

ORGANISATION DE COOPÉRATION ET DE DÉVELOPPEMENT ÉCONOMIQUES



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

**FORUM FOR ENTREPRENEURSHIP AND
ENTERPRISE DEVELOPMENT (FEED)
FOR THE RUSSIAN FEDERATION**

**POLICY GUIDELINES
AND RECOMMENDATIONS**

PUBLISHER'S NOTE
The views expressed do not necessarily reflect
those of the OECD or UNIDO or of their respective Member countries.

FOREWORD

The OECD and Russia have a long standing partnership. It began in 1992 and has evolved over the years into a close co-operative relationship with the shared objective of building in Russia a fully-fledged market economy based on the rule of law and helping the country meet the conditions of accession to the OECD. As in other economies in transition, entrepreneurs and the small and medium sized enterprises they create have a key role in the process of transformation of the Russian economy by engaging a wide cross-section of society. Fostering a more encouraging environment for private enterprise is a core priority of the OECD programme of co-operation with Russia.



The OECD's Forum on Entrepreneurship and Enterprise Development (FEED) has several years of experience working with transition economies in creating conditions conducive to enterprise development. The Russian FEED programme builds on this rich experience and expertise.

This publication presents a set of policy guidelines and recommendations which the Russian FEED programme has agreed. These guidelines and recommendations are based on a process of dialogue between business development officials from OECD Member countries and the Russian Federation. This process involved active participation by experts from selected Russian regions, thereby allowing regional specifics to be addressed. It is intended that the policy guidelines and recommendations will be widely shared in Russia with national and regional administrations, legislatures, and the business community.

This publication is particularly timely as it coincides with the launching of a new phase in the transition process in Russia under the leadership of President Putin. I hope that it will serve as a stepping stone in further deepening our partnership with Russia in this critical area of policy reform.

Donald J. Johnston
Secretary-General
OECD

FOREWORD

The importance of small and medium enterprises in a modern economy can scarcely be exaggerated. In developed countries this sector forms the largest part of gross national product and exports and at the same time the sector is now seen as a key job creator. We consider promotion of SMEs as a basis for stable economic and political development.



In recent years, great efforts were focused on SME sector development in the Russian Federation. The general orientations of State policy in this sphere were reflected in the Federal Program of State Support for Small Enterprises in the Russian Federation in 2000-2001, which was approved by the Government of the Russian Federation and the State Duma at the beginning of 2000. As a federal executive body which conducts State policy in this sphere, the Russian Ministry of Anti-Monopoly Policy and Entrepreneurship introduced several bills and advanced proposals for the Government of the Russian Federation concerning amendments of the law and creation of institutional frameworks for SME promotion.

Nevertheless, the situation for small enterprises in the Russian Federation still remains problematical. The solution to these problems will be found in gradual work focused on: improving the legislation, ensuring access to finance, increasing effectiveness of regional programmes for SMEs, deregulation of the economy, elimination of administrative obstacles and anti-corruption measures.

In this context, we appreciate OECD assistance to the Russian Federation. For several years, the Russian Federation and OECD have been co-operating in the field of small business promotion. The urgent tasks are addressed mainly within the OECD Forum for Entrepreneurship and Enterprise Development (FEED) devoted especially to entrepreneurship promotion in regions.

The Policy Guidelines and Recommendations issued by the Forum for Entrepreneurship and Enterprise Development, provide the diagnoses of the problems for small enterprises and their special way of development. The document contains recommendations that will be very useful for State policy development in this area.

The Russian Ministry of Anti-Monopoly Policy and Entrepreneurship looks forward to further development of collaboration with the OECD and considers it an important contribution to Russia's intention to become a Member of the OECD.

Ilia A. Yuzjanov
Minister of Anti-Monopoly Policy and
Entrepreneurship of the
Russian Federation

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INTRODUCTION

The Policy Guidelines and Recommendations for Entrepreneurship Promotion in the Russian Federation has been developed by the Organisation for Economic Co-operation and Development (OECD) with the goal of providing the Federal and regional authorities of the Russian Federation as well as international organisations and bilateral development institutions with a policy framework for improving the conditions for the creation and operation of small and medium-sized business in the country.

The Policy Guidelines and Recommendations were brought together on the basis of research, analysis and discussions conducted within the framework of the OECD Forum for Entrepreneurship and Enterprise Development (FEED) for the Russian Federation. They draw on the direct experience of representatives of different government bodies, business associations and entrepreneurs of the Russian Federation and of OECD Member countries, which was shared during the meetings of the Working parties of the FEED in April and July 1999 and at the annual meeting of the Forum in December 1999 and the subsequent final drafting meeting in July 2000.

The current document is in full coherence with the OECD Policy Guidelines and Recommendations for Entrepreneurship and Enterprise Development in Transition Economies, prepared in co-operation with the United Nations Industrial Development Organisation (UNIDO) for the Transition Economies Forum on Entrepreneurship and Enterprise Development, in which delegates from the Russian Federation also took part. Both of these documents are mutually re-enforcing, forming a broad base for developing policies on entrepreneurship promotion.

The structure of the Policy Guidelines covers six main areas of small and medium-sized business development that have been discussed during the meetings of the Forum for Entrepreneurship and Enterprise Support for the Russian Federation – tax policy; institutional framework; rule of law and corruption; financial support measures; business advisory services; regional and local development

Objectives of the Policy Guidelines and Recommendations

Participants to the FEED meetings agreed on the fundamental importance of the development of small and medium-sized business in the Russian Federation in the overall context of market reform. At the same time, different opinions were expressed on how to assist the process of SME promotion and development. The FEED Policy Guidelines and Recommendations represent a consensus document, laying out the main priorities in the area of entrepreneurship promotion and suggesting ways of addressing key problems facing entrepreneurs in the Russian Federation. In this respect, the Policy Guidelines and Recommendations serve the purpose of:

- Identifying priorities and key issues related to small business development in the Russian Federation;

- Proposing measures, actions and instruments needed to meet identified SME development objectives and priorities;
- Engaging authorities at different levels in a policy debate on issues of entrepreneurship promotion;
- Creating a better understanding of the roles of Federal and regional authorities and providing the basis for future work in designing and evaluating enterprise development policies;
- Providing examples of good practices and reflecting the experience gained by transition and OECD Member countries in developing small business policies and programmes.

Key issues of concern

The meetings of the Working parties of the FEED for the Russian Federation have shown that during the relatively short years of transition to a market economy interesting and positive experience in the field of entrepreneurship development has been accumulated in the country. Nevertheless, much more needs to be done for the creation of an environment favorable to small and medium-sized business. Delegates agreed that fundamental to doing this successfully is the state cutting on the wide range of barriers it has been setting up deliberately, or just as an accidental side effect to other policy objectives, to private businesses. Targeted support policies can only make a difference if they are based on the state reducing unnecessary involvement and interventions in the sphere of businesses. This is a general principle of the guidelines and needs to be taken into account all over the different recommendations so to avoid that targeted support policies end up in becoming an additional and costly bureaucratic layer for business.

One of the main pre-conditions for sound private sector development in the Russian Federation is an **appropriate and effective institutionalisation of SME policy**. Key roles for the state in this regard are to develop a strategy for removing the obstacles to enterprise creation at the federal, regional and local levels, to establish a facilitating environment for private sector development and to contribute to the development of appropriate market institutions. The effective institutionalisation of SME policy involves different forms of partnership between federal and regional authorities, as well as between government at different levels and various private sector bodies. A key priority in this respect is to establish the mechanisms for effective dialogue between the state and representatives of SMEs. The principle of partnership also applies to the relationship between the state and donor organisations, who can provide the necessary technical support to help to develop appropriate institutional arrangements for SME development in then Russian Federation.

Another key requirement for the successful development of a SME sector in Russia is a **stable and well functioning tax system**. The present system is too complex, involving too many taxes and too many agencies, that simply encourages entrepreneurs to conceal their real income, which both reduces the income of the state and contributes to a culture of illegality. Moreover, in a situation where it is often difficult for entrepreneurs to calculate their tax liability, with future liability even more uncertain, businesses find it difficult to plan and small firms often incur unnecessary additional costs in paying for advice to help them operate within the law. A tax system that is facilitating to the development of entrepreneurship, must be simple, equitable, stable and transparently implemented.

Improving the regulatory framework and the rule of law is another clear priority, as far as the development of the SME sector is concerned. Moreover, strengthening the legal environment can be a highly cost effective strategy for stimulating and promoting entrepreneurship in a situation where resources are scarce. There is a need to reduce bureaucracy in areas such as business registration procedures, licensing and in the allocation of premises. The cumulative cost for small firms, in terms of money and time, of meeting the demands placed upon them by different aspects of bureaucracy is considerable, which consumes resources that could be put to productive and wealth generating uses. Regulatory reform and a reduction in bureaucracy are also necessary conditions for reducing the size of the informal and shadow economy in Russia. However, establishing the rule of law is about more than passing legislation; it also requires committed implementation. In this regard, it is also important that strong action is taken to implement anti-corruption measures at all levels.

Finance is a key resource in starting and developing any business and a lack of finance is one of the main difficulties faced by Russian entrepreneurs. The main priority in this respect is to develop the market for SME finance by taking steps to make SMEs more attractive to investors and promoting a culture of business banking. At the same time, there is a need to address demand side deficiencies that reflect a lack of market experience on the part of entrepreneurs, weaknesses in relation to certain management competencies and a lack of knowledge about contemporary financial management methods. State financial support should only be used where market failure can be demonstrated and according to certain conditions which, past experience in Russia suggests, must include: clear rules and legal regulations to enable effective implementation; clear objectives with respect to specified target groups; explicit eligibility criteria; and clear guidelines concerning the terms and conditions of loans. Other priorities include the co-ordination of state funds available for SME support, between different arms and levels of government, in order to maximise the impact.

An important influence on the sustainable development of a SME sector in Russia is the establishment of **a support infrastructure of business advisory and information services**. This is another area where the state needs to work closely with the private sector, acting as a catalyst and co-ordinator, with private sector organisations representing more appropriate delivery mechanisms. Business incubators have a special role by offering a mechanism through which entrepreneurs with innovative business ideas can obtain assistance, particularly when they are establishing technology or knowledge based businesses. There is also a priority need to create an efficient and accessible information network, since information (about potential customers, suppliers and sources of finance) is a basic business need.

Experience in other countries shows that policies which are based solely on central design and implementation are not effective. Moreover, the size and structure of the Russian Federation makes it particularly important that there is a strong **regional and local dimension to enterprise promotion and support**. An emphasis on decision-making and support at the local level is important because it is here that policy is close to the real needs of entrepreneurs and their businesses. Within the context of increasing the involvement of regional and municipal authorities in SME support policy, there is a need to clarify the respective aims and responsibilities of federal and regional authorities, improve the co-ordination of federal and regional support programmes and take steps to facilitate co-operation rather than competition between regions. It is also necessary to take steps to reduce bureaucracy at a local level since it is here that excessive bureaucracy impacts on businesses most directly and where an effective dialogue between public authorities and entrepreneurs is particularly pertinent. Both should be key elements in regional and local development strategies to encourage and support enterprise.

Dialogue, implementation and monitoring

The FEED process is an integral programme that includes three mutually reinforcing parts:

- Dialogue, discussion and review of small business issues, as well as applied research and comparative analysis of problems related to SME development;
- Production and publication of Policy Guidelines and recommendations;
- Implementation of the Guidelines, monitoring of progress and positive feedback for future work on particular issues.

The programme is currently at the second stage related to the preparation of the Policy Guidelines. The approval of the Policy Guidelines and subsequent wide dissemination will need to be followed by the actual implementation by relevant authorities in co-operation with small business support organisations. The implementation of the Policy Guidelines will require an associated system of monitoring their application in practice. This will allow to bring together the efforts of different government agencies, business support organisations and entrepreneurs in moving forward the interests of small business. It will also help donor countries and organisations better co-ordinate their respective programmes of support.

ENTREPRENEURSHIP IN RUSSIA:

BACKGROUND, TRENDS AND POLICY PERSPECTIVES

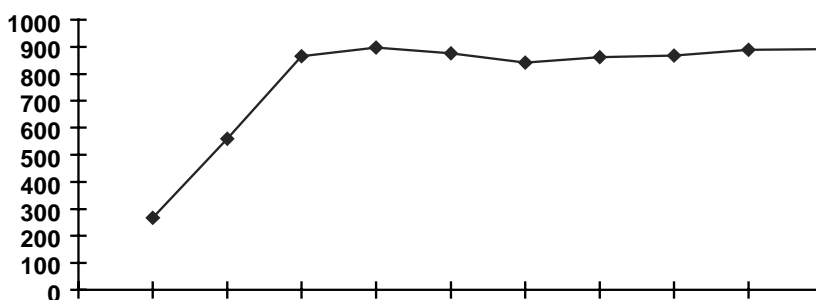
This chapter presents an overview of the conditions with respect to entrepreneurship and enterprise development in the Russian Federation. It is intended to place the policy guidelines and recommendations developed through the FEED process into a broad analytical context. The chapter begins by describing the main phases in the development of the small business sector in Russia, leading to an evaluation of the state of the small enterprise sector in Russia following the financial and economic crises of 1998. Key questions that need to be considered from a policy perspective include: how have small enterprises fared during the crises? Who were the winners and losers in this enforced restructuring? What implications should be drawn for small business support policy in the future?

The second part of the chapter focuses on a review of the experience with respect to small business support policy in Russia during this period, in which some of the main policy lessons are highlighted. Both aspects are an important part of the contemporary policy context in the Russian Federation, in which the guidelines and recommendations outlined in the rest of the document should be considered. The experience so far suggests that it is necessary to reconsider enterprise development policies and give new momentum to the design and implementation of reform policies. This can help to create a climate conducive to entrepreneurship and job creation to enable the small firms sector to achieve its potential contribution to economic and social transformation.

The Development of the Small Business Sector in the 1990s

According to official statistics, the number of small enterprises in Russia has not increased since 1994. After doubling each year in 1991/2 and 1992/3, the total number of registered enterprises levelled off and has fluctuated between 800-900,000 (Graph 1). In terms of total employment, SMEs are said to account for 12-13 per cent of the active population, whereas for example in Poland employment in SMEs (firms with fewer than 250 employees) represent more than 60 per cent of total employment. At the same time, it must be recognised that the picture emerging from business registration statistics is potentially misleading since only registered enterprises are included; individual entrepreneurs without legal status are excluded. In view of the fact that the number of individual entrepreneurs in Russia is estimated to be about 3.5m, or four times the number of registered enterprises, the scale of entrepreneurship development in Russia is considerably greater than that reported in the official statistics.

Graph 1 **Number of Small Enterprises in Russia, 1991-2000 (thousands)**



Source: Goskomstat data.

Box 1. Definition of “small enterprise”

The “small enterprise” was first defined by the Russian Federation Council of Ministers’ Decree “On Measures for Support and Development of Small Enterprises in Russia” (18 July 1991, N406). The number of workers and employees (including part time and contract workers) was selected as criteria for definition of small enterprise with respect to industries as follows:

Industries	Number of employees
Industrial production and construction	200
Science and scientific services	100
Other production activities	50
Retailing, catering and other non-production activities	15

This was substantially modified by the Law “On State Support of Small Enterprises in the Russian Federation” of 14 June 1995. The following criteria were defined:

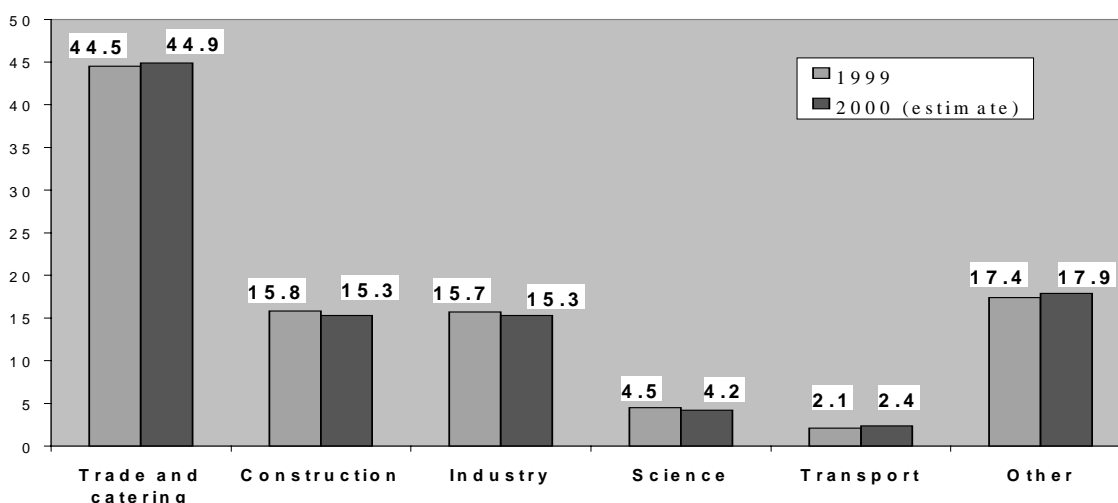
Industries	Number of employees
Industrial production, construction and transport	100
Science, scientific services and agriculture	60
Retailing and consumer services	30
Catering, other non-production activities	50

Additional criteria was defined in 1995 Federal law: the share of federal subjects, public and religious associations and charity foundations, as well as the share of large and medium enterprises in SME equity capital should not exceed 25 per cent.

