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**THE DEVELOPMENT OF SMALL
AND MEDIUM SIZED ENTERPRISES
(SMEs) IN RUSSIA 1993-1995**

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Summary

Numbers of small and medium-sized enterprises (SMEs) have grown rapidly in Russia since transition began. Growth in total numbers was particularly rapid in the period 1991-93, and then slackened off in 1994, to be resumed in 1995. The slowdown in 1994 seems to have been largely a function of uncongenial changes in the tax regime facing SMEs, which may simply have forced many SMEs into the grey economy. There were in any case already signs in 1994 of the new boom in SME formation of 1995, with SME entrepreneurs already bullish in their investment plans in that earlier year. Continued optimism on the investment front has brought to the fore the problem of investment finance, which is currently perceived as one of the major problems facing Russian SMEs. Appropriate tax breaks would certainly help with the problem, but there is general recognition that the state will not be able to do much more than that. With the domestic banking system still weak, the spotlight turns to foreign capital. In general, however, Russian SME entrepreneurs do not show a high degree of interest in cooperating with foreign businessmen. The exception is the sub-sector of R&D-based SMEs. SMEs which do look abroad for financial support are generally firms which already have good access to domestic sources of credit - so that foreign finance is seen in a strictly supplementary role. It is clear that in the context of the general weakness of large-scale industry, and the crisis in the public sector R&D sector, that SMEs, especially high-tech ones, could play a critical role in the transformation of the Russian economy. But they will need more sympathetic treatment from the Russian government, and better links with the outside world.

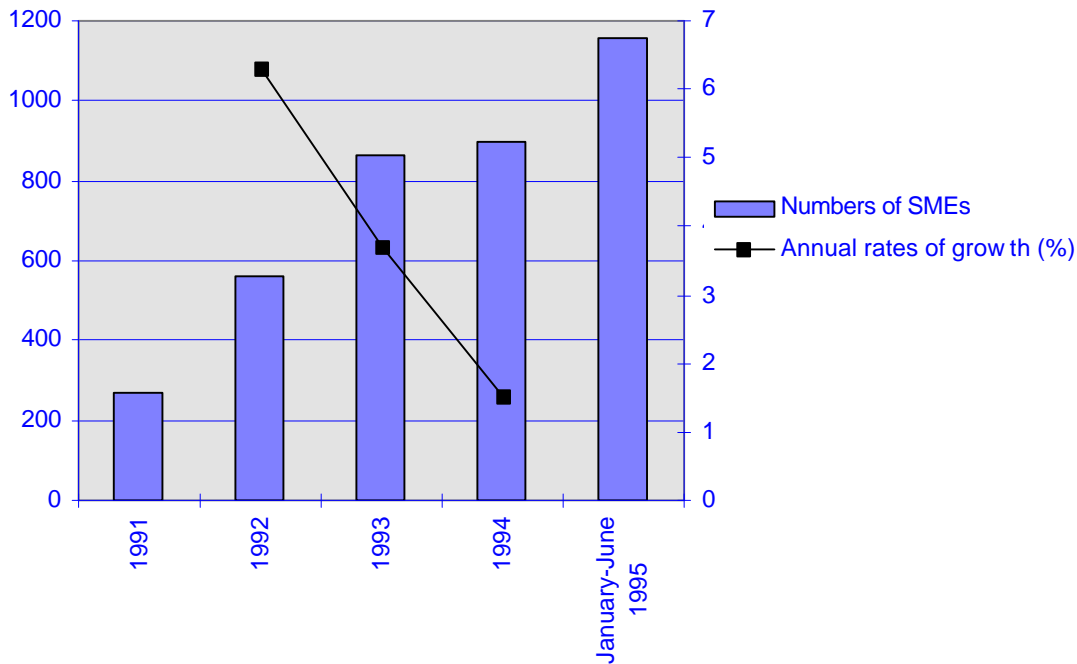
1 Introduction

Since mid-1993 regular sample surveys of the activity of small and medium-sized enterprises (SMEs) in Russia have been carried out under the auspices of the Russian Independent Institute for Social and National Problems (RNISiNP). Over the past two years the sample has embraced more than 800 operational SMEs - about 0.1% of the total number of SMEs registered in Russia. It includes companies registered in Moscow, Tula, Volgograd and Syktyvkar, and covers 12 major sectors of the economy. The balance of the sample, in sectoral and territorial terms, has been designed to achieve the maximum possible correspondence with the national pattern in the off-farm SME sector (see Diagram 1). The sample does not cover small agricultural enterprises. The (rather arbitrary) official definition of an SME as a company with less than 200 employees has been relaxed somewhat in the sample surveys, which include a small number of enterprises with slightly more than 200 employees.

The questionnaires contain a maximum of 45 questions, normally offering six or seven (but in some cases up to thirteen) alternative replies, thereby offering the respondents a fairly wide choice. The sample surveys were carried out on the basis of complete anonymity for the respondents.

2 The development of the SME sector from 1991 to mid-1995

The survey findings enabled us, not only to obtain a picture of the current state of affairs at the enterprises in the sample, but also to make a retrospective reconstruction of their pattern of development. Our questionnaires indicate that the most rapid growth in numbers of SMEs was recorded for the period 1991-92, after which there was a marked slow-down. (See Diagram 2.) There is no consensus among Russian experts on the reason for this deceleration in the rate of formation of new SMEs. It has been argued that 'we should regard this phenomenon not as a decline, but as a natural stabilisation of the pattern of development of

Diagram 2 Numbers of SMEs: annual trends

Source: Goskomstat

small business', as a result of an unavoidable 'slowing down in the rate of growth of total employment in small business, as well as in that of numbers of SMEs'.¹ It is certainly true that in conditions of a mature market economy a certain stability in the ratio of SME activity to general economic activity can be observed. Thus in the Netherlands, for example, the ratio of employment in SMEs to total employment is much the same today as it was in the early 1950s. But in Russia, a country only just setting out on the road of structural reform, the corresponding ratio is still very low by international standards (See Diagram 3). In my view, therefore, it is quite premature to talk about any process of 'natural slowing down' in the development of the SME sector. Indeed the 'natural slowing down' thesis may serve as a smoke screen and an indirect justification for misconceived economic policies, and can only

¹Goethe Institut Moskau; Administration des Gebiets Tula, *Klein- und Mittelunternehmensentwicklung und Arbeitsmarktprobleme*, Materialien des Kolloquiums in Tula, 7-9 December 1994, Goethe Institut Moskau, 1995

