UCL SCHOOL OF SLAVONIC AND EAST EUROPEAN STUDIES
CSESCE

CENTRE FOR THE STUDY OF ECONOMIC & SOCIAL CHANGE IN EUROPE (CSESCE)

RUSSIA: FIRM ENTRY AND SURVIVAL

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Economics Working Paper No. 67

August 2006

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Russia:
Firm entry and survival barriers

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1. Introduction

Since the collapse of the Soviet Union in 1991, the Russian Federation has struggled with the complexities of a 'triple transition': democratisation, marketisation and state building (Gelman 2004:2). The economic and political transformation of the Russian Federation into an independent nation has had mixed results. On the one hand, a rapid modernisation has taken place in the larger urban areas providing citizens with lifestyle possibilities similar to those found in advanced western countries. On the other hand, income inequality has dramatically increased providing evidence that the new economic benefits are not spread equally. This leads to striking economic disparities amongst individuals as well as between different regions.

As the world's largest country rich in natural resources, the Russian Federation wields a considerable amount of influence in the global community. Currently, in an environment of record high oil prices, Russia needs to do little else than extract its wealth from the ground in order to meet its budgetary needs. Though this can be seen as a blessing, it may actually act as a curse in disguise, resulting in the neglect of developing other economically important areas such as domestic small and medium enterprises. Quite strikingly, the recent increase in Russia's economic growth through oil exports has had little effect on increasing the number of domestic small and medium enterprises (SMEs)[1].

[1] As Kontorovich notes: '*… the Russian economy underwent a meltdown in 1998, followed by 4 years of healthy growth. Meanwhile, stagnation in the number of registered small firms has continued… apparently barriers to new business formation are so high that even rapid growth in 1999 – 2002 was not enough to spur this process*' (2006a:3).

The development of new firms is crucial for Russia in order to further advance the values and norms of a free-market economy in the post-Soviet landscape[2]. This chapter analyses the barriers to business entry and development in the Russian context. It highlights many of the numerous entry barriers as well as survival barriers in an environment characterised by a high level of uncertainty created by the lack of rule of law. In Russia, enforcement of laws occurs on a selective or arbitrary manner and there is no consistency or stability for firms to count on from the regulatory environment. The business climate is especially hostile due to the predatory nature of many regulatory authorities and inspectors. This situation is currently perpetuated through state capture (especially at the regional levels) but the existence of this mentality derives in part due to path dependence stemming from the Russian historical context. Russians have become accustomed to a corrupt and malfunctioning legal environment[3]. Even during the Soviet period, the prevailing mentality was one of how to get around the laws or enforce them for personal gain rather than a respect and understanding of the law as something that protects the rights of citizens and (private) businesses.

The current problems with tax evasion provide an illustration of this mentality. President Vladimir Putin has decreased the tax rate for small enterprises to a 15 percent flat tax on profits (which is lower than in many western and other transition countries) yet business owners complain about it and tax evasion is rampant. On the one hand business owners claim they receive nothing in return for their tax payments (such as business support or infrastructure) and this is certainly a valid argument. On the other hand, tax evasion is quite simple to carry out while corrupt practices are tolerated and more often than not accepted as the norm.

There have been some high profile cases of government crackdowns on tax evasion such as with Mikhail Khodorkovsky, the founder of Yukos but once again these cases seem to occur at random and motives other than 'tax evasion' seem more important (such as

[2] In addition, new firms have proven instrumental in post-Communist economic recoveries of transition countries (McMillan and Woodruff 2002).

[3] As Gelman notes: *'In the late Soviet period, informal ties penetrated all levels of government and served as a survival kit in the everyday life of Soviet citizens, Such ties defended ordinary people from the arbitrary state, but they also contributed to a vicious circle of cynicism, clientelism and corruption*' (2004:4).

political involvement). Once again, this type of governmental behaviour only reinforces the view that the government does whatever it wants whenever it wants increasing the uncertainty and lawlessness of the business environment[4]. In addition, given the strength of regional authorities in Russia, regional governmental agencies can play a critical role not only for business start-ups but more critically for further business development and growth.

The very criminal nature of business operations for even legally registered businesses acts as another barrier to business development. It is very difficult, if not impossible to engage in legal business practices without also engaging in illegal business practices such as bribing and corruption. Obviously if the business owner is not willing to engage in these practices or does not hire a staff member willing to engage in these practices, than they will encounter difficulties in starting and growing a business in the Russian context.

In this chapter, our aim is twofold: Firstly, to highlight the main barriers to business development (entry and survival barriers) in Russia and secondly, to focus on two specific sectors contrasting an old industry, the textile industry with a new industry, the information technology (IT) industry in order to provide some sector specific characteristics. Furthermore, in order to place Russia in a comparative perspective with regards to other emerging economies, we include the results of a number of large studies conducted by international agencies such as the World Bank (WB) and the European Bank of Reconstruction and Development (EBRD) in addition to literature specific to Russia.

This chapter is divided into eight sections. Section 2 provides an overview of institutional barriers for business development in Russia using an international comparative perspective. Section 3 focuses on the specific barriers to entry in the Russian context. Barriers to firm survival are presented in section 4 and barriers to firm exit are presented in section 5. Section 6 focuses on the IT industry sector's development in Russia and the textile industry is highlighted in Section 7. This chapter concludes in section 8.

[4] As Kontorovich writes: *'...the sight of high-level officials attacking the oligarchs, as happened in July 2003 when the Russian general procurator arrested a key official in Mikhail Khorodovsky's empire, cannot but tempt the low level officials to do their part with smaller fish'* (2006a:25)

2. Overall Institutional Barriers to Entry and Exit in Russia

In order to understand Russia in a comparative perspective, this section discusses Russia's business environment as compared to advanced western economies as well as other emerging economies.

2.1 World Bank's Doing Business Data

The World Bank's Doing Business indicators offer quantitative indicators of the quality of business regulation in 145 countries[5] around the world. Specifically, the Doing Business indicators measure government regulations, their enforcement and their effect on businesses. Since 2004, five sets of business environment indicators are assessed in its annual report including starting a business, hiring and firing workers, enforcing contracts, getting credit, and closing a business. In 2005 two new indicators, registering property and protecting investors, were included.

The general findings of the 2005 Doing Business show that businesses in poor countries face larger regulatory burdens than those in rich countries. Poor countries impose higher costs on businesses to fire a worker, enforce contracts, or file for registration; they impose more delays in going through bankruptcy procedures, registering property, and starting a business.

According to their results, i.e. "on paper", a number of issues such as starting a business, hiring and firing workers, getting credit, enforcing contracts and closing the business are not ranked as 'high' barriers for businesses in Russia. As for registering property, it takes 37 days to register property in Russia, compared with the regional average of 133 days and OECD average of 34 days. However, the cost of enforcing contracts are high in Russia[6]. Below we examine three of these issues: "starting a business", "hiring and firing workers" and "closing business" more closely and also address the issue of informal

[5] These include all economies with populations over 1.5 million except for the International Development Association's inactive borrowers (Cuba, Korea, Democratic Republic of Korea, Liberia, Myanmar, Somalia, Sudan) or countries that are or recently have been in a military conflict or where data is unavailable (Afghanistan, Eritrea, Iraq, Libya, Tajikistan, Turkmenistan, West Bank Gaza).

[6] The cost of enforcing contracts is 20.3, compared with the regional average of 17.7 and OECD average of 10.8. These results are available at Doing Business database at http://rru.worldbank.org/DoingBusiness/.

barriers.

Starting a business: The World Bank regulatory barriers for starting a business are measured by a number of procedures and costs in terms of time and money that the firm must bear before it can start to operate legally. In Russia, entrepreneurs must deposit at least 5.6 percent of per capita GNI (gross national income) in a bank to obtain a business registration number, compared with the regional average[7] of 51.8 percent of per capita GNI and the OECD average of 44.1 percent of per capita GNI. In general, administrative barriers to entry have noticeably been decreasing in Russia. As the World Bank notes:

> *In the Russian Federation, a 2002 reform transferred all registration powers to the State Tax Inspectorate, thereby cutting the number of business entry procedures from 19 to 12. Thanks to a single registration form, separate notification to the local registration chamber, the pension fund, the health fund the statistical committee, and the social security fund, and application of making a seal are no longer necessary. Moreover, the registration of the new legal entity and tax registration are merged into one procedure (World Bank 2004:18).*

In addition, according to a study conducted by CEFIR[8] monitoring the administrative barriers to small business development in Russia, administrative barriers have decreased. Moreover for the majority of regions covered in their study, the fastest growth of the small business sector took place in 2002, the year when the most de-bureaucratisation laws took effect. These laws included those on inspections, licensing, and on registration, which came into force in August 2001, February 2002, and July 2002, respectively.

