The Slow Development of Small Business in Russia

Of the many countries making the conversion from a communist state to a market-based economy, Russia's transition has been among the slowest to succeed and grow. "The economic transition in Russia has been characterized by the limited development of small business which has been particularly disappointing when compared with the leading transition countries, Poland, the Czech Republic and Hungary" (Kihlgren 193). The lack of development in this sector is important because small business is often a driving force behind overall economic recovery. In the United States, the importance of small businesses is not underestimated. <u>The Annual Report on Small Business and Competition</u> lists two "indispensable contributions" that small businesses make:

1) "They are an integral part of the renewal process that pervades and defines market economies. New and small firms play a crucial role in experimentation and innovation that leads to technological change and productivity growth" (Glover).

2) Small firms are the essential mechanism by which millions enter the economic and social mainstream of American society…. A great source of American strength has always been the dream of economic growth, equal opportunity, upward mobility"(Glover).

While the second reason may seem a bit hopeful, its general idea is true in every country. Many people throughout the world have made millions through starting their own enterprise. It may be obvious, but small businesses spawn larger ones. As the first reason above states, small business is essential to the development of new and better products that can increase productivity throughout an economy. Small business "generates a resilient productive environment in which entrepreneurs can afford to take risks in creating new products and new markets and in which continuous technological progress can be sustained at a minimum cost"(Lowrey 5). Small firms allow for more variations among products as well as specialization. With several firms competing in similar markets, each must create something that sets itself apart from the others. Some may only produce extremely high-end goods while others may make the same good at a fraction of the cost by lowering its quality. This kind of product diversity is beneficial not only because consumers have more to choose from, but also because it generates a more balanced economy. Those firms whose products are in high demand are those that eventually become large enterprises. The mere opportunity for this type of growth is what ensures that these smaller firms will continue to exist and continue to change.

The importance of small business goes beyond its contributions to improved technologies, product specialization, product diversity and increased personal wealth. In the United States small businesses "are the stabilizers of business cycle, the vehicle that brings disadvantaged groups into the American mainstream and the driving engine of the nation's economy" (Lowrey 3).

In most developed countries and even in the leading transition nations, small and medium sized enterprises not only employ a large portion of the workforce, but they also account for a sizable share of GDP. In Poland, for example, "By the late 1990's small and medium enterprises (SMEs) accounted for two-third[s] of GDP" (Kihlgren 194). In 1999, American small businesses accounted for more than 52% of GDP. But at the same time in Russia, small enterprises accounted for a meager 10 - 12% of GDP. Just as surprising is the difference in the percentage of workers employed by small businesses between the United States, Russia and fellow transition country, Hungary. In 1996 small firms in Hungary accounted for 64% of total employment, while by 1999 they accounted for only 12.8% of total employment in Russia (Kihlgren 194). In the same year American small businesses employed more than 98% of the total workforce. If small business has played an important role in the economic recovery of countries such as Hungary and Poland, and an important role in the success of the American economy, why has it not done the same in Russia?

Comparison of Small Business Performance in Russia, Leading Transition Countries and the United States:

Economic Factor	Leading Transition Country	United States	Russia
Percent of GDP (Late 1990s)	66% (Poland)	52% (1999)	10 – 12%
Percent of Total Employment	64% (Hungary 1996)	98.2% (1999)	12.8% (1999)

Source for US GDP data: Small Business Share of Economic Growth, Contract # SBA-HQ-00-C-0001. http://www.sbaonline.sba.gov/advo/research/rs211tot.pdf

Source for US employment data: Statistics of U.S. Business (1988 – 2001 U.S. and States, totals)

http://www.census.gov/csd/susb/Totals88-01.xls

The clear answer to this question is simply that Russia hasn't experienced the significant growth in the small business sector that Poland and Hungary have. There are several theories explaining the poor development of small business in Russia. According to Alessandro Kihlgren, one primary explanation involves the historical conditions that contributed to Russia's lack of an entrepreneurial culture (195-6).

Kihlgren's theory suggests that Russia's history has something to do with its lack of development in small business. Under this theory it is thought that 70 years of communist dictatorship has had an effect on Russian business behavior. In addition Kihlgren states, "Private entrepreneurship in Russia has a weak tradition, as even before the revolution the principal entrepreneur was the state"(196). Under a communist regime the average worker does not have to worry himself with how to run a business; those decisions are left to the state. It is understandable that a worker who has not had any real experience with business management and who has no real business knowledge to speak of would be unprepared to own and operate a small business. Although countries like Poland, Hungary and the Czech Republic were all under communist control similar to that of Russia's, they do have a history of private ownership prior to the communist regime. It is also important to note that these three countries were also allowed to engage in limited entrepreneurial activities while under communist rule. Perhaps this theory can explain why Russia has not experienced the same economic recovery that these leading transition countries have, although it would be very difficult to measure its effect.

