

The Legal and Regulatory Environment for Micro and Small Enterprises in Russia: Survey Evidence from Samara

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Executive Summary

The purpose of this paper has been to report on legal and regulatory obstacles to the survival of micro and small enterprises in Russia. Survey data reveal the breadth and depth of regulatory intrusion for these businesses. The findings suggest that even the lowest echelon of entrepreneurs, those who would generally operate outside or on the boundaries of the formal sector in other countries, are penetrated and subjected to the same levels of bureaucracy, inspections, and penalization, as one would expect for much larger firms in such an environment. High degrees of regulation and their corollary, rent-seeking practices, have emerged as a major impediment to business growth.

Empirical results demonstrate that firms rank regulatory problems, particularly taxation, as among the most severe obstacles to the long-term success of their enterprises. Furthermore, the problems associated with a highly regulated economy do not appear to impact firms uniformly. Firms that are larger, more “entrepreneurial”, and who experience more seasonal revenue fluctuations are more vulnerable to a higher degree of regulatory enforcement. Highly regulated firms also exhibit a greater demand for credit, yet are more likely to be rationed out of the credit market than less-regulated firms.

Rent-seeking, particularly in the form of bribery, is ubiquitous in the business environment of Russia. It plays a significant role in the business dealings of enterprises, and it is a requirement to secure certain government services. Incidences of bribery appear in conjunction with regulatory inspections, suggesting that bureaucrats use their office to exploit and harass enterprise owners rather than offer them a legitimate service of avoiding red tape. Similar to regulation, we find evidence that certain firm-specific characteristics appear to attract the attention of government officials. Larger, more successful firms are more likely to endure bribery and extortion than slow-growth firms.

Furthermore, firms do not have access to the types of public goods and services that facilitate enterprise growth and survival in other countries. Particularly troublesome are the lack of a safe working environment and a poor legal system. Inefficient public safety has forced many firms to pay for protection, which increases their probability of dealing

with organized criminal operators. A poor system to arbitrate disputes implies that enterprises must rely on informal or self-enforcing contracts, limiting the scope of potential activities and partners for these firms.

The policy implications of this study suggest that significant reform needs to be implemented regarding the degree of regulation and regulatory enforcement as well as the design of proper incentives and standards of accountability for the regulatory and supervisory authorities, in order to create a more enabling working environment for this sector of the economy. In the short or medium term, however, this scenario is unlikely to emerge. A second best, though less satisfactory strategy would be to design policies and programs for micro and small enterprises that take into account and help mitigate existing regulatory constraints

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I. Introduction

The micro and small enterprise (MSE) sector in developing and developed countries has been the object of considerable attention and research over the past decade.¹ MSEs are an important economic sector which fosters economic growth and development by contributing to (1) household income and welfare, (2) social change, political stability, and democracy, (3) distributional or development objectives, as well as (4) self-confidence and empowerment of the individual (Liedholm and Mead, 1999). Furthermore, MSEs play an important role in providing productive employment opportunities for an increasing number of job seekers (Mead, 1995). Employment generation is a particularly important role for Russian MSEs, given the recent enterprise restructuring programs, as well as the August 1998 crisis that led to the hitherto delayed systemic unemployment.

The MSE sector in Russia has been slow to grow, however, and it currently accounts for less than 10 percent of the total labor force (EBRD Transition Report, 1998).² In part, the limited contribution of micro and small enterprises stems from their historical absence, since the lack of small private enterprises was among the most typical features

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¹ Small enterprises are increasingly prominent in and given credit for economic development in the West, where they account for about two thirds of employment and approximately 50 percent of total enterprises in any country (Aslund, 1997).

of the former centrally planned economies (Aslund, 1997). Nevertheless, the absence of a historical presence is insufficient to explain the retarded growth of the sector in Russia. Many East and Central European countries have experienced explosive growth in the private small enterprise sector, while in Russia expansion in this realm has been, and continues to be, quite stunted (Aslund, 1997).³

The slow growth of the Russian micro and small enterprise sector can be attributed to a variety of factors. One can easily point to economic policies that favor large enterprises at the expense of small ones, to limitations in the economic infrastructure, such as transportation, trade networks, financial services, and information facilities, as well as to high and arbitrary tax policies, regulatory burdens, unpredictable government intervention, and inadequate provision of legal recourse. While there is ample anecdotal and policy evidence that would support this reasoning, there is little empirical information that would allow for a more rigorous analysis. The scarcity and unreliability of statistical information on Russian MSEs makes it difficult to isolate and identify the principal obstacles to the growth and evolution of the sector.

The purpose of this report is to provide an overview of some of the more relevant features of the Russian legal and regulatory environment that impede the birth, growth, and evolution of micro and small businesses. Survey data on Russian micro and small enterprises highlights some of the key constraints and documents the frequency, severity, and magnitude of their incidences. The goal of the investigation has been to provide information regarding:

1. The general profile of micro and small enterprises with respect to employment, business activities, investment opportunities, and firm growth.

² This contrasts with the high share in Western countries, where MSEs account for almost 75 percent of employment, or in developing countries where MSEs account for between 20 and 30 percent of total employment (Liedholm and Mead, 1995).

³ Russia, for instance, ranks twentieth out of twenty-five countries in terms of private sector share of GDP.

2. The business environment for the micro and small enterprise sector. The study assesses the quality and availability of public goods and services, such as infrastructure, law and order, public safety, and health services.
3. The existence of and extent to which regulations and bureaucracy impede enterprise transactions and operations. The survey was designed to document the frequency of regulatory intrusion and to assess the degree to which rules, regulations and activity monitoring are arbitrarily applied to selected types of enterprises.
4. The pervasiveness of corruption fostered by the inefficient bureaucracy of the Russian civil administration. The study seeks to document the extent of corrupt activities and to identify types of government services that require firms to pay bribes. We test whether the opportunity to pay bribes provides a return to firms by lessening the regulatory obligations for those who pay them and to test whether certain firm-specific characteristics invite predatory behavior by officials.

The Data

The difficulties of collecting reliable empirical information from Russian enterprises are pronounced. In the past, firms were often required to participate in time-consuming statistical surveys designed to monitor regulatory and policy compliance on behalf of the government. This legacy resulted in a pronounced suspicion towards legitimate attempts to investigate the internal and external dynamics of the firm. The sensitive nature of many issues under investigation had to be taken into account when the survey was designed. As a result, due to the many non-responses they evoked, many standard questions used in MSE studies throughout the world could not be included. Furthermore, the survey was implemented during the peak business season for many enterprises, making participation in the survey inconvenient. Despite these obstacles and the inevitably narrow scope of the observations, the results from the survey are quite credible and consistent, and overall they seem quite satisfactory.

The survey was designed to collect information on firm-specific characteristics, legal and regulatory compliance, corruption, financial flows, and access to public goods. To avoid

suspicion about the overall objective of the data collection effort, the survey was implemented through a reputable local university, Samara State. Enumerators were primarily graduate students and sociologists with substantial training in survey techniques. Members of the Ohio State University team trained and monitored all enumerators, and only questionnaires that met high quality standards were used in the analysis. Furthermore, the most sensitive questions (corruption, mafia, finance, and tax compliance) were carefully tested and built around existing surveys on regulatory constraints. Most of the questions on corruption, for example, were phrased in an indirect fashion to avoid implicating the respondent of wrongdoing. Additionally, the most sensitive questions were asked at the end of the interview, by which time the enumerator had established the necessary credibility and trust.

The Respondents

Data was collected from 304 micro and small enterprises located in and around Samara City. The definition of a small enterprise in Russia is quite liberal, and it can include firms with up to 200 workers, depending on the sector (Buyev, 1999). However, following the work of other surveys on Russian firms, we revised the definition of micro and small enterprises, choosing only those firms that employed up to 30 workers, regardless of sector.⁴ Firms that employ less than 10 workers are considered as microenterprises, while any enterprise employing between 11 and 30 workers is categorized as small. In spite of a fairly narrow size restriction, we found a surprising degree of heterogeneity among the firms with respect to many of their characteristics. Furthermore, the information collected provides valuable insight into the lowest economic strata of firms, a constituency that is often ignored in both statistical and policy analysis in Russia.

