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Private Service Firms in a Transitional Economy

Findings of a Survey in St. Petersburg

Martha de Melo and Gur Ofer

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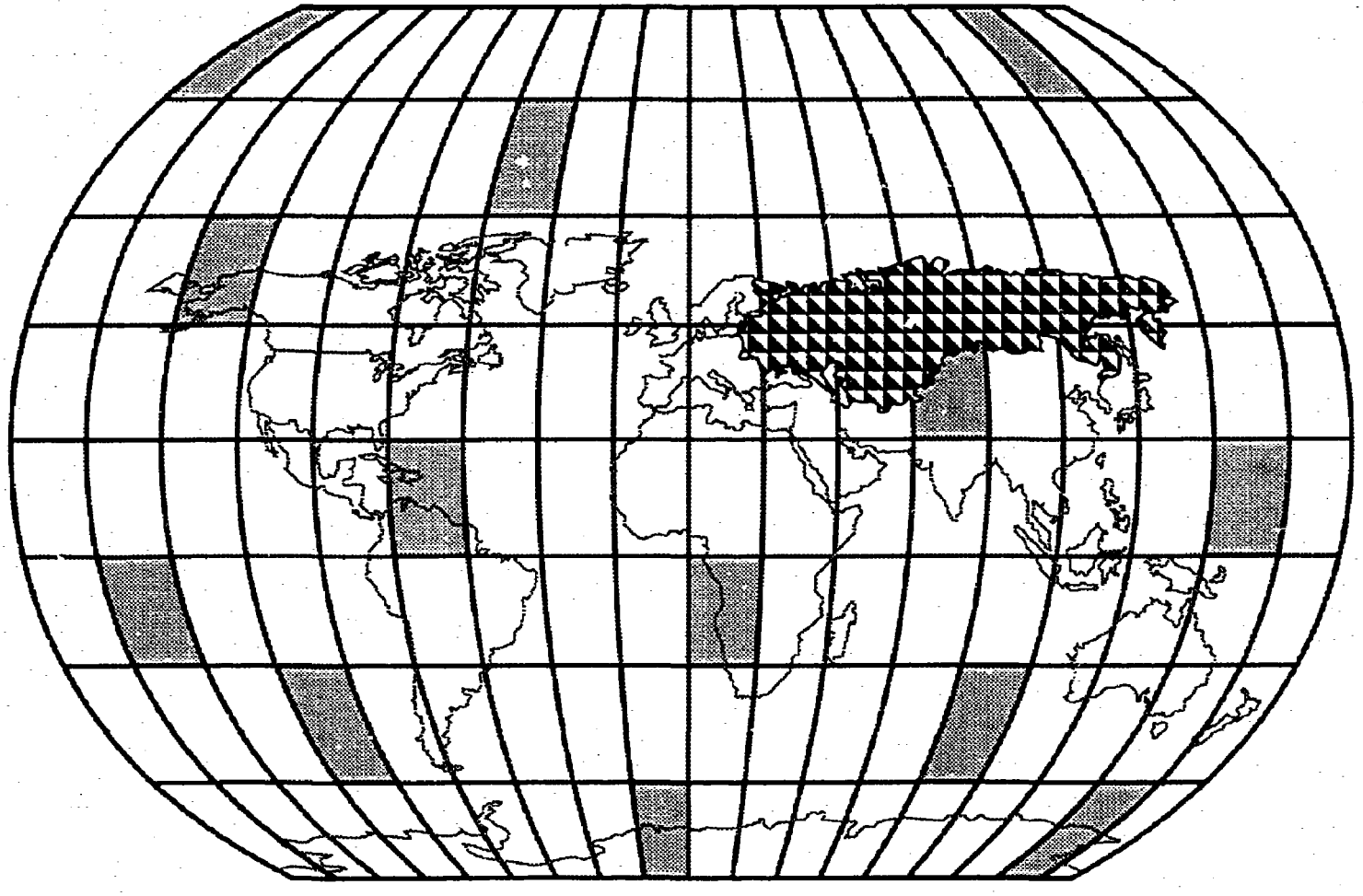

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Foreword

Privately owned service firms are crucial to market economies. Because they are involved in most transactions, such firms in some sense *are* the market. The successful development of such firms is vital to Russia and other economies in transition, yet little is known about the emergence of service sector entrepreneurs and firms in the former socialist economies or about the problems they face.

This survey of private service firms in St. Petersburg helps fill this gap. The study examines in detail the origin and characteristics of 86 small and medium-size firms representative of the city's emerging private service sector and identifies key barriers to their growth. It then recommends policies to boost development of small and medium-size privately owned service firms in Russia and other economies in transition.

St. Petersburg is not typical of Russia. The city's historically close economic and cultural links with Europe, as well as the large number of professionals who have worked in the city's military-industrial complex, have contributed to a more favorable business environment than that found in most other Russian cities. Even so, St. Petersburg's service sector entrepreneurs have encountered many problems that are experienced —with more or less intensity—elsewhere in Russia, as well as in other economies in transition.

This study was prepared in the World Bank's Policy Research Department and is intended for policymakers, multilateral and bilateral aid agencies, and other researchers or academics. Foreign businesses and non-government organizations interested in private sector development in Russia may also find this report useful.

Russell J. Cheetham
Director
Country Department III
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Acknowledgments

This paper presents the findings from a survey of private firms providing services in the St. Petersburg area. The survey was undertaken January 17-27, 1993. The interview teams were headed by Martha de Melo, Gur Ofer, and Olga Sandler from the World Bank; Tom Adshead and Joanna Chataway from the European Bank for Reconstruction and Development; and Eugene Tankhilevich, Senior Researcher of the Russian Academy of Sciences' Institute of Economic Forecasting. Olga Sandler also organized the field work, the data files, and all the statistical work. Elena Belova of the Leontief Center in St. Petersburg was the local Project Manager; and interpreters were Tim Chernov, Kirill Kalinin, Mikhail Pelienko, and Julia Smirnova. We thank all these colleagues—and especially the entrepreneurs of St. Petersburg who shared their experience with us—for their valuable contributions to this research.

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Abstract

This report presents the findings of a survey of private service firms in St. Petersburg. Services are defined as all sectors of the economy other than agriculture, manufacturing, construction, and utilities. Services are the largest and most dynamic part of the emerging private sector in St. Petersburg and elsewhere in Russia, yet relatively little is known about private service firms.

The report examines in some detail the characteristics of the city's new entrepreneurs and their firms. It discusses wages, prices, and the markets in which these firms operate, and it analyses firm performance. Most entrepreneurs were highly educated, energetic and resourceful; their firms were typically small but growing, diversifying, and self-financing. Wages and prices are flexible, but markets are still poorly developed.

Despite a difficult business environment characterized by high inflation and declining output, most firms were performing reasonably well. Good performance was associated with new firms unconnected with state enterprises, firms run by academics or technical specialists, and firms selling primarily to other private companies. Poor performance was associated with low total revenue, privatized firms unconnected to state enterprises, firms selling primarily to households, and consumer services activities.

The problems most frequently mentioned by entrepreneurs were an unstable macroeconomic and legal environment, the lack of bank financing, and high taxes. Other problems included lack of demand, finding good workers, and obtaining satisfactory space.

Considering the importance of rapid private sector development in services, entrepreneurs require more stable and supportive surroundings. Based on the study's findings, the key recommendations for policy reform are to:

- *Improve the business environment.* Stabilizing the economy and raising credibility about the direction of reforms will reduce risk and provide a solid base for investment, and hence growth. It will also help to normalize financial markets and interest rates, setting the stage for increased provision of bank credit.
- *Strengthen core government institutions while reducing intervention into markets.* Government needs to contain expenditures, so that revenue requirements are reduced, and eliminate civil service corruption. Necessary regulations should be simple, clear, well-publicized, standardized, long-term, and not retroactive.
- *Reduce and simplify taxes.* Reducing the number of taxes and simplifying and standardizing the tax code will assist small businesses, which have difficulty coping with complex procedures and frequent changes. Tax authorities should analyze the cumulative as well as individual effects of the tax system with a view to ensuring both equity and adequate incentives to entrepreneurs.

■ *Open the real estate market and increase the security of ownership.* Government should sell excess real estate holdings of government entities, permit an upward adjustment in real land rents, and encourage creation of a competitive market for the renovation and rehabilitation of historic buildings.

■ *Provide equal treatment for different economic activities.* Regulations, taxes, or other forms of government intervention should not discriminate between different types of economic activities, such as trade and manufacturing. Rather than tax traders heavily, government should reduce the distortions that make high profit margins possible.

■ *Offer special assistance to small businesses during the transition.* In addition to policy reforms, special assistance for small businesses may be needed to encourage private sector development during the transition. Such assistance should include programs to encourage lending to small businesses by existing financial institutions and to create business centers offering information, training, and technical assistance.

■ *Minimize direct government involvement in targeted assistance programs.* The existing strains on government and entrepreneurs' low confidence in government suggest that its involvement in targeted assistance programs should be minimal. Instead, government should concentrate on law enforcement, tax collection, and improved efficiency of services, while the private sector—supported in part by foreign aid—should handle small business assistance.

1

Introduction

This report presents the finding of a survey of private service firms in St. Petersburg, Russia. Services are defined as all sectors of the economy other than agriculture, manufacturing, construction, and utilities. The focus is on services because they are the largest and most dynamic part of the newly emerging private sector in St. Petersburg and elsewhere in Russia, because the development of services is crucial to the transition to a market economy, and because relatively little is known about private service firms. The purpose of the study is to explain the origin and characteristics of private service firms, to identify the main difficulties they face, and to recommend policies to facilitate stronger growth of services in Russia and other transition economies.

Services and small business in a transitional economy

In developed market economies, both the service sector and the small-business private sector play important roles in the economy (box 1.1). The two sectors overlap substantially, as most of the activity in the service sector is performed by private small and medium-size enterprises, most of which provide services. The last twenty years have witnessed an increase in the importance of small and medium-size enterprises in most market economies and a growing recognition of their contribution to growth and employment, innovation and productivity, and competition.[1]

In the former Soviet Union the service sector was run by the state and was extremely underdeveloped. Enterprise development began with the legalization of private activity in 1987; it continues despite many difficulties. The development of small and medium-size enterprises in the service sector, in particular, needs to be encouraged during Russia's transition to a market economy because, in a sense, such firms *are* the market and because, among all the tasks ahead, their development may be one of the easiest.

The formation of a large sector of small and medium-size enterprises can be achieved by creating new firms and down-sizing and privatizing state firms, but closing the gap in services will require a change in the structure of the economy. Even during the early stages of transition, the creation of new firms will predominate, resulting in substantial employment growth in the private sector.[2] New, privately supplied consumer services will improve the quality of life, thereby increasing the political support for reforms.

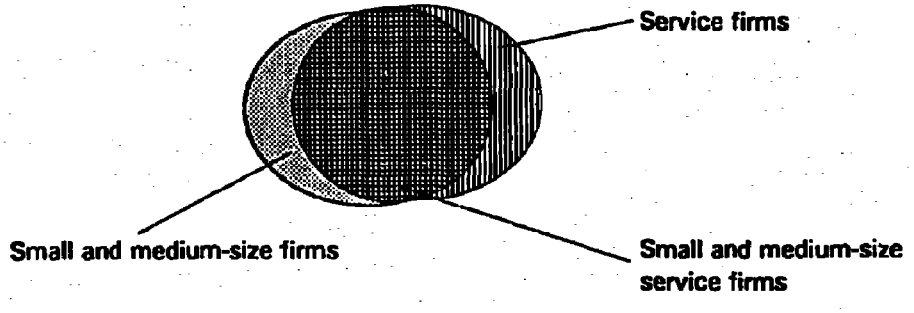
Small and medium-size enterprise development is relatively simple. Entrepreneurial demands and risks assumed by new owners are not unreasonable; indeed, starting a small enterprise can provide training for new entrepreneurs, who may later diversify into more complex and demanding activities. The requirements for technology and capital assets are often modest, particularly in the service sector. The experience in Eastern Europe shows the importance of small and medium-size

Box 1.1 Small and medium-size service firms are crucial to market economies

Small businesses in the Organization for Economic Cooperation and Development (OECD) countries are defined by revenues, value of assets and employment. The most common definition is by employment, and the term "small and medium-size enterprises" is typically used for firms with fewer than 500 employees. The term "small business" is applied to firms with fewer than 100, 200 or sometimes 250 employees and may be subdivided into several categories. The European Union uses the term "microenterprise" for small businesses with fewer than 10 employees.

The following facts about services and small and medium-size enterprises demonstrate their importance:

- The service sector—including transportation and communications, trade, financial and business services, personal services, and public services such as education and health—accounts for the major share of economic activity in OECD countries and has been growing in importance. Its average share of GNP was 51 percent in 1970 and 62 percent in 1990; its share of the labor force was 50 percent in 1970 and 67 percent in 1990.
- Small and medium-size enterprises made up 99.8 percent of all enterprises and 57 percent of all private sector employment in the United States in 1990; enterprises with fewer than 100 employees accounted for 98 percent of enterprises and 43 percent of private sector employment. In the European Union small and medium-size enterprises accounted for 99.9 percent of all enterprises and 72 percent of private sector employment in 1986.
- In the European Union, 73 percent of all small and medium-size enterprises are service firms, and 99.9 percent of all service firms are small and medium-size enterprises. In the United States 69 percent of all employment in firms of this size was in the service sector in 1977, compared to 64 percent in 1987.



Source: OECD National Accounts, OECD 1985; U.S. Small Business Administration 1982, 1992; Storey 1982, 1983, 1987, 1991; Acs and Audretsch 1993.

enterprises, particularly service firms, in reversing the trend of declining output, creating new market infrastructure, and generating rapid private sector development (Johnson 1992 and Grabowski 1993).

But small and medium-size enterprise development in Russia faces considerable difficulties. The law on entrepreneurship is in place, but other laws—especially on contracts and property rights—are not. Litigation and arbitration systems and law enforcement are poorly developed. The police are inexperienced and ineffective, and there is a high incidence of corruption in public administration. Criminal "mafia" groups have become widespread, extorting fees for the provision of "protection" and debt collection.

At the time of this survey, January 1993, the economic and political situation in Russia was highly unstable, increasing the uncertainty and risk involved in any entrepreneurial activity, especially for services. Russia has a long heritage of negative social attitudes about services, which were considered "nonproductive" under the socialist system. Such attitudes are currently reflected in discriminatory policies favoring manufacturing over service firms. Trade firms, for example, are subject to higher profit tax rates and rental rates than manufacturing firms. There is also a lack of know-how and experience in running private service activities.[3]

The St. Petersburg survey

Despite the importance of services and small business development for Russia's transition to a market economy, relatively little research has taken place.[4] This survey of 86 private service firms in St. Petersburg was undertaken in January 1993 to help fill the gap. To the authors' knowledge, it is the first survey of Russian private sector development to focus on services.

The purpose of the survey was to determine the origin of private service firms; the qualifications and motivations of the entrepreneurs; the firms' characteristics, performance, and interaction with the markets they deal in; and the factors in the internal operation of the firms and in the external business environment that encourage or impede smooth operation and growth. Based on this information, we recommend policies and programs to expedite small and medium-size enterprise and service sector development.

The location of the survey in St. Petersburg was determined by the ready availability of a sample of firms willing to be interviewed.[5] In many ways, the political and institutional setting in this, second largest city in Russia—with a population of 5 million in the city and another 1.7 million in the surrounding Leningrad Oblast—is similar to that of other large Russian cities. But St. Petersburg also has some special characteristics that make it particularly conducive to private sector development.

St. Petersburg is a beautiful city with strong historical, cultural, and economic links to Western Europe; it therefore has a particular appeal to foreign investors. It has one of the largest concentrations of heavy and military industries in Russia and is an important center of research and development.[6] It has a large pool of highly trained academics and professionals in all fields. The government of St. Petersburg is known for its support of reform, and more than half of the municipally-owned enterprises were privatized by the end of 1992. Even so, other aspects of reform, such as large-scale privatization or sales from the large stock of municipal real estate, have lagged.

The firms in this survey were chosen randomly from respondents to 3,000 interview requests, which were sent to a random sample from 10,000 firms registered by August 1992. Adjusting for inactive firms, about one in three firms responded. The firms included in the survey were screened to satisfy three criteria: more than 50 percent of revenues from services, more than 50 percent privately owned, and less than 50 percent foreign owned. No restrictions were placed on their legal form or number of employees. Not included in the original sample or in the survey are self-employed persons who need a license but do not have to register as a legal entity.[7]

At the time of the survey, no independent information was available on the structure of private sector service activities. Subsequently, however, data on the structure of service activities of "small enterprises and cooperatives" in 1992 were obtained from the St. Petersburg Statistical

Office. The correspondence between the survey data and the Statistical Office data is quite close, although not all the firms in the latter data set are private (table 1.1). For both groups, the main categories of services, in decreasing importance, were: trade, business services, consumer services, health and education, transportation, and finance.[8]

Table 1.1: Structure of small enterprises and cooperatives in the service sector: Comparison of Statistical Office and survey data (percent share)

Main activity	Statistical office data	Survey data
Trade	39.7	37.2
Business services	36.6	31.4
Consumer services	12.1	15.1
Health and education	9.2	8.1
Transportation	2.0	4.7
Finance	0.4	3.5
Total services	100.0	100.0

Source: St. Petersburg Statistical Office, *Main Activity Indicators for Small Enterprises and Cooperatives in St. Petersburg and Leningrad region in 1992*, St. Petersburg, 1993.

Each of the firms included in the survey responded to a questionnaire, which was quite broad and took an average of three hours to administer. The questionnaire elicited both quantitative and qualitative responses, and many of the latter were organized in a manner permitting statistical analysis. Missing frequencies occur because not every question was applicable to every firm, because entrepreneurs occasionally refrained from answering a question, and because time constraints sometimes meant that not every entrepreneur was asked every question.[9] In addition to straightforward reporting of the quantitative and qualitative information gathered, this report uses cross-tabulations and statistical correlations to test selected hypotheses.

Entrepreneurs were assured of confidentiality, and most appeared to be frank in their qualitative responses. They occasionally considered some subjects sensitive, and a few entrepreneurs were reluctant to discuss their export activities, their revenues, or their relations with the "mafia." Some entrepreneurs may have adjusted their responses about monthly revenues or wages to match more closely their tax declarations. Nevertheless, this and other quantitative data vary widely, and no systematic bias was evident—with the possible exception of a performance bias. A large number of firms had relatively good performance indicators (appendix), and it is possible that positive response to the interview request was greater among successful firms. Regardless of how representative survey firms are of performance in the sector, their experiences are interesting and provide insight into the new private sector in Russia.

Notes

1. The role of services has also expanded, reflecting shifts in demand in favor of services as income rises and lower productivity growth in services than in agriculture and industry (see Griliches 1993).

2. For further evidence on the service gap and its implications for economic growth in Russia, see Easterly, de Melo and Ofer 1994.

3. Some services—such as finance, marketing, and other business services—are almost completely new activities in Russia. Others—such as trade and household services—existed before but require a new approach to quality.

4. The World Bank has sponsored two previous surveys of new private firms in Russia that are largely small and medium-size enterprises. One was a 1993 survey of 100 manufacturing firms in St. Petersourg (Webster and Charap 1993). The other was a 1992 survey of 180 firms in eight locations; no report is available. In addition, Cristiano Codagnone and Andrei Veikher undertook a

survey of private businesses in St. Petersburg in 1993, focusing on entrepreneurship (Codagnone 1993). Other World Bank sponsored surveys are focussing on state enterprises or large privatized companies.

5. These firms, several of which were located in the Leningrad Region, outside St. Petersburg proper, were identified in a study of manufacturing firms in St. Petersburg (Webster and Charap 1993). Of the 504 usable responses, 35 percent were identified as services, 40 percent as manufacturing and construction, and 25 percent as "mixed" activities. Most firms indicating mixed activities are likely to be service firms, many of them in trade; local statistics indicate that 52 percent of small enterprises and cooperatives are services.

6. The high concentration of heavy and military industries in St. Petersburg also has a cost, as production and income levels have fallen dramatically (Odink 1992).

