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**Current Status and Development Opportunity Analysis of Small and  
Medium Sized Businesses in Moscow Region (Russia)**

Summary

Economic changes in Russia have created a foundation for establishment and development of private property and launched the basic principles of market regulation. Under the circumstances small and medium sized businesses have become of great importance for modern economy and will be one of the main factors for further economic growth in Russia. Moscow region is one of parts of Russia where we can find important changes made lately in this field. A period of small and medium sized business development associated with 'quick and easy' profits gained mainly in multiple resale operations is over now. Therefore, this stage of evolution has much tougher requirements for economic, law and infrastructure background in the country as a whole and Moscow region as a part of it. The paper touches upon the main problems that small and medium sized businesses face today in Moscow region. Analysis of small and medium sized business development in Moscow region and current state policy in this sphere has led the authors to several conclusions they would like to share in the paper.

## 1. Introduction

The insight into statistic and analytical information concerning status and development dynamics of small and medium sized businesses (SMBs) in Russian Federation shows that the necessary foundation for growth of SMB has been already created.

By implementing effective actions for support and development of SMB this part of economy should become the key strategic factor for economic growth and social stability in the country.

The essential factors for success of such program exist:

- Traditionally high entrepreneurship activity level among Russian people
- Constitutionally approved right for citizens to be engaged in entrepreneurship
- SMB are officially announced as special part of economic activity where additional state support may be applied
- Availability of all the infrastructure units (different types of which are at different stage of development) necessary for successful operation of SMB

Despite of definite success in SMB development, this important part of economy in modern Russia still do not add to the whole economy and social life of the country as much as it does in some advanced countries of Western Europe, America and South-East Asia, where SMB can have up to 60% share of GDP.

Slow growth of SMB prevents from achieving social aims which are traditionally supported by effective operation of SMBs: forming of the middle class – the main factor of social and political stability in a society; creation of new work places; reduction of unemployment, social unrest and economical inequality of people.

This paper touches upon the situation in SMB sphere in Moscow region or, to be more exact, *Moskovskaya oblast* in Russia, which can be defined as Moscow suburb or a region within 80-100 km around Moscow with its own head and government (Moscow city itself is not included). The Moscow region is taken as an example of one of the regions where SMB sector of economy develops faster than in other parts of Russia, regardless of the problems which still exist and should be solved. Therefore the experience gained in the Moscow region can be used by the other parts of Russia.

In this study the authors' aim is to give main characteristics of current SMB structure in the Moscow region and also to do the following:

- Identify the main problems of SMB development in the Moscow region by analyzing the history of its growth and current situation in this sector of economy (statistic information, expert reports, publications in mass media, etc.)
- Find the parameters in the current SMB support system which do not correspond to the main trends of SMB development
- Suggest the basic recommendations for improvement of SMB support policy in the Moscow region

## **2. SMB brief history overview in Russia and current status of SMBs in Moscow Region**

### ***a. History and background***

The history of modern SMB in Russia is not very long as the right for people to be involved in private entrepreneurship was officially announced in 1987.

Now we can define three main stages of SMB development in Russia with the first one started in 1987 and lasted till 1994-95. This period is associated with appearance and rapid growth of first SMBs side by side with lack of necessary laws, state regulations or support of SMBs. Experiencing huge problems in political, social and economic spheres, the state officials seemed not to realize the importance of SMBs in setting up good background for solving these problems and nearly ignored the existence of SMBs.

Nevertheless the newly acquired right to have private business combined with giant demand especially for consumer products resulted in fast increase of SMB activity in the country. It was in that period when the first private capitals emerged and today biggest private owned companies in Russia were established.

