

**Business
Environment
in Ukraine**

2005



Business Environment in Ukraine

2005

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Introduction

This report, prepared by the International Finance Corporation (IFC) and co-funded by the European Commission, presents the results of the ninth annual survey of the business environment in Ukraine. The goal of the survey was to examine the legal framework and business environment in the SME sector in Ukraine, identify key regulatory barriers impeding business development, and, most importantly, provide practical recommendations for improving the main aspects of doing business for small and medium-sized enterprises in Ukraine. As a member of the World Bank Group, IFC assists with creating an enabling business climate in Ukraine by recommending modifications to the existing regulatory and institutional framework.

The qualitative characteristics of a multi-stage sample, along with face-to-face interviews with respondents, focus-group discussions, and polling of government officials generated a broad array of data, which allowed for comparison with previous years' results and made it possible to follow the dynamics of the development of the business environment in Ukraine, assess the national business climate, and arrive at conclusions about the extent to which state regulatory policy satisfied the needs of small and medium-sized enterprises.

In a year of presidential elections, the difficult political situation had a major influence on the business climate in Ukraine. This survey focused not so much on an analysis of the macroeconomic situation as on key barriers to the development of entrepreneurship, namely regulatory procedures and corruption. The solutions proposed, particularly the Law On the System of Permits for Business Activity, drafted by IFC's experts and the State Committee on Regulatory Policy and Entrepreneurship of Ukraine and approved by the Ukrainian Parliament, are intended to address the problems identified in the report. This report is not a comprehensive review of the problems faced by SMEs in Ukraine. Rather, it presents the views of more than 3,000 entrepreneurs in Ukraine's regional capitals, Kyiv, and Simferopol. The respondents represented varied sectors of the Ukrainian economy, including manufacturing, construction, and consumer services.

This report is published in English and Ukrainian. The project team did their utmost to ensure that the two versions are identical; however, in the event of any discrepancy, the original English version is to be considered definitive. An electronic copy of the report is available in English, Ukrainian, and Russian on IFC's web page: www.ifc.org/SME_Ukraine. The report is available, in both printed and electronic formats, at the following address:

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Summary



The International Finance Corporation (IFC), with the support of the European Commission, conducted its annual survey of the business environment in Ukraine between February and April 2005.

The goal of this report is to identify major regulatory barriers impeding the development of the private sector in Ukraine and to make recommendations to the Ukrainian government for improving the business environment. The indicators of the regulatory environment in 2004 discussed herein will provide a reference point for measuring the effectiveness of reforms carried out by the new government for the support of entrepreneurship.

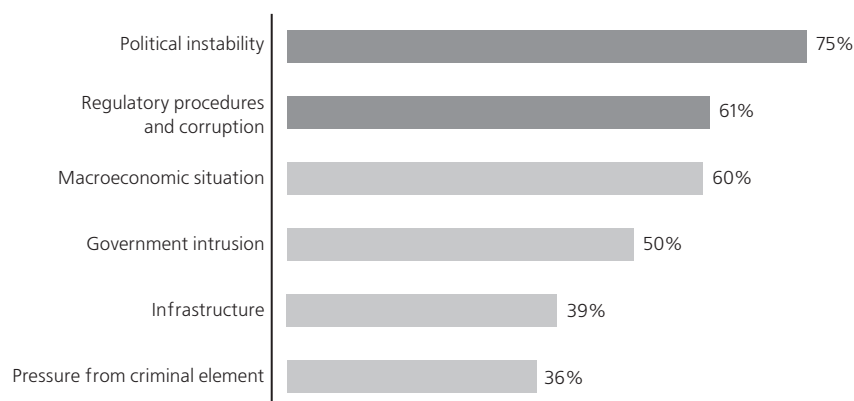
This section provides an overview of the main findings and conclusions of a survey of the directors of more than 3,000 small and medium-sized enterprises in Ukraine on the current state of the business environment.¹

In a year of presidential elections, the difficult political situation in Ukraine had a strong impact on the business climate. Three quarters of respondents ranked political instability as the most serious impediment to the development of their businesses in 2004.



Political instability, regulatory procedures, and corruption inhibited business development in 2004

% of respondents citing these factors as serious or very serious obstacles for their businesses



¹ In this report, SMEs are categorized according to number of employees: micro – less than 10 employees; small – 11 to 50 employees; medium – 51 to 250 employees, and large – 251 to 1,000 employees. These definitions conform to internationally accepted standards, not the definitions in the Economic Code of Ukraine of 1 January 2004. Under the Code, a “small” firm is defined having fewer than 50 employees and gross revenue under €500,000. A “large” firm has more than 1,000 employees and more than €5,000,000 in gross revenue. The rest are defined as “medium-sized.”

Regulatory policy and corruption together were ranked as the second-most serious barrier to business development. According to respondents, these were more important than macroeconomic factors.

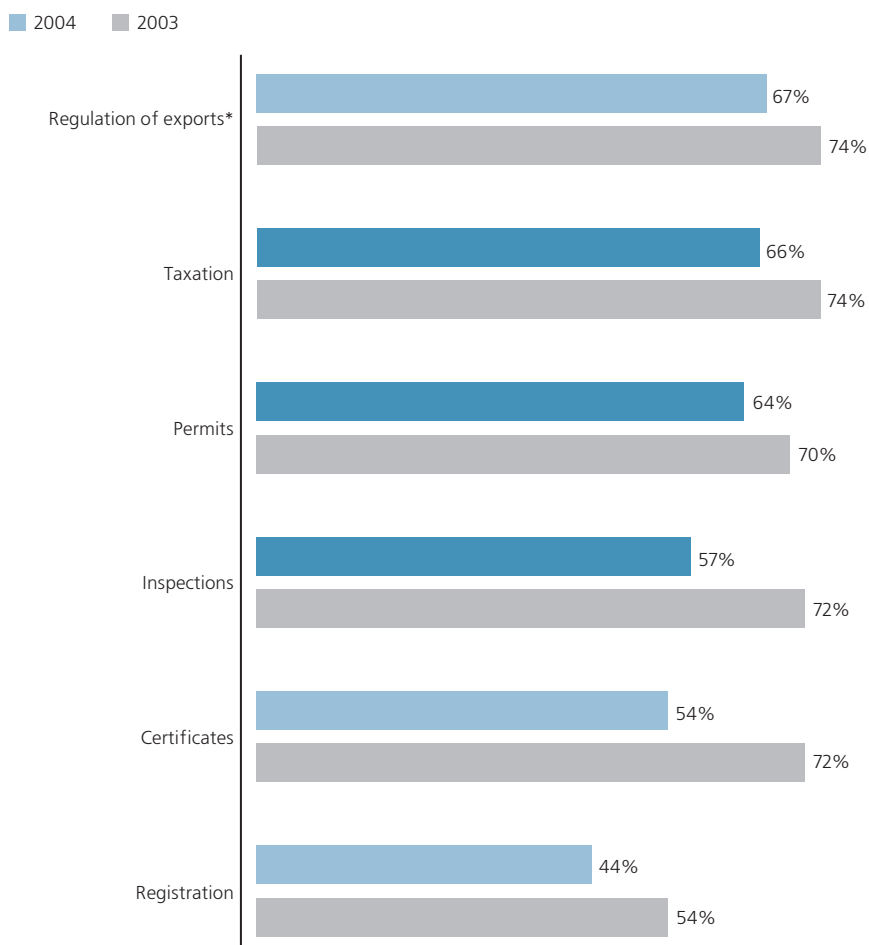
Taxation, permits, and inspections were cited as the regulated processes representing the key barriers to small and medium-sized enterprise development in 2004, just as in the preceding year.



1.2

Taxation is the main regulatory barrier to business development

% of respondents citing these procedures as complicated or very complicated



* Exporting firms ranked foreign trade procedures as the most serious regulatory barrier. However, this issue concerned a relatively small group, since only 6% of respondents were exporting in 2004.

There are several factors behind the noticeable improvement in respondents' perceptions of the regulatory environment in 2004, including:

- impressive economic growth (up by 12% in 2004)
- suspension of inspections by inspecting agencies during the election campaign (in the last quarter of 2004)
- the first attempts to improve the business environment (enactment of a new law with respect to registration, one-stop shop initiatives, and so on)

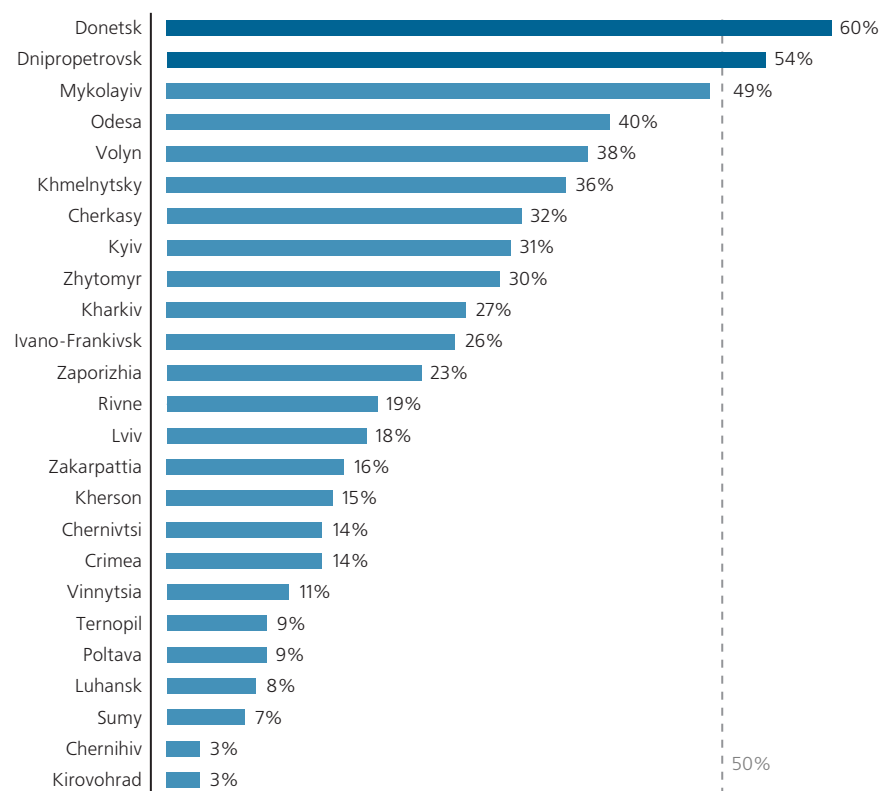
However, since there was no substantial change in the regulatory environment, the rankings for the regulated processes did not change and the number of respondents reporting problems with the three most frequently cited issues – taxation, permits, and inspections – remained significant.

Most companies assessed local business conditions negatively. The only exceptions were Donetsk and Dnipropetrovsk, where the majority of respondents stated that the local business environment was favorable for their businesses in 2004. The most negative assessments were found in Kirovohrad and Chernihiv.


1.3

In only two regions did a majority of respondents assess business conditions positively in 2004

% of respondents stating that local conditions were favorable for doing business and attracting investment



For what reasons were business conditions considered so poor? Which regulated processes caused the most problems for businesses and why? What can the Ukrainian government do to advance business development and curb corruption? This report seeks to answer these and other questions:

- The chapter *Entrepreneurs' perception of state authorities* looks at the respondents' assessment of the performance of state authorities and judicial bodies
- The chapters *Taxation*, *Permits*, *Inspections*, and *Regulation of exports* discuss the most problematic issues mentioned by respondents
- The conclusions at the end of each chapter were based on the survey findings and an in-depth analysis of the current situation. Recommendations for the Ukrainian government on improving the business climate in Ukraine are included
- *SME sector at a glance* provides a summary of the growth rates and performance indicators for small and medium-sized enterprises
- The *Methodology* gives background information and describes the sample

The following section provides an overview of the survey findings and the main recommendations in each chapter. The final part of this section presents recommended measures which, if implemented, would considerably improve the business environment in Ukraine within a short time.

Main survey findings



Entrepreneurs' perception of state authorities

In the survey, most respondents assessed the performance of the central and local authorities in 2004 as poor due to frequent changes in legislation, corruption within state authorities, and lack of effective mechanisms for defending the rights of entrepreneurs.

- Frequent changes to legislation in 2004 presented a problem for 78% of the businesses surveyed. The number of rules and standards regulating business activity increased by 4,100. Drafts of regulatory documents were not discussed publicly, virtually at all, contrary to the Law On the General Principles of State Regulatory Policy in Economic Activity.
- About 30% of respondents made unofficial payments to civil servants in 2004.
- The majority (80%) of business proprietors surveyed did not feel that either the Ukrainian judicial system or business associations were capable of defending their rights.

Recommendations

- » Enforce the provisions of the Law On the General Principles of State Regulatory Policy in Economic Activity with respect to public discussion of draft regulations and evaluation of the impact of existing regulations.
- » Plan a series of comprehensive measures to eradicate corruption in government organizations, including:
 - monitor performance and rotate civil servants in positions where the risk of corruption is highest
 - reduce the number of direct contacts between entrepreneurs and civil servants in the course of regulated procedures
 - disclose complete and accurate information about regulated procedures to businesses
 - increase financial compensation and other incentives for civil servants, including judges
- » Ensure that the interests of business associations are taken into account by local/municipal and regional authorities.



Taxation

Respondents saw taxation as the most serious regulatory barrier to the development of business in 2004.

- More than 75% of respondents stated that the current taxation system hampered business development.
- Taxation rules changed frequently. There were 34 amendments to key tax laws in 2004.
- 69% of firms following standard taxation regulations and 60% of firms paying the flat tax considered tax administration procedures to be complicated or very complicated.
- Income tax and payroll taxes were the most difficult payments to calculate, cited by 27% and 19% of respondents respectively.



- Only 18% of respondents stated that companies similar to theirs did not underrepresent revenue for tax purposes.

Recommendations

- » Adopt a tax code, including provisions for clear, simple, and unvarying tax administration procedures, to stabilize and streamline the tax legislation applicable to small and medium-sized enterprises. All regulations inconsistent with the new tax code should be repealed to prevent misinterpretation by tax authorities.
- » Combine pension and mandatory social security contributions into a single tax to facilitate payroll tax calculation and payment procedures.



Permits

In September 2005, the Ukrainian Parliament passed the Law On the System of Permits for Business Activity, drafted by the State Committee on Regulatory Policy and Entrepreneurship of Ukraine in partnership with consultants from IFC. The key provisions of this framework law were designed to address problems faced by enterprises in the course of obtaining permits for doing business. The Law came into force on 6 January 2006 and provided for bringing into compliance with it all regulations having to do with permits. The survey findings reflect the situation before the Law was passed.

The survey showed that in 2004, as before, the permit system was a major regulatory barrier to business development. The Ukrainian permit system was characterized by its broad scope and by the complexity, long duration, and costliness of the procedures. Unofficial payments during the process were common.

- In 2004, 43% of respondents had to obtain permits. One-third required more than three permits during the year.
- The agencies from which the greatest percentage of respondents required permits were the Fire Department, the Sanitary and Epidemiological Service, and the Labor Protection Department. (Respectively, 34%, 26%, and 14% of respondents obtained permits from these agencies in 2004.)
- About 90% of the most common permits were temporary, in that they were valid for a limited time because the recipients failed to meet all of the requirements established by the agencies issuing the permits. However, only 2% of respondents were denied permits as it was in 2003. This suggests that permits can and should be issued based on the declaration/application principle.
- 64% of respondents obtaining permits in 2004 considered the process of obtaining them difficult or very difficult.
- The complexity of permit procedures promoted the growth of corruption. One-third of businesses surveyed made unofficial payments in the course of obtaining permits.



Recommendations

The following steps will further improve the permit system:

- » Bring regulations into compliance with the provisions of the new Law On the System of Permits for Business Activity as soon as possible:
 - stop issuing permits not required by law
 - set out permit procedures only through laws and resolutions passed by the Cabinet of Ministers of Ukraine
 - allow 80-90% of firms to obtain permits through the declaration principle, in accordance with EU practices
 - enhance communication between government organizations and entrepreneurs by introducing the office of “state administrator”
- » Introduce a system based on risk assessment, determining the necessity for obtaining permits according to the degree of risk to public and environmental safety. (No risk: cancel the requirement for a permit; low risk: apply the declaration principle; high risk: require a permit.)
- » Harmonize technical regulations with respect to public safety with EU standards:
 - review mandatory standards and regulations and develop lists of minimum requirements for businesses: general technical regulations
 - give technical regulations the status of laws; that is, remove from ministries and departments the power to change them



Inspections

The most distinctive features of the Ukrainian inspection system are the high incidence of inspections, their costliness, and their ineffectiveness in detecting and preventing violations.

- The system of government inspections is redundant and inefficient: 78% of firms were inspected in 2004, each undergoing nine inspections on average.
- One-fifth of respondents whose businesses were inspected admitted making unofficial payments to inspectors. Officials of the Ministry of Internal Affairs, the Fire Department, the Sanitary and Epidemiological Service, and the Tax Administration asked for unofficial payments most frequently.
- In 2004, small and medium-sized enterprises alone went through more than 1.4 million inspections, which cost the companies surveyed a total of UAH 500 million, including fines and unofficial payments.
- Keeping an inspection log is the tool most frequently used by entrepreneurs to protect their rights.

Recommendations

- » Adopt the Law On the Protection of the Rights of Entrepreneurs During Government Inspections and Oversight of Business Activity. The key principles of the Law include:



- Base inspections on risk assessment, with classifications determining the frequency of inspections according to:
 - type of business
 - degree of risk the business presents to public health and safety and to the environment
 - inspection history
- Restrict the scope of inspecting officials' authority and introduce accountability for inspecting agencies for omissions or failure to perform their duties
- Develop a standard inspection checklist
- Grant businesses more power to defend their rights during inspections
- Prohibit inspecting agencies from financing their operations using funds collected from penalties imposed on businesses



Regulation of exports

Growth in the percentage of exporters among small and medium-sized enterprises was hindered by regulations, problems with VAT reimbursement, and lack of funds for foreign market research and promotion.

- In 2004, enterprises in Ukraine had limited export capacity, primarily due to internal difficulties. Of the companies planning to export, 28% cited regulatory policy as an inhibiting factor and 25% mentioned commercial factors.
- VAT reimbursement became an even more serious problem for exporting firms. Of the respondents exporting, 64% complained of difficulty with VAT reimbursement in 2004.
- Due to lack of resources, most exporting firms either did not actively market to potential foreign clients or relied only on partner recommendations and the Internet. Only 6% of the respondents exporting used information available from Ukrainian embassies abroad, and 26% obtained information from the Ukrainian Chamber of Commerce and Industry.
- Respondents were in favor of Ukraine's membership in trade partnerships. Accession to the World Trade Organization (WTO) and the Common Economic Zone (CEZ) was supported by 40% of the companies surveyed and only 6% were opposed.