7. In addition, there are believed to be many individuals, in St. Petersburg and other parts of Russia, who are neither registered nor have a license and who are operating out of their own homes, providing such services as tailoring or consulting.

8. The original survey sample included only one financial firm. Thus, as an exception to the rule of random selection, two financial service firms—one bank and one insurance company—were added, explaining the larger survey data share of financial service firms in table 1.

9. In general, missing frequencies are well below fifty percent; the number of missing frequencies is indicated in a footnote in the few instances where they exceed fifty percent. In general, percentages are calculated using the number of responses to a given question as the denominator. The questionnaire is available from the authors on request.

2

Entrepreneurs and firms

The entrepreneurs in the survey were on the whole highly educated, energetic and resourceful. The firms' main activities according to revenue shares, indicated that the largest group, trade, included mostly wholesale and mixed wholesale and retail companies, with only five solely retail companies (including one kiosk owner) and three restaurants (table 2.1). The second largest group, business services, included computer services, research and development, and legal and management consulting. The third largest group, consumer services, included travel, repair, custom tailoring, hairdressing, and publishing. The other three groups—health and education (public-type services that cater to both businesses and households), transportation, and financial services—each include only a few firms. Separate discussion of these groups is minimized in view of the limited number of observations.[1]

Table 2.1: Main activities of private service firms in the survey

Main activity	Number	Percent
Trade	32	37
Wholesale trade	12	14
Retail trade	5	6
Mixed / unidentified trade	12	14
Restaurants	3	3
Business services	27	31
Computer services	5	6
Research and development	8	9
Consulting, legal, and other	14	16
Consumer services	13	15
Tourism	4	5
Publishing	1	1
Repair	4	5
Custom tailoring	2	2
Hairdressing	2	2
Health and education	7	8
Health	3	3
Education	4	5
Transportation	4	5
Finance	3	3
Total	86	100

The entrepreneurs

The survey data provide an interesting picture of the new entrepreneurs and their backgrounds.[2] Entrepreneurs are individualistic by nature. They come primarily from the elite of the labor force and are looking for both personal fulfillment and financial gain. The private sector has provided a release valve for pent-up talent and ambition. Entrepreneurs typically rely heavily on themselves and on personal contacts in their day-to-day business. Box 2.1 describes a "typical" entrepre-

Box 2.1 Vladimir X: A "typical" entrepreneur

Vladimir X doesn't exist; but his dreams about moving to the private sector, along with his subsequent frustrations and successes, are all real. He is a fictional composite drawn from the entrepreneurs interviewed for the survey. The need for confidentiality prevents the presentation of individual case histories.

Vladimir X worked 15 years for a state high-technology enterprise after receiving an engineering degree from the St. Petersburg Polytechnical Institute. Vladimir had not been satisfied with his job in the public sector because the enterprise was inefficient and he had little freedom in decision-making with respect to his own professional activities. When private sector activity was permitted in 1987, Vladimir began to dream of becoming his own boss and getting rich. In 1990, he and a friend quit their government jobs to start their own business.

Vladimir and his partner started a household appliances repair business. They arranged a two-year lease on the ground floor of a run-down building in the historic section of St. Petersburg and acquired tools and equipment at a good price from the state enterprise where they worked. The two friends initially employed seven people, including themselves, but business was slow as household incomes had fallen. They soon diversified into car repair, and doubled their work force during their second year of operation. Monthly revenues were low, but so were costs, and they maintained an adequate cash flow by requiring payment on delivery.

Soon after opening business, they found themselves trading in spare parts and second-hand appliances. Trade was not only a natural extension of the repair business; it was a convenient way to generate undeclared cash income. Fortunately, Vladimir's trading activities have not yet attracted the attention of the "mafia."

Vladimir is glad he went into business for himself, but says he did not expect so many difficulties. Personnel problems are frequent, and it is almost impossible to keep abreast of tax and other regulations. Tension has developed with his partner, who would rather translate profits into a higher personal income than expand the business. Fortunately for Vladimir, his initial equity share was 60 percent, so he has operational control of the firm, subject to the occasional compromise.

In spite of such problems, Vladimir is helping his cousin set up a service business to provide information on local real estate. The cousin is a computer expert and has access to information on current real estate holdings. He plans to develop his own data base that records the date and price of various real estate transactions. Both men want to know more about financial management techniques and plan to take an evening course to improve their knowledge.

Vladimir complains a lot about the city government. His complaints are not about the lack of subsidies or special programs for new entrepreneurs, but about excessive regulations, absence of information, and high taxes. But, despite these frustrations, he is determined to succeed.

neur, "Vladimir X," a composite of several participants in the survey.

On the whole, entrepreneurs appeared to be energetic and resourceful. The youngest entrepreneur interviewed was 21, the oldest 70; however, most were between the ages of 30 and 55. Their median age, 41 years, seems to strike a balance between adequate experience and daring or risk-acceptance. Eleven of the 86 entrepreneurs interviewed were women; they were in trade and restaurants (4); education and health (2); consumer services, such as hair dressing (2); and business services, such as computers and publishing (3). The high percentage of women in service industries and managerial positions in the former Soviet Union might lead one to expect a high share of women among entrepreneurs.[3] Systematic factors in the emerging private sector may discourage women from starting their own businesses. Such factors might include a tendency for couples to hedge their bets by maintaining one public sector job and a tendency for women to opt for the more predictable, and probably shorter, public sector work schedule given their household responsibilities.

Education, experience, and motivation

Overall, the entrepreneurs interviewed were characterized by a very high level of education. Almost 85 percent had university education, compared to 77 percent for all Russian managers; 20 percent had post-university education.[4] Fourteen entrepreneurs had only a high school (including technical/vocational) education or less. Most entrepreneurs had held high-level jobs in the past. Some 83 percent had held managerial, academic, or "specialist" jobs, indicating that they came from the elite of the labor force in terms of both formal education and human capital acquired on the job.

Most business owners worked previously in companies or institutes that provided services of some type or in service departments inside production companies; only six previously worked in manufacturing jobs and only three in construction. This close correspondence to previous jobs implies a clear self-selection process. The prevalence of entrepreneurs with previous experience in services—even if the particular activity differed—is striking, given the relatively small share of all workers in such activities under the previous regime.

Entrepreneurs' stated motivations for moving to the private sector were, in order of frequency:

- The opportunity to make more money.
- The desire to become independent.
- The opportunity to pursue their profession.
- The chance to pursue other interests.

A few entrepreneurs had previously worked in the second economy while holding a state sector job, and several entrepreneurs were able to turn their personal hobbies into commercial activities, specifically in such areas as computer programming, commercial design, and the arts.

Where did the entrepreneurs come from?

Almost all owners of private enterprises—whether new start-ups or privatized state enterprises—were employed at one point in the public sector. While still working in the public sector, however, the entrepreneur belonged to one of three groups: managers of state-owned enterprises, academics and technical specialists, or clerical/administrative/blue-collar workers (table 2.2).[5]

- *Former managers* were either general managers of state enterprises (12) or held other public sector managerial positions (29), representing almost half the group. They were slightly older than the survey average. They tended to have a university or technical education, and the vast majority had previously worked in state enterprises.
- *Former academics and technical specialists* were the best educated group (34). They included relatively few women; their median age was close to the survey median. Many had completed post-university degrees and employed a high proportion of professionals in their firms. The majority worked previously in academic institutes rather than state enterprises.

Table 2.2: Characteristics of owners by past job (percent)

		Age	Gender	Education	Previous work place		Activity	Ownership
Owner's past job	Number of firms	Above survey median	Women	Higher education	State enterprises	Academic institutes	Same	Involved in other firms
General or technical manager	*38-41*	59	17	80	85	5	47	50
Academic or technical specialist	*31-34*	47	6	97	19	68	31	56
White or blue collar worker	*11*	18	18	55	55	9	55	45
Total	*81-86*	49	13	84	57	29	42	52

Note: Chi-square values: age = 0.06, gender = 0.30, education = 0.00, previous work place = 0.00, activity = 0.26, ownership = 0.64. (The chi-square statistic shows the probability that the data are distributed randomly across the cells.)

- Former workers (11) were typically younger and tended to have a lower level of education than the other two groups. Many previously worked in state enterprises.

Entrepreneurship as a human conversion program

There is much talk in Russia about military conversion—the conversion of space and equipment used in Russia's large defense sector to the production of consumer goods. But far more dynamic is the spontaneous "human conversion program", whereby talented people in former state industries or academic institutes—managers, academics or technical specialists, and workers—choose a life of opportunity and risk as entrepreneurs in the newly emerging private sector. Some new owners of service firms got their opportunity through the privatization program, but the majority had to make their own opportunity, sometimes with help from their previous workplace.

Examples are many: a former captain of a government cargo vessel started a travel company, capitalizing on his experience and contacts abroad; a transport company owner, who formerly discharged his energy in a high-risk sport, became engrossed in computerized management analysis and expansion plans. Such people are learning fast and testing their limits; new entrepreneurship is analogous to a coiled spring, previously tightly constrained, which can now expand to its full potential.

One indicator of entrepreneurial spirit is ownership stakes in other private companies. More than half the entrepreneurs interviewed had part ownership in at least one other company, and half of these in more than one (table 2.2).[6] This pattern of multiple stakes is common among small businessmen in the United States and Western Europe, and it is interesting to note its prevalence at this early stage of private sector development in Russia. Other entrepreneurs interviewed had virtually no formal relationship with other companies. Only a quarter were members of trade or other business associations; a sense of rivalry and lack of mutual trust among firms appear to limit such associations.

Although few entrepreneurs have formal business, finance or marketing skills, they are interested in and capable of acquiring such skills rapidly through training, self-study and foreign working visits. Many expressed interest in management courses, market-related skills such as financial accounting and marketing, and foreign languages.

How do entrepreneurs operate in the market economy?

In most cases, owners demonstrated a fairly good understanding of market forces, including differences between nominal and real values and the effects of inflation and the exchange rate on their businesses. In many cases, they seemed to be taking effective measures to protect themselves against losses, including holding financial assets in hard currency rather than rubles. Owners who were reluctant to take loans at negative real interest rates often had good explanations—either that real rates were not as low as they might appear or that changes in input and output prices were too unpredictable to make a financial plan. In a few cases, they seemed to suffer from "money illusion", whereby nominal and real values are confused.

Entrepreneurs rely heavily on personal contacts to accomplish business objectives, substituting them for the information networks and standard government and business procedures that exist in most market economies. Personal contacts originate in family relationships, ethnic or regional ties, work relationships, or military service. Such contacts are used to hire workers; to sell products, including exports to former soviet republics; and to deal with the government, banks, and state enterprises.

Entrepreneurs also rely on bribes. Close to half the entrepreneurs disclosed the use of bribes in connection with their business activities. A quarter of the firms said they used bribes to lease real estate; a third, to obtain the equipment they needed; 20 percent, to obtain inputs; 10 percent, to obtain financing; and a few, to help get licenses. In addition, bribes were mentioned anecdotally by several entrepreneurs who had not responded positively to the specific questions on this subject. There was frequent reference to the need to pay a government official in order to get something. One person claimed he and others had made hundreds of bribes within the last year and not one was refused.

On the whole, entrepreneurs operated independently, without outside support, although 40 percent had heard about special programs to help private business with credit or with training. Three entrepreneurs mentioned the Soros Fund, one the British Know How Fund, and one the programs of the European Union. There was considerable interest in such programs, but very low expectations. About 15 percent of firms had received some foreign technical assistance, mostly from foreign firms; the rest was from foreign governments' training or technical cooperation programs.

The firms

Most of the 86 firms in the survey were small in terms of revenue and number of employees. Firms varied in size and made extensive use of part-time and contract workers. The smaller firms were typically owned by individuals; larger firms had substantial corporate ownership. A number of the newly established joint stock companies featured inter-locking ownerships with parent, sister, and subsidiary firms. The old system was represented by a relatively small number of leaseholds, cooperatives, privatized firms owned by workers' collectives, and privatized firms with residual state ownership. Common features were their tendency to diversify and their reliance on trade. Financing from banks was scarce.

Firm size

The firms in the survey varied widely in size, from a health care company with one person and monthly revenues of $100 (R10,000) to an insurance/trading company with 1000 employees and another trading company with monthly revenues of $20 million (table 2.3).[7]

The median monthly revenue for survey firms during the last quarter of 1992 was $20,000 (R2 million). As expected, revenues from trade were

high, because of the high value of goods purchased for a given value added. But the median revenue of the few finance and transport firms interviewed were much higher, reflecting the high profitability of the former and the need of the latter to recover capital costs. The minimum monthly wage in the economy at large during the last quarter of 1992 was R900, and the average monthly wage about R10,800. Using these comparators, the minimum revenue per worker exceeded 5 times the minimum wage, but was only about two thirds the average wage. The maximum revenue per worker was far above the average wage.

The median number of full-time employees in the survey was 13, and the average, 55. The average is strongly affected by the inclusion of several large firms in the survey, but the median is quite typical of small and medium-size enterprises in Western Europe (Commission of the European Community 1990, chapt. 3). Three-quarters of all firms surveyed had fewer than 40 workers, and another 13 percent had 40 to 69 workers. Eight firms employed 100 to 400 workers. Three firms—a transportation company and two trade companies—had labor forces of 800 or more. Using number of employees as a proxy for size, firms providing business services tended to be smaller than average, trade firms tended to be larger than average, and consumer services about average (table 2.3).[8]

Table 2.3: Firm size by revenue and employment

		Monthly revenue (R 1000)			Number of full-time workers		
Main activity	Number of firms	Average	Median	Number of firms	Average	Median	Percentage of firms with fewer than eight full-time workers
Trade	27	98,711	4,000	32	95	25	16
Business services	26	9,200	1,500	27	22	11	33
Consumer services	11	6,522	600	13	40	17	31
Health and education	7	985	500	7	10	7	57
Transportation	4	9,925	9,750	3 [a]	5	6	67
Finance	2	38,750	38,750	3	146	41	0
Total	64	40,263	2,000	85 [a]	55	13	28

[a] These figures exclude one large transportation company for which the breakdown between full-time and contract workers is not available.

Origins and legal status

More than two-thirds of the firms were new start-ups, fully private from the beginning; only one-third were privatized state enterprises. This is contrary to the popular perception that privatization is more important to private sector development than new start-ups. The distinction between privatized firms and new start-ups, however, is not as sharp as one might expect. Of the new start-ups, most originated within a public ("host") organization, often without any formal arrangements but with important economic links. For example, the owner of the new start-up firm might "moonlight" on the job at the host organization, "rent" space from it (in theory or in fact), use its equipment, or provide it with services. In many cases such symbiotic relationships gradually eroded, leading to full separation, but 22 firms classified as "start-ups" in the survey still maintained one or more of these relationships with their host organization.

Of the privatized firms, most had become 100 percent private by the time of the survey; only 12 of them still had partial public sector ownership. A majority of the trade firms had been privatized, accounting for two-thirds of all privatizations. Almost 40 percent of consumer services had also been privatized. Most of the firms providing business services were new start-ups, suggesting that conditions of entry are particularly important for such firms. Most firms became private—either as new start ups or privatized companies—in 1990 and 1991 (figure 2.1). As of January 1993, their average age since becoming majority private was 21 months.

At the time of registration, a new firm has a number of legal forms to choose from. The earliest legal forms available for registration were *private individual*, equivalent to self-employed; *small enterprise*, cooperative, and *leasehold*.[9] As might be expected, almost all firms with high shares of individual ownership were registered as small or private individual enterprises. Enterprises with fewer full-time workers tended to be registered as small enterprises or private individuals.

About half of all firms were registered as *joint stock closed* (JSC) or *limited liability*, making owners not personally liable for their debts. The *joint stock closed* form was introduced only in 1990, but it has more prestige because it can issue preferred stocks and bonds and form subsidiaries. A few older enterprises altered their legal status to *joint stock closed* when this became possible. In addition, there was one *commercial bank*, one *joint venture*, one *joint stock lawyers company*, and one *non-state academic institute*, all of similar legal status to joint stock closed, but covered by

Figure 2.1: The pace of private sector development in St. Petersburg

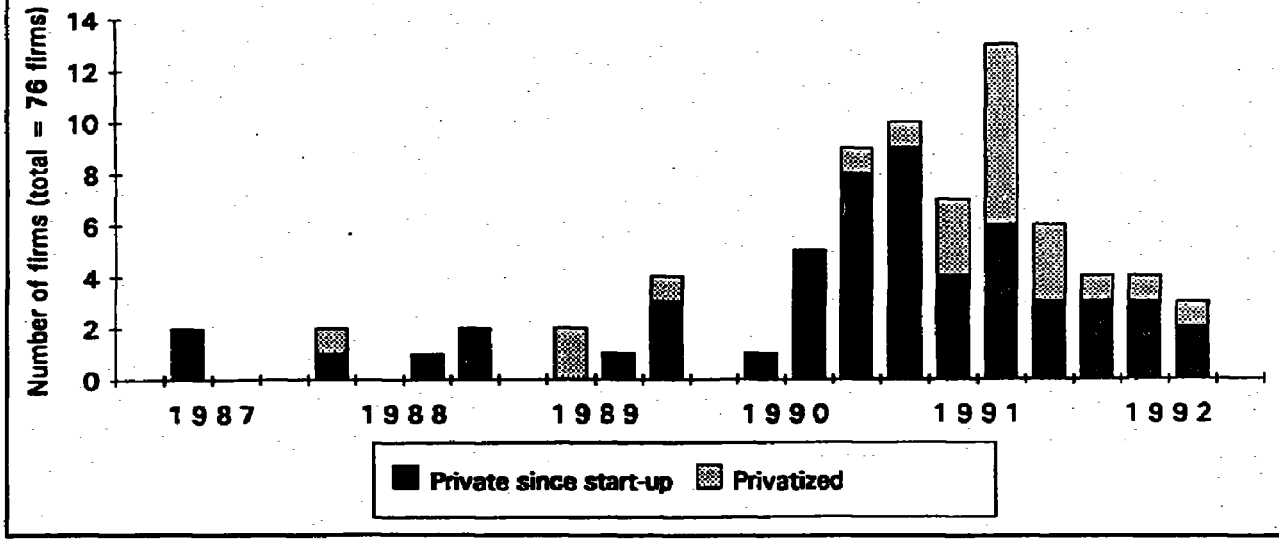


Table 2.4: Registered legal status by main activity

	Main activity						
Legal Status	Trade	Business services	Consumer services	Health and education	Transportation	Finance	Total
Limited liability	9	6	6	2	1	1	25
Joint stock closed	8	5	3	1	0	1	18
Private individual	8	3	0	2	0	0	13
Small enterprise	1	6	2	0	1	0	10
Leasehold	5	0	0	0	1	0	6
Cooperative	1	3	1	1	1	0	7
Other	0	4	1	1	0	1	7
Total	32	27	13	7	4	3	86

Note: Chi-square value: 0.02.

particular laws. Registration as a *joint venture* is no longer an option, and most joint ventures have converted to other legal forms. Only one enterprise was registered as an *open*, or public, *joint stock* company (table 2.4).

Ownership structure and interlocking shares

Ownership of the 82 firms for which there was a clear ownership structure was heavily concentrated in private hands—often in one individual. The degree of public ownership in the sample was generally small, as was the ownership of private companies and workers collectives. Interlocking shareholdings were fairly common, however. Only 5 percent of ownership shares were held by another private domestic company, but some firms had subsidiaries, and some had connections to other firms through shares held by their private individual owners (figure 2.2).

