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The USAID Strategy for SME Development in Ukraine

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Preface

This report was drafted October in 1996 following a three week field study conducted by Management Systems International (MSI). The MSI team consisted of three small-business development specialists: Russell Webster (Team Leader and MSI Principal Associate), Leslie McCuaig (whose services were provided through USAID/Moscow), and David Burton, (MSI Senior Associate). The team also benefitted from valuable background work done by Hans Shrader of the ENI Office of Small Business Development. Sections of the report were updated in March 1997 following Mr. Webster's participation in a conference on Ukrainian support to the SME sector, which was organized by the Ukrainian Cabinet of Ministers, with participation from public agencies and private sector organizations. A main theme of the conference, which is directly relevant to issues discussed in this report, was how to improve the legal and regulatory environment for small and micro businesses in Ukraine. Mr. Webster and a team of Ukrainian experts provided technical assistance to this effort.

The team wishes to thank all of the individuals in Ukraine who helped with their time, insights and recommendations. As a strategic planning exercise, it was vital that representatives from USAID, other donors, implementing organizations, government counterparts, business organizations, enterprises, and banks participated in the team's investigations. We sought out as many people as we could in the time given, and we are grateful for having had an opportunity to discuss this very important area for Ukraine's economic, and democratic, future. We invite any comments, and look forward to future collaborations.

Russell Webster
Team Leader

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Annex A: Tax Policy in Ukraine



Executive Summary

The promotion of privatization and the stimulation of newly-formed businesses have been priorities for USAID since it began operating in Ukraine. Privately owned micro, small and medium sized enterprises¹ deserve special attention in these efforts because it is in this sector where jobs, income, and capital investment will be created in order to fuel Ukraine's economic transition to an open market economy. In addition to much needed economic development, these businesses — particularly the micro and small enterprises — will become the working place for entrepreneurs, managers, and skilled labor that constitute the middle class necessary to bolster democratic reforms in Ukraine.

However, the situation for SMEs in Ukraine needs to be greatly improved. The sector is hindered by an onerous legal and regulatory environment, a taxation system that features high rates and endless codes, poorly developed financial services, underdeveloped markets (domestic and international), and a lack of experience in managing competitive enterprises for profit. This strategy is intended to help guide USAID's thinking and programming as it moves forward with a stronger commitment to the SME sector in Ukraine.

The strategy proposed in this report contains two complementary areas of emphasis:

- Promoting an "enabling environment" with fair and transparent laws that promote competition among a broad range of businesses.
- Helping entrepreneurs to start and grow their businesses profitably.

USAID's approach to implementing this strategy should include:

Creating an Enabling Environment for SMEs:

- Analytical support and training services for private sector groups (associations and NGOs) so that they can more effectively advocate for legal reforms.
- Collaboration with independent "think tanks" and research institutions to analyze legal constraints to SME development and propose solutions thereof.
- Technical assistance and advisory services to the Government of Ukraine on SME policy development and legal reform.
- Technical assistance and training to municipal and regional authorities on promoting private-public partnerships for business development.
- Public education programs to promote the importance of privately-owned, small-scale businesses to the economic growth of Ukraine.

¹This covers a broad range of enterprises, from sole-proprietorships to businesses that employ up to 200-250 workers.



Assistance to Enterprises:

- Creation of model operations of technical assistance and training service centers for SMEs.
- Development of information networks and training workshops to improve the skills and techniques of SME service providers.
- Provision of institutional support and training for business associations so that they can effectively serve their membership.
- Stimulation of SME financial services (equity, debt, leasing) to promote business expansion, and demonstrate the importance of this market to Ukrainian banking institutions.

Some elements of this strategy can be implemented through existing grants or contracts, whereas others will require new initiatives in the Mission. Because the strategy is broad-based, involving numerous players in government, the private sector, as well as the donor community, USAID should also increase its staffing allocation to the SME program. Specific recommendations appear in the report, with action items outlined in Chapter 4. In summary, top priorities at this point for the Mission should be:

- More work on SME policy reform, focusing mainly on building a private sector constituency that advocates for those reforms. Included should be training and institutional support to viable business associations, and sponsorship of an SME policy roundtable series to bring together businesses, think-tanks, and public officials.
- Helping SMEs to get financing for their businesses, while at the same time pushing for the policy and institutional reforms needed to develop Ukraine's capital markets.
- Hiring a Senior Manager to provide leadership in implementing the overall SME strategy.

Second-level priorities include:

- Creation of a center to enhance coordination among USAID implementors, private sector counterparts, and other donors working in the sector with the aim of maximizing effectiveness and impact.
- Using the proposed incubators scheme to provide financing for a wide range of promising SMEs in Ukraine.
- Reviewing the "commercial viability" focus of the SBDCs to see whether this mode of operation detracts from reaching small businesses, and if so, developing a better strategy to serve smaller clients.

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Chapter 1. Overview

1.1 Purpose and Background to the SME Strategic Planning Exercise

This report was prepared at the request of USAID/Washington and USAID/Kiev, and is intended to assist USAID in planning its next phase of support to small and medium enterprises (SMEs) in Ukraine. Field work was carried out over a period of three weeks in September 1996, and involved meetings and roundtable discussions with numerous individuals from businesses, associations, government, bi-lateral and multi-lateral donors, and organizations which implement programs to assist the SME sector in Ukraine. The report was drafted upon completion of the team's fieldwork in September. Some additions and changes were made in February 1997 following a three-week conference sponsored by the Cabinet of Ministers in which a public-private sector team of specialists prepared a) a draft law, b) an SME financing scheme, and c) a Presidential decree to support SME development in Ukraine. The SME strategy team leader served as an advisor to the conference. Issues related to the proceedings of that exercise are noted in the text of this report. In general, the conference represents a significant initiative on the part of the Government of Ukraine (GOU) to bolster the SME sector; as such, it presents USAID and other international donors the opportunity to move forward on much needed legal reforms.

The team was made up of specialists with SME strategic planning, policy, and program management experience in Russia and several countries of Central and Eastern Europe.² One purpose of the Ukraine exercise was to build on lessons learned in nearby regions that would help guide USAID in planning its assistance to Ukraine. Although Ukraine has a unique set of circumstances, there indeed are elements from USAID's experience in other ENI countries, particularly Russia, which are relevant to the Ukraine program. The program priorities and management recommendations take these experiences into consideration.

The tasks of the team were to:

- Review the state of the SME sector in Ukraine today, identifying constraints to and opportunities for investment and growth in SMEs.
- Meet with key players to discuss lessons learned and future priorities.
- Review USAID's current portfolio of programs in the SME sector, and identify areas where greater coordination and/or the addition of resources could produce better results and greater impact.
- Advise USAID on how to implement an expanded, more strategic program for

²Russell Webster (Team Leader and MSI Principal Associate), Leslie McCuaig (Ms. McCuaig's services were provided through the USAID/Moscow office), and David Burton (Consultant to MSI and Principal of the Argus Group, Washington D.C.)

SME development in Ukraine.

As will be seen in the following report, some elements of the strategy can be implemented by modifying or expanding existing grants and contracts. Other elements, particularly in the area of developing a legal framework that promotes fair and open competition among businesses, will best be accomplished through a new initiative. To be successful, the SME strategy also needs to be implemented with senior-level support, backed by a strong management team that has the vision and leadership skill to build on the best that each implementor in USAID's portfolio has to offer.

USAID/Kiev has a tremendous opportunity to influence positively the development of SMEs in Ukraine. Many key players in the private sector, government and the donor community — not to mention the Ukrainian entrepreneurs themselves — know that small, privately-owned businesses are vital to Ukraine's transition to an open-market economy. The demand for SME services and for a new legal framework is great, and USAID should act now to address this demand with as many resources as possible.

1.2 Current USAID Efforts to Support SMEs in Ukraine

There are several programs and activities in the USAID/Kiev portfolio that contribute to some aspect of SME development in Ukraine. Some programs work directly with entrepreneurs, banking institutions, other financial institutions, and non-governmental organizations serving the interests of the business sector. Other programs are aimed at improving macroeconomic policies, capital markets, or fiscal and monetary management. Still others are aimed at promoting civil society, democracy, and better governance, all of which are important for the development of newly-emerging small businesses, since they represent what will hopefully be a vibrant middle class in Ukraine's future economy.

In managing the SME strategy, USAID/Kiev should a) recognize the contribution made by each of these implementors, and b) facilitate a process by which there is ongoing interaction and support among the implementors. This also needs to be extended beyond mission management to involve other partners in government, the private sector, and the donor community. In practical terms, the USAID staff in charge of these various programs (both inside and outside of the privatization office) should become part of Ukraine/Kiev's SME strategy team. Their participation will add synergy to the program, promote greater awareness and enthusiasm for this vital sector, and produce better results and impacts for Ukraine. Primary management responsibility still rests within the mission's Strategic Objective 1.3, "Accelerated Development and Growth of Private Enterprises." The team offers specific management recommendations for the SME strategy in Chapter 4.

1.3 Efforts of the Ukrainian Government and of Other Donors

The Ukrainian government is not actively pursuing a policy of promoting privately-owned SMEs. In fact, the government has taken decisions, particularly in the area of taxation, that make it more difficult to run a legally-registered, profitable business.³ Most businesses operate either partially or totally in the “shadow economy.” Several Ukrainians we spoke to described what they called the “paradox” that the government talks about economic reform, but acts in an “anti-business” fashion. For this reason, most Ukrainians cited the lack of an “enabling environment” as the most critical problem facing SMEs today.

From the governmental side, policy formulation and program development for SMEs is being managed by the Division of Entrepreneurship within the Ministry of Economy. The division has prepared a three-year program for SME development which will be submitted to the cabinet of ministers this year for approval. However, the division, like many other government offices, is operating on scarce resources and a limited capacity to have real impact on the sector. The team has specific recommendations about providing support to this division — or whatever agency that might arise out of the February 1997 deliberations on how best the GOU should organize its support to the sector — based on USAID negotiating a commitment from the GOU to support an expanded program of legal and regulatory reform for SME development. An approach and recommendations for providing this support are outlined in Chapters 3 and 4 below.

Some progress is being made at the local level by a cadre of progressive mayors and city council members. Many of these are active in the Ukrainian Association of Cities, which is also being supported by USAID. This Association and its members have helped draft new legislation on local government, which will be introduced into parliament imminently. If passed, it will give local governments control over twenty-five percent of locally-generated revenues, whereas now they have control over only two to three percent. This will allow the more progressive municipalities to implement programs to attract investment and stimulate business in their communities.

Other donors are active in some facet of SME development as well. Under the World Bank’s Enterprise Development Adjustment Loan, TA will be provided in the development of professional business associations, and in the creation of a commercial company database. The European Union’s (EU) TACIS program is supporting two business centers in Kiev, developing a database on joint venture and market opportunities in the EU, and supporting a project preparation unit that helps Ukrainian firms prepare business plans used in applying for credit, particularly from the EBRD’s credit program (which has an average loan size of \$1.0 million). TACIS is now in the process of designing its next phase of assistance to the SME sector. In addition to expanding its support of business service centers and an information network for

³See Annex A for an analysis of how small businesses are impacted by the Ukrainian tax system.

small businesses, it is giving some consideration to supporting an SME policy unit in government, and in piloting a program of microenterprise financial services.

Among the various programs of support to SMEs, USAID distinguishes itself by working closest with the private sector. This puts USAID in a good position to build a grassroots initiative that promotes better business, and a better business environment. This also gives the mission added credibility in advising on the need for policy and legal reforms at the national level.

Chapter 2. Factors Affecting the SME Sector in Ukraine

According to the Ministry of Economy, there are approximately 100,000 registered small businesses in Ukraine, employing approximately 2,000,000 people. It is not known what percentage of these businesses are active. In addition, there are no good estimates as to the number of businesses operating in the shadow economy, partly or fully. But, general estimates are that 30 - 50 percent of GDP comes from the shadow economy. This figure has been increasing, and will continue to increase because of governmental policies and laws that make it difficult, if not impossible, to run a small business in which most of the revenue stream is open to audit. There are a number of other difficulties facing SMEs in Ukraine today, summarized below. The strategic approach outlined in Chapter 3, and the program recommendations in Chapter 4, relate to these findings.

2.1 Policy and Regulatory Constraints

The business climate in Ukraine is very hostile, particularly with respect to small and medium-sized enterprises (SMEs). In order for SMEs to grow and prosper, provide employment and bring dynamism to the Ukrainian economy, government policy must become more benign toward SMEs.

The major obstacles to SME growth are taxation, the lack of access to capital, and corruption. However, many other government policies (or the lack of such policies) also have an adverse impact on small businesses. An overview is presented below.

Taxation

In interviews with Ukrainian entrepreneurs, the tax system was universally described as their most serious problem. Certainly, based on the information collected, this judgment is largely correct. The problems with the tax system are discussed in significant detail in Annex A. Accordingly, the discussion here is abbreviated.

The present tax base can lead to effective tax rates all out of proportion to the statutory rate and effective tax rates that bear little relation to profitability. In fact, even unprofitable businesses may face hefty profits tax bills. A large proportion of legitimate business expenses are not deductible for tax purposes. In other words, the tax base for the profits tax is not profits but some other economically unsound tax base that has no apparent unifying rationale. Capital cost recovery allowances are extremely inadequate.

The so-called Kiosk Tax, really a flat fee on most retailers, is almost three times the official monthly wage and approximately equal to the typical underground economy monthly wage. This tax is imposed regardless of profitability. It will drive a large proportion of small traders underground or out of business. Coupled with the scheduled prohibition of liquor sales by Kiosks (January 1, 1997), this tax will devastate small retailing. It would be difficult to devise a

tax program more directly aimed at impeding the growth of small business.