Recommendations

- » Streamline VAT reimbursement and customs control procedures by shortening the list of documents required for customs and other kinds of clearance of goods. Bring customs clearance procedures in line with international standards with a view to joining the International Convention on the Simplification and Harmonization of Customs Procedures (the Kyoto Convention).



- » Formally direct Ukraine's diplomatic trade missions to promote SME exports as a matter of priority. Design and implement a system to independently evaluate trade mission employees based on their accomplishments in export development.
- » Consider the possibility of organizing expenses-paid trade missions to trade partner countries for exporting firms. Such events are useful for building partner confidence and are seen by many researchers as the most productive form of government support for exports.

Other survey findings

Registration

The time required for registering a business dropped from an average of 8 weeks in 2003 to 4.5 weeks in 2004.

Several factors contributed to the reduction in the average period for registration, but the most important was the enactment of the Law of Ukraine On the State Registration of Businesses—Legal Entities and Individuals. However, the law could not be fully implemented due to the limited technical capacity of the registration authorities.

At the same time, the cost of registration was UAH 1,200 (\$226), more than a two-fold increase over the previous year.

About 20% of respondents registering or re-registering² reported that they had to make unofficial payments.

Licensing

About 40% of respondents were required to obtain a license for specific kinds of business in 2004. The licenses most commonly obtained were for trade in alcoholic beverages (16% of respondents obtaining licenses) and tobacco products (11%) and for construction (12%).

The most serious problems during the licensing process in 2004 included the large number of documents required (55% of firms reporting problems), long waiting times for responses to applications (35%), and frequent changes in licensing procedures and ambiguity in the requirements (23%).

About half of respondents obtaining licenses in 2004 (45%) paid state authorities a fee to prepare the documents required to obtain a license. Two-thirds of those who paid the fee complained about the high cost of the services. One-fifth of respondents obtaining licenses in 2004 had to make unofficial payments.

Certification and standards

Similarly to previous years, about 20% of respondents went through mandatory certification procedures in 2004.

The need to obtain several conformity certificates was the source of the most complaints. One-third of respondents completing certification procedures in 2004 had to obtain certificates for both components and finished products. One-fifth of those obtaining mandatory certificates complained about unofficial payments and the large number of documents required.

About 17% of respondents stated that their products were subject to standardization. The most common types of standards were national (DSTU)

² Re-registration means registering any change to the statutory documents of an existing firm. It is very similar to registration.



and CIS (GOST) (applicable to 68% of respondents subject to standardization) and ISO (31%).

One-fifth of respondents developed their own specifications. This group of firms found that registering the specifications was the most time-consuming and expensive procedure, taking approximately nine weeks and costing almost UAH 2,700 (\$509).

One-tenth of respondents subject to standards or registering specifications reported the need to make unofficial payments.

External financing

In the aftermath of great political instability in 2004, only 53% of respondents invested new funds in their businesses – a drop of 18% over the previous year. About half of those needed external financing.

Most of the problems with obtaining external capital were related to the high cost of new funds (indicated by 72% of respondents), high collateral requirements (71%), and short financing terms (62%). More than three-quarters of the respondents stated that access to external financing did not improve in 2004.

Bank loans in hryvnya were for an average term of 15 months at an annual interest rate of 21%, while loans from non-banking institutions were available for an average term of 25 months at an annual rate of 30%. Partner financing was for a term of 15 months at a 10% annual interest rate. Loans were covered by guarantees of up to 200% of the amount borrowed.

The following are recommendations for measures that would improve the business environment in Ukraine considerably within a short time [Table 1.1 on page 14].



1.1

Urgent steps to improve the business environment in Ukraine

Entrepreneurs' perception of state authorities	Enforce the provisions of the Law On the General Principles of State Regulatory Policy Governing Business Activity with respect to public discussion of draft regulations and evaluation of the impact of existing regulations.
Taxation	Adopt a tax code, including provisions for clear, simple, and unvarying tax administration procedures, to stabilize and streamline the tax legislation applicable to small and medium-sized enterprises. Repeal all regulations inconsistent with the tax code. Combine pension and mandatory social security contributions into a single tax.
Permits	Bring regulations into compliance with the provisions of the new Law On the System of Permits for Business Activity as soon as possible: <ul style="list-style-type: none"> • stop issuing permits not required by law • set out permit procedures only through laws and resolutions passed by the Cabinet of Ministers of Ukraine • allow 80-90% of firms to obtain permits using the declaration principle, in accordance with EU practices • enhance communication between government organizations and entrepreneurs by introducing the office of “state administrator” <p>Introduce a system based on risk assessment, determining the necessity for obtaining permits according to the degree of risk to public and environmental safety. (No risk: cancel the requirement for a permit; low risk: apply the declaration principle; high risk: require a permit.)</p> <p>Harmonize technical regulations with respect to public safety with EU standards: <ul style="list-style-type: none"> • review mandatory standards and regulations and develop lists of minimum requirements for businesses: general technical regulations • give technical regulations the status of laws; that is, remove from ministries and departments the power to change them </p>
Inspections	Adopt the Law On the Protection of the Rights of Entrepreneurs During Government Inspections and Oversight of Business Activity. The key principles of the Law include: <ul style="list-style-type: none"> • risk-based classifications to determine the frequency of inspections, according to: <ul style="list-style-type: none"> - type of business - degree of risk the business presents to public health and safety and to the environment - inspection history • restriction of the scope of inspecting officials' authority and introduction accountability for inspecting agencies for omissions or failure to perform their duties; granting businesses more power to defend their rights during inspections • prohibit inspecting agencies from financing their operations using funds collected from penalties imposed on businesses
Regulation of exports	Review and streamline VAT reimbursement and customs control procedures. Formally direct Ukraine's diplomatic trade missions to promote SME exports as a matter of priority.

SME sector at a glance



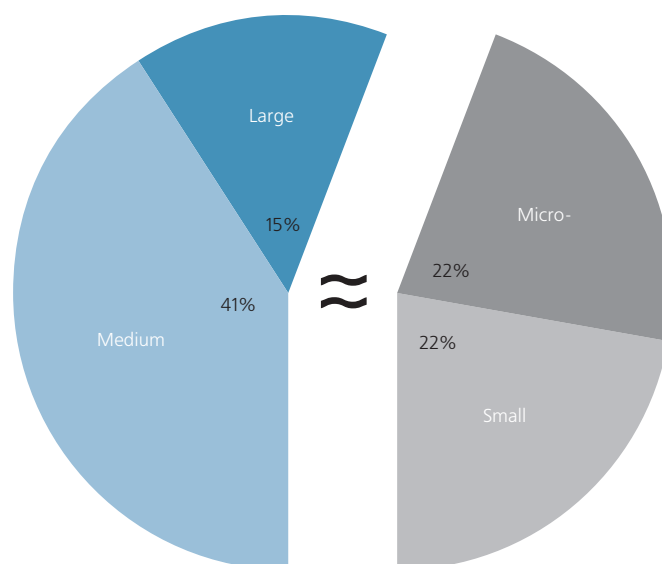
According to the State Statistics Committee, the number of registered enterprises had increased by 42 thousand over the previous year in 2004, reaching 1.023 million. Incremental growth dropped from 4.8% in 2003 to 4.3% in 2004.

The survey showed that the average revenue of large and medium-sized enterprises was 11 times higher than that of small and micro-companies in 2004. However, the total combined revenue of large and medium-sized enterprises was only slightly higher than that of micro- and small companies.

2.1

Despite a striking difference in average revenue, the total combined revenue of micro- and small firms was essentially the same as that of large and medium-sized businesses

% of total revenue



More than 50% of respondents reported higher official revenue in 2004; only one-fifth reported a drop in sales of goods and services year over year.

The companies surveyed reported an average 14% increase in revenue over the previous year for 2004—higher than the consumer price index (9%) but lower than the producer price index (20.4%). Despite the increase in average revenue from the sale of goods and services in 2004, total revenue declined. The percentage of companies operating at a loss or breaking even doubled year over year.

The survey confirmed that the regulatory environment was an important factor driving business development. Most respondents (55%) expected the regulatory environment to improve in 2005.

Entrepreneurs' perception of state authorities



Most survey respondents assessed the performance of central and local authorities in 2004 as poor. The reasons for this were the frequent changes in legislation, corruption within state authorities, and the lack of effective mechanisms for defending the rights of entrepreneurs.

- » Only entrepreneurs in Donetsk and Dnipropetrovsk assessed the effect of the regulatory environment on local business conditions as positive in 2004. Respondents in Kirovohrad and Chernihiv gave the poorest ratings. [Chart 1.3 on page 7]
- » Frequent changes in legislation in 2004 presented a problem for 78% of the businesses surveyed. The number of rules and standards regulating business activity increased by 4,100. Drafts of regulatory documents were not discussed publicly, virtually at all, contrary to the Law On the General Principles of State Regulatory Policy in Economic Activity.
- » According to the survey, about 30% of respondents made unofficial payments to civil servants in 2004.
- » The majority (80%) of business proprietors surveyed did not feel that either the Ukrainian judicial system or business associations were capable of defending their rights.



Entrepreneurs assessed the efficacy of local authorities negatively

According to the survey results, entrepreneurs were critical of the efficacy of local authorities in 2004. Respondents believed that authorities in their regions did not abide by the law, and hindered development of entrepreneurship and fair competition. In only two regions did the majority of respondents assess positively the effect of the regulatory environment on business conditions in 2004.

3.1

Entrepreneurs in most regions rated local government performance negatively in 2004

	Local authorities abide by the law	Local authorities do not hinder entrepreneurship	Local authorities help start-up businesses	Local authorities create a level playing field	Local infrastructure is conducive to business development	Local authorities operate transparently and do not demand unofficial payments	Business environment is conducive to attracting investment	Business environment in the region is better than in the rest of Ukraine
Donetsk	+	+	+	+	+	-	+	+
Dnipropetrovsk	-	-	-	-	-	-	+	-
Mykolayiv	-	+	-	-	+	-	-	+
Odesa	-	-	-	-	-	-	-	+
Volyn	-	-	-	-	-	-	-	-
Khmelnysky	-	+	-	-	-	-	-	-
Cherkasy	-	-	-	-	-	-	-	-
Kyiv	-	-	-	-	-	-	-	+
Zhytomyr	-	-	-	-	-	-	-	-
Kharkiv	-	-	-	-	-	-	-	-
Ivano-Frankivsk	-	-	-	-	-	-	-	-
Zaporizhia	-	-	-	-	-	-	-	-
Rivne	-	-	-	-	-	-	-	-
Lviv	-	-	-	-	-	-	-	-
Zakarpattia	~	-	-	-	-	-	-	-
Kherson	-	-	-	-	-	-	-	-
Chernivtsi	-	-	-	-	-	-	-	-
Crimea	-	-	-	-	-	-	-	-
Vinnysia	~	-	~	~	~	~	~	-
Ternopil	-	-	-	-	-	-	-	-
Poltava	-	-	-	-	-	-	-	-
Luhansk	-	-	-	-	-	-	-	-
Sumy	-	-	-	-	-	-	-	-
Chernihiv	-	-	-	-	-	-	-	-
Kirovohrad	-	-	-	-	-	-	-	-

"+" most respondents agreed with the statement; "-" most respondents disagreed with the statement; "~" responses were split.



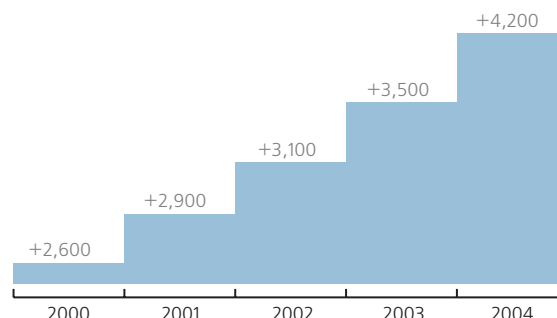
Frequent changes to legislation resulted in misinterpretation

The quality of the legal framework regulating business activities in Ukraine can be judged by the number of regulations passed annually.



The number of legal acts regulating business activity continued to grow in 2004

number of regulations*



* Source: Liga software legal system

The following areas of legislation were examined: Budget/Finance, Banking, Entrepreneurship/Licensing/Certification, Taxation, Stock Market, Customs, Foreign Economic Activity, Enterprises/Industry/Fuel and Energy, Transport/Communication, Accounting.



“No sooner has the law been approved than they begin making changes to it. We have plenty of laws that can be variously interpreted.”

Focus group participant

Obviously, even experts involved in the drafting process cannot possibly assess the impact of such a multitude of regulations. Often, approved legislative documents contain conflicting provisions and do not fulfill the intent behind them, so they are replaced by new ones. It can be stated, therefore, that the regulatory policy applied to business is not constructive enough, and that the law defining the basis of that policy and intended to achieve change is not observed.

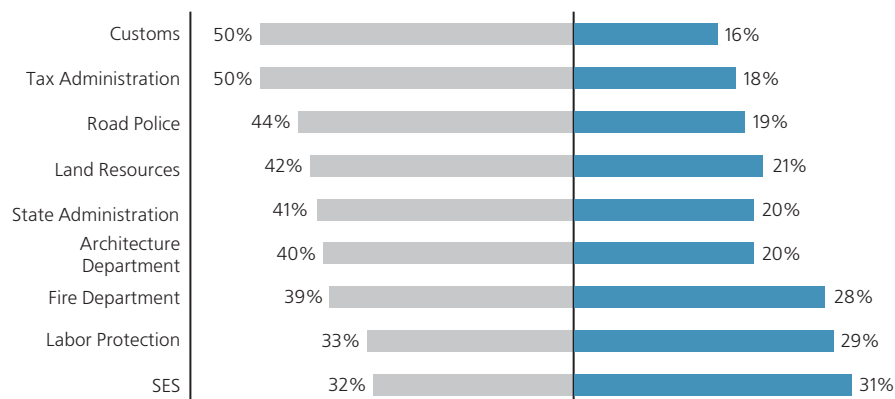
Legislation that changes frequently is difficult to interpret, even for lawyers, and it creates additional opportunities for civil servants to abuse their positions. According to respondents, the Customs and Tax Administration agencies interpreted legislation incorrectly or inconsistently more often than other state agencies in 2004.



Interpretation of legislation was most inconsistent in Customs and Tax Administration

% of respondents evaluating consistency in interpretation

■ Interpret inconsistently ■ Interpret consistently





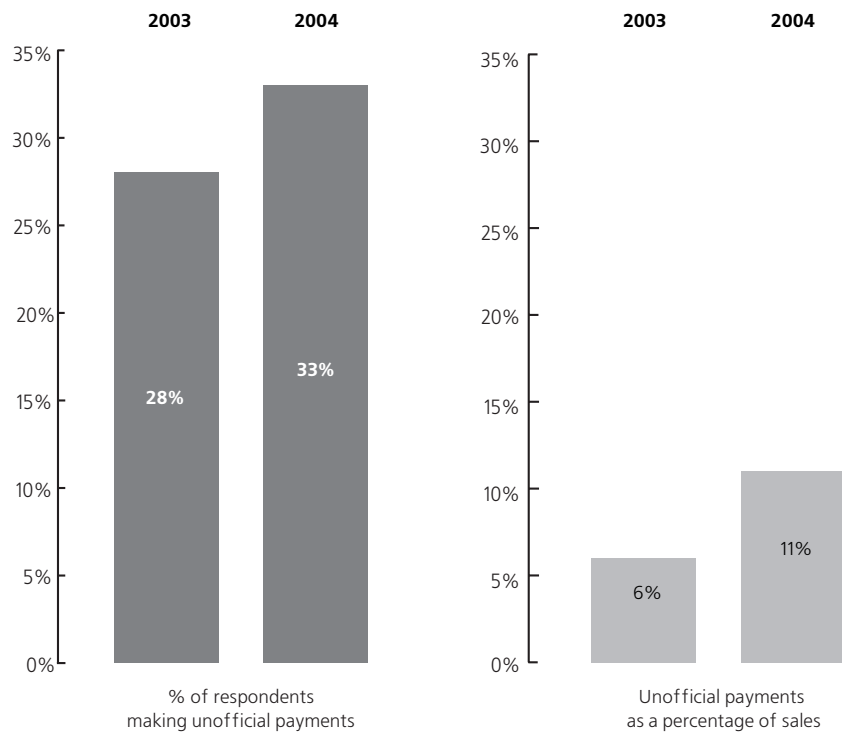
It is clear that frequent changes in legislation and inadequate regulations that allow for misinterpretation inhibit business development in Ukraine. In 2004, inconsistent legislation was cited as a problem by 78% of the companies surveyed. Moreover, one-quarter of the survey participants stated that the situation had deteriorated in 2004.

Unofficial payments continued to be prevalent, and in higher amounts

The survey showed that unofficial payments to public officials continued to be common in 2004, with about 30% of respondents making such payments. Although the frequency of unofficial payments increased only slightly over 2003, the amounts paid increased considerably. As a percentage of business income, unofficial payments in 2004 were at least one and a half times the 2003 figure.



Amounts of unofficial payments increased in 2004



Tax Administration, the Fire Department, and Customs demanded unofficial payments most frequently

In 2004, respondents made unofficial payments to all state authorities dealing with the private sector more often.

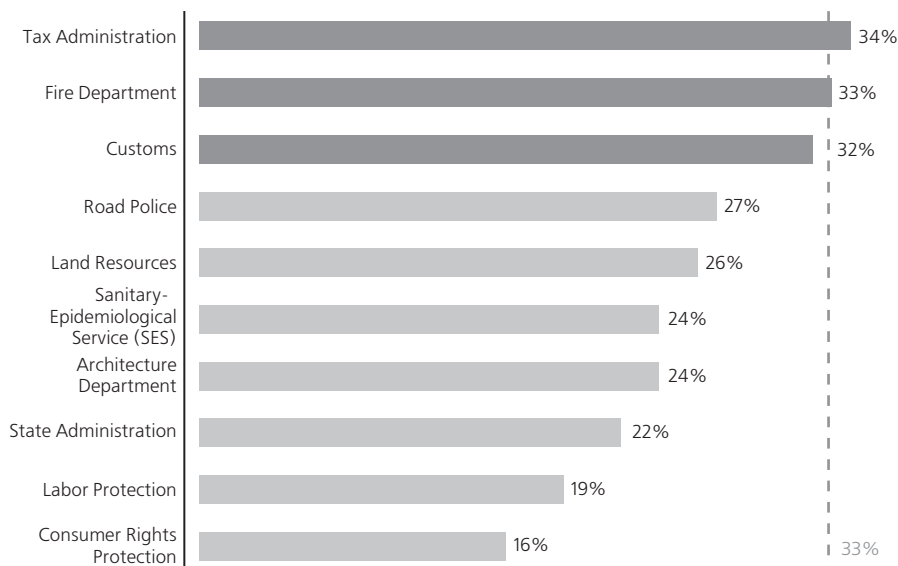
Most commonly, unofficial payments were taken by officials of the Tax Administration, Fire Department, and Customs. More than one-third of respondents admitted to having made unofficial payments to these organizations. Officials of the Committee for the Protection of Consumer Rights were more “incorruptible,” accepting unofficial payments from one in six businesses.