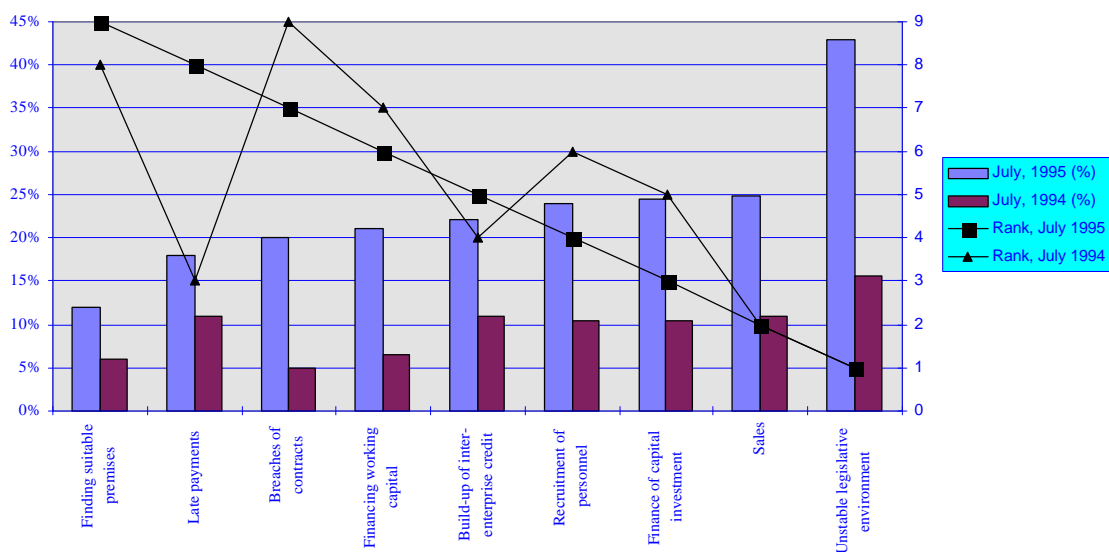
lead to a dangerous underestimation of the depth and likely consequences of the structural crisis in the Russian economic at present.

This deep systemic crisis, in the course of which the volume of industrial production has fallen by 45% of the 1990 level and the entire system of economic relations turned upside down, has certainly had a highly adverse effect on the development of SMEs in Russia. But the impact of the systemic crisis has nevertheless been less critical than that of poorly thought-out and inconsistent government policies. Most of the businessmen we spoke to averred that the lack of a stable legislative base and the high tax burden were, and remain, the main obstacle to the development of the SME sector.

3 State 'support' - and its consequences

Gaps and contradictions in the legislation create a situation where businessmen fall victims to the arbitrariness of officials representing a host of bureaucratic bodies, all of them supposedly looking after the interests of SMEs. Against that background, hopes of future improvement become inextricably entwined with fears of further impositions, to create an *ambience* of uncertainty that makes it impossible for them to plan their activity, even for the short term. Judging by the results of our surveys, this is far and away the most serious problem facing Russian SMEs. (See Diagram 4.)

Diagram 4 Critical problems facing Russian SMEs in their day-to-day operations



We can illustrate the short-sighted nature of the decisions of the Federal Government in relation to business activity by reference to Decree No 2270, signed by President Yeltsin on 22 December 1993, which increased the rate of profits tax, and gave local authorities the right to levy additional taxes and compulsory contributions, with the result that aggregate budgetary deductions for companies rose to the level of 80-90% of profit. Indeed the sum of taxes, rental payments and payments for public utilities came to exceed the volume of total profits. In that context, it is perhaps not so surprising that the rate of growth of formation of new SMEs slumped in 1994 - government policy at that time seemed bent on forcing small business into the 'shadow' economy.

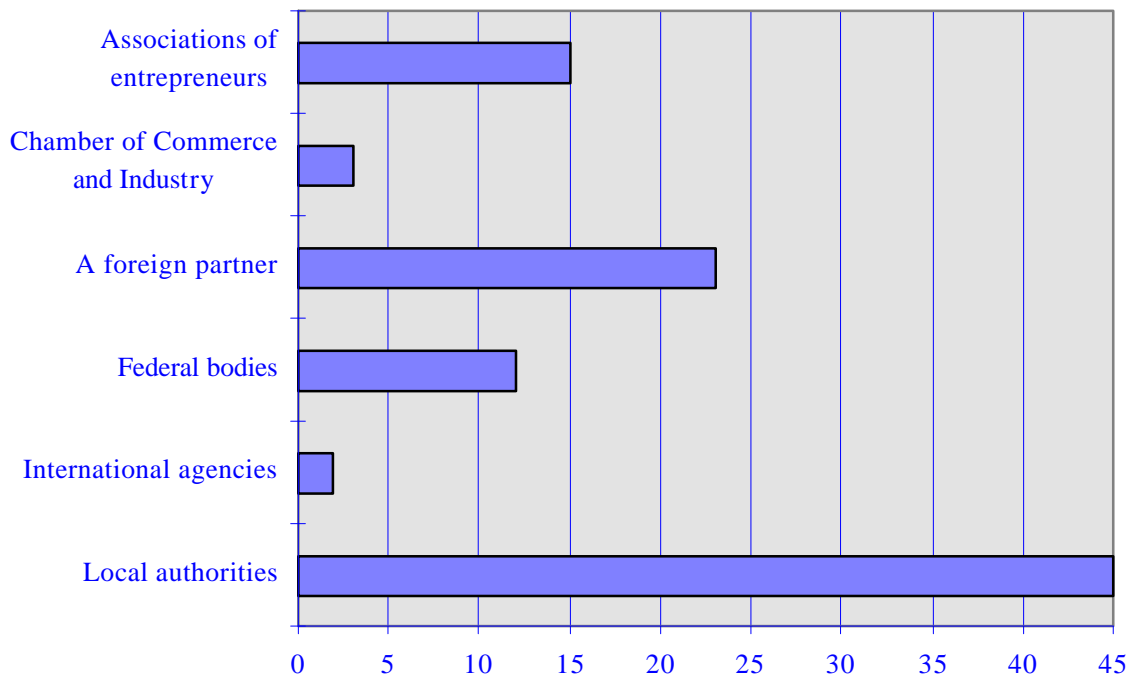
How could a policy so unpopular in business circles have been approved at the highest level? It seems that the experts on industrial policy were adamant that the rate of profits tax had no significant impact on incentives for the creation of new SMEs, because, they alleged, it was so easy for the latter to evade tax. This notion again formed one of basic premises of the economic development forecast for 1995 worked out by the Federal Economics Ministry in the summer of 1994. All our results tend to the conclusion that these preconceived ideas are totally erroneous. Rather, lower taxes, and a simpler and fairer system of taxation, are regarded by businessmen as essential conditions of any operational programme to support SME activity. (See Diagram 5.)

