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The papers study the following problems: sustainable development of local production systems, business strategies of LPS, innovativeness of clusters, critical infrastructure protection, corporate social responsibility, environmental protection, local production system management, governance of local production systems in Bulgaria, Poland, Ukraine and Russia, policy guidelines with some measures of general application, aimed at problems observed in all LPS, and some specific measures differentiated according to a typology of local production systems.

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IS THERE A LINKAGE BETWEEN POVERTY AND DEVELOPMENT OF SMALL ENTERPRISES IN RUSSIA?

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INTRODUCTION

Russian reforms were accompanied by deep economic depression that led the population to impoverishment, low consumption and dramatic polarization of incomes. At the same time, reforms have removed the ban on private entrepreneurship, changed the size category of small enterprise, switched on market mechanisms which demonstrated very vividly the inefficiency of many of former industrial giants. Very soon small enterprises began to appear, providing self-employment, employment and new sources of incomes.

When questioned during numerous interview surveys the entrepreneurs say that their principal problem is liquidity constraint caused by extremely low effective demand and insufficient market capacity. Where a great part of regional residents have low incomes and low living standards their demand for products of small enterprises is low. At the same time, new jobs in the new-enterprise sector provide new incomes and, thus, help to fight poverty. What is, then, the cause and what is the effect of the linkage between poverty and self-employment? This question is far from idle. In Russia it is associated primarily with the strategy in use of budgets of all levels (federal, regional, municipal). The answer to this question is important also for western countries who give aid to Russia to implement the reforms. As a rule, financial sources of aid to small enterprises and to reduction of poverty are the same.

Then, where to assign the funds in the first place? How to fight poverty through self-employment and what policy to choose at federal and regional levels? What regional characteristics must be taken into account when deciding on this strategy?

The main interest in this paper is to answer these questions and reveal factors underlying the level of wealth (poverty) and new-enterprise formation in the regions; to explore how deep they affect each other and how to make use of the revealed patterns.

LITERATURE REVIEW

This article makes an attempt “to build a bridge” between small enterprises and poverty of the population, examining the linkage between these processes. Until now most authors concentrated only on one side of the process: either level of poverty and inequality or development of new enterprises.

Substantial contribution to the research of poverty and inequality was made by Atkinson (1987), Foster, Greer and Thorbecke (1984), who suggested several variants of the so called poverty line. In order to compare incomes and wealth, Sen (1976) suggested a few axioms and introduced a function of personal utility.

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Of Russian researchers we note Korchagina, Ovcharova and Turuntseva (1998) who attempt at re-estimation of official poverty statistics in Russia. They use per capita consumer spending including not only money expenses but money equivalent of food produced on individual plots and of such crucial components of the economic potential of households as movable and immovable estate.

Shiviyakov and Kiruta (1999) show that the problem of reduction or total elimination of poverty in Russia is only little related to insufficient social subsidies but is caused largely by limited opportunity for the households to put to use their own potential of economic activity.

This potential is realized primarily in self-employment, creation of small enterprises. Kornai (1990) argues that formation of new enterprises is crucial in stimulating growth in post-socialist economy. The crux of his argument is that new enterprises are relatively free of the kinds of distorted incentives that influence state-owned enterprises, and are therefore relatively efficient and responsive to market conditions.

Blanchard and Kremer (1997) note that by providing expanded employment opportunities, new enterprises better enable politicians to implement efficiency reforms, which reduce state-sector employment without losing political support. The authors emphasize the importance of new-enterprise formation in mitigating output reductions resulting from the restructuring and privatization of state enterprises, and breakdowns in the state supply system.

Loveman, Sengeberger (1991) show that in advanced countries the surge in the number of small enterprises is accounted for by rising incomes of households: opportunities appear to satisfy more diversified needs and to segment markets, and small business is more adaptable in this than large companies. They performed empirical analysis based on data from six countries members of OECD and showed that increment in the number of employed in small enterprises is hinged to industrial restructuring of two types: decentralization of enterprises and mergers of new small enterprises. In the view of these authors, this relationship is response to increased consumer demand for more diversified commodities.

