

PN-ARN-303  
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**Small Enterprise  
Development in  
Ukraine**

*GEMINI Technical Report No. 49d*

**GEMINI**

**GROWTH and EQUITY through MICROENTERPRISE INVESTMENTS and INSTITUTIONS  
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# **Small Enterprise Development in Ukraine**

by

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**December 1992**

**This work was supported by the U.S. Agency for International Development through a buy-in to the Growth and Equity through Microenterprise Investments and Institutions (GEMINI) Project, contract number DHR-5448-Q-53-9081-00.**

## PREFACE

The U.S. Agency for International Development plans to support, through activities that can be implemented quickly, the start-up and expansion of small private enterprises in the newly independent states (NIS) of the former Soviet Union. To help achieve this objective, the NIS Task Force contracted the Growth and Equity through Microenterprise Investments and Institutions (GEMINI) Project of the Bureau for Private Enterprise to field a multidisciplinary team in Ukraine to analyze the small business sector and make programming recommendations. Issues examined by the GEMINI team included recent sector developments, the availability of financial services, the legal and regulatory environment, and the role of public and private institutions in encouraging private sector growth.

The GEMINI team visited Ukraine October 5-23, 1992. Team members included Dennis De Santis, enterprise development specialist; Jean Gilson, finance and banking specialist; Max Goldensohn, policy and regulatory specialist; and Jennifer Santer, institutions specialist. The team was joined in the last week by Timothy Smith, Manager of the NIS GEMINI project. All team members are permanent staff of Development Alternatives, Inc.

The team, assisted by locally hired translators and drivers, centered its activities in Kiev. Interviews were conducted with national and municipal government officials; financial institutions; business training institutions and associations; Ukrainian entrepreneurs; private farmers; members of the Ukrainian-American community in Kiev; and U.S. government representatives, businesses, technical assistance teams, and media representatives. Two team members conducted a four-day trip to Lviv in western Ukraine to assess conditions outside the capital. Lviv was chosen based on its reputation as a likely center for rapid private sector development.

The team analyzed the major factors affecting Ukraine's business climate and recommended a strategy and specific activities designed to alleviate constraints to the formation of small businesses and to assist them in their growth. Many facets of the recommended program can be coordinated with other U.S. government-supported efforts, and this coordination and leverage of resources is considered an integral part of the program's design.

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## EXECUTIVE SUMMARY AND RECOMMENDATIONS

### UKRAINE'S BUSINESS ENVIRONMENT

The environment for small enterprise development is created by the combination of several interlocking factors that cross sectoral lines. The principal factors affecting the business climate include the macroeconomic and political environment, the availability of financial services, the legal and regulatory framework, and the public and private institutions that provide services to businesses. The business environment is further affected by reforms in such areas as privatization and by social values. Through an analysis of these factors, a picture of the business climate begins to emerge, and in turn constraints to the development of small private enterprises can be identified. The recommended Small Enterprise Development (SED) program is designed to alleviate these constraints.

The following summarizes the major factors that define Ukraine's business environment:

#### Economic Factors

- **The state-owned economy continues to dominate the national economy.** Prior to 1989, private ownership of productive assets was illegal and even today the state still accounts for up to 98 percent of the GDP. Private commercial activity is extremely limited and constrained for a multitude of reasons. Some regional variation in the degree of private commercial activity exists for historical, political, and economic reasons.
- **Ukraine is suffering from high inflation, recession, and currency problems.** Ukraine has left the ruble zone and replaced rubles with its own coupons. Coupons were originally exchanged at 10 times the value of rubles, but they have been constantly devalued and are now about half the value of rubles. At the same time, by some estimates inflation is running at about 5 percent per day. Real wages are dropping, especially at state-owned enterprises where salaries have been only nominally adjusted. The economy has contracted sharply and unemployment is rising.
- **The legacy of the Soviet economy has created a situation in which barter, favors, and personal contacts compete with currency as mechanisms to procure goods and services.** Under the Soviet system, artificially low prices contributed to shortages, and having money to pay for goods did not ensure access to scarce consumer goods, commodities, and services. Increasingly, barter and favor-trading were employed to obtain goods and services at nearly all levels of society. These practices continue in Ukraine, and the situation has been exacerbated by high inflation that further devalues the country's currency.
- **The weakest links in the chain of market activities are the distribution of supplies to producers and the wholesaling and retailing of finished goods to consumers.** Ukraine has a relatively strong industrial and agricultural base, but consumer demand for virtually all goods exceeds supply. The inability to produce more or to reduce the losses in agriculture can be attributed largely to inefficient supply and marketing networks.

- **The disintegration of the Soviet Union and breakdown in inter-republic trade has created raw material shortages.** The Soviet strategy to economically link the former republics by separating processing facilities from raw materials and markets created a dependency on inter-republic trade. Isolation from the West further reinforced these linkages. Around 80 percent of Ukraine's former trade was with other Soviet republics. Following the Soviet Union's break-up, inter-republic trade fell sharply, simultaneously stalling economic growth and creating raw materials shortages.
- **Private sector growth is likely to occur at a different pace in different regions of the country.** Western Ukraine fell under Soviet domination only after World War II, and it has benefited from greater capital inflows from workers in Austria, Hungary, Czechoslovakia, and Poland. Economic assistance and investment have also been contributed by descendants of the Ukrainian diaspora, many of whom originated in western Ukraine. These factors have helped create a somewhat more conducive environment for private business activity. Eastern Ukraine and parts of southern Ukraine were under longer and more direct Soviet domination. These regions experienced greater development of heavy industry and collective farms, resulting today in less private commercial activity.

### **Political and Legal Factors**

- **The national political and legislative environment is in a chaotic and transitional stage.** Ukraine voted for its independence less than a year ago, and since then it has sought to forge a national identity and consciousness. At the same time, breaking away from the Soviet Union ushered in a period of political instability. With the exception of President Leonid Kravchuk who has managed to remain in office, most other leaders have been replaced by successive governments. Former communist leaders have been elected or appointed to leadership positions, thus contributing to uncertainty about the government's commitment to reform.
- **Business-related legislation still needs to be written and implemented.** Basic laws on ownership and privatization have been enacted but they have not been tested or interpreted, thus creating uncertainties about their applicability and enforcement. A comprehensive commercial code still does not exist, and tax laws giving favorable treatment to small businesses are poorly understood. Despite laws that presumably encourage and protect small businesses, most entrepreneurs are forced into the position of paying bribes for everything from registering their businesses to securing protection from local racketeers.
- **Privatization of state-owned enterprises and assets has not begun in a comprehensive fashion.** The slow pace of privatization is keeping land and productive assets from being profitably employed. Some private entrepreneurs and farmers have managed to lease or otherwise use state assets for private production. In other instances, de facto privatization has occurred as former government officials and directors of enterprises have expropriated former state assets; the legality of this de facto privatization is questionable.
- **Agricultural reform and the promotion of private farms through the break-up of collective and state farms are proceeding slowly.** More progress has been made in land reform than in privatization of enterprises, but only 10 percent of the land is scheduled to be privatized by the end of 1992. Private farmers are constrained from making planting and cropping decisions by the unavailability of supplies and equipment. Farmers continue to sell

primarily to state-owned enterprises, partly to obtain supplies but also because state outlets are their only dependable markets. The quality and grade of agricultural produce are inconsistent because of lack of proper inputs, outdated equipment, and inefficiencies of postharvest handling and processing.

### **Banks, Enterprises, and Business Institutions**

- **The financial system remains under state control, unregulated, inexperienced, and reluctant to lend to small private enterprises.** The existing financial institutions are operating in an unregulated environment in which capitalization requirements are insufficient, banking services are not well defined, and financial management for banks is insufficiently understood. Bank staff are poorly trained in free market principles and Western banking practices. Personal contacts largely determine an enterprise's ability to obtain credit and financing. Enterprises can offer little in the way of collateral, credit history, or business feasibility to qualify for a loan.
- **Small private enterprises in trade and professional services are more numerous and further developed than those in agribusiness or manufacturing.** The barriers to entry in the trade and services industries are lower, requiring less capital investment, equipment, and technical inputs. Potential for the development of an agribusiness industry exists, but it is constrained by lack of capital, appropriate equipment, and supply and distribution channels. The absence of investment capital or borrowed capital, coupled with unclear laws on the ownership of land and fixed assets, creates additional barriers for the start-up of manufacturing firms.
- **Public and private sector institutions provide inadequate services and representation to small enterprises.** Ukraine's various public and private institutions and associations are inexperienced in market economics and the principles of sound management. Their organizational structures reflect the Soviet penchant for multitiered hierarchies of boards, committees, and panels that are often more concerned with procedures and privilege than substance. Under these conditions, small business advocacy and the provision of services become subordinate concerns.

### **Social Factors**

- **Concepts of private ownership and the free market held by many in the government, private sector, and banking community are vague, conflicting, and distorted.** Few people have direct experience operating in a free market economy. For most, knowledge of the capitalist system is based on theory.
- **A lingering anticommercial bias has created a business environment that many view as dominated by profiteers and racketeers.** Socialist ideology scorned entrepreneurship and profit making. Private enterprise was illegal until recently, and this illegality resulted in black market activities. In this underground economy, where everybody was already disregarding the law and popular ideology, illegal rackets formed. When the law changed, these activities surfaced and today rackets still control widespread small-scale commercial activity. Unfortunately for legitimate businesses, they have been stigmatized by the perception that all enterprises are controlled by mafia-like networks.

- **The market for goods and services at all levels of society is strong because of pent-up demand.** Businesses and consumers deal with market shortages in everything from housing to food. Purchases of goods and services appear to be more constrained by availability than cost. Although the level of accumulated wealth and income is low, the domestic market is numerically large enough to support a variety of production. Demand is highly elastic: consumers would buy more even at a higher price.
- **Women are disproportionately represented in both the general population and low-level occupations.** The wars, repression, and famine that plagued Ukraine this century have resulted in the country having 16 percent more women than men. The economic hardships of the command economy and socialist idealism placed a double burden on women. The pervasive shortage of all goods and services forced women to devote an inordinate amount of time to the family and household management. At the same time, women were encouraged to join the labor force, but anecdotal evidence suggests that they disproportionately occupied low-paying and low-status jobs.
- **Ukraine is rich in human resources.** Ukrainians are basically well educated and technically skilled. The people are known for their ability to endure hardship, but many are anxious about the future and the impact of political and economic reforms on their lives.

The foregoing factors define the general context for small business development in Ukraine. The following SED program recommendations are designed to address constraints and impediments to the sector's growth by strengthening entrepreneurial ability; enabling private businesses to access information, equipment, and other forms of assistance; and expanding the availability of financing and related services. In the process, interactive linkages will be developed among small enterprises, the financial sector, and public and private institutions and associations. Through a hands-on approach that concentrates on practical problems, the program will yield results that can influence policy and sector reforms.

### **PROGRAM RECOMMENDATIONS**

The GEMINI team recommends a national SED program for Ukraine aimed at assisting the development of small private enterprises involved in production and services. The program would place a long-term adviser in Kiev for up to 18 months to identify and pursue opportunities to assist in private sector development. Initially, these interventions would focus on:

- Training for entrepreneurs and bankers to strengthen business and banking practices;
- Technology transfer to improve and facilitate access to information, technology, and equipment by small enterprises; and
- Credit and financial services to stimulate investment in small businesses and expand the range of services available to entrepreneurs.

Each of these recommended activities is described in detail below.

## **Long-Term Adviser**

The SED program will be directed by a long-term technical expert skilled in small business development, financial operations, and program management. The adviser's principal role will be to influence the environment for private enterprise and play an advocacy role by conveying the interests of small private enterprises to policy makers and managers in the Ukrainian government. Through contact with enterprises, the financial community, and public and private sector business institutions, the adviser will bring a hands-on, bottom-up, and practical orientation to the dialogue on national reform.

At the same time, the adviser will be responsible for implementing and managing specific interventions in the training, technology transfer, and finance components. Activities in these three areas will be developed and modified as the adviser becomes more familiar with conditions and needs. The three components lend themselves to a quick start-up of activities and will allow the design of more complex and longer-term interventions.

## **Training Component**

The objective of the training component is to impart a free market orientation to private individuals, former state enterprise managers, government officials, bankers, and others engaged in the fledgling private sector. Training will be designed around two modules: one for entrepreneurs and managers, and the other for bankers and financial managers. Whenever possible, training and materials development will be conducted in conjunction with institutes and associations in Ukraine. The Kiev International Management Institute (KIMI), the Lviv Management Institute (LMI), and Kiev Polytechnic Institute (KPI) are three local organizations that have expressed an interest in participating in the proposed training activities.

Training for entrepreneurs and business managers would consist of seminars, workshops, and work-study tours focusing on practical business skills, business planning and operations, and financial management. The concepts taught would include free market economics, market demand analysis, and financial and cost accounting as a method to strengthen practical business concepts. Other targeted training and assistance for entrepreneurs would include assistance with local legal, tax, and regulatory requirements, as well as the development and analysis of loan proposals, credit and financial arrangements, and business plans.

Training for bankers will focus on the special requirements of small enterprises, and the appraisal, management, and servicing of the loans made to small enterprises. Specific topics will include risk analysis and risk diversification, business and project evaluation, potential for profitably lending to small businesses, loan monitoring and evaluation, loan classification and portfolio aging, due diligence, and loan monitoring and collections. In addition, Ukraine's banks have little experience in calculating their operating costs and cost of funds, and training will focus on calculating these costs as a basis for understanding and setting interest rates.

The role of the adviser in the training component will be to work with the existing institutions on developing training curricula and content, help in the recruitment and selection of the participants, and assist in the training of trainers. On an ongoing basis, the adviser will assess the possibilities for expanding the number of institutes and organizations involved in the training program. Working with existing programs in Ukraine represents a cost-effective way to deliver training. By taking this approach, A.I.D. can avoid redundancy, move quickly to expand training throughout the country, and maximize the impact of its resources.

The first institutions with which the adviser will work to deliver training are KIMI; KPI, which has recently established a business incubator program; and LMI in western Ukraine. Both KIMI and LMI have established themselves as relatively independent institutions with professional staff, curricula developed in conjunction with U.S. counterparts, and a high rate of program success as demonstrated by the number of graduates who go on to work for foreign joint ventures or establish their own businesses. KPI's business incubator program promises to combine professional business management training with facilities and services designed to encourage business start-ups.

Although these institutions already have training programs, assistance from A.I.D. would expand their outreach to entrepreneurs and improve the quality of their training. Two areas in particular in which A.I.D. can make a significant contribution are:

- Developing high-quality off-the-shelf training materials. To date, much of the training has been ad hoc and uneven, with no effort to develop training materials that can be easily shared and that address all major issues adequately. Developing off-the-shelf training materials is a cost-effective mechanism that provides needed tools to trainers, facilitates an expansion of training efforts, and ensures some consistency in training.
- Organizing subsector training courses. Industry-focused sessions will provide a forum for entrepreneurs to identify particular subsector constraints and develop skills for solving these problems. Also, they will serve as a mechanism for delivering technical information and advice along with general business training. Finally, grouping entrepreneurs from the same subsector will allow them to develop an awareness of their common interests, which is an essential prerequisite for forming the types of independent trade associations that are almost nonexistent in Ukraine.