However, in spite of these improvements, administrative barriers still form formidable barriers for many businesses. Some intermediary companies have even been established specifically to cut through the red tape for businesses for a fee[9]. So though much political attention has recently been focused on reducing administrative barriers (such as by President Putin), much still needs to be done. As often is the case, the devil lies in the details and in the Russian case, the lack of implementation of administrative reforms

[7] These include obtaining all necessary licenses and permits and completing any required notifications, verifications or inscriptions with relevant authorities.
[8] CEFIR – Centre for Economic and Financial Research in Russia (http://www.cefir.org) CEFIR (Centre for Economic and Financial Research) 2005. 'Monitoring of Administrative Barriers to Small Business Development in Russia, Round 4'
[9] Approximately 300 – 400 USD. This additional cost may form a barrier for entry for the smallest firms.

remains a major barrier[10]. Further reducing the administrative barriers for registering a new firm would be a welcome improvement.

Labour regulations: According to World Bank indicators, the flexibility of firing index is the highest (and therefore the best) in Russia when compared to other middle income countries such as Brazil, India and China. These World Bank indicators show the regulatory difficulties that employers face in hiring and firing workers. The three measures included are (a) how difficult it is to hire a new worker, (b) how rigid the regulations are on working hours, and (c) how difficult it is to dismiss a redundant worker. The overall Rigidity of Employment Index is an average of these three abovementioned indices. For the Russian Federation, the overall index is 27, compared with the regional average of 41.8 and OECD average of 34.4. Firing costs are calculated on the basis of the number of weeks of severance pay and the notification and penalties that must be paid in order to dismiss a worker (World Bank 2005). However, in Russia, large enterprises located in one-company-towns may have difficulties in firing workers since this would undermine their relationship with regional authorities. It is important to note that in Russia good relations with regional authorities must be maintained if an enterprise is to function without selective interference from these authorities.

As summarised in table 1 below, if we compare Russia using the World Bank's Doing Business indicators to other middle income emerging economies, Russia's situation looks quite favourable. However, as is often the case in transition countries, these numbers do not tell the 'whole story'. As will be demonstrated later in this chapter, these indicators fail to capture some of the most essential necessities for smooth business operations, namely the rule of law.

Table 1: Summary of the World Bank's Doing Business Indicators, 2003

[10] For example, the widespread violation of recent laws by local government agencies (Kontorovich 2006a: 25).

		World	Brazil	China	India	**Russia**
Starting a business	Number of procedures	10	15	11	10	**12**
	Duration (days)	60	152	46	88	**29**
	Cost (% GNI per capita)	49	11.6	14.3	49.8	**9.3**
	Min. capital (% of GNI per capita)	214.6	0	3,855.90	430.4	**29.8**
Hiring and Firing Workers	Flexibility of Hiring Index	51	789	17	33	**33**
	Conditions of Employment Index	75	89	67	75	**77**
	Flexibility of Firing Index	40	68	57	45	**71**
	Employment Laws Index	55	78	47	51	**61**
Getting Credit	Public Credit Registry (PCR)	-	Yes	Yes	No	**No**
	Year PCR Established	-	1997	1999	-	**-**
	PCR Coverage (per 1000 capita)	40.5	44	3	0	**0**
	PCR Index	27	50	56	0	**0**
	Private Credit Bureau (PCB)	-	Yes	No	No	**No**
	PCB Coverage (per 1000 capita)	238.4	439	0	0	**0**
	Creditor Rights Index	1	1	2	3	**2**
Enforcing Contracts	Number of procedures	27	16	20	22	**16**
	Duration (days)	323	380	180	365	**160**
	Cost (% GNI per capita)	43.5	2.4	32	95	**20.2**
	Procedural Complexity Index	60.6	47.9	52.1	49.7	**47.9**
Bankruptcy	Actual time (in years)	3.5	10	2.6	11.3	**1.5**
	Actual Cost (% of estate)	15	8	18	8	**4**
	Absolute Priority Preserved	65	33	100	33	**67**
	Efficient Outcome Achieved	0	0	0	0	**0**
	Goals-of-Insolvency Index	48	24	51	21	**58**
Courts-Powers Index	Courts-Powers Index	60	67	67	33	**67**

Source: World Bank (2005) http://rru.worldbank.org/DoingBusiness/

2.2 Business Environment, Corruption and Governance

In order to explore the differences in business environments in transition countries, the Business Environment and Enterprise Performance Survey (BEEPS) was implemented jointly by EBRD and the WB in 1999 and 2002. The first round of the survey in 1999 covered 4,104 firms in 25 transition countries[11]. The second round of the survey conducted in 2002, covered 6,153 firms in 26 transition countries. The BEEPS survey is multi-dimensional and covers key aspects of governance provided by the state such as business regulation and taxation, law and order and the judiciary, as well as infrastructure and financial services. The survey also investigates issues such as corruption, both in terms of administrative corruption and state capture.[12]

The general findings of the BEEPS survey show that in virtually all transition economies the business environment has improved significantly between 1999 and 2002. Another important outcome regards the nature of corruption and its effects. Corruption related to tax administration which tends to be centralized, is found to be less costly than corruption in business regulation, which is decentralised. The results indicate that real revenue growth rates of firms that engage in state capture increases but acts as a block to the growth performance of other firms.

Table 2: Qualitative assessment of the business environment for Russia

Scale from 1 (best case) to 4 (worst case)

	Finance	Infrastructure	Taxation	Regulation	Judiciary	Crime	Corruption	Average
1999	3.32	2.10	3.47	2.29	2.38	2.70	2.83	2.73
2002	2.26	1.43	2.64	1.77	1.88	1.80	1.99	1.97

Source: Fries, et al. (2003)

As table 2 shows, the results for Russia indicate that the business environment has improved in all seven areas assessed from 1999 to 2002. However a closer look reveals that though the average bribe tax as a percentage of annual firm revenues has decreased (from 1.7 percent in 1999 to 1.4 percent in 2002), the percentage of firms that responded that they give bribes “frequently” has actually increased (from 30.6 percent in 1999 to

[11] The 25 countries included in the 1999 survey are Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech R., Estonia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kyrgyz R., Latvia, Lithuania, Moldova, Poland, Romania, Russia, Serbia and Montenegro, Slovak R., Slovenia, Ukraine, and Uzbekistan. Tajikistan was added to the 2002 survey.

[12] Wherein firms seek to influence the content and application of specific laws and regulations to their benefit, in many cases leading to negative consequences for the broader public interest.

38.7 percent in 2002) (EBRD 2002:28).

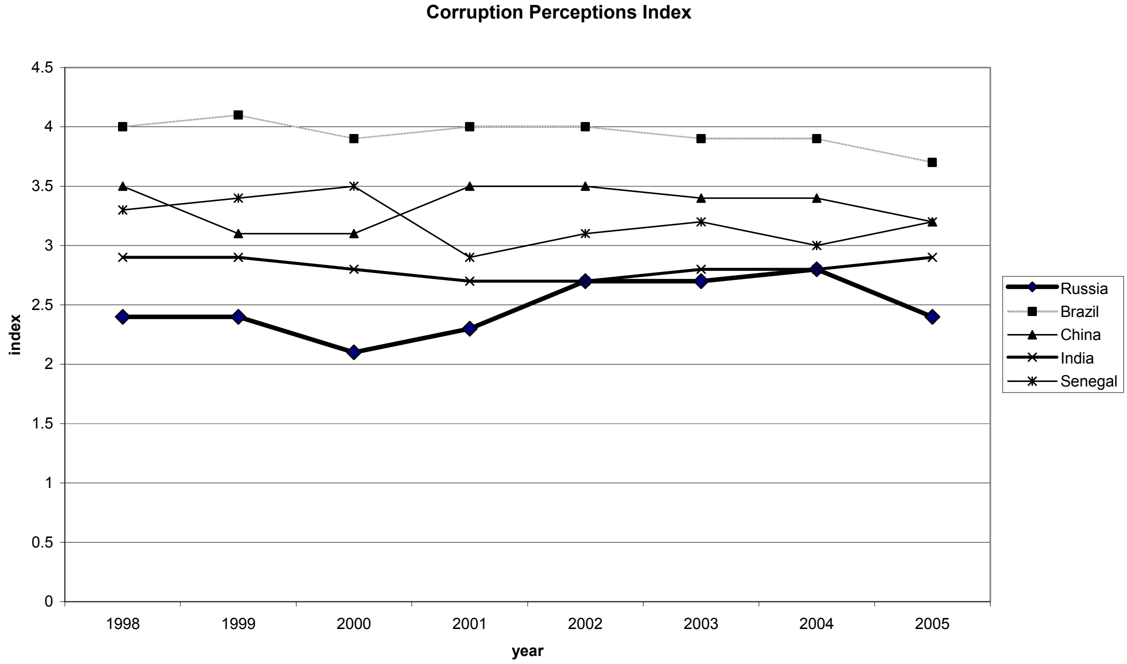
Of even greater concern is the fact that corruption seems to be on the increase in Russia. The 2005 BEEPS survey indicates that in 2005 more than 39 percent of the respondents in Russia agreed that they have to pay some irregular payments or gifts for activities related to customs, taxes, licenses, regulations and services frequently. As the average percentage of corruption is decreasing for transition countries as a whole (and in 2005 was under 21 percent), it is significant that Russia's level of corruption is rising (EBRD 2005).