Keeble (1990) suggested a few theoretical models to explain processes of emergence of new small enterprises in England, including the model of income growth of households, which leads to subsequent change in the market demand and formation of new small firms.

O. Blanchard, A. Shleifer (2000) theoretically defended a proposition that growth arises if regional governments administer a policy stimulating the formation of new enterprises. And, finally, Berkowitz and DeJong, (1999) using statistics on Russian regions argue that the new-enterprise growth promotes growth in per capita incomes thus providing regional growth.

As is seen from this brief review of literature, different authors explored new-enterprise formation and its influence on per capita incomes. Some writers examined diversified consumer demand as the factor of establishment of small enterprises. This paper provides integration of these two approaches and a statistical check of the linkage between wealth and self-employment, which has not been done before.

CONCEPTUAL FRAMEWORK

In pre-reform Russia the population was employed largely in the budget sector where only wage determined the level of incomes and, therefore, level of wealth. The opening of any small enterprise is the result of the choice made by a concrete individual to change his status by moving from state sector to sector of self-employment. The conceptual framework of the research is drawn on a model which binds the behavior of the individual maximizing his utility with a model of the aggregate demand-supply of labor at the aggregated small enterprise segment. This shift has allowed us to link the major determinants of individual's movement to self-employment with factors of new-enterprise forma-

tion and to project the influence of particular factors on labor demand and supply; to bind household wealth with new-enterprise formation.

Consider the economy of a particular region consisting of two sectors. The first sector- the traditional sector- will be called the wage sector. The other sector is that of small enterprises. This sector includes not only self-employed business owners, but also those employed in small businesses.

N – is the total employable population.

Every person from N can either work in the wage sector, or be an employee in a small enterprise, or set up a new enterprise himself. The employable population, therefore, is divided in the following way:

$$N=L_1+L_2+E+L_0,$$

where

L_1 is employment in the wage sector ,

L_2 is employment in small enterprises ,

E are the individuals who made the self-employment decision and became entrepreneurs.

For simplicity, assume that one entrepreneur owns only one small enterprise,

L_0 are those unemployed, including voluntarily unemployed. Shadow employment is not considered.

The decision of each individual i , $i = 1, \dots, N$ will be modeled on the basis of discrete choice, that is assuming that he chooses out of a number of alternatives and decides on that which gives him maximum utility u_i .

Assume that an individual maximizes his utility by setting up a small enterprise. Then he must have entrepreneurial vision and sufficient capital. We can presume that if an individual has no entrepreneurial vision or capital, his utility from a small enterprise is minus infinity.

Let β be a proportion of the employable population with entrepreneurial flair. These people see opportunities where others do not.

There exist a multiplicity of potential projects for small enterprises, for which different amounts of capital are required; this amount is k . The capital is assumed to be randomly distributed among the population. The relevant function of the density for those who possess entrepreneurial vision is $\varphi(k)$; k lies between 0 and 1. For convenience, normalize the richest person's capital assets at unity. The proportion of those with capital less than k is $\Phi(k)$. That is

$$\Phi(k) = \int_0^k \varphi(k) dk .$$

Since in the economy there is asymmetry of knowledge and the profit from a project can be estimated only by a person with entrepreneurial capacity, there is a low probability that a potential entrepreneur without capital can get loan for his project. The probability of getting a loan is ρ .

It is natural to assume that among projects the first to be implemented are those that require less expenditures of capital. The boundary capital is k^* , that is the amount required to implement a marginal project by a marginal entrepreneur. Projects requiring greater capital are not implemented. Knowing k^* , we could estimate the number of entrepreneurs. The probability that an individual will have capital sufficient to set up a new enterprise is

$$\int_{k^*}^1 \varphi(k) dk = 1 - \Phi(k^*).$$

To this probability the probability of obtaining a loan by people without sufficient capital should be added:

$$\rho \int_0^{k^*} \varphi(k) dk = \rho \Phi(k^*).$$

The number of entrepreneurs E will be the sum of these two probabilities multiplied by β and by the total employable population N :

$$E = \beta \cdot N \cdot \left(\int_{k^*}^1 \varphi(k) dk + \rho \int_0^{k^*} \varphi(k) dk \right) = \beta \cdot N \cdot (1 - (1 - \rho)\Phi(k^*)).$$

Let $\pi(k, w_2)$ be the profit from a project requiring capital k , while wages in the small business sector are w_2 , and in the wage sector, w_1 . Profit includes, among other things, the entrepreneur's satisfaction from his activity. It is normal to believe that π is a function increasing in k since the first projects to be implemented are the more profitable ones, yielding higher profits. Defining such a function we assume that if some entrepreneurs have already established small enterprises, the same opportunities are not narrowed to others.

