

NEW BUSINESS CREATION
AND
RUSSIAN ECONOMIC RECOVERY

Vladimir Kontorovich*

Department of Economics, Haverford College, Haverford, PA 19041-1392
Tel.: 609-275-9535; Fax: 609-275-7198; e-mail: vkontoro@haverford.edu

Presented at the Association for Comparative Economic Studies panel in Chicago, January 1998.

* I am grateful to G. Brock, F. Kaegi, Iu. Kuznetsov, F. Pryor, P. Rutland, and V. Shironin for valuable suggestions. L. Freinkman commented extensively on the first draft, and E. V. Kontorovich edited it.

TABLE OF CONTENTS

1. OLD FIRMS CANNOT DO IT	1
2. NEW FIRMS CAN	3
3. APPROACH TO MEASURING NEW BUSINESS CREATION	5
3.1 NEW BUSINESSES ARE BORN SMALL	5
3.2 LEGAL AND STATISTICAL DEFINITION OF SMALL BUSINESS IN RUSSIA	6
4. SMALL BUSINESS SECTOR STAGNATES	8
4.1 THE MEANING OF THE DATA AND THE RECORD OF NEW BUSINESS CREATION	8
4.2 SOME INTERNATIONAL COMPARISONS	10
5. COULD STAGNATION BE A STATISTICAL ARTIFACT?	12
5.1 RE-REGISTRATION ELIMINATES INACTIVE FIRMS	13
5.2 THE SHADOW ECONOMY, CHANGING DEFINITIONS, MERGERS, AND GRADUATION	14
6. POSSIBLE CAUSES OF STAGNATION	16
6.1 GENERAL APPROACHES	16
6.2 HYPOTHESES TO BE TESTED	18
7. CONCLUSION	20
REFERENCES	21

LIST OF TABLES

TABLE 1. SMALL BUSINESS SECTOR IN 1991-1996	9
TABLE 2. NUMBER OF FIRMS IN POST-COMMUNIST ECONOMIES, GROWTH RATES, %.	12
TABLE 3. DISTRIBUTION OF SMALL FIRMS RELATIVE TO POPULATION BY ECONOMIC REGION	17

1. Old firms cannot do it

The original plans for post-Communist transformation focused on making the existing, state-owned firms behave efficiently. The alternative methods of privatization and the timing of its implementation relative to stabilization and liberalization became the central issues of transformation research. The prevailing school of thought favored rapid privatization (Murrell, 1995, p. 164).

Russian privatization in 1992-94 has been hailed as the most rapid and thorough, compared to other transitional economies. It is also said to lay down the foundation for “the coming Russian boom” (Layard and Parker, 1996, pp. 125-131). Yet recovery, let alone boom, has been elusive. A number of microeconomic studies found privatization had little impact on firm performance in Russia.¹ Meanwhile Poland, which has been slow to privatize its industry, and China, which has not even started, have been more successful in terms of economic growth.²

Of course, privatization needs time to bear fruit. For political reasons, privatization favored the incumbent management, which may be unable to learn the new tricks needed for success in the market. The sluggish incumbents will be bought out by the enterprising outsiders, who will turn the privatized firms around.³ However, the experience of the last two years shows that this may be a protracted and messy process. Incumbent management resists being dislodged,

¹ See Bekker, 1995; Commander and Yemtsov, 1994, p. 14; Kotov, et al., 1996, pp. 32-33; Earle, et al. (1996, p. 31). Dokuchaev (1995) and Earle and Estrin (1996) reached the opposite conclusion, but the former’s methodology had been disputed (Kuzenkov, 1996, p. 40, quoting *Ekspert*, no. 16, 1995, p. 3).

² On Poland, see *OECD Economic ...*, 1996, pp. 66-67; on China, see Perkins, 1994, pp. 24-5, 36-7.

³ Layard and Parker, 1996, pp. 128-130; Nellis, 1996, p. 7. Empirical evidence (Barberis et al., 1996) supports the importance of management and ownership change for restructuring.

and some outsiders may be as inept or as intent on asset-stripping as the worst of the insiders.⁴ It has also been noted that privatization can only work in concert with other institutions, such as corporate governance, competitive markets and a hard budget constraint (Brada, 1996, p. 84). These are still far from being fully operational in Russia. Having done everything by the book, Russia will have to wait still longer for the fruits of its efforts.

This paper argues that even after the property rights in privatized firms are sorted out and all the other conditions for an efficient market are met, the privatized enterprises will not become an engine of durable economic recovery in Russia.

One reason for this has to do with the life cycle of firms and industries in any economy. The privatized firms, all of them created before 1992, are concentrated in older sectors that are growing more slowly than the economy as a whole.⁵ Apart from the sectoral effect, the old firms grow slower than the new ones (Evans, 1987 and 1987a). The incumbents' fixed capital and organizational knowledge represent the choices appropriate for the past, but not necessarily for the present, and their ability to adapt to new conditions is limited.⁶ Lifecycle considerations preclude privatized firms, as a group, from becoming an engine of growth, even though individual privatized firms can do very well.

The legacy of central planning greatly aggravates this general condition. The state owned enterprises embody "a structure of production - location, capital, employment, materials and energy use ... created, without any regard for economic opportunity costs ...". They are "fundamentally non-viable in an environment determined by market valuation" (Ericson, 1996, pp. 1-2).

⁴ *Rossiiskie...* 1995, pp. 76-77; Kuzenkov, 1996, p. 37; Deriabina, 1996, p. 29, 34, 35.

⁵ On industry lifecycle, see Williamson, 1975, p. 215, and Klepper, 1996.

