

# Small Businesses in Russia: Institutional Environment

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## 1. Small firms in transition economies

A successful post-communist economic restructuring is driven by growth of private firms, which make up for the contraction of output of traditional enterprises. The shares of employment and output of the latter invariably decline as a result of correction of structural distortions left by central planning, closures of enterprises unable to sustain themselves under market conditions, disorganization of exceedingly complex and often unsustainable inter-enterprise links, and the possibility to divert inputs from the state-owned sector of the economy in search of higher return. These processes result in the transitional recession. The economy recovers when the nascent private sector picks up and becomes an engine of the subsequent economic growth (see e.g. Murrell, 1992). Vigorous development of the private sector shortens the recession, speeds up recovery, and reduces the social costs of transition by creating new jobs and generating market income for the labor released from traditional firms.

The most dynamic and vibrant part of the newly emerging private sector are small and medium enterprises. They are the first to respond to market signals and fill numerous niches left by the central planning, notorious for its rigidity and lack of attention to consumer demand. At the same time, small and medium firms give a natural outlet for heretofore suppressed entrepreneurial energy. Smaller firms usually can be created with limited resources, and in particular with minimal start-up capital. This is an important factor, given the lack of private wealth at early

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stages of transition, and reluctance of potential lenders to extend large loans to borrowers with no track records. Finally, small businesses form a natural constituency for the competitive market economy, and also contribute to the formation of a middle class which stabilizes the society and serves as a bulwark against political extremism. Therefore the SME sector could play an important and positive political role in the post-communist transition.

Robust development of small enterprises is a common feature of practically all “success stories” in post-communist economic transition. For example, in Hungary private sector employment increased from 9 % of the total number of jobs in 1990 to more than 40% in 1993. At that time approximately three quarters of those working in the private sector were employees of partnerships and fully private firms, or were self-employed (Commander, Kollo et al., 1995). These measures are proxies for SME employment. In Hungary, the number small firms increased in 1990 by 175%, in 1991 by 109%, and in 1993 by 30% (Shleifer, Treisman, 2000). In the Czech Republic in 1990-1994 the number of self-employed grew up from 17,000 to 910,000, and firms with less than 100 employees accounted in 1994 for more than 96% of all enterprises (Small Business ... , 1998). High labor intensity of small firms allowed them to absorb much of the labor released by the state sector, resulting in low unemployment throughout the Czech transition. This was in sharp contrast with neighboring Slovakia, which experienced slow growth of SMEs, and consequently a massive and lasting unemployment (The Czech Republic ... , 1995). The SME sector in Poland also proved to be a potent transitional shock absorber and a launching pad for the ensued economic growth (Small Business ... , 1998).

Comparisons reveal common patterns of SME sector development in early stages of post-communist reform. At that time small firms usually sprung up to fill numerous market niches, earn arbitrage profits after price controls had been lifted, and otherwise appropriate various transitional rents. Throughout the period of initial growth, small firms weren't constrained by neither consumer demand, nor competition by large manufacturers and retailers which were slower to respond to the needs of transitional markets. Since the first SMEs were mostly small-scale trade and service operations, their modest needs in production inputs were usually met by owners' initial endowments and/or loans from friends and relatives. Equally importantly, during the first, “profiteering” stage of SME development, this sector was relatively insensitive to the country's institutional setup, since most of the SMEs' income was earned on spot markets, and protection of property rights, third party contract enforcement etc. were not of prime importance. Consequently, a rapid expansion of private economic activities in the aftermath of economic liberalization has been typical for most of transition nations.

With time, economic adjustment and restructuring had closed transient sources of “easy money”, and small firms, if they were to survive and grow, had to change their modes of operation and to find sustainable sources of income in a market environment with no easy-to-close major imbalances, opportunities for arbitrage and non-appropriated rents. At that turning point small businesses did not have to start from scratch, since the earlier period allowed for self-selection of would-be entrepreneurs, and for accumulation of human and financial capital for future operations. In other words, after the initial stage of the post-communist economic

transition, the SME sector had the necessary starting conditions for long-term sustainable development.

However, such development, unlike the earlier “gap-filling” growth, is heavily dependent on the institutional setup, including legal and regulatory environment, tax regimes, efficiency of markets for factors of production, etc. (Polishchuk, 1997). The latter are public inputs that complement those held privately by prospecting entrepreneurs. Different transitional countries had various degrees of success in providing such public inputs. Consequently, the end of the “gap-filling” stage, when the relevance of institutional setup had sharply risen, had become an important bifurcation point for small businesses. Beyond that point, trajectories of SME sector development in various countries started to diverge.

In some transition countries the number of small businesses kept growing, and the most successful ones developed into larger firms. In others post-communist nations SME sectors are stagnating, unable to go beyond the initial push, or even declining, failing to find sustainable sources of growth in an inhospitable regulatory environment and against the backdrop of a deep and prolonged recession. Data presented in the next section show that the Russian SME sector has been following the last of these patterns. The emergence and stalling of the SME sector in Russia mirrors the country’s economic and institutional conditions. At the origin of the problem are the deficiencies of the Russian institutional setup in general, and in particular in relation to small firms.

## 2. Dynamics of the Russian SME sector

Tracing the dynamics of the Russian SME sector poses a number of methodological problems. First, the definition of a small firm used by the government statistical agency *Goskmstat* changed in 1996, which complicates comparisons of official data.<sup>1</sup>

Second, one has to keep in mind that much of Russian small businesses operate underground partly or in full, and therefore *ceteris paribus* official statistics underestimates both the number of small firms and their employment. Even officially registered small firms have the incentive to employ their labor informally in order to evade high payroll taxes. On the other hand, about 1/3 of officially registered small firms either have never started their operations, or have gone out of business while failing to formally liquidate themselves (Small Business ... , 1998). De-registration in Russia is legally ambiguous and costly (Impediments ... , 1998). In addition, a

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<sup>1</sup> According to the current Russian law, a firm is deemed small if it meets two criteria – one restricts the number of employees, and another – the ownership structure. Namely, the labor force of a small firm should be below a certain ceiling which depends on the sector of economy (100 in industry and construction, 60 in R&D, 30 in trade and services, 50 in education and health care, etc.), and the share in the firm’s equity of the central and local governments, non-profits and other legal entities not involved in running the firm, could not exceed 25%.

large number of fly-by-night small firms existed for the sole purpose of conducting shadowy transactions of larger enterprises (Yakovlev, 1999), and therefore the number of bona fide officially registered small firms is lower than the one reported by state statistical agencies.

When non-reporting and non-performing segments of the SME sector are taken into account, such adjustments at least partly cancel off each other. Moreover, according to expert estimates, these adjustments are of the same order of magnitude<sup>2</sup>. Therefore the following official statistics (*Kommersant*, March 16, 2000) could serve as a proxy for the real dynamics of the Russian SME sector<sup>3</sup>.

