

**THE FINANCIAL EXPERIENCE
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OF MICRO AND SMALL ENTERPRISES IN RUSSIA:
PRELIMINARY SURVEY RESULTS FROM SAMARA**

by

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THE FINANCIAL EXPERIENCE AND ATTITUDES TOWARD REGULATION OF MICRO AND SMALL ENTERPRISES IN RUSSIA: PRELIMINARY SURVEY RESULTS FROM SAMARA*

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1. The Demand and Supply Dimensions of the Microfinance Market

The efficiency and sustainability of microfinance organizations matter. The vigor and stability of their clients enterprises also matter for the expansion of the frontier of microfinance. Without healthy clients, microfinance organizations cannot prosper.

A microfinance organization needs clients with sufficient productive opportunities, who are able to take loans and able to repay the principal plus sufficient interest to cover the costs of the microfinance organization. A microfinance organization needs clients with capacity to save and with stable cash flows that allow them to make regular repayments. Weak clients mean a sick microfinance organization.

It appears that in Russia these demand dimensions of the microfinance market matter even more than in other countries for the sustainability and expansion of microfinance organizations. The supply of microfinance is very weak in Russia, but the demand is also weak.

An explanation of this last statement is necessary to avoid misunderstanding. There is a huge unsatisfied demand for microfinance in Russia. The challenge is, however, that this large potential clientele includes many vulnerable enterprises, with a limited, unstable, and unpredictable repayment capacity.

The main reason is that this large potential demand is threatened by unusual and unexpected shocks, including major regulatory and policy shocks. A dramatic example is the August, 1998 devaluation. Moreover, at the local level, frequent changes in rules and regulations influence the operations of small and microenterprises.

Thus, there are problems with the demand for microfinance in Russia; nevertheless, the supply of microfinance is even weaker. This weak supply, even when compared to an unstable demand, implies that there is a large unsatisfied *legitimate demand* for microcredit in Russia.

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2. Regulatory Determinants of Client Performance

A multitude of factors influence the state of the clientele of a microfinance organization. The regulatory environment in which these enterprises operate is an important one (but not the only one) among these factors. Essential to the success of microfinance organizations is a good understanding of the evolution of these determinants of the state of their clientele.

In particular, a microfinance organization must anticipate changes in the circumstances (including changes in the regulatory environment) that may influence the financial health of the clients. A deterioration of these circumstances may rapidly result in a non-performing portfolio, in losses from default, in decapitalization, and in the inability to function effectively and to pursue the mission of the organization.

In general, a microfinance organization must learn to interpret the environment. This is particularly true in Russia, because in Russia the environment matters a lot. The OSU research team has attempted to understand the influence of the Russian regulatory environment on the clientele from two complementary perspectives:

- (a) from the perspective of the features of the regulatory framework applicable to the typical clientele of a microfinance organization (Nadolnyak and Hartarska, 1999), and
- (b) from the perspective of how the clients themselves evaluate the extent to which this regulatory framework has actually constrained their ability to take advantage of their own opportunities, as reported in this paper.

3. Survey Design

To accomplish this task, a survey of entrepreneurs was implemented in July-August 1999 in Samara City and other cities in the Samara oblast, where Finca operates. Implementation of the survey had to overcome severe obstacles, in part due to limited time and resource availability and in part due to the difficulties of asking probing questions about private activities of nervous and usually very busy respondents.

Despite these obstacles and the inevitably narrow scope of the observations, the results from the survey are quite credible and consistent, and overall they seem quite satisfactory. The field work was undertaken by 10-15 students and sociologists from Samara State University, under the supervision of Hartarska, and respondents were revisited to obtain clarifications. This paper reports partial and preliminary results, but even these data already allow for a rich understanding of the situation and for numerous shades of interpretation of the information.

The survey was implemented through three independent but complementary samples:

- (a) A sample of 41 of Finca/Samara clients, the very first clients the organization had reached. It is assumed here that these clients are representative of the typical microfinance clientele in the Samara oblast.
- (b) A sample of 62 observations, to create a control group of entrepreneurs similar to the Finca/Samara clients, selected from the same market areas where the former operate. This sample was created to gain some understanding of the broader pool from where the potential clients of Finca/Samara will be drawn as it expands its operations.
- (c) The combination of these 103 observations constitutes the group of *microentrepreneurs*, the original target group for Finca/Samara.
- (d) A sample of 208 *small entrepreneurs* (as contrasted to microentrepreneurs), which may be a potential market niche for a microfinance organization interested in serving individual clients with somewhat larger loans. This third sample was randomly selected from the list of enterprises with less than 30 employees registered with the Statistical Department of the City of Samara. Such registration is required of all enterprises (anyone with an economic activity). This third sample comprises, in turn, a group of 58 private individuals (*physical* persons) and 150 partnerships and companies (legal or *juridical* persons).

The analysis below presents some paradoxes, uncovers some contrasts, and highlights some surprising results that may require further exploration. The results for the Finca/Samara clients are compared to those for the control group first, and then the combined results for these microentrepreneurs are compared to those for the small entrepreneurs.

4. Who are the Finca Clients: A Preliminary Profile

A first important observation is that, with the exception of a few traits, the profiles of the Finca/Samara clients and of the microentrepreneurs in the control group do not reveal significant differences in their socioeconomic characteristics. This, in part, suggests that the survey was successfully implemented as designed; the enumerators were instructed to seek enterprises with similar characteristics as those of the Finca/Samara clients, in order to construct the control group and, apparently, they were successful in this task.

