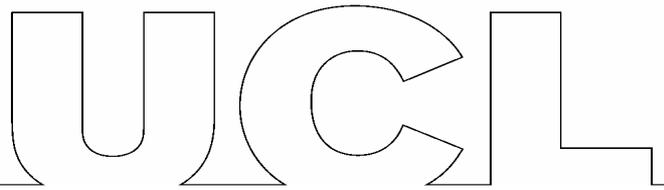


CENTRE FOR THE STUDY OF ECONOMIC AND
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UCL SSEES
Centre for the Study of Economic and Social Change in Europe

**ENTREPRENEURSHIP
IN
RUSSIA**

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Economics Working Paper No. 88

April 2008

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Entrepreneurship in Russia

Ruta Aidis, Julia Korosteleva, Tomasz Mickiewicz

Abstract

This paper presents an account of the environment faced by entrepreneurs in Russia. In section one we give a brief introduction to the country which is followed by the overview of a public policy on small and medium enterprises in the next section. The current state of SMEs and some particularities of the entrepreneurial environment are discussed in section three, whereas section four focuses on the prospects of internationalisation of Russian SMEs. In section five we draw some conclusions.

Keywords: Russia, SMEs, Entrepreneurship, Entrepreneurship barriers, Government policy

JEL classification: P36, P48, M13

1. Introduction to Russia

Russia is the world's largest country, a nuclear superpower with unsurpassed energy resources. It also is a country which finds itself at the crossroads of possible development paths. Market oriented mechanisms have been introduced but Soviet era laws remain on the books. Corruption has become a way of life and freedom of the press has been gradually eliminated in early 2000s. Within this backdrop, private entrepreneurship has emerged, albeit in a distorted way. To understand Russia's current situation, one needs to understand the dramatic developments that have characterised its recent history.

As the heart of the Soviet empire, Russia had tremendous control of enormous amounts of natural resources and human capital. Yet, twenty years ago, in the late

1980s, it was a country where entrepreneurship was marginal¹, the economy was stagnant and the ruling communist hierarchy had no clear formula for solving the deepening crisis. Unfortunately the reforms characterising Russia's attempts at rebuilding statehood after the collapse of the Soviet Union in the 1990s, first under M. Gorbachev and then Boris Y'eltsin were inconsistent and did not foster macroeconomic stabilisation.

However, under the leadership of V. Putin (since 2000), macroeconomic stabilisation as well as institutional stability has been achieved. In addition, unprecedented increase in the price and demand for oil and gas resources has resulted in a rapid growth of Russia's GDP. Russia now has a large private sector, though not without its limitations. At first glance, 'de jure' regulations often seem reasonable, yet it is the selective and arbitrary manner by which they are enforced that results in a lack of consistency or stability for firms (Aidis and Adachi 2007; Aidis *et al.*, 2008). In addition, the inadequacies of the Soviet system resulted in Russians becoming accustomed to a corrupt and malfunctioning legal environment (Gel'man 2004). Unfortunately, this negative legacy continues to characterise the business environment today. As a result, large, politically connected enterprises dominate Russia's business landscape. Moreover, the lack of universal property rights is reflected by the uneven distribution of income, and Russia is plagued by some of the most extreme social differences and pockets of dire poverty (Glaeser *et al.* 2003; Gerry and Nivorozhkin, 2008; Buccellato and Mickiewicz, 2008).

2. Government Policy on SMEs and Entrepreneurship

Similar to most other economies emerging from the Soviet system, the creation of the private sector and the development of entrepreneurship was a new phenomenon

for the Russian population. The first resolution of the Council of Ministers on ‘Primary measures on development and state support of small entrepreneurship in Russia’ was issued in 1993 and was followed by the Federal Law in 1995 which approved state support for small enterprises via regional, sectoral and municipal programmes of development. There have also been numerous presidential decrees, governmental resolutions and programmes all aimed at creating better legal conditions for small entrepreneurship. However, in practice, the vast majority failed to be implemented. A study evaluating the effectiveness of the 1995 Federal Law on SME support indicated that nearly 80 per cent of this law was never implemented, due both to the lack of its practical applicability as well as the absence of implementation mechanisms (OECD 2000, p.50).