Year	1994	1995	1996	1997	1998	1999
Number of firms (thousands)	896	877,3	841,7	861,1	868,0	890,0
Number of full-time employees (thousands)	8,479.9	8,994.8	6,269.1	6,514.8	6,207.8	6,292,3
Number of part-time employees (thousands)	6,676.6	4,926.2	2,352.1	2,124.4	1,193.6	970.2

The table shows a quick start of Russian small firms in the early 90s – from virtual non-existence to almost a million. Private enterprises in Russia were legalized in 1990-91. Legislation passed at that time established various forms of privately owned firms, including small businesses. The latter option proved to be particularly popular, and was widely used both to establish new businesses and to re-register commercial ventures existed earlier under the guise of cooperatives. Another major part of the “first wave” of Russian small businesses were private firms established by state-owned enterprises as affiliated commercial ventures that used assets, premises and other resources of the parental company (Dolgopyatova, 1999).

The table further shows that the impetus of the initial “push” was short-lived: after a vigorous start, the Russian SME sector stagnated for the rest of the decade. Official employment by small firms has, in fact, experienced a precipitous decline in the late 90s. The decline was not just quantitative, but qualitative as well: recent surveys of Russian small firms (see e.g. Glisin, Rogachevskaya, 1998) reveal a growing number of SMEs reporting worsening business conditions. According to (*Small Business ...*, 1998), since 1994 the number of small firms that were able to establish themselves and maintain their operations for extended periods of time has

<sup>2</sup> The size of the shadow economy in Russia is estimated as 25-40% of the country’s GDP (Yakovlev, 1999). Expert estimates of the percentage of dormant and moribund small firms of the registered total are in the same numerical range.

<sup>3</sup> Official data has been adjusted to reflect the evolving statistical criteria of a small firm.

not growing, and has, at times, even declined. This is evidence that starting a business in Russia is easier than sustaining it. As a result, the process of formation of rational economic structure in Russia where small firms play a prominent role has been stalled (op. cit.).

In mature market economies the share of GDP produced by the SME sector is 5-6 times larger than in Russia, and the share of SME employment is 4-6 times higher. The growth of Russian SMEs has been arrested well below the “natural” level of this sector. The following table (Small Business Statistics, 1998) put the size of the Russian SME sector in 1997 in an international perspective.

Country	Number of SMEs ( thousands)	Number of SMEs per 1,000 of population	Employment by SMEs (million)	% of total employment	Share of GDP
UK	2,630	46	13.6	49	50-53
Germany	3,920	37	18.5	46	50-52
Italy	3,920	68	16.8	73	57-60
France	1,980	35	15.2	54	55-62
EU	15,770	45	68	72	63-67
USA	19,300	74.2	70.2	54	50-52
Japan	6,450	49,6	39,5	78	52-55
Russia	844	5.7	8.3	13	10-11

While it would be unrealistic to expect that Russian SME sector to catch up in less than ten years with the developed world, the level at which SME development has been stalled in Russia is clearly inadequate both to the country’s needs and growth potential of small firms.<sup>4</sup> Russian government’s sources and experts of grassroots Russian Association of SME Development agree that creation of truly competitive markets in Russia requires at least 2.5-3.5 million small firms, or 3-4 times the current numbers (Afanasieva et al., 1998). At the same time, various surveys report a high propensity of Russians to start their own businesses. This comes about partly in response to the massive dislocations and lack of employment opportunities in a recession-struck economy (see e.g. Vitkovskaya, 1998), and partly to utilize heretofore suppressed entrepreneurial skills. A low level stalemate is a clear indication that the development of small firms in Russia is trapped by formidable obstacles which outweigh the natural pent-up “demand” of the Russian economy for small enterprises, and the country’s vast capacity for SME development.

The August 1998 crisis dealt a severe blow to Russian small firms. It is estimated that 30-50% of small businesses had to close down or suspend operations in the aftermath of the crisis, and that the Russian SME sector was as a result pushed back four to five years in its development

<sup>4</sup> In 1995 Poland, with population of 1/4<sup>th</sup> of Russia, had two million small businesses, or more than twice the present number of small Russian firms (Shleifer, 1997).

(Bukhvald, Vilenski, 1999). This is an indication of fragility of small business, and the failure of the SME sector to firmly establish itself in the new Russian economy. The crisis also undermined the base for future development of small firms, as potential owners lost their savings as a result of collapse of Russian banks, and suffered heavy losses from non-payments and bankruptcies of business partners (ibid). Particularly hard hit were small businesses specializing in small-scale import of consumer goods (often informal one-person operations, known as *chelnoki* – ‘shuttles’). This part of the Russian SME sector, which had been declining for several years, was decimated by the multi-fold devaluation of the ruble, which has made imports unaffordable for the lower-income part of the population – the main target of *chelnoki*. Small businesses operating in the service sector also suffered heavy losses, due to high elasticity of demand to diminishing incomes.

The modest recovery that the Russian economy has been experiencing lately is based primarily on an expanded utilization of the previously existed production capacities of traditional firms. The Russian SME sector has not been affected so far by this process to any significant extent, and against the backdrop of an expanding economy small firms in Russia continue to operate in the “surviving mode” (*Kommersant*, March 16, 2000). Therefore while Russian small firms, alongside with larger enterprises, bore the full brunt of the crisis, they are slower to benefit from improving economic conditions.<sup>5</sup> The country’s SME sector thus features one-sided elasticity to the dynamics of the GDP: it was highly sensitive to the post-1998 contraction, and is sluggish in responding to the subsequent recovery.

### 3. Barriers to small businesses

The above analysis indicates that the development of the Russian SME sector is constrained by formidable obstacles. The latter can be aggregated into three main categories:

- demand constraints – SMEs are failing to find sufficient markets for their goods and services;
- resource constraints – small firms experience difficulties in securing necessary production inputs;
- institutional constraints – the official legal, regulatory and fiscal regimes are not conducive to emergence, functioning and growth of small firms.

The last group of barriers seems to be in the center of the problem, at least in the opinion of owners and operators of small firms (see below). It was already mentioned that over time the

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<sup>5</sup> In particular, small manufacturing firms so far have been failing to take full advantage of the massive import substitution triggered off by the multi-fold devaluation of the Russian currency. Unlike large traditional enterprises, small businesses don’t have excess production capacities that could be put in use to meet increased demand for domestic products. Being unable to raise capital to expand their operations (see Section 3), Russian SMEs are losing out to larger firms the market niches left by the 1998 devaluation of the ruble.

Russian SME sector has become much more sensitive to the quality of the institutional setup, and at that critical point the necessary institutions were not made available to small firms. While it is agreed that institutional failures are primarily responsible for the overall lackluster performance of the Russian economy, one could argue that such failures are particularly harmful for small firms. Indeed, large producers often managed to sustain themselves by using their market power and political clout to make up for lacunae in the institutional setup, effectively substituting their own resources for unavailable public production inputs. Small businesses are much more restricted in their ability to deploy their own compensatory mechanisms – the only “passive” defense, discussed below, is an escape into the shadow economy.

3.1. Views from the grassroots. Obstacles to the operations and growth of small firms in Russia, and in general to doing business in the country, have become a common theme of numerous surveys and analyses. One of such surveys, released by authoritative Russian business weekly “Ekspert” (Gurova et al., 1999), summarizes opinions of Russian managers and entrepreneurs on the main shortcomings and gaps in the country’s institutional framework. The high economic cost of poor institutions has been highlighted against the backdrop of the current recovery of the Russian economy, accumulation of human capital, strengthening of market incentives, etc. (see also Kostin, 2000). The still missed ingredient, in the opinion of those surveyed, which is the key to sustainable economic growth, is a legal and regulatory setup which is transparent, predictable, and conducive for investments. As long as this ingredient is missed, the considerable growth potential of the Russian economy, including its SME sector, remains suppressed by an institutional “glass ceiling”.