2.3 Corruption Perceptions Index

Transparency International has been compiling the Corruption Perceptions Index (CPI) to compare levels of perceived corruption in different country contexts since 1995. The CPI ranks countries in terms of the degree to which corruption is perceived to exist among public officials and politicians. It is a composite index, drawing on corruption-related data in expert surveys carried out by a variety of reputable institutions. It reflects the views of businesspeople and analysts from around the world, including experts who are locals in the countries evaluated.

When compared to other transition countries, Russia's level of corruption is perceived as quite high with regards to the other 22 transition countries surveyed (see appendix 1b). As figure 1 further shows, though Russia's overall level of perceived corruption has improved, it is much higher than most other middle income emerging economies. Converging with the level of corruption in India in 2002 and 2004 only to deteriorate slightly in 2003 and to a much greater extent in 2005.

Figure 1: Corruption Perceptions Index in Middle-income emerging economies



Key: > 5 very little corruption; > 3 corrupt; < 3 very corrupt.
Source: Transparency International (1998 – 2005)

Based on numerous studies compiled by the World Bank, some improvement has taken place according to six key indicators of governance in Russia, however, in all cases, the final percentile rank remains low (Kauffman, et al. 2005). As show in table 3, indicators measuring voice and accountability, political stability and regulatory quality have all deteriorated since 1998 while the percentile rank for government effectiveness, rule of law and control of corruption have improved though there rank still remains strikingly low.

Table 3: Governance Indicators for Russia in 1998 and 2004 compared

Governance Indicator	Year	Percentile Rank (0 – 100)
Voice and Accountability	2004	25.7
	1998	41.4
Political Stability	2004	21.8
	1998	23.6
Government Effectiveness	2004	48.1
	1998	23.5
Regulatory Quality	2004	30.5
	1998	31.5
Rule of Law	2004	29.5
	1998	22.7
Control of Corruption	2004	29.1
	1998	25.7

Source: Kauffman et al. (2005) http://info.worldbank.org/governance/kkzz2004/sc_chart.asp

Key: Voice and Accountability measure political, civil and human rights; Political Stability measures the likelihood of violent treats to, or changes in, government including terrorism; Government Effectiveness measures the competence of the bureaucracy and the quality of public service delivery; Regulatory Quality measures the incidence of market-unfriendly policies; Rule of Law measures the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence; Control of Corruption measures the exercise of public power for private gain, including both petty and grand corruption and state capture.

With the weak role of the transitional state and the legacy of black market activities characterising the centrally planned economies, it is not surprising that a large informal sector would emerge during the transition process. Though notoriously difficult to measure, estimates of the size of the shadow economy in the transition countries indicate that this sector is larger than the OECD average (which was 18 percent of GNP in 2002) (Schneider 2002). The average size of the shadow economy in transition countries is approximately 38 percent. The shadow economy is largest in the Commonwealth of Independent State (CIS) countries ranging from over 67 percent in Georgia and over 52 percent in the Ukraine to just over 46 percent in Russia. The percentages are much less in the Central and Eastern European and Baltic countries (CEEB) countries ranging from just over 30 percent for Lithuania to almost 19 percent in the Slovak republic, with most CEEB countries having a shadow economy which is between 20 – 30 percent of their GNP (ibid.). As the transition economies advance in enforcement of the ‘rule of law’ and the elimination of market distortions, it can be expected that the size of the informal economy will shrink. However, in ‘delayed’ transition countries such as Belarus and Ukraine, the informal economy will probably continue to form a substantial amount of the non-registered entrepreneurial activity. As a result, distorting the official data on SME activity. Another related problem being the hiding of output and tax evasion[13].

In the Russian Federation, it is assumed that most businesses today are legally registered (except for petty traders and open air market traders), though large portions of their operations occur informally in order to evade paying taxes (Kontorovich 1999).

However, there are a number of compelling reasons why the total number of firms may be statistically overestimated. Firstly, many firms may want to take advantage of the

[13] Moreover, hiding business output has been found to be significantly associated with high bureaucratic corruption in Poland, Slovakia and Romania (Johnson et al. 2000).

lower tax rate for smaller firms so as a result, they may register as multiple new businesses in order to remain under the size threshold. Therefore officially they may be registered as two or more separate businesses but are actually managed as one business. Similarly, larger enterprises will register new small shell businesses which they use to disperse profits and avoid paying taxes. Furthermore, most new enterprises are started by old entrepreneurs (i.e. existing business owners) and not new entrepreneurs (i.e. new start-ups) (Aidis and Estrin 2006). This phenomenon in itself indicates the existence of barriers to new 'owner' firm entry. Finally, the statistics on small enterprises may be overestimated since many dormant firms remain listed as there are no incentives for them to de-register[14].

The Russian Federal State Statistical Office[15] figures may miss additional 'entrepreneurs' since they also show enterprises registered as 'small enterprises' and not the self-employed or license holders. License holders form a considerable group of enterprises who are not legally permitted to employ additional workers but in many cases employ workers illegally. The overall figure does include consultants and freelance researchers, though there are few people in Russia that fall into this category[16] .

3. Barriers to Entry

This section presents a further in depth discussion of some of the fundamental barriers to entry which are not included in international comparative studies yet form sizeable barriers for Russian business development. These include: lack of enforcement of formal institutions, regional factors, access to networks and lack of capital.

3.1 Lack of Enforcement of formal institutions

Arguably the greatest barrier to entry in Russia is uncertainty generated from weak law exacerbated by a situation in which legislation can be interpreted in multiple ways and laws can be applied selectively as authorities see fit[17]. Moreover, the judicial system lacks

[14] This has been documented in other transition countries (see Aidis 2006; Kontorovich 2006b)
[15] Formerly called "Goskomstat", now "Rosstat".
[16] Some large firm employees have taken advantage of this mechanism. For example a number of Yukos's top management were listed as 'consultants' and not employees so that they could receive large sums of money as consultancy fees that would be taxed at a lesser rate than if they were registered as Yukos employees.
[17] See also Kontorovich (2006a:25).

independence and property rights are not well protected. According to a study conducted by Radaev (2002) over 80 percent of Russian entrepreneurs have suffered from broken contracts. These are manifestations of the underlying problem of weak institutions results in the chronically weak rule of law in Russia. This sense of lawlessness affects domestic as well as international firms.[18] In a survey of 50 major foreign companies investing in Russia, half estimated their annual losses from intellectual property violations to be at least $ 1 million USD. With a third reporting $5 to $50 million USD in losses[19]

In addition, the uncertain stance of President Putin's regime towards business development further fuels the economic uncertainty for existing firms as well as new business entrants. In July 2001, the government began to implement its 'medium term programme of social and economic development for 2002 – 2004. This programme called for the government to reduce barriers to business growth and to create a favourable entrepreneurship and investment climate. However, since 2001, President Putin has not sent out a clear signal of support for business development[20]. Some of Putin's ministers such as the Economics' Minister German Gref seem committed to improving the business environment. However Putin's position remains unclear. As a result, under President Putin's current regime there are no assurances that the business environment will improve significantly in the future. Moreover, though President Putin is attempting to centralize his authority throughout the country, most regions are relatively autonomous in their application and enforcement of the law resulting in considerable regional variation.

In addition, many Soviet regulatory documents are still in force. As a consequence it is not always clear which regulations apply in a specific case, creating confusion for regulators and the regulated community alike (OECD 2005). In fact, 'No one really knows which laws and regulations are implemented and observed, although it is clear that many are not implemented at all, or only partially' (ibid.). It is not surprising that given the current situation, *'Russian entrepreneurs fear bureaucrats more than criminals'*[21]

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[18] For example, some time ago, a law had been passed restricting the employment of foreign nationals. This document lay dormant, until without any warning, this law was suddenly enforced in 2005. As a result, all foreign nationals not working for Russian companies technically became illegal workers in Russia.

[19] Quoted in Puffer and McCarthy (2001). Original source: Intellectual Property rights: a key to Russia's economic revival. Russia Business Watch 8(2) summer 2000, p. 32.

