

Towards a modern SME policy in Ukraine

Friedrich Naumann
STIFTUNG **FÜR DIE FREIHEIT**

 Berlin
Economics

Consultant:

BE Berlin Economics GmbH

Schillerstr. 59

10627 Berlin

Germany

Tel: +49 30 206 134 640

Fax: +49 30 206 134 649

service@berlin-economics.com

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kiew@fnst.org

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Executive Summary

Small and medium-sized enterprises (SME) contribute significantly to Ukraine's economy in terms of value creation and employment. While the SME sector is rather heterogeneous, it is dominated by single entrepreneurs and micro businesses with low productivity.

A direct comparison with the SME sectors in other European countries suggests that Ukraine's SMEs grow slower and are less innovative than their European counterparts. This is partly due to current policies towards SME in Ukraine that are largely based on tax exemptions for single entrepreneurs and micro-businesses and almost entirely ignore the needs of medium-sized companies.

However, the flip side of the currently underdeveloped SME sector is its potential for growth, job creation and innovation once the right policies are in place. In order to do so, SME-oriented policies need to distinguish between various target groups within the sector as each group has its specific problems and requires a specific policy approach. We recommend therefore the following long-term strategic policy objectives:

1. Help subsistence businesses to transform into scalable sustainable businesses.
2. Provide freelancers a framework to carry out their businesses in an efficient way.
3. Help "stuck-in-the-middle companies" grow and become big companies.
4. Support innovative and growth-oriented enterprises which are likely to challenge the incumbent industries.
5. Help pseudo self-employed transform into proper businesses.

Objective three and four should receive particular attention as they have the highest potential for enhancing competition, which in turn would lead to more innovation, increased growth and employment. To achieve this, the following main impediments for the development of a growth-oriented SME sector in Ukraine have to be addressed:

- The current macroeconomic instability, especially limited access to finance
- The unfavourable regulatory framework, especially the high administrative burden

Those obstacles can be overcome with a range of short-term policy measures that are easy to implement and can immediately produce positive effects while not requiring extensive public expenditures. We recommend:

- Measures to facilitate SME access to bank credit finance by promoting a better coordination of credit bureaus and a broad use of transparent accounting standards by SMEs
- Measures that reduce the administrative burden drastically and consistently, e.g.
 - Reform the inefficient system of primary documentation
 - Further reform of the system of business supervision
 - Further reform of the tax system

Given the significant size of Ukraine's SME sector, a modern SME policy can boost the country's economic development while at the same time enabling SMEs to challenge the present big businesses and break up oligopolistic networks.

Contents

1.	Introduction	5
2.	SME in Ukraine – What are we talking about?.....	6
3.	Strategic recommendations for SME policy in Ukraine	12
3.1.	Principles of a modern SME policy	12
3.2.	The major challenges for Ukraine	13
4.	Selected Recommendations on Policy Measures	16
4.1.	Transform subsistence businesses.....	16
4.2.	Provide freelancers with an efficient framework.....	16
4.3.	Help stuck-in-the middle companies.....	17
4.3.1.	<i>Reducing regulative growth barriers</i>	<i>18</i>
4.3.2.	<i>Access to finance</i>	<i>20</i>
4.4.	Support innovative and growth-oriented companies	21
4.5.	Transform pseudo-self employed into proper businesses.....	22
5.	Outlook.....	23
6.	References	24

List of Tables and Figures

Table 1: The heterogeneity of SME in Ukraine.....	7
Table 2: The structure of SME in Ukraine.....	8
Table 3: Benchmarking Ukraine’s SME sector.....	8
Table 4: SME definition in Ukraine.....	10
Table 5: Target vs. actual structure of SME in Ukraine.....	13
Table 6: Overview of SME development framework in Ukraine.....	15
Figure 1: Regional diversity of small and medium corporations.....	9

1. Introduction

Small and medium-sized enterprises (SME) have played an important role in Ukraine's transition process since the 1990s. However, the SME sector has not received much attention of Ukrainian policy makers for decades. The economic and legal conditions for SMEs are significantly below the international average and a consistent policy framework supporting SME development is yet lacking. The SME policy, if any, has been limited to tax incentives and privileges for micro businesses, but it does not take into account the needs, problems and impediments of growth-oriented companies.

It is only recently that some of Ukraine's policy makers have come to recognize that SMEs can contribute to the country's economic development. The brighter side of having no strong policy legacy is that Ukraine has the chance to design a state-of-the-art SME development policy from scratch. This paper intends to support policy makers by designing a modern SME policy.

This policy paper is a joint undertaking of the Friedrich Naumann Foundation for Freedom and Berlin Economics.

The motivation and contribution of the Friedrich Naumann Foundation for Freedom is based on the FNF 2014-2016 project objective for Ukraine "to identify the major SME needs in Ukraine and propose appropriately targeted measures to improve the SME framework, thus expanding liberal policy approaches, identifying obstacles and initiating learning processes and social change to facilitate economic activity". The objective is to come up with realistic and specific recommendations for improving the framework for SME development in the short term and promoting competition within the Ukrainian economy in the long run. This should be achieved through personal consultations with relevant decision-makers, national experts, representatives of civil society (business associations) and international organizations, as well as by collecting comprehensive and reliable data.

Berlin Economics is a company that has advised the Ukrainian Government and other public authorities such as the National Bank of Ukraine on a wide range of economic policy issues and on financial sector development for many years. Its analytical work is presented and discussed during regular meetings with high-level decision makers.