⁴ For example, an EBRD study of Russian enterprises categorizes micro enterprises as firms employing less than nine workers, while small enterprises can range up to 200 workers. However, this same study found that 90 percent of the small enterprises interviewed actually employed less than 49 employees. Our categorization of micro and small enterprises by employment size is very similar, then, to the natural structural breaks that occur in employment.

It should also be noted that all firms that participated in the survey were legally registered private enterprises, rather than those involved in the underground economy. In Russia, this is an important defining criterion, because illicit status usually implies serious economic distortions or illegal activities (Aslund, 1997).

The survey data that were collected come from two distinct populations. The first set of observations focused on more formal micro and small businesses, which were randomly chosen from a list provided by the Statistical Service of the City of Samara. These businesses are quite heterogeneous and include manufacturing, retail trade, and service enterprises, while employment in these firms ranges from 1 to 30 employees. This group accounts for two-thirds of the sample and includes 202 observations.

The second set of respondents, which account for the remaining third of the observations are comprised of market traders, working both within and outside the city of Samara. These market traders represent a more homogeneous group of entrepreneurs, with one essential distinction. One group of traders had access to microloans and represented the initial recipients of the FINCA-Samara loan program.⁵ The second group of traders were chosen to create a control group similar to FINCA Samara clients and were randomly selected from the same or similar market areas where the former operate. It should be noted that the environment in which these traders operate is arduous. Markets are highly competitive, characterized by minimal product differentiation and low profit margins.

We should also note that because the samples were drawn from distinct sample populations, all descriptive statistics for the firms are generated separately.⁶ The broad spectrum of the observations, however, allows us additional room to observe differences within and between the two samples. With this data set, we are able to make comparisons within the group of micro and small enterprises and between MSEs and market traders. For the remainder of the paper, micro and small enterprises drawn from the Samara

⁵ Average loan sizes for FINCA-Samara clients are between \$300 and \$500 USD.

⁶ Statistical methods will be applied to determine if the two sub-samples come from the same population or not.

Statistical Bureau will be referred to as MSEs, while FINCA and non-FINCA microenterprises will be jointly referred to as market traders. Denoting one group as MSEs, while referring to the other group as traders is not a reflection of their importance to the MSE world; it is merely used for notational purposes, to distinguish between the two samples.

The Project

At this point it is important to briefly describe the FINCA/Ohio State University Policy Initiative in Russia. This USAID-supported project was designed to foster the development of sustainable microfinance institutions (MFIs) in Russia. One of the most prominent constraints to the expansion of microfinance has been an inhospitable policy and regulatory environment, characterized by confusing regulations and repressive taxation (Safavian and Graham, 2000). While this policy environment has had an adverse impact on MFIs, little is known about the impact on their traditional client base.

One component of the study was to document the existing regulations that *de jure* pertain to micro and small enterprises (Nadolnyak and Hartarska, 1999). In contrast, the purpose of this data collection exercise was to examine the degree to which regulations are relevant in practice and the manner in which they are enforced (*i.e.* systematically or arbitrarily) as well as to investigate the relative regulatory vulnerability of particular types of micro and small businesses. The two distinct classifications of respondents (*i.e.* MSEs and market traders) enrich the study, because the market trader component of the survey provides information on current types of clientele, while the information on micro and small firms offers insight into the problems that affect a potential, untapped clientele, in which FINCA and other microfinance organizations may eventually tap, especially if they move into offering individual loan products.

Anyone working in the area of MSEs is conscious of the great heterogeneity of the universe of small producers and traders. A central theme of this study is the search for meaningful patterns of growth for different components of this diverse universe.

The Economic and Political Setting: Russia and Samara City

Russia

Russian micro and small enterprises have the difficult task of operating within a backdrop of recent economic and political destabilization and negative economic growth in the wake of the August 1998 financial crisis. While economic conditions marginally improved over the past year, the economic environment in Russia is still characterized by slow growth and under-investment in most sectors. Per capita GDP growth for 1998 was negative (-4.6 percent) and the estimated projection for 1999 was between zero and two percent growth, depending on the source (EBRD Transition Report, 1999 and *Business Central Europe*, 1999).⁷ While there were some tentative indications of recovery, much of the minimal growth that occurred since the August 1998 crisis can be attributed to the apparent windfall gains for exporters from devaluation (*Business Central Europe*, 1999).

Comparative economic indicators for transition countries place Russia seventh (out of 26) in per capita GDP and twenty-first in the category of GDP growth. This poor ranking can be attributed to the missing economic and institutional conditions that have facilitated the prolonged growth at rates of 5-7 percent achieved by some central European economies. In fact, the present climate for business in Russia is quite hostile in several respects.⁸ A complex tax system and high statutory tax burden, onerous regulatory requirements, backlogs at regulatory and administrative agencies, and inadequate legal infrastructure all

⁷ One shortcoming of Russian statistical estimates, however, is the difficulty of accurately estimating the true value of goods and services produced in the country. Official statistics likely underestimate production, due to the relatively large and active informal economy. The State Statistics Committee, for example, calculates that 25 percent of production is informal, and it adjusts GDP figures upwards on this basis; yet some independent calculations put informal production closer to 40 percent of GDP. Partly as a result of efforts to improve them, statistical series are created, altered, and discontinued frequently, and methodological changes often go unexplained (EIU, 1998). One notable point, relevant to this report, is that the most important sector in the economy is retail trade and services, which contributed 55.7 percent of GDP and 51.3 percent of total employment in 1998.

⁸ In part, this hostile environment stems from Russia's long bureaucratic tradition, of which nineteenth-century Russian literature gives many examples. Traditionally, Russian entrepreneurs belonged to two categories: large entrepreneurs linked to the ruling class and minority entrepreneurs who were looked upon with disdain. Hence, the historical and sociological background for Russian entrepreneurs is weak. While this is not enough to impede the present development of entrepreneurship in Russia, it is sufficient to make it more difficult (EBRD, 1998).

serve to deter business starts, drive businesses into the gray economy, and reduce business profitability and rates of expansion (Buckberg, 1997).

The legal and regulatory environment for enterprises in Russia is both oppressive and ineffective. Rules, regulations, and statutes abound which govern all levels and types of economic activity. At both the individual and the firm levels, high transactions costs are incurred in either fulfilling or avoiding excessive regulation. Regional and local political autonomy have led to uneven enforcement of the rules, and the local authorities enjoy a high degree of regulatory discretion. A relatively large number of rules, coupled with this regulatory autonomy of authorities have led to an institutional environment where bribes, extortion, and side-payments are the norm to do business.

Furthermore, the rule of law remains relatively weak, and this is likely to prove a major impediment to economic growth over the long term. The security of property rights is lacking, and unless corrected, weak property rights, pervasive corruption, and poor contract enforcement could constitute a long-term drag on investment, leaving more profit to be made through rent-seeking pursuit of monopoly and tariff privileges than through entrepreneurial behavior (EIU, 1998).

The painful transition process that has characterized this decade has been severe, more problematic for Russia than for most transition countries. The most important reasons for the length and depth of the post-soviet depression, which exceeded post-communist output contractions in most of central Europe include:

- the prolonged history of communism and central planning,
- the unraveling of economic ties attendant on the collapse of the Soviet Union,
- sharp falls in the production of a range of goods, particularly defense-related, for which demand collapsed as a result of the shift from planners' to consumers' preferences and the shrinkage of the state sector,
- the delayed macroeconomic stabilization and reluctance to impose hard budget constraints on enterprises, and

- political uncertainty, which has continued to fuel doubts about the durability of the reforms.

Turbulent economic changes that characterized the decade had a strong negative impact on household income. Collapsing output and rising inflation had a devastating effect on living standards, which fell sharply in the early part of the 1990s, as incomes were lost either through unemployment and wage arrears⁹, or were eroded by steeply rising prices.¹⁰ Moreover, income inequality has increased dramatically, with the average income of the top 10 percent of the population estimated at 15 times that of the bottom 10 percent. The average monthly wage is now below \$70, down over one-third in real terms from the previous year, and unemployment is officially at 18 percent (*Business Central Europe*, 1999). Since the crisis, real incomes have fallen to 36 percent of pre-crisis levels, leading to a significant deterioration of the social situation (EBRD Transition Report, 1999). Currently, some 35 percent of the population operate below the officially defined poverty line, while 60 percent of the population consider themselves poor (Milanovic, 1999). Many of the microenterprise start-ups emerging over the past several years have been in direct response to these worsening economic conditions for the lowest economic strata.