[20] Though he has publicly stated his support, his words have not been followed by actions.

[21] According to a survey of Russian small business owners carried out by OPORA in 2005 (OPORA 2005).

(Smolchenko 2005b). These factors combined form further barriers to entry as potential entrepreneurs evaluate the situation and decide the business environment is simply too hostile for an entry to occur .

3.2 Regional factors

The Russian Federation constitutes a vast empire that consists of 21 republics, 6 krais (territories), 49 oblasts (regions), 2 federal cities, 1 autonomous region, and 10 autonomous districts. In 2000, seven federal okrugs (districts) were established as super districts covering Russia's 89 regions and republics (see appendix 2 for a map). Many regions are governed first and foremost by the local authorities who wield extremely high levels of power[22]. In this way, the local government has the power to selectively enforce regulations and laws in an arbitrary fashion (Chazan 2004).

Three distinct characteristics of the Russian Federal system should be mentioned. First of all, each region negotiates its agreements with the central government independently, secondly, there is no agreed basis for collecting and distributing revenue. Federal taxes, which are levied on enterprises, are raised by the centre and collected by federal officials based in the regions. In practice, many of these federal officials become co-opted by the regional authorities to selectively collect taxes from enterprises. Thirdly, Russia has a regional support system policy which provides funds for poorer regions. Though beneficial in theory, in practice, many would argue that it has outlived its usefulness (Nicholson 1999:34). This system may actually be an incentive for regions to minimize their economic activity in order to qualify for increased federal aid.

There is great diversity amongst the regions in terms of business development. In some regions, the local authorities support the development of a competitive market economy and as a result new enterprises have been able to enter and grow. A survey by OPORA[23], a Russian NGO representing small and medium-sized enterprises, conducted in 2005, found that the top five regions friendliest to small business were: Yamal-Nenets

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[22] As Chebankova writes: '… *the initial gubernatorial appointments demonstrate that the Kremlin emphasised political stability and gubernatorial loyalty at the expense of effective governance. Of nearly 32 governors appointed between January and September 2005, only 9 were new'* (2005:946).

[23] OPORA, Russia's NGO representing small and medium-sized enterprises conducted a survey of 4,350 entrepreneurs in 80 of Russia's 89 regions in 2005 (OPORA 2005).

autonomous district, Bashkortostan, Stavropol, Tula and Smolensk (OPORA 2005, Smolchenko 2005b). Other less favourable regions are monopolistic and local authorities selectively support and protect certain business development (such as those owned by friends, relatives, etc. or established firms who pay the right bribes, have the right contacts etc.) to the detriment of developing a competitive business environment. An example of such a region is Oryol, located 384 kilometres from Moscow, which has been governed by Governor Yegor Stroyev for over 16 years. Critics claim that he has given relatives and close friends a free hand to run the economy and has crushed any opposition (Chazan 2004).

Another example of monopolistic local authorities is in the region of Kursk discussed by Kryshtanovskaya and White (2005: 304). The governor of Kursk Alexander Rutskoi made his elder son the general director of 'Kurskpharmacy' by handing him the control of the region's network of pharmacies. The governor's younger son became manager of the oil concern 'Kurskneftekhim' of which 49 percent was owned by a Moscow firm in which the son was the director. The governor's older brother became head of a state-joint stock company and his younger brother became deputy head of the regional department of public security. The governor's mother became the cofounder of a local firm and the governor's father in law took over responsibility for the regional cultural affairs. Such favouritism exhibited at the regional levels by local officials result in '*…companies which have relatives and friends with ties with the local administration (to) have an obvious privileged position …in respect of access to such important business resources as finance, licences, information, premises, etc….The remaining unlucky firms face only difficulties, pressure and absolute tyranny from bodies authorized to regulate the activity of firms'* (Barkhatova 2000:670).

On the far end of the spectrum is Yurii Goryachev, the Governor of Ulyanovsk Oblast, who has maintained non-private business oriented elements from the Soviet economy including low pay and taxation, high social spending, price controls and rationing (Nicholson 1999:26).

Though not suffering from this sort of anti-market activities by the local authorities, both

Moscow and St. Petersburg[24] rank as some of the most hostile environments for small business (Smolchenko 2005b).

Furthermore, favouritism of incumbent industries strengthens the general trend of the Russian economy toward industrial concentration. As consolidation of industry proceeds, entry barriers become higher due to the diminished opportunities to build market share exacerbated by the lack of a level playing field. According to estimates by World Bank experts, twenty three of the biggest Russian business groups with either sales exceeding $400 billion USD a year or with more than 19,000 employees were responsible for around 35 percent of industrial output sales and employed approximately 16.4 percent of industrial workers (World Bank 2004). As consolidation of industry proceeds, power and influence of incumbents is likely to increase (Guriev and Rachinsky 2004), which means that the barriers for new entrants increase due to diminishing opportunities to build market share.

Regional differences also influence the trust and subsequent increased use of courts to settle business-related disputes[25]. Business owners in the Far East and the Urals were found to be more trusting of the legal system while Moscovites were found to be the least trusting. However in spite of these differences, the vast majority (61 percent) of business owners surveyed by OPORA in 2005[26] would not go to court to solve a business dispute (OPORA 2005; Smolchenko 2005b).

In sum, in spite of Putin's efforts to recentralise authority, regional autonomy remains high and as such local authorities continue to exert an undo influence on local SME development[27].

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[24] As Kihlgren notes: '*In St. Petersburg, a clear commitment from the local administration to promote small business has been absent. It has so far done very little to support this sector, merely approving mandatory federal legislation and programmes for small business support which have, however, largely remained unimplemented'* (2001: 481).

[25] As OPORA notes: '*By no means do the courts always rule 'dishonestly'. It has long been common knowledge that in the absence of any 'external influences', the Russian courts scrupulously adhere to the letter of the law. ...when none of the parties has levers of influence on the court that are more powerful than the opponent's, its completely possible to count on a legal and well-founded decision from the court. However, full equality of the parties occurs very rarely*' (2005:15).

[26] OPORA, Russia's NGO representing small and medium-sized enterprises conducted a survey of 4,350 entrepreneurs in 80 of Russia's 89 regions in 2005 (OPORA 2005)

[27] See also Kihlgren (2001:459).

3.3 Informal Barriers: Networks and Corruption

In most advanced western countries, businesses focus on developing networks with suppliers and customers. In Russia, such a network is a necessary but not a sufficient condition for business development. It can be argued that networks between enterprises and officials are indispensable for business survival and growth. Friendly ties with government officials and bureaucrats are crucial in smoothing the way for businesses to operate in Russia. The lack of good connections and networks can be considered as an institutional barrier to entry[28].

Giving bribes is not enough to establish networks in Russia. It is important to be well-connected and have informal relationships with local authorities. Studies focusing on the effectiveness of networks in Russia indicate that the lack of broad networks (that include weak ties) have resulted in entrepreneurship development via networks based on strong ties (family and friends) which are most efficient for Russia's elite. (Hsu, 2005; Aidis & Estrin, 2006). New businesses without any such connections are in most cases destined to fail. Even foreign firms need these networks in order to operate successfully in Russia. They can obtain these connections by hiring a government relationship (GR) officer. Anecdotal evidence suggests that if the GR is well connected the business will flourish, if not, the business will encounter problems. In addition to use of their connections, the GR would also be involved in giving bribes[29].

As already indicated by the CPI's rankings, bribing and corruption is widespread in

[28] Based on interview material collected by Barkhatova (2000), a quote from the head of the oblast Fund for support of small businesses describes the selection of companies for investment in the following way: '*Informal contacts are more reliable, I have already checked it. When there are informal contacts it is easier to work. It is our Russian tradition to work with our own people'* (Barkhatova 2000:670).

[29] In this sense foreign firms may claim that they do not engage in any corrupt behaviour in Russia. Most likely in reality some of their Russian staff such as their GR officer is engaging on it in their behalf (based on anecdotal information).

Russia.[30] In fact in Russia, entrepreneurs have been found to be more corrupt than the population as a whole (Djankov et al. 2005). This creates a major barrier to entry for businesses that do not want to pay bribes since it is virtually impossible to function without paying bribes[31].

3.4 Factor supply constraints (Economic barriers): Lack of capital

Financial barriers constitute a barrier for both start-ups and business expansion worldwide however have special significance in the weak institutional environment which characterises the Russian context. Ten years ago it was possible to start up a business with very little capital and most Russian entrepreneurs could rely solely on their personal savings. However, the costs have increased mainly due to market competitiveness and the need to enter at a much higher level of sophistication. As a result, start-ups generally need at least a $10,000 – $20,000 USD investment which is beyond what most entrepreneurs have in their savings (estimated per capita GDP in Russia in 2004 was $9,800 USD[32]). As data collected from the Global Entrepreneurship Monitors study of business start-ups in Russia in 2001 indicates (shown in figure 2), most start-up businesses rely heavily on self financing or funds generated from family and relatives (Aidis and Estrin 2006).

