

## **FEATURES OF SMALL BUSINESS DEVELOPMENT IN THE CIS COUNTRIES: DOES INSTITUTIONAL ENVIRONMENT AFFECT**

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### **Abstract**

*The article analyzes the development of small businesses at the national level through a comparative analysis between the former Soviet countries – Ukraine, Russia, Belarus, Kazakhstan, Uzbekistan, and Kyrgyzstan. These countries are comparable by the previous path dependence (the period of the USSR, communism), by the position of the geographical location, as well as by similarity of cultural development. As can be seen from the analysis, which was conducted in article, the quantitative characteristics of small business development in the above countries are similar, based on the dependence on foreign markets and conditions in national economies. However, qualitative indicators of small business development in these countries are different. These differences can be attributed to the activities of the institutional environment (formal and informal institutions) and its impact on the national economy. Conclusions about the effectiveness of quality of development of small business sector through the analysis of its contribution to the national economy are done.*

### **Keywords**

small businesses; the trajectory of previous development; institutional environment; GDP; development; growth rate; share

### **JEL Classification**

E020; M10

### **Introduction**

The importance of the small business sector can be shown through its role in the economies of developed countries (about 50% of GDP). However, in the Ukrainian national economy model its development has not yet reached the required level (about 15 % of GDP), that is why the question about identification of major barriers functioning of small business in the economy as well as appropriate ways to its stimulation remains to be actual. Particular attention should be paid to the influence of the institutional environment for the development of small businesses, because these characteristics are a reflection of a particular model of the economy and are subject to change over a long period of time.

### **Literature review**

The studies of the influence of domestic institutional environment for the development of small businesses are empirically carried out mainly on the results of ratings of international organizations (Vasiltsiv, 2009; Golovko, 2011; Nureyev, 2010), and are based on the analysis of regulations in this area (Yurkiv, 2012).

Investigation of the influence of the institutional environment for the operation of the most complex enterprises is reflected in the works of foreign researchers: Commander S. et al. (2008) came to the conclusion that the institutional environment (according to

surveys of individual enterprises and according Doing Business) has little impact on performance, which in turn, explains the subjectivity of data; Estrin et al. (2005), had investigated the possibilities and limitations for business development, defined among them the institutional environment and the characteristics of people who entered into changes; the main obstacles in the way of institutional environment of development of small businesses were studied in work of Polishchuk L. (2013); Aidis R. (2006) identified the main barriers for the small business sector in various stages of transition and among influencing factors on the initial conditions of a particular country were identified geographical factors, cultural and institutional legacy of central planning. However, questions about depending of vector of small business development from the previous path-dependence as well as from changes in the institutional environment in the national economy have been still covered in the scientific literature insufficiently.

**Aim of this research is** to determine the degree of influence by the institutional environment on the development of small businesses.

This analysis was planned to conduct for the post-Soviet countries, because they are similar by variations of reform from single paths dependence way. Small business development is dependent process (from the position of neo-institutional theory) from a trajectory of previous development. Many scholars have noted the importance and significance of the previous trajectory of development for the subsequent choice of institutional way.

Aslund (2005) argues that Russia, Ukraine and Kazakhstan experienced the appearance of large business groups able to influence political decision-making, while in the smaller CIS states these actors did not emerge. Kazakhstan started the catching-up reforms already in the late 1990s, Russia in the early 2000s and Ukraine in the second half of the 2000s. The shape of graphs for three countries is relatively similar (which is to be expected, since they represent reform variations within one particular model of post-Socialist economies).

Although, as noted by Libman A. (2006), most CIS states created the formal framework for markets including private property, corporate and contract law and similar institutions there are still important problems with both completeness and consistence of these formal norms and, more important, with their implementation and enforcement, as well as with corruption, deficit of trust and low quality of governance.

Estrin S. et al. (2005) stated, that the development of the entrepreneurial sector is sensitive to the institutional environment with a sharp distinction between the more market-oriented economies of Central and Eastern Europe and slower and more erratic pace of change in the former Soviet Union. Successful entrepreneurship depends not only on initial conditions in the transition economies but also on the speed and consistency with which the reform process has been applied. Growth in the private sector share was caused by privatization of existing firms as well as the emergence of entirely new enterprises.