3.5

One in three respondents made unofficial payments to the Tax Administration, Fire Department, and Customs in 2004

% of respondents making unofficial payments



Corruption of state power exists because public officials have the opportunity to handle funds that do not belong to them in the course of making decisions.

“Top” corruption exists among senior and middle-ranking public officials and involves high-price matters (lawmaking, government procurement policies, changes in ownership, etc.)

“Bottom” corruption is associated with routine interaction between bureaucrats and individuals (fines, permits, etc.)

“Bottom to top” corruption is where a public official bribes his boss to buy his protection. A bridge between bottom and top corruption, bottom to top corruption indicates that the phenomenon is pervasive.

From a report by INDEM Foundation (www.indem.ru)

In “bottom to top” corruption, managers cover up for subordinates

Unofficial payments pave the way for bottom to top corruption, in which unofficial payments pass from lower-ranking functionaries to higher-ranking officials in return for covering up illegal activities.

The survey revealed a relationship between unofficial payments to low-level bureaucrats and protection by top management. This kind of protection strips the private sector of the opportunity to defend their rights and redress injustices by appealing to other public officials or their managers.

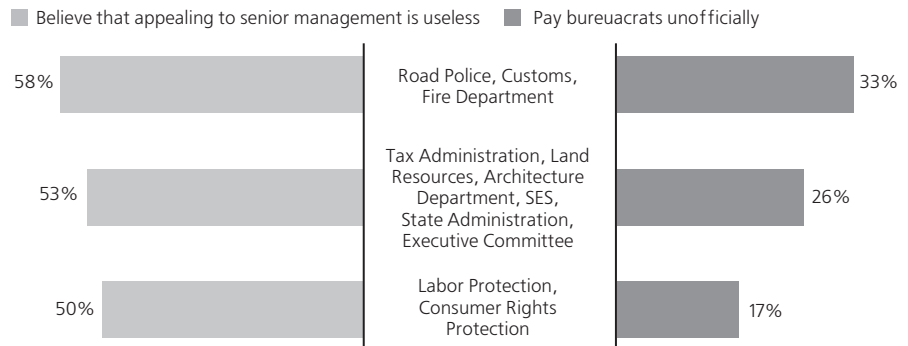


Unofficial payments were most commonly demanded by agencies notorious for being offices where appealing for justice is hopeless.

3.6

Protection and unofficial payments are connected

% of respondents



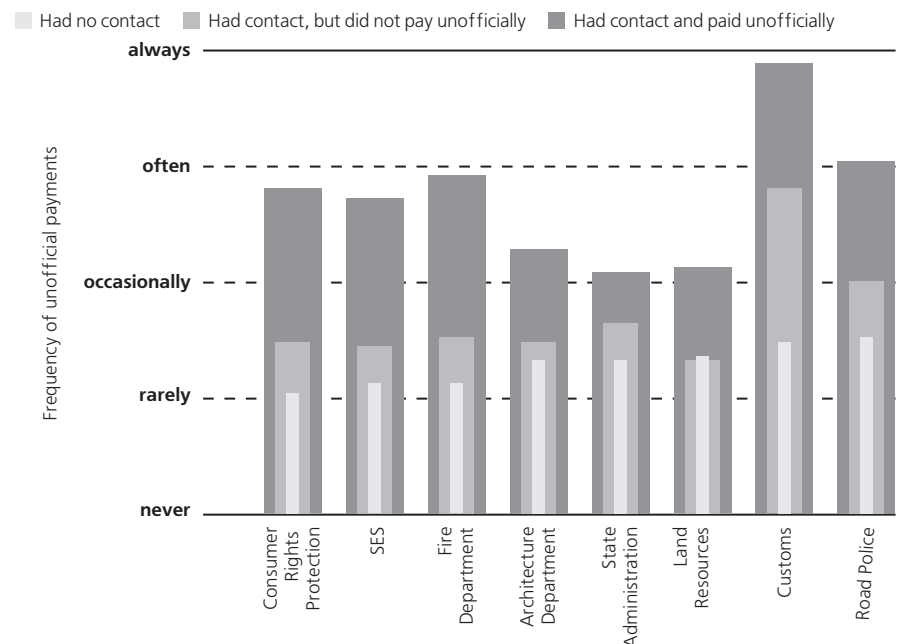
The level of government corruption was perceived as growing year by year

Respondents who did not have any contact with state authorities believed that unofficial payments to officials of those organizations were not widespread. However, with each incremental contact with government officials, entrepreneurs perceived the level of corruption in state authorities as worse. Thus, they had increasing reason to make unofficial payments on subsequent occasions.

3.7

The level of corruption in government organizations was perceived as worse with every contact

assessment of vulnerability to corruption by frequency of dealings with government organizations





Disclosing complete and accurate information about regulatory procedures limits opportunities for corruption in government organizations. The survey found that one in five respondents who were informed about permit procedures did not make unofficial payments, while almost all respondents who complained about a lack of information did make unofficial payments.

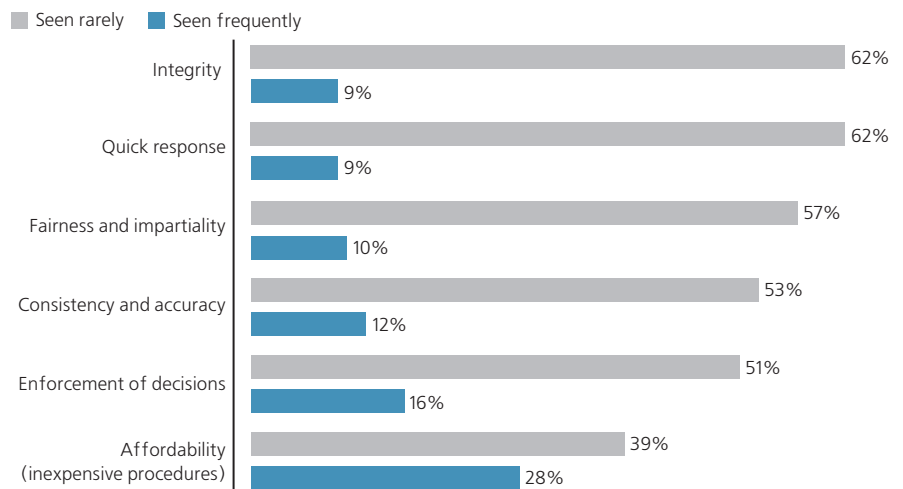
The vast majority of respondents did not trust the judicial system

Only 20% of survey participants believed that the Ukrainian judicial system could protect their interests. In answering the related question, three out of four respondents also stated that the situation had not changed at all from the previous year. Corruption, slowness, and bias were cited as the major shortcomings of the judicial system.



Respondents saw the Ukrainian judicial system as corrupt, slow, and biased in 2004

% of respondents



“Have you ever taken your case to the commercial court? Even though everything there looks cheap on paper, the end result is very expensive.”

Focus group participant

The companies surveyed were slightly more satisfied with the low official cost of going to court. However, considering the other characteristics of the court system, the inexpensiveness of procedures was not enough to encourage entrepreneurs to seek justice in court.

Business associations remained small in number and unpopular among entrepreneurs

Closing ranks and uniting in business associations could become an effective mechanism for entrepreneurs to protect the interests of small enterprises in relation to government organizations. However, the survey showed that only one in five enterprises in Ukraine were members of an entrepreneurs' association in 2004, just as in the year before. Prevalence of association membership depended on the size of the firm: only one in seven micro-businesses belonged to an association, but one in two large firms were members. Most respondents who did not join associations refrained from doing so because they did not see the benefits of membership. Only 3% of respondents indicated that they were deterred from membership by high membership fees.



"Because they [the association] do not tell us concretely what they can do for us..., everyone decides for themselves why they need it."

Focus group participant

"My competitors will resolve problems at my expense, for free, and then crush me with price because I spent the money and they didn't."

Focus group participant

"We turn to them [the association] but they turn a deaf ear to our problems... We don't trust them."

Focus group participant

The lack of interest in membership in private sector business associations in Ukraine is inconsistent with the solidarity of the country's population, including entrepreneurs, who stood up against violations during the presidential campaign in 2004. But due to a variety of concerns – threats from more than one government organization and competition among firms – the forces that could move the private sector to unite in business associations are weaker than the forces opposing unity.

Yet another factor is that associations do not have a reputation as true defenders of their members' interests rather than the personal interests of their administrators.

Recommendations

- » Enforce the provisions of the Law On the General Principles of State Regulatory Policy in Economic Activity with respect to public discussion of draft regulations and evaluation of the impact of existing regulations.
- » Plan a series of comprehensive measures to eradicate corruption in government organizations, including:
 - monitor performance and rotate civil servants in positions where the risk of corruption is the highest
 - reduce the number of direct contacts between entrepreneurs and civil servants in the course of regulated procedures
 - disclose complete and accurate information about regulated procedures to businesses
 - increase financial compensation and other incentives for civil servants, including judges
- » Ensure that the interests of business associations are taken into account by local/municipal and regional authorities.

Taxation



Respondents saw taxation as the most serious regulatory barrier to the development of business in 2004.

- » More than 75% of respondents stated that the current taxation system hampered business development.
- » Taxation rules changed frequently. There were 34 amendments to key tax laws in 2004.
- » 69% of firms paying tax under the general tax system and 60% of firms paying the flat tax considered tax administration procedures to be complicated or very complicated.
- » Income tax and payroll taxes were the most difficult payments to calculate, cited by 27% and 19% of respondents respectively.
- » Only 18% of respondents stated that companies similar to theirs did not underrepresent revenue for tax purposes.



The existing taxation system hampered business development

Key features of the Ukrainian taxation system

In 2004, the Ukrainian taxation system consisted of 28 nationwide and 14 regional taxes and contributions. Of these, 25 and 9 taxes respectively were applicable to the operations of small and medium enterprises. Business income tax, value added tax (VAT), and excise duty generated the most revenue for the Ukrainian state budget. Together they accounted for 55% of the consolidated state revenue in 2004.

Companies in Ukraine pay income tax at a uniform rate, which was lowered from 30% to 25% on 1 January 2004. They are also required to pay a payroll tax of 36.8% in the form of contributions to the pension fund and social security insurance for unemployment and temporary disability. In addition, if a firm's operations pose a health or safety hazard for the employees, the firm pays 0.2% to 13.8% in payroll tax for industrial injury and occupational disease insurance. The VAT rate is 20%.

Starting in 1998, companies in Ukraine with annual revenue of less than one million UAH and fewer than 50 employees were allowed to switch to the simplified taxation system, paying a flat tax of 10% of revenue or 6% plus VAT. For these companies, the flat tax replaced income tax and pension and mandatory social security contributions. In 2004, 34% of the companies surveyed were paying the flat tax.

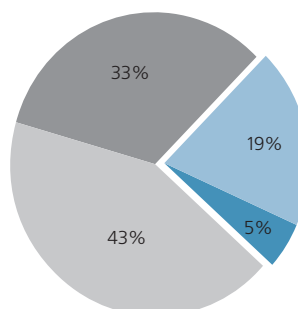
The proportion of respondents who saw taxation as a barrier to business development did not change in 2004. More than 75% of respondents cited taxation as a problem, and one-third saw it as a very serious problem. Only 5% stated that the current taxation system was not an obstacle to private sector development.



More than three-quarters of respondents cited taxation as a problem in business development

% of respondents

- Very serious problem
- Serious problem
- Insignificant problem
- Not a problem



Tax legislation was unstable in 2004

According to the Tax Administration, the tax system comprises more than 1,900 legal acts and regulations, the provisions of which are often found to conflict. As in the year before, there were many changes to tax laws in 2004. According to IFC experts' estimates, 34 changes, to key tax laws alone, came into effect in 2004.



“Tax authorities often send us instructions and memoranda which are inconsistent with the law.”

Focus group participant

“You wake up in the morning and you don’t know what changes you’re going to find in the law.”

Focus group participant

The survey showed that respondents saw a correlation between the instability of legislation and the complexity of taxation. Among respondents citing unstable legislation as a barrier to business development, 85% considered taxation and tax administration to be the same thing.

Tax amendments in 2004:

- 10 amendments to the Law of Ukraine On Taxation of Corporate Profits (28 December 1994)
- 12 amendments to the Law of Ukraine On the Value Added Tax (3 April 1997)
- 2 amendments to the Law of Ukraine On the Taxation System (25 June 1991)
- 3 amendments to the Law of Ukraine On the Mandatory State Pension Insurance (9 July 2003)
- 2 amendments to the Law of Ukraine On the Mandatory State Pension Insurance Contribution (26 June 1997)
- 1 amendment to the Law of Ukraine On the Mandatory Social Insurance for Work-Related Accidents and Occupational Disease Resulting in Disability (23 September 1999)
- 4 amendments to the Law of Ukraine On the Mandatory Social Insurance for Temporary Disability and Birth and Funeral Expenses (18 January 2001)

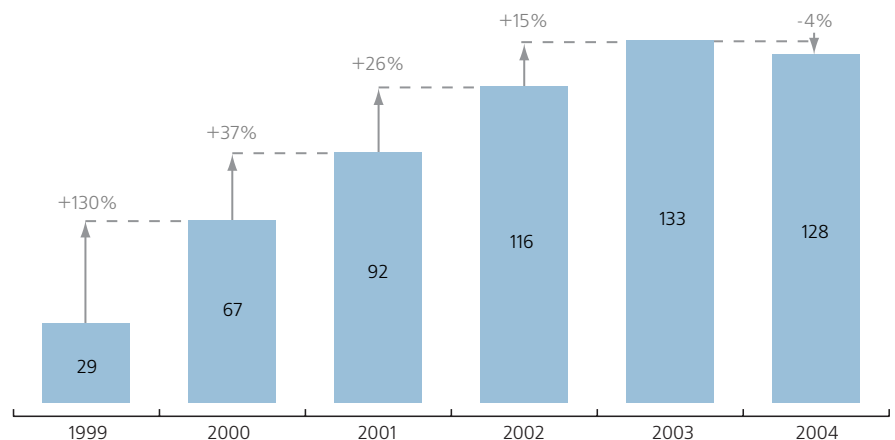
Amendments to pension legislation in 2004 curtailed the number of firms opting to pay the flat tax

The number of firms opting to pay the flat tax was rising steadily from 1999 to 2004. The pattern changed with the enactment of the Law of Ukraine *On the Mandatory State Pension Insurance*¹, which required companies paying the flat tax to make the same pension and social security contributions as those that were not. Over nine months of 2004, the number of firms opting to pay tax under the simplified system decreased by 4%.



Law On the Mandatory State Pension Insurance made the flat tax less attractive for businesses

number of firms opting to pay the flat tax, thousands*



¹ Law of Ukraine On the Mandatory State Pension Insurance (No. 1058-IV, 9 July 2003).

* Source: Tax Administration statistics.

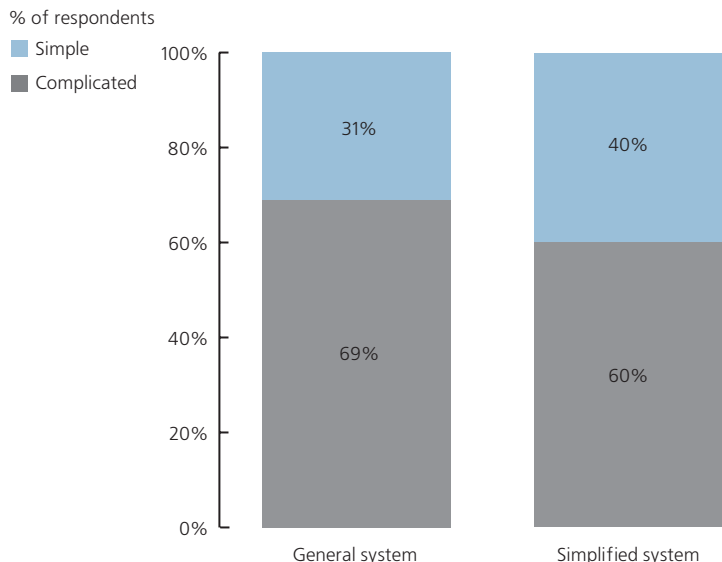


Businesses found tax procedures complicated

Tax payment and reporting procedures were rated as complicated by 64% of survey participants in aggregate in 2004, including 60% of firms paying the flat tax and 69% of firms paying taxes under the general taxation system.

4.3

Respondents rated both the general and the simplified tax systems as complicated



Income tax, pension and social security insurance contributions, and VAT were cited as the most difficult payments to calculate in 2004. Firms paying the flat tax saw pension and social security fund contributions as the most complicated payment calculations, while those paying taxes under the general system found calculating income tax most difficult.

4.4

The income tax payment was the most difficult to calculate



Payroll deductions and reporting procedures could be improved by combining all social security contributions into a flat “social” tax. This would allow firms to reduce the number of obligatory financial statements and save working time. A flat social tax would be particularly beneficial for micro- and small businesses, which have limited human resources to spare for dealing with taxation issues.



Tax evasion was an indicator of the ineffectiveness of the taxation system

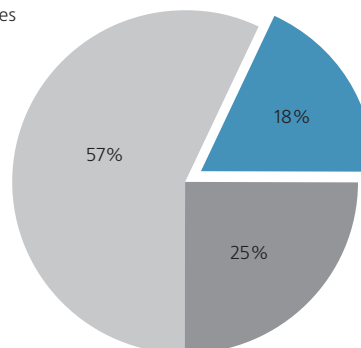
Tax evasion remained common practice among small and medium enterprises in Ukraine in 2004. Only 18% of respondents stated that companies similar to theirs did not underrepresent revenue for tax purposes (57% declined to answer the question). One in four respondents who admitted to tax evasion stated that they concealed more than 50% of revenue from taxation.