Consider the decision made by a typical entrepreneur who has the possibility to set up a small enterprise. We assume that he makes his decision based on his function of utility, $u_E(\pi)$. He compares the expected utility of the venture with the utility \bar{u}_E that he could get from another activity. The expected utility is estimated taking into account probability μ that the newly created enterprise will go bankrupt and that the entrepreneur will get zero income. The probability μ is the determinant of the small business risks. The level of utility \bar{u}_E can be also determined, among other things, by the wage obtainable by the person as an employee either in the wage sector or in the small business sector. Therefore, the minimum level of small enterprise profitability which makes sense for a typical entrepreneur to create a new firm, π^* , is determined by the following equation:

$$(1 - \mu)u_E(\pi^*) + \mu u_E(0) = \bar{u}_E(w_1, w_2).$$

This relation sets the boundary π^* as a function of the risks and income from alternative activities:

$$\pi^* = \pi^*(\mu, w_1, w_2).$$

The condition of utility increase in profit from self-employment ($u'_E > 0$), and the condition of utility increase in wage rates ($\bar{u}'_{Ew_1} > 0, \bar{u}'_{Ew_2} > 0$) determine the kind of relation of π^* on parameters:

$$\frac{\partial \pi^*}{\partial \mu} > 0, \quad \frac{\partial \pi^*}{\partial w_1} > 0, \quad \frac{\partial \pi^*}{\partial w_2} > 0.$$

The relation for the boundary size of capital, k^* , has the form:

$$\pi(k^*, w_2) = \pi^*(\mu, w_1, w_2).$$

Hence

$$k^* = k^*(\mu, w_1, w_2).$$

The form of the function of labor demand of small enterprises is determined by the relationship of k^* to μ, w_1, w_2 .

$$L_2 = L_2^D(w_2, \mu, \rho, \beta, B_2, w_1).$$

The demand function also includes parameters ρ and β , determining the number of small enterprises and exogenous factors B^2 affecting small enterprises.

On the other hand, consider the wage sector of the economy. For simplicity, it will be modeled on the basis of the aggregate production function $f(L_1)$. Then the production function has the form:

$$f(L_1) - w_1 L_1.$$

Maximizing this function in L_1 , we get the standard condition of the first order:

$$f'(L_1) = w_1,$$

which means that wages are equal to marginal labor productivity.

The function of marginal labor productivity is, therefore, the inverse function of labor demand in the wage sector:

$$f'(L_1) = w_1^D(L_1).$$

Assuming the decreasing effect, the inverse demand function $w_1^D(L_1)$ is decreasing. Converting this function, we obtain the direct demand function $L_1^D(w_1)$.

Assuming the production function's dependence on some exogenous factors B_1 , i.e., $f = f(L_1, B_1)$, demand will also be a function of these factors, that is:

$$L_1 = L_1^D(w_1, B_1).$$

The labor demand in our model draws on the model of discrete choice. Individual i makes a choice out of three utilities: the utility of working in the wage sector $u_i(w_1, A_1)$, the utility of working in a small enterprise $u_i(w_2, A_2)$ and the utility of becoming involved in activity outside the above sectors, including voluntary unemployment $u_i(w_0, A_0)$. Variables A_s , $s=0, 1, 2$, include all additional factors affecting the individual's decision. In this model we take them as exogenous, like w_0 , too. The individual chooses that type of employment from which he earns the greatest utility. According to this, we can write the following functions of labor demand in the two analyzed sectors:

$$L_1 = L_1^S(w_1, w_2, A_1, A_2, A_0)$$

and

$$L_2 = L_2^S(w_1, w_2, A_1, A_2, A_0).$$

Both functions include the same factors.