Certain aspects of SME development policies have already been addressed by the Friedrich Naumann Foundation for Freedom and Berlin Economics in the past. The objective of the current joint work is to provide not only selected policy recommendations but also to sketch out the principles of a comprehensive and holistic SME development policy. Consequently, the paper addresses policy makers of Ukraine, and it also aims at contributing to the public-private dialogue between policy makers and the civil society, such as SME associations.

The paper is organized in the following way: Chapter 2 presents an overview of the SME sector in Ukraine and highlights some peculiarities that are important for efficient policy development. Chapter 3 outlines and explains the strategic objectives for the SME policy that derives directly from the analysis presented in the previous chapter. Chapter 4 provides some specific policy recommendations which are easy to implement and can lead to significant improvement of the SME development in Ukraine. Chapter 5 provides a final outlook.

2. SME in Ukraine – What are we talking about?

During our research we realized that there is no common understanding in regarding what small and medium enterprises (SME) in Ukraine are. There are definitions, mainly with respect to the number of employees and amount of turnover (see Box 1), and those definitions are more or less consistent one with another, but there is no common understanding about what the real phenomenon behind those artificial categories is. This is especially the case for the assessment of the current and future relevance of SME for the Ukrainian economy.

We have analyzed statistical data from both official and non-governmental research sources. We have interviewed politicians, governmental officials, scientists, SME managers, consultants, tax lawyers, spokesmen of business associations, managers of SME promotion programmes and SME experts from financial institutions and from international development organizations.

Our comprehensive research reveals that the SME sector in Ukraine is in fact a very heterogeneous sector. There is vast variety of economic players who possess very different characteristics and who face different challenges, problems and hurdles. Thus, putting all these different economic players into one category would not reflect the situation in an adequate manner.

Having said it, we were able to identify some patterns, though. According to our findings, the SME sector in Ukraine can be divided into five different groups of economic players. All of those groups meet the criteria of the SME taxonomy (see Box 1), but the groups are in fact very different one from another. The groups are as follows:

- Subsistence businesses
- Freelancers
- Stuck-in-the middle companies
- Innovative growing companies
- Pseudo self-employed

Subsistence businesses are self-employed businesses and micro-enterprises with the only aim to generate enough income for simply personal surviving. There is, if any, only marginal entrepreneurial motivation behind it. The only reason for their existence is the absence of any other income opportunity. Typical examples for such a subsistence business are little market stalls or tiny retailers. Subsistence businesses result mainly from the fact that unemployment benefits in Ukraine are insufficient to cover the living costs.

Freelancers are self-employed people that have non-scalable business models, such as journalist, writers, scientists, designer, photographers etc.

Stuck-in-the-middle companies are corporations that have a scalable business model, but are not growing, either because of lacking growth-aspirations or because of growth barriers. Typical examples are manufacturing companies, trade businesses, service businesses etc.

Innovative growing companies are corporations that have a scalable business model, that entails some kind of market, product or process innovation, and that aim to grow and scale the business.

Pseudo self-employed are people who possess the legal status “self-employed” but do in fact by no means act as entrepreneurs. They can be divided into three subgroups. The people of the first subgroup of the pseudo self-employed are single entrepreneurs that work like employees, because they have not been able to transform their service offer into a proper business. The second subgroup of pseudo self-employed are in fact employees with no intention ever to form a business, but they claim to be entrepreneurs in order to evade income tax and social taxes or to circumvent employment regulation (fictitious self-employment). The third subgroup encompasses people that are engaged in tax fraud and money laundering systems, without having any serious business activity at all (see Box 2). Although the three subgroups differ with respect to their ambitions and with respect to their involvement in illegal activity, all three share a common characteristic: they are often victims of power abuse. In most cases, they are forced into such a position. People can hardly choose between a normal employment and a fictitious self-employment without risking their dismissal. They have fewer rights than formal employees, have lower income respectively less social contributions than employees and have additional administrative burden (tax and reporting compliance requirements). People from the subgroup three are in the worst position of all. They are at the very bottom of huge tax fraud networks. They give their names and entrepreneurial legal status and bear all the risk of legal persecution, whilst the powerful heads of these networks appropriate most of the black money.

Applying the SME definition of the national statistics (see Box 1), the following matrix emerges:

Table 1: The heterogeneity of SME in Ukraine

	Single entrepreneurs	Micro enterprises	Small enterprises	Medium enterprises
Subsistence businesses	X	X		
Freelancers	X			
Stuck-in-the-middle companies			X	X
Innovative growing companies		X	X	X
Pseudo self-employed	X			

In figures: 77% of the 1.6 m economic agents of the SME sector are single entrepreneurs. According to expert’s estimations, half of the amount of single entrepreneurs is pseudo self-employed, which is 38% of total SME. The other half of the single entrepreneurs consists mainly of freelancers and subsistence businesses. 18% of all agents of the SME sector are micro-enterprises that can mainly be classified as subsistence businesses. That means that only 5% of all SME are actual enterprises. The next table shows these numbers. The numbers are by no means based on sophisticated statistic methods. However, it is not about having

double digit precision. Instead, these numbers shall illustrate a striking peculiarity that the SME sector in Ukraine is dominated by pseudo-self-employed and subsistence businesses.

Table 2: The structure of SME in Ukraine

	Share of all SME
Subsistence businesses & Freelancers	57%
Stuck-in-the-middle companies and innovative growing companies	5%
Pseudo self-employed	38%

Source: Expert's estimations based on the Ukrstat data

This is important to have in mind when interpreting the following data in table 3 that benchmark Ukraine's SME sector with that of other countries. The typical economic indicators draw a picture that let Ukraine's SME sector look alike other European countries, as the following table shows. However, these aggregated indicators do not reveal the structure within the SME sector. Subsistence businesses and pseudo-employment are, although not neglectable, but less important problems in the other peer and benchmark countries. Furthermore, other SME sectors show more growth dynamics, i.e. more companies grow out of the medium-sized stages.