Of course, complaining about high taxation is a favourite pastime of businessmen, whatever their economic situation or the size of the firm, all over the world. It would be strange if it were otherwise. We noted that our respondents were sometimes inaccurate in their comparisons of aggregate taxes, direct and indirect, and the volume of profit. (They generally underestimated the latter.) In any case, indirect taxes (VAT, social security contributions, etc) are in practice largely passed on to the consumer.

One thing is, however, indisputable. When an SME sector is in the initial stages of development, its investment requirements are particularly high, while the in-house capacity to

finance these requirements is inevitably limited. Obviously, in conditions like that, and considering the job-creation potential of SMEs, the state would be well advised to provide tax holidays to small firms over the first 3-5 years of their active existence, *irrespective of any negative side-effects such a measure might produce*. A substantial part of the financial resources siphoned off, through taxation, from the SME sector, is in fact channelled into support for industry. But only a very meagre proportion of those resources comes back to the SME sector - a proportion quite incommensurate with the volume of resources siphoned off in the first place. Of the businessmen we interviewed in mid-1995, only 8% indicated that they had received real financial support from any source; and only 4.6% had financial support from the state. (See Diagram 6.)

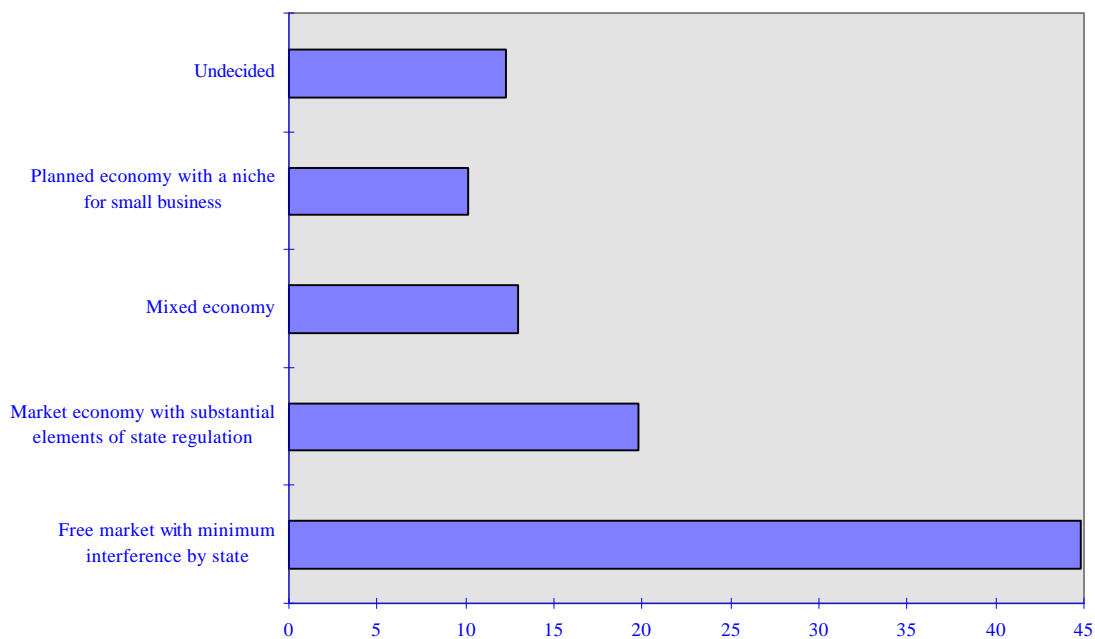
Diagram 6 Who offered real assistance to Russian SMEs during the first half of 1995? (In % of the respondents who gave a positive reply to this question)



The deep disillusionment felt by businessmen with state programmes of support for business, the extreme discontent with government taxation policy, are illustrated by the changing pattern

of views on the role of the state in the economy. In 1993, the responses to our question 'What is your preferred economic policy model for Russia', were dominated by the category 'market economy with substantial elements of regulation by the state' (30% of those polled). By mid-1995, however, that option had largely lost support, with barely 20% of the respondents in favour of it, while the proportion of the sample in favour of a free market with minimum interference from the state had risen to 45%, from 22% in 1993. (See Diagram 7.)

Diagram 7 Preferred economic policy model as viewed by Russian SMEs



4 1994-95: a turning point?

Our surveys demonstrate a quite clear principle. The better the situation in a given enterprise, the less its owners rely on assistance from state bodies, and the more active is their support for economic liberalism. Thus the growth in support for maximum liberalism among businessmen is indicative, not only of growing discontent with government policy, but also of a degree of financial consolidation leading to an increased level of economic maturity and self-reliance.

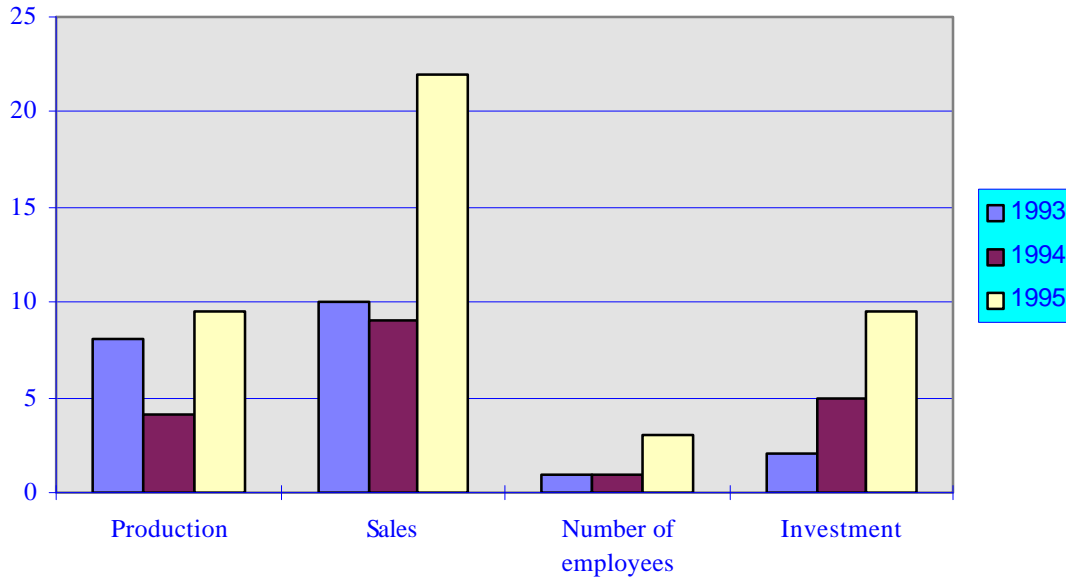
Goskomstat (State Statistical Committee) data for 1994 indicate that, despite the critical state