- *Owner and other private individuals.* Private individuals held an average 83 percent ownership share. The owners interviewed held slightly more than half these ownership shares. In many cases, the other private individuals were family members or founding members who left a state enterprise or institute with the owner to establish the new company. A quarter of the firms were completely owned by one person, and eight were majority owned by one person, giving control to one owner in more than a third of all enterprises. In another 30 percent, the owner had a controlling share of 26-50 percent.
- *Workers.* In eight enterprises, about one-third of all privatized firms in the survey, workers' collectives held majority ownership, ranging from 51 to 98 percent. Their average ownership share was 7 percent. These were not cooperatives; they were privatized enterprises that chose the workers' ownership option (partial or total). In all but one,

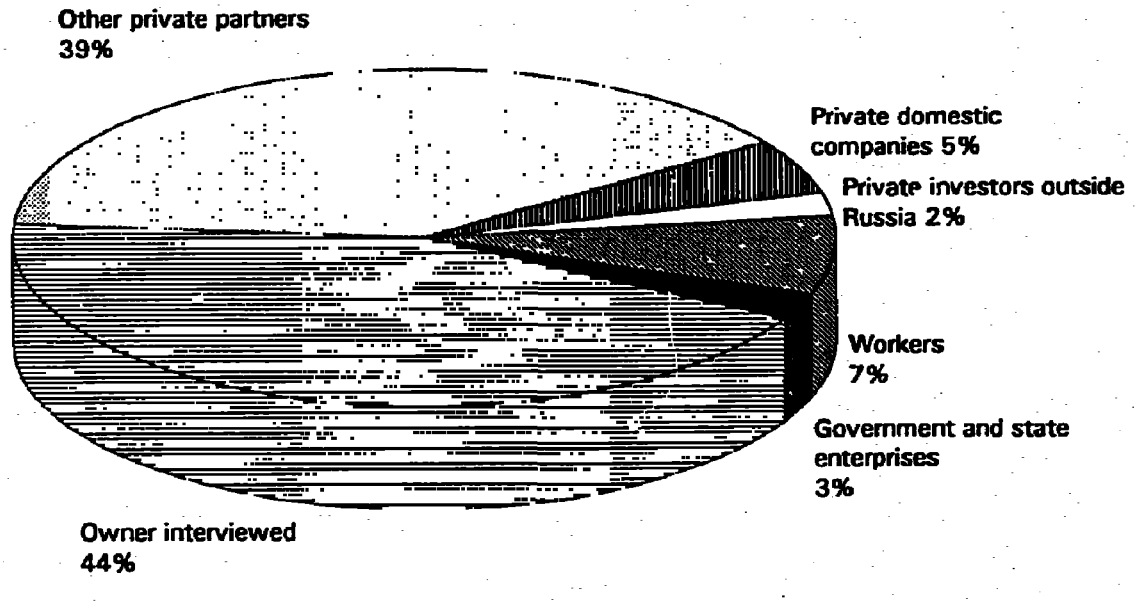
residual ownership belonged to the "owner", who in most cases had a higher personal share.

- *Private domestic companies.* In 11 firms, partial ownership was held by another private company; in three, the other company had a majority share. The average ownership share of private companies in the sample is 5 percent; but, within the group of companies with corporate ownership, the average is 39 percent.
- *Private foreign companies.* Three of the companies had external partners. In all cases the external partners were passive, interested mostly in the export of raw materials to their countries and almost not at all in investments in Russia. When a foreign partner is more active, it tends to insist on majority ownership, thereby excluding the firm from this study.
- *Public ownership.* Only 12 firms were partly owned by the Russian Federal government, state enterprises, or the city/oblast governments. For these 12 firms, the average public ownership share was 20 percent, while for the entire sample, the average public ownership share was 3 percent.[10] In some cases, the state ownership share was compensation for space made available to the enterprise, reflecting a stage in the privatization process rather than a long-term commitment.

Several firms indicated that they belong to a group of firms—as a parent, sister, or subsidiary—characterized by interlocking shares. Considering the relatively small size of most service firms and the recent introduction of company law in Russia, these interlocking shares suggest some degree of business sophistication. These relationships were often important to the firms' diversification strategy and a major vehicle for venture capital. For example, one food wholesaling company also ran a restaurant and a retail store, had undertaken research and development for vegetable oil production, and had started to trade in timber. And one transport company was linked to a specialized trading firm formally owned by the entrepreneur's sister and a real estate operation run by his brother.

Interlocking shares may also provide a way to avoid or evade taxation. For example, they give an entrepreneur the flexibility to shift operations into another district of the city where officials may be more lenient. And they may facilitate access to bank financing. Three firms were in the

Figure 2.2: Average ownership of firms surveyed, January 1993



process of creating their own banks, and another four firms had small ownership shares in existing banks. In two cases, banks owned partial shares in firms. Some interlocking shares were in "shell" companies whose sole use was to maintain an existing bank account, since it is difficult to open a new one.

Diversification and the special role of trade

A number of firms surveyed were undertaking a variety of activities, many of which were in flux.[11] Trade activities were common, and many firms were beginning to use profits from trade to help finance other activities.

The firms surveyed tended to be highly diversified, especially considering that they were mostly small and relatively new. About half drew 10 to 50 percent of their revenue from secondary activities, and those firms deriving all their current income from a single activity such as trade, had several diverse businesses; for example, both wholesale and retail trade, or trade in very different product lines. Moreover, aside from the activity mix observed at the time of the survey, it is estimated that well over two thirds of all firms had changed their activities during the previous year (box 2.2).

The most prevalent activity was trade. More than a third of the firms cited trade as their main activity, and another third indicated secondary activities in trade. Diversification into trade was also common, with a third of all firms having moved into trade or new areas of trade during the

Box 2.2 Motives for entrepreneurs to diversify

Diversification over time appears to have several motivations:

- *Profit-seeking*. The most common motive for diversification was profit-seeking. Most entrepreneurs understand imperfect competition and are looking for a *niche*, be it bear tracking for tourists in Karelia or constructing underground shopping malls. They are willing to move from one activity to another, gaining experience—through trial and error—with what works and what does not. Often the profit motive was fueled by a desire to accumulate sufficient capital to finance a research and development idea that originated when the entrepreneur was still working in the public sector. Thus, whereas some firms had diversified away from goods production, for example, other firms were diversifying back. Six companies were moving into manufacturing, and eight others were planning to move into either manufacturing or agriculture. Still others were moving into new service areas, such as hotel management and art exhibitions. Only one firm was planning to expand into research and development.

- *Risk reduction*. Another common motive was risk reduction. In order to achieve more balanced activities and hence reduce risk, one entrepreneur was moving out of trade into furniture manufacturing and livestock. He was also hoping to invest in a joint stock municipal utility which was selling shares.

- *Desperation*. Some entrepreneurs diversify out of need and sometimes out of fear and desperation, especially entrepreneurs in activities facing declining demand. Six firms were phasing out their research and development activities, and eight were giving up manufacturing. The demand for various consumer services (tourism, sport clubs, private medical services) was also down. A hairdresser in downtown St. Petersburg, whose clients could no longer afford a wash and set, was diversifying into facials, pedicures, and a snack bar to attract new business. Export traders, who suffered from the break-up of the Soviet Union and increasing export restrictions in 1992, were frantically searching for alternative activities, both in and out of trade.

previous year and a quarter planning to move into trade in the next six months. Only three firms had curtailed trade operations during the past year, and only two reported plans to leave trade in the future. Within trade, however, several entrepreneurs were moving away from trade in foodstuffs, where margins have narrowed and supplies, especially from the Ukraine, have been disrupted. But trade is no longer the only lucrative pursuit. Some entrepreneurs are moving into real estate, which together with financial services, looks like the next boom (box 2.3).

The importance of trade, which has a quick turnaround and may initially require relatively little capital, can be linked to the lack of institutional credit available to entrepreneurs. As one owner explained, trade is the major source of "primitive capitalist accumulation". In one case, a medical research group resorted to trade in sugar and was planning to start a fast-food chain. In another case, an entrepreneur who wanted to buy a small state manufacturing enterprise was operating a variety of trade companies, trying to accumulate funds for subsequent investment.

High profits in trade derive from three main sources. One is the abrupt price increase associated with the disrupted domestic distribution system in Russia. Under such circumstances, monopoly trade profits accrue to those who enter early and continue until the margins are bid down. A second source of high profits is the trade barrier imposed across regional boundaries. A third source is the continued sale of goods by state companies below market prices. In part, such sales are supported by benevolent officials who try to keep prices below clearing levels with subsidies (including import subsidies) and controls. They are also the product of corruption, sometimes referred to as a "redistribution of property rights." The interviewees supplied many examples. In reality, private trade—wholesale and retail—is still new to Russia and faces large expansion potential, even if trade margins are declining for some categories of goods.

Box 2.3 Real estate: the next boom

Only one company in this survey was engaged in real estate as its main revenue activity, and another had real estate as a secondary activity. Three companies had construction as a second activity. However, real estate, and also construction and renovation, is an increasingly popular commercial activity in St. Petersburg. Seven companies in the survey reported new or increased activities in real estate, construction, and renovation in the past year; and another seven stated plans to go into these areas. Other firms indicated less specific plans, often oriented to obtaining satisfactory work space for their activities. Such ventures are not easy. One entrepreneur saw his renovation costs increase by several multiples of general inflation and had to scale down his renovation schedule dramatically to fit his cash flow.

Many entrepreneurs understood the potential for huge profits from the privatization of land, housing, and commercial structures. As in trade, some profits will come from exploiting the low valuation of state property; other profits will come from trading in real estate. The real estate market is likely to be developed more rapidly than the stock market and will therefore attract people wanting to invest in real assets as an alternative to hard currency holdings, almost the only inflation hedge at present. The unique character of the historical center of St. Petersburg will be a focal point for rehabilitation and renovation and is already attracting considerable foreign interest.

Employment structure, skill adequacy, and training

Although the majority of employees in the firms surveyed worked full time, firms also employed part-time workers and workers on contract, particularly in small family firms and small transport firms. Most firms were providing some type of training to upgrade their employees' skills, and only trade and finance firms expressed substantial dissatisfaction with their employees' skill level.

Information was gathered on three categories of workers in the surveyed firms: owners and family members working full time, other full-time employees, and part time and contract workers. Complete information was available for only 60 firms, and the larger firms are disproportionately absent. Thus, the average number of full-time workers in tables 2.5 and 2.6, which show the structure of employment by main activity and firm size, is only 23, as compared to 55 in table 2.3. Data on part-time and contract workers are presented by number and also by full-time equivalent.[12]

The majority of the labor force in most firms consisted of a core of full-time workers—a sign of stability. About one-third of all full-time workers in this sample of 60 firms were owners and their families. This large share reflects the fact that many small firms were family businesses, and several large firms were cooperatives or privatized firms bought by worker collectives, where everyone working for the enterprise was a part owner. Owners and family members accounted for a particularly high share of workers in consumer and business services.

Table 2.5: Structure of labor force by main activity (average number of employees)

Main activity	Number of firms	Owners and family	Other full-time	Total full-time	Part-time and contract: Number of workers	Part-time and contract: Full-time equivalents	Total full-time plus part-time and contract equivalents
Trade	*21*	3	23	26	20	8	34
Business services	*22*	11	10	22	25	14	36
Consumer services	*9*	15	18	33	16	7	40
Health and education	*6*	2	9	11	6	2	13
Transportation	*2*	2	2	4	59	44	47
Finance	*0*	–	–	–	–	–	–
Total	*60*	8	16	23	21	11	34

Note: Only firms that provided detailed data on labor force are included. This accounts for the differences with table 2.3. Discrepancies in numbers are due to rounding.

More than half the full-time workers were classified as "professionals" having formal academic or technical training above high school. This share is much higher than for the entire Russian labor force, including the service sector.[13] As in other countries, business and financial services had the highest share of professionals, whereas trade and consumer services had the lowest. Women accounted for 47 percent of all full-time workers—a lower percentage than in the entire labor force of Russia and substantially lower than in any service activity in the state sector. This fact may reflect the factors discussed above that systematically discourage women from entering the private sector.

At least 70 percent of all firms employed part-time or contract workers. Almost half of these employed more than 10, and 15 percent employed more than 100. Part-time workers included people with other jobs, in many cases in the state sector, who were supplementing their incomes and testing private sector prospects. Part-time employees gave entrepreneurs flexibility in the level of activity and an opportunity to test new workers. Contract workers were also used to enhance flexibility and to avoid payroll and excess wage taxes.

Part-time and contract workers made up 32 percent of full-time equivalent workers for all firms. They were particularly important as taxi drivers in the small sample of transport firms, and in business services brokerage firms, which hired scientists and other specialists when contract work was available. In small firms with less than eight regular full-time workers, part-time workers made up three-quarters of the labor input; they represented about 40 percent in medium small firms of 8 to 39 employees.

Table 2.6: Structure of labor force by firm size (average number of employees)

Number of full-time workers	Number of firms	Owners and family	Other full-time	Total full-time	Part-time and contract: Number of workers	Part-time and contract: Full-time equivalents	Total full-time plus part-time and contract equivalents
Fewer than 8	*22*	2	2	4	19	13	17
8 to 39	*30*	3	14	17	25	11	28
40 to 99	*4*	2	53	56	10	6	61
100 or more	*4*	78	64	142	16	6	149
Total	*60*	8	16	23	21	11	34

Note: Only firms that provided detailed data on labor force are included. This accounts for the differences with table 2.3. Discrepancies in numbers are due to rounding.

Space and capital equipment

Firms occupied on average about 700 square meters of workspace; median space was about 200 square meters. Almost half the firms found the size of their space sufficient for their needs. About 40 percent complained that their space was too small, and a few others said that it was badly located. Because ownership of commercial real estate (including land) has just become legal in principle and only a few deals have been made, fewer than 10 percent of firms actually owned their space; the other firms rented space.

Most workspace in St. Petersburg is rented from a state enterprise, a public institute, or a government agency. More than half the firms held long term leases, most directly with government agencies or through the Municipal Property Agency (MKI). Long-term leases are typically for 15 years with option to buy but are renewable every year. Uncertainty about renewal left most entrepreneurs unwilling to invest in the improvement of their workspace. Some firms had short-term leases of a year or less and were afraid of being asked to leave, a fear that had materialized for a few. Most short-term leases were from public institutes such as schools but also from the city and other private companies. In some cases, space was obtained from the owner's previous enterprise and in other cases through personal connections. One property owner occupied his own privatized apartment but was not sure whether or not he should be using it for business purposes.

With the exception of transport, equipment needs of most firms were modest. Forty percent of the companies required only office equipment for internal use and to provide such services as photocopying and communications. Activity-specific equipment for trade and restaurants, repair, research and development, and design was rarely of high value. In a third of the firms the equipment was all new, and in half it was new or mostly new.

Fewer than a third of firms had imported equipment. Office equipment had a higher import share, was typically bought from a private trade firm, and was owned rather than leased. Specialized equipment was to a large extent used, domestically produced, and leased or bought from state enterprises. In one case the equipment was reported to be stolen from a state enterprise.

More than three-quarters of firms owned all their equipment, and the fewer than 15 percent that borrowed or leased most of their equipment did so from the owner's previous enterprise. Only

Figure 2.3: Financing patterns in private firms

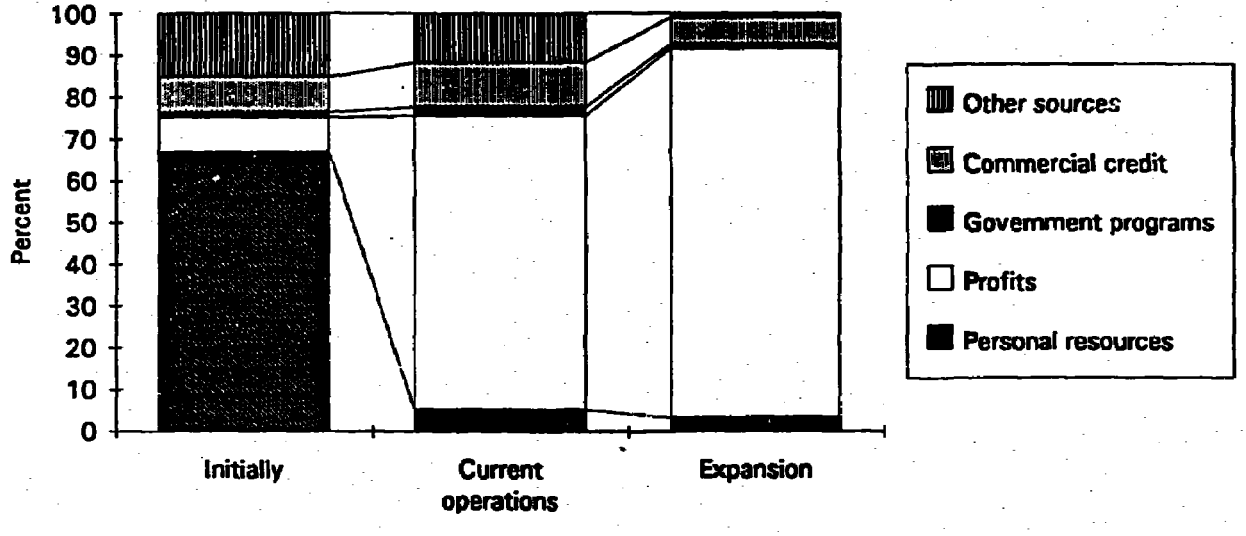


Table 2.7: Financing of firms by revenue size (percent)

Source of funds	Monthly revenue (R 1,000) Less than 100	100 to 999	1,000 to 9,999	10,000 to 99,999	100,000 or more	Total for all firms
Initially / when established or privatized						
Personal resources	100	77	62	60	13	65
Commercial credit	0	8	6	12	25	9
Profits from business	0	7	15	0	25	9
Other sources	0	9	17	28	38	18
Number of Firms	*2*	*23*	*26*	*17*	*4*	*72*
Current operations						
Personal resources	53	0	8	3	0	5
Commercial credit	0	13	6	8	13	8
Profits from business	48	75	67	73	88	71
Other sources	0	12	20	16	0	15
Number of Firms	*2*	*21*	*29*	*15*	*5*	*72*
Expansion						
Personal resources	0	6	4	0	0	3
Commercial credit	0	8	1	15	0	6
Profits from business	100	81	96	85	100	88
Other sources	0	6	0	0	0	2
Number of Firms	*2*	*20*	*21*	*12*	*3*	*58*

one firm worked with equipment rented from clients. Two firms had no equipment, one because it contracted out its work.[14]

Financing

Financing patterns for firms in St. Petersburg were typical of financing patterns for small private companies elsewhere in the world. Most financing at the time of establishment came from the owners' own resources, and most financing for subsequent operation and investment came from internal profits. A minority of firms obtained credit and on very short terms; firms that did receive bank credit were those with higher revenues. Firms complained of high interest rates, although nominal interest rates appeared highly negative in real terms. A variety of factors contributed to higher real rates in practice as well as some entrepreneurs' reluctance to borrow.

Firm financing at the time of establishment, for day to day operations and for new investments was provided mainly by the original owners and from the firms' profits (figure 2.3). On average, firms were established with 62 percent of financing from the owner, 5 percent from family and friends, and 8 percent from early profits—a total of three-quarters of all resources. Working capital

Table 2.8: Characteristics of firms by owner's past job (percent)

		Ownership history	Activity					Foreign aid	Size
Owner's past job	Number of firms	Privatized	Trade	Finance and business services	Consumer services	Health and education	Transportation	Received	Average number of full-time workers
General or technical manager	*36-41*	51	51	22	20	2	5	14	59
Academic or technical specialist	*31-34*	12	21	49	12	15	0	29	62
White or blue collar worker	*10-11*	27	36	27	9	9	18	0	20
TOTAL	*77-86*	33	37	35	15	8	5	18	55

Note: Chi-square values: origin = 0.01, activity = 0.02, foreign aid = 0.52. Using regression analysis, no statistically significant relations were found between owner's past job and size.

and subsequent investments were financed from internal profits by 70 and 88 percent respectively, with new owners' and family money contributing 3 to 5 percent.[15] Share capital from companies and banks provided 8, 1, and 0 percent respectively during the three stages, leaving 15, 20, and 7 percent to credits, nearly half of which came from customers' advances.[16] Thus, bank credits contributed only from 7 to 11 percent to financing at each stage, and government programs contributed only 1 to 2 percent.

In general, firms with higher revenues and higher employment had better access to credits, especially at the time of establishment. Firms with lower revenues received little credit at any stage, but other patterns are also evident (table 2.7). Firms registered as small enterprises, private individuals and cooperatives received little credit at the time of establishment and depended more on owners' capital. Leaseholds were established with more reliance on credit and profits and less on owners' capital than all other forms, and they continued to receive more credits for later investments. Trade firms had more access to bank credits for start-up and generated early profits for reinvestment.