Far from being an engine of growth, privatized firms as a group will shrink in both relative and absolute terms. Many of them will close. In an established market economy, the exit of failed firms is an incremental process.⁷ The post-Communist transformation leads to the realization of the exits “pent-up” for decades, so the exit rate should be much higher than in a long-running market economy. The output contraction since 1990 and the financial ruin of privatized firms suggest that many of them are already dead, if not yet buried. Three quarters of the privatized firms are “in need of ... far-reaching restructuring”, and at least a quarter should be bankrupt (Blasi, et al., 1996, excerpted in *Transition*, April 1997).

2. New firms can

For the economy to grow, both the natural attrition of the existing firms and the weeding out of the unviable legacy of the central planning has to be more than matched by the creation of new businesses. This is exactly what happened in the East European countries. The private sector’s share of the Czech GDP increased from 5% to 60% in 1989-95. “Most of this growth is due to small-scale, owner-operated businesses, while the output of the large-scale industrial state enterprises has declined. ... Despite little progress in privatization in Slovakia since 1993, the private sector contribution to GDP has increased from 27% in 1991 to 62% in 1995.” (Borish and Noel, 1996a, pp. 6, 9). “The return to growth of Poland and Romania ... cannot be attributed to their formal privatization programs, which have been slow, but rather to their strong record on new entry.” (World Development, 1996, p. 63).⁸

⁶ Bureaucracies’ conservatism appears to increase with age (Williamson, 1975, p. 200).

⁷ See Audretsch, 1995, p. 159, on the age composition of exiting firms in the US manufacturing, and Acs, 1996, p. 41, on exit rates for all US firms in 1980-86.

⁸ See also Ernst, 1997, p. 32.

The transformation literature itself has not come to grips with the fact start-ups turned out to be the main movers of recovery. The very authors pointing to new business creation as the main source of growth pay surprisingly little attention to it. *The World Development Report 1996* devotes a chapter to privatization and just one page to new firms. OECD surveys of Russia and East European countries in 1995-96 all contain sections on privatization but hardly any mention of new business. Even some of the authors extolling supplying the above-quoted praise for new business formation (e. g., Borish and Noel, 1996) concentrate on the private/state-owned dichotomy and have little to say about the creation of new businesses as a subject in itself. The same is true for such Russian publications as *Russian Economy - 1996* and earlier issues. In conversations, Russian researchers rate the topic of new business formation as a low priority.

Kornai (1986, p. 1730) observed such a phenomenon in the Hungarian reforms under the old regime: “The naive reformers were concerned with the problems of the state-owned sector and did not spend much hard thought on a reconsideration of the non-state sector’s role. It turned out, however, that up to the present time, it has been just the non-state sectors that have brought the most tangible changes into the life of the economy.”⁹

The reason for this existing-firm bias is that economics has little to say about the difference between new and old firms. New firms play a central role in Schumpeter’s theory of economic development, serving as the main source of new combinations of resources, that is, technological and organizational innovations (Schumpeter, 1911, p. 66). Empirical studies of technological innovation have confirmed this view (Scherer, 1992, p. 1425). New business formation is less crucial for other aspects of market performance. It is just one of several types of market en-

⁹ Johnson and Loveman (1993, p. 191) and Janusz Szyrmer (personal communication) saw the role of new business formation early on.

try (Mueller, 1991, p. 11). While entry has long been held important for the functioning of competitive markets, recent empirical studies have tempered this view, suggesting that changing market shares of incumbents may be more important (Geroski, 1991 and 1991a).

One can argue that adaptation to market conditions requires a radical change in resource combination, an innovation at which new firms are better than the old ones. Alternatively, one can note that there are just three types of actors in a post-Communist economy, Communist-era firms, domestic entrepreneurs, and foreigners. With privatized enterprises bearing the burden described in section 1 above and foreigners being handicapped by an information disadvantage, the new firms emerge as the heroes of transformation by default.

3. Approach to measuring new business creation

3.1 New businesses are born small

The study of new business creation is closely related to that of small business (OECD, 1996; Acs, 1996). The reason is that most new businesses are born small, and need to cope with the specific problems of small firms in order to survive. Many countries set up special government bodies for aiding small businesses and collect data on their numbers. Thus, the research on new business formation in the US benefited greatly from the Small Business Administration's longitudinal database tracking all manufacturing firms starting in 1976 (Audretsch, 1995, ch. 2).

The observable event that most closely correlates with the creation of a new firm is the legal act of incorporation or registration with tax authorities. This excludes new plants built by an existing firms and the purchase of an existing firm by another one - all forms of expansion of existing businesses. The new firms that are wholly or partially owned by the existing ones fall into the inevitable gray area.

This paper uses the data on the number of small firms collected and published by the Russian State Committee for Statistics (Goskomstat). The data's coverage and limitations are discussed at length in this and the next 3 sections. Surveys of small firms conducted by Russian researchers serve as a major source in sections 5-6 of this paper. They are supplemented by cases reported in the business press.

3.2 Legal and statistical definition of small business in Russia

The legal creation of private businesses in Russia started with the law broadening the scope of self-employment in November 1986 (*Pravda*, Nov. 21, 1986). In March 1988, the Law on Cooperatives allowed for *de facto* private enterprise (*Pravda*, June 8, 1988). Cooperatives started cropping up as early as 1987, and by the end of 1991 numbered about 170,000 (Goskomstat, 1992, p. 74).

