

Political connections and strategic choices of emerging market firms

Case study of Russia's pharmaceutical industry

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Abstract

Purpose – The purpose of this paper is to investigate the importance of political connections in the emerging market context.

Design/methodology/approach – A case study analysis of three Russian pharmaceutical firms is conducted to uncover how they performed through the Russian transition – the institutional upheaval of the 1990s – and the ongoing state-led industrialization.

Findings – In the early years of transition, firms heavily rely on political networking to gain legitimacy and fill institutional voids. As institutions strengthen, the need for political networking is being substituted by arm's length networking. Strengthening of institutions also results in a more stable business environment, evolving firms' strategies from short-term core competency concentration to long-term innovative visions.

Research limitations/implications – Firms operating in the Russian, Commonwealth of Independent States and some other Eastern European state domains must be wary of complex ties that are prevalent in these countries and often can assist or hinder firm performance. Although formal institutions strengthen arm's length networks, a close cooperation between strategic firms and the state remains.

Originality/value – The paper proposes two phases of the Russian transition and provides a taxonomy of strategic choices of Russian firms during the transition. Further, the paper describes the key institutional developments in the two phases of the Russian transition. Finally, a framework of political connections and their role in business operations in the two phases of the transition is provided.

Keywords Russia, Transition economies, Institutional environment, Strategic choices, Government relations

Paper type Research paper

Introduction

There is a growing interest in the literature on the impact of changing institutional contexts in transition economies, and the strategic choices made by businesses to cope with sudden and rapid liberalization. Limited research identifies the bilateral and inter-dependent relationship that politics and businesses often share (Boddewyn, 2016; Hillman and Hitt, 1999) and how prospective firms entering emerging economies need to be cognizant of these relationships (Peng and Luo, 2000). What has received less attention in the literature is how political networking (Kotabe *et al.*, 2017) becomes an essential part of the strategy toolbox employed by firms to deal with the uncertainties of rapidly changing institutional contexts.

Some studies have touched upon the issue of how former state-owned enterprises (Peng and Heath, 1996) or enormous oligarchic companies (Braguinsky and Myerson, 2007) forge ties with the government but have not devoted sufficient attention to the discourse on the implications of how firms from developing countries leverage government relations in uncertain institutional environments. A recent paper by the Peterson Institute for International Economics, based on *Forbes'* 1996–2015 Richest List, finds 64 percent of self-made billionaires in Russia owe their riches to political connections, compared to only



3.8 in the USA, 9.2 in China, and 20.4 in Europe, and 10 percent globally, on average. In Commonwealth of Independent States (CIS) and some Eastern European countries, the situation is even more dire, where 100 percent in Kazakhstan, Romania, Georgia and 55.6 percent of billionaires in Ukraine are politically connected (Freund and Oliver, 2016).

Two research questions are posed:

RQ1. Are political connections a prerequisite for building business to fill institutional voids in Russia?

RQ2. Does strengthening of institutions influence the strategic choices of Russian pharmaceutical firms insofar as the extent their networking with the government?

To achieve this objective, strategic choices of firms within the rapidly changing institutional environment of the last quarter of a century are documented.

The paper begins with a review of studies on political networking and its implications, an exercise that also uncovers the gap in the literature and lack of comprehensive empirical research on transition economies, especially on Russia and CIS. Building on these insights, this paper explores how political networking affects distinct competitive strategies of firms within the two phases of transition in Russia. Based on the analysis, a framework that demonstrates how firms adapt utilizing political networking within transitioning institutional environment is drawn.

Firms' strategic choices – political network-based growth

Institutions are a critical resource as a factor of production and also prescient in their role of bestowing institutional legitimacy to actors within an economic framework (Hillman and Wan, 2005). The creation of new ventures without formal institutions, such as functioning laws and regulatory frameworks, and informal institutions, such as shared industry norms and common business practices, involves high levels of risk and complexity (Peng, 2001). This can be a trigger for spawning inter-dependent informal institutional relationships between those with legitimate authority and power and those who are resource dependent on the former.

Theoretical contributions to the field of political connections portray interesting elements. Boddewyn and Brewer (1994) report political connections formed an integral factor of competitiveness within the resource-based view. The connections provide intelligence, access, bargaining power, money, and influence. Hillman and Hitt (1999) developed a taxonomy of political strategies that shape the business environment and competitiveness of the players and found a positive relationship between personal political ties and firm performance in a wide range of US firms (Hillman *et al.*, 1999). Some studies have shown corporations seek harmonious cooperation with governments that provides favorable conditions for innovative ventures (Sigurdson, 2000). When considering first mover advantages, political resources create significant entry barriers and competitive advantages, especially in key strategic industries, despite globalization and liberalization trends (Frynas *et al.*, 2006). What is also instructive is that late movers with stronger political ties can challenge the privileged positions of pioneers (Frynas *et al.*, 2006). In transition economies, political networking and functional experience is beneficial to new ventures (Li and Zhang, 2007).

Organizations seek to establish congruence between their values implied in their actions and the acceptable and desired behavior within the wider institutional environment. This congruence is referred to as organizational legitimacy (Dowling and Pfeffer, 1975). Suchman (1995) identified three principal forms of organizational legitimacy – pragmatic, moral and cognitive. This study mainly relies on self-interest of organizations in gaining competitive advantages and recognition, i.e., pragmatic legitimacy. Political connections may enhance the legitimacy and competitive advantages of organizations (Boddewyn and Brewer, 1994;

Pfeffer, 1973). Further references to legitimate behavior are provided throughout the paper specifically in the context of emerging market firms (EMFs).

Studies on EMFs dwell primarily on how institutional voids govern firms to adopt a network-based strategic approach. This perspective is popular in analyzing development of firms on transition economies in the absence of formal institutions that facilitate firm growth, shared access to tangible and intangible assets, just to name a few (Danis *et al.*, 2009; Michailova and Worm, 2003; Puffer and McCarthy, 2007; Wright *et al.*, 2005). More recently, Boddewyn (2016) summarized 70 years of IB and government relations literature in arguing there is little known about IBGR, and the output has been declining in the past two decades. Yet, the literature on institutional voids falls short of devoting sufficient attention to the importance of government relations in the dynamics of the firm in the ex-Soviet Union context. As well literature on strategic choices of Russian firms is limited. There is a consensus in the literature in the need for more empirical papers investigating these relations. This paper intends to fill this gap by providing a comprehensive case study analysis of the key strategic industry in Russia on political connections and firm strategies. This paper, therefore, is a valuable contribution on understanding how strengthening and leveraging existing ties with regulatory authorities can avoid bureaucratic hurdles and gain legitimacy (Filatotchev *et al.*, 2000; Hillman and Hitt, 1999).

Political connections are not always shown as a panacea for competitiveness in all studies. Kotabe *et al.* (2017) observe that political ties may create complacency and inefficiency in firms reliant on protectionist measures. Political participation may require firms to meet social and political objectives, rather than their own (La Porta *et al.*, 1999). The over-embeddedness may influence the way a company operates, restricting innovativeness and potential (Luo, 2000). Firms tunnel resources into political relationships, and those connected tend to be more likely to win political favors, e.g. public procurement. More corrupt localities tend to support less productive firms in Russia (Mironov and Zhuravskaya, 2016).

While political networking substitutes formal regulatory structures and enhances efficiency (Peng and Luo, 2000), those firms that face the drawback of newness and disconnectedness, as well as those that are “outsiders,” encounter significant difficulties in competing with connected firms and gaining legitimacy (Hillman and Wan, 2005; Luo, 1997). The seemingly advantageous effects of political networking expand onto gaining insider information, access to resources that are otherwise unavailable and increasing opportunity recognition (Gu *et al.*, 2008). In China, political *guanxi* influences the legitimacy of a business within the system and influences the growth strategy of businesses by creating loosely structured networks (*guanxihu*) to facilitate economic exchanges and avoid bureaucratic hurdles (Luo and Chen, 1996). In the Russian context, *blat* is often compared to Chinese *guanxi*. *Blat* goes back to Soviet years when money and goods were in short supply and parties “helped out.” It served as alternative currency – an informal exchange of favors (Puffer and McCarthy, 2011) that substituted markets. Due to the generic nature of the phenomenon, *blat* constituted relations between businesses, people, and politicians. *Blat* has evolved since the transition and is different to *guanxi* in its more arm’s length approach using material goods, mostly money, and can mean one-off transactions between parties (Michailova and Worm, 2003).