In a study of barriers to Russian SMEs, Radaev (2003) identified uncertainty of the federal SME policy, the lack of policy coordination at both the federal and regional levels, the lack of special-purpose funding and conservatism in financial support policy² among the main reasons for the breakdown in Russian SME policy in the late 1990s. In addition, the 1998 financial crisis had a significant negative impact on both SME support and development. Instead of assisting SMEs, in the aftermath of the crisis the state largely curtailed its support programmes.

Interestingly, until recently, small enterprises³ were the only legally qualified private entity explicitly defined in Russian legislation. The definition for medium-sized enterprise was missing. This situation changed in 2007 with the Federal Law ‘On Development of Small and Medium Entrepreneurship’, which for the first time provided a clear definition of different types of SMEs including micro- (less than 15 employees), small (between 16 and 100 employees) and medium-sized (between 101 and 250 employees) enterprises. This law also sets two other criteria for SMEs: 1) the

independence criterion – i.e. the total percentage of shares owned by the state, local government, large companies, foreign individuals and companies should not exceed 25 per cent; and 2) an upper limit for annual turnover - which should not exceed a limit set by the federal authorities for each SME category once in five years.⁴ The law further differentiates between the following categories of SMEs: legal entities, individual entrepreneurs⁵ and farmers.

The 2007 law on SME development envisaged the following primary support policy measures: special taxation regimes, simplified accounting, financial support, business infrastructure development, including the creation of business incubators and provision of counselling services, transfer of state and regional property to start-ups at favoured conditions, and allocation of state orders to SMEs. This is truly an admirable list of support that the government has identified yet it is too early to declare if this new initiative will be successfully implemented and have a more substantial impact on SMEs as compared with the previous efforts.

2.1 Tax policy

According to the World Bank's 2008 Doing Business tax survey, Russia is ranked 130 out of the 178 participating countries in terms of the quality of its tax regime. The total tax rate as a proportion of profit that normally a medium-sized business would pay has been steady at the level of 51.4 per cent over 2006-2008. Following the 2001 tax reform a profit tax rate was reduced from 35 to 24 per cent, but at the same time all sorts of tax privileges were abolished (Radaev 2003, p. 120).

A large number of SMEs pay taxes in accordance to special tax regimes, namely a simplified tax system (UNS), introduced in 1995, and a single tax on businesses' imputed income (ENVD), introduced in 1998⁶. Whereas entrepreneurs have discretion

over the adoption of a simplified tax system, a single tax (ENVD) is compulsory for a number of business activities subject to regional law.⁷ Which in practice results in the discretion of regional authorities as to which tax regime an SME is able to adopt.

Many entrepreneurs find the ENVD system to be inefficient since it is based not on actual income but on imputed income⁸. (Zlobin *et al.* 2005). However, in light of the mandatory nature of the ENVD, businesses do not have the freedom to transfer to a simplified or standard tax system. Prior to 2003, regional authorities set a base yield for various types of business activities, subject to an ENVD. Consequentially, this gave them significant power over the calculation of the ENVD providing ample opportunities for corrupt behaviour to flourish.

Furthermore, following the tax code amendments in January 2002, social tax was excluded from the single tax, significantly increasing the overall tax burden on small firms. This caused many small firms to partly move to the shadow economy leading to an overall drop in tax collection. As a result, regional authorities raised the base yield in the vain hope to compensate for the losses, which only increased the incentives for businesses to retreat further into the shadows to avoid the growing tax burden.

A new tax policy, which was introduced on 1 January 2003 and revised in 2006, aimed at addressing some of the aforementioned deficiencies, in particular freeing small businesses from the social tax, simplifying accounting, and centralising the setting of a base yield used in calculation of the imputed income. Thus, the regional authorities were no longer allowed to set a base yield. However, in spite of this improvement, municipal authorities have gained some discretionary power to regulate a coefficient which is used to correct a base yield, taking into consideration some particularities of businesses such as the range of goods sold, seasonality of operations and location⁹. The

declared objective was to create opportunities to reduce the tax burden for businesses facing the least favourable conditions. However, in reality, this approach has allowed municipal authorities to pursue a differential policy towards SMEs favouring well-connected business owners.

According to OPORA's 2006 survey data¹⁰, 61 per cent of the interviewed entrepreneurs paid a single tax on imputed income. Half of these respondents believed that the overall tax burden had increased since the municipalities have obtained some discretionary power over the ENVD. A similar percentage of entrepreneurs stated that if given the option, they would transfer to a simplified tax system.¹¹

2.2 State financial support

Though state financial support for SMEs exists, the 2003 OPORA survey of Russian SMEs found that 42 percent indicated that one of the main obstacles preventing businesses from accessing state finance was lack of information about these programmes.