SMEs by Industry

The vast majority of SMEs in Russia are dealing with trade and catering (Graph 2) and exhibit a relatively steady growth over the last years. 15.8 per cent of SMEs in 1999 were in construction sector. Almost the same number of SMEs (15.7 per cent) are in industrial production sector. The majority of enterprises are dealing with engineering and metal-working, light industry, wood manufacturing and the food industry. There was an important growth of SMEs in science and skilled scientific services in 1992-1993, but then the number fell in 1994-1995 and continued to decrease over the last years.

Graph 2 Number of small enterprises by main industry (1999-2000) (%)



Source: Goskomstat data.

Overall, the hoped for broad-based development of small business activity in Russia has not materialised, in the face of rising economic barriers to market entry on the one hand and a failure to reduce administrative barriers on the other. The need to reduce the number of regulatory bodies involved in licensing economic activity and rationalising the regulatory responsibilities among various state executive bodies has been recognised by Presidential Decree¹. But there has been little improvement in the situation in practice. As a consequence, small business owners continue to complain about the level of taxation, the complexity and instability of the tax system, gaps and

¹ A special *Decree of the President of the Russian Federation on Measures for Abolishing Administrative Barriers for the Development of Entrepreneurship* was issued on June 29, 1998

inconsistencies in legislation, a lack of financial resources and bureaucratic pressures as the main barriers they face in establishing and developing their businesses.

Reviewing the development of the small business sector over the last 12 years, five stages can be identified:

Stage One: (1988-1991): This was a period of rapid growth in the number of small and medium sized enterprises, associated with processes of liberalisation and spontaneous privatisation. Institutional support for small business development was largely absent during this period.

Stage Two (1992-1994): This was a period characterised by economic liberalisation at the macro-level and mandatory privatisation of many small businesses by municipalities. Despite this, and the stimulation provided to small business development through tax incentives, this was a period of decelerated growth in the number of SMEs.

Stage Three: (1995-1997): This was a period of relative macro-economic stability, with a boom in legislative initiatives and institution building in the field of SME support at the federal and regional levels. Despite this there was no increase in the total number of registered enterprises.

Stage Four (1998-2000): Initiated by the 1998 financial and economic crisis, the contemporary period of small business development has seen a re-orientation of their markets, with domestic products benefiting from the effects of the devaluation in their competition with imported goods. At the same time, SME support programs have been largely curtailed.

Stage Five: A fifth stage of the SME development can now be discerned since the positive effects of the 1998 devaluation have come to an end, even though the Russian economy may be entering a phase of economic growth. Under these new conditions government policy with regard to the small business sector needs to be fundamentally reconsidered.

The 1990s have also seen important qualitative changes in the role of small and medium sized firms in the Russian economy, as well as changes in numbers:

- Initially, a major part of small firms were established to bring resources from large state-owned enterprises into productive use, whereas today the small business sector is aimed more at providing services to large establishments, including mediating and subcontracting activity.
- During the initial stage of development, small business activity expanded by filling the market with goods and services that were in scarce supply. Today its success is based more on flexibility and lower transaction costs.
- In the early years of transformation, small businesses were absorbing the most skilled and energetic groups of managers and workers, who were searching for new opportunities associated with high political and economic risks. Today small business is more diverse. Alongside the development of high-tech firms and professional services, small firms are increasingly contributing to employment of disadvantaged groups.

Trends in SMEs since 1998

The financial crisis of 1998 had a major impact on the Russian economy, with implications for firms of all sizes. However, there are different views about the precise nature of the impacts on the small business sector. Few firms were unaffected by the fall in demand for goods and services as purchasing power shrank rapidly (by 23 per cent in the Autumn of 1998). Approximately 30 per cent of small enterprises had to cease trading after August 1998; of which 10 per cent ceased trading permanently. In addition, about half of all cross-border shuttle traders (or chelnoki) were driven out of business.¹

The crisis led to enterprises experiencing problems in receiving payment from their customers, increasing pressure on cash flow. According to a survey of 400 entrepreneurs², 59 per cent experienced problems with suppliers and clients during the October-November 1998 period and 52 per cent with commercial banks [Pichugin 1998, p. 16]. The immediate response of small firms to the crisis was to reduce output and/or seek to decrease production costs. According to Goskomstat, the output of SMEs declined by nearly one third in 1998, although in trade and catering, the decline reached 46 per cent. In addition, Gfk Market Research Russia data showed that 45 per cent of the small firms surveyed experienced a decline in sales in 1998, compared with just 19 per cent that showed an increase and 35 per cent whose the level of sales remained stable. Although small enterprises had less economic reserves than larger firms, they were often more flexible in their response to falling sales.

Considerable efforts were made by enterprises to reduce costs. According to a survey undertaken in 20 Russian cities by the U.S. Chamber of Commerce, the main forms of cost reduction strategy used by firms were: to cut wages and salaries (98per cent), reduce transport costs (70per cent), cut advertising expenditure (48 per cent), send workers on unpaid administrative leave, with a further 38 per cent who did not know what to do [Polyakov 1998, p. 10]. However, Gfk survey data points to a different set of post-crisis adaptive strategies used by firms in the latter part of 1998: 56 per cent cut wages, including placing workers on administrative leave, 51 per cent cut office expenditure, 40 per cent changed market strategy, 32 per cent dismissed personnel, 5 per cent sold property, with 20 per cent taking no action (Pichugin, 1998, p.16).

As a result, about 500,000 skilled professionals are reported to have lost their jobs, particularly in Moscow as Russia's main financial centre. Nearly 300,000 workers and employees from other categories also joined the ranks of the unemployed. At the same time, employment was a relatively stable parameter compared with output because a policy of dismissal and administrative lay-off was only pursued by a minority of firms (30-35 per cent). Cutting wages was often used as an alternative strategy to dismissals.

¹ Interviews with small entrepreneurs were specially conducted for the purpose of this study, in order to identify immediate post-crisis effects. Fifteen interviews were taken in January-February 1999 in Moscow, Tomsk, and Novosibirsk, in small firms covering high-tech production, light industry, food industry, transportation, communication services, wholesale trade, retailing, business investment consulting, patent and intellectual property consulting, and farming. More detailed analysis of the situation after the 1998 crisis was carried out by the author in the Tomsk oblast [Radaev 1999]. This was designed as a follow-up study of the small business sector in the region tracing the changes, which had occurred since the year 1997 [Radaev 1998a]. Data from several standardised surveys of entrepreneurs are also used, conducted by various research centres.

² Gfk Russia Market Research conducted a survey of 400 entrepreneurs in Moscow, St Petersburg, Ekaterinburg, and Nizhnii Novgorod in November 1998.

The crisis also resulted in a change in the aspirations of small entrepreneurs with respect to their businesses. According to survey data, before the 1998 crisis three quarters of small business managers were considering expansion. However, one year after the crisis the situation had completely changed since two thirds of surveyed small business owners pointed to mere survival as their main target [Ne preuspet' – khotya by vyzhit'... 1999, Chepurenko 2000]¹. At the same time, it should be noted that the negative trends in the small business sector started to develop before the 1998 financial crisis. According to survey data the financial indicators of SME activities had been deteriorating during the two previous years, and the 1998 crisis aggravated existing tendencies [Chepurenko A. 1998, p. 110, 177].

The economic impact of the crisis was not uniform for all businesses. A key factor in this respect was the extent to which firms were reliant on imported inputs, because of the dramatic effect of a fourfold devaluation of the Russian rouble within the space of a few months (Radaev, 1999b). While other factors such as the quality of management and the choice of bank (because of the effect of money lost through closure of some banks) also affected a firm's survival chances, it was the level of exposure to rising import costs that was the key influence. One result was that those firms that had access to local inputs found themselves facing new domestic market opportunities, created by the effects of rising import prices which reduced the demand for imported products and products based on imported materials.².

The economic impact of the crisis also shows considerable sectoral variation. Although the banking system has recovered rapidly since 1998, banks remain weak and undercapitalised and private bank deposits are currently at only two-thirds of their pre-crisis level. Not surprisingly, confidence in the commercial banks and financial institutions has been severely dented, which is an issue that needs to be considered in relation to future policy development.

Firms involved in the wholesale trade were among the worst affected, especially those dealing with foreign suppliers. In mechanical engineering, imports declined by 36 per cent and by between two and five times in chemicals, clothing and footwear. Declining imports also affected firms involved in transport and distribution since they were often dealing with imported goods. The crisis also damaged the small cross-border traders (chelnoki), particularly those involved in food and clothing markets that already faced severe competition and were hit badly in September 1998. Nevertheless, by the end of 1998, cross-border trading had started to recover, proving to be more stable overall compared with other forms of trading (Radaev, 1999a).

The decline in the business of cross-border traders, combined with decreasing real income among the middle classes contributed to a decline in the volume of tourist business. Revenues declined by 30-40 per cent on the main tourist routes and more than 10 per cent of firms were driven out business. There were some attempts by tourists to switch to Russian resorts, although this was limited by the low quality of services in these centres. However, tourism had begun to recover by the end of 1998 and has continued to improve since then.

In addition, the Russian advertising industry has been severely hurt. The amount of orders for advertising decreased by four times in 1998 and even today is three times less than in 1997. Sales in the information technology industry were also badly hit by the crisis. According to IDC data, IT sales

¹ These results are taken from the 1999 survey of Russian Independent Institute of Social and Ethnic Problems (see: Note 2).

² One of the Tomsk producers that was interviewed, stated: 'The Russian Government finally supported us by arranging this financial crisis although they had no intention to help'.

fell by 54 per cent in 1998, with the rate of growth in the number of Internet users being halved in Moscow and reduced by 10-20 per cent in other regions. Since 1998, sales of personal computers to individuals has largely ceased [Pichugin, Poluektov 1999].

Traditional export industries, such as oil, gas, and metallurgy have fared rather better during the post-crisis period, aided by the effects of rouble devaluation. Sales in consumer oriented sectors have also recovered, including automobiles, food products, chemicals, pharmaceuticals, consumer services and consumer durables. These sectors found themselves in a privileged position as imports fell, despite the fact that some of the larger import dealers cut their dollar prices in order to retain market share. In the markets for refrigerators and washing machines, for example, prices fell by 10-30 per cent, with a commensurate decrease in profits, although sales of consumer durables have recovered, encouraged by price reductions [Tereschenko 1999].

In the case of agriculture, although export conditions became more favourable as the value of the rouble fell and domestic purchasing power fell, a bad harvest in 1998 led to crop shortages which in turn resulted in administrative barriers to the exporting of food products being introduced in 17 regions.

The situation in the Russian economy after the 1998 crisis resembled the conditions in the early 1990s in a number of respects. Niches were created as a result of demonopolisation in many market segments, most businesses faced liquidity problems and consumption patterns returned to the more primitive forms observed at the beginning of the reform process in 1992. The difference is that the experience accumulated prior to the crisis in August 1998 makes a stabilisation and re-establishment of businesses easier than in the early 1990s.

The Crisis as a Window of Opportunity for Small Businesses

The crisis created new opportunities for businesses as well as causing losses. Since the early 1990s, many Russian markets had been largely monopolised, making it difficult for new entrants to penetrate them. However, the 1998 crisis created opportunities for small businesses to enter and occupy some of the niches left by the withdrawal of larger enterprises. This particularly applied to domestic producers and traders whose activities were based on local inputs. At the same time, all enterprises were forced to look for additional resources and to review their management strategies in conditions characterised by the following features:

- Cheaper bank credit, as interest rates (in roubles) have fallen to a negative level. Although commercial banks generally remain reluctant to offer credit to the small business sector (even if they have sufficient financial resources), Sberbank and Promstroibank appear to have extended credits to some small businesses at least.
- Small enterprises selling products to consumer markets have found themselves in a privileged position since they are able to generate cash, thus reducing their reliance on barter trading.
- Some costs have decreased. For example, labour has become cheaper as employees are now more tolerant of wage cuts and payment delays.
- Changes in management behaviour as managers have become aware of the need to respond quickly to new opportunities, to strengthen internal management control and to fire staff found guilty of misconduct.

A Shift towards Domestic Products

As mentioned previously, one of the key results of the crisis was a shift towards domestic production, although the substitution of domestic for imported products has been a selective process, influenced by a number of factors:

- Consumer choice is affected by the relative price levels of different goods, with the result that more expensive consumer goods of European origin (e.g. from France, Italy, Germany) were partially replaced by cheaper items. The transportation patterns for supplying these goods also changed. For example, in some Siberian regions, supplies from Turkey, Saudi Arabia and European countries, accessed through markets in Moscow, were replaced by cheaper imports from China and Korea accessed through the markets of Novosibirsk.
- The pattern of consumer choice is also affected by the elasticity of demand. As a result, while necessities such as butter continued to be imported, the trade for imported furniture almost stopped completely.
- Consumer choices have also been affected by the quality of those Russian goods that were potential substitutes for imported products. In many cases consumers initially changed their preferences in favour of cheaper domestically produced food items but subsequently turned back to higher quality, imported products.

The competitive advantage of domestic producers depended mainly on their willingness and ability to maintain a price differential with imported goods, since consumer behaviour is mainly driven by considerations of price in relation to quality. In practice, many Russian entrepreneurs set prices for domestically produced goods that were very close to the prices on imported items, relying on ‘buy local’ campaigns¹ that were of limited impact.

The crisis encouraged a long awaited inflow of capital into the production sector. Faced with a severe shortage of working capital to obtain the necessary inputs, many producers found themselves in a weak bargaining position with respect to their suppliers and were therefore willing to negotiate. In this situation, the suppliers of inputs purchased production rights, which gave them revenues from the sale of the finished products. In these circumstances, entrepreneurs who had spare capital to spend on purchasing domestic supplies and production rights were in a strong position, whereas those without capital suffered.

Prospects for the near Future

The development of the small business sector two years after the crises needs to be seen in the context of a number of positive features of the economic situation in Russia that may, in combination, be viewed as a window of opportunity for entrepreneurship development, provided that an appropriate policy framework is in place.

One positive factor has been an increase in industrial production, 12 per cent (by volume) in 1999. Foreign investment has also shown some recovery, with new leaders appearing. For example, the food industry attracted 15 per cent of direct foreign investment, raising it to second position after the fuel

¹ An example was the “Let us buy Tomsk products” (Pokupaite Tomskoye) campaign.

industry. Direct investment in production facilities within Russia has become a more profitable alternative for foreign firms compared with importing finished goods. One likely consequence is a future increase in the demand for skilled production managers.

Moreover the crisis forced entrepreneurs to review their strategies, drawing attention to deficiencies in their business plans. It produced new perceptions of business development, based on domestic resources rather than relying on cheap imported goods [Barsukova 1999].

Overall, the Russian economy has demonstrated impressive economic growth since the middle of 1999, with GDP and industrial production increasing by 3 and 8 per cent respectively since then, with the latter rising by 12 per cent to mid-year 2000. A smaller increase can be observed with respect to direct investment and construction capacities.

At the same time, the positive benefits to small businesses arising from the import substitution effects of rouble devaluation were short-lived, ending in mid 2000 as the rouble started to strengthen. The price gap between domestic products and imported goods has narrowed as a result of rising domestic prices and the flexible pricing policies adopted by large importers. As a consequence, the rate of economic growth has declined, becoming more dependent on the level of foreign and domestic investment. In this context, it is important to create an enabling environment to encourage the development of entrepreneurship, if Russia is to grasp the opportunities created by the crisis for sustainable economic development.

