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**RECONSTITUTION OF POST-SOVIET EX-STATE  
ENTERPRISES INTO RUSSIAN BUSINESS FIRMS UNDER  
INSTITUTIONAL WEAKNESSES**

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# **Reconstitution of Post-Soviet Ex-State Enterprises into Russian Business Firms under Institutional Weaknesses**

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## **Abstract:**

The paper provides an interpretation of the transformation of post-soviet Russian enterprises from the resource-based perspective of the firm in the context of institutional change. Based on the resource-based perspective, which conceptualises a firm as a collection of resources embedded in business functions that are organised within an administrative framework, this paper demonstrates that the restructuring of post-Soviet enterprises entailed their reorganisation or reconstitution into business units, able to engage in commercial activities and compete in a market oriented environment. Building on the resource-based interpretation of the firm in the post-socialist context, and focusing on the institutional environment in which firms operate, the paper analyses the role of informal business practices in Russia—particularly in the area of corporate governance—from the perspective of reconstitution of post-soviet enterprises into business units. Taking the case of Yukos Oil Company in the 1990s, it argues that considering informal practices in the context of fulfilling tasks of corporate reconstitution points to their functionality in the face of disintegration of the Soviet economic system and institutional weaknesses.

**Keywords:** Russia, resource-based perspective of the firm, corporate governance, restructuring, Yukos Oil Company, informal practices, institutional change.

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# Reconstitution of Post-Soviet Ex-State Enterprises into Russian Business Firms under Institutional Weaknesses

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## 1. Introduction

Since the collapse of communism in Central and Eastern Europe and Former Soviet Union, a key requirement for the systemic change from centrally planned to market-based economies has been the restructuring of enterprises. Restructuring generally refers to the measures taken by managers to achieve greater efficiency in firms, through the following actions including shedding labour and eliminating non productive assets (so-called defensive restructuring), as well as introducing new technologies and investments (strategic restructuring) (Roland 2000: 232-6). In the report entitled *From Plan to Market*, the World Bank stressed that since enterprise managers under the planned economies faced perverse incentives which led to poor performance, “[a]t the heart of transition lies a change in incentives, none more important than those for managers of enterprises” (1996: 44). Privatisation, together with liberalisation, sought to expose enterprises to hard budget constraints and competition, thus promoting market-based incentives. The efficiency improvement of enterprises was to be reached under private ownership, with a mechanism which enables owners to encourage value maximising behaviour of managers.

In this way, the dominant theoretical approach in the literature on firms in ex-socialist economies in general, and on enterprise restructuring in particular, has been based on agency perspective. Although the agency approach has illuminated governance aspects of firm development in terms of ownership and managerial incentives, the extensive empirical research based on this view has shown inconclusive results, particularly with regard to the privatisation effect on firm restructuring in the CIS (Djankov and Murrell 2002; Carlin, Van Reenen and Wolf 1995; Megginson and Netter 2001; Nellis 1999). This suggests that other theoretical perspective of the firm may shed light on aspects of the firm and its restructuring hitherto lacked attention.

By altering the approach from the predominant agency perspective, this paper offers an interpretation of transformation and restructuring of post-Soviet enterprises in Russia from the resource-based perspective of the firm. While the existing research has given much emphasis on a change in ownership and creation of appropriate incentives which

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<sup>1</sup> Comments are welcome.

would facilitate restructuring of enterprises, relative inattention has been paid to the actual object to be restructured—i.e. Soviet-type enterprise's organisational attributes in terms of its set-up of resources and capabilities. That is, in the theoretical context of the resource-based perspective of the firm, according to which a firm is conceptualised as a collection of resources and capabilities within an administrative framework, Soviet enterprises were not really 'firms' comparable with those operating under a capitalist system. In other words, the resources and capabilities necessary to engage in commercial activities in the market were not self-contained within a single individual enterprise, which had basically functioned as 'production units' under the central planning system. Therefore, the restructuring of post-Soviet enterprises entailed their reorganisation or reconstitution into business units, able to survive, compete and grow in a new market oriented environment.

Moreover, enterprises progressed through the post-communist transformation under the condition of institutional weaknesses. Market supporting institutions, such as a legal framework ensuring the protection of property rights, well-regulated banking system and capital markets were underdeveloped. Economic and political instability, combined with state's weak administrative capacity and weak rule of law, have all created an environment of uncertainty. Against this background, Russian businesses have routinely relied informal practices not entirely compatible with the formal rules. Phenomena such as capital flight, 'tax optimisation' and non-transparent corporate governance practices have all been associated with informal, extra legal practices. The significance of informal institutions has been underscored by Douglass North, who has argued that because the informal constraints will not change immediately in reaction to changes in the formal rules, which can be changed overnight, the tension between altered formal rules and the persisting informal constraint produces outcomes that have important implications for the way economies change (1990:45).

Given the pervasiveness of informal order of 'getting things done', it is impossible to fully understand Russian firms' transformation process without taking informality into account. Therefore, resource-based interpretation of post-Soviet Russian enterprises in this paper incorporates specific institutional contexts in which firms operate, with a particular focus on informal business practices in the area of corporate governance. During the course of the 1990s, an array of practices such as manipulation of transfer pricing, designing a convoluted ownership structure using a network of offshore entities; making last minute changes to the time and venue of shareholders' meetings to limit participation of shareholders; increasing charter capital and offering newly issued shares only to insiders have reportedly become widespread in the running of joint-stock companies. The abusive nature of these practices is obvious and well documented. Indeed,

they have undermined the foundation of good governance and have been detrimental to investor confidence. However, it is important to recognise that they served as tools of ‘coping strategies’ to aid the reconstitution of Soviet-type enterprise into a coherent Russian business unit in the condition of uncertainties associated with the post-communist transformation. An analysis presented in this paper shows that from the perspective of corporate reconstitution, informal practices were utilised to rectify the lack of resources and capabilities that companies had to have in order to perform in a market-oriented environment in the context of the disintegration of the Soviet economic system and the weak institutions.

The paper’s contribution is twofold. First, it demonstrates an additional facet to the restructuring of enterprises from the resource-based perspective of the firm, thus indicating that the dominant agency view on enterprise restructuring can be complemented by the resource-based perspective in order to enhance our understanding of the post-socialist firms. Secondly, it shows a constructive aspect of informal business practices from the perspective of reconstitution of enterprises into business units in the wake of the collapse of Soviet system and institutional change.

The paper is organised as follows. In order to show that Russia’s post-communist economic transformation of the corporate sector involved the reorganisation of post-Soviet enterprises into business units, Section 2 discusses the concept of the firm as a collection of resources that render various business functions organised within an administrative framework. Section 3 analyses how enterprises were organised under the Soviet economic system from the resource-based view. Section 4 identifies a set of fundamental tasks faced by Russian enterprises in reconstituting themselves as business units. These tasks included a) establishing an effective administrative hierarchy; b) integrating business functions under a single point of control; and c) reconstructing the production chain. Section 5 examines the role of informal practices in the area of corporate governance from the perspective of reconstitution of enterprises into business units. It suggests that these informal practices, while they were abusive to shareholders, also served as tools of coping strategies to fulfil the three tasks from the perspective of corporate reconstitution under the condition of weak institutions. Taking Yukos Oil Company as a case study, it shows how informal practices in effect aided the company’s reconstitution into a coherent business unit in the 1990s, pointing to the functionality of practices in the face of disintegration of the Soviet economic system and institutional weaknesses.

## **2 The Firm as an ‘Administrative Organisation’ and a ‘Collection of Resources’**

In order for a firm to actually operate—to engage in the production and sale of goods and

services in a market economy, it must have certain basic attributes. This point derives from Edith Penrose's influential work, *The Theory of the Growth of the Firm* (1959/1995), which laid the intellectual foundation for the resource-based perspective of the firm. According to this view, a business firm is a collection of resources, both human and material, and the services or business functions those resources render (Penrose 1959/1995; Richardson 1972; Wernerfelt 1984; Foss 1996; Knusden 1996). Defining a firm "as a collection of resources bound together in an administrative framework, the boundaries of which are determined by the 'area of administrative coordination' and 'authoritative communication'" (Penrose 1995: xi), Penrose conceptualises a firm based on two sets of attributes: 1) "a coherent administrative organization" and 2) "a collection of resources". With regard to the boundary of the firm, the author (1995: 19-20) argues that "it is a firm's ability to maintain sufficient administrative co-ordination to satisfy the definition of an industrial firm which sets the limit to its size as an industrial firm".

First, an administrative coordination is an essential aspect of the firm, as one important component of the firm "involves its role as an autonomous administrative planning unit, the activities of which are interrelated and are co-ordinated by policies which are framed in the light of their effect on the enterprise as a whole" (Penrose 1995: 15-6). For an industrial firm to function, it must have an effective administrative control over the administrative framework within which its industrial activities are coordinated.

The second aspect of the definition of the firm is that the firm is a pool of resources—"a firm is essentially a pool of resources the utilization of which is organized in an administrative framework" (Penrose 1959/1995:149). Resources include tangibles as well as intangibles. The physical resources of a firm consist of tangibles such as plant, equipment, land and natural resources, raw materials, semi-finished goods, waste products and by-products, and unsold stocks of finished goods. There is also a variety of human resources available in a firm, including unskilled and skilled labour, clerical, administrative, financial, legal, technical, and managerial staff (Penrose 1995: 24-5).