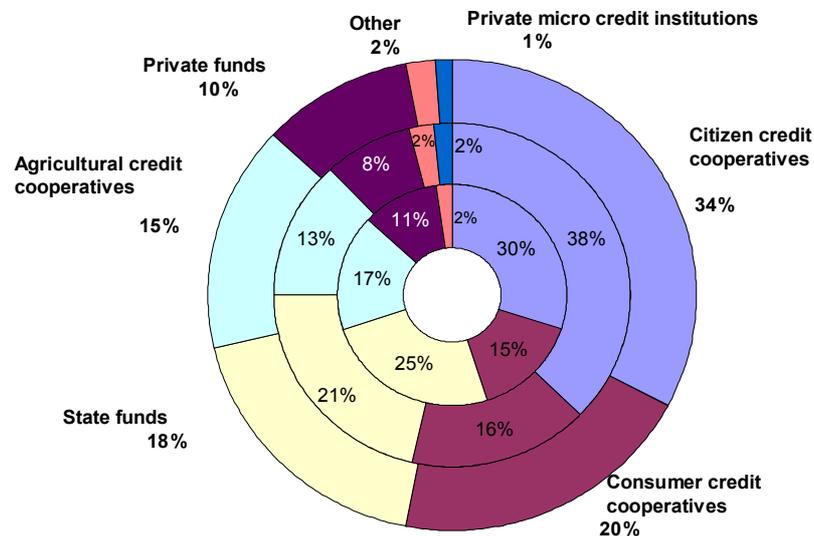
The 2007 Federal Law set provisions for financial support of SMEs primarily in the form of state subsidies and state and municipal guarantee schemes. The federal budget funds are provided to Russian regions through various tender schemes announced by the Ministry of Economic Development and Trade. Unlike its predecessor - the 1995 Law on SME state support - the new Law does not contain the provision for subsidised loans to SMEs.

Currently based on the 2005 Resolution¹², state subsidies are largely allocated to support export-oriented SMEs, in particular to subsidise up to 50 per cent of their interest fees on loans issued to finance the production of goods and services for export¹³; to subsidise up to 50 per cent of costs related to certification of exported

goods; to subsidise up to two thirds of costs related to participation of SMEs in international fairs and so on.

Apart from case-by-case financial support, the new state policy sets provisions for developing infrastructure for SME financial support, namely providing guarantee schemes and creating investment funds which attract venture capital to finance SMEs, and, finally, facilitating micro credit financing. The state participates in micro credit schemes through providing subsidies to regional and municipal funds, and subsidising micro credit institutions such as consumer and agricultural credit cooperatives. However, as Figure 1 shows, alongside the dynamic development of the financial sector in Russia, the direct provision of funds by the government has shrunk over recent years, which paradoxically, is probably a good sign: given the largely unchecked discretionary power of officials coupled with corruption, state intervention is more likely to distort the competitive environment than provide real assistance to entrepreneurs that display a genuine potential for business success.

Figure 1: The Typology of Micro Credit Organisations by their Market Share, 2003-2005



Source: RCSME (2007), p.14.

Key: The inner circle – 2003; the middle circle – 2004; the outer circle – 2005.

Overall, the state policy towards SMEs can be regarded as largely declarative in nature, inefficient, lacking coordination and poorly implemented at best. Where implemented, these policies tend to be used to favour the businesses that have close ties to government officials to the detriment of businesses that do not. In addition, the legacy of corruption and favouritism inherited from the Soviet period results in many Russians simply accepting the lack of ‘level playing field’ for business development as the norm¹⁴.

Table 1: Russian Entrepreneurs’ Awareness of State Support Programmes

SME Programmes	I am aware of these programmes and I believe that many can benefit from	I am aware of these programmes, but I believe they will not work and there is no	I am not aware of these programmes, %

	them, %	benefit from them	
Creation of business incubators	10	11	79
Micro credit schemes	17	14	69
Subsidising of loan interest fee	16	14	70
Partial guarantee schemes	18	13	69
Export support	12	10	78
Creation of venture capital funds	6	8	86

Source: OPORA 2006.