Legal Form

In both groups of respondents, most of the subjects are physical individuals who are private owners. This is true in about 90 percent of the cases (Table 1; all tables are in the Annex). Although there are a few partnerships in either group, companies are found only among the control group.

In Russia, even private individuals must register as enterprises. Because registration procedures are simpler, however, for physical than for juridical persons, it is expected that registration problems will not be a formidable barrier to entry for these microentrepreneurs.

Gender

Most of these enterprises are run by women. According to Table 1, 83 percent of the Finca/Samara clients and 72 percent of the control group are female operators. Although this difference may reflect Finca/Samara's inclination to reach women, the predominance of female owners in both groups mostly reflects a concentration of the potential clientele in trade occupations, where Russian women dominate.

In turn, microfinance attracts many of these women because their trading activities generate the regular cash flows that are needed to make regular loan payments. There is some unwarranted discussion in Russia as to whether *trade* is a *productive* activity or not, which has been inherited from the old-fashioned views about industrialization. Clearly, there is *value added* in these trading activities, which represent an important source of income and employment, and the gender dimension (concentration of women) in trade makes this sector socially important.

Age of the Enterprise

Most of these microenterprises have been established for several years. Although the date of registration goes as far back as 1992 for some of them, over half of them were registered between 1995 and 1997 (Table 1). The lesser proportion of enterprises of recent establishment among the Finca/Samara clients than among the control group may reflect the fact that this organization requires some established experience of the business in order to grant a loan.

Limited Diversification

On average, the enterprise generates over two-thirds of total household income. Thus, the performance of this one enterprise is key for the welfare of the household. Indeed, these households seem to have very few opportunities for diversification of their sources of income. There are several reasons for this:

- (a) Household size is small. As is typical in Russia, on average, households have only about 3.5 members (parents and one or two children). As shown in Table 1, household size is slightly larger for the Finca/Samara clients than for the control group. As a consequence of small size, the average number of household members who work is small. It is difficult to diversify when only one or two household members are in the labor force.
- (b) Most of these entrepreneurs do not hold additional jobs (over 90 percent of them do not), and almost no one operates a second line of activity (Table 1). This may be due, in part, to an apparent dearth of part-time jobs and to the difficulties of capitalizing a second enterprise when the entrepreneur faces major credit constraints.

Because they face high risks and uncertainty and have few opportunities for diversification of their sources of income, these households are very vulnerable to the fate of this one enterprise. A

single shock can easily wipe them out. This is in significant contrast to microentrepreneurs in developing countries, where the poor household usually undertakes an elaborate strategy of diversification of its sources of income.

As a consequence of these limited opportunities for diversification, access to credit offers the household an additional opportunity to smooth cash flows and to cope with the volatility of income in this risky environment. While this indeed generates a demand for loans, the resulting vulnerability also threatens the ability of these entrepreneurs to pay back these loans.

In summary, a major challenge to microfinance in Russia is to address these demands for loans while at the same time keeping the accompanying credit risks within reasonable bounds.

Enterprise Size

All of these microenterprises are very small. In addition to the owner, on average they hire 1.4 workers (Table 1). That is, on average, the enterprise creates 2.4 jobs.

There are some differences, however, between the Finca/Samara clients and the control group. Among the control group, 55 percent of these entrepreneurs work by themselves, with no employees at all, compared to 38 percent among the clients of Finca/Samara (Table 1). Among the Finca/Samara clients, 60 percent employ at least one person beyond the owner. In fact, median employment beyond the owner is one worker for the clients of Finca/Samara and none for the control group. At the same time, a few entrepreneurs in the control group have more than 10 workers.

There are two possible explanations of the different employment outcomes for the two groups of microentrepreneurs, and at this time we do not have the ability to solve this identification issue. On the one hand, if an entrepreneur does not have employees, this may reflect reasons for not demanding credit. On the other hand, the greatest access to credit exhibited by the Finca/Samara clients may have itself created the opportunity to expand the operations of the enterprise and to hire additional workers.

The small size of the enterprise is also corroborated by the apparent limited capitalization of the business. Only 20 percent of these microentrepreneurs operate in fixed premises (Table 1). The majority operate out of tents in the street and other mobile or semi-permanent structures.

Education

The most significant difference between the Finca/Samara clients and the control group that was found by the survey concerns their level of education. The Finca/Samara clients are generally less educated than the entrepreneurs in the control group. This was a surprising result, given that all of the other traits are so similar for the two groups.

Usually, education is a good proxy for productivity, access to information, and ability to understand loan procedures. More educated people would have been able to approach the

Finca/Samara operation more easily. This result does not confirm this presumption. This suggests that there may be characteristics of individuals (entrepreneurship, willingness to take risks, ingenuity, flexibility) that in Russia are not captured by the *education* variable.

In summary, there are little differences among the *microentrepreneurs* in the sample, both the Finca/Samara clients and the control group, except with respect to their educational achievements. Surprisingly, the clients of Finca/Samara are less educated than their peers.

5. The Small Entrepreneurs

There is a clear distinction between the *microentrepreneurs* of the former two groups and the *small entrepreneurs* of the third sample. Compared to microenterprises, the small enterprises are less frequently operated by individuals (physical persons). As shown in Table 2.39 percent of them are *companies* (more formal corporations) and 16 percent are *partnerships* (less structured but most of the time with limited liability), while only 45 percent are operated by individuals.

In this case, the regulatory framework presents additional challenges, not only because of more elaborate procedures to create and register a juridical person, but because of the different treatment of physical and juridical persons by a number of statutes and tax regulations. Unfortunately, the survey did not reveal reasons to upgrade the legal status of the enterprise to a legal entity or not to pursue this route because of the implications, particularly with respect to tax incidence.