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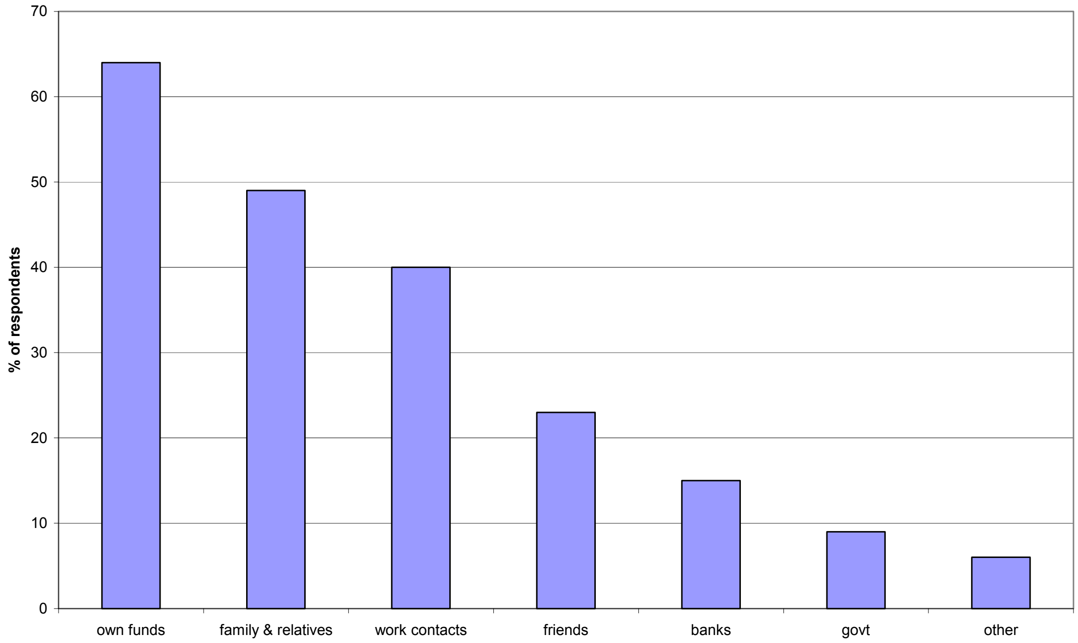
[30] See also Ledeneva (2003).

[31] For example, a major U.S company set up its operations in Russia and allegedly boasted that were not paying any bribes. Two months later they were shut down by customs officials (based on anecdotal information).

[32] According to the CIA World Factbook (http://www.cia.gov).

Figure 2: Sources of funding



Source: Aidis and Estrin (2006)
Note: percentages add up to more than 100 percent since respondents could choose more than one category.

External sources for start-up capital are virtually non-existent indicating the underdeveloped nature of the Russian banking system[33]. However, the increased presence of foreign banks may provide more opportunities for accessible bank loans in the future. Currently most bank loans available are only suitable for short-term loans and not for long-term investments. In addition, the interest rate remains high[34]. Similarly, growth capital is also very difficult to acquire since Russian banks are not interested in providing loans at reasonable interest rates. Other sources such as venture capital is virtually non existent and the stock market[35] is severely underdeveloped.

This combination of barriers results in a low overall level of business entry illustrated in tables 4 and 5. Table 4 uses data from the Amadeus dataset. The sample is largely

[33] According to a survey carried out by OPORA (A Russian NGO representing small and medium sized enterprises) only 15.9 percent of small businesses across Russia make use of bank loans (OPORA 2005; Smolchenko 2005).
[34] In the OPORA survey, among the reasons cited for failure to obtain a loan, more than 47 percent of business owners stated high interest rates as the main reason (OPORA 2005).
[35] It should be noted that majority of Russian firms are underreporting their earnings for tax evasion purposes and as such are not prepared to engage in the type of transparent financial accounting necessary to become a listed company. Also many businesses are wary of giving up any ownership (Based on anecdotal information).

restricted to firms with more than 50 employees, and therefore focuses on entry into the middle size firm category, rather than the creation of small firms. However, the dataset has the advantage that it contains the year of registration of firms, and hence provides a record of the formal entry rate into this size class. Table 5 provides information from the GEM dataset about different types of self-reported entrepreneurial activity.

Both samples tell a very similar story. According to Amadeus, entry rates in Russia during 1998 – 2002 were extremely low by international standards. The literature suggests that entry rates in Western Europe and North America are more typically in the 5-15 percent range, and for developing and some transition economies possibly somewhat higher. The Amadeus data suggest that entry rates in Russia are consistently amongst the lowest recorded internationally[36]. Though the GEM sample suggests that a slightly more normal proportion of individuals in Russia are interested in trying to create a firm (though the levels remain low by international standards), the number of people actually creating an active firm represents only 1.7 percent of the sample.

Table 4: Entry Rates of New Firms in Russia

Amadeus Dataset	**1998**	**1999**	**2000**	**2001**	2002
Entry rate % (new registrations as % firm numbers)	2.0	1.1	0.8	0.6	0.8
No. Of firms in sample	5226	972	8442	18,374	10,407

Source: Aidis and Estrin (2006)

[36] Kontorovich refers to this situation as: *'The anemic state of entrepreneurship'* and argues that it is *' a potential constraint on the country's long-term growth prospects'* (Kontorovich 2006b:1).

Table 5: Global Entrepreneurship Monitor measure of entrepreneurial activity in Russia 2001

GEM Dataset: Alternative measures of Entrepreneurship

	2001 (% sample)
Start-up - respondents trying to start new business	6.4
Start-up - active in past year	5.2
Nascent firm – active in starting business but not yet paying wages	3.0
New firm – owner/manager of new firm paying wages	1.7

Source: Aidis and Estrin (2006)

It should be noted that in spite of the considerable barriers to firm development in Russia, foreign firms continue to increase their presence on the Russian market. This is due to the fact that though Russia's consumer demand at present is small (similar in size to that of Spain) it is expected to increase exponentially. As evidenced by the growing automotive industry where domestic demand is expected to rise from 2 million to 2.5 million in 2006, up from 1.76 million in 2004 (Smolchenko 2005a).

As a result, foreign multinationals such as Toyota are increasing their presence in Russia in order to capitalize on this expected growth. Also as GDP growth increases indicating the possibilities for higher revenues, the same level of risk becomes more attractive since it can result in higher profits. Similar trends are taking place in the retail sector with many new foreign multinational entrants such as IKEA, Metro and Carrefour.

The need for multinationals to seek new consumer markets means that even if the general business climate in Russia does not improve substantially, foreign firms will continue to enter the market due to their need to increase shareholder dividends and the desire to get a foothold in a market that is expected to experience exponential growth in the coming decade.

4. Survival Barriers

As the previous sections illustrate, there exist numerous formidable entry barriers hampering business start-ups in Russia. However, as was indicated in the introduction and further argued below, additional business barriers in Russia are related with business survival. In this section we specifically discuss some barriers to business survival in Russia such as the regulatory environment (taxes and inspection agencies), labour regulations, lack of labour resources and industry concentration.

4.1 The regulatory environment: Taxes and inspection agencies

Once again these issues do not constitute a direct barrier to firm entry but an indirect one since small firms in general are required to pay quite low levels of taxes. However, it could be argued that the negative business climate characterised by the predatory tax behaviour of authorities may dissuade potential entrepreneurs from entering in the first place. In this regard, there are regional effects. Of the eighty regions covered in a survey of small and medium-sized enterprises in Russia conducted by OPORA in 2005, businesses in Moscow were hardest hit by tax and sanitary inspections. It was found that business owners in Moscow spent approximately 11.5 percent of their monthly earnings on kickbacks. In comparison, the national figure was 8.9 percent (Smolchenko 2005b). The exceptionally hostile environment in Moscow has resulted in firms choosing to register and pay taxes in other less hostile regions though their de facto operations take place in Moscow.