Note: In response to the question: ‘Are you aware of SME state support programmes which the Ministry of Economic Development and Trade has realised in the regions, and if so, how you evaluate their effectiveness?’

3. The Environment for Entrepreneurship and the State of SMEs

Similarly to many other transition economies, small private enterprises mushroomed in Russia at the beginning of 1990s. This development was a result of both the response to the availability of tremendous market opportunities as well as the lack of governmental regulations. This growth stagnated in the second half of the 1990s due to increasing economic entry barriers, as the initial division of markets was finalised (Radaev 2003).

Indeed, Broadman (2002) identifies an unprecedented degree of concentration of industrial output in Russia. He suggests that at the oblast level this figure could be well over 95 per cent while in comparison, the average national 4-firm concentration ratio is approximately 60 per cent. This dominance of large vertically integrated enterprises poses a real threat to the further growth and development of Russian SMEs not only on a purely competitive sense, but perhaps even more importantly, through the preferential treatment (both legal and illegal) given to large enterprises by local authorities. Indeed, according to the 2006 OPORA study the preferential treatment (both legal and illegal)

given to large enterprises by local authorities is of a greater concern to entrepreneurs than unscrupulous competition on the part of large businesses¹⁵.

A decrease in the number of SMEs in 2004 (see Table 2) can also be partly attributed to the fact that many individual entrepreneurs failed to re-register their businesses that year¹⁶. The contribution of Russian SMEs' to the total annual turnover is moderately high and it is likely to be underestimated, given that there is a large proportion of small enterprises and individual entrepreneurs who operate in the shadow economy¹⁷.

Table 2: Small and Medium-sized Enterprises in Russia, 2002-2005

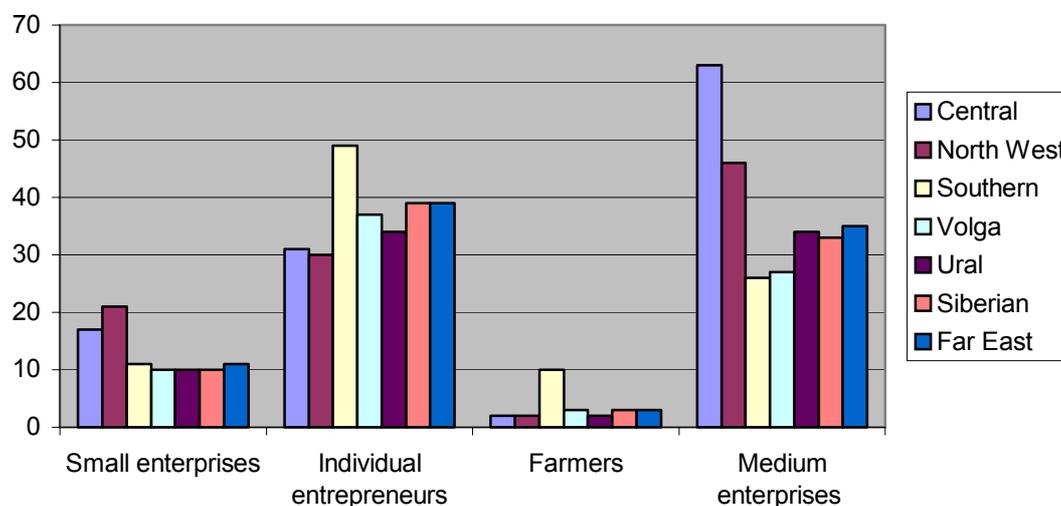
SME indicators	2002	2003	2004	2005
Number of SMEs, (000s)	8,000	8,441	6,212	6,891
Share of SMEs as a % of total number of enterprises,	93	94	92	92
Market share, as a % of total annual turnover	39	47	51	46

Source: RCSME (2006).

Note: SMEs are defined according to the standard EU employment size criterion

However, it is important to note that SMEs are not evenly distributed across Russia. In general, they are largely concentrated in the Central and North Western districts, whereas individual entrepreneurs and farmers prevail in the Southern district (see Figure 2).

Figure 2: Density of different types of SMEs per thousand of economically active population, by Federal Districts, 2005 (in physical units)



Source: RCSME (2006)

Note: SMEs are defined according to the standard EU employment size criterion

The uneven distribution for regions ranges from a mere 50 in the Republic of Ingushetiya to 186 in Moscow city, when measured per thousand of economically active population (RCSME 2006).

