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**Small Enterprise  
Development in  
the Russian Far  
East**

*GEMINI Technical Report No. 49A*

**GEMINI**

**GROWTH and EQUITY through MICROENTERPRISE INVESTMENTS and INSTITUTIONS  
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# Small Enterprise Development in the Russian Far East

by

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## TABLE OF CONTENTS

	<u>Page</u>
<b>INTRODUCTION</b>	v
<b>EXECUTIVE SUMMARY</b>	vii
<b>SECTION ONE PROFILE OF VLADIVOSTOK</b>	1
<b>SECTION TWO SMALL BUSINESS IN VLADIVOSTOK: GROWTH AND PROBLEMS</b>	5
<b>SECTION THREE TARGET GROUPS</b>	9
<b>SECTION FOUR BANKING AND CREDIT</b>	13
Vladivostok Commercial Bank	14
Small Business Credit Program	17
<b>SECTION FIVE SMALL ENTERPRISE DEVELOPMENT TRAINING AND TECHNICAL ASSISTANCE</b>	19
Developing Local Training Capacity	20
Specialized Training for Financial Institutions	21
Establishing a Business Advisory Services Office	22
Outreach	22
Training and Technical Assistance in Nakhodka	23

<b>SECTION SIX GENDER ISSUES</b>	<b>25</b>
<b>SECTION SEVEN PRIVATIZATION</b>	<b>29</b>
<b>The Primorski Regional Fund Technical Assistance</b>	<b>30 31</b>
<b>SECTION EIGHT LEGAL AND REGULATORY ENVIRONMENT</b>	<b>31</b>
<b>SECTION NINE AGRIBUSINESS</b>	<b>35</b>
<b>ANNEX A: SMALL BUSINESS CREDIT PROGRAM ISSUES AND RECOMMENDATIONS</b>	<b>A-1</b>
<b>ANNEX B: INSTITUTIONAL PROFILES</b>	<b>B-1</b>
<b>ANNEX C: GENDER ISSUES AND SMALL ENTERPRISES DEVELOPMENT</b>	<b>C-1</b>
<b>ANNEX D: PRIVATIZATION</b>	<b>D-1</b>
<b>ANNEX E: LEGAL, REGULATORY AND TAX ENVIRONMENT IN RUSSIA</b>	<b>E-1</b>
<b>ANNEX F: CONTACTS</b>	<b>F-1</b>

**LIST OF TABLES AND FIGURES**

<u>Table</u>		<u>Page</u>
1	ENTERPRISES IN VLADIVOSTOK BY OWNERSHIP TYPE	6
D-1	DISTRIBUTION OF STATE FIRMS IN PRIMORSKI KRAY SCHEDULED FOR PRIVATIZATION IN 1992	D-8
E-1	RELEVANT TAX SCHEDULE APPLICABLE TO ENTERPRISES IN RUSSIA	E-5
 <u>Figure</u>		
1	TARGET GROUP FOR THE GEMINI PROJECT IN VLADIVOSTOK	11

## INTRODUCTION

The U.S. Agency for International Development's NIS Task Force has contracted the GEMINI project of the Bureau for Private Enterprise to advise on the design and implementation of small enterprise development projects in six of the former Soviet republics. Under this contract, Development Alternatives, Inc. (DAI), fielded a team of small business experts to Russia's Far East from August 24 to September 8, 1992. The team comprised Martha Blaxall, Yasuo Konishi, Virginia Lambert, Jennifer Santer, and Timothy Smith. The team concentrated its activities in Vladivostok, but some members visited the nearby port city of Nakhodka. Overall, the purposes of this mission were to:

- Assess the status of small enterprise development in the Vladivostok region;
- Identify constraints to establishing and expanding small businesses;
- Recommend short- and long-term activities for A.I.D.'s assistance to the emerging small business sector; and
- Identify possible counterparts for future A.I.D.-sponsored activities.

The team members' areas of specialization included business development, finance and credit, policy and legal reform, institutional development, and agribusiness. In addition, a specialist on Women in Development (WID) examined the impact of the region's economic changes on women as well as the need and mechanisms for incorporating a WID focus in future A.I.D. efforts.

Foreign investment activity in the Russian Far East is dominated by Japan, China, and Korea. Some U.S. investors have visited the region but, to date, little has resulted, and it is likely that the U.S. role in the area's commercial development will continue to be overshadowed by its Asian neighbors. At the same time, there has been little bilateral technical assistance — thereby providing an opportunity for A.I.D. to make a valuable contribution to the region's development. It should be emphasized, however, that Vladivostok is far removed from Moscow, and the immediate goals of a technical assistance program need to be defined by community and regional needs, and not in pursuit of national objectives per se. Over time, activities initiated in Vladivostok will help define the nature of small business efforts elsewhere in Russia, and these activities could have a national impact by serving as local or regional models.

Designing a technical assistance program for the Far East is a difficult task. In terms of small business development, many problems are obvious: lack of entrepreneurial skills and training opportunities, cash and credit shortages, inadequate legal structure and enforcement, poor distribution and supply networks, and an overriding emphasis on privatization that has been slow and at times dubious. Although the problems can be identified, the challenge lies in designing a response in an environment where laws change almost daily, reliable data are largely unavailable, the economy continues to deteriorate sharply, the majority of business transactions seemingly occur through networking and bartering, and people are anxious about the future and lack confidence in the sustainability of economic

and political reforms. These conditions create uncertainties for investors and development specialists alike.

This report highlights the team's key findings and recommendations. The annexes should be referred to for more detailed discussions of select topics. A list of contacts appears as Annex F.

Timothy J. Smith  
Team Leader

## EXECUTIVE SUMMARY

The GEMINI team recommends an integrated and comprehensive program for addressing the complex problems facing Russia's emerging entrepreneurs. Although the program will be implemented initially in Vladivostok, the basic elements could be replicated elsewhere in the country. In general, the program addresses skills development through training, problem solving through hands-on technical assistance, limited access to financing through a credit program, and problems at both the macroeconomic and the subsector levels through targeted technical assistance. These activities have short- and long-term components, and have been designed to encourage and foster sustainability by Russian counterparts. The report's principal findings and recommendations are summarized below.

**Target Group.** At various levels of government, substantial resources have been targeted to assist enterprises in the transition from state to private ownership. In this process, inadequate assistance has been provided to workers displaced as a result of privatization and to entrepreneurs in start-up companies. The team recommends that A.I.D.'s small enterprise development program target these groups for assistance. (See Section Three.)

**Small Business Credit Program.** Credit is in short supply, and the credit that is available is directed largely to state-owned enterprises on preferential terms. Typically, small businesses loans must be repaid within a few weeks, making them an inappropriate source of financing for equipment purchases and other capital investments; and small businesses have no access to hard currency loans needed to purchase imported equipment and goods. The team recommends that A.I.D. support the expansion of small business lending by Vladivostok Commercial Bank (VladCom Bank), a semi-private financial institution targeting its services to the private small business sector. An infusion of A.I.D. funds will enable VladCom Bank to expand its local currency lending, offer hard currency loans for offshore purchases of equipment and new technology, and address the credit needs of starting up and expanding small private enterprises. In addition, at least at the local level, the program will introduce market-based concepts to the banking sector, change current lending practices and terms to correspond more closely to small business needs, and improve bank efficiency and operations. The design and implementation of the credit program will require one long-term advisor and some short-term consultants. (See Section Four and Annex A.)

**Training and Technical Assistance.** The credit program will be supported by a combination of training and technical assistance. An introductory small business training program will be offered in December 1992, and will be followed by a longer-term effort to provide training on a regular basis. Three elements or stages of business training will be developed: an introductory program on the fundamentals of starting and operating a business; regular seminars focused on specific problems (for example, marketing, display and advertising, cash management, legal concerns, and employee-customer relations); and subsector-specific topics. The training will be offered to all interested small business owners or would-be entrepreneurs, and not only to borrowers under the Small Business Credit Program. In addition, bank training will be offered to VladCom Bank and other local banks in such areas as risk and market analysis, asset valuation, business plan assessment, portfolio management, client services, deposit mobilization, and funds management. The training program will be developed through a

counterpart institution still to be identified, with assistance from one long-term advisor and some short-term consultants. (See Section V and Annex B.)

**Business Advisory Services Office.** A Business Advisory Services Office (BASO) will be established to provide hands-on technical assistance to current and potential entrepreneurs. Initially, BASO will be located on VladCom Bank's premises, but it will be an independent entity providing services to VladCom Bank's borrowers and other small businesses. BASO will begin to provide services through the GEMINI contract mechanism, but eventually it will be established as a foundation or nonprofit organization, depending on applicable Russian law at the time of its registration. BASO's basic services will include business consulting, legal advice, and referral and information services. Initial funding for BASO will require a start-up grant from A.I.D., which will be supplemented by a portion of the interest paid on A.I.D.'s loan to VladCom Bank. To become self-sustaining, BASO will rely increasingly on fees for services. BASO's technical assistance program and business plan will be developed by one long-term advisor, locally hired staff, and short-term consultants. (See Section Five.)

**Gender Issues.** The economic changes occurring in Russia are not gender-neutral. A disproportionate number of women are losing their jobs; and social services that enable women to join the work force, such as day care, are being cut back as a result of budget deficits and privatization. Professions once dominated by women, such as banking, are attaining new status, and, in turn, men are being recruited for these jobs. Measuring the impact of the country's reforms on women is made difficult by a lack of gender-disaggregated information for small enterprises, but in Vladivostok it appears that traditional gender roles are re-emerging, as evidenced by the planned retraining of women in traditionally female and low-paying occupations (for example, seamstress or beautician). Anecdotal evidence also suggests that women are concentrating in trade and service enterprises and not in professional, managerial, or industrial occupations. These distinctions and trends need to be incorporated into A.I.D.'s small business program by offering training geared to women as potential entrepreneurs and managers; outreach to women to ensure their participation in training, technical assistance, and credit activities; and periodic monitoring to better understand the impact of Russia's socioeconomic reforms on women. (See Section Six and Annex C.)

**Privatization.** Privatization is fundamental to the government's economic reforms, but it requires the private sector to have sufficient resources to purchase state assets. The voucher scheme to be introduced in October 1992 will account for some of this required investment, but in the Vladivostok region, government officials and local bankers concur that savings are insufficient to complete the privatization process. In response, the Primorski Regional Fund is being established with investment capital from both state and private sources. However, the Fund is still in its early organizational stages, and decisions have not yet been made in fundamental areas such as structure and management, the use of funds, and operating procedures. Regional officials have requested immediate short-term technical assistance from A.I.D. on these matters. The team recommends that A.I.D. use an appropriate mechanism to respond to this request that it falls outside of the general scope of the GEMINI project. (See Section Seven and Annex D.)

**Legal and Regulatory Issues.** Substantive business laws and regulations are introduced at the national level, not at the regional or local level. For this reason, in Vladivostok, technical assistance in business law must focus on the needs of local enterprises. Recent legal changes have eliminated any special treatment or incentives for small enterprises, laws are changing constantly and important

regulations are often unpublished, and new enterprises have little access to or knowledge of their rights and obligations. The team recommends that a legal component be incorporated into BASO's activities, including training for local attorneys and advisory services for small enterprise development clients. (See Section Eight and Annex E.)

**Agribusiness.** Agribusiness is a major employer in the region, and many small food-processing facilities and related businesses need technical assistance. More generally, detailed studies are required in specific subsectors to assess their technical requirements, comparative advantages, and market potential for small businesses. Russia's agricultural and agribusiness sectors offer limitless opportunities for providing technical assistance, but based on the priorities identified by local officials and agribusiness specialists, two subsector studies are recommended: a dairy sector assessment and a feasibility study for producing baby foods and formula. (See Section Nine.)

## SECTION ONE

### PROFILE OF VLADIVOSTOK

Vladivostok is a major seaport on Russia's east coast; it is the capital of Primorski Kray.<sup>1</sup> With 650,000 residents, Vladivostok is a bustling city, dramatically situated on coastal hills, that retains some architectural charm — making comparisons to San Francisco inevitable. According to the 1989 census, more than 90 nationalities reside in Vladivostok, but the city remains relatively homogeneous; 88.7 percent of the population is Russian.<sup>2</sup> In the past thirty years, Vladivostok has more than doubled in size, but the break-up of the former Soviet Union has slowed migration to the city, which, in turn, has slowed the city's population growth.<sup>3</sup>

Until earlier this year, Vladivostok had been a closed city because of its importance in the former Soviet Union's military-industrial complex.<sup>4</sup> Economically, Vladivostok is still dominated by large state-owned enterprises (SOEs), including port industries and fisheries, and is suffering from a sharp economic contraction that mirrors national conditions. A small business sector is emerging but, in general, the city sorely lacks basic consumer services and light manufacturing firms; development in both areas is needed to create new employment opportunities.

Throughout the Russian Federation, political and economic reforms have ushered in a period of hyperinflation and sharp economic contraction. Consumer prices rose a mere 6 percent in 1990, jumped 100 percent in 1991, and — following price decontrols at the beginning of 1992 — rose an estimated 400

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<sup>1</sup> Within Russia's boundaries exist a variety of principal administrative units that are united to form the Russian Federation. These administrative regions include *oblast(s)*, generally translated as "state"; *kray(s)*, generally translated as "territory"; autonomous republics; and even autonomous *oblasts*. Many of these areas, particularly in central and eastern Russia, are vast regions themselves. There are 85 such administrative regions, and for the most part they share about equal authority. The autonomous regions are generally home to separate ethnic groups and feel themselves less tied to the government in Moscow. Reportedly, they do enjoy somewhat more independence, but the distinctions are unclear.

<sup>2</sup> The next largest population groups are Ukrainians at 6.6 percent and Koreans at 2.5 percent. All other nationalities represent less than 1 percent of the population.

<sup>3</sup> In 1990, Vladivostok's population increase attributable to migration was 2,800, but in-migration fell to 200 persons in 1991. Source: Statistics Bureau for Primorski Kray.

<sup>4</sup> Vladivostok had been closed since the mid-1950s. At the beginning of 1992, local politicians declared the city open, but local military officials wanted to maintain its closed status. For several months, the situation remain unresolved, but Vladivostok was eventually opened to foreigners.

percent for the first quarter of 1992 alone.<sup>5</sup> The inflation rate fell during the second quarter, but rose again in August to an estimated monthly rate of 17 percent. President Yeltsin's decision in late summer to raise oil prices again before year's end will add to inflationary pressures, and some analysts predict that the year's overall inflation may reach a staggering 1,000 percent to 1,200 percent.<sup>6</sup> The rise in industrial prices is roughly equivalent to consumer price inflation, while only a fourfold increase in farm prices is projected.<sup>7</sup>

Russia's economy gradually slowed during the 1980s, and by 1990 it was pushed into recession when the NMP fell by 5 percent.<sup>8</sup> The economy contracted even more sharply the following year, when the NMP fell by 11 percent. During the first six months of 1992, industrial production fell at an annual rate of 13 percent to 15 percent, and the recession deepened in July and August when production fell 21 percent and 27 percent, respectively, compared with 1991.

These national conditions are reflected in Vladivostok. Local officials estimate that, for the first seven months of 1992, compared with the same period for 1991, overall production dropped 18 percent, the food industry experienced a 23 percent decline, and the production of consumer goods fell 9 percent. Milk production alone was down 63 percent.<sup>9</sup> In 1992, Moscow cut military procurements by 85 percent,<sup>10</sup> which has had a major impact on Vladivostok; the lack of raw materials caused by the breakdown of inter-republic trade has further dampened industrial output. Unemployment is on the rise, and officials predict that there will be nearly 20,000 unemployed workers in Vladivostok by the end of 1992.

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<sup>5</sup> 1990 and 1991 figures from Whitlock, Erik, "Mid-Year Update on Russian Economic Indicators," draft Research Paper from Radio Free Europe/Radio Liberty, August 11, 1992, p. 4. 1992 figures from *Business International*, "Prospects for Profits: Russia through 1994," April 27, 1992.

<sup>6</sup> Ibid.

<sup>7</sup> Op.cit., Whitlock.

<sup>8</sup> The NMP, or Net Material Product, is roughly equivalent to the Gross National Product, a measurement of economic performance widely used in the West.

<sup>9</sup> In the past, milk production was monopolized by one large *kombinant*, or state-owned enterprise, located in Vladivostok but, with the collapse of the state's supply and distribution systems, farmers are finding alternative outlets and processors.

<sup>10</sup> Op.cit, Business International.

The faltering economy has resulted in a nearly 15 percent budget deficit for the city. In 1992, the city's proposed budget totals R 5.112 billion (approximately US\$ 25.6 million),<sup>11</sup> but it has a R 750 million deficit. As a result, the city's budget has not been approved by kray-level officials, and both kray and municipal officials are endeavoring to reach a budget compromise. Some R 1.3 billion of the city's budget is channeled to various subsidies, including R 400 million for housing. Privatization is expected to provide some budget relief, but not a significant amount. To date, the city has received approximately R 80 million in privatization proceeds, but these funds were disbursed to various housing projects. If all municipally owned enterprises are sold, city officials estimate that budget savings would amount to only R 500 million. The budget deficit has forced a curtailment in local investment and services. The city lacks funds for new capital investment (for example, roads and schools), maintenance of existing infrastructure, and provision of social services such as day care and kindergarten.

In 1990, Vladivostok's leaders foresaw these problems and proposed establishing a municipal bank that would mobilize resources for investment in the city's infrastructure. Just days prior to the bank's registration, however, new national banking regulations prohibited municipal ownership of banks. The proposed bank was reorganized as a joint stock company; stocks were sold to 32 investors representing private and smaller state enterprises; and on January 11, 1990, the Vladivostok Commercial Bank (VladCom Bank) was registered. With the passage of more time, municipal officials have recognized the important role of small and medium enterprises (SMEs) in local economic development, and, with the city's encouragement, VladCom Bank has become the city's principal small business lender.

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<sup>11</sup> Throughout this report, the exchange rate used is US\$ 1 = R 200. U.S. dollar figures are used only to convey some sense of value, but they should not be taken too literally. The ruble is still in a free fall against hard currencies, and during the short time that the GEMINI team was in the field, the ruble fell by 25 percent.

## SECTION TWO

### SMALL BUSINESS IN VLADIVOSTOK: GROWTH AND PROBLEMS

Accurately measuring the growth of Vladivostok's private sector is difficult. Most data are incomplete, are based on inconsistent definitions, and are soon outdated by the rapidity of change in Russia. Information that is available, however, suggests the sector will expand quickly. Vladivostok officials reported that, during the first six months of 1992, more than 2,000 new businesses were registered, and the majority of enterprises privatized this year were small retail and service establishments owned by the municipality. This growth exceeds the city's own projections for new private businesses in 1992, as shown in Table 1. Between 1991 and 1993, the city predicts a sixfold increase in private businesses, a fourfold increase in partnerships, and a tripling of the number of joint stock companies.

Civic leaders are eager to support and encourage this growth, and they are actively seeking foreign assistance and know-how. South Korea's Hyundai Corporation has proposed building what would become the city's largest commercial center; in cooperation with Japan's Mitsubishi Research Institute and UNIDO, local officials are pursuing the Great Vladivostok Project that would result in creating a free economic zone; and the Japanese government is working with regional authorities to establish an International Training Center for Small and Medium Enterprises.<sup>12</sup> Taking more direct aim at assisting small businesses, the city has opened business registration offices in each of its five districts and has streamlined the licensing procedures.

To date, most new businesses operate in the areas of trade and services (for example, hairdressers and restaurants), but officials want to encourage the growth of small producers and exporters. However, investment in manufacturing will require a more stable investment climate and types of financing currently unavailable. Changing economic conditions, laws, and policies have created a chaotic business environment. Moreover, holdovers from the recent past result in a general bias against small businesses; these holdovers include a tax system that favors producers at the expense of traders and distributors and a credit system that offers preferential terms to state-owned enterprises. In some respects, small businesses experience many of the same impediments to growth and development as larger enterprises, but they have fewer channels or contacts through which they can secure credit, supplies, or services. Major problems facing Vladivostok's entrepreneurs include:

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<sup>12</sup> All these initiatives have experienced delays, and recent events may stall further progress on the International Training Center. Originally, the Japan Small and Medium Business Association had expected to begin a short-term technical assistance program in early 1993 through the International Training Center. However, President Yeltsin's last-minute decision in September 1992 to cancel his trip to Japan is likely to have a major impact on the start-up date of Japan's aid program. This has created a window of opportunity for another donor to take a leadership position in establishing a technical assistance program for small enterprise development in the Russian Far East.