Samara

The survey was implemented in and around Samara City, the capital of Samara Oblast. Samara Oblast is considered one of Russia's key regions, both economically and

⁹ In fact, the restructuring and privatization of the industrial sector in large measure contributed to these worsening economic conditions for those members of the lower economic strata. State-Owned Enterprises (SOEs) who were privatized largely benefited an insider group, a limited cadre of *nomenklatura*, as assets and ownership were transferred to them at little or no cost. Some SOEs managed to retain their ownership status, maintaining artificially high levels of employment and continuing to provide social benefits to their workers through the benefits of soft budget constraints. This delay in adjustment was unsustainable, however, and resulted in a largely redundant workforce, who were nominally employed, but who neither worked nor received wages.

¹⁰ At the root of many of the problems described above is the government's inability to impose fiscal order. A vicious circle of unpaid wages, taxes and debts between state, corporate, and household sectors, set in motion by the government's need to cut spending to match revenue shortfalls, has delayed the recovery of production, and has further reduced investment incentives. While fiscal reform has continued to be on the government's agenda, some of the largest debtors are state-owned, while others are liable to meet tax demands by deferring debt and wage payments.

politically. Its political strength stems from its size and higher than average degree of urbanization. Recently, the oblast has acquired a reputation as a region that has been developing dynamically and is relatively prosperous, at least in the national context of economic crisis (Romanov and Tartakovskaya, 1998). The city is large, with a population of over one million inhabitants, and it is characterized by a high degree of economic diversity.

Samara is considered relatively prosperous, and the oblast rates sixth in real per capita income levels. Because of the dominance of many former state-owned enterprises, however, arrears of wage and salary payments remain large and widespread, indicating that the region is subject to all of the economic ills which plague Russia as a whole. The overall scale of the registered small firm sector is not easy to assess.¹¹ One account is that they make up 6 percent of total firms (Romanov and Tartakovskaya, 1998), a figure that is likely to be a significant underestimation of the total number of the firms, as it ignores informal and unregistered firms. Privatization has been extensive in the region. The non-state sector accounted for over 90 percent of all industrial output, but the bulk of this output comes from privatized firms, rather than from new private firms.

In short, the region provides an excellent backdrop in which to examine the MSE sector. It is characterized by a relatively prosperous economy, yet it exhibits economic deficiencies pertinent to enterprise growth. Caution must be exercised, however, in generalizing the results and policy implications to Russia as a whole. Regional oblasts are extremely heterogeneous with respect to federal budget funding, tax and regulatory policy, and arbitrary enforcement of federal statutes and laws, all of which influence firm behavior (Freinkman, 1999 and Zuravskaya, 1998). Nonetheless, limiting the survey to one region eliminates the statistical problems of controlling for variations across regions in regulatory enforcement policies, regional economic health, and institutionalized corruption.

¹¹ The statistics regarding the small firm sector may not necessarily give insight into the MSE world, as small firms in Russia can range in employment up to 200 workers.

II. Enterprise Characteristics: A Snapshot

The overall profile of MSEs provides the context for examining dynamic issues and regulatory constraints, which are listed in *Table 1* below. Since many aspects of this structure have by now become familiar, this review will be brief, highlighting aspects that are relevant to the discussion of enterprise constraints, the central focus of this report (Gonzalez-Vega, 1999). The analysis of the descriptive statistics that follow will be reinforced through three case studies reported in separate text boxes.

Table 1: Characteristics of MSEs and Traders

Enterprise Characteristics	MSE's	Market Traders
How Enterprises were Started (percentage)		
New Start Ups	73	96
Purchased or Inherited from State	13	0
Other	14	4

Legal Form (percentage)		
Physical Persons	38	90
Partnerships	8	7
Companies	51	2

Age of Business (percentage)		
1990-1994	39	20
1995-1997	33	57
1998-1999	29	23

Type of Business Activity (percentage)		
Production	23	5
Retail/Trade	48	93
Services	26	<2

Employment		
Mean Number of Workers	8.6	1.4
Median Number of Workers	5	1
Mean Employment Growth (persons per year)	.61	.22
Percentage of Enterprises that Grew	40	27
Mean Employment Growth of Growing Firms	2.17	1.09

Premises		
Fixed	71	20
Mobile	29	80

Enterprise Start-Ups

The majority of enterprises in the survey are recent start-ups, although a small proportion of MSEs (13 percent) began as state-owned enterprises. The limited number of small firms that germinated from the state sector reflects the overall failure of the privatization effort to reach the lower tier of stakeholders in the companies. A much larger proportion of the surveyed firms were start-ups, which may reflect survival efforts by those with few options. While not always true, a significant proportion of new enterprise starts are driven by the necessity to find any source of income, even those providing only minimal returns, in situations where few alternatives are available (Liedholm and Mead, 1999). This phenomenon is particularly relevant to the Russian context, which was characterized by an initial systematic enterprise restructuring in the early part of the decade, followed by a more recent industrial restructuring as a result of the August, 1998 crisis. Both events resulted in widespread layoffs accompanied by a sharp increase in the level of underemployment and unemployment.

It is also interesting to note that a fairly large number of firms (29 and 23 percent, respectively) were established within the last two years, during a time of economic crisis or post-crisis adjustment. This is not surprising, given that the MSE sector in most countries grows during periods of macroeconomic instability (Liedholm and Mead, 1999). However, both theoretical and empirical studies on micro and small businesses (McPherson, 1992; and Liedholm and Mead, 1999) point to the high attrition rates in the early years of new enterprises. Thus caution must be exercised with respect to evaluating very recent start-ups, because employment opportunities which might come into being as a result of new businesses being started may be short-lived.

The Legal Form

The legal form of the enterprises is a key characteristic in determining the costs of market entry, access to legal recourse, access to financial services, and tax liability. Businesses registered as individual enterprises (physical persons) face a much less complex registration procedure than companies (juridical persons), and registration can usually be

completed within one week for the former type of firms. Contract enforcement is much more problematic for these individual enterprises, however, because businesses registered as physical persons do not have access to the same arbitration courts as do companies.¹² Since it is required for both parties to be registered as juridical persons to arbitrate disputes in a Commercial Court, individual enterprises are less attractive clients or customers for companies, because contract enforcement would be more costly, while disputes are less likely to be resolved.

Many tax regulations that apply to individual entrepreneurs are less stringent than for firms established according to other legal forms (Nadolnyak and Hartarska, 1999). Firms registered as individual enterprises generally enjoy a much lower *de facto* tax burden because it is more difficult to monitor their activities, and they typically find it easier to hide a large proportion of their income from the tax authorities. In an effort to shore up perceived tax evasion, however, regulations require that firms registered as companies report to the tax authorities all business transactions that take place with individual enterprises. Seemingly positive attributes of individual enterprises thus actually impede their interaction with other enterprises, and contribute to a perception (by both the supervisory authorities and other types of enterprises) that individual entrepreneurs are less trustworthy and more skilled at avoiding regulations. As a result, they are harassed and inspected more often by the supervisors and are avoided by more institutionalized businesses, such as companies and partnerships. Note that the overwhelming majority of market traders are registered as individual entrepreneurs (90 percent), while a much smaller proportion of MSEs are registered in this form (38 percent).

Case Study 1: An anonymous enterprise on *legal form*. “If I go to a company and try to offer some of my goods I would first have to introduce myself. If I say I am an individual private entrepreneur, I will inspire very little trust and respect and the probability that I sell my goods will be low. If I say that I own a company, I will at least be given the time to present my goods. Furthermore, companies do not want to buy from private entrepreneurs because they have to report to tax authorities each transaction they have incurred with individual private entrepreneurs” (Nadolnyak and Hartarska, 1999).

¹² Physical persons have access only to the Court of General Jurisdiction, while juridical persons can arbitrate disputes in the Commercial Court system, which is smaller, better financed, and less costly (Discussions with Dennis Whelan J.D., *Center for Russian Law*, Nov., 1999).

Type of Activities

The majority of enterprises in both samples are retail distributors (48 and 93 percent), followed by services (26 and 2 percent), and manufacturing or processing enterprises (23 and 5 percent). This overall distribution may reflect, in part, the difficulties for small manufacturing firms to compete with larger and more favored industrial firms. In Russia, large-scale producers are generally given favorable tax treatments, more access to loans, and are held to softer budget constraints (Gaddy, 1998).