The category "small firm" was introduced by the decree of the USSR Council of Ministers in the fall of 1990. It was defined as having a maximum of 200 employees for the industrial and construction sectors, 100 in R&D, 50 in other "productive" sectors, and 15 in retail and other "non-productive" sectors. Both the regular full time workers and the full time equivalent of part-timers, contractors, and other irregular workers were counted towards the limit. Firms with all forms of ownership recognized by law at the time, from state owned to private, could be classified as "small" if they met the size constraint. This definition of a small firm was confirmed by the decrees of the Russian Council of Ministers regarding the development and support of small business in July 1991 and in May 1993 (Goskomstat, 1995, p. 230; Belokonnaia and Plyshevskii, 1995, p. 3).

Firms established under the Soviet law (e. g., cooperatives) had to re-register in accordance with Russian law on property in 1991-92. The first part of the Civil Code, enacted in late

1994, again changed the definition of some forms of enterprise (*Grazhdanskii ...*, 1994, Chapter 4). The law regulating the introduction of the code stated that the bylaws of all businesses have to be changed to comply with the Code. Such change necessitated obtaining a new registration. Deadlines for the change varied from mid-1995 for some organizations (*polnye* and *smeshannye tovarishchestva*) to mid-1999 (*Grazhdanskii ...*, 1994, pp. 297-8).

The June 1995 law “On the state support of small business” redefined small firms as private entities employing up to 100 people in industry, construction and transport firms, 60 in agriculture and R&D, 50 in other “non-productive” sectors and 30 in retail (Solomennikova, 1996, pp. 155, 159; Zavarina and Fidler, 1995, pp. 13-14). Furthermore, for the firm to be considered “small”, no more than one quarter of its charter capital could be owned by government bodies, non-profit organizations, or large firms. Private farms and self-employed individuals were also classified as small enterprises (Belokonnaia and Plyshevskii, 1995, p. 6).

Official statistical data collection is supposed to use the legal definition of small firm.¹⁰ Special reporting forms are collected from a fraction of the small businesses (about half in 1994). The firms are, apparently, not legally obliged to file these forms, or the law is not being enforced. Starting in 1994, Goskomstat combined the data from the reports with the estimates for the small enterprises that had not submitted the reports.

The total number of small businesses is estimated using tax agency data and the Unified State Registry of enterprises and organizations. Using local samples, statistical organs could then determine the share of registered small firms that were inactive (more than a third overall). While Belokonnaia and Plyshevskii (1995) are not entirely clear on this, it appears that the number of small firms reported by Goskomstat is an estimate of the number of active small firms. Goskom-

stat then estimates employment, wages, output, sales, profit, investment and other magnitudes for the non-reporting firms and combines these estimates with the corresponding data reported to it. Starting in 1995, sample research has been used for the quarterly monitoring of the small business sector. Goskomstat intends to get all small firms to file annual forms, but it is not clear how successful it has so far been in this respect.

Data collection procedures have been changing between 1991-95, and will change again to accommodate the 1995 decree. The sources used in this paper do not explain how the consistency of data over time has been assured in the face of these changes.

4. Small business sector stagnates

4.1 The meaning of the data and the record of new business creation

In this study, net new legal business formation (the number of births minus the number of deaths) is approximated by the change in the number of small firms from one year to the next.

Perhaps as many as one third of the small firms are privatized state enterprises or their subsidiaries (Alimova et al., 1997, p. 12). These are not new firms by our classification, so at the height of privatization our measure of new business formation must have been upward biased. However, by October 1, 1994, state and municipal enterprises each made up about 2.5% of all small firms, and those with mixed ownership, a further 11% (Zavarina and Fidler, 1995, p. 13). Whatever the origin of small enterprises, changes in their number after 1994 constitute the new private business formation.¹¹

The change in the number of small businesses fails to catch two types of new business

¹⁰ The rest of this section is based on Belokonnaia and Plyshevskii, 1995.

¹¹ Remarkably, new private businesses are adapting significantly better than small businesses

formation: new self-employed people and new firms which start out large. The latter are few in number, but the former are very numerous. However, the nature of self-employed economic activity is specific enough that it is accounted for separately in most national statistics systems. While small firms can do many of the same things as the big ones, the range over which the self-employed can substitute for firms of any size is trivial.

It would seem that the data on changes in employment, sales, and profit of small businesses contain more information than just the change in numbers. However, the latter are more reliable (Sutherland, 1997, p. 10). Therefore, we focus on the number of small businesses, and make little use of the other variables.

It has been argued above that the established firms in post-Communist economies are likely to have a much higher mortality rate than in a going market. One would also expect a much higher rate of new business creation. Under Communism, there was an untapped supply of individuals who wanted to be their own bosses. Centrally planned economies had too few small firms compared to the market economies.¹² The sectors where small firms predominate in market economies (retail, consumer services, farming) were underdeveloped. “One of the challenges confronting nations throughout Eastern Europe is to generate or regenerate the entrepreneurial sector in order to achieve a more balanced industrial structure.” (Acs and Audretsch, 1993, p. 229). And high rates of exit itself would have freed resources for more start-ups.

Table 1. Small business sector in 1991-1996

originating, in one or another way, in the state sector (“Malyi ...”, 1995, pp. 27, 53).

¹² See Acs and Audretsch (1993, p. 228) on Polish, Czechoslovak, and East German manufacturing, and Brown et al. (1993, p. 15-16) on Russian industry compared to the US and Western Europe.

Year	Number, year end		Employment	
	thousand	growth rate %	millions	growth rate %
1991	267.0			
1992	560.0	110.0		
1993	865.0	54.5		
1994	896.9	3.7	15.1	
1995	877.3	-2.2	13.9	-8.0
1996	810.0	-7.6	14.0	0.7

Sources: 1991-1995: Goskomstat 1996, pp. 688-90. 1996: Dokuchaev, 1997. Employment in 1995: "Razvitie ...", 1996, p. 64.