Recent policy Initiatives to support entrepreneurship development

The recognition of the need to improve the legislative and regulatory basis for small business development is reflected in the adoption of four important federal laws since 1998, relating to:

- A Single Tax on Imputed Income for Certain Activities
- The Licensing of Certain Activities
- Leasing
- Mortgages (Real Estate Guarantees)

In addition, a new version of the fundamental Law of June 14, 1995 ‘On State Support of the Small Enterprise in the Russian Federation’ is being developed and draft laws are also under discussion with respect to:

- The Protection of the Rights and Legal Interests of Entrepreneurs
- Consumer Societies of Mutual Assistance and Mutual Insurance
- Franchising

At the same time, the actual results achieved so far are limited. The laws on leasing and mortgage have yet to be implemented and those on a single imputed tax (see Box One) and licensing (see Box Two) have become a subject for public debate.

Box 2: The Single Imputed Tax

The federal law on 'A Single Tax on Imputed Income for Certain Activities' was introduced in July 1998, with similar regional laws being adopted in 35 regions of Russia by April 1999. The aim of the single tax is to replace many of the existing tax payments, with a single payment. It is calculated quarterly on the basis of imputed income, with a number of correcting coefficients. The tax is paid monthly in the form of advance payments. It is compulsory for small enterprises and individual entrepreneurs in certain areas of activity, namely construction and repairs, consumer services, consulting, auditing, legal advice, catering, retailing, transport services and car parking.

However, in practice, the experience has been:

- A simplified system of taxation and reporting is strongly required for the small business sector in Russia, but unfortunately the form of single tax that has been introduced makes it difficult and time consuming for business owners to calculate the amount of payments for which they are liable. The entrepreneur has to calculate the tax for each site and area of activity, which is subject to tax. Those who also have activities that are not subject to the law on single tax are forced to keep two parallel accounting systems, leading to new complexities.
- The new legislation has introduced further instability in the taxation system. It is difficult to determine coefficients that are absolutely fair, reflecting objective differences between the locations of different enterprises. As a result, there has been a stream of claims for corrections which contradicts the principle of tax stability.
- The new system encourages further bureaucratic barriers and corruption. The entrepreneur is supposed to get approval of his/her own tax calculations from the tax authorities, which have the power to correct it, thereby creating a situation where bribes and favours are encouraged.
- The federal law on the single imputed tax has led to considerable regional discrepancies, because the calculation of coefficients has been left to the regional authorities.
- The new legislation has created tensions on the side of small business owners. For example, in the Tomsk region the introduction of the new tax system was met by demonstrations of small entrepreneurs organised by the Trade Union of Entrepreneurs in December 1998.

Overall, the introduction of the new law on a single tax on imputed income had led to outcomes that are not compatible with the long-run requirements of the small business sector. While the idea of imputed payments contain some positive elements, there needs to be some change in the basis of tax calculations. In the light of this experience, Russian policy makers (e.g. Ivan Grachev) have proposed two main amendments:

- To abolish the compulsory character of the new single tax system;
- To reduce the level of advance payments for the single tax.

Box 3: Licensing

Problems associated with the licensing of activities are still a major barrier to small business development in Russia. In order to obtain a licence from the State Licensing Chamber, it is necessary for a business owner to submit numerous documents from a multiplicity of institutions: Fire Surveillance, Sanitary Surveillance, Standardisation Committee, State Committee on Statistics, Architectural Department, Communal Service, and many specialised branches responsible for certain types of economic activity.¹

Many small entrepreneurs complain more about the actions of state licensing authorities than about the tax system. The problem is not so much connected with the policies and actions of regional and local administrations but with the dozens of federal state ministries and committees, that still have branches in the Russian regions. Although these branches are supposed to pursue a common state policy in their respective areas, they also have the prerogative to license and certify certain activities.

This complex bureaucratic system has experienced dramatic changes in recent years. Although the federal authorities often have insufficient funds to maintain their regional departments, they are typically reluctant to close them down. Instead they have allowed their branches to survive on their own by building up administrative barriers in ways that have facilitated the mutual reinforcement of the positions of the different agencies. This has been achieved by making a permit from one agency a requirement for obtaining a permit from another, and vice versa. Being state monopolists in their specific areas, these agencies are able to price their 'services' accordingly. The system encourages bribes while agencies fail to exert the control necessary to eliminate the causes of possible violations.

The long awaited federal law on '*the Licensing of Certain Activities*' (adopted by the State Duma on September 16, 1998) did not improve the situation. The list of activities subject to licensing was increased rather than reduced. The Centre for Strategic Studies has estimated that about 500 activities are currently subject to licensing. Moreover, the law on licensing contains a number of major controversies. Formally, the minimum period of licensing was extended from one year to three years, although a statement was also included which allowed the authorities to confine it to one year if the entrepreneur 'appealed for it', thereby giving the licensing authorities a means of applying pressure on firms. Similarly, while the Law also defines the list of documents which are necessary to submit to the Chamber for Licensing and limits the scale of licensing fees, it also includes a statement which leaves the door open for wide interpretation in practice:

'Depending on the specific character of the activity, the submission of other documents to prove that the applicant is meeting the licensing requirements can be introduced in the special provisions for licensing certain activities'.

The systemic nature of the licensing problems means that radical changes are required to change the situation. Screening the functions of federal institutions with branches in the regions may be more effective than lobbying to get certain activities removed from the licensing list at the federal level. At the regional level the main change required is for a shift from a licensing approach based on authorisation (razresheniye) to one based on notification (uvedomleniye). This would allow the controlling bodies to check the activity of the firms and entrepreneurs while removing them from the licensing process. Licence payments could be centralised in the Chamber for Licensing, while also decreasing their total amount, thereby making the process of starting a new business easier. Certainly, the practice of agencies being able to establish their own prices for administrative services must be eliminated.

¹ For details of licensing practices and bureaucratic extorting, see: Loskutova 1998, p. 3

Although these attempts to change the tax, regulatory and licensing systems are important, effective implementation in a Russian context is fraught with difficulties, because of the vested interests of the various controlling bodies. To make policy reform effective in such conditions requires both clear diagnoses of the nature of the problems and a strong political will to implement the required solutions.

The Development of SME Support Policies in Russia

The development of state support policies for SMEs during the 1990s has not been a continuous process. Following a period of political indifference towards the development of small private firms in the early 1990s, some attempt was made to support them through the use of tax privileges that were selectively targeted on small manufacturing enterprises. This was followed by the first national support programme for SME (for 1994-95) that was eventually adopted in 1995. International financial institutions and donor organisations started their funding of large-scale SME support programs in 1992-94. The efforts of EBRD, EU-TACIS, USAID and others stimulated the involvement of Russian commercial banks, the creation of business incubators and consulting and training agencies for small business owners.

In fact, 1995-96 can be considered as the most active period in terms of the institutionalisation of state support policies for SMEs, reflected in a variety of initiatives. These included the second national support programme for SMEs (for 1996-1997), which received the status of a special federal programme, adopted by the State Duma; a fundamental Law on SME State Support (of 14 June 1995) which laid down the legal basis for SME policy; and the establishment of a Special State Committee for SME Support and Development. In addition, the Federal Foundation for SME Support and Development was restructured as an independent institution with responsibility for providing financial support for SME programmes, and a simplified system of taxation and reporting was introduced for part of the SME sector by the end of 1995. Finally, the First Russian Congress of SME Representatives held in the Kremlin in February 1996, opened by the President of the Russian Federation, Boris Yeltsin. In short, the prospects in terms of state support for SMEs appeared generally positive in the mid-1990s, based on the number of pronouncements and institutional developments.

Legislative initiatives were also undertaken at this time at the regional level, with special state institutions dealing with SME support being established in more than 70 regions. While influenced by the activities of the federal authorities, there is considerable variation between Russian regions in the nature and extent of the support offered to SMEs. On the one hand, there are some regions where the infrastructure for SME support is relatively well developed (such as Moscow, St. Petersburg, Ekaterinburg, Nizhnii Novgorod, Samara, Tomsk), while on the other hand, there are regions where the opposite is the case (such as Chita, Magadan, Northern Caucasus). The attitudes of the regional authorities with respect to small business development is critical in this respect, especially that of the governor.

Steps towards strengthening SME support taken in the mid 1990s have not been sustained and fully implemented, with some contraction at the federal level at least, since the early part of 1996. The special Federal SME support program was not funded in 1996, and under-financed in 1997, and the new SME support programme for 1998-2000 was elaborated but not adopted. There were continuous disputes between the Federal SME Support Committee and the Federal SME Support Foundation with respect to their powers and areas of responsibility, leading to a dismantling of the Committee in 1998. The Federal Foundation for SME Support and Development lost its status as the main contractor for the Federal SME Support programme, following problems with the accounts in Mezheconomsoyuzbank in 1996 and the SBS-AGRO bank during the 1998 crisis.

The ineffectiveness of these institutions concerned with SME support is mirrored by the failure to channel federal budgetary resources into SME support in the period since 1996. The special allocation in the federal budget for SME Support was lost and the tax privileges previously granted to SMEs were eliminated. Although institutional systems of SME support remained at the regional level, financial support from federal sources was largely withdrawn. In addition, a number of international programmes have either been terminated or experienced a reduction in resources.

The decline in financial support for SMEs in the late 1990s has also been affected by the reduced priority given to subsidising employment in new business start-ups by the Employment Foundations of the Federal Employment Service, which had been an important source of funds for entrepreneurship previously. Only a small part of the funds accumulated from the levies placed on the salary bill of existing enterprises is currently allocated to training and re-training programmes and to subsidies for new enterprises. The bulk of this money is spent either on unemployment benefits or on administration costs of the Federation.

The crisis of 1998 was an additional negative impact on SME financial support, because the banking crisis made any further creation of guarantee funds for SMEs highly questionable. This was one of the factors contributing to policy makers starting to look for 'non-monetary' measures of entrepreneurship support. Recent institutional changes have included a transfer of the responsibility for co-ordinating SME support policy to the Ministry of Anti-Monopoly Policy and Entrepreneurship Development (MAP) where a special Department was established.

Implications for Future Policy Development

The experience of the late 1990s have important implications for the FEED guidelines. The following three points are fundamental lessons that were taken into account when the FEED group formulated the policy guidelines.

- In retrospect, it is clear that political support for SMEs has tended to be strongest during election campaigns, while fading afterwards. This occurred in 1995-96 and again in 1999-2000, preceding the Presidential and state Duma elections. Yet already the failure of the State Duma to support a proposal to introduce a special budget line for SME support in November 1999, indicates the difficulty to concentrate political support for SMEs at this institutional level. This might hint to the importance of developing strong business and employers organisations to act as a lobbying force, to ensure that the interests of entrepreneurs are promoted and protected at a political level. Moreover, the experience in OECD countries suggests that it is advantageous for these organisations to co-operate with various political parties, rather than become wedded to a single political group.
- Another important policy lesson from this period is the need to pay close attention to implementation mechanisms, in order to avoid the recurrent 'implementation gap' in Russia between policy pronouncements and actions, that contributes to a lack of credibility of state support for SMEs in the minds of business owners. There is little value in Government adopting a State Programme for SME Support (such as that on 18/11/1999) without a budget allocation to implement it. In this context, the MAP has a critical role to play if state support for SMEs is to be more effective in the future.
- The impact of the 1998 crisis in Russia has some positive features as far as the longer term development of the small business sector is concerned, -- features that policy must seek to exploit. The crisis gave an opportunity to small businesses to occupy some of the niches left by larger establishments, particularly those that were able to exploit domestic inputs. The crisis also encouraged a long awaited inflow of capital into the production sector. However, since the initial rouble devaluation and import substitution effects have come to the end, it is particularly important that a new and more effective policy approach is developed with respect to entrepreneurship promotion.

Chapter 1

INTRODUCTION TO POLICY GUIDELINES AND RECOMMENDATIONS

Introduction

If Russia is to achieve stable economic growth, there will need to be an intensified effort to stimulate underlying economic development, in which the small business sector has a critical role to play. It is widely recognised that the development of entrepreneurship and small and medium sized enterprises (SME) has an important contribution to make to the process of economic and social transformation to a market based system, offering a possibility to involve a wide cross-section of society.

At the same time, there are distinctive features of the conditions in the Russian Federation that present challenges to the successful development of small businesses and for the effective institutionalisation of small business policy. One of the key challenges facing the Russian Federation in this respect is gaining the acceptance throughout government and the Russian population of the potential welfare benefits for the economy and society of developing a small business sector. Another is that the successful development and implementation of small business policy requires that the interests and needs of small firms must be taken into account by all government departments and state bodies, at all levels. These are necessary conditions that need to be fulfilled if the policy guidelines developed through the Russian FEED programme are to be effectively implemented.

Attitudes towards Entrepreneurship and Small Businesses in Russia

The process of economic transformation inevitably leads to inequalities and conflicts of interest between different social groups. The positive contribution of small business to the interests of a majority of the Russian population is not commonly known throughout the country. In this respect, there is a need for a promotional campaign to explain the benefits of legitimate private enterprise, in order to counter the negative image that many Russian people have at the present time.

A critical policy challenge for the State

The state has a key role in influencing the nature and extent of entrepreneurial activity in the Russian Federation. The absence of both a tradition and the experience of self governing business organisations, combined with a lack of belief by the population at large of the positive nature of the contribution of small businesses to economic transformation hitherto, means that the state needs to take a more active role in modifying the institutional and social conditions facing entrepreneurship.

According to official declarations, Russia has been living under market conditions for a decade. Yet the reality is that the slow pace of de-monopolisation and decentralisation of the economy has limited the opportunity for the development of the small business sector. This has restricted the development of a middle class, which has in turn contributed to the slow pace of development of democratic civil institutions. In this respect, a large-scale economic initiative to develop the private sector would be an important step towards a more broadly based transformation of Russian society. One of the main reasons why this has not occurred is that state officials place their role in society considerably above that of the private entrepreneur, which is a mentality carried over from the days of the centrally planned economy, in which entrepreneurs are viewed as speculators with low social status.

Extracted from the statement of Mr. Ioffe, President of the Russian Association for SMEs Development

One of the first priorities for the state is to accept and develop the role of entrepreneurs as ‘social partners’. This involves guaranteeing the protection of their legitimate interests and rights of privacy and creating the conditions to enable the gradual re-distribution of economic regulatory functions for business activity from the state to professional self-governing organisations.

FEED participants stressed that despite political declarations about state support and the accelerated development of small business development during the transition period, the actual level of development of entrepreneurship is still very low. At the same time, it is difficult to accurately measure because of the absence of the sector from the economic monitoring, reporting and forecasting processes by the state. However, there are considerable variations between different parts of Russia, reflecting variations in local market opportunities, resource availability and infrastructural development.

Factors influencing the Level of SME Development in the Russian Federation

Unlike large enterprises, successful small business development depends not on economies of scale but rather on the flexibility of firms and their responsiveness to customer needs, which often involves focusing on particular market niches, many with a high degree of local market orientation. As a result, successful small business development is often associated with growing local markets for goods and services (which are themselves related to the level and distribution of purchasing power of the population), where it is possible to identify profitable niches. Successful small business development is also associated with the level of development of a market infrastructure in particular localities or regions.

In the Russian Federation, successful small business development also depends on small firms being able to overcome obstacles that include the power of local monopolies, a low level of business discipline reflected in unreliable business partners, a lack of professional knowledge about aspects of economic and administrative control, an unstable legal, regulatory and tax regime, an absence of budgetary resources to implement business projects (including rapid payments to firms for work undertaken on a contract basis for the state), as well as poor business strategy on the part of owners and managers.

The ability of individual SMEs to survive and grow is influenced by a combination of internal and external factors. While internal problems may often be dealt with largely by SMEs themselves and at the local level, many of the external barriers require actions by the state at the federal and regional levels to help to solve them. However, internal and external problems are often closely inter-related

(for example: adverse taxation systems make systematic financial planning overly complex or impossible). Moreover, an inefficient treatment of small businesses by public authorities can engender a range of additional barriers to development sometimes creating a vicious circle.

