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# Introduction

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This book was published 17 years after the collapse of the Soviet Union in December, 1991. The transitional path to a market-oriented economy in the Russian Federation, where socialism had been developing for decades, clearly shows that the overall restructuring of a planned economy is a time- and resource-consuming social process. Due to such difficulties, there is a broad consensus among scholars that systemic transformation in Russia should continue into the future to achieve a well-functioning market economy.

Nevertheless, government and citizen reform clearly extricated the country from a dire predicament. Russia is currently in its eleventh year of economic recovery from a severe financial crisis in 1998. Table I.1 shows that the gross domestic product (GDP) has averaged 7% annual growth from 1999 through 2007. The other macroeconomic indicators also suggest great improvements in the Russian economy. Most economists agree that this remarkable rise in macroeconomic performance occurred as a result of the rapid expansion of Russia's export markets against the historical setting of increasing energy prices (i.e., oil and natural gas) in the world markets.

It is noteworthy, however, that the long-lasting economic developments in Russia also depend on the extensive improvement of its corporate sector as a result of 17 years of structural reforms. Progress is undeniable regarding ownership reform and the management restructuring in Russian enterprises in the post-privatization period. Furthermore, Russian investors and business people are now very actively launching their own companies on the international stock markets. The expansion of Russian businesses in the world economy and the considerable growth of foreign direct investment (FDI) into the Russian real sector have also taken place. In fact, Figure I.1 indicates significant growth of FDI inflow into Russia in 2006 and 2007 in both gross and net terms. Despite a political backlash to market liberalization observed in recent years, these facts strongly attest to the intensive integration of Russia into the global markets and the openness of the Russian domestic markets for multinational enterprises and other foreign investors.<sup>1</sup>

Table I.1 Selected macroeconomic indicators of the Russian transition economy, 1992–2007

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
GDP growth rate (annual change in real term, %) <sup>a</sup>	-14.5	-8.7	-12.7	-4.1	-3.6	1.4	-5.3	6.4	10	5.1	4.7	7.3	7.2	6.4	7.4	8.1
GDP per capita (USD) <sup>a</sup>	576	1,237	1,866	2,112	2,642	2,736	1,834	1,328	1,768	2,096	2,379	2,975	4,104	5,326	6,923	9,075
GDP deflator (2006 = 100) <sup>a</sup>	0.1	0.8	3.4	8.3	12.1	14.0	16.6	28.5	39.3	45.8	53.0	60.3	72.5	86.4	100.0	113.5
Consumer price (end-year, annual change, %) <sup>a</sup>	1526.0	839.9	215.1	131.3	21.8	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	10.9	9.0	11.9
Industrial gross output (annual change in real term, %) <sup>b</sup>	-16.0	-14.0	-21.0	-4.6	-8.0	1.0	-5.0	9.0	8.7	2.9	3.1	8.9	8.0	5.1	6.3	6.3
Agricultural gross output (annual change in real term, %) <sup>b</sup>	-9.4	-4.0	-12.0	-8.0	-5.0	2.0	-13.0	4.0	7.7	7.5	1.5	1.3	3.0	2.3	3.6	3.3
Fixed capital investment (annual change in real term, %) <sup>b</sup>	-40	-12	-24	-10	-18	-5	-12	5	17	10	3	13	14	11	17	21