of the economy and the uncongenial economic policy environment, SMEs managed, by and large, to operate rather successfully in that year, and to accumulate considerable financial resources. Thus with just 3% of the fixed capital stock and 10% of the labour force (not counting part-time workers), SMEs produced 12% of the total volume of goods and services in the country and accounted for one-third of total profits generated.

In all this it should be born firmly in mind that statistics and survey data portray primarily the situation in the legal economy. But of course business, including small business, in Russia has, like the iceberg, an 'invisible part'. The legal and shadow segments of the SME sector are interrelated like communicating vessels. Thus any actions by the authorities tending to inhibit the legal sector tends to encourage movement into the shadow sector, and vice versa. On the other hand, the macroeconomic parameters of the economy have more or less the same impact on both segments of the SME sector. To that extent, the appraisal of trends in the 'white' economy can provide a basis for a more general evaluation of the situation in the SME sector as a whole.

The end of 1994 proved to be a critical turning-point in the still short post-Soviet history of Russian business. In the SME sector it witnessed the beginning of a new acceleration in the rate of development. Our survey strongly suggests that the rate of creation of new SMEs rose over the first half of 1995 - though it is of course hard to be certain that the sample is strictly representative of Russia as a whole on this indicator. The qualitative dimension of the changes in the SME sector taking place over the period 1994-5 becomes clear when we analyse the strategies employed by businessmen in the sector at this time. A comparison of the results of our surveys for mid-1994 and mid-1995 indicate an abrupt shift in the patter of intentions, in favour of a larger scale of production and sales in 1995, against the background of still deep recession at the level of the economy as a whole. (See Diagram 8.) It is particularly gratifying to observe the willingness of businessmen to expand their work-forces. Trends in investment plans are also indicative of an upswing in SME activity. And it is noteworthy in this connection that the upward trend in investment intentions was already

Diagram 8 SMEs intending to change the basic parameters of their activity, 1993-1995 (the ratio of SMEs planning to increase the given parameter to the number of SMEs planning to reduce it)

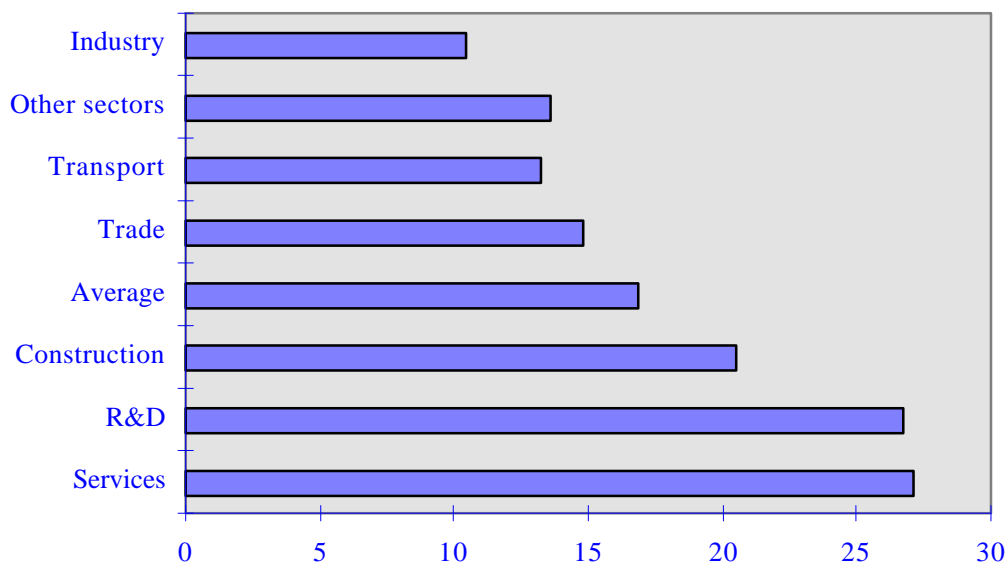


visible in mid-1994, whereas the upturn on other indicators does not manifest itself until 1995. Clearly, then, investment was the 'early turner', with the more far-sighted businessmen prepared to increase investment even though there was no immediate prospect of increasing production or sales. This is clear evidence that at least some businessmen in the SME sector have long-term strategic goals.

Strategic investments are usually aimed at restructuring production lines with a view to upgrading them to a higher technological level. We would expect, therefore, that they would be accompanied by increased demand for new technologies. A study undertaken in mid-1994 by the British consulting firm Segal Quince Wicksted in Russia and in the countries of Eastern Europe confirms that at that time SMEs were more active in Russia as purchasers of new technologies than large enterprises. Thus sales to SMEs account for 20% of the total profits of companies selling technology - nearly twice the ratio of SME sales to total sales in the economy, and of SME employment to total employment.

The specific nature of the demands generated by the SME sector produces, in turn, through its impact on relative rates of profitability in other sectors, conditions conducive to increases in investment in the development of new technologies - including in SMEs specialising in the development of new technologies. According to Goskomstat, the level of profitability of SMEs specialising in this field was twice as high as that for trade SMEs, and 1.6 times the average level for the whole SME sector. (See Diagram 9.)