Table 2 shows a greater proportion of older and of comparatively recent enterprises among the small compared to the combined group of microenterprises. Older successful microenterprises would have had more chance to grow into small enterprises. The presence of comparatively recent small enterprises reveals, in turn, the dynamism typical of these sectors.

It is important to realize, moreover, that the enterprises that have been observed are those that have survived in this volatile environment. The survey does not provide evidence about the numbers of enterprises that might have failed during the same period or about the features of the successful versus unsuccessful enterprises.

In contrast to microenterprises, which are clearly female-owned businesses, only 29 percent of the small enterprises are operated by women (Table 2). In places where men can more easily get a stable job, they would not operate an independent enterprise unless the returns are sufficiently high. Moreover, women may be less inclined to expand their enterprises while men may be better positioned to expand the operation, when they have a greater ability to overcome some of the high transaction costs incurred in gray markets through their more extensive networks..

On average, a small enterprise generates over 90 percent of total household income, and very few small entrepreneurs have another business or occupation (Table 2). This concentration of household labor effort in the one enterprise is thus even greater than was observed for

microentrepreneurs. For more than half of the small entrepreneurs, the enterprise is the only source of household income. In effect, the median proportion is 100 percent.

The reasons for this concentration are similar to those found for microentrepreneurs. In the case of small enterprises, moreover, average household size (3 members) is even smaller than among microentrepreneurs. Not only are the opportunities for diversification limited, but in the complex environment in which these enterprises operate, they require all the attention of the owner.

Even though by survey design they are larger, small enterprises also operate mostly from non-fixed premises (80 percent). A few operate from home. Beyond the owner, on average the small enterprises hires 8.6 workers. The median number of workers is 5, compared to 1 for the Finca/Samara clients and 0 for the control group. Also, fewer (only 22 percent) work alone, while about one-third of the small enterprises have more than 10 workers (Table 2).

The operators of small enterprises are better educated than the microentrepreneurs of the control group and the Finca/Samara clients. Almost 70 percent of them have university degrees, compared to 45 percent among the control group and 25 percent among the Finca/Samara clients (Table 2). At this level, education seems to matter. The high levels of formal education of these entrepreneurs contrasts with those in developing countries. Their productivity is not as high as it could be, however, because of the absence of institutions to support market operations in Russia.

In summary, while the profile of small enterprises reveals that they operate in a different market niche than microenterprises, this segment is also vulnerable to shocks and regulatory uncertainty. These small enterprises may still be within the scope of operations of microfinance organizations.

6. Credit Experience

The most salient paradox revealed by the survey is that, while the profiles of the Finca/Samara clients and of the control group of microenterprises are very similar, their credit experience is very different, even when one ignores the Finca loan. The paradox is particularly intriguing because, while the Finca/Samara clients are clearly less educated compared to the microentrepreneurs in the control group, their credit experience is much richer, even if the Finca/Samara loan is not taken into account.

Usually, one expects more educated entrepreneurs to encounter better productive opportunities and to gain more access to credit. Not in this case. Compared to the Finca/Samara clients, the control group has a narrower experience with credit.

The experience of the Finca/Samara clients with credit is shown in Table 3. The question asked was: "Since registration of your enterprise, have you ever applied for and received a loan from ...--list of sources." The results are reported below.

Institutional Sources

Prior to the Finca/Samara loan, the experience of its clients with institutional sources of credit was almost non-existent. Among the 41 clients in the sample, one had had experience with banks, one with a government credit program, one with leasing, and two with private firms that retail credit (several of these observations may belong to the same individual). None had had experience with NGOs or with cooperatives (Table 3). For this group of entrepreneurs, their loan from Finca/Samara thus represents a substantial improvement in their credit options.

The experience of the control group with institutional sources of credit had been equally dismal. One or two had had experience with banks, government credit programs, NGOs, cooperatives, or private firms (Table 3). The only difference is that they do not have a Finca/Samara loan.

Trade Credit Sources

The greater experience with credit of Finca/Samara clients becomes evident with respect to trade credit and informal finance sources. While merchants and input suppliers have made sales on credit to 34 percent of Finca/Samara clients, this has been the case for only 23 percent of the control group. Advances from clients have also been more frequent among Finca/Samara clients (Table 3).

Informal Sources

Friends and relatives are the most frequent source of loans for these microentrepreneurs. Finca/Samara clients, however, received these loans in 70 percent of the cases, compared to only 52 percent among the control group. The ability to attract funds from friends and relatives reveals a latent savings capacity that is mobilized for these purposes.

While they may not carry interest, loans from friends and relatives may carry reciprocal obligations that imply intermediation of savings flows across members of these groups. These reciprocal obligations can be carried over to joint liability pledges among the members of a credit group, such as the *village banks* of the Finca lending technology. The greater experience of Finca/Samara clients with loans from friends and relatives may suggest a greater ability to engage in these reciprocal obligations.

The difference is even more pronounced with respect to their experience with moneylenders. While 34 percent of the FINCA/Samara clients have had an opportunity to borrow from moneylenders, only 8 percent of the microentrepreneurs in the control group have had such dealings. It is not possible, again, to solve the identification problem implicit in this difference. It may be that the Finca/Samara clients demand more credit than their peers in the control group, but it may also be that they are more successful, for some unknown reason, to signal their creditworthiness to lenders.