The payroll tax is much too high and constitutes a major incentive to pay employees at least partially under the table.

The tax law is a complex agglomeration of legislative acts, decrees, regulations and tax inspectorate pronouncements. Literally thousands of changes have been made in the past two years. Even accounting and legal professionals are overwhelmed. Typical entrepreneurs have no chance of keeping up with these requirements. Compliance costs on those wishing to comply with the law in all of its particulars would be ruinous. Certain tax motivated banking restrictions on cash withdraws would make it literally impossible to survive, if complied with, in a cash-oriented economy like Ukraine's.

The effective tax rates borne by Ukrainian SMEs are punitive. Taxes constitute a pronounced drag on the development of the sector and make it virtually impossible for a normal, thriving small business community like those in the West, particularly in the United States, to develop. Law-abiding businesses find it difficult or impossible to compete with those that evade taxes. The level of taxation is so high that it virtually requires evasion if an SME is to survive. Vast proportion of total retail sales in Ukraine are made in the underground economy (probably 65 percent). Estimates are that perhaps thirty to fifty percent of GDP is underground. The tax system is the primary reason.

Penalties are all out of proportion to the tax liability asserted, running as high as 400 percent of the tax owed. The penalty rate is not graduated in proportion to the severity of the compliance infraction. Tax liabilities bear interest rates held over from the days of extreme inflation, varying between 109 percent to 1,825 percent per annum. Penalties are structured in such a way as to provide little incentive to comply once a payment is late.

Corruption – An Implicit Tax

Although regional variations are significant, protection fees paid to the mafia typically exceed ten percent of gross revenues and can be as high as twenty percent. These fees may be viewed as an implicit tax brought about by the failure of the government to provide public safety services and control organized crime. In fact, corrupt government functionaries sometimes cooperate with the mafia to extort money from business. It was generally agreed, however, that the mafia was accommodating when the health of the business was at stake as they would not want to “kill the goose that lays the golden egg.” Corrupt tax and health officials were regarded as not sharing the same aversion to destroying businesses by extorted ruinous bribes. Corrupt tax officials routinely use the prospect of ruinous penalties to extort bribes.

2.2 Credit, Banking and Monetary Policy Issues

Capital is the lifeblood of a business. Capital is required to start a business and capital is required to grow a business. Capital formation is a critical determinant of whether an economy will grow. Virtually all capital deployed in the Ukrainian SME sector is generated from personal savings of entrepreneurs and their families and by the retained earnings of operating business.

Borrowing (including advances in cash, goods, or raw materials) from other companies is another source of financing for small to medium sized enterprises. Ukrainian banks typically do not loan to small businesses. Collateral requirements are very high, interest rates are very high and the banks have neither the inclination nor skills to build a successful small business lending program. Most capital in Ukraine is used to fund government deficits and to support state-owned enterprises. Venture capital firms are generally unknown.

Alternative lending arrangements, including leasing arrangements and secured non-bank loans, are in a doubtful legal position since the lessors' or non-bank secured lenders' legal rights are not well defined. It is not clear that lessors have the right to lease or that non bank lenders have the right to lend. It is doubtful that lessors or non-bank lenders have the legal right under current law to recover property when the lessee or borrower has failed to make payments. Hence, such markets, although common in most developed economies, have not even begun to develop in Ukraine. The law needs to provide unqualified recognition to the property rights of lessors, recognize the right of non-bank lenders to lend and protect the security interests of non-bank lenders.

Finally, small and large businesses alike will find it difficult to engage in normal economic decision-making, including even moderately long-term investments, unless monetary policy brings down inflation and interest rates. Complaints were common place that even if loans were available, the cost would be too high. The most insidious aspect of very high interest rates is that projects and investments that do not have stratospheric returns do not get done. Thus, because of the combined impact of the tax system and interest rates, investment in manufacturing plant and equipment, attractive retail space, or large inventories (to offer customers broader choices) becomes largely uneconomic. If a project doesn't double the invested money in a year, one would do better by putting money in a bank or, more probably, holding tangible but liquid real assets as a hedge against accelerating inflation.

2.3 Nascent Marketplace for SME Services

Under the former system of central planning, enterprises had no reason to compete. They weren't concerned about reducing costs, expanding markets, and increasing profits. However, in an open market economy, businesses of all sizes must learn to compete to survive. Because small businesses can't afford to carry the internal costs of a full-blown strategic management and consulting team, they must find those services in the marketplace.

USAID and other donors recognize this problem, and are promoting programs, like the NewBiznet project and the IFC business centers,⁴ that are designed to serve the management consulting needs of the emerging private sector. In addition to developing the service, businesses need to learn the value of such assistance from outside specialists. This is, of course, a challenge on the demand side, because most entrepreneurs and managers are still learning what it is they

⁴The International Finance Corporation (IFC) has a grant from USAID to establish four business development centers around Ukraine.

need to grow their businesses. Right now SME service providers — ranging from accounting, to marketing, to advertising, to strategic systems analysis — are struggling to establish themselves in the marketplace.

2.4 Limitations to Local Government Capacity

While it is true that most policy issues small businesses complain about are national, emanating from Kiev, implementation is largely at the discretion of regional and local governments. Degree and severity of enforcement, application of fines and sanctions and granting of privileges such as access to credits or premises, are all decided by officials in the community where they live. This explains the wide disparity in conditions for businesses in different cities, despite the fact that they are facing the same onerous tax policies, regulatory morass and macroeconomic conditions.

The team's conversations with local officials in various cities revealed a fair amount of enthusiasm for supporting small business, with uneven levels of understanding of what this really means. No one was hostile to small businesses, although some seemed more sincere and knowledgeable than others. All expressed frustration with a lack of tools and resources to do something. A common theme was seeking funding to set up incubators, enterprise zones, and small business development centers in vacant space that the city still owns. A major issue is the degree to which locally-generated tax revenues are controlled at the center, an issue that will hopefully be resolved once proposed legislation is introduced.

2.5 Limited Capabilities and Experience of Business Associations

There is a nascent business association community. Although entrepreneurs are reluctant to join forces with other businesses, they are starting to organize both locally and nationally.⁵ These groups typically are small, poorly funded and not well organized. Most are largely staffed by volunteers, not yet having the resources to build a professional staff. There is relatively little coalition building and cooperation, particularly at the national level. They have done little public policy research necessary to lay the empirical and intellectual groundwork in support of the public policy changes they seek. They have not yet developed adequate grass roots lobbying potential.

In spite of this lack of organization and experience, the existing associations are vibrant and enthusiastic. They represent the foundation of an association community that could play a critical role in influencing the outcomes of public policy debates and in enacting legislation needed to improve the business climate and economic growth in Ukraine. They can, with the

⁵The reasons for this reluctance appear to be twofold. First, there is a lingering suspicion of joining anything that is collective in nature, in favor of applying new-found individual freedoms of the Post-Soviet era. Secondly, many businesses want to keep a low profile, staying in the shadow economy, in order not to attract the attention of either the tax collectors or the mafia.

proper training and support, become an effective constituency for economic liberalization, and thereby have a major impact on future economic policies.

Chapter 3. A Framework for USAID's SME Strategy in Ukraine

The USAID/Kiev SME program strategy proposed by the team has two broad components. The first focuses on developing a legal framework that establishes a transparent set of rules and regulations governing an open marketplace into which businesses can enter, compete, and exit with minimal transaction costs. This is essentially the issue of creating an “enabling environment” for business, something which is sorely needed for Ukraine’s economic development. This goal merits becoming a top priority for the Mission’s assistance program.

The second part addresses the development of an SME services sector: technical assistance, training, information services, financial services, etc. Such services are critical over the long-term if SMEs are to grow and become more competitive in the local, regional, and international marketplaces. This section draws heavily on lessons learned from the USAID effort in Russia, which the team feels has a strong relevance to the situation for SMEs in Ukraine.

Some of these recommendations can be implemented through existing Mission contracts or grants. Others may require new initiatives. A management and implementation plan is discussed in more detail in Chapter 4.

3.1 Component One: Promoting a Legal Framework that Enables Businesses to Compete in an Open Marketplace

This component is where the greatest attention is needed to strengthen the Mission’s strategy for SME development. Nearly all of the groups we spoke to — whether from the private sector or from government — mentioned the “legal environment” or some aspect of it (taxation, in particular) as the biggest obstacle to starting and growing a small business. Most businesses are operating either partly or totally in the “shadow economy” of Ukraine, because of the fact that it is difficult to run a profitable business under the current legal regime.

USAID is supporting some work aimed at improving the macroeconomic environment in Ukraine, but more resources must be committed by the Mission to promote the interests of the private small business sector. The team proposes a strategy which is aimed at creating a more active policy dialogue among stakeholders in the private and in the public sector. This dialogue is critical to achieving a sustainable process of economic development based on open, competitive, markets for Ukrainian entrepreneurs. The enactment and enforcement of new laws must be done with this objective firmly in mind.

For legal change to be successful, three elements are needed: ⁶

- The private sector organizes itself to advocate fair and open markets for businesses in Ukrainian.
- The government commits to, and follows through to implement, reforms that promote an open market economy for businesses of all sizes.
- Better information and analysis about constraints to, and opportunities for, SME sector development in Ukraine is introduced into the debate about how to improve the legal environment for SMEs.

The USAID program can directly support the first and third elements. The second element, government commitment, although difficult to predict, can be influenced by the donor community as it negotiates with the Ukraine government about foreign aid and development programs. The government also can be influenced by element one, the private sector, particularly if it is armed with the third element, better information. Finally, through training and technical assistance targeted at decision makers and policy administrators, USAID may be able to help influence government officials to act in support of a competitive marketplace for small business.

The approaches outlined below are designed to strengthen these three elements, and achieve their desired results. The following sections discuss the rationale and purpose for various assistance efforts the team sees necessary for the USAID/Kiev SME strategy. Specific programs are discussed in more detail in Chapter 4.

3.1.1 Training and Institutional Support for Business Associations to Advocate Effectively for Legal Reform

Advocacy is one of the important “services” provided by business associations. Lobbying efforts play a special role in achieving a set of laws and regulations that empower, rather than encumber, small businesses. By banding together around issues of common interest, SMEs can impress upon government the fact that business is an important constituency, and must be taken seriously.

Making this point is difficult in a transitioning economy such as Ukraine’s because the government is mainly focused on the problems associated with privatization. They are worried about the political backlash of destroying jobs, rather than turning their attention to the economic task of creating new jobs in a re-energized private sector economy. Business associations can help politicians and government bureaucrats appreciate the fact that they — private businesses, particularly small- and medium-sized — are a big part of the solution to the problems of job creation and income generation.

⁶These “elements” can also be seen as “intermediate results” within the Mission’s overall program strategy for Ukraine, most appropriately within Strategic Objective 1.3. “Accelerated Growth and Development of Private Enterprise.”

USAID's experience in other countries shows us that it is important to "build on what's already there" to achieve an effective grass-roots lobbying program. In Ukraine, there are several associations starting to take shape. They suffer from inadequate skills and resources, however, and will require training, TA, and institutional support to make them more active players in the policy dialogue process. USAID is in a good position — because of its demonstrated commitment to working with the private sector, and because it has already established some networks through its other project activities — to serve as a facilitator in helping nascent associations in Ukraine mature.

Although USAID can support a broad-based program of technical assistance and training to business associations, it should be more selective in choosing which associations to support in promoting legal reforms. This is so for two reasons:

- Helping groups to mount a lobbying effort is a more intensive process than providing basic training in organization and management. They will need guidance, advice, and encouragement at each step of the way. Because of this more intensive commitment of resources, USAID should chose to work with those groups which already have basic skills of management, an active membership, and a willingness to approach government with a policy reform agenda. Other candidates may start to emerge over time as well.
- USAID should also be careful not to align itself too closely with organizations that have strong ties to any single political party. Other groups to avoid are associations that were created mainly to serve the political ambitions of its founder. Strong political affiliations can undermine a successful advocacy program for business development if the government in power is opposed to the political views of any single group. The groups USAID works with on legal reform should be seen as representing the interests of private sector businesses and entrepreneurs. This of course has some political implications in an environment where there is a party of reform and a party that favors re-instating some form of socialism or communism. But, to maintain credibility among its members, and with the government, associations need to represent business, rather than a certain political party.

3.1.2 Analytical Support and Policy Advisory Services to Decision Makers and Administrators in Government

Special Note: This sub-section and those that follow provide the basis for USAID's support to activities such as the February 1997 Conference on Ukraine Support to SME Development. This conference, which was sponsored by Ukraine's Cabinet of Ministers, included representatives from several ministries, businesses associations, small business development centers, as well as other SME experts from Ukraine and the U.S. This group worked together to achieve the following objectives:

1. Development of new legislation which outlines the Ukrainian government's policies, legal reforms, and programs to promote the growth of the private SME sector in Ukraine;
2. Research into the feasibility of, and proposed structure for, a loan guarantee scheme to stimulate commercial lending to the SME sector; and
3. Preparation of a Presidential Decree which a) establishes the priority of small business development in Ukraine, and b) creates a national agency that represents the interests of small businesses, and provides leadership in the ongoing effort to strengthen the small business sector.

USAID's technical assistance in this effort helped to underscore to the participants the importance of creating an "enabling environment" for small business development, an environment which will promote competition and economic benefits to consumers at all levels. In addition to the development of new laws, policies and priorities for small businesses, the conference also succeeded in creating a public-private sector working group that will continue to focus on needed reforms, policies, and programs for the small business sector.