One of the main difficulties in solving the 'external' environmental problems which hamper SME development, is that the measures taken by different state agencies to support SMEs and the action plans/programs to implement them, are typically poorly co-ordinated. It is difficult to divide responsibilities for successfully implementing policy when the functions of the executive branches of power and the distribution of competencies in the budget, taxation, credit and finance, and tariff spheres are not properly focused on the need to have a unified policy of SME support. Therefore the Federal Government needs to focus on eliminating the contradictions between the various agencies (regional, sectoral/branch) related to SMEs.

Key Themes in the FEED Guidelines

One of the main pre-conditions for sound private sector development in the Russian Federation is an appropriate and effective institutionalisation of small business policy (see Chapter 2). Key roles for the state in this regard are to develop a strategy for removing the obstacles to enterprise creation at the federal, regional and local levels, to establish a facilitating environment for private sector development and to contribute to the development of appropriate market institutions. The effective institutionalisation of SME policy involves different forms of partnership between federal and regional authorities, as well as between government at different levels and various private sector bodies. A key priority in this respect is to establish the mechanisms for effective dialogue between the state and representatives of small businesses. The principle of partnership also applies to the relationship between the state and donor organisations, who can provide the necessary technical support to help to develop appropriate institutional arrangements for SME development in then Russian Federation.

Another key requirement for the successful development of a small business sector in Russia is a stable and well functioning tax system (see Chapter 3) The present system is too complex, involving too many taxes and too many agencies., This encourages entrepreneurs to conceal their real income, thereby reducing the income of the state and contributing to a culture of illegality. Moreover, in a situation where it is often difficult for entrepreneurs to calculate even their current tax liability, businesses find it difficult to plan and small firms often incur unnecessary additional costs in paying for advice to help them operate within the law. A tax system that can facilitate the development of entrepreneurship must be simple, equitable, stable and transparently implemented.

Improving the regulatory framework and the rule of law (see Chapter 4) is another clear priority, as far as the development of the small business sector is concerned. Moreover, strengthening the legal environment can be a highly cost effective strategy for stimulating and promoting entrepreneurship in a situation where resources are scarce. There is a need to reduce bureaucracy in areas such as business registration procedures, licensing and in the allocation of premises. The cumulative cost for small firms, in terms of money and time, of meeting the demands placed upon them by different aspects of bureaucracy is considerable, which consumes resources that could be put to productive and wealth-generating uses. Regulatory reform and a reduction in bureaucracy are also necessary conditions for reducing the size of the informal and shadow economy in Russia. However, establishing the rule of law requires more than passing legislation; it also requires committed implementation. In this regard, it is also important that strong action is taken to implement anti-corruption measures at all levels.

Finance (see Chapter 5) is a key resource in starting and developing any business and a lack of finance is one of the main difficulties faced by Russian entrepreneurs. The main priority in this respect is to develop the market for small business finance by taking steps to make small firms more attractive to

investors and promoting a culture of commercial banking. At the same time, there is a need to address demand side defects that reflect a lack of market experience on the part of entrepreneurs, weaknesses in relation to certain management competencies and a lack of knowledge about contemporary financial management methods. State financial support should only be used where market failure can be demonstrated and according to certain conditions which, past experience in Russia suggests, must include: clear rules and legal regulations to enable effective implementation; clear objectives with respect to specified target groups; explicit eligibility criteria; and clear guidelines concerning the terms and conditions of loans. Other priorities include the co-ordination of state funds available for SME support, between different arms and levels of government, in order to maximise the impact.

An important influence on the sustainable development of a small business sector in Russia would be the establishment of a support infrastructure of business advisory and information services (see Chapter 6). This is another area where the state needs to work closely with the private sector, acting as a catalyst and co-ordinator, with private sector organisations representing more appropriate delivery mechanisms. Business incubators have a special role by offering a mechanism through which entrepreneurs with innovative business ideas can obtain assistance, particularly when they are establishing technology or knowledge based businesses. There is also a priority need to create an efficient and accessible information network, since information (about potential customers, suppliers and sources of finance) is a basic business need.

Experience in other countries shows that policies which are based solely on central design and implementation are not effective. Moreover, the size and structure of the Russian Federation make it particularly important that there is a strong regional and local dimension to enterprise promotion and support (see Chapter 7). An emphasis on decision-making and support at the local level is important because it is here that policy is close to the real needs of entrepreneurs and their businesses. Within the context of increasing the involvement of regional and municipal authorities in SME support policy, there is a need to clarify the respective aims and responsibilities of federal and regional authorities, improve the co-ordination of federal and regional support programmes and take steps to facilitate co-operation rather than competition between regions. It is also necessary to take steps to reduce bureaucracy at a local level since it is here that excessive bureaucracy impacts on businesses most directly and where an effective dialogue between public authorities and entrepreneurs is particularly pertinent. Both should be key elements in regional and local development strategies to encourage and support enterprise.

Chapter 2

INSTITUTIONALISATION OF SMALL BUSINESS POLICY

Overview

An appropriate and effective institutionalisation of small business policy is one of the main preconditions for sound private sector development in the Russian Federation. Developing effective institutional arrangements for the governance and support of small businesses in the economy is a challenge shared by all transition countries. The state has an important role to play in fostering entrepreneurship by developing a strategy for removing obstacles to enterprise creation, for establishing a facilitating environment for private sector development and for contributing to the development of appropriate market institutions, which are an important part of the business environment in a market economy. Together with elaborating appropriate support programmes, the state also has a responsibility to develop appropriate institutions and instruments in order to implement these strategies.

However, most of the delegates to the Working party meetings of the FEED for the Russian Federation expressed their concern about the fact that the needs of small businesses are not effectively reflected in Russia's current economic development policy. The lack of a clear government strategy concerning the SME sector, together with an absence of agreed and co-ordinated actions by the various interests and authorities involved, contributes to the precarious state in which many SMEs find themselves in Russia. In addition, businessmen often have to face a negative attitude of society towards entrepreneurship, especially towards small firms. As a consequence, much of the potential contribution of the small business sector to social and economic development in Russia remains currently unfulfilled.

Need for a Coherent Policy Framework at the Federal and Regional Levels

Within the context of an overall strategy for small business development, one of the key roles for the state is to develop a well co-ordinated relationship between the various 'actors' involved in the process of SME support, including those at the federal, regional and local levels. In Russia, the overall development of small businesses has been disadvantaged by poor co-ordination of policies at the federal level and frequent changes of responsibility for small business issues within the government structure. Moreover, while extensive institution building has been carried out at the regional level, the problem of determining the role of regions in the establishment of the support system for SMEs still exists, as does the problem of policy co-ordination at the federal and regional levels. The views of the Director of a regional SME Agency with regard to the respective responsibilities of the state at the federal and regional levels are summarised in the box below.

It is necessary to separate more distinctly and unambiguously the functional roles and spheres of competence within the state and to allocate appropriate responsibilities between the federal, regional and municipal levels, in order to ensure complementary actions within the context of an overall strategy.

Discontinuity of actions of different branches and levels of state power results in an unnecessary waste of resources and a loss of time, contributing to internal conflicts and tensions (such as, between fiscal protection mechanisms and policies to assist employment generation and small business development). The role of government at the federal level is to determine the basis of policy assistance to small firms and the general economic infrastructure, together with the legislative “rules of game” and general legal mechanisms.

At the regional level, it is necessary for the state to focus on the basic economic measures of SME support and development, proceeding from national priorities to develop policies that also reflect the region’s development priorities and to identify appropriate instruments for effective policy implementation. It is here, that the selection of instruments for the realisation of policy of assistance to small businesses is accomplished.

(From the report of S. Makovetskaya, Director of Regional SME Agency)

The main elements of state support for small businesses should be included in a coherent business development policy, set within the broader framework of a national enterprise development strategy, which should include specific measures to improve conditions for entrepreneurship. It should also contain clear institutional responsibility for small business policy within both federal government and the regional administrations for SME policy, ensuring that there is a common acceptance and understanding of the respective roles of regional and federal authorities in policy implementation.

Particular attention needs to be given to developing policy that addresses the local and regional dimensions of the small business sector. Local and regional government should be empowered to develop small business policies that reflect specific regional and local needs, reflected in clearly specified objectives for the SME sector being incorporated within regional development plans.

Priorities for Institutional Development

In assessing the role of existing institutions in influencing the development of the small business sector in Russia, FEED delegates emphasised that the key issue is not so much the number of institutions but rather the lack of coherence in their actions that is the main constraint on the successful implementation of SME support policy. Other issues highlighted include a lack of co-ordination between institutions, a lack of consistency in the assistance offered to small businesses and a lack of transparency in their operation.

At the same time, delegates pointed to certain gaps in the existing legislation, particularly with respect to medium sized enterprises. While the legitimacy of state support for small enterprises is underpinned by legislation, criteria defining medium sized businesses are still to be determined, which partly reflects the relatively short time that has elapsed since the process of transformation towards a market based system began in Russia. The issue needs to be resolved since many of the distinctive characteristics of small enterprises are shared with medium sized firms.

Partnership and Participation

Institutionalisation of small business policy is about strategies and partnerships. At a strategic level, the removal of obstacles to SME development is a cost-effective approach to encouraging entrepreneurship for federal and regional authorities. Stability in rules and regulations is also a necessary part of a favourable environment for business development. However, one of the weaknesses in the current institutional arrangements affecting small business development in the Russian Federation is the lack of an effective dialogue between the public authorities and institutions on the one hand, and entrepreneurs and their representatives, on the other, which means that the principle of partnership has been slow to gain acceptance.

In mature market economies, self-governing, self-regulating organisations act as professional intermediaries in this process, in order to ensure that the interests of businesses are taken into account in the decision making of public authorities at different levels. As a result, one of the policy priorities for effective SME support in the Russian Federation is the development of institutional arrangements by creating appropriate and effective intermediary organisations. At the same time, it needs to be recognised that creating appropriate organisations is not a sufficient condition to ensure that the views and interests of entrepreneurs are adequately represented in policy development. To achieve this also requires a degree of regulation of these organisations in order to avoid excessive fragmentation, together with a programme of training and capacity building to assist them in developing an effective lobbying function.

The creation of a facilitating environment for business development requires the effective participation of representatives of entrepreneurs and small business owners in the dialogue with government on policy formulation, implementation, monitoring and evaluation. In addition, mechanisms for assessing conditions for business development and for measuring the impact of different policy tools should also be created and effectively implemented. In this regard, effective communication between government and entrepreneurs is crucial, which reflects the critical role of the Ministry for Anti-Monopoly Policies and Entrepreneurship Support (MAP) in its work on enterprise promotion and contacts with entrepreneurs.

The Role of Donor Organisations

There is a clear potential of foreign and international organisations in helping to develop appropriate institutional arrangements for SME development in Russia. In this regard, it is necessary to draw on relevant good practice and foreign experience as well as to learn from any relevant negative experiences. Co-operation with international organisations can also help to integrate Russia into the international community and offer a mechanism for facilitating co-operation between Russian small business and their counterparts abroad.

Russia has received technical assistance worth more than \$3 billion from a variety of donor organisations, 20% of which has been directed to the support and development of small entrepreneurship. More than 6000 projects of technical assistance have been realised in total, of which 2000 are focused on small business. Most of these resources have been applied to professional training and exchanges, with policy support, consultations and equipment for small enterprises only accounting for about 10-15% of the total. The regional distribution of this assistance is irregular, with the major portion being gained by the Central and North-Western regions and the Urals region.

Of the 21 foreign donor organisations involved, the most prominent are USAID, the German Ministry for Co-operation, the European Commission and EBRD. More than half of all international assistance to the Russian Federation for small enterprise development is in the form of bilateral projects.

(Based on materials presented at the FEED by donor-countries' representatives)

Specific examples of assistance from the international community:

EBRD: At the end of September 2000, the European Bank for Reconstruction and Development (EBRD) had 110 Board-approved projects in Russia for a total of c £3.9 billion of loan and equity financing – with a total project value of about £12.4 billion. A total of 94 of these projects had been signed, with EBRD financing of £3.3 billion (including sub-projects) and with a total value of £10.9 billion. (<http://www.ebrd.com>)

EC: Technical assistance, equipment and initial funding for the Moscow Agency of Entrepreneurship Development and 23 Regional Development Agencies for SME Support. (<http://www.eur.ru>)

USAID: 19 business incubators created, approximately 140 locations of technical aid, credit lines totaling more than \$600 million. (<http://www.usaid.gov>)

(From reports of FEED participants)

<p style="text-align: center;">POLICY GUIDELINES AND RECOMMENDATIONS ON INSTITUTIONALISATION OF SMALL BUSINESS POLICY</p>
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- 1. Review the structure and operation of the existing institutional arrangements for small business development in the Russian Federation, paying particular attention to the specific roles of public and private sector institutions.**
 - 1.1 Undertake an audit of the operation of the existing support infrastructure for small business development and the division of responsibilities of functions between the federal, regional and local levels.
 - 1.2 Develop a clear strategy for removing the obstacles to enterprise creation and development, at the federal, regional and local levels, in order to focus the activities of public bodies on taking steps to improve the operation and development of market mechanisms.
 - 1.3 Seek to improve the availability of reliable data concerning the small business sector, by establishing a system of monitoring and analysing the development of small businesses, distinguishing where appropriate between micro-, small and medium-sized businesses.

- 2. Assign clear institutional responsibilities for small business promotion and support policy within federal government and also in regional and municipal authorities.**
 - 2.1 Create clear institutional responsibility at central government level for coherent SME policy, with an appropriate budget allocation.
 - 2.2 Consider the use of an inter-Ministerial group functioning on a permanent basis to review, co-ordinate and harmonise small and medium-sized business policy activities, as well as sharing views on policies that may impact upon small and medium sized firms.
 - 2.3 Ensure that all institutions at the federal level have relevant structures for addressing SME policy development and implementation (Council of Federation and State Duma of the Federal Assembly), while creating a Forum enabling them to act as one voice in seeking to create better conditions for private sector and entrepreneurship development.
 - 2.4 Establish mechanisms to ensure that the federal and regional strategies for small business support are closely co-ordinated.
 - 2.5 Seek to strengthen the role and significance of the Federal Programme of State Support and Development of Small Business. The immediate priorities in this respect are to:
 - 2.5.1 Create a register of Ministries and agencies engaged in the support of small businesses and the role that each of them play in this support.
 - 2.5.2 Undertake a detailed elaboration of the institutional mechanisms for specific programme measures, paying particular attention to the specific division of responsibilities between federal and regional authorities and

between public bodies and self-governing professional organisations representing small businesses.

- 2.5.3. Establish effective communication procedures between participants in the programme.
- 2.5.4. Organise effective record keeping by programme participants to enable monitoring by independent (non-governmental) institutes.
- 2.5.5. Strengthen the evaluation of the effectiveness and appropriateness of programmes to the needs of small businesses with a view to facilitating the continuous improvement of these programmes.

3. Create the conditions for local and regional governments to support small businesses, based on different regional and local needs, working in close co-operation with federal Ministries and state agencies.

- 3.1. Develop and implement the federal programme of entrepreneurship support to include a clear specification of the role and responsibilities of the central, regional and municipal authorities with respect to its implementation.
- 3.2. Eliminate any contradictions between local, regional and federal laws with respect to the overall legal framework for small business policy.
- 3.3. Establish an inter-regional forum to enable close co-operation between regional authorities, state agencies and Federal Ministries in the field of small business support.
- 3.4. Take steps to build capacity in local and regional authorities with respect to the development of small business policy, paying attention to methods of assessing the needs of firms and to the development of sectoral and local/regional development strategies.

4. Take steps to create close co-operation and working relationships between the state and representatives of entrepreneurs.

- 4.1. Create a system of representative bodies to represent the interests of small firms and entrepreneurs vis à vis government at different levels, with specified responsibilities in fields such as anti-corruption control, while providing a mechanism by which the needs of small firms and the impact of government legislation on their performance and behaviour may be brought to the attention of government.
- 4.2. Promote the practice of wide consultation of draft legislation that may affect small businesses, providing representatives of small business bodies with an opportunity to express their views on relevant draft legislation and regulations.
- 4.3. Strengthen the role and significance of non-governmental institutions in relation to the delivery of small business support policy.
 - 4.3.1. Enhance the responsibilities of self-governing organisations as participants in small business development projects, while reducing the power of state officials to interfere in this process.
 - 4.3.2. Seek to strengthen small business agencies so that they can contribute to publicly voicing the needs of small firms and improve the legal and regulatory infrastructure for them.