Indeed, the number of small firms grew quickly in 1992-93 (see Table 1). Yet in 1994, the growth almost stopped. In 1996 the number of small firms has declined to 90% of its 1994 level.

Table 1 shows that the total number of people employed by small businesses declined in 1995 and did not increase in 1996. While part-time labor is crucial for small businesses, it is also an inherently more difficult magnitude to measure. The number of full-time workers is reported to go up by 8% in 1995 ("Razvitie ...", 1996, p. 64).

4.2 Some international comparisons

Russian small firms produce 10-12% of GDP, employ 12% of workers and 3-3.4% of the economy's fixed capital and earn 20% of the economy's profits.¹³ This is far less than in long-standing market economies. Firms with less than 100 employees accounted for 56% of all jobs in

¹³ Babaeva and Chirikova, 1996, p. 165; Dokuchaev, 1997; interview with Ivan Grachev in Kap-

the 12 European Union countries in 1990 and 39% in the US. In countries closer to Russia in terms of their level of development - Greece, Spain, Italy - firms with 20 and fewer employees made up 40-50% of all employment (OECD, 1996, pp. 19, 21).¹⁴ Therefore, the end of growth in the number of firms in 1994-96 cannot be ascribed to the maturation of the small business sector in Russia, which remains too small by international standards.

The above comparison is not meant to faithfully represent the relative size of small business sector in Russia and other economies. Definitions of small business vary across countries, as does the extent of the underground economy and of self-employment. Including the latter would make Russian small business sector larger relative to the similarly adjusted European one in terms of labor and output. Still, as argued below, underground business activity is a very imperfect substitute for the legal one. The data cited here give a rough indication of the relative underdevelopment of the Russian legal small business sector.

Table 2 provides some idea of how the number of small businesses in Russia should have grown if that country followed the successful transformation trajectory. Russian data were shifted 2 years back to provide comparability with respect to the stage of transition.¹⁵ While definitions vary across countries (thus, small firms in Hungary are those with fewer than 50 employees), the numbers are suggestive. Growth rates are higher for all the countries in all the years, with one exception. The number of sole proprietorships in Poland grew at a lower rate in 1990-91 than that of small businesses in Russia. The reason for that is the much higher starting

kov, 1996; Kriviakina, 1996; Solomennikova, 1996, p. 154.

¹⁴ There does not appear to be a relationship between a country's stage of development and the small business' share in employment for the range represented by the OECD countries. Naughton (1995, pp. 139-141), writing about China, makes a similar argument for both developed and developing economies.

¹⁵ This aligns the first post-Communist year in Russia (1992) with that in Eastern Europe (1990).

point for the former country. In 1990, Poland already had more than 1,100,000 sole proprietorships, while Russia had only a quarter million small enterprises in 1992. (Poland's population is about one fourth of Russia's). Even so, the growth of number of sole proprietorships continued through 1992-94.

Table 2. Number of firms in post-Communist economies, growth rates, %.

	1990	1991	1992	1993	1994
Hungary, small firms	174.9	108.7	30.0		
Slovenia, small firms		82.4	24.6		
Macedonia, private firms			162.9		
Poland, corporations	153.9	51.9	28.3	14.3	
Poland, sole proprietorships	39.6	25.1	14.8	9.4	
Russia, small firms, 2-year lag	110.0	54.5	3.7	-2.2	-7.6
Ukraine, small firms, 2-year lag	157.7	48.5	6.4	14.7	1.6

Sources: Russia - Table 1, Poland - Johnson and Loveman, 1995, p. 9; Hungary, Slovenia, Macedonia - Bartlett and Hoggett, 1996, pp. 163-4; Ukraine - Lakoza, 1997.

The last row in Table 2 shows that Ukraine - like Russia, mired in a transformation recession - had a similarly anemic rate of growth in the number of small businesses.

5. Could stagnation be a statistical artifact?

It could be that the growth of the small business sector continues as it should, but in the forms that official statistics are unable to fully capture.

5.1 Re-registration eliminates inactive firms

Vilenskii (1996, p. 36) suggests that the re-registration of small firms to comply with changes in the law weeds out inactive firms, reducing the total number of registered firms. It is implied that new business birth rate may remain as high as before, but the observed death rate is exaggerated because deaths that occurred in earlier periods get discovered during the registration. If so, statistical data on stagnation may be masking actual growth in the number of small businesses.

However, Goskomstat itself tries to check registration data against the tax returns to eliminate the inactive firms (see 3.2 above). So the reported stagnation applies to the (however poorly estimated) number of active small businesses. Even if these attempts are largely unsuccessful and the reported number of firms includes many inactive ones, the re-registration still would not matter. Most of the re-registration of Soviet-era firms was completed before 1994, when the growth stopped.¹⁶ And the compliance with the new Civil Code in 1995 cannot explain the lack of growth in 1994 and 1995, since most firms did not have to re-register right after the adoption of the Code (see 3.2 above). A survey of small businesses in Moscow in March 1996 found plenty of firms with organizational structures not in compliance with the Civil Code. No one was being forced to re-register or punished for failure to do so (“Malyi ...”, 1996, pp. 27-28, 38). Finally, there is no evidence of a decline in the share of inactive small firms in recent years. Thus, out of 20,000 small firms registered in the Magadan region, only 4,000 filed tax returns (Babaeva and Chirikova, 1996, p. 166). In Moscow, two thirds of small businesses filed tax returns. The share of “fictitious” firms in their total number is estimated to be 10-12% (Latynina,

¹⁶ A nationwide survey of small businesses in 1994-95 found a small number of cooperatives (“Malyi ...”, 1995, pp. 22, 54).