Among the deficiencies of the existing institutional environment as revealed by the quoted survey, the main two, in the order of their importance, are *suffocating taxation* and *the government “racket”*.

These findings are consistent with those reported earlier. Since early 90s taxes have been invariably problem No. 1 for Russian small firms, which can be seen from a series of surveys conducted nationwide and in different regions from 1992 through 1997 and reported in (Small Business ... , 1998). Similarly, extortion by corrupt officials is an everyday reality of small businesses: 90% of managers polled in 1996 at the First All-Russia Congress of Small Entrepreneurship reported incidences of such extortion, and more than 40% complained of frequent government “racket” (Radaev, 1996).

Small firms do not view the existing legal system as either a sound and stable basis for their operations, or a defense against violation of their rights. *Lack of reliable legal guarantees and volatility of laws and regulations* pertaining to small businesses is another major concern of Russian SMEs. This problem, according to (Small Business ... , 1998), is invariably among the top three most frequently reported by surveyed small firms. Existing rules and enforcement practices do not establish the necessary parity in relations between small businesses and government officials, and leave SMEs defenseless in the face of predation of bureaucrats (Kommersant, March 16, 2000).

Widespread among Russian small firms are concerns about a *lack of protection of property rights* (op.cit.). This includes intellectual property rights, which have recently become of particular importance for the country's SMEs (Gurova et al., 1999). While a sizable part of the Russian SME sector takes advantage of a lax enforcement of the copyright and patent laws by engaging into small-scale commercial piracy, Russian R&D companies are suffering heavy losses from theft of their know-how (op. cit.). Obtaining patent protection, especially abroad, is often prohibitively expensive for a small venture firm. As a result, the earlier hopes that the SME sector would be able to absorb and put into effective use the human capital and facilities of the gigantic Soviet R&D complex, have been frustrated. The proportion of small businesses specializing in R&D was steadily declining – from 8.23% in 1994 to 5.12% in 1997 (Small Business ... , 1998). Given the concurrent decrease of the total number of small firms in Russia, the contraction of the research segment of the Russian SME sector in absolute terms was even more dramatic – in four years this segment was reduced to approximately 40% of its initial size.

It is noteworthy that appreciation of intellectual property rights is a relatively recent trend in the Russian SME sector. In surveys conducted during mid-90s, less than 5% of polled firms mentioned this problem as a significant concern. This is a yet another indication that priorities of Russian SMEs are shifting from short-term speculative gains towards a stable and effectively enforced institutional framework, which would allow them to accrue and secure return on various accumulated assets, including human capital.

In the following analysis the obstacles that Russian small firms face are subdivided into two groups: barriers to entry and impediments to operations of existing SMEs.

3.2. Entry barriers. It is often claimed that prospective entrepreneurs in Russia are faced with formidable entry barriers. The previous analysis suggests that these concerns are perhaps somewhat exaggerated, especially in comparison with difficulties of ongoing operations of *existing* businesses.

Indeed, *administrative* barriers to entry are steadily losing their significance. The Russian law requires registration of small firms, and in some cases – their licensing and certification of produced goods and services. While bureaucratic delays and unnecessary hurdles in registration are still common, and procedures often cumbersome<sup>6</sup>, there has been a clear tendency towards streamlining and simplification of these procedures. In addition, registration formalities at present are commonly handled by private consultants<sup>7</sup>, or could be sidestepped altogether by buying an

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<sup>6</sup> Difficulty of registration varies from one region to another, since this is a matter of subnational jurisdiction. If a regional government is hostile to private enterprise (e.g. in Krasnodar region), registration could still pose a serious problem (Small Business ... , 1998).

<sup>7</sup> According to (Barkhatova, 2000), when a would-be owner of a small business attempts to fulfill all registration formalities him/herself, the process could take several weeks, if not months. When registration is contracted out to a specialized private agency, it can be completed in a couple of weeks. This is an example of a market response to excessive regulation – it is noteworthy that in the early 90s such services were not available, and as a result official entry barriers were de facto higher than they are at present.

earlier registered ‘shell’ firm. As a result, registration increasingly becomes a matter of cost, rather than a drain on time and energy of business owners (Legislative Regulation ... , 1999; ... , 1999). According to the following table, registration was cited as a barrier to entry by less than 11% of owners of small businesses polled in 1997 (op. cit.).<sup>8</sup>

Problem with starting a small firm	Percentage of firms reporting the problem
No problems	4.5
Registration	10.9
Premises	28.8
Financial problems	71.6
Choice of field of operation	4.3
Finding suppliers	14.9
Finding customers	25.3
Obtaining equipment	29.4

The situation with licensing and certification is by and large similar to that of registration. Businesses often value a certificate or license as means to build consumers’ credence, and are willing to bear the necessary costs. Still, such costs are often viewed as excessive, especially if they have to be paid periodically (Impediments ... , 1998).

According to the above table, *resource* constraints to entry are much more significant than bureaucratic ones. Lack of start-up capital is the most frequently mentioned entry barrier. The gravity of this problem has increased over time, because upcoming small businesses are faced with tighter competition, and low-cost cottage industry type start-ups are no longer possible. An earlier option of gradual entry, when simple trade operations and other niche-filling activities generated capital for more sustainable undertakings is not available either: in the matured Russian market sources of “easy money” have dried up.<sup>9</sup> As a result, prospective small businesses have to pay a substantial fixed cost upfront. Such costs are currently estimated within the \$10,000 - \$40,000 range, which could be hundreds of times higher than the monthly wage of a prospective entrepreneur (in the late 1980’s several months’ modest wage was sufficient to start a quasi-private business) (*Kommersant*, March 16, 2000).

Factors of production other than money are lesser a problem. Thus, in the mid-1990’s, fewer than 20% of small firms reported difficulties in finding premises for their operations. Some

<sup>8</sup> One should keep in mind an obvious self-selection bias: firms polled in the survey *have been able* to overcome entry barriers. If those which have failed to do so were included in the sample, the results could have been quite different, likely pointing out to more severe entry problems.

<sup>9</sup> “Managers of small firms that have been in business for several years stress in interviews that it is unlikely that they would have been able at present to launch their operations anew: required start-up capital has risen multifold, and one cannot expect a quick return, since most profitable niches are already filled” (Small Business, 1998, p. 109).

SMEs emerged within traditional firms and were able to use facilities of “mother” companies. Others – the majority – took advantage of the broad availability of property for lease from various firms and organizations that have lost their funding and were scrambling for alternative sources of revenue. Moreover, often small firms were responding to deteriorating economic conditions by getting rid of redundant premises acquired or leased earlier (op. cit.). This trend further reduces the cost of commercial real estate.

Overall, owners and operators of small firms regard non-monetary entry barriers as surmountable, although start-up costs are increasingly difficult to cover. However, after these costs are paid and a small firm is in business, it immediately encounters severe operational impediments, and first and foremost oppressive taxation.

