

## **JOINT INVESTMENT WINDOW**

A Barents Region project  
Under the Barents Regional Council

How to improve conditions for establishment of SME's with foreign capital in The Russian Part of the Barentsregion ?





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### SUMMARY

The Joint Investment Window project is a project initiated by the Regional Committee of the Barents Region Cooperation. The aim of the work is to find out why it was so difficult for the Nordic SMEs to establish economic long-term activity in Northwest-Russia in the 1990-ies and what are today the challenges and opportunities that meet the foreign SME investor moving into Northwest-Russia.

The project has had its focus on the SME companies that wants to invest in the Russian market by establishing or buying into production activity, assembling, maintenance and service. Pure trade operations are not taken account for in this study.

One has also tried to focus on the challenges and problems that can be dealt with by the Regional level of the Barents Cooperation. Problems such as customs procedures, demands on certificates etc. are examples of questions being handled by the WTO-negotiations and will not be part of this reports recommendations.

**Part I** of the report gives information as to the projects aim and methods, and some definitions to what SMEs are and their part in the developed market economies.

**Part II** of the report gives a review of the development and the business climate for SMEs in the post-Soviet Russia. This review will give the readers a good basis for understanding the situation of the small and medium sized companies during the 1990-ies.

The chapter "Factors influencing the development of SMEs in Russia" is about the administrative and legislative barriers. This chapter is mainly based on World Bank / FIAS findings during their survey of 8 districts of Northwest-Russia concerning SME policy. It is an updated survey of 2003 and its findings was presented and discussed in Repino outside St.Petersburg in September 2003. Some articles presented at this Seminar are used in this chapter and are referred to in the text. The Ministry of Economy and Trade has also given their evaluation of the legislative process of reducing administrative barriers for the SMEs which is included in the same chapter.

**In part III** "Cases" the Nordic companies themselves tell about the challenges as they see them. Some information are given as a summary and then 3 cases show how three different companies experienced their attempts at setting up production companies in Northwest-Russia the past 2 years.

**In Part IV** the recommendations are given for how the Regional Barents Cooperation can assist SMEs with information, financial mechanisms and by lifting the profile of the region.

The main findings and recommendations of this work are the following;

- The economic conditions and the legal framework for the SMEs of the Barents Region, operating in the Russian market has changed considerably the last 3-4 years. The change is positive in most terms, but there is no doubt that there still are a lot of challenges for the SMEs starting up new business in the Russian market. These are burdens that the Barents Region cooperation can help to ease of the SMEs.
- There is a need to change the IMAGE of the Northwest-Russian region. The problems of the foreign companies establishing activity in this area in the beginning and middle of 1990-ies is still the image that is imprinted in the memory of the Nordic business community and the policy makers. The changes that have been taking place both economically and policy wise are important to inform about. This could partly be done through a SME conference for the Barents Region, partly through an active policy towards the media.
- There are several financial institutions and programs active in the Barents Region. Most of them give pre-project financing, a few give loans or participate in the investments through share capital. For the

latter (loans and share capital) these mechanisms seem to be available only for Finnish and Norwegian companies<sup>1</sup>. In order to make the different mechanisms obtainable for the SMEs of all four countries, for Nordic and for Russian companies one should investigate the possibility of joining forces of these financial mechanisms into a Barents Region Development and Investment Fund for SMEs.

- The companies suffer from lack of information. Russian laws and regulations are published in Russia, but for the Nordic companies the language barrier is an obstacle. In addition to the laws and regulation itself it is important to get a more thorough presentation of “How to set up business in Russia”, including information like where to go for information, where to register, important issues to decide upon concerning the registration, how to get help etc. etc. An “Investors Guidebook” for Northwest-Russia made out in the Nordic languages is among the recommendations of this project. For the further work in the project Barents 2010 this is most important. If one want to succeed with promoting the Northwest-Russian market for the SMEs within the sectors; Minerals and metallurgy, Forestry, Oil and Gas, Transportation, these companies should be aware of the challenges and demands of doing business in Russia.
- Companies and organizations have underlined challenges met by the different business style and culture between the Nordic business communities and the Russian. This is connected both to the economic and political situation in the countries, but also to different social and economic history. For Nordic entrepreneurs that intend to set up business in Russia, it is important to know more about the country’s history and the cultural aspects of life in Russia. This will help to understand everyday life, their staff, their partner and in the end help running the business in a better way, adapted to the Russian community. Such business courses should be encouraged.
- There is no doubt that the different regions of Russia differ between themselves as to how they look upon SME activities. This is often connected with the structure of the regions economy. In highly industrialized regions like Murmansk oblast SMEs do not have the same consumer and service market as they would find in St.Petersburg and Moscow. Hence the attitude towards them and the regional policy making for supporting SMEs differ between these regions. The same goes for Archangel oblast and to a large degree for the Republic of Karelia. To help the regions find rationale for a more structured and active SME policy it is recommended to ask the World Bank assist through FIAS (Foreign Investment Advisory Service) to organize a survey and policy changing process for the the business climate for investments in the Barents Northwest-Russia, as have been successfully done for many other regions in Russia. Such a work by the World Bank and FIAS would result in a more process like follow up towards the different regions based on their different needs.
- At last, to coordinate these suggested measures and the different projects run in order to promote the business development in the Barents Region, it is recommended that a regional working group is established under the Barents Regional Council. Such a working group should be attached to the BEAC WG on Economic Cooperation, either through participation or mutual meetings.

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<sup>1</sup> Russian companies can also obtain microloans through FORMAP and co-investments from NORUM if the investments are large (usually no less than one million USD).

## **PART I - INTRODUCTION**

### **1.0 Background for the report of the Joint Investment Window**

This report is done on behalf of the Barents Secretariat in Kirkenes, for the Regional Council of the Barents Cooperation. The aim of this report is to present the challenges and the opportunities that meet the foreign SME investor in Russia.

**Focus is aimed at SME companies that want to invest in the Russian market by establishing or buying into production activity, assembling, maintenance and service. In this report export / imports and mere sales activities are not taken into account. This does not mean however that these not significant activities. Such activities, sales and deliveries / services are very often the first step-stone for getting into the Russian market. But since commercial activities have been going on in the Barents Region for more than 10 years, with market surveys made for all major economic sectors and business contacts established, one have decided this time to focus on the next step in the market development .**

**Notwithstanding the different focus, SMEs investing into production or assembling or SMEs doing trade and deliveries there are common areas that need to be taken care of. These are support systems for information, training, border crossing formalities, meeting places for SMEs, changes in attitudes towards SMEs activities and needs, physical infrastructure. Alas this report and its finding should also be of use for the trading companies.**

The first 10 years of the Barents Cooperation has led to many fine results when it comes to environmental, cultural, educational and people-to people cross border cooperation. Business cooperation has somewhat lacked behind, due to economical, legal and political uncertainties in Russia. Now these uncertainties are to a large degree eliminated by the reform work that has been carried out in Russia in the last years, and there are hopes for more active business cooperation across the Barents borders.

For the Barents Cooperation the main concern is who to help the business entrepreneurs of small and medium sized companies to move into new markets and locations in Russia. The SME companies of the Barents Region are to a large extent not involved in international business and lack experience in establishing business outside their country.

When talking about establishing business in Russia, many Nordic businessmen tend to refer to a lot of myths about Russian business climate, and say it's too difficult, uncertain and costly. Common myths are:

- Bureaucracy and corruption are too difficult to handle
- Tax system is incomprehensible
- Customs regulations and duties are difficult to understand/  
Handle
- If running with profit, you can not take it out of the country
- If running with profit, you'll loose it all to the "mafia"

To what extent these myths are valid or false we will try to reveal during this project work, as well as suggest ways the regional authorities in the Barents Region can help reduce the trade barriers.

Some of the problems are well know, such as differences in certification system between Russia and the Nordic countries, customs regulations, etc. These are regulations and legislation governed by federal authorities and which regional authorities can do little to remove. WTO negotiations are taking care of many of these questions, and we will there fore not make this a case for the Regional Council of the Barents Region

Nordic companies that has established their business in Russia is a source of valuable information. As their experiences first hand can give us some guidance to where the real problems are, and how to help out. Their experiences, good or bad, will serve as case studies for this report.

### 1.1 Method

This report is made on the basis on fact finding and interviews. There has not been conducted any methodological surveys, all facts are taken from studies recently done by other institutions and foundations. When using facts and figures from these surveys we have stated this in the report.

Interviews have been carried out with representatives of companies, authorities and institutions in Moscow, St.Petersburg, Rovaniemi, Archangel and Murmansk in the period of September to November 2003. These have been conducted as informal interviews.

The Steering group of this project has been Thor Robertsen, Finnmark county adm. (leader), Svetlana Gorlanova, Arkhangelsk oblast adm., Alexander Kamenetskij, FORMAP, Jouko Jama, Lapiinlitto, Anders Jonsson, Vesterbotten county.

The Secretariat has been: The Barents secretariat: Rune Rafaelsen, with external consultants: Storvik & Co, Kristin Høiby, St.Petersburg administration, Georgy Psarev.

The report has been written by Kristin Høiby, Storvik & Co.

### 1.2 SME – what are they – what part do they play in the economy

The SME sector plays an important role in developed economies and has been traditionally regarded as an important instrument for accelerating economic growth in countries with transitional economies. Before moving on we need to clarify the conception of small and medium sized companies.

In Norway, Sweden and Finland “Small and Medium sized” companies are characterized as:

Micro:	1-4 employees
Small:	up to 19 employees,
Medium:	20 to 100 employees.

In Russian legislation SME are defined in the following terms:

#### Micro:

All sectors	up till 10 employees
Turnover	up till 15 million roubles

#### Small:

In industry, construction and transport:	up till 100 employees
In Agriculture and Science:	up till 60 employees
In wholesale and trade:	up to 50 employees
In Retail business and service	up to 30 employees
Turnover:	up to 45 million roubles

In the Russian legislation there is no mentioning of medium sized companies.

The World Bank uses the terms,

Micro:	Up to 10 employees
Small:	From 10 to 50 employees
Medium	From 50 to 300 employees

So there are different definitions in the different countries. This is however not significant. More important is that the countries acknowledge the SME sectors contribution to their economy.

The World Bank statistics show that in most developed countries (including the Nordic countries) the SME sector is the Engine of Growth. The SME sectors covers around 95 – 99.9 % of the employment.

But if one looks at the small business development trends that have been observed in Russia in recent years, one will find that the contribution of small business to Russia's economy is remaining small. According to the World Bank the contribution of the small business sector to Russia's GDP does not exceed 12 %, while its contribution to total tax revenues of the consolidated budget is about 8 – 10 %.

In Russia, according to official statistics, small businesses provide jobs for about 18 % of the economically active population, while the respective figure for EU is about 40 – 50 %. In Russia the average of small firm pr. 1.000 inhabitants are 6 (in St.Petersburg 17, in Murmansk and Archangel 3.6). In EU countries there are no less than 30.

### **1.3 Why focus on the SMEs? Why do they need special care and attention?**

SMEs are among an economy's most flexible factor. They have relatively easy entry and exit in the economy. They ensure flexibility and competitiveness in the market. If there would not have been several SMEs in one sector, we would have a few large companies that divided their market between themselves as monopoly structures. And through this tie the market mechanisms down.

SMEs play an essential role as subcontractors in the downsizing, privatization and restructuring of large companies. Larger numbers of SMEs create competitive market pressure, - and a more flexible economy overall.

SMEs are also important for poverty reduction, as ( they)

- tend to employ poor and low-income workers
- are often only source of employment in poor regions and rural areas
- self-employment is the only source of income for many poor

SMEs are not so capital intensive as larger companies, and for that reason should be easier to start up with. But SMEs very often get started on the basis of private capital. They do not have the financial muscles or the knowledge to deal with extensive bureaucracy for starting up and running their business. And they can not compensate the lack of knowledge by hiring consultants or lawyers, because of lack of capital.

The rationale for public support for SMEs is that they are subjected to what we can call “**Internal barriers**”

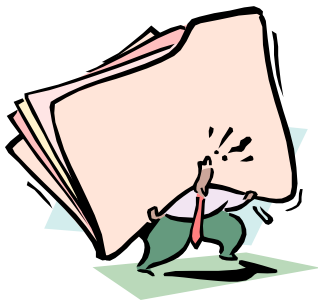
- lack of economies of scale and high cost of information
- market failure that cause biases against SMEs
- lack of collective voice and influence on policies
- limited in management capabilities
- limited in capability development

This means that they are subjected to higher cost of R & D and training. They have higher transaction costs as they are not as interesting to banks and financial institutions as larger companies. The same situation applies to private institutional agreements where SMEs do not get as favorable agreements as economies of scale.

SMEs working in municipalities and smaller regions, tend often not to be very cooperative because of the competitive situation in getting hold of scarce resources, and they therefore have difficulties forming a united group to be of political importance when regulations and policies are made.