ASSUMPTIONS, ECONOMETRIC MODEL AND PROCEDURES OF ESTIMATION

The econometric analysis will be focused on empirical test of the assumptions ensuing from the theoretical model:

1. The new enterprise formation and wealth (poverty) correlate with each other. The new-enterprise level is related to the level of wealth (poverty) of the population. The less wealth (more poverty) in the region, the less new enterprises are there. The more there are small enterprises, the more the wealth (less poverty).

2. The new-enterprise level in a region correlates with individuals propensity to risk-bearing (the higher this propensity, the higher new-enterprise formation) and with the

presence of starting capital required to open own business (the higher initial capital available to households, the more new enterprises are created).

3. The new-enterprise level in a region is related to reform attitudes of its policy-makers and to economic potential of regional institutions. High potential of institutions and reform orientation of regional leaders encourage entrepreneurship.

4. Level of wealth (poverty) also depends on urbanization level, proportion of economically active population, unemployment rate and pre-transition initial conditions in the region. Poverty is lower in the regions with higher percentage of urban population, higher pre-transition growth, lower unemployment, higher percentage of economically active population.

These assumptions imply simultaneous estimation of two interrelated regression equations, that is, a system of simultaneous equations where dependent variables are new-enterprise formation and level of poverty in region i in year t , and the major regressors are regional social-economic characteristics.

We estimate the system of equations:

$$\begin{aligned} Small_{it} = & \alpha_{it} - b_1 IB_{it} + b_2 (Regvlst * BudGRm)_{it} + b_3 (Polor * Ostvklad)_{it} \\ & + \sum_{t=1995}^{1998} b_t dummy_{it} + \gamma_i + \varepsilon_{it} \end{aligned} \quad (1)$$

$$\begin{aligned} IB_{it} = & \beta_{it} + c_1 Small_{it} - c_2 Nastrud_{it} - c_3 City_{it} - c_4 GRP_{i1990} + c_5 Unemp_{it} + \\ & + \sum_{t=1995}^{1999} c_t dummy_{it} + v_i + u_{it} \end{aligned} \quad (2)$$

where

$Small_{it}$ – is number of small enterprises per 1000 inhabitants in regions i in year t ;

IB_{it} – is the measure of (wealth) poverty in region i in year t ;

$City_{it}$ – is the percentage of urban population in region i in year t ;

$Regvlst_{it} * BudGRm_{it}$ – is regional policy in region i in year t ;

$Polor * Ostvklad_{it}$ – is new-enterprise potential of region i in year t ;

$Nastrud_{it}$ – is workable population in region i in year t ;

GPP_{1990} – is pre-reform initial conditions in region i in 1990;

$Unemp_{it}$ – is unemployment rate in region i in year t ;

$dummy$ – is dummies for appropriate year;

γ_i, v_i – is fixed effect of spatial organization;

ε, u – is a symbol of error.

The model includes spatial and temporal dummies that reflect specifics of the region and a period of time.

Enterprise potential of a region. We assumed that a good indicator of low risk aversion risks can be stability of political preferences of the inhabitants.

In present-day Russia entrepreneurship is a new kind of activity. It is undertaken mostly by that part of inhabitants who have inclination, receptivity to social innovations and, in a broader sense, to economic and political reforms. The results of election campaigns in Russia rather consistently demonstrate political preference of electorate which can imply that behind these results steady factors of territorial differentiation of society in propensity to risk-bearing exist. Variable $Polor$ – stability of political preference of inhabitants estimated through processing the election data was taken from a database prepared on the order of the Russian Unions of Industrialists and Entrepreneurs. The higher $Polor$

variable, the more consistent and liberally oriented preferences are demonstrated by region's inhabitants and the higher proportion of them have low risk aversion.