3.3 Tax regime for small businesses. Representatives of small firms are unanimous in their opinion that the current tax system obstructs growth of Russian firms, often interfering with their payments of legitimate production costs. Russian manufacturers estimate their tax liabilities at 70-120% of their firms’ net income (Gurova et al., 1999). The most burdensome and distortionary are the 40% payroll taxes; in combination with personal income tax they result in the aggregate 70% tax burden on personal services.

Russian firms are still subject to antiquated turnover taxes, a vestige of the Soviet tax system. Although nominal rates of these taxes are low, the fact that they are levied on gross sales, plus the possibility of ‘cascading’, makes these taxes a major component of the total tax burden upon Russian producers. Firms are also protesting against the provisions of the profit tax law which prohibits deductions of such cost components, as advertising and marketing expenses, interest payments, and personnel training, which are accepted worldwide as standard and legitimate costs of doing business<sup>10</sup>.

Apart from deficiencies of the tax system per se, small businesses are suffering from irregularities of tax administration, erratic changes and ambiguity of the tax law<sup>11</sup>, insufficient and/or delayed information about tax rules, lack of parity in relation with tax officials and tax police, and the high cost of filing and compliance. In a 1996 survey of small businesses in Moscow, 88.5% of managers complained about unacceptable “mechanism of taxation” (an aggregate of such factors as instability<sup>12</sup>, excessive complexity and ambiguity of tax law, and a large number of

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<sup>10</sup> The tax reform which is currently underway in Russia is aiming at partial elimination of turnover taxes, and is addressing the issue of deductibility of the above listed costs.

<sup>11</sup> Owners of small businesses point out that tax officials use ambiguities and contradictions in the tax law to their advantage, invoking regulations and choosing their interpretations on the case-by-case basis (Barkhatova, 2000). Small firms are particularly vulnerable to this sort of abuse, because they cannot afford expensive legal and accounting advice to buttress their positions in tax disputes. While large companies sometimes manage to win court cases against tax authorities, for small businesses even clear violations by tax inspectors of the Russian tax law are not remedied (op. cit.).

<sup>12</sup> A telling illustration of the volatility of the Russian tax law is the fate of the Tax Code. Instability of earlier tax legislation was one of the main rationales for introducing a comprehensive tax code. However, in less than year and a half of the Part I of the Tax Code in effect, its major revision is pending. The proposed

different taxes), 74% protested high burden of taxes, and 64.4% pointed out to an unprofessional and unfair tax administration (Small Business . . . ., 1998).

All of the above problems are systemic for the whole Russian economy, not just its SME sector. Russian tax law provides for special treatment of small firms, which is supposed to offer some relief from excessively heavy and cumbersome taxation. Thus, the law “On Simplified System of Taxation, Accounting and Reporting for Small Enterprises” passed in December 1995, offers SMEs the option to amalgamate numerous federal, regional and local taxes into a single tax calculated as a percentage of gross sales or income (sales net of the cost of inputs) of a firm. However, this law makes eligibility subject to numerous restrictions; most importantly, only firms with less than 15 employees qualify for these tax regimes. Under the law, all small businesses are still responsible for paying the payroll taxes in full. In other words, this law does not relieve small businesses from the most burdensome component of the Russian tax system.

Another law – “On Unified Imputed Income Tax for Certain Activities”, passed in June 1998, allows to replace practically all of the taxes payable by small businesses – this time including the payroll taxes – by a single tax which is calculated as 20% of the imputed income of a small firm. The law imposes federal restrictions on eligibility for the imputed income tax, and leaves it up to subnational governments to develop procedures for estimation of imputed income that would serve as a base of taxation. The law lists, however, some 15 factors (such as location, proximity to roads, assortment of goods and quality of services, etc.), which should be reflected in regionally enacted formulas. Unfortunately, the regional discretion allowed by the law opens broad opportunities for bureaucratic manipulation and abuse, especially when subnational governments are hostile to small businesses (Smirnov, 1999)<sup>13</sup>. Further, it is not clear if this law will be upheld by the pending Part II of the Russian Tax Code.

An excessive tax burden makes tax evasion a necessary condition for staying in business. However, chronic tax evasion becomes increasingly costly. The costs of violating tax laws are multi-fold. The main components of these costs are:

- vulnerability of businesses to blackmail and extortion of government officials;
- inability to obtain public protection against the criminal underworld, necessitating entry into contractual relations with rackets providing “protection”;
- growing deadweight losses of “tax optimization” schemes, which make transactions unnecessarily elaborated and costly;
- non-transparency of firms’ accounting, which prevents them from raising investment capital on financial markets or officially borrowing from banks;

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amendments would severely curtail safeguards of taxpayers’ rights, which were considered as a major accomplishment at the time the Tax Code was passed.

<sup>13</sup> A recent report on Russian SMEs calls this law “a disaster”, since it “gives regional officials wide discretion in how to implement the tax and many regions have elevated the amount of money small businesses must pay, driving lots of them out of businesses and increasing unemployment” (Russian Regional Report, December 8, 1999).

- diseconomy of scale of tax evasion: being small makes it easier to escape the taxman (see also Yakovlev, 1999), which puts limits to growth of smaller businesses.

The last of the above factors is particularly pernicious for growing SMEs. At present small businesses and large producers enjoy scale-related advantages of tax evasion – the former do to their low profile, and the latter because of their political clout which usually allows to strike a deal with tax authorities. It is small-to-medium-size firms which are particularly vulnerable and defenseless before oppressive taxation, which is a yet another barrier to growth of small firms and the economy as a whole.

3.4. Legal and regulatory environment. As it was already mentioned, Russian small firms view deficiencies of the legal and regulatory environment as a major hurdle for their operations. In addition to the above discussed tax law, areas of legislation which are of particular concern for small firms are those dealing with property rights and contract enforcement, accounting, real estate and customs regulations (Small Business ... , 1998; Gurova et al., 1999). Small firms are also suffering from a large number of regulations imposed by various federal, regional and municipal agencies and even providers of public utilities. Inspections by these agencies<sup>14</sup> are numerous and time-consuming, often leading to bribes and extortion. The existing law establishes no limits on the frequency of inspections and offers no remedies for losses suffered due to excessive control.

The following table (Shleifer, 1997) puts the regulatory burden upon Russian SMEs in a comparative perspective by juxtaposing results of surveys of shop managers in Russian and Polish capitals.

	Moscow	Warsaw
Inspections last year	19	9
Percentage of shops fined	83	46
Number of inspecting agencies	3.6	2.7
Legal vulnerability (scale 1-10)	5.1	3.6

According to another survey, reported in (Radaev, 1998), 38.5% of polled business managers consider bribe extortion by controlling officials as frequent. Another 48.5% acknowledge that such extortion happens from time to time, and only 13% believe that it doesn't happen. These attitudes are shared by managers of small and large firms alike. However, the incidence of

<sup>14</sup> In the city of Moscow small firms are subject to inspections by over 50 controlling bodies, including tax authorities and tax police, police, fire and sanitary controls, licensing and registration offices, administrative inspection, heat and energy providers, center for disease control, architectural control etc. (*Kommersant*, March 19, 2000). In Voronezh there are 33 inspection agencies dealing with small firms; these agencies can apply such punitive measures as closing down a business, arresting its bank account, etc. (Russian Regional Report, December 8, 1999).

extortion against small firms are much higher: 90% of Russian small businesses surveyed in 1996 have been victims of extortion by public officials, and over 40% reported frequent extortion. Small enterprises are also more skeptical about the possibility of a “clean” business: 40% of small firm managers consider corruption as universal and unavoidable, against 27% of executives of middle-size and large companies. This is a clear evidence of greater vulnerability of small business to bureaucratic predation.