At the time of the survey, 22 percent of the firms had outstanding loans from financial institutions. Several had loans from friends and one from another enterprise. Since the survey includes some large private firms, and since such firms are more likely to receive credit, the percent of small business receiving institutional credit is clearly below the norm in industrial countries, where between a quarter and a half of small and medium-size enterprises obtain credit.

Box 2.4 Service firm entrepreneurs—on the frontier

Service firm entrepreneurs are the real pioneers in the transition economies—and St. Petersburg is no exception. They have to be, because most services were systematically suppressed in socialist economies. The groundbreaking role of service firms is clear compared to private manufacturing firms interviewed in a similar survey (Webster and Charap 1993):

- *More diverse entrepreneurs.* Entrepreneurs in service firms were more diverse than those in manufacturing. Many brought experience from public administration and academic institutions rather than from state enterprises and a higher share were women—13 percent, compared to only 1 percent in manufacturing. Their age range was greater, although their average age and educational level were quite similar.

- *Younger, more independent firms.* Service firms were somewhat younger and less dependent on state enterprises than manufacturing firms, and only half as many were still legally connected to state enterprises. Service firms owned a larger share of their equipment, a greater percentage of which was new and imported. They obtained only half their equipment, largely office equipment, from state enterprises, whereas manufacturing firms obtained virtually all their equipment from state enterprises.

- *More competition.* Output markets were more competitive for service firms than manufacturing firms. Five out of every six service firms reported having serious competitors, twice as many as manufacturing firms, and fewer service firms were dependent on one large customer. Two-thirds of service firms reported an increase in the number of competitors during the previous year compared to only one-third of manufacturing firms, even though services sold a larger share of business locally.

- *New markets.* A quarter of all service firms experienced an increase in demand because they entered new markets, compared to only 5 percent of manufacturing firms. Although export revenues were low, as many service firms as manufacturing firms were engaged in export. Partly as a result of diversification and entry into new markets, the performance of service firms was somewhat better, and they appeared to be more oriented toward future expansion. Service firms complained most about the uncertain macroeconomic and legal environment and the lack of financing—both perceived as impediments to expansion. Manufacturing firms complained most frequently about taxes.

Loan terms were unusual by international standards, although not surprising given Russia's high inflation. There was not one medium- or long-term loan, although several owners said their short-term credit lines could be rolled over. Two outstanding loans were for 12 months; the rest for five months or less. Nominal interest rates appeared to be extremely negative in real terms, ranging between 14 and 240 percent annually; the median rate was about 120 percent annually, during a period when inflation was about 2,000 percent. In reality, real rates were much higher due to discounting up-front, extra fees, and bribes.

In sum, most firms either relied on reinvestment of their own profits or found a silent partner to provide office space or financing for in-kind return or a share of profits. For this and other reasons such as low demand, about a quarter of the firms declared that they were not actively seeking a loan. A number of firms were looking for a "serious" foreign partner to provide hard currency financing, take a long term interest in the company, and help identify export markets. The fact that entrepreneurs were ready, indeed anxious to finance investments and trade deals through equity rather than bank credit highlights both the very high risk and difficulty of obtaining bank credit. Several firms were making equity investments in banks to assure adequate supplies of credit in the future.

Patterns of business characteristics

Despite the diversity of business characteristics illustrated above, some clear patterns emerged. Firms owned by former managers were more likely to be privatized and to engage in trade (table 2.8). Firms owned by academics or technical specialists were more likely to be new start-ups, to be smaller, to engage in business services, and to receive foreign aid in some form. Firms owned by white or blue collar workers were more likely to be small, and they received no foreign assistance. Overarching these distinctions, however, was a general sense that service firm entrepreneurs are on the frontier. They tend to be more diverse, more independent, facing more competition, and more expansive than private manufacturing firms (box 2.4).

Notes

1. The U.N. ISIC coding system was used to classify activities (see United Nations 1990: 53-70). Exceptions are that tourist services, repair services, publishing services, and custom tailoring are excluded from transportation, trade, and manufacturing respectively and included under consumer services, as is the practice in many countries.

2. Interviewees are referred to as "entrepreneurs" or "owners". However, seven interviewees were managers, not owners; in these cases, they were asked for biographical information on the most important owner.

3. In 1989, women accounted for 75 to 90 percent of the labor force in service industries in the Soviet Union. Their shares in managerial positions were: public administration, 49 percent; social institutions, 40 percent; and production sectors, 26 percent. (Goskomstat of the USSR, *The National Economy of the USSR*, 1988: 40. *Women in the USSR*, 1991: 16-19).

4. The educational level of managers in services in the USSR was likely to be less than the average, given the ideological bias against services. However, the only data located is for communications, where the proportion of those with higher education was 59 percent (see Center of Information and Publishing of the Russian Federation, 1991: 115).

5. Data on the background of entrepreneurs nationwide are unavailable, but a comparison of this survey's service firm owners with data on owners of manufacturing firms in the St. Petersburg area (Webster and Charap 1993) indicates that more service firm owners came from government or academic institutions and more had a background as technical, rather than general, managers.

6. The chi-square statistics in table 2.2 indicate that ownership is the only characteristic shown with high probability of random distribution among the three categories of entrepreneurs.

7. Rubles are converted to U.S. dollars using an estimated purchasing power parity exchange rate of 100 rubles/$1. This compares to the nominal exchange rate of 400 rubles/$1 in the fourth quarter of 1992 on the Moscow International Currency Exchange Market.

8. Only registered firms are included in the survey; self-employed craftsmen and service providers may operate with a license without registering.

9. All but one of the firms registered as leasehold had an option to buy.

10. Although one criterion for inclusion in the survey was that a firm have less than 50 percent state ownership, one firm had exactly 50 percent state ownership, divided between two state enterprises. It was included since one of these state enterprises was being privatized within a few weeks. Without this firm, the state average share is only 15 percent.

11. Firms declare many activities at the time of registration in order to avoid the need to re-register, but they may undertake only a few. For this reason, entrepreneurs were questioned directly about the revenue shares of their firm's current mix of activities, past experience with diversification, and future plans for expansion.

12. The full-time equivalent for part-time and contract workers was calculated on the basis of weekly hours as reported or, for those who reported the number of part time workers but did not provide information on hours, the median of 17 hours per week for all those reporting.

13. Less than a third of the Russian (non-collective farm) labor force have "higher or technical" education (Goskomstat of the USSR, 1991a: 111–14).

14. This is significantly different from the private manufacturing sector where farming out or leasing the equipment of others was more common (Webster and Charap 1993).

15. For most firms, the main use of profits is reinvestment. Other uses are paying bonuses and higher wages to workers, investing in inventories, and investment in hard currency financial assets.

16. Customer advances are particularly important for working capital in business services and health and education services.

3

Wages, prices, and markets

Wages, prices, and the markets in which firms operate are intimately linked. In a market economy, wages vary to reflect the supply and demand for labor, and prices fluctuate to facilitate market clearing of goods and services. Wage and price flexibility is both a prerequisite and a characteristic of a market economy. But despite wage and price flexibility, markets are still poorly developed in St. Petersburg as well as in other parts of Russia.

Wages and prices

The survey shows that wages and prices are flexible and that pricing rules used by entrepreneurs were heavily influenced by market considerations. The average wage in survey firms was similar to the average public sector wage, but it varied substantially across activities, with the average wage in trade much higher than elsewhere. Real wages appear to have declined somewhat during the six months before the survey, lowering living standards of employees but helping firms to remain profitable.

Wages are moderate but variable

Although average wages in the private sector were not dramatically higher than in the public sector, there was high variability among firms as well as across activities. Non-wage benefits in the private sector appeared to be relatively modest.

Average monthly wages in December 1992 were reported to be R16,400 for professionals, R14,700 for non-professionals, and R15,500 overall (table 3.1).[1] These averages were about 25 percent higher than the national average wage of R13,000 in December 1992, and much higher than the minimum wage of R900.[2] The high proportion of professional employees in the firms surveyed suggests that they might have a high average wage, but the low wage level typically found in services would suggest that they might have a low average wage.[3] On balance, wages in the firms surveyed did not appear to be particularly high, considering the substantial non-wage benefits received by state workers.

The average wage masked wide salary differentials among activities and among individuals. Among activities, trade salaries were two-thirds higher. Among individuals, monthly salaries ranged from as low as R900 (the minimum wage) to as high as R150,000, more than twelve times the average. Such high wages were unlikely to be reported to tax authorities, since wages in excess of four times the minimum wage are included in profits for tax purposes. In any case, the reported range in wages was much wider than under the old regime and probably wider than in the state sector. Interestingly, the reported gap between the average wages of professionals and non-professionals seemed rather narrow—not surprising given the traditional underpayment of professionals in Russia compared to blue collar workers.

Table 3.1: Average monthly wage by main activity

		Average wage in rubles		
Main activity	Number of firms	Professionals	Other employees	Overall
Trade	22	26,134	17,801	20,766
Business services	22	11,070	13,464	11,580
Consumer services	11	14,473	12,386	12,738
Health and education	7	23,015	5,074	13,532
Transportation	1	0	15,000	15,000
Finance	0	–	–	–
Total	63	16,401	14,695	15,474

The median cost of fringe benefits provided by the firms surveyed amounted to an estimated 20 percent of basic salary.[4] This level is relatively modest by international standards and is probably lower than in the public sector, where substantial wages in kind are rationalized as protecting workers against inflation and accommodating firms suffering from cash shortage. Owners reported giving their workers a variety of goods and services, including: paid vacation (typically one month), meals, take-home food and clothing, transportation allowances, loans, presents of various kinds, and personal use of the firm's equipment. Only a few reported provision or financial coverage of healthcare, pensions, and miscellaneous social benefits in addition to those covered by the payroll tax.

Despite the relatively modest fringe benefits, total labor costs for firms were relatively high because of the high payroll tax of about 50 percent, covering personal income tax withholding (typically 11 percent) and the broad social security tax (39 percent) for pensions, healthcare, and unemployment insurance. In all, a firm's labor costs amounted to about 1.7 times the take-home wage, not including the excess wage tax (see Section 4 on Taxation).

Trends in real wages

Survey data provide conflicting information on trends in real wages during the preceding six months. Two sets of observations on changes in nominal wages in survey firms were made, one for 59 firms and the other for 42 firms (table 3.2). The smaller group also provided data on changes in product prices. The differences in wage data between the two sets of observations are significant, due to very large nominal wage increases in two health and education firms and several trade firms in the larger set. On balance private sector wage trends appear to be similar to those in the public sector, as an average of real–wage indices from the two data sets is similar to the 9 percent decline in public sector real wages reported by Goskomstat for the same period.

Of course, changes in real wages are perceived differently by different economic agents. From the point of view of employees, their living standard will change with a change in their real consumer wage, where the consumer-price index (CPI) is used as the deflator. For example, it may be difficult to attract workers from the public sector to consumer services, where the real consumer wage clearly declined in late 1992.

Table 3.2: Changes in nominal and real wages by activity, June - December 1992: Comparison of St. Petersburg survey data and Russia as a whole (June 1992 = 100)

	Firms with wage data			Firms with both wage and price data					All Russia	
Main activity	Number of firms	Index of nominal wages	Index of CPI - deflated wages	Number of firms	Index of nominal wages	Index of CPI - deflated wages	Index of price of firms' main activity	Index of firms' real producer wages	Index of nominal wages	Index of CPI - deflated wages
Trade	*21*	285	109	*12*	208	81	242	88	266	102
Business services	*21*	225	88	*18*	212	83	332	81	235 [a]	90
Consumer services	*10*	197	77	*7*	207	83	337	74	241 [b]	92
Health and education	*5*	803	305	*3*	223	85	718	49	200 [c]	77
Transportation	*2*	371	144	*2*	371	144	386	91	224	86
Total	*59*	266	103	*42*	211	83	310	81	238	91

Note: Survey data exclude one financial firm that increased wages by 1,200 percent. Survey averages are weighted by firm employment. Consumer Price Index (CPI) for Russia at end December 1992 was 261.

[a] Wages in science.

[b] Wages in housing and communal services.

[c] Average wage for education and health.

From the point of view of entrepreneurs, their profitability depends in part on their ability to raise output prices faster than wages. Thus, profitability will increase with a decline in the real producer wage, an index of nominal wages paid divided by an index of the firm's output price. According to the group of 42 firms where wage and output price data were available, the real producer wage declined almost everywhere, and it declined most in health and education, where output prices rose rapidly. The real producer wage of the median firm declined by a third, and it rose in only a quarter of the firms. If this is an overall pattern, private entrepreneurs have been able to benefit from inflation—enhancing profitability by raising their output prices faster than the general price level.

Such conclusions need to be interpreted with caution, however. First, they are based on a small number of firms. Second, high inflation creates a problem of measurement because of unsynchronized price and wage adjustments. Third, entrepreneurs complained extensively about inflation, suggesting that the costs of risk and uncertainty

arising from inflation outweigh the benefits of a lower real producer wage.

Furthermore, the data on wage and price changes for individual firms show wide variation. Output price increases ranged from 0 to 6,000 percent, and wage increases ranged from 0 to 1,200 percent. Changes in the real producer wage for individual firms ranged from 20 to 400 percent. Such wide ranges highlight the uncertainties facing firms with respect to changes in their income and profits over very short periods of time. They also help to explain the reluctance of some entrepreneurs to take commercial bank credits at what appear to be negative real interest rates.

Output prices reflect market demand

Output prices in the private sector reflected the fact that prices of most goods and services in Russia have been set free. At the time of the survey the state order system still existed for some products, but the associated price controls affected firms' inputs, not outputs. Most owners changed their output prices frequently and took market demand into account.

Sixty percent of the owners said they based their pricing policies on considerations of demand and competition, while one-third emphasized costs and profits. When asked how they determined trade markups, traders in particular emphasized demand: "I charge a little less than the competition in order to increase my income" or "The lower the markup, the larger the volume and the profits." Some said they charged "a little bit less" than big companies, and others said they charged 2 to 3 times the "official" prices published by the mayor's office. In any case, most owners seemed to understand the principles of market pricing.

Almost half the owners said they changed their prices every week, and another quarter changed them once a month. The remaining quarter changed their prices once every few months. Two or three firms kept their prices constant for longer periods, but in hard currency. Half the firms offered printed price lists for their products, and slightly more than half said they were charging uniform prices to all customers. Those who were charging different prices to different customers explained this practice by differences in product quality, size of orders, and the customers' ability to pay. The ability-to-pay argument was motivated in most cases by profit and in some cases by social conscience.

The only price controls mentioned by any of the owners was a 25 percent trade markup limit, which by January 1993 applied to only a few consumer goods such as bread, milk, meat, and alcohol. Some said they respected the markup limit; most said they ignored it. Actual trade markups mentioned ranged from 5 to 50 percent, with most ranging from 20 to 30 percent, close to the 25 percent legal limit. Anecdotes collected during the survey suggested that markups on special deals can be much higher, however, reaching several hundred percent.

Markets

Markets for labor, capital equipment, intermediate inputs, and outputs were all functioning, but not efficiently. The labor market operated largely on an informal basis, as did segments of the other markets (box 3.1). A small share of firms advertised their services or job vacancies, but most firms relied on existing supplier or customer relationships or on personal connections. Some owners experienced difficulty in labor recruitment, especially for professionals. Firing employees is relatively easy; two-thirds of the owners had fired someone in the previous year.

Suppliers and customers are increasing in markets for capital equipment, intermediate inputs, and outputs, yet problems persist. Most enterprises could obtain whatever capital equipment they wanted as long as they were willing to pay the price, but finding spare parts—especially for old domestic equipment—was a big problem. Many firms experienced difficulties in obtaining intermediate inputs—both goods and services—in part because the input markets were still dominated by state enterprises, although the number of suppliers was said to be increasing. Output markets also experienced some increase in competition over the past year. They were more diverse, with private companies and households each accounting for a third of all customers.

Box 3.1 Transactions rely on personal connections

In "The F-Connection: Families, Friends and Firms and the Organization of Exchange," Yoram Ben-Porath analyses the conditions for the distribution of transactions among family, friends, other personal contacts, and firms. (*Population and Development Review*, 6 (1): 1-30) The more simple, uniform, predictable, and common the transaction is, the more likely it will be carried out in an impersonal market with minimum transaction costs. The more subtle, unique, complex, :nultifaced, variable-over-time, and long-term the transaction is, the more likely it is to take place through personal connections.

Transactions by enterprises in St. Petersburg are primarily the latter. The private service sector is still very heavily dependent on family, friends, and personal business contacts; reliance on other firms for transactions is progressing slowly. The invisible hand of the market and the impartial hand of the law play very limited roles. A well established legal infrastructure and more experience with markets are required to move transactions away from costly and less efficient personal connections to the impersonality of the market.

Fully 70 percent of firms recruited new employees through personal contacts, and another 10 percent through people showing up at the door. Business service firms recruited almost entirely through personal contacts. Only 7 percent of firms—largely in trading—recruited through a government or private employment exchange, and only 6 percent used advertising. A few other firms recruited directly at a school or academy or through a business contact.

Although a third of all firms said they found their customers mainly through advertising, twice as many found them through personal contacts, business contacts, people "off the street," or word of mouth.

Personal connections are common among small businesses in developed market economies. Small firms everywhere use personal information and contacts to hire, buy, sell, get credit, and clear their tax forms. Informal networks among small firms are considered necessary to help offset the market power of large firms and their ability to execute many transactions inside the firm. In St. Petersburg and throughout Russia, however reliance on personally determined exchanges and the personal factor within each transaction are much more important.

The labor market

More than half the entrepreneurs reported having problems recruiting professionals, while only 30 percent reported problems recruiting other employees. Trading firms experienced the most difficulty recruiting professional and non-professional employees, possibly because of the lack of experience in trading under central planning and the poor image of trade as an "unproductive" activity. Non-trading firms experienced little difficulty recruiting other employees, although one entrepreneur commented that the average citizen is less interested in working for a private firm since late 1992 when wages increased in public enterprises. The need for an improved employment exchange and skills certification was mentioned by several entrepreneurs.

Entrepreneurs said they had difficulty locating professional managers "in the American sense" and people with knowledge and practical experience in specialized areas such as tourism, for-

warding, finance, insurance, accountancy, and foreign languages. In recruiting non-professional employees, a shortage of bookkeepers and construction workers was mentioned. More general complaints about dishonesty and the absence of work ethic were mentioned for both professionals and other employees, as was the difficulty of offering a competitive wage.

A majority of owners said their workers were sufficiently skilled, but 40 percent said they were not. Dissatisfaction about workers' skill levels was concentrated in trade and finance. All three firms in finance and 60 percent of the firms in trade said that workers were not sufficiently skilled for their jobs. A common complaint was the lack of market related skills and skills in such new areas as management, marketing, accounting, tourism, and law. Seventy percent of all firms provided some training to their work force or financed outside training. More than half of all firms provided training in accounting; other popular training was in market-related skills, training in new technologies including computers, and foreign languages.

Entrepreneurs say the most serious problem with employees is their character and attitude. Many satisfied employers emphasized the importance of being able to choose the best available job candidates. One hospital head said he retained only one nurse in ten. A perhaps symbolic story, told by one entrepreneur, concerned the manager of a private hotel who refused to employ someone who had previously worked in a state-run hotel, on the grounds that the person would have already acquired bad habits.

Weak work ethics, including dishonesty, poor work effort, and lack of responsibility were often cited as causes for firing workers, which was relatively easy (box 3.2). Sixty-five percent of the owners had fired someone during the previous year. Trading firms were the most likely to fire an employee, and this may explain in part why recruitment was more difficult for these firms. One firm engaged in trade and commerce had fired 100 employees in the previous year. The median number of dismissals for all firms that fired someone was 4 employees, where the median staff level was 13 full-time employees. In about half the firms at least one employee left voluntarily. Close to 200 employees left one firm more or less voluntarily, where the equipment was no longer usable because of age and neglect. Fewer people left voluntarily in trade, where salaries were high. It is not clear how voluntary departures should be interpreted, since, as several owners pointed out, it is always possible to make life difficult for an employee so that he will leave voluntarily.