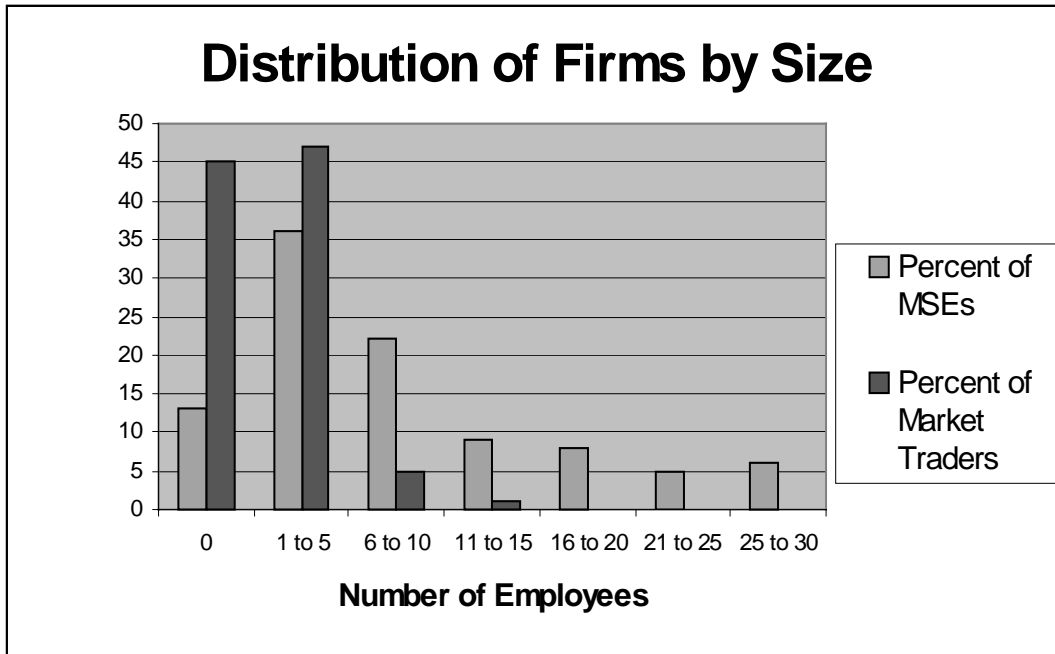
Additionally, firms that were started after the initial transition primarily gravitated towards sectors that had previously been repressed, in essence exploiting the pent-up demand resulting from prolonged central planning (EBRD Transition Report, 1999). The predominance of service and retail firms is also due to the facility of starting up an enterprise in these sectors, which is less difficult because smaller initial levels of capital and inputs are required.

Retail and service firms are generally more vulnerable, however, to financial and macroeconomic shocks. Indeed, many domestic manufacturing producers benefited from the August 1998 crisis, when the devaluation of the Ruble made domestically produced goods more competitive than imports. Wholesale and retail trading, in contrast, experienced increased difficulties from the collapsed value of the Ruble.

Employment

Firms in both samples are small when employment is used as a proxy for firm size. MSEs have significantly higher employment levels (8.6 workers on average) than do market traders (1.4 on average). *Figure 1* shows the distribution of employment for MSEs and market traders. The majority of traders (93 percent) employ less than five workers, besides the owner, while the MSE sample shows a more even distribution but with the largest proportion of firms also employing less than five employees.

Figure 1: Distribution of MSEs and Market Traders by Size



Employment levels also vary by type of enterprise. Manufacturing firms, for example, are less likely to be run by a self-employed owner only, and which a larger proportion of these firms generate employment levels in the 21-30 worker category (*Table 2*).

Table 2: Employment by Type of Business (MSEs Only)

Type of Business	Percent of Businesses by Number of Employees				Mean Number of Employees
	0	1-10	11-20	21-30	
Manufacturing	8	67	11	9	9
Retail/ Trade	20	64	7	5	6
Services	20	56	16	4	6
All Firms	13	58	17	11	8

N=203

Enterprise growth is an important indicator of success, and a barometer of qualifications for medium-term survival. Indeed, McPherson (1992) shows that growing MSEs are

more likely to survive than those that remain of the same size. While we do not have information on enterprise attrition rates to test this theory directly in the Russian environment, we do know that results from several empirical studies on MSEs in other countries indicate that for every one percent annual increase in employment, the MSE reduced its likelihood of closing during the year by approximately 5 percent (McPherson, 1992).

Employment growth rates for MSEs are higher than for traders (0.61 persons per year, vs. 0.22 persons per year, according to *Table 1*). Many enterprises appear to be relatively successful, with 40 and 27 percent reporting growth in employment since their inception averaging 2 and 1 persons per year, respectively. This statistic, however, likely underestimates true enterprise growth, because labor is usually the last production input to be added in a successful firm.

Enterprises in the survey do intend to increase the size of their firms in additional ways, however. Responses to questions about expansion plans reflected a certain element of optimism as of August, 1999. *Table 3* shows the degree and manner in which firms in our sample planned to expand their activities over the following 12 months.

Table 3: Plans to Expand Enterprise Activity

Type of Expansion	Percent of MSEs	Percent of Market Traders
Capital or Assets	30	31
Inventory Turnover	40	43
Employment	28	10
Other	12	8

Seventy-five percent of the firms that plan to expand intend to finance their activity by using either personal savings or the profits from the firm, while only 8 percent would borrow from an external source, either a bank or an informal source.

Mobility is also an important characteristic for firms operating in a highly regulated and volatile market. The ability of a firm to move lends flexibility for enterprises striving to

uncover new markets and allows firms to adjust to seasonal changes in demand. Most market traders (80 percent) enjoy some form of premise flexibility, while MSEs are much more constricted in this sense (29 percent). Firms that are more mobile may also have an advantage in avoiding arbitrary inspections.

Registration and Licensing

The registration process is generally perceived as a laborious effort, requiring numerous forms of documentation a multitude of fees or payments, and multiple visits to statistical, tax, and other regulatory bureaus. For example, required documentation and procedures include, but are not limited to, preparation of status documents, notary witnessing of constitutive documents, state registration duty, certification by notary of signatures for bank purposes, registration at the statistical office, opening of a bank account, legal address acquisition, environmental review, equity capital, and a stamp issuance. In its entirety this process can be time-consuming. Firms in the sample, however, appear to encounter fewer difficulties in registering and licensing than what was discovered in similar studies in other parts of Russia (EBRD Transition Report, 1998). *Table 4* shows that the average registration time for MSEs was 30 days, while traders took less than half of the time (12 days). The notable differences in registration time are most likely due to the legal status of MSEs that, for the most part, are registered as companies or partnerships, while traders are generally registered as private individuals (physical persons).

Table 4: Distribution of MSEs and Market Traders by Registration Time

Type of Registration	Mean Number of Days Needed to Obtain License or Permit	Percent of Firms				
		<7 days	7-14 days	14-30 days	30-180 days	>180 days

MSEs	Legal Status	30	31	26	28	12	3
	Additional Permits	31	5	15	17	6	4
	Additional Licenses	34	34	24	24	15	3

Traders	Legal Status	12	57	25	16	2	0
	Additional Permits	5	85	12	4	0	0
	Additional License	21	57	14	14	14	0

The facility of registration is reflected in the firms’ rating of the difficulty associated with registration. The majority of enterprises (52 and 62 percent, respectively) rated the difficulty of registering as “not problematical.”