Russian small businesses do not trust official institutions of commercial arbitration and third-party contract enforcement. Monitoring of small businesses reveals that only 9% resort to such institutions in settling their disputes; other rely on direct negotiations between involved parties (Small Businesses ..., 1998). This finding is corroborated by the aforementioned comparison between Moscow and Warsaw: in Moscow, 45% of polled shop managers reported that they needed to use courts but did not do so, against 10% in Warsaw. Percentages of those who actually brought their cases to courts were 19% and 14%, respectively (Shleifer, 1997).

The unreliability of the official third-party contract enforcement restricts the operations and growth of small businesses. When business transactions are confined to a relatively small circle of personally known and trusted commercial partners, it inevitably stifles growth and reduces efficiency. This leads to segmentation of the Russian SME sector, and impedes integration of small firms into the system of national markets for goods, services and factors of production. This barrier to the development of the Russian SME sector will be further discussed in section 4.

3.5. Access to inputs. Deficiencies of the institutional environment for Russian small businesses are not limited to excessive regulations and taxes, but also restrict access by SMEs to input markets.

Russian small firms experience serious difficulties in raising *capital* for their operations. According to surveys (Small Business ... , 1998), more than 50% of SMEs consider shortage of financial resources as one of their most severe constraints. This finding in itself is not unusual, since small firms around the world are subject to hard budget constraints. The real issue is how Russian small businesses manage to maintain cash flows and raise capital for expansion. Analysis of these questions makes clear that institutional problems constraining Russian SMEs are not confined to government regulations and excessive taxes, but also hamper access of Russian small firms to input markets.

The following table (Small Business ... , 1998) presents proportions of respondents that resorted to a particular means of financing. It shows that internal sources of funds – revenues from past operations and money invested by owners – prevail by far over externally raised capital. In search of the latter Russian SMEs more frequently turn to privately arranged loans, than to the banking sector.

	Sample total	15 employees	over 15	upcoming	mature SMEs
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		and less	employees	SMEs	
Internal sources, including:	83.2	88.6	79.0	88.9	82.0
own revenues	75.6	78.6	73.3	75.0	75.7
shareholder loans	34.4	54.3	20.8	55.6	29.3
External sources, including:	45.8	38.6	51.0	55.6	43.2
bank loans	15.6	5.7	22.8	13.9	15.0
loans of new shareholders	5.6	7.1	3.0	11.1	4.3
private loans	32.4	34.3	33.0	50.0	28.8

It can be concluded that the official financial sector in Russia is failing to perform its function of channeling financial resources into potentially the most dynamic and vibrant part of the Russian economy, which is in a particularly acute need of venture capital. Bank credits are available, if at all, under prohibitively high interest rates. Often considerations of economy of scale make banks disinterested to deal with small firms at all<sup>15</sup> (Impediments ..., 1999). While this is a common feature of small businesses worldwide (Small Business ... , 1998), the systemic problems of the Russian banking, and in particular the small percentage of industrial investments in banks' portfolios, make it very difficult for small firms to access bank loans.

Another barrier that hampers access of small businesses to bank financing is the excessively lengthy process of approval of loan applications, which could drag on for months – a practice that SMEs can ill afford. Obtaining an overdraft protection and other instruments that would allow SMEs to smooth out their cash flow fluctuations is also next to impossible even for more successful small companies, which have established lasting relationships with commercial banks.

The evident failure of the official banking sector to provide small firms with external capital, and overwhelming reliance of small businesses on privately, often informally, arranged loans, hinders efficiency and growth of the SME sector. Under the present conditions availability of venture and working capital becomes a matter of personalized relation to a wealthy lender, and only in the second instance – of the profitability of a small business, merits of the investment project,

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<sup>15</sup> According to a survey of small firms in Novosibirsk, “obtaining a small short-term loan of \$5,000-\$6,000 seems impossible for [small] companies as banks are only interested in loans over \$20,000” (Barkhatova, 2000, p. 668).

etc. This practice also sustains the informal segment of the SME sector, since private loans most of the time go unrecorded officially (Barkhatova, 2000).

Another problem is asymmetric information, which leaves potential investors unaware of attractive investment opportunities offered by small firms. Among newly established firms, only one in ten manages to get bank loans, and five times as many borrow from private sources.

Even when in business, small firms lack the resources to advertise themselves and otherwise make visible (to “reel off”, in the slang of Russian public relation specialists) to prospective investors. There are no sufficiently active and credible consulting firms to objectively and professionally evaluate investment projects and pass the results on to venture capitalists (Gurova et al., 1999). This can also be seen from the above table, which shows that dependence of Russian SMEs on internal funding is reduced only slightly as firms grow bigger and older.

Internal and privately arranged sources of funding appear to be barely sufficient to cover the needs of small firms for working capital, and clearly fail to meet their needs for capital investments. In 1994-1996 surveys, the percentage of small firms reporting their inability to raise investment capital was consistently higher than those reporting difficulties in obtaining working capital (Small Business ... , 1998). It is symptomatic that a survey conducted in 1997 revealed a different picture – at that time SMEs were more concerned with their ability to cover operational expenses, than with investments (op. cit.). These findings are consistent with the general trend of the Russian SME sector, which had fallen in the mid-1990’s into a “sleeping mode”.

Given the vast unemployment produced by Russian transition, SMEs obviously face no shortage of *labor*. However, the SME sector has not established itself as a socially and institutionally acceptable employment alternative to traditional enterprises. On the one hand, over two-thirds of those hit by open and hidden unemployment in Russia have additional sources of labor income (in cash and in kind) – about one-third are cultivating private plots of land, mostly for consumption within the household, and another one-third work on the side, either as self-employed or for private small and medium size employers (Transitional Economy, 1998). But even those who draw most of their income from employment in the SME sector do not view their new jobs as sufficiently reliable and durable, and many hold nominal non-paying jobs at traditional firms as a means to maintain social status and have access to state-run safety nets. (The aforementioned motive of tax evasion further strengthens this phenomenon). It means that employment at small firms remains largely informal, and only as a second-best option. Informality is therefore the common feature of small firms’ operations on the capital and labor markets, even if the first of these production inputs is in short supply, and the second one is abundant.

Recent surveys report a shortage of modern *management skills* as a major bottleneck for Russian SMEs. This was less a problem at the onset of the market economy in Russia, when the nascent Russian market needed entrepreneurs able to take risks, identify a market niche and

launch a business. Once a firm has established itself, its main priorities in an increasingly competitive marketplace are sustainability and growth, which requires adequate managerial skills. The latter appear to be in short supply, not in the least due to relative immaturity of the Russian market economy. Insufficient time has passed to develop a corporate culture and a new cadre of modern business executives. This problem is particularly acute for small firms, which can rarely afford to hire professional managers, and where owners usually have to learn the art and science of management without help. A grassroots solution of this problems could be business consulting which accumulates and disseminates the necessary knowledge and skills (Small Business ... , 1998; Russian Regional Report, December 8, 1999).