However, it should be pointed out that "it is never *resources* themselves that are the 'inputs' in the production process, but only the services that the resources can render" (Penrose 1995: 23, emphasis in original). The services rendered by the resources are dependent on the way in which the resources are used. In addition, the services that the resources yield depend on the capacities of the people using them, and development of the capacities of these people is partly shaped by the resources that they are required to deal with. Resources and the capacities are the two factors that create the special productive opportunity of a firm, which eventually leads to the growth of the firm (Penrose 1995:

78-9).<sup>2</sup>

What emerges from the foregoing is a picture of the firm as a collection of resources that are embedded in business functions. The resources of the firm render such functions, as production, procurement of raw materials, marketing, sales, financing, investment, research and development (R&D). Or to put it differently, and following Penrose, it is useful to conceptualise the firm's resources as enabling the firm, as a business organisation, to perform its business functions. This, in practice, implies the presence of top management and other personnel with appropriate knowledge, skills and capabilities to carry out those business functions—that is, to procure raw materials, produce the actual goods, coordinate production, organise financing, marketing, distribution, research, and so on. In addition to this resource aspect, there is an administrative aspect to the definition of a firm as emphasised above. In other words, how the business functions are organised is a crucial attribute of the firm, which relates to the question of an administrative control within an appropriate administrative framework. That is, in a firm, the resources that render certain business functions are organised and managed under a single administrative point of control. This conceptualisation of the firm based on resource and administrative aspects is depicted in Figure 1. The firm is represented within a triangular administrative framework, in which the collection of the various resources embedded in business functions is pooled. These resources, in turn, are organised within the firm by a top management.

[FIGURE 1 Here]

### 3 Soviet Enterprises from the Resource-Based Perspective of the Firm

#### 3.1 Firms under a Market Economy and the Socialist System

The resource-based perspective, and any other theories of the firm for that matter, have been advanced on the basis of the experience of Western firms operating under a capitalist system. However, firms played different roles under the capitalist system and the socialist system (Uhlenbruck et al. 2003). Firms operating under the market system and enterprises under the socialist system were different creatures because they served

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<sup>2</sup> Eventually, some firm resources are developed into so-called 'organisational capabilities', which in turn contribute to the growth of the firm. The chain starts with the *collecting* of resources to become an actual *collection* of resources that render various business functions; from the collection of resources to firm's 'organisational capabilities'; and then from 'organisational capabilities' to firm growth. In this paper, the focus is placed on the resource parts of this chain only, which involves the establishment of initial resource position (Kock and Guillen 2001: 86), i.e. the most basic attributes or the prerequisites for an organisation to become a 'firm', rather than the issue of how the resources develop into 'organisational capabilities' that lead to competitive advantage and growth of the firm. The concept of 'organisational capabilities' was introduced by Richardson (1972), who elaborated Penrose's ideas. He argued that firm's activities are "carried out by organisations with appropriate *capabilities*, or in other words, with appropriate knowledge, experience and skills". For a recent empirical account of 'organisational capabilities', see Dosi, Nelson and Winter (2000).



different purposes, and therefore had different features in order to fulfil those purposes.

However, the fact that Soviet enterprises were not really ‘firms’ in the sense of those operating under a capitalist system, may not have been obvious; Clarke (1996) points out that the assumption made in Western analyses of Soviet enterprises is that Soviet enterprises were like any other capitalist firms, but had inappropriate incentives. Western analyses of Soviet enterprises have not taken account of the fact that capitalist firms and socialist enterprises had different objectives, served different functions, and thus inevitably were different types of organisations. Clarke (1996: 12-3) emphasises that Soviet enterprises were not simply an imperfect realisation of capitalist firms, but were “social organisms at the heart of the local community”, that sought to expand production for their own benefit, which in turn benefited the social infrastructure of the local community.

In market economies, a firm is a business unit. The general purpose of the firm is to organise the use of resources for the production and sale of goods and services at a profit (Penrose 1995: xi). In a system-to-system comparison, Kornai (1992: 263-4) shows that one of the main aims of competitive private firms under capitalism is to increase profits, while state-owned enterprises under socialism are primarily interested in gaining recognition from superior organisations for meeting performance criteria. Under the capitalist system, entry and exit of firms are determined by the market, selling prices are set by the firm, and firms are uncertain of demand; under the classical socialist system, the bureaucracy decides on all entries and exits, a price authority sets the selling prices, and enterprises are sure of demand. A firm within the former system is characterised by hard budget constraints, while this does not apply to enterprises operating in the latter system (Kornai 1992: 264).<sup>3</sup> Peng (2000: 6) points out that enterprises in post-socialist economies exhibit a number of differences from Western firms, such as “lack of complete discretion to acquire and allocate resources and little knowledge and experience to compete in a competitive, market-based economy”.

The systemic change from socialism to capitalism necessarily required the transformation and restructuring of Russian enterprises. Russia’s economic reforms, centred on liberalisation and privatisation, sought to stimulate adjustments in incentives and to expose enterprises to a buyers’ market, hard budget constraints, and competition,

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<sup>3</sup> Kornai (1992: 245-252) argues that in general, the fundamental difference between the classical socialist system and the capitalist system is that the former is marked by a ‘seller’s market’ – with some caveat in the use of the word ‘market’ – while the latter is a ‘buyer’s market’. In this connection, Havrylyshyn and McGettigan (1999: 10) point out that the workable ‘model’ of transformation from socialism to capitalism includes the following two key changes: First is the enforcing of the move from a sellers’ to a buyers’ market (through price liberalisation) and second is the imposition of a hard budget constraints (through privatisation and eliminating various government support mechanisms).



encouraging increased entry of new enterprises and the exit of unviable ones (World Bank 1996). However, the resource-based perspective points to the basic prerequisites for a business firm to operate in a market economy. Hence, the resource-based perspective sheds additional light on the tasks Russian enterprises faced as they sought to transform from state-owned enterprises under the Soviet system to business firms in the market-oriented system. To appreciate this task more, it is worth examining what former Soviet enterprises looked like, and in what ways they differed from Western firms from the resource-based view discussed above. In the context of the resource-based view of the firm, and more specifically, Penrose's definition of a firm as a collection of resources organised in an administrative framework, the following section discusses the general features of Soviet enterprises based on their administrative as well as their resource aspects.

### **3.2 Administrative Aspects: 'USSR Inc.'**

Soviet enterprises were an integral part of the Soviet economic system, a system that was based on centralised planning, implemented administratively through commands and instructions (Ericson 1991: 12). The Soviet economic system was characterised by the party bureaucracy as a single entity encompassing the whole of society (Kornai 1992: 97). The core concept of the Soviet economy, at least until the mid 1980s, was that the economy as a whole must be run as an integrated, single complex on the basis of a system of commands (Spulber 1991: 22-3). An individual Soviet enterprise, in such a system, was more appropriately a 'production unit', located at the lowest level of the economic hierarchy.

The hierarchical economic planning system of the Soviet Union was composed of all-union ministries and state committees. State committees included the State Planning Committee (Gosplan), the State Committee for Material-Technical Supply (Gossnab), and other committee for prices, labour, etc. The heads of those committees, and industrial ministers constituted the Council of Ministers, the chief executive body of the Soviet government. The Communist Party of the Soviet Union (CPSU) stood at the top of the hierarchy, with the main economic policy makers belonging to the Central Committee of the CPSU (IMF et al. 1991: 8).

Under the Soviet economic system, central planning and bureaucratic control dictated to the enterprises about product lines, procurement, and distribution (Ericson 1991: 19; Lawrence and Vlachoutsicos 1990: 37-45). Relations between enterprises were also bureaucratically coordinated (Kornai 1992: 98). The central planning system, via Gosplan, the top planning agency, administratively imposed production targets on each producer-enterprise. Gosplan dictated to enterprises what they should produce, and how

much to produce, and allocated their production either for delivery to other domestic enterprises, or for export. Finances were also allocated according to established plans. Based on the quantity of products required from them, enterprises were provided with the resources needed and the items needed to maintain and replace equipment. Soviet enterprises, therefore, were production units whose responsibility was to meet the targets set by the central plan. Even large enterprises, despite their huge scales of production, were not autonomous entities with economic accountability. As Yudanov (1997: 404) argues, “large Soviet industrial enterprises could be regarded not as independent entities, but as operating units within the framework of the countrywide superstructure”.

As operating units, or production units of the Soviet economic system, Soviet enterprises had limited decision-making managerial power. Each enterprise was ultimately subordinate to a branch ministry, the administrative body that supervised the particular sector of the economy. Branch ministries were responsible for selecting enterprise managers. They were charged with controlling planning targets, and managing resource availability, flows of capital, R&D, product introductions and the distribution of output by enterprises. They also coordinated vertical and horizontal relationships between enterprises (Hewett 1988; Joskow and Schmalensee 1997). Ministries were divided into main administrations known as *glavki*, which had different responsibilities within the ministry. Managers of enterprises had a degree of influence over decision making through various bargaining processes (Kogut and Spicer 2002: 13) but primarily in terms of trying to achieve looser plans, i.e. negotiating a lower target output assignment, or more generous input quotas.<sup>4</sup> A vast majority of decisions, and particularly the more crucial ones, were made at higher up in the hierarchy (Kornai 1992: 271).

