.68 (38,80) 1.03	272 1.05 (0.87) 0.93	284 1.13 (1.52) 0.96
Firms in "informal" business groups	56 3.11 (7.56) 1.14	54 5.40 (22.94) 1.24	59 1.27 (1.94) 1.05	61 1.60 (3.00) 1.08
Firms in "formal" business groups	64 1.44 (1.87) 0.96	64 9.49 (61.88) 1.00	70 1.64 (5.40) 0.96	71 1.44 (3.99) 0.99
Sample average	363 5,13 (57.23) 0.90	362 5.64 (41.98) 1.06	401 1.18 (2.48) 0.94	416 1.25 (2.36) 0.97

** Data in cells are number of observations, mean, (standard deviation), and median.*

Table 2. **Demand for the products of "stand-alone" enterprises and firms in business groups (proportions of respondents of relevant types, %): Survey 2002 (answers are for the previous year)**

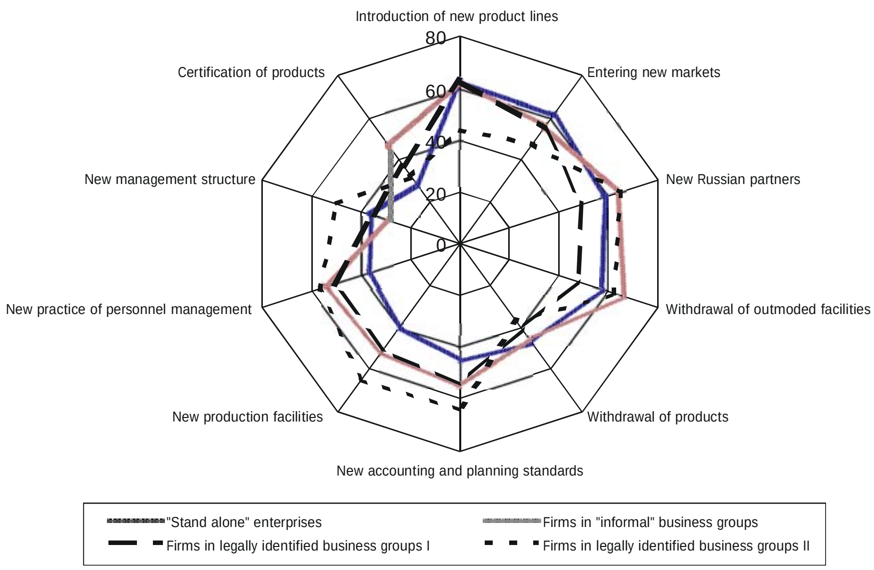
Period to complete orders received	**"Stand-alone" enterprises**	**Firms in "informal" business groups**	**Firms in "legally identified" business groups**	**Sample average**
< 1month	25.00	17.81	8.75	21.10
1-3 months	25.32	30.14	15.00	24.30
3-6 months	14.42	20.55	21.25	16.60
6-12 months	28.53	17.81	37.50	28.40
> 12 months	6.73	13.70	17.50	90
Number of respondents	312	73	80	465

Different groups of enterprises apply innovation (or restructuring) strategies which differ significantly (fig.1 and 2).

Among the firms within business groups the share of those that introduced new production facilities, changed management structure or top management, organized management training, introduced new accounting and planning standards, increased R&D and marketing expenditure and financed investment project was higher in comparison with the other group of respondents. At the same time, the introduction of new product lines and adjustment of product variety by removing products less in demand are less frequent in this group of firms.

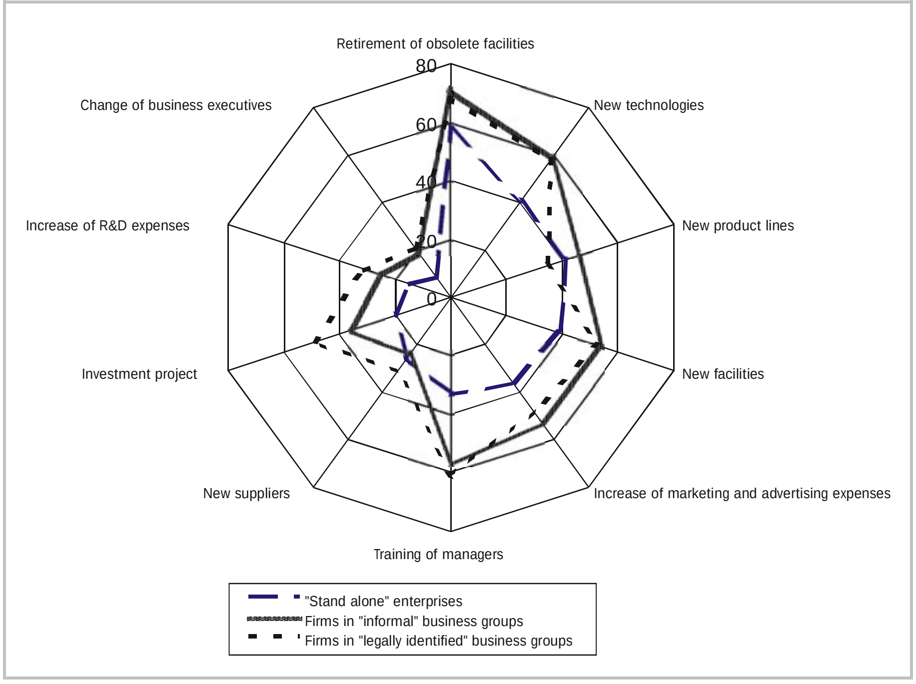
If we eliminate some actions connected with the expansion of output (for instance, new production facilities), we can conclude that firms within business groups apply fewer innovations connected with marketing (especially the adjustment of product variety), in comparison with other changes, such as management organization and changes of CEO and staff. It seems that innovation strategies of business group firms are more "inside-oriented" while restructuring of "stand-alone" companies is outwardly oriented (toward marketing and external demand).