When it comes to management capabilities SMEs can be compared to “a one engine plane”. The management has to concentrate on the daily running of the business. They can seldom afford costly support services (e.g. financial, human resources, legal, training) and their ability to access and analyze information is particularly weak. There is simply not enough time. SMEs often “don’t know what they don’t know”. And a SME that is setting up new business in another country leaves its “business home alone”. Which can not be done for a long time, or else the home base of the company could be in trouble.

If we look to Nordic SMEs that wants to establish activity in Russia, they are expected to have somewhat better financial situation than a start-up Russian company. But they will meet up with a lot of extra challenges connected with establishment of company in Russia with foreign capital, - as import regulations, documentation and paper work connected with registration of company, visa and work permit. First and foremost however they have a lack of understanding of Russian business culture and language. Very often SMEs avoid hiring external help in form of consultants or lawyers, as this is considered too expensive.



So a challenge for the regional authorities that wants to attract foreign capital in form of business activity of SMEs is to keep this in mind. Investor’s handbooks and information of laws and regulations should be made out with focus on the foreign SME entrepreneur, not with address to large multilateral companies with several hundred employees and extensive knowledge and capital on how to establish new business in new markets.

### **SMEs need special attention because they often:**

- **lack resources (capital and knowledge) of how to establish foreign entities**
- **“time is money”, an SME manager can not use months and years to set up new business**
- **about 95 % of the companies of the Nordic partners of Russia in the Barents Region are SMEs. So if one wants to develop the business cooperation, it should be done related to the needs of SMEs.**

## PART II – Business climate for SMEs in Northwest-Russia

### 2.0 Business climate in Northwest - Russia, facts and figures

In the following we will try to give a picture of the business climate for SMEs in Northwest-Russia. Business climate is not only legislation and taxes. Even more important for SMEs is that the environment that they will operate in is understandable, transparent and most of all stabile. Any region that can ensure this, together with information and support systems will be an interesting region for new investors.



**In October 2003 the World bank released its report on business climate for SMEs. In this report it is stated that start-up registration procedures for companies in Russia is taking on average 29 days and include 12 procedures, in Sweden 3 days are on average needed, and include 3 procedures.**

### 2.1 Looking back at Nordic SME operations in Northwest-Russia in 1990 – 1998

In 1990 – 98 many of the Nordic companies in the Barents Region that tried to establish commercial activity in Northwest-Russia were companies and managers that had not been involved in international activity before. There was to a large extent short term thinking, combined with not sufficient capital and human resources allocated to the work. In addition to this most of these companies experienced that their Russian partner was no better of, capital wise and experience wise.

This took place at a time when the Russian legislation was in a constant reform process regarding tax regime, customs codex and registration procedures. Old and new legislation existed side by side, and the interpretation on which one was valid for the activity the companies run, was decided by the different federal organs. The inflation was at a rate of 120 % . This led to highly risky operations and insecure times for the SMEs of the Barents Region. It all terminated by the default / crash of the Russian economy in August 1998.

During this period several Norwegian, Swedish and Finnish companies experienced losses and shut-downs of their Russian operations. Many lost money and some even production equipment.

This picture is what is often presented as the reason why Russia is still looked upon as a demanding and insecure market by the SMEs, notwithstanding the large changes that have taken place in the economic and legislative situation in the country.

### 2.2 Russian Economy and Policy in 2003 <sup>2</sup>

#### Economic development

**The Russian economic growth in 2003 exceeded all mainstream forecasts.** At the start of the year, the expert consensus forecast for GDP growth was below 4 %. The actual growth for 2003 is estimated to almost 7 % for

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<sup>2</sup> Chapter is based on information from *Finlands Bank, "BOFIT Russia Review 1, 2004"*.

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2003. The GDP figures for the two previous years are revised, and now show a growth for 2001 at 5.1 % and 4.7 % for 2002. These figures are quite impressive if one take into account the economic crisis of 1998.

The figure below show that the year 1998 ended up being a breaking point for the Russian economy. The devaluation that followed as a result of the crisis, and the import restrictions and restructuring of the cash flow situation made the national industry get back on their feet again.

Industrial production grew from – 5.2 % to 11 % the year after, and with an additional growth of 11.9 % in 2000. At the same time the average wages fell with 43 % in one year from 1998 to 1999. From 1997 to 1999 the wages fell with 62 %!! It was a major set-back for the population and the consumption. But already in 2003 the wages are twice as high as in 1998, which have lead to a considerable growth in consumption. The inflation is kept under control, and the rise in consumer prices slowed in December to 12.0 from an all time high in 1995 at 131 % and 84.4 % in 1998.

### Growth in prices came in sectors as:

Services	22 % growth
Municipal and housing services	29 % growth
Food prices	10 % growth
Non-food goods	9 % growth

The peculiarly Russian problem of enterprises' large and sustainable payments arrears has significantly eased since the 1990s. At the end of September 2003 payments arrears amounted to less than 12 % of GDP, down from some 50 % of GDP after the 1998 financial crisis. The number of enterprises in arrears has also decreased. Between 2002 and 2003 it was down by 12 %. While there seems to be a group of enterprises persistently in financial difficulties, it also appears that few new firms are entering into this group.

At the end of September 2003, almost half of arrears was debt to suppliers, less than third arrears to federal and regional budgets and the rest debt to banks, wage arrears etc. Industrial enterprises accounted for almost half of arrears.

The Russian economy of the 1990-ies is by many economists called a “roller coaster economy”. Looking at the figure below it is obvious that setting up a small company in the period of 1990 – 1999 based on the market demands of such an economy was to put it mildly, difficult.

### Macroeconomic Indicators..

	1996	1997	<b>1998</b>	1999	2000	2001	2002	<b>2003</b>
GDP %	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	6.7
Inflation 12 month %*	22	11	84.4	36.5	20.2	18.6	15.1	12.0
Average wage, \$	154	164	108	62	79	111	142	201
Industrial production	-4.5	2,0	-5.2	11.0	11.9	4.9	3.7	6.8
Enterprises payments ar (debts) - % of GDP			50	30	22	18	15	12

\* Inflation in 1995 was at 131 %.

Source: Goskomstat, CBR

### Policy issues - Customs and Taxes

2003 was a year when important pieces of legislation were passed. Russia do now have a reformed tax system, a new customs act, a law on the right for private ownership to land and improved legislation on registration of companies.

In 2004 many new key laws enter into force. One of the most important laws taking effect at the start of 2004 was the customs act passed May 2003. In accordance with WTO guidelines, the new rules bring Russian customs practices closer to international compliance. Among other things, customs clearing times at the borders are expected to shorten substantially.

Amendments to several taxes were made from the start of 2004 with the aim of easing the economy's overall tax burden. The value-added tax was reduced from 20 % to 18 %, the ceiling on the corporate property tax was lowered to 2.2 %. The 5 % sales tax, introduced after Russia's financial crisis to bring funds to regional budgets, was abolished.

The amended act on currency controls, which will come into force in the summer of 2004 eases currency controls and simplifies their procedures. Transactions that are not explicitly prohibited by the act will be allowed. The aim is that almost all currency controls excluding the repatriation requirement will be abolished from the start of 2007..

#### 2.2.1 Specifics of the economy of Northwest-Russia

The economy of the Russian Part of the Barents Region, in all the areas, Murmansk, Arkhangelsk, Nenets, Komi and Karelia, are mainly based on production based on natural resources.

Murmansk, - fisheries, mining, some forestry, oil and gas supplier sector  
Archangel – fisheries, forestry, oil and gas supplier sector, some mineral based activity  
Nenets – oil and gas (production, transportation)  
Komi – forestry, oil and gas (production, transportation)  
Karelia – forestry, agriculture, inland fisheries

The above is not meant as a full description of the areas, but a sketchy outlining of the main areas for each region.

In addition to the resource based industry there is the mechanical yards and factories, engineering companies and service and supplier industry connected with the sectors. Including transportation.

The main aspect is that in all the Russian "Barents" Regions the economy is to a large extent dependant on the larger "town-forming" companies. These are companies that are self sufficient with their own supplier chain inside their own "company - family". There are few opportunities for new SME companies to access this market as suppliers to the larger companies, if they do not offer new technology, concepts or equipment that will raise the efficiency of the companies' activities.

The Consumer market is another feature of the Russian North that differs from the more wealthy regions of Central Russia (Moscow, St.Petersburg, Leningrad oblast). The inhabitants of the northern regions have had a raise in their consumption the last years, but it is still far to go before the Northern regions can show the same kind of possibilities for SMEs selling products and services for the regular population of the North.

#### The average salary for

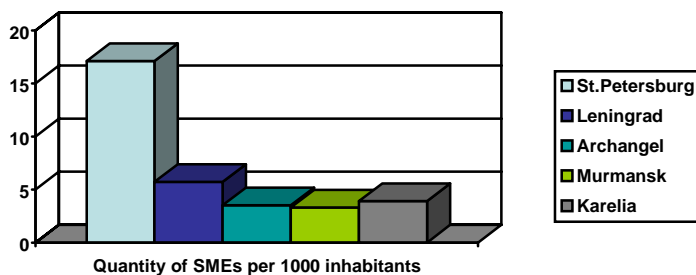
Murmansk / Archangel is	6000 RUR pr. month
St.Petersburg is	9000 RUR pr. month
Moscow is	12000 RUR pr. month

**2.3 SMEs in North-West Russia – in figures<sup>3</sup>**

Below we will give you some of the results from the study "Support for Small and Medium Sized business in Northwest-Russia, Nr. 1" by Northwest-Centre for Support of SMEs, Leontiev Centre and St.Petersburg Foundation for Business Development, shown as graphics;

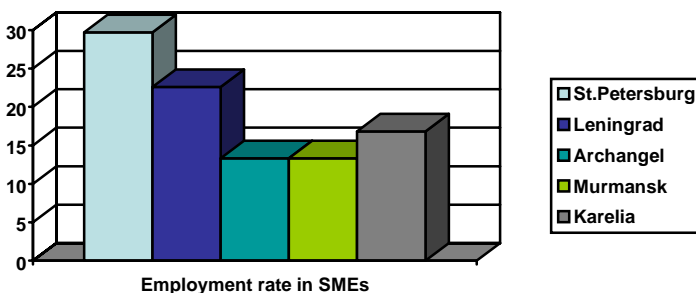
Fig. 1 shows how many SME-companies are established in each region pr. 1000 inhabitants. St.Petersburg has 17 companies' pr. 1000 inhabitants, whereas Murmansk has 3.5 companies, Archangel 3.3, and Karelia 3.9. As mentioned earlier the Russian average is 6, while the average for EU countries are 30.

**Fig. 1**



In Fig. 2 we can see that SME's employ almost 30 % of the population (workforce) in St. Petersburg, but in Murmansk and Archangel the employment rate of SMEs are only 13 %. The Russian average is 18 % while the average for developed countries (OECD and EU figures) are from 95 – 99.9 % employment rate.

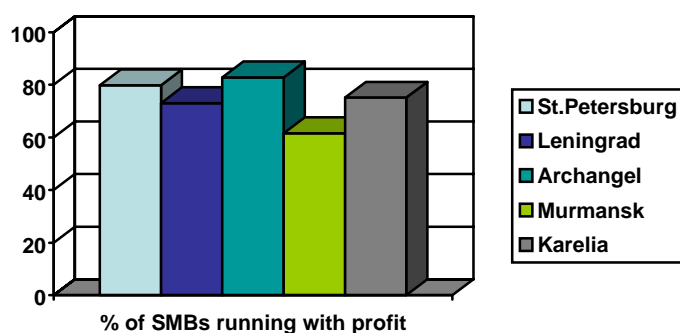
**Fig. 2**



The following graph shows the share of SME companies that run with a profit. Here the results for Archangel oblast are better than for the rest. 83 % of the SME companies in Archangel run with profit, but in Murmansk the correlating figure is only 62 %.

<sup>3</sup> The graphs and statistics in this chapter is taken from the study "Support for Small and Medium Sized business in Northwest-Russia, Nr. 1" by Northwest-Centre for Support of SMEs, Leontiev Centre and St.Petersburg Foundation for Business Development.

Fig. 3



As the reader will find, the SMEs part in the economy in these regions are not very large. Even in advanced areas like St. Petersburg and Leningrad the share of SMEs are quite small compared to the overall economic development. But taking into consideration that Russia have had a only a decade of “market economy” and such a very short history of market based economy, it is quite impressive that the SME rate has reached such level as it has. To all this statistics there is important to notice that a substantial part of the Russian micro and small businesses are leading a life in the shadows, and thus are not included in the statistics, or the statistics might not show the whole picture of the companies economic situation.

#### 2.4 Development of SMEs in post-soviet Russia<sup>4</sup>

To better understand the specific features of Russia’s small business sector it would be worthwhile to briefly consider its short, but eventful history.