Relations between employer and employee are governed by an employment contract, which covers the terms of employment including firing. Terms of employment are, in turn, regulated by the Law on Employment and the Law on Enterprises and Entrepreneurship Activity, which include provision of a guaranteed minimum wage and social security.

About two-thirds of entrepreneurs said that their employees were not represented by a union or workers' council. A third said they were, and two said they didn't know. In firms without a union, most entrepreneurs simply said "we don't need it" or "it doesn't make sense". Employees in a few firms had formed their own internal collective, council, or association without any outside affiliation.

The market for capital equipment

Capital equipment currently available in Russia includes imports as well as new and used domestic equipment, although recent changes in the tax regime has made imported capital equipment less competitive. The biggest problem associated with capital equipment, experienced by 43 percent of firms, concerned availability of spare parts. Several interviewees commented that state firms did not like dealing with small firms and that bribes were necessary to get parts. By contrast, only a quarter of the firms reported problems with repair and maintenance services, in part because some firms have learned to handle this in-house. Problems with repair services included low quality, unfamiliarity of repair persons with imported equipment, and cost.

Box 3.2 Job protection in the private sector

About half the owners said their employees have no protection against losing their jobs. More than a third said employees are protected by job security laws and the rest said they are protected by other measures. The difference in response seems to reflect the fact that the Russian Federation Law on Employment, dated April 1991, is more theoretical than real. According to this law, the employer-employee relation should be covered by a labor contract that includes a provision for firing with reason.

Even without such a contract, however, owners are able to fire an employee with reason. A reason is not hard to find, but an employer must give the employee a warning. Typically, the employer might encourage the employee to leave voluntarily by offering reduced working time or a low salary for long hours. Where there are structural changes within a firm, it may be possible to place skilled workers elsewhere. Where employees are working on a term contract, the employer can simply refuse to renew. Ultimately if the employee refuses to leave, the employer can file a petition to fire and go to court. Only one owner complained that the current labor law is too restrictive, and one said the required four month separation pay is too costly.

Although lack of job security is clearly a strain on employees, the many complaints by owners about the lack of honesty and work ethic—punctuality, effort, sobriety—suggest that during this transition period, it is important to emphasize the rewards of good employee behavior and the consequences of bad. Firing is an extreme, but probably necessary, way of responding to poor performance. Other than the labor law, measures that help protect employees from being dismissed include protection provided by the labor contract, employee participation as shareholders or members of a cooperative, and restrictions on firing associated with the lease of property from a state enterprise.

A more intractable problem for some entrepreneurs was the difficulty of getting rid of a dishonest or unreliable co-owner and finding an honest partner to share management and financial responsibilities.

Most enterprises could obtain whatever capital equipment they wanted, as long as they were willing to pay the price. Most firms did not experience problems in acquiring the domestic equipment they wanted. For those that did, the main problems were lack of money to purchase equipment and high prices. Other complaints included poor quality and inadequate supply. In fact, quality of domestic equipment is a problem. Trucks, for example, do not meet international safety and environmental standards. Some firms experienced problems acquiring imported equipment, including equipment from former soviet states. The most significant problems were cost, lack of money, and availability. A few firms had problems obtaining foreign exchange.

A majority of firms reported many suppliers for their main equipment, a substantial minority reported a limited choice, and a few dealt with a monopoly seller. As one would expect, those who paid bribes were mainly dealing in restricted markets. Only 10 percent of firms dealing with many sellers paid bribes, whereas one-third of firms dealing with monopolies or a limited number of sellers paid bribes.

Markets for inputs

The principle inputs to service firms vary enormously. For firms engaged in wholesale or retail trade, they included a variety of traded goods, especially food, clothes, construction materials, and computers. For other firms, they included such goods as paper, spare parts, metal, oil products, fabric, hair products, textbooks, art work, and medical supplies. Forty percent of the firms experienced problems in obtaining these inputs.

In addition to goods, inputs included a variety of externally provided services including banking, which most firms used. Half the firms purchased transportation and legal services from outside suppliers, and between a third and a half purchased advertising, training, and security services. Less than twenty percent purchased accounting, consulting, insurance, real estate, and information processing services outside the firm. Building renovation, cleaning, and parking were other services sometimes purchased from the outside. Nearly 30 percent of the owners provided services directly in support of economic reform—particularly financial and legal consulting—to both public and private companies.

Some entrepreneurs found the following services difficult to obtain: insurance; advertising; building renovation; repair; real estate services such as dealing with industrial space, foreigners, or housing; training in such activities as banking and personal services; and information services such as locating new technology, information about domestic laws and regulations, and directories of domestic and foreign businesses in a given field. Other entrepreneurs complained about the quality and cost of existing legal and bookkeeping services or transportation.

Owners were asked to estimate the share of their intermediate inputs purchased from various sources. The most important sources were:

- State enterprises—58 percent
- Private companies—25 percent
- Individuals—10 percent
- Imports—7 percent

Firms were almost equally divided between those that dealt with many suppliers and those that dealt with a limited number; only rarely did a firm face a single-source supplier. Almost half the firms believed there was some price competition among their suppliers. Another third thought there was a lot of price competition, and the rest said there was none. About three-quarters of the owners thought the number of suppliers had increased over the last year—in part because of imports, availability of previously hoarded goods, and a new willingness by factories to sell to anyone willing to pay. Only a third thought the variety and quality of the inputs supplied had improved; and a few firms indicated that the quality or the variety of inputs had decreased—notably in foodstuffs, because of disruptions in supplies from Ukraine, and in spare parts, because of the reluctance of state enterprises to supply the private sector.[5]

Markets for outputs

Although state enterprises were clearly the most important source of inputs, the structure of customers for outputs was more diverse. Individuals and private companies each accounted for about a third of the firms' customers. State owned enterprises accounted for another quarter. Government administration accounted for 6 percent, and exports for 2 percent. Individuals were the single most important client group for consumer services and trade. Domestic-owned private companies were the single most important client group for business services. Business services and trade also earned more than a quarter of their revenues from state enterprises.

Fifty-seven percent of firms received less than a quarter of their revenues from a single customer. About 30 percent received only a quarter to a half of their revenues from one customer. The remaining firms received more than half their revenues from a single customer, typically a state enterprise. Business services firms tended to be dependent on a single large customer, with only 30 percent not having at least one customer providing a quarter of their revenues.

Only 30 firms answered the question on changes in sales shares. More than 80 percent of the firms selling to state enterprises experienced a decline in the share of sales to these companies, and about the same number experienced an increase in their share of sales to private firms. One explanation for the decline in the sales share of state enterprises was that they do not pay their bills. As many firms increased their sales to individuals as decreased them.

Most firms sold their services mainly locally and in surrounding towns. Another third sold mainly nationally, while only 5 percent mainly exported—half to central Europe and the former soviet states and half to other countries. Although only 2 percent of output is exported, a quarter of all firms, or 22 firms in all, are engaged in some form of export. One explanation for the low export share is that several trading firms engaged in export of raw materials (oil, timber, and metals) did not want to talk about these operations. Half of exporting firms are engaged primarily in trade, another 20 percent are in trade as a secondary activity, and the remainder provide services in tourism, transportation, design, and information services.

About three-quarters of the exporting firms are exporting to the former soviet states, and one quarter to the rest of the world. No details were provided by firms exporting raw materials, but most of the others were not aggressive at marketing. One entrepreneur had a permanent arrangement with a firm that represented him in the Ukraine. Not surprisingly, constraints to exporting were said to include delays in payments, government bureaucracy, and marketing. Exporting is discouraged through a variety of measures that penalize hard currency use—including mandatory foreign exchange surrender requirements, delays and low rates in foreign exchange conversion by the government, high fees by banks on foreign exchange transactions, and visibility with mafia groups. Nevertheless, 86 percent of exporting firms experienced an increase in exports over the previous year.

Trade across new state borders was considered very difficult by many entrepreneurs, especially because of difficulties with financial transactions. A number of firms stopped trade with other former republics because of difficulties in getting paid. Two transportation firms had trucks and railway cars moving across state borders at the

Table 3.3: Market orientation by owner's past job (average percentage shares)

		Customers						Source of inputs		
Owner's past job	Number of firms	Public admin.	State enterpr.	Private comp.	House-holds	Exports	Number of firms	State enterpr.	Private comp.	Imports
General or technical manager	*37*	1	27	20	47	0	*28*	69	13	6
Academic or technical specialist	*31*	7	27	43	13	5	*22*	49	28	9
White or blue collar worker	*10*	8	8	31	44	0	*7*	36	49	1
Total	*78*	4	24	31	33	2	*57*	57	23	6

time of the interview, although the rail transport was with an armed escort. Reports conflicted on difficulties crossing oblast or even rayon borders. Several traders told heroic stories of armed escorts, the need for bribes, and huge profits for successful trips.

About a fifth of the firms interviewed said they had no serious competitors. About a third said their main competitors were small private firms, and a fifth each indicated state enterprises or institutes and large private firms respectively. Only a few mentioned cooperatives or imports as serious competitors. A third of the firms said more than 50 other firms were competing in the same output market, and more than half said there were 10 or more. Less than 10 percent said no other firms were competing in the same output market. Most firms felt the pressure of competition and reacted by reducing prices, improving quality, and diversifying. Other strategies included cutting costs, increasing market share by expansion, and agreeing on market shares with competitors. Some firms claimed to escape the pressures of competition by maintaining their standards or charging lower prices.

Entrepreneurs and markets in perspective

A synthetic profile of firms' product markets classified by their owner's past job shows rather clear patterns among the three categories of owners previously discussed (table 3.3). Firms owned by former managers were more likely to have more business relations with the state sector and with individuals. Firms owned by academics or technical specialists were more likely to have more business relations with other private sector firms, were more likely to import, and were the only firms engaged in export. Firms owned by white- or blue-collar workers were more likely to rely on private companies for their inputs and to sell to individuals.

Notes

1. Unless otherwise specified, wages mean monthly take-home salary as reported by the owner. Typically, this means *after* the personal income tax withholding of 11 to 14 percent. As with other financial data in the survey, there is no clear case for a bias in reported wages.

2. *PlanEcon Report* 9: 28. The minimum wage was reised to R2,250 a month in January 1993 and has been increased periodically since then.

3. According to Goskomstat of the USSR, wages in trade were 85 percent of the national average; in housing and communal services, 60 percent; in science, 70 percent; and in financial services, 250 percent.

4. This calculation was available for 42 firms, slightly less than half those surveyed. A separate question indicated that only 3 percent of all wages were paid in kind, but this estimate covers only specific goods purchased and given to workers, not such things as vacation time or interest-free loans.

5. Only 41 firms, or just under half of those interviewed, answered the questions on the increase in the number of input suppliers and the improvement in quality and variety.

4

Constraints in the business environment

In the context of Russia's transition—with its turbulent environment, declining output, and lack of private sector tradition—the performance of firms surveyed looks surprisingly strong. Approximately 30 percent were rated highly successful and another 40 percent moderately successful. Seventeen firms were judged to be "muddling through", and five firms were evaluated as very weak. The appendix on Firm Performance provides a detailed statistical analysis of performance based on responses to the questionnaire and the interviewer's independent evaluation. One indicator of success was employment generation: two-thirds of the firms expanded employment since start up or privatization, and another quarter maintained their initial employment level. Less than 10 percent reduced their labor force since becoming private.

There are several explanations for the relatively good performance of survey firms. One is that successful firms may have been more likely to respond to the interview request letter, creating a positive bias in average performance. Service firms, however, performed somewhat better than manufacturing firms that responded to the same interview request letter. Another is that private business in St. Petersburg has attracted very well educated individuals who learn fast, and it has developed into a critical mass that permits some firms to operate successfully by dealing primarily with other private businesses.

Despite this relatively good performance, Russian firms face a number of difficulties. Entrepreneurs were asked about the three biggest problems affecting their business today, and the most important of these were the external constraints discussed here. The single most frequently cited problem was the uncertain and unstable macroeconomic and legal environment in which firms must operate. The second most frequently cited problem was the lack of bank financing—mainly for investment purposes, but also for working capital. Related to this were problems encountered with banking services. The third problem was high taxes. Other constraints were lack of demand, getting good workers, and obtaining satisfactory workspace.

Some problems of Russian entrepreneurs are similar to those cited by small and medium-size enterprises elsewhere, but others differ. The most common complaint all over the world is lack of financing and, where funds are available, high interest rates. Other common complaints are—as in Russia—high taxes, shortage of space, and lack of demand. But small and medium-size enterprises elsewhere also complain of insufficient supply of skilled labor, unfair competition of large firms, and weakness of internal management and organization. Rarely (the United States during the 1970s) is inflation mentioned as a problem, and rarely are institutional barriers to entry mentioned. In Russia, most problems are considered secondary to

the enormous instability in the macroeconomic and legal environment (Storey 1983; Hull 1987: 82–88; Vivarelli 1991: 220; Hall 1989: 39-56; Barber et. al. 1989).

The macroeconomic and legal environment

The macroeconomic environment in Russia deteriorated dramatically in 1992 and has continued to be highly unstable. For new entrepreneurs, it was like learning to swim in a stormy open sea. Inflation during 1992 reached 2300 percent and by late 1993 exceeded an annualized rate of 1000 percent. Large and unexpected changes in relative prices occurred, and a number of key prices were still under some degree of control. During 1992, GNP declined by 19 percent, and by end-1992, real wages had fallen by 32 percent. Real household income had fallen by 26 percent since January 1991, depressing demand by both businesses and households (*PlanEcon Report* 1993).

The legal framework governing economic relationships remained uncertain. Russia was still operating under the amended constitution of the Soviet Union. The right to engage in private activity, for most businesses, was guaranteed by the "Law on Enterprises and Entrepreneurship Activity", but laws on private and corporate property rights and new contract laws were still not adopted. New laws and decrees were frequently revised, and there was disagreement about their validity. The courts and arbitration systems were poorly developed.

Firms' experience with the macroeconomic and legal environment

The inescapable problem of macroeconomic instability left entrepreneurs with three main concerns, the first of which was inflation. Most entrepreneurs seemed to understand the main effects of inflation and realized that they should get rid of rubles and credits to customers as quickly as possible and hold any surplus assets in the form of real estate, goods, or hard currency. To combat the effects of inflation, firms focused on short-term projects and short production cycles. Many insisted on cash-on-delivery payment arrangements. Some introduced an "escalator" clause in contracts to allow for price adjustments, and some firms priced their services in dollars, calculating the ruble equivalent for the customer at the time of payment. Frequent and unexpected changes in relative prices were more disturbing for many entrepreneurs than the overall increase in the price level. The fear that input and output prices might move against them over the short run—say three months—depressed their demand for credit, even at extremely negative interest rates. A worrisome corollary of high inflation was the volatility of the ruble/hard currency rate. Sometimes contracts were broken because of changes in the exchange rate, aggravating business relations.

Uncertainty about the future course of reform in Moscow was the second most frequently mentioned concern. Survey interviews took place during the first month of the new Prime Minister Chernomyrdin, and a number of interviewees were worried that the reform policy of Gaidar would be reversed. They saw themselves the losers if such a reversal were to take place, although some entrepreneurs criticized Gaidar for raising taxes to reduce the deficit and then bailing out state enterprises. Nonetheless, private entrepreneurs were providing essential political support for market reforms.

The third macroeconomic concern was that the decline in economic activity and the resulting low income of the population created sluggish demand for many services—especially personal services such as private health care, hairdressing, restaurants, and tourism. Some services—such as consulting, tailoring and hairdressing—also suffered from competition from unregistered individuals operating out of their homes. In addition, there was a drop in government research and development contracts and in state enterprise demand for social services. In the area of consumer services, only the demand for food stayed at a satisfactory level. In the area of business services, demand for consulting and legal services was strong, mostly in connection with the privatization process.

The major complaint of most interviewees with respect to the legal environment was the absence of a stable and transparent body of laws and regulations, including tax laws. Existing laws were badly defined, open to discretionary interpretation by officials, and subject to frequent and unexpected changes. Frequent changes in standardized forms for such things as registration, taxes, and exports obliged entrepreneurs to hire consultants to help them deal with the red tape. Firms found little legal recourse in the face of injustice; one interviewee reported a two year backlog in court cases. Given the overcrowded agenda and long delays, entrepreneurs made little use of the court system for debt collection or settlement of commercial disputes; some firms used government-sponsored arbitrage facilities.

Public administration

Enterprises encountered problems in their day–to–day dealings with both the federal government and the St. Petersburg city administration. The unstable macroeconomic and legal environment provided fertile ground for bureaucratic inefficiencies and corruption, leading to frustration and mistrust on the part of entrepreneurs. In general, local government was expanding, adding new organizations to address the needs of transition and satisfy the demands of new interest groups. Chains of command between and among federal and local authorities were becoming less clear. The police force was inexperienced and ineffective. Criminal "mafia" groups were extorting fees for protection and debt collection. Polls indicated low public ratings for the mayor and the city council, with a survey in March 1993 indicating that only 14 percent of Petersburgers had confidence in the city council and only 22 percent in the mayor (Usova 1993).

Despite these problems, some improvements in the regulatory environment have been made. Limits on trade margins and profits have been removed, and a more liberal passport system was put in place, although foreign–country restrictions on Russian travelers have tightened and can be aggravated by government policy. Entrepreneurs claim that in the past, visa quotas imposed by other countries were given to state enterprises such as Intourist and Sputnik; other firms needed to pay bribes to get a quota allocation.

The St. Petersburg City Council had begun an investigation of what should be done in response to President Yeltsin's Decree 1484 of November 20, 1992 on "Support for Small and Medium Businesses. No city-wide programs of technical assistance or credit for private business were yet available, although some federal grants were available to private firms, for example in the area of medical research. Several training programs existed, some of them supported by international assistance from Germany, Finland and the United Kingdom.

One important function provided by local administration was registration and licensing of businesses. To establish itself, a firm must open a bank account and register with the city authorities, with the tax office, and with the pension fund. For registration the firm needed a charter, a legal address, and several other documents, for example, showing the availability of a business space. It used to be possible to have a post office box address provided by the mayor's office, but this is no longer possible. Small businessmen claimed that these box addresses helped them avoid the mafia.

Generally, all applications for registration were approved unless the activities were illegal or the documents or rules of operation of the firm were not in accordance with the law. The nominal cost of registration was R2,000 (less than $4 at the January 1993 exchange rate) but city officials said that consulting firms would arrange for registration within a week for R20,000 to R30,000. Firms also need to obtain licenses for a variety of service activities, including transport, construction, renovation, banking, international finance, securities trading, trading of goods, legal services, education and training, publishing, hairdressing, medical care, operation of casino, operation of restaurant, sale of alcohol, foreign trade, and dealing in foreign exchange. Formal provisions for exit have only recently come into force, with the new Law on Bankruptcy that took effect on March 1, 1993.

Firms' experience with the federal government

Although entrepreneurs spoke mainly about local authorities, they also pointed out problems with the federal government. Federal government ministries—as well as state enterprises—were sometimes seen as inefficient, corrupt, and discriminatory toward the private sector. Some entrepreneurs complained that the government sanctioned such unfair state enterprise behavior as charging private firms higher prices or refusing to authorize purchases from private firms. Others claimed that government authorities permitted monopolistic behavior by state enterprises engaged in law, medicine, and building restoration and renovation. Authorities allowed regions to set up administrative and fiscal barriers to free movement of goods, and refused to allow private entrepreneurs to participate officially in international professional conferences alongside or instead of state enterprise managers.

Firms' experience with local administration

Although undoubtedly the city administration has efficient, honest, conscientious employees, many entrepreneurs saw public officials as bureaucratic and corrupt. Bribes and personal connections played an important role in obtaining favors from the government. One owner claimed that he had offered hundreds of bribes over the previous year or two, and not one was refused. When another entrepreneur was asked how he acquired the lease for a nice building, he responded that he was a member of the oblast finance committee. Many entrepreneurs complained about excessive documentation, conflicting regulations, and divergent interpretation of laws and regulations by officials in different city districts. Other irritants mentioned were a government decree defining the assortment of goods that each store had to carry and seemingly arbitrary increases in prices and fees of municipal enterprises such as building renovation design or billboards.