3.6. Demand constraints. At the onset of SME sector development in Russia, small firms were not particularly concerned about finding customers for their goods and services. This was hardly surprising, given the numerous market niches that were the main source of demand for small enterprises. According to a 1994 survey, almost one-third of small firms selected their specialization in response to a shortage of consumer goods and services (Small Business ... , 1998). At that time only 25% of small firms reported difficulties in sales of their products.

With time, shortages have been eliminated and market niches filled, often by superior quality products and services of larger firms, including massive imports. Limited abilities to win the quality contest is clearly recognized by Russian SMEs: about 50% estimate competitiveness of their products as average, 17% as poor and only 7% as high (Glisin, Rogachevskaya, 1998). At the same time, households' disposable incomes were declining or stagnating. As a result, a large number of small enterprises hit the demand constraint, failing to find ready-to-pay customers. Sluggish sales have become the top problem of Russian SMEs, as much a matter of concern as high taxes and poor regulatory environment.

In a 1997 monitoring of small firms, 70% complained about the low effective demand of their potential customers, and viewed the demand constraint as the most binding of all those restricting growth of surveyed businesses. It is worth mentioning that SMEs with more than fifteen employees fared a bit better in dealing with the demand constraint than those with fewer than fifteen workers. For the first of these groups, 63% of businesses were concerned about low demand, whereas for the second one the number is 73% (op. cit.). If the size of a firm is positively correlated with its age, this is an indication that more mature firms, by way of learning-by-doing, are better able to find customers than those which have less experience. Another explanation is that older SMEs have established themselves in earlier available market niches, and could keep the earlier developed relations with customers, while for newcomers no such niches are available. This can be indirectly confirmed by the observed higher flexibility of new entrants in the SME sector in their pricing and marketing policies (Small Business ... , 1998).

Demand for the products of SMEs exhibits deep inter-regional variations, which is reflected in the highly uneven distribution of small firms across Russian regions. There are profound spatial disparities in such indicators per capita, as the number of small firms, their employment and output. These indicators, in their turn, are positively correlated with economic conditions in

regions. Thus, the city of Moscow, where living standards exceed by a large margin those in the rest of the country, is also an indisputable leader in SME development: the number of small firms in Moscow, their employment and output per capita are 3.4 -3.6 times the corresponding national averages (Goskomstat data, November 1999). Moscow and St. Petersburg have 1/3 of all of Russia's officially registered small firms (op. cit.). At the same time the presence and economic role of SMEs in depressed regions are barely noticeable.

Unevenness of the demand constraint for small firms makes the Russian SME sector a 'spatial inequality multiplier' (Polishchuk, 1996). The latter works as follows. Small businesses are heavily concentrated in retail trade and services (in 1997 – 44% of the total amount of small firms) and in construction (17%)<sup>16</sup>. These are areas of activities which cater primarily to local demand – within city limits or within a region. Manufacturing SMEs (16%) often branch out of large firms and serve their needs in components and semi-finished products (Bukhvald, Vilensky, 1999). Such small enterprises also emerge around existing economic activities and sources of wealth. In addition, competitiveness of small firms involved in manufacturing remains poor, which usually restricts their sales to nearby areas, often within their home town (Glisin, Rogachevskaya, 1998). Overall, more than 80% of Russian small businesses sell their products locally (Small Business ... , 1998).

Areas with better economic conditions, robust industries and higher household income offer broader opportunities for SME development. Responding to these opportunities, small firms further contribute to regional wealth. In contrast, in poor regions emergence and growth of small firms are inhibited by weak demand and the prevalence of moribund traditional firms.

Localization of demand constraint prevents Russian small firms from performing the expected role of offering new opportunities of employment and income to those left jobless in the course of economic restructuring. The more dire the need for such adjustment, the more severe the demand constraint upon small firms, and consequently the lower their ability to make up for the losses suffered in the transitional recession.

This conclusion is further supported by a negative correlation between the intensity of labor turnover in Russian regions, and the regional economic situation (Transitional Economy ... , 1998). Depressed regions feature lower labor mobility, despite the dire need of workers to quit loss-making firms and to find new places of employment. It means that new vacancies, including those at small enterprises, are not being created in the regions in most urgent need of restructuring .

#### **4. Patterns of behavior**

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<sup>16</sup> Small Business ... , 1998, pp. 60,61.

At early stages of the Russian SME sector development, modes of operation of small businesses were heavily influenced by firms' origins. Small firms were either created from scratch, or established by state-owned enterprises as affiliated commercial ventures using assets, premises and other resources of the parent company. De novo small firms were highly flexible and subject to hard budget constraints, which made them strive to fill market niches, and overall sensitive to market signals. Offshoots of traditional companies were under the inertia of old management styles, and often served the purposes of employment maintenance, cross-subsidization of money-losing parts of the parental firm, asset-stripping and tax evasion.

However, over time the surviving small firms in Russia have become less path dependent in their operation, and are employing, regardless of their origin, similar strategies and modes of operation. As revealed in surveys of the Russian SME sector, these strategies can be aggregated in the following categories:

- greater responsiveness to market signals;
- development of personalized networks;
- escape to the shadow economy.

The first group of strategies is used in dealing with customers, the second with commercial partners, and the third is a means of protection against the predatory bureaucracy.

At present, Russian small businesses are faced with much tougher *competition*, both from small and large-scale producers and distributors, than several years ago. This trend became apparent in the late 90s, when ability to compete, previously not a major concern, became a top priority for Russian small firms (Small Business ... , 1998). Competitive pressure strongly affects pricing policies of small firms. They are forced to modify traditional cost-based methods of price calculation, to consider market demand and competitors' pricing. Small businesses also resort to quality competition, offer warranties, customer services and deploy other means to sustain themselves in an increasingly competitive marketplace. Vigorous advertizing, flexible production and diversification of SMEs' operations all work towards the same end (op. cit.).

These are positive evidences of increasingly competitive behavior of small Russian firms, rarely seen in the early part of the decade. At that time a lack of competitive awareness among Russian small businesses was in sharp contrast with successful transition economies of Central and Eastern Europe, where SME sectors were highly competitive virtually from the outset of post-communist transformations. A comparative study (Shleifer, 1997) juxtaposed Polish businessmen's complaints about "awful competition" with those of their Russian colleagues about government inspections, registration, and rackets. Healthy development of the Russian SME sector should have relieved Russian small businesses of those concerns, allowing them to concentrate their resources and energy on winning customers by offering new products, improving quality and cutting costs. Instead, while competitive motives are now placed prominently on the agenda of Russian small firms, they have not replaced the traditional needs to cope with the bad institutional environment, but coexist with such needs.

Consequently, Russian SMEs have to solve a dual problem of facing *both* competitors and poor institutions. As a result, Russian small firms usually combine strategies adopted to deal with increasingly competitive marketplace, with those employed to alleviate the deficiency of an institutional environment which remains adverse to SMEs. The common feature of these combined adjustment strategies is reliance on *informal* alternatives to malfunctioning official institutions.