##### 1987- 1991 (the cooperative movement)

The cooperative movement which began in the last years of perestroika could be considered to be the forerunner of private entrepreneurship in Russia.

The development of cooperatives in the USSR was accounted for by a total absence of market supply of consumer goods and services, and focused first and foremost on meeting the needs of the population.

The competitive advantages of the Soviet-time cooperatives were based on two factors: the huge difference in the purchasing power between the “cash” and “non-cashable” Soviet rubles and the possibility to establish prices rather freely within the planning system. So obtaining raw materials from government-owned enterprises at fixed prices (paid for with “non-cashable” rubles), the cooperatives sold to the consumers at high prices and for cashable rubles. It was a re-distribution of already produced goods.

Onto this the grass-root development of entrepreneurship in Russia the fundamentals of national “small business culture were formed”.

##### 1992-1995 (systemic and structural crisis)

The “Golden Age” for small businesses was the first half of the 1990s. The system was in structural crisis, which lead to an open market for the SMEs. The main factors that had a positive effect on the development of SMEs in this period are:

- Legalization of practically all types of small businesses
- Release of a substantial portion of resources (mainly human resources of the former public sector – sizable and cheap labor market)

<sup>4</sup> Yury Simachev, “Russia’s small and medium-sized business: Key problems and major development trends” Institute of Complex Strategic Studies. Moscow, 2003.

- “Small privatization” – which enabled the employee to become owners of fixed assets.
- The incapacity of government agencies to exercise control over small business operations, and their consent to the existence of private entrepreneurship operating outside the legal realm because of “self-employment”. To dampen social crisis and prevent massive social unrest.
- Low efficiency of the big and medium sized companies during the privatization period made it possible for small companies to compete with them.

At the same time, the economic crisis in combination with the absence of normal market infrastructure put limitations on the capacity of small businesses to develop. The main negative factors were the following;

- Unstable economic situation and high inflation rates, which did not make it possible to make long-term or even medium-term plans.
- Extremely limited possibilities for obtaining credits and loans, and very high interest rates on those credits and loans given.
- Demonetarization of the economy and an enormous spread of barterization and other surrogate means of payment. Massive mutual non-payment practices among medium-sized and large companies.
- Lack of, or very weak legal instruments for protection of property

The combined effect of these factors has given the basic characteristics of Russia’s peculiar small business sector. The SMEs of this period can be divided into following three segments.

The first segment was then comprised of firms operating in the retail markets (in trade, private construction, home renovation, etc). Those types of businesses, which usually existed in a competitive environment, either totally or largely operated in the “shadow”.

The second segment was comprised of firms that were closely connected with particular enterprises (and their leadership) and engaged in servicing the cash or material flows of those enterprises. These did not compete on the market, they served their special relationships.

A third segment was the “normal” small businesses, those which operated legally on the competitive markets, though at the first stage of the transition of the Russian economy, they were a minority.

### **1996 – 1998 (economic stabilization to financial crisis)**

The period of relative macroeconomic stabilization is the period when the SME sector in Russia became more institutionalized. The business linkages and economic chains stabilized, while increased personal incomes generated more demand, including that for the products and services of small businesses.

At the same time, competition in the retail segments of certain markets became tougher because the main niches had already been occupied by that time. The demand for intermediary services with respect to barter-based and promissory note schemes still remained rather high.

This period brought by a boom in legislative initiatives and institution building in the field of SME support at the federal and regional levels. Despite this there was no increase in the total number of registered enterprises.

The financial crisis of 1998 had a major impact on the Russian economy, with implications for firms of all sizes. However, there are different views about the precise nature of the impacts on the small business sector. Few firms were unaffected by the fall in demand for goods and services as purchasing power shrank rapidly (by 23 % in the Autumn of 1998). Approximately 30 % of small enterprises had to cease trading after August 1998, of which 10 % ceased trading permanently. In addition, about half of all cross-border shuttle traders were driven out of business.

### 1999 – 2002 (growth stage)

Initiated by the 1998 financial and economic crisis, the contemporary period of small business development has seen a re-orientation of their markets, with domestic products benefiting from the effects of the devaluation in their competition with imported goods. At the same time, SME support programs have been largely curtailed.

The SMEs that were initially founded to take care of the assets of the privatized state enterprises and put it into productive use, now have to aim more at providing services to large establishments, including mediating and subcontracting activities.

During the initial stage of development, small business activity expanded by filling the market with goods and services that were in scarce supply. Today its success is based more on flexibility and lower transaction costs.

## 2.5 Factors influencing the development of SMEs-



*“Too much red tape drives much legitimate business activity into the untaxed poorly documented world of the informal sector. The economic impacts are felt especially hard by SMEs, which lack big businesses’ resources and political influence for finding solutions.”*

IFC SME Department

### 2.5.1 Administrative barriers<sup>5</sup>

One of the most common complaints from businesses and citizens all over, not only in Russia, is the number and complexity of government formalities and paperwork – “administrative barriers”.

It is however important to acknowledge that many administrative procedures, even if badly implemented, defend legitimate public interests (protect the environment, collect taxes for public purposes, protect the consumers. etc). So eliminating them is not the solution. Implement them in a more effective way and hence reduce the transaction costs for the companies are more of a solution.

Studies done by the OECD (Organisation for Economic Co-Operation and Development) shows the disproportionate effects the administrative costs have on SMEs. Fig. 4 shows the total annual administrative costs (in US dollars) in 11 OECD countries – average per employee by company size.

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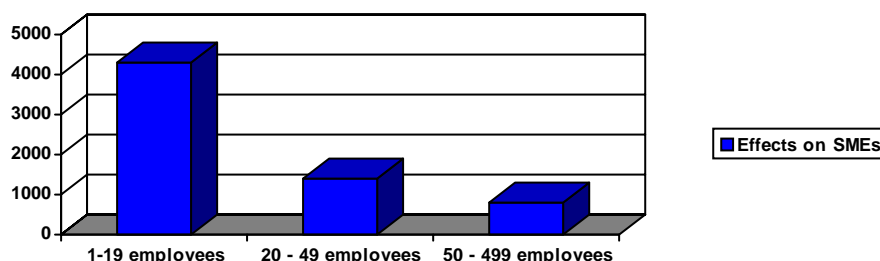
<sup>5</sup>Some data taken from Scott Jacobs, “Removal of Administrative Barriers in the Context of Legal and Regulatory Reforms”. Jacobs & Associates, St.Petersburg 2003.

Small companies with 1 -19 employees have an average of 4.300 USD in administrative cost per employee. While a larger company with more than 50 employees will have an administrative cost per employee at about 800 US dollar.

**Fig. 4 Average annual administrative cost per employee, by company size.**

**Total annual administrative costs in 11 OECD countries**

(Fig. made by Jacobs & Associates)



For a small company, such cost level means that they have to charge more for their services, they will have less profit, they have less to invest, less to use on research, less to use on new market activities.

There is no reason to think that the situation for the SMEs is any better in Russia. Simeon Djankov of the World Bank has in his paper “The Regulation of Entry” reported that the Russian Federation was among the bottom 10 of 85 countries in terms of number of procedures needed to start up a company and number of days.

- Number of procedures for starting up a company in the Russian Federation: 20 (average 10.48)
- Number of days needed: 57 (average 47.10).

State inspections (health and sanitary, fire, building requirements, tax-police) are viewed as some of the most resource demanding any company can be exposed to. For SMEs they can halt the activity of the company for the whole inspection period. Survey among SMEs in Northwest-Russia this year, shows no changes in the respect of amounts of inspections.

The most significant barriers to doing business are those related to obtaining construction permits, land use regulations, customs procedures and the regulation of intellectual property rights. The licensing situation still remains, with companies engaged in high tech activities and construction suffering most of the licensing costs in terms of both time and money used.

**Common administrative barriers to start-ups**

Immigration and expatriate visas, Work permits and residence permits.	Local and municipal business licenses
Investment approval (if any) and other preliminary authorizations	Registration of intellectual property (trademarks etc.)
Registration procedures, including company, tax, social security and municipal registrations	Access to land and land titles or long-term leases
Sect oral business licenses (from line ministries)	Construction and building permits
Environmental permits and approvals	Utility hook-ups, including water / sewerage, electricity, telephone,
Reporting / paying taxes	Other relevant public services (e.g. gas, heat, roads, etc.)

Import / export procedures	Hiring / firing procedures for labour
Foreign exchange procedures	Product certification / standards Inspections as fire, sanitary, workers safety and environment

This list is only to give a view into the amount of procedures that has to be undertaken for a start-up company. All the necessary information and documents will have to be obtained at the different authority in charge of this or that sector, in municipal, regional and / or federal level.

This is a tiresome path for any company. For a foreign SME company it is almost undoable. Language problems, culture differences related to “how to approach a Russian authority”, the resources of time and cost related to understanding how and why very soon takes away any enthusiasm that might have been there from the start.

Without a Russian partner (company partner) that can help the foreign SME through this, the probability for failure is quite large. Unfortunately, in the Barents Business Cooperation so far the Russian partners are as fresh in this game as the foreigner. It is often “the blind leading the lame”.

### **2.5.2 Legislation**

The recognition of the need to improve the legislative and regulatory basis for small business development is reflected in the adoption of four important federal laws since 1998, relating to:

- A Single Tax on Imputed Income for Certain Activities
- The Licensing of Certain Activities
- Leasing
- Mortgages (Real Estate Guarantees)

In addition, a new version of the fundamental Law of June 14, 1995 “On State Support of the Small Enterprise in the Russian Federation” is being developed and draft laws are also under discussion with respect to:

- The Protection of the Rights and Legal Interests of Entrepreneurs
- Consumer Societies of Mutual Assistance and Mutual Insurance
- Franchising.

The Law on State Support of the Small Enterprise gives all formative norms and regulations for SME activity in Russia. When this act was launched it was acknowledged as a progressive legislative document. But as seven years have passed, with intensive changes in the Russian legislation, this law has fallen behind and is today contradicting several legislative acts of the Russian Federation, as the Budget legislation, the Civil codex and the Taxation codex. This is today one of the major problems of the SME regulatory framework.

The Russian Ministry of Anti-Monopoly Policy and Entrepreneurship is in charge of the work of adapting changes to this legislation. The suggested changes that have been put forward will also demand changes in other legislative acts of the Russian Federation, like;

- the act on accounting
- the act for protection of the juridical person or the individual entrepreneur during state control activity
- the act of licensing of certain activities
- the act of state registration of juridical person

This will lead to changes in the Tax and Budget codexes of the Russian Federation. These changes will take 2-3 years to work out, and then there will be some time to get it all implemented.

Analysis made by different organizations (Ministry of Economics, Ministry for Anti-monopoly and Entrepreneurs, Ministry of Finance o.a.) have shown that the areas of greatest difficulties are; taxes, licensing system, certificates, ecological control systems and anti-competitive actions of the local administrations.

**The Ministry of Economics have made their own evaluation<sup>6</sup> of three new laws that were implemented in 2002 connected with the de-bureaucratisation of the economy. Below is a summary of their findings and conclusions.**

### **About governmental registration of physical person (company)**

This law was supposed to simplify the registration procedures for the companies. Before 2002 there were more than 50 different regulations concerning the registration of a company.

The evaluation showed that the new principle of “One Window” which means that all necessary documentation for establishment of a company can be obtained and registered within 5 days in one place was not implemented.

#### Conclusion

The average registration time was not 5 days as stated in the regulation but 27 days. The 5 day guarantee for registration of a company is not implemented in any region or municipality. In addition to this, the registration expenses increased in all Russia, in Moscow the expenses concerning registration of a company increased 10 times, in Rostov 2.5 times!

### **About licensing of different kind of activities**

Obtaining licenses for commercial activity varies in cost from 5.000 – 200.000 Roubles. In the new regulation it is stated that the state fee for issuing licences should not exceed 1.300 Roubles.

This is a result of the “one window” principle, where federal organisations have established a “support / consultancy organisation” which offer help to the companies regarding their applications and thereafter issue the licenses, all on a commercial basis.

*Conclusion: The ambition of the law to reduce the costs of obtaining licenses for different kind of activities was not successful.*

### **About protection of companies and single entrepreneurs in connection with state Inspections (“Law on Protection of Rights”)**

According to the evaluation of the Ministry of Economy the analysis gave no clear answer.

This is connected with:

- 1) the unclear content of the regulation itself,
- 2) the way the regulation was implemented
- 3) the non-efficient state control system.

The evaluation concluded that in Russia there is no existing governmental control system that is able to see that the rights of the companies and citizens is upheld by the federal control institutions during their inspections.