Table 3: Benchmarking Ukraine's SME sector

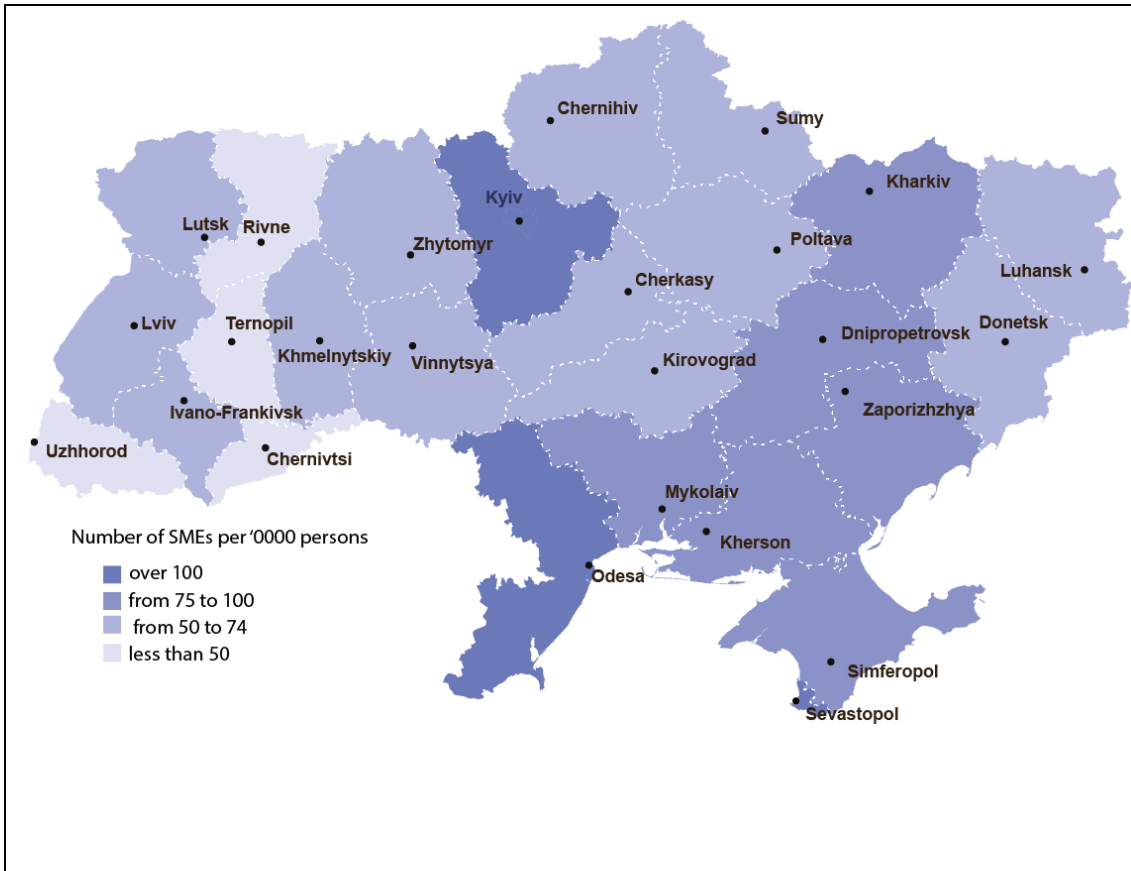
<i>SME's share of</i>	Ukraine	Slovakia	Poland	EU 28	Germany
Enterprises	99.9%	99.9%	99.8%	99.8%	99.5%
Employment	75.5%	71.2%	69.0%	66.9%	60.9%
Sales	60.4%	62.7%	51.0%	57.9%	53.8%

Sources: Ukrstat, Eurostat

Table 3 also reveals another correlation. The more developed a country's economy is, the smaller is the share of SME of the economy. As Ukraine's SME sector is the (relatively) biggest in the comparing group, Ukraine's economy is apparently the less developed one. That conclusion corresponds to other economic indicators such as GDP etc.

The next Figure 1 illustrates the regional diversity within Ukraine. The figure shows corporations only (i.e. it excludes single entrepreneurs). The highest density of SME is in the Kiev region and other industrial regions. This is not surprising, because these regions have the strongest economic activity.

Figure 1: Regional diversity of small and medium corporations



Sources: Ukrstat

To sum up this analytic chapter: The SME sector of Ukraine is dominated by tiny economic activities that are in many cases not entrepreneurial.

Box 1: SME definition in Ukraine

The SME definition is stated in the *Commercial Code* (Art. 55.3). Micro enterprises - irrespective of the ownership form - are enterprises with an average number of employees per reporting year (financial year) below 10, and the amount of gross product sales returns for such period does not exceed the amount equivalent to EUR 2 m at the average annual rate of the National Bank of Ukraine against the Hryvnia. Small enterprises have an average number of employees per reporting year below 50, and the amount of gross product sales returns does not exceed EUR 10 m. Large enterprises have an average number of employees higher than two hundred fifty and gross product sales do not exceed EUR 50 m. All the remaining enterprises are classified as medium-size. The definition can be represented by the following table.

Table 4: SME definition in Ukraine

Enterprise category	Average number of employees	Gross income from sales
Single entrepreneurs and Micro enterprises	0 – 10	≤ EUR 2 m
Small enterprises	10 – 50	≤ EUR 10 m
Medium enterprises	51 – 250	≤ EUR 50 m
Large enterprises	> 250	> EUR 50 m

Ukrstat uses the same definition as in the Code. Ukrstat data focus on enterprises, but also shows basic structural indicators of all economic entities, i.e. enterprises and natural entities-entrepreneurs. The Tax Code does not contain an explicit definition of SME, but there are different groups of economic entities under the simplified taxation system.