- 4.4 Introduce training programmes for government officials that have dealings with small firms, in order to increase their level of awareness and understanding of the needs of entrepreneurs.
- 4.5 Take steps to increase the level of client orientation in the operation and functioning of state SME support services
- 4.6 Create Ministerial consultative committees, which would include representatives of Ministries and small firms for on-going discussions on their needs.
- 4.7 Create conditions that encourage increased co-operation between small firms, especially in such spheres as credit (e.g. through credit unions and/or mutual guarantees), insurance, materials procurement, marketing, auditing, leasing, importing, exporting, co-operation with foreign partners.

5. Take steps to ensure close co-operation with international and foreign national donor organisations and create favourable conditions to encourage the exchange of relevant ‘good practice’ experience.

- 5.1 Create favourable conditions to promote an exchange of experience with respect to donor programmes.
 - 5.1.1 Use the FEED framework to assess and disseminate the results of completed donor programmes, with a view to identifying good practice and to seek ways of utilising and building on this experience in current small business development programmes.
- 5.2 Work in close co-operation with donor organisations and international agencies to develop new approaches to small business support.

Chapter 3

TAX POLICY FOR SMEs

Overview

A stable and well-functioning tax system is of particular importance to the successful development of SMEs. The current system in Russia has been subject to severe criticism by entrepreneurs, and is considered by many of them as the major obstacle to business development in the country. This is a problem shared with some other transition countries. For example, an EBRD survey of some 7000 businesses in transition countries revealed that the tax system is perceived as one of the main constraints on doing business in these countries. Nevertheless, the pace of change in Russia has been slower in this respect than in some other transition economies. In this context, FEED participants discussed the specific problems which Russian entrepreneurs experience with respect to the current tax system and the changes that need to be introduced in order to find an appropriate balance between the needs and interests of entrepreneurs, on the one hand, and the needs of the state (at different levels) to generate tax revenue, on the other.

At present, three federal laws establish the basis for special regimes applicable to small businesses:

1. Federal Law regarding State Aid for Small Business: (no 88-FZ, June 14, 1995, amended July 31, 1999)
 - definition of small business based on number of employees for enumerated sectors of activity
 - does not provide special overall tax regime per se - only that small business should be able to take double depreciation deductions
 - directs government to devise simplified accounting regime
2. Simplified System of Taxation
 - definition of small business based on turnover and number of employees; same criteria for all sectors of activity
 - establishes system of patents, amount of fee set by regional governments depending on type of activity
 - creates entirely different method of computing tax base and different tax rates
 - allows for greatly simplified accounting requirements

3. Imputed System of Taxation (No.148-FZ, July 31, 1998, amended March 31, 1999)
- supersedes all other systems of taxation for particular listed activities
 - not limited to “small businesses” per se
 - imputed taxable income determined by formula based on specific factors that differ for each type of activity
 - different tax rates from regular rates and system is mandatory for the particular listed activities
 - simplified system of keeping books and records

The Tax Burden on Entrepreneurs

The tax compliance burden on small businesses in Russia is excessive because of the large number of different taxes imposed (up to 40 different taxes) and the complicated nature of these taxes. This system fails to stimulate business activity, thereby contributing to the failure of the small business sector to fulfil its potential contribution to economic development and to employment generation. It also encourages businesses to conceal their real income, thereby increasing tax avoidance, which both reduces revenue for the state while also contributing to a culture of tax evasion. FEED participants emphasised that as soon as the state attempts to tighten the fiscal system, SMEs reply by increasing the amount of their activity that is concealed in the informal economy. Both entrepreneurs and the state recognise that this ‘vicious circle’ needs to be resolved, since it not only damages the state but also the wider social fabric.

The intricacy and complexity of the current tax system encourages even the most law-abiding taxpayer to oppose taxes in general. Indignation is an almost inevitable reaction following contact with tax officials, because of the burdensome procedures that one is subjected to in order to fulfil one’s civic responsibilities. As a result, the feeling of fulfilment of civil duty is superseded by one of an unproductive loss of time and money, which is not taken into account when the costs and benefits of the fiscal system are assessed.

(From the statements of a representative of small enterprises at the Forum).

The overall picture is one where the legal base for taxation remains incomplete and unresponsive to the needs of small businesses. It is made more complicated by the fact that a number of different Government agencies claim to have responsibility for taxes and fees, while the Duma is simultaneously considering more than a dozen tax bills. As a consequence, under the present system an entrepreneur’s total tax liability is often difficult to calculate and his/her future liability typically uncertain.

The complaints of Russian entrepreneurs with respect to taxation are not only concerned with the level of taxes but also with the system itself, which they claim is unfair, inflexible, excessively complicated and fragmented. A high level of dependence on external conditions (such as market fluctuations),

combined with the effect of a limited internal resource base on the costs of compliance, means that small enterprises can be particularly seriously affected by the operation of such a system. The high cost of compliance with legislation in general falls disproportionately on small enterprises. Therefore many OECD countries have used this argument to justify offering small firms certain legislative exemptions.

FEED delegates also drew attention to the difficulties that Russian entrepreneurs often experience in finding out what their tax liabilities are. They stressed that it is not current practice for Russian tax officials to advise entrepreneurs on possible tax preferences, or on how to reduce their tax liability, within the law. This contributes to the negative attitudes which entrepreneurs typically express about tax officials and to a lack of an effective dialogue between them which, in a democratic society, helps to establish the rule of law.

Since small businesses are viewed by the state as recipients of state support as well as potential sources of tax revenue, it is important that an appropriate balance is struck between these two functions. For example, with respect to investment, a rational approach would seem to be to minimise the incidence of taxation until a project reaches the 'breakeven' stage, from which point it is able to generate tax revenue for the state, as well as profit for the entrepreneur. Viewed in this way, the tax system can become one of the instruments of policy assistance to enterprise development, by providing appropriate incentives to entrepreneurs to develop wealth and employment-generating projects, which will contribute to taxable income in the future.

Establishing an Appropriate Tax Environment for Business Development

Delegates to the FEED meetings agreed that three fundamental characteristics should guide policymakers in the work on the Russian tax code, namely simplicity, equity and stability. Simplicity is necessary for easy compliance and to reduce the non-productive time spent by entrepreneurs in dealing with tax matters and/or paying tax advisers/consultants to assist them; equity, to ensure fair tax legislation; and stability so that a firm's future tax liabilities can be planned for. Policymakers should recognise that excessive number of taxes and the overly complex procedures imposed on small businesses not only complicate their daily functioning, but also often results in enterprises moving into the shadow economy, which leads to a reduction in total tax revenue.

An Equitable Tax System

Tax equity requires that persons with equal ability to pay taxes should pay equal amounts of tax and that persons with greater ability to pay should pay more tax. In other words, for a tax to be "fair," it should not impose significantly different burdens on persons in similar economic circumstances. This means that small businesses, like taxpayers, should ordinarily pay the same amount of tax regardless of the sources or uses of their income.

Within the context of a need to create a uniform system of taxation for all businesses, based on the common set of principles outlined above, there may be circumstances where some tax preferences may be justified, reflecting the special needs of certain types of firm (e.g. seasonal fluctuations in production cycles, social structure of employment). In certain circumstances, there may also be a case for some local/regional variations in the use of tax allowances or preferences, reflecting local needs.

Unfortunately, the experience in this respect in Russia hitherto has tended to be that such allowances are more commonly associated with some attempt to protect local monopolies (often owned by those affiliated to the local administration) than to stimulate entrepreneurship and job creation. As a

consequence, any selective use of tax allowances to promote entrepreneurship must be linked to an attempt to promote enterprise by offering incentives that overcome market failure and that do not set barriers to entry for other entrepreneurs. It must also be recognised that such preferences should only be used in exceptional circumstances and where market failure can be demonstrated. Moreover, in a market based system, the displacement effects of interventions (in this case tax preferences) need to be assessed alongside the potential welfare gains from the intervention.

A Transparent Tax System that is Simple to Operate

All tax laws and procedures should also be transparent and as simple as possible to make them easily understood and applied by small businesses. Transparency necessitates the publication of all laws and interpretative guidance, the free distribution of all tax forms, as well as handbooks which describe the tax obligations of those opening or operating small businesses. By contrast, a system in which entrepreneurs are often confused and unclear about what their full liability for tax is, breeds corruption. It can also add unnecessarily to business costs by creating a need for advisers to help business owners that are attempting to work within the law. Simplicity refers to the ease with which a business is able to understand and execute its tax obligations.

Stability in the Tax System

The stability of the tax system should be promoted by resisting frequent changes to laws and the methods used to implement them, in order to assist businesses to plan their tax liability. Unfortunately, frequent changes to tax legislation have been a common occurrence under transition conditions, which has, at best, hindered the ability of entrepreneurs to plan for their future tax liability and, at worst, has left them with a backdated additional tax liability. In the absence of any preliminary discussion of, or consultation with, small businesses, or their representatives, such changes (and impacts) have often added considerably to the unpredictability of the external environment facing small business owners and managers. As one FEED delegate put it, the instability in the tax system becomes a question of life or death for small businesses; at least, those that are attempting to operate within the law.

A Need for Consultation and Dialogue

Small and medium sized businesses should be consulted on a regular basis in the process of designing or reviewing tax laws that affect the sector, ensuring that the consultation itself is transparent. Apart from helping to inform entrepreneurs about possible future changes in tax requirements, this could also help to inform policy makers of the likely effects and impacts of new tax laws on business behaviour, as well as to improve relations between business owners and tax officials. Ideally, such consultation should take place before tax laws are enacted. Finally, the success of the implementation of the policy guidelines and recommendations requires comprehensive training for tax policy-makers and tax officials, by creating an understanding of the needs of SMEs and of the particular aspects of their development and functioning.

The Regional Dimension

Another issue raised by FEED delegates concerns the variations in tax obligations between the federal level and the regions of the Russian Federation and its effects on the functioning of small businesses. Related issues are the laws on the regional sales tax and the tax on imputed income for certain types of activities of small businesses.

**POLICY GUIDELINES AND RECOMMENDATIONS
ON TAX POLICY FOR SMEs**

- 1. Simplify the tax system, reduce the number of taxes for which firms are liable, and reduce the burden of tax compliance, which can fall disproportionately on small businesses.**
 - 1.1 Undertake a fundamental review of the fiscal system, in which the effects of its operation on the performance and behaviour of small businesses are assessed, alongside other criteria.
 - 1.2 Recognise that the operation of current tax system results in many enterprises avoiding paying taxes and/or moving into the shadow economy, thereby leading to a reduction in the total tax revenue.
 - 1.3 Continue the work of reducing the overall tax burden on small businesses and reduce the number of taxes to which they are liable.
 - 1.4 Review existing tax reporting procedures with respect to the use of accounting methods, the tax reporting forms used and the amount of advance payments.
 - 1.5 Establish annual sales thresholds below which small enterprises would not be liable for VAT.
- 2. Avoid frequent changes to the tax system in order to increase stability.**
 - 2.1 Recognise that the small business sector generally lacks the financial and human resources needed to master new tax laws and that constant change will result in a drop in compliance.
 - 2.2 When changes in tax laws are enacted, ensure that sufficient time is provided in order that both the tax administration and entrepreneurs are able to understand and comply with the new provisions.
- 3. Take steps to increase the level of transparency in the operation of the tax system.**
 - 3.1 Publish, and distribute free of charge, all tax laws, tax forms, and handbooks describing tax obligations and interpretative guidance, in order to assist entrepreneurs to understand their tax liability.
- 4. Rationalise the distribution of tax burdens for businesses between the federal level and the regions of the Russian Federation, aiming to reduce distortions and inequalities.**
 - 4.1 Create a distribution of tax liabilities for businesses to be allocated to the federal and regional budgets that seek to seek a balance between the social and economic goals of the state and the regions of the Russian Federation, while also considering the interests of entrepreneurs.
 - 4.2 Seek greater harmonisation between the level of tax imposed on businesses throughout the regions of the Russian Federation, with a view to reduce distortions and inequalities of the present system.

5. Streamline the operation of the imputed tax (tax base inferred from simple indicators) for small businesses.

- 5.1 Analyse the implementation and application of the Federal Law on the uniform tax on imputed income for certain types of activity.
- 5.2 Avoid discriminatory provisions that are contained in the sales tax against compliant entrepreneurs.
- 5.3 Improve co-ordination between the application of the national VAT tax and the regional sales tax in order to avoid complexity and confusion among taxpayers and tax collectors.

6. Take active steps to improve communications between tax policy makers, administrators, officials and small business owners and managers

- 6.1 Provide comprehensive training for tax policy makers, administrators, tax officials and tax assessors in order to increase their understanding of the particular features of the SME sector and the effect of the fiscal system on business operations.
- 6.2 Avoid frequent tax inspections of small businesses.
- 6.3 Prioritise the development of ‘user-friendly’ explanatory material in consultation with SME representatives, in order to assist enterprises in understanding their liability for taxation.
- 6.4 Extend the existing duties of tax officials to include the provision of free advice to entrepreneurs on their tax liability and also possible tax preferences for which they may be eligible.

7. Adopt a cautious approach to the use of tax preferences, accompanied by a strict enforcement of their use.

- 7.1 Tax policy with respect to small firms must be compatible and co-ordinated with the overall strategy for state support for small businesses. The aim should be to remove inconsistencies and situations where positive benefits from state support are outweighed by any negative effects resulting from the tax system.
- 7.2 The use of tax preferences should be used with caution and only where prior analysis of the potential welfare gains has been assessed in relation to possible displacement effects.
- 7.3 The power to grant tax preferences should be embodied in law, not administrative discretion.
- 7.4 Any use of tax preferences should be accompanied by a strict enforcement and monitoring of their cost to ensure that the benefits in terms of increase economic growth and employment outweigh the revenue loss.

CHAPTER 4

THE RULE OF LAW AND THE REGULATORY FRAMEWORK FOR SMALL AND MEDIUM SIZED BUSINESSES

Overview

A strong point of consensus among FEED participants, during the Working Party meetings in 1999 and 2000, was the importance of removing constraints and obstacles to business formation and enterprise development. As in the case of tax policy, a key guiding principle is that “business must submit to the law, while the law must also protect businesses”. The elimination of needless laws and regulations, administrative barriers and other constraints should be an integral part of a strategy for stimulating and promoting entrepreneurship through improving the quality of the legal framework for entrepreneurship.

In fact, FEED participants agreed that the appropriateness, effectiveness and overall quality of the legislative and regulatory framework can have a greater impact on the development of the SME sector in the long run than direct support measures that are specifically aimed at helping small businesses. At the same time, the opposite is also the case, in that the negative effects of an inadequate and poorly implemented legal and regulatory framework can impair the development of legitimate private sector activity at the expense of a burgeoning informal economy. It was also pointed out that strengthening the legislative environment can be a highly cost-effective strategy for stimulating and promoting entrepreneurship, particularly when government resources are limited.

In this context, FEED participants focused firstly on the extent to which the existing legislative and regulatory frameworks in Russia are appropriate to the needs of an emerging SME sector; and secondly, on the changes that need to be made to these frameworks in order to create an enabling environment for small business development.

Establishing the Rule of Law

The rule of law is concerned with creating, building and consolidating a legal framework that not only provides the judicial base for legal business activity, but also set the rules of participation in the market economy. In this regard, it is important that the rule of law is established so as to define the parameters within which small businesses can legitimately operate. SMEs are not unique in requiring well-defined “rules of the game” and a strong legal system, yet they are disproportionately vulnerable to situations of unpredictability and confusion created in the absence of such a system.

FEED delegates gave numerous examples demonstrating why many entrepreneurs operate outside the law. Faced everyday with legal obstacles, there is often a choice between remaining within the law while losing time and money in the process, or operating outside the law in order to gain time and avoid what business owners view as unnecessary costs.

Reducing the number of laws is likely to contribute to increased observance of the remainder, particularly if the pruning is focused on those laws that are impractical and difficult to implement, since they contribute to a diminishing of the value placed on the law by entrepreneurs (see box below).

An independent examination of the implementation of the Federal Law • 88-FZ “About government support of small business in Russian Federation” (carried out by some public organisations before the All-Russian Congress of businessmen Active in Small Business in September 1999), showed that almost 80% of the paragraphs of this law had not been implemented due to their impracticality and/or the absence of any effective implementation methods. Moreover, laws that came in to force after 88-FZ simply aggravated the incompleteness of 88-FZ, causing some inconsistency with the current legislation. Duality of interpretations has contributed to increased contradictions between different state departments, which in turn has contributed to the inability of the Federal budget to finance the implementation of the program of government support of small business in the period 1997-1999.