Other possible explanations are less difficult to prove. Kihlgren describes several conditions specific to Russia that have had a negative impact on the growth of small business:

1) High levels of corruption;

2) Strong income inequality;

3) A business-unfriendly legislative framework and the general situation of instability caused by the lack of clear rules;

4) The scarcity of financing for small businesses;

5) The economic condition of large industrial enterprises;

6) Lack of social capital.

Corruption is a very real problem in Russia. Studies have placed Russia among the most corrupt nations in the world. Throughout the country, people driven by greed and little fear of the law regularly engage in illegal activities. From presidents of large corporations to government officials, there are few people with power who have not engaged in some sort of corrupt behavior. Unfortunately these behaviors have a negative effect on economic growth. “Several studies have shown that [corruption] reduces investment, both domestic and foreign, and, as a result, stifles the growth rate. High levels of corruption also have a detrimental effect on tax revenues”(Kihlgren 198).

While this situation may not make much of a difference for the large companies in Russia because they often benefit from these behaviors, it certainly hurts the development of small businesses that depend on this investment to grow. In addition to lost investment, “Small businessmen are also compelled to make ‘voluntary contributions’ to all manner of pet projects dear to the hearts of bureaucrats at all levels” (Khakamada 2). It is estimated that various types of corruption end up costing small businesses $3.3 billion per year (2). In order for Russia to put a stop to this corruption it is necessary first that there be a working law enforcement agency, and second that those convicted of engaging in corrupt behavior be punished appropriately. Until this occurs small businesses will continue to pay the price for others' criminal behavior.

The next issue of income inequality is something that has had an impact on all the transition countries; however, it has had the greatest impact in Russia. The Gini coefficient, which measures income inequality, had been recorded in Russia at "0.48 in 1995, one of the highest figures in the world." (Kihlgren 198) Although a Gini coefficient this high is undesirable, it is close to that of the United States for the same year. In 1995 the Gini coefficient for the US was 0.45, yet in Poland, one of the leading transition countries, this number "remained fairly stable in the 0.29 to 0.3 range through 1996"(Walt 20; Keane 5). This coefficient suggests that there are a small number of people in Russia who are very wealthy, and that a large gap exists between the very wealthy and the middle class as well as between the middle class and the poor. As a result, there are few members of the middle class with enough capital to finance starting their own businesses and the remainder of the population, the very poor, is unable to learn the necessary skills needed to run a business because they cannot afford an education.

In addition, as Kihlgren points out, the very wealthy are hurting matters more as "they have not been inclined to invest in the domestic economy, preferring to send their wealth abroad" (Kihlgren 198). This is clearly unhelpful to small businesses that desperately rely on investment to get started. It is absolutely necessary for the people with money in Russia to start putting it back into the domestic economy. If the rich continue to send their savings elsewhere the rest of the Russian people will continue to have a difficult time accumulating enough money to start and operate their own businesses.

The next issue is perhaps the largest contributor to the slow development of small business. In Russia it is government regulation that inhibits the growth of small business. Irina Khakamada notes in her article “Small Enterprises Not Smiling Yet” that “government red tape stifles small business more than anything else” (1). In Russia, the requirements and fees associated with starting a new business are completely overwhelming. In total, the Russian government takes nearly $4 billion from small businesses. “This figure represents income that could otherwise be plowed back into enterprises to expand production and raise wages, or which business owners could use for personal expenditures such as insurance and education” (2). Most of this money is acquired from companies through very high taxes. In Russia about 80% of a company’s profits are used to pay these taxes, which leaves very little for anything else (Kihlgren 199). Clearly this type of framework is not supportive of the smaller privately owned companies trying to get started and stay afloat in Russia.

Small business does not only suffer from extreme taxation in Russia, it suffers significantly from the numerous conflicting rules within the system that make it next to impossible for an entrepreneur to follow the law (Kihlgren 199). Add to this the fact that new rules are added regularly while old ones are taken away or redefined, and it becomes apparent just how difficult owning a business in Russia can be. While the Russian government claims that adjustments to the system are taking place that will lessen the difficulties associated with small business ownership, few results have actually been seen. Even today, “after almost a decade, legislation seems to serve the purpose of discouraging business, rather than providing a framework in which it can prosper" (Kihlgren 199).

In nearly all situations, it is absolutely necessary that a newly formed company receive some sort of financial assistance until such a point when it can survive on its own. In most western countries this comes in the form of loans from banks. This is yet another system in Russia that remains much the same as it did during the communist regime.

Unlike in the leading transitional countries, the banking sector in Russia has not grown in size. The existing "banks have been very cautious in financing small businesses, especially new start-ups which are considered too risky" (Kihlgren 201). This situation implies that those individuals who need the money most to start a business are unable to get it. Even when the banks are willing to give loans to entrepreneurs they are usually short term (frequently one year loans) and they charge extremely high interest (between 30% and 70%) (201). This arrangement doesn't really allow those who receive the loans to finance the starting of their businesses enough time to even make the money back. Even if the business were profitable during its first operating year, the ridiculously high interest rates place more of a burden on the entrepreneur to keep his business open. These factors certainly do not help a small firm grow into a medium or large sized firm. The entire banking system in Russia needs to be redesigned if it is to help support newly formed companies as they try to enter the market.