Unemployment rate (end-year, %) <sup>b</sup>	5.2	5.9	8.1	9.5	9.7	11.8	13.2	12.6	9.8	8.8	8.5	7.8	7.9	7.1	6.7	5.6
Current account balance (% of GDP) <sup>a</sup>	-1.4	1.4	2.8	2.2	2.8	0.0	0.1	12.6	18.0	11.1	8.4	8.2	10.1	11.0	9.5	5.9
Trade balance (Million USD)	10.6	15.3	6.5	20.1	19.8	14.6	16.9	36.2	60.1	48.1	46.3	59.9	85.8	118.4	139.2	132.1
General government balance (% of GDP) <sup>c</sup>	-42.6	-15.9	-9.7	-6.6	-9.4	-8.5	-8.2	-3.1	3.2	2.7	0.6	1.4	4.9	8.1	8.4	3.7
Private sector share in GDP (%) <sup>c</sup>	25	40	50	55	60	70	70	70	70	70	70	70	70	65	65	65
Private sector share in total employment (%) <sup>b</sup>	19.3	28.1	33.0	34.3	35.6	39.9	43.2	44.3	46.1	47.7	49.6	50.2	51.8	54.1	55.4	56.4
RTS index (end-of-year) <sup>d</sup>	NA	NA	NA	82.9	200.5	396.9	58.9	175.3	143.3	260.1	359.1	567.3	614.1	1,125.6	1,921.9	2,290.5

Sources: <sup>a</sup> IMF; <sup>b</sup> Rosstat; <sup>c</sup> EBRD; <sup>d</sup> RTS website (<http://www.rts.ru/en/index/rtsi/>).

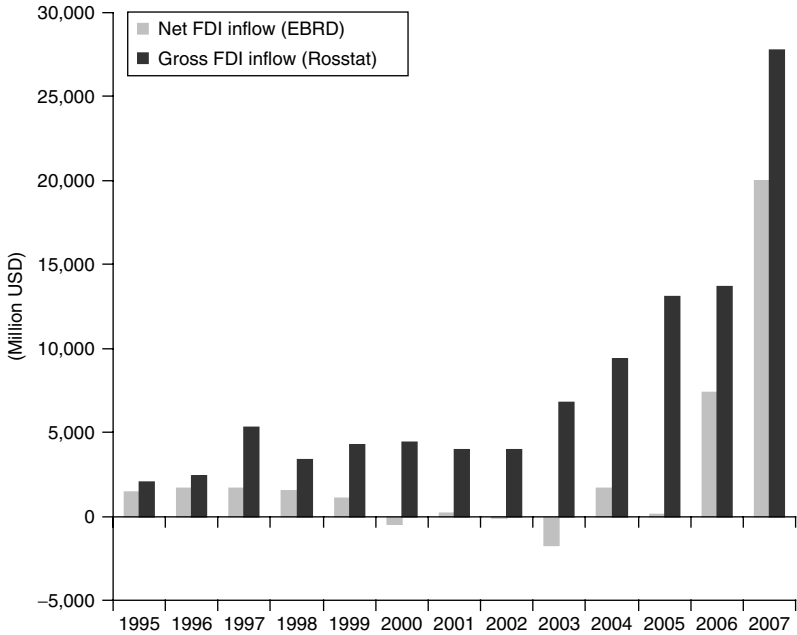
4 *Organization and Development of Russian Business*

Figure 1.1 Foreign direct investment inflow into Russia, 1995–2007

To study the development stage and organization of the contemporary Russian business sector is essential to assess the potential of the Russian economy in the global context. This book is designed to make a clear contribution to this issue through its focus on the following key aspects of Russian firms: (a) the mechanism of monitoring and the decision-making control given to a highly concentrated ownership structure, which is different from the case in developed countries; (b) the impacts of business integration via the formation of holding companies and other types of business groups upon corporate governance and firm performance of affiliated firms; and (c) the role and influence of various external agents, such as financial institutions, business associations, and the state, in the process of corporate governance of nonfinancial enterprises. We believe that a thorough examination of the outlined objectives will result in a clear understanding of current Russian business practices.

To fulfill the research objectives stated above, we mainly utilize the results of an enterprise survey conducted throughout Russia by a Japan–Russia joint research team from Hitotsubashi University in Tokyo and the State University – Higher School of Economics (SU-HSE) in Moscow.