Registration. Firms found registration more time consuming than the norm as stated by city officials. Only one third of all firms were able to complete their registration in less than a month—one did it in a day—and 85 percent were able to register in less than 6 months. Cooperatives experienced more problems than other firms in registering, as did a lawyers association that was similar to a cooperative. Some firms—newly established banks and security traders and all open joint stock companies—had to register with federal authorities, a much more cumbersome process than local registration, as it requires traveling to Moscow. About half the firms hired an attorney as a facilitator to help register and obtain activity-specific licenses. Among those that did not, several were lawyers themselves or had a lawyer working in the firm, and several used personal contacts to facilitate the process.[1] A "turnkey" operation for starting a business was said to cost R65,000 (about $650 or seventy times the monthly minimum wage at the time), including opening a bank account, drawing up a charter, and registration.

Approximately half the firms characterized as problematic the process of registering or obtaining the licenses and permits they needed to operate. Those who did complained that the process was very time consuming and that government officials picked on every word. They also complained of having to pay bribes. Several firms found it almost impossible to obtain a license to undertake education and training activities, and another to open a bank. All in all, registration appeared to be more difficult and costly than it should have been.

Security. Public safety was a concern, and some firms hired private security guards to provide round-the-clock protection. Thirty percent of entrepreneurs said they were subject to outside interference from the local mafia. This occurred in several forms, but the most common form was demands for "security" payments, which included protection from other mafia groups. One entrepreneur had his life threatened for undercutting the standard price markup on imported consumer goods, and another had his windows broken after refusing to make a payment. Some firms made payment in the form of free or reduced-price services. Once the relationship was established, the mafia might serve as debt collector. In this

capacity, it would collect not only the original debt to return to the creditor, but also some multiple of the original amount as compensation for its services. The mafia might also sit in on contract negotiations with another firms, to reinforce the bargaining position of its client and help ensure compliance by the second party.

Shopkeepers and wholesale traders were most likely to be contacted by one of the three main mafia groups active in St. Petersburg. One entrepreneur said that each street retailer had to pay 1,000 rubles a day to the mafia. Firms with higher revenues and more employees suffered from more interference. Such firms generally made special arrangements with the police or the mafia itself for protection. Other firms tried to keep a low profile. They maintained modest offices or refrained from advertising or opening a hard currency account. The St. Petersburg "yellow pages" were described by one interviewee as a "hit list."

Other public services. Complaints about public utilities were not among the major problems expressed by entrepreneurs. About 15 percent of firms had no complaints about public utilities. Other firms typically had problems with one or two public utilities, but not all. Very small companies generally found the cost of utilities high.

The most frequent complaint was about telecommunications. Some services such as facsimile and telex transmission were not readily available, and intra-city telephone lines were expensive and also hard to obtain—sometimes requiring an order from a city district council. One owner claimed it cost R150,000 just to change the name on the telephone line of a state-owned store that was privatized; others estimated the cost of this service between R4,000 and R15,000. Another owner had to pay for his own workers to run telephone lines from the central exchange to his office. Telephone services were improving, however, with direct dialing and an increasing number of available lines.

The second most frequent complaint about public utilities was irregular operation of the overcrowded city bus system. The inter-city bus system was also characterized as bad, but it does not affect most firms. Additional complaints were made about the water system, especially the intermittent lack of hot water, which seriously affected specialized firms such as hairdressers. The electricity supply, characterized as unstable, complicated the operation of modern equipment such as computers.

Attitudes of public officials. Relatively few entrepreneurs saw a positive attitude toward private business and profit-making on the part of public officials. Table 4.1 shows entrepreneurs' ratings of attitudes by public officials in St. Petersburg compared to attitudes of state enterprise managers and the "average citizen". Only 19 percent of entrepreneurs thought that attitudes of local officials were positive. Most of these thought that the positive rhetoric on private sector development was unsupported by concrete action or related to personal gain from bribes.

In contrast, 40 percent thought that attitudes of state enterprise managers were positive, and 51 percent thought that attitudes of the average citizen were positive. Some entrepreneurs saw state enterprise managers as conservative, afraid of losing their privileges and envious of others' success: "They believe we are millionaires." Others saw them as activist, with their own private business interests: "They all have their own—the clever ones." A few entrepreneurs commented that state enterprise managers appreciate the availability of new or improved services.

Table 4.1: Ratings by entrepreneurs of attitudes of different groups toward the private sector (percent)

Category	Negative	Neutral	Positive
St. Petersburg public administration	37	44	19
Managers of state firms	30	30	40
Average citizens	39	10	51

Many entrepreneurs rated public officials as having a neutral attitude toward private business and profit-making and thought officials just did not care, although some pointed out that the attitude depended very much on the person with whom they were dealing. In contrast, entrepreneurs saw private citizens as polarized—either blaming the deteriorated quality of their lives on the market economy or seeing job opportunities for themselves and/or improvements in the supply of goods and services.

Taxation

The tax system in Russia has been subject to continuous revision. When this survey took place, late January 1993, the main taxes were the value-added tax (VAT) at 20 percent on most products, the 32 percent profits tax, several payroll taxes totaling 38 percent, and personal income tax with marginal rates from 12 to 60 percent.[2] In addition, there were tariffs on imports and exports, excise taxes, contributions to extra-budgetary funds such as the Road Fund, and an excess wage tax equal to the profit tax on any portion of the average wage bill exceeding four times the minimum wage. At the local level, there were a number of small taxes, bringing the total to about 25 different taxes; however, any one firm may be liable for only half this number.

Services received differential treatment under the VAT, the profits tax, and import–export tariffs and quotas. Services exempted from the VAT included: city transit, passenger commuter service other than air transport, housing rentals, financial operations, art and culture, education, medical services, and legal and translation services. Services subject to higher profits tax rates included middleman, or "brokerage" services for trade and investment at 45 percent and entertainment at 50 and 70 percent, depending on the type. Services were typically not subject to import–export tariffs and quotas.

Firms' experience with taxation

Entrepreneurs complained extensively about taxes. High tax rates were one of the three major complaints of entrepreneurs. As in many countries, no provisions for inflation accounting existed, so that inflation quickly eroded the real value of deductions based on depreciation allowance. One entrepreneur estimated that 80 percent of his estimated before-tax profit was paid in taxes of various kinds.[3]

Entrepreneurs also complained about an excessive number of taxes. Besides the major taxes mentioned above, firms interviewed paid: land tax (1.5 percent of land value), real estate tax (2.5 percent of building value), local police tax (1 percent of wages), advertising tax (5 percent of advertising costs), inventory tax (1 percent of value of inventories), public transport tax (the minimum monthly wage times the number of employees), road tax (0.4 percent of sales), and car ownership tax (1.5 percent of value). Implicit taxes included mandatory foreign exchange surrender at an unfavorable rate and import–export quotas and licenses.

Firms also complained about tax administration. This is not surprising, since in many countries small businesses believe the tax code penalizes them. Small size, lower administrative capacity, and little chance of influencing tax authorities put them at a disadvantage. In St. Petersburg, entrepreneurs made these points and several others. First, direct taxes paid by individual private businesses and households were a new phenomenon and would take time to get used to. Second, the tax system was still subject to frequent changes and sometimes required prepayments or retroactive payments. Advance payment of the profit tax is in fact authorized by law, with provision for retroactive adjustment. Third, tax collectors had greater discretion in dealing with taxpayers than in other developed countries. Fourth, poor tax accounting rules meant, for example, that contract work could not be expensed but had to be paid out of profits.

Generally, firms complied superficially with the tax law by paying a portion of the tax due, but they reduced the tax base through avoidance and evasion. Almost all firms withheld the personal income tax on behalf of their employees, for the most part at the minimum rate of 12 percent. All but one firm paid payroll taxes at an average rate

of 38 percent of total wages. Less than half the firms, however, pay the excess wage tax, and most firms tried to reduce payroll and profits taxes in various ways. Where possible, firms used cash transactions, since it was difficult to avoid paying taxes on bank transactions. They also paid some wages in kind, padded the input bill, failed to report certain activities, redefined activities subject to a higher profits tax, and shifted wages or profits to another firm.[4]

Firms could resort to legitimate means of avoiding the profit and other taxes by applying for discretionary tax treatment. Discretionary reduction in tax liabilities from local authorities could be obtained for engaging in a charitable activity or reinvesting profits. One research and development firm, for example, paid lower taxes because it provided medical services to children, and a trading firm ran a soup kitchen with the hope of obtaining a reduction in taxes. A firm engaged 100 percent in ecological activity could also get a reduced tax rate. Prior to 1993, service firms with 15 employees or less could reinvest profits tax free for the first two years of operation, but this advantage no longer exists.

The banking system and obtaining credit

There were approximately 30 banks with about 60 branches in St. Petersburg, plus some branches of national banks. They offered a variety of traditional bank services, including facilitation of business transactions and provision of short term credit. Virtually no funds were available for small and medium-size enterprises from Central Bank of Russia resources. Given high inflation, medium and long-term credit was virtually non–existent.

Traditionally, banks in the former Soviet Union collected and transferred to the government substantial information on their pre-assigned clients. Indeed, they performed the roles of tax inspector, tax collector, and auditor. Commercial banks have been instructed by the Central Bank of Russia to continue this traditional role, verifying a firm's compliance with tax liabilities such as the VAT before approving any withdrawals or bank transfers, including salary payments. Given these continuing duties and various other constraints, relatively few Russian banks offered the range and quality of services that can be found in good banks elsewhere.

Loan insurance, the main instrument used to cover the financial risk of lending for private business, is in its infancy, as is most insurance activity. The companies dealing in financial risk are typically linked in some way to banks. The legal basis for insurance is only now being established; a new insurance law was passed in January, 1993. Most insurance activity is to cover the financial cost of lending; only a few companies deal in shipping, property, car, and life insurance. The processing of claims is slow, and the levels of public trust and know-how of insurance agents and actuaries are low.

All over the world, small and medium-size enterprises complain that the banking system refuses to extend credit to them and, when offered, it is much more expensive than for large enterprises (Bosworth 1989; Hall 1989, 1992; Storey 1982: esp. 148-178 and Ch. 11; Storey 1983; Storey et. al. 1987: 76-80; Vivarelli 1991; *The State of Small Business* 1992, Appendix B). The reasons for this vary: the risk involved in small business activity may truly be higher, or market and institutional imperfections may exist. In either case, small business may provide positive social externalities, resulting in a gap between the private cost as the bank sees it and the social cost. To address this gap, most governments create special credit channels or guarantee instruments for small and medium-size enterprises, on a concessionary basis. Such a program has not yet been established in Russia but could be especially important for the entry of new firms, where innovation is more important.

Firms' experience with banking services

Ninety percent of firms relied on banking services in their day–to–day operation. The majority of firms used a private commercial bank, a substantial minority used state banks, and a few used Sberbank, the state savings bank. On average, entrepreneurs claimed that three-quarters of their monthly transactions went through the banking system, although a much lower share is likely.[5]

The remaining transactions were made primarily in cash rubles, with only a small fraction taking place in hard currency. No barter transactions were reported.

About 90 percent of entrepreneurs complained about banking services. The most common complaint was the delay in payments, particularly for payments made outside the St. Petersburg area. Several firms noted that the larger the bank transfer, the longer the delay—suggesting that someone else was using their money. In the St. Petersburg area, the average number of days required for a local bank transaction by firms surveyed was six, with a minimum of one day and a maximum of 30 days—not excessively long, even by western standards. The second most common complaint was high fees for services. Opening a foreign currency account was expensive, as was an individual hard-currency transaction, on which the bank took a fixed percentage. Some banks also took a percentage of cash withdrawals in rubles. As of January 1993 these fees were falling, however, as a result of increasing competition among banks.

The third most common complaint was difficulty in withdrawing cash for purposes other than payment of salaries. As a result, there was a premium on cash earnings, and firms often underreported cash earnings to their bank—and by extensions to the tax authorities—in order to pay cash for their inputs. Other complaints concerned delays, mistakes, the lack of medium- and long-term financing, and lack of confidentiality. Regarding confidentiality, banks were believed to share information on firms with the government, potential competitors, and the "mafia." One person said that the day after he applied for a loan the entire town talked about it. A few entrepreneurs said that banks concentrated on their preferred customers, frequently larger enterprises owning shares in the bank, or that banks wanted bribes for making loans. In the past, opening a bank account had been difficult, though this appeared to be changing with the increase in the number of banks and the expansion of bank branches.

Firms' experience with obtaining credit

Only short-term financing was available through the banking system. Medium or long-term financing to start a new enterprise or to invest in an existing one was completely outside the realm of possibility. Maturities usually extended from several weeks to a year, the latter being very exceptional. There were a few cases of credit lines with renewable annual contracts. Many firms in the sample were not able to obtain a loan for a period sufficiently long to cover even their commercial transactions, taking into account delays in deliveries and in payments.

Nominal interest rates ranged from 80 to 240 percent a year. Banks could charge these highly negative real interest rates because they were paying either low or no interest on deposits. Nevertheless, about half the firms found interest rates too high. There are several explanations other than the sometimes assumed "money illusion" of people not familiar with inflation and the need to distinguish between real and nominal values. One explanation is that actual interest rates were much higher than the quoted rates because of such additional charges as interest paid-up-front, which greatly increases the effective interest rate; insurance premiums; and bribes. One entrepreneur claimed that his bank added unexplained extra charges over and above the agreed interest rate. Another explanation is that the volatility of relative prices can make interest rates positive for a particular firm in the short term; this could present a major problem since penalty rates for loans not repaid on time were quite high, as much as 5 percent a day.

To obtain a loan, a client had to have either collateral, a guarantee from another company, or loan insurance. Many firms had no collateral and obtaining a guarantee from another company was not easy, unless the borrower was a part of a formal or informal association. Insurance was too expensive for many firms. Premiums charged for loan insurance were typically one-half to two thirds the interest charges. For example, a six week commercial loan with an interest rate of 18

percent would be charged an insurance premium of 9 to 12 percent of the loan. Such premiums dramatically increased the cost of borrowing. About a third of the firms said they were unable to obtain a bank loan because of inadequate collateral or high premiums for financial risk insurance.

From the banks' point of view, both collateral and guarantees have serious limitations. Collateral is not currently registered, and there are no procedures for sales when the borrower defaults. Thus, banks may end up owning firms that owe them money and not know what to do with them.

Real estate

Real estate laws and practices in Russia were complex and unclear, although a recent decree authorized the right of citizens to buy and sell properties freely. In St. Petersburg, special limitations on ownership, development, and transactions in the historic center of town compounded these problems. In principle, non-historic buildings could be bought, and anyone purchasing an entire building and the equipment in it could also buy the land underneath it. Historic buildings and the land under it could be leased for a maximum of 49 years. Space within a building could be leased for a maximum of 15 years, with an option to buy when the law permitting purchase is passed.

Long-term leases plus the option to buy were allocated through auction and competition. Competitions for leasing historic buildings are divided into commercial competitions—where the highest bidder takes the property—and non-commercial competitions, where renovation proposals are evaluated by a committee on the basis of aesthetics and contribution to the value of the property. Lease payments were set by a detailed regulation that distinguished between categories of lessors as well as categories of property. Lessors were divided into six categories, each associated with a coefficient of adjustment to the basic rent for the property category. For example, a trading firm paid more than a manufacturing firm, and a foreigner paid more than a Russian citizen. Budgetary agencies including schools, hospitals, and research institutes, paid the lowest rents, followed by state enterprises. Official land and building rents had been recently raised several times, but prices remained low. For example, annual land rents for commercial enterprises varied from R2 to R270 per square meter ("Offices and Dachas in Demand": 14–15). Building space rents were substantially higher.

At the time of the survey, very few outright sales or 49-year leases of public property had taken place. The municipal administration, public institutions, and state enterprises were all holding their assets in anticipation of higher prices. Developers therefore confronted much difficulty in obtaining entire buildings for development purposes, both in and out of the historic district.

For most small private service firms, however, the 15-year-lease-plus-option-to-buy was the relevant option. Most were interested in limited space within a building, not the building itself. One possibility was to sublet from a public entity. This was allowed, provided the public entity obtained approval from the Municipal Property Committee (MKI), which charged a fee equal to 10 percent of the monthly payment. Renovated business space in the center-city was attracting strong interest, particularly from foreign firms that paid high prices, mainly in dollars.

Shortage of adequate premises for small business at desirable locations and at affordable prices is also common in other countries. Small service firms have been crowded out by rising real estate prices in downtown business districts, and expansion of small firms has often required moving to new premises (Storey 1983: 107-108). Testimony to the general difficulty in this area is the involvement of many governments in the construction of "industrial parks" for rent. Problems with real estate in St. Petersburg are more fundamental. City officials need to create a real estate market, promote reconstruction of the city center, and rationalize the system of long-term leasing.

Firms' experience with real estate

Real estate was a popular topic of conversation among entrepreneurs and a major source of concern. Half the enterprises obtained their space through long-term leases from state entities, and

one third from short-term leases. Many firms disregarded the approval requirement for subletting and established informal arrangements with their landlords, sometimes an enterprise or an institute where the entrepreneur had previously worked.

Entrepreneurs had three main concerns about real estate. Most important was the lack of security concerning continuing use of space. The second was price. About half the owners said they could not afford to pay the prices demanded for suitable space and location. Many moderately or highly profitable firms also claimed that better space was available but was too expensive. Largely because of price, fewer than 30 percent of the interviewees said that suitable space for their business needs was available and affordable. The third concern was availability: 10 percent of the owners said they could not find a suitable space for their needs at any price, and a few other firms, on temporary leases, feared having to move.

The complaints about high prices reflect the relatively recent and frequent increases in rent by the St. Petersburg municipality—some retroactive and within the contract period. When prices soared in early 1991,the city was faced with the problem of lease agreements and property prices quoted in nominal terms. To address the inflationary environment, the city introduced a program of rent indexation and attempted to reduce the large subsidy embodied in the old rents by renegotiating lease agreements and property prices. Even before the increase in the general price level, rents covered only 20 to 25 percent of the maintenance costs borne by the city, excluding depreciation and interest. This is one reason why building maintenance is generally poor in St. Petersburg; for example, two entrepreneurs complained of major flooding in their buildings.

The new lease regulations have provided a reasonable framework for lease stability, with lease payments indexed annually for inflation and rents generally realigned to market prices every 5 years. The failure to respect leases in the past, however, led entrepreneurs to question whether any lease regulations will be honored in the future. Many owners believed that bribes contributed to the failure of the city to honor lease agreements. Small enterprises paying low rents were particularly worried that the city would not only increase rents but evict them if someone provided a sizeable bribe to obtain the space.

Given this history, small entrepreneurs wanted to buy the property they occupied, or other suitable property, at the relatively low prices offered, much below their real future value. They also wanted full property rights, in order to be able to develop their properties without risk, to trade them, and to use them as a store of value, source of business finance, and collateral. They understood that acquisition of properties at good prices could help them generate financial savings through real estate construction, renovation, and management.

Additional problems with the real estate sector mentioned by some entrepreneurs included:

- The monopoly position and pricing practices of state renovation companies and their subsidiaries, which discouraged renovation by many entrepreneurs, especially in the historic district.
- The lack of readily available information about space for rent or for purchase.
- The need to establish the right personal contacts or pay bribes in order to deal successfully with the asset authorities.

These problems tend to affect most severely the smaller firms with weaker links with state enterprises or state institutions.

Notes

1. Only 42 firms, or just under half the total number of firms interviewed, answered the question on use of facilitators.

2. The basic payroll taxes are payroll pension fund (30.6%), individual supplementary pension fund (1%), social security (5.4%), and employment fund (1%).

3. It is difficult to keep up-to-date on the tax code in Russia. The basic VAT rate was reduced from 28 to 20 percent on January 1, 1993, and the exchange rate used for mandatory foreign exchange surrender (effectively a tax) was improved. Import taxes have increased, and failure to change tax brackets for progressive taxes under

inflation results in increasing taxation in real terms. An article in the Russian weekly, *Commersant*, highlights the problem of high taxes in Russia ("Will Law-Abiding Firms Survive?").

4. It is not clear what effect such incentives had on employment levels reported. One firm might have overreported workers to reduce the average wage and avoid the excess wage tax, while another firm might have underreported workers to reduce the income and payroll taxes.