Figure 1. **Innovation strategies of enterprises in the "Survey 2001" (during three years before survey), %**



*Note: *"Legally identified business groups I" – business groups which "perform only strategic management" for the firm;*
"Legally identified business groups II" – business groups which "perform both strategic and operational management" for the firm.

Figure 2. **Innovation strategies of enterprises in the “Survey -2002” (2001-2002), %**



The reasons for different innovation strategies can be found in industry-specific factors, size of typical stand-alone and business group enterprise, and also in the ownership structure and corporate governance. The last point requires special attention. It is surprising that stand-alone enterprises and firms within business groups do not demonstrate remarkable differences in ownership structure, concentration, and structure of executive bodies. We can mention that ownership concentration is slightly higher in firms in legally identified business groups, but the general trends of ownership distribution for different groups of enterprises almost coincide (Table 3). The typical size of the board of directors (seven members) and representation of different groups of owners are almost the same. The executive director worked quite a long time both with this enterprise and in this position in the companies of both types.

Table 3. **Ownership concentration in public corporations: 1998 and 2001***				
	"Stand-alone" enterprises	**Firms in "informal" business groups**	**Firms in "legally identified" business groups**	**Sample average**
Share of the biggest shareholder in 1998 (%)	129 36.26 (24,41) 30.00	42 30.78 (23.26) 20.00	43 39.79 (25.17) 39.00	214 35.89 (24.40) 29.29
Share of the biggest shareholder in 2001 (%)	141 40.39 (25.58) 34.00	44 39.41 (25.06) 38.00	47 43.69 (23.29) 48.50	232 40.88 (24.82) 38.00
Share of three biggest shareholders in 1998 (%)	103 46.99 (22.81) 45.10	35 48.99 (29.42) 45.00	32 55.50 (24.93) 52.50	170 48.44 (24.63) 46.50
Share of three biggest shareholders in 2001 (%)	115 54.49 (23.97) 54.00	37 58.32 (27.61) 59.00	36 64.49 (24.27) 67.00	188 56.77 (24.85) 55.00

** Data in cells are number of observations, mean, (standard deviation), and median.*

3.3 Competitive Advantages and Incentives to Join Business Groups: In-depth Interviews

Results of in-depth interviews highlight the specificity of corporate governance and overall decision-making at the level of firms within business groups. Respondents pointed out all the possible explanations for entering into business groups mentioned in analytical papers devoted to big business in Russia (Dolgopyatova, 2003).

Let's give several examples[3]. As we already mentioned, the firm boundaries which were exogenously determined in Soviet times became inefficient after liberalization. The same can be said about market structures: too many sellers found themselves in the market. This problem was most acute for firms in industries which faced tough competition from imported products (namely food, textiles etc.). Almost all respondents in the in-depth interview mentioned this.

«Recently our market segment… changed dramatically. From 23 Russian producers only 12 are in the market now, and only 7 of them have modernized capacities and increased output. It seems clear that in three-four years time only 4-5 of the biggest firms will remain in the industry. Our enterprise is not among the biggest and recently has become

[3] *Citations from interviews are given in italics.*

detached from the market leaders… Enterprises like this will be captured by the market leaders anyway" (respondent is a deputy director general of a firm in the food processing industry, it employs 840 staff).

Several respondents mentioned the possibility of cutting costs within a business group because of unified procurement and marketing policies. Almost all respondents insisted that the advantages of the "full technological cycle" within the firm were crucial in the Russian context. For all of them competitive strategy was to develop the value chain from raw materials to the supply of production and then to the final consumer. Respondents were not unaware of the losses caused because of weak incentives in the complicated system of hierarchical control, but they were absolutely certain that these losses are outweighed by gains from centralized decision-making at the level of business group.

«It would be better for the owner to buy the firms on subsequent stages of the technological chain instead of any certain enterprise… He must have professional staff for any technological process and professionals for the whole production. Starting from the supply of raw materials to the sale of products to final customer… all questions must be solved at the top level» (respondent is an executive director of a textile company with 300 employees).

As an incentive to enter into a business group respondents mentioned the problems associated with the quality control of raw materials and reliability of supply, which are much easier to solve inside an integrated company. This kind of evidence confirms the traditional view that business groups result from high transaction costs in Russian markets, which have decreased very slowly in comparison with what would have been expected ten years ago. The prevalence of vertical as opposed to horizontal integration inside Russian business groups also seems to provide additional arguments for this point of view.

The real surprise is that according to the results of interviews the insufficient adaptation of managers to a market environment is still a valid reason for the creation of business groups. The common tool to overcome this problem at the business level is to drive a set of important managerial decisions out of the firm that becomes a "production facility" only. Mentioned in the case of big businesses (Pappe 2002a, 2002b), this effect takes place in medium-size companies, too.

«People are used to work in the old manner; they cannot work in the new environment. That is why all the questions about procurement, about tariffs on processing, on marketing and dealing – all these questions are solved here (by new owner). Some time ago I tried to delegate a set of responsibilities to the level of the enterprise but the only thing I received was a mishmash in accounting files… So I decided that it should be better to do all here…" (respondent is a new (initially outside) owner / executive director of a textile firm with 300 employees).