The classification of SME in Ukraine is very similar to the EU definition. The Ukrainian SME definition encompasses fewer companies because it excludes those enterprises that have high sales amounts but small balance sheets.¹ However, the statistics on the SME sectors in Ukraine and EU countries are very much comparable. As a matter of fact, Ukraine has implemented its current SME definition in 2011 with the main objective to make its statistics comparable to EU statistics.

¹ The EU definition uses three criteria instead of only two. The classification of SME in EU countries is as follows:

<i>Enterprise category</i>	<i>Average annual number of personnel</i>	<i>Annual turnover m EUR</i>	<i>Annual balance sheet total m EUR</i>
Micro enterprise	1 – 9	≤ 2	≤ 2
Small enterprise	10 – 49	≤ 10	≤ 10
Medium enterprise	50 – 249	≤ 50	≤ 43
Big enterprise	> 249	> 50	> 43

According to the EU classification, a company has to meet the criterion “No. of employees” and one of the criteria “turnover” or “annual balance sheet total”.

Box 2: Money laundering with pseudo self-employed

Corruption is one of the biggest problems of the Ukrainian economy and entire society. It is very difficult for businesses to elude the corruption network system since it is omnipresent in the business sector and in authorities. Some companies respectively business managers use the corruption system intentional to gain unfair advantages over competitors, some can simply not withstand to buy themselves out with bribes from the massive oppressions they would otherwise face. (There are many companies that do withstand, though.)

However, corruption is officially forbidden and bribes are not regarded as costs that can be deducted from the tax base. Therefore, a corrupt company needs to generate black money when it wants to spend bribes. The generation of black money with pseudo self-employed works as follows: The company contracts the self-employed with a fictional order. The pseudo self-employed issues an invoice and the company settles the invoice. The invoice-payment is a deductible cost for the company. The pseudo self-employed declares this money as official income and pays its taxes and social contributions. From the point of view of tax authorities there is no indication for any illegal action. However, the pseudo self-employed will never deliver anything, since the contract is only fictional. Instead he gives back a part of the received money to the company in an "envelope". He will keep the other part, which cover his taxes and social taxes and also includes an agio for his "service". This counter deal is unofficial and the money kickback, that the corrupt company receives, is now black money and can be floated in the bribe circuit.

Some peculiarities of the Ukrainian tax and reporting system have facilitated such methods of money laundering. This is still the case even though Ukraine has reformed its tax and reporting system in 2011 and uses now a quite modern approach. However, there are some elements left from the former tax system that have not been reformed, yet. And it is those leftovers from the former tax system, which are misused heavily.

3. Strategic recommendations for SME policy in Ukraine

3.1. Principles of a modern SME policy

A State-of-the-Art SME policy is in fact competition policy. A modern policy supports companies to overcome their liabilities of newness and smallness and helps them to grow out of a premature stage until they reach a sustainable size.

This is in contrast to a policy approach often found in public discussions that focuses on sustaining the small and medium-size status. Many policy makers and international development organizations have high expectations regarding the outcome of a policy that is aimed at supporting and promoting the development of small and medium-sized enterprises in Ukraine. The most popular expectations include: the SME can create jobs, contribute to the countries technological and economic development and enhance the economic transition process. These expectations are valid, but there is a widespread misunderstanding of scientific research in the public discussion: It is not the SME sector that creates jobs. It is those companies that grow out of the small and medium-sized stage that create jobs and innovation, according to long-term scientific research.² It is desirable to have dynamic company life cycles: start-ups that flourish and grow. In other words, only the development of companies leads to positive effects for the economy, precisely the development from small to big.

Supporting SMEs for their sake is by no means a recommendable objective. Table 3 (see above) illustrates strikingly the fact that having many SMEs is not a success. Quite the opposite is true. The companies have, as long as they are small and medium-sized, destabilizing effects on the economy, for the following reasons:

- SMEs, and in particular small and micro enterprises, are the Achilles' heel of the economy: They are especially prone to closure and thus most vulnerable to economic shocks.
- SMEs, on average, usually have lower productivity than big enterprises.
- SMEs, on average, usually pay lower wages than big enterprises do.
- SMEs, on average, provide less training for their employees than big enterprises do.

That is why a policy that attempts to keep companies small and medium is counterproductive.

Start-up promotion, for instance, makes only sense, if you want the start-ups to become the big companies of tomorrow. A good example for high economical dynamics is the USA: One-third of the top 500 companies are replaced within five years.³ On contrast, in case the SME only compete with each other, a start-up promotion policy would result in crowding-out effects: the new promoted (subsidized) start-ups crowd out the incumbent SME and the net effect on job creation and value creation is zero, if not negative.

² Cf. for instance Audretsch (2003b); Storey (1994); Van Stel/Storey (2004); Shane (2003).

³ Cf. Parker (2009).

The competition within the SME sector is fierce in most countries of the world anyway, but it usually does not go along with significant (net) positive welfare effects. The positive effects emerge when growing companies challenge the incumbent big companies.

This is important to point out: The objective of modern economic policy towards SME is to enhance economic dynamics. That means that such a policy always challenges the big companies. Competition pressure on the big companies leads to an innovation race on both the SME side and the big enterprises side, and innovation leads to productivity growth, and the latter can result in job creation, especially when the country improves its international competitive advantage.

What does that mean for Ukraine? Ukraine’s big-sized enterprise sector has a monopolistic respectively oligarchic structure. An effective SME policy would threaten that structure and thrill the existing system of wealth appropriation and wealth concentration. We strongly support such an approach.