3.1. Entrepreneurial Environment

In March 2005 OPORA together with VTsIOM, Russia's public opinion research centre, conducted a survey to study the conditions and factors affecting the development of small entrepreneurship across the different regions in Russia (summarised in Table 3).

On the basis of the results of the survey, OPORA's experts constructed an aggregate index for each of the key indicator variables, characterising the entrepreneurial climate, which allowed assessment of regions' positions in relation to

one another. A ranking greater than 100 suggests that the situation is rather favourable, whereas a ranking below 100 suggests the opposite¹⁸.

Table 3: Evaluation of the Entrepreneurial Climate in Russia

Aspect of entrepreneurial climate	Brief description	Average value of the index for all regions	Number of regions with an index over 100
Financial situation	An entrepreneur's self-assessment of financial situation of his/her business	124.5	71
Transaction costs	Assessment of the costs related to dealing with authorities, including business regulation and corruption-related expenses	114.3	68
Support for small entrepreneurs by regional & local authorities	Assessment of the treatment of small entrepreneurs by regional and local authorities, including state SME support policies	113.2	57
Business motivation	Assessment of the conditions of business for SME and outlook, including business objectives, financial results, economic situation in the region	93.5	27
Level of security	Assessment of the risk level of interaction with the authorities and criminal milieu	68.7	7
State of competitive environment	Market entry barriers	75.8	3
Access to property resources	Assessment of the accessibility of production space	55.3	3
Legal conditions	Adequacy of availability of legal (judicial) protection	47.6	0

Source: OPORA Russia 2006

As table 3 shows, the majority of Russia's regions scored favourably (above 100) for the three top listed indicators, namely financial situation, transactions costs and state support to small entrepreneurs, which seems to indicate that these three issues are not the main hindrances facing small entrepreneurs (OPORA 2006).

Specifically, with regards to the financial situation, more than half of the respondents characterised it as ‘relatively favourable’ and ‘stable’ in terms of the adequacy of financial resources to sustain business, but it is important to note, not enough to grow a business¹⁹ (ibid.). This finding suggests that Russian entrepreneurs have learned to adapt and function within the existing ‘restrictive’ conditions relying on personal savings. About 54 per cent of the respondents agreed that it was impossible to secure a banking loan. Most of these entrepreneurs still largely pursue a survival-oriented strategy which hampers further business development and growth. In addition, widespread corruption may prevent businesses from growing above a threshold level, as a means to avoid expropriation by officials, especially tax administrators (Barkhatova, 2000) and also to avoid engaging in ‘illegal’ practices (Aidis and Adachi, 2007). Sadly, many local authorities continue to use their power to extract funds from entrepreneurs treating them as a source of ‘informal’ income rather than viewing them as important sources of regional development, creating local employment, fostering well-being and aiding in the eradication of poverty.

In general, the poor quality of legislation, its weak enforcement, and lack of trust in courts are among the primary characteristics of inadequate legal conditions for entrepreneurial development (see also Aidis *et al.* 2008). In Russia, the OPORA survey data suggests the entrepreneurs search for other methods of protecting their interests and rights rather than appealing to courts. When asked what their chances of winning their case in the court against administrative or municipal authorities, only a meagre 7 per cent of the respondents were confident about a positive outcome.