4.5

Only one in five respondents indicated that companies similar to theirs did not underrepresent revenue for tax purposes

% of respondents

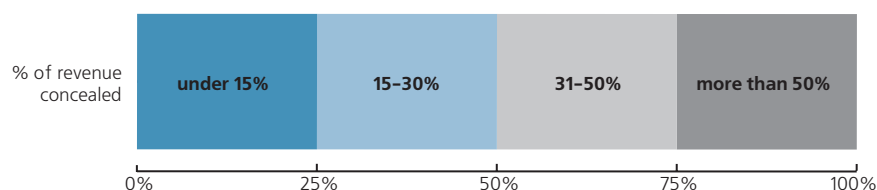
- Do not underrepresent revenues
- Refused to answer
- Underrepresent revenues



4.6

One in four respondents who underrepresented revenue estimated the amount concealed from tax at more than 50% of revenue

% of respondents underrepresenting income for tax purposes



One reason for tax evasion by businesses in Ukraine was the complexity of tax procedures. For example, respondents who paid tax under the general system at an average annual rate of 30–40% and who rated tax procedures as complicated were 1.8 times more likely to underrepresent revenue than those who gave the procedures a neutral or positive rating. The same correlation applied to those paying the flat tax.

In the years since independence, Ukraine has made progress in the development of its tax system, including an increase in state revenue, a gradual decline in tax rates, and the introduction of a simplified taxation system for the private sector.



“If the tax system were to become simple and straightforward, firms could stop devising [tax evasion] schemes, humbling themselves before the tax authorities, waiting in line, and doing all that mad bookkeeping.”

Focus group participant

Despite these positive accomplishments, however, entrepreneurs in Ukraine still regarded the system of tax administration as the most serious impediment to business development. Their perceptions stemmed mainly from the frequent changes in tax legislation and the complexity of tax procedures, which also contribute to further proliferation of the shadow economy in Ukraine.

Recommendations

- » Adopt a tax code, including provisions for clear, simple, and unvarying tax administration procedures, to stabilize and streamline the tax legislation applicable to small and medium-sized enterprises. All regulations inconsistent with the new tax code should be repealed to prevent misinterpretation by tax authorities.
- » Combine pension and mandatory social security contributions into a single tax to facilitate payroll tax calculation and payment procedures.

Permits



In September 2005, the Ukrainian Parliament passed the Law On the System of Permits for Business Activity, drafted by the State Committee on Regulatory Policy and Entrepreneurship of Ukraine in partnership with consultants from IFC. The key provisions of this framework law were designed to address problems faced by enterprises in the course of obtaining permits for doing business. The Law came into force on 6 January 2006 and provided for bringing into compliance with it all regulations having to do with permits. The survey findings reflect the situation before the Law was passed.

The survey showed that in 2004, as before, the permit system was a major regulatory barrier to business development. The Ukrainian permit system was characterized by its broad scope and by the complexity, long duration, and costliness of the procedures. Unofficial payments during the process were common.

- » In 2004, 43% of respondents had to obtain permits. One-third required more than three permits during the year.
- » The agencies from which the greatest percentage of respondents required permits were the Fire Department, the Sanitary and Epidemiological Service, and the Labor Protection Department. (Respectively, 34%, 26%, and 14% of respondents obtained permits from these agencies in 2004.)
- » About 90% of the most common permits were temporary, in that they were valid for a limited time because the recipients failed to meet all of the requirements established by the agencies issuing the permits. However, as in 2003, only 2% of respondents were denied permits.
- » 64% of respondents obtaining permits in 2004 considered the process of obtaining them difficult or very difficult.
- » The complexity of permit procedures promoted the growth of corruption. One-third of businesses surveyed made unofficial payments in the course of obtaining permits.



All businesses in Ukraine require permits

Under Ukrainian law, all businesses in Ukraine must apply for certain kinds of permits¹ as a prerequisite to starting a business. The current system is regulated by numerous legal acts and regulations, from laws to resolutions of local self-governance authorities. Permits are issued by government agencies, local self-governance authorities, and utilities. According to the State Committee on Regulatory Policy and Entrepreneurship of Ukraine, more than 1,200 permits currently exist in Ukraine. Obsolete and ineffective, the Ukrainian permitting system is in need of urgent reform.

Under the law, if a firm meets all fire safety requirements, a permit from Fire Department to begin operations² should be issued free of charge and should be valid for an unlimited period³. In practice, however, firms can rarely fulfill the many obligatory requirements, which are often obsolete and conflicting. As a result, enterprises are forced to resort to unofficial payments to obtain a permit. The permit-issuing agencies responsible for public safety acknowledge this problem and accommodate businesses by issuing a “temporary” permit, normally valid for one year. Thus, public safety is compromised, and business proprietors must keep going back to the authorities to “extend” the permit, arrange to repeat the assessment, and make official and unofficial payments.

The permit from the Fire Department is the only one that all firms in Ukraine must obtain regardless of the nature of their business or corporate form [Chart 22 in Annex]. However, the survey showed that in 2004, respondents obtained an average of three permits each. This was because the type of permits required and how frequently they had to be obtained or renewed depended on the nature of the company’s business. Businesses in the food industry obtained the highest number of permits or approvals (an average of six).

¹ A permit represents permission (an opinion, assessment, certificate etc.) for a business entity to do certain kinds of business or carry out particular individual transactions, and is issued in the form of evidence of a project assessment, approval, or other document, as required by the permit process.

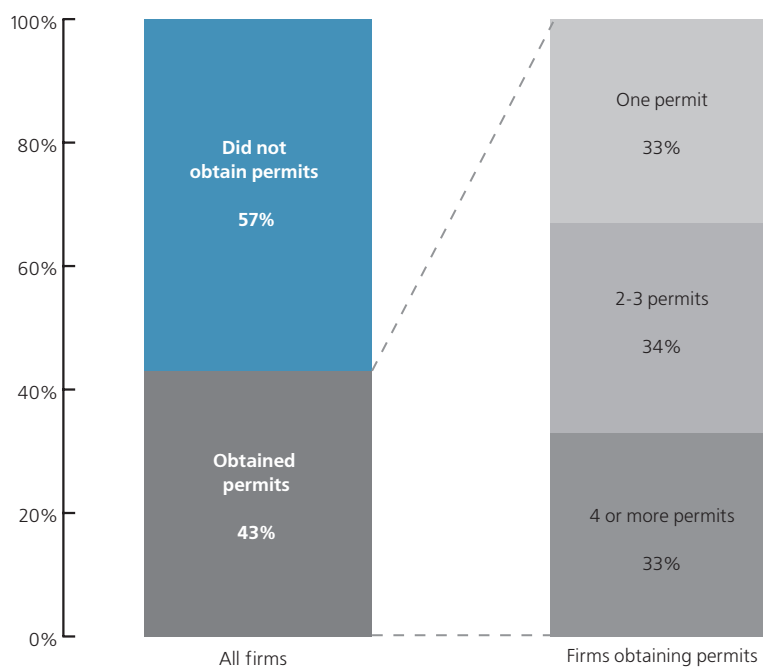
² The issuance of the permit for a start-up business to begin operations is regulated by the Law On Fire Safety, 17 December 1993, No. 3745-XII, Article 10.

³ Resolution of the Cabinet of Ministers of Ukraine On the Approval of the Procedure for the Issuance of Permits by the State Fire Department for Enterprises to Begin Operations and Lease Premises, 14 February 2001, No. 150.

5.1

More than 40% of respondents obtained permits in 2004

% of respondents



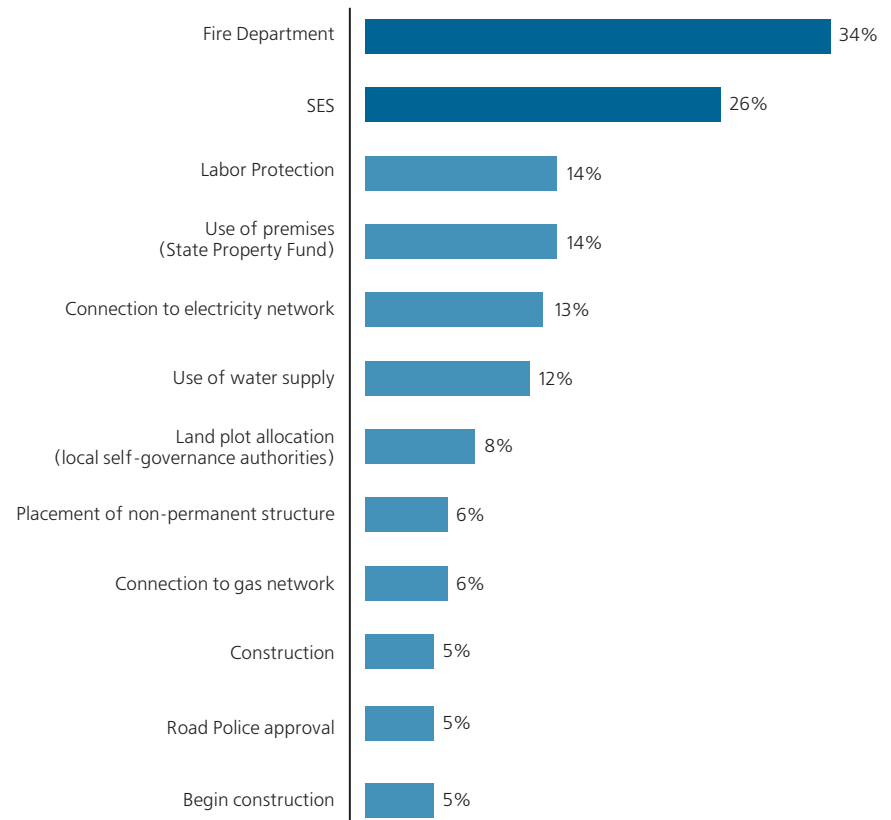


In 2004, the group of permits issued most commonly was virtually the same as in the previous year. Permits to begin operations, issued by the Fire Department and the Sanitary and Epidemiological Service, continued to be most frequently applied for in 2004. It is worth noting that, although the requirement to obtain a permit to begin operations from the Sanitary and Epidemiological Service was revoked as far back as in 2002,⁴ 26% of respondents undertook the complex procedure of obtaining that permit in 2004.

5.2

Permits from the Fire Department and the Sanitary and Epidemiological Service were obtained most commonly

% of respondents obtaining permits in 2004



⁴ The Law On Amending the Law On Public Sanitary and Epidemiological Safety, 7 February 2002, No. 3037-III, repealed the Order of the Chief Public Health Official of Ukraine, 23 April 2001, No. 51, which required enterprises to obtain a permit to begin operations from the Sanitary and Epidemiological Service.

Firms registered in 2004 spent an average of UAH 1,070 (\$202) and waited almost three and a half months to obtain permits. Businesses that had been in operation for more than a year spent an average of UAH 1,500 (\$283) and waited three months for their permits.

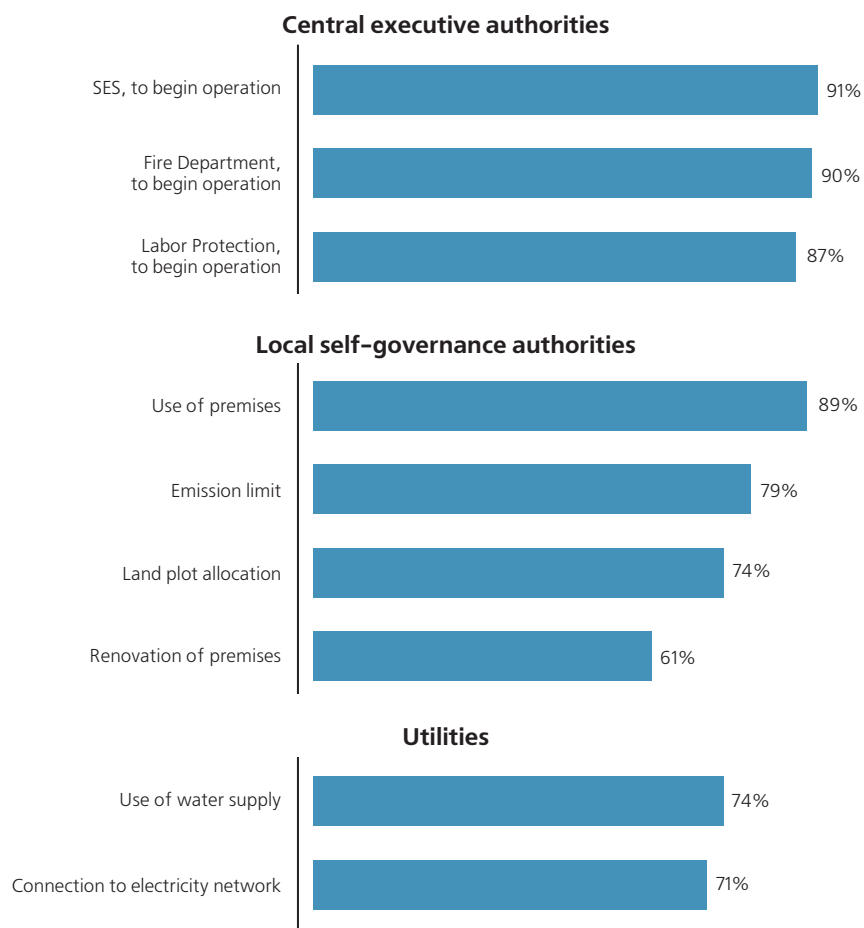
Firms cannot meet permit requirements

Most permits are issued for a limited validity period, at the end of which firms have to apply to state agencies again to renew them. Usually, temporary permits are issued for a term of 12 months. The most commonly issued permits in 2004 — from the Fire Department, the Sanitary and Epidemiological Service, and the Labor Protection Department — were valid for an unlimited term in one out of ten cases.

5.3

Most permits in 2004 were valid for a limited period

% of respondents obtaining temporary permits in 2004



Since temporary permits are issued chiefly because a firm has failed to meet the requirements of a permanent permit, the high percentage of temporary permits (about 90%) indicates a general inability to fulfill all of the requirements established by permit-issuing agencies.

At the same time, only an insignificant number of respondents were denied permits in 2004. For most permits, the figure did not exceed 2%, indicating that almost every enterprise applying for a permit obtained one. The number of denials has been low for several years, and the figure was the same in 2003. This speaks in favor of introducing the declaration principle in issuing permits, and for reviewing, consolidating, and reducing the number of compulsory requirements. The declaration principle allows the business proprietor to begin operations upon informing the appropriate government agency and undertaking to comply with requirements prescribed by the agency in question. This would reduce the time between registration and starting operations for start-up enterprises and save resources for existing firms.



“Every year, one needs to obtain a confirmation from the Sanitary and Epidemiological Service or other [permit-issuing] agencies that the permit will be extended. Often, their requirements are fair, but impossible to meet. That is why permits have limited validity.”

Focus group participant



The declaration principle is applied successfully in the countries of the European Union. In the “Land” (city-state) of Berlin (Federal Republic of Germany), 90% of businesses do not have to obtain a permit to begin operations. Whether a company needs one is determined based on risk. This approach assumes that only firms engaged in potentially hazardous business activities must obtain a permit. In all other cases, a new business can start operations upon simply informing the appropriate agency and declaring a commitment to meet all the requirements established by law.

The Law of Ukraine On the System of Permits for Business Activity provides for applying the declaration principle to permits for enterprises in which the business activity does not entail high risk. However, in order to implement it fully, appropriate changes to permit legislation will be required.

Permit procedures are complicated and unclear

In 2004, the large number of documents required, the very long processing periods, the lack of clarity in the requirements, and the need to apply to numerous agencies were cited as the main problems encountered during the permit process.

The survey showed that 64% of business proprietors considered permit procedures to be complicated or very complicated.

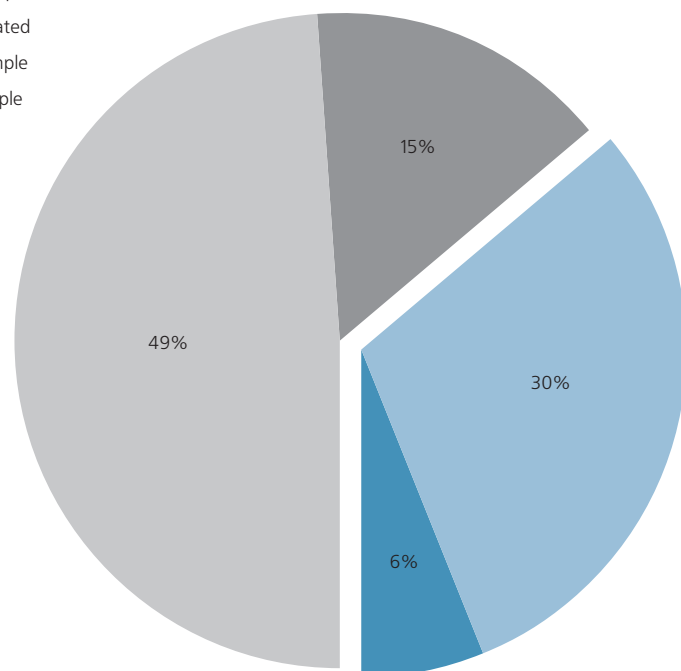


5.4

The majority of respondents considered permit procedures complicated

% of respondents obtaining permits in 2004

- Very complicated
- Complicated
- Fairly simple
- Very simple

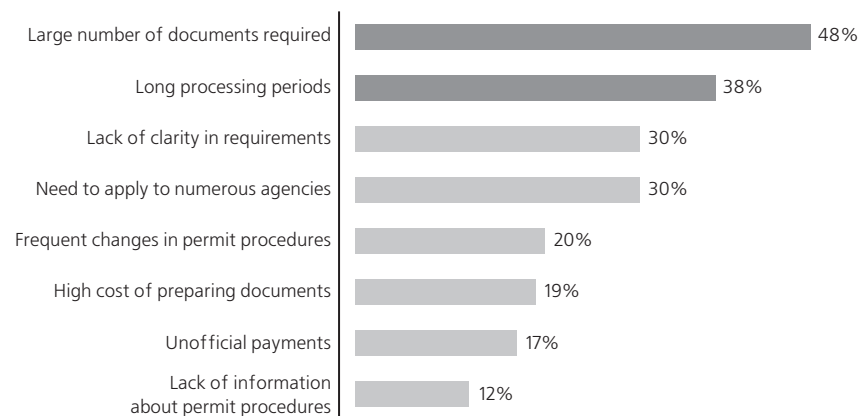




5.5

The number of documents and the long processing periods were the main problems encountered in obtaining permits

% of respondents obtaining permits in 2004



One in three respondents complained about the need to apply to many organizations to obtain permits. A solution to the problem is found in the Law On the System of Permits for Business Activity,⁵ which provides for creating the office of state administrator.