3.2. The major challenges for Ukraine

The following matrix shows how the situation should look like.

Table 5: Target vs. actual structure of SME in Ukraine

		Single entrepreneurs	Micro enterprises	Small enterprises	Medium enterprises
Subsistence businesses	<i>Actual</i>	X	X		
	<i>Target</i>	should not exist or at least play only minor role			
Freelancers	<i>Actual</i>	X			
	<i>Target</i>	X			
Stuck-in-the-middle companies	<i>Actual</i>			X	X
	<i>Target</i>	should not exist resp. be insignificant			
Innovative growing companies	<i>Actual</i>		X	X	X
	<i>Target</i>		X	X	X
Pseudo self-employed	<i>Actual</i>	X			
	<i>Target</i>	should not exist at all			

In an efficient economy, there are only two types of business models: Scalable business models and non-scalable business models.

Every scalable business model should be scaled. It is counter-intuitive and even counter-productive to stay small respectively medium when the business model is scalable in its nature. Scalable businesses are always subjected to economies of scale, which means that the productivity grows with the company’s size. At the same time the average costs decrease with a growing size. The latter is due to fixed overhead costs (such as compliance costs). Therefore, every scalable business should try to grow in order to utilize the economies of scale. When the company has reached a size of several hundreds or even thousands of

employees, then a discussion of restricted further growth could make sense (some scientists argue that there is a maximum efficient company size for each industry), but remaining a small company makes in most cases no sense in the long-term perspective. The small and medium size should be seen as stages in the company's life cycle. The company needs to reach such stages soon after establishment and then needs to grow out of such stages. Taking into account that reasoning, a small or medium sized company is actually in a premature stage. Stuck-in-the-middle companies are caught in that premature stage; in an efficient economy such growth-stuck companies should be the exception.

Non-scalable business models are the field for freelancers. The sector of freelancers is important for providing certain professional and personal services. However, in a developed economy, that sector plays a niche role.

Subsistence businesses should not exist in a developed or emerging economy. Subsistence businesses can play an important role during the transform process from an undeveloped agricultural stage into an industrial stage. But in an emerged economy like Ukraine's, it is a sign of system failure that so many of this kind of business exist.

Pseudo self-employment should not exist either. Our naming of this category implies already our position towards that phenomenon. The idea of freedom of occupation is founded on the concept of individuality and personal freedom. Entrepreneurial activity is a means of free development of the individual in a self-determined life and professional career. Fictitious self-employment is the opposite of freedom of occupation. People are locked in an uncomfortable position: on one hand pseudo self-employed people depend heavily on their principals and are thus not free in their decision making, on the other hand they have to hide illegal activities from authorities which also curtails their chances.

As a consequence of the analysis, it is evident that nothing like a single promising SME policy approach for Ukraine exists. For the reasons described above, there is no chance to address all the different economic challenges with one SME policy programme at once. Any SME policy approach that tries to make a "one-fits-all" policy is cursed to fail. Instead the policy formulation needs to reflect the heterogeneity of the sector.

As an implication of the target structure as sketched in Table 5, the following five major challenges for the economic policy concerning the SME sector emerge:

1. Help subsistence business owners to either transform their activities into a scalable sustainable business or help them to find alternative sources of income.
2. Provide freelancers the framework to carry out their businesses in an efficient way.
3. Help stuck-in-the-middle companies to grow and become big companies.
4. Support such innovative and growth-oriented enterprises that are likely to challenge incumbent industries.
5. Help pseudo self-employed to either transform into a proper business or help them to escape from illegal activities.

The next table provides an overview of the framework of economic conditions in Ukraine that are especially relevant for the development of SME. The framework condenses all influence factors that have been identified by scientific research. As the table demonstrates, there are few favorable framework conditions in Ukraine.

Table 6: Overview of SME development framework in Ukraine

<i>Economic conditions area</i>	<i>Conditions that are especially relevant for SME development</i>
Macroeconomic stability	<ul style="list-style-type: none"> ⊖ High and volatile inflation rate ⊖ Negative growth of aggregate demand
Regulation and legal environment	<ul style="list-style-type: none"> ⊖ Inefficient entry regulation, i.e. registering, licenses, permissions⁴ ⊖ Inefficient exit regulation ⊖ High compliance costs and massive regulatory burden ⊖ Inefficient product certification, inefficient customs regulation⁵ ⊖ Inefficient enforcement of business contracts ⊖ Very restrictive labour market regulation ⊖ No efficient investment protection ⊖ Corruption and fraud in business and authorities
Labour market	<ul style="list-style-type: none"> ⊕ Availability of educated workforce (at least with respect to formal education) ⊕ Competitive labour costs (e.g. in comparison to EU countries)
Infrastructure	<ul style="list-style-type: none"> ⊕ Quite developed sector of business related professional services ⊖ Partly good quality of roads, airports, communication, rail and port infrastructure, but on average behind peer countries in the region ⊖ Limited availability of business parks, building sites, water supply, energy supply, broadband internet access etc.
Taxation	<ul style="list-style-type: none"> ⊕ Moderate tax burden (e.g. in comparison to EU countries) ⊖ High administrative burden of tax regulation
Access to finance	<ul style="list-style-type: none"> ⊖ Restricted access to credit finance ⊖ High and volatile interest rates ⊖ Low availability of 'non-traditional' financing such as pre-seed and start-up financing, angel investors, mezzanine financing

As table 6 illustrates, the priority areas for a policy towards SME in Ukraine are macroeconomic stability and regulation.