Diagram 9 SME profitability level before tax in 1994 (% of gross turnover)



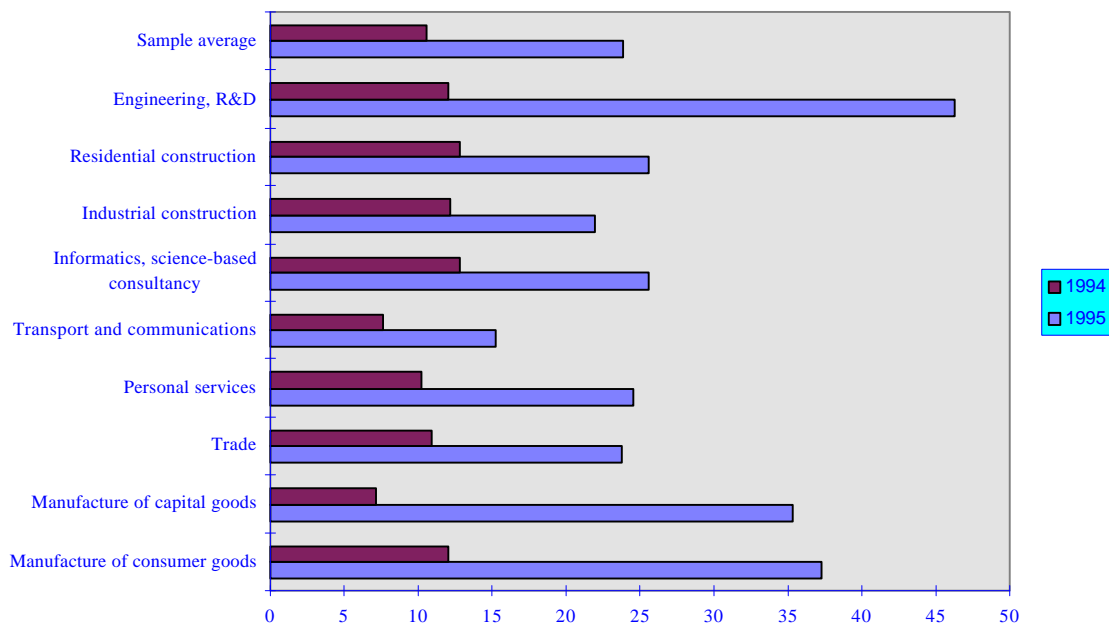
5 Financial problems of Russian SMEs

5.1 Investment finance

As noted above, for all the complaining about the desperate financial situation, Russian SMEs do manage to find funding for investment, with nearly 58% of the respondents to the 1995 poll stating that they intended to increase the level of investment, or at least maintain it at its existing level. The severity of investment finance problems does, in fact, vary a great deal between segments of the sector. Thus, for instance, while 23.9% of the total 1995 sample cited investment finance as their main problem, the corresponding figure for engineering and R&D was 46.2%. For transport and communications, however, it was as low as 15.2%. It is

worth noting that whereas trade and trade facilitation organisations reported minimal problems with investment financing in the period 1992-93, they found themselves by 1995 in much the same situation as the average SME. The same trend is apparent in relation to the financial services segment. (See Diagram 10.)

Diagram 10 Problems of fixed investment finance viewed as a particularly acute problem by SMEs, Summer 1995 compared with Summer 1994, by sector (% of total respondents)*



Note: In the 1994 survey, the respondents were requested to name up to three particularly acute problems, in the 1995 survey - only one.

The general picture, as laid out in Diagram 10, is of increasing difficulty in finding investment finance in 1995. Looking at the break-down of the figures by segment, we see that while the sub-sectors with the biggest investment finance problems in 1994 were residential and industrial construction, manufacture of consumer goods and high technology, it is engineering and R&D, and manufacture of capital goods, along with (still) manufacture of consumer goods, that stand out in 1995. This is clearly explicable in terms of the evolution of the Russian economic situation from one of recession to one of low-level stagnation.

Like any turning-point in economic activity, this phase is characterised by a very high degree of uncertainty among businessmen about the future. It is significant that nearly half of those polled in 1995 were unable to answer the question 'Do you expect your investment finance problems to worsen or ease in the future?' The exception was the engineering and R&D segment, where only 7.7% of those interviewed were undecided. It is again noteworthy that it is in this segment that views are most optimistic as to the prospects for overcoming the investment crisis - 46.2% of respondents said that they were confident on this score, as compared to just 6.6% for the sample as a whole. But the proportion of committed pessimists - 34.6% - is also above average for the sample as a whole (28.2%). The most pessimistic groups were in manufacture of consumer goods, financial services and transport, with between 36% and 40% of total responses for those segments anticipating that it will get harder to find investment finance over the foreseeable future. Strikingly, it is among SMEs manufacturing capital goods that the general view is most pessimistic, with 40.3% of the respondents from this sub-sector expressing scepticism as to the prospects for easier access to investment finance in the future. Given that the SME sector is the most dynamic in the Russian economy, and that sustained economic recovery will be critically dependent on new investment, this pessimism gives substantial grounds for doubt as to the soundness of official forecasts of early economic recovery in Russia.

We certainly cannot blame the specialised state-owned banks for the fact that some segments of the SME sector suffer from investment finance problems of a particularly acute nature. Just 8.9% of the total sample use credits from these banks, and the corresponding figure for informatics and science-based consultancy is only 2.4%, and for personal services only 3.4%. For engineering and R&D, by contrast, it is 30.8%, and in the manufacture of investment goods - 31.3%. Private commercial banks, too, are actively involved in the provision of credits to engineering and R&D SMEs, with 26.9% of the total number of respondents from that sub-sector using their facilities, as compared to an average for the sample as a whole of 13.9%. Of all the SME sub-sectors, only financial services reports a higher corresponding figure - 31.8%. It is noteworthy also that non-banking institutions and private individuals

make a substantial contribution to the financing of the investment process in high-technology SMEs. As many as 15.4% of the respondents from that segment use such resources on a regular basis, as compared to 11.0% for the sample as a whole.