Theory assumes that effect on enterprise formation is made by the share of inhabitants with low risk aversion and presumably necessary capital. The effect of *Polor* variable in our model is increasing (decreasing) according to the presence of capital to start up own business. For appraisal of this capital we used the indicators of balance on deposits in saving bank. We were guided by information obtained from questionnaire data of the surveys of entrepreneurs which show that starting capital for opening own business in Russia was, as a rule, borrowed from near relatives, acquaintances or was the property of the entrepreneur. Bank loans practically were not used because of high interest rates. Before price liberalization the inhabitants in Russian regions preferred to keep their money in the saving bank. Therefore, the entrepreneur potential of region – variable $Polor * Ostvklad_{it-1}$ – is determined in our model by the combined effect or product of two variables – *Polor* – assessment of propensity to risk and $Ostvklad_{it-1}$ – demand balances in saving banks in year $t-1$.

Variable $Polor * Ostvklad_{it-1}$ corresponds to our conceptual model where enterprise formation depends on the availability of required capital among individuals with low risk aversion.

Regional policy in a region. $Regvlast_{it} * BudGRm_{it}$ is measure of regional policy in region i in year t . The product of two variables is $Regvlast_{it} * BudGRm_{it}$. $BudGRm_{it}$ is indicator of economic potential of institutions in region i in year t . It is measured as ratio of expenditures of regional budgets to GRP in region i in year t . It is used in measures relative to national average.

This indicator was suggested by Kolodko (2000) and Popov (2000) who noted that the dynamics of state expenditures in the period of transition turns out to be a factor important for successful transformation. A sharp cutback of state expenditures is a straight way to the collapse of institutions and to deep fall in output accompanied by increased social inequality. This observation concerns not only the national but also the regional level as well.

For the regions in Russia at the beginning of perestroika not only the relative size of the institutions economic potential was very important but also the political orientation of those who disposed of these resources. As an indicator we used a combined effect of variables $Regvlast_{it}$ and $BudGRm_{it}$. Variable $Regvlast_{it}$ – the measure of influence of regional elite and the attitudes of authorities toward reform – is taken from the database prepared on the request of the Russian Union of Industrialists and Entrepreneurs. The higher is this measure, the more influential and more liberal is regional elite.

The statement that “elite as a variable” is central among the reasons for the regime downfall is a keystone in transition studies (Rustow, 1970). It is argued that the role of elite in nations in transition is multiplied many times since the process itself of necessity destroys the consensus within the old elite, creates a cleavage between old and new elite in the field of ideology demanding negotiations between the old elite and new public forces. The establishment of democracy requires that there is a moral concert within the elite (Higey, Burton, 1989).

The combined effect of variables $Regvlast_{it}$ and $BudGRm_{it}$ shows the presumed strategy of economic reformation. The higher this measure, the higher size of resources is under jurisdiction of liberally oriented government officials in the region and, therefore, the more probable is that economic transformations in the region will go in democratic direction, business risks will go down, credibility of business rules among entrepreneurs will enhance. This measure is one of those determining political risks.

Poverty. A difficulty arises in selection of measures of poverty and standards of living. We use here a conventional measure of poverty, which is percentage of inhabitants with incomes below poverty-line. Other determinants are estimated from Goskomstat data.

The model of (1)–(2) equations is estimated by two procedures: 2SLS (Two stage Least Squares) that is a special case of the instrumental variable (IV) estimators and FIML (full-information maximum likelihood) (Green W., 1997, Chapter 16).

The choice of this period is explained by that in 1995 small enterprises began to be defined in a different way than previously which changed their number against what it was in 1994, and this might cause distortions in estimation.

The assumptions are empirically checked through a system of simultaneous equations where wealth (poverty) is measured by percentage of population with incomes below poverty line.

The results of model estimation using the share of population living below poverty line as a measure of poverty are represented in Table 1 and 2. The model draws on data from 1995–1999. Endogenous variables in this model are: log small enterprises per 1,000 inhabitants and population with incomes below poverty line.

Equation 1: dependent variable is population with incomes below poverty line. Regressors are: logarithm of small enterprises per 1,000 inhabitants, percentage of unemployed to total economically active population, pre-transition regional conditions – relative GDP in 1990, yearly dummies.

Equation 2: dependent variable is log small enterprises per 1,000 inhabitants. Regressors are: population with incomes below poverty-line, regional entrepreneurial potential, regional policy, yearly dummies.