The limited executive decision making authority within individual Soviet enterprises differentiates Soviet enterprises from Western firms. The basic responsibilities of top management in capitalist industrial firms include strategic planning and the allocation of funds and personnel necessary to implement the strategy: In a firm, it is the top management, or administration, that carries out executive action, gives orders, and makes decisions related to coordinating, appraising and planning the work of the firm and allocating its resources (Chandler 1962: 8). However, as Soviet enterprises were the lowest units working within the framework of the countrywide administrative planning hierarchy, they did not perform these executive functions.

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<sup>4</sup> Kornai (1992) explains the ‘plan bargaining’ that characterised the socialist economies. There was continuous vertical bargaining between superiors and subordinates, who regularly pushed for a looser plan. As the economy became more deregulated the subject of bargaining gave way to officially permitted prices, wages, taxes, subsidies, credit terms, import licenses and foreign exchange allowances.

Given the narrow scope for managerial power vested in individual enterprises in the USSR, Yudanov (1997: 405) points out that an ‘enterprise’ in the Russian meaning is synonymous with a ‘plant’ rather than a ‘firm’ in the Western sense of the word. In other words, a Soviet industrial enterprise was not a business firm in the Western sense of the word, but was more like a production unit within a single huge firm, as Hanson (2003: 9) puts it, ‘USSR Inc.’ From this viewpoint, ‘USSR Inc.’ was the largest firm in the world (Nove 1986: 7). This huge countrywide structure of economic hierarchy is illustrated in Figure 2. ‘Top management’ of the ‘USSR Inc’ was the state bureaucracy. CPSU developed the overall policies, Gosplan rendered the policy operational, and the ministries supervised the enterprises. Enterprises were the lowest production units within the administrative framework of ‘USSR Inc.’

**[FIGURE 2 Here]**

At the level immediately above enterprises, was the so-called production associations, under whose umbrella were several production units. Production associations were established as part of the 1973 reforms of industrial reorganisation, by amalgamating and integrating related enterprises. The establishment of production association merged enterprises to become a smaller number of larger units. In this way the reform sought to create more efficient and more controllable units (Hewett 1988: 248-9). The 1973 industrial reorganisation also aimed at devolving some of the decision making function to the production associations, and drawing power away from the ministries. However, the state bureaucracy continued to be the ‘top management’ of ‘USSR Inc.’, and the production associations were really no more than “production units writ large” (Nove 1986: 7; Yudanov 1997: 401) .

Subsequent developments did not fundamentally alter the administrative aspects of Soviet enterprises. At the time that Mikhail Gorbachev initiated a reform process in 1985, Gorbachev promoted a policy designed to decentralise the decision making in order to increase the economic autonomy of individual enterprises (Hewett 1988: 322-3). For example, the 1987 Law on the State Enterprise gave enterprises more control over their finances, and allowed them to set their own production plans. However, the law did not change the position of enterprises in the economic hierarchy (Hanson 2003: 196-8). They were still subordinate to a superior branch ministry, and Gosplan. Gosplan coordinated the flows of materials based on the processes of production and distribution (Dolgopiatova 1995: 56). The enterprises’ own plans still had to be in line with branch objectives, guideline figures, and state orders for output from the central authorities (Hanson 2003: 196-8).

### **3.3 Resource Aspect: ‘Outsourcing’ of Business Functions**

From the resource-based view, the enterprises under the Soviet economic system lacked various resources and were therefore not self-contained business units. In other words, several of the business functions that were performed by individual firms in the West, were not organised as ‘in-house’ activities but were ‘outsourced’ to ministries and other organisations (Radosevic 1999: 282, 293). Resources embedded in various business functions were scattered across a huge Soviet industrial framework of ‘USSR Inc.’ and enterprises, whose business functions were ‘outsourced’ to other organisations in the Soviet economic hierarchy, were not fully-fledged business firms.

Soviet enterprises did not internalise business functions within themselves in the following sense. For example, in the area of procurement, branch ministries were responsible for allocating supplies to their enterprises. The financing function was managed by various agencies, such as the Ministry of Finance and Gosbank (the State Bank). The Ministry of Finance provided a portion of the funds directly from the state budget. The Investment Bank was in charge of the actual disbursement of finance, while Gosbank provided funds for general repairs (Gregory and Stuart 2001: 98).<sup>5</sup> In the area of R&D, there were technical or research institutes that served industry as a whole. The marketing of products abroad was the responsibility of the Ministry of Foreign Trade, which was subordinate to Gosplan and the Council of Ministers. Actual sales were conducted by the Foreign Trade Organisations (Gregory and Stuart 2001). Thus, individual enterprises were production units that ‘outsourced’ their other business functions to various different organisations.<sup>6</sup>

By the 1970s, the ‘outsourcing’ of various business functions across the system was recognised as a weakness of the Soviet economic system. Aleksei Kosygin, the then prime minister who initiated the 1965 reform, in 1970 wrote: “Standing alone, the plant finds it hard to identify demand, arrange supply and marketing, improve specialization and cooperation, centralize auxiliary operations, etc. These functions must be vested in the [production] associations” (Quoted in Yudanov 1997: 407). As mentioned above, production associations were established as part of the 1973 reform. However, these production associations fell short of internalising such functions as distribution, marketing, purchasing and financing, that were found in an industrial firms in market economies (Yudanov 1997: 410).

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<sup>5</sup> The primary function of Gosbank was to grant credit to enterprises in whatever amount necessary to fulfil the plan for output and investment. From enterprise’s point of view, capital was virtually a free good (IMF et al. 1999: 10).

<sup>6</sup> The operation of the Soviet economic system involved all the actors in the hierarchy, be they Gosplan, the branch ministries, or the production units/enterprises, who were linked through often complex hierarchical relationships. See Radosevic (1999: 290-292).

### ***Integration of Business Functions***

The ‘outsourcing’ of business functions under socialism meant that individual enterprises were not acting as integrators of the various functions.<sup>7</sup> That is, enterprises did not have the capability to bring together various business functions under one umbrella. However, in order to produce a product, different resources or business functions need to be integrated. For example, the R&D function has to be in place for the product to be developed. Financing has to be secured to fund the product. Sales and marketing functions are necessary to enable the product to be distributed and marketed. Moreover, production needs to be integrated or linked with all of these functions, and a management has to be in control of the whole process. In market economies, a firm is an integrator of resources in the sense that these various business functions are integrated within a single firm. Under the Soviet system, these individual business functions were distributed across the hierarchy. Financing was carried out by Gosplan and the ministries. Marketing was located in the foreign trade organisations. Strategic decision making was managed by Gosplan, the branch ministries, and *glavki*. Thus, in the context of post-Soviet transformation of enterprises, these functions had to be brought together, i.e., to be integrated and self-contained, within each of the enterprises, in order that a marketable product could be produced by a single unit.

### ***Organising a Production Chain***

There is another layer to the resource and capabilities side of a firm. Production must be organised across several tiers of suppliers that are all involved in successive stages of production. However, Soviet enterprises did not have the capacity to organise successive stages of production by facilitating the linking of a network of related enterprises (Radosevic 1999). For example, a multi-component product, for example a car, involves several components that are products in themselves, such as the engine. In order to produce a product that is comprised of several component products, a firm has to integrate or organise a network of first tier suppliers, second tier suppliers, and so on. While firms in market economies act as organisers of a production chain, in the Soviet system the centralised planning system took care of organising the production network and operated as organiser of the production chain (Radosevic 1999).

### ***Soviet Enterprises as a Collection of Resources?***

Although the Soviet enterprise can be viewed as a collection of resources, these resources were those suited and needed in the Soviet type economy (Uhlenbruck et al. 2003). For example, to survive under the shortage economy that was characteristic of the Soviet economy, certain managerial skills were required (Berliner 1952). They included

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<sup>7</sup> Radosevic (1999) terms this integration of business functions as *the system integration at product level*.

bargaining skills in order to negotiate over performance targets, or to secure supplies. Particularly crucial was the ability to mobilise informal networks, using *blat* (Ledeneva 1998). Although Soviet enterprises possessed the resources needed to function as production units of the Soviet economic hierarchy, they were not endowed with the technical, financial and organisational resources typical of firms in market economies (Peng 2000: 82). Individual enterprises did not integrate various business functions under a single control, or did not organise the production chain. Nevertheless, as pointed out earlier, Soviet enterprises performed significant social functions, such as provision of welfare services to the local community (Clarke 1996: 28-9).

#### **4 Reconstitution of Post-Soviet Enterprises into Business Unit: Tasks Confronting Management**

Based on the foregoing discussion, the most basic attributes of a business firm in a market economy can be identified from the resource-based perspective of the firm. The most important is evidence of effective administrative coordination and control, which defines the framework of a business firm. This requires clear administrative control, and top management able to take on the responsibility of coordinating and appraising and plan. Secondly, the firm must integrate the technical and organisational resources embedded in various business functions such as production, raw materials procurement, financing, marketing, R&D, etc. In other words, these various business functions must be brought together under a single control within the administrative framework of the firm. Third, a business firm organises an input-output chain of production—a network of several tiers of related enterprises involved in production.