USAID will continue to track the evolution of the legislative initiative, and provide advice to the working group. If the establishment of a national agency for small businesses goes forward, it will be a priority for USAID to help the small business community in Ukraine utilize this agency as an effective small business advocate within government. The Mission's priority continues to be hands-on work with the private sector; however, the establishment of a national-level agency creates an opportunity to give small businesses in Ukraine a public sector ally in the important cause of private-sector led economic reform.

Coming out of a command economy, the government of Ukraine has little experience in developing and implementing policies and regulations that promote an enabling environment for privately owned SMEs. The concept of "creating a level playing field," and then letting the marketplace do the rest, is new to government officials and policy makers. Many, in fact, have a negative attitude towards business, influenced in large part by the dominant images of racketeers and a "wealthy elite" in Ukraine today.

USAID needs to work with the reformers in government, giving them the advice, technical assistance, and training to implement better laws and regulations for SMEs. The USAID Mission has indicated some difficulty in identifying a “small business champion” to work with in government. This is a problem that was also raised by Ukrainian partners interviewed by the team. However, the advice given the team was that USAID should conduct a high-level dialogue in the Ministry of Economy about providing assistance to either the existing division in charge of entrepreneurship development, or to a new department, if necessary, that has a mandate to help support SME development in Ukraine. An offer of assistance from USAID could help to solidify the Minister’s commitment to supporting SME development.

Some work was underway at the Ministry in the fall of 1996. This has been largely superceded by the SME conference which was held in February 1997. A new draft law prepared at that time, if enacted, will assist small businesses by simplifying licensing procedures, reducing the number of tax codes and tax rates, reducing the number of government “inspections” required, simplifying accounting requirements for micro-businesses, allowing the formation and legal operations of credit unions having SME members, allow the formation of limited liability companies having minimal capital requirements, and allow the development of business associations on a non-profit, tax-exempt basis.

Another objective of the SME conference was to establish a national agency for SME development, the chair of which is to be appointed by the President of Ukraine. With the proper support and technical assistance, this division could well serve the SME sector in Ukraine by becoming an advocate within government for private, small business development. An advocate within government can help in giving credibility to efforts aimed at promoting privately owned small businesses. This agency can network internally among decision makers. It can work with private sector groups to draft and introduce new legislative initiatives. It can also, on an informal and even formal basis, help educate government officials about the importance of SMEs to Ukraine’s economic development.

USAID support in promoting this advocacy role is much needed. Experience from other ENI countries shows us that the natural tendency of governmental units such as the Division of Entrepreneurship is to try and establish themselves as a central coordinating body for program funding going towards SME development. This is an understandable attitude, given the history of the Soviet Union and Soviet Bloc countries. Although coordination is an important role, government agencies shouldn’t be given control over funding that might be better utilized in a decentralized fashion, or better targeted directly to non-governmental groups. (The strength of USAID SME programs, in fact, is that they work directly with the private sector.)

The team’s approach to working with government on legal reform issues would include:

- Technical assistance and training in how to analyze policy initiatives for creating an open, competitive marketplace for Ukrainian SMEs (enabling environment).
- Training workshops and seminars for legislators and other decision makers in government on a) the importance of privately owned SMEs to Ukraine’s economic development, and b) the role of government in promoting a legal

framework that supports an open-market economy.

- Technical assistance and training for municipal authorities in promoting local initiatives that attract investment. (Work in this area is presently being done by RTI under the municipal finance project, and can be expanded in collaboration with USAID/Kiev's new SME development strategy.)

Institutional support and staff training for the proposed SME Agency are also important, but not as high a priority as working with private sector groups. The training programs outlined above are critical, however, and should be done at reasonable cost.

3.1.3 A Strengthened Public-Private Sector Dialogue About Legal Reforms to Support SME Development

The previous two sections describe an approach to a) strengthening the private sector voice, and b) improving the attitudes and capabilities of government to take decisions that reduce the economic costs of doing business, and promote competitive markets. Work with these two sets of stakeholders should not be done in isolation of each other. The main goal is to promote an ongoing process of policy dialogue in which business interests and governmental bodies discuss specific legal and regulatory reforms necessary for a more rapid development of the private sector in Ukraine. Such efforts would include:

- Creation of a small business committee within parliament that meets regularly with entrepreneurs and other representatives of the private sector.
- Broad dissemination of proposed legislation that affects Ukrainian businesses.
- Regional "public hearings" which give the private sector opportunities to comment on proposed legislation.
- Support for a task force on SME development which has representatives from national and local governments and the private sector that meet on a regular basis to discuss problems facing SMEs, and solutions to those problems that can be brought about through changes in Ukrainian laws and regulations.

These efforts can be supported with a modest amount of resources, but their impact will be significant in terms of raising the profile of SME constraints to the public, and to key decision makers in government. This will aid in pushing reforms forward more rapidly, and with more public support, than if government is left to "do as it sees fit" in restructuring the economy. The point must be stressed that the fora of meetings, publications and hearings described here are just as important, if not more important, to the legal change strategy as are other activities proposed by the team. Changes and refinements in Ukrainian laws and regulations will be an ongoing issue for some years to come. In order that this be a sustainable and productive process, regular interaction among private and public sector actors will be needed. This is something in which the U.S. has a great deal of experience, while former communist countries do not.

3.1.4 Support for Local Think-Tank Organizations to Conduct SME Research and Policy Analysis

Information about the SME sector in Ukraine is sorely lacking. The difficulty is exacerbated by the fact that an estimated 30 - 50 percent of GDP is in the “shadow economy,” evading official statistics. A recent survey conducted by the IFC helps to fill this gap, but more work needs to be done to support ongoing analysis of issues facing SMEs, and identify ways to improve the legal framework, strengthen markets, and promote investment.

Timely data and good quality analysis of the issues is an important component of policy debate. Business associations and policy units within government can help to serve this function if they have the necessary skills and resources available to them. Another good source for conducting research on policy alternatives are local independent think tanks, and sometimes university faculty departments of economics or business. The team met with one such group, the Center for Economic Development, which publishes The Ukrainian Economic Monitor, a monthly newsletter of analysis and discussion about Ukraine’s economic development progress. Frequently such think-tank operations like the Center are seen as more “objective” to both the private and the public sector interests, and therefore may be preferred partners for USAID in promoting better research and analysis on SME issues.

The following types of activities help improve the source and flow of information about legal and regulatory changes needed for the SME sector to grow in Ukraine:

- A small grants facility to support SME research efforts of local organizations, and provide technical assistance as needed to ensure quality of research design and analysis.
- Seminars to present and discuss policy papers with various stakeholder groups.
- Publication and broad dissemination of policy papers and recommendations resulting from policy seminars.

3.1.5 Public Education Programs to Promote the Ukrainian Small Business Sector

Small, privately-owned businesses were not a part of the Ukrainian culture prior to the fall of the Soviet Union. During the difficult political and economic transitions taking place now, citizens are focused on the day to day problems of survival. Their point of reference is on those things that they used to have but don’t have now, such as: an income they can live by, cheap housing, and other formerly subsidized services that are now increasing daily in cost. Most people know that the reforms need to go forward, but no one enjoys the difficulties they have to live with to get to a new economic order. And, there is a wide difference of opinion as to just how far from a socialist economy the government should swing.

Part of changing attitudes means showing Ukrainian citizens — the new class of consumers — that private SMEs can provide the goods and services they will need in a new Ukraine.

Consumers need to see and hear about success stories, examples of how an entrepreneur was able to create a viable business that not only benefits him or her, but that also benefits that business' clients. Without these examples, Ukrainian consumers will be influenced only by the darker side of the changes taking place, such as racketeering, government corruption, and the wealth amassed by a few well-connected elite.

In addition, consumers need to be educated about what role the government has in a) creating a better legal framework for private business development, b) letting the market decide which businesses survive and which don't, and c) protecting consumer rights. Government can no longer be seen as the provider, but rather the protector of fair and open markets that cater to the new class of Ukrainian consumers.

A public education program is the best way to deliver this message in a cost-effective, broad-based fashion. The program should include:

- A multi-part series for television and radio that:
 - showcases several successful small Ukrainian businesses
 - describes what it takes to start a small business
 - discusses some of the difficulties of doing business in Ukraine, including problems associated with the current legal regime
 - interviews reform-minded government officials, at the municipal and national levels
 - discusses the rights of consumers, and the role of government in protecting those rights
- Training for journalists in the principles of an open-market economy, role of small businesses in Ukraine, and the need for an enabling legal framework.
- Training for business associations in public relations, communications, and advertising. This can be done as part of a business association strengthening program, discussed earlier. It is important to mention here, because business associations can do a great deal to promote "better business" and thereby improve public perceptions about SMEs in Ukraine.

3.2 Component Two: Improving SME Business Operations and Profitability

The provision of technical assistance, training and information services has been the primary focus of the Mission's efforts for SME development to date. The current activities are in a good position to improve the availability of services to newly emerging and recently privatized SMEs.

As the NewBiznet project matures, it is becoming a focal point for targeting services to SME clients, promoting information services for SMEs, and helping to network among local SME

service providers, associations, government officials, and other donor activities in the sector. The IFC centers will also take on this role as they develop. The work of the Alliance and other volunteer programs in Ukraine will serve to complement the efforts of NewBiznet, IFC and other SME development programs of USAID, as well as other donors.

In terms of financing, the team's discussion with the director of the West/NIS Small Loan Fund suggests that the Fund is interested in collaborating with NewBiznet and others in order to a) identify potential clients, and b) provide clients technical assistance needed to maintain the integrity of those businesses the Fund chooses to finance. Also, they are expanding operations outside of the Kiev region into areas where NewBiznet is operating (initially into Lviv).

The team has identified areas where more emphasis needs to be placed in order to ensure greater impact of the strategy as it relates to improving the ability of SMEs to manage their operations more profitably in an increasingly competitive environment. Most of these efforts can be done through existing — or some slight increase in resources to existing — contracts and grants. Implementation issues and recommendations are discussed in greater detail in Chapter 4.

3.2.1 Promoting Greater Sharing of Information and Lessons Learned Among SME Service Providers and Business Consultants

Information is a critical need at several levels within the SME sector. The NewBiznet Project, as well as others, is focusing on business-information services through the creation of databases, on-line services, "yellow-page" directories, etc. that will help businesses identify suppliers, buyers, and joint-venture partners.

In addition, the NewBiznet Project has the objective of establishing local support networks (LSNs) that strengthen linkages between various business support groups (BSGs). The objective is to eventually link these local networks into a national network of business service providers.

Although implementation of the NewBiznet information network component was behind schedule, it is now being given greater priority in the project's operations. Under the scope of work, the BSGs supported by the project are to serve as models for others that are seeking to develop their services to SMEs. The networking operations are, of course, critical to this objective, and to achieving broader impact of the NewBiznet project.

The team wishes to emphasize the strategic importance of this network to the emergence of a professional and effective SME services sector. USAID is in a good position to stimulate the development of this network since it is operating, through NewBiznet, IFC and others, at several levels, those of: businesses, local governments, business associations, banks, and (to a lesser degree at present) the national level, principally through the policy work of HIID and the tax administration work of Treasury advisors.

The creation of a business services support network should have the following features, some of which are planned for under the NewBiznet Project. Chapter 4 outlines specific recommendations for creating such a network, similar to the Business Collaboration Center (BCC) effort which USAID supported in Russia:

- A national information directory (computerized and printed) of SME service providers (including consulting firms), updated at least annually.
- Creation of a professional association for SME service organizations and consulting companies (for-profit as well as non-profit).
- Sponsorship of a national annual workshop for SME service professionals that would be utilized to review experiences to date, discuss constraints faced by their clients (legal and financial, for example), review state-of-the art techniques and methods for training and technical assistance to SMEs. A particular focus could be on how to provide low-cost training services to micro and small (vs. medium-sized) businesses.
- Sponsorship of regional workshops designed for the same purpose of the national outlined above; these could be done on a fee-basis, minimal at first but increasing to full cost recovery over a period of two to three years.

The result of these efforts will be a better trained, better qualified SME services sector, able to help small businesses to start and to become competitive in the marketplace.

3.2.2 Low-cost Training Techniques and Materials for Very Small Businesses

Many of the smallest businesses (microenterprises having up to 10 or so employees, and even small businesses having somewhat more) are unable to pay the full cost of technical assistance services offered by commercially-viable business service centers. Whereas business service centers need to have paying clients, and these are typically medium to large enterprises, they are also in a good position because of their knowledge, networks, and staff resources, to help entrepreneurs who are thinking about starting, or have recently started, their own business. They too represent an important sector of the private economy of Ukraine, and they need to be nurtured.

Such ventures, even in the U.S., aren't able to fully "pay their way." For these reasons, the U.S. Small Business Administration, for example, provides standard training materials, manuals, and classroom sessions to help micro businesses and aspiring entrepreneurs. The objective in Ukraine should be to develop some low-cost techniques which can be used by business service centers to give new small- and micro-business managers basic training and orientation that will help them understand how to improve their operations and profitability. Typically, these techniques are in the form of booklets, videos, and standardized, minimal-fee classroom sessions with trainers and business practitioners. In addition, a counselor could spend some minimal amount of time, for which the entrepreneur would pay a modest fee, to work through a business or marketing plan one-on-one.