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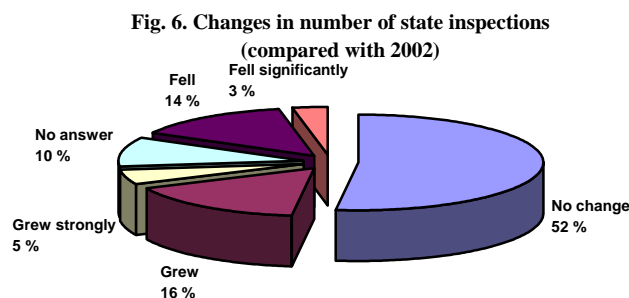
<sup>6</sup> Ministry of Economic Development and Trade, Russian Federation: “About the introduction of normative legal acts, directed towards reduction of administrative barriers in the economy”, Moscow 2003.

For example:

- The number of inspection increase
- Financing of the Inspection Organisation is done on the basis of “inspection-fees”
- The Inspection Organisation is at one time both Governmental Inspectoral Body and a Commercial participant in the economy.

The Ministry concludes with the following remark: *“This leads to increase in expenses for the honest entrepreneur and create a situation where the entrepreneur is in the hands of the controlling unit, with no possibility to complain about the decisions made. – Without going to court. This often makes the entrepreneurs take their company and activity in to shadows of the grey economy”.*

In the survey mentioned earlier done by Northwest-Centre for Support of SMEs, Leontiev Centre and St.Petersburg Foundation for Business Development, 73 % of the companies answered that the number of state inspections had either not changed or had grown /grown strongly the last year, - after the implementation of the new legislation.



### 2.5.3 Taxes

For small and medium sized companies there are 3 different tax regimes that they are eligible

- 4 The Standard Tax Regime (designed for all type of companies)
- 5 The Simplified Tax, Reporting and Accounting System of 1996 /2003
- 6 The Single Tax on Imputed Income (STII) of 1998

The last two tax regimes are designed for most of the small business companies.

**The Simplified Tax, Reporting and Accounting System** for small businesses introduced in 1996 did not become widespread because the maximum allowable company size was limited only to 15 persons. Besides, the choice of the object of taxation (earnings versus income) under the Simplified Tax System was put under the authority of Tax inspection and not at the discretion of the taxpayer. In addition, the rates were set at a rather high level, and the obligatory contributions to social extra-budgetary funds were not removed. Nor was the payment of the Single Social Tax that was introduced later. Moreover, the companies that had switched to the Simplified System could no longer be eligible for either federal or regional profit tax discounts that existed until 2002.

The changes in 2003 to this law removed some of the limitations, - the maximum allowable number of employees of company was increased, and the taxpayer was granted the right to choose the object of taxation himself. But at the same time, the amount of income which makes a company eligible for switching to the Simplified System remains low.

The problem of reimbursement of the VAT to customers of those companies that have switched to the Simplified Tax System still remains unresolved. The problem is that small companies are exempted from the VAT once they switch to this regime. Consequently, such small companies' partners that use the standard tax system can not assume the VAT for further deduction. Thus, the Simplified Tax System hinders interaction between small companies on the one hand and the medium-sized and large firms on the other hand.

*As a result many small companies go back to the standard tax system.*

The federal law on “**A Single Tax on Imputed Income for Certain Activities**” was introduced in July 1998, with similar regional laws being adopted in 35 regions of Russia by April 1999. The aim of the single tax is to replace many of the earlier tax payments, with a single payment. It is calculated quarterly on the basis of imputed income, with a number of correcting coefficients. The tax is paid monthly in the form of advance payments. It is compulsory for small enterprises and individual entrepreneurs in certain areas of activity, namely construction and repairs, consumer services, consulting, auditing, legal advice, catering, retailing, transport services and car parking.

In practice, the experience has been:

- \* The form of single tax that has been introduced makes it difficult and time consuming for business owners to calculate the amount of payments for which they are liable. The entrepreneur has to calculate the tax for each site and area of activity, which is subject to tax. Those who also have activities that are not subject to the law on single tax, are forced to keep two parallel accounting systems, leading to new complexities.
- \* The federal law on the single imputed tax has led to considerable regional discrepancies, because the calculation of coefficients has been left to the regional authorities.
- \* As the entrepreneur is supposed to get beforehand approval of his/her own tax calculations from the tax authorities, which have to power to correct it, it creates a situation where bribes and favours are encouraged.

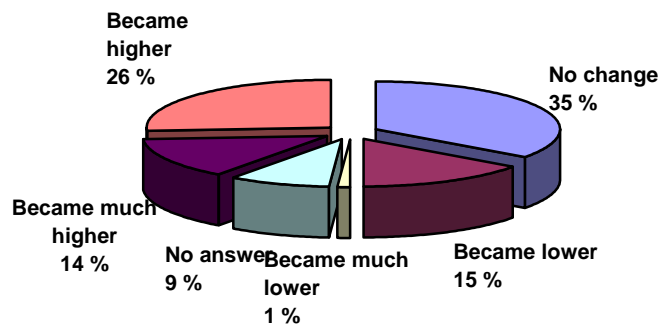
The initially established principle of maximum possible decentralization in the application of tax regimes and the lack of a unified methodology have led to a significant overstating of the STII taxable base in some regions, and also to a substantial inequality of taxation conditions for a number of taxpayer categories within some regions.

When the tax rates are too high and the entrepreneurs have no right, by law to refuse to use the STII system, they face a dilemma: either to continue doing the loss-making business, move it to another region, terminate the business at all, - or go into the “shadows”.

Poor predictability of the Small business taxation conditions within a given tax system makes some entrepreneurs to “diversify” their risks by they way of owning several companies at a time (in the same business) that use different tax systems. Then, depending upon the situation they shift the bulk of their activity to the company which appears in the most advantageous tax position.

In the earlier mentioned survey 75 % of the companies answered that there were no changes in the taxation level within the last year, or it had become higher.

Fig. 7 Change in taxation level within the last year

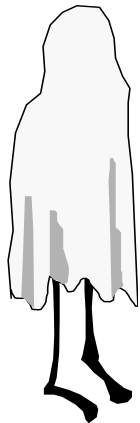


**2.5.4 “Shadow” activities in small businesses**

A company operates in the “shadow” when it conceals information in order to minimize costs and in particular to evade taxes.

The problem of “shadow activities” within the small business sector was addressed in a report of the Ministry of Antimonopoly Policy and Entrepreneurship of Russia. The share of shadow activities in the small business sector continues to remain at a high level, and according to different estimates, constitutes from 30 – 50 % of the real turnover of small businesses.

According to GOSKOMSTAT the contribution of the shadow economy sector to Russia’s GDP is about 25 %. At the same time, some empirical studies<sup>7</sup> indicate that the shadow economy has expanded so dramatically that it has absorbed an overwhelming majority of all small businesses. In 1999 the shadow activities of the Russian small business companies were estimated by the following figures. Many experts still think this is the situation, 5 years after the publication of these facts.



- The real number of employees in small business sector was understated by ¼.
- The reported monthly salaries of the employees were 1/3 of their actual size
- The reported turnover of small business companies was understated by 20 – 30 %
- The actual number of small business companies operating in the market was 10 – 20 % larger than the official figure.

**2.5.5 Financing<sup>8</sup>**

From the small business perspective, the most critical problem is the formation of start-up capital. In most cases small companies begin from scratch.

<sup>7</sup> A.Ju. Chepureno, “What is the rational behavior pattern for Russia’s small business entrepreneurs?” in *Investment Climate and the Prospects for Russia’s Economic Growth*, Moscow State University – Faculty of Economics 2001.

<sup>8</sup> Yury Simachev, “Russia’s small and medium-sized business: Key problems and major development trends” Institute of Complex Strategic Studies. Moscow, 2003.

The basic sources of small companies start up capital is the capital of their founders, as well as funds provided by the founders friends or acquaintances, with the role of external sources being insignificant.

In the surveys done, 86 % of the respondents use their own money for financing. About 14 % of them use credit lines from commercial banks, 13 % use another types of credit sources. International development support programs reach 1 % of the SMEs.

The possibilities for small business companies to obtain bank credits are limited by a number of factors, of which number one problem is to provide guarantees for the return of credits. The banking sector is largely focused on servicing medium-sized and large companies, and when lending to SMEs their lending costs appear to be high. Another negative problem is that the major bank assets is concentrated in the economic centers.

Generally speaking, access barriers to bank lending and venture investments for very small firms are quite substantial. In such conditions, government- supported microlending mechanisms for the small business sector are of paramount importance.

When talking about the Barents Region, SME companies have few possibilities to obtain loans and investment support from the existing support system.

### Formation of SMEs' Start-Up Capital (Survey made of Russian SMEs)

Start-up capital sources	Eight-region survey
Personal savings	
Money contributed by shareholders and partners	86 %
Money contributed by friends, associates and relatives	
Bank loans	14 %
Other loans	13 %
Financial aid granted by enterprise support foundations	3 %
Financial aid provided by bodies of power	3 %
Funds provided under foreign enterprise development programs	1 %
Other sources	7 %

#### 2.5.5.1 Financing support structures for companies in the Barents Region

Most support systems of the Nordic countries eligible for companies working towards Russia, like FINNVERA, SIDA, Innovation Norway (SND), NIB, NOPEF, NEFCO, Barents Secretariat, give project financing for market studies, partner search, even for registration procedures. But when it comes to the investment part (buying premises, equipment, hiring staff, construction work etc.) there is not so many places to turn to. So far no Nordic or Russian bank have been willing to lend money as there is no collateral and it is viewed upon as too large a risk to co-invest with micro and small start up companies..

But still there are a few possibilities to get some funding and assistance concerning investments into business activities in Russia.

### • FINVERA – INVESTMENTS LOANS / GUARANTEES and PROJECTS SUPPORT

FINNVERA has primarily two financing facilities for business activity in Russia. It is Fund for financing of Preparative projects with Neighbouring Areas in Russia and the Internationalization Loans for Finnish SME companies abroad. This is part of the FINNVERA strategy for internationalizing SMEs.

FINNVERA Fund for financing of **Preparative projects with Neighbouring Areas in Russia** is a cooperation with the Ministry of Foreign Affairs in Finland. Which was put into force from the 8<sup>th</sup> of January 2003. The Ministry allocates 0.5 million Euro pr. year to this fund. This mechanism shall be used for the development of business sector cooperation between Finland and Russia. Among the criteria are the objectives of the Northern Dimension.

Criteria:

- Support can be given for:
  - Pre-Feasibility Studies
  - Training of employees and hiring of external experts for the start-up periode
- Cash grant
  - max. 50 % of the eligible costs
  - max 50.000 Euro pr. Project
- No funding from other public sources
- Where eligible there can be a cooperation with NOPEF and FINNFUND for the further development of the project / company
- The decisions are made by the Ministry of Foreign Affairs, the project evaluation is done by Finnvera.

**The target group** is mainly SMEs with strong Finnish interest either through ownership or close cooperation. Financing can be granted to all sectors, but focus is especially directed towards sectors as energy, environment, forestry, foodstuff, IT, clothing and metallurgy. The location of the project should be in the neighboring Russian areas.

FINNVERA **Internationalization Mechanism for Finnish SME companies abroad** has been in operations for 2 years. 30 projects have been financed of which 20 is in Russia, mostly in the St.Petersburg region. This facility has in 2002 given loans and guarantees for 9 million Euro and for 8 million Euros in 2003. FINNVERA experience good interest among the finnish business life for investments into the Russian market

Typical objectives eligible for this mechanism are:

- establishing a subsidiary abroad
- buying shares in a foreign company
  - The Finnish SME should after the capital investment have at least one fifth of the votes in the foreign associated company
- expanding or developing a foreign subsidiary or associated company
- Business operations abroad must considerably promote the operations of an SME operating in Finland
- The operation of the foreign company for which financing is requested must primarily comprise
  - Production
  - Assembly
  - Maintenance or services
  - Funding can not be used for exports or to set up a sales office.
- The subsidiary or joint venture granted this financing may be located in any EEA country, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland or Russia.

The total amount of Finnvera funding may not exceed 50 – 70 % of the total cost of the project. The loan or guarantee period is 3-10 years, the first two of which may be amortization free. Collateral is negotiated separately in each case.

**Target group:** Finnish SME that expand their activity abroad.

### • INNOVASJON NORGE – INVESTMENTS LOANS AND PROJECT SUPPORT

Innovasjon Norge is responsible for two investments funds related to Russia and Eastern Europe, - “**The Investment Fund for Northwest-Russia**” and “**The Investment fund for Eastern-Europe**”. The Funds are an offer to Norwegian companies and investors that intends to establish activity in these areas.

The objectives for the funds is to strengthen the cooperation between Norwegian and Russian business communities. The Investment Fund for Northwest-Russia covers Murmansk and Archangel oblast, Nenets aut.okrug and the Republic of Karelia.

The Investment Fund for Eastern Europe covers the other regions of Russia as well as the CIS-countries and the Balkans.