Will the Finca/Samara contract substitute for the relationship with the moneylender? Or, are these entrepreneurs so credit-constrained that FINCA will merely become an additional source of funds, to be added to the already existing sources of credit? Again, the identification issue cannot be resolved without further analysis. One of the most pertinent questions is this degree of substitutability between microfinance and the more expensive (and sometimes dangerous) option of borrowing from moneylenders.

In summary, across all sources of credit, the clients of Finca/Samara have had more experience with credit than the control group, even if one ignores the loan from Finca. In fact, on average, the clients of Finca/Samara have had experience with 2.7 different types of sources of credit. If the Finca loan is excluded, this is an average of 1.7 classes of sources, compared to less than one for the control group. The large number of entrepreneurs who rely on multiple sources of credit further suggests that they are credit-constrained.

7. Most Formal Source

Table 3 reported the entrepreneurs experience with *all* of their different possible types of sources of credit. Table 4 shows only the most *formal* source used. This adjustment is necessary when the individuals have access to multiple sources and the number of sources varies from one individual to the other. Thus, an entrepreneur who has had loans from a bank, a merchant, and a moneylender will be listed here under *banks* only, while someone who has had loans from moneylenders and family and relatives will be listed under *moneylender*. In Table 4, therefore, the categories are mutually exclusive and the shares add up to 100 percent, which was not the case in Table 3.

This information confirms the dominant experience with credit that the clients of Finca/Samara have had over their peers in the control group. Over 90 percent of the respondents in either group had had no experience with institutional sources, but the proportion of Finca/Samara clients who had had this experience (9.8 percent) versus the control group (6.5 percent) is higher (Table 4). There is still a need to verify the statistical significance of these differences.

When those who have not had access to anything more formal than trade credit sources are added to those able to borrow from institutional sources, the dominance of the Finca/Samara clients becomes clearly significant. Among the Finca/Samara clients, 49 percent have been able to obtain loans from trade credit sources or banks, compared to 34 percent in the control group. This would have created a discipline to repay loans that would be valuable in the Finca/Samara contract.

The distinction between the two groups becomes even more accentuated when those who at best had obtained a loan from a moneylender are added to those in the former two groups. Two-thirds of the Finca/Samara clients had had experience with either institutional, trade, or moneylender

sources of funds (*market* financial transactions). This had been the case for only one-third of the entrepreneurs in the control group. Two-thirds of the control group have had experience with only loans from friends and relatives or none at all.

More importantly, while only 7 percent of the clients of Finca/Samara had had no experience with any source of credit before their loan with this organization, 37 percent of the control group had not had any experience with credit, from any source, despite the fact that several of these enterprises have been operating for several years now.

In conclusion, the clients of Finca/Samara appear to have been more actively seeking for loans and they appear to have been more frequently successful in obtaining them from all types of sources than the entrepreneurs in the control group, except with respect to institutional sources where, if one ignores the Finca loan, their experience is similar.

8. Initial Funding

In contrast, this distinction between the two groups does not appear to have been appreciable at the time of creation of these enterprises. At the time of creation, their financial strategies (opportunities) were very similar.

Indeed, 58 percent of the Finca/Samara clients and 53 percent of the microentrepreneurs in the control group financed the establishment of their enterprises fully with their personal savings. Their own funds accounted for 100 percent of the initial capitalization of the enterprise. The rest of the microentrepreneurs used some combination of their own funds and loans from moneylenders.

This pattern of initial funding is not unusual. All over the world, enterprises are mostly created with the owner's own savings. Access to credit for this purpose is very limited because, since the enterprise is not yet in existence, there is no way to evaluate if it will generate the cash flows needed to service the loan. This is particularly difficult in microfinance, as no feasibility studies and projected financial statements are available. Credit programs cannot resolve the funding problems of start up enterprises. This is why programs that facilitate the accumulation of personal savings are so important for the development of new enterprises.

Once the enterprise has been established for some time, then it can signal its creditworthiness by demonstrating its own success and, in this way, it can gain access to loans. By then, the asymmetric information about the enterprise's true potential is less severe and the microfinance organization can use this information in its client screening process.

In summary, the interesting contrast is that, while both the Finca/Samara clients and the entrepreneurs in the control group had very similar financial profiles in the beginning, later on the clients of Finca/Samara were considerably ahead of their peers with respect to their credit experience. There are several implications of this finding:

- (a) the screening ability of the Finca/Samara promoters (loan officers) seems to have allowed them to successfully pick winners in this market niche;
- (b) given their recent access to the Finca/Samara loan, these entrepreneurs with a greater credit experience will further consolidate their competitive advantage over their peers, provided they do not fall into overindebtedness; and
- (c) the limited credit experience of the control group, despite their similar characteristics and greater education as compared to the Finca/Samara clients, suggests that there is a very large market niche of unsatisfied demanders of credit to be conquered.

9. Credit Experience of Small Entrepreneurs

This underserved market also includes numerous small enterprises. As suggested by Table 5, however, the credit experience of these small enterprises is also significantly different from that of the microentrepreneurs in the combined group.

Institutional Sources

In contrast to microentrepreneurs, about one-third of the small entrepreneurs have had some experience with institutional sources of credit. Most of this experience has been with banks (14 of the 49 small entrepreneurs for whom information had been processed had had a bank loan). This is not the case, however, for government credit programs or for NGO or cooperative activities, as even among this subsector there is little experience with these other sources. In general, government credit programs in support of small business development have not been successful in either outreach or sustainability terms (Nadolnyak and Hartarska, 1999).