(Extracted from the materials of the Organising Committee of the All-Russian SB Conference, September 1999, delivered at the FEED Forum)

A Need to Reduce Bureaucracy

The regulatory environment for small firms in Russia imposes serious limitations on their efficient functioning, and is currently hindering the development of the small business sector. This is visible in such areas as taxation, business registration procedures, licensing, the allocation of premises and/or land and the provision of quotas. Participants in the meetings of the Working Parties of the FEED for the Russian Federation stressed that the lack of well-implemented procedures, the absence of clearly identified obligations and legal rights of small businesses, combined with the notoriously bureaucratic nature of administration represents a serious barrier to entrepreneurial initiative. Moreover, these factors represent a continuous source of difficulties and a financial burden for small businesses, constraining the choices available to entrepreneurs and contributing to the flight to the informal economy. In addition, excessive bureaucracy represents one of the main factors contributing to corruption in the country.

From an entrepreneur’s standpoint, the cumulative cost of meeting the demands placed upon business by the Russian bureaucratic machine is considerable. This is because small businesses are forced to pay administrative fees to the state for the right to undertake many routine tasks associated with running a business (see box below). Reflecting a highly inefficient situation, FEED delegates referred to the need for the state during the post-Soviet period to find work for the existing officials. Slimming down and reviewing the operation of state bureaucracy is a critical part of creating a facilitating environment for private sector business development, particularly for small firms, faced with the disproportionate burden of compliance costs.

Some Views and Experiences of Russian Entrepreneurs with Respect to Bureaucracy

1. The post-Soviet mentality of many officials makes them regard businesses in general (even if it is very small) as highly profitable activities, with its actual profitability not being a concern.
2. For each law there is a launching mechanism. To make a law active many officials are involved, each carrying a definite responsibility in their own working area, resulting in a state bureaucratic machine which lacks coherence. The more laws – the more officials. Entrepreneurs are expected to know all rules and laws and be ready to use their knowledge to achieve market success in a legal way. Unlike state bureaucrats, small business owners and managers need expertise across a wide spectrum, some of which is only made necessary by the demands of state bureaucracy.
3. The state is, legally, the entitled to collect money from businessmen for carrying out state inspections, inventory making, registration, licensing, certification etc. That's the field where the bureaucracy machine is enterprising and full of initiative, even by business standards.

(From the reports of Russian entrepreneur at FEED Working Group meeting).

Entrepreneurs need to pay for a range of administrative fees, for example:

- basic registration of a business (e.g. state business registration and all related procedures);
- choosing the field of work and being active in that field as a businessman (e.g. acquiring licences and paying for all necessary certificates, inspections etc);
- carrying out the ongoing business (e.g. contract registration, receiving industrial and office premises, production certification, custom duty permissions, building, cash-book procedures etc.);
- commercial financial operations (e.g. through registration of loans, credits, grants and guarantees);
- business safety (e.g. insurance of property and risks);
- protecting their interests (e.g. applying to court);
- liquidating their business.

There are different ways of paying the unaccountable administrative fees, either legally (i.e. according to the legislation), half-legally (i.e. in different development funds) or illegally (corruption). In contrast with money, time is irreplaceable. In practice, businessmen “buy time” from the bureaucratic bodies, deciding on each occasion what is cheaper and more effective: to pay the state (legal fees), to pay the development funds (half-illegal), to pay certain officials (bribery, illegal) or to pay for the illegal ‘cover’ or protection.

Yet even if a business decides to pay, it still needs to infringe the law in order to organise double-entry bookkeeping, because non-registered money is needed. As a result, unproductive expenditures will increase because it will need a bookkeeper and a lawyer (who receive additional fees). Law abiding small entrepreneurs cannot afford this since they do not have “additional” money. Only those who became rich in the early stage of the transition and illegally working through the “grey” market pay, which further reflects the fundamentally wrong incentive structure of the economic system.

(From the reports of Russian entrepreneurs at FEED).

The Informal Economy

Businesses operating in the informal and shadow economy deprive governments of much needed tax resources, as well as increasing the fiscal burden for those companies that are legally registered. Cumbersome laws and procedures inadvertently encourage the development of the shadow economy by forcing entrepreneurs to avoid proper legal procedures, relying on bribes or fines to deal with the consequences that arise. According to some estimates, the informal economy contributes as much as 45% of Russia's gross domestic product, although others put the figure lower, at 20-30%. Moreover, according to surveys, from 15-30% of the total workforce was reported to be engaged in informal sector employment.

Factors contributing to the scale and scope of the informal economy in Russia include barriers to market entry, weak legislative protection of entrepreneurs, the numerous procedures required for business operation, the myriad of authorities that supervise business activities, the high tax burden, the existence of informal networks through which transactions can be undertaken and resources mobilised, together with the whole nature of business ethics, the corruption of government officials and the pressures for organised crime. Reducing bureaucracy and creating a more facilitating environment for legitimate private sector business development by reducing the costs to business of operating in the formal economy, is a necessary condition that needs to be fulfilled if activity currently taking place within the informal economy is to be drawn into the formal sector.

The scale and scope of the grey economy in the Russian Federation is testimony to the defects and incompleteness of the current legislation and existing implementation methods. This is a policy concern not simply because of the loss of tax revenues, which such activity represents, but also because of the need to establish proper rules to govern business relations that offer legal rights and protection to the parties involved in business transactions.

Corruption

FEED delegates also strongly emphasised the urgent need for action in implementing anti-corruption measures and for ensuring that regular review and action is taken, within a continuing programme of systematic measures to fight corruption. This needs to be tackled at different levels. While the corruption of state power may attract the most attention from the media and from society at large because of its high profile, steps to eliminate petty bribes at a local level are also important. In this regard, special attention needs to be paid to the attitudes and practices of local officials towards petty traders, craftsmen, shuttle merchants and owners of illegal taxis. Such activities are an important part of contemporary entrepreneurial activity in the Russian economy. A toleration of 'double standards' at this level may be incompatible with raising the ethical code of business practice in the longer term.

Enforcement and Implementation Issues

Clearly, the promotion and protection of entrepreneurial rights through the law is only as good as the enforcement of the law itself. The weakness of implementation and enforcement of existing laws and regulations is a critical barrier to the emergence and functioning of small private sector entrepreneurs. It is also a strong disincentive to potential investors that could bring much needed capital investment into the Russian small business sector.

**POLICY GUIDELINES AND RECOMMENDATIONS ON THE RULE OF LAW
AND REGULATORY ISSUES WITH RESPECT TO SMALL FIRMS**

- 1. Take active steps to improve the legal and regulatory environment for small and medium-sized businesses, taking steps to reduce bureaucratic obstacles**
 - 1.1 Review current legislation with a view to eliminating excessive regulation and contradictions between laws, normative acts and administrative regulations.
 - 1.2 Reduce the number of state bodies concerned with the control, management and regulation of business relations.
 - 1.3 Increase the transparency and public availability of information regarding government regulations and legislative proposals affecting businesses.
 - 1.4 Continually monitor and take action to address new barriers and obstacles that may emerge, both in the introduction and implementation of laws and regulations.
 - 1.5 Take steps to strengthen the court system by:
 - 1.5.1 Improving the financial position of courts, public prosecutors and bailiffs
 - 1.5.2 Increasing co-operation between these judicial bodies, as well as between state anti-monopoly bodies (arbitration tribunals) and public bodies concerned with collective legal protection of small and medium enterprises.
- 2. Reduce the burden of small business registration, licensing and administrative procedures, and necessary to start and run small businesses.**
 - 2.1. Simplify enterprise registration, preferably reducing it to the entry of requisite data in a unified register of legal entities, i.e., it should be of a notification nature.
 - 2.2 Reduce approval licensing to the strict minimum required by prevailing public interests.
 - 2.2.1 Set a relatively short and unified timeframe for the completion of all registration formalities and establish monitoring procedures to ensure that the specified timescale is adhered to.
- 3. Establish improved working relationships and communications between government officials (at all levels) and small and medium-sized businesses.**
 - 3.1 Seek to change the attitudes of civil servants towards small business by setting an example at the very top of government.
 - 3.2 Provide training to all public officials dealing with small firms, at the federal, regional and local levels, including public prosecutors, representatives of anti-monopoly bodies and professional self-regulating SME organisations. The aim of such training would be to increase the level of understanding by public officials of the problems and needs of SMEs and to contribute to improved communications between them.

4. Take effective action to combat corruption.

- 4.1 Support systematic research and professionally conducted surveys, where necessary, to define, understand and monitor the specific developments in the informal economy.
- 4.2 Develop special programmes of anti-corruption measures, paying particular attention to the impact of corruption on small businesses.
- 4.3 Encourage private sector initiatives to create business ethics centres.
- 4.4 Actively participate in international networks and initiatives dealing with anti-corruption measures and international programmes concerned with tackling such issues as money laundering, organised crime and economic corruption. Relevant examples include the Steering Group on Business Integrity and the OECD Anti-Corruption Network for Transition Economies.
- 4.5 Recognising that ‘the punishment should fit the crime’, take steps to ensure that the sanctions for illegal economic activity are proportional to the nature and extent of the violation.
- 4.6 Take steps to eliminate corruption in government organisations at different levels, by establishing procedures where formal allegations of corruption against officials may be registered and transparently investigated, according to clearly defined procedures and enabling such investigations to be reported in the mass media and the results published.

5. Take steps to increase the level of access of small firms to public procurement contracts.

- 5.1 Review public procurement procedures, paying particular attention to lot sizes, the documentation required and tender conditions from a small business standpoint.

Chapter 5

FINANCIAL INSTRUMENTS FOR SMALL FIRMS

Overview

The potential for small business development depends to a considerable extent on their ability to access and successfully mobilise sufficient financial resources. In this regard, the lack of such finance is one of the main difficulties facing Russian entrepreneurs when attempting to start and develop their businesses. Most small enterprises suffer from a shortage of capital, that mainly reflects defects in the supply of finance available to them through the market and in the methods of financing used. In this context, FEED delegates considered the barriers faced by small firms in accessing external finance in Russia, the range of financial instruments and services available to them and the type of policy measures that need to be introduced in order to improve the situation.

Defects in the Supply of Finance to SMEs in the Russian Federation

There are a number of reasons why financial markets do not work perfectly as far as small firms are concerned. According to FEED delegates, the main obstacles currently in Russia are a lack of development of finance and credit services, reflecting poorly developed financial markets and a lack of knowledge on the part of small business managers of some of the contemporary methods of financing that are used in OECD countries.

One factor influencing defects in the supply of finance is that small businesses are considered by commercial bankers to be a high credit risk, which leads them to demand a level of collateral that firms are often unable to provide. In Moscow, for example, it is estimated that only one in seven small firms manage to secure commercial credit financing. New business start-ups are viewed as particularly risky propositions by bankers because of their absence of a business track record.

A lack of sufficient collateral causes many promising projects to be abandoned because of a lack of sufficient financing. If commercially viable business propositions that otherwise warrant financial support, are failing to attract sufficient and appropriate finance because the proposers cannot meet the high Russian requirements for collateral (often 150% to 300 % of the credit amount), then this can be interpreted as a sign that the market is incomplete. Such a situation may involve potential welfare losses for the economy, as well as being detrimental to the (potential) entrepreneur.

In many OECD countries such circumstances have been the basis of selective intervention by the state in the market through, for example, loan guarantee schemes. Yet in Russia the state at present is not in a position to mobilise the necessary public resources to provide financial support for small firms, which was emphasised by representatives of the Federal government during the meeting of the FEED Working party in St. Petersburg.

Other problems that small businesses in Russia experience with respect to loan finance include the excessively high interest rates demanded by commercial lenders, the lack of availability of long term loans, and the lack of interest on the part of the banks in dealing with small-scale borrowers compared with larger ones. In other words, Russian small firms face an underdeveloped commercial market for loan finance, combined with a lack of effective participation by government in supplying finance to small firms, either directly or indirectly by offering guarantees.

Demand Side Defects affecting Access to Finance by Small Firms

Although a major part of the difficulties experienced by Russian small firms in accessing external finance are supply side issues that are rooted in the banking system, demand side defects also contribute. The commercial behaviour of small business owners and managers and their inexperience in a market context are additional factors contributing to a lack of confidence in the eyes of potential lenders of the potential borrowers ability to repay a loan. A lack of knowledge, on the part of entrepreneurs, of some of the financing methods and approaches that are used to increase working capital by firms in mature market economies is another problem. Moreover, the common inability of small firms to produce business plans that are convincing to bank managers with cash flow forecasts to support their loan applications, may also be seen as a deficiency in terms of converting their need for external finance into an effective demand for it.

Increasing the Supply of Finance to Small and Medium Sized Businesses

As a consequence, improving the financial conditions of SMEs in Russia requires actions on two fronts: firstly, measures designed to directly improve the supply of capital available to them; and secondly, taking steps to improving the management capacities and competencies of small business owners and managers, focusing specifically on their financial management skills and increasing their knowledge of alternative methods of financing.

Taking steps to increase the supply of finance to SMEs is a key task for federal and regional authorities that need to work with the financial sector to find ways of reducing credit risks associated with lending to SMEs. In principle, the state should avoid direct financial support to entrepreneurs but rather play a role as a catalyst to attract domestic and foreign capital into the SME sector. Delegates agreed that the key challenge is to make the small business sector more attractive for investors. Steps need to be taken to create conditions to increase investment activity by enterprises and individuals, to encourage financial institutions to provide support for small businesses and to implement joint programmes with donor organisations. To achieve this, will require initiatives at the federal, regional and municipal levels.

A key theme that FEED delegates emphasised in relation to improving the access of Russian SMEs to finance in the future was a need to raise awareness of the variety of types of financing methods available, which involves drawing on appropriate experience elsewhere. FEED participants emphasised the variety of financial tools that may be used to help to increase the supply of appropriate types of finance to small firms, including:

- local micro-credit schemes, in which borrowers are expected to make regular repayments and reports indicating how the funds are being used.
- banking micro credits (based on EBRD criteria)
- mortgage credits

- use of trade credit for materials
- mutual credits (either loan-saving or mutual credit companies) and credit unions
- lease-back with “revolving” banking credits on leasing financing;
- methods that combine budget credits (e.g. for investment) with commercial and credit co-operation, where the risk is distributed between the parties (e.g. relevant experience in certain TACIS projects);
- venture capital invested through joint ventures and strategic partnerships between small businesses and other firms.

Sources of funds for the SME sector include public sources (both international or bilateral aid programmes) as well as private sector sources, such as business associations. Such organisations have an interest in promoting the development of small and medium sized business specifically or in using them as tools to contribute to job generation and/or economic development. Clearly, increasing the supply of capital available to small business is one of the measures available to help to achieve such objectives. This is potentially significant since it allows financial services to be extended to a broader range of enterprises than are likely to benefit from commercially sourced funds. In other words, the role of such organisations is to address areas where market mechanisms are unlikely to offer a solution to the financial needs of (potential) business owners. The potential welfare gains (e.g. in terms of jobs, contribution to regional development) may be used to justify a degree of intervention in this respect. Discussions in the FEED working group suggested there are a number of requirements and challenges concerning the establishment and management of these non-traditional financial instruments, which are set out in the guidelines below.

State Financial Support for SMEs

FEED delegates identified a number of problems with state financial support for small businesses in the Russian Federation that have hitherto limited its effectiveness and impact, including a lack of legal regulations to enable effective implementation of these programmes. More fundamentally, however, participants pointed to the poorly specified objectives of these programmes, reflected in an absence of clearly defined target beneficiary groups, an absence of explicit criteria by which the eligibility of loan applications can be assessed, and a lack of clear guidelines on the terms and conditions on which financial support can be offered to SMEs. In many OECD countries easy access to cheap budget financing is covered by stricter but clear-cut terms.

Russian Government Financial Support for Small Business:

- a)* Through intermediate links (such as government and municipal funds being used to support particular programmes);
- b)* Directly (e.g. state customers concluding contracts with SMEs who win tenders to supply the state with goods or through investing projects financed by the Development Budget).

Most state financial resources for small businesses are represented by the regional budgets or special funds (such as the “Fund for developing small-sized engineering and technological business”, which is funded from the federal budget, and the regional government funds for small business support). Additionally, in some regions preferential loan terms are available to SMEs from funds that are part of regional development projects. At the same time, these funds only cover a small fraction of the total demand for finance from small enterprises in Russia.