The state administrators will be appointed by the heads of district administrations to coordinate the process of issuing permits to entrepreneurs. Their main duties will include:

- provide entrepreneurs with complete and detailed information about processing periods, procedures, and costs involved in obtaining a permit
- receive and register documents submitted by entrepreneurs and transfer them to the appropriate permitting agencies and organizations
- coordinate activities and document workflow among permit-issuing authorities
- issue permits to entrepreneurs

Appointing a state administrator as intermediary between applicant firms and permit-issuing organizations will improve the process considerably, since the administrator will perform the procedures that entrepreneurs find difficult. Having a state administrator in place will reduce the number of contacts between entrepreneurs and civil servants, and thereby limit the potential for corruption. Entrepreneurs will still retain the right to apply directly to permit-issuing agencies without using the services of a state administrator.

⁵ Law of Ukraine On the System of Permits for Business Activity, 6 September 2005, No. 2806-IV.

The permit system promotes corruption

The survey showed that one-third of respondents made unofficial payments in the course of obtaining permits. The more complicated the process, and the more unclear the requirements, the greater the likelihood that business proprietors made unofficial payments. With almost all kinds of permits issued to businesses, the instance of unofficial payments was higher if permit procedures were described as complicated. For example, in the case of permits from the Fire Department and the Sanitary and Epidemiological Service, the likelihood of



making unofficial payments was 1.5–3 times greater among respondents who perceived the procedures as complicated or very complicated. The same was true for permits from Labor Protection Department, where the likelihood was 2–5 times greater.

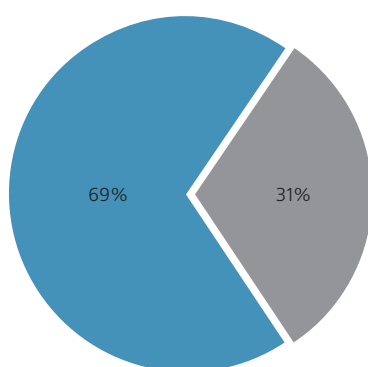
5.6

One in three firms obtaining permits in 2004 made unofficial payments

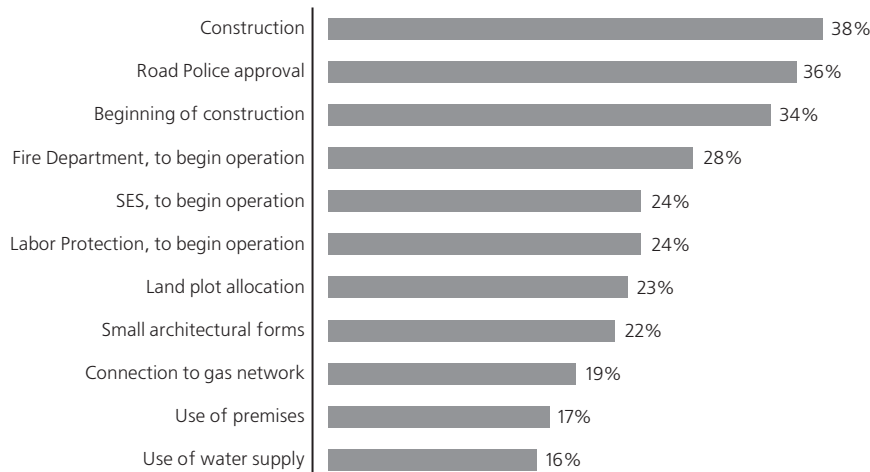
% of respondents obtaining permits in 2004

Firms obtaining permits in 2004

- Did not pay, or refused to answer
- Made unofficial payments



Unofficial payments made by type of permit



“The official says, ‘you need a permit, and we need this or that, and if you help us, we will help you.’ And an employee comes and shows us a receipt for office supplies or subscriptions to magazines or newspapers.”

Focus group participant



“One needs to pay ‘fees’ to bureaucrats to obtain almost any kind of permit; only the amount varies.”

Focus group participant

Unofficial payments often take the form of buying office supplies or subscription to periodicals and a contribution to charitable organizations. Fire safety legislation even provides for the possibility of financing the Fire Department’s operations through voluntary contributions from individuals and legal entities.⁶ In situations where an assessment is required in order to obtain a permit, permit-issuing agencies often drive entrepreneurs to pay for the services of their own assessment departments instead of using independent inspectors. For example, entrepreneurs are inclined to use the Fire Department’s assessment services because, that way, the assessment for permit purposes simultaneously completes the annual planned inspection by the Fire Department. Fire Department officials, claim that assessments are made and permits are issued free of charge, but only 10% of respondents said that they did not pay for fire safety permits.

A lack of accurate and clear information about permit procedures, requirements that are impossible to meet, and the government monopoly on performing assessments and issuing expert findings create the conditions where civil servants can demand unofficial payments from entrepreneurs.

The problems faced by businesses in obtaining permits in 2004 are the product of an ineffective and obsolete permit system and more evidence of the need for comprehensive reform. The Law On the System of Permits for Business Activity, passed by the Ukrainian Parliament in September 2005, provides a mechanism for resolving these problems.

⁶ Law of Ukraine On Fire Safety, December 17, 1993 No 3745-XII (Article 24).



Key provisions of the Law On the System of Permits for Business Activity

1. Requirements for permits can only be determined by laws, and not by controlling agencies themselves. Whether a permit is needed, whether it is issued for a fee or free of charge, the processing time for granting/denying a permit, and the grounds on which a permit can be denied/revoked, can only be stipulated in laws.
2. The business proprietor has the option to apply for a permit to the appropriate permit-issuing agency or to a state administrator, who organizes the issuance of the permit and oversees the interaction among local permit-issuing agencies during the permit process.
3. The declaration principle is introduced, which allows a business owner to do business without first obtaining a permit by informing the administrator or the appropriate permit-issuing agency that the business facilities conform to legal requirements.
4. Permit application processing periods are limited. Under the Law, the processing period cannot exceed 15 business days.
5. The requirement is eliminated for lessees and other occupants of premises to obtain permits if the premises or facilities are occupied temporarily on the basis of a lease or other agreement, on condition that the nature of the business does not change and that the premises or facilities are used in accordance with their intended purpose.
6. Public officials authorized to issue permits are held liable for illegal actions. The final provisions of the Law stipulate amending the Ukrainian Code of Administrative Offences to include a clause providing for holding public officials liable if they violate entrepreneurs'

Recommendations

The following steps will further improve the permit system:

- » Bring regulations into compliance with the provisions of the new Law On the System of Permits for Business Activity as soon as possible:
 - stop issuing permits not required by law
 - set out permit procedures only through laws and resolutions passed by the Cabinet of Ministers of Ukraine
 - allow 80-90% of firms to obtain permits through the declaration principle, in accordance with EU practices
 - enhance communication between government organizations and entrepreneurs by introducing the office of “state administrator”
- » Introduce a system based on risk assessment, determining the necessity for obtaining permits according to the degree of risk to public and environmental safety. (No risk: cancel the requirement for a permit; low risk: apply the declaration principle; high risk: require a permit.)
- » Harmonize technical regulations with respect to public safety with EU standards:
 - review mandatory standards and regulations and develop lists of minimum requirements for businesses: general technical regulations

Inspections



The most distinctive features of the Ukrainian inspection system are the high incidence of inspections, their costliness, and their ineffectiveness in detecting and preventing violations.

- » The system of government inspections is redundant and inefficient: 78% of firms were inspected in 2004, each undergoing nine inspections on average.
- » One-fifth of respondents whose businesses were inspected admitted making unofficial payments to inspectors. Officials of the Ministry of Internal Affairs, the Fire Department, the Sanitary and Epidemiological Service, and the Tax Administration asked for unofficial payments most frequently.
- » In 2004, small and medium-sized enterprises alone went through more than 1.4 million inspections, which cost the companies surveyed a total of UAH 500 million, including fines and unofficial payments.
- » Keeping an inspection log was the tool most frequently used by entrepreneurs to protect their rights.



The number of inspection visits remained high

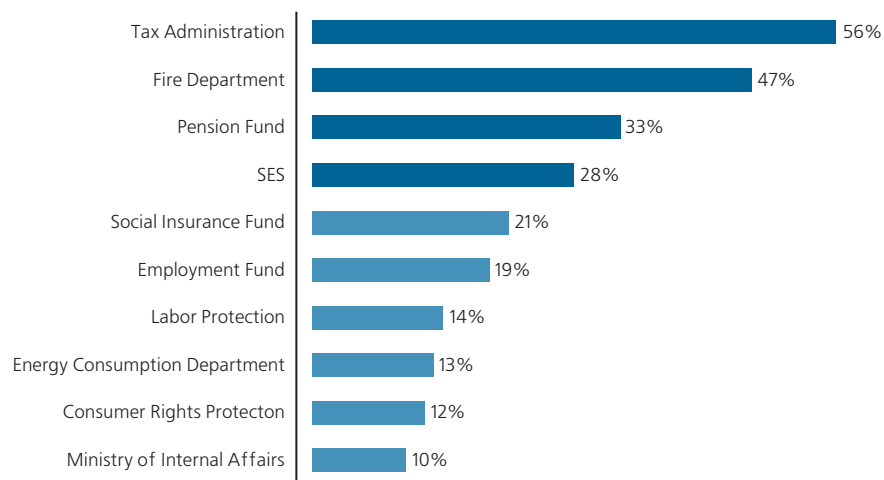
The percentage of businesses inspected decreased from 84% in 2003 to 78% in 2004.

The agencies conducting inspections most frequently included the Tax Administration, which inspected 56% of all respondents who were inspected, the Fire Department (47%), the Pension Fund (33%), and the Sanitary and Epidemiological Service (28%).



The Tax Administration, Fire Department, Pension Fund, and Sanitary and Epidemiological Service showed the most inspection activity in 2004

% of respondents inspected by the given authority in 2004



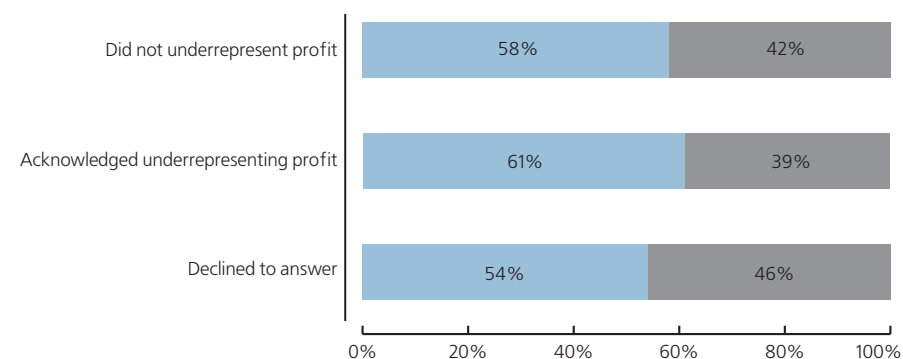
The high incidence of inspections was a result of an ineffective system of targeting and conducting them. In 2004, the tax authorities inspected just slightly more than half of the respondents who underrepresented their profit for tax purposes. It can be concluded that the Ukrainian inspection targeting system is not much more effective than random selection.



The system of selecting enterprises for inspection is not effective

% of respondents

■ Inspected ■ Not inspected





“As soon as the director of my company decided to pay a legal salary, I found myself under fire from tax authorities. Why? Because we were showing all expenses and legal salaries, which were still high even after all the social security deductions. As a result, the net income dropped. Now the tax authorities are after us because we pay low income tax. Why do I need to make excuses all the time?”

*Focus group participant,
company owner*



“The inspector told me point blank that he needed to split whatever fee he would get from me with ... other inspectors, but I still had to pay the tax and he would not leave empty handed.”

Focus group participant

¹ According to a focus group participant.

The high incidence of unofficial payments encouraged non-compliance with the standards inspected

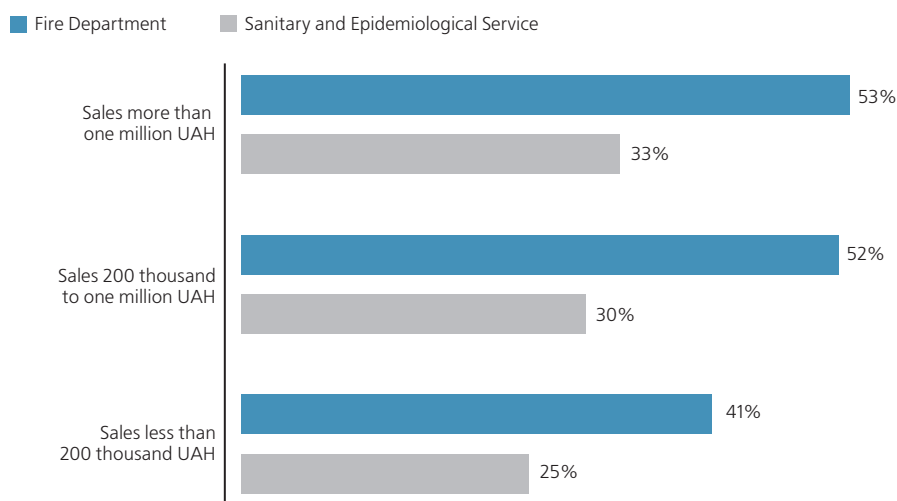
Despite the massive scale of tax control, tax inspectors could not find any violations in more than half of the firms undergoing inspections.

Even though inspections by the Fire Department and the Sanitary and Epidemiological Service do not involve the financial condition of businesses, their approach to conducting inspections in 2004 revealed a correlation between a firm’s earnings and the likelihood of its being inspected.

6.3

Despite the stated objective of inspections, agencies inspected firms with higher earnings more frequently

% of respondents inspected by the given authority in 2004



This focus is not surprising: a high-activity business is much more likely to be subject to rules and laws of which the proprietor is not aware, and the likelihood of finding fault during an inspection is therefore much greater.

In addition, companies with higher earnings (and therefore with more profit to lose from ceasing operations) are more inclined to make official or unofficial payments when faced with a direct threat along the lines of “I will shut down your business right now.”¹ The inspector’s ability to cause problems for the firm undergoing inspection, even before any violations were actually detected, was the main reason why some respondents (about 20%) made official or unofficial payments during inspections even when the inspector found no evidence of violations.

Unofficial payments undermine the correlation between violations and penalties, which limits the ability to achieve the main goal of inspections—to prevent offences. Often, when faced with a choice between making an unofficial payment and eliminating a violation, an entrepreneur will choose the least-costly option. One-fifth of firms undergoing inspections paid the authorities unofficially. The survey showed that in 2004, unofficial payments were received most frequently by officials of the Ministry of Internal Affairs, the Fire Department, and the Sanitary and Epidemiological Service.



Unofficial payments pose a particular kind of security threat to society. The survey showed that in 2004, the authorities inspecting the safety of business operations (Ministry of Internal Affairs, Fire Department, Sanitary and Epidemiological Service) demanded unofficial payments more frequently than did those inspecting the accuracy and timeliness of tax remittances and mandatory social security contributions to the Tax Administration, the Pension Fund, and the Social Security Fund.

The 2004 survey revealed that the Ukrainian system of imposing penalties for tax-related infractions not only does little to prevent violations, it actually encourages them. For example, the more money a firm conceals from taxation, the less onerous the penalty and the more likely that the firm will resort to making unofficial payments during inspections. The total amount of penalties and unofficial payments at firms concealing less than 200,000 UAH from taxation came to 19% of the amount concealed. Penalties and unofficial payments for enterprises concealing more (between 200,000 and 3 million UAH) were only 1% of the amount concealed.

One factor that encourages unofficial payments is the complexity of the requirements and the lack of information about inspection procedures. The survey found that 40% of respondents who experienced problems during inspections also complained about the ambiguity of requirements, with one in five referring to the lack of information about inspection procedures.



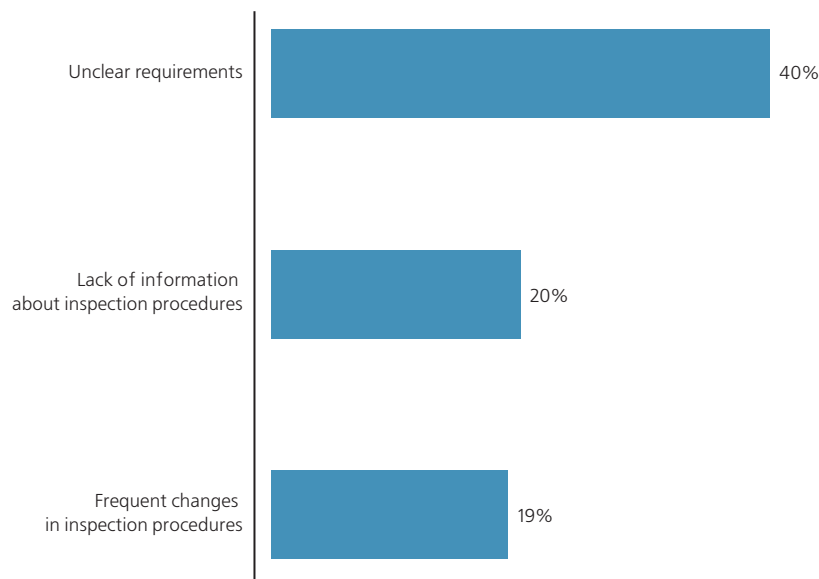
“You should understand that the way it works is like that line from a popular movie: “In this country, it is easier to steal big.”

Focus group participant



Unclear requirements and lack of information were major problems for SMEs

% of respondents experiencing problems during inspections



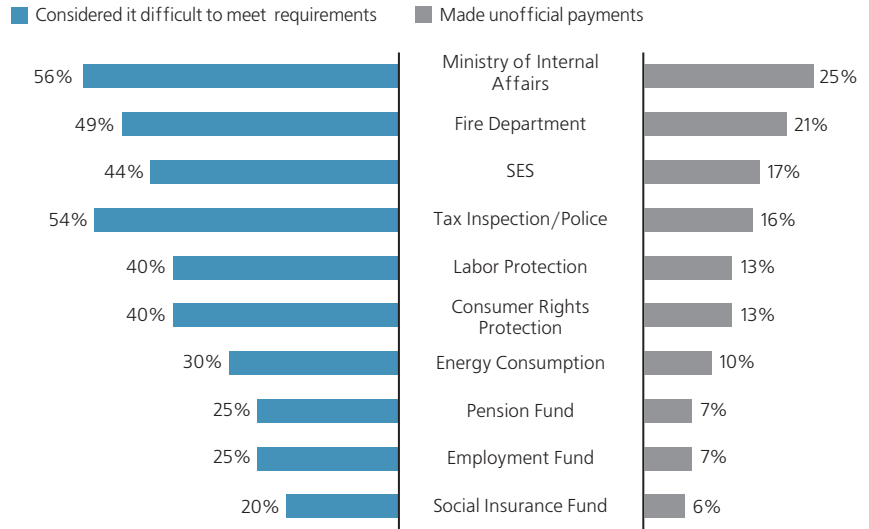
Real and perceived difficulties in meeting requirements often forced respondents to seek a compromise with inspectors through unofficial payments. The survey showed that the more difficulty a firm had in meeting standards, the more likely it was to make unofficial payments to inspecting agencies.