In this work I test **hypothesis** about the possibility of studying of changes in the institutional environment and their influence on economic processes through the analysis of post-Soviet countries, because they have a common trajectory of the previous development (during the Soviet era), they are similar by geographic location and cultural factors (as noted by Aidis R. (2006) - factors influencing the initial conditions of the country). As noted Sterjneva M. (1999) the region still united by social integration factors, such as the Russian language, shared values, informal interpersonal communication network, common customs and ways of doing business, and so on. But at the same time in these countries at the moment small business sector are developing differently.

## Empirical results

Exploring the importance of the institutional environment in the development of the small business sector and the national economy we may refer to overseas studies. In the work of Estrin S. et al. (2005) noted, that the development of entrepreneurship is basic mechanism of transformation (a period of economic and institutional changes) of post-communist countries, and institutional environment affects the speed of change. Countries with policy implementation gaps may have advanced business law on books but reality may be different due to informal institutions, this creates problems for comparison of 'real' levels of institutional development between countries.

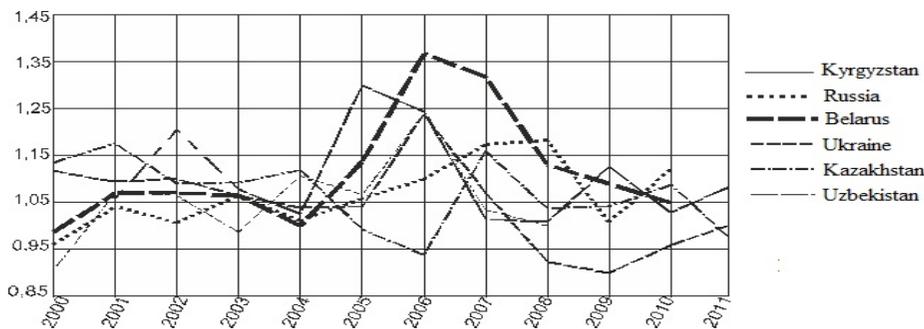
In a study of Paul G. Hare (2001) ways of influence of institutional environment for economic development were determined as "institutional environment affects behavior of enterprises in different ways, and results of changes in the behavior of enterprises leads to different economic outcomes".

Polishchuk L. (2013) had conducted comparison of general laws of development of the SME sector in the early stages of post-communist reforms noted that the rapid expansion of the private sector in the period after the liberalization of the economy was typical for most of the countries with economies in transition. On the first stage of development of small business this sector had been relatively insensitive to the institutional structure of the country. But over time of economic reformation and restructuring the transient sources of "easy money" were closed, and small businesses were forced to change their modes of operation and to find sustainable sources of income, which makes it dependent from the institutional structure. Consequently, the end stage of "filling in the gaps", when institutional relevance has increased dramatically, had become an important point of bifurcation for small businesses. Beyond this point, the trajectory of previous development of this sector in the various countries began to diverge.

In view of this, it is expedient to study the influence of the institutional environment on small business sector after the initial stage of transition economies. In confirmation of this it should also be noted that during the 1992-99 years in Ukraine most basic market rules didn't work (Von Hirschhausen and Opitz, 2001). Therefore the period was selected for study since 2000.

Determining the impact of institutional factors on the development of small business sector the quantitative growth (chain) of small businesses in post-Soviet countries was analyzed (Figure 1.) As quantitative indicators of business reflects the characteristics of the institutional environment, which affecting the behavior of this subjects. However, increasing of number of small firms may also be driven by legalization of gray and black markets of enterprises, and by the formation of paper enterprises (Estrin et al., 2005).

As can be seen from Figure 1, the process of quantitative development of small enterprises is quite similar between the post-Soviet countries. This can be explained by the economic location of countries, as well as by globalization of the world economy. Peak of chain growth of the number of small enterprises in Ukraine, Belarus and Kyrgyzstan fell on 2006 year, what could be justified by dynamics of development of the economies of these countries, and for Russia and Kazakhstan this peak began in a year later - in 2007. You can also note the general trend of falling of growth rates in 2009 year due to the complexity of the development of small enterprises in the global crisis. Therefore, from this study it's clearly that although the quantitative parameters of the small business sector are special for every economy, in the dynamics for close countries they may experience certain common characteristics. Analyzing the growth (basic) in the number of small businesses between chosen countries it could be stated that the trajectory of quantitative growth in many countries during the study period is also similar (Figure 2.).

