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POLITICAL SURVIVAL OR ENTREPRENEURIAL DEVELOPMENT? OBSERVATIONS ON RUSSIAN BUSINESS NETWORKS

Peter Huber and Andreas Wörgötter¹

Networks are hybrid forms between hierarchies and markets. The present article focuses on the structure of Russian business networks and their potential for integration into European business networks. In Russia, two competing types of networks can currently be identified: *survival networks* and *entrepreneurial networks*. In the latter, the main interests of the enterprise managers are to improve market performance and profits. But in the former, enterprise managers are involved in a large “rent-seeking” game, in which political and market power are the major means by which rents are extracted. Managers within survival networks evaluate both internal and external business relationships with reference to their effects on rent-extraction capacities. In Russia today, survival networks predominate and entrepreneurial networks are relatively few in number.

BUSINESS NETWORKS IN A “NORMAL” ENVIRONMENT

In institutional economics, attention to networks has been driven by the realization that many innovations are taking place primarily in the space between markets and hierarchies (Lindenberg 1996). Many phrases have been used to describe these hybrid forms: symbiotic contracts (Schanze 1993); networks (Williamson 1991); clans (Ouchi 1980). Business networks, which we define as sets of connected exchange relationships between actors controlling business activities, have been interpreted as important contributors to regional development and as determinants of the comparative advantage of nations (Porter 1990).

The business relationships that comprise networks may differ in form, such as whether they are based on trade or capital ties. The relationships may also differ in content, such as whether they are based on common technologies, knowledge, administrative routines, or social ties. Moreover, business relationships tend to be highly complex, involving more than one activity and requiring substantial efforts to resolve the conflicts that inevitably arise. Then too the bases of relationships tend to change over time; indeed, mutual adaptation of the partners is typical, as a result of which cooperation may be reduced, intensified, or shifted to new bases. On the whole, though, and notwithstanding these adaptations, business relationships in mature economies tend to be relatively stable.²

Why do such networks arise? A number of theories have been advanced. Transaction costs theory (Williamson 1975) holds that networks arise as a special institutional arrangement—governance structure or mechanism of cooperation—for handling problems that combine asset specificity, bounded rationality, and human opportunism.³ Williamson (1991) argues that the particular advantage of networks over other methods of coordinating human economic activities (such as hierarchies and markets) is that they minimize transaction costs in cases of medium asset specificity and a high need for flexibility.

Empirical research has gone part of the way toward confirming this hypothesis. Business networks have been more prevalent in industries that require high flexibility—due to rapidly developing markets—and substantial human capital. Examples include networks of universities and biochemical enterprises (Powell 1996) and the consumer electronics industry (Ernst 1995). Networks are also more prevalent in cases in which producers have found innovative ways to upgrade standardized products by linking themselves to upstream enterprises through the creation of limited asset specificity. Examples include woodworking and pulp-processing networks spanning Denmark and Sweden (Hakanson and Snehota 1995) and quality-label poultry in France (Menard 1996). At the same time, empirical research has qualified Williamson's hypothesis. The original architecture of networks is often influenced heavily by such factors as enterprise culture, history, and the institutional background available during the process of creation. Thus, Zysman (1995) has found that networks in Southeast Asia and the United States differ

substantially between nations with respect to their openness and verticality—that is, the ease with which networks are penetrated by outsiders and the extent to which they are organized as groups of social peers.⁴

NETWORKS IN THE RUSSIAN ECONOMY

Networks emerge within concrete cultural, historical, and institutional environments and are subject to continuous evolutionary change. The context within which they have arisen in Russia is quite different from that in mature market economies, which should lead us to expect their structure and consequences to be different as well.