⁴ Ukraine has currently improved its rank from No. 50 to No. 47 out of 183 in the World Bank "Doing Business 2014" report with respect to start-up procedures, which is a success. However, the WBDB report uses a standardized research method that is not applicable to most start-ups. Besides, scientific empirical research has not found any effect of WDBD start-up procedure rankings on start-up numbers in 39 countries over 2000-2005 (van Steel et al., 2007).

⁵ This situation will improve when the DCFTA is going to be implemented fully.

4. Selected Recommendations on Policy Measures

The following Recommendations are structured in five sections, based on the five challenges identified in chapter 3.

4.1. Transform subsistence businesses

The challenge is to help subsistence business owners to either transform their activities into a scalable sustainable business or help them to find alternative sources of income. This challenge has two aspects, one on individual level and the other on framework level.

On individual level are entrepreneurial skills the striking point. In other words, the challenge is helping business owners to become entrepreneurs. Policy programmes can help the individuals to assess and develop their entrepreneurial skills. There is long-term international experience available regarding such programmes. Here are some examples for programmes that are suitable for Ukraine:

- Assessment Centers for Entrepreneurs help individuals to reflect their entrepreneurial skills. The Assessment Center analyses personal strengths and weaknesses, but it also spots issues of the business concept.
- Entrepreneurial training helps individuals to develop sustainable business models, formulate business strategies and use financial planning tools.
- Labor market integration programmes and vocational training can help bringing individuals into an employment that generates higher and more sustainable income than the business activities.

The support on individual level needs to be flanked by an improvement on framework level. Entrepreneurial success cannot be controlled by individual skills alone. The success of a business depends on market situations and regulation conditions, both not controllable by the entrepreneurs. We say more on the framework conditions below in section 4.3.

4.2. Provide freelancers with an efficient framework

Freelancers with non-scalable business models rely on their own personal productivity only. It is in the nature of their business that their capacity is restricted to their own working hours. The best thing to support freelancers is to release them as much as possible from regulatory burden that consumes their time. This goes for administrative burden of tax regulation, legal compliance, reporting requirements etc.

In Ukraine is a system in place that is aimed at releasing single entrepreneurs from tax and administrative burden. The problem with that system is that it is very inefficient. It is designed in such a way, that it facilitates fictitious self-employment and tax fraud. The regulation as it is now can hardly distinguish between freelancers and “normal” businesses.

There are companies that disguise themselves as freelancer networks in order to exploit the regulation regarding lower tax and administrative burden.

How does this affect the regular freelancers? The problem is that the freelancer markets are especially prone to ruinous competition. This is due to low market entry barriers and atomistic market structures. When the supply of freelancing services is contaminated by fictitious self-employment supply, the average quality of services decrease and thus prices of freelancing services decrease which in turn can ruin freelancing businesses.

The task for the policy is to design a regulation system that facilitates freelancing activities but at the same time protects real freelancers from the illegal competition of fictitious self-employment. Measures could be moderate market entry barriers, a moderate quality control mechanism and measures to fight pseudo self-employment (see below).

4.3. Help stuck-in-the middle companies

The challenge is helping stuck-in-the-middle companies to grow and become big companies. As discussed in chapter 3, the major impediments for companies' growth are the instable macroeconomic environment and massive regulative growth barriers.

The latter should be the priority field for SME policy in Ukraine. There is much international experience that shows how effective regulation boosts the development of SME.⁶ As table 6 reveals, the following fields of action are especially important for Ukraine:

- a) Ease entry and exit regulation, not only registering, but also licensing, permissions, supervision
- b) Reduce compliance costs and regulatory burden
- c) Improve the regulation of product certification und customs regulation⁷
- d) Improve the enforcement of business contracts
- e) Ease restrictive labour market regulation
- f) Protect SME investments from illegal expropriation
- g) Fight against corruption and fraud in business and authorities

The first two issues a) and b) have already been addressed by recent reforms. Section 4.3.1 will briefly discuss these recent reforms and points out the need for further reforms.

With respect to the macroeconomic instability, SME suffer more than big enterprises from the restricted access to finance. Section 4.3.2 deals with that issue.

The other issues c) to g) are important to mention, but shall not be discussed in detail here, because they are beyond the scope of this paper.

⁶ Cf. a list of selected references in the appendix.

⁷ Implementing the DCFTA would improve this situation tremendously

4.3.1. Reducing regulative growth barriers

As stated above, the bad regulatory framework conditions form the major hurdle for SME growth in Ukraine. Nevertheless, there have already been some improvements of the regulatory framework in the last years.

The most considerable improvement was the reform of taxation with the introduction of the Tax Code. The tax system has started to converge to modern international standards, although there is still much room for improvement. The policy has continued this process of taxation modernization in 2014 and has initiated some reform steps in this area; among those:

- Reducing the number of corporate income tax (CIT) declaration submission per year (longer reporting periods)
- Improving the efficiency of tax registration for businesses, especially with respect to VAT registration
- Reducing administrative burden of tax regulation
- Improving the cooperation between tax authorities and custom authorities and thus reducing administrative burden for exporting and importing businesses
- Improving efficiency and fairness of tax audits

A second regulative barrier is the current system of business supervision. That includes a broad variety of state authorities that formulate specific requirements regarding doing business and that regularly undertake inspections, i.e. send representatives of the respective authorities to the companies who check whether or not the companies fulfill the requirements. Examples are: fire inspections, sanitary inspections etc. Both the number of authorities dealing with business supervision – currently 56 - and the number of inspections per company are way above the international averages. This is, firstly, a huge administrative burden for companies, i.e. it requires many resources to meet all the requirements and to process all the inspections. It is, secondly, a major gateway for corruption, because many inspectors use their power to blackmail companies' owners. This works as follows: The requirements are in many cases either unclear or they contradict other legal requirements. Thus, it is impossible for the company to meet all the legal requirements at once and thus impossible to receive the needed certificate. In such cases, many inspectors require bribes for giving the company the needed certificate.