Thus, the level of new-enterprise development in Russia's regions and the level of poverty are interrelated endogenous variables: the poorer the population, the lower new-enterprise formation; the higher new-enterprise formation, the lower the measures of poverty.

Table 1

Model of wealth

	2SLS	FIML
Consta	32.435534085** [6.8588660202]	32.924470587** [5.7482399046]
Log new enterprises per 1,000 population	–7.4708606588** [–2.8829024731]	–8.0618091236* [–2.43049163]
Percentage of unemployed to total economically active population	1.1224719265** [8.1271855608]	5.7482399046** [8.0377899151]
Initial conditions of the region – GDP in 1990	–2.4611181688** [–2.8211422629]	–2.5701634151** [–2.9227322952]
Dummy1997	–7.5848567853** [–4.7078482252]	–6.2991213923** [–3.9138858367]
Number of observations	356	356
R ² arj	28.09%	27.5%
F statistics	F(4,351)=35.67254 [0.0000]	F(4,351)=34.80261 [0.0000]

In brackets t-statistics * – 5% level of significance, ** – 1% level of significance

Table 2

Model of new-enterprise formation

	2SLS	FIML
Consta	1.3912907324** [9.9522287479]	1.2718446043** [9.3114433357]
Population with incomes below poverty-line	-0.0117963288** [-3.8238041737]	-0.0092857272** [-2.992233465]
Regional policy	0.3991604369** [5.4045881004]	0.4494861122** [6.3121144313]
regional entrepreneurial potential	4.51041E-08** [4.6411009993]	4.247151E-08** [4.3826568126]
Dummy1995	0.20566368098** [3.6637938367]	0.1840167076** [3.2761770695]
Number of observations	356	356
R ² arj	21.7%	21.2%
F statistics	F(4,351)= 25.68985 [0.0000]	F(4,351)= 24.96339 [0.0000]

* -5% level of significance, ** - 1% level of significance.

CONCLUSIONS

In Russia in the period of transition impoverished was the most educated and high skilled part of the population. For this large group the most effective means of dealing with poverty was a policy promoting the development of small business. It was shown that the development of new enterprises and level of poverty are interrelated endogenous variables: the poorer the regional population, the lower the new-enterprise formation; the higher the new-enterprise formation, the lower the poverty. The level of small business corresponds also with regional entrepreneurial potential and political orientation of local leaders, and the level of poverty with the pre-reform conditions in the region, rate of unemployment, educational potential and labor potential, i.e., with the situation at the labor market. These conclusions indicate that problems of poverty and new-enterprise formation must be coordinated financially and organizationally. While at present they are the responsibility of different departments and, therefore, are not considered jointly, it is advisable not only to coordinate them but also to focus in a single body at the executive and legislative level: committees of Duma, Council of Federation, ministry or state committee. Similar changes would be made in regional and local administrations.

It is reasonable, in the development of budgets of all levels, to correlate poverty programs with those of small business, so that in assignment of federal transfers the indicators stimulating new-enterprise formation are included. In all forms of grants to territories the federal center must consider not only economic but also institutional characteristics of the regions: the influence of regional leaders, their cohesion, risk aversion of the inhabitants. Russia is a multi-ethnic country, and national traditions of many peoples living on its territory may blame entrepreneurship.

If self-employment is stimulated in a region with a high share of the poor, for example, through credits, then, most probably, such practice would be unsuccessful. Absence of effective demand for goods and services produced by new enterprises will make them bankrupt, not able to pay back the taken credits. The number of the poor will increase.

If social benefits are given to the poor, but new-enterprises are not stimulated, it will be a “trap of poverty” eliminating incentives to open business for fear of high risks. It is obvious that in regions with high poverty, the development of small business will be slow because of low demand. In such regions state activities to help the population is necessary. The support of new enterprises can be given in forms that set off the insufficient demand and guarantee to entrepreneurs their sales. For example, regional government may make order to small enterprises for their products.

The results of this work may also be used by policy-makers in Russia and by international funds and non-government organizations in their regional programs of social adaptation to changes. The theoretical propositions presume that poverty and small business linkage can be found not only in Russia but in other countries, too. Therefore, the practical advice of this work may be applicable not only in Russia.

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