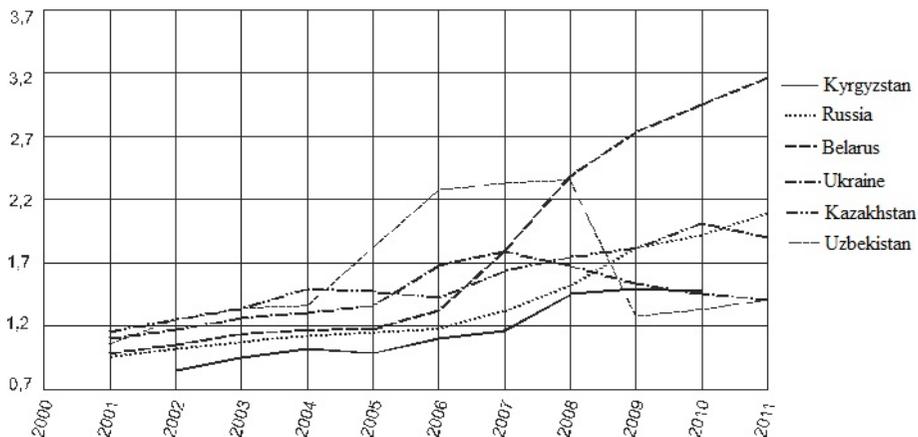


**Figure 1 Growth rate (chain) of small businesses in the CIS countries**

Source: compiled by the author according to "Review of status of small business in the Kazakhstan Republic", available at: <http://www.damu.kz/145>; Agency of statistics of the Kazakhstan Republic, available at: <http://www.stat.gov.kz>; Federal State Statistics Service of the Russian Federation, available at: [www.gks.ru](http://www.gks.ru); Official site of The National Statistical Committee of Ukraine, available at: <http://www.ukrstat.gov.ua>; The National Statistical Committee of the Belarus Republic, available at: <http://belstat.gov.by>; The National Statistical Committee of the Kyrgyz Republic, available at: <http://www.stat.kg>; The State Committee of Statistics of Uzbekistan, available at: <http://www.stat.uz>

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At the same time in Ukraine since 2008 slowing of growth of small businesses began, even though the legislative extension of the classification criteria of small businesses (as a result of which some medium-sized enterprises had already come under the category of small, which in turn should significantly increase its number (The Commercial Code of Ukraine, 2008)). It could be noted that slowing growth in the number of small businesses the most early started in Ukraine. This phenomenon can be determined by influence of the global financial crisis on the economy. On the basis of this speculation small business in Ukraine, unlike in other post-Soviet countries, was the most susceptible to changes in the external markets and worldwide. Noting that small businesses in Ukraine are tax havens for big business, the amount of this reduction should have been expected.



**Figure 2 Growth rate (basic to the 2000/2001 data) of small enterprises in the CIS countries**

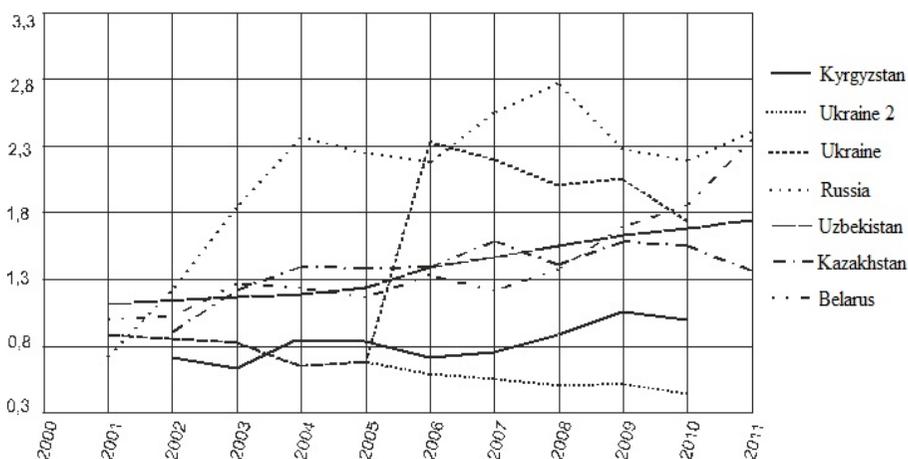
Source: compiled by the author according to "Review of status of small business in the Kazakhstan Republic", available at: <http://www.damu.kz/145>; Agency of statistics of the Kazakhstan Republic, available at: <http://www.stat.gov.kz>; Federal State Statistics Service of the Russian Federation, available at: [www.gks.ru](http://www.gks.ru); Official site of The National Statistical Committee of Ukraine, available at: <http://www.ukrstat.gov.ua>; The National Statistical Committee of the Belarus Republic, available at: <http://belstat.gov.by>; The National Statistical Committee of the Kyrgyz Republic, available at: <http://www.stat.kg>; The State Committee of Statistics of Uzbekistan, available at: <http://www.stat.uz>