To date, the business education programs of KIMI and LMI have been affordable primarily to high-level employees of state enterprises that cover their tuition, much of it payable in hard currency. LMI's program, for example, costs the equivalent of \$1,400, \$500 of which is payable in hard currency and the balance in coupons at the prevailing exchange rate. The proposed SED training would be shorter, less expensive, and at least initially subsidized by A.I.D. In turn, more entrepreneurs will be able to participate, especially women who are less likely to be sponsored by a state-owned enterprise.

The success of the proposed SED project will be enhanced by the effective integration of training with other activities. Entrepreneurs participating in training programs are potential candidates for other services to be provided through the SED program.

### **Technology Transfer and Information Services**

Americans take for granted their access to information. Almost every industry, subindustry, and pastime has a trade association or national organization that provides its members with practical information. The U.S. Small Business Administration publishes how-to booklets for starting a wide range of small businesses; most libraries have reference books on foundations and nonprofits, and newspapers and magazines carry feature articles and advertisements replete with advice and practical information. By comparison, the yellow pages in a telephone directory for a medium-size U.S. town may contain more information than the average Ukrainian has ever seen in one place. And despite the plethora of programs, technical assistance, funds, and interested investors that have emerged in the wake of Ukraine's independence, few Ukrainians know how to avail themselves of these resources.

The objective of the technology transfer component is to link Ukrainian entrepreneurs and business associations with U.S. sources of assistance, including information, equipment, and technical assistance. The long-term adviser will endeavor to provide this service in three ways: (1) directly, by establishing contact with an American manufacturer or broker of information, equipment, and technical assistance; (2) through local referral, by coordinating service delivery with other technical assistance organizations such as Peace Corps, VOCA, IESC, and CDC;<sup>1</sup> or (3) by U.S. referral — establishing contact between the enterprise and such Private Voluntary Organizations (PVOs) as the Ukrainian National Association (UNA).<sup>2</sup> Over time, the adviser will identify and work with a local organization to develop and institutionalize the capacity to provide these services.

### **Finance Component**

Currently, Ukraine's entrepreneurs have limited access to credit. Commercial loans to non-state enterprises are made for very short terms (typically only a few weeks) at high interest rates, and these terms discourage the start-up or expansion of production enterprises. Hard currency loans are generally unavailable, yet borrowing in coupons does not enable businesses to purchase needed imports; and small enterprises have no access to investment capital for the purchase of equipment, land, and other fixed assets. Banks themselves are unwilling and unprepared to make business loans. Without some intervention, it is unlikely that this situation will correct itself in the near term.

The finance component combines technical assistance with financing as a means of providing needed resources to entrepreneurs while influencing the development of Ukraine's banking sector. These activities will be phased into the proposed SED program, thus allowing the adviser time to work with and prepare entrepreneurs and bankers for the start-up of a credit and investment program. Eligibility for the proposed financing would be limited to small private firms with a minimum level of equity. At least initially, credits would be limited to \$25,000 per borrower, and priority would be given to entrepreneurs wanting to purchase equipment or fixed assets. Loan and investment terms would be established through consultations with A.I.D. and local banks. The credit and investment activities would be supplemented by other technical assistance that addresses specific sectoral and institutional problems.

Sources of credit and investment that will be examined in more detail in terms of their potential use in the SED program are:

- Capitalization by A.I.D. of a credit line through an existing bank or financial institution;
- Creation of a venture capital and lending fund such as A.I.D.'s proposed Ukrainian Enterprise Fund; and
- A.I.D. loan guarantees.

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<sup>1</sup>These are the Volunteers in Overseas Cooperative Assistance, International Executive Service Corps, and Citizens Democracy Corps.

<sup>2</sup>U.S.-based organizations dedicated to assisting Ukraine, such as UNA, can provide valuable assistance during the country's reform period. UNA, now almost 100 years old, is creating a foundation to fund development activities in Ukraine. UNA has extensive contacts with Ukrainian-American professional associations of lawyers, doctors, engineers, and business people, and it subsidizes Ukrainian-speaking professionals to deliver short-term technical assistance in Ukraine.

### **Line of Credit Capitalization**

The SED activity could establish a capitalization account through a local bank to make loans to start-up or expanding small enterprises. Loan terms would be based on an enterprise's repayment ability and use of funds, thus reforming current banking practices and introducing commercial concepts. Potentially, some loans could be made in hard currency.

### **Ukrainian Enterprise Fund**

A.I.D. is examining the merits and feasibility of establishing a Ukrainian Enterprise Fund (UEF) similar to funds in Poland and Hungary. If a UEF is established, between \$30 and \$40 million may become available for credit and equity investment in Ukrainian businesses. The SED program will be able to identify qualified businesses for UEF's assistance.

### **Loan Guarantees**

A.I.D.'s Private Enterprise Bureau has a Loan Portfolio Guarantee (LPG) that can be accessed by private financial institutions providing loans up to \$150,000 to new small business borrowers. The LPG will guarantee between \$500,000 and \$3 million per institution, or up to 50 percent of a total portfolio of \$6 million.

### **Counterpart Relationships**

The most likely public sector counterparts for the SED program are the State Committee for the Promotion of Small Business and Entrepreneurship or the Economic Department of the Office of the President. Both bodies could provide basic operational support as well as some programmatic guidance, but too close an association with either one could prove counterproductive to the program's efforts to work with the private sector. The public sector is still dominated by the old guard and has not gained the private sector's confidence.

Working with a local institution such as a business association or voluntary organization has an intrinsic appeal, but no suitable group was identified with the management and development experience to support the diverse components of the SED program. Under these circumstances, there is the risk that A.I.D.'s resources would be diverted to strengthening the institution rather than assisting enterprises. Also, at this stage, it is very difficult to ascertain which organizations truly represent private enterprises.

Accordingly, it is recommended that a relatively independent SED program office be established in Kiev. The office would operate in loose association with both the USAID Mission in Kiev and the President's Economic Department. This arrangement would confer legitimacy on the program and enable it to work with public officials on national issues while maintaining its private sector focus.

## SECTION ONE

### MACROECONOMIC OVERVIEW

Despite Ukraine's diversified and relatively well-developed industrial base, its dependency on inter-republic trade (which accounted for 80 percent of all trade) has resulted in numerous dislocations since the collapse of the Soviet Union. These markets are not permanently out of Ukraine's reach. However, the necessity of hard currency payments, problems in allocation of credit, competition from Eastern Europe and other markets, and high rates of inflation make progress with these relationships difficult. To compound its problems, Ukraine has been heavily dependent on outdated technologies that are no longer competitive and military procurements that are no longer forthcoming.

In the last two years, manufacturing output has fallen sharply. Coal production fell by 20 percent in 1991, with major consequences in the key metallurgy and machine-building sectors. Food production declined significantly in the wake of a poor, weather-affected harvest and continuing effects from the Chernobyl disaster. Net Material Production (NMP)<sup>3</sup> increased 3.4 percent in 1989, decreased 3.5 percent in 1990, decreased 9.5 percent in 1991, and will decrease an estimated 15 percent in 1992.

In 1991, Ukraine experienced a budget deficit equal to 14 percent of its estimated GDP, primarily as a result of significant expenditure overruns. Excluding outlays from the union budget, total state budget expenditure rose to 46 percent of GDP, from 28 percent of GDP in 1990. The deficit was covered entirely by recourse to bank financing, bringing Ukraine's state debt to 48 billion rubles, or 20 percent of GDP.

This spiralling industrial decline has contributed to hyperinflation. Retail inflation in 1991 rose nearly 85 percent, while consumer price inflation was closer to 200 percent. Wages increased 120 percent. January price liberalization, minimum wage increases, and sharply administered retail price adjustments in April seem to have only fed inflation. Estimates of inflation for 1992 range from 200 to 2,000 percent. Accurate measurements are not available.

Fueling economic uncertainty are the upcoming introduction of a national currency, the *gryvnia*, and concerns about unemployment that may accompany privatization.

Recognizing the urgent need for comprehensive measures to stabilize and restructure the economy, the Cabinet of Ministers, on March 30, 1992, approved a Draft Program of Economic Reform. Although preliminary and subject to revision, the plan addresses three areas: stabilization via a combination of fiscal, monetary, and income policy measures; further price liberalization, rapid privatization in the trade, distribution, and service sectors, commercialization of state enterprises, and the liberalization of external trade; and social support schemes designed to give greater assistance to the most vulnerable groups at the lowest possible cost.

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<sup>3</sup>Net Material Production, a statistic commonly used in socialist economies, differs from Gross Domestic Product (GDP) in that it excludes certain goods and services and is therefore generally smaller than GDP. The IMF estimated the 1991 GDP/NMP ratio for Ukraine was 1.23.

## SECTION TWO

### THE SMALL BUSINESS SECTOR

Statistics available from Ukraine's Ministry of Economics and Kiev's municipal administration do not distinguish between state-owned and private small businesses. The municipality, which registers small businesses, also does not distinguish between operational and nonoperational businesses. The following figures on the number of businesses were extrapolated with the assistance of the city's registration office; they have been compared with other data sources in an effort to present an accurate assessment of the magnitude of the overall small business sector.

Ukraine is estimated to have 80,000 small enterprises, including 20,000 enterprises located in the greater Kiev region. These 20,000 registered small enterprises are a mix of state-owned, partially state-owned, and privately owned enterprises. Approximately 12,000 of the enterprises in Kiev are privately owned, with 4,000 of them organized as cooperatives. Kiev's municipal authorities and the quasi-private Association of Small Commercial Ventures estimate that up to 50 percent of the registered small private enterprises are not fully operational. Thus in Kiev there are an estimated 6,000 to 9,000 registered and operational small private enterprises, including cooperatives. By extrapolation, this would place the number of operational private small enterprises in Ukraine at approximately 24,000 to 36,000. This is an exceedingly small number of enterprises for a country of this size when compared with a Western economy.

Private small enterprises are emerging in a variety of sectors of the economy. As a result of severe barriers to entry into the productive sectors, however, most of the new private businesses are involved in trading or services. The retail and wholesale trading industries have the lowest barriers to entry, require less capital and equipment, and benefit from quick turnover potential in a society starved for goods and services of all types. Many licensed trading activities deal in a variety of goods depending on availability and prices.

A smaller number of enterprises are involved in production. Many of these enterprises were spin-offs of formerly state-owned enterprises that have begun semiprivate operations. Although ownership remains fluid, some state assets in the form of equipment, raw materials, and personnel are finding their way into private production. Often, these enterprises negotiate an arrangement with a state-owned enterprise to lease buildings and equipment during slack times to produce for the private enterprise. Some enterprises have started with foreign joint venture partners who provide scarce capital, equipment, and raw materials. In many cases, manufacturers are involved in trade to finance their production and barter to obtain raw materials and equipment.

## SECTION THREE

### LEGAL, REGULATORY, AND TAX ENVIRONMENT

In the last three years, Ukraine enacted legislation that evolved over centuries in the West. In the process, the country's leaders have consciously adopted policies to avoid economic shock therapy. Instead, Ukraine prefers to embrace free market economics more gradually than, for example, Poland. As a result, Soviet legal and philosophical structures as well as personnel have remained in operation even as free market legislation is passed. Ukraine, possibly to a greater degree than other former Soviet republics, has maintained in power the same people who ran the country under Soviet authority. Thus, the old boy networks and history play significant roles in government and business, and in their intersection.

The Soviet legal system provided reasonable judicial recourse in cases of personal injuries or conflicts, but laws governing business and banking are new. Local lawyers have little expertise in these areas, and the jurisdiction and independence of local courts are questionable. The government itself has little or no experience in implementing laws and regulations related to private business.

Official policies and statements of the Ukrainian government since 1989 support the development of small private businesses. Ukrainian laws specify that private ownership of the means of production is now legal, and a large body of law has been passed to encourage private sector development. But the laws are often contradictory and their application and interpretation are uneven. Frequently cited problems with the legal system include the following:

- Tax laws change frequently and unpredictably. For example, in 1991, small businesses paid taxes on profits. In 1992, they pay on a vaguely defined notion of "income." The government expects to return to profit-based taxation in 1993.<sup>4</sup>
- The law on the ownership of land is unsatisfactory and unclear.
- The Law on Leasing and the Law on the Privatization of Small Enterprises contradict the Law on Privatization of State Owned Enterprises. The first two give priority to workers' collectives to lease property on a non-competitive basis before it is sold, while the latter calls for competitive bidding for all privatized state enterprises. The state enforces the priority given to the workers' collectives, in turn negating much of the legislation on privatization and rendering the voucher system moot.
- Ukraine has not determined which branch or level of government should oversee the implementation of which laws and regulations, and three levels of government are battling for control: national, state and district.<sup>5</sup>

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<sup>4</sup>One entrepreneur reported that in three years of operation, her company has only once worked under the same tax laws in two consecutive quarters.

<sup>5</sup>Governance of the collective farms provides an example of the confusion that can result from ill-defined and overlapping jurisdictions. The collective farms consider themselves private businesses. Policies and regulations for them come from the Ministry of Agriculture, but the Ministry of Finance sets

- The Parliament is supposed to set the rules of administration and justice but not implement those rules. In the current state of flux, Parliamentary Commissions have begun trying to take control of state and local administration.
- The Cabinet, led by the Prime Minister, feels that its role is insufficiently defined. Ministries and State Committees<sup>6</sup> are charged with drafting, analyzing and implementing laws, but the Presidential Representatives and Parliamentary Commissions intrude on this domain. Because Ukraine has not yet approved a national constitution, there is no point of reference to settle these disputes, nor is there a point of authority sufficiently strong to enforce any decisions.
- The current state of economic and political flux in Ukraine has resulted in a series of market distortions that mitigate against clear analyses of the impact of given laws and the consistent application of rules and regulations.

## **LEGAL AND REGULATORY ENVIRONMENT**

### **Legal Forms of Business Ownership**

Prior to 1989, private commercial activities in the Soviet Union and the Ukraine Socialist Republic were illegal. As a result, private commercial activities were conducted in the informal sector. The shadowy nature of these activities created an environment conducive to racketeering and profiteering, and private business was viewed with disdain by a large segment of the general population. Socialist theory propagated over the last three generations also fueled a negative view of commercial activity. Both new and existing legitimate businesses will have to deal with this negative view.

In 1989, the cooperative law was passed permitting the creation of enterprises that were jointly owned by at least 10 individuals who invested in and managed the enterprise. Under the law, nonstate commercial activities were permitted provided that all workers were members of the cooperative. In practice, many of these cooperatives were managed by a small group of members, other members were silent investors, and outside workers were hired. Many of the existing private businesses operating today were begun as cooperatives.