The Investment Fund for Northwest-Russia amounts to 150 million Norwegian kroner. The Investment Fund for Eastern Europe amounts to 120 million kroner.

The principles for the use of the Funds are as following:

- They are run on a commercial basis
- The projects should have a Norwegian co-investor, that invest as much or more capital as Innovasjon Norge.
- The Funds can be used as share capital in business activity in the defined Russian areas
- Loans can be given in certain cases
- The Funds share in an investment should normally not exceed 35 %, and never more than 49 %. The maximum invested capital in one project can not exceed 30 million Norwegian kroner for the Northwest-Russia Fund, and 15 million Norwegian kroner for Eastern Europe.

Innovasjon Norge has for the past 7 years invested as shareholders in 8 companies in Murmansk (23 in total). Most of these investments have been done after 1999, most of them in 2001 – 2003. All the investments have gone to SME companies in establishing activity in Northwest-Russia. Specifically Murmansk and Archangel regions. The amount invested in projects range from NOK 0.5 million to NOK 15 million.

One of their challenges in the start was to find good investment objects that could meet their demands regarding profitability, risk level and management skills.

In order to seek out good investment projects Innovasjon Norge has participated with pre-project funding for about 65 projects. Such funding can be given for projects related to Northwest-Russia only. The conclusions for many of these were that it was too premature for the Russian market, although interesting. Some of these projects have now been reanimated and are under evaluation again. The past couple of years have shown that both the market mechanisms in Northwest-Russia have improved, as well has the know-how of the Norwegian entrepreneurs about the Russian market.

### **SIDA**

Sida has a separate department for Central and Eastern Europe, Sida-East. Among the 6 divisions is the "Division for Russia / CIS". In Russia the main focus is directed towards the northwestern parts of Russia including St.Petersburg and Leningrad region, Kaliningrad, Pskov, Novgorod and the Barents region.

Most of the support consists of transfer of know-how and exchange of experience in strategically important sectors in the region. In addition is the Start-East programme that has as aim to help small and medium sized Swedish companies become establish Eastern Europe, including Russia (in the above mentioned regions).

The objective is rapid establishment of productive activities in recipient countries, often in the form of joint ventures or sub-contracting with the aid of transfer of know –how and expertise. Swedish companies are given support in the form of write-off loans which make it possible for them to invest in a new market which can appear full of risks.

The programme is implemented in cooperation with ALMI Företagspartner AB.

The Start Financing consists of two part;

- Write-off loans, upp till 500.000 SEK for educational purposes in connection with the establishment of company / activity
- Credits for necessary investments, i.e. machinery, production equipment etc. (Not for costs connected with buying of property, buildings, raw materials and such).

These to facilities combined should not exceed 750.000 SEK pr. Project / company, and should not be more than 40 % of the total investment.

### **The American-Norwegian Northwest Russia Small Grants Initiative**

Through an American – Norwegian Small Grants Initiative, the Eurasia Foundation together with the Barents Secretariat in Kirkenes have established a micro credit line for helping SMEs in Murmansk getting started. This micro credit line is administered by FORMAP in Murmansk.

### **FORMAP - MICRO CREDITING**

FORMAP was established in July 1995 by the administration of Murmansk oblast, as a non-commercial business support organization. It is located with its head office in Murmansk, and with three branch offices in Apatity, Poljarnye Zori and Monchegorsk.

Since April 2001 FORMAP has been conducting micro-loan activity based on funding from the Norwegian Ministry of Foreign Affairs through the Barents Secretariat in Kirkenes, Norway. In the 2-year period after this, FORMAP have provided Micro up-starts with more than 800 micro-loans, with the total amount of 27 million roubles.

Based in this success, the Barents Secretariat in Kirkenes has together with Eurasia Foundation, Moscow provided FORMAP with yet another micro-crediting facility.

The main task for this micro crediting facility is to help small companies gain additional knowledge necessary for the development of their businesses, as well as allowing them to grow through borrowing. The first 2 year of micro crediting had shown that there was a group of entrepreneurs whose business had been successfully

established that needed to expand and modernize. These entrepreneurs will now have an opportunity to get such loans. The conditions are p.t. the following; Amount, from 100 – 300.000 roubles, 1 year loan period to 3 % interest. Larger loans can be obtained if the business as investment plan of the company shows a sound management and probability for return on investment.

**Target group:** Russian micro and small sized companies. Just starting up, or expanding from micro to small sized.

### **· NORUM – VENTURE FUND / INVESTMENTS IN RUSSIAN COMPANIES**

Norum (The Nordic Russian Management Company Ltd.) is a private Fund Management with the following nordic owners; - Den norske Bank ASA, Norway 45 %, Sitra Management Oy, Finland 35 %, Finnfund Ltd, Finland 10 %, CES Nordic AB, Sweden 10 %. The Fund has 7 years of experience in equity financing, business management and restructuring in Russia. Their team of management are located in St.Petersburg, Helsinki and Tromsø.

Norum has evaluated more than 3000 projects in the Russian regions, 23 companies have been invested into. Norum has sold their previous ownership position in 7 companies with good profit. Norum has a staff of highly qualified and experienced professionals, which would be of great value to get support from for new Nordic start-ups in the Barents Region.

It operates two Regional Venture Funds in Russia on behalf of the European Bank for Reconstruction and Development. It has total funds of 85 million USD with the operating “lifetime” set from 1995 – 2007. Today 69 million USD of the Funds are committed. By the end of 2003 they aim at setting up a new Private Equity Fund for Russia, with a total capital of 150 million Euro. This is made on the basis on their analysis of the current trends of doing business in Russia:

- Investment infrastructure is improving
- Market potential for growth in the region is substantial
- Multinationals and Russian groups based in Moscow and St.Petersburg are now moving fast into the regions
- An increasing number of Russian SMEs need external funding for growth
- Private equity investments with good support are welcome among the new Russian entrepreneurs

The objectives of Norum’s activities are;

- To be an active equity partner for small and medium sized private Russian Companies
- Finance new technology and increase the companies ability to become attractive suppliers of products and services for domestic and foreign markets
- On a commercial basis create competitive and profitable companies
- Make good profit for the investors

NORUM invests in companies starting at 1 million USD. Smaller projects are not interesting for the time being because the job working with the portfolio companies are just as time consuming the company being small or larger.

Norum started its activities in Murmansk and Archangel regions, and later moved southwards. The region is still of interest for Norum.

### RUSSIAN BANK OF DEVELOPMENT

Russian Bank for Development is by the Ministry of Trade and Economical Development supposed to be the Manager of the new program for SME support. The Russian Bank for Development do not have any branches in the regions, but will use local and regional banks that will qualify themselves as the regional partner of the Russian Bank of Development in the SME program.

The program will not have more than approximately 40 million roubles for 2004, but in addition to this the bank itself will use its own resources to invest in businesses.

Critical principle of the Program implementation is the choice of region. The key region selection criteria are:

- sufficient creditworthiness level
- Good small business development history
- Presence of commercial banks servicing small business

The Banks representatives underlined the importance of having a regional political and practical support to this program. Without guarantees based on the regional administrations budget, - regional banks and The Russian Bank of Development will not have possibilities to support start-up SMEs. So far such guarantees have been given by the Regional authorities in Leningrad and St.Petersburg. In the northern areas one has so far not come to this. In Murmansk Monchebank has been evaluated to be one of the possible partner banks in the SME program.

For the time being the bank gives loans to existing and expanding business. Start-up companies are so far not in their portfolio as the collateral is a problem for these. In 2002 the bank developed its own Russian Small Business Lending Program, and intends to invest up to 600 million roubles in small business credit support. The small business support programs most preferred sectors are Industry and Construction.

#### 2.5.6 SME support in the Russian Federation

The development of state support policies for SMEs in Russia has had a troublesome development.

The period 1995-96 is considered as the most active period in terms of the institutionalization of state support policies for SMEs. The first national support program for SME was adopted in 1995, partly as a result of International financial institutions and donor organizations funding of large-scale SME support programs in 1992 – 94. The efforts of EBRD, EU-TACIS, USAID and others stimulated the involvement of Russian commercial banks, the creation of business incubators and consulting and training agencies for small business owners.

The second national support program for SMEs came in 1996-1997, and it received the status of a Special Federal Program. During this period the fundamental Law on SME State Support (of 14 June 1995) was established, which laid down the legal basis for SME policy. There was also established a Special State Committee for SME Support and Development.

Further on the Federal Foundation for SME Support and Development was restructured as an independent institution with responsibility for providing financial support for SME programme. A simplified system for taxation and reporting was introduced by the end of 1995. In February 1996 the First Russian Congress of SME Representatives was held in the Kremlin. In the regions legislative initiatives were also undertaken, with special state institutions dealing with SME support being established in more than 70 regions.

In the mid-1990s the prospects in terms of state support for SMEs appeared generally positive.

**But;** the steps taken towards strengthening SME support taken in the mid 1990s have not been sustained and fully implemented on the federal level since the early part of 1996.

- The special Federal SME support program was not funded in 1996, and under-financed in 1997.
- The new SME support programme for 1998- 2000 was elaborated but not adopted.
- There were continuous disputes between the Federal SME Support Committee and the Federal SME Support Foundation with respect to their powers and areas of responsibility, leading to the dismantling of the Committee in 1998
- The Federal Foundation for SME Support and Development lost its status as the main contractor for the Federal SME Support program.

The ineffectiveness of these institutions concerned with SME support is mirrored by the failure to channel federal budgetary resources into SME support in the period since 1996. The special allocation in the federal budget for SME Support was lost and the tax privileges previously granted to SMEs were eliminated.

Although institutional systems of SME support remained at the regional level, financial support from federal sources was largely withdrawn.

The crisis of 1998 was an additional negative impact on SME financial support, because the banking crisis made any further creation of guarantee funds for SMEs highly questionable. This was one of the factors contributing to policy makers starting to look for “non-monetary” measures of entrepreneurship support.

As of today it is the Ministry of Anti-Monopoly Policy and Entrepreneurship (MAP) which has the responsibility co-coordinating SME support policy. On the 16<sup>th</sup> of October 2003 Prime Minister Kasianov had a meeting with the Cabinet of Ministers on the issue of Development of Small Entrepreneurships and a more efficient system for state purchasing. For the small enterprises a system for state guarantees within the frame of 3 billion roubles will be established. However, the cabinet of Ministers did not manage to agree upon who will be responsible for the management of this state guarantees. The Russian Bank for Development is one likely bet, but not yet decided upon.

**In the regions** the earlier established support systems for SMEs are still operating. Financial funds are retrieved from regional budgets, project grants and in some cases from the federal budget. Some of these organizations work on commercial basis and hence getting the necessary funds for their operations. In the Northwestern Federal District SME support is provided from the regional authorities in the following ways;

- rental discounts,
- information support,
- consulting in different spheres (legal, managerial, marketing etc.
- rental discounts for land, micro-credits, credit guarantees.
- give preferential credits and preferential state orders.
- insurance discount for the SME's.

## **PART III CASE-STUDIES**

### **3.0 With the eyes of Nordic companies running their business in Russia**

This Chapter is made on basis on interviews with different Norwegian, Finnish and Swedish companies who are registered and operates as Russian companies. They do sales of own production, partly produced out of Russia and assembled in Russia, full scale production in Russia and sales of different kind of imported products. The companies have been operation in Russia from 2.5 to 5 years. Some of the managers have more than 10 years of experience through other companies.

The companies will not be referred to by their names, but we will give a summary of the information and advice that they gave during the meetings.

A “run-through” of the start-up process gave the following comments and information:

#### **1. Registration.**

This your lawyers will help you with. They will give you a list of things to do. All kind of documents based on the mother company and their activity. Documents needs stamp of “right copy” from Notaries with Apostils.

#### **2. Charter**

As things function in Russia today, you can in principle get a company registered with all necessary documents for a cost of 500 USD. The challenge is how to set up the company. The challenges are deciding on which kind of company you should set up. To understand the difference between the charters in these and to set the charter up correctly and hence avoid getting into problems with the local Tax-inspections. The charters are very important as it influences on the possibility to attract and separate investors and paying out dividend of future profit. In order to set up a company, you are totally dependant on buying services from external environments that can guide you through the process.

#### **3. Charter-capital ( Stock-capital)**

A minimum of 10.000 roubles is required, which at the present rates is less than 400 USD.

#### **4. Office premises / production premises**

This is connected with Registration. Without a legal address you can not register a company. But without having a registered company, you will not be able to rent or by premises for the company. Many “get by” this by starting their operations from an apartment or get help from 3<sup>rd</sup> parties.

Getting production premises in St.Petersburg / Leningrad oblast is difficult to obtain as these are in shortage. There is also a difficult question to establish who the right owner is. Before doing any expensive reconstruction work you need to be sure that you deal with right person.

#### **5. Capital**

Hiring staff, rent office premises, production location, equipment – all require resources. This should be covered by the business operation.