TABLE 1  
ENTERPRISES IN VLADIVOSTOK  
BY OWNERSHIP TYPE

	1991 (Actual)	1992 (Projected)	1993 (Projected)
Government	667	384	116
Municipal	14	189	86
Private	544	1,570	3,260
Partnerships	1,396	3,519	5,430
Joint Stock	117	199	395
Affiliates/representative offices	37	88	100
Associations	471	200	128
Employee-owned	133	117	96
Consumer cooperatives	12	20	20
Other cooperatives	906	825	785
Other public sector	349	346	340
Joint ventures	81	119	150
Banks	18	28	35
<b>Total</b>	<b>4,745</b>	<b>7,604</b>	<b>10,941</b>

Source: City of Vladivostok

**Lack of credit.** Credit is in short supply, only in part because of tight national monetary policies. Banks are not trained to assess credit risk; thus, they are reluctant to lend to new types of businesses. The credit that is available is directed largely to SOEs on preferential terms. Credit and access to foreign exchange are virtually unavailable to small enterprises for importing new technologies and equipment needed to start, expand, or modernize production. Most loans are extended only for a few weeks, making them an inappropriate source of financing for equipment purchases and other capital investments. Interest rates are high (sometimes exceeding 100 percent) for SMEs, but state enterprises can obtain credit at around 25 percent interest. The lack of securities or other financial markets prevents entrepreneurs from mobilizing private capital.<sup>13</sup>

**Uncertainty regarding laws and regulations.** Laws governing business relations and ownership of assets are changing so quickly that it is difficult for entrepreneurs to know the status of applicable laws or enter into contractual arrangements with investors or foreign joint venture partners. Benefits and incentives introduced in legislation to encourage small business development have been weakened or eliminated.

**Lack of business skills.** Lack of experience in market-oriented business methods is hindering managers from taking the steps necessary to reduce costs, improve profitability, and respond to changing market conditions.<sup>14</sup> Financial statements are not available in formats that permit identification of real costs and revenues.

**Lack of representative organizations.** There are few business associations; most are weak; and in Vladivostok, none was identified that could effectively represent the common interests of their members through advocacy, training, or other assistance and services.

**Tax laws.** Tax laws are contradictory and unpredictable, are arbitrarily enforced, and are frequently antagonistic to business development. A 1992 law designed to increase central foreign exchange reserves places a 26 percent tax on exports and requires 50 percent of hard currency profits to be paid to the Russian Federation. A provision in this law to reimburse businesses in rubles up to 50 percent of the value of the hard currency paid in taxes has not been honored. This tax provision has rendered many exporting firms uncompetitive and has hindered the formation of joint ventures that are export-oriented. A substantially higher tax rate on wholesalers than on producers penalizes activities that are important for building supply and distribution networks.

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<sup>13</sup> There are some brokers selling stock in joint stock companies, but information on them is scant and corruption is reportedly widespread.

<sup>14</sup> As an example, Russian businesses typically have provided social services for their employees, including day care, vacation houses, kindergartens, and health care, and managers find themselves under pressure not to reduce employment or curtail these services.

**Lack of information.** Information on changing laws, market conditions, and prices is difficult to obtain or is unavailable. Entrepreneurs have no source of information on alternative technologies or equipment, and a lack of information about world markets for potentially competitive goods produced in Russia makes it difficult for smaller firms to develop export markets.

## SECTION THREE

### TARGET GROUPS

At the federal, regional, and municipal levels of government, substantial resources have already been targeted to assist enterprises, both small and large, in the transition from state-owned to private enterprises.<sup>15</sup> At the same time, the privatization process has not adequately addressed the needs of workers displaced in the privatization process or of owners and managers of new start-up companies. These potential or current entrepreneurs are critical to the grassroots development of a market economy in the Russian Far East, and they could benefit directly and immediately from an A.I.D.-sponsored small business program. Specific issues are discussed below:

- **Displaced workers.** Job displacement resulting from the privatization process is likely to produce two distinct sets of displaced workers:
  - **Non-Transferable Labor Force.** According to preliminary interviews, older career workers whose working habits and principles evolved under the former command economy have displayed minimal interest in and capacity for adjusting to new market demands. Consequently, this portion of the displaced work force is likely to become passive contributors to economic activity, often drawing on pensions and part-time work as a source of income.

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<sup>15</sup> For example, the International Business Center for Small and Medium Enterprises, sponsored jointly by the Anti-Monopoly Committee (a regional office of a federal agency), other regional governments in the Russian Far East, and the Small and Medium Enterprise Association (SMEA) of Japan, expects to provide training for SMEs created through privatization. According to preliminary plans, in 1993 the Center's training program will begin offering courses to approximately 200 managers and technicians of newly privatized enterprises. During the first year, tentative plans call for the SMEA to deliver approximately 50 technical experts on short-term assignment to Vladivostok to work with the Center through counseling and training programs, as well as to work directly with newly established enterprises.

- **Transferable/Mobile Labor Force.** Two subsets of workers are likely to evolve from this category:<sup>16</sup>
  - Workers wanting to learn new skills and receive training to enable them to start their own businesses.
  - Workers with "fixed" skills seeking a job, some of whom could use their skills in a new business.
- **Entrepreneurs with new start-up businesses.** According to preliminary data on new business registration, a large number of new businesses are cropping up each month to take advantage of market opportunities created by the liberalized economic environment.<sup>17</sup> These new businesses are started by individuals leaving their current jobs and those persons newly joining the labor force.<sup>18</sup>

It is recommended that A.I.D.'s small business program in the Russian Far East target the two groups in the transferable/mobile labor force and entrepreneurs with new start-up businesses.<sup>19</sup> As Figure 1 below indicates, potential services to be offered in Vladivostok will not exclude entrepreneurs entering the market through other channels, but programming that would yield tangible results in the short term is likely to result from working with the entrepreneurs found in the two categories above.

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<sup>16</sup> It is important to note that although both groups of workers may be interested in entrepreneurial activity, the types of training, skills development, and market support required for these two groups may differ. For example, those with fixed skills may already possess an audience for their services from their previous jobs. Consequently, training in basic management and accounting skills may be the minimum level of assistance necessary for this group of entrepreneurs to begin operation. On the other hand, it is highly likely that the newly trained will experience a demand for their services. As result, training in marketing, client maintenance, referrals to supplier groups, and other counseling services may be required before new ventures are launched successfully.

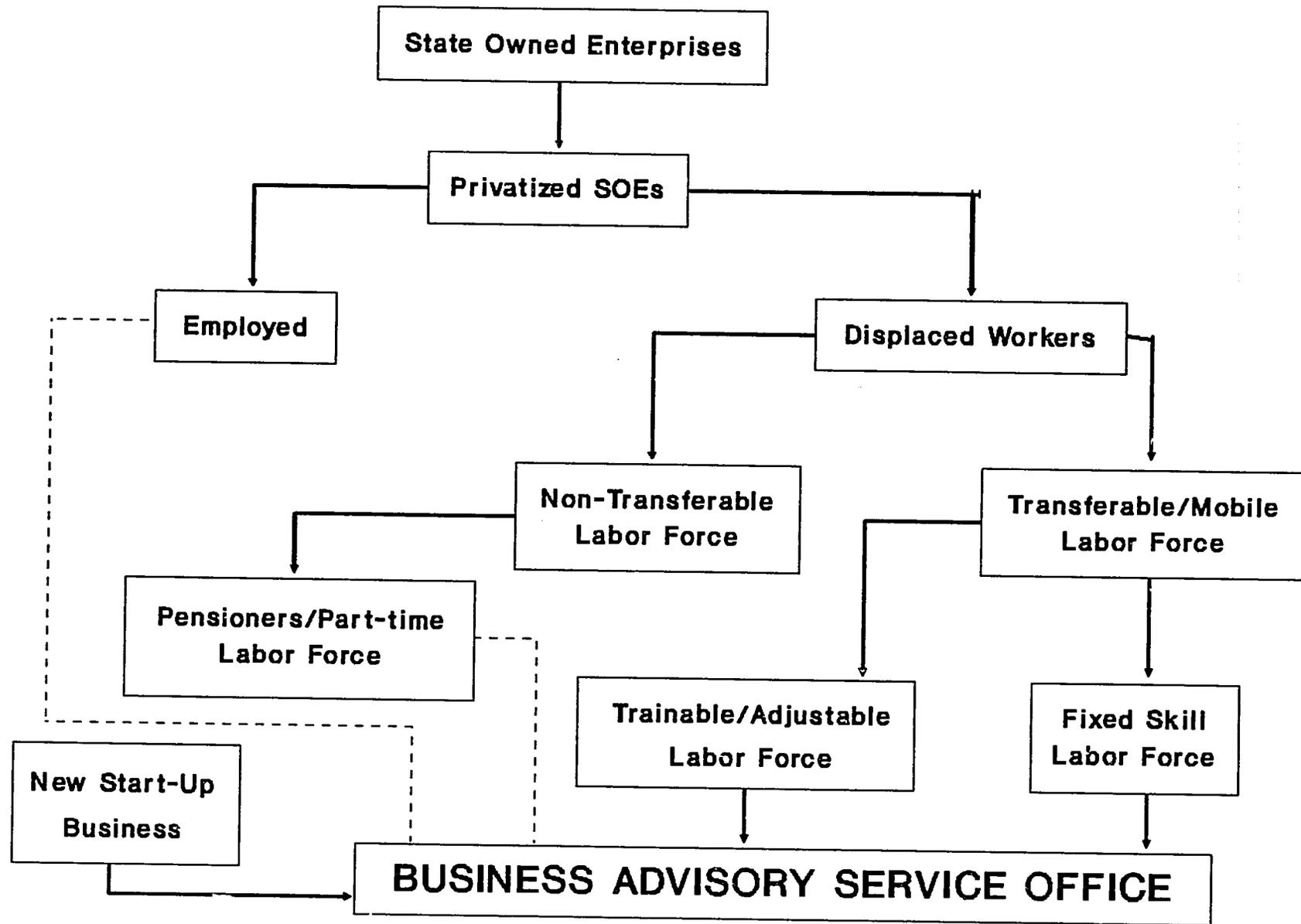
<sup>17</sup> In the past six months, more than 2,000 new businesses were registered with the city's five registration offices. While not all registrations translate to positive economic activity, the data provide a glimpse at the level of entrepreneurship already taking place in Vladivostok.

<sup>18</sup> Workers newly joining the labor force are made up of young workers with no previous job history, housewives, and other individuals not accounted for as a part of the labor force before the liberalization of economic activities in Russia. In particular, women who were previously involved in domestic activities are now participating in piecemeal business activities as well as contributing to the growth of cottage industries.

<sup>19</sup> A more general development assistance program should be considered to create a social safety net to address issues related to dislocated workers and the non-transferable labor force. Preliminary interviews suggest that budgetary constraints at federal, regional, and municipal levels will place critical limitations on support services for the unemployed and pensioners in Russia.

# FIGURE 1

## Target Group for the GEMINI Project in Vladivostok



## SECTION FOUR

### BANKING AND CREDIT

In the former Soviet Union, the government's 70-year monopoly over the banking system began to weaken in 1987.<sup>20</sup> Commercial banks were spun off from the central Gosbank and converted to joint stock companies. These banks inherited regional banking structures and still remain largely state-owned. The establishment of other commercial banks soon followed, but most of these institutions are dominated by large state-owned enterprises that use the banks to provide loans for themselves. Cooperatives have been permitted to set up their own banks, a few foreign joint venture banks have been licensed, and some of the newer commercial banks are more market-oriented but, in general, the sector remains underdeveloped.

Banking practices in Russia have little resemblance to those in the West, and state interference limits their commercial nature. The Central Bank of Russia (CBR)<sup>21</sup> regulates interest rates on both deposits and loans, and encourages extending credit on preferential terms for investments in state-defined priority sectors (for example, agriculture). All interest rates are negative, but under current inflationary conditions, any effort to achieve real positive interest rates would be unrealistic and perhaps catastrophic for the sector in general.

An acute shortage of rubles throughout the country has caused the government to try to limit the amount of cash depositors can withdraw from their accounts.<sup>22</sup> Businesses are not able to borrow for current operating expenses, but must cover these costs through their cash flow. Business loans are made for specific transactions, and the bank simply transfers funds between the buyer's and supplier's accounts without any cash exchange. The only purposes for which businesses are permitted to withdraw cash are to pay salaries and to purchase agricultural products.

Under present macroeconomic conditions, banks are reluctant to extend credit for more than a few weeks or, at most, a few months. This lack of longer-term financing for the purchase of fixed assets and equipment further stalls economic recovery by not enabling investment in production. In addition, there is a shortage of hard currency for purchasing imported equipment needed to start new production or modernize existing facilities. In general, banks are fearful of lending to small businesses because of the perceived risk and the banks' inexperience in commercial lending and risk assessment.

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<sup>20</sup> In 1987, only four banks existed in the entire Soviet Union, and all of them were subordinated to Gosbank, the Soviet Union's central bank.

<sup>21</sup> Two years ago, as the former Soviet republics began to declare their independence and establish their own central banks, Gosbank was replaced by the Central Bank of Russia.

<sup>22</sup> The government has imposed this restriction at Sberbank, the state's savings bank. Monthly, depositors are permitted to withdraw only R 5,000, or approximately US\$ 25, to cover basic household expenses. Some other banks, including VladCom Bank, permit larger withdrawals.

Primorski Kray has about 20 commercial banks with 500 branch offices, and the state retains majority interest in most of them, either directly or through SOEs.<sup>23</sup> There are no private banks as defined in Russia,<sup>24</sup> and only two of the commercial banks are licensed to conduct international hard currency transactions. The banks are still providing preferential credits to the agricultural sector, and the Vladivostok branch of the central bank expects new sector-specific credit programs for housing, transportation, and technology development. Only one bank, the Vladivostok Commercial Bank, appears to have identified small business lending as its principal market niche.

### **Vladivostok Commercial Bank**

In January 1990, the Vladivostok Commercial Bank (VladCom Bank) was established, under the municipality's auspices, as a joint stock bank. Changes in the national banking regulations prevented the city from owning the bank itself, and shares were issued for a total R 5 million to 32 founders.<sup>25</sup> In January 1992, the bank's authorized capital was increased to R 15 million, and the bank's directors subsequently raised this amount to R 50 million. As of September 1992, VladCom Bank's paid-in capital amounted to R 33 million, and its management was in the process of selecting new shareholders. VladCom Bank reports that there is a waiting list of potential shareholders and that paid-in capital could be increased further, if warranted by an increase in resources for on-lending.

Originally, 60 percent of VladCom Bank's paid-in capital came from state-derived sources, but it appears that, currently, private shareholders and soon-to-be-privatized small municipal enterprises account for more than 60 percent of the bank's ownership. VladCom Bank is trying to reduce the

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<sup>23</sup> Promstroi Bank is a case in point. Promstroi Bank will soon celebrate its 70th anniversary, making it one of the oldest banks in Russia. During the communist era, Promstroi Bank was subordinated to Gosbank, but in 1988 it became a joint stock company. The bank's shareholders are all large industrial enterprises. There are only two local shareholders, the Primorski Kray's coal company and a Vladivostok-based defense company. The bank's investment policy is aimed at "fulfilling the national investment program" — that is, providing credits to nationally defined priority sectors (for example, energy). Shareholders receive credit on preferential terms, typically at interest rates between 25 percent and 55 percent, while joint stock companies, wholesalers, and small businesses pay 85 percent interest. Promstroi Bank has a special small business loan program, but it does not make a distinction between private and state-owned small enterprises. Under this special program, the average loan size is equivalent to approximately US\$ 95,000. The bank has made two loans for about US\$ 1.9 million, suggesting that these businesses fall outside the range of what is commonly considered a small business.

<sup>24</sup> In Russia, "private bank" refers to a bank owned by one individual or a group of partners, and not joint stock banks with shareholders, even if the majority of shareholders are individuals and private enterprises.

<sup>25</sup> At the time, the city created a new small enterprise, Pavel, which in turn purchased 34 percent of VladCom Bank's shares. Subsequently, Pavel's percentage of total shares has been more than halved as additional stocks have been sold. Also, presumably in the next few months, Pavel itself will be privatized, since it does not fall within the category of enterprises banned from privatization.

percentage of shares owned by state enterprises to under 25 percent as quickly as possible, to be able to participate fully as a trustee in the government's privatization voucher scheme. The bank's policy is not to permit any single shareholder to gain a controlling interest in the bank and, in fact, ownership in VladCom Bank is well distributed among its shareholders, with most having less than a 10 percent interest in the bank.

In many respects, VladCom Bank is more progressive than other commercial banks in the city. A higher percentage of its shareholders are private and VladCom Bank expects to have a majority of private shareholders in the near future. The bank has targeted small — preferably private — businesses as its market niche and is actively seeking their business. Most local banks discourage small accounts by charging a monthly servicing fee of R 20,000 (US \$100), but VladCom Bank's fee is only R 2,000.

VladCom Bank currently operates out of small offices in disrepair that it took over from a state bank, but it will soon start construction of a new building in the city's center. The current building will become a branch office; VladCom Bank is opening another branch in the nearby town of Tudavor; and it already has a branch in Samara on the Volga River.<sup>26</sup> VladCom Bank has obtained a license to conduct foreign currency transactions within Russia; it is preparing an application for an international foreign currency license; and it has taken the initial steps to form a correspondent bank relationship with a Japanese bank. In addition, the bank is in the early stages of computerization that will enable it to handle more efficiently the accounts of small savers and borrowers.

VladCom Bank has 2,000 accounts and, at any one time, it has about 200 outstanding loans. It also processes about 200 loans per month, which underscores the short-term nature of its lending. By its own policy, VladCom Bank limits the value of its total outstanding loans to 20 times its paid-in capital; thus, its current ceiling, with paid-in capital of R 33 million, is R 660 million, or approximately US\$ 3.3 million. This will increase to about US\$ 5 million when paid-in capital reaches R 50 million. VladCom Bank maintains an 8 percent reserve account to offset losses. VladCom Bank also reports a high demand for hard currency loans.

Most of VladCom Bank's resources for on-lending come from funds held in business accounts, but the bank is aggressively pursuing individual depositors. For years, individuals could save only at the state savings bank Sberbank; through its far-flung network of offices Sberbank still dominates the country's savings.<sup>27</sup> Earlier in 1992, VladCom Bank opened a window at a local jewelry store where it could receive deposits and process purchases by transferring funds between accounts. Largely as a result of this activity, the nominal value of VladCom Bank's individual savings accounts has grown from just over R 2 million in January to R 15 million in early September — or a 626 percent increase — and

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<sup>26</sup> Samara was chosen because it has a similar socioeconomic profile to Vladivostok. Both cities were previously closed and local industries were involved in military production. In addition, VladCom Bank wanted to secure a market niche in the more populous western part of Russia.

<sup>27</sup> As of July 1, 1992, Sberbank held R 432 billion in savings, compared with R 8.2 billion in all commercial banks. It should be noted, however, that commercial banks have mobilized most of these resources since the beginning of 1992, while the increase in Sberbank's savings in nominal terms for 1992 is only 15 percent.

it currently has about 1,400 individual depositors. VladCom Bank's interest rates on deposits range from 3 percent on current accounts to 55 percent on term deposits, with a blended cost of funds at about 45 percent.

VladCom Bank's lending practices are consistent with national laws and regulations. VladCom Bank extends credits for as low as 25 percent for businesses operating in priority economic sectors to 85 percent or even higher to traders. Overall, VladCom Bank realizes a 55 percent return on its loan portfolio. Consistent with banking practices throughout the country, shareholders can borrow at a preferential 25 percent rate, but shareholders have no loan approval authority and the bank's management has disapproved some shareholders' loan requests.

As of July 1992, VladCom Bank had R 759.6 million (US\$ 3.7 million) in outstanding loans, an increase of more than 188 percent since January. Loan size averages less than US\$ 20,000. Of VladCom Bank's total loans, R 741.2 million, or 97.6 percent, represented short-term credits. Fifty-three percent of the short-term credits went to private business entities, including small businesses and cooperatives, and another 43 percent went to municipally owned retail stores, pharmacies, and service establishments.<sup>28</sup> Nearly 91 percent of the loans to private businesses were repayable within four months, with interest payable each month. The remaining credits were used for even shorter-term working capital requirements, and the interest was deducted from loan proceeds at the time of disbursement. Much of VladCom Bank's lending activity is "transaction-driven," meaning that credit is made available only for specific pre-approved transactions, but the bank's managers indicate a willingness to extend credit terms and structure loans to better address business requirements, provided the bank staff receives needed technical assistance.

Like other Russian banks, VladCom Bank employs any combination of three options for securing its loans: a mortgage on fixed assets (for example, equipment and property), credit insurance, and the guaranty of another well-established enterprise. The last option generally is not available to emerging entrepreneurs, and most newly established private enterprises have few assets that can be secured. Even if they did, in many instances credit insurance seems to be a preferred form of collateral. The notary fee for registering a mortgage is 5 percent of the loan amount; thus, it is often less expensive to buy credit insurance and, in the event that VladCom Bank were to initiate foreclosure proceedings on collateral, the process would be lengthy and costly for all parties involved.<sup>29</sup>

Credit insurance is a growing industry, and VladCom Bank has started recently to use one insurance company, Salamandra. Established in September 1990, Salamandra's shareholders are Gostrac, the state insurance company; Finistbank, a commercial bank; and a commercial enterprise of Primorski Kray. Insurance fees range from 1.5 percent to 25 percent of the loan amount, averaging 8 percent.