Analysis of Soviet enterprises from a resource-based view of the firm suggests that because the notion of a business firm was not applicable to the Soviet economic system, the former Soviet enterprises had to be reconstituted as business firms for them to be able to function in a new market environment (Radosevic 1999: 295). Specifically, enterprises, whose activities had hitherto been controlled and coordinated under the Soviet central planning system, were faced with several fundamental tasks of reorganisation in order to fulfil the criteria of a business firm. First, administrative coordination needed to be established. Second, integration of business functions was necessary. Third, the production chain had to be reconstructed.

##### **4.1 Integrating Business Functions under Single Control**

In the wake of the disintegration of the Soviet economic system, the main challenges confronting enterprise management were to rectify the lack of resources and to bring together various business functions, which up to that time had been ‘outsourced’ across the Soviet economic structure, and to integrate them under a single administrative



framework.

After the collapse of the Soviet Union, the privatisation of former Soviet enterprises became a central part of Russia's economic reform, along with the liberalisation of prices, the reduction of government expenditure, and trade liberalisation. As these former Soviet enterprises went through the process of corporatisation and privatisation, they were only endowed with resources and capabilities geared toward serving the needs of a centrally planned economy. However, privatisation of state owned enterprises did not automatically transform these enterprises into business firms. In fact, the main objective of privatisation in Russia was depoliticisation – to get rid of political influence over economic life by removing the control rights of former state enterprises from the hands of politicians (Boycko et al. 1995: 10-12; Shleifer 1995).<sup>8</sup>

The basic principle of privatisation in Russia was the assigning of private property, namely, the transfer of state owned enterprises into private ownership. The idea was that privatisation would help to establish a secure property rights system through the creation of an efficient structure of ownership rights (Boycko et al. 1995: 10-12; Shleifer 1995). In fact, the primary concern of privatisation appeared to be the rapid reallocation of ownership rights, with little focus on the resources and business functions that needed to be integrated within a single administrative control, for these former enterprises to restructure as business units. Apparently, a consideration over firm resources and capabilities was not the key focus of privatisation. Thus, it is likely that privatisation in Russia was not primarily directed towards the fact that a firm in a market economy is a collection of resources operating as an integrator of various business functions.

While it is often argued that privatisation of state owned enterprises will lead to improved economic performance, solely because ownership will provide the proper incentives, it seems unlikely that a change in ownership alone will be sufficient (Brown et al. 1994: 40). Also important in a post-socialist context is the reconstitution of enterprises into business entities. In other words, if these former state owned enterprises were to survive and compete in a market environment after privatisation, equal attention needed to be given to the resources that they must possess and develop, and the organisation of these resources and business functions within an appropriate administrative structure.

#### **4.2 Reconstructing the Production Chain**

The breakdown of the Soviet economic system posed enterprises with the problem of reconstructing the production chain linking downstream and upstream production. The

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<sup>8</sup> Shleifer (1995: 100) argues that “In a transition economy the problem of establishing property rights largely comes down to shrinking the range of political control”.



collapse of centralised planning resulted in a break-up of a production chain, a phenomenon described as ‘disorganisation’ (Blanchard and Kremer 1997). Disorganisation refers to a disruption in the production chain, particularly in the provision of materials and intermediate inputs, resulting from the collapse of central planning, which led to the dismantling of the Soviet structure that was characterised by a complex set of highly specific relations between enterprises.<sup>9</sup> The Soviet industrial hierarchy was made up of interrelated enterprises, production associations and branch ministries, and the collapse of the Soviet economic system triggered an overhaul of the industrial structure, leading to a break-up of pre-existing networks of related enterprises for production (Joskow and Schmalensee 1997).

In addition, privatisation brought about the deconcentration of Russian industry, as privatisation in principle took place at the level of the individual enterprise, the lowest unit in the Soviet industrial hierarchy.<sup>10</sup> The reason that this fragmentation of the industrial hierarchy was favoured was that “The huge Soviet industrial hierarchies contained the lumbering bureaucracies that were at the heart of the failure of the central planning system” (Joskow and Schmalensee 1997: 103). At the same time, it was argued that this fragmentation of the industrial hierarchy through privatisation would lead to a disruption in the chains of vertical and horizontal relationships. These production chains were supported by relation specific human and physical capital that were important for maintaining production (Joskow and Schmalensee 1997). Some scholars have argued that privatisation in fact brought disorder to the industrial structure, which led to the dissolution of many potentially effective production associations (*ob’edineniia*) and concerns (*kontserny*), and that privatisation led to a destruction of the production chain (Deliagin 2000; Peregudov 2001), while others point out that the collapse of the Soviet economic system contributed more to the disruption in the production chain than did privatisation (Fortescue 1997: 147).

It should be noted that the task of reconstructing the production chain should also be considered from the perspective of transaction costs. While the resource-based perspective highlights the competence of the firm as the organiser of several stages of production, the transaction cost view focuses on whether a production chain should be organised inside or outside a single firm. In view of economising on transaction costs,

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<sup>9</sup> Disorganisation explains the reason for the collapse of output after the disintegration of the USSR, and the notion of disorganisation does not assume that the chain that existed under the Soviet system was efficient, or that its destruction would lead to an efficient outcome (Blanchard 1997).

<sup>10</sup> Posing the question “what should be the boundaries of the firm [that is] to be privatised?” Joskow and Schmalensee (1997: 110-1) criticise the Russian privatisation programme from the point of view of industrial structure, noting that the decision to quickly privatise existing enterprises at the lowest level of the industrial hierarchy was not based on detailed analysis of the best way to reform the industrial structure.

firms generally have to decide whether to organise transactions along the production chain inside the firm by vertically integrating with their suppliers and/or buyers, or to arrange transactions in the market. According to this theory, given the incompleteness of contracts, vertical integration, where related assets are organised under a common ownership, can curb opportunism and deal with uncertainty under the condition of recurring transactions that involve specific assets (Williamson 1985; Hart 1995; Milgrom and Roberts 1992). In other words, vertical integration becomes likely and more attractive way of organising transactions when the assets used in production are most valuable in a specific relationship, and when transactions are frequent (Klein et al. 1978; Hart 1995; Williamson 1985). In the situation of Russia, where market-supporting institutions were underdeveloped, the higher costs of organising transactions through the market seem to strengthen the case for vertical integration. Vertical integration reduces the risk of uncertainties in the market, such as uncertainty over price movements, reliability of supply, and access to markets. Undeveloped product, labour and financial markets would make transactions in the market difficult. Besides contracting costs, in Russia the costs of contract enforcement are high due to the weak legal system and weak enforcement mechanism. Moreover, particularly for industries where a successive production process involves relation specific assets, including oil, aluminium, nickel, steel and copper industries, the cases for vertical integration arguably become stronger (e.g. Teece 1972; Stuckey 1983; Joskow 1985; O hUallachain and Matthews 1994).

Therefore, the task of reconstructing the production chain implied the adjustments to the boundaries of the firm, i.e. deciding on which successive stages of production should be brought within the firm. As noted above, the transaction cost theory explains vertical integration in terms of so-called ‘make-or-buy’ decisions aimed at economising on the transaction costs. The resource-based view complements the rationale for vertical integration by explaining vertical and horizontal integration in terms of what Teece, Rumelt, Dosi and Winter (1994) call ‘corporate coherence’. As they put it, “Firms are coherent to the extent that their constituent businesses are related to one other. In the language of economics, businesses are related if there are economies to their joint operation and/or ownership”. They argue that lateral and vertical integration stem from the growth/diversification motives of the firm, because “firms over time add activities that relate to some aspect of existing activities” (Teece et al. 1994). Thus, firms diversify and grow through lateral and vertical integration by arranging their complementary assets coherently. In order to make the meaning of the word ‘coherence’ more articulate here, it would be perhaps useful to differentiate *administrative coherence*—what Penrose (1959/1995) terms ‘coherent administrative organisation’, and *resource coherence*—what Teece et al. (1994) term ‘corporate coherence’. From this point of view, a ‘coherent company’ has both administrative coherence and resource coherence.

### 4.3 Establishing Effective Administrative Coordination

The previous two tasks—integrating business functions and reconstructing production chain—must be accompanied by the task of establishing effective administrative coordination and control. The three tasks go together, i.e. business functions have to be integrated under a single control and the production chain has to be under the control of management. However, the breakdown of the Soviet central planning authorities removed the ‘top management’ of ‘USSR Inc.’ Individual enterprises had increased autonomy through the process of spontaneous privatisation, and the programme of mass privatisation that followed, but this was not necessarily accompanied the transfer of management responsibility—i.e. coordinating, appraising and planning the operation of the enterprise—to the new owners.<sup>11</sup>

As has been emphasised, a firm is an administrative framework within which central management coordinates and controls the industrial activities. Establishing effective administrative coordination requires the establishment of management control over a company’s operations. In Russia, in order to establish management control over a company, obtaining control of the cash flows and assets was essential. Further, in the Russian context, establishing management control necessitated concentration of ownership as discussed below.