One of the most concerning developments in this area has been the implementation of the 'Back tax bill' which allows tax inspectors a free hand to collect back taxes from any existing business for up to a 10 year period. It has been implemented in the high profile case of Yukos and has also targeted other large enterprises such as Sibneft and TNK-BP. As a result, it has sent jitters throughout the domestic and international business community highlighting the predatory nature of tax authorities and a firm's vulnerability to random applications of tax regulations[37]. It may be possible and highly likely that

[37] The randomness of actual payments also seems to indicate a biased application of the law. Yukos as a

these cases of 'back tax' business targets are limited in number from the central government's point of view to certain 'rogue' oligarchs in an effort to restore their obedience to central authorities. But these actions have a further negative consequence by sending a 'green light' signal to regional authorities to go ahead and target existing businesses in a predatory way in order to boost regional government revenues. The immediate effect of these actions may have an 'unintended' positive consequence for small business reducing tax inspections and harassment as tax authorities focus on the hefty penalties that can be gained from targeting large enterprises. But unless the tax policies are altered after large enterprise targets are exhausted, tax authorities may refocus on small enterprises with possibly more vigour than ever. Other unusual tax practices also continue to persist[38].

In addition, the existence of multiple inspection agencies (such as fire, health and sanitation) with the independent powers to inspect businesses at any time form a major barrier for firm survival in terms of both time and cost. The impact of inspection agencies is intensified due to weak regulatory environment (i.e. the fact that regulations and laws are applied selectively and randomly) and that there exists no limit to the frequency or duration of inspections. On average, a Russian small enterprise was inspected by various inspecting organs approximately seven times a year. By comparison, for Swedish firms, one inspection is held once every two years (OPORA 2005: 17). The multiple inspections increase the likelihood for corruption[39]. In addition, the system is often inconsistent[40].

5. Exit Barriers

company, has been dismantled and for all practical purposes destroyed, yet Abramovich's Sibneft was given a reduction (Sibneft received $1 billion USD for back taxes and settled for less than $350 million USD, reported Bloomberg on Sep 25, 2005, citing Vedomosti) on his back taxes and was able to continue its operations. Since October 2005, Gazprom owns over 50 percent of Sibneft.

[38] According to Russian law, the tax authorities and various public utilities are entitled to take money they consider owing to them from the taxpayer's bank account without prior permission of the account holder. This forms a further disincentive for businesses to operate in the legal sector or for holding substantial funds in domestic bank deposits (Ellman 2000).

[39] It has been shown that excessive regulation and bureaucratic administration inevitably leads to increased levels of corruption (Djankov et al. 2002).

[40] The law '*on the protection of rights of legal entities and the self-employed in the process of state supervision' effective in August 2001. It limits the number of reasons for scheduled inspections and makes state organs liable for inspections that are too frequent or last longer than a year*. However, '*firms report that they are inspected more often than stipulated in the law, and fines for violations do not conform to the official schedule. Fees for licenses exceeded the official levels in 80 percent of the cases and the terms of the licenses were shorter than the legal 5 years in 77 percent of the cases*' (Kontorovich 200a: 24).

The World Bank study measures the time and cost required to resolve bankruptcies. Costs include court costs as well as fees of insolvency for practitioners, lawyers, accountants and others. The Recovery Rate measures the efficiency of foreclosure or bankruptcy procedures, expressed in terms of how many cents on the dollar claimants recover from the insolvent firm. The recovery rate in the Russian Federation is 48.4 percent, compared with the regional average of 30.5 percent and OECD average of 72.1 percent.[41]

However, in Russia, bankruptcies are often used not to carry out a closure of insolvent firm but rather as a measure of hostile takeover. Due to the weakness in the bankruptcy law of 1998, bankruptcy proceedings were manipulated for the purpose of hostile takeovers.[42] It was claimed in 2001 that in approximately 30 percent of bankruptcy cases, creditors were more interested in taking over a company rather than recovering a debt.[43]

6. Information Technology (IT) Sector

In this section, we provide an in depth analysis of a new industry sector emerging in Russia. Since the IT sector includes a vast array of activities, we will limit our discussion to the software sector.

6.1 Background

IT is one of the fastest growing sectors in Russia, with an average annual growth rate of 23-25 percent (2001-2004) (table 4). Demand is increasing, in particular by the banking sector and oil companies. Moreover, the strengthening competition in the consumer segment forces companies to increase IT investment. In 2002 – 2003, growth in software outsourcing grew by 277 percent. Despite the growth of the consumer market, state-related IT projects were the main growth driver in 2005.

Russia's strength lies in the technical talent of its population especially in terms of mathematical and computational skills. However, Russia needs human capital that could make the best use of these technical talents in areas such as marketing, advertising and

[41] Djankov et al. (2002).
[42] See Tompson (2003), Volkov (2004), Revised bankruptcy law came into effect in December 2002.
[43] Interview with Tat'iana Treifilova by Vitalii Golovachev in *Trud-7*, 23-29 August 2001, (http://bankr.ru/doc/75))

management. Russia's main IT advantage stems from the fact that the global IT market has saturated outsourcing havens such as India and is looking for other options. As a result, Russia may become a target for western outsourcing activities by default rather than by any supportive steps taken by the government.

Table 4: Computer Hardware and Software (figures in USD millions)

	2002	2003	2004 (estimate)
Total Market Share (computers & peripherals)	3040*	3370*	3930*
Total Local Production	1520**	1850**	2300**
Total Exports	70	40	50
Total Imports	1590	1560	1680
Imports from the US	48	56	68

Note: The above figures are based on Russian Customs and US Department of Commerce data. **RosbusinessConsulting estimate, ** Commercial Service estimate
However it should be noted that the informal export of software is not reflected in these statistics (which can take place through direct cash payments or through transfers to foreign bank accounts).
Source: Doing Business In Russia: A Country Commercial Guide for US Companies (2005).

As the number of Russian companies that compete in the global arena grow, the domestic demand for IT services will increase. Oil companies illustrate this trend. It is typical for an IT division to be set up as part of major Russian oil companies. Unfortunately, domestic software demand is limited in many large Russian companies since they prefer to used global software brands (such as Microsoft) since it has a better chance of long-term continuity and is therefore considered a better investment.

6.2 Structure of Industry

There was no IT independent sector in existence during the Soviet era, therefore, no substantial power of incumbents exists to deter new entry. The sector is said to be fragmented, which implies relatively low entry barriers and an opportunity to build market share. There are currently 8,000 registered IT companies in Russia including 160 in software outsourcing. The major domestic IT players include: IBS, 1C, Lanit, IT Company, Verysell and Parus.

There are two main types of software development: those firms oriented towards the domestic market and firms oriented towards outsourcing. As will be further discussed below, each type has specific characteristics. In general most software companies are small (with few exceptions) and the temptation is great to operate illegally as a way to avoid paying taxes (especially social taxes) and avoid inspections (which oftentimes do not take the specifics of the IT sector into account and penalize for practices unrelated to IT operations). However the negative consequence to illegally operating their businesses is a decreased ability to growth and the pressure to stay small. This interferes with branding and developing a reputation (crucial for outsourcing) or gaining access to outside financing (necessary for business growth and further capital intensive innovation).

6.3 Government support

IT is a sector in which the government's investment is considered to be conducive to growth (Krasnov, 2003). The government has introduced a programme "Electronic Russia 2002-2010" which aims to develop the use and access to IT technology at all levels[44].

6.4 Operational barriers to productivity (hence to prospective entrants)

Software piracy and lack of leading-edge business customers have been identified as the major barriers to productivity in the software sector (McKinsey 1999). The lack of intellectual property rights (IPR) enforcement forms a barrier for domestic software developers. Though there are laws protecting IPR they are in most cases, not enforced[45].

More critically, the government sanctions pirating by using pirating software itself. A Russian Microsoft official estimated that 89 percent of Microsoft programs used in Russia are illegal version and that the main culprit was the government, who is itself using pirated copies. As a result software companies can only rely on voluntary compliance since legislation is not being effectively enforced.

It should be noted that outsourcing operations have little problems with IPR since per definition their operations are directed to foreign countries.

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[44] However, Russian government has invested much less in the IT sector than other middle income emerging economies such as China and India.
[45] Even though there have been some high profile raids of software pirates recently, most experts feel these were isolated incidents and do not indicate a tougher governmental stance.

6.5 Regulatory barriers

A complicated customs regulations regime forms a major barrier for software developers involved in either importing or exporting technology. Customs officials form a wealthy and powerful class in modern day Russia. Bribing is the norm. Software developers trying to export or import technology run up against an array of barriers. Most notably in the case of exports, difficulty in valuation of their product (and as a consequence difficulties in getting VAT payments returned) and for imports, the imported technology must be inspected and can run up delays of many months.

6.6 Regional dimension

Four main regions including Moscow, St Petersburg, Novosibirsk and Ekaterinburg are known for their IT sector development in Russia. Of all regions in Russia, Moscow and St. Petersburg enjoy the greatest Internet penetration.[46] Lack of adequate infrastructure is the main barrier to IT development in most other regions. However, in spite of Moscow's benefits, the high cost of living (and labour) in Moscow is resulting in IT businesses losing competitiveness due to high costs.