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<sup>28</sup> VladCom Bank's lending in other sectors is negligible: 0.7 percent to fisheries and a regional agricultural production complex, 1.4 percent to construction, 0.25 percent to suppliers, and 1.25 percent to other types of businesses.

<sup>29</sup> The head of the CBR's international division in the Vladivostok branch reports that registering a lien against assets has always been an option, but he can not remember a single case in which foreclosure proceedings were initiated.

Salamandra assesses credit risk and sets a fee accordingly; occasionally, Salamandra itself registers a security interest in the borrower's fixed assets. Insurance rates are lower for any production activity and higher for retail trade and wholesalers, and SOEs receive preferential rates.

In the past two years, Salamandra has accumulated a R 14 million reserve fund. It has insured some 400 loans, and only about 20 loans, with a total value of R 3 million, have been bad. In theory, the insurance is intended to cover both principal and interest, but in practice only the principal has been covered. Salamandra can insure loans up to R 7 million; larger loans must be reinsured by Gostrac. The company has a license to engage in hard currency transactions, but to do so would require a hard currency reserve fund.

### **Small Business Credit Program**

It is recommended that A.I.D. develop and implement a Small Business Credit Program in partnership with VladCom Bank. The objectives of this program would be:

- To increase the availability of credit for new and expanding small private businesses;
- To reform the lending practices of VladCom Bank — in order to improve its small business credit program — by introducing new credit terms, loan conditions, and use of loan proceeds and providing technical assistance in risk assessment and portfolio management;
- To use the loan program as a vehicle for providing related technical assistance and training for borrowers, other entrepreneurs, and bank staff; and
- To serve as a model small business loan program in Vladivostok's banking community.

Annex A outlines a number of issues and recommendations for structuring the credit program. In essence, A.I.D. would make a loan to VladCom Bank, repayable in approximately five years. After an initial advance, VladCom Bank would draw down on this loan, based on performance. Funds would be on-lent in rubles and U.S. dollars, thus providing a source of needed hard currency financing. Interest accruing on A.I.D.'s loan would be used to offset part of the foreign exchange risk and to fund the Business Advisory Services Office (see Section Five). The size of A.I.D.'s loan is still to be determined, but it probably should be in the range of \$3 million to \$5 million.

In proceeding with the establishment of a credit program, a number of issues still need to be negotiated and resolved. Two major issues, on-lending interest rates and foreign exchange risk, are discussed below.

- **Interest rates.** Interest rate ranges paid on deposits and loans in rubles are established by the central bank, and currently they are negative in real terms. The CBR has raised rates significantly in the past year, but they still remain well below the prevailing

inflation rate. As inflation slows and interest rates remain steady or rise, this gap will close, and it appears that the national government is committed to economic reforms that will require significant changes in the banking system if the overall reforms are to succeed. Thus, even within a few months, a new interest rate structure may be in place. As a local project, however, the proposed Small Business Credit Program must operate within the confines of national banking law and regulations. The purpose of this program is to provide needed credit to local entrepreneurs and, only over time, to have some impact on the larger banking sector. Loans made in U.S. dollars, of course, can be lent at positive interest rates, but any hard currency lending will entail a foreign exchange risk.

- **Foreign exchange risk.** It is proposed that the Small Business Credit Program offer both ruble and U.S. dollar loans. Hard currency borrowers would use these funds primarily to purchase imported equipment, but in most instances, it can be assumed that their earnings will be largely in rubles and not hard currency. Thus, the borrowers will face a foreign exchange risk, assuming that the ruble will continue to be devalued, and they will be using rubles to purchase dollars to repay their loans.<sup>30</sup> A number of mechanisms or techniques can be employed individually or in some combination to offset and minimize the foreign exchange risk, including:
  - Creating a reserve fund with the interest accruing on A.I.D.'s loan, to offset part of the foreign exchange risk;
  - Fixing the ruble-dollar exchange rate at the time of borrowing; and
  - Using a combination of indexation of principal and longer repayment terms to allow revenues to increase as a result of rising prices.

Russia's changing economic conditions make it difficult to calculate with any precision the foreign exchange risk. Further analysis will be required to determine the demand for hard currency credits, and sensitivity analyses will be needed to establish acceptable parameters for making dollar-denominated loans.

Further development of the Small Business Credit Program will require additional short-term consultancies that should begin as soon as A.I.D. has approved the program in principle. The first consultant could be fielded in fall 1992. The implementation of the credit program will require a long-term advisor assigned to VladCom Bank for 12 to 24 months. The credit program will be supported by training and technical assistance activities as described below.

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<sup>30</sup> Assuming that domestic prices are increasing at the same rate as inflation, then the real foreign exchange risk is the difference between the rate of devaluation and the rate of inflation, and not the rate of devaluation alone.

## SECTION FIVE

### SMALL ENTERPRISE DEVELOPMENT TRAINING AND TECHNICAL ASSISTANCE

Institutional support for private small enterprises in Vladivostok is largely undeveloped at this time. Most organizations claiming to represent or assist entrepreneurs fall somewhere along a continuum ranging from purely state to quasi-commercial institutions, with the degree of state involvement generally inversely related to the degree of credibility an organization enjoys among private entrepreneurs. At this time, there are no private sector professional and trade associations representing or supporting SMEs;<sup>31</sup> a non-profit non-governmental structure does not exist; and rarely are relevant adult education courses offered.

The mixture of state and quasi-state institutions that does exist provides a range of services to support enterprise development in general, rather than targeting assistance to small enterprises.<sup>32</sup> Moreover, these services are scattered across a number of municipal or kray-level offices and institutions, rather than concentrated in a way that would make them readily identifiable and accessible to entrepreneurs.

Small entrepreneurs' access to support is further hampered by the lingering mistrust of all institutions and individuals associated with the former communist government. For this reason, organizations such as the Chamber of Commerce and Industry are not readily approached by entrepreneurs seeking assistance, even when such entities are beginning to try to serve SMEs. Similarly, the numerous institutes of higher education in Vladivostok, most of which were established by the government and are still state-funded, generally are not regarded as having the required expertise to teach business and management courses. More progressive educational institutions are attempting to attach commercial programs to their curricula but these courses are typically taught by foreign faculty, for a fee, to managers and directors of still-to-be-privatized large enterprises.

Given the complexity and changing nature of the current economic and institutional environment, it is too early to identify specific institutional counterparts for initiating a long-term program to provide training and advisory services to the small business sector. Institutions that actually, or potentially,

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<sup>31</sup> In fact, there many organizations that call themselves "associations," but local usage of the term applies to entities that are more like limited partnerships of state and partly privatized enterprises created for investment purposes rather than open membership associations in the way the term is used in the United States.

<sup>32</sup> The distinctions between state and private enterprises are still blurred in terms of data collection and reporting, as is the distinction between small enterprise and enterprises in general. The term "private" is frequently used interchangeably with "small" — even where small is still quite large — while the official definition of "small" varies by industry. This confusion is mirrored in the absence of a legal definition of small business and lack of specialized administrative systems and procedures for providing support to the private business sector.

provide services to small business are themselves continuing to evolve by changing their types of services, modes of delivery, and target clients.

At the same time, the need for services is acute, particularly among the emerging small private businesses that require assistance on a whole range of start-up and operational issues: preparing charters and other legal documents; registering the business; understanding applicable laws and regulations; developing business plans; preparing and analyzing cash flow projections; acquiring credit; and obtaining information on inputs, distribution systems and markets. More general needs include access to regularly scheduled and affordable courses that offer a basic introduction to entrepreneurship and training in the basic skills required for managing a private business, such as accounting, marketing, and advertising.

In response to these needs and conditions, an incremental approach is recommended that will address some of the most immediate SED training needs and, at the same time, lay the groundwork for developing a longer-term local capacity to provide business education and assistance programs. The proposed program for training and technical assistance comprises the following elements:

- Developing local training capacity;
- Offering specialized training to finance institutions;
- Establishing a hands-on technical assistance capacity for small businesses; and
- Outreach to targeted groups.

### **Developing Local Training Capacity**

There is no shortage in Vladivostok of institutions purporting to provide business training, and new programs are appearing almost every day. Most of the programs are of poor quality; little effort has been made to develop an ongoing business training program; and the better programs tend to be expensive long-term courses of study.<sup>33</sup>

However, there are several organizations that are offering or planning short-term business training courses. The Regional Education Center, a quasi-state institution supported by the Primorski Kray's government, runs vocational and evening programs in business management, directed primarily toward students. The High Commercial School offers short courses primarily directed toward already practicing entrepreneurs in business management, business law, financial management, and foreign commercial activities. In addition, the women's organization ANNA has a commercial training program focused on job retraining for the service sector, and it hopes to start courses directed at women interested in starting their own businesses. Each of these institutions should be explored further to assess the ways A.I.D.

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<sup>33</sup> An example is the international business degree offered through the joint program between the Far Eastern State University and the University of Maryland that costs more than US\$ 10,000 and requires students to be sponsored by large (usually state) enterprises.

assistance can best support development of these training initiatives and to determine which of these institutions, if any, could serve as an institutional base for developing a business education program.

The process of establishing local institutional capacity in Vladivostok to provide practical business training courses will necessarily be an iterative one. The team proposes to begin this process by implementing a three-day workshop this December. The Regional Education Center has agreed to host this event and provide logistical support.

The workshop will be targeted to current and potential entrepreneurs, and it will cover basic topics such as what it means to be a private entrepreneur; understanding and dealing with the current legal environment for small business; the basic steps involved in running a small business, such as developing a business plan; marketing and promotional strategies; preparing and understanding cash flow projections; and an overview of possible opportunities for small business in Vladivostok. The workshop will be conducted by U.S. business experts, and local representatives will be asked to make presentations on relevant topics (for example, business registration procedures).

In addition to its educational aspects, this three-day session will serve two other purposes. First, it will provide small entrepreneurs, representatives of local institutions, and government representatives with initial exposure to all the elements of the GEMINI small enterprise assistance program. Second, it will provide a basis for better assessing the appropriateness of the Regional Education Center and other participating institutions to serve as A.I.D.'s long-term institutional counterpart for delivering training services.

Eventually, a major thrust of A.I.D.'s training efforts should include a training-of-trainers program for local staff currently teaching business courses at other institutions. This approach is particularly desirable in view of the fact that many of the same individuals teach at a number of different institutions. For example, staff of the High Commercial School and Far Eastern State University also teach courses at the Regional Education Center. Bringing together this pool of local experts for specialized training in the area of small business development will be an efficient way of disseminating relevant skills to the audiences already reached by current programs.

### **Specialized Training for Financial Institutions**

The credit program with VladCom Bank will be the point of departure for the proposed delivery of an integrated package of credit, training, and technical assistance to small entrepreneurs. The concept and practices of commercial banking are still very new and the macro-environment for operating a private bank remains challenging. For these reasons, a substantial thrust of the proposed technical assistance and training effort will focus on developing the systems and capacity of VladCom Bank and other banks to manage a small business loan program effectively. Additional assistance will include designing appropriate MIS systems for managing credit and deposit accounts; preparing an operations manual for the credit program; designing loan applications and other forms; and managing the loan portfolio.

Staff training will be an ongoing process coordinated by the long-term advisor. Although the initial bank training efforts will be directed at VladCom Bank to ensure effective implementation of the loan program, the expertise and materials developed for providing this training in the Russian context will

be made available for training efforts directed at other banks in Vladivostok and, possibly, Nakhodka. The long-term advisor at VladCom Bank will develop scopes of work and schedules for providing training and technical assistance to banks interested in starting or expanding their own small business loan programs. Depending on the level of demand, an option to be explored is developing the capacity of a local institution to provide bank training on a regular basis.

### **Establishing a Business Advisory Services Office**

Initially, the team concentrated on trying to identify an appropriate local institution in which to develop the capacity for providing focused, problem-oriented business advisory services to small businesses. However, it quickly became apparent that all the existing institutions in which such a function might be housed are neither trusted nor deemed competent by small private business. For this reason, the team recommends creating an independent Business Advisory Services Office (BASO), structured as a non-profit organization or foundation, located on the premises of VladCom Bank. This approach overcomes the difficulties involved with obtaining space, and also provides a mechanism for coordinating the delivery of advisory services and credit.

BASO will be staffed by a long-term business advisor and locally hired personnel. An initial task for the business advisor will be to recruit and hire a local counterpart who will be trained to take over as director of the BASO upon departure of the expatriate advisor.

BASO will be structured in a way that allows it to attain financial self-sufficiency over time. Initially, BASO can operate rent-free at VladCom Bank, and other expenses could be partially offset by a portion of the interest earned on A.I.D.'s loan to the bank. It is proposed that services initially be provided free of charge, with a full fee schedule phased in at a later date; one of the business advisor's tasks will be to establish an appropriate fee structure for BASO's services.

BASO will provide small businesses with assistance in drawing up charters, registering the business, and developing business plans. In addition, BASO will provide hands-on advisory services to solve immediate problems related to production, distribution, and marketing, and it could coordinate the delivery of other A.I.D.-funded technical assistance. BASO will work with local counterparts to conduct focused analyses of subsectors that hold the potential for substantial involvement by small private enterprises and to develop a body of information for guiding cost-effective technical assistance.

### **Outreach**

To ensure the effectiveness of the proposed training and technical assistance activities, the issue of outreach must be addressed in an explicit fashion. Each of the initiatives outlined above must include clear plans for reaching the target audience with information about the programs.

There are a number of logical referral points in the current administrative system that lend themselves to disseminating information about available services to displaced workers and new entrepreneurs. These include the business registration offices at City Hall and in the city's five districts, where new entrepreneurs must register their businesses, and the Labor Exchange, where displaced

workers file for unemployment benefits and sign up for retraining. Appropriate locations can be identified in institutes of higher education to reach out to the substantial number of highly trained graduates seeking employment each year. Lawyers that currently help new businesses draw up their charters could also provide referrals (although they may be reluctant to do so if BASO is perceived as a source of competition). In addition, VladCom Bank, BASO, and the local training counterpart will provide referrals to each other.

Particular attention should be given to reaching women who are potential entrepreneurs. ANNA, the commercial association of women-owned businesses, would be one appropriate avenue; other efforts should be made to identify women at farmers' markets, medical centers, and day care centers.

### **Training and Technical Assistance in Nakhodka**

Nakhodka, east from Vladivostok, also has a underdeveloped institutional framework for supporting small businesses. There are no small business associations, institutes of higher learning, or public sector agencies responsible for SED activities. Most of the economic activity in Nakhodka's Free Economic Zone (FEZ) is associated with joint ventures involving foreign partners and large export-oriented enterprises, with tax incentives and financial resources targeted to support these ventures. The FEZ's Administrative Committee identifies profitable investment opportunities, locates foreign partners, and allocates grants and loans in support of these ventures. Domestic small businesses receive only indirect support, insofar as they benefit from joint venture activity. The 1,500 small businesses in Nakhodka are not eligible for the tax benefits to which foreign investors and joint ventures are entitled. Local entrepreneurs are not well organized as a group; most lack basic business skills. With the city's support, the emerging small business community has tried twice to create an association called the Entrepreneur's Alliance, but both attempts failed because of the members' inability to identify areas of common interest and because of distrust of the city's involvement.

The proposed approach recommended for Nakhodka recognizes Vladivostok as the initial focus of A.I.D.'s SED initiatives in the Russian Far East, but will extend selected training and advisory services to Nakhodka over time. As a first step, the three-day small business training workshop planned for Vladivostok in December will also be offered in Nakhodka. The Administrative Committee has already expressed interest in serving as the counterpart for sponsoring this type of event. The workshop will help gauge the extent of the small business community and the types of small business services required.

The consultants will also attempt to identify local institutions that could serve as an institutional base for a longer-term training or technical assistance program. Apparently, there are six vocational schools in Nakhodka that have been rendered largely irrelevant by the current economic transformation. It is possible that one of these would be interested in, and capable of, reformatting the content of its program to focus on small business development training. The consultants will also assess how A.I.D. can support the third attempt, now under way, to establish a local small business association.

A further option to explore is the possibility for extending to Nakhodka the credit and advisory services model developed in Vladivostok. Initial interviews with the Bank of Nakhodka indicated strong interest in participating in a similar type of program. If the program is extended, it will require

developing a plan for corresponding bank training activities; training materials developed for VladCom Bank and other financial institutions in Vladivostok could be used in Nakhodka as well. The business advisory function could be situated on the premises of the Bank of Nakhodka, as in Vladivostok, or, if A.I.D. can facilitate successful creation of a small business association, the business advisory function could be established there. In either case, a local expert could be trained in Vladivostok by BASO's Business Advisor to carry out this function in Nakhodka.

## **SECTION SIX**

### **GENDER ISSUES**

Historically, industrial sectors and occupations in the Soviet economy were highly stratified by gender. Although men and women were employed at the same rate, they held different types of jobs. Women's jobs tended to be lower paid and women rarely reached top levels of management.

From the point of view of small business development, there is no evidence that women and men in Vladivostok face different barriers in the mechanics of starting a business or in access to credit. At the same time, little gender-disaggregated information is available on private sector entrepreneurs and employees — or on employment in general. Since by law there is no sex discrimination, disaggregated information is considered irrelevant. Anecdotal evidence, however, suggests that men and women entrepreneurs are concentrating in different types of small businesses. Women entrepreneurs tend to concentrate in trade and service enterprises and in the historically female-dominated sectors of industry such as publishing and pharmaceuticals. The apparent differences between men's and women's small businesses reflect both the traditional divisions between their work in the former Soviet Union and traditional gender roles that emphasize women's responsibility for home and family. Over time, differences between businesses involved in production and those in trade and service may become apparent, and the unique characteristics of enterprises in the trade and service sectors may require direct attention.

The current disruption and restructuring in the economic and social systems could lead, hypothetically, to a breakdown of gender stereotypes or to an increasing reliance on the traditional gender division of labor. The latter appears to be occurring in Vladivostok. It is reflected in the planned retraining for women workers in traditionally female and low-paid occupations (such as seamstress, accountant, beautician, and secretary) and in the increasing necessity for the family to fall back on informal and non-market mechanisms for household support.

In response to inflation and a lack of funds, state industries have begun to lay workers off; the majority of displaced workers are women. Budget deficits and the privatization process are contributing to decreases in the availability of public services such as day care, housing, and medical care, and previously free services are being commercialized or are simply not offered. These services have been essential to women's participation in the labor force.

A program directed toward displaced workers must necessarily focus primarily on women. A small business project may affect these women as entrepreneurs or as employees. The impact of the program on women as entrepreneurs will depend on factors such as access to commercial space, supplies, financing, and information. The impact on women as employees will depend on the type and quantity of new job creation, retraining programs, job characteristics (for example, salaries, hours, location, and social services), and access to information about employment opportunities.

The only unique constraints for women in business are household and child care responsibilities. With cutbacks in services and family economic hardships, these responsibilities are likely to become more

onerous. At a minimum, A.I.D.'s small business program should be aware of these constraints and adjust to women's schedules. More broadly, the program could explore ways for new businesses to alleviate these constraints and fill the void created by the breakdown of the state system.

Specific recommendations for integrating gender considerations into A.I.D.'s SED program in Vladivostok are:

- In the design of SED credit, technical assistance, and training programs, particular attention should be given to differences between enterprises in the service and trade sectors and enterprises involved in production. Examples of these differences may include legal and regulatory parameters, tax policies, cost structures, and credit availability, as well as cultural acceptance. The cultural bias against "non-productive" enterprises should be countered with concrete measures to even the playing field across sectors. At present, gender considerations are not a factor in the bias against "non-productive" businesses. In the future, if women predominate in these sectors, an interaction between gender and the cultural bias could create further negative consequences.
- Attention should be given to the differences between men and women as entrepreneurs in the constraints placed by household responsibility, especially housework and child care. These constraints may be important, for example, in setting the time and location of technical assistance and training activities, and in deciding where to advertise these activities. Placing announcements in ANNA's monthly newspaper is one example. Offering training programs outside working hours (perhaps on weekends) and in local neighborhoods rather than in the central city is another. In the longer term, attention should be given to development of businesses to help women cope with the demands of working and maintaining a household.
- A.I.D.'s small business program should include concrete measures to offer displaced women workers an alternative to retraining in traditionally female and low-paying activities. These alternatives might include special training courses geared to women as entrepreneurs, employment referral services for private small businesses, and design of retraining courses for displaced women workers based on employment demands of new enterprises. This targeting would require documentation of the employment demands of new enterprises or a study to identify market niches for entrepreneurship particularly suited to the skills, interests, experiences, and constraints of displaced women workers.