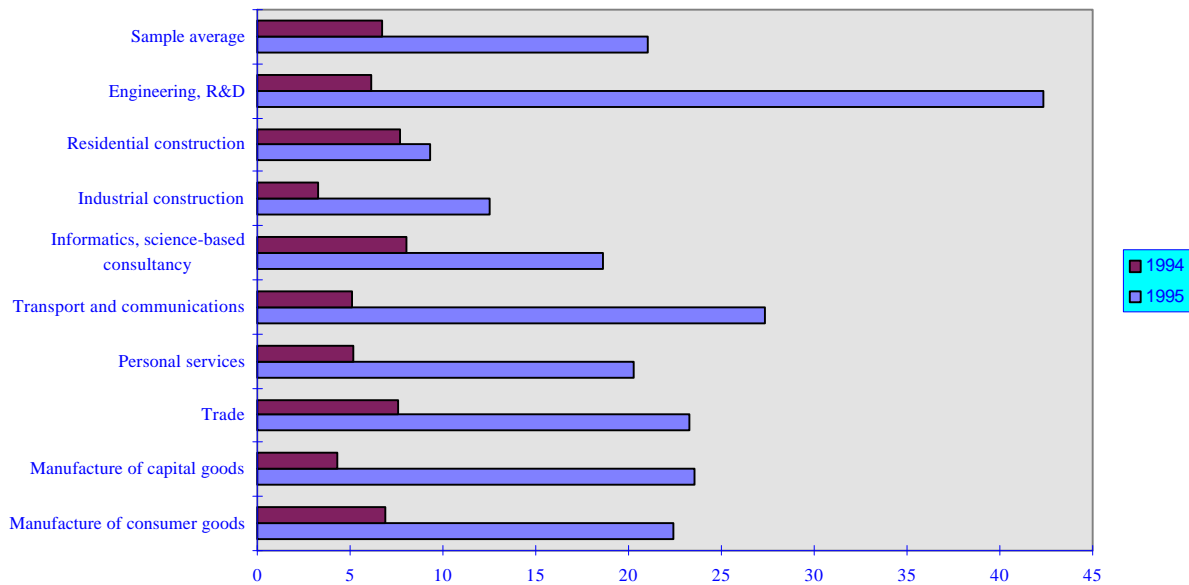
There seem to be three main reasons for the rather specific pattern of investment finance problems in the innovation and R&D and investment goods sub-sectors:

- Initial investment requirements in these sectors are comparatively large
- The demand for services and products of this kind from the private sector is very low, partly because of the general economic situation, partly because Russian firms tend to prefer to import R&D and capital goods
- There is substantial demand for engineering and R&D services and investment goods from the public and semi-public sector. This explains why state-sector banks are so ready to provide credit in these sub-sectors. It also helps to explain why firms in the engineering and R&D sector tend to more certain, one way or the other, about their investment finance prospects.

5.2 *Provision of credit for working capital*

Diagram 11 shows the present situation with respect to the supply of credits for working capital. Thus in 1995 the situation with respect to the manufacture of consumer goods was slightly worse than the situation in the sector as a whole as reflected in our sample. In our view, this can be explained by the strength of competition from imports of consumer goods, and by the collapse of effective demand. The pattern is the same for the trade and trade facilitation segment, again partly because of the collapse in demand, partly because of a certain inability to adapt quickly to the new circumstances and show enterprise in the quest for external sources of additional working capital. There is no doubt that the situation in the

Diagram 11 Problems of working capital finance viewed as a particularly acute problem by SMEs, Summer 1995 compared with Summer 1994, by sector (% of total respondents)



Note: In the 1994 survey, the respondents were requested to name up to three particularly acute problems, in the 1995 survey - only one.

field of transport and communications has been compounded by the sharp rise in fuel prices. As for engineering and R&D, the very high rate of citation of working capital problems as being particularly acute (42% as compared to an average of 21%) seems to be related to the high levels of risk pertaining to this sector in the context of an economy in the process of privatisation, and the slow rate of turnover of working capital in a sector where lead-times tend to be comparatively long, and where demand tends to be erratic rather than steady.

But the really striking thing about the survey results is not so much the differences between sub-sectors as the overall change from 1994 to 1995. The responses to our questionnaire indicate that in 1994 SMEs in segments like manufacture of capital goods, transport and communications, and even engineering and R&D, were suffering less than average from problems of supply of working capital. By mid-1995 the situation had been exactly reversed. This trend seems to have been the result of a combination of changing general macroeconomic

conditions and tightening of monetary policy on the part of the government. It raises a real possibility of unfavourable structural shifts within the Russian SME sector.

It must be said, at the same time, that respondents from these crisis segments of 1995, the capital goods segment apart, remain generally as optimistic as the sample as a whole about the prospects of improving the working capital situation (25.2% of the total sample expected the situation to worsen). It is rather the consumer goods and industrial construction sub-sectors that showed a marked degree of pessimism in 1995, with, respectively, 38.8% and 34.4% of respondents expressing the fear that the situation would deteriorate further. The latter statistic is particularly disturbing, since it suggests that at mid-1995 there was still no upturn in investment expectations, such as might have heralded a recovery in the Russian economy as a whole. It is true that in the beleaguered engineering and R&D subsector one-half of those polled said that they believed that the situation with respect to the supply of credit for working capital would get better. But that may reflect a sense of 'things can hardly get any worse', combined with a certain confidence that the state will ultimately provide support for this sub-sector.

Everyone complains that Russian banks give very little help to small business, as it tries to adapt to the critical situation on the financial markets. In fact, however, the data from our surveys indicate that SMEs in problem sectors, ie manufacture of capital goods, industrial construction and, especially, the engineering and R&D sub-sector, resort to short-term credits from specialised state-owned banks two-three times as often as the sample average of 8.7%. Private banks, by contrast, grant short-term credits mainly to SMEs in the financial services (31.8%) and residential construction (23.3%) sub-sectors. (Just 14.8% of the 1995 sample as a whole used short-term credits from private banks.) It is clear that, in the conditions prevailing, the crisis-ridden banking sector simply cannot make a more substantial contribution to the crediting of working capital. And it will not be possible to remedy the situation until a whole network of semi-state-owned mortgage loan and venture capital institutions is in place,

and until support is forthcoming for existing initiatives to set up credit partnerships and other forms of financial self-help within the SME sector.

Analysis of our survey results demonstrates, then, how fragile the hopes and tentative the plans of most of our respondents are. Their technical capability, their experience of working for the market, and the relative success of their business operations, are a necessary, but not a sufficient condition for buoyant growth of the SME sector in the context of a transformed general economic environment. The extra factor required is a well-conceived package of initiatives of financial support for small business, including tax and institution-building measures.