This system of business supervision needs to be reformed and the Ukrainian government has taken a promising step, already. The number of supervising authorities shall be reduced from 56 to 26, the number of supervising functions shall be reduced from 1032 to 680 and the staff of those authorities shall be reduced by nearly 50%.⁸ Such changes point in the right direction, the direction of releasing the businesses from unnecessary burden. To state clear, we are not arguing for a deregulation for the sake of it, but we talk about immense inefficiencies that encounter neither social nor environmental welfare effects. Supervision of businesses is necessary, but the way it is organized in Ukraine is just a huge administrative

⁸ Government Resolution № 442 "About the optimization of central executive authorities" as of 10 September 2014.

burden with no welfare improvements. Such administrative burden hits SME more than big companies for two reasons: Firstly, the compliance and inspection costs are fixed costs that hurt the more the smaller the company is. Secondly, SME have fewer resources, less capabilities and less experience to identify and fight the traps of corruption that are set by corrupt state representatives.

A third regulative growth barrier that we address is the system of primary documentation. Ukraine has enormous requirements regarding primary accounting documents. Primary accounting documents are documents that are related to tax accounting and reporting. The requirements include much more than archiving the invoices, but encompass all kinds of bills, receipts, documents, mails, warrants, pieces of evidence etc. This is, again, a massive burden on companies. And again, the burden is higher for SME than for big companies, because these costs are regressive costs, which means that the relative burden (average cost per output unit) decreases when the sales increase. The consequence in reality: when a companies starts, it needs a fulltime employee just for the primary accounting, even if there is no other worker employed than the company's owner itself. And this is not due to the taxation itself, but due to the primary document system. This is important to point out: The taxation gets closer to international standards, but the primary accounting is still Soviet legacy. It is one of the most inefficient systems in the world and needs to be reformed as soon as possible. We can see some tiny reform steps here, for instance the abolishment of the seal requirement has received much public attention. However, there is still huge room for improvement.

Last but not least, the system of simplified taxation is a regulative growth barrier for businesses. When a company grows out of the sales threshold of the simplified taxation scheme, then it will face a huge increase in administrative burden. Therefore, many companies try to avoid growing, because they fear this administrative burden. What Ukraine needs is a release on administrative burden for all sizes of businesses and afterwards a limitation of privileges and compliance exemptions.

Box 3: The incomplete seal reform

The abolishment of the necessity of having a seal on business transaction documents is one of the most welcomed reforms. It is expected that the cancellation of seals ...

- will bring Ukraine closer to the developed countries;
- will reduce risks of raiding;
- will reduce corruption;
- will reduce costs on seals production;
- will simplify doing business;

However, there are many legal acts and norms that are not in line with this new reform. The reform has already changed 30 laws, but a large amount of legislative norms and acts still requires the mandatory usage of seals in economic activity.

Additionally, official guidelines regarding the interpretation and application of the law are lacking. For instance: It is not clear how to proceed in case the business possesses a seal, because there are some documents that are still requiring a seal "in case of its presence".

Therefore, businesses will not be able to completely eliminate the use of seals in their work.

To sum up: The government and the parliament have already addressed some important regulative growth barriers that are especially relevant for SME development. The above mentioned reform measures are currently in the status of discussion; some have passed the parliament already, some have already come into force and some are expected to come into force as of November 2014.

Reading the changes in Ukrainian law literally would mean a move towards simplification of running businesses. Reforms that concern simplification of registration of businesses and reducing administrative burden save time, effort and money of the companies. However, the current reforms steps are quite inconsistent and not brave enough. Box 3 shows an example for such an incomplete reform. Ukraine would need much more effort in this field.

4.3.2. Access to finance

The restricted access to finance for SME is another serious growth barrier in Ukraine. The following explains why and how to address this issue.

One crucial element for company growth is real investment, i.e. the purchasing of capital goods. As of today, many growth-oriented SMEs in Ukraine have profitable possibilities for conducting investments, which would allow them to save cost and/or to expand business, thus becoming more competitive. Based on interviews conducted by the team during the research for this paper, we can identify two main opportunities for such investments. One such area is energy efficiency. Due to increasing energy prices, companies can save significant amounts of money by substituting gas through cheaper sources of energy or by reducing energy consumption. The other major area is the export of goods to the EU market in light of the deep and comprehensive free trade agreement (DCFTA) between Ukraine and the EU. In order to comply with high EU standards – a necessity for exporting to the EU – companies have to invest in new equipment.

While these investment opportunities are there, companies need to finance such projects. As of today, as reported by several medium-size firms during interviews, their access to finance is quite limited. The main reason for this is high nominal interest rates of ca. 25% per year for loans in national currency. While one could argue that inflation is also high (14.2% yoy in August 2014) and thus real interest rates are not that high, a nominal rate of 25% is nevertheless a detriment, especially because forecasting inflation is not an easy task at current circumstances. So the key question here is why (nominal) interest rates are that high.

One crucial factor is the unstable macroeconomic situation, which has its roots in the military conflict in the east of the country. As such, there is little that economic and monetary policy can do about it in the very short term. Consequently, the problem of high interest rates concern not just SMEs, but all business.