- **The program should provide for periodic monitoring of its relative impact on men and women, in light of the changing social and economic environment in Vladivostok and the relationship between these changes and gender. Gender-disaggregated data are not available on employment or entrepreneurship, and BASO should advise and provide assistance to the government to collect this information. Since the changes occurring now in Russia are clearly not gender-neutral, important questions to follow during project implementation are: If women continue to bear a disproportionate share of the cost of this change, is the program doing anything to counter that trend? Is the program hampered in its operation because of these patterns?**

## SECTION SEVEN

### PRIVATIZATION

Currently, 4,599 SOEs have been identified in the Primorski Kray for privatization. Of this total, 2,806 will be privatized by federal and regional governments and another 1,783 will be privatized by the city's authorities. Among the latter, only 110 enterprises have been privatized to date. According to guidelines set in Moscow, the bulk of privatization proceeds go directly to the regional governments that use the revenues for general public expenditures.<sup>34</sup>

The federal government has established clear guidelines and priorities on the process for privatization. According to the regional Privatization Committee, the percentages of enterprises to be privatized within various industries or sectors are:

Light industry	60%
Footwear	30%
Construction	50%
Automobile and transport	60%
Retail and trade	60%

On average, 50 to 60 percent of all industries are expected to be privatized. In addition to defining sector-specific selection guidelines, the Russian government has set out explicit criteria for the selection of enterprises to be privatized. Enterprises exhibiting one or more of the following traits are placed in a bracket for immediate privatization:

- Enterprises suffering from insufficient profits;
- Enterprises holding the largest market share in a given sector; and
- Enterprises with recent investments for refurbishing or upgrading of facilities.

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<sup>34</sup> According to statistics from the Privatization Committee, proceeds from sales of SOEs in the Primorski Kray during 1992 and 1993 will be distributed as follows:

Privatization Committee	11.1%
Municipal government	23.1%
Regional government	43.6%
Federal government	22.2%

On a quarterly basis, enterprises are selected for privatization and the manner in which they will be sold is designated. Enterprises can be sold by auction or competitive bidding or through the sale of shares.<sup>35</sup> Privatization guidelines have been issued by the national government, and these procedures are elaborated in more detail at the local level.

Although data on aggregate personal savings and cash availability at banks in the region are not available, preliminary interviews with government officials and bank managers suggest that the region is cash-poor and does not have the capacity to support the privatization of SOEs currently under consideration. In response to this cash-poor environment, privatization funds are being set up by governments, associations, the private sector, and other sources to consolidate investment monies to channel scarce capital into priority enterprises with high-growth potential. The principal fund that is planning to establish a joint government-private sector initiative with a private sector management structure is the Primorski Regional Fund.

### **The Primorski Regional Fund**

At the regional level, the most visible and, potentially, the most ambitious source of investment capital is the Primorski Regional Fund (hereinafter, the Fund). The Fund was conceived jointly by the Primorski Kray State Property Fund and regional non-state businesses. By October, a draft charter for the Fund was expected to be submitted to Moscow for review and approval.<sup>36</sup>

According to the Fund's Chairman, provisions in the draft charter recognize and specifically address the need to support small and medium enterprises. Although the draft charter acknowledges the need by the Fund to assist SMEs, little has been done to define the role of the Fund in supporting SMEs.

The initial plan was for the Fund to establish a Board of Directors, consisting primarily of private sector businessmen, to direct the activities of the Fund. The State Property Fund would retain a member on the board but would allow the day-to-day management of the Fund to be dictated by board members from the private sector. However, a recent review by the State Property Fund of potential board members for the Fund revealed that prospective candidates from the regional business community were

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<sup>35</sup> Annex D provides a step-by-step description of the privatization procedures. In general, however, small enterprises are sold through auctions or competitive bidding, and larger enterprises are converted to joint stock companies and sold through shares. Competitive bidding generally implies that the enterprise is being sold with certain conditions (such as continuing to maintain the same type of business on the premises — for example, a bakery), whereas no conditions are attached to auction sales.

<sup>36</sup> According to the Fund's Chairman, Valeriy F. Lutsenko, the Fund will be a for-profit organization with a fixed capital base of R 50 million to 60 million; approximately one billion shares will be issued through a stock issuing plan. The State Property Fund is expected to contribute R 25 to 30 million to the Fund, using proceeds from sales of SOEs. In addition, the Fund expects to raise R 20 to 30 million from commercial and other non-state sources.

unsuitable to manage its operation.<sup>37</sup> Consequently, the Fund has identified other potential candidates for the board, but it is seeking assistance in training these candidates, selecting an appropriate organizational structure, and adopting procedures and strategies for the Fund's management.

The Fund's organizational and management structures have not yet been defined nor have guidelines on the type of financial participation and target areas for investment been developed for the use of funds.<sup>38</sup> Potentially, the Fund could become a source of credit or equity financing or a combination of both. Consequently, placing a short-term advisor at the Fund to help establish investment policies and guidelines may result in an investment environment more supportive of small businesses and may minimize potential conflicts of interest that could arise if the Fund actively seeks equity positions in SOEs.

Difficulties currently facing the Fund in establishing a credible program to assist SMEs create an opportunity for A.I.D. to make an immediate and tangible impact on the privatization process, specifically at the regional level. The needs of the Fund are immediate, and the technical assistance necessary to support the Fund's activities are clearly defined.

#### **Technical Assistance**

The immediate short-term technical assistance needs of the Fund are to:

- Define the appropriate policies, organizational structure and operating procedures for the Fund;
- Assist the Fund's Board of Directors in developing an investment strategy;
- Develop job descriptions to fill positions necessary to operate the Fund effectively;
- Assist the Fund in screening potential candidates for the Board of Directors;
- Design a training course that reflects guidelines set out in the executive training program; and

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<sup>37</sup> According to Chairman Lutsenko, candidates from the business community had little to no experience in managing venture capital or mutual fund operations.

<sup>38</sup> Under current Russian law, enterprises in which the state has a 25 percent or greater interest are prohibited from purchasing shares in other SOEs being privatized. Taking into account that the Fund's legal status has not been defined, it is still unclear whether this law will apply to the Fund. If not, the Fund would qualify to take direct equity stake in SOEs. Doing this would have doubtful merits in terms of privatization and could result in creating new barriers to private sector development.

- **Train prospective board members and staff in areas related to operating an investment or credit fund, including risk assessment, financial analysis, asset valuation, business management, and related skills.**

**Review and approval of the draft charter for the Fund is expected by October. Assuming that the language and substance of the charter are completed as planned, the Fund is seeking technical assistance by mid-November. An initial two months of technical assistance is required to address the Fund's immediate needs. Subsequent short-term follow-up visits are recommended to monitor the Fund's progress and to assist in troubleshooting.**

## SECTION EIGHT

### LEGAL AND REGULATORY ENVIRONMENT

Prior to 1988, entrepreneurial activities were punishable by imprisonment; several thousand "premature" entrepreneurs are reported still languishing in Russian jails. In 1988, entrepreneurial activities were taken out of the criminal code and were legalized under a decree on small and medium enterprises introduced by the Council of Ministers. This change helped reduce market activities in the informal sector and was the turning point for the introduction of market infrastructure to service SMEs. By 1990, SMEs were recognized as a critical economic entity, and explicit laws were set aside to facilitate and accelerate market activities among them. Such laws included the mandatory 15-day company registration approval period, favorable tax treatment,<sup>39</sup> and fiscal and monetary incentives for the formation of SMEs. In practice, however, due to severe budgetary constraints, neither financial assistance nor incentives were ever offered to this category of enterprises.

By late 1990, the bureaucratic structure set up for accommodating SMEs started to erode, and laws that once existed to stimulate entrepreneurial activities suddenly became barriers to entry. This problem was further aggravated by the lack of access to input resources, insufficient credit, multiple taxation, and the collapse of delivery mechanisms for financing SMEs, all of which contributed to an increase in the number of bankruptcies among SMEs.

At the same time that the failure of SMEs began to snowball, the Russian Federation passed a new law on enterprises and entrepreneurial activity that neglected to acknowledge the existence of SMEs in the body of the law. Joint stock, sole ownership, limited partnerships, and other categories of legal entities were recognized, but SMEs were no longer designated a specific category as a legal entity. In most instances, SMEs were treated as business entities falling within the category of a limited partnership, and their activities were categorized under "individual and private initiatives." Finally, earlier this year, amendments were introduced that eliminated any remaining special incentives for small businesses. Even if the legal environment were more conducive to and protective of small businesses, legal enforcement would be constrained by budget deficits at every level of government as well as by the lack of understanding of law and its powers to protect individuals and groups.

Laws dictating the behavior of small businesses continue to be conservative. In particular, limitations or restrictions on market activities and a prohibitive tax structure continue to plague this category of enterprises. Firms must pay a 28 percent value-added tax, in addition to which they pay a 32 percent or 45 percent profit tax, depending on the type of business. If any offshore transactions are made, firms are further taxed on hard currency earnings. Under federal law, enterprises involved in the

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<sup>39</sup> Corporate taxes for SMEs were scheduled at a rate of 8 percent for the first year of operation, 16 percent for the second, and 32 percent for the third year.

production of consumer goods qualify for one- or two-year tax exemptions.<sup>40</sup> The only case where a regional government has authority to issue incentives to enterprises is where enterprises are involved in the reconstruction and repair of industry.<sup>41</sup>

The pace of change and the behavior of businesses at the regional level are set by substantive law introduced at the federal level. Consequently, very little autonomy exists for regional governments to influence change in the legal system to support business development.<sup>42</sup> For this reason, any technical assistance offered in Vladivostok in business law and regulations must focus on the needs of local enterprises and cannot be expected to have a direct impact on national law.

New enterprises have limited access to and knowledge of laws affecting their rights and obligations; this gap can result in long and costly lawsuits. Consequently, to raise the level of understanding and to introduce preventive measures to avoid unnecessary legal repercussions, it is recommended that the Business Advisory Services Office develop a legal counseling and referral capacity. Either in BASO itself, or through training of local lawyers, the capacity should be developed to provide legal counseling in the following areas:

- Tax law;
- Customs law;
- Contract law;
- Corporate law;
- Labor law;
- Enterprise law;
- Administrative law; and
- Property law.

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<sup>40</sup> To qualify, enterprises must draw more than 70 percent of revenue from the production of consumer goods.

<sup>41</sup> The regional government may offer tax relief of up to 19 percent to qualified enterprises.

<sup>42</sup> The governor of a region has the authority to introduce new regulations through decree. However, draft regulations are closely scrutinized by Moscow, thus leaving little to no power for regional governments to take initiative in creating a legal environment conducive to the pace of change occurring in the private sector.

**BASO's long-term Business Advisor and short-term consultants should design a training program for local lawyers and identify qualified lawyers and law firms to participate in this program. Consideration should also be given to developing an apprenticeship program for young Russian lawyers, similar to programs offered in the United States. To ensure quality, an apprenticeship program must be supplemented by a training program offered by U.S. lawyers to local lawyers through BASO. Initially, these activities are expected to require approximately two person-months of work in Vladivostok. Additional consultants will be required to conduct training for lawyers, and longer-term support may be required, depending on the demand for these services.**

## SECTION NINE

### AGRIBUSINESS

The agribusiness sector is a major employer in the region; many of the small food processing facilities are primary candidates for technical and financial services. Forty-one of the 51 food industry firms scheduled for privatization in the first year of the program have fewer than 200 employees, and 52 of the 61 firms providing agro-industrial inputs and equipment fit into this category. Many of the small retail, wholesale, and food service operations are involved in agribusiness-related activities.

Primorski Kray has an estimated 3,360 private farms, averaging 15 hectares and comprising about 7 percent of the region's arable land.<sup>43</sup> In addition, there are about 230 *kolkhoz* (collective farms) and *sovkhos* (state farms) employing 81,000 workers, many of whom are not directly involved in agricultural production. As some of the *kolkhoz* and *sovkhos* are broken up into individual farms, unemployment is expected to increase in rural areas.

Independent farmers are required to sell 25 percent of their agricultural output at state-regulated prices to state-owned food processors and outlets. Other outlets include farmers' markets and smaller food processors. *Dacha* farmers, commonly women, also sell their surplus production at local markets.<sup>44</sup> Farmers' markets are not insignificant in terms of sales; about 60 percent of the fresh horticultural products consumed in Vladivostok are purchased in the city's three farmers' markets. A large percentage of agricultural production is processed and preserved at home.

Many of the smaller food processing facilities and farmers have joined together in an effort to sell and distribute their products. The Primorski Region Consumers Cooperative Union comprises 98 agricultural production and processing facilities, 1,500 retail outlets, and 200 food service outlets. Altogether, these enterprises employ 18,000 individuals and serve more than 440,000 people throughout the region. Most of these are small entities employing fewer than 200 people, and the overwhelming

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<sup>43</sup> The majority of independent farmers belong to the national farmer's organization, the Association of Farmers and Agriculture Cooperatives (AKKOR). In Primorski Kray, AKKOR has about 2,000 members and is growing rapidly. Farmers value AKKOR principally for its advocacy nationwide on behalf of independent farmers' rights, including assisting in obtaining benefits and pensions to which farmers are entitled. By contrast, the Ministry of Agriculture is regarded as being more concerned with the needs of the collectivized agricultural sector.

<sup>44</sup> "Dacha" refers to any garden plot or home outside the city; typically, they have been allocated to workers at state enterprises and farms. Most dachas consist of small garden shacks situated on about 0.15 hectares, but they are a major source of agricultural production. For instance, between 1986 and 1990, the small private plots allocated to state and collective farm workers accounted for less than 3 percent of all agricultural land but produced nearly 25 percent of all agricultural output. Reported in U.S. Department of Agriculture, "USSR: Agriculture and Trade Report," Economic Research Service, May 1991.

majority have fewer than 50 employees. The Consumers Union is owned by 234,000 shareholders, 70 percent of whom are engaged in agriculture or agribusiness.

The principal major problem facing farmers, processors, food distributors, and retailers is the lack of knowledge and financing to modernize production, processing, packaging, and marketing operations. Even the most rudimentary technologies do not exist, such as full pasteurization of milk to extend its shelf life. Aseptic packaging materials are simply unavailable, even though the predominance of ocean shipping would provide a ready market for this type of spoilage-resistant packaging. To date, few joint ventures in agriculture have formed, given the large amount of investment needed to bring the agricultural sector up to international standards.

In the agribusiness sector, several specific projects have been identified that require feasibility studies, technical assistance, and the introduction of new technologies and equipment. Two priority areas for assistance that have been identified by government officials, farmers, and agribusinesses are:<sup>45</sup>

- **Dairy Sector Assessment.** A detailed technical assessment of the region's dairy industry is required to prioritize the kinds of technical assistance and technology transfer needed to modernize and raise the productivity of this sector. Assessment team members should be familiar with pasteurization methods for small farmer operations, the complete fodder and milk production cycle, and the appropriate genetic strains of cows for the locality. In addition, the assessment should examine which cheeses should be produced in the area and through which processing methods.
- **Feasibility study for producing baby foods and formula.** At present, there is no production of baby food in the Russian Far East and there is very limited access to these products. Given the complications associated with non-pasteurized milk and the difficulties that working mothers often face in trying to breast-feed beyond the first few months after birth, there is a large demand for a full range of inexpensive baby food and formula products. Both soy-based and milk-based formulas have been specified. A feasibility study is needed to determine what raw materials exist that could be readily processed and marketed by a new baby food and baby formula production facility.

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<sup>45</sup> Russia's agricultural and agribusiness sectors offer limitless opportunities for providing technical assistance. Other areas specifically identified for assistance include commercializing local honey production for domestic and export markets; providing the latest technologies for a sausage plant, a biscuit and crackers plant, a confectionery plant, a bakery, a processing facility for vegetable oils and canned meat, and a plant for processing corn into value-added items such as corn flakes; transferring modern technologies for brewing and bottling beer; transferring production line technologies for producing soft drinks such as orange soda and for producing plastic bottles in which to package them; providing equipment and know-how to produce crab-like fish sticks from surimi blocks; and improving grain-threshing technologies.

**ANNEX A**  
**SMALL BUSINESS CREDIT PROGRAM**  
**ISSUES AND RECOMMENDATIONS**

## ANNEX A

### SMALL BUSINESS CREDIT PROGRAM

#### ISSUES AND RECOMMENDATIONS

The proposal to establish and support a Small Business Credit Program at the Vladivostok Commercial Bank (VladCom Bank) will require substantial additional design, definition, and negotiation. From the outset, it is important that A.I.D. and VladCom Bank understand the objectives of the credit program. The program is not intended to reform Russia's banking system. A local program can accomplish only local objectives and, in doing so, serve as a model in its community. Over time, potentially, this experience will have a regional or national impact, depending on its success.

At the local level, the objectives of the Small Business Credit Program are:

- To increase the availability of credit for new and expanding small private businesses;
- To reform the lending practices of VladCom Bank in order to improve its small business credit program by introducing new credit terms, loan conditions, and use of loan proceeds and, at the same time, maintain an acceptable level of credit risk;
- To use the loan program as a vehicle for providing related technical assistance and training for borrowers, other entrepreneurs, and bank staff; and
- To serve as a model small business loan program for the local banking community.

Below, a number of issues are outlined that still need to be resolved. The following discussion is intended only to serve as a starting point for addressing these issues. Many details will need to be worked out in consultations between A.I.D. and VladCom Bank.

#### **I. Form of capital infusion**

**Discussion.** A.I.D. can provide assistance through a grant or loan. Typically, grants are made to non-profits, but loans or loan guarantees frequently are made to sovereign governments and public sector institutions (for example, ministries). There may be a restriction on providing grants to for-profit entities for profit-making purposes.

**Recommendation.** This project should be structured on a commercial basis. A.I.D. should make a loan to VladCom Bank bearing an interest rate pegged to the U.S. prime rate or U.S. treasury bill rate at the time of drawdown, whichever is less. Each drawdown should have a loan term of five years to enable VladCom Bank to better match loan terms with on-lending terms.

Drawdowns should be minimized in number to reduce the administrative burden on both A.I.D. and VladCom Bank.

## **II. Application of interest on A.I.D.'s loan.**

**Discussion.** The use of interest payable to A.I.D. on its loan to VladCom Bank should be consistent with the program's objectives.

### **Recommendations:**

- Part of the interest accrued and received on A.I.D.'s loan should be placed in a special account and made available to cover the operating expenses of the Business Advisory Services Office (BASO). These funds should be converted into rubles at the prevailing market exchange rate and transferred immediately to BASO's account.
- The balance of interest accrued and received on A.I.D.'s loan should be used to offset borrowers' foreign exchange risk and should be reinvested in the Small Business Credit Program for on-lending purposes.

## **III. On-lending terms, conditions, and eligible borrowers**

**Discussion.** A.I.D.'s purpose for funding this program is to expand the availability of financing for small businesses on terms and conditions consistent with small business needs. Current banking practices that need to be addressed through this program include:

- Repayment periods are too short to enable small business to invest in fixed assets and equipment.
- In general, loans are based on individual transactions between buyers and sellers, and not on credit requirements as calculated in a business plan and cash flow analysis.
- Hard currency is not available for the purchase of imported equipment and other goods needed to start or modernize local production.
- State-owned enterprises have easier access to credit and they borrow on preferential terms.
- Bank shareholders are eligible to borrow funds at below a bank's cost of funds.

**Recommendations:**

- **Eligible borrowers.** Eligible borrowers will be limited to individual entrepreneurs and small private businesses, including cooperatives. State-owned enterprises, including small enterprises that have not been privatized, will not be eligible for credits made available with A.I.D.'s funds. A private business is defined as having 51 percent or more of its shares or assets owned by private individuals or other private enterprises. A small business is defined as having 25 permanent employees or fewer in retail trade and public services, and 50 permanent employees or fewer in construction, production, or manufacturing.
- **Repayment period.** The repayment period should be consistent with the use of loan proceeds. Typically, working capital loans should be made for 6 to 12 months and loans for the purchase of equipment and other assets should be made for 3 to 5 years.
- **Currency.** Loans should be made in rubles, U.S. dollars, or a combination of both.
- **Eligible uses of credits.** Loan funds should be made available for most small business needs, including start-up and operating capital; purchase of equipment, vehicles, property, and other assets; and repair, renovation, and modernization of equipment and buildings. U.S. dollar loans should be used only for purposes requiring hard currency, such as the purchase of imported equipment and supplies, and not for purposes that could otherwise be financed in rubles. Consideration should be given to targeting a percentage of these funds for businesses involved in manufacturing and production.
- **Ineligible use of credits.** Loan funds should not be used for any defense-related activities, including manufacture or sale of weapons; any activity determined to be illegal under U.S. or Russian law; currency speculation; or the purchase of shares in another company.
- **Interest rates.** The interest rate on ruble loans should be consistent with guidelines established by the Central Bank of Russia. The interest rate on U.S. dollar loans should not exceed 6 percentage points above the interest rate on A.I.D.'s loan to VladCom Bank.
- **Shareholders loans.** Shareholders should not be permitted to borrow under this program on preferential terms.

**IV. Guaranty of A.I.D. funds**

**Discussion.** VladCom Bank does not have prior experience in borrowing from external sources. Various possibilities for securing A.I.D.'s loan include a guarantee of the bank itself or a guarantee from the central bank.