Low levels of institutionalization in a particular environment pose severe challenges for firms (Peng, 2001; Tracey and Phillips, 2011). While describing transition economies, Peng (2003, p. 285) argued “[...] they have to rapidly build ties to establish legitimacy, thus necessitating an intense networking strategy.” Not surprisingly in a highly paternalistic environment, multinationals in strategic industries are observed to gain competitive advantages by overcoming various forms of entry barriers and gaining first mover advantages if home and host governments provide support – as in Lockheed Martin entering Russia (Frynas *et al.*, 2006). Therefore, in countries with regulatory uncertainty and

emergent institutions, engaging directly with decision-makers may create policy changes and catalyze the success of multinationals (Choudhury *et al.*, 2012). Overall, through the enhanced system of reciprocity and monitoring of incentives, governments are able to drive economic growth through collaboration and protection of key industries (Amsden, 1997).

During the process of transition, when formal institutions such as regulatory frameworks are developing, connections on all levels of government are necessary to gain critical resources such as land, approvals and other bureaucratic levers (Ahlstrom *et al.*, 2000; Xin and Pearce, 1996). Entrepreneurial start-ups link with other firms and the government (Peng and Luo, 2000; Xin and Pearce, 1996). These firms utilize prospecting to prove their legitimacy within the environment by doing more with less (Peng, 2001). As transition continues, incumbent firms resist the market-based competition and strengthen their connections (Greenwood and Hinings, 2010). Restructuring and developing new market-based capabilities may also form a part of the strategy of these firms (Wright *et al.*, 2005). New firms must maintain at least minimal networks and contacts and build extensive market-based capabilities (Peng, 2003).

Connections with politicians facilitate approvals and avoid bureaucratic hurdles (Luo and Chen, 1996; Puffer and McCarthy, 2011). Sometimes, when institutions are emerging, political networking supplements formal regulatory structures and enhances business efficiency (Peng and Luo, 2000). However, when institutional contexts are chaotic, political connections are the only means to do business. Under such circumstances, many firms without connections face the drawback of newness and disconnectedness. Outsiders have significant difficulties competing with connected firms (Hillman and Wan, 2005; Luo, 1997). These difficulties could be triggers for perpetuating informal institutional relationships between those with legitimate authority and power and those who are resource dependent on the former. Such endemic networking could, however, subvert and delay the process of institutionalization and perpetrate cronyism.

In Russia, the shock therapy “destroyed virtually all major state dominated institutions creating countless voids in the process” (Puffer *et al.*, 2016), followed by some mending process instituted by the new president in the 2000s. During the early phase of transition, oligarchies were heavily involved in politics through which they could leverage key strategic resources (Braguinsky and Myerson, 2007). While businesses sought preferential treatments in tenders, subsidies, legislation (Shekshnia *et al.*, 2014), the politicians used their administrative resource for personal enrichment and a secure place within the business society (Gans-Morse, 2013; Ledeneva, 2009). The country is still characterized by cronyism and corruption, creating the need for businesses to create networks and connections to fill the institutional voids (Ledeneva, 2009). Larger local firms and MNEs entering Russia are constrained by the need to legitimize their operations within this environment (Ahlstrom and Bruton, 2010; Ledeneva, 2012).

While the literature on transition economies is extensive on the analysis of the transition in the 1990s and the later years of a more autocratic regime, little has been done to analyze, compare and differentiate the two phases of the transition. Further, little research shows how the role of political networking evolves through the transition. It is the aim of this paper to compare the two phases of transition and demonstrate the significance of political connections within the strategic choices of firms in the two phases.

The investigations into the emergence of Russian MNEs and their expansion also ventures into the role of government. While state ownership shows a trend of decline, the largest firms are state-owned or in close cooperation with the government (Panibratov, 2014). The firms with the highest level of government involvement include those in the natural resource, infrastructure, and other heavy industry sectors, reason being that heavy industry is the largest contributor to Russia's budget and the most important token of the state's productive power (Filippov, 2010; Kalotay and

Sulstarova, 2010; Panibratov, 2014). The Russian Government realizes the need for innovative development of the country to reduce the dependence on oil exports, hence the increasing trend of public-private partnerships (PPP) in various strategic sectors (Vertakova and Plotnikov, 2013). However, the absence of literature on other sectors, especially that of the pharmaceutical industry, creates the gap addressed in this paper. Research into institutional reforms, both nationally and in the pharmaceutical industry, is therefore presented in this study.

Methodology

The literature on institutional transitions and firm strategies of Russian firms is limited and there are several reasons why this is the case (Panibratov, 2016; Volchek *et al.*, 2013). These include absence of unified data banks due to fast-paced institutional changes, inconsistencies of aggregate data between different sources, extreme difficulty in gaining access to organizations among others (Hoskisson *et al.*, 2000; Wales *et al.*, 2016). Further, this topic is contentious, and finding respondents and data is challenging.

An empirical investigation into an innovation-dependent pharmaceutical industry was carried out to demonstrate the impact of weak government policy, the “free-market” liberalization (1991–1999), against the performance of companies in the state-led industrialization (2000 to date). This study uncovers how knowledge-intensive firms from transition economies make strategic choices during the two distinct phases of transition. The investigation takes the form of a case study approach, categorizing and understanding the constructs and creating frameworks as opposed to quantitative methods that are more suited to testing the phenomena (McClintock *et al.*, 1979; Maxwell, 2004; Eisenhardt, 1989; Yin, 2009). This case study research design was a type of “naturalistic inquiry” in which inductive logic was used to obtain insights (Greenwood and Suddaby, 2006). Political events and processes are often covert in nature and best analyzed through case study research (Frynas *et al.*, 2006). There is no other way to gain an understanding of these intricate relations other than the interviews with senior management of the companies in question. Triangulation of interviews with archival sources creates a more in-depth and robust picture of political connections and strategic choices of firms. Case study methods allow for exploration, holistic views, most appropriate to analysis of real-life examples (Yin, 2009) of the chosen firms.

To study the political connectedness in the Russian setting – strategic firms and industries tend to be the choice for academics (Freund and Oliver, 2016; Frynas *et al.*, 2006; Guriev and Rachinsky, 2005; Melkumov, 2009; Puffer and McCarthy, 2007). The choice of the Russian pharmaceutical industry, particularly organizations Pharmstandard, Protek and Biotec as case studies, is driven by several factors. First, the pharmaceutical industry is part of the healthcare network, a key strategic sector in the Russian economy. The government realizes the need to support the domestic manufacturing industry to be able to sustain the sovereignty of the country in medicines and boost innovation and development. This results in inter-industry diversification into the knowledge-based sector, reducing the overreliance on the natural resources sector. Second, although the industry is strategic, it is fully privatized, unlike natural resources, manufacturing, agricultural sectors that are partially state-owned (Baker and McKenzie– CIS limited, 2016). This creates a spotlight for the industry that represents private firms, which are strategic to the state. It is difficult to find a better industry to relate business performance and political connections. Third, the pharmaceutical industry is one of the fastest growing industries in the world and in Russia. The industry is innovation and technology driven; it can be characterized as fast-paced and responsive to institutional changes. Finally, the three chosen firms were idiosyncratic in their rise to top pharmaceutical performers. Idiosyncratic development shows there are commonalities in strategic choices, specifically the need to maintain connections to the administrative resource.

Pharmstandard was set up as a manufacturer in 2003 with financial help of the Roman Abramovich, one of the then prominent oligarchs. Protek started as a small importer of Hungarian goods and finally medicines in 1990 and 1992, respectively. Biotec was established by a politician in 1991 as a supplier of medicines to the state sector. These differences in the growth of the companies, positioning and differing strategies undertaken, provide validity of the findings in proposing the necessity of political connectedness in the Russian context.