The survey was performed over a five-month period, from February to June 2005, and 822 members of top management from industrial and

communications enterprises from 64 regions of the Russian Federation were interviewed. It was one of the largest-scale questionnaire surveys conducted in Russia. The sampling and the interviews were conducted by specialists of the well-known social research organization “Levada-Center” – the former USSR Public Opinion Poll Center. All samples are joint-stock companies (JSCs), and the average number of workers in each company is 1,884 (median: 465). The total number of workers of these surveyed firms is 1.55 million, and they accounted for 10.3% of the average workforce in both the industrial and the communication sectors through 2004, according to official statistics.<sup>2</sup>

In addition, our survey results are reinforced by the commercial Internet database of the two major company information agencies in Russia, SKRIN, and SPARK Co., in order to carry out empirical analyses on financial and operating performance of our sample firms that are compatible with those in earlier studies of listed companies in developed countries.

Using this unique firm-level dataset as a common empirical basis, we present multi-angle pictures of the Russian corporate system from the institutional and microeconomic viewpoints. This is the most clearly distinguishing feature of this volume in comparison to prior literature dealing with firm organizations and corporate governance in the post-communist transitional countries, including Russia.

In the framework of this joint project, we have also published several journal articles and books in English, Japanese, and Russian (Avdasheva 2007; Dolgopyatova 2006, 2007; Iwasaki 2006, 2007, 2008; Dolgopyatova, Iwasaki, & Yakovlev 2007; Sugiura 2007; Yakovlev 2007). Compiled in this volume are developed research and new products obtained from the project.

The book consists of 12 chapters and a conclusion.<sup>3</sup> Chapter 1 discusses how Russian firms developed from Soviet enterprises into market-oriented firms on the background of large-scale institutional changes in the national economic system. This chapter also addresses the issue of Russia’s peculiarities in terms of its business environment in comparison to countries at a similar level of socioeconomic development, such as Central and Eastern European countries, which passed through a transition from a planned to a market economy, and the possible impacts of those differences on the enterprise behavior in Russia.

The next five chapters in Part I, entitled “Ownership, Internal Control, and Management System,” provide readers with deep insights into the organizational architecture of Russian enterprises, including their ownership structure, legal form of incorporation, board of directors, and managerial team. These chapters represent an attempt to examine the empirical relationship among the internal organizations and enterprise behaviors, including operating and financial performance.

Chapter 2 examines the linkage between ownership structure and the corporate control system in Russian firms. In this chapter, evidence of simple

hypotheses regarding the role of a high concentration of ownership in the evolution of intra-corporate control forms and business performance is provided. Our empirical data demonstrates that the largest shareholder owned more than 50% of the total stock in 70% of the companies and about 13% of companies had no block-holders (owners of more than 25% of the stock). The high concentration of ownership is paralleled by its hidden structure and affects intra-corporate relationships. We also show that some of these relationships include the development of a set of formal and informal tools used by dominant shareholders for the supervision of executive management in a weak institutional environment. A combination of ownership and control based on the direct participation of shareholders in management as top-managers is a characteristic of the vast majority of Russian JSCs; however, the current trend is for the separation of executive management from ownership. We argue that concentrated ownership will encourage the owners to restructure and develop their business and companies with dispersed ownership will thus be less competitive in performance, investment, and restructuring.

Chapter 3 is a study of the legal form of incorporation of Russian JSCs. The vast majority of Russian corporations are compelled to become closed JSCs that lack a modern fundraising mechanism in order to attract capital from a wide range of private investors. The empirical results in this chapter suggest the following four factors encouraging many Russian firms to be closed JSCs. That is (a) a widespread insider-dominating corporate ownership structure emerging as a result of the mass-privatization policy; (b) a strong orientation among managers toward closed corporate organization due to the underdeveloped capital and managerial markets; (c) slumping needs for corporate finance; and (d) insufficient financial support from local financial institutions. The impact of ownership structure on the choice of corporate form exists, even if we assume that the two elements are determined endogenously.

In Chapter 4, we examine the endogenous formation of corporate boards and its determinants. The findings reported in this chapter strongly suggest that the theories and empirical methods of financial and organizational economics help accurately pinpoint the determinants of board size, proportion of outsider directors, and appointment of outside chairmen in Russian firms. We also found that their board structure can be reasonably explained by the bargaining hypothesis. Furthermore, the empirical evidence demonstrated that Russia's legal system and peculiarities as a transition economy also have a great deal of influence in determining board formation.