Prepayment, showing no trust, giving no favours and treat all equal were the common advice. In addition to your own cost, it should also cover the cost connected with customs clearance and finance the company’s growth. Since the average time for getting the business up and running, covering its own cost was around 2 years – you would need support.

Most foreign companies operating in Russia have a “mother company” paying out this initial cost as part of their market enlargement. Another possibility is to attract the attention of a venture fund, which so far are none existent in Russia.

### **6. Customs**

Customs duties are among Russia’s largest contributors to the State finances. So they are upheld in a strict fashion. The laws and regulations are based on the assumption that the businesses will “do anything” to escape customs duties, and customs act accordingly with great suspicion until you have proved yourself.

The managers operating out of the St.Petersburg region said that after 2-3 years of running a clean operation the customs was no longer a problem. If there turned up any problems they had contacts and friends that could help.

The companies working in the Barents Region have expressed their complaints to the Barents Euro –Arctic Council at their 9<sup>th</sup> Session in Umeå 2003. The Barents Business Advisory Group (BBAG) stressed the need to improve the border crossing efficiency in the Barents Region, both the Finnish – Russian border crossing points and the Norwegian – Russian border crossing point. There are complaints concerning all involved countries in respect to the efficiency of the control procedures, the attitudes of the officials, the unsolved questions related to the ATA-Carnet system. It is noted that the Customs on the Russian side have been implementing new and more efficient procedures, while at the same time the Finnish and Norwegian customs and police have changed towards a “tougher attitude”.

### **7. Certificates**

Getting the right certificates for imported equipment or for the products you sell is a matter of “learning by doing”. There are companies that can help you with this, for instance SGS in Gothenburg or the Russian state institution Gosstandart. Normally an import certificate will cost about 200 – 300 USD in fees.

### **8. Taxes**

Companies operating transparent and legal will in operate with higher overhead than the average Russian company. Many companies pay parts of the salary official and the rest in an envelope. In this way they avoid part of the taxes paid to the social fund, - 35.8 % of the salaries.

Profit tax is 24 % and constitute no problem with the new tax regime which has been introduced. Earlier you had tax on the total resources running through the company, you even paid tax on losses.

The tax system of 1992 was characterised as “messy”, and with the tax police which is now abolished it was “wild times”. After the crisis of 1998 and the new legislation the tax inspection now behaves different, and it is possible to have tax audits in a normal fashion.

### **9. Pension fund**

A big concern for the managers was the economical security of the employees when they retire. Notwithstanding the company’s willingness to pay all taxes to the social fund, the employees still experience that the pension to be paid is limited to 2000 RUR pr. Month. For the younger generation this might be changes according to their working time under the new social security system. But this is again dependant on all the companies paying taxes into the social fund. Many Russian companies pay only parts of the wages in the open (with according payments to the Social Fund), the rest is paid in cash. It reflects on the company’s tax burden and profit.

### **10. Profit**

Paying out dividend to foreign stakeholders is no longer any problem, as long as it is stated in the charter of the company.

### **11. Accountancy**

All the foreign companies that was a part of this study run their accounts according to western practice alongside with the Russian accounting system. This in order to get the needed information about the company's real economical situation. All managers admitted that they used a lot of resources on getting the accounts done right.

Many foreign SMEs are neglecting the need to find a loyal and clever bookkeeper. It is the most important function in a company for calculating, report and pay taxes correctly. If this fail, experience shows that the company is likely to get problems with the locale tax-inspection and to face significant claims of penalties. During such tax disputes a small company gets almost paralysed as almost all resources goes to dealing with these questions and the demands of the tax-inspection for documentation etc.

### **12. Inspections**

State Inspection, the total number being more than 40 can be a real nuisance to a start up company, especially if you start up with production and have production facilities / factory. Then you have to deal with Fire inspection, Sanitary inspections, Building and construction inspection etc. etc.

### **13. Security**

Transport of valuable goods inside Russia demands armed guards onboard. The companies use both western and Russian insurance companies with good experience.

### **14. Staff / Personnel**

Russian education is well known to be of high quality. But all companies experienced the need of doing additional education within sales and marketing, accounting and upgrading the technical skills and knowledge.

As soon as you do that, these people get interesting for other companies and you need to raise the salary and make other arrangements to keep them with you.

As a SME company you should use your best people on the Russian engagement, as well as hiring in experts. They will help you avoiding the many of the initial difficulties for the beginners.

### **15. Corruption and bribes**

It is almost unavoidable to not to get into the small time bribing. If you want wheels to turn quicker it is expected that you pay up. But there is not big money, - 200 USD or a cassette player.

Much of this can even be avoided if you have a good social network or you establish good friendly working relation with the local authorities.

## **3.1 Cases and Scenarios, the good and the not so good experiences**

One possibility to help develop SME activity is to focus on a few sectors, and make use of the force of the existing companies and the know-how and competence existing in these structures. The Energy sector, the Mining Complex, the Forestry or the Fishing sector are all industrial sectors where two or more of 4 countries of the Barents Region cooperation have extended knowledge and active companies. Some attempts have been made at such a cross border cooperation. The latest and largest initiative in this respect is the Barents 2010

program. The Archangel costal fishing program can serve as an example, and show the challenges and possibilities of such activities.

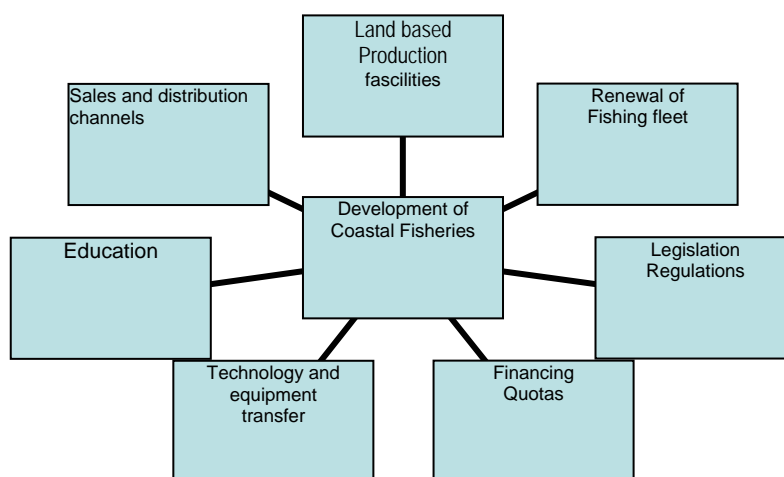
Micro financing is one of the ways being tried out, as to help getting new companies started up. This program is directed towards the single entrepreneur, often women wanting to start up small scale business. The Euroasia/Barents Secretariat micro financing project in Murmansk is an example of this. (see chapter 2.5.5.1 – FORMAP).

### 3.1.1 Archangel's costal fishing program

For Archangel region the fishing sector is traditionally one of the fundamental sectors for the economy. As for the whole region the fishing sector has been through extensive changes in the 1990-ies. Archangel region has had one of the largest fishing fleets in the Russian

Federation, mainly based on the trawler fleet. The traditional coastal fisheries more or less disappeared during the last 10-15 years, as a result of lack of financial resources to keep up the maintenance and investments in the fleet and the land based production facilities.

Archangel regional authorities decided to renew this sector and established a whole new program for the “rebirth” of the coastal fisheries in Archangel region. This program included the whole cluster;



The Regional Authorities, through its Committee for the Fisheries Complex developed a complex program including separate programs for the different “parts” of the industry.

- In order to start up again one needed new fishing vessels that were of smaller sizes and that would operate closer to shore.
- One needed new technology so that these vessels could be operated by fewer persons than the labour intensive trawler fleet.
- One needed training of the fishermen, so that they could use the new equipment and the vessels, and information about the coastal areas as to where and when the fish would be found.
- In order to get financing to build new coastal vessels, it was impudent to get quotas for the coastal fisheries, guaranteed over several years. This demanded changes in the legislation and the regulations for distribution of the yearly quotas.

- And finally, when the vessels and the fishermen started fishing, they had to be able to deliver the fish to onshore production or handling facilities.
- These had to have a local market to deliver the fresh (not frozen) fish products.

Today Archangel Region sees the outline of a reborn industry, consisting of several small and medium sized companies that have been established on the basis of this program. There has been established a new fresh fish market in Archangel city, there has been established a new production line of fish products (private), and more are in the line. The shipyards have been given new orders to build and rebuild coastal fishing vessels, new technology (Norwegian) has been introduced and bought and Archangel Marine College has established a new faculty for training fishermen and students in coastal fishing and management. A great effort has been put into the legislation and regulation work, and ensuring fish-quotas for the coastal fishing activities. The Archangel Region program for supporting the rebirth of coastal fisheries has even become a Federal program.

Into this process the Norwegian Coastal Fishing Group intended to actively participate, selling their products and starting production in Archangel. The Finnmark County administration also wanted to participate, mainly with the regional Educational Centres for Fisheries in Vardø and Honningsvåg.

For the companies of the Norwegian Coastal Fishing Group, there have been some result, as some equipment has been sold as result of the Barents Secretariat support to the project – technology transfer. But so far none of the equipment companies want to establish their own production or sales offices in the region.

Selfa Arctic, the Norwegian producer of coastal vessels is the only Norwegian investor into this sector and program. They have bought an old Russian shipyard, and put it into production of coastal fishing vessels. With much support and effort of the regional administration they managed to turn the old shipyard into an efficient production facility. But the help that they expected from Norwegian authorities, regional as well as state did not appear. There were no financial support to this investment as the risk was considered too high. Pre-project money from the Barents Secretariat was all. The starting up of the shipyard and transfer of equipment and modules, hiring of staff and training was all done with capital from the mother company in Norway.

As a case this shows a good story and a sad story. The good story is that the regional authorities, in this case Archangel oblast administration can achieve a lot as soon as they set their minds and all best efforts to the task. Regional authorities and the local business community have so far pulled this off together. .

The sad side of the story, is about lost opportunities for Norwegian SME companies. This program was promised a lot of support from the Norwegian side as coastal fisheries is among the basic, traditional industries of Northern Norway. Know-who, technology, institutions and companies – all things available... But this time the Norwegian company Selfa Arctic ended up as a sole provider of Norwegian support, using its own resources.

**The lesson is:** Russia has no time to sit and wait until one get all “bits and parts” together. On the Nordic side one tend to plan a lot before one get going; - business plans, regional plans, financial plans, then there are all the applications for support, grants and loans. This take time, while the Russian side start up with their plans, which often have the form of actions.

Regional cross border- programs directed towards supporting development or disintegration of industrial complexes, should from starting point include the companies that one wants to attract / include. And the regional and state authorities should have the necessary financial support available as one starts, or else the program suffers from time loss and after a short while lack of trust. There is no use in referring to “that the business community will have to finance its activities themselves”. Experience shows that they will not. If talking about SMEs of the Barents Region they seldom have the money to do so, and as they are asked to operate in Russia, they will have difficulties getting bank loans as the risk is too high.

### **3.1.2 SELFARCTIC AS – “Purchase and development of OAO Solombola Shipyard, Archangel”**

#### **Objectives of the project**

The Main Objective of the project was the conduct a Due Dilligence of the Russian limited company OAO Solombola Shipyard, in order to decide to buy the majority of the shares in the company.

#### **Sub Objectives:**

Clear out the juridical and financial position of the Shipyard.

Clear out the price of the shares, and how to settle.

Draw out a development plan for the Shipyard, which would combine decades of tradition of building high quality wooden vessels, and Selfa Arctic’s production of small fishing vessels in plastic.

Draw out competence plans and budgets.

Draw out how to organise logistics and administration.

Clear out how calculation is effected, and if needed, harmonise the system with Selfa Arctic.

Estimate needed investments and investment plans.

Estimate Operational and Cash budgets for the first 2 years of operation.

Work out a Business Plan.

Work out a Finance Plan

#### **Short summary of the project**

Selfa Arctic AS received at proposal from Norwegian majority owners of purchase of their shares in OAO Solombola Shipyard in Archangel. The Selfa group are producing small fishing vessels in plastic. Their vessels have a reputation of high quality, and are exported to 14 different countries. The production of the vessels took place in Norway.

The OAO Solombola Shipyard in Arkhangelsk was established in 1911, and privatized in 1992. When the project was initiated, the Shipyard was producing wooden vessels in small and large editions. One claims that the Shipyard is the only remaining Russian Shipyard of this kind, focusing building in wood, based on a strong workmanship skill and competence. The enterprise has a reputation of quality, and the majority of their vessels are exported to western customers.

#### In the Business plan of the project, Selfa Arctic stated:

“OAO Solombola Shipyard is a well driven and strongly financed enterprise. We have not faced unexpected problems within the enterprise during the survey. The conclusions of the projects are positive, and Selfa Arctic AS has decided to purchase the 51% of the total shares in the shipyard, that was offered. Selfa Arctic AS has for practical reasons purchased the shares in November 2001. We have contributed to close investments obligations of USD 37.813, as a cash transfer to the Shipyard. This is increasing the solidity of OAO Solombola Shipyard . Further more, we also have made a new investment plan for the remaining investments of USD 183.240.