Initially, the government’s privatisation programme resulted in a dispersed ownership.<sup>12</sup> At the same time, the privatisation programme had expectations that the initial allocation of ownership would ultimately lead to an improvement in management (Boycko et al. 1995: 94-5; Frydman et al. 1996: 189).<sup>13</sup> Although the initial pattern of dispersed ownership posed a principal–agent problem, it was expected that the secondary market trading of shares would lead to the development of an effective system of corporate governance which would improve enterprise performance (Aukutsionek et al. 1998: 495). It was hoped that outside owners, including foreign investors, would accumulate equity stakes large enough to allow them to control or to offer a degree of monitoring to prevent managerial opportunism, and to allow the influx of capital to the enterprise (Frydman et al. 1996: 189; Goldberg and Desai 1999: 42-3). In fact, Russian reformers seemed to be

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<sup>11</sup> Clarke and Kabalina (1995: 143) emphasise that the basis of Russia’s privatisation process was the ‘destatisation’ of property in the absence of a strong state, which “left the enterprise directorate in control of the means of production, with all rights but none of the responsibilities of ownership”.

<sup>12</sup> The voucher privatisation programme led to dispersed patterns of ownership structure. In the early period of privatisation, a survey of enterprises in 1994 reported that management on average held 9 percent of shares, while employees held 50 per cent. The remaining 41 per cent was held by the government or minority shareholders who bought their stakes in auctions (Boone and Rodionov, 2001: 10, citing a survey by Blasi in 1994).

<sup>13</sup> It should be emphasised that politically, speed was considered the priority, and the official privatisation programme aimed to stop the spontaneous privatisation process (See Radygin 1995)

aware that a secondary reallocation would be needed to transform the initial ownership pattern into an economically more efficient one, putting enterprises into the hands of owners who would be able to restructure them (Tompson 2001: 176).

What happened in Russia was that ownership became concentrated in the hands of those who owned and managed the companies (Boone and Rodionov 2001). Many scholars have reported the continued trend in the concentration of shareholdings in Russia.<sup>14</sup> Radygin (1999) and Starovoitov (2001) pointed out that the redistribution of property after privatisation resulted in the concentration of ownership. This is in line with other observations that dominant shareholders have emerged. Dolgopiatova (2001) found that in one of every five enterprises at the end of 1998, there were large shareholders with controlling packets of shares (more than 50 per cent), and forecasted further concentration of corporate ownership. Aukutsionek et al. (1998) reported that managers were the dominant shareholders. Dolgopiatova (2001) points to the problems of quantitatively illustrating this fact, but argues that the composition of the growing concentration of corporate ownership with large numbers of shares remaining in the hands of insiders, indirectly indicates that the managers are concentrating their ownership. Further, she also emphasises that the characteristic feature of the emerging ownership structure is that the owners and managers are usually indistinguishable, i.e. they are same group of people (Dolgopiatova 2001).

From the managers' perspectives, concentration of shareholding was of prime importance for the managing of the company, given a legal environment which had weak protection of property rights. Ownership concentration above all lessened the risk of hostile takeover in an environment where struggles over the redistribution of property were rife. Relating to the instrumental use of law prevalent in Russia, the law has been used as ammunition in Russian businesses (Golikova 2001). In some cases, legal manoeuvres enabled a 30 per cent shareholder to take control away from the management (Bloom et al. 2004; Drakina 2001). Generally, control over a company was contingent on a shareholding of 75 per cent plus one per cent. That is, owning 75 per cent plus one share in a company was considered to be a secure threshold from which to exercise managerial control. With a holding more than 75 per cent plus one, the possibility of key decisions being blocked was eliminated as, in accordance with Russia's Joint Stock Company Law, this required a shareholding of 25 per cent. In addition, super majority control provided owner-managers with the security to manage the assets more productively, because control rights and cash flow rights were both in their hands (Boone and Rodionov 2001: 15; Nash 2001). Therefore, owner-managers sought to increase their equity holdings to the super majority level range

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<sup>14</sup> Here, concentration of ownership refers to the concentration of shareholding at the level of the individual company. For Russia's industrial concentration, see for example, World Bank (2004).

of 70-100 per cent.<sup>15</sup> In Russia, concentration of ownership by owner-managers has become the means to establish stable administrative control over the operations of enterprises.<sup>16</sup>

#### **4.4 Tasks under Institutional Weakness**

Russian enterprises were faced with these tasks for the reconstitution of enterprises into business firms against a background where market-supporting institutions were insufficiently developed. In particular, Russia's emerging market order suffered from an underdeveloped financial system, such as capital market and banking sector, and from a weak legal and judicial system (Hanson 1997; World Bank 2002). In addition to lack of an adequate legal infrastructure, the weakened capacity and autonomy of the state made rigorous enforcement of law difficult (McFaul 1997; Tompson 2001). Moreover, the overall political and economic environment was uncertain and volatile. During the most of the 1990s political stability was not ensured and the decade was a period of macroeconomic instability and output decline (Berglof et al. 2003). The three tasks, summarized in Table 1, were challenging particularly in the context of the disintegration of Soviet economic system and accompanying institutional weaknesses.

[TABLE 1 Here]

### **5. Role of Informal Practices in Fulfilling the Tasks**

#### **5.1 Informal Corporate Governance Practices in Russia**

During the 1990s businesses in Russia routinely relied on practices not entirely compatible with the formal rules (Dolgopiatova 1998; Kapeliushnikov 2001; Ledeneva 2001; Leitzel 1997; Radaev 2001). Phenomena such as capital flight, barter, tax evasion, and non-transparent corporate governance have all been associated with informal, extra-legal practices (Ledeneva 2001; Golubkov 1999; Rozinskii 2002; Iakovlev 2000; Tikhomirov 1997). Unwritten codes of behaviour and informal practices have penetrated formal institutions, reducing the effect of Russia's economic reform. In the area of corporate governance, several practices have reportedly become widespread in the managing of joint-stock companies in Russia: selling the products of the company at

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<sup>15</sup> Boone and Rodionov (2001: 15) show that after a group of owner-managers achieved 70-100 per cent control of their companies, the productivity of these companies increased, and they argue that "Our general conclusion from these observations is that dispersed ownership was not an equilibrium outcome for Russian companies".

<sup>16</sup> A notable aspect of ownership concentration in Russia from a principal-agent view was that the concentration brought about the unification of ownership and control. To use the concept of the agency chain argued by Stiglitz (2000), ownership concentration resulted in shortening the agency chain by unifying principal and agent. Stiglitz and Ellerman (2003) argue that implicit in the voucher privatisation scheme was the imposition of long, multistage chains of agency relationships that are only feasible in developed market economies. Therefore, one way to interpret the concentration of ownership in Russia was that ownership concentration virtually removed the separation of ownership and control.

below market price to entities controlled by insiders; designing a convoluted ownership structure using a network of offshore entities; withholding information about the timing and venue of shareholders' meetings and barring shareholders from exercising their voting rights at meetings; increasing charter capital and offering newly issued shares only to insiders; and executing hostile takeovers through bankruptcy proceedings (Black et al. 2000; Fox and Heller 1999; Ikonnikov 2001; Mobius and Filatov 2001; Sprenger 2000; Vasiliev 2001). I use the term 'informal corporate governance practices' or ICGPs to refer to these practices collectively. ICGPs are informal in the sense that they represent informal ways of 'getting things done'. They are not entirely compatible with the behaviours that are envisaged by the formal rules, they often rely on the instrumental use of law, and are based on unwritten agreements that are non-transparent to outsiders.

Russia's ICGPs, which became widely publicised as corporate governance abuses, are destructive in that they undermine investor confidence and the foundations of good corporate governance. However, understanding the firm from a resource-based view sheds light on the ambiguity of these practices. An ambiguity of ICGPs is that although these practices have been abusive and detrimental to investors, they acted as 'coping strategies' from the perspective of owner-managers, who had the task of reconstituting business entities in the face of institutional weaknesses and disintegration of the Soviet economic system.<sup>17</sup> In examining the cases of the Yukos Oil Company, which in 2003 became Russia's largest oil company before it experienced dismemberment in 2004, the following subsection investigates how informal practices functioned to fulfil the three tasks described above.

## **5.2. Yukos Oil Company and ICGPs**

During much of the 1990s, Yukos Oil Company was mostly associated with corporate governance practices that were abusive to minority shareholders. Nevertheless, it eventually developed into one of the well-respected companies in Russia, with improved corporate governance and transparency. By 2003, Yukos was the largest and most profitable oil company in Russia. However, the company faced back tax claims and its CEO Mikhail Khodorkovskii and his associate Platon Lebedev were arrested on charges of fraud and tax evasion in 2003. Then the company lost Yuganskneftegaz, the main production unit, as the state auctioned it off in 2004.

Of all the turbulent history of Yukos, this section focuses on the role played by ICGPs during the 1990s, when the major challenge confronting the management of Yukos Oil

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<sup>17</sup> The assumption here is that owner-managers have a stake in the survival and eventual growth of their companies as going concerns. It can be argued that this assumption does not contradict the view that managers are opportunistic actors in the sense that if companies cease to function, opportunistic owner-managers will lose their vehicle to act opportunistically.



was to establish effective administrative control and to build a company with the potential to become the largest oil producer in Russia by 2003. Yukos Oil Company was established as part of the reorganisation of the Russian oil industry following the break up of the USSR. In November 1992, President Boris Yeltsin issued decree 1403, detailing specifications for the corporatisation and privatisation of oil enterprises.<sup>18</sup> The first pillar of the reorganisation policy was the establishment of holding companies to create ten to twelve vertically integrated oil companies (VIOCs) in Russia. The establishment of VIOCs was done in an effort to restructure the Russian oil industry. Vertically integrated companies were designed to encompass an entire production linkage ‘from the well to the gas station’ (Moe and Kryukov 1994: 93). Such a vertically integrated structure was in part modelled on the vertically integrated Western oil majors (Diens 1996: 10; Moe and Kryukov 1994: 93).