What is described above was largely included in the original NewBiznet scope of work. Because of funding restrictions and other priorities, this component was shelved. However, it is one of the only techniques in the strategy that will service the smaller-end of the business sector. A

logical step would be to prepare the training materials and videos on “How to Run a Business” in tandem with a program for public education, described earlier in section 3.1.5. The following efforts would fit well into this element of the strategy:

- A multi-part video series, filmed in Ukraine, on how to operate a small business. This would then be made available to business support centers, educational institutions, and public television for broad-based dissemination. A set of standard instructional materials can also be developed to use along-side the video series. These would be valuable tools for business centers and educational institutions working with new entrepreneurs.
- A series of “how to” booklets for new entrepreneurs and small-business managers. These should be simple, and low-cost, produced in Ukraine for Ukrainian businesses. The U.S. Small Business Administration booklets can serve as useful guidance in preparing this series.

3.2.3 SME Services Provided by Business Associations to Their Members

Business associations can play several roles that serve the interests of small businesses. In addition to their lobbying functions described in Section 3.1, associations often provide member services such as: licensing assistance, marketing information, import/export opportunities, insurance benefits, and information on sources for project financing. These services, in fact, are vital to attracting membership. In addition, associations serve the interests of consumers by requiring that their members commit to high standards of quality in the goods and services they produce.

Private business associations are beginning to emerge in Ukraine, but they have limited experience in how to effectively manage their operations, and how to promote and retain active members. Through its support to the Counterpart Foundation, USAID has funded the development of training modules and handbooks that are geared towards the effective management of NGOs. In addition, this project has trained 39 trainers in techniques of non-profit management, and management of social enterprises. With some modification, these materials could be adapted to meet the organizational and financial management requirements of nascent business associations in Ukraine. In addition, the Counterpart-trained trainers (who can offer their services on a free-lance basis) could be contracted as needed to organize and deliver seminars and workshops for business associations around the country.

Strengthening business associations needs to be a top priority in USAID/Kiev’s strategy for SME development. Although NewBiznet is networking with business associations, the need is great, and the benefits significant enough, to warrant more resources aimed at making Ukrainian business associations more effective and financially self-sufficient. This is vital not only for improving services to members, but also for creating an enabling environment for small business through effective advocacy and lobbying efforts. (This aspect is discussed in greater detail in Section 3.1 above.) These objectives can be met through a training a technical assistance effort

which includes the following:

- Basic techniques of effective association management
- The organization and facilitation of “subject matter committees” to focus on special issues, concerns and needs of members
- Provision of valuable membership services and benefits
- Membership organization and information services

Other areas for training to support business associations’ role in promoting legal reforms could include:

- Grass roots lobbying techniques and tools
- Media relations
- Coalition lobbying
- Public policy research

There has been a good deal of experience gained by USAID in other CEE countries as well as in Russia that can be utilized by USAID/Kiev to get a firm and quick start in this effort. The experience gained through the Mission’s Counterpart NGO is also relevant in this regard.

3.2.4 SME Financial Services That Operate Independently of the Present-day Ukrainian Banking System

For all practical purposes, Ukrainian banks do not lend to small businesses. Only short-term loans are available, meaning that businesses without a lot of spare cash can’t borrow to purchase major capital equipment. Collateral requirements are reported to range from 120 - 150, and sometimes upward to 200 percent. As a result, most credit is being extended to finance trading operations. Interest rates are high, up to 180% per year.

This problem is widely acknowledged. Banking reform programs are being supported by various donors, including USAID. It is unlikely, however, that any major shift in Ukrainian bank behavior will occur in the next two to four years. To help address this problem in the immediate term, USAID is supporting other financial service activities that operate independently of the bank. Although the capital available through these programs is small in relationship to the demand, at least some small businesses are being served, and the programs afford USAID an opportunity to demonstrate to Ukrainian banks the commercial viability of the small business market.

The U.S. presently supports a few programs aimed at getting financing to small businesses in Ukraine:

- The Small Business Loan Fund of the Western NIS Enterprise Fund, which as of September 1996 had financed 28 applications (27 of them leasing arrangements) totaling \$1.2 million. This Fund which still serves the Kiev area primarily,

recently opened an office in Lviv which plans to work cooperatively with the USAID NewBiznet office. The Small Loan Fund was successful in obtaining its license to operate as a financial institution, and now plans to expand into more lending deals with small businesses. They are currently capitalized to \$5.0 million.

- The Eurasia Foundation Small Business Development Lending Program, which, because of the difficulty in obtaining a lending license, operates in partnership with the Aval Bank. Eurasia reviews business plans prepared by Aval, approves the loans that pass scrutiny, and shares the risk with the Aval Bank. It provides training to Aval employees to improve lending and monitoring operations of the bank. The maximum loan amount is \$100,000 with an average size of \$50,000 among the thirteen loans made to date. Eurasia also provides training to credit analysts and loan officers of Aval.
- The Ukrainian credit union movement, which USAID supports through a grant to the World Council of Credit Unions (WOCCU). WOCCU is providing technical assistance and training to the Ukrainian National Association of Savings and Credit Unions (UNASCU), which represents 38 of the 140 registered credit unions in Ukraine. The 38 credit unions represented by UNASCU have about 30,000 members. They receive modest-sized loans from their credit unions, typically as operating capital for their small businesses, with loan durations ranging from one to three months only. Although the loan amounts available through credit unions are small, the movement is growing rapidly, and providing individuals with incentives to save.
- Other USAID programs, such as development of an Over-the-Counter stock exchange network (which had seen trading of over \$250,000 from July - September 1996), privatization (to relieve the state budget from having to support inefficient enterprises), tax reform, and macro-economic policy reform advisory services, will help eventually in creating a better financial services system for SMEs.

The demand for financial services is great in Ukraine. Whatever the Mission can do to assist in bringing financing (debt, equity or leasing) directly to SMEs will be helpful. Chapter 4 recommends some expanded and new initiatives to get additional financing to small scale enterprises, including an allocation of the \$5.0 million for business incubators. However, if budgetary resources are limiting factors, priority should be placed on improving the legal environment for business, and on strengthening SME service providers, information services, etc. before using additional resources for SME credit.

Some steps also can be taken within the existing program:

- NewBiznet/Lviv should introduce some of their clients to the Small Loan Fund. The team met with the Fund's director, who expressed strong interest in collaborating not only with NewBiznet to help identify credible projects, but also

with members of the Alliance group to tap into technical assistance resources for the Fund's borrowers.

- The Small Loan Fund director has focused over the past year on getting administrative matters in order before beginning an expansion program to other regions. USAID should meet with the Fund to discuss what plans the Fund has for setting up offices in other NewBiznet areas (Odessa and Kharkiv), time frame, and whether USAID or its implementors can do anything to speed up that expansion effort.
- As the credit union movement grows, they may provide more opportunity to channel credit to small entrepreneurs. However, Ukrainian credit unions are operating under a temporary decree signed in 1993 which doesn't distinguish them, in terms of taxes, from other businesses operating in Ukraine. Therefore, credit unions are hesitant to handle much cash flow, because they would then have to pay high tax rates, rates that are hampering small business development in Ukraine. Lobbying efforts, supported by WOCCU, are underway to enact a proper law on credit unions. Once in place, USAID could consider channeling additional capital into the movement for the purpose of expanding lending to small and microenterprises.

Other efforts, which can be included under USAID's strategy to create a better environment for small business, deserve high priority. These include a) a leasing law, b) collateral law, and c) a central collateral registry. The team understands that collateral law expert has been hired to work in Ukraine. This is an important step towards strengthening the financial sector for all businesses.

Chapter 4. Implementation and Management of the USAID/Kiev SME Strategy

USAID/Kiev has in place many of the necessary components for a strategically coordinated SME program. Existing projects can be used as the base for a more comprehensive approach to support of the sector, and can be pulled together to form the nucleus of a dynamic new approach. Some new activities will also be needed.

Whereas Chapter 3 lays out a conceptual framework for USAID's SME strategy in Kiev, this section describes the strengths of the current portfolio in terms of the proposed strategy, and identifies areas that need additional resources or some realignment. Recommendations are made in the context of the projects as they were designed and are operating today, specifically suggesting how to move from the present position to a more strategic, results-oriented program.

Although each of these initiatives is important for the strategy, three areas are of topmost priority:

- Reforming laws and regulations that impact the competitiveness of firms,
- Helping SMEs get access to financing, and
- Hiring a senior manager/small business expert to guide the strategy and support implementing organizations.

Various activities and implementation requirements related to these priorities are described below. Second and third-level priorities are described in sections 4.2 and 4.3, with section 4.4 addressing additional management actions necessary to implement the full strategy. The first three items in section 4.1, however, are critical to both immediate and long-term success of the strategy.

4.1 Topmost Priorities -- Policy Reform, Financing, Strategy Management

4.1.1 Promote Reform of Laws and Regulations Impacting SMEs and Their Ability to Compete in an Open Marketplace

Although the HIID project is addressing some of its attention to how SMEs are affected by the Ukrainian tax system, the critical issue of a disabling legal framework for SMEs needs to be given a higher profile within the Mission and among its partners. Three elements of a stronger policy reform initiative should be undertaken immediately. These are outlined below.

Design a New SME Policy Reform Initiative

The mission should design a new initiative that works at the elements of legal reform outlined in Section 3.1. Although there are other SME program implementors who should participate in this

effort, the magnitude of this problems warrants the mission making new funding commitments to a program that would provide policy advice to government, at the national and the local levels, organize fora for policy dialogue, circulate publications and papers among stakeholders, and facilitate the advocacy role of the private sector.

Special Note: A good way to begin this initiative will be through follow-up support to the February 1997 Conference on Ukraine Support to SME Development. The Mission plans on expanding the role of NewBiznet to help bolster policy reform initiatives at the local level. However, there is a continuing need to link these efforts into a national agenda. It is not clear how this link will be established in the current set of SME programs. Assuming that NewBiznet will be successful in getting local and regional SME policy working groups active, the natural focus for a new initiative will be to support and build upon these grassroots efforts to form a stronger national-level movement. Whether or not the Government moves ahead aggressively with economic reforms, USAID should put resources now into supporting an organized SME constituency for reform. This relates directly to strengthening business associations.

Given the uncertainty of Government of Ukraine commitment to policy changes, the strategy to be pursued is one which builds on private sector demand for legal reforms.⁷ By strengthening those institutions that represent SMEs, and promoting dialogue among private and public sector representatives, the aim is to encourage government to make decisions in the interest of Ukraine's transition to an open market economy. This is not intended to under-value the importance of advising government and providing technical assistance to concerned Ministries when such opportunities present themselves. However, USAID/Kiev should not wait for these windows of opportunity to form the basis of their strategy. Building consumer awareness and private sector support for change will be an ongoing need whatever direction the government is leaning towards.

Implement an SME Policy Roundtable Series

Although this should become an important function of the proposed new SME initiative, it is an area that could be pursued now, prior to the design of a fuller SME policy reform activity. In fact, the ENI Bureau has expressed interest in funding a policy dialogue series, and in this way help the Mission move quickly to address the issues of legal reform and creating an enabling environment for business.

⁷ It should be noted that in a recent IFC survey, the majority of SME owners "considered the actions and policies of the government to be the greatest obstacle they face in trying to make their small businesses succeed." IFC Survey of SMEs in Ukraine (Draft), 11/30/96 pg. 2.

Special Note: Here is also a good opportunity where the public-private sector legislative drafting group that came together in February 1997 can be used to form the basis of an ongoing policy roundtable. This group could be linked into the local level with the addition of other private sector representatives and local or regional government authorities (preferably progressive thinkers and doers) from around the country. NewBiznet, other USAID implementors, and other donor-supported projects can support and prepare local groups to serve as effective participants in a national forum to promote legal reforms that benefit Ukrainian SMEs.

USAID/Kiev's current SME program recognizes the importance of facilitating a dialogue at the national level on issues of importance to small business. It is included in the scope of work of the NewBiznet contract, and the IFC grant refers to pulling together policy recommendations to be communicated to national authority. NewBiznet, however, has made only limited progress toward this, and IFC has very meager resources with which to do anything significant.

Virtually everyone with whom we spoke expressed great enthusiasm for creating a policy roundtable -- from national officials, to local leaders, to representatives of business associations. This is an area with a clear mandate, requiring focus rather than extensive resources. A grass roots program, particularly if effectively networked by NewBiznet, IFC, and the proposed BCC (see section 4.2.1 below), provides an excellent means of improving the flow of information from the regions to the center. This will contribute to immediate policy improvements and help build a mechanism and a tradition for ongoing feedback and participation.

This area needs to be given more attention and priority than is currently the case. An important step would be to move the task out of the NewBiznet contract, and make it a principal task of the proposed new SME policy initiative. The new activity would collaborate with NewBiznet and other USAID activities to sponsor events or studies, and create a dynamic information flow on policy and legal reform issues (using, for example, the proposed BCC as a dissemination point). Ideally, a senior representative from the Mission should be an active participant. With Washington support for buying into existing USAID projects that are technically competent to work in the SME policy reform area, the Mission can start now to implement a policy roundtable for Ukraine. The BCC could also play an important local support role in helping to organize and facilitate the policy roundtable.

Strengthen the Capacity of Business Associations to Lobby for Reforms

One of the first consequences of establishing a donor-supported business services center to help businesses is the formation of new business associations. Voluntary collaboration between individuals with similar problems but no previous family or work connection is very new in the ENI countries, particularly those of the former Soviet Union (FSU). Business associations are also one of the clearest signs of the development of civil society in transitioning economies. The benefits of this should be clear — associations contribute to structural change in social, political and economic relationships and form the means by which the business community can participate in the political process and advocate its interests. Finally, business associations

provide services to their members and can provide moral support, training and other needed assistance.