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7. Textile Industry

In this section, we discuss the current development of the textile industry which represents one of the oldest industry sectors in Russia. During the transition process the textile industry was privatized.[47] As a result of the type of privatization method used, management was able to obtain a large controlling stake in the companies. Currently, most textile companies have been bought up by larger 'holding companies' which are involved in a diverse array of industrial sectors (Parshukova 2001). Since in most cases, the existing management held the majority of shares, negotiations for buying the textile firms were advantageous for the existing management and resulted often in a change of ownership without a corresponding change of management. This has led to mixed results. Some existing managers have embraced change and brought in new and efficient manufacturing methods while other managers have not encouraged any change or

[46] As of March 2005, the Russian Federation had 22,300,000 Internet users which is a 15.5 percent penetration (source: http://www.internetworldstats.com)

[47] Some experts said that it was completely privatized while the Industry report of Russian textile firms indicates that at least 2 firms are still state owned.

modernisation[48].

The textile sector experienced the sharpest decline in production in the aftermath of the collapse of the USSR. In 1998, the production volume was only 12 percent of 1990[49] and employment fell from 932 thousand people in 1990 to 424 thousand in 1998 (IRG 2002, 5). Between 1991 and 1998, its production volume decreased by almost 80 percent. The decline in the textile industry's output from 1990 to 1998, was the worst decline amongst all industrial sectors in Russia. This was due in part to three main reasons: (1) the disruption in the relations with former Soviet republics that supplied Russian producers with raw materials such as cotton; (2) the increase in cheap imports of textile and apparel goods, and (3) the low labour productivity caused by obsolete equipment (IRG 2002: 5). Consequently, the 1998 rouble crisis positively influenced the industry in terms of production volume through increased domestic demand. After the 1998 default, the industry became a leader of growth in 1999 and 2000 (IRG 2002).[50]

As far as is known, no new textile plants have been developed and all textile operations are based on existing Soviet plants which are located throughout Russia. In this sense, textiles are a closed industry since new entry only occurs in terms of the takeover of existing plants and not in terms of the building of new plants. Most textile managers are from the Soviet period. Only a few are completely new entrants. It was possible for new entrants to enter the textile industry in the late 1990's but it would be much more difficult to enter today due to industry concentration.

7.1 Sector-specific barriers to productivity

Major obstacles to the development and productivity of the sector include the lack of credit and loan-financing, lack of modern manufacturing technology, need of equipment replacement, and poor wholesale and retail network (Parshukova 2001). Also, competition from abroad has negatively affected the industry (specifically, competition from China and Turkey providing cheap imports has been increasing). In addition, shuttle

[48] Krueger (2004) observes a lack of proactive initiative of managers in textile industry firms, when compared with other branches of the economy in his case studies. For specific details, see chapter 5.
[49] This may have created an impression that Russia's textile sector is dying.
[50] In 2002 the growth stopped, but there is optimism that the growth of production of textiles will increase.

traders[51] are still operating and create the phenomenon of 'grey imports' in the textile sector. Since the break-up of the Soviet Union and the breakdown of internal resource trade, the textile sector also suffers from a lack of raw materials and hence operates under the system of tolling.[52] In 1999, for example, between 80-90 percent of textile production were made under tolling operations, which are considered to restrain textile producers' growth and development (IRG 2002: 6).

7.2 Structure of the sector

Currently, horizontal and vertical integration in the textile industry is taking place. There is a general trend towards concentration, which increases the power of incumbents. Some of whom are from the Soviet era as well as some new managers[53].

After the collapse of the Soviet Union, the Ministry of Textiles of the Russian Federation was reorganised and the state concern called Rostekstil was created. At the time of its establishment, it was comprised of 350 textile enterprises from 36 Russian regions (Kanunnikov and Kochetova, 2001). Rostekstil is a joint stock company which unites 400 textile enterprises that manufacture approximately 70 percent of the industry's total production (IRG 2002:24). Another major player in the Russian textile industry is a company called Alliance Russkii Tekstil – which is one of the largest vertically integrated textile companies in Russia. The holding company is composed of the following five enterprises: (1) Teikovskii cotton combine, a cotton fabric producer in Ivanovo region; (2) Power International, a cotton importing company; (3) Novaia Tekstilnaia Kompaniia, a trading company with a distribution network of 27 subsidiaries in Russia and Ukraine; (4) Tverskaia manufaktura, a cotton fabric producer in Tver region; and (5) Kamyshinskii combine, a spinning and weaving mill in Volgograd region.[54] Other prominent companies include: Trekhgornaia manufaktura, Balteks, Novaia Ivanovskaia manufaktura, Shuiskii sitsy, Tiroteks, Komiteks, Serpukhovskii tekstil, and Cheboksarskii trikotazh.

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[51] Shuttle traders travel to foreign countries as 'tourists', and come back with as much undeclared merchandise as they can carry. Since they do not pay any import duties, they are able to sell these goods at very low prices.

[52] Tolling is a system of production based on raw materials provided to the producer, who processes the material on commission. For a discussion on tolling, see Avdasheva (2000) and Adachi (2005: Chapter 5).

[53] No known influence from so-called 'Oligarchs' seems to take place in the textile sector.

[54] IRG (2002), See also Alliance Russkii Textile's company website: http://www.textil.ru/production

7.3 Regional dimension

Ivanovo is the region best known for textile production in Russia. In mid-1990s, the region suffered a decline in production.[55] Total industrial production in the region in 1993 reached only 56 percent of its 1990 level, and fell another 30 percent in 1994. Employment losses were much more limited and amounted to roughly 25 percent[56]. Still, the official unemployment rate in the region in 1996 was about 11 percent, making it the second highest among all regions in the Russian Federation[57]. In Ivanovo, the production of cotton fabrics is the largest segment of the textile industry (41 percent of the total production volume in the industry), and approximately 70 percent of cotton manufacturers are located in the Ivanovo region. For instance, of the ten top Russian producers of cotton fabrics in 2000, the top eight places are occupied by cotton mills located in Ivanovo region (IRG 2002).

7.4 Regulatory barriers

In 2001, Russia introduced a 20 percent VAT on the total value of imports of cotton fibre, which had previously been tax exempt. Due to the large amount of imports of raw materials (approximately $ 24.5 million USD), Russian textile manufacturers that rely on raw material imports have to calculate additional VAT Payments. In addition, in 2000, the government halved various customs tariffs on imports of some raw materials for textiles to 10 percent. But total import charges can reach 33 percent of the contract value. The lowering of import tariffs is influenced by the preparation for WTO accession.

7.5 Is the textile industry profitable?

This is very difficult to assess for a number of reasons. On the one hand, since most textile firms are now owned by holding companies, their profits may be redirected to other firms informally for tax evasion purposes, so that on the books the textile companies may record no profits but in reality they may be profitable. However, on the other hand, since many textile plants are the sole employer in a number of regions in Russia, the local government may have an inherent interest in maintaining the plant's

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[55] "Economic Restructuring and Social Dialogue in the Ivanovo Oblast, Russia" ILO (International Labour Organisation) SRO-Budapest Bulletin, Newsletter 1- 1996.

[56] Employment subsidies and labour hoarding prevented massive open unemployment.

[57] "Economic Restructuring and Social Dialogue in the Ivanovo Oblast, Russia" ILO (International Labour Organisation) SRO-Budapest Bulletin, Newsletter 1- 1996.

operations even if they are not profitable and will provide them with tax concessions (so that they do not have to pay any taxes)[58]. As a result these firms may be profitable on the books but actually loss making if they were obliged to pay the existing tax rate. Some textile business owners complain of the declining profits in the textile industry while on the other hand, some companies are increasing their profitability and consultants in Russia indicate that textile companies are increasingly contracting them for their services[59]. Ivanenko (2000) shows that as for the situation in mid 1990s, textile sectors were very loss-making, and argues that low productivity contributed to its unprofitability than excessive taxation[60].

7.6 Intellectual Property Rights

Lack of enforcement of intellectual property rights present a special barrier for textile firms since other firms can easily copy their techniques, designs and methods with no repercussions. Light industry accounts for 70 percent of all fake goods in Russia[61].

7.7 Barriers to entry and exit

The barriers to entry for new firms in the textile sector are quite high and come from several main areas. The increasing globalisation of the textile industry has increased access to inexpensive textiles from countries such as China which reduce the profitability of domestic textile production. The collusion between regional authorities and existing textile firms creating unfair competitive advantages for incumbents. Also there is a

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[58] Ivanenko has argued that '…*the unprofitable textile and other manufacturing and agriculture sectors have been found to face relatively low statutory tax rates compared with effective rates*…' (2005: 1041).

[59] Andecotal evidence from a consultant working for a large international consultancy firm in Moscow (2005).