It is also surprising that the respondents representing firms consider this kind of authority sharing to be an advantage despite the fact that it evidently restricts the self-dependence of the firm. The executive managers of firms in Russian business groups – even if they are controlling owners, - have almost no decision rights in the field of marketing.

«Enterprise is free from the unusual and unnecessary decisions. The holding company performs the functions of the Soviet Glavk (industrial planning body under socialism). We don't have to care about what and how much to produce… The holding company supplies the raw materials, sells our products, and decides all accounting, tax and financial issues. Director don't have to think about taxes, wages etc… The holding is a buffer that saves us from the market…» (respondent is a director general of a machine building enterprise with 1100 employees).

«(The holding's authority) *is in the first place in marketing. I do not have to care any more to whom to sell the product and at what price»* (respondent is a director general of a food processing enterprise with 430 employees).

In this context, analyzing the results of interviews we again found the answer to the question about why the processing arrangements are so popular in Russian industries. The specific feature of processing (tolling) arrangements is that it drives all the important marketing functions out of an enterprise (Avdasheva, 2002). Among the respondents of this sample survey, those who operated under processing contracts were mainly found in the textile industry. As they mentioned, initially processing contracts were considered only as a temporary tool to solve the problem of a deficit of working capital. But now the respondents are absolutely certain that this form of organization has important advantages for their firms.

"Under this scheme, under processing arrangements… there is no need for substantial managerial efforts… We know all the suppliers of materials for processing and they

know us… The question is only to sign a contract, and after that business becomes very simple" (respondent is a new (initially outside) owner / executive director of a textile firm with 300 employees).

In the context of the question on the authority of business groups towards their member firms, the largest part of respondents mentioned the *"unified marketing and technological* (and of course, financial) *policy"* within the group. Business groups make decisions about product specialization, as well as the amount and directions of capital investments. At least in two firms in the sample for in-depth interviews business groups initiated large-scale restructuring, including significant changes in the variety produced in order to complete the "technological chain" associated with massive capital investments. The latter example raises very important questions: do the firms within business groups have better access to the market for investment funds?

From our sample we did not find any positive dependence on availability of investments because of the fact that the firm belongs to a business-group. Comparing capital investments during the four years before the interview[4] with the other characteristics of the firms (including the relationships with business groups), we found (as expected) that the decisive determinant for capital investments was the financial performance of the enterprise (Table 4). In turn, financial performance does not depend on whether an enterprise is a part of a business group or not.

The data about the sources of the enterprise investment funds is very interesting. In addition to the enterprise profits, which comprise the main source of investment funds, a significant part of respondents (two thirds of the sample) have obtained bank credits in recent years. Seven respondents mentioned state support (mainly indirect incentives such as tax privileges and special guarantees, as in one case where there was repayment of 50% of the interest on debt) as one source to attract investments. Funds from business partners (including holding companies) are also significant as a source of investment funds, but an interesting fact is that the possibility of using this source does not differ for enterprises that form a part of a business group and those that do not. From our sample, four respondents of the first type and three respondents of the second type mentioned this source of funds. Therefore, the results of interviews do not confirm the statement that

[4] *When interpreting the results of interviews it is, unfortunately, impossible to estimate the scale of capital investment. We tried to separate capital investments from investments in expansion of working capital or nonsignificant expenses for equipment, where it was possible.*

better access to investment funds is a common consequence of entering into a business group.

Table 4. **Financial performance, relationships with business groups and capital investments (% of respondents)**

		Financial performance			Overall
		Unsatisfactory	**Satisfactory**	**Good**	
Capital investments in the last years	No	75.0	25.0	0.0	26.7
	Yes	25.0	75.0	100.0	73.3
Enterprise is a part of business group	No	50	40	66.7	46.7
	Yes	50	60	33.3	53.3
Number of respondents		4	20	6	30

Summing up, the results of interviews allow us to draw important conclusions about the national model of distribution of authority and responsibility between insider manager and outsider owner (firm and business group in our context). In spite of many authors who mentioned extremely high centralization of decision-making in the hands of a controlling owner as an important feature of Russian corporate governance, we found very little evidence of strong centralization of *all type of decisions.*

One possible solution of this paradox may be connected with the fact that distribution of authority and responsibility between firms and the business group is subordinated to the logic of "marketing center – production facility" but not to the logic "strategic decisions – day-to-day management". All the marketing and financial decisions are highly centralized while "production" decisions are decentralized enough. The following statement is typical:

"Key decisions are made at the enterprise level, the business group developed only for marketing" (respondent is a director general of a machine building enterprise with 300 employees). Very critical in this statement is the strong opinion expressed by the respondent that marketing decisions are of secondary importance to him.

The examples of complete centralization of decision-making at the level of business groups are more rare, but also present. In all of these examples the firms, including those with controlling inside shareholders, function only as pure "production facilities":

«The holding controls all the finance, buys all the inputs for production, provides us with technologies, including all the documentation… We supply the final products in

exchange for that» (respondent is a director general of a machine building firm with 1800 employees).

But the typical situation is where most of the "production" decisions (technology, personnel, even product variety and product quality) are delegated to the level of the firm. Assessing this type of allocation of authority and responsibility from a more or less traditional point of view, one can find "excessive centralization" (financial and marketing decisions) and "excessive decentralization" ("production" decisions, including input management).