**Recommendation.** VladCom Bank should propose alternatives to A.I.D. for securing its loan.

42

**V. Loan size**

**Discussion.** By the end of this year, VladCom Bank's loan portfolio will total approximately US\$ 5 million. As new private businesses are established, demand for credit is expected to increase substantially.

**Recommendation.** A.I.D.'s loan to VladCom Bank should be US\$ 3 million to US\$ 5 million. The loan should be drawn down in stages based on demand and VladCom Bank's compliance with other terms of the loan agreement.

**VI. Leverage**

**Discussion.** In order to expand VladCom Bank's small business lending beyond the amount of resources provided by A.I.D., VladCom Bank should be required to mobilize local resources and participate in the subloans.

**Recommendation.** On ruble loans, VladCom Bank should be required to participate on a 60/40 match, with 60 percent of the resources coming from VladCom Bank's accounts and 40 percent coming from A.I.D.'s resources. On U.S. dollar loans, there should be no matching requirement.

**VII. Foreign exchange risk**

**Discussion.** U.S. dollar borrowers will use these funds primarily to purchase imported equipment, but in most instances, it can be assumed that their earnings will be largely in rubles and not hard currency. Thus, the borrowers will face a foreign exchange risk, assuming that the ruble continues to be devalued, because they will be using rubles to purchase dollars to repay their loans. A number of mechanisms or techniques can be employed individually or in some combination to offset and minimize the foreign exchange risk, including:

- Creating a reserve fund with the interest accruing on A.I.D.'s loan, to offset part of the foreign exchange risk;
- Fixing the ruble-dollar exchange rate at the time of borrowing; and
- Using a combination of indexation of principal and longer repayment terms to allow revenues to increase as a result of rising prices.

**Recommendation.** Various options for minimizing the foreign exchange risk should be examined in depth and acceptable parameters should be established for making dollar-denominated loans.

**VIII. Increasing VladCom Bank's capital base**

**Discussion.** VladCom Bank's current policy is to limit the size of its loan portfolio to 20 times its paid-in capital.

**Recommendation.** Drawdowns on A.I.D.'s loan should be contingent upon VladCom Bank's ability to increase its paid-in capital. VladCom Bank should provide a plan to A.I.D. for capital expansion, including limitations on the sale of shares to state-owned enterprises or public sector agencies, to ensure that VladCom Bank continues to increase its percentage of private shareholders.

**IX. Technical assistance and training**

**Discussion.** In conjunction with the Small Business Credit Program, A.I.D. is proposing to undertake related technical assistance and training activities, including establishing a Business Advisory Services Office. The credit program itself will need to be supported by one long-term advisor and short-term consultants.

**Recommendation.** VladCom Bank's participation in this project should be contingent upon its willingness to accept assistance from a long-term advisor in establishing and operating the credit program; ensure that bank staff will participate in A.I.D.'s proposed bank training seminars; and provide office space for BASO.

44

B-1

**ANNEX B**  
**INSTITUTIONAL PROFILES**

## **ANNEX B**

### **INSTITUTIONAL PROFILES**

#### **INTRODUCTION**

Annex B offers an overview of the key institutions involved in providing services or support to the emerging small business sector, with particular emphasis on those providing training, information, and advisory services. Although representative of the types of state and quasi-state institutions in Vladivostok, the listing is not exhaustive. The following institutions and programs are profiled:

- Regional Education Center
- High Commercial School
- International Business Center
- ANNA
- Peace Corps' Small Enterprise Development Program
- Chamber of Commerce and Industry
- Far Eastern State University
- Vladivostok Employment Center
- Women's Protection Committee
- Social and Economic City Development Association

#### **Regional Education Center**

The Regional Education Center (REC) operates under the auspices of the regional government. Established six years ago, the Center originally served as a training school for members of the Soviet fishing fleet and then opened a vocational and evening school for business training, with courses directed primarily at high school students. Many of its graduates become accountants and secretaries. The Center has also been heavily involved in retraining military personnel. In addition to business courses, the Center offers training in foreign languages and computer skills. There are Regional Education Centers throughout Russia, and the Vladivostok branch is the principal Center for the Russian Far East.

Although established as a state institution, the REC is currently in the process of developing a more commercial program. Courses under the business program are offered for a fee, and many of the students are sponsored by state enterprises. Each year, about 200 students graduate from the business program — most of them young people pursuing these courses as an alternative to the state university system. The Center offers short-term certificate courses and retraining diplomas, as well as standard four-year bachelor's degrees.

There are no full-time trainers on the staff; instead, the Center hires instructors from other institutes on a contract basis. The Center recognizes the need to attract lecturers with practical experience in market economies in order to develop a program that responds to the needs of the emerging Russian

private business sector. The Center has also been involved in hosting workshops sponsored by other foreign groups, including a recent seminar on private sector development sponsored by the Washington, D.C.-based Kriebel Institute.

**Program Implications.** The Regional Education Center is an appropriate host for the three-day workshop scheduled for December. It is a well-known entity in the institutional landscape of Vladivostok, and it has the support of the Primorski Kray's government. Given that this will be the first follow-on support from the initial visit, maintaining this link to the kray government is appropriate and should help ensure the support required to launch the event. The Center has adequate facilities to host the workshop and has already expressed interest in doing so.

### **High Commercial School**

Formerly under the Ministry for Foreign Economic Relations in Moscow, the High Commercial School (HCS) is splitting from Moscow and establishing itself as a joint stock enterprise with the Vladivostok Polytechnic Institute. The association with the Polytechnic Institute, the oldest and most prestigious institute of higher education in the city, not only provides the school with good facilities and a desirable downtown location but, most important, will give it more independence in defining its program and operating as a private commercial entity.

HCS's director recognizes that all segments of the population need to be re-educated as part of the transition from a centralized to a market economy, and the school is attempting to provide programs that respond to this need. At this time, staff qualified to conduct the training is the scarcest resource and the main constraint to further expansion of the program.

Courses at HCS are targeted toward training practicing entrepreneurs. The school recognizes that individuals in this category cannot afford to leave their enterprises for very long, so they offer concentrated one- to two-month courses. Their programs cover five basic areas: business management, commercial activity, finance, foreign trade, and conversational and business English. By the end of each course, students are required to prepare a written thesis on practical problem solving, such as preparing the documents for a joint venture. Many of the trainees are repeat students who take several courses. About 30 percent of all students are from private sector businesses, and approximately half are women.

The business management and foreign trade courses are among the most popular, especially since HCS is the only school offering a course on conducting foreign trade. Where possible, fees for these courses must be paid in hard currency to cover the school's overseas staff training expenses. Staff are sent to England, Canada, Japan, and Korea for training, as well as to Moscow.

HCS has 20 full-time staff and hires an additional 50 to 70 teachers each year on a contract basis. All of its courses are offered on a fee basis, and most of the courses contain 25 students or fewer. The school also sponsors workshops and seminars utilizing foreign specialists from Japan and Korea. HCS strives to keep the program as up to date as possible, and it regularly updates its curriculum to reflect changing legal and economic conditions. Next year, HCS plans to open a college offering an 18-month program in foreign economic relations for students already holding a bachelor's degree. This program will resemble the joint program currently offered by Far Eastern State University and the University of Maryland, and will include overseas practical experience.

**Program Implications.** The initial assessment of the High Commercial School is that it appears to be the local institution that comes closest to providing the type of short, practically-oriented business training courses envisioned under the proposed A.I.D. small business program. One issue that remains to be clarified is how much of the program is currently targeted toward the needs of small private businesses as opposed to training managers to function in privatizing state enterprises. Regardless, the HCS is in the business of training people to work in the market economy. If given assistance in developing an appropriate curriculum and training staff, HCS would probably be able to implement an ongoing program effectively. In December, the consultants and trainers for the three-day workshop will assess in more depth HCS's capacity for and interest in collaborating on a longer-term training project with A.I.D.

### **International Business Center**

The International Business Center is an integral part of the Great Vladivostok Project being proposed by the Japanese with UNIDO's support. The proposal is spearheaded by the Japanese Ministry of Industry and Trade and the Small and Medium Industry Association; the key Russian counterpart is the Anti-Monopoly Committee. The project envisions Vladivostok as the stepping stone to the rest of the Russian Far East, with the International Business Center serving as the hub for developing information on commercial opportunities across ten provinces. The Center is also intended to sponsor seminars and exchange programs, provide training, disseminate information on new technologies, identify joint venture partners, and analyze tax and other policy issues affecting small business. The Russians will provide space for the Center and cover local expenses, while the Japanese will cover the costs of foreign specialists and other expenses incurred overseas.

The Center is still in the design stage, with important details yet to be worked out — including the ownership structure. The Japanese envision the Center as a non-profit organization that will provide training and technical assistance while helping to develop critical information about the structure of present and potential markets and investment opportunities in the Russian Far East. The Russians want to set it up as a for-profit joint stock company over which they retain primary ownership and control. Finally, the level and timing of funding allocations for the development of the Center are also somewhat uncertain.

**Program Implications.** Assuming the design goes ahead as planned, it is likely that the International Business Center will offer training and advisory services useful to private small business, although it remains unclear whether the main focus will be on small enterprises resulting from the privatization of large state enterprises or on emerging new businesses. In any event, serious start-up of the technical assistance portion is unlikely to occur before April, the beginning of the Japanese fiscal year. Once the Center begins to take shape, A.I.D. can assess the option of supporting its training function in some capacity, but waiting for the resolution of the many issues surrounding development of the Center would slow implementation of A.I.D.'s efforts in this area unnecessarily.<sup>1</sup> There is also the

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<sup>1</sup> Discussions appear to be underway between the Russians and representatives of the U.S. government in Moscow concerning the larger question of the desirability of U.S. involvement as a co-founder in this undertaking, and there are some indications that the United States may not wish to participate in that capacity.

danger that the Center may be too closely associated with state agencies and, in turn, it may suffer from an image problem that would discourage entrepreneurs from seeking its services.

## **ANNA**

The women's organization ANNA was established in November 1990 as a charitable and commercial organization. ANNA is a dynamic money-making enterprise, founded and run by well-connected women, many of whom previously held positions in the regional or municipal government. ANNA's directors serve as the heads of major organizations in Vladivostok, including Gum Department Store, Promstroi Bank, and the Primorski Regional Pharmaceutical Administration.

The central mission of this innovative organization is to reach out to women throughout the Russian Far East and provide investment capital to support women-headed joint ventures; training and medical services on a commercial basis; and charitable support to families with multiple children, orphanages, the handicapped, veterans, and other disadvantaged groups. In addition, ANNA publishes a monthly newspaper with a current circulation of 40,000.

Structured as a collective, ANNA has six initial founders, including the Russian Red Cross, that contributed in equal shares a total of R 40,000 in start-up capital to cover operating expenses and fund the organization's first trade mission. Currently, ANNA has 38 members. Membership is open, with the only requirement being that members must represent enterprises that employ primarily women. ANNA receives no money or special tax breaks from the state; rather, the commercial ventures fund the charitable activities.

As is the case with many of Russia's new businesses, ANNA's commercial operations are diverse. To date, ANNA has provided the start-up capital for four joint ventures: a trading house, an auditing firm, a company producing medicinal creams, and a sewing workshop. The trading operation is the most profitable part of ANNA's portfolio. Trade in clothing, household appliances, shoes, and foodstuffs takes place between Moscow, St. Petersburg, former Soviet republics, and China, primarily in the form of barter. A typical transaction involves supplying a textile factory in Moscow with canned fish and noodles from China in exchange for textiles that are then used in ANNA's sewing workshops. More recently, ANNA has also been involved in foreign tourism, primarily receiving foreign business delegations and arranging programs, accommodations, and interpreters. ANNA's members are also trying to develop home-based activities in garment manufacturing and silicon chip welding, and they are planning to establish a babysitting service.

ANNA charges fees for its training courses, with exceptions made for disadvantaged groups; training has become ANNA's second most profitable undertaking. Courses focus on preparing women for work in the service sector and developing skills for management positions in industry. At present, it does not have a course that focuses on skills required for starting and operating a private business, but it is interested in developing such a course modeled after a program at the School of Women Entrepreneurship. ANNA also provides some job retraining courses and job referral services, although this is not a major part of its activity. All of ANNA's courses include a component on women's issues,

covering topics related to health, nutrition, cosmetics, fashion, and home economics.<sup>2</sup> ANNA hires instructors on a contract basis and has utilized more than 2,000 specialists to date.

ANNA's newspaper includes an information exchange where new businesses introduce their services. It also includes professional columns by doctors and lawyers; tips on cooking, sewing, and cleaning; literary pieces; and personal advertisements from men seeking female partners. Politics and current events are deliberately eschewed. For the first six months, the paper operated at a profit, but operating costs have increased substantially and it now operates at a loss. Nonetheless, ANNA continues to expand the circulation, considering the paper one of its primary vehicles for reaching and supporting women.

Finance has not been a constraint to the expansion of the organization, in part because the director of Promstroi Bank is one of the members of ANNA's management board. In the past two years, ANNA has obtained credits totaling R 68 million at highly favorable annual interest rates — around 27 percent. Most of the credit is used to purchase goods for trade. The organization has flourished during its first two years and has just moved from a single office in the Regional Education Center to a building leased from the municipality on favorable terms. In return for completing extensive renovation of this downtown property, ANNA will pay only utilities for five years, with an option to buy after that time. The new building will allow ANNA to house all of its functions under one roof for the first time.

**Program Implications.** Given the diverse nature of ANNA's commercial operations and its primary focus on women, it is unlikely that the organization would be appropriate as the principal institutional base for developing a long-term training capacity. At the same time, ANNA is a relatively well-known organization, especially among women, and it is respected for the training and other social services it provides. Moreover, its monthly newspaper is an important vehicle for outreach to women. Probably the best way to work with this organization is by supporting its efforts to develop a training course on starting and operating a small private business. Representatives of ANNA will be invited to participate in a three-day seminar in December, and they will be asked to identify other women entrepreneurs to attend it. Another possibility is to work with ANNA on developing a column in its monthly newspaper focusing on small business issues and providing information on where to go for specific kinds of assistance.

### **Peace Corps Small Enterprise Development Program**

Peace Corps is already well known in the Vladivostok area. Most of the individuals and institutions visited by the GEMINI team had heard of Peace Corps. Support was expressed for Peace Corps' intention to place some volunteers in enterprises, in the belief that this will have more direct

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<sup>2</sup> ANNA's health care center provides treatment to disadvantaged groups and offers other services on a commercial basis, such as acupuncture, massage treatments, and weight reduction courses. ANNA also provides direct financial assistance for the medical treatment of children.

impact than if benefits are dissipated by going through government channels.<sup>3</sup> By working on a long-term basis with counterparts, others see Peace Corps as being able to overcome the limitations associated with short-term consultants unfamiliar with Russia.

Peace Corps' SED program faces considerable challenges in meeting these high expectations. Peace Corps' initial program design proposed creating semi-autonomous Small Business Centers attached to municipalities but working on a regional basis.<sup>4</sup> Four volunteers and counterparts were to operate each Center, and a network of other volunteers were to be assigned to municipalities throughout the region to provide a range of SED-related services to local governments, training institutions, independent farmers, and entrepreneurs. However, Peace Corps has decided to back away from this type of concerted approach, citing the difficulties in identifying appropriate counterparts in Russia's complex political and economic environment.

Rather than planning and implementing a comprehensive program of Small Business Centers at this time, Peace Corps has shifted the current emphasis onto finding individual placements for most volunteers; information and experience gathered from the first volunteers in the Russian Far East will be used to develop and refine a longer-term SED program. The first volunteers are scheduled to arrive in November and, after undergoing three months of pre-service training, will be assigned to Vladivostok, Nakhodka, and Khabarovsk, as well as to other communities in Primorski and Khabarovsk krays. Volunteers will work in a variety of regional and institutional contexts, including local government, educational institutions, financial institutions, and private companies. Volunteers will organize and conduct management training programs, advise on developing and implementing privatization legislation,

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<sup>3</sup> Though local support for this approach is high, there are some factors that should be considered. First, firms receiving the services of a skilled salary- and tax-free employee for two years are placed in a distinct competitive advantage over other firms. Second, there is the question of whether truly small firms, the ostensible target group of Peace Corps services, can make effective use of a full-time volunteer for a two-year period. If not, the volunteers may need to be moved around repeatedly.

<sup>4</sup> Smith, Timothy J., "Small Enterprise Development in Russia: An Assessment of Programming Opportunities for Peace Corps Volunteers," prepared for the U.S. Peace Corps, April 1992.

assist in the development of banking efforts, provide direct technical assistance to entrepreneurs, and collect information about the small business sector through market surveys.<sup>5</sup>

**Program Implications.** Given the challenges Peace Corps is facing in mounting its own program, it is doubtful there will be significant opportunities for immediate collaboration with A.I.D. Furthermore, to the extent that volunteers are placed in individual firms, it will be hard to tap into them as a source of expertise available for providing assistance more broadly in conjunction with an A.I.D.-funded program. If Peace Corps eventually moves in the direction of establishing business centers, such centers could complement or augment the services available through the Business Advisory Services Office proposed by this team or, alternately, Peace Corps may view BASO as an appropriate institution for placing volunteers. Ultimately, the shared SED focus of Peace Corps and A.I.D. makes coordination of their efforts indispensable and unavoidable.

### Chamber of Commerce and Industry

Under the former communist government, the Chamber of Commerce served as the primary vehicle for helping selected state enterprises form linkages with overseas partners in key industries. More recently, the Chamber has been attempting to redefine its mission and target audience as part of its efforts to play a broader role in promoting business development in a market economy. The many new foreign trade associations that have recently emerged are competing to attract enterprises and develop foreign trade partners, causing the Chamber to intensify its efforts to attract the membership of a growing private business sector.<sup>6</sup>

Although the Chamber has traditionally focused on large state enterprises, it is increasingly paying attention to the needs of smaller businesses. The Chamber distinguishes between two categories of private business — those that are temporary, marking the transitional phase the economy is going through, and those that are established with a view toward permanence. Firms in the latter category are the main target membership for the Chamber.

Among the short-lived firms are many of those created through the privatization of state industry; the Chamber views these as "artificial," in the sense that, in effect, they have been created by decree. The new managers or directors of these firms do not become businesspersons overnight and, even when workers participate in the purchase of these enterprises, they do not really understand what their role is

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<sup>5</sup> As one example, Peace Corps will be developing business training programs at Vladivostok's Far Eastern Maritime Academy. In addition to its traditional curriculum in transportation, shipping, and marine biology, the Academy has expressed interest in strengthening its fledgling School of Management and Center for Small Business Development. Peace Corps has signed a Memorandum of Understanding with the Academy to place several volunteers there in the next few months. The volunteers will work with the Academy to develop business management courses and collect business information. Courses are scheduled to begin in the spring. Volunteers placed at the Academy will conduct some seminars, but for the most part they will be involved in setting up systems and training trainers for a business management program offering courses to a wide audience.

<sup>6</sup> See note, in the overview section in the main text, on the usage of the term "association."

52

in influencing its operation and development. The Chamber's assumption is that many of these enterprises will not survive. Also among the transitory firms are many traders and middlemen who, to avoid paying high taxes, were closing down their new businesses as soon as they realized their first profit and registering a new business a few weeks later in another district. According to the tax authorities, between three and five small enterprises register each day in the city of Vladivostok, while two to four close.

In the Chamber's estimation, the more "permanent" enterprises are newly established small businesses in which entrepreneurs are forced to operate in a true market economy from the beginning. These face the most difficult situation. Typically, they must pay high rents and high interest rates for credit. They do not have the benefit of established linkages to former state enterprises but must secure equipment, inputs, finance, and markets by utilizing their own resources. If they approach a state enterprise to purchase machinery or equipment, they are charged high prices. In addition, they encounter high transportation costs and substantial obstacles from the tax committee if they attempt to engage in foreign trade. These are the clients now beginning to approach the Chamber for assistance in drawing up business charters; obtaining information on training, market opportunities, and laws and regulations; and identifying potential overseas business partners.

The Chamber sees an acute need to develop reliable sources of information on business and economic issues, develop a new class of entrepreneurs who are prepared to take business risks, and train individuals in how to perform in a market economy. At present, the Chamber acknowledges that most of the available business training takes place under corporate sponsorship, largely for those under the age of 25 — thus ignoring a large segment of the population — and it believes that most of the courses being offered by local institutions are too theoretical.

**Program Implications.** The Chamber of Commerce is an institution in transition. Although its director is a holdover from the communist period, other staff appear to be more progressive, and they have a better understanding of the challenges posed in a market economy. At this time, however, it is still unclear to what extent the Chamber will be successful in divesting itself of its former image in exchange for becoming an advisory and advocacy organization for the new private sector. At least for the time being, the Chamber is likely to continue emphasizing its work with larger firms that are seeking export opportunities.