Decree 1403 established VIOCs comprising holding companies, under the umbrella of which the existing enterprises were organised as subsidiaries. In other words, each oil holding company was made up of subsidiary operating companies, i.e., oil production subsidiaries, refining subsidiaries, and the enterprises that dealt with the distribution of oil products. The first three vertically integrated oil companies to be established under decree 1403, were the Yukos Oil Company, Lukoil and Surgut Holding. The original constituent enterprises of these three VIOCs can be seen in Table 2. Yukos Oil, for example, was made up of a dozen subsidiaries, including oil production enterprises such as Yuganskneftegaz, Samaraneftegaz, and refineries such as Kuibyshevnefteorgsintez. The name of the company Yukos was derived from Yuganskneftegaz and Kuibyshevnefteorgsintez.

**[TABLE 2 Here]**

The establishment of VIOCs in 1992 was facilitated by the general directors of former Soviet oil enterprises who wanted to maintain the newly gained autonomy and control over their enterprises. They opposed a plan to create a unified state oil monopoly on the lines of Gazprom, the gas monopoly (Moser and Oppenheimer 2001: 305-6). The general directors of the enterprises therefore actively promoted the creation of VIOCs: Vagit Alekperov, former First Deputy Oil Minister in the Soviet government, played a pivotal role in these endeavours and ultimately became president of Lukoil (Moser and Oppenheimer 2001).

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<sup>18</sup> Decree Number 1403, 17 November 1992, entitled ‘On Specifications for Privatisation and Reorganisation as Joint Stock Companies or State Enterprises, Production, Scientific–Production Associations in the Oil and Refining Industries and in Oil and Petroleum Supply.



## ***Tasks Confronting Yukos***

### ***1) Establishment of Administrative Control***

Since its establishment in 1992 as Russia's vertically integrated oil company composed of the holding company and its subsidiaries, Yukos Oil Company has suffered from a lack of internal cohesion and organisational integrity. The lack of internal cohesion between the holding company and Yukos's constituent subsidiaries was in part due to the manner in which privatisation was conducted. Corporatisation and privatisation took place both at the holding and the subsidiary levels, which meant that the constituent subsidiaries were privatised as independent units, each with its own lock of shares. This two-tiered privatisation created a multilevel governance structure at both holding and subsidiary level, and created different groups of management and shareholders, including minority shareholders.

The subsidiaries effectively maintained their operational independence and the Yukos management was unable to control them. For example, since the privatisation of the subsidiaries and the creation of the holding company, Yukos did not exert administrative control over its main subsidiary Yuganskneftegaz (Kryukov and Moe 1998: 13). Yuganskneftegaz had its own company charter, management, and board of directors, and continued independent operation (Memorandum ob AO "Yuganskneftegaz", 1994).<sup>19</sup> Although the first general director of Yukos Sergei Muravlenko, was also the general director of Yuganskneftegaz, Yukos was unable to control resource and financial flows of Yuganskneftegaz; Yukos management eventually sought state intervention to resolve this lack of internal cohesion (Kryukov and Moe 1998: 13). Another subsidiary, Novokuibyshev Refinery, also did not want to give up its autonomy to Yukos. The Novokuibyshev Refinery, against the will of Yukos's general director, planned to independently strike a deal with a Canadian bank to obtain investment (RPI, October 1993: 55-6).

Clearly, the operative administrative hierarchy essential for the Yukos Oil Company to "make [the] operations of the whole enterprise more than the sum of its operating unit", to use the words of Chandler (1990: 15), did not exist. Therefore, the crucial task for Yukos was to resolve the lack of administrative cohesion and to establish an effective administrative framework, in which all activities were organised and controlled by the management. In other words, the most immediate task for Yukos from the perspective of its reconstitution into a business unit lay in the sphere of its administrative coordination.

### ***2) Integration of Business Functions***

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<sup>19</sup> As an example of independent activity, Yuganskneftegaz became the main founder of the then leading bank Tokobank, and became a 20 per cent shareholder (Kryukov and Moe 1998).

In considering to what extent the Yukos Oil Company was a pool of resources that rendered various business functions, Yukos was better placed than an individual Soviet production unit, the lowest unit in the Soviet economic hierarchy. Yukos had a better set up in the sense that it was more than a production unit, because it was comprised of several subsidiaries, which themselves were composed of several production units. In other words, to a degree Yukos was a collection of resources able to render certain business functions including oil production, refining, distribution, and R&D. Yuganskneftegaz, for example, was a former production association (PO—*proizvodstvennoe ob'edinenie*), itself composed of several oil and gas production units (NGDU—*Neftegazodobyvaiuschie upravleniia*) such as Yuganskneft' and Pravdinskneft' (Memorandum ob AO “Yuganskneftegaz”, 1994: 3). In addition to these units that performed oil producing functions, refining and distributing were pooled under the umbrella of Yukos Oil, as the company included such subsidiaries as the Novokubyshev refinery, and several distributors of oil products. The holding company also included the R&D function, i.e., it encompassed research institution and design bureaux serving the enterprises that belonged to the holding (Gokhberg 1999: 48). Thus, Yukos was, at least nominally, a collection of resources that could in theory render certain business functions including oil production, refining, distribution, and R&D as a single integrated unit, while individual Soviet production units were not. Several entities responsible for business functions such as production, refinery, exploration and distribution were assembled under Yukos's umbrella when the VIOC was established.

However, the resources of a firm must be bound together in an administrative framework, and the administrative hierarchy must be able to integrate and organise these resources. In other words, business functions rendered by resources have to be linked to one another and integrated under a single administrative control. Yukos had no effective administrative framework within which the business functions under its umbrella were organised. The operational independence that was maintained by Yukos subsidiaries led to a disintegrated corporate management within Yukos as a whole, and the absence of a proper administrative hierarchy and resultant lack of administrative control over the subsidiaries made the integration of business functions within Yukos very difficult.

### ***3) Reconstruction of the Production Chain***

Yukos's lack of administrative control over its subsidiaries adversely affected its ability to organise the production chain. Yukos was established as a vertically integrated oil company which envisaged integration of the entire production linkage ‘from the well to the gas station’, i.e. the production chain linking crude oil production to refining, and refining to distribution. In a vertically integrated company, management must be in control of the whole process of organising a network of related enterprises dealing with

extraction, production, refining and distribution, in order to be the organiser of the production chain. However, despite the fact that Yukos had been established as a vertically integrated company, it was vertically integrated in name only. The production chain from the well to the gas station was not linked closely within the structure of Yukos. The constituent subsidiaries of Yukos were independent legal entities, which also operated outside the Yukos boundaries.

To make the production chain work within the boundary of a VIOC, successive stages of the industrial process had to be coordinated and brought together. In order to achieve this, the company required an effective administrative hierarchy controlled by a single management. Because of this need to establish a single management control over the subsidiaries, the tasks of organising business functions and of reconstructing the production chain overlapped.

### ***How Yukos was Reconstituted into a Coherent Entity: Use of ICGPs***

From the perspective of constructing coherent business units, the most immediate task for Yukos Oil was the strengthening of a single administrative control. In the case of Yukos Oil, the establishment of an effective administrative framework was indispensable to the fulfilment of the other two tasks, i.e., to integrate business functions and organise a well functioning production chain. In order to establish administrative control, the priority for management was to centralise cash flows, so that all product and revenue streams were under direct control of Yukos management, rather than the managements of the individual subsidiaries. As a result of the loans-for-shares auction in 1995, by which the state handed over its shares in the oil company in exchange for loans at a fraction of its potential market value, the Menatep group, headed by Mikhail Khodorkovskii, became the new owner of the holding company, and thereby the controlling shareholder of Yukos' subsidiaries. As the shareholdings in Yukos increased, the top management of Yukos came to be dominated by representatives of Menatep, who sought to limit independent transactions by subsidiaries.

The practice of transfer pricing was used to force subsidiaries to sell oil to the holding company at a very low price. In order to transfer oil cheaply from the subsidiary to the holding, Yukos classified what they were buying from the subsidiaries as 'liquid from the wells' (*skvazhinnaia zhidkost'*). What the subsidiaries sold to the holding was not 'crude oil', but a much less expensive product on paper. Thus, Yukos was able to set an 'intra corporate price' for 'liquid from the wells' from its own subsidiaries (Latynina 1999).<sup>20</sup> As a result of subjugation of subsidiaries to the holding through transfer pricing, the

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<sup>20</sup> For example, in the intra corporate price was set at 250 rubles (USD10.2) per ton in 1999, when the domestic market price was 800 rubles (USD32.6) per ton, and the international market price was USD73.0 per ton (Latynina 1999).

independence of the subsidiaries was further constrained.

Yukos's management then proceeded with the plan to make subsidiaries wholly owned by Yukos through cancellation of the separate listings of the subsidiaries' shares, and the transformation of these shares into single Yukos shares representing all constituents. The process of consolidation of Yukos was envisaged as a single share conversion, i.e., a swap of subsidiaries' shares for a holding company share. This was designed to ensure that there would no longer be a situation where subsidiaries' shareholders and holding company shareholders coexisted within the framework of a single VIOC. The consolidation thus aimed at resolving the problem of establishing effective administrative control within the framework of Yukos Oil.