Some firms, however, reported great difficulties in registering their business (20 percent), with the process taking over one year to complete. Only 25 percent of firms reported needing additional permits beyond the completion of their legal status, and 27 percent reported having to apply for additional licenses. Licensing was more problematical than permits or legal status, with the maximum reported licensing time being over two years.¹³

Case Study 2: An anonymous entrepreneur on *licensing*. “It is very inconvenient. The legislators didn’t think of how to make registration easier. Its too much paperwork. Each office needs different papers. Nobody tells you what documents to prepare and where to go next. When you ask for help, the government officers answer that it is not their duty to help you. It is usually better to hire someone to do it all for you. Licenses usually average

¹³ Licensing requirements in Russia are demanding. An applicant has to submit as many as ten documents, including information about qualification and professional background of the personnel, with attached

In spite of the relatively favorable perception of market entry ease by this genre of enterprise, it is difficult to ascertain the degree to which the registration and licensing process constrains market entry for new participants. Statistically, it is not possible to capture the incidence of firms that were deterred from entering the market due to this initial phase of regulatory obstacles because these firms do not exist. Furthermore, registration is required for some firms to be completed within 5 days. If all of the proper documents are not submitted within this period of time, the firm is required to begin the process again. While the specific interval of registration only takes 5 days, the period required to complete the entire process can be much longer. Finally, it should be noted that many businesses prefer to operate underground or to shortcut administrative approval processes by paying bribes. In this case, the low rating for registration difficulties might be offset by the relatively high rating of government corruption, examples of which are illustrated later in this paper.

III. Business Environment

The overall environment and economic infrastructure in which small enterprises operate play a significant role in their profitability, their ability to market goods, adjust to clientele demand, and expand their activities. When public goods and services, such as law and order, contract enforcement, or public safety are missing, the outcome can be detrimental to enterprise survival. For example, when public safety is deficient, one often finds the growth of competing institutions, such as organized crime, that specialize in enforcing contracts or providing property protection (Frye, 1998). When the overall level of public services is poor, both individuals and firms are less likely to voluntarily comply with regulations (Campos and Levi, 1994). Non-compliance increasingly pushes firms into the unofficial economy, which can impose excessive costs and risks on these enterprises.

copies of the documents certifying the corresponding qualification and professional training, organization and technical capacities for performing the declared kind of activity, a certified copy of the report of the state commission about accepting the production premises, information about the former activity and work experience of the owner in storing, processing, and selling the good. Some activities that require licenses include firms that sell beer, tobacco, cars, petrol, jewelry, pharmacy and food products.

Firms in the survey were asked to rate the level of a variety of public sector goods that they rely upon for the successful operation of their enterprise. *Tables 5 and 6* highlight the answers to questions addressing the quality of public services for MSEs and market traders. Note that the proportion of firms with “No Opinion” reflects the number of enterprises that do not rely on that particular public service in carrying out their business activities.

Table 5: MSE Ratings of Public Services Categorically (Percentages)

Public Service	Firms' Evaluation of Public Services				
	Rate "Good"	Rate "Fair"	Rate "Poor"	Total	No Opinion
Public Transport	11	61	27	100	69
Water&Sewage	12	63	25	100	25
Electricity	21	63	16	100	11
Telecommunications	23	59	17	100	29
Garbage Collection	23	47	31	100	22
Street Repair	20	42	38	100	30
Public Safety	16	38	46	100	15
Settlement/Disputes	6	40	54	100	58
Public Health	16	47	37	100	57

Note the percentage of firms which rated each public service is based on the number of respondents who have an opinion, not on the total number of respondents. N=203

Table 6: Percent of Market Traders that Rate Public Services Categorically

Public Service	Firms' Evaluation of Public Services				
	Rate "Good"	Rate "Fair"	Rate "Poor"	Total	No Opinion
Public Transport	5	68	28	100	61
Water&Sewage	5	60	35	100	36
Electricity	11	69	19	100	13
Telecommunications	17	69	14	100	36
Garbage Collection	20	44	36	100	26
Street Repair	19	37	44	100	33
Public Safety	7	38	55	100	15
Settlement/Disputes	6	33	60	100	53
Public Health	9	49	42	100	57

N=102

The most notable feature of the responses is that not one single public service was ranked as “Good” by a majority of respondents (at least one-fourth). The large-scale service

sectors (*i.e.* electricity, telecommunications, street repair, and garbage collection) appear to be the most relatively efficient, reflecting in part the legacy of successful large-scale operations under central planning.

The more idiosyncratic services appear to be more problematic, however. Public safety, the settlement of disputes, and public health are overwhelmingly evaluated by both types of firms as being the poorest of government services, with the highest proportion of respondents ranking them as “poor.” Lack of public safety causes firms to depend on gray market operators to perform state functions in the governance of relationships. For example, approximately 40 percent of both sets of respondents reported having to pay for protection. Providing an appropriate and efficient institutional and regulatory infrastructure is thus the greatest challenge.

The absence of formal institutional arrangements to properly enforce contracts implies that firms will only engage in contracts that rely on purely private mechanisms such as trust, reputation, and constructed mutual dependence (Hendley, 1999). This is reflected in the statistics on trust with suppliers and clients. Over 80 percent of firms in the samples reported working only with clients and suppliers for whom the level of trust was either high or very high.

The Settlement of Disputes category invoked the most severe rankings by the two classes of respondents, with the majority of respondents (54 and 60 percent, respectively) ranking the Russian court system as “poor”. An orderly environment for business requires a comprehensive and effective legal system to impose the rule of law and resolve disputes, and a well functioning court system is essential to validate property rights. In the absence of a functioning and unbiased legal system, firms are forced to rely more on informal or self-enforcing contracts rather than on impersonal arms length arrangements. Additionally, secure property rights directly impact access to finance. Kaufman (1999) shows that imperfect enforcement and weak property rights were one of the principal causes of credit rationing by banks in transition countries.

Table 7 highlights the nature and frequency of disputes that are resolved by the court system. As shown, few firms choose to resolve problems in court. For those firms that do take their problems to court, the settlement time is lengthy (over 6 and 4 months, respectively), although the majority of claims are eventually resolved. Of the disputes that were resolved outside the court system, over 90 percent of both types of enterprises choose to resolve disputes by negotiating directly with the party in question.

Table 7: Nature and Frequency of Judicial Disputes

	MSEs	Traders
Percent of Respondents Who Used Court System	26	7
Percentage of Disputes Resolved in Court System	62	80
Days Required to Settle	198	120
Most Disputes Involve	Buyer	Government

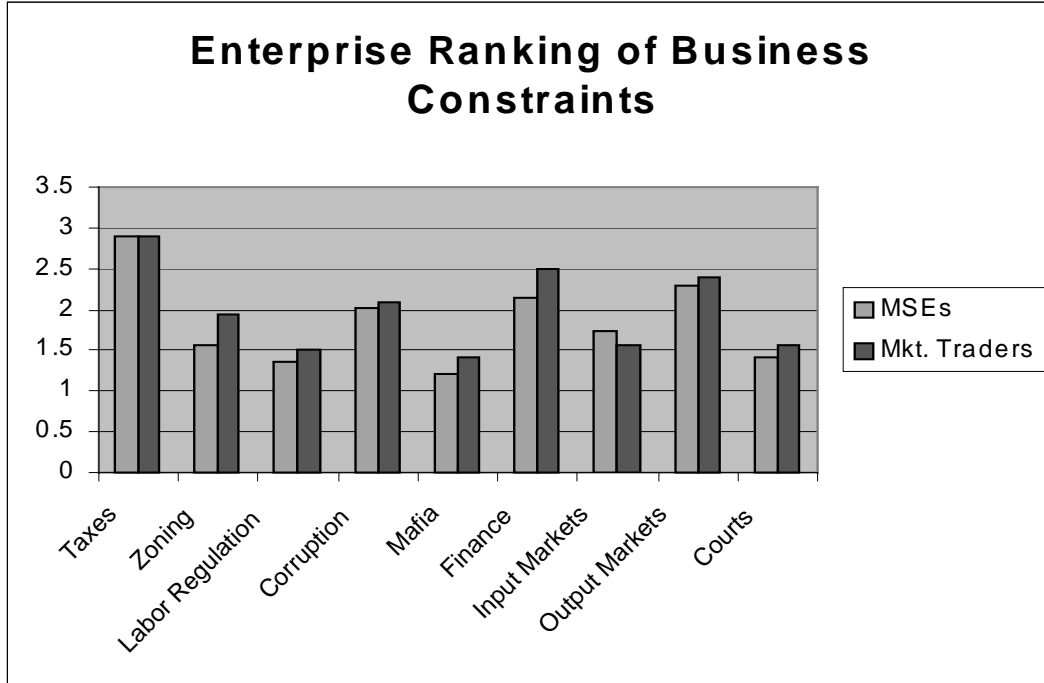
The propensity for firms to resolve disputes directly reflects the efficiency of the informal contracting and enforcement mechanisms that govern inter-enterprise relationships.