The second period for SMB evolution (1995-1998) is connected with “The Federal Law on State Support of Small Entrepreneurship” of 14 June 1995, whose main purpose was to introduce the main principles for SMB operation Russia. For the first time the law gave exact explanation of what enterprises could be considered SMBs:

“...Self-employed Individuals, or a company in whose authorized capital a share of public sector bodies, charities, or businesses have no more than a 25% and where the

average number of employees does not exceed the following limits according to main sector of activity:

- 100 - Industrial production and construction
- 80 – Agriculture
- 60 - Science
- 50 - Wholesale trade
- 30 - Retail trade and domestic service
- 50 - Other sectors...”

This period of SMB development had also a good background of rather stable political situation and noticeable overall economic growth in the country. Due to these factors and also more attention paid by the government resulted in creation of federal and local SMB support structures, people became more active in launching private businesses.

Finally, the beginning of the third stage of SMB evolution is associated with the crisis of 1998 causing devaluation of the local currency - Ruble. Under the circumstances SMBs showed good “surviving” potential, high flexibility and ability to quickly adopt rapidly changing environment. After President Putin had been elected, the government started more consequent policy in the field of SMB support. Following the President’s initiative the Russian Duma made several steps to reduce bureaucracy of state authorities – one of the main problems for Russian SMBs. Actually, a special “anti-bureaucracy package” was launched consisting of three main laws, already approved by the Duma: “The Registration of Legal Entities” law simplifies the necessary procedure for registration of legal entities and getting a business started; “Licensing of certain kinds of business activities” law decreases the number of business spheres (now there is a list consisting of 114 exactly specified business spheres) where companies must have license for operation; “The protection of rights of the legal entities and entrepreneurs during the state control execution” law, as the name suggests, prevents companies from abusing powers by the officials given to them by the nature of their services.

The forth law which is being prepared now to stand in a row with the above three ones will change the certification procedure of goods so that it will meet the international standards.

**b. Current status of SMB development in Moscow region**

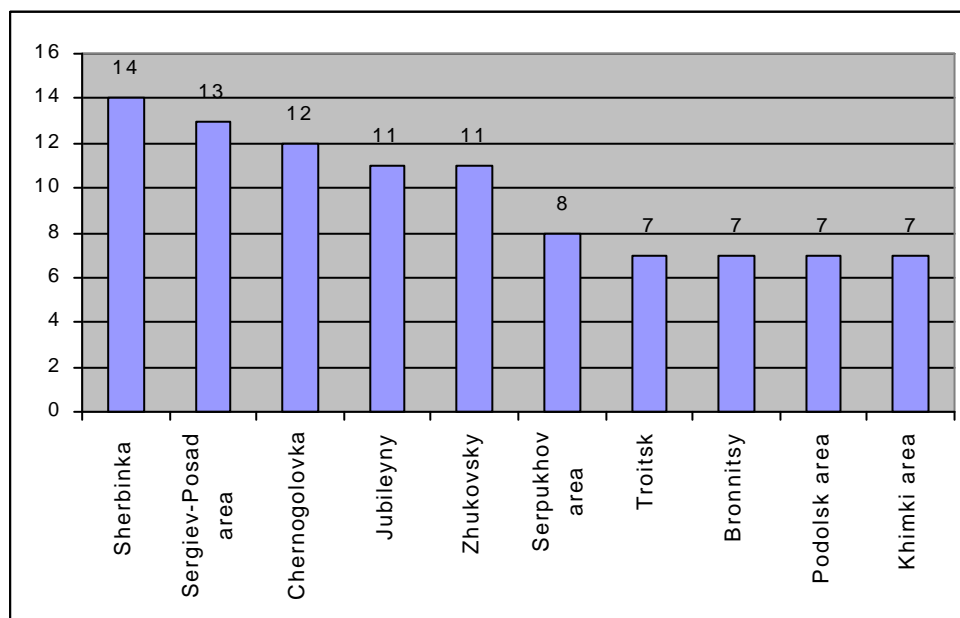
Around 30% of the Russian SMBs are registered in the Central region (Moscow Oblast region and Moscow city included), and 18% - in the Northwest region. Therefore, almost half of all SMBs are to be found in and around Russia's two largest cities.