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pricing policies for inputs and for production and the Ministry of Resources provides equipment and inputs at official prices. For day-to-day administration, the rayon (district) takes charge and is the official owner of their land, but the farms report their activities to the oblast (state or region). For small businesses, which are new entities, the picture is even less clear. They register at the oblast level, but pay their taxes to the rayon unless the oblast decides they should be paid to the oblast; in some cases, the taxes are divided between the two. The ministry-level State Committee for the Promotion of Small Businesses and Entrepreneurship has been established to protect their interests, but the Presidential Representatives appointed to the rayons and oblasts are also responsible for helping the business community. Presidential Representatives assist businesses in acquiring inputs, negotiating tax deals, and facilitating their leasing of space and equipment from state-owned enterprises.

<sup>6</sup>State Committees are ministry-level bodies with special legislated purposes.

In Ukraine today, the chaotic business environment has spawned a bewildering array of cooperatives, associations, and enterprises. Legal forms of business organization have been outlined in the law and are roughly parallel to those found in the United States, but the interpretation and implementation of these laws are constantly evolving, especially in an environment characterized by transition and flux. For example, legislation provides for four principal forms of business ownership, but these ownership forms vary widely in practice. The confusion arises because underlying legal principles of private ownership and a commercial code are not operational. The four forms of business ownership and their analogous U.S. structures are:

- **Limited ownership:** Analogous to privately held corporations in the United States; one or more investors form a legal entity, and their losses are limited to the level of their respective investments. Owners are permitted to engage in the management of the enterprise, and profit is divided based on the level of capital invested.
- **Complete/full ownership:** Owner or owners are accountable for all liabilities incurred by the enterprise and profits are distributed based on an owners' agreement. The analogous business structure in the United States is the sole proprietorship. There are still few enterprises of this type in Ukraine.
- **Joint stock ownership/economic associations:** Ownership shares of the enterprise can be held by individuals, private firms, and state-owned enterprises. A joint stock company can be owned by several state-owned enterprises without private participation. Also, ownership shares can be purchased by individuals without right to management. Many enterprises classified as private are controlled by several state-owned enterprises. A rough analogy in the United States is a private or limited partnership.
- **Command ownership:** The general public invests capital in return for a share of the organization, but it does not participate in the management of the enterprise. Currently, no mechanism exists to publicly trade shares of ownership stock. The U.S. analogy is a publicly held corporation.

### **Laws on Agricultural Enterprises**

One consistent aspect of the legal and regulatory structure of small business in Ukraine is that agriculture, including production and processing, is specifically mentioned as a small business sector that merits priority attention. Three types of farm enterprises are included: collective farms, private farms, and individual plots on collective farms.

Ukrainian law mandates the establishment of individually owned private farms. Because all arable land has been controlled by collective farms, each collective farm is required to relinquish up to 10 percent of its land to private farmers who request an allocation. Currently, less than .5 percent of the arable land in the country is in the hands of private farmers.

The maximum size permitted by law for a private farm is 50 hectares, and the present average size is about 20 hectares. Land ownership is vague most private farmers have free use of their land and they anticipate owning the land eventually, but they cannot sell it or use it as collateral. Land can be leased and passed on to heirs, but because these rights are new, their enforcement remains untested.

The Ukrainian government considers collective farms to be private businesses, and they receive no direct state subsidies. However, they enjoy special privileges and their profits are guaranteed despite relatively low productivity and staggering postharvest losses. Collective farms can purchase inputs directly from the state at state prices, while private farmers have to pay the commercial price — if they can get the inputs officially. More often, private farmers obtain needed supplies through barter and bribes. Collective farms may, in theory, sell their produce to whomever they like, but the state provides a guaranteed market at guaranteed prices. Local Government and Small Businesses

### **Local Government and Small Business**

Ukraine's slow pace of transition from a centrally planned to a free market economy has enhanced the authority of local government. Local authorities have great latitude to determine the policies and regulations governing business activities in their jurisdictions, and they have taken de facto administrative responsibility for collective farms, state-owned factories, and tax legislation. Private farmers can get local government assistance to establish processing contracts with local factories and local entrepreneurs can get unofficial leases of premises, equipment, and even personnel from underused state-owned production facilities.

In general, local authorities are more progressive than central authorities. Many are former Communist Party members and officials, but others are pragmatists who are ready to do what is necessary to make their own way in today's Ukraine. Some leaders are free market ideologues with no real idea of how to move toward privatization of the economy. Others are hard-line survivors of the Soviet regime who want to slow the process of change and protect their positions of power and privilege.

Ukraine is divided into oblasts (states or regions), which are further divided into rayons (districts). Each oblast and rayon has an administration responsible to the Minister of Interior; at the same time, a Presidential Representative has been appointed to each oblast and rayon, and report directly through their own chain of command to the President.

In Kiev, which has an oblast-level government and is subdivided into 14 rayons, the Presidential Representative acts as Mayor. In theory, the Mayor is chosen by the elected City Council, but Kiev's Council chose the man named by the President as his representative to city government. The Mayor's appointees hold all financial control in the city, including the right to impose local taxes and account for national budget allocations to Kiev. They can impose city taxes and keep the revenue for city purposes.

Small businesses must register with the city government to be legal and to qualify for tax privileges. If small businesses want to negotiate their taxes or other privileges, they must deal with the city government, and thus with the Presidential Representatives at the city level. The same is true in the rural areas for private farmers.

### **TAX ENVIRONMENT**

Efforts have been made to encourage business by adjusting the tax code. For example, new small enterprises in industry, agriculture, or construction receive a 75 percent tax break in the first year and 50 percent in the second year on the standard income tax rate of 18 percent. Other legislation provides tax breaks on reinvested profits and, in some instances, enterprises can attain tax exempt status. Local governments have the authority to negotiate special tax deals to encourage small business.

The government has exercised its right to channel investment to certain economic sectors through a policy of taxes and subsidies. Tax policies favor productive activities over trade and intermediation. Income from manufacturing is taxed at 18 percent, while intermediation (wholesaling) is taxed at 75 percent.

Income tax is only part of the tax structure. Entrepreneurs complain more vociferously about the Value Added Tax (VAT) which has been applied like a sales tax on manufacturers and wholesalers. The VAT is currently 28 percent and is added directly to the price of goods. Many entrepreneurs said that this made their products too expensive for consumers. They have given up manufacturing or wholesale trade to go into unofficial trade operations or barter.

Barter is taxed at 10 percent of gross income but, because money is not involved until the goods are sold, the income is often difficult to calculate and tax avoidance is common. Many entrepreneurs and collective farmers practice barter to raise funds for their business start-ups. Barter also helps avoid the prohibitive taxes on foreign exchange operations. Examples of barter transactions include:

- Ukrainian gas masks for Bulgarian vehicle batteries;
- Farm produce for used German agricultural equipment;
- Ukrainian prefabricated steel shelters for Hungarian soft drinks and canned food; or
- Molasses for British agrochemicals.

In addition to VAT and income taxes, all businesses must pay social taxes. Only businesses, and not employees, are assessed these charges that include 37 percent of gross income to the Pension Fund, 3 percent of gross income to the Employment Fund,<sup>7</sup> and 12 percent of gross income to the Chernobyl Fund. This combined 52 percent is also added to the final cost of the product they sell; however, income tax is not paid on revenues from the social taxes or the VAT.

The problem posed to small businesses by taxation laws is two-fold. First, the overall level of taxation is excessive. In the context of the current economic situation, in which real calculations of profitability are difficult if not impossible, many entrepreneurs are driven out of the productive sector into trade or intermediation. High taxes also serve as a barrier to new business start-ups, and many existing entrepreneurs endeavor to conceal their income to avoid taxation. Second, the constant changes in the tax rules and the tendency of local authorities to interpret rules arbitrarily increase the difficulty of forecasting revenues and profits.

## JOINT VENTURES

Many foreigners have come to Ukraine since independence to invest in a wide variety of enterprises, but few deals have actually been consummated. Nearly all joint ventures have state-owned enterprises or entities as partners; as examples, AT&T is working with the Ministry of

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<sup>7</sup>Ukraine has very little unemployment now but, as the market economy takes over, the government expects significant layoffs from state-owned factories and farms. This fund is to provide money to cushion the impact of this development once it begins.

Telecommunications and Johnson Wax with the State Property Fund. Many small businesses would like foreign partners to take advantage of the tax holidays and to gain access to imported equipment and raw materials. Without foreign partners, dealing with imports and exports becomes extremely onerous.

Ukrainian law encourages joint ventures with foreign partners if the foreign partners contribute at least \$100,000 or 20 percent of the capitalization of the firm. Foreign partners can own any proportion of the joint venture up to 99 percent. Advantages extended to joint ventures include:

- Taxes holidays from the first year the firm declares a profit: 5 years for production enterprises, 3 years for trading enterprises, and 2 years for intermediary enterprises;
- Freedom to import and export goods and services; and
- Freedom to repatriate profits.

Wholly owned foreign companies are also legal but do not have the same privileges as joint ventures.

## RECOMMENDATIONS

Ukraine has many groups providing advice on legal and regulatory matters. The Harvard-based Project on Economic Reform in Ukraine (PERU) and the Council of Advisers funded by the Soros Foundation have provided legal specialists, and many distinguished members of the Ukrainian diaspora have returned to take positions as government advisers.<sup>8</sup>

New laws and regulations will achieve only superficial impact on the Ukrainian economy and society until the business community can see them in operation. For this reason, practical interventions at the firm or subsector level rather than high-level policy advisers are required to work with enterprises. In turn, the experience and knowledge gained from a bottom-up approach can have a significant impact on policy and legal reforms. The types of practical assistance from which entrepreneurs could benefit include:

- Training for Ukrainian lawyers, accountants, and auditors on business and financial law and normal business practices;
- Funding for new entrepreneurs to employ lawyers and auditors to provide specialized services;
- Training in the culture of business through case studies, practical experience with Western firms, or by direct work with Western advisers (for example, IESC volunteers); and
- Direct support to entrepreneurs who have the potential to develop their fledgling businesses into successful enterprises. This might include subsector analyses to identify and eliminate bottlenecks, identification of joint venture partners, identification of appropriate technology,

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<sup>8</sup>The Deputy Minister of Finance and the Deputy Chairman of the Central Bank are both American-Ukrainians.

and financial support. Experience gained through this assistance would contribute to the national policy dialogue and reform efforts.

In addition, the role of local government in Ukraine's economic transformation will become more important when privatization starts. Although the laws state that privatization is a national program, local administrations have already taken some initiative to ensure that they control the process within their jurisdictions. For this reason, interventions in Ukraine should include some support at the oblast and rayon levels. In doing so, A.I.D. can gain the support of the local authorities for new policies and programs that can filter up to higher levels and have a significant influence at the national level.

## SECTION FOUR

### FINANCE SECTOR

#### OVERVIEW OF THE BANKING SYSTEM

Financial institutions have enormous potential to be powerful players in the development of small private businesses. Through the efficient distribution of capital, banks can stimulate economic development and affect in a positive way the distribution of income. Poorly managed or undercapitalized financial institutions can hamper economic development and exacerbate inequality, inefficiency, and instability through lending for unproductive uses. Unfortunately, the latter case currently plagues Ukraine. The success of current and future financial intermediation in Ukraine is hampered by:

- A weak regulatory framework;
- Persistent lending to failing state-owned enterprises;
- Reluctance to lend to fledgling enterprises without personal contacts within the bank;
- Balance sheets that misconstrue the financial conditions of banks and firms; and,
- A dearth of adequately trained bank personnel and qualified borrowers.

The gradual dismantling of the state banking system began, as in many other former Soviet republics, with the USSR's Law on Banking enacted in April 1987. The break-up of the Soviet monobank, Gosbank, prompted the emergence of the National Bank of Ukraine (NBU), which serves as the country's central bank. Sectoral state banks formed at the same time Zhilsotsbank (now Ukrsootsbank), Agroprombank (now Bank Ukraina), Promstroybank, and Oschadbank specialize in agriculture, construction, or savings. In the last year, most have re-registered and recapitalized as joint-stock banks, or what Ukraine terms commercial banks.

Initially, these banks were unsure of the political and legal environment. They believed protection from the NBU was necessary for survival. In 1989, a group of bankers established the Commercial Bankers Association to protect the new system of commercial banks. As tension between NBU and the commercial banks subsided, commercial banks proliferated. Membership in the Association grew from 10 to 80 members in a three-year period.

The rapid pace of commercial bank growth continues. There are now 135 commercial banks in Ukraine. New banks form and existing banks open branches at a startling rate. This unchecked growth flourishes because banks, or their owners, are able to gain influence and ensure their position in a time of radical change. By lending to a personal network that is connected with powerful bureaucrats, bankers secure their future. Some of the growth, in fairness, may result from entrepreneurs discovering a window of opportunity to provide services and become profitable through market practices. The financial viability of the banking system is questionable, the regulatory framework ambiguous, and meanwhile the small business community remains unsatisfied. These combined factors suggest that unimpeded bank growth may further impair a flawed system. Table 1 gives statistics on the banks.

TABLE 1  
SUMMARY STATISTICS  
October 1992

	Bank Ukraina	Vidrogenya Bank	Agio Bank	Commercial Bank for Innovation
Year Founded	1988	1989	1990	1989
Capital (rubles)	18 B.	1 B.	150 M.	1.1 B.
Loans Outstanding (rubles)	405 B.	15 B.	5 B.	30 B.
Average Interest on Loans <sup>9</sup> : ST/LT	23%/35%	70%/20%	75%/20%	100%
Deposits (rubles)	16 B.	10 B.	N/A	N/A
Average Interest on Deposits	N/A	35-40%	35-90%	75%
Number of Branches/Planned	610	14/8	4/5	14/12
Number of Employees <sup>10</sup>	20,000	150	90	700
Correspondent banks	11	14	3	yes, # not available

### REGULATORY FRAMEWORK AND ITS WEAKNESSES

A key tool for developing a healthy financial sector in Ukraine's emerging market economy will be an effective regulatory framework that clearly establishes, defines, implements, and enforces fair rules of the game. The current banking law of Ukraine, enacted in March 1991, fails to meet this mandate.

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<sup>9</sup>Note that the interest rate charged on long-term loans (traditionally higher than on short-term loans to compensate for increased risk) is lower than on short-term loans, except for Bank Ukraina. Lending to bank owners' enterprises at discounted rates accounts for this disparity. The concept of matched funding is not apparent. There is no link between the level of short-term deposits to short-term loans or long-term deposits to long-term loans. Banks are paying higher rates for longer-term time deposits, so their cost of funds for longer-term loans bears no relationship to the final lending rate to the borrower. These distortions only exacerbate the problem of access by small businesses.