1996). In Moscow's central district, with the country's highest concentration of registered firms, about half did not submit reports to tax authorities. For the newly formed firms this share reaches two thirds (Rumiantsev, 1996). The Moscow registration office estimated that by the end of 1995, 30% of businesses, most of them small, stopped operating without formally liquidating themselves ("Malyi ...", 1996, p. 46). In yet another sample, only a half of the registered small firms filed tax returns. Of these, one third submitted returns showing no activity (Vagina and Tjukanova, 1996, p. 133).

Either the re-registration process did not weed out the inactive firms thoroughly enough, or new inactive firms have been created as fast as the old ones were liquidated. In either case, the impact of re-registration on the reported number of small firms should not have been significant.

5.2 The shadow economy, changing definitions, mergers and graduation

Several sources allege that small businesses are increasingly going into the shadow economy, presumably to avoid taxes and other levies.¹⁷ If so, one could argue that the growth of the small business sector continues, only in forms invisible to Goskomstat.

Operating underground is just one way to avoid taxes. Creating many shell firms is another (see Filippov, 1997, Rumiantsev, 1996, Dokuchaev, 1997a). These firms register with the municipal authority (thereby becoming visible to Goskomstat). They also acquire a seal and stationery, but never register with the tax authorities or the pension fund. They may not even need a bank account (which cannot be opened without registering with tax authorities). There is little threat of detection for about a year, and some manage to stay below the tax inspection's radar even longer. Others close down within a year, either without the audit (obligatory for closing

¹⁷ Kapkov, 1996; Kriviakina, 1996.

down a firm), or having bribed the auditors (Barkan et al., 1995, pp. 39, 42). Alternatively, a firm may register with tax inspection and open a bank account, but wind down its operations and empty the account by the time it has to file a tax return. The demand for such “shells” is high enough to give rise to specialists who register and sell corporations (Rumiantsev, 1996).¹⁸

Evading taxes by not registering a firm involves substantial costs. Unregistered business cannot operate on the same scale and grow the same way as a registered one. They cannot use the banking system, engage in anything visible (hang a shingle, advertise broadly) and grow large.¹⁹ Therefore, the preferred tax avoidance strategy is for the registered firms to hide more of their activity (Kaufmann, 1996, p. 14).²⁰ Therefore, the effects of increased tax avoidance on the reported growth of the number of small firms are ambiguous.

If indeed prospective entrepreneurs increasingly choose not to register their ventures, this is not a statistical, but a real phenomenon. New underground businesses are very imperfect substitutes for the legal ones because of the more limited growth opportunities.

The new legal definition of small enterprises, adopted in 1995, apparently was not used in the Goskomstat report for 1995, since non-private small firms were still counted (“Razvitie ...”, 1996, p. 63). It remains unclear whether the new definition was applied in 1996. The switch to the new definition, when it occurs, will not necessarily depress the reported number of enterprises. On one hand, the maximum number of employees for industrial and construction small

¹⁸ This practice is not limited to fraudulent firms. Most new firms in Moscow buy registrations from such intermediaries (“Malyi ...”, 1996, p. 37).

¹⁹ See “Malyi...” (1996, pp. 32, 39) on the factors counteracting the lure of dropping out of the legal economy.

²⁰ An estimate of the share of “underground” dealings in small businesses’ total operations, based on surveys in Moscow, did not change in 1994-1995 (“Malyi ...”, 1996, p. 39). A comparison of regional surveys for these years does show a significant increase of underground sales (Alimova et al., 1997, p. 17).

firms will be lower and non-private firms and those with more than a 25% stake owned by large firms will be excluded. On the other hand, the maximum number of employed for retail outlets, one of the most numerous groups of small firms, will be doubled, and farms and the self-employed will be included.

Rapid growth of new businesses would not show up in the data on their numbers if every year a large number of small firms grew into larger ones. Mergers of small firms could also keep the total number stagnant, even if new businesses are created at a healthy clip. While theoretically possible, such a turn of events does not seem plausible. In a mature market economy, only a tiny fraction of small firms ever grows large (Geroski, 1991, Ch. 2). This fraction may be substantially higher during the transition, but there is no evidence of too many small firms in Russia growing large or swallowing up other small firms.

It appears that the cessation of growth of the small firms' numbers is a real phenomenon, rather than statistical artifact.

6. Possible causes of stagnation

6.1 General approaches

Registration procedures have become easier throughout the country and the local authorities' hostility towards private business declined in 1994-95 ("Malyi ...", 1995, p. 21; Alimova et al., 1997, p. 16, 44). A survey of small businesses in Moscow in 1996 found a significant improvement over the recent years in the ease of opening a bank account, finding a place to conduct business and registering a business ("Malyi ...", 1996, pp. 34, 36, 37). These positive changes must have been swamped by the negative ones to produce the observed stagnation in the number of new businesses.

The end of growth in the number of small businesses could be the result of a falling number of births, a rising number of deaths, or some combination of the two phenomena. Having separate data on these two variables would help in identifying the causes of stagnation. Thus, a decline in the birth rate without a change in the death rate would suggest that new business creation is impeded by a different set of factors than the functioning of the existing firms. It appears that in Moscow, stagnation resulted from a sharp drop in new firm registrations in 1993 and another decline in 1995 (“Malyi ...”, 1996, p. 29).

A few regions, with their particular circumstances, could shape the national trend. One reason to look beyond the aggregate numbers is the very large influence of *oblast*’ authorities on firms in their territory (Dolgopiatova, 1995, p. 238). Regional policies appear to influence the emerging firms more than the established ones (Alimova et al., 197, p. 15). The distribution of small businesses across the country is very uneven. There is an extraordinary concentration of small business in Moscow and St. Petersburg (20% and 8% of the national number) (“Razvitie..”, 1996, p. 63).²¹ The regions around these two cities, Central and Northwestern, account for 26% of the country’s population and 40% of small firms (see Table 3). The share of all the other regions is no larger than their share in the population, and even less for most of them.