Trade Credit

The experience of the small enterprises with trade credit sources has also been extensive: 35 percent have had credit from merchants and input suppliers and 39 percent have had advances from clients. The proportion of small entrepreneurs obtaining advances from clients is much higher than among microentrepreneurs. Thus, as shown in Table 6, about two-third of the small enterprises had had loans from some institutional or trade credit source.

Moneylenders

The proportion of small entrepreneurs who could not gain access to a more formal source of credit than moneylenders (4 percent) or to no more than friends and relatives (10 percent) is much less than among microenterprises, most likely because their greater access to more formal sources of credit has made dealings with these informal sources less necessary. This suggests, therefore, some degree of substitution of formal for informal sources of credit.

Finally, only 18 percent of the small enterprises have not had any experience with credit, compared to 39 percent among the control group of microentrepreneurs. This was the case for only 7 percent of the Finca/Samara clients before they obtained their loans from this organization.

In summary, small enterprises have had more access to credit than microenterprises. Nevertheless, even for this segment, there is a large underserved market niche. Because these small enterprises appear to have a greater capacity to generate employment, to the extent to which they could be made less credit-constrained, they might become an important source of economic growth for this sector.

10. Determinants of the Experience with Credit

The identification problem is particularly pronounced in any attempt to explain different degrees of experience with credit. The reason is that the observation of any credit contract is the result of the interplay of supply and demand factors. *Ex post*, it is not easy to identify which of these factors was critical in the emergence of the credit relationship. This is the *identification* problem. Sophisticated econometric techniques can, in some cases, be used to resolve this problem, but we have not attempted this identification at this time.

Demand Constraints

Thus, some entrepreneurs may have less experience with credit simply because they do not want it; they demand credit less frequently or they do not demand it at all. There are several possible reasons for this:

- (a) some entrepreneurs may have limited opportunities, which reduces their demand for credit (*e.g.*, it appears that the individuals in the control group have less attractive opportunities than those that would justify the hiring of additional workers); and
- (b) some entrepreneurs may be more risk averse and may not like to be in debt. This is frequently the case when enterprises operate in risky environments and the entrepreneurs have a limited cushion to absorb adverse shocks.

Supply Constraints

Even when they demand credit, however, small and microenterprises may not be able to obtain the loans. This is a usual situation in financial markets characterized by acute asymmetric information and contract enforcement limitations, as is the case in Russia. In particular, small and microentrepreneurs may have difficulties in establishing their creditworthiness:

- (a) if they are not able to pledge the required collateral, or
- (b) if they do not have an established reputation that can be easily corroborated.

Moreover, some entrepreneurs may not even apply for loans if they perceive that the transaction costs are too high, particularly when there is a high expectation that their application may be rejected. In this case, their demand cannot be directly observed.

Furthermore, the results of the survey suggest that there is significant ignorance in Samara about the existence of credit sources and about the terms and conditions of their potential contracts. Information is critical, however, in the development of a demand for financial services.

To explore this question, the respondents were asked: “What were the reasons for not applying for a bank loan?” and respondents were asked to rank their answers. Table 7 reports the results for the most important reason cited. Some of these entrepreneurs did not want loans. Clearly, this was not the case among the Finca/Samara clients, but 16 percent of the microentrepreneurs in the control group and 33 percent of the small entrepreneurs answered: “I have enough money; I do not need a loan.”

It is unlikely that this answer implies that they are wealthy. Most likely, this answer signals that these entrepreneurs have enough funds of their own to take advantage of their current opportunities. That is, this answer is a proxy for the absence of sufficiently profitable marginal opportunities today, and this is the reason why they do not need additional funds. If the circumstances changed, they may need a loan.

Even fewer entrepreneurs answered: “I do not like to be in debt.” This may imply that, even though the environment is quite risky, not borrowing is not a generalized preference among these entrepreneurs. This preference prevails more, however, among the small entrepreneurs (13 percent).

The number of those who do not apply for a bank loan because they do not want to attract further scrutiny of their enterprises or because they fear the tax consequences is very small. The proportion who would not like the associated scrutiny is highest, however, among microentrepreneurs (5 percent).

The most important reasons for not applying for a bank loan reveal weaknesses of the supply. These reasons are associated with answers reporting:

- (a) their perception that they would not be able to fulfill the requirements demanded by banks. This perception was strong among the Finca/Samara clients (22 percent) and among the small entrepreneurs (20 percent), but surprisingly not so much among the control group (10 percent). The latter result may reflect the fact that the microentrepreneurs in the control group showed less drive in seeking loans in general (and therefore did not know what these requirements are);

- (b) their perception that the procedure is too complicated and that approval would take a long time. This was particularly true among small entrepreneurs (30 percent), who would most likely have considered the possibility of applying for a bank loan but who would have discovered that the transaction costs were too high. The perception was most frequent, as well, among the control group than among the clients of Finca/Samara. The latter seem to have overcome their credit fright; and
- (c) their perception that the interest rate charged is too high. Again, this perception was more frequent as the main reason for not applying for a bank loan among the clients of Finca/Samara (20 percent) and among the small entrepreneurs (23 percent) than among the control group. A likely explanation is that the entrepreneurs in the control group would have not inquired or would have not been interested in obtaining information on these terms and conditions, given their perception that in any case they are not eligible for bank loans.

11. Policy Implications

What are the policy implications of these preliminary findings on the determinants of the experience with credit of these small and microentrepreneurs in Samara?

Economic Environment

First, improvements in the general economic environment will increase the demand for credit for those entrepreneurs who currently have limited opportunities or who are risk averse. A more dynamic environment, which increases these opportunities and reduces uncertainty, would lead some of these entrepreneurs to demand loans so they can take advantage of a more attractive set of options emerging from the improvements in the environment.