<sup>10</sup>Note that there is no clear relationship between the level of personnel and the services provided.

The first weakness of the law is that it does not define adequately the roles and functions of a bank. The law should, but does not, delineate such functions as deposit taking, lending, check clearing, foreign exchange transactions, and trust services. Capital requirements should also be revised. Instead of the current legislative requirement of an absolute level of capital, bank capital requirements should be defined in terms of a percentage of a bank's assets. Under the existing law, a bank's capitalization does not necessarily have a bearing on its lending activities, thus placing depositors, borrowers, and owners at risk.

The law does not require banks to make provisions for expected losses, nor does it require or give guidance on portfolio aging. As a result, banks do not classify their loans as current, past due, nonperforming, or loss-generating. It becomes impossible for start-up banks, or any bank that must suddenly operate according to market rather than centrally planned principles, to maintain a clean, viable balance sheet.

The National Bank of Ukraine, serving as executor of monetary policy, is not regulated under a separate act. The existing law does not sufficiently detail a central bank's role and functions regarding lending to enterprises, trade and currency regulations, relationships with multilateral agencies, and political independence. Related to this problem, the law is deficient in banking supervision. NBU has played a minimal supervisory role in bank licensing and reserve requirements. However, there is no independent agency whose role is to enforce compliance with regulations. The absence of supervision makes a weak regulatory system even less sound.

These and other regulatory weaknesses ranging from clear ownership laws to excessive tax burdens have a significant impact on the ability of small, private businesses to survive. Without bankruptcy, collateral, or contract laws or skills in risk assessment and management, it is unrealistic to expect that banks will lend to unknown business start-ups. Rather, the banks will continue to lend primarily to shareholders and other borrowers known to them through personal contacts. This widespread practice, which seems unfair if not corrupt when analyzed in depth by Western analysts, will not change unless an adequate regulatory system is implemented and bankers receive appropriate training in commercial finance. Also, as the nascent private sector establishes a track record of its own through alternative financing mechanisms outside the formal financial sector, its creditworthiness will become more obvious to the banks.<sup>11</sup> USAID can have the most immediate impact in this area by concurrently conducting bank training programs and developing alternative financing mechanisms to help bridge the gap created by undeveloped formal sector banking.

Weaknesses in banking regulation also hamper small business development by not defining noncredit financial services. Such services are nearly nonexistent in Ukraine because the banking law does not define the legal basis for such activities as checking accounts, clearinghouse mechanisms, and foreign exchange transactions. Banks have no experience pricing such services nor assessing the profitability of providing such products. The notion of service provision as a means to improve a bank's competitive position is nascent at best. Time and demand deposits are not prevalent in Ukraine. The Commercial Bank for Innovation has a type of share draft (which they call a check), but it is not universally accepted as a method of payment. Bank clearinghouse activities are so ambiguous that when suppliers are finally paid through the banking system, the payment has been devalued significantly due

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<sup>11</sup>Alternative mechanisms for the private sector might include venture capital funds, start-up lending programs channelled through banks or nonbank financial institutions, or loan guarantee programs that alleviate some of the existing collateral constraints. Existing alternative financing mechanisms are discussed below.

to inflation. With clear regulation may come advances in offering the range of financial services that enterprises require.

### **FINANCIAL HEALTH OF THE BANKING SYSTEM**

Banks are operating in a highly inflationary environment, yet banks continue to lend at excessively low interest rates particularly in strategic sectors such as agriculture. Although lending at some rate above zero is better than not lending at all (given that the banks' other investment options yield no higher rates), the persistence of below market rate lending endangers the capital base of the financial system. Other traditional measures of bank viability such as assets, earnings, and liquidity are difficult to impossible to assess.

As previously mentioned, banks do not classify their loans (except to disaggregate between long- and short-term) or age their portfolio, making a proper diagnosis impossible. Earnings, or profits in the Western sense, are a new concept for most banks and enterprises. The Russian word for revenue is the same as income, implying that costs of doing business have not been relevant. "Profit" estimates cannot be taken at face value as the costs of doing business are not accurately reflected in the calculation. Liquidity poses additional problems. Balance sheets are not stated according to generally accepted accounting principles. As one example, it is not clear whether Bank Ukraina's dangerously low .45 coverage ratio of current liquid assets to short-term liabilities is really a problem of liquidity or a problem of accounting.

The concept of bank financial viability is new to the former Soviet republics. The purpose of banks and the role of credit in socialist banking was to fulfill mandated performance targets by directing resources to state-owned enterprises. The intention of the central plan was not to improve profitability of enterprises but, rather, to enhance production. Repayment of resources or credit was not an issue. Banks did not need to assess a project's risk. Enterprises did not need to manage profitability in order to ensure coverage of interest and principal. Both banks and enterprises continue to struggle under this legacy.

Solvency is neither regulated nor predictable under the current system. Many of the existing commercial banks have been founded by the nomenklatura. Agio Bank, for example, was founded by high-ranking bureaucrats from the Ministry of Economy, Ministry of Trade, Ministry of Statistics, the State Pension Fund, and the Ukrainian Orthodox Church. As apparatchiks hurried to form their own quasi-private businesses, they simultaneously founded the banks that would lend to their companies. Under the prevailing formula, every ruble of injected capital translated into 25 rubles of loans. To complicate matters, while enterprises are founding banks, banks are also founding enterprises. In an attempt to protect depositors (whose money is being lent to the owners), banks may not have a deposit to capital ratio greater than 1:1. As the numbers indicate, this regulation is not being enforced, putting depositors at risk.

Although collateral and liquidity are important issues facing entrepreneurs and banks, they are not the central constraints. Without acceptable contacts in the bank, businesses looking for investment loans or capital will be crowded out. The banks are lending on a long-term basis only to shareholders, and on a short-term basis primarily to enterprises involved in trading. Without improvements in banking regulations that prevent cronyism, creative alternatives that provide the private sector with access to start-up capital and ongoing working capital finance or programs such as A.I.D.'s Loan Portfolio Guarantee Program that alleviate collateral constraints and obviate the need for expensive credit

insurance, the crowding out will continue. Training programs that bring bankers and entrepreneurs together will also help entrepreneurs establish much-needed contacts and track records with bankers.

The team found that few banks comprehended questions concerning the inevitable decapitalization and loss of deposit resources resulting from below market rate lending and deposit taking. The banks have not calculated their true cost of funds or determined what interest rate they should be charging to maintain financial self-sufficiency. Few of the following determinants of interest rates have been calculated or even considered: direct cost of funds, overhead expenses, loan origination and administration costs, default risk, interest rate risk, competitive rates available to the borrower, bank-borrower history, rates of return earned by bank on other investments, and the return on equity demanded by owners.

In addition to an understanding of the way to determine interest rates, banks need training in risk analysis and risk diversification, project evaluation, loan monitoring and evaluation, loan classification and portfolio aging, matched funding, performing due diligence, collections procedures, and understanding and lending (profitably) to small businesses. Qualified bank management and staff will prove critical to a fully functioning system of credit delivery to the emerging private sector.

### **ALTERNATIVE FINANCING MECHANISMS FOR SMALL BUSINESSES**

Recognizing the scarcity of resources available to the emerging private sector, governmental and nongovernmental organizations (NGOs) also have responded by creating small finance programs. Some are channelled through the formal banking sector and then on-lent to enterprises at subsidized interest rates; others reside outside the formal financial sector. To some extent, these programs should help entrepreneurs overcome such obstacles as collateral constraints and lack of personal contacts.

- The Ukrainian National Free Enterprise Fund (NFEF) was created in December 1991 and began operations in March 1992. Like the U.S. Overseas Private Investment Corporation, NFEF receives funding from both government and private members. In 1992, the government allocated 1 billion rubles to NFEF. The Fund's representatives anticipate an annual government contribution but are uncertain of the amount. Private organizations that invest 5 million rubles in NFEF generate additional resources. Member contributions are continuously reinvested.

NFEF's priorities are projects in food and building material industries, consumer goods manufacturing, and innovation and new technology. As of August 1992, the NFEF loan review committee had evaluated over 1,000 business plans and approved 40 for a portfolio of 850 million rubles. The committee, after screening applications for priority sectors, evaluates loan requests on technical and economic merit and financial feasibility. The average term for NFEF loans is six to eight months at an average rate of 50 percent. Loan proceeds are generally used to purchase equipment. The major drawback to NFEF is that it does not limit participation to private businesses.

- The government also supports a fund for support of small private farmers. Funds are not available for state farms, collectives, or subsistence plots. The fund's board consists of three private farmers, three government officials, and one representative of the association of private farmers. Relying on Parliament every year for funding, the fund's 1992 resources total approximately 1 billion rubles. Funds are currently provided by the National Bank to

such banks as Ukraina and Vidrogenya and are then on-lent to farmers. The interest rate to the final borrower is 2 percent. Prospects for fund replenishment from internally generated funds are minimal at such rates. It is unlikely that the government considers this to be a long-term solution to the problem of start-up capital for farmers.

- A third fund, the Ukraine Fund (UF), was formed in June 1992 and hopes to attain capitalization of \$10 million. UF expects to make initial investments in small to medium-sized private businesses in the \$25,000 to \$50,000 range. The objective of UF is to achieve a superior rate of return on capital invested. It expects to focus on consumer goods including building materials, home furnishings, small appliances, hand tools, medical supplies, food products, distribution, publishing, computer services, communications, media, and financial services.
- A fourth and promising option for promoting small business in Ukraine is A.I.D.'s proposed Ukrainian Enterprise Fund (UEF), modeled after the Polish, Hungarian, and Czech Enterprise Funds. Though smaller in magnitude than previous funds, UEF could leverage resources by serving as a magnet fund to attract additional capital from non-U.S. government sources. UEF could require a matching fund component or finance fund-raising activities to bolster its capital. In keeping with its smaller budget, UEF would target small companies requiring smaller amounts of debt or equity capital. UEF would be a likely conduit for coordinated technical assistance activities in the small business sector. For example, UEF might need assistance in setting up its small business window, help target direct assistance to participating firms, and coordinate both banker and entrepreneur training.

### **RECOMMENDATIONS**

- **Credit.** An urgent and practical area in which USAID can have a lasting impact on the development of Ukraine's private sector is to fund a loan program designed to alleviate start-up capital constraints. Loans would be used primarily to purchase machinery and equipment for productive use. The loan program would be instrumental in helping entrepreneurs (and bankers) to establish track records essential to future banking relationships, make decisions based on market principles, and look at long-term investments and profits rather than short-term gains based on patronage.

The program could be implemented in several ways. Because entrepreneurs have little cash flow with which to pay interest as they are starting out, interest could be capitalized for an initial period. The program could be set up under the auspices of a progressive bank such as the Commercial Bank for Innovation which, with a long-term adviser's guidance, would provide project evaluation and loan monitoring functions without getting involved in actual disbursements and money transactions. Equipment purchases could be transacted through the U.S. banking system. Initially, loans would likely range between \$5,000 and \$25,000.

Later in the program as entrepreneurs repay the start-up capital loans and require continued access to funds for working capital purposes, the program could expand and channel through the bank. Alternatively, if the bank has reached a point where it sees the merits of lending to program participants and other eligible clients, it will begin direct lending outside the program. Clearly, the latter development is the goal of such a USAID intervention.

- **Training.** Although there are substantial indirect training benefits to be derived from the above program, supplemental direct training for bankers and entrepreneurs will be necessary for the development of credit services to small businesses in Ukraine. The training needs are well documented, and A.I.D. has existing contracts that would permit a rapid response in this critical area. Training for the banking sector should include risk analysis and risk diversification, project evaluation, loan monitoring and evaluation, loan classification and portfolio aging, matched funding, performing due diligence, collections procedures, and understanding and lending (profitably) to small businesses. Among the many areas for entrepreneur training in Ukraine are fundamentals of accounting, budgeting, managing and financing growth, break-even analysis, preparation of business plans and loan applications, and understanding and working with banks.
- **Leverage.** Apart from a start-up loan program and banker/entrepreneur training, USAID may capitalize on several of the alternative financing mechanisms described above. The Ukraine Fund and the Ukrainian Enterprise Fund will both be searching for borrowers and firms in which to invest. These funds could provide additional capital to entrepreneurs who have participated in other aspects of the SED program, and the program itself could serve as a screening mechanism to identify borrowers and enterprises.

## SECTION FIVE

### PRIVATIZATION

Since the early 1980s, thousands of enterprises around the world have been privatized. When correctly conceived and implemented, privatization provides numerous benefits. It frees scarce public resources for investment in infrastructure and social programs, generates revenues for the state (either through sale or coherent tax policies) and new jobs for workers, eliminates subsidies, and distributes ownership more widely. Despite these benefits, most emerging democracies face numerous constraints to privatization.

To conservative Ukraine, the impediments seem insurmountable. Such constraints include legislative gaps such as the transfer of statutory state-owned companies into stock corporations; social issues ranging from labor dislocation to concerns over infrastructure development and food security; competition, pricing, and regulatory needs; barriers such as a lack of credit that preclude many Ukrainians from participating in the privatization process; ownership distribution concerns; and the lack of a developed capital market. Ukraine will need to consider both the benefits of and constraints to privatization over the course of its transition to a market economy.

Ukraine has passed all the laws and regulations required to carry out a privatization program but has not yet begun to privatize its small or large state-owned enterprises. Three basic laws establish the privatization program:

- Law of Ukraine on the Privatization of State-Owned Enterprises;
- Law of Ukraine on the Privatization of Small State Enterprises; and
- Law of Ukraine on Privatization Certificates.

Submitted in draft from late 1991 through April 1992, these laws received Parliamentary approval in July 1992. In addition, Ukraine has enacted regulations for the valuation of property.<sup>12</sup> The essential elements of the privatization process are listed below:

- Every citizen of the Ukraine will receive privatization vouchers worth 30,000 coupons.
- Vouchers are nontransferable.
- Citizens will not receive actual vouchers; rather, they will have the use of them through special accounts established at the National Savings Bank.
- Privatization methods include purchase by workers, auctions, and public bidding (tenders).

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<sup>12</sup>According to representatives of the International Finance Corporation, valuation of property will prove very difficult under the current regulations.

- The State Property Fund and local privatization bodies will be the sellers of small businesses; they will do the valuation of the enterprises for sale. The law includes general methods of valuation but no specifics.
- Foreigners may participate in bidding or tender procedures using foreign exchange.

Several elements have slowed the privatization process.