IV. Firm Constraints

Firms were asked to rank the constraints to business that most affected their operations. Rankings were on a scale of one to four, with four indicating the most constraining, while one indicated that there was no affect on business operations. These constraints fell into four distinct categories: *Regulation* (Taxes, Zoning, and Labor Regulations), *Corruption* (Corruption of Government Officials and the Mafia), *Finance* (Access to Working Capital), and *Economic/Institutional Environments* (Input Markets, Output Markets and Dispute Resolution). *Figure 2* shows the results of their rankings. The most important constraints to enterprises are taxes, finance, output markets, and corruption of

government officials. Note that for all categories, market traders consistently rank these constraints as more problematic than MSEs, with the exception of input markets.¹⁴

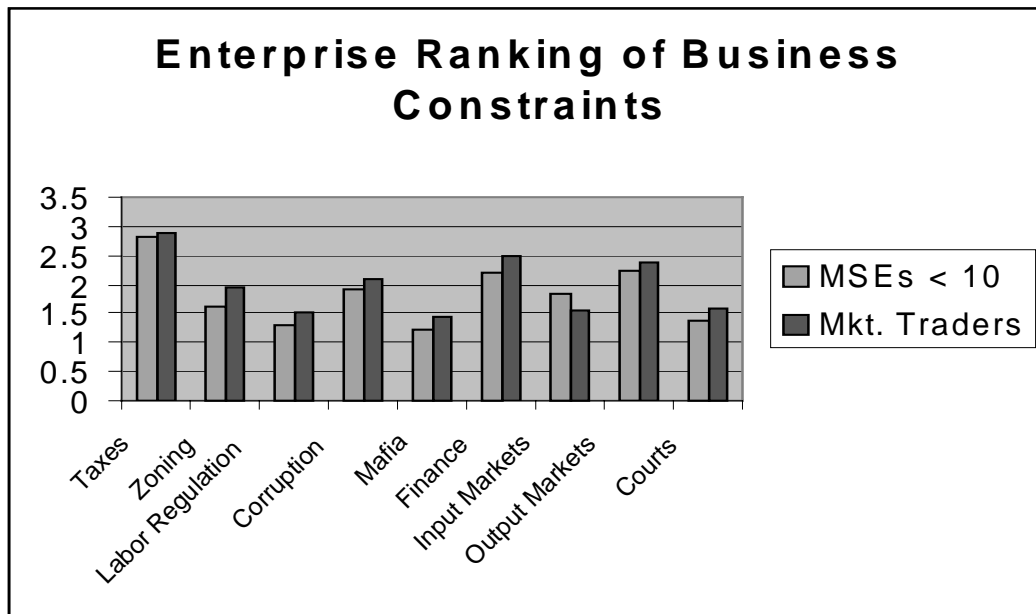
Figure 2: Enterprise Rankings of Business Constraints



One possible explanation of the more unfavorable rankings given by traders is that MSEs are on average larger than traders, and perhaps smaller enterprises are more vulnerable to many of these problems. However, when traders were compared to MSEs of less than 10 employees (*i.e.* the microenterprises), controlling for size differences, the results still very similar (*Figure 3*).

¹⁴ The fact that market traders do not rank input markets as problematic is not surprising since many traders are captive outlets for wholesalers and input supplies are guaranteed.

Figure 3: Comparisons of MSEs with fewer than 10 employees to Market Traders



On average, the differences between constraints for only micro MSEs (i.e. less than 10 employees) and market traders are minimal. There are two implications of this finding. One is that *within* the group of MSEs, the micro firms (<10 employees) are not less vulnerable to regulatory, corruption and financial constraints than are small businesses (10-30 employees). On the other hand, the categorical differences between perceptions of business constraints between MSEs and market traders is not due to differences in the size of operations, but instead must be associated with some other institutional feature of the environment in which they operate.

Furthermore, barriers to the development of micro and small enterprises affect different types of firms differently, depending on the sector in which they operate. See *Table 8*.

Table 8: Mean Ranking of Constraints by Type of Firm (MSEs Only)

Regulatory Constraints	Manufacturing Enterprises	Retail Enterprises	Service Enterprises
Taxes	3.26	2.81	2.83
Zoning	1.27	1.77	1.51
Labor Regulations	1.40	1.27	1.46

Corruption	Production Enterprises	Retail Enterprises	Service Enterprises
Local Officials	2.16	1.95	2.05
Mafia	1.24	1.20	1.29

Finance	Production Enterprises	Retail Enterprises	Service Enterprises
Working Capital	2.26	2.17	2.01

External and Institutional Environment	Production Enterprises	Retail Enterprises	Service Enterprises
Input Markets	2.04	1.62	1.77
Output Markets	2.34	2.33	2.09
Dispute Resolution	1.41	1.40	1.40

Rankings for constraints are based on a 1-4 scale, with one indicating not problematic at all, and 4 indicating highly problematic. N=203/MSEs only

All of the principal constraints to businesses reported by the sample (i.e. taxes, corruption, and finance) consistently receive the highest ranking from the production sector.

V. Regulation and Corruption

The regulatory environment for firms in this sample is one of the central focuses of this report, which measures the extent of state interference and monitoring of the activities of small enterprises. A high degree of regulation has an adverse effect on the economy, is usually subject to political influences, and is rarely implemented with the sole purpose of improving economic efficiency (Guasch and Hahn, 1999). The costs of various kinds of process regulation caused by inefficient bureaucracies and high levels of corruption can add substantially to enterprise burdens. The existence of numerous regulations imposes a variety of costs on entrepreneurs, both directly and indirectly, through the following:

1. The excessive costs of devoting resources to ensuring proper compliance,
2. Fines imposed on firms for non-compliance,
3. The time taken when firms are frequently monitored, and
4. Exposure of firms to corrupt government officials.

Issues (3) and (4) are explored in depth in this section.

Taxation

The regulation to which firms in the sample are most vocal about is the high and arbitrary tax burden. This is not surprising, given that the issue of taxation is notoriously problematic in Russia. The business community in Russia commonly argues that its total tax burden, as a share of profits, is excessive due to the simultaneous taxation of turnover, wage costs, profits, and capital, such that full compliance may leave almost no after-tax profit.¹⁵ Furthermore, the system of taxation of MSEs in Russia is complicated, inefficient, ambiguous, and highly dynamic. Taxes are subject to continuous change, are rarely stable for more than two or three years, and are open to re-interpretation by the local authorities. Enterprises often complain of being double or triple taxed (OECD, 1998).¹⁶ As a result, tax evasion is the norm, rather than the exception, has become increasingly sophisticated, and is considered a necessary business practice to ensure survival.¹⁷

Case Study 3: An anonymous entrepreneur on *tax evasion*. Firms that are legal entities, earning revenues they don't wish to report, usually open a satellite firm, which is also a legal entity. As the principal firm accumulates income, fictitious contracts are signed with the satellite firm, and money is transferred to its account. The revenue then becomes an expense to the principal firm, and is not subject to the profits tax. Since the satellite firm is dismantled within a year, it avoids the annual tax inspection, and does not need to present a complete account of its operations to the tax authorities. Before closing down the firm, it illegally cashes its revenues, using the services of firms that specialize in cashing bank accounts. The charge for this service is typically 5 percent of the value of the cash (Nadolnyak and Hartarska, 1999).

¹⁵ For example, expert estimations report that Russian enterprises (both large and small) are subject to a total of 40 to 50 federal, regional and local taxes (OECD, 1998). Producers are subject to a value-added tax, a profit tax on enterprise income, property tax, and various employment and social taxes.

¹⁶ Anecdotal evidence of the phenomenon of double taxation in Russia is abundant. Entrepreneurs or their accountants often report that if enterprise income were to be properly reported, the business would owe taxes ranging from 150-250 percent of total revenue.

¹⁷ For example, firms rely heavily on legal means of reducing reported profits, using transfer pricing to report all profit as accruing to offshore subsidiaries, under-invoicing of exports, and concealing income in the general directorate office by overstating the offices' expenses.