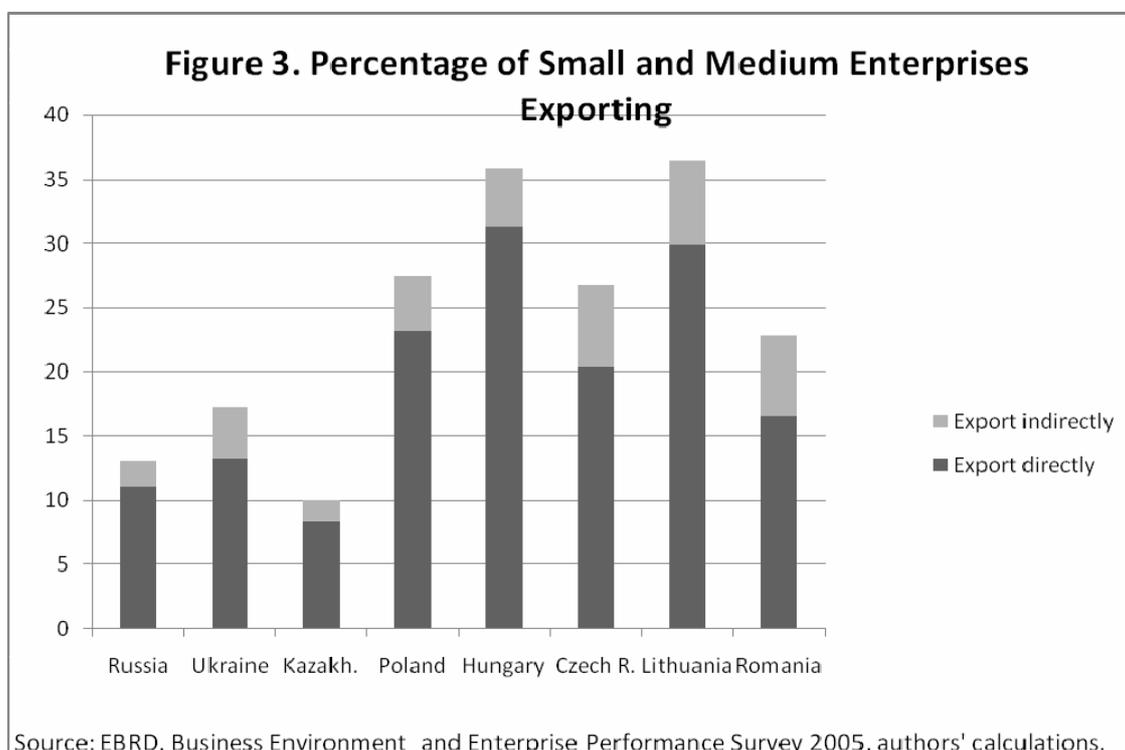
4. Internationalisation of entrepreneurs and SMEs: Drivers and Roadblocks

Only 13.1 percent of Russian SMEs are exporting, either directly or indirectly, according to the European Bank for Reconstruction and Development's (EBRD) Business Environment and Enterprise Performance Survey (BEEPS) in 2005. This percentage is far below that of other transition countries in Central Europe though it falls within a similar range with other Western CIS countries (see Figure 3).

This outcome may be partially explained by the negative impact of the appreciation of the rouble driven by revenue from oil and gas exports (i.e. a form of the Dutch Disease). But a much greater portion of this situation is attributed to the weak institutional environment in Russia. Direct bureaucratic barriers on exporting are one of the two most serious barriers identified characterizing Russia's business environment (alongside licensing requirements) as found in the World Bank's 'Doing Business' (2008) survey. On this dimension Russia ranks a dismal 155 out of 178 countries. In particular, this low ranking is attributed to the high cost of exporting which measures the fees associated with completing the procedures to export goods, including administrative fees for customs clearance and technical control, terminal handling charges and inland transport²⁰.

Tovstiga *et al.* (2004) identify the internal institutional weakness of the Russian business environment as the key factor constraining Russian entrepreneurs from internationalising their operations. The authors also present two additional factors that limit Russian entrepreneurs from entering international markets: insufficient competences and differences in culture and business practices. Technologically advanced sectors could play an important role in exports, yet, Russia's base of active researchers has diminished significantly as throughout the 1990's scientists have left in

search of higher wages and better working conditions. In addition, even those researchers who stayed and attempted to set up their own business often lacked the basic business skills needed to develop a successful business. In general, the inheritance of Soviet legacies ranging from the isolation of the Soviet economy from market mechanisms, to the development of negative cultural practices such as a general acceptance of a weak rule of law and corruption did not equip Russian entrepreneurs with adequate skills and understanding of how to succeed in the international business environment.



5. Conclusion

Overall, despite numerous policy announcements oriented towards entrepreneurial development, entrepreneurs in Russia face a hostile business environment characterised by the weak rule of law and widespread corruption. As formal structures in Russia fail, they are complemented by informal networks, which

form 'intangible assets' for certain well-connected entrepreneurs that allow them to overcome environmental barriers (Aidis *et al.* 2008). However, though some businesses learn to cope, the lack of a level playing field for businesses in general seriously distorts the development of a thriving business environment. The crucial issue is not the existence and number of small businesses, but rather the fact that most of them have either no incentive to grow or are severely restricted in doing so given that if they are successful they face a serious risk of expropriation or forced takeover by those better connected to the intertwined economic and political structures of power.

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¹ Private enterprise was severely restricted under the Soviet system.