- Most Ukrainians do not have bank accounts. In a country in which electronic transmission of any information is nearly impossible, the establishment of 54,000,000 accounts for the deposit of privatization certificates is a daunting task.
- The value of the certificates, as determined by law, is not indexed to inflation. The certificates might have had some value in early 1991, but now each citizen will receive vouchers worth less than \$60.
- When the privatization bill passed in Parliament in July, an amendment was attached to the general law that gave the workers' collectives at all establishments the right to lease their place of employment with option to buy within three years. In this bill, the workers' collectives have an absolute priority in acquiring complete control of their enterprise. This clause was originally included in the Law on Leasing that passed in April 1992, but this law retained some state control by ensuring a competitive process in privatization. The current privatization bill provides for competition only if a workers' collective does not exercise its option to lease the premises.
- Local authorities, particularly the President's Representatives in the oblasts and rayons, have taken far more control of the state's assets than originally anticipated. For example, the Kiev's Committee on Economics Finance and Budget feels that all state property in the capital, with the exception of military and defense plants and installations, belongs to the city. They will give certain assets to the rayons to dispose of ("Whatever we do not need").

The government of Ukraine has given up control over a large part of the privatization process to workers' collectives and another large part to local authorities. For example, the A.I.D.-funded pilot privatization program in Lviv that is to be implemented by the International Finance Corporation has stalled over two issues: (1) the workers' collectives have exercised their right to lease their work places in every enterprise selected for the program; and (2) the state, oblast, and rayon cannot decide who owns what. The IFC has reduced its projects to a list of sites for which no workers' collectives exist and which belong unambiguously to the Lviv city government. Most of these are unfinished construction sites.

The privatization program will no doubt go forward in one way or another over the next year. At this time, there seems to be little additional assistance that A.I.D. can offer, except perhaps in the area of support to the valuation process. Even this sort of support should probably follow the IFC's example and start as a pilot activity in a specific area. The problems in privatization have less to do with concepts than they do with major national policy options about the future economic course of the country; as the process unfolds, resources should be made available to assist those Ukrainians who succeed in acquiring small state-owned assets in the future.

## SECTION SIX

### AGRICULTURAL REFORM AND AGRIBUSINESS

#### OVERVIEW

Rich agricultural land is the principal natural resource of Ukraine. Long known for its extensive fertile "black earth" zone, Ukraine currently has over 42 million hectares under cultivation, most of it in grains, sugar beets, potatoes, and vegetables. Fruits and vegetables dominate in the more moderate climatic zone of Crimea. Despite production inefficiencies and relatively low yields when compared with the West, Ukraine has earned the reputation as the bread basket of the former Soviet Union.

With an industrial and agricultural base similar to the northern Midwest in the United States, Ukraine has a large diversified economy. Agriculture is the country's second largest sector of the economy, which is dominated by heavy manufacturing industries. In 1989, industry accounted for 42.6 percent of the NMP, followed by agriculture at 28.2 percent and construction at 10.5 percent. Over 6 million people, or 28 percent of the labor force, are engaged in agriculture, including workers on collective farms. A significant number of workers counted in the industrial labor force are assumed to be employed in the large food processing industry.

The indication of the size and impact of the agricultural sector can best be described in terms of its overall contribution to the former Soviet Union's output. In 1989, Ukraine produced more than one-fifth of the Soviet Union's total meat and dairy output; one quarter of total grain, potato, and vegetable production; and more than half of total sugar production. These contributions are even more significant in light of the fact that Ukraine comprised only 2.7 percent of the land and 18 percent of the population of the former Soviet Union. After Russia, Ukraine was the most productive of the Soviet republics in both agriculture and industry.

Agricultural production was and still is dominated by a system of large collective and state farms. Under Stalin in the late 1920s and 1930s, productive agricultural land was organized into large collective and state farms. Forced collectivization continued over the decades and, by 1989, Ukraine had approximately 7,500 collective and 2,500 state farms. These farms average over 4,000 hectares and comprise 98 percent of the cultivated farm land in Ukraine. Collective farms nominally hold the land in the name of the workers, while state farms hold the land in the name of the state.

The primary feature of the collective farm system is the centralized planning system. Each collective or state farm is responsible for achieving production quotas for specified crops. The government, through various agencies and state organizations, obtains the total farm output from the collectives. Technological inputs are allocated through central planning ostensibly to support the prescribed level of production, but in the past this has seldom been the case because the supply of both inputs and outputs has been unavailable, siphoned off, or misallocated. These structural inefficiencies have resulted in a system reliant on accounting and control mechanisms to obfuscate production inefficiencies and hedge on production quotas.

Collective and state farms reflect the structure of the communist state and society. Most are vertically integrated and own — in the name of the state — all land, equipment, buildings, transportation equipment, and large storage and processing facilities. The collectives are also horizontally integrated

through their ownership and management of the farm workers' houses, stores, clinics, and schools. Thus, farm workers are inextricably linked to the collectives and dependent upon them for jobs, food, shelter, and social services.

There is widespread agreement that the collective farms have exhausted their potential without providing results because of poor farm management practices, inappropriate use of agricultural inputs and equipment, and low worker productivity. Poor natural resources management and excessive industrial pollution have contributed to soil degradation that has further reduced the agricultural sector's economic potential. Up to 25 percent of production is lost through careless handling, storage, and distribution methods. Farm equipment is in short supply and technologically obsolete.

Production in the state-owned agricultural sector is declining due to disruptions in the flow of agricultural inputs and in the market for agricultural production. A tenet of the Soviet system was to link the former republics through trade. Through 1990, more than 80 percent of Ukraine's total exports and imports was accounted for by inter-republic trade. With the disintegration of the Soviet Union, these internal trade links have been severely disrupted. Foreign trade has also been disrupted with the collapse of the Eastern European market and the currency crisis.

The data in Table 2 indicate clearly a substantial decline in all agricultural production since 1989. The trend is expected to continue for 1992.

The potential for the food processing industry is mixed. On one hand, Ukraine has underutilized productive capacity, a large domestic market, and a geographic location capable of exploiting large markets in Europe and the Middle East. However, the quality and sophistication of the food processing industry from the supply of raw product through the handling, processing, packaging, and distribution of the finished product do not meet current international marketing standards.

In fresh products, the unavailability of proper inputs compounded by completely inadequate handling and packaging techniques results in fruits and vegetable of uneven quality, poor appearance, and huge loss percentages due to bruising and spoilage. Processed foods are adversely affected by inappropriate and obsolete equipment, irregular supply of packaging materials such as jars and tins, and archaic labelling practices. Distribution systems do not ensure timely delivery of product and inputs. Structural changes in agriculture, including the privatization of farms, are required before agribusiness can be considered seriously as a development option. Without infusions of capital investment and training, the agribusiness sector cannot compete in the world marketplace.

## **PRIVATE FARMING**

Progress in agricultural reform has been extremely slow. Of the approximately 10,000 private farmers in Ukraine, 8,000 of them received land in 1992. An estimated additional 5,000 private farmers are unregistered. Approximately 200,000 hectares are thought to be in the hands of private farmers. It is projected that 10 percent of agricultural land, or 420,000 hectares, will be privatized in the next five years. By the end of 1992, it is believed that approximately 1 percent of the arable land in Ukraine, or 400,000 hectares, will be controlled by private farmers.

Many of these new farmers are inexperienced and many others have not had the benefit of a full growing season. In most cases, land ownership, although legal, is not clearly defined. Private farmers have the "perpetual right" to use the land, but they cannot transfer title of the land. Many farmers augment

TABLE 2  
DECLINE IN AGRICULTURAL PRODUCTION IN VOLUME  
AND PERCENTAGE OF DECREASE FOR 1989-1991

Agricultural Production			
	1989	1990 (in physical volumes)	1991
<b>Output</b>			
Grain	53,186	53,167	40,517
Meat	4,430	4,358	4,082
Milk	24,377	24,508	22,675
Eggs	17,393	16,287	15,297
Potatoes	19,308	16,732	14,617
Vegetables	7,443	6,666	5,910
Fruits	3,289	3,737	2,157
Sugar beets	51,769	43,283	36,353
Cotton	111	108	106
Wool	30,101	29,793	26,182
<b>(percentage change from previous year)</b>			
<b>Output</b>			
Grain	.....	.....	-23.8
Meat	.....	-1.6	-6.3
Milk	.....	.5	-7.5
Eggs	.....	-6.4	-6.1
Potatoes	.....	-13.3	-12.6
Vegetables	.....	-10.4	-11.3
Fruits	.....	13.6	-42.3
Sugar beets	.....	-16.4	-16.0
Cotton	.....	-2.7	-1.9
Wool	.....	-1.0	-12.1

Source: Ukrainian Ministry of Statistics: Reprinted by IMF.

their small landholdings through leases on extended terms from collective and state farms. Most production is sold to a collective farm or another state agency. In some cases, private farmers are obligated to meet production quotas for securing services from a collective farm.

In addition to the land currently considered as private, most collective farm workers maintain small private plots of land on the collective or state farms. These small plots average .3 hectares and, nationally, these privately managed plots are estimated to total 3 million hectares or 7 percent of all arable land. An indication of the failure of the collective farm system and the potential of private farming is exhibited by the high agricultural output of the small private plots. These small producers account for over 20 percent of all agricultural production, with estimates for production of vegetables, meat, and dairy products ranging up to 40 percent of all production. Most production is consumed by the growers with surpluses sold or bartered in mostly informal markets.

Cropping decisions by small farmers are not entirely market oriented. Small private farmers are currently constrained from making market-based decisions by the unavailability of appropriate equipment or production inputs. Instead of responding to the perceived needs of the market, small farmers plant what they are able to produce and harvest based on available inputs. Inputs are obtained through the collective farm, which then resells to the individual farmer. The private farmer also makes use of storage and equipment from the collective farm through an informal leasing system.

Some small farmers have begun buying trucks and tractors from various sources including collective farms. The equipment is obtained with savings accumulated from years of off-farm employment. Bank financing is unavailable.

### SUMMARY

Ukrainian agribusiness is currently unable, despite enormous potential, to satisfy domestic demand or to compete in the international export market. The principal constraints to the development and growth of an agribusiness sector are the political economy, the supply and distribution of appropriate technological inputs, and the inexperience and capital inadequacies of small farmers and processors.

- **Political economy:** The major impediment to the growth of private farms and increased productivity to support the development of agribusiness is the slow pace of agricultural reform and land privatization. Ownership remains vague. Without clear title and clear ownership, investment is constrained, collateral is limited, and risk is perceived as high.
- **Supply and distribution:** The marketing channels for both inputs and products are extremely constricted. Equipment and inputs are severely limited as are the methods of handling and delivery. The break-up of the Soviet Union has further fractured even the inadequate channels that previously existed. Ukraine presents a case in which production and demand potential is high, but the channels linking production to the markets are missing.
- **Small farmers constraints:** Small farmers and processors are handicapped by their inability to make market-based farming decisions. Private farmers are still dependent on the state system for supplies, equipment and markets, and they lack sources of needed capital.

## **SECTION SEVEN**

### **INSTITUTIONAL FRAMEWORK FOR SMALL ENTERPRISE DEVELOPMENT**

The framework of institutional support for private small business development in Ukraine reflects the complexities and tensions of the still-evolving political and economic environment. Tensions between progressive, nationalist forces and conservative, pro-Russian forces continue to dominate the political landscape, producing unexpected alliances and factions and slowing concerted efforts toward establishment of policies, laws, and regulations solidly in support of private sector development. The tensions between these groups exist at the national, state, and municipal level and manifest themselves in an array of seemingly redundant councils, committees, associations and institutes professing support for small business development.

At this point the institutional framework for small enterprise support is still dominated by organs of the state. Customary distinctions between public sector and private sector institutions are blurred in a context in which most organizational entities are newly established and reflect some degree of continuing oversight, if not ownership, by the state. The role that the state plays in each organization depends on the outlook of the particular political supporters in question. These may be representatives of the nationalist Rukh Party, ex-communists who have understood and seized on the opportunities presented by economic reform, or members of the old guard whose primary concern is defending former party privileges and who determinedly resist all change. This makes it necessary to look beyond the name in trying to assess whether a given organization is genuinely committed to reform and private sector development.

In addition to the state bodies and quasi-state associations and institutes charged with small enterprise development, the emerging private sector has two other increasingly important sources of support to draw on. One of these is the growing Ukrainian American community centered around Kiev and in western Ukraine. These members and descendants of the diaspora constitute a growing source of direct private sector assistance through corporate investments, remittances from relatives, and charitable donations. Finally, the international donor community is taking hold in Ukraine and establishing programs in support of private sector development. Each of these elements of the institutional framework is discussed below.

#### **THE STATE COMMITTEE**

The State Committee of Ukraine for the Promotion of Small Business and Private Entrepreneurship is responsible for implementing agendas developed at the ministry level. Its primary mission is to promote and support private enterprises. The committee represents small business interests to Parliament, the Cabinet of Ministers, and the Presidential Administration. Two of the principal activities of the committee are implementing the State Fund for the Promotion of Entrepreneurship and spearheading efforts to develop alternate systems of business education.

The fund seeks out and assists entrepreneurs with viable business proposals according to clearly established criteria. Priority is given to firms involved in agribusiness, construction and building materials, consumer goods production, and innovative technology development. The fund is especially

interested in supporting firms that will subsequently have a broader economic impact at the national level, such as firms that build machines that make concrete (as opposed to supporting a single firm that produces concrete). Expected profitability and ability to repay are key criteria. Proposals are reviewed by a panel of internal and external experts, including some paid technical experts.

Eligible entrepreneurs are awarded loans ranging from 200,000 rubles to 50 million rubles for six to eight months at an interest rate of 45 percent. The fund contributes a maximum of one-third of the total cost of a project. Since its inception in April 1992, the fund has received almost 300 proposals and has approved funding for 10 percent of them. Requests from state enterprises are rejected automatically. This year, the fund has 1 billion rubles at its disposal, of which 5 percent is used for overhead expenses. An attempt is made to replenish the fund by insisting on repayment; however, inflation will quickly decapitalize the fund even when repayments are prompt. It is unclear whether the fund will receive additional resources in 1993.

The State Committee is also concerned about the quality of business education available for entrepreneurs. Under the communist system, each branch of industry was overseen by a separate ministry, and each ministry had an associated institute that provided continuing technical and management training for employees of state enterprises. Most of these institutes had narrow programs focused on the needs of specific industries, and in most cases attending an institute for refresher training was more of a perk than an educational experience. Now, as the ministries themselves are being restructured, these institutes are hurriedly being established as independent entities. Many are trying to develop curricula in business management not only because of the importance of the subject matter but also because of the commercial opportunity represented by offering business training courses on a fee basis.

So far, the Ministry of Education has retained a firm hold on its power to certify educational institutions. Certification is contingent upon the ministry's approval of curriculum and without it, institutions are not allowed to issue diplomas. Recently the State Committee facilitated the creation of an association of 15 educational institutes, and in the charter established itself as the body authorized to issue certification for all of its members. Theoretically, this frees the institutes to develop their own curricula. In fact, it leaves the State Committee, rather than the ministry, in a position to influence decisions on admissions, tuition waivers, and overseas training opportunities.