According to Moscow Regional Statistics Committee information dated January 1, 2001, there were more than 37 thousand SMBs in Moscow region. The leading areas are shown in the graph below:

**Graph 1. Moscow Region: Quantity of SMBs by area**

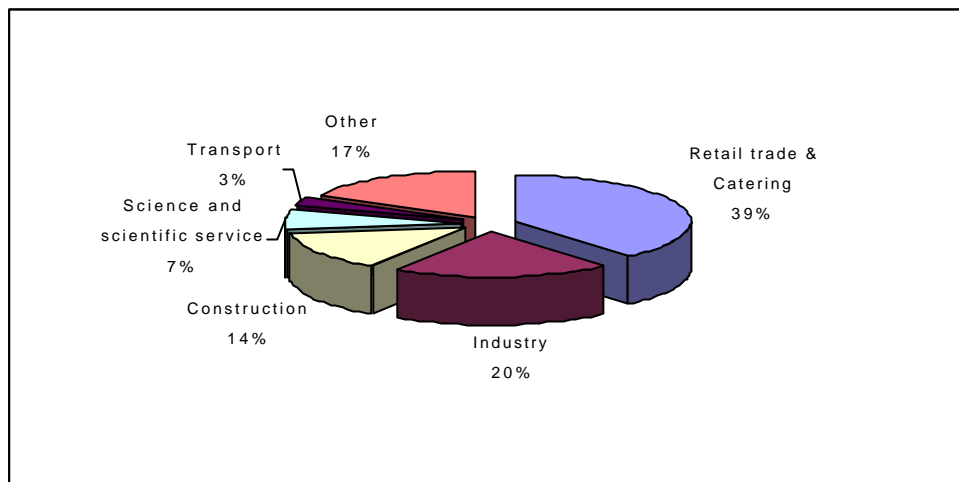
Despite of the fact that Moscow region is one of the leading areas in respect of SMB development level, this level is still insufficient. For example, according to Goskomstat (Russian Statistics Agency), there are only five SMBs per 1000 inhabitants in Moscow region, while in the United States this number is 74, in Great Britain 46, in Italy 65.

Nevertheless it should be pointed out that in some areas of the region this figure is higher:



**Graph 2. Moscow Region: number of SMBs per 1000 inhabitants by area**

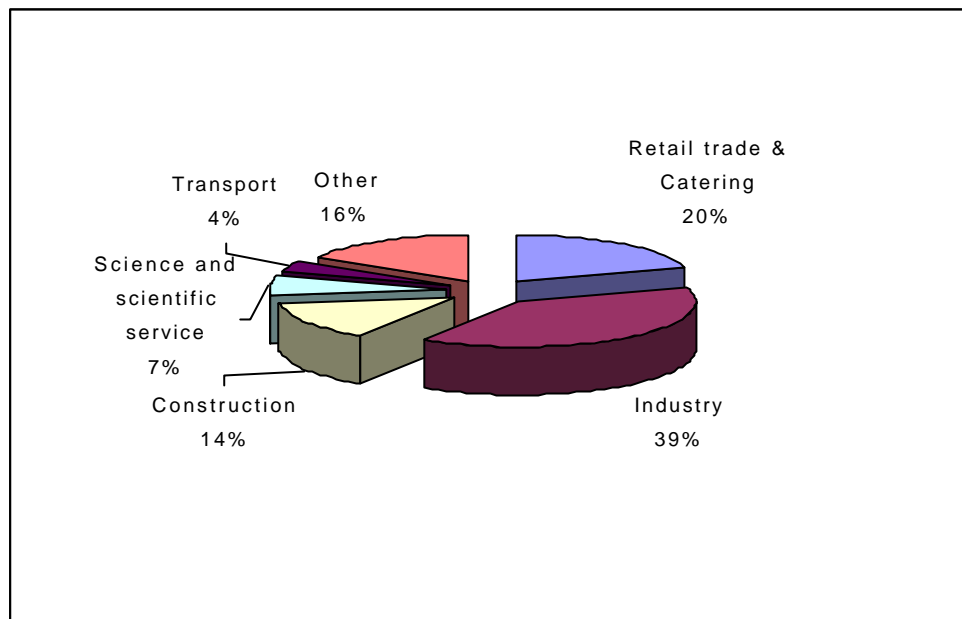
Classification of SMBs by business area shows that the majority of SMBs work in the field of retail trade and catering (39%):