HISTORICAL CONTEXT

Networks in transition economies predate the collapse of communism. They were formed during the era of state planning, products of both the trade relationships of that era and the unofficial ties that emerged within the gray and black markets. But the nature of the networks was different from those in mature market economies owing to the extremely hierarchical nature of central planning, the absence of prices as means of generating meaningful information, and the exclusive concentration on quantity of production (Hirschhausen and Hsui 1995). Organized around territorial industrial complexes, official relationships between firms mainly served delivery functions. Joint ventures in research and licensing relationships—characteristic of business networks in mature market economies—were almost completely lacking. And to mitigate the costs of planning, transactions between firms were highly integrated horizontally, such that the number of transactions was relatively small (Rühl 1995).

The networks that derived from the gray and black markets were also distinctive. Relationships within these markets were based on personal ties, such as friendship, rather than on impersonal business ties. While the authorities tolerated these networks, they also eyed them with suspicion. Accordingly, the networks had to be less

formal and more conspiratorial than those which predominate in market economies.

Substantial empirical evidence concerning corporate structures and financial-industrial groups (FIGs) in Russia suggests that relationships forged under the planning system remain operative, especially in large-scale industry. Thus, according to Gorbatova (1995), banks that had once channeled export financing and credits to industrial enterprises have remained closely linked to those enterprises even after their organizational devolution, and in some cases emerged as owners of those firms. Similarly, Gurkov and Asselsberg (1995) found that as of 1994, old, excessively long transport routes for products were still being used, despite their economic irrationality.⁵ Finally, historical continuity has been maintained by the privatization of the former departments (*glavki*) of ministries. These were transformed into joint stock companies; they now provide consultancy and export services to their former clientele (Starodubovskaia 1995).⁶

Some evidence also exists of price discrimination by old networks against new ones. Dolgopiatova and Evseyeva (1995), for example, found that in 1993, 10 percent of the managers of state-owned enterprises that they interviewed refused to work with managers of private firms, and 45.7 percent stated that they would do so only under dire necessity.

At the same time, newly founded enterprises are building new networks of their own. Freinkman (1995) argued that the underground enterprises (*tsekhi*) founded during the Gorbachev era usually had good connections to both criminal and political circles and may have served as points for the crystallization of new network structures.

PRODUCTION PROCESSES

One legacy of the planned economy was a production structure in which enterprises were unusually large relative to the resource markets in which they were located. Russian enterprises, accordingly, differ from American counterparts less in their total size than in their level of concentration (Joskow, Schmalensee, and Tsukanova 1994). An extreme example is Krasnoyarsk *kray*. Of the ten towns

with more than ten thousand inhabitants, six are dominated by one producer, employing more than 40 percent of the townships' workforce. Indeed, for many of these towns the next possibility for employment is several hundred kilometers away (Huber, Nagaev, and Wörgötter 1996). Although Krasnoyarsk is extreme, the phenomenon is widespread. This means that in many Russian localities, there will not be enough diversity of enterprises to support the construction of new networks.

This monopsonistic position of firms on labor markets has additional implications. They can get away with not paying workers their overdue wages, even when the enterprises are profitable.⁷ They have a strong influence on regional politics, due in part to their contributions to regional budgets.⁸ But because these firms are also highly dependent on the localities in which they produce, they will feel threatened by the entry of new enterprises into the region—even in sectors that do not compete directly with the indigenous firms—because new entrants will weaken the strategic positions of firms in regional input markets. Then too managers of large enterprises use these as bases of power for activities outside the enterprise that serve as major sources of income. Thus, in 1994, the majority of managers of formerly state-owned enterprises owned a multitude of firms (Gurkov and Asselsberg 1995). Similarly, Bim (1996) found that 73 percent of managers interviewed admitted to owning firms that were either deliverers or suppliers to the very firm they managed. It is not surprising, therefore, that harassment of new firms is a common phenomenon in these regions. Given these orientations, we find little organization of production on the basis of relatively open and nonhierarchical networks.

A second feature likely to influence the nature of emerging networks in Russia lies in the production structure of Russian industry itself. The typical Russian producer is an enterprise that is horizontally integrated, located in heavy industry and/or mass production of standardized goods, and uses relatively few specific assets. Such a technological profile is not well suited to network creation, unlike, for example, the electronics producers of Central Asia or other instances of production that foster cross-border networks.

