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Gregory Brock
Georgia Southern University, gbrock@georgiasouthern.edu

Practitioner Dialogue

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The author lived and worked in Russia from 1990-1991 and 1994-1998 and professionally evaluated many projects.

Opening a business in any market can be a difficult but rewarding experience. In Russia, the experience can be even more rewarding as the market potential is vast, and a new business often may be the first of its kind and offer previously unavailable products. However, the pitfalls and barriers to opening new businesses are severe and require a sustained effort with good local partners.

While business theory suggests that new small businesses are a major engine of growth in market economies, Russia has failed to make the transition to an economy where the engine can even get on the track. Although the number of small businesses that open and are sustained is unknown, small business openings have stagnated, and even fallen, since 1994 (Kontorovich, 1999). With the recent elections in Russia and the return of real Gross Domestic Product (GDP) growth (Slay, 1999), discussions about opening a business in Russia are again in the limelight. This author seeks to discuss several important areas of opening a business for the practitioner in Russia in the year 2000 and beyond.

Gregory Brock is assistant professor of economics, College of Business Administration, Georgia Southern University, Statesboro, GA 30460.

Small Business Development 1990-1999

Small business development in Russia began with cooperative legislation in the late 1980s during the Soviet era. Small cooperatives and a few joint ventures blossomed as the Soviet economy continued the long 1980s recession that sparked greater reform efforts under Gorbachev. With the Soviet Union's demise at the end of 1991, shock therapy in the form of the ending of most price controls was believed to be the path toward growing small businesses and improving the economy. A real sense of euphoria with market economics, despite the high inflation, led to many new businesses and joint ventures, especially in the capital city, Moscow. Following a large increase in the number of small businesses from 1992-1994, development stagnated, and even fell, after the August 1998 financial crisis. The Russian economy for 1999-2000 appears to be improving once again suggesting a need to look at practical small business development in the world's largest (in area) country. The important issues of taxation, registration, and hiring that normally confront new businesses in any economy have important special features in Russia. A September 2000 attempt to find a Russian market for two Georgia firms provides some specific examples of how these issues can be overcome.

Taxation

Western entrepreneurs find the Russian tax system to be a major obstacle in their paths. They must usually hire local people to sort out the system for several reasons. First, the tax system of Russia is brand new with a Russian Tax Administration (RTA) that was created in 1992. Though taxes existed before 1992, the ruble was neither domestically nor internationally fully convertible, and so money itself was passive and taxes were not important as most firms were owned by the federal government. This lack of a tax history presented an opportunity to develop a new code that could be simple, and much better, than the complex codes of many market economies. However, the opportunity to implement such an ideal code has now probably been lost. In its place is a code that heavily taxes businesses and poorly taxes individuals. Recognizing the importance of small business development, reformers passed and implemented a new small business tax in 1998 that lightened the tax burden on small businesses. However, taxes continue to be much higher relative to those in the U. S. and Western Europe.

The RTA is composed of both regular tax administrators and a tax police. The RTA is a federal agency that exists at all three levels of government—federal, regional, and local. Unfortunately, because of federal budget problems, the regional and local tax offices of the RTA are often financially supported by both the federal and regional governments leading to a "dual loyalty" of regional and local tax administrators. As taxes are almost exclusively controlled by federal authorities in terms of rates and base, this leads to protracted bargaining between regional and federal authorities over the collection and division of the revenues from the three largest taxes of Value Added Tax (VAT), profit, and personal income. Businesses take advantage of this bargaining process when paying taxes.

Several quite legal, but extraordinary, methods of paying taxes can ease the tax burden. For example, it is often the case that a business may have opaque ownership of its assets including the land on which the business is placed. Agreements can be made with tax authorities to offset tax dues with lease payments. Schools and other social institutions to whom the business may be providing goods and services may accumulate debts to the business that can be used to pay taxes with the cooperation of local tax authorities. Indeed, the most traded commodity in Russia today is not a commodity at all, but debt. Swapping tax payments for debt is often done and is quite legal as the local tax authorities often oversee such a swap.

Uncertain property rights, combined with taxation, are another reason for low small business development. One method to overcome this obstacle is to lease premises from loss making, government-owned firms that have relatively clear property rights compared to greenfield property. Local authorities often seek out investors who can help workers stay at the firm where they have worked for many years and offer tax incentives for investors to do so. Businesses that can use a lot of local employees are favored by local authorities. Having good relations with local authorities can lead to fewer ad hoc inspections by utility regulators and tax authorities—another key impediment to business success in Russia. The Cadbury plant in Novgorod is an excellent example of a plant that has weathered the 1998 crisis thanks to good relations with progressive local authorities.

However taxes are paid, the Russian Accounting Procedures (RAP) must be followed in addition to Generally Accepted Accounting Principles (GAAP) or International Accounting Standards (IAS) procedures at most businesses. Cheap local hires or software often make such issues easy to overcome. While RAP is being reformed to be closer to IAS, dual books will remain the norm for some time to come. Firms that cannot afford to keep two different sets of books will keep their accounts in RAP as is required by Russian law.