**Graph 3. Moscow Region: SMBs division by business area**

According to Moscow Regional Statistics Committee information dated January 1, 2001 the number of employees in SMBs was more than 283 thousand. More than 30% employees are engaged in industrial field, retail trade and catering - more than 28%, construction - 14%, transport - 6%, science and scientific service - more than 4%. At the same time quantity of registered individual private entrepreneurs in Moscow region has exceeded 156 thousand. In total SMBs comprise about 440 thousand employees, that is 18,7 % of labor force engaged in Moscow region.

Rough estimation of goods and services volume sold by SMBs in 2000 is around 50 billion rubles (VAT and excise excluded) or 21 % of the total sales in the region. The greatest sales volume is achieved by industrial SMBs (39 % of total sales in the region), retail trade and public catering (20%), construction (14%), science and scientific service (7%), transport (4 %).



**Graph 4. Moscow Region: Sales volume share by SMB business area**

In 2000 Moscow regional consolidated budget revenue generated by SMBs was 5,7 billion rubles that is some 22% of total collected taxes (regional budget – 1,5 billion rubles or 17% and municipal budgets 4,2 billion rubles or 25% correspondingly).

Nevertheless, returning back to comparing SMB development in modern Russia and advanced countries, the share of SMBs in the total number of companies in Russia is estimated some 29%, while in the European Union their share is over 90%

Despite the mobility of small enterprises, they encounter multiple problems the authors would like to have a closer look at below.

### **3. Main problems and recommendations**

The general problem of SMB development is clear, namely that Russian SMBs have not yet become a driving force for creating new jobs and improving the economy. A strong effort is needed to change this situation. In the period from 1995 to 2001, two regional programs designed to support SMBs were adopted.

Unfortunately SMB support budget is not sufficient to create a comprehensive framework for SMB development. An increase in financing of SMB support programs is a prerequisite for their success.

### *Tax policy*

Tax policy affecting SMBs is clearly the key factor preventing SMB sector from more active development. The vast majority of entrepreneurs are concerned about unclear reporting system, complicated tax collection procedures and tax rates themselves. This fact can probably be attributed to widespread use of “double accounting”, which provides for keeping two sets of books – one with actual profit figures for the company and the other one with significantly lower or no profit – for tax authorities. Thus, analysis of the current situation points two major faults of the existing system out:

- Underdeveloped/poorly developed legislative acts;
- High tax rates
- Extreme bureaucratization of government agencies (particularly, the ones carrying out fiscal functions, such as, tax collection and customs control).

### *Interference of officials*

The main challenge resulting from interaction with government officials is related to the fact that government officials tend to abuse powers given to them by the nature of their services.

Actually, there is a lot of different authorities officially allowed to perform SMB audit: Police (militia); State fire prevention service; Tax office; Tax police; State standardization, metrology and certification body; State sanitary & epidemiology control authority; State ecological control authority; Antimonopoly body; Federal labor inspection; State trade inspection; Russian transportation inspection; State power supervision; State architecture supervision body; State veterinary supervision.

It is very common for government officials to demand bribes from SMB owners, which is especially typical for tax and customs offices, representatives of city and regional administrations and local fire departments. In the majority of cases officials make arbitrary subjective judgements based on vague statements articulated in the laws and multitudes of internal instructions. Entrepreneurs are often denied the opportunity of getting acquainted with the internal instructions and rules defining the scope of responsibilities, rights and obligations of the various governmental agencies and services.