The following year, following overall challenges is considered:

- To develop the OAO Solombola Shipyard to be a strong partner in introducing coastal fishing in the Northwest-Russia.
- To establish a production of Selfa plastic vessels at the size of 10-20 meters.
- Contribute to a transfer of competence to OAO Solombola Shipyard, regarding:
  - Further strengthening the skills of the boat builders.
  - New administrative routines.
  - Training and education in English language.
  - Develop strategy and implement actions towards existing and new markets.

- Develop new sales and marketing organization both in the yard and in Norway
- Improve the market position in the existing wooden boat production.
- Melt the Norwegian companies in the Selfa Group and the OAO Solombola Shipyard together. This covering the enterprises will have a common
  - Idea
  - Strategy
  - Operation modus of the yards.
- Run a project in the OAO Solombola Shipyard with the objective:
- Harmonizing reporting of accounts of OAO Solombola Shipyard with the Selfa Group.
- Use of “Sold and Purchased Man-hours” as a tool for cost controlling and profit measurement. Reporting of accounts and “Sold and Purchased Man-hours”.
- Complete remaining investments according to Agreement 2381 at Federal State Property Committee, Archangel, with an amount of USD 183.240.
- Increase the financial basis for further needed investments in OAO Solombola Shipyard. This as an emission towards the existing owners, or in worse case, only from the Norwegian owners.

The SND ROED will be invited to invest on the Norwegian side, to increase the financial strength of Solombola Shipyard.”

**Obstacles in the project, and how they have been solved**

<b>Obstacles</b>	<b>How they have been solved</b>
<p>In the initial and planning phase of the project, there were problems getting information regarding the financial and juridical situation of the Shipyard. The General Director said he was fed up with consultants and industrial tourists wasting his time.</p>	<p>Selfa engaged a Russian external lawyer to get access to public information. The ice-front from the General director disappeared when he realised that Selfa had intention to buy the shares, and were willing to further develop the shipyard.</p>
<p>In the privatisation process, the Russian Foundation of the federal Property, Archangel regional branch, placed massive investment clauses on the shares that was bought by the Norwegian investors. Some of the investments had been conducted and authorized. Significant amount were still unsettled, and some of them had to be settled latest December 31. 2001. If this failed, the Norwegian shares would be transferred back to the Russian Foundation of the federal Property, Archangel.</p>	<p>Selfa negotiated with the Regional Foundations. The parties postponed the time limit, in order to make a new investment plan that was anchored in the Business Plan and the new development of the Shipyard.</p> <p>All investment obligations were settled by Selfa according to the new plan.</p>
<p>A minority group of Russian shareholders tried to increase control over the Shipyard. They tried to purchase shares owned by other Russian shareholder. This made a lot of insecurity for Selfa. Selfa had the philosophy that existing Russian shareholders were welcome to increase their control, but they should contribute with new capital to the Shipyard, as Selfa did. Selfa considered the attempt as hostile. Their view was that the group tried to get hold on more shares in order to just benefit from the present and future investments from Selfa, without participating in any kind.</p>	<p>Selfa and the key personnel at the Shipyard made a joint strategy to stem up the hostile activity. Further on, they brought the case to the Administration of Archangels Oblast. They saw the hazard that Selfa would pull out, and gave instructions to the hostile share owners.</p>

<p>The process of harmonising Selfa Arctic and Solombola Shipyard is more expensive than estimated. The investments done regarding purchase of the shares and the Investments clauses were significant. Further development of the Shipyard needs more capital.</p>	<p>Some of the costs connected to education and harmonising have been financed by Barentssekretariatet and The Norwegian Ministry of Foreign Affairs. Selfa Arctic is now working with a private placement towards SND ROED to get more equity. The process was planned in the Business Plan.</p>
<p>Selfa Arctic and Solombola Shipyard could not find customers with financial resources to order the first plastic vessel.</p>	<p>The group started the building the first vessel even if they had no order for this. The building was financed by the internal working capital. As soon as the first hull was produced, Russian potential clients saw the perspective of the new plastic vessels. Solombola Shipyard has during the last few months experienced to go from having zero orders, to several orders.</p>

### 3.1.3 BAREL AS –“The Raduga Project – establishing in Murmansk”

#### Objectives of the project

The main objective of the project was to work out the scope of establishing a fully, or partly owned production company for electronics in Murmansk Oblast. This to exploit the close distance to Russia, low wages and low costs to do manual mounting production.

BAREL started this evaluation as a result of the Growth Zone project of Murmansk oblast Government, since the value of the proposed taxed reduction and administrative help that was promised reduced the initial barrier to look at Russia as an opportunity for such production.

#### Sub objectives:

- Work out a stakeholders analysis.
- Decide on where to locate.
- Find out structures of ownership of Norwegian and Russian enterprises,
- Find out tax consequences, and establishing costs.
- Find out how to organise, and costs for logistics, administration and reporting to Russian authorities and Norwegian owners.
- Find a market outside Barel, draw up a marketing plan with a budget.
- Define the need for know-how, work out a know-how / training plan with a budget.
- Work out an investments budget.
- Work out operational and cash budgets for the first 2 years period.
- Estimate total need of finance, financing plan, and clear out available finance.

#### Short summary of the project

Barel AS was established in Kirkenes in Norway in 1993, and is producing controlling electronics for the professional lighting and heating industry. The company had 45 employees, was liquid, and had a share holding capital of NOK 7,6 millions. Almost all products are exported outside Norway. Barel AS is established only 15 kilometres from the Norwegian-Russian border. Before the project was initiated, Barel had run a test production in Murmansk at a Russian company the last 2 years to gain experience.

In the Preliminary Study, one made a huge effort to clear out juridical matters of company form, taxation, and how to set up business. One studied business taxation, and partly civil taxation, to be able to do exact calculations of hour’s costs, operating and investments budgets. Calculation of hours cost is showing a very

competitive cost comparing to Norwegian level, which is 7 – 8 times higher. This is one of the major reasons for why a production in Russia may be very profitable.

The conclusions of the study were positive, and Barel had the choice between continuing the sub production at the Russian partner, or take the step into investments. This would demand an increased exposure, and contribution of significant resources to develop the concept. Except from the company Techmorgeo, Murmansk has no experience and competence within production of electronics. The establishment would implicate major investments in equipment, technology and know-how. Even tough, Barel AS preferred to defend the increased engagement strategically and financial, despite to place the resources in developing an existing Russian company, in which they will have no influence or control.

To take care of the activities, Barel established the limited company OOO BR Electronics in Murmansk.

The operating budgets where showing a careful start, where the initial production should from Barel AS. In the budget years 2 and 3, one would exploit the potential of the new factory, and attract additional production from new clients outside Russia by focusing on compatibility in price, quality and being able to deliver in time. Such addition of new production was considered to be realistic.

### **Establishing activity witing the proposed “Growth Zone”**

In the early phase of the project, Barel considered setting up the new enterprise in the planned Economic Growth Zone in Murmansk harbour. This process was initiated by the administration of Murmansk Oblast. The arguments where that this zone should provide buildings and reduced taxes.

During the process, it was cleared out that the proposition from Murmansk of giving financial privileges in the zone was rejected in the Duma in Moscow. Further on, the potential building in the planned zone needed massive refurbishing, since they had been closed and neglected for several years. These elements made the decision not to establish in the planned zone.

The idea of the Economical Growth Zone was quite interesting, and Barel did a detailed analysis of the financial benefits of the zone.

The intention was that the zone should give the following benefits the three first year after establishing:

<b>Taxation of profit</b>	Outside Zone	Within Zone
Federal rate	11,0 %	11,0 %
Regional rate	9,5 %	0,0 %
Lokal rate	9,5 %	0,0 %
Total Profit Taxes	30,0 %	11,0 %

<b>Property Taxation</b>	Outside Zone	Within Zone
Federal rate		
Regional rate	1,0 %	0,0 %
Lokal rate	1,0 %	0,0 %
Total Property Taxes	2,0 %	0,0 %

<b>Road Taxes</b>	Outside Zone	Within Zone
Federal rate	1,0 %	1,0 %
Regional rate		
Lokal rate	1,5 %	1,5 %
Total Road Taxes	2,5 %	2,5 %

## JOINT INVESTMENT WINDOW

Based on these figures, Barel made a simulation model to see which consequences the figure gave. The model was quality assured by the Financial department of Murmansk Oblast. Barel stressed that this was a model only, and not their future budget of profit and losses. The model gave the following figures:

Simulation model	Rate	Outside Zone		Within Zone		
		Annual RUB	NOK	Rate %	Annual RUB	NOK
Turnover		24.000.000	8.888.889		24.000.000	8.888.889
Use of raw materials	0,0 %					
<b>Included investments</b>		<b>24.000.000</b>	<b>8.888.889</b>		<b>24.000.000</b>	<b>8.888.889</b>
Salaries – Production – Included Taxe	59,2 %	8.596.800	3.184.000		8.596.800	3.184.000
<b>Contribution Margin II</b>		<b>15.403.200</b>	<b>5.704.889</b>		<b>15.403.200</b>	<b>5.704.889</b>
Salaries - Administration – Incl. Taxe	59,2 %	3.009.504	1.114.631		3.009.504	1.114.631
<b>Contribution Margin III</b>		<b>12.393.696</b>	<b>4.590.258</b>		<b>12.393.696</b>	<b>4.590.258</b>
<b>Fixed costs</b>		<b>8.115.000</b>	<b>3.005.556</b>		<b>8.115.000</b>	<b>3.005.556</b>
Operation profit		<b>4.278.696</b>	<b>1.584.702</b>		<b>4.278.696</b>	<b>1.584.702</b>
Depreciation of fixed assets		420.000	155.556		420.000	155.556
Quality costs	5,0 %	1.200.000	444.444		1.200.000	444.444
<b>Profit before Taxes</b>		<b>2.658.696</b>	<b>984.702</b>		<b>2.658.696</b>	<b>984.702</b>
Property Taxes	2,0 %	84.000	31.111	0,0 %	-	-
Road Taxes	2,5 %	600.000	222.222	2,5 %	600.000	222.222
Taxes of motor vehicles						
Tax of education, exceeding normative	30,0 %	72.000	26.667	11,0 %	26.400	
Tax of commercials, exceeding normative	30,0 %			11,0 %		
Tax of representation, exceeding normative	30,0 %			11,0 %		
<b>Total Taxes</b>		<b>756.000</b>	<b>280.000</b>		<b>626.400</b>	<b>231.940</b>
<b>Profit for taxation</b>		<b>1.902.696</b>	<b>704.702</b>		<b>2.032.296</b>	<b>752.762</b>
Profit of Taxation	30,0 %	570.809	211.411	11,0 %	223.593	82.804
<b>Net profit</b>		<b>1.331.887</b>	<b>493.292</b>		<b>1.808.743</b>	<b>669.958</b>

**476.856**      **176.666**  
**35,8 %**      **35,8 %**

The use of raw materials is set to 0. It was organised a solution where Barel in Norway will supply all materials for the production orders. The turnover is net figures as prices to produce units. Since the customer is supplying raw materials, there will be no use of raw materials, nor raw materials or fully produced units on stock. This stock and balance reduction will reduce the Property Taxation.

### Obstacles in the project, and how they have been solved

Obstacle	Solution
The effort from the Regional Duma in Murmansk to use reduced taxes as benefit to attract new enterprises was rejected by the Sentral Duma in Moscow.	This became clear early in the process, and Barel focused outside the areas of the planned Zone.
The need of qualified personnel with formal competence is massive.	Murmansk State Technical University will start an education program together with Barel. The program will be financed by Barents – secretariat, The Norwegian Ministry of Foreign

## JOINT INVESTMENT WINDOW

	Affairs and A-Etat.
The project budget is exceeded. All investments have to be financed by equity, and the need of capital is rather high.	All exceeds have been financed by equity.
The private placements to achieve enough equity took time.	Investments and educational budgets were reduced. There has been conducted a massive job to achieve sufficient equity.
There have been problems to find suitable buildings, and landlords willing to take the investments to refurbish the building.	Barel has made the strategy that their equity shall be used for education programmes, machinery's and markt development. Since all investments have to be covered by equity, they have been working patiently to find the "right" building.
The start up is delayed.	Barel has made agreements with new customers and found new volumes. The obstacle with building is solved recently. The progress with start up is running at full speed. Russian key personnel are hired, and the production will start 1,5 years after schedule.

### 3.1.4 SIMILARITIES BETWEEN THE TWO CASES SELFA ARCTIC AND BAREL

In the two cases that has been shown above about Selfa Arctic's activities in Archangel and Barel's activities in Murmansk there is possible to draw some general conclusions.