Pharmstandard is the leading pharmaceutical producer in Russia, with 6.2 percent share of medicines within the domestic market. The 2014 revenue of the company reached approximately \$0.7bn with the net profit of 27 percent (Pharmstandard, 2015). The company, as it is known today, was established in 2003 when the umbrella corporation of Sibneft – Millhouse Capital invested \$55m into an acquisition of five Russian plants (Oktyabr' in Saint Petersburg, Marbiofarm in Yoshkar-Ola, Leksredstva in Kursk, Polifarm in Chelyabinsk and Tomskkhhimfarm in Tomsk) and 96 pharmacies from a failing Russian subsidiary of an American multinational, ICN Pharmaceuticals. ICN Pharmaceuticals was one of the first rare investors in the 1990s that could procure and run Russian plants. There are nine production subsidiaries of the company, two of which are overseas – Pharmstandard-Biolek in Ukraine and Bever Pharmaceuticals PTE Ltd in Singapore. Unlike other manufacturers that established new plants in compliance to the international standards, Pharmstandard acquired and restructured existing modernized Soviet-era plants to become the biggest Russian pharmaceutical manufacturer.

Protek is an open joint-stock company and a diversified group in all main segments of the pharmaceutical industry, including production (Sotex, Protek-SVM, Protein Contour and AnviLab), wholesale and retail distribution (CV Protek), IT development and distribution for the pharmaceutical industry (Spargo Technologies), customs and storage facilities concentrating on handling pharmaceutical products (Transservice Customs), marketing services (Promofarm) and retail pharmaceutical services (Rigla, Bud' Zdorov and Evroapteka). All the company's segments mentioned above are among the leaders in their respective fields. The annual growth rate is estimated to be approximately 10–15 percent, and the market capitalization of Protek is around \$400m (Bloomberg, 2015).

Biotec was established as a wholesale supplier of medicines to state facilities in 1991. Since then, it has become one the largest vertically integrated pharmaceutical companies in Russia. Its success can be attributed to the right alignment of the strategy and capabilities guided by a visionary leader in dealing with the dynamic and turbulent changing environment. When the company was established, it fulfilled the government demand for medicines through the extensive networks of the owner. Through the 2000s, years of comparative stabilization, vertical integration of the company, with the government resource, boosted the competitiveness of Biotec. The current requisite of import substitution allows the company to maintain its market share and sustains an important link with the regulatory apparatus that supports companies such as Biotec.

The interviews were carried out from 2014 to 2015; almost all the senior managers, nine in total, were involved in taking key strategic decisions over the operations of the respective companies and knew the dynamics of creating and utilizing political resources. Annual reports, press reports, company and industry websites, industrial analysis and reports, journal articles, and other archival data were collected from the beginning of the 1990s to date and thoroughly examined to provide a reliable analysis. The breakup of the interviewees is provided in Table I. Excerpts of the interviews are provided within the text; the text with no visible citation was obtained through interviews. The rest of the information is from a variety of archival research as referenced.

Data analysis included a grounded methodology (Langley, 1999) process to identify firms' strategies during the two phases of transition based on the previous literature on

Table I.
Interviewee
participants

| Case study | Interviewee | In-text referral |
|---------------|--------------------------------|------------------|
| Pharmstandard | Pharmstandard Senior Manager 1 | Ph1 |
| | Pharmstandard Senior Manager 2 | Ph2 |
| | Pharmstandard Senior Manager 3 | Ph3 |
| | Pharmstandard Senior Manager 4 | Ph4 |
| Protek Group | Protek Group Senior Manager 1 | Pr1 |
| | Protek Group Senior Manager 2 | Pr2 |
| | Sotex Senior Manager | PrS1 |
| Biotec Group | Biotec Group Senior Manager | Bt1 |
| | Biosintez Senior Manager | Bz1 |

strategic choices of EM, specifically Russian firms. Further, an event history data set (Garud and Rappa, 1994) was established through the narrative accounts of interviewees, field notes and archival documents. This brought forth a vivid picture of “what is going on” in every case (Wolcott, 1994, p. 16). A continuous movement back and forth between the empirical data and theoretical literature on strategic choices was necessary when constructing this taxonomy of strategies (Miles and Huberman, 1984).

This research was challenging for several reasons. A major challenge was with how to deal with the Russian tradition of secrecy and low trust of outsiders that make it difficult to gain access to reliable firm-specific information and credible official government data (Puffer and McCarthy, 2011). The subject of the research being political connections, discussion of sensitive information pertaining to strategies of firms, and probing of interviewees on political connections often evoked refusals by interviewees to answer questions. Ethics procedures prevented researchers from asking direct questions relating to these connections. Instead, interviewers were forced to lead interviewees unobtrusively toward the discussion of these subjects. Interviewees were wary of the fact that, if this information was to be published and available in the public domain, it would lead the information to be shared. Finally, Russia is a network-oriented society (Aidis *et al.*, 2008; Rose, 2000), so the researcher had to depend on personal networks, persistence, and exposure. This is one of the rare case study papers that provide first-hand accounts gained through interviews with top management of the companies, depicting how such companies adapt to the environment and succeed in transition economies.

Archival research into the Russian context and the pharmaceutical industry with interviews are summarized in the following findings and analysis sections. These sections depict the strategic choices of firms and their connections, comparing the two distinct phases of transition in Russia. Rapid liberalization of the country in the 1990s resulted in a major reshuffle of the industry, creating closures, changed ownerships, and new enterprises, replacing the old state-run system. Research shows most firms in the industry have been established in 2000s or in 1990s, some of which inherited Soviet-era facilities, while others have built their own. Regardless of the age, they all face the same constraints and challenges for innovation and development in the uncertain institutional environment that is Russia. Based on the above, the discussion section draws a framework of the role of political networking and summarizes strategic choices in the two phases of transition.

Findings: institutional upheavals and shift to a liberal market economy, shock therapy years 1990–1999

Structural problems of transformation in the beginning of the 1990s, with severe financial difficulties, prevented the Russian Government and the newly liberalized organizations

from supporting scientific and innovative investments and strategic directions (Yeltsin, 2000). Missing domestic market institutions and profound deficiency in the supply side led to newly opened international borders that facilitated trade, foreign investment, and intermediary relations. Newly created businesses that replaced the command and control public institutions introduced commercial activities, where profits were instantaneous and the demand ever-increasing (Kvintradze, 2010).

Continuous changes in legislation and excessive taxes along with galloping inflation-led new businesses to rely on network-based trading. Businesses engaged in various quasi legal practices: gray schemes, involving barter transactions, inter-firm loans, avoidance of tax payments, and little attention to continuously changing legislation (Kuznetsov and Kuznetsova, 2003; Yakovlev, 2001). Dishonest civil servants and organized crime syndicates were further impediments to firms (Gans-Morse, 2013). Johnson *et al.* (2000) find, in 1995, the size of the Russian and Ukrainian unofficial economy was approximately 50 percent; in 1997, as much as 90 percent of managers said it was normal for bribes to be paid to government officials, 90 percent of firms admitted firms in their industries pay for “protection” to criminal associations, and finally, 29 percent of firms underreported sale activities.

The Russian pharmaceutical industry was no exception, marked by financial constraints, asset stripping by management, and the disruption of trade between the “bulk substance” manufacturing enterprises in Russia and the finished goods pharmaceuticals companies in the newly detached countries (Balashov *et al.*, 2009; Chibilyaev, 2011; Dorofeev, 1995; Sidorov, 2008). Strategic choices of firms during the early transition phase (1990–1999) in the following sections are synthesized through the interview data and the literature on strategies of EMFs.

Prospecting

Prospecting involves a focus on leveraging opportunities in a changing and volatile market environment. New possibilities thrown up by sudden liberalization require quick adaptation and capture of the deregulated markets and activities, such as services and trade. In such an environment, firms are headed by younger, more aggressive managers, characteristic of entrepreneurial firms in transition economies (Peng, 2001; Peng and Heath, 1996). Firms also orchestrate a flexible organizational structure.