² There has prevailed direct case-by-case SME financial support in Russia. Though acknowledging the importance to move away from direct assistance to an indirect SME support through creating a favourable business environment, Russian authorities have been largely reluctant to do this, as this would limit their command over distribution of designated financial resources and therefore reduce their authority (Radaev 2003).

³ Small enterprises were defined on basis of employment size criteria set for different branches of the economy (see Russian Federal Law 'On state support of small enterprises in the Russian Federation', No. 88-FZ, 14 June 1995).

⁴ Given the fact, that the distinction between different categories of SMEs has only been made very recently, this criterion will not be used for a while, as there are no statistical data available yet.

⁵ Equivalent of self-employed in the UK.

⁶ The adoption of either a simplified tax system or a single tax is subject to meeting certain criteria set in the Russian Federation's Tax Code. Currently, for a firm to be eligible for the simplified tax system (UNS), its total revenue (including extraordinary income) should not exceed RUR 15 mln. In the case of a single tax (ENVD), firms should operate in the territory where an ENVD tax is in place and firms' activities fall within the list of business activities, subject to a ENVD, as specified in the Tax Code, Chapter 26.3. For example, only retail traders with trading space for each trading unit not exceeding 150 sq. meters will be subject to an ENVD. In essence, both the UNS and ENVD regimes introduce a single tax that replaces a number of taxes, including an income tax, VAT, assessed tax and single social tax (excluding mandatory pension fund contributions). In the case of the UNS, it allows entrepreneurs to choose a tax base whether it is a total revenue or net profit. Currently, the tax rates are respectively set at 6 and 15 percent. Some particularities of calculating an ENVD are discussed further.

⁷ By 2002 the respective regional laws had been adopted by the overwhelming majority of the regions of the Russian Federation.

⁸ Imputed income is the base yield - a conditional monthly income set for certain types of business activities by the federal law -, multiplied by a physical indicator, characterising a certain type of entrepreneurial activity (e.g. number of employees in the case of veterinary services or parking area in sq. meters in the case of parking services).

⁹ The value of base yield needs to be multiplied by a corrective coefficient to allow for the differences in business conditions.

¹⁰ OPORA is Russia's NGO representing small and medium-sized enterprises.

¹¹ It is interesting to note that a corrective coefficient is currently set between 0.005 and 1 (The Tax Code of the Russian Federation), that by all means should only decrease the single tax, given that the value of base yield is multiplied by this coefficient. Prior to the 2003 tax reform, the coefficient could have both a 'decreasing' and 'increasing' power. However, we anticipate that local authorities may pursue differential policies for SMEs, so that enterprises, which are eligible for a similar treatment in terms of the corrective coefficient in theory, may pay different tax rates in reality. This may explain the respondents' answers.

¹² See the Resolution of the Council of Ministers No. 249 'On conditions and order of providing federal budget funds to support small entrepreneurship, including farming' (22 April 2005 with additions and amendments as of 23 February 2007).

¹³ An interest rate on rouble loans should not exceed half the refinancing rate set by the Central Bank; for loans issued in foreign currency, an interest rate should not exceed 6 per cent per annum.

¹⁴ Within the Soviet Union, entrepreneurs were considered ‘exploitative capitalists’ and ‘enemies of the state’. Even though the new economic system in Russia is based on private ownership and entrepreneurship, these negative entrepreneurship stereotypes continue to persist amongst the general population.

¹⁵ The responses were respectively 40 and 24 per cent (OPORA 2006).

¹⁶ As of 1 January 2005, only 2.7 out of 4.8 million entrepreneurs re-registered their businesses. Out of those who failed to re-register, 20 percent shut down or transformed into enterprises with legal entity; 60 percent were in essence ‘dead’ businesses and were taken off the register upon the completion of the re-registration; the rest 20 percent did not undertake their re-registration on time and were given extra time to re-register in 2005 that explained an increase in SMEs in that year.

¹⁷ This can be also explained by the way the data has been aggregated, allowing for inclusion of medium-sized enterprises, defined according to the EU criterion – under 250 employees - whereas according to Russia’s Ministry of Statistics SME’s employment size was limited by 100 employees until the adoption of the 2007 Law.

¹⁸ For more detail on the methodology used by OPORA’s experts and the results of the survey see OPORA (2006).

¹⁹ See also Aidis and Adachi (2007).

²⁰ Note that this measure excludes tariffs.

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