Another reason for the slow development of the small business sector has been the weak economic state of large industrial enterprises in Russia. These enterprises have experienced difficulties for several reasons. Perhaps the largest of these is the lack of management turnover. Unlike the Czech Republic, many large enterprises in Russia chose not to replace their existing management as they transitioned to become privately owned companies. Instead they kept the old management despite their lack of ability to manage their firms in a productive manner (Kihlgren 202). As a result many of these enterprises have struggled to survive in the new capitalist economy. Additionally these firms rarely received payment for the sale of their goods. Surprisingly, "in 1997 an enterprise received on average less than 20% of its sale revenues in cash, rather than in non-monetary forms of payment"(202). Clearly this lack of cash revenue contributes to the inability of these enterprises to operate normally. Without receiving payment for the sale of their goods these firms have been unable to purchase goods and services from other vendors. This has directly affected small businesses in Russia because it virtually eliminates a major sales outlet for them. With few buyers it is difficult for these smaller enterprises to prosper. In order to restore this sales outlet for small firms, it is necessary that large businesses in Russia hire properly qualified management as well as ensure that payments are received for the goods they deliver.

The final explanation that Kihlgren offers as to why the development of small business in Russia has been so slow is most likely a result of the all the previous reasons. It is apparent that there is little trust for the small business owner in Russia, not only by the banking industry, but also by the government itself. The Russian entrepreneur is essentially left to fend for himself. In fact "94% of entrepreneurs are not members of any association," meaning they receive no help from private organizations or from government institutions (Kihlgren 203). Kihlgren describes the Russian entrepreneur as having low social capital. "Social capital can be interpreted as the "existence of networks which link individuals or groups to information or credit or as a set of trusting social relationships which facilitate the development of productive activities" (203). These networks benefit the small business owner because they tend to lower the transaction costs associated with running a firm. The difficulty that these owners frequently experience when selling their goods demonstrates how having low social capital hurts them. In many cases they must waste time and money just making sure that they receive payment for these sales, which can greatly increase their transaction costs and reduce any profits they might make. Perhaps the area where this lack of social capital has the most negative effect is the banking industry. The Russian banks have little faith that these entrepreneurs will succeed and be able to repay their loans and thus, are extremely hesitant to make them. Without this form of investment, the small business sector may never be able to expand. While it is difficult to pinpoint all of the effects that low social capital has on entrepreneurs, "there is little doubt that the scarce development of supporting networks has played a part in holding back the growth of small business in Russia" (203). Building these networks takes time. Until the Russian people really embrace and believe in privatization, it is unlikely that they will develop.

All of these factors seem to paint a pretty bleak picture of private ownership in Russia. The system as it is today is still not designed to support the development of the small business sector. Instead, it seems to do the exact opposite by making it as difficult as possible for entrepreneurs to enter into the private sector. The system is full of regulations and barriers that the small business owner must overcome, yet it does not focus nearly enough attention on the real problems such as crime and corruption. Hundreds of millions of dollars that were in many cases acquired illegally leave the country and are deposited into foreign economies without ever being noticed by authorities. In response, it seems that the government sees small- and medium-sized businesses as a source of revenue to offset some of those loses. Instead of providing a framework that encourages growth in a market style economy, Russian authorities employ a system that is reminiscent of the communist setup, where privatization is undesirable.

This arrangement is quite different from the way small business is handled in the United States, where “the level of opportunity available to Americans to create and develop new businesses is indicative of a high degree of freedom and political democracy; the result is a high degree of economic efficiency”(Lowrey 5). Unlike the Russian government, the American government has found it to be productive and beneficial for the economy to assist small businesses. It is certainly in Russia’s best interest to adopt policies more similar to those of the American government if it wants to experience a more effective transition.

It will be difficult for small businesses to grow large enough to ever present a threat to the oligarchs and their huge industrial companies, but there is an entire section of the economy that has yet to be explored. The manufactured goods and services sectors remain relatively untouched. These are the sectors that the small and medium sized enterprises can dominate. In fact, these areas of the economy must develop as the large enterprises become more and more dependent on the goods and services that they provide. As large enterprises grow in Russia, they will begin to reach their limits of being completely self-sufficient. They must support the development of small business if they plan to increase their own productivity by concentrating solely on producing the raw materials while they purchase finished goods and services from the small business sector.

The speed with which Russia will experience significant economic growth in the small business sector is dependent upon how they chose to deal with these factors. Russia has seen countries like Poland and Hungary take steps in this direction, and they have seen these same countries experience significantly better economic recovery than the transition countries who adopted similar policies as Russia.

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