The waning budget support for state-run organizations and institutes as well as trade possibilities during the shock therapy opened opportunities to establish many new enterprises. Leveraging the opportunity, Biotec was established in 1991 by Boris Spiegel, who was Deputy Director of the Russian Research Institute of Agricultural Biotechnology. Seeing the disintegration of supply-chains of medicines to government-run hospitals and the military, Mr Spiegel quickly utilized his networks to establish the link between suppliers and the government institutes as an intermediary wholesaler in 1991. The first manufacturing investments were made in 1996 to a packaging and market distribution of mostly foreign medicines plant, called MFPDK Biotec. Seeing the potential for distribution of medicines and the niche to work closer with the government on one side and foreign firms looking to expand to untapped Russian markets on the other, the first facility was established[1].

The long-standing government connections and rapid disintegration of the value chain created gaps for the company to become a successful supplier to government-run hospitals and the military. In 1995, the Chairman of Biotec became a Senior Advisor to the Social Issues Chairman; further, he became a Senator for the Penza region. Although he officially left the business to his wife, the Senator was and still is deeply involved in medicine procurement schemes that benefit the company (Kutuzov, 2006). Biosintez plant (later procured by Biotec), being one of the rare survivors of the Soviet to Russian transition, had gone through major changes from originally being established as a substance manufacturer in 1951 to one of the leading ready-to-use (RTU) drug manufacturers. In the 1990s, even after losing its main customer base in other CIS states in substance supply, the company tripled

the portfolio of RTU medicines in five years by satisfying the demand of the population for cheap day-to-day generic medicines. The planned economy specified Biosintez to remain a substance manufacturer; after the liberalization, the changes in the customer base forced the company to diversify into RTU medicines to survive[2].

Protek understood the demand for foreign products that were unavailable and prohibited during the Soviet-era. As the country reeled under chronic shortages and undersupply, Protek established distribution channels of foreign goods. The owners were quick to realize the acute need for quality foreign medications, a strategy that paid off in the company entering the top 20 best-performing companies in Russia in 1998 and becoming the leading wholesale distributor of medicines. Protek became one of the first-movers in distribution of foreign medications reaping the advantages in an unregulated market. The company's inter-organizational networking was purportedly among the main competitive advantages[3].

The founders of Pharmstandard started as brokers, bidding for companies on behalf of large conglomerates or oligarchs. The company could tap into administrative resources and locate the most lucrative auctions as these were only open to insiders and people in-the-know[4]. The importance of knowing the right people in the local government meant access to auctions and the right to bid for vouchers or shares of companies (Guriev and Rachinsky, 2005; King, 2002).

Inter-firm networking

The sudden move to a capitalist economy created new firms with little or no experience in the market-based economy. Rapid changes and institutional voids in imperfect laws and regulations led to value chain disintegration, subsequently hindering business efficiency. Firms formed networks and relationships to gain legitimacy in the markets. Much of the economy relied on barter, meaning the firms needed to engage in networks more than ever before (Ledeneva, 2009; Michailova and Worm, 2003).

Pharmstandard owners took advantage of the unstable environment by leveraging connections with power brokers. Some enterprises that managed opportunistically to align their strategies with market demand duly backed by owner's capital became engaged in acquisitions and takeovers. Biotec and Protek also prevailed as trustworthy suppliers during difficult times of non-payments, barter economy, and missing market-supporting institutions. The other companies naturally had to gain reputation and trust within the high-context society where the barter economy was prevalent. Inter-firm networking remained important for survival (Peng, 2001).

Key competence focus

The collapse of the Soviet Union saw the change from a centrally planned economy, where the state managed the value chain, to self-managed market capitalism. This meant the customer-supplier link, or in other words, the supply chain was broken. Businesses were left to fend for themselves with little institutional infrastructure and experience. For many, it was a shock from which they could not recover, resulting in mass closures and struggling businesses (Yeltsin, 2000). The rapid changes created a hostile environment, where firms were forced to navigate in-between corrupt politicians, organized criminal syndicates, and rapidly changing markets. This led to short-termism and distrust; firms abstained from long-term growth investments, such as R&D and modernization (Filippov, 2011; Puffer and McCarthy, 2011; Radosevic, 2003).

Protek's core business in the 1990s remained wholesale distribution of mainly foreign product. In the interview, it was clarified the instabilities of the Russian environment prevented the company from establishing operations and large investments into production of pharmaceuticals. Nevertheless, the company became the biggest wholesaler of pharmaceuticals by 1998 and one of the top 20 performing companies in Russia.

Pharmstandard procured troubled pharmaceutical plants for later resale or asset stripping. No long-term investments were made due to a hostile and changing business environment[5].

The role of political networking in the 1990s

In an ideal market economy, firms have equal access to product, factor, financial, international markets and the government (Knight, 2013). In the years of early formation (transition) when sufficient institutions that facilitate market trade are missing or weak (Rutland, 2013), firms and individuals form personal connections to make sense of the forming and underdeveloped markets. Although product and factor markets are open for the individuals and businesses, personal connections provide information and optimal choices in participation within these markets (Goldman, 2004).

Financial markets also remain unregulated and the financial institutes are in the early stages of formation. Here too, the connections to the administrative resource provide various advantages. Businesses and individuals have almost no access to the financial systems due to infancy of the sector (Kogut and Spicer, 2002). The connections provide financial institutions' backing (Guriev and Rachinsky, 2005).

Personal connections also serve as bridges to administrative resource (government) that provide ways to work around institutional voids, deal with bureaucracy, circumvent regulations, avoid tax and other advantages (Gans-Morse, 2013).

Similarly, international markets are only available to those with connections and resources. As international investors are wary of dealing in a transition economy, collaboration with foreign firms is open to the largest and most stable firms (Filippov, 2010). This is coupled with inexperience, underdevelopment of international relations and missing or weak institutional formation of these relations.

The weakness and inadequacy of the legal system including judiciary and enforcement requires for strong interpersonal links between players to gain legitimacy within the playing field and provide some security for these transactions especially in the early stages of relationships (Black and Tarassova, 2003).

In the Russian context, shock therapy years led businesses to navigate through various institutional voids. Connections to administrative resource provided legitimacy, security, and sometimes, opportunities in new markets. Oligarchs had an immense influence over federal and local governments and could create preferential treatments (Black and Tarassova, 2003). Figure 1 demonstrates the need for businesses to link with the administrative resource in the early years of transition when institutional voids are prevalent. The formal and informal institutions that govern the behavior of firms are lacking and/or are weak during the early stages of the transition; therefore, firms utilize government relations to provide sense-making mechanisms to operate within this environment and fill the voids.

To summarize, the shock therapy phase resulted in most firms scrambling for effective survival strategies to weather the turbulent environment. Analysis shows the three strategies

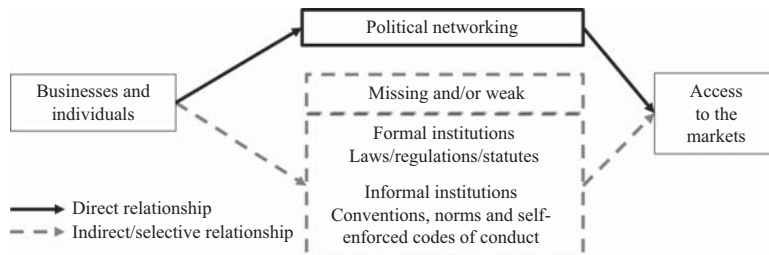


Figure 1. Political connections during shock therapy years of transition phase, 1990–1999

illustrated above – prospecting in the new forming environment, inter-firm networking, and concentration on key competencies. In an environment where rules and regulations change rapidly and policy-makers are engaged in self-enrichment, firms are forced to “grease” the wheels of the bureaucracy (Black and Tarassova, 2003; May *et al.*, 1998). Lack of transparent regulations in such areas as taxation, health and safety, HR and others, hinder business operations, especially in the early years of transition (Gans-Morse, 2013). Knowing the “right people” in the “right places” are the means to circumvent these obstacles.