### **Far Eastern State University**

The Far Eastern State University (FESU) was one of the first institutes of higher education in the Russian Far East. Opened as the Oriental Studies Institute in 1899, it became FESU in 1920, closed in 1939, and re-opened in 1956. FESU has an enrollment of about 8,000 students, about half of them full-time. The university offers programs in mathematics, science, law, journalism, history, oriental studies, English, and Russian. Last year, FESU added a new faculty to create the Joint Program of International Economic Relations and Management, offered in conjunction with the University of Maryland. This is a fairly sophisticated expensive four-year program designed to educate and provide international experience to a select group of individuals who are sponsored by large enterprises from the region. Connections are important in being selected for this program. The American portion of the program costs US\$ 10,000 and must be paid in hard currency, effectively precluding enrollment without a sponsor.

— 57

Students graduating from the program receive two degrees, one from FESU in international economic relations and the other a B.A. degree in management from the University of Maryland. The first two years of the program are in Russian and include intensive study in English. The second two years are taught in English and include a one-month practical assignment in Tokyo or the United States. Students write a thesis in Russian and in English, which they must defend before a joint committee.

The program's full-time staff includes thirteen Russians and ten Americans. Half of the U.S. professors spend the first semester at the State University in Irkutsk and exchange places with their colleagues in Vladivostok for the second semester. Additional specialists are recruited as needed.

In addition, FESU has been involved with Alaska Pacific University in organizing week-long seminars for business leaders. The first of these, held last year, was attended by 100 people. The second will take place this fall. The view of the FESU staff is that joint efforts are preferable to those conducted only by foreigners who may have useful skills but are not familiar with Russian laws and context.

**Program Implications.** FESU's program is breaking new ground in terms of developing university-level programs designed to educate the next generation of Russia's private sector managers. The program is already serving as a model to other institutions trying to develop a similar curriculum and linkages with institutions overseas. However, the program is virtually inaccessible to actual and potential small business owners. There is no short-course structure at FESU and tuition for the Joint Program is prohibitive. When asked whether there would be interest in developing training targeted to small entrepreneurs, FESU's staff has indicated that their priority is launching and refining the Joint Program, and they are unwilling to divert resources from this task. However, FESU staff occasionally lecture at the Regional Education Center; it is possible the visiting American lecturers could also conduct some short-term training programs at other local institutions. The fact that the same staff lecture at a number of institutions allows for the possibility of achieving some real leverage by training trainers and developing a set of materials that have applicability in a variety of program settings.

### **The Vladivostok Labor Exchange**

The function of the Labor Exchange has changed substantially since June 1991. Prior to that time, the emphasis of the Exchange focused on finding employees for openings at state enterprises. Enterprises paid for this service and training was not part of the Exchange's activities. With the deepening economic crisis and increasing unemployment, the Exchange has started administering unemployment benefits, providing welfare services, and offering training. The large quarters allocated to this office in a former military laboratory testify to the increasing importance of the Exchange's functions.

The Exchange serves the city of Vladivostok, and a separate Primorski Kray Labor Exchange serves the rural areas and other areas outside the jurisdictions of other district or municipal Exchanges. There are 35 Labor Exchanges in the kray, one for each district and city.

As the privatization process proceeds, the Labor Exchange is the primary branch of the state charged with providing relief and job placement services to displaced workers. Two months before an enterprise is going to be closed, it must supply the Exchange with a list of all employees who are

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going to lose their jobs. Once an employee is let go, he or she registers for benefits and begins searching for new employment. Three months of severance pay are covered by the former enterprise; thereafter, the former employee is eligible for unemployment compensation for an additional 12 months.<sup>7</sup>

One of the primary functions of the Labor Exchange is to assist displaced workers in acquiring the skills necessary for new jobs. Most of the Exchange's recent trainees have been women — who constitute 79 percent of the individuals registered as unemployed. The Exchange has relationships established with a number of institutions that provide specialized training in accounting, sewing, and other skills that are in demand. Much of the training focuses on skills required in the service sector as new openings are created by the decline of state-provided services. The Center generally will not provide training for individuals within two years of retirement age, which excludes a large number of women over 50 who are displaced from their jobs.

The Exchange reports that an increasing number of young people are choosing not to finish formal courses of study as they see their peers unable to find jobs. Before, when students graduated, they were hired by one of the state enterprises, where they worked for at least two or three years, but now such appointments are no longer automatic. As a result, many students are dropping out of school and trying to go into business, which for most of them involves engaging in petty trade in the streets. During the summer months, the class of recent graduates is considered to be on "summer vacation," but by the end of September, all those who have not found jobs will be added to the number of unemployed. The staff of the Labor Exchange is beginning to develop outreach services for young people by visiting high schools and universities to talk to students about ways to find a job and discuss with them the specialties and industries in which there are likely to be opportunities.

The Exchange is trying to develop its sources of information and its ability to forecast employment demands of different segments of the economy. Two key sources the Exchange relies on for information are the Industry Planning Commission, which compiles data by sector and prepares annual reports, and the Registration Office, where new businesses are required to register. However, obtaining accurate information is complicated by the fact that most state enterprises are slated for privatization in the near future and it is unclear to what extent they will continue to be involved in the same line of production. Furthermore, new private businesses tend to be set up with very broad charters — making it difficult to discern what kinds of skills will be in demand — and tend to locate new employees themselves rather than contacting the Exchange. As a result, frequently the only time the Exchange hears from private businesses is when they are failing and their employees come seeking assistance.

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<sup>7</sup> An unemployed worker receives 75 percent of previous monthly salary for the first 3 months and 40 percent in subsequent months. Benefits are calculated by averaging the last two months' pay. Benefits cannot be less than minimum wage, which is currently R 900 per month but scheduled to increase to R 1,300 in the near future. For individuals who lose their job within two years of retirement, the Labor Exchange provides early retirement by paying their pension until they are eligible for regular retirement benefits from the state. The usual retirement age is 55 for women and 60 for men, although this varies by industry. Retirement age for military personnel is 45.

Currently, funding for the Exchange is raised through a 1 percent payroll tax paid into an Employment Fund by all enterprises. Every business except state universities, military enterprises, and enterprises employing high numbers of handicapped people must contribute to this fund. Although the level of funding has been sufficient to cover the program to date, the Exchange's costs are projected to increase.

The Exchange is obtaining computer equipment and automating its accounting department, and has plans to establish computerized links with the employment offices of state enterprises, which should facilitate monitoring the numbers of laid-off and re-employed workers. It is not clear, however, whether this linkage will serve any useful function when state enterprises are privatized.

**Program Implications.** The Labor Exchange is attempting to cope with the immediate unemployment repercussions of privatization and economic change. It is not directly involved in training and it is unlikely to develop that capacity. The main way in which the Labor Exchange can link with the proposed A.I.D. program is by serving as a key information and referral point for disseminating information about business skills workshops, training programs, and the Business Advisory Services Office.

### **Women's Protection Committee**

The Women's Protection Committee (WPC) is a state organization that was established about four years ago, under the Communist Party's auspices, to provide charitable support to women with large numbers of children, unemployed women, poor women, women heads of households, and women who have suffered some other disaster. The committee is headed by a full-time director and includes 24 other women from a variety of backgrounds, including doctors, engineers and teachers. Women's committees in state enterprises and local women's groups elect representatives to serve on the WPC. The committee represents an estimated 300,000 women in the Vladivostok area.

Women requiring assistance apply to the central WPC committee, which screens them and certifies their eligibility for benefits from their local committee. Assistance is primarily in the form of clothing and food supplies (for example, rice and milk). The committees also provide assistance in trying to help unemployed women find work, often simply by putting them in contact with the Labor Exchange. They will also assist women to take legal recourse in situations where they believe they have been unfairly terminated from a job and, apparently, they provide some assistance to women wishing to open stores and start private businesses. They also help women learn to sew and make handicrafts which can be sold at the WPC's store or exchanged for other clothing items. However, these skills are taught on an ad hoc basis. The WPC has plans to start giving classes in knitting and sewing, but it has no program at this time.

The central WPC receives approximately R 30,000 per year from the state government and an additional R 15,000 from individual state enterprises, and it raises around R 10,000 rubles per month in sales. WPC is also supported by charitable donations from abroad, primarily by the Japanese who donate food, clothing, and handicraft materials. The committee has been approached by Catholic Relief Services, which may provide support in the future. Other U.S. organizations are not providing support at this time. WPC estimates that approximately 50 percent of its income goes to services and the balance

covers its operating expenses. Local committees also have funds available from local enterprises, which are used to provide direct support to eligible women.

**Program Implications.** WPC is a charitable organization that does not provide any type of training or services on an established basis. It does not have a forward-looking agenda for assisting women to become involved in private small business activities, and it acknowledges a lack of staff expertise to address the problems associated with the country's economic changes. WPC could benefit from assistance in developing a handicrafts skills training program, but it has expressed a preference for receiving donations to further support its charitable activities.

### **The Social and Economic City Development Association**

In 1990, the Social and Economic City Development Association was founded as a private entity to make investments in key development projects in the city. More a limited partnership than an open membership association, the Association was founded by large state industrial enterprises that paid R 11,000 to join. Many of its founding members were involved in military production and all of them are now slated for privatization. Among the key members are the City of Vladivostok, the city's Telephone Exchange, the Vladivostok Shipyard, the Port of Vladivostok, and the Promstroi Bank. The head of the Association is a former mayor of Vladivostok.

The original intent was for the founders to pool resources to finance urban development projects. The Association's proposed ventures include constructing marketplace infrastructure in the city's center for informal and small businesses involved in trade, developing an auto market, and developing a US\$ 3.5 billion marine and air terminal complex. The Association has been granted a two-year tax exemption by local government, and any profits resulting from these ventures are pro-rated for each member's respective investment. In fact, with the deteriorating economic situation and the rising debt burden of most state enterprises, investment resources have not materialized, most of the Association's proposed projects have stalled, and the members are now trying to identify outside investors.

The Association's involvement with small private business is tangential at best. The marketplace scheme is promoted as facilitating small business activities but, in fact, will result largely in regulating the activities of informal vendors. Under the scheme, the Association will lease four hectares of land from the city for ten years at a low price, and in turn it will auction or lease spaces for a year at a time to small businesses and traders. The Association expects to realize a return on its investment within six months of operation.

**Program Implications.** The Association exemplifies one of the emerging types of enterprise structures being created to pursue investment opportunities in the evolving private sector. Founded by influential members of the former and present administration and key industries, the Association capitalizes on the connections of its well-positioned members, thus maintaining an advantage over new small businesses that lack these connections. While the Association could be a good contact for donor-assisted programs interested in military conversion, it is unlikely to provide support to the proposed A.I.D. small business program.

41

**ANNEX C**  
**GENDER ISSUES AND SMALL ENTERPRISES DEVELOPMENT**

## ANNEX C

### GENDER ISSUES AND SMALL ENTERPRISES DEVELOPMENT

Gender analysis requires a focus on the social environment and on the men and women who are entrepreneurs and employees in small businesses. In which sectors are they found? What barriers do they face? What benefits do they reap? What is the relationship between broad patterns of social change and small business? What are the differences between men and women in the opportunities to become entrepreneurs and to take advantage of new jobs?

#### BACKGROUND

The literature on women and gender relations in the Soviet Union has pointed to dual and, at times, contradictory roles in the work place and the home.<sup>1</sup> The strong ideological stance for gender equality resulted in the participation of women in the work force at a rate equal to men and in public commitment to support services like day care, nurseries, and medical facilities. Employment was a natural part of a woman's routine and a necessity for supporting the family. Equal pay for equal work was the operative principle, but gender segregation in the work place, by industry and occupation, meant that men and women were rarely in the same jobs and women tended to be in the lower-paid positions. At the same time, the "double shift" of Soviet women — working full time and having the major responsibility for the household — is well known. Household responsibilities and gender relations in the family remained very traditional in spite of women's employment. Hedryck Smith quotes one woman as joking:

Under capitalism, women are not liberated because they have no opportunity to work. They have to stay at home, go shopping, do the cooking, keep house and take care of the children. But under socialism, women are liberated. They have the opportunity to work all day, and then go home, do the shopping, do the cooking, keep house and take care of the children.<sup>2</sup>

The current disruption and restructuring in the economic and social system could, hypothetically, lead to a breakdown of gender stereotypes or to retrenchment and increasing reliance on traditional attitudes and gender division of labor. Initial impressions suggest that, at least in terms of the labor market, the latter pattern will dominate in Vladivostok as it has in Eastern Europe.<sup>3</sup> In retraining

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<sup>1</sup> As one example, see Gray, F., *Soviet Women Walking the Tightrope*, 1990.

<sup>2</sup> Smith, Hedryck, *The New Russians*, New York: Avon Books, 1990, p. 183.

<sup>3</sup> "Women in the Newly Emerging Democracies of Eastern Europe: Phase I," Coopers and Lybrand, May 1991.

programs and planned entrepreneurship activities, traditional gender roles predominate. In terms of family roles and private lives, the most likely hypothesis is that the hardships accompanying economic transformation, such as inflation, cutbacks in public services, and unemployment, will increase the reliance on women for the care of home and children and will force the family to fall back onto informal and non-market mechanisms for household support.

The hypotheses presented here about the relationship between gender and patterns of change are based on observations of an economy and a society that are in flux. Minimal data are available to document the nature of the changes and there is a strong sense that the structures are unsettled. On the other hand, it is clear that the processes we are observing are not gender-neutral and that A.I.D. project inputs will be affected by — and will possibly influence — gender relations and roles. The principal recommendation of this study is to use the hypotheses to monitor the process and to be aware of gender as an important factor as the project develops.

This annex touches on two aspects of the relationship between the economic transformation and gender: in the work place — in terms of displaced workers, the privatization process, and emerging business structures; and in the family — in terms of support services, informal markets, and other mechanisms to support the family. Next, it examines the interaction between gender and the proposed project inputs, especially in terms of women as entrepreneurs and employees in new businesses. Finally, it offers specific recommendations for integrating gender into the project as it develops.

### **ECONOMIC TRANSFORMATION AND THE WORK PLACE**

In January 1992, women made up 52 percent of Vladivostok's work force and 51 percent of the population. With the shift in the economy, however, employment has declined in Vladivostok, from 322,915 in 1989 to 317,982 in 1991. Last year, 4,795 jobs were cut by enterprises in the city, and women are losing their jobs at a much higher rate than men.

## Displaced Workers

Through the first eight months of 1992, 75 percent of the 7,200 people registered as unemployed at the Vladivostok Employment Exchange Office were women.<sup>4</sup> Women are losing their jobs because the industries that are cutting back on employees, especially scientific research laboratories, employ mostly women. The pattern of more women than men losing their jobs is expected to continue, with cuts in engineering in the large state industrial firms and privatization of small public enterprises in the service sector. Most engineers in these firms are women — so the cuts will affect more women than men. The director of the Employment Exchange has suggested that women might be adversely affected as large enterprises let some workers go in order to raise the salaries of remaining employees to keep pace with inflation. In addition to the unemployed, according to the municipal Office of Economic and Social Planning, there are 20,000 people of working age in Vladivostok who are not working and are not registered.

Unemployed women do not constitute a homogeneous group. Those registered with the Employment Exchange Office include women who lost jobs because of industry cutbacks, recent university graduates who have been unable to find employment, and women returning from maternity leave or retirement. Women make up 79 percent of employees cut from large industry, and the majority appear to be women age 50 or more. They are highly educated — primarily engineers, instructors in production and design institutes, economists, trade inspectors, and the like. Because the retirement age for women is 55, many will be given early retirement or will simply drop out of the labor force. New job placement by the Labor Exchange must be at an educational and salary level commensurate with the previous job. Younger women in this group will be prime candidates for retraining.

Anecdotal evidence suggests that privatization of small trade and service enterprises will result in loss of jobs for technical workers and service employees. Again, women predominate among this group. This group of employees may be eligible for retraining and a small percentage may become entrepreneurs in the trade and service sectors.

Among university graduates, women are having a harder time locating employment than men. According to the director of the Labor Exchange, employers who now have more latitude in selecting employees prefer to hire experienced people and prefer men over women. The areas of specialization of women, such as engineers, economists, and pediatricians, are not in demand. The expanding areas in the local economy are manual labor and skilled trades such as carpentry and welding, particularly in

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<sup>4</sup> The Labor Exchange opened in June 1991. It assists unemployed people in finding jobs, pays welfare to those who cannot locate employment, and sponsors retraining programs for some workers who have been laid off. Every enterprise must pay 1 percent of its payroll into the fund to support the local Employment Exchange Office. These offices replaced the Employment Bureaus that were responsible for job placements under the previous full employment system. By law, two months before a layoff, an enterprise must give the local Employment Exchange Office the names of those who will be unemployed. The unemployed people then contact the Office directly. They receive three months of severance pay from their previous employer while the Employment Office assists them in finding a new job. If no job is found, the Employment Office takes over "welfare" payments for the next 12 months. Workers selected for retraining programs supported by the Employment Office receive payments during training.

construction and ship repair. Both are regarded as men's fields. The municipal Office of Economic and Social Planning reports 9,000 unfilled jobs in the city, but most are manual labor jobs such as garden watering, street sweeping, garbage collection, and construction.

Two groups of women who are technically not in the labor force — pensioners and those on maternity leave — have been registering with the Employment Exchange in increasing numbers. In spite of increases, maternity benefits and pensions have not kept pace with inflation. Women are entitled to three years of maternity leave and are guaranteed a position with their previous employers upon return. They may work part time during this period, and they are the major source of employees for positions such as sales in kiosks.

While some in these groups are seeking formal employment, others are engaging increasingly in supplemental income-generating activities in the informal market (for example, selling garden surplus, sewing at home, and caring for children). A recent article in the *New York Times* describes the increasing dependence of a family in Moscow on the wife's new-found skill to generate income at home by sewing for neighbors.<sup>5</sup> These are not new activities, but their prevalence seems to be growing, and formalizing these activities could be a new arena for entrepreneurship. The manager of ANNA said that their organization is planning to start a babysitting service, for example, and is looking at the possibility of developing a network of homeworkers in textiles.<sup>6</sup>

The evidence suggests a strong disjuncture between the training, salary, and capabilities of the women who are unemployed and the available positions in the economy. The options for many highly educated women faced with cutbacks appear to be either to drop out of the labor force or to be retrained in a less skilled occupation. This perception is in part a function of the public program of the Labor Exchange that assists displaced workers in finding new jobs through its contacts with large state enterprises. The Labor Exchange also pays for retraining of selected displaced workers. Projections of employment demand and training needs are also based on information from large industries.

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<sup>5</sup> *New York Times*, July 20, 1992.

<sup>6</sup> ANNA is a "commercial charitable" organization, started in November 1990 by the Red Cross and a small group of well-placed women representing powerful institutions in the city (such as the central department store, the territorial pharmaceutical administration, hotels, and the Promstroi Bank). ANNA was modeled on a similar organization in Moscow to support women in the private sector and to support the development of women-owned enterprises. It is the only organization we found in Vladivostok that has an explicit mandate to work with women in business. It is linked to a network of women's business organizations in other cities of Russia and to international programs in Japan and the United States. Activities include training programs for displaced workers, a medical center for women and children, a monthly women's newspaper with a circulation of 45,000, and starting of new joint enterprises with women entrepreneurs. ANNA assists by providing start-up capital. The new enterprises to date are an auditing firm, a trading house (with goods from central Asia, Moscow, the former republics, and China), a sewing workshop, and a company to develop and produce cosmetics.

The private sector and small businesses may offer an alternative for displaced women workers, either as entrepreneurs or as employees, but information about these businesses is not fed into the public program. According to the Employment Exchange's director, most small private businesses find their own employees without consulting the listing of people available through the Exchange, and planning documents developed by the municipal office of Economic and Social Planning do not take into account the activities and employment needs of the private sector. New business charters are so broad that little can be gleaned for planning purposes from the stated activities of the firms, and data-gathering instruments for the private firms are not as well established as they are for the state firms. Data on number of employees, for example, are collected annually and are not disaggregated by occupation or by full- or part-time workers.

In interviews with entrepreneurs, we were told they recruit their key employees through personal channels, preferring to hire relatives and acquaintances. For non-professional positions, such as sales clerks, chamber maids, and drivers, newspaper advertising is used. In all cases, new employees had been hired away from other jobs rather than from the ranks of the unemployed.

Private employers report that they pay more than state industries but also demand stronger performance on the job. Several indicate that they are seeking young employees (one tourist agent said that he will hire only people under age 30), and that they prefer to train new employees on the job.

### **Privatization**

Privatization in Vladivostok is only beginning. A principal impact of the process, at least in its initial stages, is a contraction of the service sector, because most of the firms to go through the process first are small service enterprises such as restaurants and repair services. Privatized businesses are required to continue their previous activities for one year but many will change their functions after this time.

Later, the privatization of the large state industries through subdivision by functions may further affect provision of services. Many hotels, restaurants, day care centers, laundries, and the like are currently part of the large enterprises. These may be privatized as separate entities or dropped as unprofitable.