Regulatory Burden

Second, it appears that a less repressive regulatory framework would probably increase the demand for credit only a little. Indirectly, however, changes in the regulatory environment that contribute to a reduction in uncertainty and to improvements in the business climate would have a more significant impact.

Innovations in Lending

Third, it is clear, however, that the greatest expansion in the experience with credit will come from innovations in lending *technologies*. That is, more of these small and microentrepreneurs will gain access to credit after:

- (a) innovations are introduced that make it possible to lend to them with less requirements than the current banking technologies demand (such as the Finca/Samara program does);

- (b) innovations are introduced that simplify loan procedures and that, in general, lower transaction costs for the clients; and
- (c) innovations are introduced that lower the costs of lending to these clients, in such ways that the microfinance organizations are in a position to charge lower interest rates even if they want to cover their costs in order to become sustainable.

The introduction of these innovations will depend critically on the creation of a more hospitable regulatory environment, conducive to the expansion of the frontier of microfinance. Until this more conducive environment is developed, microfinance will remain shallow in Russia (Safavian and Graham, 1999).

12. The Incidence of the Regulatory Framework

As suggested by the analysis of the determinants of the experience with credit, the *direct* elasticity of the demand for credit with respect to fears about the regulatory framework seems to be low. That is, *per se*, changes in the regulatory framework would increase the demand for credit little. The *total* elasticity of the demand for credit with respect to the regulatory framework, however, might be large, through the *indirect* impact of the framework on the operations of these enterprises and on the opportunities and constraints that they face. Moreover, the elasticity of the supply of microfinance with respect to favorable changes in the regulatory framework appears to be very large, given the significant burden that the framework represents for microfinance organizations (Safavian and Graham, 1999).

To explore these questions further, the respondents were asked to list problems that they have faced at several stages of their evolution and to rank these problems according to their importance. In particular, these questions were asked concerning the time when the enterprise was created, for the current times, and for plans for expansion in the future.

Problems at the Beginning

At the time when they were established, the most important problem that these enterprises faced was the insufficiency of funds to initiate operations. This was particularly true in those cases when an important initial investment was needed. Funding was the most important problem for 73 percent of the Finca/Samara clients and 83 percent of the microentrepreneurs in the control group, but for only 47 percent of the small entrepreneurs (Table 8). Lack of sufficient funding was considered as the second most important problem by many additional small and microentrepreneurs.

Regulation-induced obstacles were not the most important problem for the majority of these new entrepreneurs, but they were still very important. These problems were the most important constraint for 24 percent of the Finca/Samara clients, 12 percent of the control group, and 16 percent of the small entrepreneurs. These regulation-induced problems included difficulties associated with registration, licensing, payments to the government, and finding a place to operate. Prominent among

them, however, were problems related to taxes. These problems seem to be related not only to the rate of the different taxes but mostly to their implementation and the arbitrariness and uncertainty that may be associated with tax administration.

We wanted to assess the burden of registration for these entrepreneurs. They were asked to measure, on a scale of 1 (easy) to 4 (very difficult), the degree of difficulty associated with registration procedures. None of the average answers were above 2; the average answer of Finca/Samara clients was 1.8, of the entrepreneurs in the control group was 1.5, and of the small entrepreneurs was 1.9. That is, registration was not a major problem, although for the small entrepreneurs these requirements appear to have been more burdensome than for the microentrepreneurs.

These results must be interpreted with caution. Most microentrepreneurs are individual (physical) businesses, for which registration requirements are less demanding. Second, even though registration is burdensome, other problems are even more formidable. Most importantly, the analysis reports *ex post* outcomes. This is a common weakness in this type of analysis. When a constraint is sufficiently significant *ex ante*, the activity is not undertaken and, therefore, the consequences of the limitation cannot be observed. That is, only those things that are not too difficult are actually done; those that are too difficult are never done. These activities that are never attempted represent the most important opportunity cost of an excessive regulatory burden.

In effect, 26 percent of the Finca/Samara clients, 10 percent of the entrepreneurs in the control group, and 16 percent of the small entrepreneurs indicated that they had wanted to start new activities and could not do so because of regulatory constraints. These figures missed the most important opportunity cost, however, related to those who never have gone into business for similar reasons.

Current Problems

To explore the importance of problems currently faced by these entrepreneurs in greater detail, we constructed an index of perceived severity of the problems. The index ranges between 1 (less severe) and 4 (more severe). In general, even today, financial limitations continue to be the most important category of problems faced by these entrepreneurs. Funding problems are not as dominant, however, as they were at the time of creation of the enterprise. The index of severity was 2.5 for microentrepreneurs and 1.9 for small entrepreneurs (Table 9). That is, funding was no longer a major problem for small enterprises, which seem to face a less severe credit constraint than microenterprises do.

The view that funding is a major problem must also be interpreted with caution. Many entrepreneurs may believe that lack of funds is their problem when it is simply a symptom of the true underlying problems. If market demand for their product is limited, if their prices do not cover their

costs, if their inventory is inadequate, they will experience liquidity shortages and may believe that they can correct for these problems with loans. But additional funds cannot correct for these deficiencies; instead, the entrepreneur will lack repayment capacity and will not be creditworthy.