5. As interviews proceeded, several entrepreneurs acknowledged that their original estimate of non-bank transactions was the "book" information and that other non-bank transactions—in cash and in kind—were taking place.

5

Policy recommendations

Private sector development of small and medium-size enterprises and the service sector is central to the transition. While most development will be undertaken directly by private entrepreneurs—and can be accomplished without massive government intervention—a number of supporting policies at both the general and sector specific levels can enhance the development of small and medium-size enterprises, thereby helping other aspects of the transition. The policies suggested here focus on easing the main internal and external problems expressed by the entrepreneurs interviewed in this survey.

The policy recommendations draw on three main sources of information:

- Knowledge of the unstable and uncertain macroeconomic, legal, and political environment in Russia, in which small and medium-size enterprises and service firms are expected to operate with almost no experience and tradition.
- Lessons obtained from the survey on entrepreneurs' characteristics, experience operating in Russia's emerging markets, and the most important constraints in their business environment.
- The stock of policies for small and medium-size enterprises that have been undertaken in developed countries and other economies.

Although the focus of this survey is on service firms, the following policy recommendations are applicable to all small and medium-size enterprises: improvements in the general business environment, specific government policies, and direct assistance programs during transition.

Improvements in the business environment

The macroeconomic environment

From the entrepreneurs' perspective, the best assistance to private sector development in Russia is to stabilize the economy and pursue reforms. A relatively stable economy would reduce risk and uncertainty, provide a solid base for investment and growth, normalize financial markets and interest rates, and stabilize the pattern of demand. The weak demand for many consumer and some business services, observed in this study and elsewhere, is one result of the general decline in output and incomes associated with the transition. Weak demand may also result from the increasing disparity in income distribution, whereby the buying power of lower- and middle-income families is reduced and the very rich turn to imports. The government's stabilization strategy should apply constraints on demand in a way that encourages demand for domestic consumer goods, which need to expand if restructuring is to occur. This strategy should also ensure that public sector wages do not compete with private sector wages; otherwise, private employers will not be able to attract public sector workers.

Government administration, regulation and service

Entrepreneurs also favor a radical reduction in federal and local government regulation and other forms of interference. Necessary regulations should be simple, clear, well publicized, standardized, long term, not retroactive, and subject to minimum discretionary power by public officials. A policy of maximum "hands-off" on the part of the government may be more important than any active programs.

Important measures to foster growth in private business could be instituted by the city government of St. Petersburg. A clear priority is eliminating corruption in the civil service. An equally clear priority is a reduction in the number of government employees, since tax levels can only be lowered if government efficiency is improved and government expenditures are reduced. Public safety and protection against extortion are also important for private sector development.

Many entrepreneurs interviewed in this survey complained about lack of information. Local government could provide useful and reliable information to the public. Laws and regulations could be published in easy to obtain gazettes, and up-to-date standard forms could be made available at well publicized business centers. At the time of this survey, statistics were not generally available in St. Petersburg; the Statistical Bulletin, produced by the former Goskomstat Agency, was provided confidentially to selected municipal employees. This bulletin could be expanded and made available to the public at a price that would permit partial cost recovery. Survey methods for collecting statistical information should be introduced to reduce costs and increase coverage and relevance.

The banking system and access to credit

Improved access to credit depends on actions on both the demand and supply side and a certain amount of institutional development. Banks need to develop skills for evaluating projects in connection with credit requests and credit guarantees. Firms need to learn how to develop and present good business proposals. Loan officers are already being trained, and there are many proposals for business centers that would provide technical and financial management assistance to entrepreneurs.

As part of the institutional development process, confidentiality within the banking system needs to be established. At present it is difficult to prevent banks from giving or selling confidential information on firms to interested parties. Bank management will need to enforce confidentiality among its staff and to use the practice of confidentiality to attract good customers. It is also difficult to argue that the government should not use banks as control centers for tax purposes when there is no effective tax administration; neverthieless, steps should be taken to separate the financial and the fiscal functions of banks.

The real estate market

A normally functioning real estate market, with properly defined property rights and a level playing field for competing uses, is a key condition for private sector development. The elements of a well-functioning real estate market are likely to include:

- Completion of the relevant legal infrastructure at the national level, including property and condominium law.
- A large increase in the supply of saleable and leasable property in St. Petersburg, requiring or encouraging budgetary agencies and public enterprises to release excess property for example, through a land tax.
- Elimination of differential rents by lessors at least to all non-government lessors.
- Encouragement of a true competitive market in design, renovation, and rehabilitation of historic buildings.

In addition to helping provide industrial and commercial real-estate for private sector development, a well-functioning real estate market will help produce true equilibrium in prices, which are likely to end up much above public rents but below some of the present commercial rents. It would also help create a store of value and collateral for obtaining loans for future private-sector investment. The privatization of commercial and

residential property will transfer resources to entrepreneurs and help them finance new investments. Opening up the real estate sector will ultimately encourage ample new activity and employment opportunities for private sector activity in renovation, construction, maintenance, tourism, and business services such as real estate agencies, architects, engineers, and interior designers. The international appeal of St. Petersburg makes such a move even much more attractive and rewarding.

Land is only now beginning to be auctioned by the city of St. Petersburg, and the supply is limited by prior claims of state enterprises and budgetary agencies. Transactions for both whole buildings and space within buildings need to be facilitated and made transparent. For example, in order to facilitate property ownership by small firms, the city might need to encourage the establishment of commercial centers by real estate developers, who could arrange for financing, including part ownership by participating enterprises.

Equal treatment for different economic activities

Private business development should be treated consistently across all sectors. Regulations, taxes, and other forms of government intervention should not discriminate between different types of activities, such as trade or manufacturing. Trade continues to suffer both from discriminatory policies in tax rates and rental fees and a strong negative attitude on the part of the government and the public.

Traders are profit maximizers. Their large profit margins reflect in part continuing price controls, ambiguous regulations, and inter-oblast and other spatial trade barriers. Traders also take advantage of the weak law enforcement powers and the rent-seeking penchant of many public sector officials and managers to maximize their incomes. But many traders interviewed in this survey also appeared to be real entrepreneurs who were reinvesting rather than consuming their profits. Rather than try to regulate prices and profits, the government's strategy should be to attack the source of distortions by eliminating geographic trade barriers, price controls, state selling at artificially low prices, special privileges for people with connections, and administrative restrictions on entry by competitors.

Specific government policies

A rational tax regime

Given the prevalence of tax avoidance and tax evasion, it is difficult to know the incidence of various taxes and what revisions would be most helpful to the smallest, weakest firms, which complain most about the tax constraint. The VAT, profits tax, income tax, and payroll tax together appear to be on the high side, although individually they may not differ much from rates sustained elsewhere. In any case, a rational tax regime, which maintains incentives for growth and investment, is of central importance to small businesses.[1] A more rational tax regime may entail a number of reforms, such as those suggested below.

One important reform is to simplify and rationalize the many small taxes that constitute a financial and administrative burden on small businesses. Another is to eliminate some taxes altogether for private firms, which—unlike many public enterprises—face severe budget constraints. Two candidates for elimination are the excess wage tax and the inventory tax, which may be appropriate for public firms but are inappropriate for private firms operating in a competitive environment. The former penalizes a firm for seeking highly skilled employees and promoting productivity improvement through wage increases; the latter penalizes a firm for having a business that typically requires large inventories. Local governments may also be able to eliminate small, sometimes poorly conceived taxes, such as the tax on advertising, by raising the urban land tax.

The fiscal implications of any tax revisions must be considered; a good data base can be useful in simulating the effects of alternative strategies. For example, it might be useful to explore ways to promote the reinvestment of profits by small businesses. One possibility, which would fit within the framework of a general tax

Box 5.1 Direct assistance to small and medium-size enterprises in other countries

Almost all countries have special programs to assist small and medium-size enterprises. Programs are implemented by the central or local governments, by public not-for-profit institutions and trade associations, and through subsidies to private providers of programs. Areas of assistance in the European Union countries are presented in the following table:

Policies toward small and medium-size enterprises in EU member states

	Fiscal support	Financing	Technical assistance and training	Supply and contracting
Belgium	■■■	■■■	■■□	■□□
Denmark	■□□	■□□	■■□	■□□
France	■□□	■■□	■■■	■□□
Germany	■■□	■■□	■■■	■□□
Greece	■□□	■■■	■■□	■□□
Ireland	■■□	■■■	■■□	■■■
Italy	■□□	■■□	■■□	■□□
Luxembourg	■□□	■■□	■■□	■□□
Netherlands	■■□	■■□	■■■	■■■
Portugal	■■□	■■□	■■□	■■□
Spain	■□□	■■■	■■□	■□□
United Kingdom	■□□	■■□	■■■	■□□

■□□ very few or no policy measures

■■□ relatively few policy measures

■■■ relatively large number of policy measures

Source: Derived from de Koning and Snijers (1992).

Box 5.1 Direct assistance to small and medium-size enterprises in other countries *(continued)*

Fiscal support: Investment tax relief or tax credit, investment interest relief, and accelerated amortization programs, especially for start-ups.

Financing: Direct government loans at low interest rates; government guarantees to special small and medium-size enterprise credit institutions; mutual guarantee organizations, with a government subsidy or partial guarantee, interest rate subsidies, and special venture capital programs.

Technical assistance and training: Technical assistance in the development of new concepts, products or services; information gathering and dissemination; research and development support; training, including worker training and training of entrepreneurs in public regulations and in the principles of running a business.

Supply and contracting: Programs to guarantee fair participation of small business in government purchases.

law, is to allow a tax deduction for reinvested profits up to a certain *absolute* level. It might also be useful to explore ways to improve tax compliance by small businesses. One possibility is to substitute the profit tax on small firms (defined by number of employees or revenue level) with a predetermined presumptive tax. The advantages of a presumptive tax are that it facilitates collection and, with a zero marginal rate, it encourages expansion. A problem might arise, however, if it is discretionary at the level of the tax collector in the current environment.

A special regulatory regime for small firms

As seen above, small firms are at a disadvantage in coping with the administrative burden of regulations designed for larger firms. They may not have easy access to the accountants, lawyers, and other experts needed to handle the bureaucratic requirements of these regulations, and the financial and administrative burden may be quite heavy. It is therefore recommended to provide small firms, as much as possible, with simplified regulations and short forms for registration, bank reporting, and taxation. In addition to the help such a simplified regime will provide to firms, it will also reduce pressures on the bureaucracy and allow the government administration to cut staff.

Direct assistance during the transition

The issue of whether or not to provide direct assistance to small and medium-size enterprises is not simple. Many countries, including the United States, have special programs to guide and assist small business development (box 5.1). The rationale is that an entrepreneur starting a new, small business is at a disadvantage compared to larger, established firms. The program addresses a temporary market failure, which needs to be corrected since small businesses make an important contribution to economic growth and job creation. In the United States, for example, nearly half the non-publicly employed labor force works in firms with less than 100 employees, and this small business sector currently creates about 80 percent of all new jobs. If such a rationale is accepted for established market economies, it would seem to be all the more valid for Russia, where private sector development has only begun. However, local governments in Russia have less experience in creating an enabling environment, and private entrepreneurs have less knowledge about how to

establish themselves. Therefore, a different institutional arrangement for support may be required.

Medium-term credit would help small businesses expand faster than they could through self-financing. Such expansion is important given the need for rapid restructuring of the Russian economy. In OECD countries, less than half of small businesses may have bank loans, but credit access is much higher than in Russia and medium-term credit plays an important role. Survey data have shown that perhaps a third to a half of small businesses in the United States received bank loans in the late 1970's (Storey 1982: 148-59).

At the same time, there are arguments against direct assistance whose efficiency and effectiveness programs in developing countries has been questioned (Webster 1991). Special financing programs for small and medium-size enterprises in particular have not always worked well. Regardless of the importance of such activity, governments often do not have the capacity and capability to carry out efficient, well-focussed support programs.

A synthesis of the two views on this issue argues in favor of special assistance to small and medium-size enterprises during the transition, though not necessarily as a permanent entitlement. Recent case studies have concluded that selected, cost effective direct assistance programs can provide valuable support to new private firms (Levy 1994). These findings suggest a pilot project approach and some innovation regarding both the who and how of the organization. Assistance should be provided to start-up firms on an equal basis with privatized firms. Some broad features of a direct assistance program are recommended below, followed by suggestions on supporting such programs.

Broad Features of an assistance program

An assistance program might best be centered in a head, or apex, agency that oversees one or more business centers and one or more credit facilities, legally separated from the business centers but located near them:

Apex agency. The head agency would help establish both the business centers and the credit assistance, its most difficult tasks. Most business centers will have to be started from scratch. At the pilot program stage, they may have to be established as joint ventures with foreign involvement, to capitalize on experience elsewhere. Credit assistance might be channeled through existing financial institutions, where staff would be tested and trained. Training programs for the staff of the apex agency, the business centers, and the credit facilities would be needed, as would a system of staff remuneration that links salaries with performance. The apex agency would need to formulate clear and transparent criteria for assistance and require a full accounting of recipients. In addition, it would need to monitor the efficiency of the second-level institutions.

Business center. The business center would provide information on domestic laws; up-to-date tax, registration, permit, and lease forms; and international production and marketing information. Trade fairs are perhaps less relevant for service firms than for manufacturing firms, but identification as collective marketing opportunities has been found to be particularly valuable to new private firms (Levy 1993). In addition, the business center could provide communication facilities; promote contacts with foreign businessmen; and offer business incubators, technical advice in financial management, and training and foreign study. The design of training programs should take into account the high level of education of most entrepreneurs in St. Petersburg, and should capitalize on their ability for self study, given the appropriate materials and references. Such assistance is particularly important for service firms, where entrepreneurs lack knowledge and experience. Whether such activities should be provided together, whether there should be competing centers, and how they should be financed are all questions that need to be explored—and are undoubtedly being explored elsewhere in Russia.

Credit and equity assistance. The credit assistance program would help provide reliable, short- and medium-term credit on a confidential basis with no bribes. Such assistance should preferably be provided through existing banks that have developed a good reputation with small business-

men. An equity investment channel should be incorporated to offer equity and possibly venture capital funding for interested firms that can provide attractive programs. Such equity financing could be combined with credit in a package that best fits the needs and liquidity profile of the firm. Survey firms were more interested in obtaining equity funds with risk sharing than in borrowing at what they considered to be high interest rates. Equity financing requires a deeper study of the requesting firm and might be provided by the financing institution in conjunction with a foreign investor.

A distinction should be made between credit needs in domestic and foreign currency. A large share of the demand for credit is likely to be for domestic resources, and therefore for domestic currency. Government policy must create a level playing field between small businesses and other sectors of the economy, such as state enterprises and agriculture, so that small businesses have ready access to loans on similar terms. This is not currently the case. For example, two banks interviewed in St. Petersburg had virtually no central bank or other government loans; they claim that such loans are reserved for state enterprises or other special programs that do not include their clients.

At present, the unregulated market interest rates on local currency are negative in real terms, because the cost of funds is quite low; but interest rates are becoming increasingly less negative. Pressures to subsidize interest rates for specific sectors should be resisted, so that credit potentially available for small businesses is not diverted. Some small businesses will continue to finance their activities through reinvested profits; but orderly and confidential access to credits, with some form of risk sharing, would encourage small businesses to use credits, even if offered at positive real interest rates. Credit facilities may be able to continue to obtain low-cost domestic ruble deposits or gain access to local counterpart funds generated from the sale of goods acquired under commodity or other grant assistance. Local currency funds at low, if not negative, real interest rates could then be provided in conjunction with hard currency loans at standard commercial rates to finance firms' foreign exchange needs.

Given the importance of export development in improving incomes, technology, and business practices, the business center might recruit professional foreign buyers—with partial expenses paid—to provide information about market demand and product specifications. At the same time, such buyers could seek out potential exporters of services or products their companies might like to purchase. In addition, the center might organize low-cost learning trips abroad for domestic entrepreneurs to visit counterpart businesses for training and possible future collaboration, and it might invite foreign investors to meet potential domestic partners.

The development of joint ventures with foreign business partners should be a major goal of an assistance program. Even though many of the Russian enterprises are small now, some will grow quickly and could prove to be valuable contacts for foreign investors. Foreigners may not want to undertake a free-standing investment under current circumstances but may be willing to provide modest amounts of capital and technical assistance to a joint venture. Such joint ventures could, over time, become the leading enterprises in their fields—setting an example in their operation and business conduct, developing new markets and products, introducing new technologies, and expanding exports.

In all these areas of proposed assistance, local surveys should be undertaken to determine firm characteristics, entrepreneurs' major constraints and needs, their willingness to buy shares in a business center or pay for various programs, and the availability of domestic consultants to supplement the staff of the business center in providing requested services. Some surveys should precede the pilot programs; others may be part of them. Further information for monitoring purposes would be gathered as a byproduct of the business center's activities.

Who should support such programs?

Direct assistance programs require the support of local government. As a minimum, local governments should allocate space and provide matching grants for some activities. But they should concentrate primarily on law enforcement, tax collecting

and increased internal efficiency—all areas where increased effectiveness would benefit entrepreneurs. Local governments' lack of experience with small business development, as well as their negative image with entrepreneurs, because of corruption and inefficiency, raise serious doubts about their participation in direct assistance to firms. For this reason, the private sector itself should take responsibility for small business assistance—initially with foreign guidance and financial assistance. Competing private sector institutions such as a Chamber of Commerce or other business associations and sector-specific groups, could organize competing business centers in large cities. Several foreign agencies, including the European Union, have talked about setting up a business center in St. Petersburg, but so far none has been established.

Assistance to small businesses from bilateral aid programs or international financial institutions might be offered on a competitive basis to oblasts and cities as long as local authorities and small business associations are supportive of private sector development. A conceptually appealing model is one where seed money is offered to assist one or more business centers on a pilot project basis, pending efforts to obtain longer term financing from fee-for-service arrangements or external grant assistance. The seed money might be used for computerization, foreign and local staff salaries, and matching grants to enterprises for consulting, information and training services provided by the center. Matching grants might also be provided for small research and development projects that introduce new or improved technologies; preparation of project proposals to interest foreign business co-investment; and business plans for credit applications.

A highly desirable variant of this model entails participation in a business center or credit facility by a foreign company. Once macroeconomic stabilization is achieved, foreign firms may see this as a useful way to enter and study the Russian market, with future profits in mind. Under current conditions, strong incentives would need to be provided through aid programs for foreign firm participation—for example, by initial matching grants or risk-sharing loan guarantees. In all cases, both profit and non-profit variants are possible, including a start-up non-profit operation converted later into a normal business enterprise.

Given the huge differential in costs between foreign and domestic staff or consultants, the assistance program should try to economize on the use of foreigners. As a minimum, however, a foreign technical advisor should be employed for two to three years to organize and manage at least the apex agency and possibly the business center(s). A Russian counterpart would be trained to take over in a year or two, with the foreign advisor shifting to a supportive role. Depending on local demand, foreign consultants might be recruited to train the Russian staff, who would then train bank credit evaluation officers, commercial/industrial designers, domestic and foreign marketing specialists, and management consultants as necessary. Technical assistance programs to enterprises could make entrepreneurs aware of available lines of credit from participating financial institutions.

Note

1. See Koning and Snijder: 30; Cross 1983: 109-110; Storey 1983. Most of the tax concessions to small firms mentioned in these sources are indeed for new firms, which would include virtually all private firms in Russia.

Appendix: Firm performance

This appendix examines the economic performance of survey firms according to data supplied by the owners, an overall performance grade supplied by the interviewers, and a separate composite grade calculated on the basis of several performance indicators. The findings on performance are then related to the characteristics of the entrepreneurs, the characteristics of the firms, changes in prices and wages, constraints imposed by the business environment, and entrepreneurs' complaints.

Judged in isolation, the firms' performance record can be considered good, but not outstanding. Judged in the context of Russia's transition—with its turbulent environment, declining output, and lack of private sector tradition—the performance record looks remarkably strong.