This process may affect women in two ways. First, women employed in service enterprises will lose their jobs. As in the case of cutbacks by large industries, many are highly qualified, skilled workers. Second, the void in the service sector may provide a primary arena for women entrepreneurs to develop new businesses. This possibility was specifically cited by the director of the municipal Office of Economic and Social Planning. As examples of potential business opportunities for women, she listed hotels, restaurants, laundries, auditing firms, retail trade, tourism, and health. Clearly, the perception of opportunities for women in these fields are linked to women's traditional occupations and activities.

The emerging opportunities for business development in the service sector are not without problems. These new enterprises may face particular barriers to profitability and growth. Services have been highly subsidized; many are being privatized now because they are losing money. Charging sufficient amounts to cover costs and make a profit may be difficult.

In the first six months of 1992, 2,052 new enterprises were registered. In a random selection of 40 of these enterprises, approximately 20 percent can be identified as directed by women (based on directors' names). Although their broad business charters make it difficult to identify actual activities, the listing shows that they are clearly linked to the service sector and to traditionally female fields — garment making, medicine, cosmetology, and tourism. In the entire sample, 59 percent of the 40 enterprises list commerce or trade among their activities, compared to two-thirds of the women-directed firms.

### **Job Structures**

The shift from a centrally planned to a market economy will require new job structures and networks. In the United States, gender stratification in the economy is not only horizontal — by occupation and industry — but also vertical — in terms of power, authority, and earnings. In Vladivostok, the new patterns will draw from the past in meeting the requirements of the capitalist system. Although hypotheses about the direction of change and the relationship to gender are very speculative, to the extent that traditional gender relationships predominate, women may be expected to lose ground relative to men in the shift to a market economy. For example, although women in the former Soviet Union were employed on an equal basis with men and many women were found in mid- and upper-level management in the bureaucracy, the top management positions in the economic and political structures were held by men. This pattern may be expected to continue and to become more exaggerated.

In discussing the newly established bilingual management degree program operated jointly by the University of Maryland and Far Eastern State University, the dean, a woman who has held high-level management positions in the university for many years, explained that women are a minority among the students because "no one wants to hire women as managers." (Out of the first 100 students, 31 are women. All students in the program must be sponsored by an enterprise in which they will be employed after graduation.) She explained that the perception is that management work is not suited to women because it often involves a lot of travel and women with young children are less reliable as employees. Also, husbands do not want their wives to be managers. She added, "I believe that a man will always be the director of the university."

Under the Soviet system, banking was completely dominated by women, both as employees and managers. Because the banks had no decision-making power, bank jobs were bureaucratic and low-paid. In a market economy, on the other hand, the bank is a central institution. In the Vladivostok branch of the Promstroi Bank, one of the oldest in Russia, the director and virtually all employees are women. Although the bank is attempting to increase efficiency through better management rather than by laying off workers, an effort is also being made to recruit men by offering higher salaries.

Given what we know about gender stratification in existing capitalist economies, these examples should alert us to possible patterns of change that might be avoided. For example, in the current environment there is no apparent link between gender stereotypes and entrepreneurship or between gender and the pervasive bias against "non-productive" businesses. In the future, if women predominate in the "non-productive" trade and service sectors, and men predominate in "production," an interaction between

gender and the cultural bias could work to the disadvantage of the service industry and of women entrepreneurs.

### ECONOMIC TRANSFORMATION AND FAMILY

A report from the Primorski Kray's Statistics Bureau suggests that social and economic disruptions are affecting private lives, as evidenced by a decline in the city's birthrate (21 percent lower in 1991 than in 1989), a decline in the number of marriages (from 8,413 in 1989 to 6,619 in 1991), and a steady high divorce rate. An income and expenditure survey of a sample of territory residents clearly documents the increasing disparity over the past two years between family income and costs. Food makes up an increasing portion of the family budget, and the types of food consumed have changed. Bread and fish consumption has increased, while that of fruits, meat, eggs, and oils has declined.

Changes in the family setting are important in examining the relationship between gender and business development because, especially for women, private lives and responsibilities impinge on employment and economic activities. The women we met in their professional roles talked about their responsibilities for family and home as key constraints in their work and as the principal barrier they faced as entrepreneurs compared with men. The link between women's dual roles is clearly acknowledged by ANNA, the only organization in Vladivostok directed explicitly to women in business. As a part of all technical training programs, ANNA includes classes on women's issues (cosmetics, health, nutrition, child care, and so forth).

Reports from Eastern Europe suggest that the rejection of socialism and a growing conservatism mean that women themselves are seeking exclusively traditional roles in care of home and children. We have no data on the extent to which this is occurring in Vladivostok. On the other hand, the shift from a planned to a market economy is forcing cutbacks in public services and in the structure that has supported working parents. At the very least, these cuts mean that women are bearing a disproportionate burden from the hardships accompanying this shift and that women will have to compensate for the decline in services by expanding what they do at home.

The Vladivostok City Women Council (or Women's Protection Society) was formed four years ago to help women in need. The council claims to represent about 300,000 women and is made up of representatives of women's committees in large enterprises and city district councils. The 24 women on the council are professionals, primarily from large state enterprises. When asked about the major problems facing women, they noted the shortage of goods and the fact that everything is very expensive. Also, women are not ready for the changes that are occurring; they do not know about business or have business skills. The women also cited the impact of factory closings and layoffs of women workers, although they noted that the council can do little to help women in these circumstances. As a council, they are involved primarily in relief work such as distribution of food and clothing. According to council members, the women suffering most from changes in the economy are single mothers and mothers in multi-children families. The council gives classes in sewing and knitting so that mothers can develop an independent source of income. It also makes referrals for job placement to the Labor Exchange.

62

An important factor is the potential cutbacks in social services — particularly in those that support working parents. Housing, day care, summer camp, schooling, medical care, and the like have been provided at minimal cost to ensure that women can be employed, although dissatisfaction with the quality of the services is a familiar theme in the literature about life in the former Soviet Union. Deficits in municipal budgets and privatization of state enterprises will undoubtedly lead to reductions in these services. Commercialization of the services will increase pressure on family incomes.

The director of the municipal Office of Social and Economic Planning reports that the city's budget deficit has reduced subsidies for kindergartens, schools, and housing. Data from the Primorski Statistics Bureau show a gradual reduction in the availability of day care, especially for the youngest children. The costs of day care for parents in public centers have increased, and some higher-priced private centers also have been opened.

Women may compensate for cutbacks in social services by dropping out of the labor force or by increasing their double shift. The traditional support of elderly parents and in-laws for young families is another structure frequently cited for household survival, and bartering is apparently common throughout the country.

## WOMEN IN BUSINESS

Official statistics offer no gender-disaggregated information on entrepreneurship or employment in small enterprises. (The only gender-disaggregated information we were able to collect was on unemployment, and some sparse data on employment by occupation in selected industries.) The anecdotes and hypotheses about women in business and potential gender-specific concerns are drawn from observations (often impressionistic) of officials involved with economic affairs and small business development and from conversations with women entrepreneurs. This overview has served to identify areas of potential importance in terms of women and business. A principal task of the project will be to gather data to verify or reject these hypotheses and to develop gender-disaggregated measures to monitor small business development.

Several people noted that, compared with men, women are relative newcomers to entrepreneurship and they are less savvy about its potential. According to one woman, this means that women have to be "more flexible, smarter, and more stubborn" than men in order to succeed. She noted that, while women have not been in leadership positions in industry, many have experience in running businesses, particularly in the service sector. Women have been trained as lawyers, women have been directors of stores and shops, and women have been responsible for staff management.

Women entrepreneurs said an important topic for training is assistance in identifying potential business opportunities. In 1991, the manager of ANNA attended a two-month School of Women Entrepreneurs at the Academy of National Industries in Moscow, which included visits to enterprises and training components specifically intended to suggest ideas for types of businesses.

6/8

The legitimacy of women in business was not questioned in our conversations in the way the role of women as managers was questioned. Women entrepreneurs spoke of the support of their husbands at home as essential to their ability to run businesses, but also noted that their husbands sometimes questioned their activities.

After praising her husband's help at home, one entrepreneur noted that "he sometimes sees this business as my hobby, even though my income is at least equal to his now." A businessman, while noting that his wife, "the capitalist in the family", started one of the first cooperative businesses in the city, joked that she would be a better wife if she did not have the business.

When questioned about where they had learned to run a business or about the training they had received for running a business, most responded that they had received none. They are learning by doing. They rely on their intelligence and knowledge of the field in which they are working, and they read the newspapers.

The major problems cited by entrepreneurs in business development are the constantly changing legal environment, lack of and cost of space, problems in hiring, and lack of information about markets. The need for hard currency, through trade, tourism, or foreign partners, is a constant theme.

The changing legal environment requires that all businesses have a lawyer on contract. (The entrepreneurs said they could not afford to have a lawyer on staff.) Legal consulting firms have developed to assist in business start-ups, and newspapers are an important source of information about new decrees and requirements.

Space limitations affect all businesses. Rents are high and, in general, only short-term leases are available. Space for production is a particular problem. Most property is still owned by public sector entities. To the extent that space is acquired through personal connections and bartering, women entering the service and trade sectors may be at a disadvantage relative to men, because they were less likely than men to have been in key power positions in the city and the associated networks.

Salaries are higher in private enterprises than in state industries, but all entrepreneurs commented on the problems of locating and holding competent and trustworthy employees. In general, they rely on personal channels and are hiring people away from other jobs rather than tapping the unemployed. Employers do their own training. They commented on the need to change attitudes toward work and customer service, and on training in the use of modern equipment. Employees in the private sector are linked into the state system of employee benefits. Private employers must register employees and take responsibility for their work records.

Gaps in information were cited as problems by several entrepreneurs. In addition to the need for updates on legal changes, business owners said that they need channels of information about markets and supplies. According to the women we met, there is no difference between men and women in access to information and supplies, in spite of the fact that supply channels in Russia tend to be very personalized, linked to personal contacts, and often involve bartering. Both men and women can be "supply specialists."

All the entrepreneurs interviewed have received credit. They emphasized that there are no differences in access to credit for men and women. Access depends entirely on the quality of the business and its capacity to meet the guarantee terms (and they perceived no link between these terms and gender). Access to credit has no relationship to personal or family finances. Problems noted in working with credit included the high interest rates, short term, and lack of flexibility. Credit is not available for routine operating expenses. Having cash on hand when needed for supplies is a constant problem, since prepayment in cash is now the norm.

One area to which little attention has been given is women in agriculture. Women are a major part of the labor force on the state farms. According to the local office of AKKOR, the association of independent farmers, women are prominent among the independent farmers as well. Fifteen to twenty percent of the members of the local branch are women, and women are active in AKKOR. Three of the four leaders at the territorial level are women and several of the district-level organizations are headed by women. Women can apply for and get land as independent farmers the same as men can, and there have been instances in which the family application has been approved with the woman listed as head of household.

Women are also the mainstay of the supply of fresh fruits and vegetables for home consumption and for sale in the farmers' markets. Speaking with women in the offices and in the markets, gardening is an essential but clearly secondary women's activity. It is a part of the woman's household maintenance task, accompanied by the need to can and preserve vegetables for the winter. Women are responsible for deciding when there is surplus and for selling it. Most women said that their husbands help them in the garden.

D-1

**ANNEX D**  
**PRIVATIZATION**

## ANNEX D

### PRIVATIZATION

#### THE PRIVATIZATION PROCESS

The following outlines the step-by-step procedures followed by the Privatization Committee (PC) to privatize the proposed 4,599 SOEs in Primorski Kray.

1. Enterprises to be privatized are registered with the State Assets Committee (SAC) one month prior to sales. Upon registration, the SAC reviews all applications to ensure that enterprises under consideration are not in sectors banned from privatization by the federal government.<sup>1</sup>
2. Upon passing SAC's review,<sup>2</sup> applications are transferred to the Privatization Committee, where the privatization plan is drafted.<sup>3</sup>
3. After the privatization plan is drafted, it is referred to the local Soviet of People's Deputies and to the enterprise's employees for approval.
4. After review from the Soviet of People's Deputies, the privatization plan must be approved by the SAC.

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<sup>1</sup> A request for voluntary privatization is considered only when a signed petition covering more than 50 percent of the work force is submitted to the Privatization Committee.

<sup>2</sup> Refusal by the government to privatize occurs under two conditions: legal restrictions are placed by the federal government on selected industries that are excluded from the privatization process, or privatization of the enterprise is waived by the federal government.

<sup>3</sup> The privatization plan must cover the following topics:

- Preferred mode of privatization;
- Time frame for privatization;
- Minimum price for sale of the enterprise;
- Statement of work force opinion;
- Proposals for the restructuring of the enterprise; and
- Revenue forecast for the enterprise.

In addition to drafting a privatization plan, the Privatization Committee is responsible for the valuation of the enterprise so that a minimum price for the enterprise can be set.

15

5. After the privatization plan is approved by the SAC, the Committee will put the enterprise on a relevant list of enterprises to be privatized and will determine the mode of sales of the enterprise.<sup>4</sup>
6. After all documents have been completed, the package of information is passed onto the Property Fund, which takes the initiative to arrange for the sales of the enterprise.<sup>5</sup> Sales of enterprises are announced one month prior to the bidding in three different sources: *Privatization*; *Morning of Russia*; and *Russian Gazette*.<sup>6</sup>
7. In Vladivostok, the Property Fund designates one of five "stock exchanges" to manage the sales of an enterprise.<sup>7</sup> Consequently, if a buyer has interest in purchasing stock of a given enterprise, he or she must appear or be represented by an agent on the day of sales at the brokerage house to participate in the bidding process.<sup>8</sup>

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<sup>4</sup> In general, the chair of the SAC plays a pivotal role in determining the method of privatization. No precedent exists where the SAC has overturned recommendations made by the chair regarding the method of privatization. The Privatization Committee lacks authority over the privatization process and can only suggest to the SAC the mode of privatization.

<sup>5</sup> The Property Fund falls under the Soviet legislative branch.

<sup>6</sup> The published announcement for the sale of an enterprise must include the following information:

- Size of the land occupied by the enterprise and any additional property belonging to the enterprise;
- Current account information, particularly sunken capital for improvement of the enterprise;
- Value of inventory;
- Value of liquid assets;
- Current liability;
- Financial breakdown of the enterprise;
- Intangible fixed assets;
- Balance sheet for the past three years; and
- Market share of the enterprise.

<sup>7</sup> What is referred to as a stock exchange in Russia is more akin to independent brokers in the United States.

<sup>8</sup> There seems to be no clear guideline to determine the allocation, to a given brokerage house, of enterprises to be sold.

11

8. Prospective buyers must pre-qualify to participate in the bidding process. In addition to completing an application form, a prospective bidder must deposit to the Property Fund 20 percent of the value of the total number of shares he or she wishes to purchase.<sup>9</sup>
9. Additional conditions placed on prospective investors are:
  - All sales are in rubles only; and
  - Foreign investors are required to open a hard currency account with a local bank and transfer funds into rubles at the prevailing exchange rate.
10. When an investor is awarded the bid, he or she is granted a certificate of ownership from the Property Fund. This is accompanied by a document allowing the new owner to apply for the purchase of land on which the enterprise stands.<sup>10</sup>

In addition to SOEs identified for mandatory privatization, an increasing number of enterprises have applied for voluntary privatization. In 1992, more than 831 enterprises in the Primorski have applied for voluntary privatization. Of the 110 enterprises that have been privatized, more than 10 percent were through voluntary privatization. The prospect of government re-evaluation of assets to bring them closer to real market values has been the driving force behind the rise in voluntary privatization.<sup>11</sup> In most instances, SOEs under privatization are sharply undervalued.<sup>12</sup> For example, at a recent auction, a hotel and a grocery store were valued at 591,000 and 300,000 rubles, respectively.<sup>13</sup>

Although assets are grossly undervalued, evidence suggests that some degree of market forces are at work. In the case of the hotel and grocery store, the final auction price for the two enterprises were R 11 million and R 8 million, respectively. From a Western perspective, the final selling prices of these enterprises are exceptionally low. However, purchasers have been primarily local investors whose cash flow would be seriously challenged by these values.

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<sup>9</sup> The purchase price of an enterprise may not be 30 percent under the minimum price fixed in the privatization plan.

<sup>10</sup> If an enterprise is not sold during the bidding process, the Privatization Committee must propose a new privatization plan within one month.

<sup>11</sup> The last valuation of assets was conducted by the government in 1973. Consequently, the prospect of a sharp rise in share prices resulting from re-evaluation of assets by the government has helped to stimulate the voluntary privatization process among small groups of enterprises in Primorski Kray.

<sup>12</sup> Assets have been depreciated over time without consideration for inflation.

<sup>13</sup> At an exchange rate of R 200 to the U.S. dollar, R 591,000 and R 300,000 are approximately \$1,970 and \$1,500, respectively.

12

Two privileges exist for those persons employed by the enterprises to be privatized:

- Employees may choose to receive, for free, 25 percent of dividend-yielding, non-voting preferred stock; or
- Employees may choose to purchase 10 percent of common stock at 70 percent of its nominal value. At the same time, managers of an enterprise are offered the option of purchasing an additional 5 percent, also at 70 percent of its nominal value. In addition to these benefits, employees are eligible to take part in the purchase of 51 percent of common stock, but at 1.3 times the nominal value prior to open public bidding.

In addition to accessing scarce personal savings, beginning on October 1st, privatization vouchers will be issued that can be used to purchase shares in SOEs. Every woman, man, and child will receive 10,000 rubles worth of vouchers<sup>14</sup> that can be used to purchase 50 percent of all stock as a discounted price.<sup>15</sup> The balance of shares sold in an enterprise must be purchased in cash. The adoption of the voucher scheme initially raised hopes among many Russians interested in ownership and control over their work place, but as the date for the scheme's implementation approaches, there is growing skepticism about the scheme's ability to result in an equitable or fair distribution of national assets.

#### **CURRENT STATUS OF PRIVATIZATION IN PRIMORSKI KRAY**

Primorski Kray, the principal region in which the team's investigations took place, is dominated by large firms engaged in marine industries: fishing and fish processing, ship repair, maritime shipping, construction, and miscellaneous industrial activities. There are more than 60 industrial enterprises in Vladivostok with more than 10,000 employees, and many others with more than 1,000 employees.

Table D-1 describes the businesses scheduled to be privatized before the end of 1992 as allocated by industry sector and by average number of employees. The vast number of firms to be privatized during the first year of the program are small businesses owned by a municipality and providing wholesale and retail trade, and cafeteria and canteen services. Only 21 businesses with more than 1,000 employees are scheduled to be privatized within this period, most of which are in the construction field, one of the largest sectors in Vladivostok. Other large firms, such as Sovrybflot, the large state monopoly for fisheries product sales, have initiated the privatization process independently and are not reported here. Also, the hundreds of newly formed trading companies and several thousand small privately or

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<sup>14</sup> At an exchange rate of R 200 to the U.S. dollar, a 10,000 unit voucher is worth approximately US \$50. Most private businesspersons and government officials express their disappointment at the limited value of these vouchers in contributing to their overall cash requirements for participating in the privatization process. In addition, most workers are not familiar with the voucher scheme and how it applies to them.

<sup>15</sup> The cost of preferred stock is discounted by 30 percent.

collectively owned firms in retail food and food service distribution are similarly excluded from this table, as statistics on these types of firms were not available.

Overall, 1,738 businesses were originally scheduled to be privatized in 1992, but the difficulties of organizing privatization procedures proved greater than originally anticipated and, by the end of August, only 116 facilities had been privatized, with another 668 in the process of being privatized. The number of firms to be privatized by 1995 in Primorski Kray is estimated at 4,599. Of these, 890 are kray-level enterprises, 1,926 are federal enterprises, and 1,783 are municipal facilities — including many of the retail shops, cafeterias, and canteens. Certain state-owned enterprises are excluded from privatization, including those dealing with natural resources, such as timber and minerals; military facilities; and essential national security and major infrastructure facilities.

14

TABLE 1

Distribution of State Firms in Primorski Kray Scheduled for Privatization in 1992, by Industry Sector and Number of Employees

BUSINESS SECTOR	Total	Total Employees	Firms by Number of Employees			
			0-50	50-200	200-1,000	1,000+
Light Industry	14	9,161	1	2	7	4
Food Industry <sup>16</sup>	21	7,146	51	16	25	10
Agro-Industrial Inputs/Equipment <sup>17</sup>	61	5,501	21	31	6	0
Construction <sup>18</sup>	94	37,705	16	48	16	13
Building Materials <sup>19</sup>	30	9,801	3	13	11	2
Auto/Truck Transport	40	13,600	3	17	18	2
Services <sup>20</sup>	495	8,825	482	13	0	0
Wholesale & Retail Trade <sup>21</sup>	682	14,484	669	13	0	0
Food Service <sup>22</sup>	219	4,367	217	2	0	0
<b>TOTAL</b>	<b>1,686</b>	<b>110,590</b>	<b>1,428</b>	<b>162</b>	<b>68</b>	<b>21</b>

<sup>16</sup> Includes agricultural and fish-processing facilities.