The Association of Institutes has been established as a legally independent commercial structure, which receives funding from the State Committee in addition to student fees. The model institute within the association, now known as The Strategy Institute, was formerly the Institute of Atomic Energy. This institute offers a four-year program that provides students at the secondary school level with specialized training in business management, including practical skills that translate directly into actually starting a small business. All courses are offered on a fee-for-service basis. In the later years of the program, groups of students develop proposals for business ventures, defend the proposals, and then spend one year in the actual implementation of their ideas. The institute acts as a guarantor to help them obtain the necessary credit, licenses, and so on. Upon graduation, students are ready to continue operation of the business they have started, while program instructors continue to provide support on a for-fee basis. The other 14 institutes belonging to the association are being encouraged to adopt this model, utilizing available infrastructure and retraining staff to create an alternative education system.

## **ASSOCIATIONS SUPPORTING SMALL BUSINESS DEVELOPMENT**

As the state planning apparatus undergoes transformation, a host of new structures are emerging in the institutional landscape, including a large assortment of associations. Most of these are newly constituted commercial structures representing the transition from direct state control of the economy to subtler forms of state management and oversight that allow for the accumulation of private profits. Associations are generally established as independent commercial entities that are legally separate from the member firms. They are usually capitalized by one-time initiation dues from members, plus fees for services.

Associations are formed by groupings of enterprises that band together to overcome constraints in obtaining critical inputs. In part their proliferation reflects the problems caused by the disruption of the state supply system. However, rather than bringing together similar kinds of firms, many of the Ukrainian associations deliberately represent groupings of different kinds of firms. For example, an association might include manufacturers, traders, and banks, all coordinated by an advisory body. The members provide each other with complementary services such as finance, supplies, and marketing outlets. The advisory committee of an association invariably includes influential founders who are not necessarily members, but they represent the members' needs and use their influence to obtain benefits and resources. In this way, many associations effectively recreate on a smaller, more flexible scale the state enterprise system of integrating economic activities.

In cases where an association is made up of state entities, the independent commercial structure of the association offers an opportunity to realize and reinvest profits. When the association is made up of private firms, the coordinating advisory board helps the individual firm secure the finance, hard currency, inputs, market access, and protection necessary to survive. Enterprises that belong to an association depend on the connections of the members of the advisory board, usually in return for some share of any realized profits. Enterprises that do not belong to an association are left to their own devices.

Associations do not provide the kind of advocacy channel between independent firms and policy makers generally associated with business groups in the United States, nor do most entrepreneurs believe that joining an association would be helpful to them. In general, entrepreneurs view the associations as lacking skills, and they feel that resources channeled through them would be wasted.

Independent business associations capable of providing real advisory and advocacy services remain a critical need of the emerging small business community. Currently the development of such institutions is hindered by continuing political instability and infighting and the small number of private firms actually existing at this time. One of the options that should be explored further by a long-term SED adviser is the role that USAID might play in supporting the development of credible small business advocacy groups. The proposed SED training and advisory activities could provide an appropriate base around which such an institution might coalesce.

### **SMALL VENTURE ASSOCIATION "COMPASS"**

The small venture association Compass was established two years ago as an independent commercial structure to unite and provide services to small enterprises throughout Ukraine. The association currently has a membership of about 2,000 firms, including private and state-run enterprises,

cooperatives, and limited partnerships. An estimated 50 percent of the member firms are private enterprises. Compass provides a broad range of services to members, including technical assistance, consulting services, training, legal awareness workshops, and information dissemination via a newsletter. All services are provided on a for-profit basis. Compass also stages international conferences and attempts to link members with joint venture partners.

Compass has a five-person permanent staff supported by membership dues as well as by any profits generated from its commercial activities. The association currently is not receiving funding from the state, but they are hoping to receive some share of the 900 million coupons that the Government of Ukraine has allocated for support of small business.

Recently, in an attempt to address the financing constraint to small business development, 16 of the founders joined together to establish a National Fund for Support of Small Enterprises. The fund will make loans available to members at interest rates ranging between 10 and 30 percent, substantially lower than rates on loans otherwise available through the banks.

Funds raised in this manner will also help finance construction of a business center to help address members' needs for office space. Individual members will be able to contribute funds in return for securing office space on the newly constructed premises. The space will also be used to hold training programs and possibly used as a hotel, both activities intended to generate income to help finance the cost of the project. The land for this undertaking has already been secured.

Staff of the association indicate that they have recently been approached by a number of potential donors. Although the long-term adviser for the SED project should coordinate with Compass, the organization does not appear appropriate for a more central role in the proposed activities, given that half their client base is not private and the apparent lack of professionalism on the part of key staff.

### **NATIONAL ASSOCIATION OF UKRAINIAN FARMERS**

The National Association of Ukrainian Farmers was created two years ago to provide support to the growing number of private farmers in Ukraine. Although currently only 10,000 private farmers are registered throughout the country, the association estimates that there are probably close to 15,000 private farmers now and expects a total of 20,000 to be registered by the end of the year. Although these private farmers have obtained land, their access to equipment, supplies, investment capital, management expertise, and markets is still severely constrained. Most of them continue to rely on the state for obtaining key inputs and are required to sell back substantial portions of their product to the state in return. They are using obsolete tools; have problems obtaining spare parts; have limited access to credit, especially hard currency; and have limited access to required technical and management training.

Started as a political movement by farmers seeking land rights, the association presently has 5,000 members represented by 25 regional offices. Representatives from each office constitute a supervisory board, which recently elected as president of the national office Mykola Scarbani, a deputy to the Supreme Council, Member of Parliament, and one of the authors of the current legislation on privatization of agricultural land. An agronomist by training and formerly chairman of a collective farm, Mr. Scarbani ensures that members' interests are represented effectively at the highest levels of government and that problems are solved in special parliamentary commissions before reaching open sessions in Parliament. This high-level representation is probably the most critical form of support the association provides.

The regional associations are commercial structures that, in addition to providing training, information, and advisory services, help found new small enterprises and share in the resulting profits. Profits supplement monthly dues as a source of regional association income. Each regional association contributes 10 percent of all income to support the staff at the national office, which receives no direct state funding. The national office is a public entity and cannot itself participate directly in commercial activities or take profits. The president's salary is covered by his job as a member of Parliament.

In addition to the strong advocacy role performed by its president, the association also provides members with the following services:

- Assists members in obtaining credit from the Central Bank of Ukraine. The government has allocated 1 billion coupons to support private farmers in the form of a fund held at the Central Bank of Ukraine. The association helps members obtain loans from the fund through over 600 branches of the Bank of Ukraine located throughout the country. Loans are available to eligible members at the negligible annual interest rate of 2 percent. The president of the association is one of the members of the seven-member board responsible for allocation decisions;
- Assists members in obtaining access to technical and management training. The association has established linkages with Canadian groups that are providing technical training on farms in Canada as well as training at colleges in six agricultural zones in Ukraine. They also have links with the Ukrainian Agricultural Academy, which offers a hard-currency-based business training program that sends students to Poland for practical training. However, despite these resources, the need for training remains widespread;
- Hosts conferences on issues related to privatization of agricultural land;
- Sponsors exhibitions of agricultural equipment, technology, and products;
- Matches private farmers with joint venture partners and represent them in negotiations with foreign firms; and
- Issues documents, conference write-ups, recent legislation, and other information and reference materials of interest to private farmers. The association also puts out a newspaper on a weekly basis.

### **TRAINING AND EDUCATIONAL INSTITUTES**

At first glance it would appear that entrepreneurs seeking instruction in the principles and techniques of market economics have ample access to a range of educational options. The two main forms of business education available are one-year MBA programs that typically include a practical training component in the United States or Western Europe, and short courses focused on the practical issues involved in starting a small private business. However, government officials, educators, and entrepreneurs report that there is substantial unmet demand for affordable and relevant courses.

Several training institutions have been set up primarily as a way of ensuring continued employment for displaced party functionaries and former employees of state educational institutes who may or may not have been "retrained." For other institutions, training is more of a sideline for

commercial structures primarily engaged in trade. As a result, courses offered to entrepreneurs vary considerably in quality and content. Some of the short courses are focused almost exclusively on completing the paperwork required to start a business and there is little instruction in basic business skills. In others, the curricula still reflect the practices used in the state enterprise system. Meanwhile, short sessions offered by visiting expatriate experts often fail to take into consideration circumstances particular to Ukraine.

The MBA programs tend to be of a higher quality, typically involving established linkages to other Western educational institutions from which they receive financial and in-kind support. However, they also tend to be quite expensive, and most require some proportion of the payment to be made in hard currency, putting them beyond the means of most small-scale entrepreneurs. At this time, the majority of the students in such programs are high-level managers sponsored by state enterprises or party functionaries for whom the hard currency requirement is waived.

Although there are opportunities for the proposed SED project to extend the reach of existing MBA programs, at present the more urgent need in the nascent small business community is for widespread availability of short, reasonably priced courses focused on the needs of start-up entrepreneurs. The content of such courses should cover the principles of market economics; instruction in firm-level skills such as development of financial plans, pricing and marketing strategies, accounting, and advertising; and practical advice on understanding and interpreting existing tax laws and other regulations, applying for credit, drawing up charters, and completing the registration process.

Following are brief descriptions of the three key institutions identified for initial involvement in the SED project.

### **Kiev International Management Institute**

The Kiev International Management Institute (KIMI) is a private, nonprofit institution created as a joint venture with the Geneva International Management Institute. Located on the premises of Kiev University of National Economy, KIMI offers a one-year MBA program, one-month training courses for executives and managers, and one-month courses for representatives of small business on starting and running a private enterprise. The institute is involved in research on private sector development in Ukraine, from which it derives case studies appropriate for its MBA program. The Director General is a Ukrainian-American with substantial private sector experience in the United States, he lends credibility to the program and differentiates it from similar state-run initiatives.

KIMI's students include instructors from other academic institutes in need of retraining, managers of large state enterprises, representatives of small businesses, and political party representatives. KIMI also provides one-month training and orientation courses for Harvard University students performing internships in government ministries under the Project for Economic Reform in Ukraine program (discussed below).

Courses for the one-year MBA program are offered during the day and at night; the night program requires two years to complete. The program, payable in hard currency, includes a practical experience component under which the student spends up to two months overseas working for a Western firm. All courses are taught in Russian, but students receive two hours each day of English language instruction. The Director is planning to implement a modified version of the MBA program next year under which each student will complete a 4-8 week consultancy for a U.S.-based firm interested in doing business in Ukraine. Each student will spend time in the United States becoming acquainted with the

procedures and objectives of the firm, and then return to Ukraine to carry out a market survey and other analyses necessary for the U.S. firm to establish its business practice. In this way students will gain experience working with Western firms, the firms obtain a valuable consulting service, and a basis is established for eventual formal employment further down the road. Last year, 75 students applied to the program and 42 were accepted, seven of them women, with the number of women enrolled in the program increasing steadily over the past few years.

KIMI also offers two different types of short courses. The first are highly specialized courses for managers of enterprises, offered in conjunction with the International Labour Organization. These courses must be paid for in hard currency and involve an overseas component in Western Europe. The other short course is for operators of small businesses. This course is currently offered about eight times per year. The content is primarily informational and is centered around completion of a packet of materials required for establishing a private business, such as registration forms, tax forms, and credit applications. At present only about 20 percent of the course material is instructional. Nonetheless, these courses are in high demand given KIMI's good reputation and the valuable service the course provides. Up to 30 students register for each class.

KIMI receives no state funding, although it does receive rent-free space on the state university campus in return for providing training to faculty of state-run educational institutes. KIMI is supported by funding from the World Bank, Harvard University, U.S. Information Agency, the European Community, and the Soros Foundation, as well as by tuition and fees from its programs. However, most of the support received from donors is provided in the form of in-kind staff training. KIMI lacks funds to develop materials focused on the needs of particular groups such as prospective entrepreneurs. KIMI is also constrained by the limited availability of desktop publishing capacity, photocopiers, and other equipment that prevent it from updating, reproducing, and disseminating course materials.

### **Kiev Polytechnic Institute**

The newly established Business Incubation Center at Kiev Polytechnic Institute (KPI) is modeled on the successful program run by Rensselaer Polytechnic Institute (RPI) in New York State.<sup>13</sup> KPI's incubator program is managed by the Department of Management and Industrial Marketing. Students qualify for participation in the program by attending a series of courses offered by the Department, and then pay a fee to use facilities and services available through the Incubation Center. The Center will primarily support projects in new technology development.

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<sup>13</sup>RPI established one of the first business incubation centers in the United States roughly 10 years ago and its program has since become a model for university-related incubator centers. The cornerstone of the program is a series of practically oriented business management courses linked to facilities and resources in a campus-based technology park that together allow students to transform ideas developed in the classroom into viable businesses. In one of the key courses, Principles of Entrepreneurship, students prepare business plans that they may then attempt to put into practice through the incubator program. RPI has helped form more than 60 companies to date. Although primarily intended to assist RPI students, the incubator program also provides seminars on entrepreneurship to delegations of business people from overseas, including Mexico, Argentina, Japan and, more recently, Hungary and the former Soviet republics. A delegation of staff from Kiev visited RPI several months ago as part of the process of establishing a similar program in Ukraine.

Financing is in short supply both for the incubator program itself as well as for the students attempting to launch ventures. KPI is attempting to address program funding constraints by constructing a new building for incubator tenants (currently scattered across campus) and renting space to some "anchor tenants" who can afford to pay substantial amounts, thereby subsidizing operating costs for students. KPI is also trying to establish links with local banks to support the start-up and working capital needs of its students/entrepreneurs. The fact that the former rector of KPI, one of the founders of the incubator program, is currently the Minister of Education should facilitate this step in short order.

It remains to be seen how successful this approach will be in Ukraine. At present, substantial obstacles must be overcome including securing adequate program funding. At present the effort is being supported by RPI and by the U.S. National Business Incubator Association, but most of this support has been in-kind in the form of staff training. RPI is currently in the process of preparing a proposal to A.I.D. to obtain further funding. One possibility that should be explored further is for KPI to broaden the audience for key courses such as the Principles of Entrepreneurship class adapted from the RPI version to reflect the legal and financial circumstances in Ukraine. Making the course available on a for-fee basis to nonstudents as well would not only expand the reach of this critically needed training but could help support the operating costs of the incubator program.

### **Lviv Management Institute**

The Lviv Management Institute (LMI) was established two years ago to provide high-quality business management training and advisory services to the emerging small private enterprise sector in western Ukraine. LMI's principal services are a one-year MBA program that includes a one-month internship in the United States, and short courses on business start-up procedures and business management skills.

Officially LMI is a state-owned entity operating on the premises of Lviv's Ivan Franko University, but it has not received any funding from the state. Operating expenses are covered by proceeds from the MBA program and consulting services. The cost of LMI's direct technical services to entrepreneurs is covered by funding received from members of the diaspora and other external sources.

LMI maintains contacts with educational institutions in the United States and Canada, including Wayne State University, University of Manitoba, and Philadelphia University. These institutions supply staff to teach some of the courses at LMI, and also identify training opportunities with firms in the United States and Canada for program participants.