6 Given how limited domestic resources are, where will the money for investment in the development of SMEs come from?

Recent publications devoted to the problem of financing investment in the Russian economy have been largely unanimous in arguing that the state will be in no position to take a leading role in the financing of the investment process - and that Russian banks and institutional investors are not in a position, in the present macroeconomic climate, to fill the gap. The problem is not any shortage of savings at the level of the population at large. But with the economic and political instability of the last few years, and with a series of financial 'expropriations' (the liquidation of the monetary overhang by Gaidar's government in 1992, and the 1994 'Black Tuesday' and 1995 'Black Thursday' financial and banking crises, to mention only the three most important), the willingness of Russians in a position to save money to invest in anything other than foreign exchange and durables has been very limited.

The world financial market is still regarded as a theoretically possible source of investment funding. Up to now, the volume of foreign investments coming into Russia has been very limited. It is easy to find reasons for this in terms of the unwillingness of Western lending institutions to lend to Russian organisations. But there has been a tendency to ignore another

important factor - the degree of willingness on the part of Russian firms to host foreign investment. For this reason, we added some questions to our survey on precisely this subject.

Significantly, the majority of the respondents - 61% of the total - gave no reply to the questions about attitudes to foreign financial assistance and investment. Only around 5% of those polled were willing to fill out a form for inputting into a data base on investment proposals for potential foreign investors. It seems that in most cases small businessmen regard domestic sources of investment finance sufficient to the extent that the idea of a foreign partner simply does not occur to them.

Of those who did reply to the relevant questions, 53.5% evinced a positive attitude to partnership with foreigners, and 33% a negative one. Of the total, 31.6% were ready to welcome 'any form of assistance', while 22% were more specific, asking for credits and technical cooperation - in fields like personnel training, creation of data bases, etc. With only 13.4% insisting on complete self-reliance, the proportion prepared to accept any form of assistance was therefore 150% greater than the isolationist minority. The greater part of those evincing a negative attitude towards foreign financial involvement did, indeed, indicate cynicism rather than outright hostility. It is interesting that 27.2% of those that replied insisted on direct cooperation with foreign partners, without the participation of the state organs 'representing' the interests of small business. This gives us a good idea of the level of efficiency of the latter.

Within the sample as a whole, the sub-group for Moscow shows very little variation from these general characteristics. But the other locations surveyed do show some specificities. Tula, for instance, stands out as a town more inclined to favour the use of foreign credits (13.1%) and direct cooperation (31.3%). This seems to be a function of the particular, positive experience of partnership which Tula has had. - since 1994 the EBRD *Small Business Fund* project has been in operation in Tula, offering credits of up to US \$20,000 to local microfirms for building up their working capital. In Volgograd, by contrast, 'isolationist'

sentiments are in the ascendancy, with as many as 20.5% of the sub-group expressing themselves in favour of self-reliance. Again, this may represent the negative reactions of a population which has seen, according to local press reports, a number of joint ventures being created on paper, but failing to get beyond that. Syktyvar is characterised by a wide scatter of opinions. On the one hand, there are a large number of sceptics (27.3%) averring that 'they only talk about assistance...' On the other, the group calling for 'any forms of assistance' is also very high - 36.7%. Clearly opinions are simply not formed here, because people have no practical experience of working with foreign partners.

If we look at the data in Table 1, which is presented in sectoral terms, we can pick out a number of patterns of response, viz:

- Small enterprises in R&D-oriented sectors (informatics and science-based consultancy, engineering, R&D and technology transfer) are clearly strongly oriented to the development of direct relations with foreign partners. Here there is little evidence of negative attitudes. There are, however, differences of emphasis. While all SMEs in this category are interested in technical assistance, and indeed inclined to seek 'any forms of assistance' (informatics SMEs even more than engineering ones), the interest of engineering SMEs in foreign credits is not matched by the informatics sub-sector. This presumably reflects the fact that engineering is a much more capital-intensive sector than informatics.
- Small enterprises in the 'old' capital-intensive industries like manufacture of capital goods and industrial construction are also primarily oriented towards direct relations. At the same time there is quite a large proportion from both sectors that considers that Russian SMEs can solve their problems by themselves. The capital goods industry is moderately interested in technical assistance, the industrial construction industry hardly at all. The latter shows a significant, the former an overwhelming interest in foreign credits - this

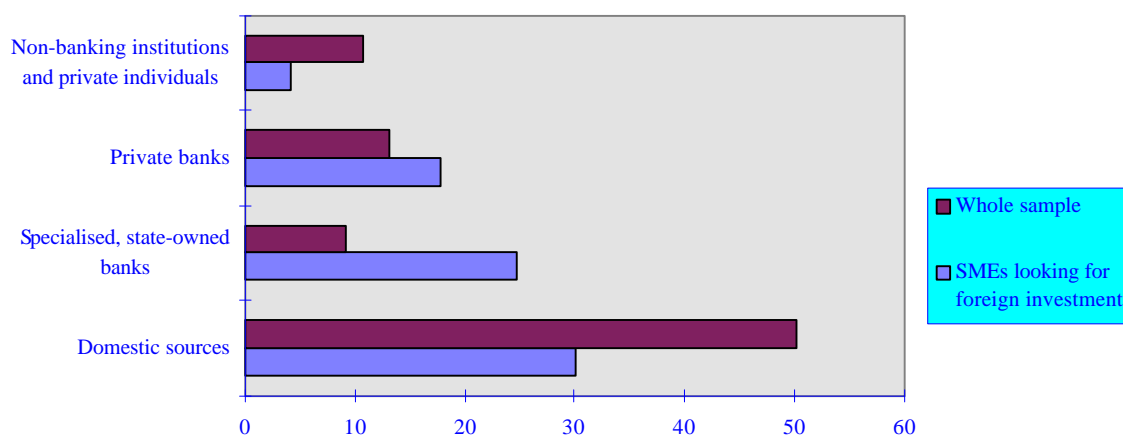
reflecting the virtual impossibility of exporting machinery from Russia without foreign credits.