<sup>17</sup> Data for number of employees are missing for three firms.

<sup>18</sup> Data on employment were missing for one firm.

<sup>19</sup> Employment figures on one firm were missing from the data.

<sup>20</sup> Includes repair shops, dry cleaners, barbers and hairdressers, photo shops, shoe repairs, tailors, public bath facilities, and government service facilities. The distribution of number of establishments by number of employees is based on the average number of employees per establishment for each group of firms to be privatized.

<sup>21</sup> The distribution of number of establishments by number of employees is based on the average number of employees per establishment for each group of firms to be privatized.

<sup>22</sup> The distribution of number of establishments by number of employees is based on the average number of employees per establishment for each group of firms to be privatized.

75

Of the 4,599 SOEs identified for privatization in the Primorski region, only 110 have been privatized to date.<sup>23</sup> Of these, the overwhelming number of enterprises (48 percent) are former state-operated retail stores. This is followed by the sales of enterprises in public service sector (12 percent), restaurants/canteens (11 percent), and agriculture (10 percent).<sup>24</sup>

Although retail stores constitute more than 48 percent of the already privatized enterprises, only 8 percent of the workers associated with the 110 SOEs are directly affected by the privatization process. Of the 6,431 jobs directly affected by the privatization process, 23 percent is accounted for in the construction sector, 21 percent by the agriculture sector, and 16.4 percent by the public service sector.

Taking into account the average volume of production for enterprises already privatized, aggregate data suggest that assets were highly undervalued, particularly for enterprises operating in the wholesale and retail trade sectors.

### PROCEEDS FROM PRIVATIZED ENTERPRISES

Projected revenues from the sale of SOEs in Primorski Kray amount to approximately R 1.543 billion. The largest sources of income for the state are expected to come from the construction industry (24.6 percent), the sales of retail stores (18.4 percent), and the food industry (10.2 percent). Although the construction industry is projected to account for a quarter of the total proceeds for 1992, this is expected to shift in 1993. The food industry is expected to account for 29.4 percent of the proceeds from

<sup>23</sup> The 110 SOEs have direct impact on approximately 6,431 jobs.

<sup>24</sup> Sector Breakdown of SOEs already privatized in the Primorski Region, 1992:

SECTOR	No. of SOEs	Percent of Total	No. of WORKERS
Agriculture	11	10	1,346
Food	3	3	204
Building materials	2	2	650
Construction	2	2	1,489
Wholesale trade	2	2	713
Public service	13	12	1,056
Others	5	5	314
Retail trade	53	48	529
Restaurants and canteens	12	11	130
Unfinished constructio	7	6	N/A

Source: Primorski Privatization Fund, Vladivostok.

privatization in 1993, followed by the building industry (29.1 percent) and the sale of retail stores (19.9 percent). Proceeds from privatization will be shared by various levels of government, as follows:

Municipal government	11%
Local/City government	23%
Regional government	44%
Federal government	22%

### METHOD OF PRIVATIZATION

As mentioned earlier, workers of SOEs to be privatized can express their interest about the mode of privatization in the privatization plan, but the final decision rests with the State Assets Committee. Further analysis is required to evaluate the creditability of the current selection process for privatization. The breakdown by privatization mechanism for the 110 SOEs is:

Competitive bidding	61%
Auctions	23%
Joint-stock	9%
Buy-out	7%

Transposing the privatization methods utilized against the sector breakdown, the following observations can be made:

- Joint stock was the preferred method of privatization in the building, automobile, and construction industries;
- Auctions were the most often utilized form of privatization in the unfinished construction and food industries; and
- Public services and stores and canteens were privatized predominately through a competitive bidding process.

### TRENDS IN PRIVATIZATION

Although the lack of credit and access to technology and equipment is cited frequently as the critical barrier to privatization and entrepreneurial activities, larger and more deep-rooted problems related to the psychological fear of change are prevalent, particularly among workers in SOEs subject to mandatory privatization. This fear is driven by uncertainty about the direction of change and, more acutely, what change will bring in terms of job security. Tangible technical assistance is critically

needed. At the same time, however, measures must be taken to offer the general population some vision of what the future may bring.

Currently, all sectors are required to go through varying degrees of demonopolization. However, according to officials at the Primorski Regional Anti-Monopoly Committee (PRAMC),<sup>25</sup> in the near future, three sectors may be excluded from the demonopolization process:

- Fuel and energy;
- Railroads (both passenger and freight); and
- Heavy industry (manufacturing of large equipment such as hydro-electric generators).

The rationale behind the possible exclusion of these industries from the demonopolization process is that these industries are already unstable and they are expected to serve as pillars to support economic growth in privatized industries. Consequently, direct government intervention is viewed as necessary to ensure that minimum requirements are met to support the economic transition process.

In addition, changes may be introduced in the organizational structure of the national Anti-Monopoly Committee (AMC), a "super agency" charged with oversight of the demonopolization process. At the same time, each regional AMC is required to take the initiative in creating an environment conducive to market activity. Examples of such activities include:

- Granting advantageous loans;
- Reducing or waiving taxes;
- Liberalizing pricing structure for commodities;
- Attracting local and foreign investors;
- Assisting in establishing joint venture activities;
- Licensing export-import operations and changing customs tariffs; and
- Stimulating market activities in depressed markets.

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<sup>25</sup> Reporting directly to the President of Russia, the Anti-Monopoly Committee (AMC) is responsible for demonopolizing state-owned enterprises and stimulating entrepreneurship at the regional level. While the AMC continues to look to Moscow for operational guidelines, each regional board, including the Primorski Regional Board (PRB), is empowered to develop its own regional programs.

Many of the activities mentioned above are the domain of boards of investment agency rather than an anti-monopoly agency. Recognizing these facts, once the initial demonopolization process is completed, the AMC is likely to be dismantled into a minimum of two separate agencies. The first agency will continue to address anti-monopoly issues, but purely from a legislative perspective. A second agency is expected to serve as a board of investment that promotes investment activities and stimulates market transactions within Russia and with foreign businesses.

### **ADDITIONAL TECHNICAL ASSISTANCE**

PRAMC currently employs four lawyers who manage the legal aspect of the demonopolization process. Since there is no precedent in Russia for anti-trust, judgements are often ad hoc and lack substantive ground. Consequently, three areas need to be addressed.

- Assistance in raw data collection, particularly in compiling anti-trust laws;
- Training in interpretation and application of these laws; and
- Case study training focused on the application of these laws and the outcome of judgments on the behavior of the market.

This type of skills development training is most likely to be effective through an exchange program where members of the PRAMC are sent to the United States to carry out one-to-one discussions with government and private sector lawyers specializing in anti-trust laws, and to take case studies, such as the break-up of AT&T, to explore the economic and social impacts of demonopolization.

In addition, U.S. specialists in anti-trust can be sent to Vladivostok to work with PRAMC to define more clearly the judicial procedures under anti-trust and to develop a framework for providing legal services to assist SMEs in anti-trust cases. Although assisting the AMC at the regional level is likely to have a positive impact on accelerating the demonopolization process and the introduction of SMEs, special consideration must be given to the fact that the AMC's agenda is driven by Moscow and that recommendations for targeted programming at the regional level will require similar programming in Moscow. Consequently, further field work is necessary in Moscow to gauge the likelihood of this type of technical assistance being accepted by the AMC in Moscow and to establish a coordinated program for all regions in Russia.

19

**ANNEX E**

**LÉGAL, REGULATORY AND TAX ENVIRONMENT IN RUSSIA**



## ANNEX E

### LEGAL, REGULATORY AND TAX ENVIRONMENT IN RUSSIA

Russia's legal and regulatory structure is experiencing great change. In addition to major changes being introduced at both the federal and regional levels, Russia continues to be plagued with numerous "unpublished regulations" left over from the former Soviet legal system. The gray area in the legal system created by these unpublished regulations gives government control over businesses that otherwise would neglect government intervention in pursuit of new economic activities.

Unpublished regulations may constitute 5 to 10 percent of all Russian laws. Examples of such laws can be found in Russia's banking regulations, such as the regulation that restricts the amount of funds a depositor can withdraw from his or her account. The discretionary employment of unpublished regulations adds yet another dimension to the complexity of understanding Russia's legal structure.

Russia's laws and regulations are in such a state of flux that it would be premature to open discussions regarding transparency and legal harmonization, particularly as they relate to SMEs. This is true at the federal level and more so at the regional levels. In principle, regional governments are given wide control over the outcome of their legal and regulatory environments. For example, a governor is authorized to enact regulations through decree. Although a governor has this authority, an executive decision without consultation with Moscow would be an unlikely scenario. Consequently, in practice, actions taken by regional governments closely comply with the pulse in Moscow.

### LEGAL UNCERTAINTIES AND SMES

The lack in Russian law of legal reference to small businesses warrants concern. According to some legal sources, this was a conscious act on the part of the government to fill two voids in the economy. First, small enterprises are expected to serve as a linkage vehicle between related and unrelated individuals and businesses to form increasingly large businesses. Consequently, the lack of characterization of SMEs under Russian law would relieve enterprises of the burden of statutory capital limits imposed on joint stock and limited liability companies. Second, as SOEs are disassembled, the lack of characterization of SMEs would provide flexibility to newly formed entities to grow and expand without the burden of making administrative and financial adjustments to accommodate legal constraints imposed on other types of enterprises.

Although these arguments are valid, the lack under Russian law of legal reference to SMEs introduces inherent difficulties in providing targeted support programs. Without clear reference to SMEs in Russian law, support for SMEs would fall under some umbrella program where entrepreneurs and small firms would be required to compete for financial and technical assistance. Furthermore, the lack of uniformity in defining this category of enterprises introduces room for discretionary interpretation of laws, and this discretion can favor or disfavor entrepreneurial activities.

95

These and other large-scale issues continue to disrupt the legal and regulatory structure in Russia. Consequently, discussions focused on legal and regulatory reform at the regional level to support SMEs continues to be outside the periphery of government officials both at the federal and regional levels.

## TAX LAWS

The evolution of Russia's legal and regulatory structure will take time. However, some parts of the legal system are taking form much more quickly than other areas. Although numerous changes are needed, tax laws have become increasingly well defined (see Table E-1 for a summary of Russia's tax schedule).<sup>1</sup>

For the most part, taxation and the administration of taxes take place at the local level. Federal and regional income and enterprise taxes are collected at the local level and apportioned to the federal government. Currently, taxes on enterprises are collected on a monthly basis. Taxes are based on an estimated revenue stream for a quarter, which in turn is divided by three to come up with a monthly tax liability. All tax payments and reimbursements are made through local banks.

At the federal and regional levels, four types of taxes are of major concern to SMEs: individual income tax, enterprise profit tax, value-added tax, and excise tax.

### Individual Income Tax

This category of taxes continues to be ill defined. Tax rates range between 12 and 60 percent, according to levels of income. However, the 12 percent bracket applies to annual incomes up to R 42,000, which is ten times the minimum wage, making other tax brackets somewhat irrelevant.<sup>2</sup>

The current schedule lacks sensitivity to low-income earners. Consequently, future adjustments may be required. In addition to rescheduling of tax rates and brackets, the capacity of local tax offices to administer tax collection and auditing is likely to become increasingly strained.

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<sup>1</sup> Certainty in the tax laws is, in part, a response by the government to meet public sector revenue needs.

<sup>2</sup> The 60 percent tax range applies to those with annual income 100 times that of current minimum wage.

TABLE E-1

## RELEVANT TAX SCHEDULE APPLICABLE TO ENTERPRISES IN RUSSIA

TAX	RATES	COMMENTS														
Individual Income <sup>1</sup>	<table> <tr><td>&lt; 42,000:</td><td>12%</td></tr> <tr><td>42,001 - 84,000:</td><td>15%</td></tr> <tr><td>84,001 - 120,000:</td><td>20%</td></tr> <tr><td>120,001 - 180,000:</td><td>30%</td></tr> <tr><td>180,001 - 300,000:</td><td>40%</td></tr> <tr><td>300,001 - 420,000:</td><td>50%</td></tr> <tr><td>&gt; 420,000:</td><td>60%</td></tr> </table>	< 42,000:	12%	42,001 - 84,000:	15%	84,001 - 120,000:	20%	120,001 - 180,000:	30%	180,001 - 300,000:	40%	300,001 - 420,000:	50%	> 420,000:	60%	<ul style="list-style-type: none"> <li>• 12% bracket represents 10 times the minimum wage</li> <li>• 60% bracket represents 100 times the minimum wage</li> <li>• Lack of sensitivity to low income groups below 42,000 rubles</li> </ul>
< 42,000:	12%															
42,001 - 84,000:	15%															
84,001 - 120,000:	20%															
120,001 - 180,000:	30%															
180,001 - 300,000:	40%															
300,001 - 420,000:	50%															
> 420,000:	60%															
Enterprise Profit <sup>2</sup>	<table> <tr><td>Standard rate:</td><td>32%</td></tr> <tr><td>Brokerage firms, investment institutions:</td><td>45%</td></tr> <tr><td>Entertainment facilities and business:</td><td>70%</td></tr> <tr><td>Halls and stadiums with 2,000 seats or more:</td><td>50%</td></tr> </table>	Standard rate:	32%	Brokerage firms, investment institutions:	45%	Entertainment facilities and business:	70%	Halls and stadiums with 2,000 seats or more:	50%	<ul style="list-style-type: none"> <li>• Liberal interpretation of "brokerage firms" have forced many enterprises to fall into the 45 percent tax bracket</li> <li>• Tax evasion among new and existing enterprises is becoming increasingly common</li> </ul>						
Standard rate:	32%															
Brokerage firms, investment institutions:	45%															
Entertainment facilities and business:	70%															
Halls and stadiums with 2,000 seats or more:	50%															
Bank Income	<table> <tr><td>Standard:</td><td>30%</td></tr> <tr><td>Commercial banks with majority credit in agriculture:</td><td>20%</td></tr> </table>	Standard:	30%	Commercial banks with majority credit in agriculture:	20%	<ul style="list-style-type: none"> <li>• The Central Bank and its institutions and enterprises are exempted</li> </ul>										
Standard:	30%															
Commercial banks with majority credit in agriculture:	20%															
Insurance Income	<table> <tr><td>Standard:</td><td>25%</td></tr> </table>	Standard:	25%	<ul style="list-style-type: none"> <li>• Employment of handicapped workers reduces the liability by 50 percent</li> </ul>												
Standard:	25%															
Investment Income of Enterprises	<table> <tr><td>Standard:</td><td>15%</td></tr> </table>	Standard:	15%	<ul style="list-style-type: none"> <li>• Exemptions are applied to income from bonds and other state securities</li> </ul>												
Standard:	15%															
Pension fund contributions	<table> <tr><td>Standard:</td><td>31.6%</td></tr> <tr><td>Farms and agri-business:</td><td>20.6%</td></tr> <tr><td>Self-employed:</td><td>5%</td></tr> <tr><td>Others:</td><td>1%</td></tr> </table>	Standard:	31.6%	Farms and agri-business:	20.6%	Self-employed:	5%	Others:	1%	<ul style="list-style-type: none"> <li>• Organizations of disabled and retirees are exempted</li> </ul>						
Standard:	31.6%															
Farms and agri-business:	20.6%															
Self-employed:	5%															
Others:	1%															
Value-Added Tax	<table> <tr><td>Standard:</td><td>28%</td></tr> <tr><td>Consumer sales of flour, pasta, cereals, milk, yogurt, cottage cheese, and sunflower oil:</td><td>15%</td></tr> <tr><td>Goods sold at regulated VAT inclusive prices:</td><td>21.88%</td></tr> </table>	Standard:	28%	Consumer sales of flour, pasta, cereals, milk, yogurt, cottage cheese, and sunflower oil:	15%	Goods sold at regulated VAT inclusive prices:	21.88%	<ul style="list-style-type: none"> <li>• Individual traders not registered as juridical person with annual sales &lt;100,000 are exempt</li> </ul>								
Standard:	28%															
Consumer sales of flour, pasta, cereals, milk, yogurt, cottage cheese, and sunflower oil:	15%															
Goods sold at regulated VAT inclusive prices:	21.88%															

<sup>1</sup> Annual income expressed in rubles

<sup>2</sup> Tax rates are reduced by 50 percent for enterprises employing handicapped workers.

TABLE E-1 — CONTINUED

TAX	RATES	COMMENTS
Excises	Spirits: 90% Vodka: 80% Liqueur: 75% Wine: 46.5% Brandy: 55% Sparkling wine: 47.5% Beer: 25% Chocolate: 40% Caviar: 40% Tobacco products: 14, 20, 35% Gas: 35% Tires: 62% Jewelry: 10% Furs: 10, 20, 35% High quality porcelain: 30% High quality crystal: 45% Carpets: 20, 45% Leather clothing: 350%	<ul style="list-style-type: none"> <li>• Goods exported outside the CIS are exempt</li> </ul>
Fuels and lubricants	Federal: 18% Territorial: 7%	
Building, premises, and structures	0%	<ul style="list-style-type: none"> <li>• Exemptions apply to Soviet heroes, certain disabled persons, war veterans, survivors of Chernobyl, pensioners, and certain low-ranking military personnel</li> </ul>
Vehicle <sup>3</sup>	Passenger cars: 0.5/HP Motorcycles: 0.3/HP Trucks: 1.0/HP Boats: 0.15/HP	<ul style="list-style-type: none"> <li>• Equipment for agricultural application are exempt</li> </ul>
Enterprise Property	Up to 0.5%	<ul style="list-style-type: none"> <li>• One-year tax holiday applies to new enterprises</li> </ul>

<sup>3</sup> Expressed in rubles

Handwritten initials or mark.

### **Enterprise Profit Tax**

Russia's enterprise profit tax was modeled after corporate tax structures used in industrialized countries, and tax rates range between 32 and 70 percent. Most economic activities are taxed at a rate of 32 percent or 45 percent,<sup>3</sup> based on Article 5 of the enterprise tax law:

The tax rate for the profit of enterprises and foreign legal entities is established in the amount of 32 percent, and the tax rate for exchanges and brokerage offices and also enterprises — on profit from intermediary operations and transactions — in the amount of 45 percent.<sup>4</sup>

According to interviews of entrepreneurs and government officials, regional governments often take a liberal interpretation of Article 5 so that many new enterprises, particularly in the retail sector, are now being assessed a 45 percent enterprise profit tax. The lack of legal recourse, the financial burden associated with receiving legal counseling, and the limited knowledge of legal rights often force enterprises to comply with the ambiguous legal structure. Response to this liberal interpretation of the enterprise tax has been the sharp rise in tax evasion. Ambiguities in the legal system, compounded by the lack of legal enforcement, have contributed to the birth of a free-for-all business environment in the Russian Far East.

### **Value-Added Tax (VAT)**

The VAT was introduced on January 1, 1992, to replace the turnover tax and the 5 percent sales tax introduced last February. Under the VAT, exports outside the Commonwealth of Independent States are fully exempted, while intra-CIS sales are taxed at the origin at a rate of 28 percent.

The VAT is a source of concern for many enterprises. In particular, the federal and regional governments have taken a liberal interpretation of Articles 3 and 4 of the "Law of the Russian Soviet Federated Socialist Republic On Valued Added Tax."<sup>5</sup> Consequently, VAT is often employed indiscriminately, particularly on entrepreneurs not familiar with the tax system and schedules. For example, one entrepreneur has been assessed VAT on rental income from office leasing. Once again, liberal interpretation of tax laws, compounded by the lack of access and knowledge of current laws, has created unnecessary barriers to and costs for smaller enterprises.

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<sup>3</sup> Of the 32 percent, 13 percent is apportioned to the federal government and 19 percent goes to the local government.

<sup>4</sup> Article 5 of the Russian Federation law of December 27, 1991, "On the Tax on Profit of Enterprises and Organizations."

<sup>5</sup> Articles 3 and 4 refer to "objects of taxation" and "determination of a taxable transaction."

## **Excise Taxes**

**Excise taxes** are levied on alcoholic beverages, tobacco products, automobiles, and some luxury goods at a rate of 14 to 90 percent. These rates are based on an excise-inclusive wholesale price. Similar to the VAT, excises are not levied on exports outside the CIS. With a few exceptions, proceeds from excises are transferred to local governments.

Tax law is likely to be one of the few areas in the Russian legal system where somewhat transparent guidelines are beginning to form. At the same time, however, the range of interpretation possible under these laws is allowing discretionary employment of these laws in favor of increased tax collection.

While legislative changes may require substantial time, heightened legal awareness on the part of entrepreneurs may serve to counter the abusive employment of laws and to improve the knowledge base of individuals about corporate rights under the existing legal structure.

Much of the abusive employment of laws can be prevented through education programs at the grassroots level. However, the lack of knowledge about commercial laws on the part of entrepreneurs has starved many businesses of cash flow needed to help jump-start the faltering economy.

F-1

**ANNEX F**  
**CONTACTS**

87

**ANNEX F**  
**CONTACTS**

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163

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92

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094

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93

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