Chapter 5 discusses the possible impacts of corporate governance and firm performance on managerial turnover. This study is different from most previous research in that we deal not only with CEO dismissal but also with managerial turnover in a company as a whole. We found that nonpayment of dividends is significantly correlated with managerial turnover. We also

found that the presence of dominant shareholders and foreign investors is another important factor in causing managerial dismissal in Russian corporations; however, these two kinds of company ownership reveal different effects in terms of turnover magnitude.

Chapter 6 focuses on the relationship between the structure of a managerial team and firm restructuring. Following drastic changes in the distribution and redistribution of property rights in the Russian economy in the last decade, a new generation of professionally trained managers has appeared in top- and middle-level management. They are expected to be great promoters for enterprise restructuring in Russia. At the same time, many Soviet-generation manager-owners are still in business. These company executives were often accused of asset-stripping in the 1990s, and they are considered to be largely responsible for the poor managerial quality due to the lack of incentives for maximizing a firm's value. However, no empirical evidence was available to support or refute this statement. The empirical analysis in this chapter revealed that neither changes in key owners nor the appointment of a new general director by shareholder decision contributed to more active firm restructuring. We also verified that firms with general directors who were large owners did significantly better than those with hired managers in the introduction of new technologies and marketing activities. Furthermore, our empirical evidence indicates that previous job experience of the CEOs in Western companies contributed positively to firm restructuring, whereas job experience in governmental bodies tended to have a negative effect.

The next three chapters in Part II, "Business Integration and Its Impact on Corporate Governance," deal with the vertical and horizontal integration of Russian companies. In Russia, almost 30 to 40% of middle- and large-scale companies are currently involved in the formation of business groups. Chapters 7, 8, and 9 present examinations of the impact of this remarkable phenomenon in the current Russian economy on the organizational behavior and management effectiveness of group companies in comparison with independent (nongroup) firms.

Chapter 7 deals with the role of business integration in the development of a form of corporate control based on the separation of executive management from ownership. As a result of our empirical investigation into the determinants of owner selection of hired management, we present the following results. First, business integration promotes the gradual separation of management from ownership in the rank-and-file membership of company groups. Second, company affiliation or non-affiliation with a company group predefines different roles of various factors in this choice. In addition, for rank-and-file members of company groups, a positive influence on the choice is connected with the complexity of corporate management in companies and in entire groups, and a negative influence is related with an incomplete restructuring of enterprises. Our findings also demonstrate

that, for JSCs not affiliated with company groups or parent companies of the groups, the influence was identified for ownership and governance features supporting the protection of property rights and for the pressure of competition with manufacturers from developed countries as an incentive for improving management quality.

In Chapter 8, we test a competing hypothesis on the nature of Russian business groups and possible tools for disciplining the executive managers in the subsidiaries of those groups. Our empirical results show that business groups act as integrated companies rather than a network of companies and that hierarchical coordination prevails inside the groups. We also confirmed that the most important way to resolve the agency problem in the groups is through the participation of the ultimate owners by themselves or represented by the parent company in the management. Corporate governance instruments are important, mostly in subsidiaries acting in regulating industries or in state-owned companies. However, one in three subsidiaries that is a private company in nonregulated industry also develops internal corporate governance. Corporate governance as a disciplinary tool is necessary in state-owned as well as new private companies.

Chapter 9 examines the impact of business integration on enterprise restructuring and financial and operating performance of group subsidiaries in Russia. Directors of affiliated enterprises and, especially, of those merged after mass privatization acknowledge the impact of groups on the market competitiveness of the enterprises. A comparison of subsidiaries and independent enterprises supports the positive attitude of directors toward group membership. Our survey results indicate, as many other studies in Russia have shown, that group subsidiaries outperform independent enterprises in terms of corporate restructuring and financial and operative performance. However, it is not clear whether the comparative advantages of group enterprises are explained by higher productivity alone. The results of our comparison of total factor productivity in affiliated and independent enterprises are mixed. The higher productivity of affiliated enterprises is mostly due to companies that joined the groups before 1995. The advantages of affiliated enterprises over independent ones provide an additional explanation of the stability of a business group as an organizational form in Russian industry. Better firm performance helps to solve agency problems in subsidiary companies.