The Russian experience shows that this is one of the areas where foreign aid can have the greatest impact and where large resources or specifically targeted projects are not required. Foreign projects don't create associations — they form on their own initiative, but the business centers can provide critical encouragement, training and resources to get these groups off the ground and help them evolve into real professional entities. In Russia, the network of business centers coordinated with both the Save the Children project and Eurasia to give more than 100 grants to business associations. They helped identify good candidates, taught them how to write grant applications and in some cases actually ran the grant competitions.

The NewBiznet project has already seen the same phenomenon and the local centers are working with associations. However, they do this at the expense of working towards commercial viability since association development is not a profit making activity. The business center managers expressed dismay at this for they believe it to be critical work that they want to continue. In addition, they have little or no resources for it. It was explained to the team that the expatriate advisors are supposed to support this aspect of the program, but, to build local capacity, this is an area that should be handled by indigenous experts and local entrepreneurs. It is they who understand the local culture, have the necessary contacts, and know how to promote collaboration.

The team recommends that three areas be supported:

- Local staff should be trained and hired to work specifically in the business association area, to teach grant writing and other organizational support. As mentioned earlier, local trainers (39 of them) have already been developed through the Counterpart NGO development effort; some of these may be good candidates to consider for either part- or full-time contracting.
- Funds need to be set aside for travel to seminars, holding conferences, training, and developing advocacy programs.
- Counterpart networks (professional linkages) need to be established with US and other FSU associations, including travel in either direction to strengthen their relations.

Also, training is needed in the following areas to help these business associations improve their advocacy skills: ⁸

⁸Training could be provided also to the newly formed Private Chambers of Commerce. The structure of the organization receiving assistance is less important than who is their target clientele, and how effectively they are serving their needs. It will be important to determine whether these new Chambers are indeed serving (or intending to serve) the small business community. If not, then it may be better to focus on other associations of small businesses as a priority over the Chambers.

- **Subject matter committee management:** The use of subject matter committees e.g. tax, trade, labor composed of association members and experts to systematically study, analyze, comment on and develop public policy initiatives that are relevant to members needs and reflect a sophisticated understanding of the “real world” situation.
- **Grass roots lobbying, membership organization and information services:** Organizing association members so that they are informed about legislative developments and can be activated as a group at the right time to intensively lobby the Rada with the message calculated to have the most impact.
- **Media relations:** How to influence public opinion, promote greater public understanding of the importance of business to improved living standards, affect legislative outcomes and create a presence for one’s association by securing positive press coverage and getting one’s message out.
- **Coalition lobbying:** How to leverage political influence by coordinating activities with other organizations within the framework of an issue coalition.
- **Public policy research:** Relevant and convincing research developing the factual and intellectual case for a better business environment.

Other areas for training, advice and assistance also needing attention include:

- **Association management:** The training of professional association management teams that understand the distinctive requirements of association management.
- **Membership development:** Effective association development, sales and marketing techniques.
- **The provision of valuable membership services and benefits:** Move beyond the abstract “fighting for your interests” to also providing concrete, tangible membership benefits that make membership more valuable and increase the retention rate. Examples might include practical business advice in magazines, pamphlets, books or tape; discounts by vendors of various products or services provided only to members, special group insurance programs, conferences and seminars, cooperative arrangements with credit unions, trade shows, trade promotion activities, etc.

4.1.2 Help SMEs to Get Financing for Their Businesses

Achieving a fundamental improvement in SME financing will take both policy and institutional reforms. USAID has programs in place to promote financial sector and capital markets development. The proposed new SME policy initiative will also bring greater attention to the problems faced by business owners as a result of not getting access to capital. In the face of Ukraine’s slow pace of reform, however, these problems will likely be overcome only in the

medium to longer term.

In the immediate term, USAID and other donors can play a role in getting at least some funding to promising SMEs, and in demonstrating the viability of this market to financial institutions and investors. In addition, USAID can support the introduction of other types of financial services that will eventually provide competition in the financial marketplace, leading to better services for SMEs.

There appears to be an even larger problem with access to credit in Ukraine than in Russia or other countries in the region. Experience shows that it is very difficult for international lending programs to do more than test approaches or demonstrate effectiveness. Significant amounts of capital have not been successfully invested using these experimental efforts. Investment in small business in Russia has picked up in the last two years, and it is mainly local money. There have been some successful pilots of micro-credit programs, where it is critical to introduce the very concept of credit along with lending technologies because there is no indigenous experience at all.

The Ukraine SME portfolio has attempted to work with the WestNIS enterprise fund to provide access to capital. Each NewBiznet center is supposed to house a WestNIS representative, which has not yet worked effectively. However, the team's meeting with the director of the WestNIS Small Loan Fund suggests that there may be a more promising relationship once the Fund places a staff member in Lviv. The recent investment by IFC of \$ 5.0 million, which mandates expansion for SME credit services out of Kiev, will help move things along. Certainly the mission should continue to work actively for the coordination of the Fund and the centers.

There is also the need to promote and demonstrate an innovative SME finance approach, again working outside of the current banking structure. The team recommends that the mission set aside \$500,000 to capitalize two business cooperative funds, using the experience of the WOCCU credit union project for legal structure and the community lending technologies of microfinance projects around the world, to lend larger amounts of capital (up to \$50,000 but probably averaging \$20,000 loans) to business members. There is a unique opportunity to test this model now in Ukraine. Also, if successful, it will have wide applicability across the region.

Finally, it is suggested that the mission support financial services to small enterprises as part of the \$5.0 million earmark for business incubators. Unlike many of the other recommendations made here, this activity would require a project design and competitive bidding process. Including a small lending and leasing component provides an excellent environment for those businesses with least access to resources in the current environment. The programs underway in Russia can be a good model for designing this project. (Section 4.2.2 below provides more detailed descriptions of the rationale and management approach for a business incubator program in the USAID/Kiev SME strategy.)

4.1.3 Hire a Senior Manager to Provide Leadership in Implementing the Ukraine SME Development Strategy

The implementation of a coordinated, decentralized grass roots program is an integral part of this

strategy. Good management is absolutely critical to its success. This means two things. Clear guidance and direction from the top, which gives all participants clear signals about the goals and priorities from the program, while allowing each activity to do what they do best without micro management, is critical. Second, a program of this nature needs itself to be entrepreneurial and opportunistic. The program management needs to be able to recognize opportunities as they arise, and to flexibly adjust course as the environment and players go forward, taking advantage of capacities and being realistic about weaknesses in the real situation.

USAID/Kiev needs to make a firm commitment to this strategy and to recruit and support a seasoned program director, who has solid regional experience and is a good practical manager. This individual should report to the top of the private sector office and have regular access to the Mission Director. Because of the growing bureaucratic burden on the Mission, and the increasing pressure to get drawn into issues driven by Washington's agenda, it is recommended that this person — a PSC recruited at the high end of US government compensation — work out of an office at the proposed BCC. This will assure that the BCC can move forward with the support of the Mission, and be able to act promptly without waiting for processing of approvals and so on from the overworked Mission. It will also give USAID/Kiev the comfort that the program can move ahead while the Mission remains fully informed of activities.

4.2 Second-Level Priorities

4.2.1 Create a Business Collaboration Center (BCC) to Enhance the Networking Among SME Service Providers

Effective strategy management requires that there be better sharing of experiences and more enhanced program coordination than presently exists. This component is absolutely critical to pulling together the various decentralized aspects of a broad-based SME development program. An information clearinghouse and independent coordinating body, similar to the Business Collaboration Center (BCC) in Moscow, will help to fill this function. Many of the Ukrainians we met with had heard of the BCC and were eager to see such an entity in Ukraine.

The purpose of a BCC is to provide the stimulus and capability to link all USAID projects in a program area, so that the network of those who manage or interact with these projects emerges. Ukrainian service providers and recipients can get access to information about a range of programs and TA activities that are not available directly through whatever project they deal with. This results in a multiplier effect and catalyzes a host of other initiatives and activities.

The BCC in Russia has been successful beyond USAID's expectations. Software and databases are the property of USAID and can be readily shared.⁹ Plugging into the Russian BCC will give the Ukrainian network access to all the Russian language courses and materials that have been developed to support business development over the past four years. Everyone we discussed this

⁹Information about the BCC and its services can be accessed on the World Wide Web at www.cbi.co.ru.

concept with expressed great eagerness to get access to this pool of wealth, assuring us it was completely applicable and relevant to Ukraine.

Some of the existing projects such as NewBiznet, the Alliance, and the Eurasia Foundation have begun information coordination efforts which could be more effectively administered by a central BCC type operation. The projects themselves are very busy managing a host of services to client groups around the country, and frequently don't afford the time necessary to support a broader vision of SME development in Ukraine. The BCC can help by supporting their efforts, and linking them and their clients into a larger community of services and opportunities for growing their businesses.

The Mission can move quickly to implement a BCC for Ukraine by taking advantage of existing capacity to launch this program. This should be one of the first orders of business for the SME Strategy Manager. It's the team's recommendation that the Alliance be tasked with this function. It is at present under-utilized, and it is being run by a skilled director with more than three years experience in the region. One of the Alliance partners, the Citizen's Democracy Corps (CDC), runs the BCC in Russia. This could make transfer of knowledge, procedures, and management operations effective in getting a quick start. The existing Alliance cooperative agreement could be modified to include this function. It is the team's feeling that other projects, such as NewBiznet, are already stretching their resources in order to manage their core operations.

4.2.2 Utilize the Incubator Program to Provide Services and Financing to Promising Business Ventures

Recommended Approach

Business incubators can be a useful mechanism for providing much-needed technical assistance and financing to promising business ventures in Ukraine. The team noted a great deal of interest among public sector officials for the idea, particularly in the cities we visited. Municipal authorities were quick to point out that they had empty factory space that could be put to use for an incubator, and some of this space was even shown to the team. The Division of Entrepreneurship in the Ministry of Economy also included business incubators in their three-year program proposal. In addition, the team met with some entrepreneurs who had products and marketing ideas that would probably be well-suited to get assistance from a business incubator.

In the U.S. and other developed countries, business incubators help to create an environment (facilities, networks, advice) that supports entrepreneurial behavior. Through the incubator, the entrepreneur is given an opportunity to implement his or her business idea with the assistance of technical and management experts, while at the same time benefitting from some cost-sharing features of the incubator. Incubators are sometimes located near university research facilities or research parks to cater to "high-tech" enterprises. The sponsors of business incubators may also take an equity position in those ventures which appear to be particularly promising.

However, what is present in these developed countries that is not present in Ukraine is an effective marketplace for new goods and services, and a legal regime that encourages (or at least doesn't disallow) competition. These elements even exist to a greater degree in many of the

former communist countries of Central and Eastern Europe than they do in Ukraine.¹⁰ This means that the incubator must select the businesses it assists carefully. Ukraine's disabling legal environment, its poor infrastructure, and its lack of capital markets all work against the development of sophisticated enterprises that need these services to grow. This must be kept in mind while designing an incubator program for Ukraine, so that the design addresses the realities of doing business in Ukraine, rather than being based solely on a model which has been used in a developed open-market economy.

The criteria for selecting a business to support should be:

- The person heading up the venture should be an entrepreneur active in the marketplace, and not just someone with a good idea. This can be gauged in their behavior, whether or not they have developed a business plan, know their markets, etc. The best indicator is whether or not they have already been successfully producing and selling their products. The team in fact met a couple of entrepreneurs in Lviv who met this criteria.
- The product should have a local market. The present restrictions on imports, and the corruption of officials involved in customs, would make an investment in technologies bound for export markets unwise. The lack of infrastructure and other problems cited above also argue against targeting exports at this time.

These then are the two basic requirements which the team recommends for selecting businesses to assist: work with entrepreneurs, and look towards local markets. International or regional markets could be part of a business' longer-term plan, but will need more time to develop. In the meantime, there are several good opportunities for SME goods and services in-country. Some of these will be tech-related, but this should not be the exclusive target for USAID's incubator program. There of course exists a lot of engineering and scientific brainpower in Ukraine, and some of these individuals may qualify for support under this program.

Following these guidelines, the \$5.0 million that is earmarked for business incubators in Ukraine can be effective in expanding USAID's program of assistance to a broad base of SMEs. In addition to providing technical assistance to selected businesses, the program should also provide financing. In most cases, this would be in the form of credits to the business. (Ukrainian businesses have limited experience working with venture capital partners, and they tend to be wary of the investor's interest in how the local firm is being managed.) However, the option of venture capital should not be ruled out. USAID, through the CARESBAC Project and others, has some good experience in providing equity, rather than debt, financial services to SMEs. Under the proper conditions, it can be the best option for a growing enterprise.

¹⁰See, for example, the "Final Program Report: Business Incubators and Enterprise Development Workshop." June 9-12, 1992. Celakovice, Czech and Slovak Republic. Prepared by the American Council on Education, in cooperation with Northwestern University Technology Innovation Center.

Structure and Management

Given the environment in Ukraine, the team is cautious about an incubator program that puts the entire earmark “under one roof.” A better approach would be one that a) minimizes overhead costs of running an incubator, and b) has good outreach to a wide range of entrepreneurs. The program needs to be operational in several cities, and well-coordinated with the NewBiznet, IFC and Enterprise Fund markets. Many of the NewBiznet and IFC SME clients, for example, may be good candidates for the incubator program.

A good model to review is the “virtual incubator” program in Russia. In this program, the business incubator (the management and TA team) goes to where the businesses are, rather than bringing them into a high-cost facility.