[60] Khanin and Ivanchenko (2003) report a large undervaluation of fixed capital in Russian industry in general on the books between 1998-2000 by calculating the gap between the book value and market value of fixed capital in Russian industry. It should be added that these authors excluded the light industry (which is comprised of textile industry, clothing industry, and production of leather goods, furs and footwear) from the overall calculation because of the questionable discrepancies among the products within the industry: according to the authors, market value of fixed capital in fabrics was 1,628 times that of book value, while in footwear, book value was 452.8 times that of market value.

It is important to point out that in part due to the undervaluation of fixed capital which has not gone through sufficient revaluation to be in line with inflation, the understatement of depreciation would result, which then leads to the overstatement of profits in official statistics. Therefore, on the books, enterprises can appear to be profitable, while in fact they are actually eating up their capital. With regard to profitability of Russia's industrial sector in general, calculations by Khanin and Ivanchenko (2003) present a different result from official data, i.e., they show that the Russian industry in general is loss-making.

[61] Source: Interfax Daily Business Report (November 7, 2003).

general market decline in the textile industry in Russia due to cheap imports, labour inefficiency and outdated technologies. However the main barrier to entry seems to be the lack of investment for new technologies in the Russian textile industry.

In terms of exit barriers, regional authorities would block the exit of local textile manufacturing plants because in many cases they are the sole employer and as a result will provide the textile firm with assistance that leads to unfair competitive advantages.

8. Conclusion

The Russian Federation finds itself at a crossroads. Being a large, resource rich country, Russia has to do little else than extract its wealth from the ground in order to meet its current budgetary needs. Moreover given the current strategies of multinational companies hungry for Russia's growing consumer market, Russia needs to do little to attract their attention or investment. In this sense, Russia can continue its current course of political and economic development without any serious economic consequences, albeit in the short term. The worrisome implications of this trend are related to long-term economic development and the current barriers to domestic business development.

Though, international studies such as the World Bank's Doing Business survey indicate that Russia seems to provide a reasonable business environment. These results paint a misleading picture. Formidable barriers exist for business entry due to regulatory uncertainty, lack of enforcement, regional differences and unfair playing field created through networks and corruption. In addition, as this chapter further illustrates, business survival is of grave concern in Russia. The main barrier to business survival is the high uncertainty in the business environment exacerbated by the lack of rule of law. Regulatory inconsistencies and high instances of corruption characterise the central government and many regional authorities. Until the rule of law is established, little improvements can be expected to the domestic business environment.

As this chapter further highlighted, new and old industry sectors encounter specific challenges for business entry and development. In terms of the software industry and the IT sector, entry barriers are quite low, though business development is severely constrained through rent-seeking bureaucrats, corrupt customs officials and the lack of enforceable property rights. As a result, many software firms choose to stay small, often functioning illegally. Though a successful short-term strategy, in the long-run, this further constrains the potential for firm growth and development. In the established Russian textile industry, the picture is slightly different. Here, entry is virtually impossible due to both internal and external constraints. Internal constraints include the consolidation of the industry leaving few possibilities for new entrants. Increasing external constraints are formed through growing foreign competition and high investment needs. In addition, the textile sector is plagued by lack of transparency in terms of profitability and efficiency of production.

These two industries exemplify a greater general trend in Russia. The weak institutional environment and lack of rule of law create conditions in where either entry (such as in the textile industry) or survival (such as in the IT industry) are reduced and result in low levels of both business entry and survival. The resulting industrial structure is 'top heavy' i.e. large enterprises without a solid counterweight balance in the small and medium enterprise sector.

Appendix 1a: Corruption Perceptions Index

Corruption Index -Transparency international

	1998	1999	2000	2001	2002	2003	2004	2005
Russia	2.4	2.4	2.1	2.3	2.7	2.7	2.8	2.4
Brazil	4	4.1	3.9	4	4	3.9	3.9	3.7
China	3.5	3.1	3.1	3.5	3.5	3.4	3.4	3.2
India	2.9	2.9	2.8	2.7	2.7	2.8	2.8	2.9
Senegal	3.3	3.4	3.5	2.9	3.1	3.2	3	3.2

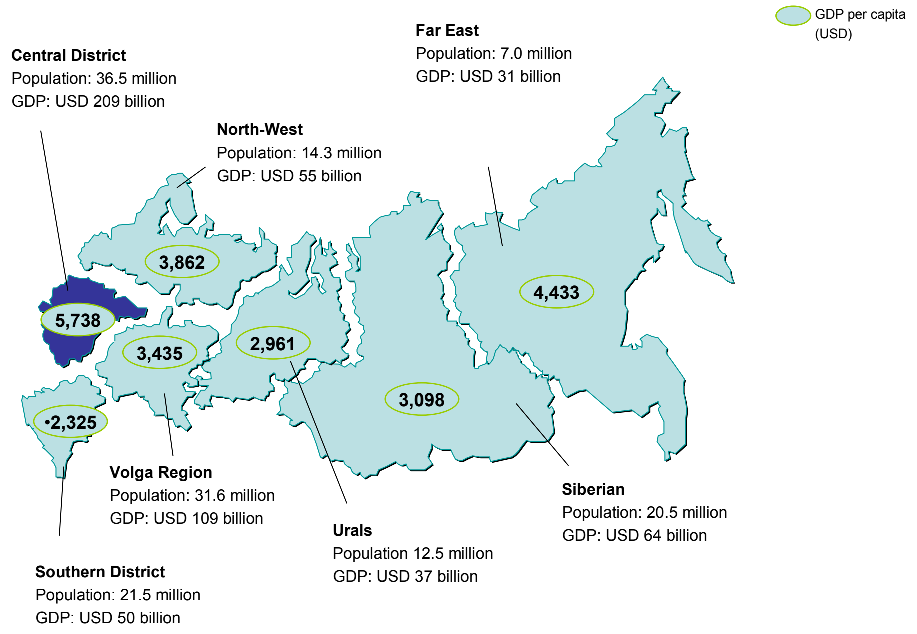
Key: > 5 very little corruption; > 3 corrupt; < 3 very corrupt.
Source: Transparency International (1998 – 2004)

Appendix 1b: Corruption Index – Transition Countries

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Albania	-	-	-	-	2.3	-	-	2.5	2.5	2.5	2.4
Azerbaijan	-	-	-	-	1.7	1.5	2	2	1.8	1.9	2.2
Armenia	-	-	-	-	-	-	-	-	3	3.1	2.9
Belarus	-	-	-	3.9	3.4	2.5	-	4.8	4.2	3.3	2.6
Bulgaria	-	-	-	2.9	3.3	4.1	3.9	4	3.9	4.1	4.0
Czech Republic	-	5.37	5.2	4.8	4.6	3.5	3.9	3.7	3.9	4.2	4.3
Estonia	-	-	-	5.7	5.7	4.3	5.6	5.6	5.5	6.0	6.4
Georgia	-	-	-	-	2.3	5.7	-	2.4	1.8	2.0	2.3
Hungary	4.12	4.86	5.18	5	5.2	-	5.3	4.9	4.8	4.8	5.0
Kazakhstan	-	-	-	-	2.3	5.2	2.7	2.3	2.4	2.2	2.6
Kyrgyzstan	-	-	-	-	2.2	3	-	-	2.1	2.2	2.3
Latvia	-	-	-	2.7	3.4	-	3.4	3.7	3.8	4.0	4.2
Lithuania	-	-	-	-	3.8	3.4	4.8	4.8	4.7	4.6	4.8
Moldova	-	-	-	-	2.6	4.1	3.1	2.1	2.4	2.3	2.9
Poland	-	5.57	5.08	4.6	4.2	2.6	4.1	4	3.6	3.5	3.4
Romania	-		3.44	3	3.3	4.1	2.8	2.6	2.8	2.9	3.0
Russia	**-**	**2.58**	**2.27**	**2.4**	**2.4**	**2.9**	**2.3**	**2.7**	**2.7**	**2.8**	**2.4**
Slovak Republic	-	-	-	3.9	3.7	2.1	3.7	3.7	3.7	4.0	4.3
Slovenia	-	-	-	-	6	3.5	5.2	6	5.9	6.0	6.1
Tajikistan	-	-	-	-	-	-	-	-	1.8	2.0	2.1
Turkmenistan	-	-	-	-	-	-	-	-	-	2.0	1.8
Ukraine	-	-	-	2.8	2.6	1.5	2.1	2.4	2.3	2.2	2.6
Uzbekistan	-	-	-		1.8	2.4	2.7	2.9	2.4	2.3	2.2

Key: > 5 = very little corruption; > 3 = corruption; < 3 = very corrupt
Note: No values available for Turkmenistan
Source: Transparency International (2004)

Appendix 2: Russia's seven main regions



Adpated from McKinsey (1999)

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