From this graph (Figure 2.) point of bifurcation could be distinguished - its 2006-2008 years. In these years the period of stable development of business was replaced by period of crisis. And after this period stable development of the small business sector purely in the national economy can be seen as the negative impact of external environment was offset. After this period in Belarus, Kazakhstan and Russia stable development of small business continued, whereas in the other studied countries growth slowed.

For further analysis of the features of the development of small business in the current model of the institutional environment, the analysis of the dynamics of the qualitative development of small enterprises was done (by the dynamics of the share (%) of small businesses in GDP of post-Soviet countries (Figure 3)).

As can be seen from comparative Figure 3, in Ukraine the dynamics of growth of share of small enterprises in sales volumes increased significantly in 2006, which was caused by the entry into force of the new classification criteria for small businesses, due to what this indicator began to reflect not only the share of small enterprises, but also parts of former medium. Therefore, leveling changes in statistical records, this analysis is based on the calculation of the share of small business in GDP by criteria of 2008, which was conducted in work of Dmitrieva V. (2011) (in figure its indicator Ukraine-2).

After the adoption of these explanations, it can be stated that the dynamics of the share of small enterprises in Ukraine's GDP is similar to their dynamics in Kyrgyzstan. However, in Kyrgyzstan it is possible to determine it by that Kyrgyzstan is the smallest of compared countries by dynamics of growth of small businesses in the economy. And in Ukraine, the growth rate of small businesses only in 2009 was declined to Kyrgyzstan level. In this case, in closest Russia small businesses more dynamic gave economic effect. In Belarus, Kazakhstan, and Uzbekistan it can be traced quite similar dynamics of economic effect of the activity of small enterprises during the compared period.



**Figure 3 Growth rate (base to the 2000/2001 data) the share of small enterprises in the GDP of the countries of the CIS**

Source: compiled by the author according to "Review of status of small business in the Kazakhstan Republic", available at: <http://www.damu.kz/145>; Agency of statistics of the Kazakhstan Republic, available at: <http://www.stat.gov.kz>; Federal State Statistics Service of the Russian Federation, available at: [www.gks.ru](http://www.gks.ru); Official site of The National Statistical Committee of Ukraine, available at: <http://www.ukrstat.gov.ua>; The National Statistical Committee of the Belarus Republic, available at: <http://belstat.gov.by>; The National Statistical Committee of the Kyrgyz Republic, available at: <http://www.stat.kg>; The State Committee of Statistics of Uzbekistan, available at: <http://www.stat.uz>

For a more complete analysis of the qualitative development of small business sector in the national economy of Ukraine and comparison with the development of this sector in other countries with similar trajectory of development, correlation analysis of the rate of growth of quantitative and qualitative development of small businesses was carried out (Table 1).

**Table 1 Correlation between growth rates (basic) of number of small businesses and their share in GDP**

Countries	Correlation	Basic year
Uzbekistan	0,97	2000
Belarus	0,89	2000
Kyrgyzstan	0,85	2001
Russia (up to 2008)	0,82	1998
Kazakhstan	0,75	2001
Ukraine	0,71	1998
Ukraine -2	-0,82	2000

Source: compiled by the author according to "Review of status of small business in the Kazakhstan Republic", available at: <http://www.damu.kz/145>; Agency of statistics of the Kazakhstan Republic, available at: <http://www.stat.gov.kz>; Federal State Statistics Service of the Russian Federation, available at: [www.gks.ru](http://www.gks.ru); Official site of The National Statistical Committee of Ukraine, available at: <http://www.ukrstat.gov.ua>; The National Statistical Committee of the Belarus Republic, available at: <http://belstat.gov.by>; The National Statistical Committee of the Kyrgyz Republic, available at: <http://www.stat.kg>; The State Committee of Statistics of Uzbekistan, available at: <http://www.stat.uz>

The correlation coefficient for the Russian Federation had been calculated up to 2008, as in 2008 economic crisis started, which significantly influenced the reduction in the share of small enterprises in the GDP, and in 2008 a new federal law was introduced "About development of small and medium enterprises in Russian Federation", which

changed the criteria for classifying enterprises to small. Therefore, for the purity of research and leveling influence on it of such factors in the Russian Federation correlation was calculated until 2008.