### *Credit policy*

Negative features of credit policies implemented by Russian banks include: high interest rates; availability of predominantly short and to a lesser extent medium term financing; required collateral the value of which often has to exceed the amount of provided loan facility. Currently banks offer business development loans at 20-25% interest rates for 6-24 month periods.

### *Government support*

Recent research indicates that the majority of small and medium companies consider government support to be most needed in the early stages of their development. Government support is needed on all administrative levels (i.e. federal, regional, and local). Federal support programs fail to address small and medium companies directly, as well as to provide them with information about existing support opportunities. According to recent research by “Business Thesaurus” Information Center, more than half of the Russian SMBs have never heard of any federal or regional support programs. Approximately the same proportion of SMBs consider these programs to be ineffective. Small and medium businesses believe that taxation and legal issues should be a priority for support programs. Another problem is apparently a lack of cooperation between federal and regional SMB support authorities, which leads to large regional differences of SMB framework environment and SMB satisfaction with government’s policies.

So, due to many unresolved problems and low efficiency of the SMB support programs to date, entrepreneurs tend to concentrate more on day-to-day difficulties instead of development. There is an immediate need to reform and establish appropriate institutional, legal, and taxation frameworks, as well as to create an economic and political environment, which would encourage increased SMB activity.

### *The taxation system for small business.*

First of all it is necessary to mention that regions of Russian Federation have very limited opportunities to influence tax load of small business. The Constitution says that only Russian Federation, and not regions, has the right to change taxation system.

But on the other hand interviews of businessmen testify the great importance of taxation problem for SMBs. According to inspection of 568 small enterprises that have

been carried out by "Business - thesaurus" agency in 2001 in 6 regions of Russia <sup>1</sup> (Moscow region, Nizhny Novgorod, Rostov-on-Don, Kursk, Novosibirsk, Ekaterinburg) businessmen considered tax privileges to be the most important thing for development of own business. Being asked what primary support should be provided by the authorities 78,2 % of the interviewed representatives answered that it was "the preferential taxation" - this opinion ranked first among desirable measures of support. Another important kind of support was a making taxation system simpler and more stable (49,8 % of representatives).

Another survey by "Business – thesaurus" agency of 999 SMBs in five regions <sup>2</sup> of Russia (Moscow region, Vladimir, Nizhny Novgorod, Great Novgorod, Tomsk) showed that among the three basic concerns at a stage of a small company launch the problem of "high taxes" was pointed out by 49,1 % of interviewed SMB representatives.

So in this paper the authors decided to focus attention to the problems of taxation system.

Nowadays in Russia there are three systems of taxation applied to SMBs:

- standard
- simplified system of taxation, accounting and reporting (SSTAR);
- system of imputed revenue taxation (single tax on imputed revenues).

The application of standard and simplified system of taxation is limited by action "of single tax", use of which is primary and obligatory for a significant list of SMBs in case of adoption of the appropriate law by Regional Dumas of Russian Federation. Currently in Moscow region this law has been already adopted.

The majority of SMBs are currently taxed according to the standard system, i. e. they pay all kinds of the existing taxes. It has been recently estimated that the number of SMBs following this taxation system is about 500 thousand, number of individual entrepreneurs - about 2,5 million.

The absence of adequate official statistical data about tax receipts collected from different categories of the tax bearers - small, average and large, does not give us a chance to estimate efficiency of the standard taxation system for SMBs. The statement for the benefit of the single imputed revenue tax based on increase of collected tax volume can not be quite right, because the growth of this parameter is caused mainly by two factors:

- introduction of single imputed revenue tax in more and more regions resulting in appropriate growth of SMB quantity paying this tax;
- constant increase of base profit parameter by tax authorities.

With no data about tax volume collected from SMBs according to the standard system, there is also no opportunity to realistically compare efficiency of various taxation systems.