Findings: state-led industrialization, 2000–ongoing

The change in government to a more centralized authoritarian system (Buzan and Lawson, 2014) coincided with rapid economic recovery of the country, boosted by increasing oil prices. Several institutional-building strategies were initiated by the new president to improve the business environment within Russia. These included the tax reform, a flat rate of 13 percent personal income tax, a substantial reduction of corporate tax from 35 to 24 percent, and ability to choose between 6 percent tax on gross revenue or a 15 percent tax on profits, which made it a comparatively favorable tax environment (Mitchell, 2003). To improve the competitiveness of Russian corporations, the government introduced large vertically integrated national champions, including Gazprom, Rosneft, United Shipbuilding Corporation, and United Aircraft Corporation among others. These companies received large inflows of capital directly from the government to “advance the interests of the nation.” The government promoted the use of national currency, rather than barter, creating transparency and boosting consumer spending. Further, the state established special economic zones to promote investment, mainly in inward foreign direct investment that provided tax allowances, abolishment of asset and land taxes, and protection against changes in the tax regime and extensive government support (Goldman, 2008). Other changes included improvement of the SME environment by reducing bureaucratic red tape and a general push toward a stronger legal enforcement system (Aslund, 2009). Finally, the centralization of power federally ensured through government control of the economy. The institutional voids mentioned during the shock therapy discussion, including the barter economy, non-payments, tax evasion, corruption and *blat*, lack of regional consistencies in laws and regulations, and the general industrialization stagnation, were prominent in the nineties (Yeltsin, 2000). These were alleviated by the strengthening government and reforms. Formal institutions were crucial in the development of business confidence and consequent aid to Russia’s impressive economic growth, see Table II.

Strengthening formal institutions meant key strategic industries, including the pharmaceutical industry, faced a complete overhaul, especially in the late 2000s (Table III). Major changes included strengthening specifics of operations by introducing “On the circulation of medicines” in 2010, replacing an outdated 1998 legislation – “On medicines” (Statute Duma, 2010). New bodies were established including Roszdravnadzor in 2004 that became responsible for licensing and control of drugs in the country while Department of State Regulation of Medicines assumed responsibility for registration of new medicines. A governmental agency in charge of intellectual property, Rospatent, was given clearer responsibilities and powers (Balashov, 2012). The government supplied 3.6 percent of GDP to the industry on average from 2011 to 2014, which amounted to \$1.8bn annually (Peterburgskiy pravovoy portal, 2015). The pharmaceutical industry became tightly regulated and standardization of Good Manufacturing Practices became compulsory, in conformance with the worldwide standards (Chernysheva, 2014; Meshkovskii, 2015).

Currently, Russia suffers from the lack of collaboration between academia and the industry (Bychkova *et al.*, 2015). The government intends to bridge the relationship between the academia and pharmaceutical businesses by PPP, grants, and venture capital funding. The creation of demand and supply of new generations of professionals is also on the

Table II.
Russian institutional
voids of 1990s and
formal institutional
development of 2000s

| Institutional voids of 1990–1999 | Formal institutions introduced in 2000s |
|--|---|
| Barter economy – galloping inflation reduces the value of money | Inflation was controlled in 1997 and monetary exchange mechanisms eliminated the barter economy. Tax reforms (see below), large companies' control mechanisms and banking sector reforms increased capitalization of banks and enforced a thorough control and promoted transparency of the financial sector |
| Non-payments due to inflation in early 1990s, lack of financial institutions and lack of bankruptcy and insolvency regulations and enforcement procedures. Tax evasion- lack of enforcement, raising taxes and decreasing public expenditure resulted in mass tax avoidance | Introduction and strengthening of laws and regulations on business practices, court reforms and updated enforcement systems ensured better market-based transactions and elimination of non-payments between businesses. Clarity introduced in institutions dealing with prosecution, courts and enforcement bodies Massive tax reforms from 2000 to 2008 included: Enforcement of tax enforcement upon extraction industries SMEs' simplification of tax burden – ability to choose between 6 percent tax on gross revenue or a 15 percent tax on profits A flat rate of 13 percent personal income tax Reduction of corporate tax from 35 to 24 percent These and several other tax changes and enforcement have reduced evasion considerably |
| Corruption and <i>blat</i> – lack of regulations, irrational state governance, high income inequality, poverty and blurred moral norms induce this behavior which is strengthened in unison with other institutional traps | Ratification of the UN convention against corruption in 2006 made corruption a criminal offense. Other legislations including “Control over expenditure of the persons holding public office” were signed in late 2000s. Anti-corruption Council was set up to report directly to the President. Reforms in the civil service department included pay rises, introduction of ethical conduct procedures, merit system of career development. Loopholes and uncertainties were resolved in the Law on Civil Service. Budgetary institutions receive a higher inflow of capital in return for higher transparency and checks and balances <i>Blat</i> is not as prevalent as in 1990s |
| Stagnation of industrialization- the abundance of natural resources creates a quick return from extraction industries and stagnation of less competitive industries creating the resource curse | Industrialization began in earnest only when the government introduced “road maps” for development in late 2000s |
| Autonomous local governments – regional centers had own legislation, own governance and appointment procedures | Federal reforms – centralization of power federally as opposed to regionally; alignment of regional laws and regulations with federal; local elections have to have an approval of the president; president may interfere and dismiss heads of local governments; a set of responsibilities for which local governments are accountable are introduced enforcing a strong checks and balances system |

agenda (Gokhberg and Kuznetsova, 2011). A regulation passed by the Ministry of Health in November 2013 makes compulsory for all students of medical and pharmaceutical educational bodies to have an internship requirement in organizations involved in medicines, such as hospitals, clinics companies, pharmacies, research institutes, and all other bodies in the field (Pharmaceuticheskii Vestnik, 2013). As a new entrant to the WTO, Russia is in the beginning of transformation toward meeting the international standards of production, control, and distribution, including the TRIPS (intellectual property protection) agreement. These and further institutional developments within the pharmaceutical industry are provided in Table III.

The rapid economic growth spurred by improvements in the institutional environment was a catalyst for greater stability and performance of firms. Despite the importance of political networking, strategies adopted by firms have undergone changes.