The chapters in Part III, "The Role of External Players in Corporate Governance," present the outcomes of our research on the relationship among industrial and communications companies and commercial banks, business associations, and the government. It is controversial whether the latter three economic entities have a specific influence on corporate governance and the performance of nonfinancial enterprises. Chapters 10, 11, and 12 present empirical evidence of these issues from a careful examination of the results of the enterprise survey.

The focus of Chapter 10 is on the banking sector. With the objective of clarifying the emerging role of commercial banks in corporate finance in economically buoyant Russia, we reveal the results of an analysis in this chapter conducted from a macro and micro standpoint. Macro-economically, the share of the banking sector in the overall corporate investment finance has been rising. The results from our joint survey reveal that about one-third of medium-to-large scale enterprises have no external borrowings, suggesting that there is still a large capacity for the banking sector to increase its role. These firms tended to be smaller, with a closely held ownership structure, and were not active in new investments. In this chapter, the role played by Sberbank, the largest Russian saving bank, is also examined; it is by far the largest major bank that has served as a main supplier of funds since the financial crisis of 1998. The enterprises that showed Sberbank as the largest financier were mostly large ones and had export records. They tended to have special relationships with the government, implying that the corporate financing mechanism had been evolving in close cooperation between the government and enterprises.

Chapter 11 scrutinizes the relationship between the business associations and their member firms. Empirical literature on the membership of Russian firms in business associations provides no clear explanation of the main incentives of the firms to participate in collective action. In this chapter, we explore whether these incentives are inspired by market pressure, or, on the contrary, whether rent-seeking and a desire to establish personal relationships with authorities influence major decisions within a firm. To clarify these issues, we empirically examine the determinants of membership in associations and explore the reasons for simultaneous membership in different types of associations, that is, the phenomenon of multiple membership. Our estimation results reveal that the larger and better-performing enterprises are more interested in joining associations in situations of competitive pressure from the Baltic countries, Turkey, and China. We also confirmed that enterprises with general directors who are large owners significantly more often become members of associations than do firms headed by hired CEOs. The main benefits from joining these business associations are related to the close interactions with state authorities. We argue that this feature may help to overcome information asymmetry in the fragile institutional environment of Russian business. In addition, multiple membership significantly increases the chances to obtain financial and organizational support from the state and, thus, is a rational strategy of market players.

In Chapter 12, we analyze the influence of the state on the improvement of corporate governance in Russia of the early 2000s. Taking into account the low quality of market institutions in the 1990s (i.e., the market failure phenomenon), we assume that state intervention is the second-best solution had a positive impact in this case. Using a firm-level dataset obtained from our enterprise survey, we test this hypothesis in two types of corporate

models: state-owned or mixed firms and politically connected firms. The first model confirmed a strong positive influence of state ownership on the corporate governance in Russia in 2001–2004. The estimation results are statistically robust in different model specifications. We connect this empirical evidence with attempts of the Russian government to use standard mechanisms and procedures of corporate governance to defend its property rights in its relationships with state-owned and mixed enterprises.

The concluding chapter summarizes the major findings in this study and discusses the remaining issues and agenda for future research.

We are hopeful that this volume will provide an insight into firm organization and management in Russian business and stimulate further discussion and research on this topic.

## Notes

1. Many experts point out, however, that a large part of this remarkable growth of FDI inflow in recent years can be explained by active repatriation of offshore Russian capital. Nevertheless, it is also a fact that many Western companies, including several world-famous multinational enterprises, embarked or decided to embark on the Russian market, which also boosts direct capital investment into Russia.
2. We describe the details of the joint survey in the Appendix of this book.
3. Chapter outlines have been prepared by their individual authors.

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