The density of small businesses should vary even more across smaller units - *oblast*’s and republics. In order to explore the role of regional conditions in the stagnation of the small business sector, time series data for small business by *oblast*’/republic would be needed.

Table 3. Distribution of small firms relative to population by economic region

Economic region	Population share, %	Share of small firms, %
-----------------	---------------------	-------------------------

²¹ Interestingly, Moscow is also doing significantly better than other regions economically (“Analiz ...”, 1996).

North	4.0	2.9
North-West	5.5	9.6
Central	20.2	30.5
Volga-Viatka	5.7	2.9
Central-Black earth	5.3	2.7
Volga	11.4	9.6
North Caucasus	11.9	9.8
Urals	13.8	10.6
West Siberia	10.2	10.5
East Siberia	6.2	5.2
Far East	5.1	5.0

Sources: population - Vishnevskii, 1996, p. 96; small firms - Vilenskii, 1996, p. 31.

6.2 Hypotheses to be tested

All the hypotheses listed here relate to nation-wide causes. Hypothesizing about the regional causes requires the knowledge of the regions.

A. Firms that have emerged before 1994, and those that are trying to start now may be facing different conditions. Those who got in early use the local authorities to block the entry for the potential competitors. Similarly, organized crime may be more than paying for itself in the eyes of the incumbent businesses by keeping the entrants out.²² The result would be the *drop in the birth rate* of new businesses.

²² See Gambetta (1993, pp. 197-225) on mafia's role as the cartelizing agent in the legitimate industries.

This is consistent with the fact that incumbents are doing fine. More than two thirds of small businesses in Moscow were satisfied with their performance in 1995 (“Malyi ...”, 1996, p. 29). A survey in two regions found that small businesses do not experience much competition (Alimova et al., 1997, p. 21). Also, casual observation suggests that the variety of providers of retail and consumer services in Moscow is often surprisingly low. Finally, surveys find that the existing small businesses do not rate racketeering as a major problem. This is usually attributed to the respondents’ lack of candor on the subject. The present hypothesis suggests that this opinion may be honest - they may be just grateful.

B. It is claimed that a worsening tax and regulatory climate after 1993 explains the end of growth in the number of small businesses (Vagina and Tiukanova, 1996, pp. 132-135). Surveys of small businesses consistently find that high taxes are rated as the main problem.²³ However, taxes were already cited as the greatest problem in 1992 (Dolgopiatova, 1995, p. 239). One would need to measure the change in tax and regulatory burdens over time in order to test this present conjecture.

A worsening tax regime may operate both through increasing *mortality* of the existing businesses and lowering the *birth rate* of new ones (either by dissuading the prospective entrepreneurs from going into business at all or by driving them underground).

C. Most cooperatives (80% by some estimates) were attached to the state enterprises and allowed the management to exploit the different status of the state and private sectors (e. g., the differences between the state-set and market prices) (Lapina, 1995, pp. 18-20). Most small enterprises created in 1990-1991 were spin-offs of larger state owned firms (Dolgopiatova, 1995, p. 232;

²³ Chernina, 1996, p. 97-98; Dolgopiatova, 1995, p. 240; Latynina, 1996; “Malyi ...”, 1996, p. 54; Markova, 1996, p. 117.

Belokonnaia and Plyshevskii, 1995, p. 8). The use of small firms to siphon off the earnings of the state-owned or privatized firms continues (Babaeva and Chirikova, 1996, p. 170). However, transferring resources from state to private enterprises has been made difficult recently (Barkan et al., 1995, p. 38).

It looks like the spurt of new business creation through 1993 was motivated by the possibilities of carving up the state-owned pie. Once the pie got carved up, the main motive for creating small firms disappeared. An explanation along these lines would work through the *declining birth rate*.

D. Bank bankruptcies have caused many small businesses to lose money on their accounts and go bankrupt themselves (“Malyi ...”, 1996, p. 37). The timing of the banking crisis (1994-96) coincides with the stagnation of the small business. This factor would have worked to *increase exit*.

7. Conclusion

Speculations that massive privatization of Russian state-owned enterprises would fuel sustained growth of the economy have been proven wrong. The privatized enterprises embody central planners’ decisions that in many cases are not viable in market economy. As a group, the former state-owned enterprises are bound to decline. New businesses *can* propel a recovery, as has been the case in other transition economies. Yet net new businesses formation in Russia appears to have stopped in 1994-96.

The end of growth in the number of small firms appears to be a real, rather than statistical phenomenon. The likely causes of this stagnation fall into several groups: increased tax and regulatory burdens and/or plunder by tax and regulatory authorities, barriers to entry raised by the authorities and/or racketeering, the use of new businesses to plunder state-owned and privatized firms, and changes in privatization procedures. Any explanation of the stagnation in new

business creation is likely to involve an important regional component.

Sustained economic growth in Russia is impossible until new business formation resumes at a healthy pace.