The ineffectiveness of the formal contract enforcement and a lack of impartiality in relations between businesses and the government prompts small firms to enter into *informal networks* with each other and with government officials. Such networks typically include long-term commercial partners, and often are centered on a large firm that has affiliated small enterprises or integrated existing SMEs. These “holdings” often practice inter-lending and cross-subsidization of participating units (Dolgopyatova, 1999).

Informal networks are based on mutual trust among participants. These networks are substitutes for ineffective official mechanisms of contract enforcement and conflict resolution. 95% of small firms included in a 1997 monitoring of the Russian SME sector sought support of their network partners in solving various problems. Assistance of government agencies, SME support centers and formal associations of small businesses was sought six times less frequently (op. cit.).

Informal relations are also instrumental in maintaining cash transactions for the purposes of tax evasion (Informal Sector ... , 1998).

Small firms use personalized relations to secure access to capital, premises and business information. It was already mentioned that private loans to small firms outnumber those from commercial banks in proportion 2:1 and more. Almost 50% of Russian small businesses rent premises from affiliated entities at below market rates. Over two-thirds of Russian SMEs exchange information with their networking partners (Dolgopyatova, 1999).

It comes as no surprise that Russian small firms view established relationships with their partners as one of their most valuable assets, second only to production equipment. The smallest “micro” depend on personalized relationships particularly heavily – they rank them above every other type of assets first (Small Business ... , 1998). It is symptomatic that established relations with government agencies are considered less significant an asset, and such relations are ranked much lower than those with commercial partners, clients, and suppliers (op.cit.).<sup>17</sup>

Although informal networks greatly facilitate operations of small firms in Russia, they are a highly imperfect substitute to conventional mechanisms of contract enforcement and markets for production inputs. Inability of small firms to enter into potentially valuable transactions with

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<sup>17</sup> This should be viewed not as an evidence that such relations would be useless for a small firms, but rather as a sober recognition that small firms are not able to compete for preferential treatment by government agencies with large producers (see the concluding section of the report).

counterparts outside of a network constrains SMEs, especially those seeking investment capital or partnerships with other firms. It also preserves the fragmentation of the SME sector and sustains regional isolation and disparities.

Another common practice of Russian SMEs is operating in the *shadow economy*. The main motive of “moving into the shadow” is tax evasion, and, to lesser extent, escape from the excessive regulatory burden. Small firms operate in the shadow economy either in full, when they are not officially registered, do not have a business bank account, etc., or partly, when a business allocates its operations between the official sector and the shadow economy (Small Business ... , 1998). In the latter case a part of transactions is conducted in cash and/or not reported on the firm’s books (Informal Sector ... , 1998). A special component of the “shadow part” of the SME sector are fictitious “fly-by-night” firms which are established with the sole purpose to handle a dubious transaction for the purposes of money laundering or tax evasion, and disappear immediately afterwards (op. cit., Yakovlev, 1998).

Estimates of the size of the “shadow part” of the Russian SME sector vary from one source to another. Official estimates of the Russian shadow economy at large are in the range of 25-40% of the country’s GDP (Informal Sector ... , 1998). It is commonly believed that in the SME sector this share is higher, due to both stronger incentives and broader opportunities for small firms to carry their operations in the shadow economy. According to surveys reported in (Small Business ... , 1998), 30-45% of SME operations are not reported on the books (“gray” transactions). Over one-third of those surveyed believe that more than 50% of sales remain unaccounted for. One should keep in mind that these estimates don’t include small businesses that remain unregistered. Recent estimates put the share of small firms operating in the shadow economy at 90% of the SME sector.<sup>18</sup>

Small firms enter the shadow economy in part as a response to competitive pressure. When a majority of businesses evade taxes, those which are in full compliance inevitably lose to competitors and would be forced either to quit or to follow suit (Sinelnikov et al., 1998). This leads to a spontaneous expansion of the shadow economy, once it has reached a “critical mass”. On the other hand, there are natural limits to the growth of the shadow part of the SME sector (see e.g. Johnson et al., 1998). Shadow operations are restricted by the rising risk of criminal prosecution and by escalating costs of servicing such operations. “Shadow” firms face growing danger from the criminal underworld, and are unable to build a reputation with partners, customers and creditors from the official part of the economy (Small Business ... , 1998).

## **5. Small business and government**

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<sup>18</sup> Interview with Ivan Grachev, leader of movement ‘Development of Entrepreneurship’ (*Kommersant*, March 16, 1999).

Support to small businesses was a declared priority of the Russian government from the beginning of the country's economic transition. Soon afterwards, in the course of decentralization of the Russian state, subnational governments entered the field of regulation of small businesses and assumed a share of responsibility for the SME sectors in Russian regions.

Various government policies, means of control and regulation were deployed to deal with small firms. As a result, at present the Russian SME sector is regulated by a growing and increasingly confusing panoply of federal laws, decrees and regulations, and scores of subnational legal and regulatory acts.

5.1. Federal policies. In the period from 1995 through 1997 alone, over 300 laws and regulations with explicit provisions for SMEs have been issued by the federal government (Small Business ... , 1998). The cornerstone of federal legislation on SMEs is the law "On State Support of Small Entrepreneurship in the Russian Federation" passed in June 1995. The law makes SMEs eligible for preferential tax treatment (including faster amortization of fixed capital). It also authorizes the establishment of various SME support institutions, most notably those that would facilitate access of SMEs to bank loans at below-market rates. The law, however, is short on implementation of the above provisions, and does not specify terms and conditions for public support to SMEs and commitments and obligations of the federal government.

It was expected that subsequent laws and regulations would stipulate the necessary details. Two such laws mentioned earlier in the report – "On Simplified System of Taxation, Accounting and Reporting for Small Enterprises" passed in December 1995, and "On Unified Imputed Income Tax for Certain Activities" enacted three years later, have established fiscal regimes for small firms. These laws, as it was shown, have failed to ease the tax burden upon small businesses, and the second law may have made matters worse.

Government involvement in the SME sector goes beyond laws and regulatory acts. The federal and regional governments have established special agencies in charge of SME development. The center of this administrative hierarchy in 1995-1998 was the State Committee on Support and Development of Small Entrepreneurship, which was eliminated as a separate government agency in the government reshuffle after the 1998 crisis, and absorbed by the federal Ministry on Anti-Monopoly Policies and Support of Entrepreneurship. Other public institutions and facilities include the federal Fund of Support of Small Entrepreneurship, regional SME funds, agencies and centers. Activities of these bodies are supposed to be organized within officially enacted federal and regional programs in support of small entrepreneurship. Such programs should provide for creation of infrastructure necessary for SME development, and offer direct support to small firms.

The impact on SMEs of this ramified bureaucracy has proven to be negligible, not in the least because in reality development of SMEs has never been government's top priority, and even limited resources allocated for SME support were rarely disbursed, falling prey of expenditure cuts. In 1998, total federal expenditures from various sources in support of small businesses

were planned at 200 million rubles, or approximately \$30 million; one half of this amount was earmarked for the aforementioned federal SME support program. In reality, no funding for this program was ever provided, and various support activities have proven to be stillborn as well (Smirnov, 1999).