The following steps should be taken in developing the Ukrainian business incubator program:

- Have a project design team visit other programs in the region — Russia (in particular), Hungary and the Czech Republic, for example — to interview incubator managers and some of the businesses they have assisted. The team would then prepare a bid document for open competition.
- The design should set aside 35 - 40 percent of the funding for micro-credits, ranging from \$10,000 to \$100,000 loans, with a target average of \$30,000.
- Solicit proposals for three incubators, each funded for \$1.75 million (including the credit facility). Bidders could be allowed to bid on all three. But, the option of writing multiple contracts gives USAID an opportunity to fund different approaches, if more than one scores high in the proposal evaluation process.
- Implementation should start by reviewing TA and investment opportunities in the regions around Lviv, Kharkiv, Odessa (and Kiev), where USAID has already established networks in the local business community.
- The program should run for three years. Management should include an explicit training component to teach staff (and local consultants where appropriate) the techniques of identifying, supporting, and developing financing packages for small businesses.
- The primary goal of the project should be to maximize the benefits to as many viable Ukrainian businesses as possible, NOT to set up commercially viable business incubators. Sustainability measurements need to be made in the SME community, not in the fees for services charged by the USAID funded project. (See discussion of the business development centers in Section 4.2.3 above.)

4.2.3 Refocus the Business Service Centers on a Developmental Objective

The three NewBiznet centers and the four recently established by IFC form a good base with which to contribute to the availability of relevant, affordable training and information to give businesses the tools to produce and compete. However, they are rather narrow and limited in scope and could make a far larger contribution with some refocusing. Also, expansion to more cities should be considered depending on budget availability. In Russia, once regional business centers were established, the demand arose to create satellites in secondary cities. The mission should consider this as a demand driven form of expansion rather than just funding an implementor to create more centers. The IFC grant also seems to be under-funded. There is an opportunity to achieve far more impact and use these resources more cost effectively by reassessing the scope of this grant. IFC has been one of the highest quality program implementors in the region.

Both IFC and NewBiznet have a dominant focus on short term sustainability which limits their effectiveness and curtails their ability to work with the intended client group. In the first instance, the short term nature of the project — commercial viability within two years — means there is no time to develop capacity and to explore the provision of a range of services to businesses (some of which were outlined in section 3.2.2). Instead, the local contractors have to try and find what they can sell now, which turns them into management consulting firms, serving clients who are willing and able to pay; this means larger businesses.

It is clear from USAID experience in the region that the business environment needs a whole range of services, not just the addition of management consulting firms that are serving larger-scaled enterprises. Over time, a services sector that meets the needs of smaller businesses, and covers most, if not all, of its costs will hopefully develop. But, this is a medium-to-long range expectation.

Foreign assistance has the capacity to greatly add to the store of curricula, materials, short courses and other aids to businesses. Some of these can be charged for but often it takes time to develop into a quality provider, and to build demand by educating clients. USAID should loosen the constraints of sustainability and allow the NewBiznet and IFC centers to function as local points of delivery of the products of foreign aid. This of course needs to be done in a cost-effective fashion, but not at the risk of reaching new entrepreneurs and small business managers.

The push to sustainability also leads business centers away from the intended recipients. In order to find clients that can pay high consulting fees the centers look for larger and larger firms. These fall in two categories. There are new, successful firms that have grown large and fat. It is not clear that these are needy recipients of foreign aid. Then there are privatized firms desperately trying to figure out how to stay alive. If they have money to pay for consultants it's because they are still effectively subsidized (not subject to hard budget constraints), which means it is state money paying consultants to try and keep non-profitable dinosaurs alive. It is not clear that this pushes reform in the right direction. And of course, the clients most in need and deserving of a helping hand — small new businesses — are left out entirely because they cannot

pay for expensive consulting. Experience in the region shows that demand for training courses grows quickly and that even tiny businesses can and will pay reasonable fees for valuable help, but it takes time to develop this capacity and market, and will probably never be as lucrative as management consulting for larger businesses.

One of the few real problems in the USAID/Kiev SME portfolio was discovered in the Alliance grant to bring over American volunteers to businesses. This can be a very valuable tool, as volunteers can provide the kind of in-depth consulting advice the enterprise would otherwise not be able to afford; the business centers ability to direct a volunteer to a business also enhances its credibility in the market. Volunteers also bring in sorely needed sector specific advice, where the differences in culture and economic system are not as evident, so the advice is often seen by the recipient as far more relevant.

As currently managed the Alliance is vastly under-utilized and coordinated with the wrong set of activities. It should work directly with the network of business centers, with a system of voluntary cross referrals. Alliance partners can get leads on companies that are good candidates for volunteers, and companies that the Alliance partners have worked with can be referred to business centers for other services and follow up training. It is not clear what the rationale for the current system is — trying to link volunteers with other contractor projects working in other areas — but it is clear that it is not working. This constraint of forcing collaboration needs to be lifted.

4.3 Other Initiatives That Will Support the SME Strategy

4.3.1 Create a Flexible Funding Mechanism for Capitalizing on Opportunities to Support the SME Strategy

USAID's experience in the region shows that the ability to fund activities or projects not anticipated, and to do so in a timely manner, has enormous and immediate effect on achievable impact. This ranges from grants of up to \$100,000 for good initiatives that contribute to the overall goals of the project, to small sums to fund conferences, travel, seminars etc. The contracts now in place for SME development in Ukraine are very tightly funded and this will seriously constrain their ability to act entrepreneurially and opportunistically in a way that further serves the Mission's strategy. In addition to loosening some of the constraints on these contracts, the team recommends that the Mission set aside a \$5 million two year fund for Innovative Initiatives. (The IPI Fund in Moscow provides a model for this.)

To administer this program, the Mission could tap into Eurasia, which has relevant experience in this regard, to serve as the grants fund manager. The BCC could also work with Eurasia and other projects to serve as a coordinator for applications to the fund. Grants distribution decisions could ultimately come from USAID, with support of the SME strategy manager.

4.3.2 Expand Programs Aimed at Local Government Development

While it will continue to be very important to work at the national and bilateral level for a more

pro-business economic policy, this is not the only area where SME initiatives should focus, for several reasons. First, the whole economic and political system is inhospitable to commerce of any sort — the problems are not specific to SMEs. To some degree at the macro level, these issues have been identified (e.g. the problem with taxes), and are receiving attention through programs sponsored by the World Bank, IMF, and USAID advisors. However, working with local governments and business associations through grass-roots programs better highlights the practical problems of operating a small business in Ukraine's local communities.

Training and other forms of support for regional and municipal leaders can have a direct effect on conditions for business today. For example, almost all rents are administered by officials and rates are set not at the market, but to control access. Also, even the implementation of better national policy, for example in the tax arena, will be undermined if arbitrary and punitive enforcement — with retroactive fees, excessive fines and poor information — continue to be the standard with which the tax code is applied. By expanding its efforts to improve the conceptual and technical understanding of local officials, and to build commitment to reforms, USAID will help build the environment in which better national policy can be effectively implemented.

USAID's Russia experience can serve as a model for working with local governments. It demonstrates that a well organized effort in this area can produce results within a couple of years, and the approach provides a blueprint of how to structure the effort. Such a program for Ukraine should be designed with the following elements:

- Local training seminars and workshops for municipal managers. These could be hosted through both the IFC and NewBiznet contracts.
- Participant training trips to the nearby region, and to the United States. Carefully selected local officials should be sent on three week trips to visit federal, state and local governments in the US. At least 30-50 slots should be allocated for this, either by specifically assigning them through the NET project, or by funding through NewBiznet. Candidates should be referred or identified through the whole network of projects. Good coordination with USIS programs can augment this component.
- Funding which can be utilized for follow-up to conferences and other initiatives. There should be a source of small discretionary funding for promising initiatives that emerge from the networking and exposure to new ideas that the activity in this area leads to. In Russia this was the key to measurable impact. Follow-up helped in the adoption of a legal framework for leasing and a national program for support to small business as a result of a series of initiatives that the mission was able to underwrite.

Some work in this area is being managed under the municipal development project headed by RTI. The team met with both the RTI chief of party and the League of Cities counterpart. Both were enthusiastic about promoting investment and private sector development at the local level by providing TA and training to city mayors and their staff.

In addition to this effort, however, a complimentary focus needs to become more prominent in the Mission's projects that are interfacing directly with businesses and business associations. In the current SME projects, primarily NewBiznet and IFC, this area is mentioned in the scope of work but isn't yet a top priority. There appears to be very little funding for real activities and neither of the projects currently sponsors activities.

To help promote this program focus, funding should be found immediately to send key representatives to Russia to see how the program there works, and to link the Ukrainian local officials with Russian counterparts. Many materials have already been developed in Russia to support this effort, but there will be additional printing and distribution costs.

4.4 Management Requirements and Actions Needed to Implement the Strategy

The most immediate action needed is hire a senior manager, as outlined above. This section outlines other steps which the Mission should take in implementing the proposed SME strategy.

4.4.1 Reorganize Existing Activities to Better Support the SME Strategy

The SME portfolio needs to be identified clearly, which will mean a reorganization of some of the project management within the Mission, in addition to developing a new initiative in SME policy reform, a business incubators program, and a public education program. Once a set of core projects is in place, the Mission's strategy can then be managed and leveraged in a coordinated way. Other projects that don't fall directly under the Mission's S.O. 1.3 (Growth and Development of Private Enterprises) but which have clear relevance and overlap — such as local government development, privatization of condominium management services, and development of environmentally sound businesses — can also be effectively coordinated by participating in the strategy, while still being managed out of other Mission offices.

A brief recap of what needs to be done to make existing Private Sector Office projects more effective in the SME strategy is listed below. The team recommends that USAID/Kiev bring in a short-term assessment team that will work with USAID and the project teams to develop a more detailed prescription for refocusing these projects, and to help USAID management implement changes.

NewBiznet

This project needs to be refocused to simplify it and take better advantage of the things it can do well, leaving some functions that were part of the original SOW to other implementors. Overall resources should be sufficient if redeployed. The Mission is advised to lift the emphasis on short-term sustainability, and to recognize the value of providing good local TA for firms, including small and micro-enterprises.

Resources should be allocated for more local Ukrainian staff to work with local government administration and to strengthen grass-roots business associations. This activity should be

coordinated closely with the proposed new initiative in SME policy reform. Redirecting resources set aside for local foreign advisors in each center should provide sufficient funds for this component. The information database envisioned for the project should not aspire to more than a) collection of good business data locally, and b) being effectively networked among the various business service centers. The national policy council should be shifted out of the project, and incorporated as part of a new policy initiative. The regional offices can continue to promote local policy working groups, and assist in linking these into a national forum.

IFC

This new project should get more Mission resources, and be encouraged to use its funding for broader development of business skills training, rather than having such a heavy focus on commercial sustainability. This additional funding could be used in part to stretch the length of time centers are supported, and otherwise to allow for sponsorship of satellite centers, if and when the capacity comes to the project.

The Alliance

The Alliance needs to be freed up to work on the basis of voluntary, not forced or directed, collaboration. Their grant funding should be augmented to establish the BCC, and to play a supporting role in establishing the SME policy roundtable.

Eurasia

It is recommended that Eurasia be in charge of operating the Innovative Initiatives grant fund, coordinated through the BCC. Alternatively, set this up within BCC or NewBiznet, whichever will have the easier time being a fiscal agent. Whoever has fiscal management responsibility, grants competition, activity coordination, and follow-up could best be operated as a function of the BCC.

Participant Training

Participant training decisions should be made on the basis of priorities laid out in the strategy above. A preference should be given to sending teams to Russia and other countries in the region to learn about new approaches to business training, public-private partnerships, business association development, SME financing, policy reform and the like. Upon returning to Ukraine, follow-up support is needed to create an active network of trainees, and to fund small initiatives that will make these networks more effective in disseminating lessons learned abroad. BCC can play a role in this follow-up, as well as in the selection and support of participant training candidates.

4.4.2 Design New Initiatives That Support the SME Strategy

As described in the previous sections, these initiatives are:

- SME Policy and Legal Reform

- Business Incubators Program
- Public Education Program
- Pilot Activity for Business Credit Unions

These are initiatives that potentially could bring new implementors into USAID/Kiev's SME program. The team recognizes Mission concern about the management requirements brought about by new activities in the portfolio. However, with the exception of the business incubators program (which isn't critical to the strategy, but has been earmarked under the current Ukraine budget), these other activities will strengthen program results and impacts. The team estimates that these new initiatives could be supported by adding one senior or two mid-level management PSCs or direct hires. (This would be in addition to the proposed Senior SME Advisor, who would operate outside of the Mission, and would support the overall SME strategy.)

The other new initiatives discussed earlier — training for local officials, the BCC, strengthening of business associations, the Innovative Initiatives fund, etc. — could be implemented by modifying existing grants and contracts.

Annex A: Tax Policy in Ukraine ¹

1. General Description of Ukrainian Tax System

The Ukrainian tax system is characterized by heavy employer payroll taxes amounting to a combined 51 percent of wages, a major value added tax, a graduated personal income tax and an enterprise profits tax that has effective tax rates far in excess of the statutory tax rate. In addition, the system has ruinously high penalties and interest that are not proportional to the severity of the offense. The tax system is corruptly administered. The substantive law is extremely complex, opaque and unstable. Even professional tax advisors are experiencing difficulty keeping abreast of developments given the pace of change, the lack of clarity in the law and the volume of pronouncements from the tax authorities. The major sources of revenue for the Ukrainian government are set forth in the Table 1 below.