As can be seen, these coefficients of correlation between quantitative and qualitative development of small enterprises there is strong correlation in some post-Soviet countries is a (Uzbekistan, Belarus, Kyrgyzstan). At the same time in Kazakhstan and Russia correlation between the studied parameters is also on significant level. In Ukraine, it could be observed a moderate relationship between the basic growth rates of the number of small businesses and their share in the GDP, but this relationship can be explained by a sharp increase in the share of small business in GDP in 2006, as a result of conversion to the new criteria. But this dependence is completely leveled, given the effect of the new criteria (2008) when quantity of small businesses and their share in GDP calculated according to these criteria throughout the studied period (correlation -0.82). In this case, the correlation coefficient is very strong and negative, indicating inefficient development of the small business sector in the economy, as growth in the number of small businesses does not increase the share of this sector in the country's GDP.

Confirmation of the hypothesis about the effectiveness of small business development through the relationship between the number of small businesses and their share in GDP is confirmed by analysis on the cross-correlation - the highest correlation is observed in the case of 0 lag.

The main conclusion from two conducted analyzes of small business sector of Ukraine can be done-small enterprises in the national economy develops at inefficient level, even compared with neighboring countries. In the economies with similar path dependence over two decades very different models of effectiveness of small business development in the national economy were formed. Given that the transition countries have different levels of market memory (Round, 2009) and different levels of integration in the Soviet command economy (Mickiewicz and Estrin, 2011) it is not surprising that in these countries business sector develops differently.

This can be confirmed by Scase (2003), who offered a different dichotomy, namely by entrepreneurs' commitment to business growth. He argues that in transition economies a large proportion of business owners are "proprietors" who use profits for private consumption rather than reinvest into business. Thus, even though SME numbers may be high, they do not necessarily constitute a growth engine, as their motivation is different from that of their West European counterparts.

As noted Melnyk A. et al. (2012), the nature of the transformations can be of two types: evolutionary and stimulated by the state. Since the investigated countries are characterized by the common trajectory of the preceding development, and they developed independently only over a small period of time (22 years), then we can talk about the transformations stimulated by the state. Therefore, in the paper we assume that precisely government actions to change the institutional environment are stimulants of changes in the development of the small business sector.

Lack of effective institutions and opportunistic behavior of the officials led to an informal culture, which explains why entrepreneurial capabilities and intentions are at a lower level than in other countries. Countries with gaps in policy implementation may have progressive laws for business on paper, but in reality they may vary due to the action of informal institutions.

Although in CIS countries there are still problems with the formation of formal rules and, more importantly, their implementation and coercion, as well as with corruption, lack of confidence and poor quality control, as noted by Libman A. (2006). The conflict between formal and informal institutions as alternative sets of norms of behavior is one of the most debated issues in modern transitional and developed economies (Libman, 2013). However, while the formal institutions can be formed

quickly, informal institutions, which contradict them, may take more time to reform (Stiglitz, 2001).

## Conclusions

Based on this research, the following conclusions could be made:

- Geographical location, cultural traditions, institutional trajectory of the previous development, as well as serving institutional environment affect the vector of development of small businesses. And as a consequence, it should also be treated with caution on import of institutions from one country to another.
- Small business in the existing institutional environment evolves inefficient in Ukraine, even compared to close countries by the initial conditions of the institutional environment. We can talk about the inefficiency of the existing formal rules and mechanisms for their enforcement, as well as their inconsistencies with established for a long time informal norms of behavior.
- The current institutional environment in Ukraine promotes the formation of ineffective behavior of entrepreneurs, which is reflected in the results of the development of small enterprises in the national economy.
- It is necessary to pay more attention to the basic steps to reduce corruption, to eliminate bureaucratic barriers to business formation and growth, as well as to improvement of the formal rules of the game and bring them into alignment with the informal norms of behavior in Ukraine.

Exploring the importance of the institutional environment in the development of the small business sector and the national economy we may refer to overseas studies. In the work of Estrin S. et al. (2005) noted, that the development of entrepreneurship is basic mechanism of transformation (a period of economic and institutional changes) of post-communist countries, and institutional environment affects the speed of change. Countries with policy implementation gaps may have advanced business law on books but reality may be different due to informal institutions, this creates problems for comparison of 'real' levels of institutional development between countries.

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