Equally problematic for enterprises is the degree of uncertainty associated with their tax obligations due to the discretion given to tax authorities. Sixty-nine and 60 percent of firms, respectively, report that tax payments are subject to change frequently, while approximately 40 percent of all enterprises in the sample stated that tax inspectors have altered or interpreted required tax payments without prior warning or announcement. Tax inspectors are given a high degree of discretion and frequently conduct on-site inspections, which may or may not be announced prior to arrival. MSEs, on average, are inspected over 10 times per year, while traders are audited on-site approximately 22 times per year. Furthermore, tax inspection varies across firms. Firms registered as physical persons are inspected at a much higher rate than those enterprises registered as partnerships or companies (*Table 9*).

Table 9: Arbitrary Tax Inspections by Legal Form

Legal Form	Individual Entrepreneur	Partnership	Company with Limited Liability	Total Sample Mean
Monitoring by Tax Authorities (visits per year)	19.6	8.3	5.3	10.9

Furthermore, larger firms are, on average, inspected more often than smaller firms. *Table 10* shows that firms in the upper half of the size distribution, regardless of their legal form, are inspected more frequently than firms in the lower tiers of the employment distribution.

Table 10: Arbitrary Tax Inspections by Enterprise Size

Size of Firm (by number of employees)	Annual Visits per Year by Tax Inspectorate	
	Companies & Partnerships	Individual Entrepreneurs
Lowest Quartile*	3.6	16.0
Second Quartile	4.9	18.9
Third Quartile	7.3	27.3
Top Quartile	5.5	22.1
Sample Mean	5.2	19.7

*indicates that means in the lowest two quartiles are significantly different from means in the highest two quartiles at the $\alpha=.10$ level.

Regulatory Inspections

While taxation receives the most attention in the literature regarding the impact of regulation on MSEs in Russia, other regulatory exigencies force enterprises to incur high transactions costs. Because of the poor drafting of laws and regulations, combined with the lack of easy access by those affected to the text of the regulations, substantial managerial and financial resources are consumed simply in identifying the statutory requirements that apply, and in determining (a) what range of approvals are needed in order to operate in full compliance with federal, regional, and local laws; (b) in what sequence; and (c) what documentation is required in each case (Buckberg, 1997).

Ensuring compliance with the multitude of statutes is a major concern for the regulatory authorities, but there is little transparency and predictability and MSEs incur very high costs compared to the size of their operations.

On average, enterprises in the survey are inspected 55 times per year, by a variety of inspectorates who have legal right to inspect unannounced, at any time, and to impose fines for cognizant or unwillful lack of compliance. *Table 11* illustrates the frequency of supervisory monitoring through visits to the enterprise, or requirements that entrepreneurs visit the supervisory office themselves.

Two things are noteworthy about this table. One is the high proportion of firms that are subject to regulatory and supervisory inspections and the frequency with which the

authorities visit them. The second point of interest is that market traders are monitored (or harassed) more frequently by tax and trade inspectors and by the militia than are MSEs.

Table 11: Inspections of MSEs and Traders by Regulatory Authorities

MSEs					
Inspecting Body	Percent of Firms	Mean Visits per Year	Hours/visit	Number of Visits to Agency	Hours/visit
Tax	68	10.9	8.2	7.7	2.7
Fire	61	7.5	1.6	2.6	1.6
Sanitation	49	16.0	1.9	5.2	1.4
Trade	30	10.7	2.3	6.1	1.7
Militia	38	81.5	0.8	9.8	1.2

Market Traders					
Inspecting Body	Percent of Firms	Mean Visits per Year	Hours/visit	Number of Visits to Agency	Hours/visit
Tax	90	22.4	2.4	7.3	3.0
Fire	18	2.0	0.5	1.0	0.0
Sanitation	41	52.5	1.2	5.3	1.8
Trade	46	16.4	1.3	6.3	1.7
Militia	66	97.4	0.5	10.3	3.6

It is difficult to compare vulnerability to harassment across distributions of firms, however, because inspectorates are matched according to the type of activity in which any one firm is engaged (*i.e.*, sanitation with food services, fire inspection with fixed premise locations). Nevertheless, one can gauge a more impartial comparison by examining only the frequency of inspections by the tax authorities and the militia, since in principle these inspectorates have jurisdiction over all types of firms, regardless of activity, location, or type of premises. When examining only the militia and tax authorities, it becomes apparent that there is a marked difference between MSEs and traders with respect to the frequency and proportion of firms inspected.

While *Table 11* shows evidence of the arbitrary nature of monitoring intensity, the survey also sought to establish the existence of firm-specific features that attract regulatory attention. In order to better understand how regulation impacts various types of firms, an index was designed to assign a regulatory burden score to firms. This index was based on the rankings by firms of the difficulties associated with registration, securing premises, taxation, zoning, and labor regulations. The index ranges from 1 to 20, with any firm with an index of 10 or more being designated as “highly regulated,” denoted as an HR firm. Firms with higher scores are denoted as highly regulated (HR) firms. *Table 12* shows distinguishing characteristics of firms that are highly regulated (approximately one fourth of the MSE sample) compared to firms that are less regulated.

Table 12: Characteristics of Highly Regulated Firms (MSEs only)

Firm Characteristics	Unit of Measurement	Less Regulated Firms	Highly Regulated Firms	Comments On Regulated Firms
Firm Size	No. of employees	8.8	8.9	No difference
Age	Year Started	1994	1995	No difference
Operating Hours	Hours/Day	9.1	10.8	Open longer hours**
Operating Days	Days per Week	5.5	6.0	Open more days**
Seasonality	Percent Change in Seasonal Revenue	117.8	160.6	More seasonal
Annual Growth	Employees Added	0.5	0.85	Higher growth**
Tax-Change	Percent responded "yes" to arbitrary tax question	65	68	No difference
Monitoring	Visits by All Regulatory Authorities/Yr	49.6	55.5	Are monitored more frequently
Female-Owned	Percent Owned by Females	32	35	Female Owned More Regulated
Corruption	Ranking of Corruption as Constraint (1...4)	1.75	2.5	Find corruption more problematic**
Working Capital	Ranking of Finance as Constraint (1...4)	2.1	2.3	More constrained by finance**
Legal Form	Percent Registered as Private Individual	34	46	Dominated by more firms registered as private individuals**
Sector	Percent of Manufacturing Firms	23	22	No difference

**indicates mean differences are significant at the $\alpha=.10$ level.

N=203, this chart only contains information on MSEs, because the homogeneous characteristics of Traders do not allow for a meaningful statistical comparison across firm characteristics.

Some notable and interesting trends emerge from *Table 12*. Firms that are open longer hours and more days per week and experience higher rates of growth tend to be more regulated. These three characteristics, if considered as proxies for firm success and entrepreneurship of the owner, would indicate that the most successful firms are most susceptible to be burdened by the enforcement of regulation. They attract regulatory and supervisory actions.

It is also interesting to note that HR firms are inspected more often and tend to rank corruption as more problematic than other firms. This supports the notion that corruption (in the form of bribery) does not provide a means of avoiding either regulations or inspections. The legal form of the enterprise is also an important factor because one would initially expect that individual entrepreneurs would be less affected by the legal and regulatory environment, given their association with more informal, less institutionalized activities. It is surprising that the opposite is the case.

Perhaps one of the most interesting findings is the relationship between HR firms and the demand for credit. In addition to the fact that HR enterprises report that access to working capital is more problematic, highly regulated firms are also more likely to apply for loans from all sources of credit and, equally interesting, are more likely to be rejected or rationed out of both formal and informal credit markets than less-regulated firms (*Table 13*). The greater demand for credit may be in part explained by a greater propensity to grow, while individuals may find it more difficult than partnerships and companies.

Table 13: Relationship between Excessive Regulation and the Demand for Finance

Source of Finance	Percent of Firms that Applied for Loans			Percent of Applying Firms Rejected by Credit Source		
	Less Regulated Firms	Highly Regulated Firms	Likelihood of HR Firms Applying	Less Regulated Firms	Highly Regulated Firms	Likelihood of HR Firms being Rejected
Banks*	36	45	More	36	48	More
Govt.*	8	17	More	72	63	Less
Input Supplier	38	42	More	1	1	N/A
Buyer	39	43	More	0	7	More
Friends/Family*	41	50	More	1	9	More
Moneylender	11	15	More	6	22	More
Private Firm	7	10	More	1	28	More

*indicates that sample means were significantly different at the $\alpha=.10$ level
n=203

Corruption

Corruption in most countries is attributed to a substantial amount of discretionary power exercised in carrying on the work of a modern administration (Klitgaard, 1988).¹⁸ The inadequate funding of administrative agencies and the low salaries of civil servants can, and often does, lead to obstructionist implementation and rent-seeking in the form of high fees for services and demands for bribes.¹⁹ Furthermore, the lack of clear, published requirements facilitates corruption because applicants cannot independently verify the requirements for approval (Buckberg, 1997).