The environment surrounding the firms is also less supportive of network creation than is the case in mature market economies. The

socialist enterprise itself provided most services, whether these were social or producer (such as auditing). This applied in particular to the organization of financial relationships. The result is that in Russia, in many instances, banks are heavily dependent on, or directly belong to, the enterprises for which they organize trade.

THE INSTITUTIONAL ENVIRONMENT

The institutional environment of firms gives additional impetus to the maintenance of survival networks and efforts to monopolize entry. The stark realities of transition make clear to Russian managers where their interests lie. Certain institutional changes are clear threats to their political and material security, and they will use their powers to prevent them.⁹ Rühl (1995), for example, has argued that the inter-enterprise arrears crisis is sustained by enterprise managers' knowledge of their power to induce the central government repeatedly to bail them out.

This willingness to use their powers to tilt balances in their favor is reinforced by the knowledge that most decisions taken during the transition have long-term implications. Hence, even if some costs are associated with the exertion of power, the long-run gains—or loss-avoidance—may be very large. Moreover, the lack of a fixed, consistent institutional and legal framework makes it almost impossible to abstain from the power-political game or to stay within the bounds of legality when conducting business. The inevitable legal breaches allow actors to compromise even those unwilling to play at the power game.

TYPES OF RUSSIAN BUSINESS NETWORKS

As noted, we divide networks in Russia into two ideal types: survival and entrepreneurial.¹⁰ Survival networks encompass enterprises that see little future for themselves in competitive market conditions; indeed, they are formed with the explicit goal of isolating participants from market competition. The purpose of the network is short-term rent extraction from the government—i.e., lobbying. The network structure is based on ties created during the socialist

era. Entrepreneurial networks, by contrast, are composed of actors that seek to compete in the new markets by developing economically viable activities. Two types of entrepreneurial networks can be identified: those that build on old structures and those composed of new structures.¹¹ Survival and entrepreneurial networks differ with respect to their architecture and their orientation toward cooperation with new foreign partners and toward the marketization process in Russia today.

SURVIVAL NETWORKS

The predominant goal of actors within survival networks is to protect or maximize their power to extract rents, which can be quite large in the conditions of Russia today. Those rents may be used to gain riches, to avert bankruptcy, or both. Moreover, since increasing one's power requires dedicated followers and since the allegiance of a new member is always hard to assess, survival networks will be relatively closed. And since increasing power also requires substantial control over the power base, survival networks will also be highly vertical. Finally, survival networks favor stability of membership and relationships over time.

The attitude toward interaction with foreigners is ambivalent. On the one hand, foreign participation can be a source of new financing, which can often be deflected for private use. On the other hand, Western foreign firms are interested in profits and typically seek to impose controls that endanger the ability of network members to extract rents from their enterprises. The preferred interaction with foreign firms, therefore, especially on the part of actors in the top levels of the network, is trade.

ENTREPRENEURIAL NETWORKS

The driving force behind entrepreneurial networks is profit-motivated actors. Some of these are actors recruited from old enterprises who believe their firms are capable of being restructured and made profitable. Others are new entrants: enterprises founded by actors previously not involved in the power game within the socialist economy.

Genuinely new firms are quite rare in Russia; most new entrants are products of the splitting up of state-owned enterprises and changes in legal forms. In addition to being relatively few in number, entrepreneurial networks based on new entrants are quite disadvantaged in the power struggle. They are led by individuals with limited experience and are not well positioned to defend themselves politically. Consequently, networks composed of these actors tend to be unstable, open, and horizontal. Entrepreneurial networks therefore look to foreign partners to help them survive despite their disadvantages; any form of cooperation and activity from abroad is welcome to these actors. Yet, as stand-alone institutions, they are usually too weak to prosper or survive in the conditions of Russia today.