Important elements	Comments
<b>Why establish in Russia</b>	Both enterprises where aware that the cost level in Russia are lower than in Norway. In the pre study, both enterprises made detailed analysis of production and Operational costs. The level of industrial workers are in some branches only 1/10 of Norwegian levels. The enterprises experienced a stabile political climate. They had help to establish a network to regional administration. The managed to achieve some grants to reduce the massive capital need in the process.
<b>Russian competence</b>	Both of the companies had a small experience from Russia. This made it clear to them that Russia has possibilities, but business development is so complex that they needed and external consultant in the planning period, and during the project. Both companies are now "self-running" without help from external consultants.
<b>Financial resources</b>	Both companies are SMEs and had a solid financial basis  However, the operations are so demanding, that SME's in general do not have enough resources to carry out such projects. These companies are no exception, and this is showing how important project financing is to obtain a positive development in the Barents Region.
<b>Financial philosophy</b>	Both enterprises have a long time perspective of getting return of the investments.
<b>Assistance from local / regional authorities</b>	Both companies started their operations with the clear understanding that they would be helped by the regional authorities.

	<p>In practical assistance Selfa Arctic can be the one to say that they got most of such assistance.</p> <p>Barel moved into Murmansk because of the “Growth Zone project” – but stayed on because of the economic soundness of their project. The Assistance and the tax reduction that was proposed through this project did not materialise.</p>
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### 3.1.5 NORELTEC – returning to Russia

NORELTEC is a Finnish company based in Rovaniemi. They produce electronic components for IT companies like NOKIA and their suppliers. Noreltecs first experience with Russia was in the early 1990-ies, when they tried to set up a sub-production facility in Murmansk. After 2 years they had to withdraw as a result of the high inflation and uncertainties connected with the logistic chain, problems mainly connected with the customs clearance.

The high inflation made the banks held on too long to the money that were supposed to be transferred and in such way created problems with the contract obligations. Constant changes in the procedures and demands at the customs, resulted in irregular and unstable deliveries.

Now NORELTEC has started the operations in Russia again, in Kostamuksha. The clients for the products made in Kostamuksha is located in Oulu and the management are encourage by the results so far, after 4 months of operation.

Setting up the business in Kostamuksha this time, the NORELTEC management experienced that the market mechanisms is being better implemented and understood today than 10 years ago. Business style in Russia is still different from the European, but as soon as one learns to know the differences these do not create any problems.

The challenge for NORELTEC was to find information about how to set up a company, what sort of company would be right for them. Finding staff and production premises was next step on the challenge line. NORELTEC has a solid partner in the Kostamuksha kombinat that has been of great help, both with practical solutions and help with formalities.

The public sector is still a bit of a challenge for foreign business entrepreneurs. It is often difficult to find a person that knows about all the different rules and regulations valid for business operations. So in order to not start on the wrong foot, it is essential that one find a middle man that can handle the different documents and registrations and the civil servants. But the management of the foreign entity and the new Russian entity have to form good relationships to those that control or influence on the situation. One has to seek solutions to problems in different ways, often the solution is to turn and go around the problems.

When NORELTEC started this new project they got funds from the Ministry of Foreign Affairs and FINNVERA for the initial stages. Nopef gave funding for the pre-planning work. But when it came to the investments on the Russian side there was no funding or financing available, as the risk was considered too high for the financial institutions. This was done with NORELTECs own capital.

Today NORELTEC expects that the FINNVERA internationalisation loans would have been eligible for their operations. And they experience that FINNVERA is now more willing to participate in Russian investments projects than they were earlier.

## **PART IV - Recommendations**

### **4.0 How to improve the conditions for establishment of SMEs in the Russian Part of the Barents Region**

Many of the problems and challenges for start-up SMEs in Russia described in this report are being discussed by and between the Russian authorities, World Bank and International Finance Institution, numerous European Union project coordinators and the SME organizations, and Chambers of Commerce of the Russian Federation. It is also part of the WTO negotiations.

Problems connected with legislation, taxes, administrative barriers, financing, corruption and shadow activities are openly and widely discussed in Russia today. These are complex challenges for such a large economy in transition.

It is somewhat of a challenge to find a pathway for the Barents Region Cooperation, - a way to go to be able to be of use and support for the SMEs in the region. What can the regional administrations of 4 different countries do that is more successful than all the other attempts that have been done or are under process ?

First and foremost, the most important thing is that the Regional authorities of the Barents Region cooperation is **AWARE of the situation**. That they understand the complex world the Nordic companies enter into when they follow the lead of the Barents cooperation, - to establish an economic cooperation across the borders. And that they as initiator and coordinator of the regional cooperation, take the responsibility to inform and guide the companies.

All the sad business stories of the 1990-ies had their reasons, - which is described above. The situation has improved, but Russia is still not an easy place to work. However, The Barents Cooperation is used to making headway into difficult territory, making cross boarder cooperation work under difficult political circumstances, in a quickly changing world. So making life easier and more understandable for the SMEs should not be a task to back off from.

The recommendations below is to be viewed as a package of measures that should be carried out more or less in total and not as one or two single projects. Making an investors guide or manual for “How to set up business in Northwest-Russia” will not help unless the financial system is ready to assist. Making a Conference of “SMEs in Northwest-Russia, - Possibilities and challenges” will in itself be interesting, but will not lead to anything unless the regions are committed to help the new ones with information, financial assistance and practical aid.

Together the recommended measures will reduce the investment risk for the companies and the financial institutions and raise the efficiency of time and resources used.

Joint Investment Window is therefore to be viewed as a package of measures including the following;

#### **4.1 Development of an Investment support system for SMEs in the Barents Region**

The largest problems for the different SMEs in the Barents Region is investment funding. As the study has shown there are good possibilities to get pre-project funding, and in Norway and Finland there are possibilities to get investment capital as share capital or loans and guarantees. But for Russian companies the access to such funding is more difficult.

For larger investments NORUM and EBRD are possible co-investors, but they do not invest in smaller companies or projects with investments below 1 million USD.

In order to have the mechanisms of SND (Innovation Norge) and FINNVERA, NORUM and EBRD open for all the SMEs in the Barents Region the suggestion is to establish a joint investment fund for the Barents Region.

By using existing financial organizations and funding, with the know-how and the experience these possess about supporting SMEs into the international market one could create an important and forceful support system for the SMEs in the Barents Region. This “Barents Region Development and Investment Fund for SMEs”, could unite the experience, the knowledge and some of the financing products that these organizations offer. Such a Fund should be open for all SMEs, Nordic and Russian. For investments in Nordic entities in Russia as well as in Russian entities establishing activity in the Nordic countries. It should of course be based on sound economical criterieias, as these are organizations working on commercial basis.

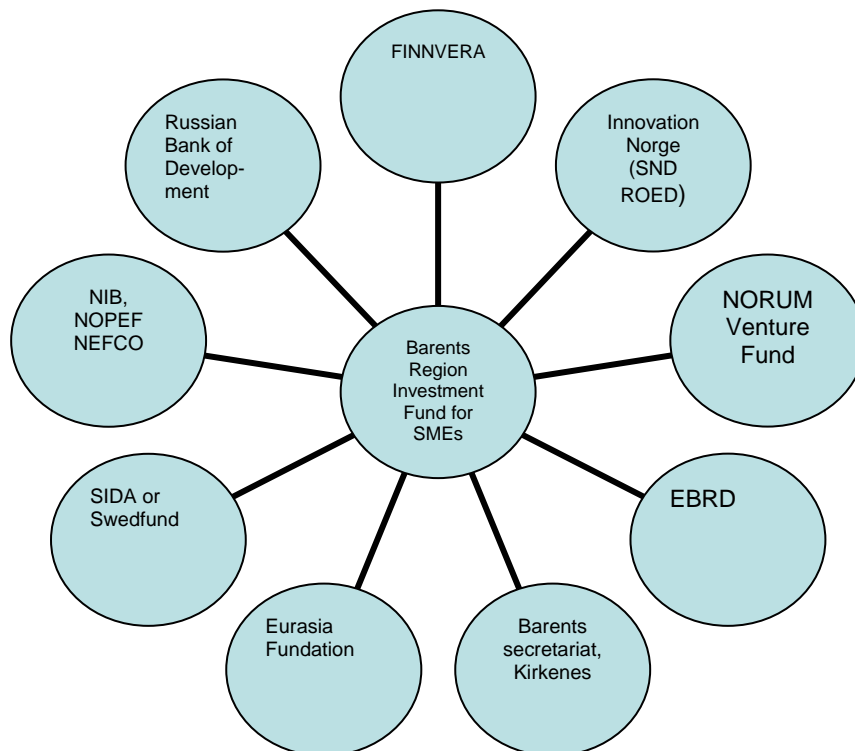
Based on the founders scope of products this fund could offer;

- pre-project grants
- loans and guarantees
- share capital

The management of such an Foundation should be located to Northwest-Russia, with management form the participating organizations. It is important that the management of the foundation is located in the area of operation, in order to be updated of the changes in the market, the legislation and economy. Such a foundation should also be in close contact with the regional administration and support the administrations in the effort to lower the administrative barriers to SMEs.

An example of what kind of organizations could be partners / founders of a “Barents Region Development and Investment Fund for SMEs” is shown below.

**Fig 8. Possible Participants in the Barents Region Development and Investment Fund for SMEs**



### 4.2 Information

#### 4.2.1 Investors Guidebook for Barents Northwest-Russia

To help the entrepreneurs to find correct information, to find experts and the right public offices, there should be made an Investor's Guidebook for each Russian Barents Region. This should be made in Finnish, Swedish and Norwegian language and contain practical information about legislation concerning business operation, registration procedures, where to find legal assistance, custom brokers etc.etc.

Together with the Investors handbook there should be established a Webside under the BEAC or the Barents Secretariats with SME information from the Guidebook.

#### 4.2.2 Conference "SMEs in Northwest-Russia, possibilities and challenges"

As this study has shown there is a lot of information about SME activities in Russia. Possibilities and challenges. In the Central regions of Russia there are held a significant number of conferences and seminars for SME. But there has not been made such conferences and exhibition for SMEs in the Barents Regions for several years. Since the economic and political situation has changed significantly the last year, this should be brought forward to the regional businesses and politicians. A Conference and Exhibition of "SMEs in Northwest-Russia possibilities and challenges" should be arranged during 2004.

### 4.3 SME support infrastructure – World Bank / FIAS evaluation

On should continue to develop the existing SME support infrastructure on Russian side

The Regional Council or its suggested new working group on Economic Cooperation and Investment is advised to use the services of the World Bank to make an evaluation of the Barents Northwest-Russia investment climate. As has been done for several Russian Regions. This is an evaluation done by specialists of the IFC (International Financial Corporation) in cooperation with the regions itself. Aim of such an evaluation is to draw attention towards the SMEs valuable contribution to the economy and analyse the regions support-systems.

The Implementation the recommendations of such an evaluation of the World Bank / FIAS into the administrative structures of the Barents Northwest-Russia would further reduce the legislative, financial and administrative barriers.

### 4.4 Education and know-how

Several companies and organizations have stated the different business style and culture between the Nordic business communities and the Russian. This is connected both to the economic and political situation in the countries, but also to different social and economic history. For Nordic entrepreneurs that intend to set up business in Russia, it is important to know more about the country's history and the cultural aspects of life in Russia. This will help to understand everyday life, their staff, their partner and in the end help running the business in a better way, adapted to the Russian community.

Educational courses for politicians, administrative personnel and businessmen have been set up both in Norway and Sweden, through the projects "RUSCA" in Norway and Barents Business School in Sweden. The Barents Business School is a concept where the participants are given part time education at University level, but organized in such a way that people with busy schedules can take the coursed in between their ordinary work.

Such courses should be encouraged and supported in the Barents Cooperation.

**5 Barents Region Regional Working group on Economic Cooperation and Investments**

To follow up the recommendations of this report and to coordinate the activities between the different Barents Region business support projects, like the Joint Investment Window, the Barents 2010 etc. it is suggested to establish a Regional Working Group on Economic cooperation and Investments, under the Regional Council. This working group should be attached to the BEAC WG on Economic Cooperation, either through participation or mutual meetings.

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#### Meetings and Interviews with:

- Company interviews
- Eurasia Foundation, Moscow
- Federal Fund for Small Business Support, Moscow
- FINNVERA
- Innovasjon Norge
- Lapland Chamber of Commers (Barents Business Advisory Group)

- Leontiev Centre, St.Petersburg
- RF Chamber of Commerce and Industry, Moscow.
- Russian Bank for Development, Moscow
- St.Petersburg Foundation for Support of SMEs
- The Ministry of Trade and Economic Development of the Russian Federation. Finance Department.
- The Russian Agency for Support of Small and Medium sized Business