3.4 Competitive Advantages of Business Groups: Contract Protection or Just Marketing?

The model of relationships between enterprise and business group described above can be considered as a special type of "dispersed company" that was described in the first place in connection with tax evasion (Kuznetsov, Gorobets and Fominych, 2002), but not explained completely by the reasons for tax evasion. This model emerged because the inside managers of Russian enterprises adapted imperfectly to the new market environment, apparent market deals actually serve to complete the decisions made and enforced under hierarchical control. A similar model was described by Stark as "recombinant property" (Stark, 1997).

In the model of "dispersed company", financial and marketing decisions are driven out of the "production facility" that is an enterprise for the level of decision-making, which is legally separated from the company. We can see the same thing in the business groups we have analyzed. An important difference is in the roles of inside managers versus inside/outside owners. The development of "dispersed companies" served the interests of inside ownership and control, for instance, allowing inside owners to receive income from property that is non-related to dividends (Rozinsky, 2002)[5], while in business groups outside owners have played a more significant role. It is important to ask,

[5] *The phenomenon of "non-dividend income from property" is essential to understand overall decision-making at enterprise level. The main idea is that the prevailing part of income of an insider top-manager is transferred from the revenue of firms affiliated with him to those that are suppliers of raw materials to the enterprise under consideration. This system is known as "participation in cost" as opposed to "participation in profits". Evidently under this system a top-manager has not enough incentives for cost saving, since cost saving would lead to the decrease of his income (Rozinsky, 2002).*

however, in what sense can we call an owner of a business group an “outsider” owner with respect to the typical Russian firm which is part of a group? Despite the recent distribution of shares, it is the executive manager (or a group of executive managers) of the business group who make important decisions for the firm. In certain cases, even if this owner initially is an “outsider”, in the course of time he becomes a very important decision-maker and can be considered as an “insider” for the business group as an integrated business. Redistribution of shares may follow redistribution of authority and responsibility, albeit relatively slowly.

Speaking about redistribution of power in favor of business groups, we must keep in mind that it takes place while there is a prevalence of insider ownership in the Russian enterprise. So we have to ask several questions. Why does an outsider business group insist on redistribution of authority described above? Why do insider managers/owners agree with it? How does this model of decision-making influence the development of a national model of corporate governance?

Because of the weakness in law enforcement, contracts between an owner and a manager should have the properties of an incentive contract. Among other things, they should be easily verifiable and should prevent opportunistic behavior. It seems that the model of business group organization satisfies these conditions. The manager’s assignment is formulated as an output program. This format requires relatively low monitoring costs, and also it restricts the possible opportunism of managers since their role in the apparent external agreement is just a technical one. On the other hand, the incentive for the insider manager (who is typically also a controlling shareholder) to accept such a contract is insured because being a “production facility only”, the firm receives more gains than being a stand-alone enterprise and trying to perform marketing and financial functions.

It is natural to assume that inside manager (who is often a controlling shareholder at the same time) will agree to give up some of his authority only if the business group insures him at least the same level and source of income. One of the ways to do so is to retain as a main supplier the firms affiliated with the top management. To remain the “traditional” source of income means to remain the traditional source of income for inside managers from the revenues of supplying firms. But that means that there is a very restricted perspective for radical restructuring of enterprise activity, since top-managers are not interested in cost-saving.

The results of surveys and interviews raise a doubt about the idea that business groups provide better contract protection. It seems possible that the main competitive advantages for business groups are connected with the removal of marketing functions from the management of the firm level and the possibility of business groups that better perform these functions. In the surveys and interviews we found little evidence of "trust" between firms and business groups. Instead, the agents apply specific strategies to create incentives for the "fair behavior" of the partner.

4 Business Groups and Innovation Strategies of Russian Enterprises

As we indicated above, firms within business groups implement innovation strategies (at least some of them) more often than "stand-alone" enterprises. This result remains true in the data of both "Survey 2001" and "Survey 2002". At the same time, the data presented above do not allow us to answer the question as to the extent to which this is an effect of the business groups themselves, as opposed to specific circumstances connected with the industry, size and even region of the firm. To explore this question more precisely we used probit-analysis, where the endogenous variables were the different innovation strategies.

For the regressions we used the data of "Survey 2002" (Table 5). Explanatory variables are industrial dummies (3-digit), regions where enterprises are located, size of enterprises (where "small" means that the number of employees is under 100, "big" means that the number of employees is over 500), dummies of competition with import and domestic producers (normalized to 1 being the toughest competition). "Orders" dummy was also normalized from the estimated period through which enterprises were confident about their orders. In several specifications we also introduced variables for the "influential stakeholders" of certain enterprises derived from the answer to the question "How frequently do you consult with (a given group of stakeholders) to make strategic decisions?" with answers "almost never", "sometimes", "often" and "almost always". Here a zero value for the variable refers to the answer "never" and one refers correspondingly to the answer "almost always". This group of variables was used to highlight the impact of different groups of stakeholders within a business group on the strategies of an affiliated firm and therefore to define the role of business groups in the development of Russian enterprises.

The characteristics of ownership and its redistribution are also introduced: the variable for state ownership – the value is zero when there are no shares belonging to the state and one —when there are, and the variable for a change in ownership for the biggest owner – the value is zero if there was no change of controlling owner in the past three years, and one if there was). The special variable reflecting the "lock-in" effect was drawn from the answer to the question "How high are the costs to change the main suppliers?" (where a value of one refers to the answer "It's almost impossible to change suppliers" and a value of zero to the answer "It's possible to change suppliers without any difficulties"). This variable reflects an important concept of "quasi-rent" and "hold-up problem" that was very crucial for enterprises in transition due to an underdeveloped market infrastructure and lack of competition.