| Institutional voids of 1990s | Formal institutional changes starting from 2000 |
|--|---|
| Unclear legislation | <p>Legislation introduced in 2010 – “On the circulation of medicines”</p> <p>Fixed guidelines for registration of new medicines including steps and timeframes</p> <p>Enhanced monitoring and reporting of safety and use of medicines</p> <p>Vital and essential drugs (VED) – a fixed price and availability for key medicines</p> |
| Unclear delegation of responsibilities between government bodies/unclear governing authorities on all levels/lack of knowledge of the procedures | <p>Ministry of Industry and Trade (MIT) takes over control of medicines and medical equipment including licensing of the manufacturing facilities</p> <p>Creation of Roszdravnadzor in 2004, comparable to FDA in the USA and EMEA in Europe – aligning and streamlining the system of licensing and control in one institution</p> <p>Department of State Regulation of Medicines responsible for registration of new medicines</p> <p>Ministry of Health and Social Development (MOH), MIT and Ministry of Justice responsible for transfer of practices to GMP standards</p> <p>Ethical approvals of the new medicines in oncology, sedative and psychotropic medicines</p> <p>Rospatent updated in 2004 ensures protection of the intellectual property</p> |
| Lack of specialized personnel | <p>MOH makes mandatory for all students of medical and pharmaceutical educational bodies to undergo compulsory internship in the relevant field</p> <p>Creation of new disciplines – industrial pharmacy, introductions of post-graduate training programs for validation and quality audits.</p> <p>Extensive exchange programs</p> |
| No GMP standardization | <p>MIT as well as the State Institute of Drugs and Good Practices form a team of over 300 professionals that check for conformance to GMP standards since 2009</p> |
| Collaboration between academia and the industry is inexistent | <p>As part of Pharma 2020, MIT is funding construction of new biomedical centers of the Moscow Institute of Physics and Technology Kazan and Ural Federal Universities, Volgograd Medical University are constructed, laboratories of the Saint Petersburg Chemical and Technological Academy are reconstructed since 2011</p> <p>Abolition of the law that stated any patents developed in collaboration with a government institute belonged to the state in 2010</p> |
| Lack of national support programs | <p>Additional medicinal supply (DLO) program introduced in 2005; replaced by Regional Medicinal Supply worth almost \$3bn and serving over 4m patients; other regional programs serving almost 9m people in 2011 (Balashov 2012)</p> <p>Seven Nosologies program started in 2008–medicines for patients with rare diseases</p> <p>MIT invested \$122m, 2011–2015</p> |
| Lack of government support for ailing industry | <p>Introductions of regulations against imported goods such as exclusion from tenders if at least two domestically produced alternatives are available in the country; 15 percent discount compared to existing domestic analogs if produced outside Russia; a maximum annual increase of 6 percent on VEDs compared to inflation rate increase for domestic manufacturers</p> <p>Up to 50 percent reimbursement of clinical trials and/or procurement of capital machinery if new development streams are made within the first three years domestically</p> <p>Reimbursement of a part of expenditures for setting up production of the full cycle, i.e. from substance to the ready-to-use (RTU) product</p> <p>Russian Industry Development Fund – subsidized loans at 5 percent interest rate, \$15m in 2015</p> <p>As part of the Strategy 2020 the MIT is intendant to support 20 innovative drug and medical equipment centers</p> <p>Cluster creation – favorable conditions including preferential customs and tax regime, allocation of land, assistance in training of qualified personnel, among others.</p> <p>Planned government expenditure on 13 clusters amounted to \$180m since 2011</p> <p>Government supplied on average of 3.6 percent of GDP to the industry in the last three to four years, which amounts to \$1.8bn annually</p> <p>ARFP and AIPM are legitimate lobby groups that closely collaborate with the government</p> |

Table III.
Institutional formation in the Russian pharmaceutical industry

Acquisitions and political networking

The Russian financial crisis of 1998 gave domestic manufacturers an edge over imported medicines because local manufacturers were able to produce and distribute cheaper non-branded generics (Balashov, 2012; Trofimova, 2006). Leveraging factor costs and strong domestic demand, Protek, Pharmstandard, and Biotec established their own production bases that guarantee higher profit margins, rather than wholesale distribution, which required little specific capabilities. Due to weaknesses in their own R&D, companies engaged in extensive acquisitions of Soviet-developed formulas and other firms that possessed the rights to these. Indeed, acquisitions is one of the favored methods of expansion and growth for EMFs (Hoskisson *et al.*, 2000). Those that engaged in aggressive acquisitions in the ex-Soviet bloc became the fastest growing and the largest firms (Bertrand and Betschinger, 2012). Firms that maintained links to the government gained lucrative public procurement contracts and access to various government research institutes with Soviet-era technologies and knowledge (see footnote 5). The cases suggest those engaged in political networking have grown rapidly during the Russian transition.

The key investor of Pharmstandard, Roman Abramovich, being one of influential oligarchs, had a connection to the Minister of Health that assisted the company in becoming the leading domestic producer of insulin as the government-procured Biosulin (Pharmstandard's insulin) for the Drug Reimbursement Scheme. Enormous capital of the first investors, strong corporate governance, and successful IPO in 2007 permitted the company a series of high-stake acquisitions of leading pharmaceutical products and innovative domestic enterprises. The IPO owners bought the controlling stake from Mr Abramovich and had acquired their own personal connections with the succeeding Minister of Health and related organs, securing the position of the "preferential" manufacturer (Kutuzov, 2009). At the time, the company was not interested in its own R&D, as acquisitions of other companies and products quickly diversified the portfolio of the company. The promptness of the expansion was dictated by the need for strategic players by the government. One of the procured drugs, Arbidol, received considerable support from the government officials, particularly from the Minister of Health and the Chief Sanitary Doctor. Vladimir Putin, the President, endorsed the product by visiting production facilities in Kursk and inquired of the availability of Arbidol in pharmacies on national television.

Biotec aimed at supplying state establishments with medicines. This came from the pre-established professional links during the Soviet times. The company remained the eighth biggest wholesale distributor in Russia until 2005, mostly supplying to the government with little commercial presence of its own. Biotec's direct linkage with the government provided a steady demand and did not require marketing or distribution to other businesses. Its main mission was successful participation in government tenders heavily influenced by connections within the federal government[6]. In 2005, Biotec's revenue had risen 75 percent due to a large stake in the DLO procurement scheme, making the company the third largest distributor in Russia. At the time of the DLO scheme roll out, the ex-Commercial Director of Biotec became the Head of Drugs Licensing Committee. The Vice President of Roszdravnadzor (a body similar to FDA in the USA) had been Vice President of Biotec in the past, and Boris Spiegel was in charge of the implementation by the Senate of Russian Federation (Kutuzov, 2006). This allowed the company to procure one of its largest suppliers, Biosintez, and the vitamin factory Marbiopharm from Pharmstandard, both in Volga District, for \$30m and \$20, respectively, in 2005.

Since the late 2000s, Pharmstandard has been active in investing in the further stages of development of potential breakthrough medicines, such as a majority contribution into immunotherapies research by US firm Argos Therapeutics. The company acquired the Danish innovative firm, Affitech, Ukrainian Biolk in 2011, a Russian innovator – Biocad, and finally, a Singaporean substance supplier, Bever pharmaceuticals.

Internalization and networks

Although the business environment in Russia improved in the second phase of transition, firms still faced various institutional voids pertinent to developing countries. To avoid these voids, firms opted to engage in wide-scaled internalization in order to maximize efficiency as firms integrated vertically and horizontally (Brown *et al.*, 2008).

Strengthening institutional environment and rapid economic growth rates provided Protek the opportunity to internalize and diversify its wholesale trade business into production, retail, consulting, and IT, becoming a large vertically integrated corporation. Since there were enormous institutional voids, namely, lack of intermediaries, standards, and facilitating agents like pooled labor markets, it was necessary to “fill the institutional gaps” through the internalization of intermediate markets that provided competitiveness in the underdeveloped pharmaceutical market. As the prominent stream of drug distribution became competitive, the production and the retail sector experienced robust growth. The production segment only started to emerge in the 2000s, as there was still an enormous demand for high-quality medications that importers and foreign subsidiaries could not provide. Similarly, the retail sector was dominated by SMEs that did not have capital resources as large corporations. Protek, with its drive for innovation, succeeded in entering these segments and spawning its chain throughout Russia[7].

To gain maximum returns from the business, Biotec had to have a vertically integrated enterprise to distribute its own produce. So, in 2002, the company opened a small facility to produce disinfection solutions, Biodez, in the Moscow region. Now, Biotec produces its merchandise through Biosintez, Marbiopharm, Biodez and provides packaging, filing, distributing, and other services mainly for the foreign enterprises in distribution on Russia. Biotec is one of the main distributors to the government and has over 320 pharmacies (Biotec, 2014).

As the government rolled out the program of additional medicinal supply (DLO) in 2005, Protek became the leading supplier of medicines for the program, with 25 percent of the share. Protek's favored treatment by the government and leading position within the DLO program resulted in an unprecedented corruption scandal in which the then CEO of Protek wholesale business segment, Vitaly Smerdov, was convicted of bribery of the top officials of the Medical Insurance Federal Fund. Another company involved in the scandal was Biotec (Kutuzov, 2010).

Public-private partnerships

In any successful market economy, the role of the business in the public sector and vice versa cannot be underestimated. In the early Russian transition, large business groups were the exclusive contractors to the state. With a consolidated formal institutional environment, smaller firms could tap into this lucrative resource. The later years of transition saw the rise of associations and other lobby groups, comprising private sector participants, large and small (EBRD, 2009; Hay and Shleifer, 1998; Vertakova and Plotnikov, 2013).