Table 1: Sources of Ukrainian Government Revenue 1995 ²

Tax	Revenues (% of official GDP)	Revenues (% of actual GDP) ³	Share of Total Revenues
Enterprise Profits Tax	9.1	6.4	23.0
Value Added Tax	8.5	6.0	21.6
Pension Fund	8.0	5.6	20.2
Personal Income Tax	3.0	2.1	7.7
Chernobyl Fund	1.9	1.3	4.8
Land Taxes	1.2	0.8	3.0
Excise Taxes	0.8	0.6	2.0
Other	7.0	4.9	17.7
Total Revenues	39.5	27.7	100.0
Total Government Expenditures	46.3	32.4	117.2

¹ Prepared by David Burton, Partner, The Argus Group, Washington, D.C.

² Ukrainian Legal and Economic Bulletin, March, 1996, quoting official Ministry of Statistics figures.

³ Assumes 30 percent of GDP is legal but unreported. See "Ukraine's Shadow Economy During a Period of Transition", Alexander Paskhaver, Ukrainian Economic Monitor, June 1996 which in turn compiles numerous sources using varied methodology.

This table shows that the enterprise profits tax generates the most revenue of any single tax, accounting for nearly one-quarter of government revenue. Payroll taxes, when all are combined, are, however, the largest source of revenue. In developed economies, enterprise profits taxes are a much less important source of revenue. In the U.S., for example, business profits are 5.2 percent of GDP⁴ and corporate taxes amount to 11.2 percent of government revenues.⁵ The difference in the Ukrainian experience could be a function of enterprise profits being a higher percentage of GDP or it could be because Ukrainian taxes on enterprises are relatively heavy. Data for the first quarter of 1996, shows that reliance on the enterprise profits tax and payroll taxes remain roughly comparable to 1995 but has, temporarily at least, declined somewhat.⁶

1.1 Enterprise Profits Tax

The enterprise profits tax⁷ is generally imposed at a 30 percent rate, but "intermediary operations" are taxed at a 45 percent rate, gambling operations are taxed at a 60 percent rate and most agricultural and food processing operations are exempt altogether.⁸ Intermediary operations include representatives and agents.⁹

The enterprise profits tax base is significantly broader than profits defined in accordance with internationally accepted accounting principles. This is partly because many legitimate business expenses are not deductible for purposes of determining taxable income. Thus, the effective tax rate on economic profits is much higher than the statutory tax rate.

The Ukrainian tax law enumerates which expenses are allowable as deductions. There is no "catch all" provision which says that business expenses incurred in connection with a trade or business for a business purpose are generally deductible. Discussions with Ukrainian attorneys, accountants and entrepreneurs make it clear that the Ukrainian tax authorities are quite aggressive at narrowly defining which expenses are deductible. If an expense does not clearly fall within the enumerated list of allowable expenses, it is not treated as deductible.

⁴ Economic Report of the President, February, 1996, p.290 and p. 292.

⁵ Ibid., p. 370. Unincorporated businesses account for a small share of total profits and taxes.

⁶ Total first quarter revenues were 650,464 billion KBV. First quarter expenditures were 764,585 billion KBV. The enterprise profits tax accounted for 19.7 percent of revenues for the quarter but 22.3 percent in March alone. See, Ukrainian Economic Monitor, June 1996, p. 5.

⁷ See primarily the Law of Ukraine on Taxation of Incomes of Enterprises (No. 335/94, December 28, 1994) as amended on October 20, 1995, April 24, 1996 and July 10, 1996) *but see also* Rules of Usage of the Law of Ukraine on Tax of Incomes of Enterprises, Resolution of Verkhovna Rada, June 27, 1995 (No. 247/95); Order of the Ministry of Finance, State Tax Inspectorate, May 5, 1995 (No. 35), On Establishment of the Rules of Calculation of Fines from Unpaid Sums on the Profits Tax"; Rules of Usage of the Law of Ukraine on Amending the Cabinet of Ministers Decree on the Rules of Usage of Profit of State Enterprises, Institutions and Organizations, February 23, 1996; and "On the Taxation of Enterprise Profits, State Tax Inspectorate of Ukraine, January 24, 1996 (No. 14-211/10-462).

⁸ Law of Ukraine on Taxation of Incomes of Enterprises (No. 335/94, December 28, 1994) as amended on October 20, 1995, April 24, 1996 and July 10, 1996), Article 4.

⁹ Ibid., section 1.17.

Capital cost recovery allowances (i.e. depreciation) are very inadequate, particularly for a society that has experienced and is experiencing (albeit reduced) hyper-inflation. The depreciation schedules are provided by regulation and the author was unable to secure a translated copy. With interest rates as high as those in Ukraine (with *monthly* interest rates ranging from 7 to 32 percent over the past several years), the present discounted value of future depreciation deductions is quite small.¹⁰ Thus, there is typically a nearly to 25 percent excise tax on capital investment.

Allowable deductions are heavily weighted toward "production" or "material" costs. The idea seems to be that production costs are legitimate but management, marketing and other administrative costs are less so. Stated in Western accounting terms, costs of goods sold is typically allowable but sales, general, administrative, financial expenses and the like may or may not be deductible. Wage payments are generally deductible.¹¹ Rental payments, which are often a much larger share of total expenses in Ukraine, are reportedly only deductible up to the official rental value of the premises while actual rents are much higher.

The author was unable to determine what inventory accounting methods are permissible for Ukrainian tax purposes. For an economy with inflation rates as high as those in Ukraine, the traditional first-in first out method would constitute a very significant effective excise tax on inventories.

1.2 Payroll Tax

Payroll taxes in Ukraine are high by any standard. Imposed on the employer, payroll taxes amount to a combined 51 percent of payroll expense. Thirty-seven percent goes to the pension fund¹², 12 percent to the Chernobyl fund¹³ and 2 percent to the employment fund.¹⁴ There is also an obligatory payment of 1 percent to a labor safety fund, analogous to workers compensation insurance.¹⁵ Forty percent of this payment goes to the Oblasts, the remainder is to be kept in a separate fund by the enterprise.

¹⁰ Assuming an 80 percent annual interest rate (which is the equivalent of only a *five* percent monthly interest rate, lower than any experienced until the past few months) and a half year convention, a ten year accelerated double declining balance recovery period has a present discounted value of only 21 percent of the investment.

¹¹ Law of Ukraine on Taxation of Incomes of Enterprises (No. 335/94, December 28, 1994) as amended on October 20, 1995, April 24, 1996 and July 10, 1996), Article 9.

¹² The Law of Ukraine "On Pension Support", November 5, 1991 and the Law of Ukraine on the State Budget of Ukraine for 1995 (Article 27).

¹³ Order of the Ministry of Finance of Ukraine, January 10, 1995 (No. 214-10-330/10-122) on keeping the rules of 1994 for payments to the Chernobyl fund. See also, the Law of Ukraine on the State Budget of Ukraine for 1995 (Article 23).

¹⁴ Decree of the President of Ukraine, December 28, 1994 (No. 812/94), The Law of Ukraine "On Employment of the Population" and the Law of Ukraine on the State Budget of Ukraine for 1995 (Article 21).

¹⁵ The Law of Ukraine "On Labor Safety".

1.3 Personal Income Tax

The Ukrainian personal income tax is graduated, reaching a top marginal tax rate of 40 percent on annual incomes over approximately \$11,860.¹⁶ (See Table 2) Most Ukrainians experience a marginal tax rate of 20 percent or less. The average official wage in December of 1995 was \$66.2 per month.¹⁷ It is about \$75 per month now. Thus, the average worker is actually paying a marginal tax of 10 percent and the effective or average personal income tax rate is half of that.¹⁸ Based on interviews, the typical unskilled worker actually earns about \$200 per month, a portion of that wage typically being underground and therefore untaxed. Ukrainian wages must be understood in context. Most Ukrainians pay little or no rent for their housing and receive utility services free. Ukrainians, even city dwellers, reportedly often grow their own food on small plots of land. These plots are often separate from the residence. Thus, housing costs and a high proportion of food costs are often not paid from money wages.

Table 2: Ukrainian Personal Income Tax Rate Schedule ¹⁹

Monthly Range in KBV(Grv)	Annualized US \$ Range	Marginal Tax Rate
0 (0) to 1,700,000 (17)	\$0 to \$119	0%
1,700,001 (17) to 8,500,000 (85)	\$119 to \$593	10%
8,500,001 (85) to 17,000,000 (170)	\$593 to \$1,186	15%
17,000,001 (170) to 102,000,000 (1,020)	\$1,186 to \$7,116	20%
102,000,001 (1,020) to 170,000,000 (1,700)	\$7,116 to \$11,860	30%
170,000,001 (1,700) and above	\$11,860 and above	40%

¹⁶ Decree of the Council of Ministers "On Income Tax from Citizens", December 26, 1992 (No. 13-92); Decree of the President of Ukraine, November 21, 1995.

¹⁷ Source: Ministry of Statistics. Published in Ukrainian Legal and Economic Bulletin, March 1996, p. 37.

¹⁸ The author is not certain whether dividends, interest and other forms of investment income are in the tax base.

¹⁹ Assumes a Gryvna/Dollar exchange rate of 1.72 to 1.

1.4 Value Added Tax

The Value Added Tax²⁰ is generally imposed at a rate of 20 percent, although a lower rate of 16 and 2/3 percent appears to apply to sales settled in CIS currencies.²¹ The Ukrainian VAT is loosely modeled on the European Community (EC) model. It incorporates both zero rating and exemption treatments. In certain cases, the VAT base exceeds value added and the effective rate is therefore at times considerably in excess of the 20 percent statutory rate. In other words, the VAT paid on certain "non-production"²² inputs is not creditable; thus, the tax cascades and the effective rate exceeds 20 percent.²³ Thirty categories of products are treated as exempt from the VAT.²⁴ Pursuant to various provisions of the law, exemptions under the Ukrainian VAT may mean exempt in the EC sense or zero-rated in the EC sense.²⁵ Items exempted, in the EC sense, include most sales to cities, baby food, children's newspapers and magazines, scientific and engineering research and design work, insurance, banking and financial operations, cultural and sports events and services, pre-schools, mass transit, agriculture and food processing. Items zero-rated, in the EC sense, include exports (imports are of course taxed at their customs value), coal, electric power, and certain religious construction. Those sole proprietors with less than \$1,000 in revenues per year are exempt.²⁶

²⁰ See primarily Decree of the Cabinet of Ministers of Ukraine on the Value Added Tax, April 30, 1993 (no. 43-93) as amended July 7, 1993 (No. 3355-12), November 19, 1993 (No. 3627-12), November 19, 1993 (No. 3630-12), February 1, 1994 (No. 3898-12), February 24, 1994 (No. 4026-12), May 27, 1994 (No. 25/94), November 16, 1995 (No. 432/95), April 24, 1996 (No. 143/96), May 6, 1996 (No. 173/96), May 16, 1996 (No. 202/96), July 10, 1996 (No. 301/96), and July 10, 1996 (No. 303/96). *See also*, Council of Ministers Decree of December 26, 1992 (No. 14-92) on the Value Added Tax; Resolution of the Verkhovna Rada, On Usage of Article 28 of the Law of Ukraine, May 31, 1995 (No. 184/95); and Decree of the President of Ukraine On Charging the VAT on Imported Goods, June 30, 1995 (No. 499).

²¹ See Decree of the Cabinet of Ministers of Ukraine on the Value Added Tax, April 30, 1993 (no. 43-93), as amended, Article 6.

²² *Ibid*, Article 7, §2. The theme of providing reasonable tax treatment only to "production" is a recurring theme throughout Ukrainian tax policy. The system is extremely biased against wholesaling, distribution, retailing and services. It is clear that the vital role that these functions play in a modern economy needs to be better understood by Ukrainian policy-makers. The precise parameters of the definition of "non-production" expenses for purposes of the VAT are found in a series of regulations which the author does not have available in translation.

²³ *Ibid*, Article 7, §2.

²⁴ *Ibid*, Article 5, §1.

²⁵ In the EC and in Canada, "exempt" means that the sale of the exempt item or by the exempt vendor is not subject to VAT but the vendor is not entitled to a refund of the VAT paid on his inputs. "Zero-rated" means that the sale of the exempt item or by the vendor is exempt (technically subject to a zero rate) and the vendor is entitled to a refund of the VAT paid on his inputs. Thus, a zero rated good is treated more favorably than an exempt good. A zero rated good has no VAT embedded in its price. An exempt good may have a considerable amount of hidden VAT included in its price since the tax on inputs is not rebated.

²⁶ *Ibid*, Article 5, §1(s). The exemption level is 100 minimum monthly salaries per year. The minimum tax-free monthly salary is currently 17 Gryvnas. At a 1.72 exchanges rate, 1700G = \$988 per year.