LMI is in the process of expanding its consulting services to the small business community. To date, LMI has offered these services on an ad hoc basis and has helped launch over 100 private firms in the Lviv region. With \$70,000 in financial support from the U.S.-based Center for International Private Enterprise (CIPE), LMI will establish a Business Center by end-1992 to provide consulting and research services on a systematic basis. The funding from CIPE will allow LMI to deliver services for one year with the goal of facilitating start-up of as many private small businesses as possible during this period.

### **UKRAINIAN-AMERICAN SUPPORT**

It is impossible to discuss the framework for institutional support of small business development in Ukraine without referring to the role of Ukrainian-Americans. Many Ukrainian-Americans in Kiev

are representatives of U.S.-based or Canadian corporations directly involved in private sector activities. Some are directors or visiting professors at prestigious universities and training institutes. Others are lawyers, journalists, or individuals involved in formal assistance programs. Taken together, they represent one of the most powerful resources for transforming the economy of Ukraine.

Ukrainian-Americans are involved in most of the 70 U.S. corporations currently represented in Ukraine, either as employees or joint venture partners. These individuals are personally motivated to be in Kiev during this historic time of transition, and are valuable for both their business and language skills and their ability to understand and translate the local economic and cultural context. Ukrainian-American businessmen are a critical force in the development of small private business in the Ukraine. As important as the capital they are providing are the knowledge, attitudes, and skills they are imparting to their partners and employees through direct participation in the business process. They are bringing in communication and computer equipment and demonstrating American techniques and styles of doing business in a market economy.

Another segment of the Ukrainian-American community relevant to small business development is represented in the international press. Several international newspapers have full-time correspondents in Kiev, including the *Wall Street Journal* and the *London Financial Times*, as well as correspondents for Ukrainian-American newspapers serving members of the diaspora in the United States and Canada. These professionals are an important source of information for foreign advisers and businessmen. The Ukrainian-American newspapers also serve as direct conduits for advertising programs, services, and business opportunities in Ukraine and recruiting Ukrainian-Americans for business, advisory, and teaching positions.

### **Ukrainian National Association**

The Ukrainian National Association (UNA) is a New Jersey-based fraternal organization founded in 1894 and dedicated to conserving Ukrainian culture and traditions. UNA is a nonprofit organization that supports the Ukrainian-American community and Ukraine through the proceeds of life insurance and credit unions. UNA has a Washington, D.C. office and lobbies the U.S. government on matters of interest to Ukrainian-Americans and Ukraine. Through its membership, publications, and organization, it maintains contact with a variety of Ukrainian-American organizations. The UNA is creating a foundation to channel development additional assistance to Ukraine and support such organizations as the Children of Chernobyl. The UNA is also developing a joint program with the World Council of Credit Unions to encourage the establishment of credit unions in Ukraine.

### **CHAMBER OF COMMERCE**

At the suggestion of the U.S. Ambassador, the 70 U.S. companies based in Ukraine have established an American Chamber of Commerce in Kiev to represent their common interests. The Chamber provides a mechanism for representatives of U.S. firms to exchange experiences and information as a way of overcoming the isolation and confusion encountered in trying to establish a foothold in Ukraine. It also serves as a vehicle for developing a network of contacts and presenting a solidified front to Ministers and other government officials whose support is required. Incorporated in mid-1992 despite opposition from the Ukrainian Chamber of Commerce, the American Chamber is setting up an office and starting its first membership drive.

Although the American Chamber is primarily intended to meet the needs of the U.S. firms, it will provide services that benefit local small businesses as well. For example, the Chamber compiles up-to-date information on legal and regulatory developments affecting foreign investors and maintains a complete set of all pertinent laws in English. This information will be accessible and relevant to local small businesses seeking to establish joint ventures with U.S. partners. The Chamber also plans to develop a mechanism for identifying and linking local small businesses as suppliers and distributors for U.S. firms operating in Ukraine.

### **OTHER U.S. PROGRAMS SUPPORTING SMALL PRIVATE ENTERPRISE DEVELOPMENT**

Among the key U.S. programs in Ukraine providing support in areas related to private business development are the Peace Corps, Volunteers in Overseas Cooperative Association, the Project for Economic Reform in Ukraine, and the Center for International Private Enterprise. Each of these programs addresses different private enterprise needs. At present there are only modest levels of collaboration among these efforts, with no single mechanism in place to serve a coordinating function. The following section highlights some of the main features of each of these programs along with tentative suggestions on how the proposed SED project could coordinate with them. This coordination would allow the SED project to make efficient use of A.I.D. funds by drawing on the considerable talent and experience represented by these existing resources. At the same time, there are specific areas in which the SED long-term adviser and short-term specialists could contribute strategic technical assistance that would reinforce the objectives of the other programs.

#### **Peace Corps Small Business Development Program**

The Peace Corps Small Business Development Program has been designed to provide assistance at several points in the overall framework for small business support. The program is flexible, allowing the staff to evaluate the effectiveness of different approaches and deploy additional volunteers when it makes the most sense, taking advantage of new opportunities as they arise. The first group of 60 small business advisers arrived in November 1992 and will be assigned as follows:

- Municipal and oblast-level government offices. Volunteers will use these offices as bases for providing a range of training and advisory services to large numbers of entrepreneurs. Placing volunteers in selected government offices also provides volunteers with the chance to work with government officials on developing programs to assist small entrepreneurs;
- Management and training institutions. Peace Corps has identified training and education as one of the most critical needs of entrepreneurs, government officials, and banks. Their training strategy is to place volunteers with existing institutions. Lviv Management Institute will be among the programs receiving volunteer assistance;
- Bank Ukraina. Peace Corps volunteers will be placed in 14 branches of the Bank Ukraina to work with bank staff on developing strategies and practices to increase lending to small business; and

- Small private businesses. Peace Corps will place a few volunteers in individual firms in which the Ukraine Fund will make investments.<sup>14</sup> Peace Corps assistance to these firms will concentrate on business development, training, and accounting.

Peace Corps is interested in A.I.D.-funded technical assistance that could reinforce elements of their program. Given the apparent convergence between Peace Corps and A.I.D. program objectives in small business development, it is highly likely that opportunities could be found for this type of collaboration. Peace Corps program staff would be able to communicate specific technical assistance requests to the SED project long-term adviser, who in turn could take the lead in identifying and mobilizing appropriate personnel.

### **Volunteers in Overseas Cooperative Assistance**

The program of the Volunteers in Overseas Cooperative Assistance (VOCA) is a two-year program funded by A.I.D. to provide technical support and increase the range of commercial opportunities available to private farmers in Ukraine. The program involves a long-term adviser based in Kiev who identifies technical assistance needs and coordinates the recruitment and deployment of U.S.-based short-term specialists. Most of VOCA's assistance has been directed to farmers in the West and South, where the majority of the private farms are located. Eastern Ukraine, which spent more time under Soviet rule, remains more collectivized and has presented fewer viable opportunities for VOCA involvement. VOCA efforts to support private farming have been hampered by the limited amount of farm land privatized to date and by continued reluctance on the part of local councils as well as certain agricultural ministries to privatize the agricultural sector.

VOCA assistance is focused on the following key areas:

- Setting up a farmer-owned cooperative bank to increase farmers' access to credit;
- Overcoming input constraints. At present, most private farmers continue to rely on the state for obtaining key inputs in the absence of other established sources of supply. In return, they are usually required to sell back some proportion of their crop to the state, diminishing possibilities to expand into alternate markets; and
- Setting up marketing associations to identify opportunities for new product development and capitalize on export opportunities.

The VOCA program emphasizes support of the production aspects of private farming; it has a secondary focus on assisting farmers to move into distribution and processing activities. Accomplishing the latter task will require the development of supply and marketing systems, management expertise, and technical processing capacity, which VOCA sees as part of a longer-term effort. VOCA is operating on the assumption that, in the short run, processing capacity will likely spin off from state enterprises and farms rather than emerge from the private farming sector.

VOCA has also identified a need for technical and business education for private farmers. Most private farmers have narrow areas of expertise and come from situations in which they had specialized

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<sup>14</sup>The Ukraine Fund is a Boston-based group that is establishing joint ventures with selected private small businesses that have the demonstrated capacity for commercial success.

tasks on cooperative or collective farms; they lack the broad set of technical and management skills required for running a commercial farm. VOCA provides some direct technical assistance on a one-to-one basis, and is attempting to establish counterpart relations with local institutions to develop mechanisms for broader delivery of training services.

The primary counterpart that VOCA has identified for work in this area is the Association of Ukrainian Farmers. However, the VOCA adviser noted that there are two organizations claiming this title, one staffed by ex-communists interested in promoting selective privatization in their own interest, and one representing reform-minded individuals for whom politics is at the top of the agenda. So far, VOCA has not found either group particularly effective to work with.

Whereas the primary target groups and objectives of the VOCA program and the proposed SED project are distinct, A.I.D. assistance under the SED project could reinforce VOCA program objectives in several areas by broadening the delivery of training services, by helping to establish the distribution systems that will allow private farmers to expand into processing and other related commercial activities, and by targeting banks involved in lending to private farmers for bank training assistance under the SED project. The SED project's long-term adviser would maintain communications with VOCA's staff to enable strategic, efficient use of the short-term technical assistance resources available under both projects. For example, SED assistance to private entrepreneurs involved in processing of agricultural products could be coordinated with VOCA assistance to private farmers focused on increasing production and identifying marketing outlets. Similarly, the SED long-term adviser could ensure that activities under the training component take into consideration the training needs of private farmers, and could assist VOCA in establishing linkages with local institutions capable of delivering appropriate business management training courses to them.

### **Project on Economic Reform in Ukraine**

The Project on Economic Reform in Ukraine (PERU) was created by professors and students from the Kennedy School of Government at Harvard University in response to requests for assistance from Ukrainian policy makers. Through its coordinating office in Kiev, PERU provides advisory services to Ukrainian officials on the development of privatization policies and legislation. Their main government counterpart is the State Property Fund, which has primary responsibility for privatization. PERU's staff also work closely with the Council of Advisers, a body created two years ago with funding by the Soros Foundation to provide expert guidance to the President and Parliament. PERU receives funding from the Soros Foundation, the Center for International Private Enterprise, and a variety of nonprofit organizations.

Primary PERU activities include coordinating requests for assistance through ongoing communications with the PERU office in Massachusetts, developing and maintaining a specialized library and undertaking dissemination activities, and identifying other potential sources of support for PERU's work on privatization. One of PERU's primary activities is coordinating an internship program with Harvard's Kennedy School of Government. The PERU program maintains a relationship with the Kiev International Management Institute whereby interns spend one month in initial orientation training before starting their internships, and on return work directly with KIMI's faculty on the development of case study materials. PERU translates and disseminates pertinent legislation, articles, and reports related to privatization; maintains a library that includes reports by international experts and program interns; and produces a newsletter.

The most likely areas of collaboration between PERU and the proposed SED project are in training and information dissemination. PERU has already been involved in the implementation of workshops and seminars that bring entrepreneurs together to identify common needs and constraints, and it has established linkages with KIMI. The SED long-term adviser could work with the PERU office to take advantage of opportunities provided by these existing mechanisms in designing and staging training programs for small entrepreneurs. Coordination with the PERU office would link the SED activity with the considerable expertise available through Harvard's Kennedy School, and it could open opportunities for U.S. training and study tours.

### **Center for International Private Enterprise**

The Center for International Private Enterprise (CIPE), an affiliate of the U.S. Chamber of Commerce, has the mandate to promote private enterprises and market institutions that support democratic development. CIPE is the business representative of the National Endowment for Democracy. In recent years CIPE has been particularly active in promoting the privatization process in Eastern Europe and the former Soviet republics, generally working with local organizations to strengthen market-oriented democratic initiatives.

To date, CIPE has provided assistance to three Ukrainian organizations:

- The Association of Cooperative Societies and Self-Supporting Scientific and Technical Organizations (SPURT), a Ukrainian association made up of cooperatives, enterprise managers, and policy makers that was created to support privatization. SPURT educates officials involved in the drafting of legislation, generates public support for the process through widespread media campaigns, and disseminates information on Ukraine's privatization to the West by means of a monthly newsletter;
- The Brokerage Project, a subsidiary of Ukraine for Free Market Economics, a limited liability company involved in developing private channels for the distribution of goods and services. The Brokerage Project also seeks to overcome negative views among the public concerning the sale of commodities, profit, and competition. CIPE is supporting development of a curriculum and texts for educating commodity brokers; training courses for teachers to train brokers; consulting and advisory services; and information on exchanges, markets, and brokerage activity; and
- The Business Support Center at the Lviv Management Institute. CIPE is supporting the establishment of a Business Support Center at LMI that will provide consulting services and training in accounting, marketing, finance, and business law on a fee basis to Ukrainian businesses. According to LMI's staff, CIPE's funding of \$70,000 is expected to carry the center through its first year of operations.

Although activities under the CIPE program are in line with the objectives of the proposed SED project, there are also clear differences. CIPE identifies opportunities to work with a broad range of private sector institutions involved at different levels of the privatization process. Their efforts range from educating government officials directly charged with designing and implementing privatization measures to raising the level of awareness of the general public. At the same time, CIPE does not appear to be involved in providing direct firm-level support or technical assistance, and there does not appear

to be a long-term, in-country point of contact for coordinating program activities or providing specific kinds of follow-up assistance to organizations or entrepreneurs.<sup>15</sup>

The long-term SED adviser could serve as an effective in-country point for coordinating aspects of CIPE's program activities, particularly those providing direct support to small private entrepreneurs. To the extent that CIPE's initiatives form part of the network of support available to small entrepreneurs, the long-term adviser could act as a referral for eligible entrepreneurs seeking the kinds of services CIPE provides. At the same time, entrepreneurs already participating in CIPE-funded programs could be made aware of the additional forms of support available through the SED project. In the case of the Lviv Management Institute, SED assistance could focus on institutionalizing the services provided by the Business Support Center that CIPE is helping to establish.

### RECOMMENDATIONS

The key feature of the training component for the SED project is to leverage project resources by building on the programs of existing Ukrainian institutions and coordinating training interventions for Ukraine with assistance designed for the other NIS countries in which A.I.D. is planning to implement programs.

Providing funding increments to programs that are already operating well represents a cost-effective way of expanding the reach of the program beyond Kiev, enhancing the quality of currently adequate materials, and deepening existing linkages with Western institutions. By taking this approach, A.I.D. can avoid spending resources on redundant efforts or starting new programs in which substantial portions of the funds go toward operating expenses rather than programmatic uses.