While it is widely accepted that the Russian business and political environment is rife with corruption, it is difficult to assess the degree to which this type of behavior exists at the local level and the extent to which it affects the types of firms found in our sample. One of the goals of the survey was to investigate the pervasiveness of bribery and corruption for micro and small enterprises, to identify government services that

¹⁸ References to corrupt activities include bribery, fraud, extortion, embezzlement, and most forms of kickbacks on public contracts.

¹⁹ For purposes of this paper, we define the term rent-seeking to be any redistributive activity that takes up resources and is costly to growth. In this environment it refers to the use of public office for private gain, and is used synonymously with corruption.

necessitate bribe payments, and to discover if firm-specific features exist within the sample that appear more inviting to rent-seeking officials (in the same manner as *Table 12* shows this is the case for regulatory requirements). We were also interested in testing the theory that corruption can actually be an efficiency-enhancing mechanism for firms, because it allows firms to pay a *fee* in order to lighten tax or other regulatory burdens.²⁰

Earlier in the report, it was shown that corruption or the rent-seeking behavior of civil servants is either problematic or highly problematic for one-third of enterprises in the survey. *Table 14* below suggests what actions may necessitate bribes and the frequency with which these types of transactions take place. Notable is the wide array of government services that are perceived to require additional side-payments to government officials, underscoring the ubiquity of this practice in the Russian setting. It is also interesting that the trading constituency perceives less incidences of bribery than MSEs do. In part, this may be because larger, more profitable enterprises are usually targeted by rent-seeking officials (Svenson, 1999 and *Table 14*).

Table 14: Government Services that Require Bribes

Government Services Perceived to Necessitate Bribes	Percent of MSEs	Percent of Traders
Issue Permits or Licenses	65 (18)	55 (20)
Secure Premises	67 (19)	57 (20)
Access Loans	59 (25)	52 (25)
Facilitate or Lower Tax Obligations	42 (26)	32 (26)
Protect Business	66 (21)	53 (21)

Numbers in parentheses indicate the percentage of respondents who did not answer the question.

²⁰ This is an interesting theoretical debate in the literature. On the one hand are the proponents of the “efficient grease” argument, which purports that corruption and bribery enhance efficiency in a highly bureaucratic environment by allowing managers to more effectively maneuver through administrative red tape. On the other hand, many researchers have found that corruption discourages investment and adversely affects both the composition and level of public expenditures, and that it is even more distorting than excessive and repressive taxation. See Svenson, 1999 for a complete discussion.

In addition to examining the pervasiveness of corrupt activities, we wanted to uncover certain firm-specific characteristics that are more likely to elicit rent-seeking behavior. *Table 15* below highlights firm-level characteristics that appear to attract attention from corrupt officials.

Table 15: Characteristics of Firms Vulnerable to Rent-seeking Officials

Firm Characteristics	Unit of Measurement	Undetected Firms	Targeted Firms	Comments on Firms Targeted for Rent-seeking
Firm Size	No. of employees	8.46	9.87	Larger firms
Age	Year Started	1994	1994	No difference
Operating Hours	Hours/Day	9.19	10.75	Open longer hrs**
Operating Days	Days/Week	5.59	5.94	Open more days per week**
Seasonality	Percentage Change in Seasonal Revenue	121	159	More seasonal variations
Annual Growth	Employees Added	0.45	1.01	Higher growth firms**
Tax-Change	Percentage responded “yes” to arbitrary tax question	61	78	More vulnerable to arbitrary tax collection**
Monitoring	Visits by All Regulatory Authorities/Yr	50.4	54.2	Monitored more frequently
Female-Owned	Percent Owned by Females	37	26	Female Owner less likely**
Working Capital	Ranking of Finance as Constraint (1...4)	2.06	2.38	More constrained by finance**
Legal Form	Percent Registered as Private Individual	38	37	No difference
Sector	Percent of Manufacturing Firms	21	29	More dominated by the manufacturing sector**

* **indicates mean differences are significant at the $\alpha=.10$ level

It is not surprising that the more entrepreneurial firms (proxied by growth in employment, hours of operation, and enterprise size) invite more extortionist behavior since officials

earn a higher rent by targeting the most profitable businesses. It is also not surprising that firms monitored more frequently find rent-seeking to be more problematic than those that are monitored less, given that official visits to firms provide ideal opportunities to extract additional rents from entrepreneurs. This result shows that, rather than attenuating the regulatory burden for firms, rent-seeking actually adds a burden to the enterprises.

Understanding the relationships between rent-seeking and the demand for finance, the gender of the owner, and the sector in which the enterprise operates is more problematic, however. Does corruption or bribery affect cash flows to the extent that firms become more credit constrained? What features of production or manufacturing firms invite additional regulatory scrutiny? Why are female owners more likely to be regulated, but less likely to be exploited? These are that clearly need to be resolved, but which require further exploration of the theoretical framework underlying the empirical evidence.

Organized Crime

Often associated with rent-seeking activities is the presence of organized crime which pervades legitimate Russian businesses. It does appear that there is some interaction with the mafia, as 39 and 37 percent of the enterprises in the survey report having to pay for protection. However, only 5 and 9 percent of the firms surveyed found the activities of organized criminals to impede their business operations, and mafia was graded with the lowest ranking for business constraints from the entire range of possible choices. This is consistent with other studies on organized crime in Russia and its impact on firms (Frye, 1997). These authors postulate that while criminal activity is pervasive, it performs a legitimate function (such as protection or contract enforcement) in the absence of the provision of these goods by the government sector. As such, they may be considered in the same realm as corruption of government officials, but are less destructive and are arguably providing a return on their payments.

Conclusion

The purpose of this paper has been to report on legal and regulatory obstacles to the survival of micro and small enterprises in Russia. Survey data reveal the breadth and depth of regulatory intrusion for these businesses. The findings suggest that even the lowest echelon of entrepreneurs, those who would generally operate outside or on the boundaries of the formal sector in other countries, are penetrated and subjected to the same levels of bureaucracy, inspections, and penalization as one would expect for much larger firms in such an environment. High degrees of regulation and their corollary, rent-seeking practices, have emerged as a major impediment to business growth.

Empirical results demonstrate that firms rank regulatory problems, particularly taxation, as among the most severe obstacles to the long-term success of their enterprises.

Furthermore, the problems associated with a highly regulated economy do not appear to impact firms uniformly. Firms that are larger, more entrepreneurial, and with more seasonal variations are more vulnerable to a higher degree of regulatory enforcement. Highly regulated firms also have a greater demand for credit, yet are more likely to be rationed out of the credit market than less-regulated firms.

Rent-seeking, particularly in the form of bribery, is ubiquitous in the business environment of Russia. It plays a significant role in the business dealings of enterprises, and it is a requirement to secure certain government services. Incidences of bribery appear in conjunction with regulatory inspections, suggesting that bureaucrats use their office to exploit and harass enterprise owners rather than offer them a legitimate service of avoiding red tape. Similar to regulation, we find evidence that certain firm-specific characteristics appear to attract the attention of government officials. Larger, more successful firms are more likely to endure bribery and extortion than slow-growth firms.

Furthermore, firms do not have access to the types of public goods and services that facilitate enterprise growth and survival in other countries. Particularly troublesome are the lack of a safe working environment and a poor legal system. Inefficient public safety has forced many firms to pay for protection, which increases their probability of dealing

with organized criminal operators. A poor system to arbitrate disputes implies that enterprises must rely on informal or self-enforcing contracts, limiting the scope of potential activities and partners for these firms.

The policy implications of this study suggest that significant reform needs to be implemented regarding the degree of regulation and regulatory enforcement as well as the design of proper incentives and standards of accountability for the regulatory and supervisory authorities, in order to create a more enabling working environment for this sector of the economy. In the short or medium term, however, this scenario is unlikely to emerge. A second best, though less satisfactory strategy would be to design policies and programs for micro and small enterprises that take into account and help mitigate existing regulatory constraints.

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