The very practice of government-run programs addressing particular economic problems is a bureaucratic tradition rooted in the Soviet past. Characteristic features of such programs are their declarative nature, unrealistic and/or vaguely formulated goals, insufficiency of resources and lack of practical implementation procedures<sup>19</sup>. As a result, such programs – those on SME development being no exception – lack credibility, and are broadly viewed as lip service and a means to serve interests of involved government agencies, rather than to bring about proclaimed ends (Afanasieva et al., 1998). In the opinion of the Russian Chamber of Commerce, “...numerous broad statements of the Government of the Russian Federation on the need to support small businesses remain mere declarations. Bodies of state power ... often become impediments to development of small businesses” (Economics in Modern Russia, Special Issue No. 2, 1999).

5.2. Regional policies. In developed market economies much of economic regulations are carried out by subnational governments, which compete for mobile economic resources by offering better conditions for entrepreneurship and investments. In particular, subnational governments are expected to have particularly strong incentives to support small businesses as potent sources of jobs and tax revenues for local budgets. It was hoped in Russia that regional governments (at least those of liberal leaning), would be more favorably disposed to small firms, and that pro-business regional policies, once they become a proven success, will be emulated by other localities.

Russian regions matched the federal government’s SME-related activities by their own efforts, which were often replicas of federal laws, regulations and programs<sup>20</sup>. Thus, the city of Moscow in 1995-1997 issued some 200 official documents on SMEs (Small Business ... , 1998), and other subnational units of Russia followed suit. By 1998, 33 of 89 Russian regions had their own laws on SME, 42 passed laws or regulations offering SMEs tax breaks, 37 regions enacted

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<sup>19</sup> The objective of the current Federal Program of State Support of Small Entrepreneurship in Russia for years 2000-2001 is “to provide favorable conditions for development of small businesses based on improved quality and efficiency of state support measures at the federal level”. To accomplish this objective, the program deems necessary “to draft proposals on amendments of tax law, ... , to develop recommendations for organizations which have the right to offer loan guarantees, , ... , to form a management system that would ensure coordinated functioning of all components of credit guarantees system, ... , to form a flexible system of state support to small businesses, ... , to organize a propaganda and educational campaign to stimulate the activities of the sector of small entrepreneurship”, etc. (*Kommersant*, March 16, 2000).

<sup>20</sup> For example, in the Novosibirsk region the regional government has established agencies and initiated programs which closely parallel those at the federal level, and did so primarily by way of emulation (Barkhatova, 2000). This is an evidence that Russian SMEs are denied the regulatory benefits of the decentralized government, where subnational jurisdictions are supposed to be particularly active in offering favorable conditions for small businesses.

local SME support programs, 74 launched SME support funds, and over 70 established small business departments within regional governments (SME in Regions ..., 1998; Smirnov, 1999).

Some regional governments were more consistent than their federal counterparts in supporting small businesses, and local laws and programs have indeed had a tangible impact on SME development. Nonetheless, regional and local authorities are often failing to stimulate and support development of small businesses in their jurisdictions. Instead, small businesses bear the brunt of predatory regional bureaucracy (Frye, Shleifer, 1997, Radaev, 1998). According to (*Small Business ...*, 1998), managers of small firms view the federal government as neutral and indifferent, but invariably complain about regional officials' excessive red tape and extortion. Instead of producing better policies, the proximity of subnational governments to the grassroots often intensifies bureaucratic abuse.

Commonly regional governments may not fully appreciate the potential of small businesses for recovery and growth of local economies. Local officials lack the experience and know-how required to create conditions conducive for SME development. Best regional practices are not sufficiently disseminated throughout the country, which allows regional government officials to cite numerous general obstacles to SME development as an excuse for poor results, thus hiding a lack of their own efforts (Afanasieva et al., 1998). Mechanisms for competitive selection of business-friendly policies are suppressed in Russia, and as a result liberal regional regimes remain isolated and sometimes short-lived phenomena (Polishchuk, 1999).

Overall, SMEs most commonly view the government as a predator, not protector, as a source of obstacles and hindrances (Aslund, 1997). As it was mentioned earlier in the report, the "government racket" is one of the gravest concerns of Russian small firms, second only to excessive taxation.

5.3. Political economy of the SME sector. Explanations of failures of the federal and regional governments in Russia to provide better conditions for small businesses invoke poor human capital of politicians, deficiencies of the system of intergovernmental fiscal relations and other causes (Shleifer, 1997). Another factor is the malfunctioning of the Russian political system which was, at least until recently, controlled by narrowly based vested interests centered around large companies and financial institutions. The latter were able to build symbiotic relationships with the government, and successfully opposed the establishment of impartially enforced rules of economic conduct applicable to all market agents, regardless of their size. Small firms, natural agents for the rule-based competitive market economy, are unable to resolve the collective actions problem (Olson, 1965). They remain dispersed, economically and politically insignificant and thus are failing to make their voice heard.

As a result, "soft" institutional regimes obtain, offering preferential treatment to large and consolidated economic interests at the expense of those which are small and dispersed (Olson; 1982; see also Polishchuk, Savvateev, 1997). Such outcomes bear features of "institutional

traps” – as long as small businesses remain in the shadow of large firms, the political incentives neglecting the needs of SMEs are reproduced, and development of this sector remains retarded.

The financial and economic crisis of August 1998 has had a strong impact on the configuration of political forces in Russia, and on incentives of Russian firms. At present SMEs have better chances to influence economic policy making in Russia and to spearhead development of a competitive market economy in the country. Several factors have contributed to this realignment. The crisis has dramatically weakened the largest financial-industrial groups, known as “oligarchs”, which previously had a strong influence over government’s economic policies, and extracted massive political rent at the expense of smaller firms and consumers. Besides, despite of the windfall of high oil prices, the government is burdened by a debilitating debt and cannot any longer afford explicit and implicit subsidies earlier available to politically influential biggest companies and banks.

Taking advantage of these trends, Russian small businesses are increasingly seeking a dialog with the government in order to correct the existing deficiencies of the institutional environment. Small firms see a radical solution in excluding the government from direct control and allocation of economic inputs and financial resources in the private sector. SMEs want a government that would be “enacting and enforcing rules of the game, with no redistribution of resources to non-competitive firms” (Gurova et al., 1999; see also Kostin, 2000). Businesses protest against a “cheap state” with a multitude of poorly paid public officials, which is a fertile ground for corruption.

It is also noteworthy that small firms have come to appreciate a good institutional environment for their operations just as much as tax relief. When asked what actions of the government they need most, SMEs put “reliable legal guarantees for small business development” second only to “provision of tax benefits”, which still tops their wish list (Small Business ... , 1998). Moreover, there are evidences that SMEs are prepared to comply with the tax law, for as long as taxes are reasonable and tax receipts are used for public benefits (Gurova et al., 1999; *Kommersant*, March 16, 2000; Barkhatova, 2000).

These are evidences that the Russian small business community has become a source of strong demand for *public* goods and factors of production, as opposed to exclusive privileges often sought by large firms. It remains to be seen whether this demand will be sufficiently strong to produce policy measures that would radically improve the institutional environment for Russian SMEs.

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