6.5

The inspecting agencies demanding unofficial payments most frequently were the ones setting requirements most difficult to meet

% of respondents inspected by the given authority in 2004



The inspection system is very time-consuming and expensive for the government and for small and medium-sized enterprises

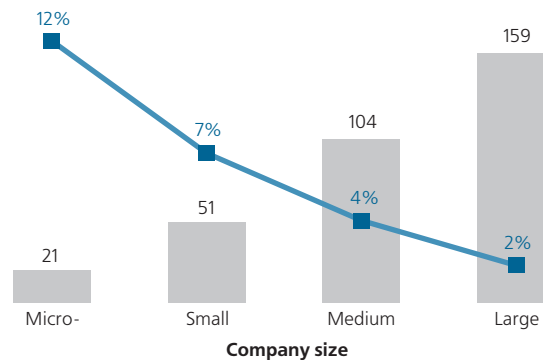
In 2004, the firms surveyed (with fewer than 1,000 employees) were inspected a total of more than 1.4 million times, which involved at least 24,000 inspecting agency officials.

The total time spent on dealing with inspecting agencies came to 16 million working days in 2004. In 2004, small and medium-sized enterprises suffered most acutely from the diverting of human resources. Even though tax inspections occupied a greater number of employees at large enterprises, the loss of business hours during tax inspections caused the most trouble for micro and small firms.

6.6

Smaller firms suffered the most lost working time due to tax inspections

■ Number of man days per firm spent on inspections in 2004
 ■ Work time spent on inspections, as a percentage of total work time at the firm in 2004





The Tax Administration was ranked as the most “expensive” among all agencies inspecting companies in 2004, both in the number of staff involved in the inspections and in the amount of money paid. The Fire Department was second.

The total cost of inspections for all respondents, official and unofficial payments combined, approached UAH 500 million in 2004.

6.7

Inspections by the Tax Administration, Fire Department, and Social Security Funds were the most expensive for SMEs

Inspecting agency	Staff involved in inspections man days, million	Total amount actually spent by firms UAH, million
Tax Administration	8.8	270
Fire Department	1.1	73
Social Security Funds	1.2	43
Sanitary and Epidemiological Service	1.7	15
Other	3.6	85
Total	16.4	486

Risk-based inspections

A system of risk-based inspections is a good alternative to mass inspections.

The existing system of government control over the private sector is based on inspecting all premises, procedures, and activities, regardless of the degree of risk inherent in the business or its inspection history. The regulating authorities must inspect everyone, always, and collect a great deal of information.

The risk-based approach eliminates groundless inspections and unjustified demands for information. Instead of routinely trying to screen all firms, the system focuses on inspecting only those businesses where the risk is highest.

The system of risk-based inspections includes:

- Risk analysis and risk assessment based on objective technical criteria
- Risk categorization, grouping businesses by degree of inherent risk, with set frequency of inspections for each group and measures designed to reduce the risk
- Risk awareness, which means collecting information about risks, distributing it among regulating authorities, and using the information to plan inspections

The new inspection system will help to:

- Use the resources of inspecting agencies more effectively, since inspections will focus on enterprises posing the greatest risk
- Relieve the burden on law-abiding firms



- Reduce the instance of improper conduct by government officials
- Discourage unfair advantage by providing incentive to law-abiding firms and penalizing law-breakers
- Increase business productivity, since entrepreneurs will know, at the start-up stage, when inspections are due

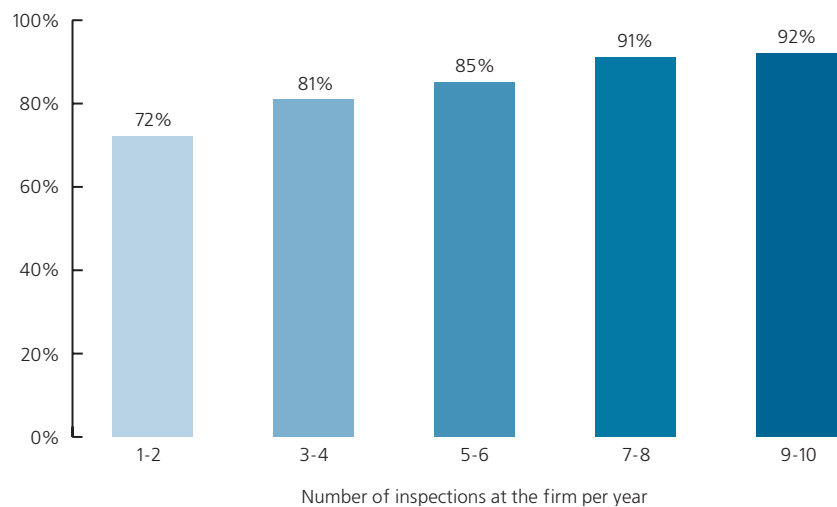
Formalizing inspection procedures curbed the number of inspections

An inspection log was the tool most frequently used by business proprietors to reduce the number of groundless allegations leveled by inspecting authorities. Most firms surveyed in 2004 (78% of respondents) kept one, and inspectors always filled it out (58% of respondents keeping an inspection log) or almost always did so (27%). According to the survey, the more times a firm had been inspected, the more likely it was to maintain an inspection log. It can be concluded that the inspection log helps to address some of the problems with inspections; for example, by keeping the number of unauthorized inspections in check.



The likelihood of keeping an inspection log increased with the number of inspections to which the firm was subject

% of respondents who kept an inspection log and were inspected in 2004



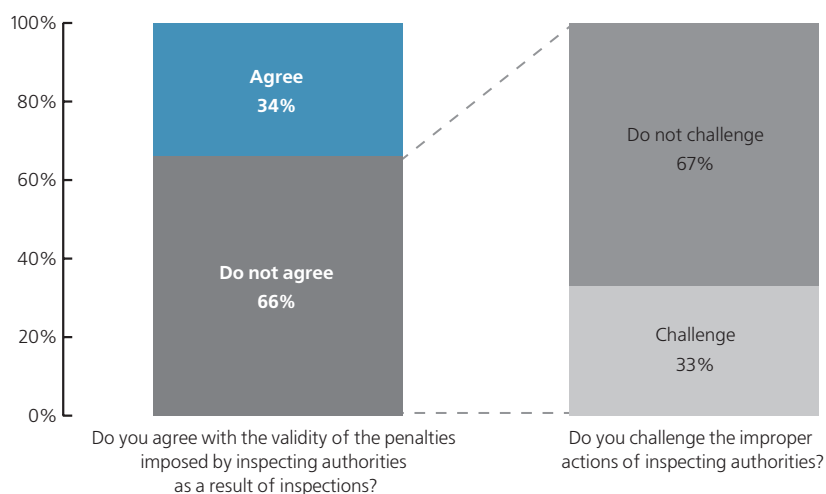
“The log makes inspectors (and not only them) render their findings in a more substantiated way.”

Focus group participant

On the other hand, because of limited recourse to the courts to challenge the actions of inspecting authorities, the effect of maintaining an inspection log alone was not enough to relieve the burden placed on SMEs by inspections. If a business proprietor does not take legal action against an inspector, even when he knows that justice is on his side, the evidence of the inspection log will be of little value. The reason for their reticence was lack of confidence that they could win the case in court or successfully appeal to any other government institution. (A more detailed analysis is given in the chapter *Entrepreneurs’ Perception of State Authorities.*)

**6.9****Entrepreneurs rarely took legal action against inspecting agencies**

% of respondents who were inspected in 2004

**Recommendations**

» Implement the provisions of the Law On the Protection of the Rights of Entrepreneurs During Government Inspections and Oversight of Business Activity. The key principles of the Law include:

- Base inspections on risk assessment, with classifications determining the frequency of inspections according to:
 - type of business
 - degree of risk the business presents to public health and safety and to the environment
 - inspection history
- Restrict the scope of inspecting officials' authority and introduce accountability for inspecting agencies for omissions or failure to perform their duties.
- Develop a standard inspection checklist.
- Grant businesses more power to defend their rights during inspections. (for example, record an inspection on audio\video tape or engage third parties to represent entrepreneurs before inspecting authorities.)
- Prohibit inspecting agencies from financing their operations using funds collected from penalties imposed on businesses.

Regulation of exports



Growth in the percentage of exporters among small and medium-sized enterprises was hindered by regulations, problems with VAT reimbursement, and lack of funds for foreign market research and promotion.

- » In 2004, enterprises in Ukraine had limited export capacity, primarily due to internal difficulties. Of the companies planning to export, 28% cited regulatory procedures as an inhibiting factor and 25% mentioned commercial factors.
- » VAT reimbursement became an even more serious problem for exporting firms. Of the respondents exporting, 64% complained of difficulty with VAT reimbursement in 2004.
- » Tension between the government and exporting companies was particularly marked during customs control. Of the exporting firms surveyed, 44% were convinced that the number of export-related documents required by government organizations increased in 2004.
- » Due to lack of resources, most exporting firms either did not actively market to potential foreign clients or relied only on partner recommendations and the Internet. Only 6% of the respondents exporting used information available from Ukrainian embassies abroad, and 26% obtained information from the Ukrainian Chamber of Commerce and Industry.
- » Respondents were in favor of Ukraine's membership in trade partnerships. Accession to the World Trade Organization (WTO) and the Common Economic Zone (CEZ) was supported by 40% of the companies surveyed and only 6% were opposed.



Regulatory procedures were a major factor inhibiting existing and potential exporters

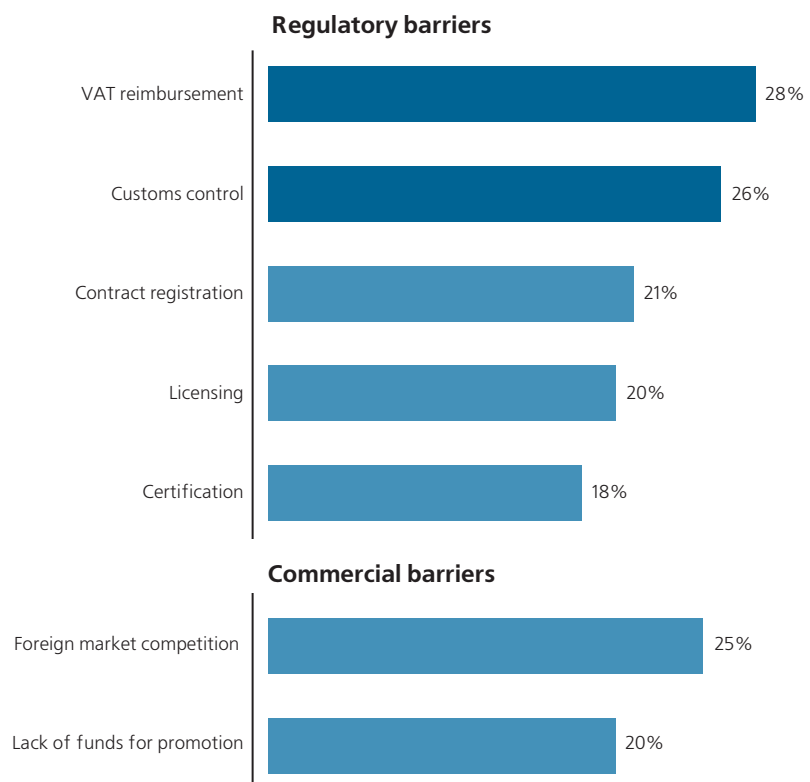
The number of small and medium-sized enterprises exporting remained insignificant in 2004, increasing to 6% of respondents from 5% in the previous year. A further 2% planned to export, but could not carry out their plans for various reasons.

Survey participants cited regulations, VAT reimbursement, customs control, and contract registration as the main issues hampering exports. Commercial factors such as competition and lack of funds for marketing and promotion were less significant for prospective exporters.



VAT reimbursement and customs control were major obstacles to entry into foreign markets by SMEs in 2004

% of respondents planning to export but failing to do so



Exporting respondents stated that regulations in Ukraine and lack of funds for foreign market research and promotion were a serious hindrance to foreign trade. It is worth noting that macroeconomic factors such as the exchange rate and foreign economic conditions, which normally affect demand for Ukrainian exports directly, were reported to be less significant than regulatory and commercial factors.

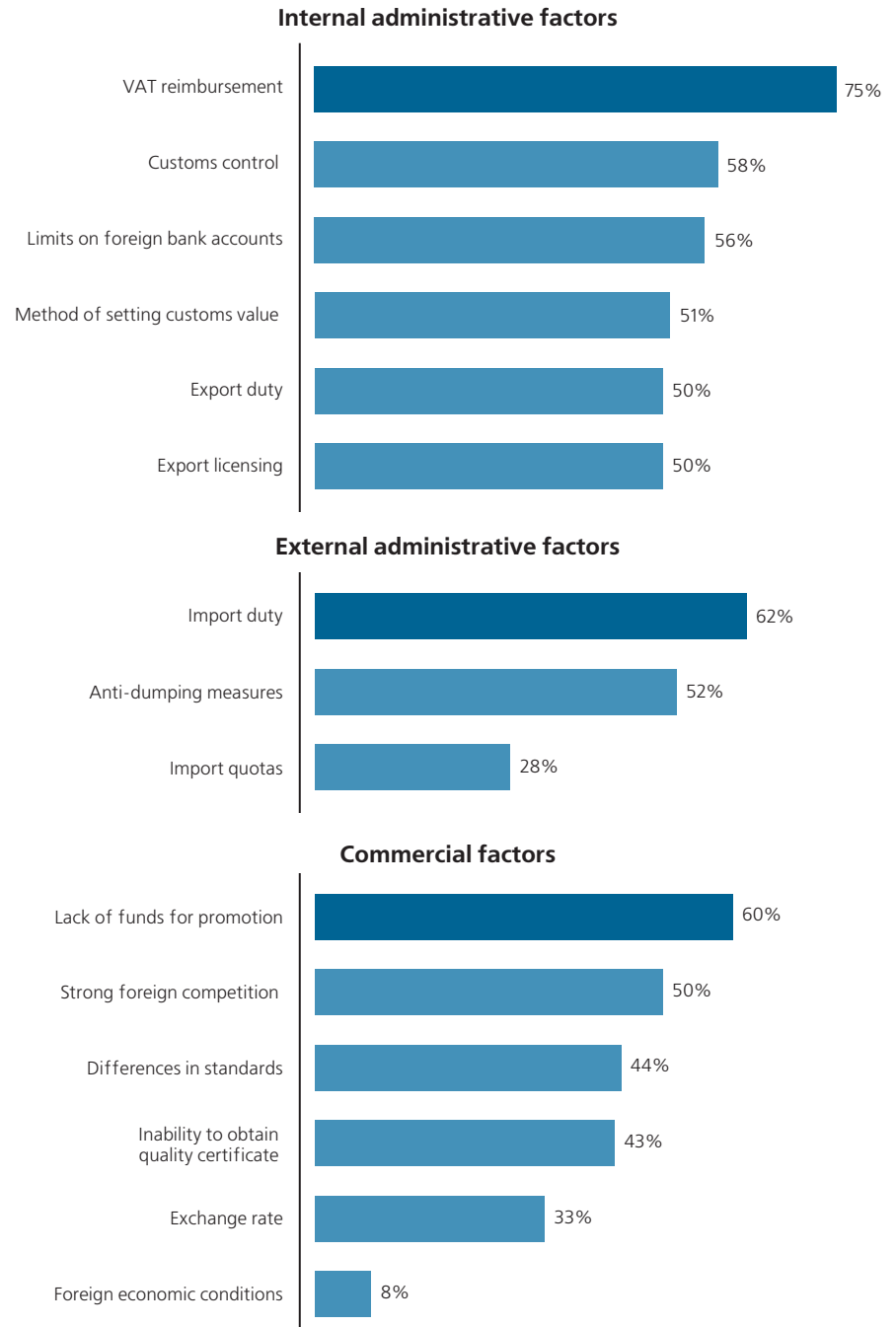
The significance of regulatory barriers compared with that of non-regulatory barriers suggests that the export capacity of SMEs in Ukraine is limited more by internal factors than by foreign demand for their products. In light of that, improving the regulatory environment will provide better incentive for local exporters than, for example, monetary and foreign currency measures.



7.2

VAT reimbursement, import duty, and lack of funds for promotion were major factors inhibiting exports in 2004

% of respondents exporting who stated that the given factor inhibited their ability to export



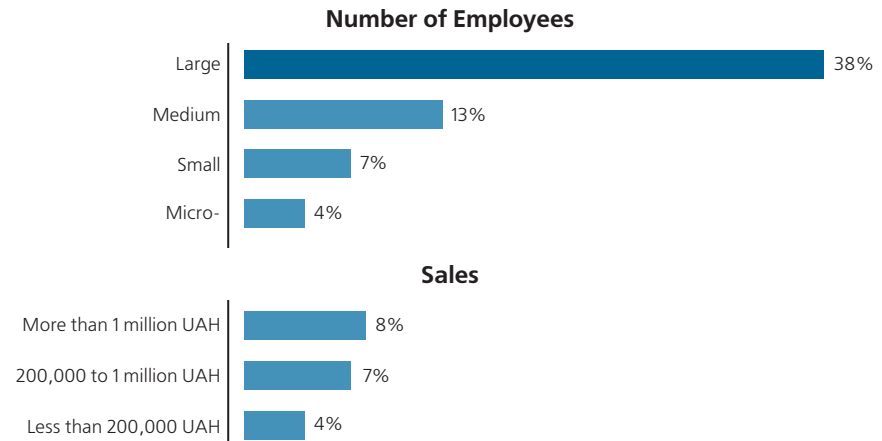
¹ Studies of the factors influencing export capability demonstrate that firms usually begin to export when the number of employees exceeds 20. Example: "How Big is Big Enough? Firm Size as a Barrier to Exporting in South Carolina's Manufacturing Sector," CUCIT Working Paper #000701.

The number of employees was another important factor driving the ability to export.¹ In a complex and shifting business environment, it was not the availability of funds but rather sufficient human resources that helped business to overcome regulatory barriers.