There are several institutions that have developed effective programs for reaching segments of the potential population requiring and seeking training in small business skills. Among the institutions with clear potential are the Kiev International Management Institute, the newly established business incubation program based at Kiev Polytechnic University, and the Lviv Management Institute in western Ukraine. KIMI and LMI have established themselves as relatively independent institutions with professional staff, curricula developed in conjunction with U.S. counterparts, and a high rate of program success as demonstrated by the number of graduates who work in foreign joint ventures or establish their own private businesses. Kiev Polytechnic's business incubation program, although new, promises to combine professional business management training with facilities and services designed to encourage business start-ups.

The proposed SED project for Ukraine is one of several A.I.D. small business development initiatives being planned for the NIS. A.I.D. is also considering programs in Russia, Uzbekistan, Kazakhstan, Georgia, and Armenia, and training is likely to figure prominently in these programs as well. Given the similar kinds of problems and levels of business skills in all of the NIS countries, it is likely that the basic training materials required will be the same. Modifications that take into consideration the particular regulations and economic conditions prevailing in each country can be introduced by the trainers. Significant economies of scale in training could be achieved by coordinating the training needs

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<sup>15</sup>The team attempted to contact CIPE in Washington, D.C. for a fuller description of CIPE activities in Ukraine; however, CIPE staff were reluctant to share this information with a contractor and expressed their preference to communicate further details of their program directly to A.I.D.

of all of the NIS programs, and having one central repository and coordinator for materials, courses, and training staff.

The following recommendations provide a series of options for A.I.D. in the area of training, all of which build on the resources of existing qualified programs. The recommendations could be implemented individually or as a package, permitting either selective support of specific programs or complete integration of training into the broader SED project. In Ukraine, the activities would be coordinated by the proposed long-term SED adviser. The adviser would also follow up on opportunities for supporting additional training institutes identified in the course of program implementation.

- Development of high-quality training materials. As discussed above, a large number of institutions are delivering training courses, and the combined outreach of existing programs is already fairly extensive. Upgrading the quality of instructional materials used by these institutions represents a cost-effective way of providing assistance to a large number of entrepreneurs at the same time. KIMI is well positioned to take the lead in producing and distributing training materials for use in short business management courses tailored to the regulatory and economic realities of Ukraine. KIMI has already expressed interest in playing this role in the development and dissemination of training materials.
- Organize business training classes according to subsector. Another way of increasing the impact of existing business training programs is by encouraging participating institutions to organize classes for groups of entrepreneurs from the same subsector. Local trainers would use the same basic course materials for each group, while focusing on specific problems and issues encountered by entrepreneurs in those industries. Industry-focused sessions provide a forum for entrepreneurs to identify their own constraints and develop the necessary business skills for solving these problems. They also offer a potential mechanism for delivering technical information and advice along with general business training. Finally, grouping entrepreneurs from the same subsector allows them to develop an awareness of their common interests, a prerequisite for forming independent industry associations that at present are almost nonexistent in Ukraine.
- Fund SED project trainer/coordinators. The success of the proposed SED project will be enhanced by the effective integration of training. Entrepreneurs successfully completing long- and short-term business training programs at participating institutions will constitute a logical set of potential candidates for other services available under the project. This linkage will enable coordination of assistance to entrepreneurs on several fronts, thus increasing the likelihood of their business success. Funding a staff person at each institution would provide direct support to the respective programs and would help insure the desired level of integration with the Kiev office. The designated staff members would be the primary liaisons with the long-term advisor. They would be familiar with the types of information and support available under other components of the SED project and could direct training course participants to the appropriate channels for further assistance. Given the low cost of local staff, this could be a very cost-effective intervention.
- Subsidize cost of student participation. Anecdotal evidence from the staff and former graduates of the KIMI and LMI MBA programs indicates that a high proportion of these students go on to establish their own private enterprise. These graduates, equipped with U.S. training, experience, and contacts, constitute an important repository of local management skill and are among the key architects giving shape to the emerging small business sector. To date, these MBA programs have been accessible primarily to high-level employees of state

enterprises who are able to afford the relatively high tuition, much of it payable in hard currency.<sup>16</sup>

Given the successful entrepreneurship demonstrated by MBA program graduates, A.I.D. may wish to subsidize a portion of the expense for selected students. For example, A.I.D. could cover the hard currency portion of tuition. Financial assistance could be in the form of a grant or a loan, the latter repayable by the student/entrepreneur on appropriate terms within some reasonable time frame. Criteria for providing financial assistance could be developed by the SED project advisory board. The criteria would reflect the objective of supporting private entrepreneurs. This mechanism could also help ensure improved levels of participation by women.

There is no indication that ability to pay is a factor limiting student participation in short courses, so financial subsidy for tuition in these programs does not appear warranted or necessary at this time.

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<sup>16</sup>LMI's program costs the equivalent of \$1,400, \$500 of which is payable in hard currency (the rest in the current coupon equivalent).

## SECTION EIGHT

### WOMEN IN THE ECONOMIC DEVELOPMENT OF UKRAINE

Socialist rhetoric on gender equality to the contrary, women in Ukraine have shouldered a disproportionate share of the hardship associated with the failed centrally planned economy and continue to struggle under the burdens of social and economic discrimination during the current period of reform. Anecdotal evidence in Ukraine paints a compelling picture of the difficulties women in particular will face as the economy undergoes transformation. This evidence points to areas that will require further attention as A.I.D. evaluates specific options for supporting private small business development.

#### OVERVIEW OF WOMEN'S STATUS IN UKRAINE

There are 16 percent more women than men in Ukraine, reflecting in large part the decimation suffered by the male population during World War II and the Stalin years. Fertility is relatively low, indicative of the hardships associated with child rearing and the poor quality of medical care. Abortion is the most practiced method of birth control. Maternal and infant mortality have been increasing, particularly since the collapse of the Soviet Union, reflecting the disruption of supply channels for vaccines and other medical equipment as well as deteriorating nutrition.

These demographics help explain women's widespread involvement in the work force, where scarcity of labor has made their participation critical for operation of the state production system. At the same time, small family size has meant that women typically do not have the luxury of older children (daughters) to count on for assisting with care of young children and household maintenance. And time spent on maintenance has been significant in Ukraine, as elsewhere in the former Soviet Union, where time-saving household technologies and consumer goods have been almost nonexistent and food and other basic necessities have always been in short supply. The twin demands of household and work, combined with the absence of any real community support, have resulted in a particularly grueling and isolating version of women's "double burden."

Despite women's prevalence in the labor force, particularly in agriculture and industry, there is little indication that gender is being taken seriously as a variable that influences the course of economic development. This applies to donor-funded support, much of which has been at the policy level where gender issues are perceived to be irrelevant. Even assistance at the firm level has been uninformed by gender analysis. For example, a recent World Bank study of 250 private enterprises designed to provide some of the first hard data on this still elusive sector failed to collect data on a gender-disaggregated basis. Part of this low concern for gender may stem from the perception in the West that, whatever else its shortcomings, there was no gender discrimination under socialism. This view is fueled by data showing that women in Ukraine are well educated, accounting for over 50 percent of enrollments at state educational institutes, and that they occupy positions as engineers and scientists, still primarily male occupations in the United States. However, this popular perception obscures some real distortions in the previous system that leave women in some ways less prepared than men to take advantage of opportunities created in the current period of reform.

Technically, women in the former Soviet Union were granted all the rights of men and feminism was considered a bourgeois Western practice, unnecessary and divisive in an egalitarian socialist society.

However, although discrimination may have been forbidden by law, women never had a role in shaping the policies or decisions that defined their supposedly emancipated state. In Ukraine, not a single woman served on the Central Economic Planning Committee, and women continue to be singularly absent from positions of political and economic decision making under the current regime. The feminization of certain positions, such as teachers and doctors, conceals the fact that these professions have not been highly valued under the old system, in which social services were never an area of great concern. Similarly, women's preponderance as bankers and scientists concealed the low status and high administrative content attached to these functions under the centrally planned economy. As these positions become associated with real power, it is not unusual to find women being replaced by men. Although wage discrimination has technically been disallowed, men are promoted more readily into categories that allow higher pay and receive more of the non monetary perks that, given the difficulty of obtaining goods and services, are often more valuable than salary increments.

One of the factors that has conspired to keep women from being hired for positions of greater responsibility is the absence of adequate day care. Although the state has subsidized the cost of child care, state-run facilities are notoriously bad and many women consider them a last resort. Special payments and favors are required to get children into better centers. Most facilities are understaffed, overcrowded, and poorly maintained, and children catch all kinds of contagious illness requiring their mothers to stay home from work. Absenteeism necessitated by child care in turn fuels prejudices against hiring or promoting women. Now day care is becoming more expensive as the state reduces its contribution to these types of social services.

Given these circumstances, it is not surprising that many women are opting to stay at home. After being required to work all these years, virtually by state imperative, many women are evincing little inclination to take on the arduous challenge of starting their own business. Psychological factors resulting from years of drudgery and state control are among the biggest hurdles that women will need to overcome in attempting to initiate independent economic activities.<sup>17</sup>

### WOMEN IN SMALL BUSINESS DEVELOPMENT

In some ways women are more prepared than men to jump into private enterprise. In Ukraine, women have had to be entrepreneurial to survive. Some of the areas they should find it easiest to move into are the range of services that are outgrowths of tasks they have already been doing. For example, almost all women, regardless of profession, are out of necessity involved in preserving, pickling, and canning food for home consumption. With few frozen or canned products available in the stores, women

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<sup>17</sup>As Ukrainian society opens up, women are receiving a mixture of messages concerning the experience and status of women in the West — messages that are contributing to the reshaping of female identity in Ukraine. For example, the best-selling books at the moment, which women are reportedly forgoing food in order to buy, are *The Joy of Sex* and *Dr. Spock's Guide to Child Raising*, underscoring women's hunger for information that will give them some power over important personal issues in their lives. Similarly, feminine hygiene products that have been available in the U.S. for decades are just now being introduced, making it possible for women to avoid missing work one week a month, which has been the case until now. At the same time women are being bombarded with advertisements exhorting them to be glamorous, erotic, and sexy, stimulating as yet unmet demand for a range of fashion and cosmetic products.

must preserve whatever foods they can during the summer months to supplement the family diet in the wintertime. Given access to appropriate financial resources and management training, women could move into the area of food processing in which tremendous market potential exists. Other activities that women will find it easy to move into include maid and beautician services and sewing. The danger is that by building on these household activities, women will be confined to the same traditionally low-paying sectors of the economy as they have been in the Third World. This would be a tremendous waste of the high level of education and skills Ukrainian women possess.

Many of the obstacles women face in trying to establish a private business are identical to those encountered by men, such as contradictory laws, problems obtaining inputs and credit, and problems involved in retailing the product or service. In addition to these obstacles, there are particular constraints that women need to overcome in order to participate in emerging private sector opportunities. Most of these have to do with male attitudes and behavior toward women. Ultimately, only women's economic success will destroy old stereotypes and confer on women the respect they deserve. In the short run, women who want to go into private business are apparently continuing to rely on spouses or other male associates to interface with bureaucrats and obtain necessary permits and inputs through the old-boy communist network. Although women may be treated politely, they have a harder time being taken seriously by bureaucrats who control the registration process, access to space, and other resources.<sup>18</sup> The general impression resulting from the World Bank study mentioned above was that most of the officially registered heads of enterprises tended to be men, although interviews at the firm revealed that women almost invariably played key roles in actually running the business.<sup>19</sup>

The hope expressed by some women is that, as Ukraine moves toward a private economy in which qualified labor and high quality goods are in short supply, the market will create demand for women's labor and products and will help establish fair wages and prices for women's economic activities. If the experience from Western countries provides any guide, close attention and specific interventions may be required to ensure that this is the case.

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<sup>18</sup>According to the President's Chief Economic Consultant, obtaining a permit for a private business without having to pay a bribe is the exception rather than the rule. The going rate for a permit to open a kiosk was 200,000 coupons plus \$200. It is likely that this practice is contributing to women's reluctance to step forward and register businesses.

<sup>19</sup>The following vignette illustrates the way women enter the sphere of private business. Irina is the owner of a small textile business that makes gloves from material scraps. The business was started as a co-operative, one of the first in Ukraine. Irina was afraid to register the business herself and had her husband do it for her. The co-op had three other women as co-owners. The women were really more like employees in that they were unwilling to share in the risk and did not put up any of their own capital to start the business. Irina had to reassure them that it was all right for them to engage in this work at a time when all private initiatives still smacked of illicit activity. The women were happy to work at home because this solved their child care problem. The three women each had a sewing machine at home and were paid a fixed salary to sew gloves. Irina acquired the throw-away scraps at low cost from a state enterprise producing training suits, and sold the finished products through state retail outlets. Any profits were hers. Irina has since earned her MBA at the Kiev International Management Institute and has now opened a second company along with her husband and an American associate. This company is a consulting and research organization specializing in issues related to private sector development in the former USSR. Irina is the formally registered owner of this second business.

## WOMEN'S ORGANIZATIONS

Prior to the years of communist rule, there was a long tradition of community organization and self-help, particularly in western Ukraine. Women's organizations were especially strong during the interwar years, emphasizing practical issues such as introduction of new food crops and other home-based economic activities. However, during the ensuing years of Soviet domination, the experience of community organization was lost as was most Ukrainians' awareness of their own history. Traditions of self-reliance were replaced by resignation and dependence on being organized by the state. As Ukrainians cast off the political constraints of Soviet domination, they will need to recover the psychological independence that necessarily underlies private economic activity.

At this time there are several women's organizations in Ukraine, but none of them is focused on practical, economic issues. These include the Rukh Women's Organization which is nationalist in character, stresses family and religious values, and undertakes charitable activities such as running soup kitchens and caring for victims of the Chernobyl disaster; several academic women's associations that publish journals on literary criticism; a radical feminist group; and a very new organization called the Ukrainian International Federation of Business Women about which little is known at this time.<sup>20</sup>

## RECOMMENDATIONS

Recommendations for ensuring women's participation in the proposed SED project parallel the overall recommendations made in this report. In most cases, it is not so much a question of targeting separate interventions for women as making sure that all project activities are structured in ways that allow women full participation. Specific recommendations include:

- Ensure that any data on the small private enterprise sector are collected on a gender-disaggregated basis;
- To the extent that the SED project succeeds in establishing a presence at the policy level, the policy adviser should ensure that policies and regulations developed in support of private business — for example, regulations for owning property or registering a business — do not explicitly or implicitly discriminate against women;
- Ensure that all bank training provided to commercial banks reflects the substantial experience gained worldwide on the outstanding performance of women as credit recipients and savers. SED advisers should assist banks prepared to lend to small enterprises to establish procedures that enable women to borrow as easily as men; and
- A.I.D.-supported training programs should be designed and scheduled to make it possible and reasonable for women to attend, bearing in mind cost factors, women's access to transportation, safety issues, and the intense demands on women's time.

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<sup>20</sup>The Ukrainian International Federation of Business Women was identified on the last day of the team's mission in Ukraine, leaving no time to locate or contact its representatives. This organization should be visited by the next follow-up team.

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