

# Small and midsize business in Russia, why institutional investors should care and what to look for



The state of small business and Russian government initiatives to promote its growth can reveal much about how much room there is for market growth and when the economy and markets can be expected to experience long-term sustainable growth independent of the resource sector, writes **Jamison R. Firestone**, Managing Partner, Firestone Duncan

To avoid confusion, Russian readers should read 'small business' as 'small and midsize businesses' since any business larger than a newspaper kiosk is considered to be mid-sized by current Russian tax legislation. In this article, small businesses are referred to as SEs and midsize businesses as MEs, and collectively as small business or SMEs.

One day back around 2002 key figures in the Russian government realised they needed to foster small businesses. Somehow, somewhere, the powers that be learned that 'Small Business' - whatever that is - is the engine of a successful developed economy. Fostering 'Small Business' became a government priority and new laws were adopted to transform the sector. It was an exciting time, but ultimately small business reform has ended or at least paused without doing what was necessary to create a healthy small business sector, let alone to double GDP in ten years.

## The Role of SEs in the Russian economy

At the end of 1993, when US and EU definitions for Small Business were applied, about 94% of all Russian businesses were SMEs and they accounted for about 48.8% of all employment. The pervasiveness of SMEs has been seen as proof of the government's success in fostering small businesses and the government has seen this success as a reason to turn its attention away from SMEs. However, these figures only tell part of the story.

When the employment figures are broken down, it turns out that 11.3% of the population were employed by SEs and another 13.3% were either independent entrepreneurs (IEs) or people employed by them. Only about 15.4% of the population were employed by mid-sized enterprises. To understand why this is important and why it is not time to claim victory, one only has to look at the contribution to GDP and the tax base made by SEs and IEs.

According to Goskomstat data, small

business (which in its definition includes most SEs and IEs but not MEs) accounted for about 12.7% of GDP in 2004. The tax contribution of small businesses is even smaller. A report produced by United Financial Group in March 2005 cited that about 28b rubles (about \$1b) in taxes was paid in 2004 by businesses and individual entrepreneurs using the simplified system of taxation. That's 1.4% of all tax collected. (About 60% of all SEs and IEs use the system, which is only available when sales volumes is less than 15m rubles per year, about \$526,000). If we estimate that the remaining 40% of SEs and IEs paid roughly the same amount of tax, we can conclude that at the end of 2004, the entire small business sector (excluding MEs), which employed 24.6% of the population, accounted for 12.7% of GDP and only about 3% of tax revenue.

Whatever success the government can claim, it is clear that these SEs and IEs are not the engines of a healthy economy. Instead of fostering growing

companies Russia has fostered the creation of a vast number of very small businesses. A 'kiosk economy' now employs a quarter of the population but makes up a disproportionately small portion of GDP and the tax base. Other than providing people with employment, these businesses add little to overall wealth creation and the majority of them will never make the transition to midsize businesses.

**The Promulgation of the 'Kiosk Economy' and the neglect of the midsize sector:**

Current legislation tends to keep small business very small. When drafting its small business legislation the government confused the word small with very small and purposely decided to offer tax breaks and a friendlier business environment only to those companies that it considered as economically insignificant for the budget. Thanks to government reforms, SEs are now easy to start and accounting requirements as well as taxes are minimal. While this is a great step forward it has not led to an explosion in the number of MEs. The explanation for this lies with the low cut-off limit for use of the simplified system of taxation and the abrupt and hugely punitive cost of moving from the simplified system to the regular tax system. Small businesses which do well under the protection of the simplified system of taxation are often not large and strong enough to survive the full weight of Russian taxation and accounting requirements. The difference between the two systems is stark: 6% vs 24% profits tax, exemption from charging 18% VAT, paying tax on a cash basis vs paying profits tax and soon VAT on an accruals basis (often in advance of receiving payment for the goods and services sold), no social or medical insurance payments due on salaries, vastly reduced filing requirements. Many businesses which grow too large to use the simplified system find that they do not have sufficient resources to thrive without it and find their growth severely stunted. Interestingly enough, the burdens of compliance and making advance tax payments are often more destructive to growth than the actual increased taxes themselves.

Unfortunately, it seems unlikely that

the government will do anything meaningful at this time to foster the growth of the midsize sector.

Officials seem to be convinced that business will cheat and use preferences to reduce taxation without taking actions that produce growth and eventually additional tax revenue. One example often given is that if the limit on use of all or part of the simplified tax system were raised to cover midsize companies, companies like Gazprom might break themselves into thousands of midsize enterprises. This is ludicrous. There comes a point where the breaking of a business into several companies just doesn't make economic (or political) sense. A few businesses might split into two companies, or even three but at some point they will just get too big for this game. However, this argument is used repeatedly to offhandedly dismiss any discussion of expanding the use of all or part of simplified system of taxation to larger businesses. The same issue of trust applies to eliminating duties for production equipment. Some businesses will cheat, but not granting well thought out tax preferences to encourage growth in key areas is a rather self defeating method of preventing tax fraud.

Interestingly enough, at a time when Russia is running a budget surplus and the stabilisation fund is ballooning, budgetary constraints are constantly given as a reason for rejecting meaningful reforms. Consider the case of the Unified Social Tax. This particular tax always tops the list of problems cited by growing businesses and it probably the most avoided tax today. The high social tax rate has led to many ways of disguising employee compensation and the resulting situation is bad for business and for the government. However the current government seems to be over-focused on the budget. When it comes to making the budget, the government's role is easy. Change nothing meaningful. After all, the budget is being fulfilled. It's easy to calculate the potential lost revenue of any reform and not so easy to calculate potential gains.

When the goal of doubling GDP is added to the mix, the government has a problem. Radical growth requires radical change and that means changes that

risk the budget. The simplified system of taxation as adopted wasn't really a big risk for the budget. It granted tax breaks to businesses that were so small that they didn't pay much tax anyway. However, granting tax breaks to businesses that pay significant tax with the hopes that there will be a long-term beneficial effect on the economy and tax base is quite another story. It's revolutionary (much like the 13% personal income tax was) and it is not a decision to be taken by anyone other than the Kremlin.

**Real Transformation; When does Russia become a good long-term bet?**

Although the Kremlin has made growing the economy a key policy goal, it seems certain that the government does not feel it has the freedom to undertake any meaningful reforms in the SME sector, the one sector that can produce the needed growth. In fact, it is not even clear that the Kremlin understands where the real barriers to SME growth lie. On 14 March the President berated his ministers for failing to help small and midsize businesses develop and suggested that people who register a small business should be given a medal for bravery. Contrast this with the findings of Round 4 of the CEFIR report, Monitoring of Administrative Barriers to Small Business Development in Russia (released much earlier) which found that most Russian small businessmen no longer consider opening companies to be a problem! Clearly the intent to do something positive is there, but an understanding of the real barriers may be lacking.

So, when does Russia become a good long-term buy, energy sector aside? When we begin to hear the President voice not only the need to double GDP but the need to take budgetary risks for the sake of growing the economy; now when State coffers are full. When members of the Russian government begin to parrot the President about the need to foster growth through tax incentives rather than speaking of the hazards of not paying taxes; and finally when proactive policies of taxation and growth become law. It's actually rather simple, when the government is ready to risk its own money to grow the economy, it's probably a good time to risk yours. **rif**