In spite of the fact that the right of voluntary choice of the simplified taxation system had rather big share of SMBs (small businesses with number of workers less than 15 men and with turnover up to 10 million rubles (except for some special categories of the enterprises), the businessmen were not eager to switch to it. As a result according to the recent data the simplified system is used only by 50 thousand of SMBs (or about 6% of all registered SMBs), and 110 thousand of individual entrepreneurs (or only 3% correspondingly).

Keeping in mind progressive features of simplified taxation, accounting and reporting system it has also restrictions for application. The basic reasons for comparatively small share of SMBs chosen this system are:

- First, for those SMBs switching to simplified taxation system, VAT is not applied, so it becomes far more complicated for them to work with their suppliers and consumers using the standard taxation system (the mechanism of VAT compensation has not been developed still).
- Next, the simplified taxation system requires payment of 10% revenue (in majority areas including Moscow region) and does not always give obvious economic advantages to SMBs. The gross revenue as the subject of taxation does not consider different structure of expenses of different SMBs even within the framework of one sphere of activity. That falls foul of a principle of validity of the taxation systems.
- Third, the simplified system does not allow to use privileges of applied in standard system (for example, lowered rates of regional part of profit tax, property tax and some other taxes, mechanism of the accelerated amortization etc.) is unavailable.
- Finally, the obligatory single imputed revenue tax eliminates the opportunity to chose simplified system of taxation, account and reporting for a wide range of the SMBs.

Used according to the Federal law from 31.07.1998 N 148-ÔÇ the single imputed revenue tax is obligatory: the independent transition of the tax bearer who is carrying out a certain kind of activity on other system is not supposed.

Alongside the size of the single tax is conclusive: the tax bearer, not agreeable with the sizes of the imputed earnings and single tax, has not an opportunity to refuse its payment, by proving, that the actual sizes of his earnings and taxes that have been counted up on the standard system, are less, than designed on imputed method. Simultaneously with it the single imputed revenue tax is also exclusive - tax obligations are applied only on imputing basis, even if the usual account rules of the tax obligations can result in higher result.

The system of imputed earnings taxation in its present kind serves mainly fiscal goals and to the purposes of simplification of tax administration on the part of rating authorities, instead of purposes of reduction of tax loading, simplification tax and book keeping for the SMBs.

The transition to payment of the single tax does not release the tax bearers from duties on representation in tax and other state authorities accounting, tax and statistical reports. As real simplification it is possible to name only replacement of account of the several taxes by one. At the same time the goal of simplification is not also achieved when the tax bearer carries out some kinds of activity, one of which are taxed with the single imputed revenue tax, others - on the standard system.

Single tax application in the obligatory order for the payers considerably differing on the sizes of the activity easy results in infringement of validity principles of taxation. Imputed earnings designed on the simple formulas on the basis of any chosen natural parameters, can strong differ from the income really received by the managing subjects of the various sizes. So, the rather large enterprises realizing economies from scales of manufacture, in such situation have the low effective rates of taxation, and it is valid the small enterprises test unreasonable tax bends.

Single "imputed" tax, as well as single "simplified", in case the object of taxation establishes gross receipts, does not take into account structure of expenses of various subjects of business and differences in real revenues of business within the framework of one kind of activity. Thus we can also mark infringement of a principle of validity. The application of "imputed tax" discriminates both beginning businessmen, and already generated, business, bringing the profits.

The stimulating role of the tax is frequently proved by the fact that it represents fixed (at least during one year) payments independent from volume of made production. However the unit of area used in Moscow region for account of imputed earnings, concerns to the factors of manufacture. Stimulating role of imputed earnings tax is only possible in short-term prospect and in case that such tax is not excessively high (at least not more than size of the tax, which is paid on the standard system). In long-term prospect, opposite, the tax to the factors of manufacture especially overestimated, has terrible effect for the development of business and conducts to curtailing investment activity of the subjects of business.