In many papers (see, for instance, Bevan et al., 2001) it has been shown that competition from imported products (in contrast with competition from domestic producers) provides significant incentives to innovate (for almost all types of innovations). Following these papers, we also introduced dummies (assigning a value of zero if there is no competition and a value of one if there is competition) for the estimate by the respondents of competition from imported products and domestic competitors.

As for business groups, the picture is mixed. On the one hand, the firms within business groups (especially informal ones) have an increased probability of introducing new production capacities. But it is necessary to keep in mind that this effect is almost completely explained by the positive dependence of probability to introduce new production capacity on the amount of orders guaranteed and on the participation of firm partners as influential stakeholders in decision-making. Firms within legally identified business groups have a higher probability of implementing investment projects and this fact can support the viewpoint (see Volchkova, 2001, Frye 2003) that investments inside the group are better protected. Within business groups there exists a credible threat that is disciplining manager (confirmed by a higher probability of change in the top management of firms within business groups).

At the same time, firms within business groups have a lower probability of introducing new product lines and of changing their main input suppliers. In other words, firms within business groups are reluctant to perform several restructuring strategies.

Table 5. **Russian enterprises: innovation strategies and business groups (probit-models), Survey 2002**

Table 5.1. – **Innovation strategies: production capacity, investment projects (cell contains regression coefficient (standard deviation in parenthesis))**

	Introduction of new production capacity				**Retirement of obsolete capacity**				**Investment projects**		
Small	-0.25 (0.18)	-0.51* (0.32)	-0.31 (0.22)	-0.47* (0.23)	-0.06 (0.18)	-0.30 (0.19)	0.06 (0.19)	-0.06 (0.19)	-0.34 (0.36)	-0.32 (0.35)	-0.14 (0.26)
Big	0.28* (0.17)	0.06 (0.23)	0.23 (0.20)	0.30 (0.19)	0.32* (0.18)	0.40* (0.19)	0.30 (0.19)	0.34* (0.18)	-0.12 (0.28)	-0.06 (0.25)	0.13 (0.22)
Competition from import	0.32* (0.18)	0.46* (0.26)	0.46* (0.21)	0.38* (0.20)	0.53** (0.18)	0.50* (0.19)	0.47* (0.19)	0.49* (0.19)	0.54* (0.27)	0.55* (0.27)	0.27 (0.22)
Competition from domestic producers	0.16 (0.17)	0.28 (0.24)	0.23 (0.20)	0.20 (0.20)	-0.06 (0.17)	-0.09 (0.17)	-0.08 (0.17)	-0.04 (0.17)	0.06 (0.27)	-0.06 (0.26)	0.01 (0.21)
"Formal" business group	0.13 (0.21)				0.35* (0.20)		0.21 (0.22)	0.47* (0.23)	1.25*** (0.34)	1.12*** (0.32)	0.66* (0.23)
"Informal" business group	0.26 (0.21)				0.36 (0.22)		0.45* (0.24)	0.34 (0.22)	0.02 (0.29)	-0.06 (0.28)	0.02 (0.24)
Orders	0.69* (0.27)	0.38 (0.40)	0.38 (0.30)	0.52* (0.30)					0.34 (0.44)	0.03 (0.42)	
Customers are stakeholders		-0.71* (0.39)	-0.31 (0.30)	-0.49 (0.31)		-0.86** (0.27)					
Suppliers are stakeholders		0.14 (0.47)	-0.21 (0.36)	0.26 (0.36)		0.36 (0.32)					
Banks are stakeholders		-0.47 (0.39)	-0.59* (0.31)	-0.62* (0.31)		0.39 (0.29)					
Partners are stakeholders		0.52* (0.32)	0.50* (0.24)	0.55* (0.24)		0.10 (0.24)			0.94** (0.34)	0.92** (0.32)	0.74** (0.26)
No state ownership									0.64* (0.32)		
New owner (3 years)		-0.35* (0.21)								-0.49* (0.22)	
Control of owner			0.32* (0.19)				0.53** (0.17)				0.54* (0.22)
Cost of changing the supplier				-0.51* (0.29)				-0.55* (0.25)			
Industrial (3 digits) and regional dummies	+	+	+	+	+	+	+	+	+	+	+
Constant	-0.34 (0.26)	0.50 (0.51)	-0.29 (0.32)	-0.48 (0.33)	0.00 (0.22)	0.16 (0.26)	-0.32 (0.26)	0.32 (0.27)	-1.79*** (0.49)	-0.69* (0.40)	-1.33*** (0.31)
Number of observations	376	224	328	312	391	344	368	367	215	226	345
P> Chi2	0.141	0.02	0.230	0.065	0.156	0.131	0.167	0.171	0.186	0.04	0.446

*Note: * significant at 10% level; ** significant at 5% level; *** significant at 1% level.*