Entrepreneurial networks based on old structures are better positioned, however. They are led by individuals who are more experienced and who have a historic, more stable power base. Relative to survival networks and new entrepreneurial networks, they are marked by intermediate levels of openness and verticality of architecture. They are open to foreign cooperation to the extent that it enhances their profitability and their capacity to restructure existing enterprises. Since the latter requires substantial capital, they prefer foreign direct investment to other forms of cooperation.

THE EVOLUTION OF NETWORK TYPES

Which kinds of networks are established in any given region depends on the interests of the managers of industrial enterprises in that region and the power base available to the actors within the network. In regions in which very few firms dominated input and output markets before economic reform, those firms retain the power to harass new entrants by discriminating against them on markets and by intervening against them in politics. In Russia today, the degree of monopolization and monopsonization varies greatly across regions and industries. Thus, while the situation in Krasnoyarsk is very well suited to rent-extraction activities, other regions are marked by much less industrial concentration.¹² This is apparent from aggregate data. Huber, Nagaev, and Wörgötter (1997), constructing *herfindahl* indexes covering the regions of Russia and

twelve industries within those regions, find that the indicator varies from 0.65 to 0.12. Similarly, industries differ substantially in their concentration statistics. Some industries are heavily localized in one region, such as nonferrous metallurgy in Krasnoyarsk and fuel in Tyumen'. Others have no such geographical specialization (Huber, Nagaev, and Wörgötter 1996b).

Whether managers are inclined to enter survivalist networks is predominantly a function of their expectations of the future. Actors who see few chances of surviving in the new circumstances will be more prone to adopt a survivalist stance than those who see some future for their enterprise. However, other factors may enter into the calculation as well. Within survival networks, there is a clear center-periphery dimension to the rent-extraction process. The old, now privatized departments (*glavki*) of the industrial ministries in the center usually control both foreign trade and the network itself. Thus, the center extracts much of the rent that might otherwise have gone to local actors. This may tempt actors in the periphery to opt out of the survivalist network, but such defection has its costs. For example, in the forestry sector, most of the transport facilities remain under the control of the center, and discriminatory pricing, also a prerogative of the center, can make products from the periphery uncompetitive in international markets.

Given the huge reduction in output in Russia during the past decade and given the incidence of concentration that provides a power base, it is not surprising that survival networks are the predominant form in Russia today. But what of the future? It seems obvious that from an evolutionary standpoint, a strategy concerned primarily with reducing the value of existing assets is not fit to survive in the long run. This would favor the eventual strengthening of entrepreneurial networks. Indeed, state-owned firms have already begun to notice that new private customers are more reliable in meeting their payments. The real question is how long existing survivalist networks can be expected to survive. We suspect that Russian networks will evolve into an entrepreneurial form only over a very long period of time. The time frame may be shorter in regions and sectors in which industry is least concentrated. But for the most part, the size of the rents still to be distributed is large, as is the ingenuity and persistence of the actors operating within survivalist networks.

INTEGRATION INTO INTERNATIONAL NETWORKS

The integration of Russia into international production networks will remain a difficult task and may fail altogether. Most Russian partners will assess agreements principally in terms of the impact on their position in the internal struggle for power and the impact on their capacity to continue extracting rents. Foreign owners who emphasize profitability endanger the rent-extraction process. This bodes ill for joint ventures. Projects that are concerned with employment reduction will also face opposition from survivalist networks. Activities geared toward upstream or downstream cooperation in existing markets are more difficult to achieve than activities geared toward selling products in new markets. Integration is also hampered by technological realities: large Russian enterprises are generally not flexible in their production processes and do not specialize in technologically advanced products.

The regional distribution of foreign direct investments as a percentage of total investments in the Russian Federation is indicative of the conditions beneficial to such investments. A clear industrial-geographical pattern emerges. Oil-rich Tyumen' leads with 17.86 percent of the total, and its two autonomous districts, which are also oil-rich, stand immediately behind. The capital city of Moscow, a "port of entry," follows with 11.97 percent of the investments. The other places in which capital investments were clustered were either regions that experienced relatively small output declines during the transition (Samara, Chelyabinsk, Bashkortostan) or that are relatively rich in resources (Sakha Yakut, Irkutsk) or that are located close to the sea (Caucasus) (Wörgötter 1997). As for the sectoral distribution of foreign direct investments, as of April 1995, 17.66 percent of all foreign investments had gone into the fuel industry (Stern 1996), making it the second largest branch in this respect after domestic trade. The forestry industry is the third largest recipient.