Although the long-term emphasis must be on improving the supply of finance of various types through market-based solutions, there remains a short-term need for government to adopt a stronger role in contributing to the supply of finance for SMEs. This is because of the incomplete nature of financial markets in Russia, combined with the weaknesses of some of the major banks, following the crisis of August 1998.

FEED delegates laid out guidelines and priorities for the state in this respect.

- i) A federal investment strategy, which, in view of budgetary constraints, must include consistent rules regulating, shared investment and co-financing projects with shared risk.
- ii) The current mechanism for facilitating co-ordination in the use of state funds available for small business support between different arms (e.g. Ministries) and levels of government (i.e. federal, regional, local) is inadequate and needs improvement. Effective implementation requires close co-ordination in order to ensure that public expenditure has the maximum impact. Currently, appropriate financial tools do not exist to enable budget money to be used to accumulate for investment purposes, or as a collective guarantee, or to subsidise interest rates or improve credit terms.
- iii) If state financial support for SMEs is to be effective, it is necessary to have clearly defined rules to regulate the circumstances and conditions in which financial support of different types can be granted, and the purposes for which they may be used.

The US Small Business Administration (SBA) has more than \$US 27 billions at its disposal in the form of loans that can be obtained by 185000 small business participants, who otherwise could not get sufficient finance.

The US “Small Business Law” states that (according to the “Program – 7a”), the SBA guarantees SME loans of 85-90% but not exceeding \$US 500,000. These loans are available for up to 25 years in order to acquire fixed capital, or for up to 7 years to re-stock working capital. Interest rates charged are not more than 2.25-2.75% above the prime lending rate.

(From the report of the USA organisations’ representative)

A Role for Local Partnerships

FEED delegates suggested that regional and local support schemes are required to enable a capacity in financial expertise, with respect to small firms, to be built up at the local level. Locally focused public/private partnerships represent one way of bringing public and private actors together in a common focus on local economic development, in which the state has a catalytic, strategic and co-ordinating role.

POLICY GUIDELINES AND RECOMMENDATIONS ON FINANCIAL SUPPORT INSTRUMENTS

- 1. Develop a national concept of state financial support for small firms, based on clear-cut principles, mechanisms, instruments and monitoring schemes.**
 - 1.1 Establish the legal requirements at the federal level to provide a range of financial tools and financing methods, appropriate to the needs of small firms.
 - 1.2 Improve co-operation between MAP and the Federal Fund, as well as between other relevant institutions at the federal, regional and municipal levels
- 2. Take steps to facilitate capacity building in the banking and financial systems to improve access to finance for small firms.**
 - 2.1. Promote a small business culture in the banks by:
 - encouraging and assisting banks to develop their internal policies to increase their business with small firms.
 - encouraging and assisting banks to train bank staff to deal with entrepreneurs,
 - encouraging initiatives by the banks to support enterprise at a local and national level, using the positive experience of the EBRD with respect to project financing and the use of microcredits.
 - reviewing small business programmes in which banks have successfully participated and promote them in other regions of the Russian Federation.
 - 2.2. Develop training programmes for the staff of state support funds, investment agencies and other financial specialists, with respect to new methods of financing and their use by SMEs. Such training could be provided within the framework of foreign technical support offered by international organisations, such as the EU and bilateral donors..
 - 2.3 Provide training and advice for entrepreneurs in dealing with financial institutions and devote resources to training staff in their enterprises in business planning and appraisal.
 - 2.4 Establish the essential legal conditions to facilitate the efficient operation of the market for commercial credit that addresses issues of collateral, bankruptcy and market exit.
- 3. Encourage and facilitate the development of new methods of financing, paying particular attention to leasing and franchising.**
 - 3.1 Adopt the legislation necessary for the development of leasing, venture capital, credit co-operatives and other alternative financial mechanisms in the Russian Federation.
 - 3.2. Support the development of credit co-operatives/unions at the local and regional level. Find ways to use the positive experience accumulated in this area for the development of new policies and draft law on the subject.
 - 3.3 Accelerate the development of legislation to regulate mutual credit schemes and take active steps to establish reliable guarantee schemes for entrepreneurs.

4. Provide public funding schemes for small firms, where market defects demonstrate there is a need, based on clear rules governing their implementation.

- 4.1 Introduce rules into federal legislation to regulate the use of the budget for financial support for SMEs.
- 4.2 Establish clear rules to govern the implementation of state support programmes that should include:
 - the eligibility criteria for beneficiaries (e.g. new business start-ups, businesses rendering specified socially important services, businesses owned by specified social groups)
 - the conditions in which state financial support may be obtained (e.g. to support innovation, exporting) and the criteria against which projects will be assessed
 - the terms and conditions on which grants, loans, guarantees and other financial support may be offered (e.g. interest rate guidelines, payback periods, and reporting requirements)
- 4.3 Ensure that public sector or state financial assistance programmes complement rather than compete directly with private sector financing.
- 4.4 Establish clear conditions and policies with respect to joint public-private project funding. This may require legislative amendments to establish the rules governing co-financed projects.
- 4.5 Recognising the need to develop higher value added activities, take steps to strengthen the role of bodies concerned with supporting knowledge based small firms, financed from budgetary sources where necessary.

5. Take active steps to ensure that the financial needs of small firms are addressed at the local and regional levels.

- 5.1 Review local and regional variations in the supply of finance to small firms in the Russian Federation.
- 5.2 Seek to establish local support schemes in areas where defects in the market for small business finance are severe, based as much as possible on working in partnership with commercial sources of credit
- 5.3 Promote the principle of partnership at the local/regional levels (both between local/regional and federal authorities and between public and private sectors) and establish clear rules for state budget participation in local expenditure
- 5.4 Promote local training programmes for staff involved in the assessment of business plans to support loan applications.

Chapter 6

ADVISORY SERVICES FOR SMALL FIRMS AND BUSINESS INCUBATORS FOR START-UPS

Overview

Delegates of the FEED Working Party for the Russian Federation placed a major emphasis on the need for well-targeted business advisory services as an integral part of a facilitating environment, conducive to the growth and effective performance of small businesses. However, one of the most challenging tasks is to decide on the role that government should adopt in this process, in relation to the private sector. While the state has an interest in creating environment conducive to the creation of the support infrastructure for small businesses because of the various contributions that small firms play in economic development, experience in other countries shows that the actual delivery of business support is best undertaken by those with a private sector business background and experience. This suggests that a key role for the state needs to be limited to the strategic one, acting as a catalyst and co-ordinator, while working closely with private sector organisations to help to build capacity in the development of market based services.

There is a wide variety of advisory services for new and developing enterprises and many different ways of delivering them. At the same time, the needs of firms for such services can vary widely in relation to their stage of development stage, sector and location. In this regard, an important distinction can be made between the support needs of businesses during the start-up and pre-start-up phases, and those of more established small businesses, which are typically more specialised. In this regard, there is an important potential role for business incubators to provide support for new ventures during the period of start-up and critical early stage of business development. As a consequence, any policy action in this area must be based on a thorough analysis of the support needs of SMEs and the possible range of business advisory services that are required to meet them.

In this context, discussions in the FEED Working Party focused on three main issues: firstly, the role of the state as facilitator in the development of advisory and consultancy services for small firms in Russia; secondly, those areas of support where improved advisory support can add value to small business development; and thirdly, the priorities for the development of business incubators for new start-up enterprises.

The Support Needs of SMEs for Business Advisory Services

The support needs of SMEs with respect to business advisory services usually relate to one of eight areas critical for enterprise development: legal, accounting, finance, marketing, production, human resources, strategic issues and general management. At the same time, the specific needs of individual clients vary considerably according to their education level, level of management training (if any) and previous private sector business experience. As a result, the delivery of these

services must be flexible enough to be able to address the wide variety of needs that individual small firms have.

Within the broad categories identified, there are more specific demands of SMEs which, according to one survey, are typically focused on requiring assistance in finding potential clients, receiving credits from regional business support agencies, finding Russian and foreign partners, and obtaining information about a variety of issues. These include information about potential sources of credit, new technologies and “know-how”, goods, services and their market prices, market research, training and education. Rapid access to the variety of types of information that are necessary for efficient business operation (such as information about potential customers, suppliers, sources of finance etc) is a basic business need. In view of the presently underdeveloped nature of the business support system in the Russian Federation, a priority need for government is to take steps to create an efficient and accessible information and communications network that could be initially focused on integrating existing reference information systems.

Some of the most successful projects targeted at SMEs in the Russian Federation have been those initiatives and projects of international organisations concerned with the development of infrastructure for the provision of consultancy and business training. There is a network of agencies supporting SME in the Russian regions. In addition, the development of the Interregional Marketing Centres (IMC) network is proceeding rapidly, the network of training and business centres (Morozov Project) is contributing to an improved business environment and the MAP Resource Centre for Small Entrepreneurship is expanding its activities into the field of information provision and consultancy structures.

SMEs have some support needs that are best addressed through advice and consultancy, but they also have needs with respect to training and professional upgrading. The development of a comprehensive commercial business support infrastructure for small businesses requires close co-ordination between training and business advisory provision that is accessible at the local and regional levels. It also requires consultants (and trainers) that both understand and are experienced in the distinctive management problems faced by SME owners compared with their large firm counterparts. In this regard, the delivery of consultancy to smaller enterprises presents distinctive challenges, particularly where the client receiving the assistance has little (or no) professional management training and/or experience. In this context, the most effective consultancy is typically that which is grounded in the experience of the client.

An Underdeveloped Market for Business Services

Delegates agreed that the market for business information and advice in the Russian Federation is not yet sufficiently developed and promoted, so that many SMEs are unaware of where to go to find what little support does exist. As a consequence, new and small businesses are unable to easily obtain access to these services and there is considerable unfulfilled and unmet latent demand for them. According to one study, only 10-15% of small businesses in the Russian Federation use the services of consulting firms and an estimated 60-65% of the potential support needs of SMEs in terms of information and advisory support are not converted into an effective demand. On the other hand, there are clear supply-side defects in the existing consultancy market in Russia, which is characterised by instability and an emphasis on short-term returns rather than long term development.

Imperfections in the market for business information might provide a rationale for some public intervention in order to help to fill these gaps, recognising that improving the competitiveness and performance of the SME sector offers potential welfare gains for the economy as a whole.

Nevertheless, as with any state interventions in the field of SME support, it is important not to restrict the emergence of a market driven supply. In addition, state intervention has to avoid supporting inappropriately targeted programmes offering services where no effective demand exists.

A key question considered by delegates concerns the extent to which advisory and information services for small firms should be subsidised. The issue is closely related to the question of the sustainability of institutions and agencies providing advisory services, especially after donor money is no longer available to support them. Strong pressure for self-sustainability could result in these agencies moving away from assisting new and small businesses (which need the help most) to work more with larger clients who are able to pay for services.

FEED delegates concluded that where business advisory services are subsidised, the subsidy should be explicit and foreseeable. Additionally, subsidies should have a definite time span or should be related to clearly established performance criteria. At the same time, there was common agreement that enterprises should make a financial contribution towards the cost of services and that free-services should in general be avoided. It can be argued that entrepreneurs are more likely to value the service that is offered to them if some contribution towards their cost is made. Sustainability in the design and organisational structuring of the business advisory service programmes and institutions is an important objective, together with a diversification of funding sources. Institutions that provide business advisory services should not be fully dependent on external subsidies, since this is a potential threat to their long term sustainability.

The Experience of Israel

In 1993, following the initiative of the Israeli Ministry for Industry and Trade, and in accordance with recommendations of the Public Commission for SME Affairs, the **Israeli SME Authority (ISMEA)** was established as independent non-commercial organisation (“•muta”). Its governing body is composed of representatives of ministries, economic and public organisations, who are not only involved in developing and approving the SME support programs, but also in supervising their implementation. ISMEA obtains financing from the Ministry of Industry and Trade as an All-Israeli structure, with a number of affiliates located in specific territories and sectors. The ISMEA implements its programs via Centres for Business Initiatives Support (BIS), located around the country. These provide businessmen with all-round assistance in setting up their businesses, their management and expansion and, when problems arise, helping to save them from bankruptcy and closure.

(From the statements of Mr. Itkhaki and Mr. Livshits, the representatives of ISMEA at the FEED sessions)

In this context, FEED delegates considered that the state can have a role to play in contributing to the development of the market for business information and advice. State subventions can be used to subsidise the provision of a minimum range of such services. However, the aim should be to build market capacity in the longer term, with the actual delivery of these services being in the hands of private consulting companies.

The Role of Support to Advisory Services in SME Policy

FEED delegates stressed that the provision of advisory and consultancy support has a special role in the wider context of small business policy. SMEs need access to information, and often advice also, if they are to take full advantage of other aspects of policy. In this regard, MAP has a potentially important role in inter-departmental co-ordination to provide information to SMEs concerning such issues as sectoral restructuring and opportunities to participate in tenders and public procurement contracts. In this regard, there is a special need for those advisers and consultants concerned with assisting small businesses, to be fully briefed on the scale, scope and terms of these opportunities, if they are to effectively assist client SMEs to access these opportunities.

FEED participants also stressed the importance of increasing the level of co-operation between the various national and international donor organisations, operating in Russia. There is potential advantage in co-ordinating the activities of those organisations concerned with offering advice and consultancy services to SMEs at a regional level, in order to increase their impact.

Alongside the provision of professional advice and consultancy, FEED delegates also identified a role for increasing the exchange of experience between SMEs themselves, through initiatives designed to promote business-to-business networking. The aim would be to share problems and good practice experience, where successful established entrepreneurs would advise and mentor their less experienced counterparts. Such initiatives could be organised at a local level in co-operation with state bodies for assisting SMEs and Trade and Commercial Chambers.

The Role of Business Incubators

Business incubators help entrepreneurs to start businesses by making the process simpler and less expensive. They feature commonly shared building, administrative and communication services, and, depending on specific circumstances, can be associated with universities, technology parks, etc. The advantages of business incubators for entrepreneurs include reduced initial investment in premises, reduced overhead costs through sharing of administrative and communication services, benefiting from interaction with other entrepreneurs in the incubator, and expertise in dealing with government institutions and agencies. Entrepreneurs can normally use the incubators only for a limited period.

Business incubators have an important potential role to play in the context of SME support policy, by offering a mechanism through which entrepreneurs with good business ideas can be offered material, organisational and advisory support to help them develop their business propositions and successfully launch their enterprise on to the market. Maintaining continuous support through the business incubation period, from the initial idea to the first commercial success, is an important principle in the development of innovative new ventures.

Good Practice in Business Incubation
Local Economic and Employment Development (LEED) Programme

“Incubators have variously been referred to as enterprise centres, nurseries, shared workspaces, managed workspaces and venture units. As this diverse nomenclature suggests, there is no unique business incubator model. The incubator industry is an assortment of different types of facilities operating under different circumstances. This variety, it was remarked, can be a hindrance both to the collection of statistics and to industry benchmarking.

Evidently, business incubators aim to assist entrepreneurs with enterprise start-ups and development. However, the underlying objectives of business incubation are varied. They have included, for example: combating unemployment; expanding the supply of infrastructure; commercialising university research; upgrading the technological capabilities of firms in a given location; assisting socially disadvantaged groups -- such as youth and minorities --, and even providing a protected space for entrepreneurship in areas where crime is a constraint on business. The public, private and non-profit sectors have all participated in establishing incubator schemes. Local and regional governments, universities, chambers of commerce, science parks and private real estate developers have all funded incubation programmes.”

A Synopsis of the Presentations and Debates, International Conference in Albi, France, 14 - 15 October, 1999, OECD LEED Programme

In addition, through providing support for the creation of new ventures in emerging sectors, business incubators also have an important contribution to economic development by contributing to the process of economic restructuring. This is particularly important when the activities of the incubator are focused on supporting new ventures in technology based sectors, where the lead-time in developing an idea and bringing it to market is often considerable and the commercial risk high. In this sense, business incubators are an important element in the infrastructure, that are necessary to support the development and commercialisation of new production technologies, complementing the roles of other agencies, such as those concerned with intellectual property rights and the preparation of patents.