- The pattern of responses from SMEs in the trade and trade facilitation sub-sector is close to the sample average, with credit and technical assistance regarded as of secondary importance. The pattern is similar in the consumer goods sub-sector, though here there is more interest in direct relations with foreign partners, and a higher degree of openness to 'any forms of assistance'

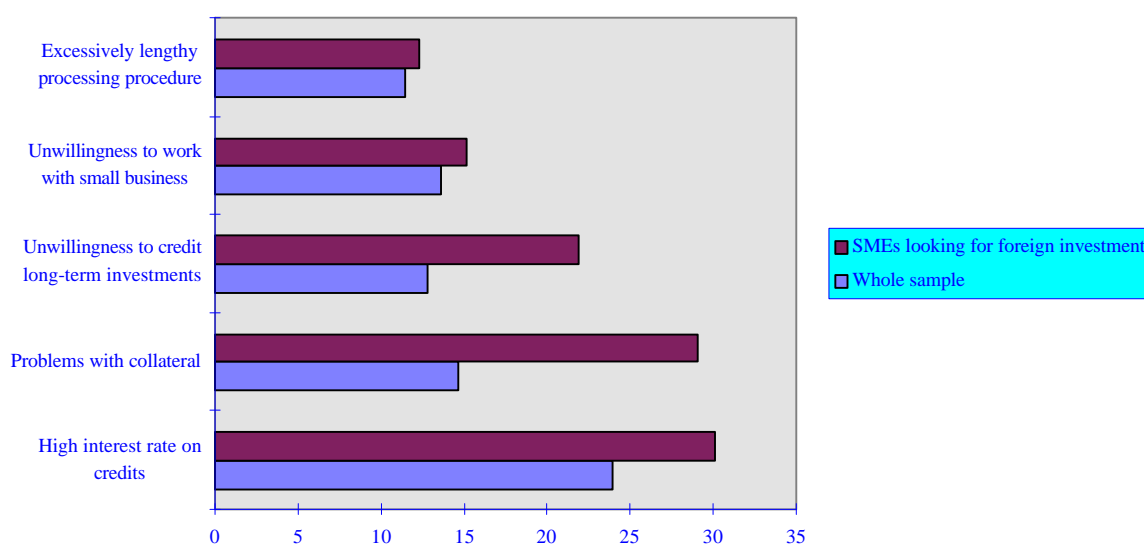
Generally, then, it is the high-tech SMEs that show the strongest desire for a direct investment partnership with the West - or indeed any other kind of partnership. The implication is that they regard such partnerships as a highly desirable, or even indispensable, way of upgrading their production capacities and improving their market position. With SMEs of a more traditional production profile, the interest in that kind of partnership is less marked, industrial construction apart.

6.1 Interest in foreign credits and provision of domestic credits

As noted above, only a minority of respondents showed a particular interest in foreign credits - just 9.7% of the total sample. The data presented in Diagram 12 indicate, however, that SMEs expressing a keen interest in foreign credits are generally those better provided with domestic bank credit, especially from state-owned banks. Within this category of SME, the proportion of enterprises having to rely on own resources is 40% lower than for the sample as a whole, and the proportion relying on non-bank intermediaries and private individuals is 60% lower. But Table 2 shows that SMEs interested in foreign credits are particularly concerned about credit problems. It is striking too (see Diagram 13) that the SMEs showing an interest in foreign credits are those that feel the shortcomings of the banking system most acutely. It seems, then, that the SMEs driven to seek foreign credits are motivated by dissatisfaction with the domestic banking system rather than lack of access to it.

Diagram 12 Traditional sources of finance for capital investment for Russian SMEs**Table 2 Main problems affecting the day-to-day activity of SMEs**

	SMEs favouring:		Sample Average
	Credits	Technical assistance	
Unstable legal framework	46.6	52.2	43.0
Shortage of credit for working capital	38.4	17.4	21.0
Shortage of credit for capital investment	31.5	17.4	23.6
Recruitment of skilled personnel	28.8	32.5	23.0
Payments arrears, growing indebtedness	26.0	27.2	21.5
Slow settlements through the banking system	23.3	20.7	17.8
Finding suitable floor space	19.2	8.7	12.1

Diagram 13 Main problem in SME relations with Russian banks

SMEs that show a particular interest in credits are generally firms going through a process of diversification (42.5% of the total sample as against 11.0% that are narrowing their field of activities), with diversification showing some tendency to take the form of a movement from predominantly production to a more trade-and-services-oriented profile (15.1% of the total sample, as compared to 6.8% diversifying from trade and services into production activity). There is also a tendency for the diversifying sub-group of SMEs to anticipate fewer rather than more investment problems in the immediate future (respectively 14.9% and 8.8% of the sub-group), and to be planning to increase levels of capital investment rather than cutting them back (14.9% as against 8.0%). It is clear, then, that this sub-group of SMEs sees foreign credits as an additional source of finance for expansion, rather than as their only hope of survival.

It is also worth noting that an above-average interest in foreign credits is displayed by SMEs that are regular customers of Russian stock and commodity exchanges, trading houses and other wholesalers in the sample (12.2%), of formerly state-owned joint-stock companies (11.3%) and of public and private sector manufacturers (12.8%). SMEs that regularly buy

from foreign firms and joint ventures show a below-average interest (8.3%) in foreign credits - probably because those foreign partners help them with trade credits.

All of this indicates that the sub-group of the SME population interested in foreign credits represents a flourishing segment of the Russian business sector. Its members give every indication of being dynamic, financially dependable borrowers, and reliable business partners. The existence of such a stratum, however small it may be, should not be overlooked by potential foreign investors. Given favourable conditions for economic growth, this sub-group of SMEs could, as vehicles of technological progress, make a notable contribution to economic restructuring. At present, however, the optimistic views of the entrepreneurs in the sub-group are at odds with the generally pessimistic view of the Russian economy held by Western investors. Much remains to be done, in Russia and at the international level, before we can be sure that the infrastructure is equal to the task of bringing together potential investors and potential host companies, and ensuring that adequate credit and insurance facilities are available for foreign direct investment in SMEs.

7 The Russian experience in the perspective of international transition

As demonstrated by Diagram 3, the Russian SME sector is relatively small by international standards. It is also relatively small by comparison with the more advanced of the transition countries. In Slovenia, for instance, SMEs account for over 20% of total employment. And while Russian high-tech SMEs report healthy rates of profit and have shown an encouraging willingness to enter into business relations with foreign companies, they are still far from playing the critical role as innovators and vehicles of technology transfer that they have assumed in some Central-East European countries. As a country seeking to make the transition from a structurally distorted and technologically stagnant central planning, Russia is, and will remain through the medium term, bereft of the large, profitable and technologically dynamic companies which fund and organise so much of the R&D that goes on in the West. With public sector R&D organisations also going through a difficult transition, a peculiarly

heavy burden of responsibility lies on the shoulders of a handful of high-tech SMEs. It should be a central concern of Russian economic policy to ensure that that handful attains critical mass.