As seen above, networking on political and business levels remained prominent (Filippov, 2010). It had also become important to acquire and retain assets as formal institutions solidified and competition from foreign multinationals increased. This synergy of external and internal resource accumulation separated the favorites from the rest. In 2009, the Ministry of Health introduced the “Strategy of pharmaceutical industry development up to 2020” (Strategy 2020). The strategy is one of many introduced by the ministries toward the end of 2000s to develop innovativeness and import substitution (Makarkina, 2013). Government support was allocated to pharmaceutical, IT, energy, metallurgy, agricultural, defense, and other sectors. This phase can be termed as the beginning of the “guided market” or “state capitalism” phase (Klochikhin, 2012) in Russia. This phase also marked the end of the availability of Soviet off-the-shelf formulae, creating the need for import substitution. In this phase, the government began to encourage cluster creation, education and training of

specialists, private research institutes, and dedicated industrial bodies working closely with pharmaceutical companies. The biggest manufacturers had no choice but to invest in collaborations, new ventures, acquisition of innovators, and their own R&D investments. In 2011, Pharmstandard became the key investor in The International Biotechnology Centre “Generium,” part of the Strategy 2020 government program to increase market share of domestic drugs, decrease imports, and aims to increase the share of innovative products. The company remains one of the largest exporters with most exports to the CIS countries[8].

Although the interviewees claim the competitiveness of their businesses depends upon technological advancement and efficiency in production of world-class medicines, foreign enterprises claim it is the government relations that is the most valuable factor in selection of the partners that lands lucrative government tenders (Makarkina *et al.*, 2014). In 2014–2015, the government provided subsidized interest rates for investments to Generium for the setup of a biotech center, also to Biotec, Marbiopharm, Nanolek, Biokad, and Tatkhimpharmpreparaty for their undertakings as vertically integrated import-substituting companies. Government linkages make Pharmstandard one of the most valuable partners for foreign multinationals wanting to “localize” their production in Russia, giving the capabilities to produce its own high-quality generics, satisfying the label of innovation within Russia. Pharmstandard senior executive (Ph3) observed:

[...] Pharma 2020 program and the overall support of the state have had a positive impact on the development of the company. In 2012, we established the Department of State Cooperation and Procurement [...]. Now the majority of our revenue comes from State Procurement Scheme, making us the second biggest supplier [...].

By contrast, Protek operates commercially in B2B wholesaling and retailing, rather than government procurement sectors. The company recently invested in the Pharmaceutical Cluster Northern, where the company aims to establish its own R&D department. Government support in subsidizing the development of the Cluster Northern, tax incentives, and preference for locally produced medicines were the key drivers for expansion. Protek's extensive internalization of the company from the IT and customs to retail sector in pharmaceuticals helped the company deal with institutional voids[9]. The government is interested in having efficient national organizations that can sustain the industry. The influence of the centralized government over even less dependent firms is omnipresent.

Biotec's modernization and low-priced medicines helped the company remain one of the leading exporters of the country. As the industry aims for raising the domestic pharmaceutical manufacturing capacities underlined by the Pharma 2020 program, successful companies such as Biotec, are keen to adjust to the new challenges within the institutional framework. Continuous investments in production facilities, resulting in higher output and increased quality of Vital and Essential Drugs (VEDs), further highlight links to sustaining legitimacy within the crony capitalism. The most prominent production project in collaboration with the government is the investment of over \$60m in partnership with Polish Bioton into a new 5,000 m² Insulin production plant. This will supply 50 percent of injectables and 75 percent of cartridges of the Russian market in the near future. A senior manager from a manufacturing subsidiary of Biotec (Bz1) observed:

[...] This would not have been possible without the support of the current government [...] We are providing the means for import substitution of strategically important products and substances.

As a cheaper generics manufacturer, the company has been hit hard by the crisis which started in 2014, as most substances used to produce drugs are foreign. Biotec is a member of a coalition of domestic producers involved in the production of vital and essential drugs. The government provides support to the coalition to ensure sovereignty in these products. Both the local and foreign Association of International Pharmaceutical Manufacturers

(AIPM) associations serve as a strong lobby for the government. A senior executive of Biotec (Bt1) observed:

[...] Together with other manufacturers we contacted government officials numerous times in regards to revising and raising the prices for the VEDs [...] As part of coalition of domestic producers we cooperate with the government to update its laws on price registrations that will ensure our survival and development.

Hindered by bureaucratic and inefficient government apparatus, the manufacturers can still continuously improve the environment for the industry. This is reminiscent of government–industry cooperation witnessed in development of strategic industries in East Asia (Chang, 2002; Kim, 2003; Lall, 1994).

In summary, during the state-led industrialization, companies utilized several strategies. Pharmstandard started as an acquirer of key products and companies backed by strong connections and the links to the government. When the government realized the need for diversification of the economy toward innovation-driven industries, Pharmstandard and its affiliated structures became a key player embedded within the system in import substitution of medicines. Biotec also expanded through acquisitions aided by government programs in an extensive public–private partnership. Protek remained an independent player and diversified its pharmaceutical operations to maintain competitiveness within the developing institutional environment.

The role of political networking in 2000s onwards

With the formation of institutions (as in Table II), the need for personal connections to administrative resource declined as stability increased and informal practices phased out. At the same time, Russia saw powerful lobby groups, such as Association of Russian Pharmaceutical Producers (ARFP) and AIPM, cooperate with the government to represent pharmaceutical producers in politics. In Figure 2, the strengthened institutions that govern the business environment are in place, allowing firms to engage in arm’s length relationships without the explicit need for government relations. Some larger strategic firms remain politically connected (demonstrated by broken lines). Intermediaries in the form of various lobby groups maintain public–private cooperation in the interest of the economy and the firms. Transition countries are characterized by institutional voids (Puffer *et al.*, 2010); hence, for the foreseeable future, the link between the government and businesses will remain, albeit becoming less explicit. The salience of connections decreases as institutions governing businesses strengthen, more so as collective institutes, such as various lobby groups and associations, become formed.

A strengthened institutional environment provided businesses with a more transparent structured system of rights and responsibilities allowing for a lesser reliance on the administrative resource. Firms note that the laws and procedures are much clearer and there is a sense of reliance on the system to protect businesses from undue pressures. Further, supporting the argument of a positive correlation between tax reforms and regulations

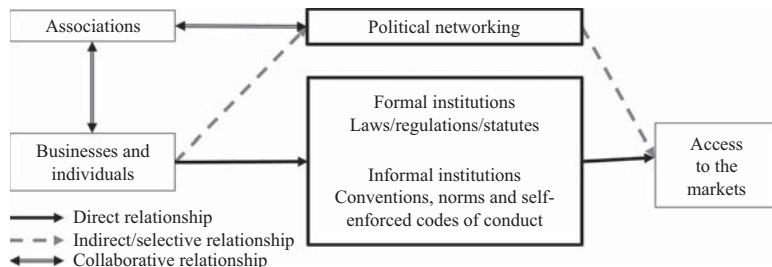


Figure 2. Political connections during state-led industrialization phase, 2000–on-going

(improved institutional environment) as well as closer international cooperation leads to more transparent and ethical firm behavior (Braguinsky and Mityakov, 2015), this paper finds that firms increasingly rely on the market mechanisms rather than personal networks in business operations. Developing countries where market institutions are underdeveloped seek a greater cooperation between the state and businesses, hence in Russia business associations are prevalent and tend to protect property rights and act as lobby groups for their members as the need for personal connections dissipates (Yakovlev *et al.*, 2014). After all, strong formal institutions protect property rights, attract investments, encourage business and economic growth, and reduce reliance on informal institutions (North, 2016).

Discussion

It is shown that state-guided consolidation of formal institutions and government support result in better business environment and long-term perspectives of EMFs and key industries. After the old system was dismantled and poorly funded scientific research institutes found themselves in disarray, newly formed market institutions facilitated the formation of intermediaries to fill the gaps. Entrepreneurs used their prospecting skills and political networks to gain access to privileged auctions to bid and acquire public firms being privatized and utilize connections overseas to fill the gaps within the market. Therefore, the strategies utilized by firms included inter-firm networking that included forming bonds with other firms to gain legitimacy and trust within an unstable environment and gaining valuable connections with conglomerates. In terms of prospecting, entrepreneurial firms with the desire for innovation and change embrace newly created opportunities to become first-movers. Incumbents concentrated on short-term exigencies and avoidance of long-term investments. Political networking was the key source of legitimacy and competitive advantage that created stability and a longer-term vision for firms.