European networks are not the only option for Russian enterprises. The Commonwealth of Independent States and/or the Russian Far East are also potential loci of integration. At present, all three regions have been objects of such network creation. Such creation follows clear regional and sectoral patterns, often dictated by the transportation costs of products. Siberian regions, for example,

have developed close ties to East Asian countries (Tak 1994a, 1994b; Obersteiner 1995).

CONCLUSION

Survivalist networks, which predominate in Russia, tend to be closed and hierarchical. When entering Russian business networks, foreigners must anticipate that their welcome will depend strongly on the effects of their presence on the rent-extraction capacities of existing enterprise managers. This stands in sharp contrast to the international business networks observed in most Western countries, in the design of which profitability is the main goal; these tend to be substantially more open and less hierarchical in their structure. Thus, any efforts to incorporate Russian firms into European networks face major obstacles. Entrance costs into Russian producer networks are high since time is needed to understand the highly complex internal structures. Largely for internal power reasons, Russian partners often fail to negotiate mutually favorable agreements and fail to show flexibility in their dealings. The goals of Russian managers working in survival networks will often diverge fundamentally from those of Western partners working in entrepreneurial networks. Given these differences in structure and interests, it is quite possible that Russian networks will remain relatively secluded from European networks and that existing network structures in Russia will become instruments largely for preserving the institutional status quo in that country.

To be sure, countervailing tendencies exist. In some areas of the Russian economy, entrepreneurial networks are more frequently found. In economically less powerful regions and industries, with smaller-scale enterprises producing food and other consumer products, networks tend to be less hierarchical, more open, more profit-oriented, and more flexible. Currently, the number and importance of such networks are relatively low. But in the long run, competitive forces are at work that may help them to proliferate.

NOTES

1. This article originally appeared in *Post-Soviet Affairs* 14, 1 (January– March 1998: 81–91). It is reprinted here with permission from *Post-Soviet Affairs*. ©V. H. Winston & Son, Inc., 360 South Ocean Boulevard, Palm Beach, Fla. 33480. All rights reserved.
2. Hakansson and Snehota (1995), for example, report that more than 70 percent of the suppliers of large companies in Sweden did not change over a ten-year period.
3. Asset specificity refers to the degree to which a particular asset is specific to one particular relationship and cannot be used in potential alternative relationships. High asset specificity thus gives rise to situations of bilateral monopoly.
4. For a similar typology, see Park (1996).
5. However, they also found that this was not ubiquitous and that many enterprises had changed their customers.
6. For more on financial-industrial groups in Russia, see Johnson (1997).
7. Although Krasnoyarsk has the third highest profit rate among Russian krays, it also has the fifth highest rate of unpaid wages (Huber, Nagaev, and Wörgötter 1996a).
8. In Tomsk, for example, 80 percent of the budget revenues to the *oblast'* administration come from one oil-producing firm (Tomskneft); see Huber, Nagaev, and Wörgötter (forthcoming).
9. Frey (1977) has argued that constitutional questions can be solved only under a veil of ignorance, in which it is not clear whether a particular member of society will profit or lose from a particular agreement.
10. Starodubrovskaja (1995) refers to “survival” and “developmental” financial-industrial groups. We stress that ours are ideal types which do not exist in pure form. In the real world, elements of both types may well be mixed within a given network. However, real-world networks may be distinguished by the predominance of one or the other element.
11. This division is also ideal-typical since old and new entrepreneurial networks interact and form alliances. The distinction, however, usefully highlights the fact that old structures are quite diverse and are not necessarily survivalist. For examples, see Prokop (1995).
12. On Tomsk, see Huber, Nagaev, and Wörgötter (forthcoming).

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