Having said that there are two structural factors which contribute to very high lending rates, specifically for SMEs, one is the lack of reliable information about potential SME borrowers, on which commercial banks can rely. There are some credit bureaus active in Ukraine, but information about borrowers is segmented and not standardised. As such, the cost of using such information is very high for banks. A better coordination of credit bureaus, e.g. by founding an industry association which sets standards and facilitates the exchange of

information between credit bureaus, would certainly help. At the end of the process, banks should be able to get a full picture about potential SME borrowers by requesting the information from just one credit bureau at a reasonable price.

A further issue relates to accounting standards. As of today, only very few SMEs use internationally accepted accounting standards, such as IFRS. As a result, it is difficult for banks – especially Western-owned banks – to make a solid judgement about the creditworthiness of a potential borrower. The same problem applies for another form of finance: equity. If a Western investor intends to acquire equity in a small or a medium-sized business, he will face the problem of not having reliable accounting books. For this reason, fresh capital, which would have financed new investments, does not flow. In this regard we should welcome the initiative of the government, in the context of the implementation of the DCFTA, to introduce international accepted standards for SMEs or at least some segments of SMEs.

In our view, by making progress in these two fields, credit bureaus and accounting standards, lending rates for SME could at least in the medium term become more comparable with lending rates for large companies, thus enabling a more level playing field and facilitating growth of SME business.

4.4. Support innovative and growth-oriented companies

Identifying innovative and growth-oriented companies and supporting them with exploiting their potential requires many resources such as public expenditure and key industry knowledge. Therefore we recommend following a focus strategy here. Examples:

- A focus on certain industries could make sense, when the industries have the potential to reach an international competitive advantage. Strengthening SMEs in such industries could contribute to the overall international competitiveness of Ukraine.
- A focus on certain regions could make sense, when reducing regional disparities is of primary interest. In that case it is necessary to find evidence how exactly SME could contribute to strengthen a region's capacity for economic growth.
- A combination of both regional and industry focus is known as regional economic cluster policy and could make sense when the promoted region has sufficient infrastructural capacity to attract and to absorb people, investment, research institutions and professional services.

In any case, it would be recommendable to concentrate on one focus strategy only. International experience shows that all attempts to follow a broad support approach have failed.

By defining the strategic focus, the interdependencies and integration with other policy measures must be considered, too. Firstly, any new SME support programme should create value that is different from that of existing economic policy programmes. This is to prevent double support. Integration means here to clearly define both distinctions from existing support programmes and interfaces with other support programmes. Secondly, the SME

support strategy must be integrated with regulatory reforms. In other words, regulation and direct support need to function hand in hand.

4.5. Transform pseudo-self employed into proper businesses

The challenge is to help pseudo self-employed to either transform into proper businesses or help them to escape from illegal activities.

Helping transforming into a proper business is similar to the recommendations regarding subsistence businesses. Specific programmes such as assessment centers and training programmes can support the individuals with assessing and developing their entrepreneurial skills.

Avoiding or escaping from illegal self-employment can be supported by a specific legal framework that precisely defines fictitious employment, using measurable criteria. Such a framework exist for instance in Germany. Real self-employment is distinguished from fictitious employment by criteria such as self-responsibility of decision making, having an autonomous business organization, and possessing a variety of business clients.

Having such precise criteria enables both potential self-employed and potential principals to evaluate the nature of their business relationship and choose a contract that is legally compliant, i.e. either a labor contract or a supplier contract.⁹

⁹ Some legal provisions dealing with that issue exist in Ukraine. However, they are inconsistent. Further, the practice of these legal provisions by authorities is inconsistent, too.

5. Outlook

We have sketched a modern SME policy approach that addresses the specific needs and problems of Ukraine's various groups of SME. Our recommendations are based on international experiences and scientific research. Ukraine's SME sector is very special in many aspects. We have adapted the international experience and research to Ukraine's characteristics in order to help policy makers to formulate an adequate policy.

Our policy recommendations differ from those of many SME experts. Firstly, we do not recommend supporting SMEs for their sake. The point is not whether a company is big or small, but whether or not it is entrepreneurial. We regard entrepreneurship as a means of individual development, reflecting the freedom of choice of occupation. Pseudo self-employment and subsistence businesses are the opposite of entrepreneurship. We, therefore, put much emphasis on helping people being in such occupations to move on to better forms of income generation. Entrepreneurial firms that intend to grow and to innovate are the ones that can contribute to Ukraine's economic development.

Secondly, we focus on those policy measures that do not require big public expenditure, that are easy to implement and that will show positive effects immediately. We do not neglect the relevance of other long-term SME policy programmes such as educational and training programmes, subsidy programmes and incubators etc. However, those measures are often not adequate for Ukraine. Ukraine faces decreasing public budgets and, therefore, cannot finance such programmes sufficiently. Ukraine has weak institutions and few capacities for administrating such programmes. Ukraine's current policy makers need short-term success stories and cannot wait for long-term effects.

Thirdly, we emphasise the link between SME policy and competition policy. One of the biggest problems of Ukraine's economy is the lack of competition. Many policy makers have served the big oligarch business networks to protect them from competition. The results of missing competition are low innovation, high prices and poor quality products and services. Ukrainian products have low chances on international markets because of that anti-competition policy. A policy that tries to support SME but avoids to threaten big incumbent companies would fail to create significant welfare effects. Foster fair competition, challenge incumbent industries and eliminate the unfair protection of oligarch networks, in sum: create a level playing field! That is the way out of Ukraine's economic deadlock.

Last but not least, we want to point out the link between SME policy and industrial policy, innovation policy, education policy, trade policy, FDI attraction policy and financial sector policy. From an institutional perspective, it is counter-intuitive to have an isolated small SME department within one ministry or to have one single SME development organisation. SME policy formulation should be a joint task of all ministries, parliament committees and state institutions that are involved in economic policy.

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