Table 5.2. – **Innovation strategies: production capacity, investment projects (cell contains regression coefficient (standard deviation in parenthesis))**									
	Adoption of new technology		**New product lines**			**Increase of R&D expenses**			
Small	0.00 (0.18)	0.06 (0.19)	-0.37* (0.19)	-0.10 (0.26)	-0.33 (0.21)	-0.31 (0.21)	-0.22 (0.23)	-0.78* (0.33)	-0.71* (0.33)
Big	0.22 (0.18)	0.13 (0.18)	-0.08 (0.17)	-0.07 (0.22)	-0.08 (0.18)	0.12 (0.17)	0.10 (0.19)	0.13 (0.23)	0.15 (0.23)
Competition from import	0.47** (0.18)	0.48* (0.19)	0.20 (0.17)	0.20 (0.22)	0.22 (0.18)	0.49** (0.18)	0.68** (0.20)	0.14 (0.23)	0.06 (0.23)
Competition from domestic producers	0.04 (0.16)	0.09 (0.16)	-0.13 (0.17)	-0.05 (0.21)	-0.16 (0.17)	0.01 (0.17)	0.05 (0.19)	0.12 (0.22)	0.04 (0.23)
"Formal" business group	0.48* (0.20)	0.40* (0.21)	-0.10 (0.21)	-0.14 (0.28)	-0.08 (0.22)	0.46* (0.21)		0.79* (0.27)	0.93*** (0.27)
"Informal" business group	0.32 (0.21)	0.32 (0.22)	-0.19 (0.20)	0.26 (0.24)	0.13 (0.21)	0.26 (0.21)		0.31 (0.27)	0.37 (0.27)
Orders							0.44 (0.31)		
Customers are stakeholders							0.32 (0.29)		
Suppliers are stakeholders							-0.66* (0.36)		
Banks are stakeholders							-0.17 (0.32)		
Partners are stakeholders							0.61* (0.25)		
No state ownership				-0.41* (0.20)					
Control of owner		0.36* (0.17)						0.48* (0.24)	
Cost of changing the supplier					-0.31 (0.25)				-0.82** (0.32)
Industrial (3-digit) and regional dummies	+	+	+	+	+	+	+	+	+
Constant	-0.44* (0.22)	-0.69** (0.26)	-0.17 (0.23)	0.23 (0.32)	0.03 (0.27)	-0.33 (0.22)	-0.53* (0.30)	-1.95*** (0.36)	-1.20** (0.34)
Number of observations	390	369	392	251	369	387	328	364	356
P> Chi2	0.104	0.106	0.150	0.082	0.129	0.244	0.148	0.178	0.814

*Note: * significant at 10% level; ** significant at 5% level; *** significant at 1% level.*

Table 5.3. – **Innovation strategies: organization and marketing (cell contains regression coefficient (standard deviation in parenthesis)**

	Change of input supplier			**Increase of marketing and advertising expenses**			**Change of executive managers**			
Small	0.14 (0.20)	0.14 (0.22)	0.25 (0.28)	-0.31 (0.21)	-0.18 (0.31)	0.12 (0.25)	-0.07 (0.29)	-0.09 (0.32)	0.08 (0.31)	-0.06 (0.31)
Big	-0.04 (0.19)	-0.06 (0.21)	-0.23 (0.22)	0.12 (0.17)	-0.08 (0.23)	0.06 (0.19)	0.53* (0.22)	0.67** (0.24)	0.39* (0.23)	0.56* (0.23)
Competition from import	0.06 (0.19)	0.19 (0.21)	0.09 (0.23)	0.49** (0.18)	0.39* (0.25)	0.55** (0.21)	-0.12 (0.23)	-0.16 (0.26)	-0.10 (0.24)	-0.21 (0.24)
Competition from domestic producers	0.13 (0.18)	0.15 (0.19)	0.16 (0.22)	0.02 (0.16)	0.01 (0.23)	0.06 (0.19)	0.19 (0.23)	0.08 (0.25)	0.20 (0.24)	0.16 (0.24)
"Formal" business group	0.07 (0.22)	0.06 (0.24)	-0.26 (0.29)	0.46* (0.21)			0.62* (0.26)		0.63* (0.27)	0.64* (0.27)
"Informal" business group	-0.13 (0.23)	0.16 (0.26)	-0.35 (0.25)	0.26 (0.21)			0.36 (0.26)		0.29 (0.27)	0.37 (0.27)
Orders								-0.41 (0.42)		
Customers are stakeholders		0.58* (0.28)			0.39 (0.33)			-0.22 (0.42)		
Suppliers are stakeholders		-0.08 (0.36)			-0.82* (0.43)			0.44 (0.48)		
Banks are stakeholders		0.11 (0.33)			-0.19 (0.39)			0.13 (0.41)		
Partners are stakeholders		-0.36 (0.26)			0.47 (0.32)	0.62* (0.25)		-0.28 (0.33)		
No state ownership					-0.31 (0.26)					
New owner (3 years)			-0.44* (0.19)							
Control of owner						0.62** (0.20)			0.78* (0.29)	
Cost of changing the supplier						-0.88** (0.29)				-0.63* (0.35)
Industrial (3-digit) and regional dummies	+	+	+	+	+	+	+	+	+	+
Constant	-0.80*** (0.24)	-1.18 *** (0.28)	-0.36 (0.32)	-0.33 (0.23)	0.25 (0.35)	-0.32 (0.32)	-2.00*** (0.31)	-1.61*** (0.39)	-2.50*** (0.40)	-1.64*** (0.37)
Number of observations	383	339	260	387	220	325	379	323	362	356
P> Chi2	0.122	0.140	0.265	0.244	0.020	0.336	0.101	0.036	0.455	0.557

*Note: * significant at 10% level; ** significant at 5% level; *** significant at 1% level.*

Interesting results were obtained about the impact of the relationships of enterprises with different "influential stakeholder groups" on innovations. According to a viewpoint that has recently become very popular, the participation of influential stakeholders in decision-making should improve the efficiency of the latter. From our survey sample, the control of decisions by different stakeholders has a differing influence on the probability of applying innovation strategies. For instance, control by partners in joint venture projects increases the probability of implementing most of the analyzed innovation strategies (e.g. introduction of new production capacity, realization of investment projects, and increase of R&D investments, marketing and advertising). At the same time, the control of strategic decision-making by the bank decreases the probability to innovate. This evidence could be explained by the fact that the bank plays an important role for enterprises with unsatisfactory financial performance. But it is not easy to explain the negative influence on innovation strategies of the control by the consumer (decreases the probability to introduce new production capacity and to retire obsolete equipment) and coordination with suppliers (decreases the probability to increase marketing and advertising expenditure).