Registration

Registering a business with local authorities is relatively easy and inexpensive. Proper registration will alert local tax authorities and other government agencies that the business is open. Businesses rarely deregister when they close, and so authorities must continually attempt to weed out shell businesses that do not operate. Though registration became easier between 1994 and 1998, registration is also used by many to avoid taxes. Registering only with the municipal government and not with the local tax authority and local branch office of the federal pension fund is often done to avoid taxes. Such a shell firm will then close within a year to avoid filing a tax return. Shell firm registration is a business in its own right, and so care must be taken when registering to hire honest locals who are not part of the shell firm registration business. However, registering is not the main method for hiding economic activity, as one must register with the local tax authority to open a bank account. Any business with a time horizon of more than one year must be properly registered. Authorities can use registration as a way to close a business as they make all businesses re-register from time to time in order to weed out fictitious firms.

Hiring and Firing

Hiring employees in Russia has the benefit of a large pool of workers with a wide variety of skills from which to choose. Although surveys of investors have found that cheap labor is not the main reason for foreign direct investment into Russia (Lankes and Venables, 1996), hiring local workers is critical to success. After the August 1998 crisis, the pool of available skilled labor increased even more as many market-oriented businesses were forced to close. With the number of Russian students spending at least a semester at a U. S. university now exceeding the number from several Western European countries such as France, the availability of local hires with language and business skills is increasing as well. Instead of sending out résumés, most Russians rely on the old system of the "work book." Work books provide employees' work histories and allow them to apply for social benefits at retirement time. Those résumés that are sent out are usually of a low quality since true job searches are a relatively new part of the employment process having only been around for about ten years. The poorest résumés usually belong to older workers who have had fewer opportunities to retool their job-seeking skills.

Combined with poor local phone systems and few cell phones, hiring usually involves more interviewing and even more skill testing than in a market economy. Firms also hire more workers than in a market economy as additional workers are often needed to complete tasks that could be done by phone or Internet in a developed country. These extra workers or "expeditors" have a long tradition in Russia with some businesses often hiring relatives of local officials to improve relations with the authorities at the same time.

Firing workers is more difficult than in the U. S., but is similar to some Western European countries. Because the idea of a worker collective has been deeply rooted in Russian culture for centuries, Russian firms have often been reluctant to break up a group of workers with layoffs. Until 1996, this practice was reinforced by an "excess wage" tax that gave a direct incentive to keep a lot of low wage workers employed while avoiding paying any workers high wages. An additional disincentive to paying high wages is that, upon dismissal, firms are required by law to provide severance pay equal to three months salary to each employee. Finally, bargaining with local authorities on other issues such as taxes and registration is made easier if a firm has hired a large number of workers, and so a fourth disincentive for firing is found when considering relations with local government (OECD, 1995). Care, therefore, must be taken as to who is hired and what the firm really needs before the hiring process begins.

Overcoming the Obstacles

A recent trip to Moscow by the author offered some specific examples of how to overcome the obstacles noted above. First, and most obvious, is to partner with a firm already established in Russia. For example, Melfoods Ltd., is the sole Folgers coffee distributor in Russia. Sometimes Melfoods' shipping containers are not completely full and could include other products for the Russian market. With an 1,800-store distribution in Russia, Melfoods is open to discussions of other food products that might be distributed in Russia. By partnering with Melfoods, another U. S. firm could avoid (a) hiring any Russian employees, (b) registering its business, and (c) paying Russian taxes (as long as a price agreement covering taxes was made with Melfoods).

Once a product is sold in Russia, a firm may want to register and hire a representative or even open a representation office. The obstacles previously mentioned would still exist but would be minimized by having only a small presence in Russia. Even a single representative would allow an expansion of sales to stores outside of the partner's network. For example, Nanjin Shipping Company in Savannah, Georgia, is ready to export any product to its warehouse in Moscow with an all-inclusive price that would avoid import tax issues for a U. S. firm. Incotec Service Company in St. Petersburg, Russia, can assist in the shipping process or serve as an independent monitor of the shipment. Small stores such as "Ovoshchi-Frukty" in Moscow are prepared to buy Western sauces and dressings, if available, at a Moscow warehouse.

A more rapid market distribution can be created as well by seeking out additional partners. Ketchup and mayonnaise, sold under the Russian brand name, "Baltimore," are currently well distributed and advertised in the major cities of Moscow and St. Petersburg. A distribution agreement with "Baltimore," or a similar firm, would provide an immediate TV and newspaper presence for a new product in Russia. Many firms such as "Baltimore" are unaware of the benefits of private labeling and establishment of a brand name, providing yet another opportunity for a U. S. firm to link with major Russian players without threatening existing product lines. Yet another method to overcome obstacles is to partner with another U. S. firm already in Russia. For example, Panola hot sauces are made in Louisiana and sold on the Russian market. Panola maintains a one-person representation in Moscow. Products that supplement hot sauces in restaurants and bars could be sold through the existing Panola network with the sharing of containers as with Melfoods, Ltd.

Conclusion

Entrepreneurs in Russia's emerging markets face important obstacles in starting and maintaining their businesses. The benefits of immediately hiring local residents exceed the costs. Good relations with local governments are essential and can be enhanced with the hiring of local workers. After nearly a decade of reforms away from the centrally administered economy of the former Soviet Union, businesses have gained a foothold in the nascent Russian market. Much more development and research is needed to fully understand how far Russia can go in fostering an attractive business environment. One clear result of the 1990s decade of reform is that local officials, as well as high Presidential advisors, fully appreciate that Russia must improve the business environment as the needed economic growth will not come from domestic investment alone (Yasin, 1997).

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