7.3

Firm size was a more important factor than sales revenue in the ability to export

% of respondents exporting



Clearly, the number of employees had more weight than sales revenue in the decision to export. The shortage of human resources greatly affected micro- and small enterprises, pushing exporting out of reach for most of them. The export capacity of micro- and small firms was therefore limited by the regulatory environment in the country, since these firms did not have employees who could devote enough time to overcoming regulatory and administrative barriers.

VAT reimbursement was a serious problem, not only for exporting firms, but also for the government

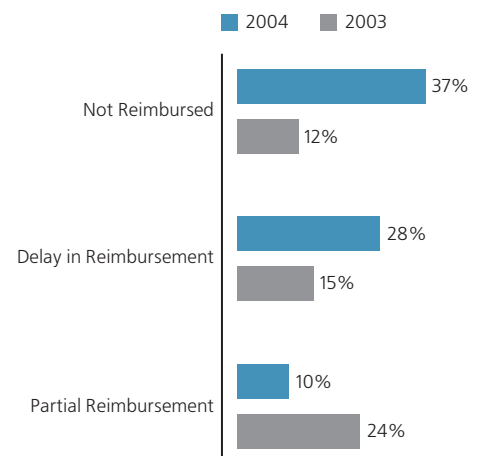
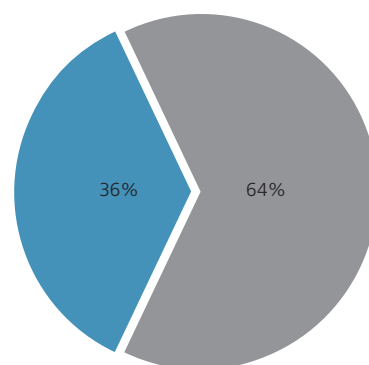
Two-thirds of the exporting respondents had difficulty with VAT reimbursement in 2004 – an increase from previous year, when the problem was reported by approximately half of the respondents.

7.4

Two out of three exporting firms experienced difficulty with VAT reimbursement

% of respondents

■ Did not face problems ■ Faced problems



“If you export, recovering VAT is virtually impossible.”

Focus group participant

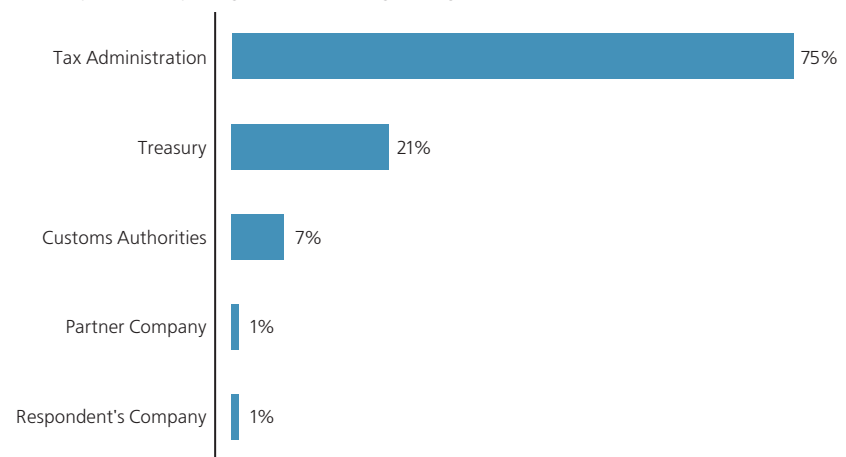


The number of exporting firms that did not recover VAT in full decreased, but the number of those not recovering any at all increased in 2004. This was due to changes in the government's VAT reimbursement policies, tax privileges for producers, and a growing number of fraudulent VAT reimbursement claims. The amount of VAT reimbursement claimed was almost equal to VAT revenue in 2004, whereas in 2003, the ratio of amount claimed to revenue was 4 to 5.² Lack of state funds and rampant abuse of power were cited as the main causes of the government's selective approach to reimbursing VAT to exporting firms. Only 30% of exporting businesses recovered a portion of VAT by using intermediary companies.³ Exporting respondents were of the opinion that the responsibility lay primarily with government agencies—the Tax Administration (75% of respondents) and the State Treasury (21%).



Tax Administration and the Treasury were mostly to blame for delays in VAT reimbursement

% of respondents exporting who blamed the given organizations



² Zerkalo Nedeli Weekly, Issue 40 (515), October 9-15, 2004.

³ The benefit of hiring an intermediary was evident from the survey. Firms that managed to recover VAT on their own in 2004 obtained an average of 20% to 35% of the amount due, whereas firms using intermediaries obtained an average of 40% to 60%.

⁴ Only half of the exporters taking legal action recovered VAT in 2003.

Only one in five respondents sued to recover VAT, and those who did won in most cases. Since two-thirds of the litigators recovered VAT, the number of lawsuits for VAT reimbursement can be expected to grow.⁴

However, given a lack of state funds available for reimbursing VAT in full, it may be safely assumed that the government will question the expediency of reimbursing the tax to exporting enterprises. At the very least, firms should expect a modification of VAT administration rules.

Despite consolidation of the legislation, customs procedures remained complex

A new Ukrainian Customs Code, designed to consolidate tax laws and eliminate discrepancies in the requirements for firms engaged in foreign trade, was enacted in 2004. However, the Code was amended four times during 2004, with some clauses being modified twice. Therefore, both exporting and non-exporting respondents considered the instability of legislation to be a barrier to business development, and 41% of the exporters surveyed stated that the number of changes to export procedures increased in 2004.



Over all, more than half of the exporting respondents reported that it was difficult to obtain information about export procedures from government organizations in 2004. One in four participants stated that the quality of information support had deteriorated compared with the previous year.

Tension between the government and exporting businesses was particularly significant in the course of customs control. Since customs clearance is considered complete only after submitting the goods for sanitary-epidemiological, veterinary, plant biology, ecological, radiological, and cultural heritage control, all of which is performed by other organizations at the customs checkpoint, these procedures affected the respondents' opinions of customs formalities. One-third of the exporting firms complained about the poor quality of the information available from Customs officials in 2004, and 12% of respondents noted that it had deteriorated compared with the previous year.

Of the respondents exporting, 44% were convinced that the number of documents required by government agencies had increased in 2004. According to estimates by Customs experts, a firm in Ukraine wishing to export in 2004 had to obtain and present at customs up to 46 permits from 13 government organizations, depending on the type of goods. One in three exporters stated that export procedures took longer in 2004.

Four out of five exporting firms had difficulty obtaining an export licenses

The survey showed that about 20% of exporters obtained various export licences in 2004. In order to conduct foreign business, enterprises in Ukraine need a variety of licences to export goods, export batches of goods (if the firm operates under the individual licensing regime), or export a certain quantity of goods (if the transaction is subject to quoting). To obtain a license, exporters have to present an extensive array of documents to the licensing authorities. Very frequently, the documents repeat information submitted to the same or other government organizations earlier, such as copies of statutory documents, certificates of registration, and so on. Respondents spent an average of 29 business days on completing the procedure and an average of 3,300 UAH per licence.

More than 80% of exporters obtaining licenses viewed the procedure as complex. About half of the exporters obtaining licenses reported difficulty with obtaining the necessary information. The same number admitted to making unofficial payments in the course of obtaining a license.

Most exporters did not look for partners

Lack of funds for foreign market research and promotion was a serious problem affecting the ability of firms to do business abroad. Due to shortage of funds, most exporting firms either did not look for partners or restricted themselves to partner recommendations and the Internet. Only one-third of the survey participants had a website.

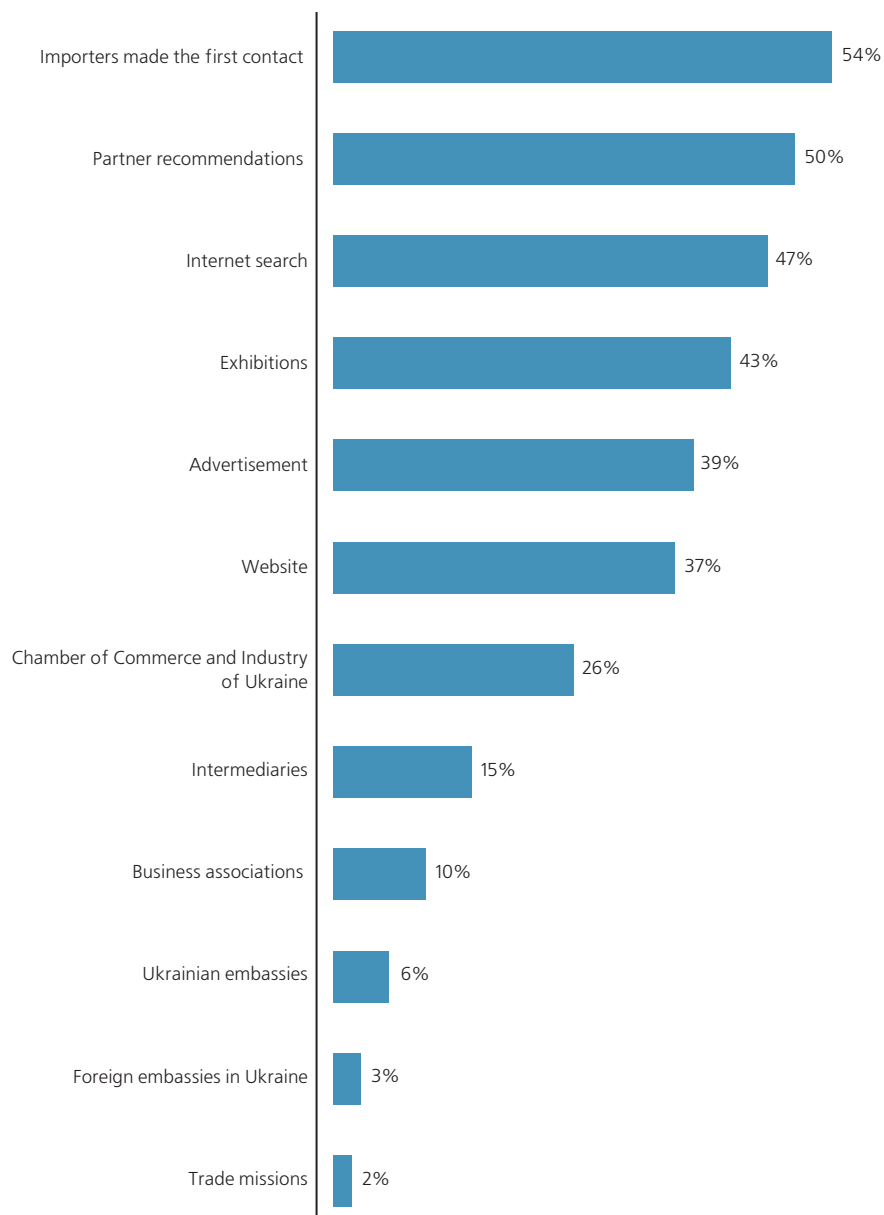
The survey showed that local exporters did not use the services of business associations or Ukrainian embassies and trade missions to find partners. This may indicate that these organizations are not sufficiently focused on promoting Ukrainian business internationally.



7.6

Most exporting firms did not look for partners

% of respondents exporting



Exporters favored Ukraine's accession to WTO and CEZ, as did other respondents

Nearly half of the exporting respondents (46%) favored Ukraine's accession to both the World Trade Organization and the Common Economic Zone. Pro-integration feeling was stronger than in the previous year, when 33% supported membership in both organizations. The increased support for integration was accompanied by a decline in the number of those who disagreed that membership in these organizations could influence their businesses. Exporting respondents who had no preference regarding membership in the two organizations dropped from 25% to 20% since the previous year.



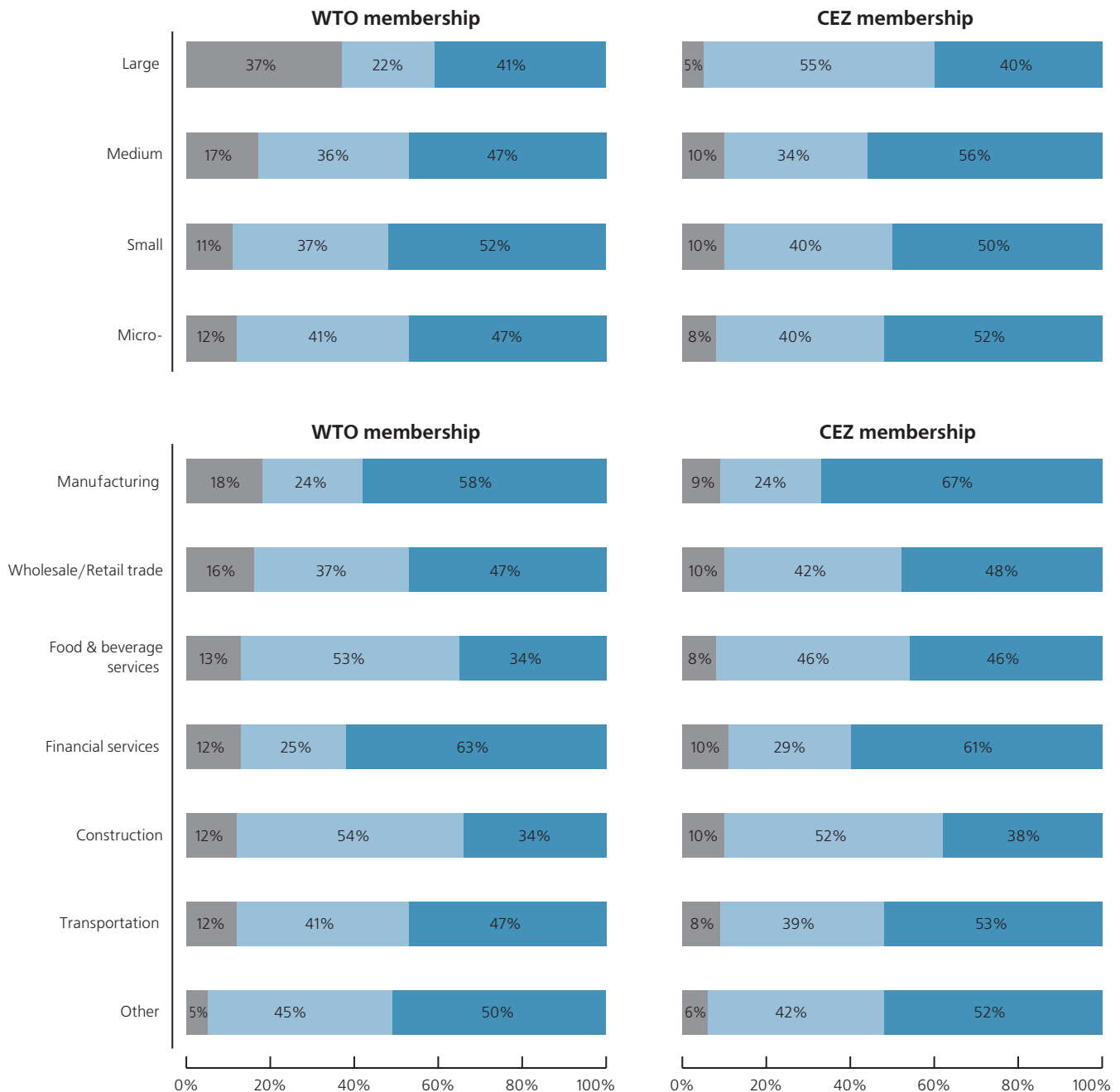
At the same time, respondents who felt that their exports would be adversely affected by Ukraine's joining the WTO and CEZ increased from 2% in 2003 to 7% in 2004. As before, the number of exporters who favored membership in the CEZ alone was greater than the number who advocated WTO accession.



The largest segment of respondents believed that accession to the WTO and CEZ would be a positive influence on their businesses

% of respondents exporting, by firm size and business sector

■ More of a negative influence ■ No influence ■ More of a positive influence





Interestingly, the opinions of exporters regarding membership in trade alliances reflected the views of respondents over all. Membership in both organizations was supported by 40% of all survey participants, with 6% opposed to integration. The remainder did not have an opinion or favored membership in one of the organizations.

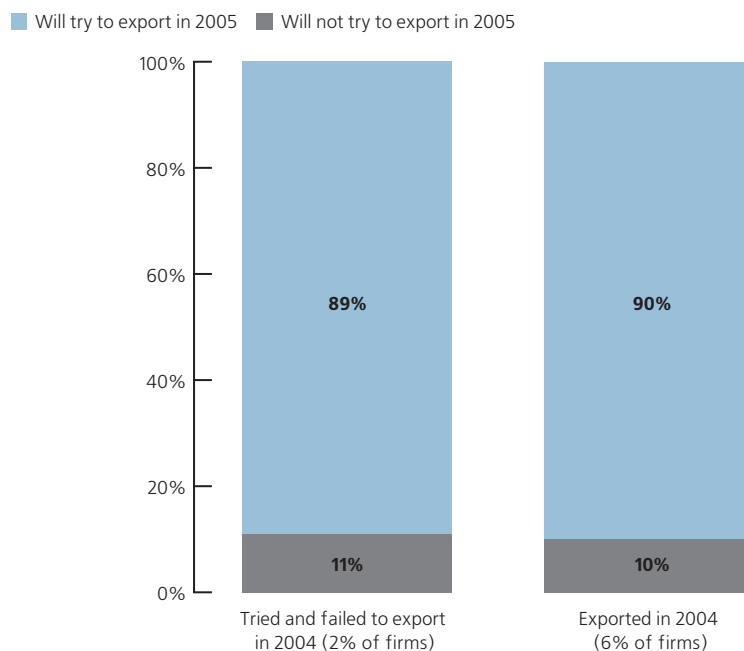
If the regulatory environment does not change, no more than 7% of SMEs will be exporting in 2005

According to the survey, roughly one-tenth of respondents who had planned to enter foreign markets in 2004, but failed in their attempt, did not plan to try to export in 2005 due to various problems with export transactions. A similar number of those who did export in 2004 decided to stop export operations in 2005.



The vast majority of respondents who tried and failed to export will try again in 2005

% of respondents, who exported or tried and failed to export in 2004



Recommendations

- » Streamline VAT reimbursement and customs control procedures by shortening the list of documents required for customs and other kinds of clearance of goods. Bring customs clearance procedures in line with international standards with a view to joining the International Convention on the Simplification and Harmonization of Customs Procedures (the Kyoto Convention).



- » Formally direct Ukraine's diplomatic trade missions to promote SME exports as a matter of priority. Design and implement a system to independently evaluate trade mission employees based on their accomplishments in export development.
- » Consider the possibility of organizing expenses-paid trade missions to trade partner countries for exporting firms. Such events are useful for building partner confidence and are seen by many researchers as the most productive form of government support for exports.