However, this process was complicated by the presence of minority shareholders in the subsidiaries. Due to the two-tiered privatisation, not only did subsidiaries have separate managements, but also there were shareholders who owned subsidiaries' shares. This two-tiered scheme gave rise to a sharp conflict of interest between the management of Yukos and the shareholders in the subsidiaries (Hoffman 2002; Moors 1999). The management of Yukos was keen to proceed with consolidation by making subsidiaries wholly owned. However, a minority group of subsidiary shareholders attempted to hinder the process (Nechaev 1999; Svarovskii 2002; *RPI*, March 1999: 57). At an extraordinary shareholder meeting of Tomskneft in 1999, the minority shareholder group that owned 13.9 per cent of Tomskneft proposed a change in a composition of the board of directors controlled by Yukos management, and elected a new board. It attempted to change the subsidiary charter, which conferred on Yukos the right to manage Tomskneft, and also sought to freeze the 51 per cent of shares in Tomskneft that were held by Yukos (*RPI*, March 1999: 57). This effectively blocked the attempts of Yukos's management to pursue the task of establishing an effective administrative hierarchy, essential for a well functioning vertically integrated company. For Yukos management, therefore, it seemed necessary to render this group powerless, in order to proceed with the planned restructuring of the company. To achieve this, ICGPs such as share dilution, limiting shareholder access to voting, and transfer pricing were utilised.

Share dilution reduced the proportion of subsidiaries' equities held by minority holders, thus weakening their voting power. The practice of share dilution was enabled as the management succeeded in excluding minority shareholders of subsidiaries from attending the shareholders' meeting where the decision to issue additional shares was taken (Fenkner 1999; Semenenko 1999). Minority shareholders of subsidiaries, who could have blocked the decision by their votes were barred from voting on the basis of court injunction allegedly arranged through "a compliant judge" (Black et al. 2000:

1771).<sup>21</sup> When ‘undesired’ shareholders are prevented from exercising their right to vote, insiders can make key decision that in accordance with the joint stock company law requires three quarters of the votes, while following the letter of the law and maintaining the appearance of legality.

In addition, at those meetings decisions were made to distribute the additional to entities which allegedly had some affiliation with the management, although they formally have no connection with the management (Black et al. 2000; Fedorov 2000; Fenkner 1999). With non-transparent ownership structure composed of entities not formally connect to the insiders, the requirements of the joints stock company law on interested party transactions can be bypassed (Hoffman 2002; Fenkner 1999). Further, under the transfer pricing schemes, the output of the subsidiaries was sold at a below–the market price to the holding company or one of its affiliates. Operating costs and debts remained with the subsidiaries while the profits were transferred to the holding company (Whalen 1998). In this way, the share value of subsidiaries was driven down, to the detriment of their shareholders. The lower the market price of the subsidiaries, the better the deal that the holding company could conclude over the share swap (Moser and Oppenheimer 2002).

Through the use of ICGPs, the Yukos management in effect strengthened its administrative control over subsidiaries by eliminating minority shareholders’ influence and concentrating ownership. As a result, Yukos established a workable administrative framework, or became what Penrose (1959/1995: 16) called an “autonomous administrative planning unit” with “managerial direction responsible for the general policies under which the firm’s administrative hierarchy operates”. The management was able to bring the operations of its subsidiaries under its control, which enabled management to integrate and organise business functions, and make the production chain operational. The acquisition of more than 90 per cent shares in its subsidiaries enabled Yukos to effectively manage upstream operations within a single Yukos framework (Sidorov 2002). Yukos Exploration & Production (E&P), a wholly-owned subsidiary of Yukos originally established in 1998, was finally in control of the oil extracting subsidiaries, Yuganskneftegaz, Samaraneftegaz and Tomskneft, which allowed it to manage the upstream chain of production operations. Similarly, Yukos Refining & Marketing (R&M), created as a wholly owned subsidiary of Yukos, had control of the Kuibyshev, Novokuibyshev, Syzran and Achinsk oil refineries and Yukos’s sales network, which covered eleven regions of Russia. Yukos E&P and Yukos R&M were under the management of Yukos-Moskva, which was responsible for developing strategy and for

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<sup>21</sup> There was also an instance where subsidiary shareholders arrived for a shareholders’ meeting to find a notice on the door that the meeting had been relocated to another place, several hours’ drive south of Moscow. The notice was posted at 9 am, which made it impossible for minority shareholders to reach the venue in time for the registration deadline of 11.45 am (*The Economist*, July 24, 1999: 64).

decision making on major strategic issues (*Moscow Times*, September 3, 1998; McChesney, 2000; Yukos website [www.yukos.ru](http://www.yukos.ru)). Thus, the company had achieved to establish an effective administrative hierarchy, with the activities of subsidiaries being brought together under a single management within the framework of Yukos as a whole (see Figure 3). In short, Yukos was now a vertically integrated oil company both in name and in substance.

**[FIGURE 3 Here]**

It should be emphasised that the ICGPs were enabled through instrumental use of the law with the exploitation of *lazeika* – a gap or loophole. In other words, Russia's institutional environment contained several weaknesses that made these practices possible. More concretely, ICGPs worked because of the imperfections of laws themselves, the instrumental-use-of-law mentality, and weak enforcement mechanism, including uneven enforcement of rules and a lack of independence in the judicial system. In addition, when minority shareholders appealed to the state over the violation of their rights, the authorities generally took no action (Fedorov 2000). Therefore, it appears that the state tolerated the use of ICGPs generally, and particularly in the case of Yukos during the 1990s.

## **6. Conclusion**

This paper has argued that post-communist economic transformation of the corporate sector involved the reconstitution of post-Soviet enterprises into business units in the theoretical context of the resource-based perspective of the firm, which conceptualises a firm in a market economy in terms of a collection of resources that render business functions. It then identified a set of fundamental tasks faced by Russian enterprises in reconstituting themselves as business units. These tasks included a) establishing an effective administrative hierarchy; b) integrating business functions under a single point of control; and c) reconstructing the production chain.

The paper then analysed the role of informal business practices from the perspective of reconstitution of enterprises into business units, focusing on Yukos's corporate development during the 1990s. Yukos used a series of informal practices in the area of corporate governance, which went against the principles of good corporate governance. Their abusive nature had adverse consequences for investors and investment climate as they violated shareholders rights. As a result, the minority shareholders in Yukos subsidiaries condemned corporate governance abuses by the Yukos management and initiated a public relations campaign against Yukos in 1999 (OAO Yukos Oil Company



2002). The share valuation of Yukos plummeted as a consequence.<sup>22</sup> Yukos's company image was severely damaged. The company was branded a 'corporate governance disaster'.<sup>23</sup>

However, these informal practices performed constructive functions in the context of the reorganisation of the oil sector and institutional weaknesses. They were used as coping strategies to build a business entity within which the operations of subsidiaries were brought under the control of the framework of VIOC. They became tools to resolve the tasks the company faced in reconstituting itself into an effective business unit. Specifically, they addressed the lack of administrative cohesion and helped establish management control. Establishment of administrative control was, in turn, necessary to integrate business functions and to organise successive stages of oil production under a single management.

It should be emphasised again that the institutional weaknesses created the room for the use of these informal practices. They became workable because the legislation contained imperfections, manipulative attitude towards the law seemed dominant, enforcement of the law was problematic and the judicial system was not strong. These practices thrived because of these institutional weaknesses, which enabled systematic exploitation of the defects in the institutional framework. In addition, they became operational in the absence of a strong, impartial state, i.e. an autonomous state with effective administrative capacity. Thus, the institutional framework and the weakness of the state invited and enabled the use of informal business practices. Against this backdrop, they were used by management facing the fundamental tasks of reorganisation when the market-supporting institutions were underdeveloped. In a situation where the financial system was underdeveloped, legal institutions were weak and protection of assets was not properly provided for, informal corporate practices became the tools to enable coping strategies to manage the tasks. From this point of view, these practices aided the reconstitution of enterprise into a coherent business firm under the condition of institutional weaknesses.

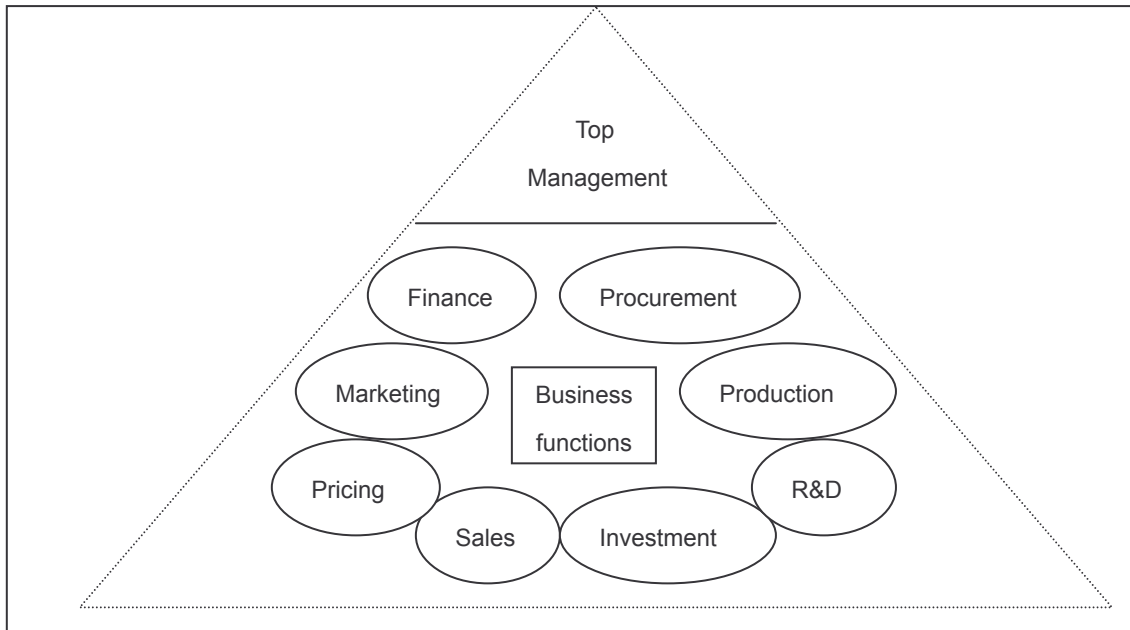
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<sup>22</sup> In June 1999, Yukos shares were trading at 15 cents, down a per cent from the high of USD 6 two years earlier (OAO Yukos Oil Company, 2002).