1.5 Other Taxes

Ukraine has many other taxes. There is a host of excise taxes, some at high rates. The excise tax rules are complex and the effective rate varies considerably from product to product. Sometimes the taxes are imposed *ad rem* and sometimes *ad valorem*. These taxes run from 10 percent to several hundred percent of value.²⁷

Import duties are high, although as often as not evaded. A comparison of Ukrainian import-export accounts with those of its trading partners implies that over 40 percent of the goods imported into Ukraine are smuggled in free of duty.²⁸ Import duties range from 0 to 200 percent but are typically in the 10 to 30 percent range.²⁹ There is a capital tax of 0.1 percent on new stock and bond issues. There is a one percent tax on the value of auctioned goods. There is 0.25 percent tax on commodities exchange transactions. There is a tax on the use of land. There is a three percent tax on gross revenues from the sale of most, but not all, imported goods in some cities. There is an annual tax on vehicles. One percent of gross revenues must be sent to the State Innovation Fund, although it seems that there are methods of keeping these funds in-house to conduct research. There is a 10 percent tax on individual crafts and trade,³⁰ although the true nature of this tax is not clear to the author. There is a 10 percent hotel tax. There is a one half of one percent tax on advertising. There are an endless number of licenses, fees and small taxes (the author has identified about three dozen), most of which involve small amounts of money but require time as well as money with which to comply. Substantial fuel taxes are levied. One association executive estimated that there are over 500 separate taxes or fees in Ukraine and indicated that there were over 377 segregated funds through which tax revenues flowed. Another estimated that there were about 35 major taxes.

Registration fees to start an enterprise are fairly modest, currently ranging from 17 to 170 Gryvna depending on the businesses legal form and its industry.³¹

A "Kiosk Tax"³² is imposed on retail businesses.³³ This tax is thus directed almost exclusively at the micro retailers that line every major Ukrainian street. The tax is a flat fee of 160 European Currency Units (ECU) per month (about \$200) in Kiev and other major cities. This fee, then, is approximately equal to the monthly underground wage of a typical worker and 2-1/2 times the typical official monthly wage. In Sevastopol and smaller cities the fee is 80 ECU. Elsewhere it is 40 ECU. An exemption is provided for those selling only domestically produced foodstuffs.

²⁷ This information may well be outdated. The author has no recent legal translations at his disposal.

²⁸ Paskhaver, Op. Cit., p. 7.

²⁹ This information may well be outdated. The author has no recent legal translations at his disposal.

³⁰ Decree of the Council of Ministers, March 17, 1993, "On Tax from Individuals Crafts and Trades".

³¹ Decree of the Cabinet of Ministers of Ukraine, April 3, 1996 (No. 406) on "The Amount of Collections for State Registration of Businesses".

³² Law of Ukraine "On Patenting {Licensing} Certain Types of Business Activity", July 12, 1996, (No. 324/96).

³³ Many interviewees indicated that this tax only applied to businesses with less than 20 sq. meters of space. The author found no written confirmation of this limitation.

The tax is not graduated on any basis (e.g. space, revenue, employees, size of inventory). This tax will undoubtedly reduce the availability of goods to consumers. This tax is aimed directly at small retailers and will in many cases make their businesses fail or force them underground.

1.6 Bribes and Mafia Payments

Although regional variations are significant, protection fees paid to the mafia are reported to typically exceed 10 percent of gross revenues and can be as high as 20 percent. This constitutes a major "tax" that businesses in Ukraine must pay because of the failure by the government to control organized crime and to provide adequate police protection. Corrupt tax and health officials were reported to regularly extort heavy bribes from businesses. In addition, collaboration between mafia figures and tax officials to extort unauthorized funds from business was reported to be fairly frequent.

1.7 Tax Administration

The Ukrainian tax system is complex and ambiguous. Even professional accountants and attorneys feel that it is virtually impossible to keep up with the pace of change and to accurately decipher the intent of the various tax pronouncements. Even for those that try in good faith to comply with the system, penalties are all out of proportion to the tax liability asserted. Tax liabilities bear interest rates appropriate only for extreme hyperinflation. The interest rate on deficiencies is 0.3 percent per day or 109.5 percent per annum³⁴ for the VAT, excise taxes and certain other taxes. Personal income tax liabilities bear an interest rate of five percent per day or 1,825 percent per annum³⁵ and profits tax deficiencies bear interest at a rate determined by the National Bank of Ukraine. For an entrepreneur having a dispute with the tax authority, the underlying tax liability is the least of his problems.

Any additional tax liability assessed by the tax inspectorate is doubled for purposes of the value added tax, excise taxes, the profits tax and certain other taxes. A penalty of five times the tax liability is imposed for repeat violations within one year. Since it is apparent that almost anyone will violate some aspect of the law, the 400 percent penalty is virtually assured once an entrepreneur has captured the interest of the tax authorities.

2. Economic Impact of Ukrainian Tax System

Interviewed entrepreneurs repeatedly remarked that it would be impossible to stay in business if all taxes were paid. While this may not be literally true, the tax burden in Ukraine is a tremendous drag on economic growth and a major impediment to the normalization and growth of the economy. A vast proportion of total retail sales in Ukraine are made in the underground economy (probably 65 percent). Perhaps thirty percent of GDP is underground.³⁶ Law-abiding

³⁴ Assuming no compounding (i.e. no interest on interest).

³⁵ Assuming no compounding (i.e. no interest on interest).

³⁶ *Supra*, n. 2.

businesses find it difficult or impossible to compete with those that evade taxes. In this respect, the failure to pay import duties is often the most important means of achieving a definitive competitive advantage. Thus, even those that want to pay their taxes cannot do so and compete. As in the West, compliance costs have a disproportionately negative impact on small businesses.

The Gross Domestic Product, as officially measured, has fallen precipitously. Compared to the previous year, it fell 16.8 percent in 1992, 14.2 percent in 1993, 23 percent in 1994 and 11.8 percent in 1995.

Actual (as opposed to official) unemployment in Ukraine is quite high. Many remain officially employed at government enterprises or in government agencies but have not been paid for months. Indications are that back wage liabilities approach 10 percent of GDP. This situation is unlikely to resolve for some time as the government seems unable to adjust its spending commitments and the central bank is unwilling to create money to meet the obligations out of fear that inflation will accelerate destroying the value of the new currency. Official unemployment is less than one percent. Estimates of the unemployed and those only able to find part time work total run as high 34 percent in Kiev and somewhat less in the regions.³⁷ Other analysts reckoned the true unemployment rate at 30 percent country wide. In Odessa, estimates were in the range of 16 to 20 percent.

The fifty-one percent payroll tax has a very detrimental impact on employment and constitutes a major incentive to compensate employees wholly or partially in the underground economy. The incidence of employer payroll taxes is generally viewed within the economics profession as being on the employees. Typical U.S. elasticities of labor response, which may or may not be appropriate to the Ukrainian case, are 0.3. Thus, for every 10 percent increase in wages, labor would increase three percent. Reducing the payroll tax by 20 percent to 40.8 percent can be expected to increase employment by 3.4 percent³⁸ Similarly, reducing the payroll tax by 40 percent to 30.6 percent, still about twice the current U.S. level would increase employment by about 6.8 percent.³⁹ Revenues would not decline by anything close to 20 or 40 percent because the new jobs would generate tax revenue rather than be a drain on the state budget and lower tax rates would promote greater compliance with the tax law. The high payroll taxes found in most European Community countries are a major cause of continuing high levels of unemployment in Western European countries.

For upper income taxpayers, the effective marginal rate on salary income is over 60 percent

³⁷ Alexander Paskhaver, Ukrainian Economic Monitor, June 1996, p. 8, quoting a survey reported in "Tendencies of Ukraine's Economy", January 1996. Monthly edition of the European Center of Macroeconomic analysis of Ukraine.

³⁸ Assuming the incidence of the payroll tax, as is the consensus view, to be on the employee a typical employee earning \$151 gross of tax would, at the margin, receive 90 after-tax (taking into account the personal income tax). A reduction of the payroll tax from 51 to 40.8 would increase the net of tax wage to 100.2, an 11.1 percent increase. Given the elasticity of 0.3, this would increase employment by 3.4 percent.

³⁹ $(151 - 30.6 - 10) / 90 = 1.227$ and given a 0.3 elasticity, this would imply a 6.8 increase in employment.

(using the normal incidence assumption that the employer payroll tax is borne by employees).⁴⁰ The tax reform experience in the United States and Europe during the 1980s shows that this rate is above even the revenue maximizing rate and could be reduced to 40 to 45 percent range without experiencing any appreciable reduction in revenue.⁴¹ This is probably particularly true in Ukraine given the high rates of tax evasion. Reducing marginal tax rates will reduce the gain to cheating the tax system. If the risk and costs of non-compliance remain comparable and the gain to evasion is reduced by reducing the marginal tax rate, then the level of compliance will increase.

The combination of high inflation and punitive enterprise profits taxation dramatically impedes capital formation and makes long-term investment uneconomic. The inadequacy of capital cost recovery allowances raises the cost of capital dramatically.

3. Recommendations

The structure of Ukrainian tax system is flawed and the tax burden on SMEs is too high for sustained growth to occur. The system must be reformed in a constructive way. Merely reducing the enterprise profits tax rate and retaining the tax base and other aspects of the system would have a relatively minor positive impact.

3.1 Make all expenses incurred by businesses for a business purpose be deductible for purposes of calculating taxable profits.

The enterprise profits tax burden should be reduced by normalizing the structure of the tax. The present tax base can lead to effective tax rates all out of proportion to the statutory rate and effective tax rates that bear little relation to profitability. In fact, even unprofitable businesses may face hefty profits tax bills. A large proportion of legitimate business expenses are not deductible for tax purposes. In other words, the tax base for the profits tax is not an approximation of economic profits but some other economically unsound tax base that has no apparent unifying rationale.

⁴⁰ After tax income is $151 - 51 - 40 = 60$, where 51 are payroll taxes and income taxes are 40. A taxpayer retaining 60 out of 151 dollars earned is experiencing a 60.3 percent effective tax rate (i.e. $91/151$).

⁴¹ The U.S. experience during the 1980s under President Reagan, the Kennedy tax cuts of the 1960s and the Mellon tax cuts of the 1920s provide similar empirical evidence that income tax rates above 60 percent actually cost the government revenue. Taxpayers alter their behavior in response to high tax rates, substituting leisure for work and non-taxable activities for taxable activities.

3.2 Expense capital investment. Alternatively, index capital basis for inflation.⁴²

Capital cost recovery allowances are extraordinarily small because of the combined impact of lengthy recovery periods and very high interest rates. Inventory accounting methods are probably similarly confiscatory. Conservatively assuming, over and above the inventory and capital cost recovery problems, that the tax base on average overstates profits by one-quarter, then the effective tax rate would be 37.5 plus a roughly 25 percent tax on capital investment.

3.3 Impose the same tax rate on all types of business enterprises. As compensation for higher compliance costs, lower marginal rates on the first dollars earned by an enterprise should be considered.

So-called intermediary operations are subject to a higher 45 percent tax rate. Besides undoubtedly creating administrative problems over the definition of intermediary activities, the tax system should not be hostile to sales and distribution activities. In a market economy, these functions are critically important. As effective compensation for higher compliance costs and to provide an incentive for job creating entrepreneurial activity, lower marginal rates on the first dollars earned by an enterprise should be considered. This course is followed in most Western countries.

3.4 Eliminate the so-called Kiosk Tax. Alternatively, reduce it and graduate it in proportion to retail space, inventory or number of employees.

The so-called "Kiosk Tax", a flat monthly tax of ECU 160 (≈\$200) per month generally imposed on retailers with less than 20 m² (≈190 sq. ft.) of space should be reduced, restructured or eliminated. This fee is almost three times the official monthly wage and approximately equal to the typical underground economy monthly wage. This tax is imposed regardless of profitability and is very high in relation to the typical wage in Ukraine. It will drive a large proportion of small traders underground or out of business. Coupled with the scheduled prohibition of liquor sales by Kiosks (January 1, 1997), this tax will devastate small retailing. It will reduce the availability of consumer goods to the public.

3.5 Reduce the 51 percent (combined) payroll tax.

The current punitive payroll tax rate dramatically raises the costs of labor, creates unemployment and destroys millions of jobs, quashes opportunity and constitutes a major incentive to pay employees at least partially under the table. The rate could be reduced or the tax imposed on a limited tax base. For example, the tax could be imposed only on salaries up to two times the average official wage.

⁴² Indexing capital basis for inflation is highly complex and is almost certainly inappropriate given the relative lack of sophistication in Ukraine's business community. It would also raise private compliance costs still higher.

3.6 Make the tax law more stable, less complex, and less costly with which to comply.

The tax law is a complex agglomeration of legislative acts, decrees and regulations. Literally thousands of changes have been made in the past two years. Even accounting and legal professionals are overwhelmed. Typical entrepreneurs have no chance of keeping up with these requirements. Compliance costs on those wishing to comply with the law in all of its particulars would be punitive. Certain tax motivated banking restrictions on cash withdrawals would make it literally impossible to survive, if complied with, in a cash-oriented economy like Ukraine's.⁴³ The tax law needs to be simplified and made much more transparent so that those inclined to comply with the law have a realistic chance of doing so. Small taxes that yield little revenue should be eliminated in the interest of simplicity.

3.7 Reform the Penalty System By Reducing Penalties and Interest to Reasonable Levels and by Making the Penalty Proportionate to the Gravity of the Offense.

Penalties and interest of the magnitude in Ukraine do not foster compliance but instead ensure that an entrepreneur who miscalculates his tax liability under the highly complex, impenetrable Ukrainian tax system will be forced to either go underground to avoid ruinous fines or pay large bribes to tax officials to avoid those fines. Penalties of this magnitude are an invitation for corruption because tax officials are given the power to ruin businesses. Moreover, the penalty system is structured in such a way as to provide little incentive to comply once a payment is late and makes no distinction between major and minor infractions and infractions made with intent to defraud and those that were less culpable or even reasonable. Entrepreneurs testified that corrupt tax officials routinely use the prospect of ruinous penalties to extort bribes.

⁴³ Evidently cash withdraws from banks have been limited to the equivalent of roughly \$100 per month.