Limitations of both output and input markets had been an important problem for small enterprises at the time of their creation (for 37 percent of these entrepreneurs, these limitations had been the most important problem, according to Table 8). These limitations, particularly in output markets, continue to be a problem for these entrepreneurs. All types of entrepreneurs evaluated the severity of these problems with an index above 2 (i.e., 2.3 for the Finca/Samara clients, 2.5 for the control group, and 2.4 for the small entrepreneurs, as shown in Table 9). Some of the limitations encountered in these markets may reflect, in turn, the aggregate impact of the repressive regulatory environment and the difficult macroeconomic conditions experienced by Russia.

On the aggregate, regulation-induced problems were ranked as second or third most important by microentrepreneurs. Observing item by item, however, the burden of taxes received the highest index of severity of problems among all the categories examined. In effect, this was the only item that was evaluated with an index above 3, as shown in Table 9. Nadolnyak and Hartarska (1999) discuss the types of taxes, their rates, and problems with tax administration. Even though entrepreneurs may complain about taxes because they are not used to paying them, it is clear that the absence of a well-designed and transparent tax system is a major obstacle to small entrepreneurship in Russia.

Expansion Plans and Constraints on Growth

The respondents were asked if they had plans to expand (to be discussed below) and if not, why not. As shown in Table 10, their perceptions are that financial constraints are the most important limitation on their plans for expansion. This was the most important reason among 78 percent of the clients of Finca/Samara with no plans to expand (that is, among 19 percent of the total of these clients), among 47 percent of those in the control group with no plans to expand (30 percent of the total in this group), and among 65 percent of small entrepreneurs with no plans to expand (15 percent of the total). This observation may also reflect the credit constraints faced at the beginning of an enterprise.

The second most important reason for not having plans to expand were limitations of the markets where they operate. One-quarter of the small entrepreneurs believe that there is insufficient market demand for their products. Although the microentrepreneurs did not perceive this to be as frequently a problem (compared to lack of funding), many indicated that they did not have a need for additional investment. That is, given a limited market demand for their products or services, there is no room for further expansion.

An interesting observation is the fact that, although they are very similar in most respects, 76 percent of the Finca/Samara clients had plans to expand, but only 37 percent of the microentrepreneurs in the control group had such plans. This corroborates the main observation of

the comparison between these two groups: the Finca/Samara clients are ahead of their peers in the game of business expansion and funding. The mystery of why this is the case remains, however, unsolved.

There are two possible explanations of this difference:

- (a) are the Finca/Samara clients inherently more optimistic and do their plans to expand reflect the fact that they are more dynamic and entrepreneurial than their peers? If this is so, the Finca/Samara promoters have been very good at identifying winners, or
- (b) the two groups are inherently equally entrepreneurial, but the Finca/Samara clients have current plans to expand that their peers do not have because access to the Finca/Samara loan has lifted the credit constraint that was keeping them stagnant? If this is so, the Finca/Samara relationship has made them winners.

Additional research is needed to find out if the Finca/Samara clients are better than their peers to begin with and, therefore, they have become clients either through self-selection or good screening, or if they are not different from their peers, but the Finca/Samara loan has given them a competitive advantage over the others. It will be intriguing to find out.

ANNEX

Table 1. Profile of the microentrepreneur^{L=} Business and Household, for FINCA Clients and Control Group

Characteristics	FINCA	Control
<i>Legal form (%)</i>		
Individuals	90	91
Partnerships	10	4
Companies	0	5
<i>Age of business (%)</i>		
92-94	22	20
95-97	59	54
98-99	20	25
<i>Gender (%)</i>		
Male	17	28
Female	83	72
<i>Share of household income (%)</i>		
Average	67	71
Median	70	80
<i>Premises (%)</i>		
Fixed	20	20
Non-fixed	81	80
At-home	0	0
<i>Number of workers</i>		
Average	1.4	1.4
Median	1.0	0.0
<i>Employment (%)</i>		
Works alone	38	55
From 1 to 4	60	37
From 5-9	2	7
10 and more	0	2
<i>Have other business (%)</i>	2	0
<i>Other employment (%)</i>	10	7
<i>Household size</i>		
Average	3.6	3.2
Median	4.0	3.0
<i>Age of the Entrepreneur</i>		
Average	42	37
Median	41	39
<i>Education (%)</i>		
Incomplete	2.6	0.0
General high school	20.5	18.6
Specialized high school	51.3	35.6
Technical University	20.5	25.4
Social Sciences, or Humanities	5.1	20.3

Source: OSU survey

Table 2. Profile of the Business and the Household, for Microentrepreneurs and Small Businesses

Characteristics	FINCA & Control	Small Business
<i>Legal Form (%)</i>		
Individuals	90	45
Partnerships	7	16
Companies	2	39
<i>Age of business (%)</i>		
92-94	20	39
95-97	57	33
98-99	23	29
<i>Gender (%)</i>		
male	23	71
female	77	29
<i>Share of household income (%)</i>		
Average	70	90
Median	75	100
<i>Premises (%)</i>		
Fixed	20	12
Non-fixed	80	80
At home	0	8
<i>Number of workers</i>		
Average	1.4	8.6
Median	1	5
<i>Employment in enterprise (%)</i>		
works alone	48	22
from 1 to 4	45	18
from 5-9	5	25
10 and more	2	35
<i>Have other business (%)</i>	2	8
<i>Other employment (%)</i>	16	8
<i>Household size</i>		
Average	3.3	3.0
Median	3	3
<i>Age of the Entrepreneur</i>		
Average	38	39
Median	40	38
<i>Education (%)</i>		
Incomplete	1.0	0.0
General high school	19.4	4.2
Specialized high school	41.8	27.1
Technical University	23.5	43.8
Social Sciences or Humanities	14.3	25.0