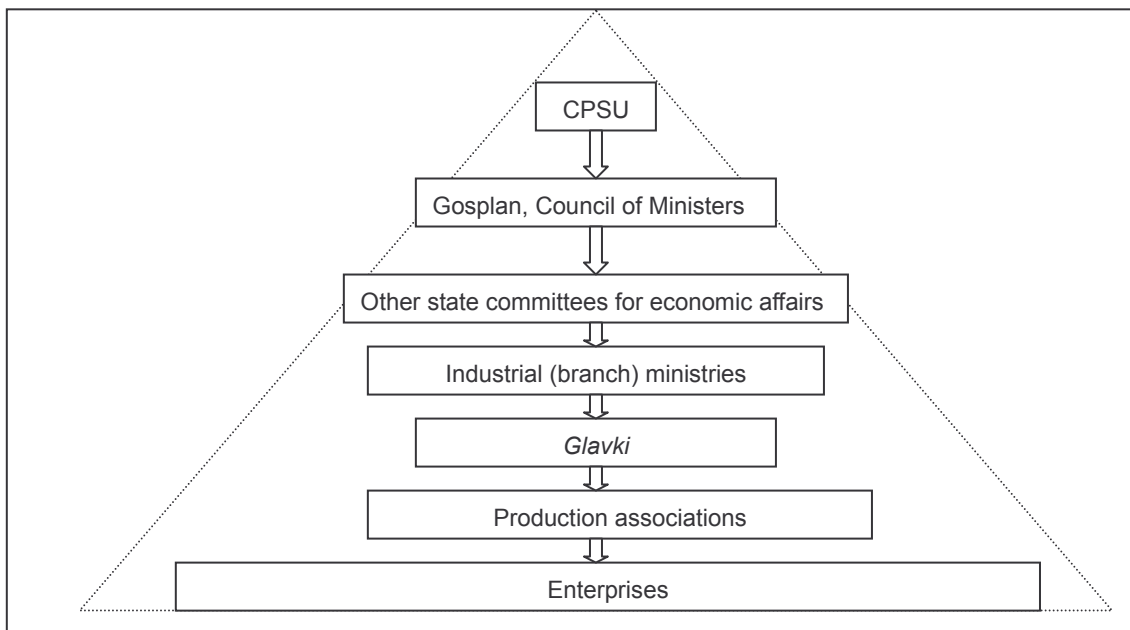
<sup>23</sup> One analyst noted that Yukos "will need the mother of all public-relations efforts to rescue their reputation" (Peach, 1999).



**Figure 1: A Firm as a Collection of Resources Organised in Administrative Hierarchy**



**Figure 2: Soviet Economic Hierarchy: 'USSR Inc.'**



Source: Adopted from Hanson (2003: 11) and Gregory and Stuart (2001: 90).

**Table 1: Tasks of Reconstituting Enterprises as Business Units**

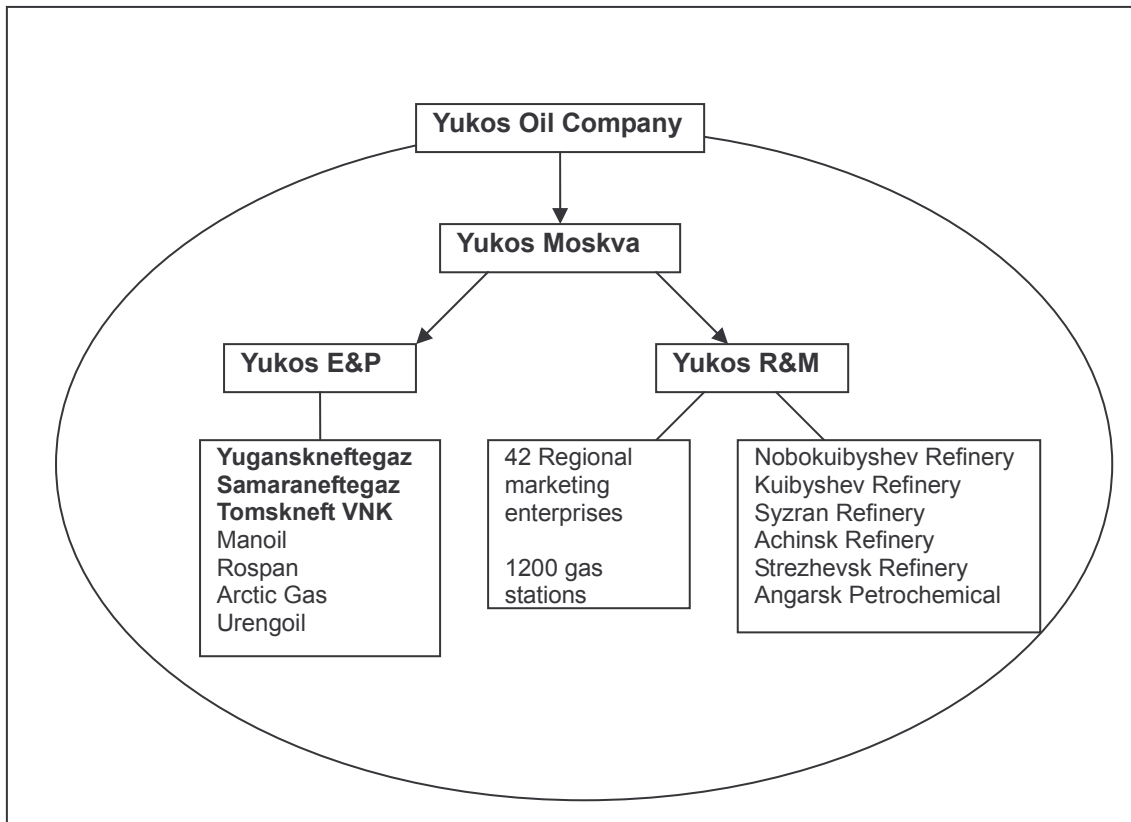
| <b>Tasks of Russian companies in Reconstituting enterprises as Business Units</b>  |
|--|
| <b>1. Establishing effective administrative coordination and control</b><br>(i.e., to establish management control to put administrative hierarchy in place) |
| <b>2. Integrating various resources embedded in business functions under single control</b> (i.e., to become an integrator of business functions)            |
| <b>3. Reconstructing a production chain and redefine boundaries of the firm</b><br>(i.e., to become an organiser of production linkage)                      |

**Table 2: First Three Vertically Integrated Oil Companies (VIOCs)**

| <b>Holding Companies</b>                     | <b>Yukos</b>   | <b>Lukoil</b>  | <b>Surgut</b>   |
|--|--|--|---|
| ↓  | ↓  | ↓  | ↓   |
| <b>Oil Production Subsidiaries</b>           | Yuganskneftegaz<br>Samaraneftegaz  | Kogalymneftegaz<br>Langepasneftegaz<br>Uraineftgaz<br>Nizhnevolzhskneft                    | Surgutneftegaz  |
| <b>Oil Refining Subsidiaries</b>             | Kuibyshev Refinery<br>Syzran Refinery<br>Nobokuibyshev Refinery  | Permnefteorgsintez<br>Volgograd Refinery<br>Novouflims Refinery                            | Kirishinefteorgsintez   |
| <b>Oil Product Distribution Subsidiaries</b> | Briansknefteprodukt<br>Voronezhnefteprodukt<br>Samaranefteprodukt<br>Orelnefteprodukt<br>Lipetsknefteprodukt<br>Penzanefteprodukt<br>Uljanovsknefteprodukt | Adygeisknefteprodukt<br>Vologdanefteprodukt<br>Cheliabinsknefteprodukt<br>Permnefteprodukt | Karelnefteprodukt<br>Novogorodnefteprodukt<br>Pskovnefteprodukt<br>Tver'nefteprodukt<br>Kalinigradnefteprodukt<br>Peterburgnefteprodukt |

Source: *Russian Petroleum Investor (RPI)*, July/August 1994, pp.16-18

**Figure 3 Corporate Structure of Yukos (in 2002)**



Source: Compiled by author based Group Menatep (2002); Sidorov (2002); Yukos website, <http://www.yukos.com>.

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