With relative stability and growth brought by an improving institutional environment in the 2000s, Russian firms developed long-term strategies. The transformation from basic trade and imports to acquisitions and internalization of operations became prevalent. PPP became crucial in maintaining leadership in lucrative government procurement programs for larger firms. Other firms enjoyed relative stability, strengthening of private property rights, and arm's length relations. Government relations varied from top-level political endorsements, including President Putin's television appearance for Pharmstandard, to blatant corruption scandals between Roszdravnadzor civil servants and Protek, and Biotec in securing lucrative government tenders for medicine supply.

Through both phases of transition, political connections were a central basis for sustaining legitimacy and competitiveness within the rapidly changing environment. During the shock therapy years, incumbents exercised caution in investments and sought networks with administrative resource or conglomerates with certain influence in the political field. Institutional strengthening in the second phase led to more arm's length contracts, better transparency, and more certainty, resulting in long-term investments. Firms that maintained government links received continuing political support. Table IV summarizes strategic choices during the two phases of transition.

| Period | Strategies | Companies |
|---|-----------------------------|-------------------------------|
| Shock therapy 1990–1999 | Prospecting | Pharmstandard; Protek; Biotec |
| | Inter-firm networking | Protek; Pharmstandard; Biotec |
| | Key competence focus | Pharmstandard; Protek |
| State-led industrialization 2000–on going | Acquisitions | Biotec; Pharmstandard |
| | Large-scale internalization | Protek; Biotec |
| | Public–private partnerships | Pharmstandard; Biotec; Protek |

Table IV.
Strategic choices of
firms during the
Russian transition

With an “import substitution” beginning in the 2010s, the government has been proactive in collaboration, support, and PPP in key industries. The formal institution strengthening facilitated more sustainable visions for businesses and resulted in more arm’s length networking, including international partnerships (Trifilova *et al.*, 2013).

This research highlights the environment within which companies, both local and foreign, operate. Similar trends of government relations and public to private collaboration is evident in other key strategic industries, including forestry, light manufacturing, agriculture, IT, automotive industries, energy, space, defense, communications, transportation, and nanotechnology (Vertakova and Plotnikov, 2013).

In terms of growth, firms engage in market-seeking foreign investments, such as the case with Biotec and Pharmstandard, to countries with cultural affinities, i.e., the CIS countries. This is further supported by findings of Kalotay and Sulstarova (2010) that find initial OFDI ventures by Russian companies take place in similar cultural institutional environments. As formal institutions improve and market matures, companies face the need to innovate to remain competitive and collaborate with high-technology foreign enterprises, as the case with Protek and Cipla Holding and Pharmstandard with Affitech and Argos Pharmaceuticals.

Entrepreneurs may work or collaborate with other social actors that help to promote their organization (Bruton *et al.*, 2010; DiMaggio, 1988). Lobby groups, such as industry associations, often fill the remaining institutional voids and effect change in the outcome of institutions. The biggest of these is the ARFP, established in 2002, and encapsulates producers with an output of 90 percent of domestically produced drugs. ARFP represents the interests of the largest Russian pharmaceutical producers and promotes the competitiveness of the domestic pharmaceutical industry by close cooperation with the Ministry of Health, Roszdravnadzor, Ministry of Industry and Trade, the State Duma Committee on Health, and actively participates in the Council for Development of the Pharmaceutical and Medical Industry (Association of Russian Pharmaceutical Producers, 2016). AIPM is another organization that represents foreign manufacturer’s interests in the Russian market.

The evidence presented demonstrates that badly managed institutional upheavals in transition economies create institutional voids filled by informal institutions and networking. The most successful firms tend to be ones that could gain regulatory and normative support from connections with the administrative resource. The salience of connections was undoubtedly stronger during the weaker institutional environment. The firms, nowadays, rely more on traditional advantages in remaining competitive. However, the formerly gray political networks have evolved to the new phase of PPP (Vertakova and Plotnikov, 2013) as the government pushes for creation of national champions that serve the interests of the nation.

Further increases in PPPs are predicted in the foreseeable future as the government maintains its stronghold on the Russian economy and society. Indeed, PPPs are the means to gain large-scale investments needed to survive in the new order of international trade brought on by WTO and TRIPS. This situation is observed in other paternalistic CIS countries, including Ukraine, Kazakhstan, Uzbekistan, Georgia, Belarus, and others. This research underpins the necessity of political connections not only in Russia or its pharmaceutical industry, but also in other CIS countries (Freund and Oliver, 2016). Investors should be mindful that domestic competitors within these countries have external resources that often shadow the government’s interests and positions (Melkumov, 2009; OECD, 2014). With Russia, MNEs that have entered and are increasingly cooperating with domestic firms or establishing subsidiaries are joining lobby groups and actively participating in the political environment.

Conclusion and implications

The study explored the influence of political networking on firm growth in transition economies and the strategic choices firms make during periods of institutional upheaval. This

research provides evidence to support the theory that amid drastic institutional upheavals, firms rely on networking to create institutions that facilitate trade and business. The administrative resource of politicians provides a significant advantage for EMFs and helps in the creation of strategic firms and national champions. Research shows that strengthening of formal institutions, such as tax reforms, anti-corruption measures, consolidation of law enforcement, and nurturing key domestic industries, results in a more favorable business environment, but only partially reduces the need for political networking. Prominent firms that are proactive in following the dynamics of the institutional environment, often rely on established networks in addition. The reliance on informal networks is a part of the culture in transition economies and is prevalent at all levels of operation. The ability to build networks and alliances and to legitimate new institutions among relevant actors is an important aspect (Lawrence and Phillips, 2004). This involves pioneering the building of networks and a set of norms and rules of the game between actors in an eco-system. This area is vast and under-researched due to several factors, one of which is the lack of transparency, data access and availability in transition economies.

Although this paper depicted the two-and-a-half-decade transition in Russia, other countries, especially those in the CIS, have undergone similar transitions and conditions. The pharmaceutical industry in Russia is a key strategic industry. There are similarities of this industry to other strategic industries in transition economies. Pharmstandard subsidiary in Ukraine and firms from CIS countries suffer from the same constraints imposed by the need to integrate political networking with strategic processes. This poses inherent implications to the countries that suffer from such institutional voids. It has been shown that politically connected wealth inequality has a significant negative effect on the economic growth of emerging markets (Bagchi and Svejnar, 2015).

The government realizes the need for strong formal institutions; these have been developing sporadically, creating a lesser reliance on informal institutions. As institutions strengthen, the salience of the networks dissipates into more transparent arm's length relationships. Firms are better protected by the rule of law and gain longer-term strategic visions. In Russia, the state is authoritarian, so the firms benefitting most remain those with political connections.

The further Russia integrates into the global economy and aims to diversify its structure from natural resource dependency, the higher is the importance of formal institutions. In their race for competitiveness, firms must align their strategies to the changing environment. It is imperative to channel resources to modernization, efficiency, and innovativeness in the bid to sustain market shares in an increasingly globally integrated economy.

Policy-makers ought to heed the necessity for a strong regulatory and enforcement environment to create greater efficiencies of the economy. The lines between corruption and political networks are blurry; it is of interest to the society to facilitate equal opportunities to all in running of business, regardless of networks. A strong institutional framework encourages competition and attenuates connections.

Notes

1. Based on transcripts from an interview with Bt1.
2. Based on transcripts from an interview with Bz1.
3. Based on transcripts from an interview with Pr2.
4. Based on transcripts from an interview with Ph3.
5. Based on transcripts from an interview with Ph1.
6. Based on transcripts from an interview with Bt1.

7. Based on transcripts from an interview with Pr1.
8. Based on transcripts from an interview with Ph4.
9. Based on transcripts from an interview with Pr1.

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