It is not easy to explain the negative influence of a change in ownership on almost every innovation strategy, and also the absence of a positive influence of completely private ownership (absence of shares belonging to the state on the probability of innovation).

Closer control of owners over the decisions of managers increases the probability to innovate and this can be considered as another argument in support of the viewpoint about the need to improve the overall system of corporate governance in Russia and to confront the attempts to prove the viability of a “national system of corporate governance” with a completely unique set of rules and norms.

Another interesting result is that the probability of almost every type of innovation decreases with the difficulty the enterprise has in changing input suppliers. This result (surprisingly) fully coincides with the institutional theory of a lock-in effect: the dependence of an enterprise on the suppliers decreases the incentives to innovate. This factor is important for Russian enterprises: in our sample only 15% said they could change suppliers easily, the proportion of enterprises which believed it was nearly impossible to change suppliers was at least twice as high.

5 Business Groups, Innovation strategies and Competitiveness of Enterprises in Transition: the Main Conclusions

The influence of the described business group functioning model on the competitiveness of enterprises is ambiguous. On the one hand, as surveys and in-depth interviews show, business groups are more successful in marketing than are stand-alone firms.

Correspondingly, firms within business groups face higher demand and demonstrate better financial and overall economic performance. Inside business groups, funds are invested in projects which are oriented to the development of competitive product lines, to new forms of accounting and management, which allow them to better estimate the economic performance and the determinants of competitiveness and therefore to make more efforts for further improvements.

On the other hand, the positive influence of business groups on the strategies of firms is still restricted by a number of factors. Some of them are connected with inside ownership which prevails in Russian industry: under inside ownership (even if it is only formal) redistribution of decision-making towards the parent company of the business group seems to be inefficient. While shares are in the hands of insider management, the investments of the business group in its affiliated firms will be less than optimal. Moreover, in many cases redistribution of shares to outsider owners is not a desirable solution, since in the context of extremely flawed institutional environment outsider owners cannot establish efficient control over insider managers without becoming an insider owner themselves. This will evidently restrict the prospect for business groups to develop to a point which allows them to support “first-hand control” of the controlling owner.

It is necessary to mention again that the development of business groups in Russian industry represents a compromise in the face of the need for market-oriented restructuring and the dominance and relative stability of insider’s control and insider shareholding.

Returning to competitiveness, it is necessary to emphasize that the described allocation of decision-making between a firm and the business group it is associated with demonstrates important inefficiencies. Those agents apprehend the market signals (business groups) which typically have restricted the ability to adopt an entirely new production according to these signals and do not have perfect knowledge about the possibilities of production to adopt. In turn, managers of enterprises, which have firm-specific knowledge about production and can adopt it, do not perceive information about the market demand. This is the cause for the lower speed of adjustment of product variety of business group firms in comparison with stand-alone enterprises.

The improved performance of business groups in the period after the1999 recovery has been determined mostly by an increase in demand, as opposed to cost saving. There are a number of evident reasons for this. Insider managers do not have incentives for cost saving first of all because the considerable source of income for them is “participation in cost” (revenues of affiliated companies). Being aware of that and being incapable of establishing efficient control over the firms, business groups too lacked sufficient incentives to invest in cost-savings. This is one explanation for the non-reliance on restructuring of Russian enterprises as a means of cost savings and cost savings being the reason for better financial performance (Bhaumik and Estrin, 2003) for the firms within business groups (which is a substantial part of Russian privatized firms).

Again, the economic and financial performance of the described business groups is mostly determined by a change in demand for the products of firms. Under import-substitution and economic recovery – when it is possible to increase output without any increase of production efficiency, - business groups demonstrated themselves to be successful enough. But we should keep in mind that a fall in demand could highlight all the weaknesses of decision-making inside the groups, which in turn would contribute to the decline of firms and business groups.

In conclusion, the entire story about privatized enterprises and business groups in Russian industries tells us that a significant portion of market participants in Russia are still in the process of transition to market economy. For many of them, the transition takes very specific forms as described in this paper.

References

Avdasheva, S. (2002): “Tolling Arrangements in the Russian Industries: an Institutional Perspective”, *East-West Journal of Economics and Business*, Vol. 5, No. 2, pp. 217-240.

Bessonova, E., K. Kozlov and K. Yudaeva (2003): “Trade Liberalization, Foreign Direct Investment and Productivity of Russian Firms”, CEFIR.

Bevan, A.A., S. Estrin, B. Kuznetsov, M. Schaffer, M. Angelucci, J. Fennema and G. Mangiarotti (2001): “The Determinants of Privatized Enterprise Performance in Russia”, *William DavidsonWorking Paper Series*, No. 452, June.

Bhaumik, S. and S. Estrin (2003): “Transition and Performance: Comparative Lessons from Chinese and Russian Companies”, *William Davidson Institute Working Papers Series*, No. 525.