Summarizing, it is possible to make a conclusion that the working system of small business taxation does not create favorable conditions for its development, and the declared goal of tax burden reduction, simplification of the reporting and accounting for the SMBs are not realized. At the same time, present special systems create the preconditions for use of their advantages by the managing subjects that are not small.

*Suggested improvements of current taxation systems for small business.*

The basic directions of state policy in stimulation of small business, in a part of taxation should become:

Reduction of tax burden,

Simplification of taxation, record keeping and reporting procedures.

In the nearest prospect it is necessary:

1. With the purpose to make conditions for competition of various systems it is necessary to provide voluntary transition of the small enterprises from one tax system on another (that at once will reveal the most ineffective system).

2. To bring in the Tax Code of Russian Federation a lot of changes and additions, namely:

- cancel for the SMBs advance payments on all kinds of the taxes;
- provide an opportunity for SMBs to apply special order of VAT payment;
- give the right to the SMBs to use the accelerated amortization of the basic means

3. add to the second part of The Tax Code of Russian Federation separate chapter "The single imputed revenue tax for the SMBs ", in which has to be provided:

- Full and detailed definitions of such term as: small business
  - The voluntary right of transition on payment of the single tax and order of such transition;
    - Replacement of duty of SMBs on payment the majority of taxes (VAT, single social tax, profit tax of organizations, tax from sales) on duty to pay the single tax, including assessments to social off-budget funds (single social tax);
      - To provide an opportunity to set imputed earnings as tax base of the single tax calculating it as a product of base yield of tax bearer and adjusting coefficient. Moreover the SMBs should have the right to choose the technique, acceptable to them, of base yield account;
4. To give to the SMBs, that use the single tax , right to apply the simplified order of the account and reporting similar to the order, working now to the enterprises, that use the simplified system of the taxation.

#### *Infrastructure development for support of SMBs*

We suggest that the special SMB development committee that has already been established as a part of Moscow regional government should focus on finding ways to do the following:

- Introduce new financial technologies directed to develop SMB sector - a provisional conclusion that would seem to follow from the above is that community financial institutions and business associations (supported by the Moscow region government) are likely to be more effective providers of retail finance to SMBs than established commercial banks;
  - Improve information sustention by providing free access to SMB dedicated databases (including regulation, crediting, tendering, sales of equipment and other means of production, etc) through specialized sites in the Internet and regional government financed SMB consulting bureaus. A particular concern is that small businesses have little or no knowledge of how they can access the government support system;
  - Establishing more staff training centers for SMB sector;
  - Create SMB “incubators”, i. e. special areas with comparatively low rent cost and all necessary infrastructure provided where newly launched SMBs could work for some time till they get stronger and move to other places;

- Promotion of SMB-created products and services to regional and interregional markets by organization of dedicated exhibitions with low participation cost for SMBs

*Other assistance to be executed by the SMB development committee in Moscow region*

- Encourage people to launch SMBs or become individual entrepreneurs by means of sustaining positive image of entrepreneurship via local mass media
  - Place more orders in SMBs by region government
  - Support exporting initiatives of SMBs:
  - Enhance small business presence in hi-tech and industrial spheres;
  - There is an urgent need to improve communication with SMBs and execute monitoring of SMB operating environment in Moscow region in order to carefully follow all the trends and develop legal principles of SMB activity regulation and regional support of SMBs correspondingly. Information about what services are available, how the strategy is evolving, and what difficulties it is confronting needs urgently to be communicated in the region.

#### **4. Conclusion**

For the Russian economy to develop its potential there is an immediate need to reform and establish appropriate institutional, legal, and taxation frameworks, as well as to create an economical and political environment, and efficient infrastructure which would encourage increased SMB activity.

SMBs are potential sources of technical innovation, renewed competition and employment creation.

Therefore, enhancing dynamic of small and medium enterprises would contribute towards the economic growth of Moscow region and the whole country.

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