Principles to Guide the Development of a Business Support Infrastructure

FEED delegates identified a number of key principles that should be applied in designing and developing an appropriate support infrastructure offering business information and advice to SMEs. The starting point is that SMEs require access to high quality services at all stages of their development i.e. from pre-start through start-up to establishment and growth. In addition, it is important that the provision of business advisory services is carefully linked with the overall design of small business policy and its delivery, as well as to the broader economic and social development goals that are set by the government. Business advisory services also need to be seen in close relationship with other support needs of entrepreneurs (such as, with respect to finance, premises, technology transfer, etc.) and experience in other countries suggests that the impact of external support for SMEs is most effective when the delivery of these different elements is closely co-ordinated.

**POLICY GUIDELINES AND RECOMMENDATIONS FOR
BUSINESS ADVISORY SERVICES FOR SMALL BUSINESSES AND
BUSINESS INCUBATORS FOR START-UPS**

- 1. Intervene only where market gaps exist in the provision of business advisory services.**
 - 1.1 Follow a general policy of providing state intervention schemes only where there is a clear market deficiency in the provision of business advisory services to start-ups and SMEs.
 - 1.2 Design and implement advisory services, taking into account linkages to other development programmes and business support infrastructure.
 - 1.2.1 Business advisory services need to be linked carefully to other support measures in the overall policy design of SME policies and delivery. Advisory services need to be seen in close relationship with other needs of entrepreneurs, for example, on finance, premises, technology transfer, etc.
 - 1.2.2 Consider the provision of related services ‘under one roof’. Advisory services, business incubators, financial services, technology transfer can frequently be integrated to maximise cost-effectiveness and to deliver the full range of services needed by the entrepreneur.
 - 1.2.3 Recognise the importance of enterprise networks. Entrepreneurs can usefully exchange know-how amongst each other and thereby satisfy a lot of their advisory needs.
 - 1.2.4 Recognise that the combination of advisory services with financial services can create synergies. Often advisory services will be taken up, remunerated and used more professionally if related to the possibility of obtaining a credit or a credit guarantee.
 - 1.3 Ensure that there is transparency and coherence for the overall system of business advisory services and SME management training.
 - Ensure that entrepreneurs can easily learn about the existence and quality of programmes.
 - Make sure that the overlap of different programmes only takes place where there are clear complimentary programmes, or demand is sufficiently high.
- 2. Take active steps to research the needs of small businesses in relation to business advisory services, feeding the results into improving service provision.**
 - 2.1 Conduct regular surveys to identify the priority support needs of small firms with respect to business advice
 - 2.2 Conduct regular surveys to monitoring the actual use of business advisory services by small and medium-sized businesses

- 2.3 Establish mechanisms to enable the results of these surveys are fed back into improving service provision.
- 3. Extend the reach of business advisory services to all regions of the Russian Federation, promoting appropriate good practice experience where it is available.**
 - 3.1 Use the existing experience of business advisory services and disseminate examples of good practice to other areas of the Russian Federation.
 - 3.2 Ensure that local conditions and experience are taken into account when designing or expanding business advisory services.
 - 3.3 Delegate responsibility for organising the network of advisory and consultancy support for small businesses and business incubation centres to the regional level
- 4. Aim for sustainability in the design and funding plans for the provision of business advisory services, seeking multiple sources of funding including local sources.**
 - 4.1 Establish business advisory service programmes as independent corporate entities, so that they are operated and managed according to business principles, rather than as public sector programmes.
 - 4.2 Make any subsidies in support of business advisory services explicit, with a definite time-span and provide for targeted and measurable objectives.
 - 4.3 Recognise that fees for services, which at least recover costs, are almost always desirable.
 - 4.4 Establish programmes that seek to involve and build the capacity of the private sector to provide these services eventually without state support.
 - 4.5. Establish clear principles governing the selection, training and supervision of staff to deliver business advisory services, moving towards a system of accreditation for business advisers, particularly with respect to those delivering state support programmes.
- 5. Establish a co-ordinated system of business incubators for new enterprises in the Russian Federation, drawing on existing good practice experience where appropriate.**
 - 5.1 Review the adequacy of existing legislation with respect to the establishment and operation of business incubators
 - 5.2 Take steps to draw on good practice experience from those foreign donor organisations involved in business incubators schemes in Russia, through a programme of monitoring, evaluation and promotion throughout the country
 - 5.3 Take steps to encourage an increase in the level of networking between business incubators, business centres, training providers and consultants specialising in small businesses

Chapter 7

SME PROMOTION AND SUPPORT AT THE LOCAL AND REGIONAL LEVELS

Overview

Enterprise development at the regional and local levels is particularly important in a country the size of the Russian Federation, which has a federal structure that presupposes a certain degree of devolution in terms of policy and decision-making to the regions. The experience of different countries has shown that policies to promote entrepreneurship based solely on central design and implementation have proven to be ineffective. While there are many reasons for this, the key point is that it is difficult to respond to the ongoing needs of entrepreneurs in a comprehensive and speedy fashion without being in continuous contact with local representatives. Emphasis on decision-making and support at the regional and local levels has the advantage of dealing directly with the real problems and opportunities facing entrepreneurs. At the same time, this does not remove the need for coherent and effective policies at the federal level.

Participants in the FEED meetings stressed the fact that regional and municipal authorities must recognise their responsibilities and potential role in the area of entrepreneurship promotion and support. In some regions the process of entrepreneurship has been carried out quite successfully during recent years, with direct contributions from local authorities and those international donor organisations which have recognised the potential and possibilities for successful entrepreneurship support at a regional level. While small business development has been most effective in the two largest cities (i.e. Moscow and St. Petersburg), other regions have been developing their own initiatives and practices aimed at supporting SMEs. These initiatives cover all areas of small business support, represented in the case studies presented to the FEED meetings by representatives of the Samara, Novgorod and some other regions of the Russian Federation.

In this context, FEED participants focused on two key issues: firstly, the policy issues that influence effective the delivery of small business support at the local level; and secondly, the institutional and policy changes that need to be introduced in order to make SME support more effective at the local and regional levels.

A Need to Establish Better Co-ordination and a Clearer Division of Responsibilities between the Federal and Regional Levels

Developments in the regions with respect to small businesses and entrepreneurship raise questions concerning the respective aims and responsibilities of federal and regional authorities, the co-ordination of state and regional support programmes, the establishment of appropriate lines of demarcation of responsibility, the creation of conditions for co-operation rather than competition between regions, and the need to take steps to avoid unnecessary layers of bureaucracy and duplication of effort.

In fact there is a sharp contrast between the highly centralised formal system and the significant de facto autonomy of Russian regions, a point that was already prominently stated in the OECD Economic Survey on the Russian Federation (199-2000). The federal government should recognise the fact that the regions have taken, and will continue to take, initiatives in this area and should review its role in the light of this. This makes the identification of the strategic interests of the state concerning the existence and development of the small business sector even more important, with an emphasis on the co-ordination of actions and activities by different branches and authorities. At the same time, there is a need to systematically take into account the interests of entrepreneurs, at every level, when adopting basic decisions with respect to entrepreneurship promotion and support. In this context, FEED participants agreed on the importance of developing a short and long-term strategy and programme of entrepreneurship support, with clearly defined roles for federal and regional authorities.

This is of crucial importance since there have been problems concerned with the interaction between federal and regional authorities in matters of entrepreneurship promotion. Representatives from several Russian regions reported difficulties with respect to engaging in a dialogue with the federal government on this issue, as well as a lack of response by the central government to the needs of the regions.

Inter-regional economic associations of co-operation have a role to play in the maintenance of effective interaction between federal, regional and municipal authorities, with respect to the provision of effective support for small enterprises (see box below). They could also contribute to the development of a positive image of the businessman in society. The role of donor organisations in the regions should also be reviewed with the aim of streamlining the implementation of international aid programmes, including a review of the distribution of tasks between central and regional authorities.

For the federal centre the inter-regional economic associations (IEA) represent a means for receiving feedback concerning the demands of the new “rules of the game”, which are necessary for the entrepreneurship development. For the regions, they represent a means of recognising the new methods of entrepreneurship support, as well as offering a balancing mechanism to increase the ability of the regions to resist excessive federal pressure. For the municipal level, they represent a chance to engage in inter-regional interaction and gain an understanding of the general logic behind the development and support of entrepreneurship in Russia.

(From the report of Mrs. Makovetskaya, Director of the Ural Agency for Support of Small and Medium Sized Enterprises)

Within the context of an overall federal strategy for SME support, FEED participants emphasised the need to delegate greater responsibility for SME promotion and support to the regional and local levels, thus enabling policy to be more finely tuned to the specific needs of entrepreneurs.

Institutional Barriers to SME Development

It is widely recognised that the overall instability at the political level combined with a lack of a solid legal framework is hampering the development of small businesses in Russia. There is also a certain resistance to economic reform in this area at both the federal and regional levels, especially where the interests of former state large enterprises are concerned. Measures to support some of these non-viable enterprises leads to situations where their domination over a whole area discourages the development of entrepreneurship. In this context, improved efforts should be made for improving the co-ordination of support for large and small business. This is especially the case when there is obvious need for restructuring large enterprises, either by creating additional co-operation links between large and small businesses, or through the creation of small and medium enterprises from the restructuring of large firms.

Another fundamental shortcoming mentioned by delegates was the considerable gap between the objectives formulated by national, regional and local governments in enterprise promotion and the actual resources, which are available to implement them. In addition, delegates pointed to the fact that analysis of the local and regional economic basis of enterprise activity and the formulation of regional development strategies was often unsatisfactory, with negative consequences as far as the role of SMEs is concerned.

FEED participants also drew attention to the wide variety of attitudes that can exist between local authorities with respect to encouraging entrepreneurship, which can have tangible effects for SMEs since it can influence their attitudes towards the implementation of regional authority directives. The development of a facilitating environment for entrepreneurship and SME development at the local and regional levels requires the authorities to respond to issues such as the existence of local monopolies, which can crowd out opportunities for new and small enterprises, poor business discipline with respect to contracts by local contractors, and low levels of professional knowledge and expertise that affects the approach to regulating local economic activity. While the scope that a regional or local authority has to manoeuvre depends on the presence or absence, in local budgets, of the specific inclusion of the means to allocate resources to support business development, it can be argued that a reduction in bureaucratic obstacles to enterprise development is one of the single most effective steps that local authorities can take to help SMEs at a local level (see box below).

A reduction in bureaucratic obstacles at the local level may be a more efficient policy for regional authorities than direct budget transfers from the centre, involving preferences and preferences from local taxes. However, direct administration should be scaled down if the local budget is unable to completely cover the expenses for the maintenance and functioning of its administrative machine.

(Extract from an OECD experts' analysis)

These bureaucratic obstacles can be related to a failure to establish the rule of law at a local level, since it is here that the interpretation and application of legal statutes affects businessmen directly. A number of examples of local bureaucrats exceeding their authority and/or intentionally inhibiting the activities of entrepreneurs were referred to in the meetings. As a consequence, it is necessary to enforce the internal and external audit functions of relevant departments in local and regional administrations, to make use of criminal investigations where necessary and to ensure that, where they are used, such investigations receive media coverage.

The existing dialogue between entrepreneurs and the executive power in the regions is not efficient due to a mismatch between the interests of the participants. The situation could be improved with the help of intermediaries acting on behalf of local entrepreneurs, who individually tend to focus on their own particular interests. This should also include those institutions that are part of the regional SME support infrastructure, for their “expert” views. Improving the dialogue between entrepreneurs and SME support agencies on the one hand and regional and local authorities on the other, is a necessary condition for successful entrepreneurship development at the regional/local level. While government, at any level, does not create entrepreneurs, it can have a major influence on the environment in which entrepreneurship can develop. Establishing and maintaining a dialogue between the state and entrepreneurs can make a useful contribution to the development of such an environment. It should be a key element in a regional strategy for encouraging and supporting entrepreneurship, which in turn needs to be incorporated into the regional economic development strategy.

Intermediaries can help to consolidate the private interests of SME into a joint, more objective, entrepreneurship interest. Executive and legislative authoritative bodies, as well as the entrepreneurs, must have confidence in these intermediaries. In this respect, both experts in the problems facing entrepreneurs and entrepreneurs’ representatives have a necessary part to play in such a dialogue

(From the statements of FEED participants)

The Role of Business Incubators at the Local Level

The role of business incubators in the promotion of entrepreneurship and small business development at a local level has been widely recognised. In the conditions of the Russian Federation, these structures are seen as one of the simplest and most cost-effective support mechanisms. Business incubators provide a mechanism for focusing on the needs of local entrepreneurs with respect to innovation, while involving participants such as local large enterprises, universities, business associations and consultant companies. However, the location and selection of the site of these incubators should be chosen carefully to ensure suitable infrastructure and facilities.

All of these issues should be reflected in the federal and regional programmes of entrepreneurship support, which should clearly set out the responsibilities of the central, regional and municipal authorities in their support for the entrepreneurship development in the Russian Federation.

**POLICY GUIDELINES AND RECOMMENDATIONS FOR ENTERPRISE
PROMOTION AND SUPPORT AT THE LOCAL AND REGIONAL LEVELS**

- 1. Strengthen the role of municipal and regional authorities with respect to entrepreneurship support policies, linked to the development of regional and municipal strategies for enterprise promotion.**
 - 1.1 Develop strategies for entrepreneurship promotion at the regional and municipal levels, based on careful analysis of the characteristics of local/regional economies from the standpoint of small business development. This should include reviewing the local economic structure, the local labour market, the environment and infrastructure as well as ongoing entrepreneurship promotion activities
 - 1.2 Periodically audit the resources and infrastructure available in the local economy for small business development, together with the level of accessibility to these resources by new and existing small businesses. Monitoring local entry barriers for new business start-ups should be a key theme in these reviews.
 - 1.3 Audit the effectiveness of ongoing policies and promotion programmes and review the level of resources allocated for entrepreneurship promotion at all levels.
 - 1.4 Ensure that all small business support activities are well co-ordinated and that no overlap and contradictory action occurs within localities/regions. Co-ordinate local/regional strategies with national and international small business support programmes, noting that the local level is a practical starting point for co-ordination efforts.

- 2. Take practical measures to support the development of entrepreneurship at the local level, such as promoting linkages between large and small enterprises and increasing the access of small firms to public procurement contracts.**
 - 2.1 Ensure that current decisions related to distribution of state procurement to SMEs are fully implemented at the regional and municipal levels, as well as at the federal level.
 - 2.2 Promote linkages between small and large firms to contribute to increased competitiveness for local/regional economies
 - 2.2.1 Seek to expand the use of sub-contracting to small firms as one of the ways of restructuring large enterprises, helping to increase their competitiveness.
 - 2.2.2 Use resources from ineffective and insolvent enterprise, where appropriate, to provide direct material support to small and medium-sized businesses.
 - 2.3 Recognise the importance and potential contribution of small businesses in finding solutions to the problems related to the employment of retired military personnel, by providing special programmes.

- 2.4 Avoid concentrating local economic development on the largest local employers and recognise that local economic development should not be restricted to the promotion of manufacturing industry.
- 2.5 Take steps to remove bureaucratic obstacles affecting entrepreneurship development by enforcing the use of internal and external audits of local and regional administrations. Be prepared to make use of criminal investigations where necessary, ensuring that where they are used, such investigations receive local media coverage.
- 2.6 Prioritise the establishment on a permanent basis of a system of representatives of small business interests with local and regional authorities, seeking to involve them as much as possible in the development of local/regional strategies for entrepreneurship promotion and support and in contributing to its implementation

3. Foster public-private partnerships at the local and regional levels as mechanisms for promoting and supporting enterprise development

- 3.1 Promote partnerships between regional and municipal authorities and private sector organisations as mechanisms for mobilising financial and human resources for local/regional development objectives.
- 3.2 Undertake an audit of the supply of finance at the local level, identifying where local banks have lending authority rather than only functioning as cashiers with no lending authority.
- 3.3 Where sufficient sources of funding from the banking sector are not available at a local level, set up local non-traditional, inter-regional and other types of funds to support small business development. (see section of the guidelines on financial instruments of support).

4. Encourage the development of business incubators as local/regional economic development tools, seeking to involve local partners such as large firms, universities, business associations and consulting firms.

- 4.1 Ensure business-like governance and management structures for business incubators are established, together with a realistic mandate in line with the resources of the business incubator and local economic conditions.
- 4.2 Seek to involve partners such as local large enterprises, universities, business associations and consultant companies, focusing the activities of the business incubator on local entrepreneurs and their needs.

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