Source: OSU survey

Table 3. Experience with Credit, by All Sources, for FINCA Clients and Control Group

Source	FINCA		Control	
	No.	%	No.	%
Banks	1	2.4	2	3.2
Government program	1	2.4	1	1.6
NGO & coops *	41	100.0	1	1.6
Leasing	1	2.4	0	0.0
Private firm	2	4.9	1	1.6
Merchant credit	14	34.1	14	22.6
Advances from buyers	7	17.1	4	6.5
Moneylender	14	34.1	5	8.1
Friends/family	29	70.7	32	51.6
Total		268.3		96.8

Source: OSU survey

* Includes FINCA loan

Table 4. Experience with Credit, by Most Formal Source Used, for FINCA Clients and Control Group

Sources	FINCA		Control	
	No	%	No	%
(a) Banks	1	2.4	2	3.2
(b) Government, NGO or coops *	1	2.4	1	1.6
(c) Private firm	2	4.9	1	1.6
<i>Institutional (a)+(b)+(c)</i>	4	9.8	4	6.5
Trade credit	16	39.0	15	24.2
<i>Institutional plus trade</i>	20	48.8	19	30.6
Moneylender	8	19.5	2	3.2
<i>Market sources</i>	28	68.3	21	33.9
Friends/family	10	24.4	18	29.0
None	3	7.3	23	37.1
Total	41	100.0	62	100.0

Source: OSU survey

* Excludes FINCA loan

Table 5. Experience with Credit, by All Sources, for Microenterprises and Small Businesses

Source	FINCA & Control		Small Business	
	No	%	No	%
Banks	3	2.9	14	28.6
Government program	2	1.9	4	8.2
NGO & coops *	1	1.0	3	6.1
Leasing	1	1.0	1	2.0
Private firm	3	2.9	4	8.2
Merchant credit	28	27.2	17	34.7
Advances from buyers	11	10.7	19	38.8
Moneylender	19	18.4	8	16.3
Friends/family	61	59.2	22	44.9
Total		125.2		187.8

Source: OSU survey

* Excludes FINCA Loan

Table 6. Experience with Credit, by Most Formal Source Used, for Microentrepreneurs and Small Businesses

Sources	FINCA & Control		Small Business	
	No	%	No	%
(a) Banks	3	2.9	14	28.6
(b) Govt, NGO or coops *	2	1.9	2	4.1
(c) Private Firm	3	2.9	2	4.1
Institutional (a)+(b)+(c)	8	7.8	18	36.7
Trade credit	31	30.1	15	30.6
Institutional plus trade	39	37.9	33	67.3
Moneylender	10	9.7	2	4.1
<i>Market sources</i>	49	47.6	35	71.4
Friends/family	28	27.2	5	10.2
None	26	25.2	9	18.4
Total	103	100	49	100.0

Source: OSU survey

* Excludes FINCA loan

Table 7. Main Reason for not Applying for a Bank Loan

Reasons	FINCA %	Control %	Small Business %
I do not need a loan, I have enough money	2.4	16.1	32.9
I do not like to be in debt	2.4	6.4	13.2
<i>Economic environment</i>	4.9	22.6	46.0
I do not want scrutiny	4.9	1.6	3.3
Creates complications with tax authorities	0.0	1.6	3.3
<i>Regulatory environment</i>	4.9	3.2	6.6
I will not be able to fulfill requirements	21.9	9.7	19.7
The interest rate is too high	19.5	11.3	23.0
The procedure is too complicated	7.3	14.5	29.6
<i>Innovations</i>	48.8	35.5	72.4
Total	58.5	61.3	125.1

Source: OSU survey

Table 8. Main Problem at Time of Creation

Problems	FINCA %	Control %	Small Business %
Regulation Induced	24.3	12.3	15.8
Registration	5.4	0	5.3
Taxes	16.2	7.0	5.3
Licensing	0	1.8	2.6
Protection services	0	1.8	0
Payments to Government	0	0	2.6
Zoning	2.7	1.8	0
Financing constraints	73.0	82.4	47.4
Initial investment	56.8	71.9	42.1
Working Capital	16.2	10.5	5.3
<i>Markets</i>	0	5.3	36.8
Output markets	0	5.3	23.7
Input markets	0	0	13.2

Source: OSU survey

Table 9. Index of Severity of Problems Now

Problem	FINCA	Control	Small Business
<i>Regulation induced</i>	2.00	1.85	1.88
Unprofessional behavior	2.07	2.02	2.36
Taxes	3.29	2.68	3.10
Zoning	1.85	2.05	1.74
Protection services	1.37	1.49	1.25
Dispute resolution	1.82	1.47	1.44
Labor regulations	1.57	1.47	1.41
<i>Financing constraints</i>	2.46	2.49	1.94
Access to working capital	2.46	2.49	1.94
Markets	1.92	2.47	2.04
Input markets	1.51	2.46	1.67
Output markets	2.32	2.47	2.40

Note: The index goes from 1 (not severe) to 4 (very severe).

Source: OSU survey

Table 10. Constraints to Growth

Reason	FINCA	Control	Small Business
	%	%	%
<i>Regulation induced</i>	0	0	10
Might attract tax authorities	0	0	0
Other regulatory burdens	0	0	0
Labor regulations	0	0	10
<i>Financing Constraints</i>	78	47	65
Insufficient capital	78	47	65
<i>Markets</i>	22	53	25
Insufficient marked demand	11	18	25
No need for new investment	11	35	0
Number of observations *	9	34	20

Source: OSU survey

* For those with no plans to grow