REFERENCES

- Acs, Zoltan J., "Small Firms and Economic Growth", in: Admiraal, 1996.
- Acs, Zoltan J., and David B. Audretsch, *Small firms and entrepreneurship: an East-West perspective*. Cambridge: Cambridge University Press, 1993.
- Admiraal, P. H., ed., *Small Business in the Modern Economy*. Oxford: Basil Blackwell, 1996.
- Alimova, T., V. Buiev, and V. Golikova, "Maloe predprinimatel'stvo v Rossii", *Voprosy statistiki* no. 2, 1997.
- "Analiz tendentsii razvitiia regionov Rossiii v 1992-1995 godakh", *Voprosy ekonomiki* no. 6, 1996.
- Audretsch, David B., *Innovation and Industry Evolution*. Cambridge, MA: MIT Press, 1995.
- Babaeva, L. V., and A. Ie. Chirikova, "'Ocherednye mery' i vneocherednye peremeny", *Ekonomika i organizatsiia promyshlennogo proizvodstva* no. 7, 1996.
- Barberis, Nicholas, Maxim Boycko, Andrei Shleifer, and Natalia Tsukanova, "How Does Privatization Work? Evidence from the Russian Shops", *Journal of Political Economy* 104, no. 4, 1996.
- Bartlett, Will, and Paul Hoggett, "Small Firms in South East Europe", in: Brezinski and Fritsch, 1996.
- Bekker, Alexander, "Rossiiskii direktor imeet bol'she svobody, chem zapadnyi menedzher", *Segodnia* Feb. 18, 1995.
- Belokonnaia, L., and B. Plyshevskii, "Razvitie malykh predpiatii v Rossii", *Voprosy statistiki* no. 9, 1995.
- Blasi, Joseph R., Maya Kroumova, and Douglas Kruse, *Kremlin Capitalism. Privatizing the Russian Economy*. Ithaca, NY: Cornell University Press, 1996.
- Borish, Michael S., and Michael Noel, *Private Sector Development During Transition*. World Bank Discussion Paper 318. Washington, DC: The World Bank, 1996.
- Borish, Michael S., and Michael Noel, "Private Sector Expansion in Central Europe", *Transition* 7, nos. 5-6, May-June 1996a.
- Brada, Josef C., "Privatization Is Transition - Or Is It?", *Journal of Economic Perspectives* 10, no. 2, Spring 1996.
- Brezinski, Horst, and Michael Fritsch, eds., *The Economic Impact of New Firms in Post-Socialist Countries*. Cheltenham, UK: Edward Elgar, 1996.
- Brown, Annette N., Barry W. Ickes, and Randi Ryterman, "The Myth of Monopoly: A New View of Industrial Structure in Russia", draft Oct. 1993.
- Chernina, N. V., "Malyi biznes v sibirskom gorode", *Ekonomika i organizatsiia promyshlennogo proizvodstva* no. 8, 1996.
- Commander, Simon, and Ruslan Yemtsov, "Privatization in Russia: Does it Matter?", Draft Jan.

- 31, 1994.
- Deriabina, M. A., Privatizatsiia v Rossii: bor'ba za real'nuiu sobstvennost'", *Ekonomika i organizatsiia promyshlennogo proizvodstva* no. 8, 1996.
- Dokuchaev, Dmitrii, "Privatizirovannye predpriiatiia rabotaiut luchshe gosudarstvennykh", *Izvestiia* Dec. 5, 1995.
- Dokuchaev, Dmitrii, "Malyi biznes podvodit itogi", *Izvestiia* Jan. 22, 1997.
- Dokuchaev, Dmitrii, "Piat' tysiach firm spasaiutsia ot nalogov v odnoi komnate", *Izvestiia* March 13, 1997a.
- Dolgopiatova, T. G., *Rossiiskie predpriiatiia v perekhodnoi ekonomike: ekonomicheskie problemy i povedenie*. Moscow: Delo Ltd., 1995.
- Earle, J., S. Estrin, and L. Leshchenko, "Ownership Structures, Patterns of Control and Enterprise Behaviour in Russia", Discussion Paper no. 315, Centre for Economic Performance, LSE, Nov. 1996.
- Earle, J., and S. Estrin, "Privatization Versus Competition: Changing Enterprise Behaviour in Russia", Discussion Paper no. 316, Centre for Economic Performance, LSE, Dec. 1996.
- Ericson, Richard E., "Structural Barriers to Transition: A Note on Input-Output Tables of Centrally Planned Economies", manuscript, July 1996.
- Ernst, Maurice, "Dimensions of the Polish Transition: The Ingredients of Success", *Post-Soviet Geography and Economics* 38, no. 1, 1997.
- Evans, David S., "The Relationship Between Firm Growth, Size, and Age: Estimates for 100 Manufacturing Industries", *Journal of Industrial Economics* 35, no. 4, 1987a.
- Evans, David S., "Tests of Alternative Theories of Firm Growth", *Journal of Political Economy* 95, no. 4, 1987.
- Filippov, Viktor, "Teneviki v zakone", *Izvestiia* Feb. 25, 1997.
- Gambetta, Diego, *The Sicilian Mafia*. Cambridge, MA: Harvard University Press, 1993.
- Geroski, P. A., *Market dynamics and entry*. Oxford: Basil Blackwell, 1991.
- Geroski, P. A., "Reflections on the Entry Process", in: Geroski and Schwalbach, 1991a.
- Geroski, P. A., and J. Schwalbach, eds., *Entry and Market Contestability: An International Comparison*. Oxford: Basil Blackwell, 1991.
- Goskomstat Rossii, *Narodnoe khoziaistvo Rossiiskoi federatsii. 1992*. Moscow, 1992.
- Goskomstat Rossii, *Rossiiskii statisticheskii iezhegodnik*. Moscow, 1995.
- Goskomstat Rossii, *Rossiiskii statisticheskii iezhegodnik*. Moscow, 1996.
- Grazhdanski Kodeks Rossiiskoi Federatsii*. First Part. St. Petersburg: Al'fa-Ravena, 1994.
- Johnson, Simon and Gary Loveman, "The implications of the Polish economic reform for small business: evidence from Gdansk", in: Acs and Audretsch, 1993.
- Johnson, Simon, and Gary W. Loveman, *Starting Over in Eastern Europe*. Boston: Harvard Business School Press, 1995.
- Kapkov, A., "Malyi biznes", *Gudok*, July 17, 1996.
- Kaufmann, Daniel, "The Missing Pillar of a Growth Strategy for Ukraine: Institutional and Policy Reforms for Private Sector Development", manuscript, Dec. 15, 1996.
- Klepper, Steven, "Entry, Exit, and Innovation over the Product Life Cycle", *American Economic Review* 86 no. 3, June 1996.
- Kolomeitseva, G., and Ie. Prokunina, "Problemy metodologii postroieniia i aktualizatsii registra predpriatii v Rossii", *Voprosy statistiki* no. 8, 1996.
- Kontorovich, V., and Boris Rumer, "Why Soviet Conversion Program Doesn't Make Sense" 1992.
- Kornai, Janos, "The Hungarian Reform Process", *Journal of Economic Literature* 24:4, Dec.