Several explanations for this good performance are possible: First, there may be a sample bias in that registered firms, from which the sample was drawn, may perform better than the undocumented unregistered firms. Also, successful registered firms may have been more likely to respond to the interview request letter. Both sources of selection bias are possible although difficult to verify. Second, despite the generally negative effects of inflation and volatility in relative prices, some firms—especially in trade and financial services—can benefit from positive effects on liquidity and profit.

The main explanation, however, may lie in the increasing demand for trade and business services created by market reforms and the collapse of the planning and centralized trade system. Private service firms in St. Petersburg have performed somewhat better than comparable manufacturing firms, giving credence to this view (box 2.4). Also, relatively small new private firms have an advantage over larger firms in that they are more flexible and free of residual responsibility for social services, including housing. A recent survey of large privatized firms in Moscow and Vladimir oblasts supports this explanation (Webster, Wackman, and Franz 1993).

Finally, the relatively good performance of firms surveyed is consistent with the findings of the survey that the private sector in St. Petersburg has developed into a critical mass that permits some firms to operate successfully by dealing primarily with other private businesses, and it has attracted well educated people who learn fast. Given the shrinking budget support for government agencies and research institutes, the private sector is likely to attract a very high caliber entrepreneur all over Russia.

The performance record

Several measures of performance are examined here in an effort to identify success:

- Eight performance indicators included in the questionnaire.

- An overall grade of 1 through 4, assigned to each firm by the interviewer and based partly on the eight performance indicators and partly on a qualitative impression of the firm, taking into account the qualities of the entrepreneur and a personal inspection of the facilities.
- A composite grade calculated as the numerical average of the overall grade and values assigned to the six positively and significantly intercorrelated performance indicators (box A1).

Four crude indicators of labor productivity were also calculated to see if they were correlated with performance: sales per full-time worker, the ratio of wages to sales, net revenue (sales less wages) per worker, and the change in the real producer wage over the last six months. The last three indicators correlated with profits, and the second and third correlated with the overall grades. None correlated with the dynamic performance indicators, past or future.

The eight performance indicators and the firms' results were:

- *Profitability.* Eighty-four percent of firms reported positive operating profits for the last quarter of 1992; one-third were highly profitable. Four firms were losing money and 10 were breaking even.
- *Change in profits.* One quarter reported declining profits since the early period of operation. Twenty percent reported no change, and more than half saw rising profits.
- *Capacity utilization.* Eighty percent of the firms were selling at full capacity. Three quarters of those that produced at full capacity said that they could expand had there been higher demand. Only one quarter cited supply constraints, internal and external, as the effective limit on sales. Eighteen percent were below full capacity because of insufficient demand.
- *Sales growth in volume.* Slightly more than a quarter of the firms reported a decline in the volume of sales during the last quarter of 1992; the rest saw increased sales.
- *Employment growth since start up or privatization.* Almost two thirds of the firms had increased employment since start-up or privatization. Fewer than 10 percent reduced employment since starting operations, typically firing workers employed by the original state enterprise. The remaining firms did not change their employment level (box A2).
- *Employment growth in last six months.* About half increased employment; fewer than 15 percent reduced employment. About 40 percent experienced no change (box A2).
- *New equipment share.* Fifty percent had more than half their equipment new. One-third had 100 percent new equipment.
- *Expansion plans.* The vast majority of entrepreneurs had concrete expansion plans, some in their own lines, others in related or different activities.

The general impression left by the firms was that performance was good, but not outstanding. According to the original grade given by interviewers, five firms were evaluated very weak and 17 as "muddling through". Together these accounted for a quarter of the firms. More than 40 percent of the firms were graded fairly successful, and about 30 percent highly successful. The most successful firms were highly profitable with concrete expansion plans. The weaker firms suffered from supply-side constraints (inputs, credit, government interference and uncertainty) and also from weakness of demand for their services.

Table A1 shows the two average overall grades and the six significantly correlated performance indicators for each of the main activities. Consumer services typically experienced below-average performance, and trading firms slightly above-average performance. Demand was sharply reduced for consumer services such as hairdressing, tailoring and watch repairing, as a result of the decline in real personal income. Anecdotal accounts were heard of such firms disappearing in the last few years. Within trade, firms in wholesale trade and restaurants seemed to do better than average, but retail stores seemed to perform worse than average. Retail trade suffered partly from depressed demand and partly from the many constraints on trade and movement of goods—all raising transaction costs. Business services rank near average by most measures; their strongest performance indicator is employment growth.

Box A1 Correlation of performance indicators and overall grades

Six of the pre-chosen performance indicators—profitability, growth in profits, growth in sales volume, employment growth since start-up or privatization, new equipment share, and expansion plans—were significantly correlated among themselves and also strongly correlated with the two overall grades. The mean and median values for the composite grade were virtually the same as for the original grade, and both grades were positively correlated with most of the six pre-chosen performance indicators. These results lend credibility to the evaluation process in that they reinforce each other. The correlation matrix shows, on a scale from 0 to 1, the strength of association between the column and row variables:

Correlation matrix of performance indicators and overall grades

	Current profits	Growth of profits	Growth of sales	Growth in employment	New equipment	Expansion plans	Original grade	Composite grade
Current profits	1.00							
Growth of profits	0.28 *	1.00						
Growth of sales	0.20	0.54 **	1.00					
Growth in employment	0.44 *	0.24	0.30 *	1.00				
New equipment	0.30 *	0.05	0.16	0.18	1.00			
Expansion plans	0.30 *	0.06	0.16	0.15	0.32 *	1.00		
Original grade	0.59 *	0.30 **	0.37 *	0.44 *	0.45 *	0.28 *	1.00	
Composite grade	0.62 *	0.69 **	0.71 *	0.55 *	0.58 *	0.34 **	0.74 **	1.00

** significant at 1% level
* significant at 5% level

The existence of concrete expansion plans was highly correlated with the original overall grade and with current profitability, but not with the main dynamic performance indicators like change in profits, sales, and employment. Perhaps the fastest growing firms had reached a consolidation stage.

The two performance indicators not positively correlated with the other indicators, and not used to form the composite grade, are capacity utilization and recent employment growth. One hypothesis is that these indicators reflect the accelerated drop in Russia's GDP by some 20 percent in 1992. Limiting the creation of new jobs during such a slowdown in general demand would have been prudent for otherwise successful and well managed firms. The lack of correlation would reflect the outcome of a combination of expanding firms and more careful but still successful ones.

Box A2 Generation of full-time employment by survey firms

Full-time employment grew rapidly, demonstrating the well-known role of the private service sector in job creation. This can be explained in part by the firms' relatively modest needs for complementary capital equipment, but it is remarkable given their limited access to bank finance for working capital and investment capital. The Box Table shows the generation of regular full-time employment by the survey firms.

The total number of workers in the firms surveyed increased by 36 percent since start-up or privatization and by nearly 10 percent during the second half of 1992. Two-thirds of the firms expanded employment since start up, and a quarter maintained their initial employment level. Fewer than 10 percent reduced their labor force since they became private. Over the second half of 1992, half the firms expanded their employment. Another 40 percent experienced no change in employment, and less than 15 percent reduced their labor force.

Employment in some firms grew very fast. In slightly less than half, employment growth since start-up or privatization was more than 100 percent and more than 1000 percent for five firms. Looking at the three main activity groups, employment in consumer services expanded the least and employment in business services expanded the most, with employment in trade also growing above average. This pattern continued over the last half of 1992, except that employment in consumer services actually declined. The most rapid employment growth was in firms with 40 to 99 employees and in firms that were independent since start-up.

Generation of full-time employment by survey firms

	Since start-up or privatized		In previous six months	
Category	Number of firms	Percent of growth	Number of firms	Percent of growth
Main activity				
Trade	*18*	75	*14*	10
Business services	*16*	291	*18*	11
Consumer services	*9*	37	*9*	-4
Health and education	*5*	113	*3*	34
Transportation	*2*	-11	*1*	0
Finance	*2*	1,691	*2*	103
Total	*52*	36	*47*	10
Number of full-time workers				
Fewer than 8	*13*	43	*12*	10
8 to 39	*26*	12	*24*	-9
40 to 99	*7*	120	*7*	21
100 or more	*6*	33	*4*	13
Total	*52*	36	*47*	10
Firm history				
New start-ups	*35*	239	*32*	28
Completely privatized	*12*	41	*11*	9
Privatized with residual state ownership	*5*	-2	*4*	2
Total	*52*	36	*47*	10

Note: Average percentage growth is weighted by the number of workers in each firm at the beginning of the period.

Table A1: Ranking of firms' performance by main activity (1 = lowest, 4 = highest)

	Performance indicators							
Main activity	Current profits	Growth of profits	Growth of sales	Change in employment since start-up/ privatized	New equipment	Expansion plans	Original grade	Composite grade
Trade	3.3	3.2	3.4	2.9	3.0	2.9	3.0	3.1
Number of firms	*32*	*30*	*29*	*18*	*21*	*27*	*32*	*32*
Business services	3.1	2.7	3.1	3.4	2.6	2.8	3.0	3.0
Number of firms	*27*	*27*	*27*	*16*	*21*	*25*	*27*	*27*
Consumer services	2.7 *	2.1 **	2.6	2.7	2.7	2.8	2.8	2.6 *
Number of firms	*13*	*12*	*13*	*9*	*12*	*13*	*13*	*13*
Health and education	2.9	2.8	2.7	3.6	3.3	2.8	2.7	3.0
Number of firms	*7*	*5*	*7*	*5*	*6*	*6*	*7*	*7*
Transportation	3.5 *	2.9	2.5	1.5 **	2.0	3.0	3.0	2.7 *
Number of firms	*4*	*4*	*4*	*2*	*4*	*3*	*4*	*4*
Finance	4.0	4.0	4.0	4.0	4.0	3.0	4.0	3.8
Number of firms	*3*	*3*	*3*	*2*	*3*	*3*	*3*	*3*
Total	3.1	2.9	3.1	3.1	2.8	2.9	3.0	3.0
Number of firms	*86*	*81*	*83*	*52*	*65*	*77*	*86*	*86*

** significant at 1% level
* significant at 5% level

Note: In regression analysis, the following statistically significant relations were found:
(i) using trade as the "norm", performance indicators marked above were found to be significantly lower for firms providing consumer services.
(ii) using business services as the "norm," performance indicators marked above were found to be significantly higher for firms engaged in finance and transportation.

Survey firms may also be considered reasonably successful by international standards, measured against the high rate of failure worldwide among new small businesses. Only a quarter of the survey firms were evaluated as weak performers, a pre-condition for bankruptcy. Since the survey records only one point in time, no direct bankruptcy comparison can be made.

The relatively good performance of the firms surveyed as measured by profitability, volume growth, and expansion plans was in contrast to the economy at large and the failing state sector. Overall GNP in Russia declined by almost 20 percent during 1992. As a result, growth in services was affected by weak demand as well as the unstable macroeconomic environment. Con-

sumer services clearly suffered from low demand, and business services experienced some slackness in conventional demand, partially compensated by demand for new services in support of systemic and structural changes. Firms that provided such new services in support of economic reform had a higher original overall grade and higher profits than other business services. They faced higher demand and were able to raise their prices; they also enjoyed higher wages and labor productivity.

Internal and external factors affecting performance

A variety of internal and external factors are associated with performance. First, new start-ups outperformed privatized firms. Second, firms whose customers were other private companies ranked high on performance indicators, while those selling to households ranked low. And third, the ability to obtain bank credit correlated with success; lack of credit was a major complaint of successful firms. It therefore appears that business services and credit facilities for small business could foster more rapid growth.

The entrepreneur and performance

Does the entrepreneur make a difference? Two characteristics that showed significant correlation with the firms' overall grades and profitability were the number of other firms owned by the entrepreneur and the entrepreneur's level of education. Both variables are associated with entrepreneurship and general knowledge, rather than with prior managerial experience or specific skills. There was no correlation between performance and age, [illegible], or previous work place, but an association exists between performance levels and the three types of entrepreneur (table A2).

Firms run by academics or technical specialists received the highest grades and performed better by most criteria. This was true despite the fact that firms run by former state managers were more concentrated in trade, a more profitable activity. This finding suggests that in services the "insider" status, defined by previous managerial rank and continuing connections to the state system, is not particularly important. Continuity in the entrepreneur's previous activity was correlated negatively with performance. One possible explanation is that such continuity reflects greater conservatism, and hence less adaptability. Another is that where the new market environment requires a radical departure from previous practices, previous experience does not contribute significantly.

Firm characteristics and performance

Large firms tended to do better than small firms according to a number of performance indicators, when measured by revenues but not number of employees. This could be because higher employment was associated with lower productivity, or it could be that successful firms were understating their employee numbers for tax purposes. In general, privatized firms received lower ratings than new start-ups on both performance indicators and overall grades. In particular, privatized firms ranked lower on employment growth, growth of sales, and growth of profits.

Within the group of privatized firms, those with residual state ownership ranked higher on both the original overall grade and the composite grade, with somewhat higher performance indicators for growth in employment, sales, and profits. Leaseholds ranked lower on employment and sales growth but higher on current profits, suggesting that they were shedding surplus labor. Among new start-ups, those unconnected to a state enterprise ranked significantly higher on growth in employment, sales, and profits. The age of firms, their history, the ownership share of the entrepreneur, and the share of professionals in the labor force were all uncorrelated with the performance indicators.

The firm's level of satisfaction with its employees was negatively correlated with the original overall grade, the composite grade, and several other performance indicators. One hypothesis is that an entrepreneur's ability to recognize labor problems, and hence his dissatisfaction, was a sign of professionalism. In a number of successful firms, including a private hospital and an investment firm, the owners were concerned with worker performance and instituted very strict hiring policies.

Table A2: Ranking of firms' performance by owner's past job (1 = lowest, 4 = highest)

	Performance indicators							
Owner's past job	Current profits	Growth of profits	Growth of sales	Growth in employment since start-up/ privatized	New equipment	Expansion plans	Original grade	Composite grade
General or technical manager	3.1	2.8	2.9	2.8	2.9	2.9	3.0	2.9
Number of firms	*41*	*38*	*40*	*24*	*32*	*38*	*41*	*41*
Academic or technical specialist	3.3	3.0	3.4	3.5	2.8	2.9	3.1	3.1
Number of firms	*34*	*32*	*33*	*20*	*25*	*30*	*34*	*34*
White or blue collar worker	2.9	2.8	2.8	3.1	2.3	2.8	2.8	2.7
Number of firms	*11*	*11*	*10*	*8*	*12*	*9*	*11*	*11*
Total	3.1	2.9	3.1	3.1	2.8	2.9	3.0	3.0
Number of firms	*86*	*81*	*83*	*52*	*65*	*77*	*86*	*86*

Note: In regression analysis, growth in employment was found to be significantly higher (at the 2% level) for firms with former general or technical managers as owners, using white or blue collar workers as the "norm."

Prices and wages and performance

Relatively higher growth rates of nominal prices and wages were correlated with high profits but not a rise in profits. Large increases in real wages, using the producer price as deflator, did not correlate with profits and were negatively correlated with the original overall grade. This seems to suggest that firms able to raise prices were typically profitable unless they raised wages even more. If their real producer wage increased a lot, profitability declined.

Outside constraints and performance

Only a few characteristics of the firms' business environment revealed some systematic correlation with their performance, one of which was output markets (table A3). Firms selling to other firms in the private sector performed better than those selling to the state; firms selling to households performed worst of all. This pattern holds true with respect to the overall grades, profitability, growth of profits and growth of sales. Firms selling mainly to households were typically those that had been privatized; had a low share of professional workers; had low employment growth; and were run by former managers in state enterprises who were engaged in the same activity, had less education, owned no other companies, and were female. Retail trade outlets and wholesale firms selling largely to private companies were among this group.

Table A3: Ranking of firms' performance by main customer (1 = lowest, 4 = highest)

	Performance indicators							
Main customer	Current Profits	Growth of profits	Growth of sales	Growth in employment since start-up/ privatized	New equipment	Expansion plans	Original grade	Composite grade
State Sector	3.1	2.8	2.5 *	3.3	2.9	2.9	3.1 *	2.9 **
Number of firms	*18*	*17*	*18*	*11*	*15*	*16*	*18*	*18*
Private Firms	3.4 **	3.3 *	3.5 **	3.4 *	3.0	3.0	3.3 **	3.3 **
Number of firms	*20*	*20*	*20*	*13*	*13*	*19*	*20*	*20*
Households	2.7 **	2.4 *	2.4 **	2.5 *	2.4	2.8	2.6 **	2.6 **
Number of firms	*23*	*21*	*22*	*15*	*18*	*22*	*23*	*23*
Total	3.1	2.8	2.9	3.0	2.7	2.6	3.0	2.9
Number of firms	*61*	*58*	*60*	*39*	*46*	*57*	*61*	*61*

** significant at 1% level
* significant at 5% level

Note: In regression analysis, the following statistically significant relations were found:
(i) using sales to households as the "norm," performance indicators marked above were found to be significantly higher for firms selling to other private firms.
(ii) using sales to private firms as the "norm," performance indicators marked above were found to be significantly lower for firms selling to households.
(iii) using sales to private firms as the "norm," performance indicators marked abve were found to be significantly lower for firms selling to the state sector.

Selling to state enterprises was positively correlated with the original overall grade but with no other performance variables. Selling to state enterprises and to state organizations took place in less competitive markets, with high sales concentration, while selling to other private companies was in a much more competitive environment. Selling to the state was correlated only with owning old equipment, a high increase in output prices, and a high level of revenue per worker. Engaging in exports, having a foreign partner, or receiving any form of foreign aid correlated only sporadically with indicators of good performance. Exporting outside the Former Soviet Union was weakly correlated with growth of profits, and having external connections was correlated with current profits and with growth of labor.

The use of bank credits was positively correlated with both overall grades and positive trends in profits and revenues. One would like to think that the causality runs from the quality of the firm and the soundness of its expansion plans to its ability

to receive credit. Since receiving credits was correlated in the survey with the use of bribes and with previously working in the state sector, however, "informal transactions" or informal connections may also play a role. Alternatively, given the frequent complaints about "too high interest rates," obtaining credits at highly negative interest rates may reflect the cleverness of the owner who perceives a substantial interest rate subsidy. Finally, trade firms are able to obtain credit because they can use traded goods as collateral; this special factor may allow them to be more successful.

Constraints and performance

Entrepreneurs were questioned about the most important constraints they face in the business environment. The more successful firms, as indicated by the two overall grades and profits, complained most often about the unstable and uncertain macroeconomic and legal environment. Credit problems were the second most frequently mentioned constraint of more successful firms, especially the lack of medium and long term credits. For companies with concrete expansion plans, the lack of financing was the biggest constraint for over half. Other constraints, in declining order of frequency, were lack of demand, getting good workers, and obtaining satisfactory space.

Because successful firms were relatively liquid, they complained much less about high taxes—the main constraint mentioned by less successful firms. The importance of taxes to the weak firms may be explained by their severe shortage of funds, a shortage that could be eased by lower taxes but not by credit, since they were basically ineligible.

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Postscript

In November 1993, a follow-up telephone survey was conducted to determine what changes had occurred during the intervening 10 months. All of the firms in the original January 1993 survey were located, and 82 of the original 86 firms were interviewed. Despite continuing economic and political upheavals, none of the firms had gone out of business.

Preliminary analysis of the data from the follow-up survey indicates that most firms experienced real growth in output, although demand remained a problem—especially for firms providing personal services. Net growth in employment continued, although many firms had started to hire under long–term contract as a more flexible option to permanent employment.

The role of private firms in real estate, equipment, and input markets for goods and services seemed to be increasing, and most firms felt that competition was increasing in their output markets. Imports have become more readily available, with both positive and negative consequences.

Most entrepreneurs believed that the tax burden has increased. Many new taxes have been imposed, and tax inspection has strengthened, making it more difficult to avoid taxes.

As in the original January 1993 survey, few firms had obtained commercial bank loans. Some firms experienced no need for credit, but many firms were looking for lower interest rates and longer-term credits. There appeared to be some demand for hard currency loans at slightly above European market rates. Changes in the quality of banking services varied by bank.

Public transportation has deteriorated, and firms have received insufficient heat. Commercial dispute resolution was still ineffective, and the Mafia was expanding. Firms were still not receiving foreign technical assistance from official sources.

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