Blanchard, O and M. Kremer (1997): “Disorganization”, *Quarterly Journal of Economics*, Vol. 67, pp. 1091-1126.

Dolgopyatova, T. (ed.) (2003): “Russian Industry: Institutional Development”, *Analytical Survey*, Issue 1, Moscow, Higher School of Economics.

Dolgopyatova, T. (2002): “Corporate Control in Russian Companies: Models and Mechanisms”, Moscow, *Higher School of Economics Working Paper Series*, No. 5.

Dolgopyatova, T. (1995): “Russian Enterprises in Transition Economy: Economic Problems and Behaviour”, Moscow, Delo (in Russian).

Dynkin, A. and A. Sokolov (2001): “Integrated business groups – breakthrough to the modernization of Russia, Institute for complex strategic studies”.
(http://www.icss.ac.ru/publish/analysis/am008.pdf)

Frye, T. (2002): “Slapping the Grabbing Hand: Credible Commitment and Property Rights in Russia”, Higher School of Economics, *Working Paper Series*, No. 2.

Gaddy, C. and B. Ickes (1998): “To Restructure or Not to Restructure: Informal Activities and Enterprise Behavior in Transition”, *William Davidson Institute Working Paper Series,* No. 134.

Hendley, K., B.W. Ickes, P. Murrell and R. Ryterman (1997): “Observations on the Use of Law by Russian Enterprises”, *Post-Soviet Affairs*, Vol. 13, pp.19-41.

Hendley, K. and P. Murrell (2003): “Which Mechanism Supports the Fulfilment of Sales Agreement? Asking Decision-Makers in Firms”, *Economic Letters*, Vol.78, pp. 49-54.

Kleiner, G. (1996): “Economy of Today as "the Economy of Physical Entities”, *Voprosi Ekonomiki*, No. 4 (in Rusisan).

Kuznetsov, P.V., G.G. Gorobets and A.K. Fominych (2002): “Non-payment and Barter as a Reflection of New Form of Industrial Organization in Russia”, in: *Russian Firms: Corporate Governance and Market Deals*, Moscow, Higher School of Economics (in Russian).

Lazareva, O. (2004): “Adjusting Boundaries of Russian Firms”, EERC – Russia, *Working Paper Series*, No. 04-08e.

Ledeneva, A. (2000): “Networks in Russia: Global and Local Implications”, in: Segbers K. Explaining Post-Soviet Patchworks, Aldershot: Ashgate, Vol. 2, pp.59-78.

Linz, S. J. (2000): “Restructuring with What Success? A Case Study of Russian Firms”, *William Davidson Institute Working Papers Series*, No. 324.

McKinsey & Co. (1999): “Unlocking Economic Growth in Russia”, *Analytical Report*.

Moers, L. (2000): “Determinants of Enterprise Restructuring in Transition: Description of a Survey in Russian Industry”, *Post-Communist Economies*, Vol. 12, No. 3, pp. 307-332.

Murrell, P. (2005): “Institutions and Firms in Transition Economies”, in: Menard C., Shirley M. (eds.), *Handbook of New Institutional Economics,* Kluwer Academic Press, forthcoming, Ch. 26.

Nureev, R. and A. Runov (2001): “Russia: Whether Deprivatization is Inevitable? Power-property Phenomenon as a Path Dependency Problem”, Proceedings of the *V-th Annual ISNIE conference*, Berkeley, USA, September.

Pappe, Ya. (2000): “Oligarchs: Economic Chronicle 1992-2000”, Moscow, Higher School of Economics (in Russian).

Pappe, Ya. (2002): “Russian Big Business as Economic Phenomenon: Specific Features, Model of Organization”, *Problemi prognozirovaniya*, (in Russian), No. 2.

Pappe, Ya. (2002): “Russian Big Business as Economic Phenomenon: the Specificity of Emergence and Current Stage of Development”, *Problemi prognozirovaniya* (in Russian), No.1.

Radygin, A. (2002): "Merges and Takeovers in the Corporate Sector (Main Approaches to and Challenges Facing Regulation in this Area)", Institute for the Economy in Transition, 2002, http://www.iet.ru/personal/radygin/ma-ve2002-eng.htm.

Raiser, M., A. Rousso and F. Steves (2003): "Trust in Transition: Cross-Country and Firm Evidence", *EBRD Working Paper Series,* No. 82.

Recanatini, F. and R. Ryterman (2001): "Disorganization or Self-Organization? The Emergence of Business Associations in Transition Economy", *World Bank Working Paper Series*, No. 2539.

Rozinsky, I. (2002): "Mechanisms to Derive Income and Corporate Governance in Russian Economy", in: *Russian Firms: Corporate Governance and Market Deals*, Moscow, Higher School of Economics (in Russian).

Stark, D. (1997): "Recombinant Property in East European Capitalism", in: Grabner G. and D.Stark (eds.), *Restructuring Networks in Postsocialism*, London, Oxford University Press, pp. 35-69.

Tkachenko, I. (2004): "Experience of Studies of Intra-Company Institutions and Corporate Value Systems in Industrial Corporations", (in Russian) Report at the HSE Conference, *Competitiveness and Economic Modernization*, Moscow, 6 -8 April.

Volchkova, N. (2001): "Does Financial-Industrial Group Membership Affect Fixed Investment: Evidence from Russia", *New Economic School Working Paper Series*, No. 28.

Yakovlev, A. (2003): "Demand for Law in the Sphere of Corporate Governance: Evolution of Economic Actors' Strategies", *Voprosy Ekonomiki*, (in Russian) No. 4.