- 1986.
- Kotov, A., N. Grachev, L. Baumgarten, V. Dudkin, "Sravnitel'naia rezultativnost' raboty predpriatii razlichnykh form sobstvennosti" *Rossiiskii ekonomicheskii zhurnal* no. 8, 1996.
- Kriviakina, Ielena, "Bol'shaia chast' malykh predpriatii ushla v ten'", *Finansovye izvestiia* Oct. 17, 1996.
- Kuzenkov, A. L., "Privatizatsiia", *Ekonomika i organizatsiia promyshlennogo proizvodstva* no. 6, 1996.
- Lakoza, Ievgenii, "Novyi glava pravitel'stva Ukrainy podderzhivaet malyi biznes", *Finansovye izvestiia* Sept. 16, 1997.
- Lapina, N. Iu., *Rukovoditeli gosudarstvennykh predpriatii Rossii v protsesse formirovaniia rynochnykh otnoshenii*. Moscow: INION, 1995.
- Latynina, Iuliia, "Malyi biznes Rossii: meniaem svobodu na bezopasnost'", *Segodnia* April 27, 1996.
- Layard, Richard, and John Parker, *The Coming Russian Boom: A Guide to New Markets and Politics*. New York: Free Press, 1996.
- "Malyi biznes Moskvy: metody analiza, itogi issledovaniia", *Voprosy statistiki* no. 11, 1996.
- "Malyi biznes Rossii: adaptatsiia k perekhodnym usloviiam", *Voprosy statistiki* no. 9, 1995.
- Markova, V. D., "Malyi biznes v proizvodstve", *Ekonomika i organizatsiia promyshlennogo proizvodstva* no. 6, 1996.
- Mueller, D. C., "Entry, Exit, and the Competitive Process", in: Geroski and Schwalbach, 1991.
- Murrell, Peter, "The Transition According to Cambridge, Mass.", *Journal of Economic Literature* 33, no. 1, March 1995.
- Naughton, Barry, "China's Economic Success: Effective Reform Policies or Unique Conditions?", in: Poznanski, 1995.
- Nellis, John, "So Far So Good? A Privatization Update", *Transition* 7, nos. 11-12, Nov.-Dec. 1996.
- OECD Economic Surveys, *Poland*. 1996.
- OECD, *SMEs: Employment, Innovation and Growth*. 1996.
- Perkins, Dwight, "Completing China's Move to the Market", *Journal of Economic Perspectives* 8, no. 2, Spring 1994.
- Poznanski, Kazimierz Z., ed., *The Evolutionary Transition to Capitalism*. Boulder, Colorado: Westview Press, 1995.
- "Razvitie malykh predpriatii Rossii v 1995 godu", *Voprosy statistiki* 7, 1996.
- Rossiiskie predpriatii: v poiskakh 'eliksira vyzhivaniia'*. Moscow: Ekspertnyi institut, Dec. 1995.
- Rumiantsev, Andrei, "Anatolii Borisovich pereplunul samogo Koreiko", *Izvestiia* Dec. 7, 1996.
- Russian Economy - 1996*. Half Yearly Report. Moscow: Institute of Economy in Transition, September 1996.
- Scherer, F. M., "Schumpeter and Plausible Capitalism", *Journal of Economic Literature* 30, no. 3, September 1992.
- Schumpeter, Joseph A., *The Theory of Economic Development*. New Brunswick, NJ: Transaction Publishers, 1993 (first published in 1911).
- Solomennikova, Ie. A., "Malaia ekonomika v istoricheskom diapazone", *Ekonomika i organizatsiia promyshlennogo proizvodstva* no. 7, 1996.
- Sutherland, Douglas, "Small and Medium Sized Enterprises in the Russian Regions: Employment Constraints and Incentives", Russian Regional Research Group Working Paper 7, University of Birmingham, UK, 1997.

- Vagina, M. M., and T. N. Tiukanova, "Kak pomoch malomu biznesu Rossii", *Ekonomika i organizatsiia promyshlennogo proizvodstva* no. 12, 1996.
- Vishnevskii, A. G., ed., *Naselenie Rossii 1995*. Moscow, 1996.
- Vilenskii, A., "Étapy razvitiia malogo predprinimatel'stva v Rossii", *Voprosy ekonomiki* no. 7, 1996.
- Williamson, Oliver E., *Markets and Hierarchies: Analysis and Antitrust Implications*. New York: The Free Press, 1975.
- World Development Report 1996. *From Plan to Market*. Oxford: Oxford Univeristy Press, 1996.
- Zavarina, Ie., and M. Fidler, "Metodologicheskie voprosy analiza razvitiia malogo predprinimatel'stva i iego mesta v ekonomike strany", *Voprosy statistiki* no. 9, 1995.