Methodology



» Objective

Assess the current business environment in Ukraine in 2004.

» Scope

Active companies in the regional capitals of Ukraine, as well as in Kyiv and Simferopol.

» Method

Survey of entrepreneurs at their workplaces through structured face-to-face interviews, targeted focus group sessions, and personal interviews with representatives of state agencies.

» Sample

Multi-stage, weighted by quotas for region, company size, and business sector in order to be representative of SMEs throughout Ukraine; thereafter, random selection of 2,500 participants. In addition, 500 exporting companies were surveyed separately.

The sampling error was 2%.



Background

Preliminary data collection was conducted between 10 February and 20 March 2005 by an independent market research company with extensive experience in implementing similar surveys in Ukraine and elsewhere.

Respondents were interviewed using a questionnaire consisting of 157 complex questions with respect to regulatory processes and barriers encountered by entrepreneurs in their day-to-day operations. The questionnaire consisted of three sections: the main questionnaire (113 questions), a section for company management (35 questions), and questions for the company accountant (9 questions).

The preliminary results were presented to media representatives, entrepreneurs, and officials of state agencies carrying out regulation of entrepreneurial activity. This report incorporates their feedback.

Sample

The sample was designed to be representative of micro-, small, medium, and large enterprises in Ukraine.¹ The survey polled 2,500 executives from the 23 regional capitals, as well as Kyiv and Simferopol. All major segments of the private sector in Ukraine were represented. Sample selection was based on:

- company size (micro, small, medium, large)
- business sector
- company location (regional centers, Kyiv, and Simferopol)

The sample pool was representative of the general population of active companies in the regional centers and in Kyiv and Simferopol. It was based on data effective 1 January 2004, furnished by the State Statistics Committee of Ukraine. The sample was weighted to normalize the statistics and to ensure adequate representation by business sector and company size category. The weighting was necessary to correct the sample where the respondents per city, business sector, and company size were not proportionate to the surveyed population. Since the methodology was strictly observed at all stages of the survey, the survey results can be extrapolated to the general business population.

The survey participants were company managers who were fully aware of the environment in which their companies operated. They were either directly involved in obtaining registrations, permits, licenses, and certificates, or they supervised the employees who were responsible. In addition, they were decision-makers with respect to company finance and export matters, informed with respect to the inspections carried out by regulatory agencies, and well versed in taxation issues.

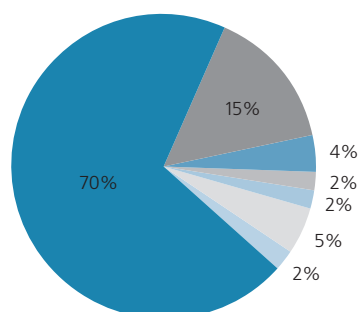
¹ These definitions conform to internationally accepted standards, not the definitions in the Economic Code of Ukraine of 1 January 2004. Under the Code, a "small" firm is defined having fewer than 50 employees and gross revenue under €500,000. A "large" firm has more than 1,000 employees and more than €5,000,000 in gross revenue. The rest are defined as "medium-sized."

8.1

Respondents by management level

% of respondents

- Director, owner, chairman of the board
- Deputy director
- Chief financial officer
- Chief executive officer
- Commercial director
- Chief accountant
- Head of unit/chief specialist





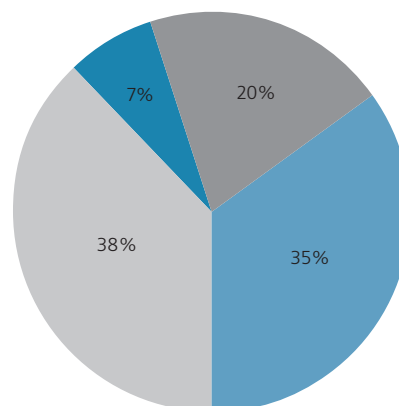
The sample reflected the SME sector in Ukraine categorized according to number of employees: micro- – less than 10 employees; small – 11 to 50 employees; medium – 51 to 250 employees, and large – 251 to 1,000 employees. The largest companies (more than 1,000 employees) were excluded in order to allow meaningful comparisons.

8.2

Respondents by firm size

% of respondents

- Large (251-1,000 employees)
- Medium (51-250 employees)
- Small (11-50 employees)
- Micro (1-10 employees)



The companies selected represented all major segments of the private sector in Ukraine except agriculture, fisheries, and forestry.

8.3

Sectors included in the survey

Sector	Business activity
Manufacturing	mining, machinery, materials processing, food processing, energy, chemicals, petrochemicals, pulp and paper, light industry, wood processing, construction materials
Construction	construction services
Wholesale/ Retail trade	retail and wholesale trade outlets
Food and beverage services	restaurants, bars, cafes, canteens
Transportation	freight and passenger transportation services
Financial services	commercial banks, insurance companies, pension funds
Other services	hotels, real estate agencies, publishers, telecommunications services, miscellaneous services

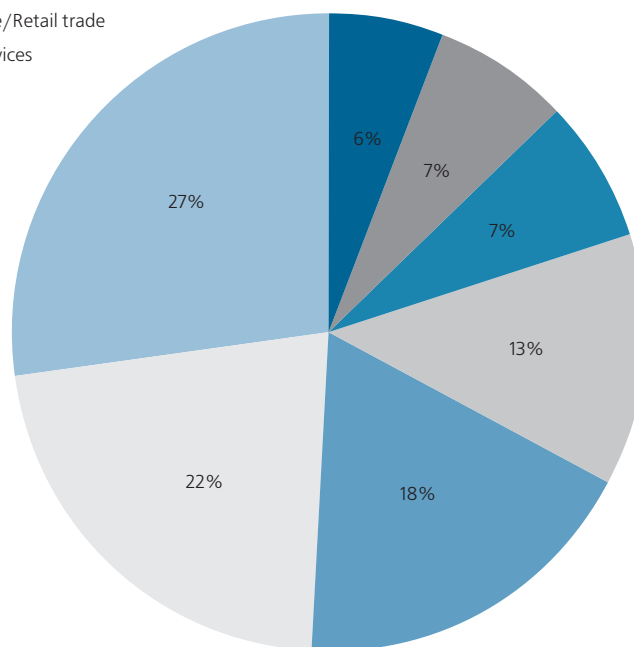


8.4

Respondents by sector of business activity

% respondents

- Food and beverage services
- Financial services
- Transportation
- Construction
- Manufacturing
- Wholesale/Retail trade
- Other services



Companies were assigned to a sector based on their core business. The distribution was as follows:

8.5

Respondents by firm size and sector of business activity

Sector	Micro-	Small	Medium	Large	Total
Manufacturing	107	134	140	71	452
Construction	80	124	85	28	317
Wholesale/Retail trade	272	182	70	23	547
Food and beverage services	55	68	17	3	143
Transportation	42	56	53	22	173
Financial services	71	62	43	12	188
Other services	338	246	83	25	692
Total	965	872	491	184	2,512


 **8.6**

Respondents by region

Regional capital	Participants
Vinnytsia	80
Dnipropetrovsk	120
Donetsk	100
Zhytomyr	80
Zaporizhia	85
Ivano-Frankivsk	80
Kirovohrad	80
Kyiv	434
Luhansk	80
Lutsk	79
Lviv	81
Mykolayiv	80
Odesa	110
Poltava	80
Rivne	80
Simferopol	80
Sumy	80
Ternopil	80
Uzhgorod	82
Kharkiv	141
Kherson	80
Khmelnysky	80
Cherkasy	81
Chernivtsi	79
Chernihiv	80
Total	2,512

The survey sample did not include state-owned companies or those funded in full or in part by the state (schools, municipal educational institutions, healthcare institutions, etc.). The largest category of participants consisted



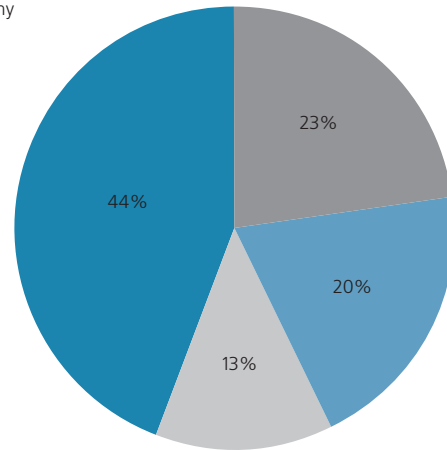
of limited liability companies. The rest were private companies, joint stock companies, and enterprises of other forms.

 8.7

Respondents by company form

% of respondents

- Limited Liability Company
- Private Enterprise
- Joint Stock Company
- Other





Entrepreneurs' perception of state authorities



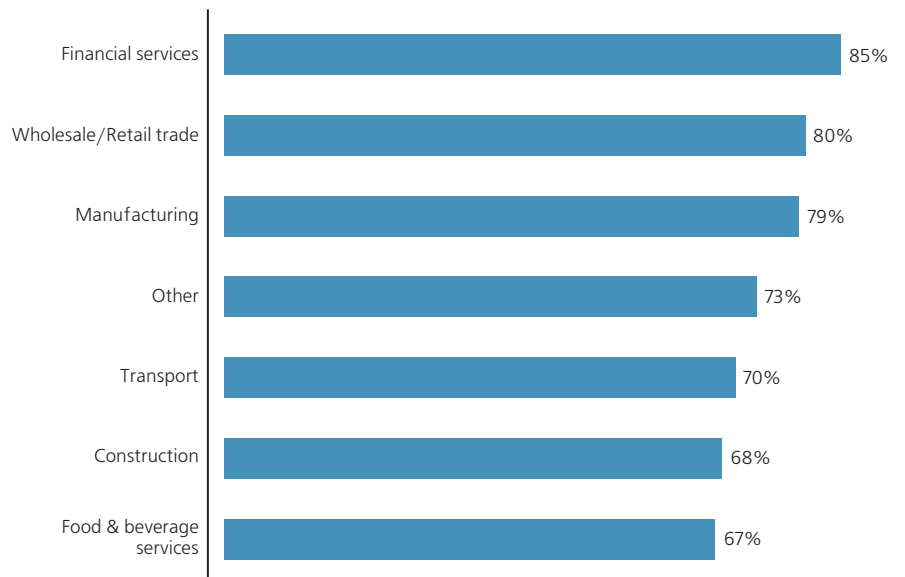
Respondents in large enterprises were most likely to say they would start their businesses over again

% of respondents, by firm size



Respondents in the financial services sector were most likely to say they would start their businesses over again

% of respondents, by business sector



3

Medium-sized enterprises spent the highest percentage of working time dealing with state agencies

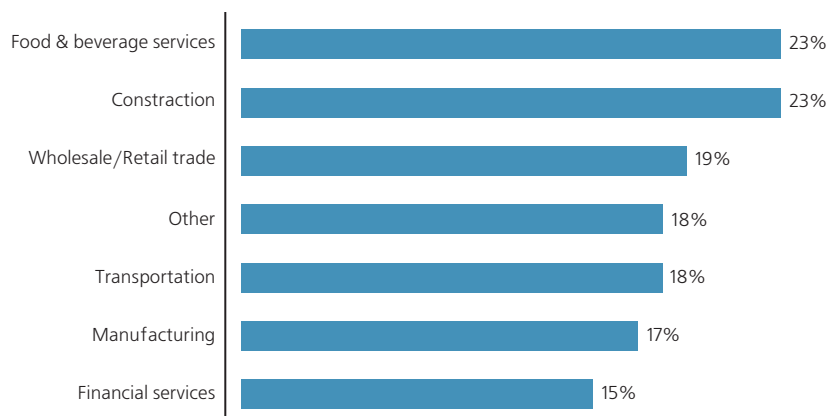
% of working time, by firm size



4

Firms in the food and beverage and construction sectors spent the highest percentage of working time dealing with state agencies

% of working time, by business sector

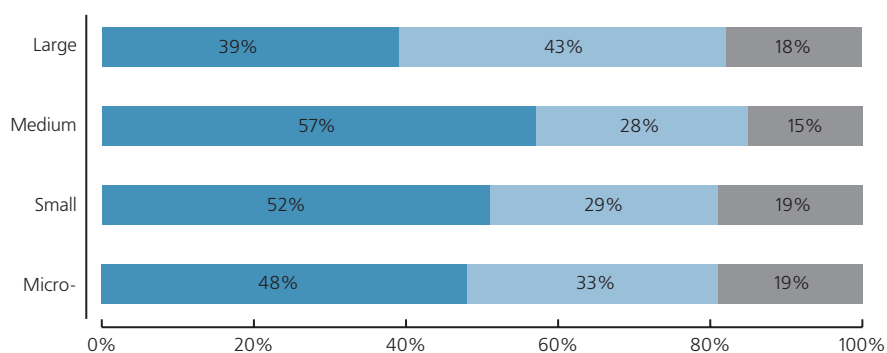


5

Most respondents were optimistic about the outlook for the Ukrainian business environment in 2005

% of respondents, by firm size

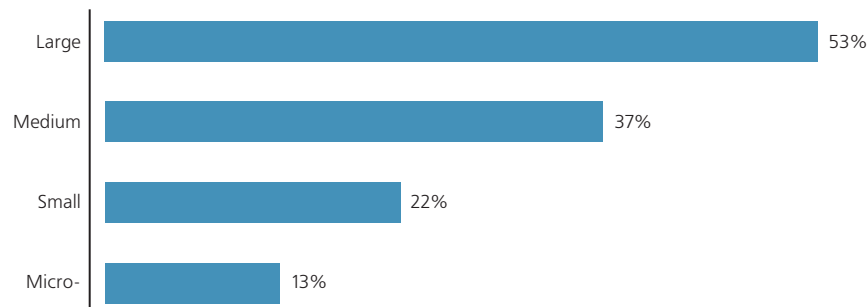
■ Will improve ■ Will not change ■ Will deteriorate



6

Membership in business associations was most prevalent among large enterprises in 2004

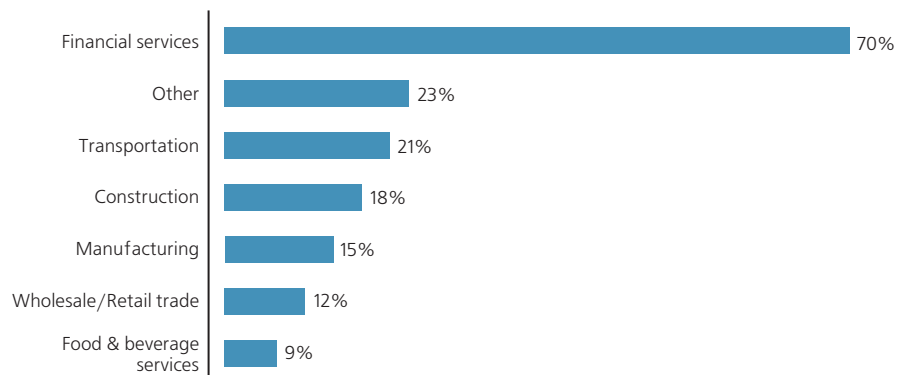
% of respondents, by firm size



7

Membership in business associations was most prevalent among firms in the financial sector in 2004

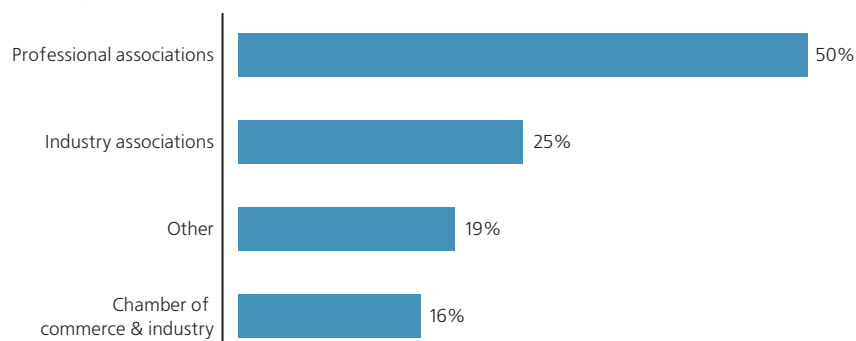
% of respondents, by business sector



8

Among associations, respondents were most likely to belong to professional associations in 2004

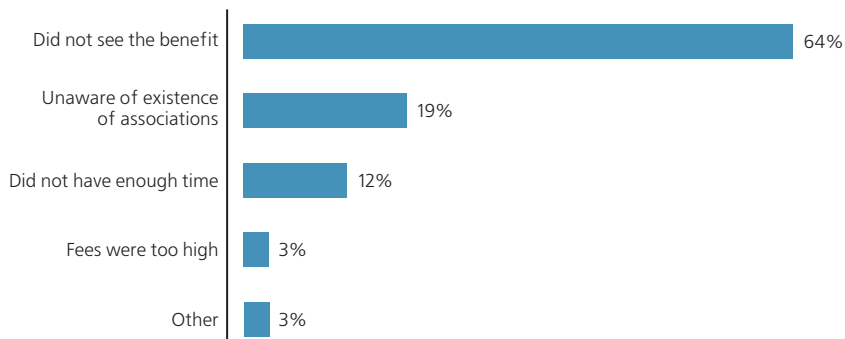
% of respondents who were association members



9

Lack of practical benefit was the main reason for not joining business associations in 2004

% of respondents who were not association members



10

The majority of companies in Ukraine had Internet access

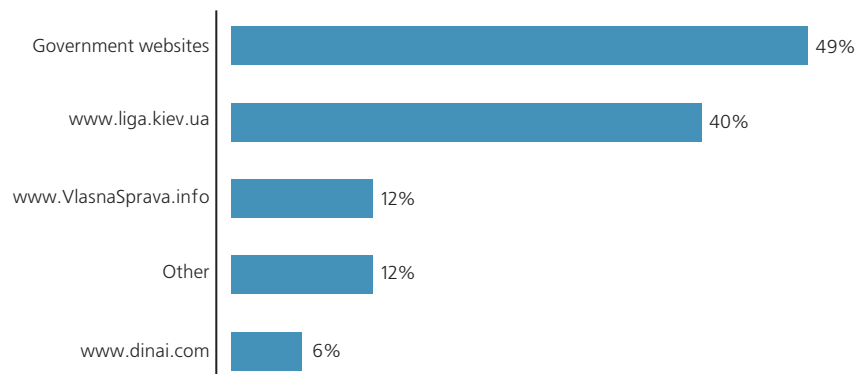
% of respondents, by firm size



11

Government websites were the most popular Internet resources among firms using the Internet for business purposes

% respondents using the Internet for work

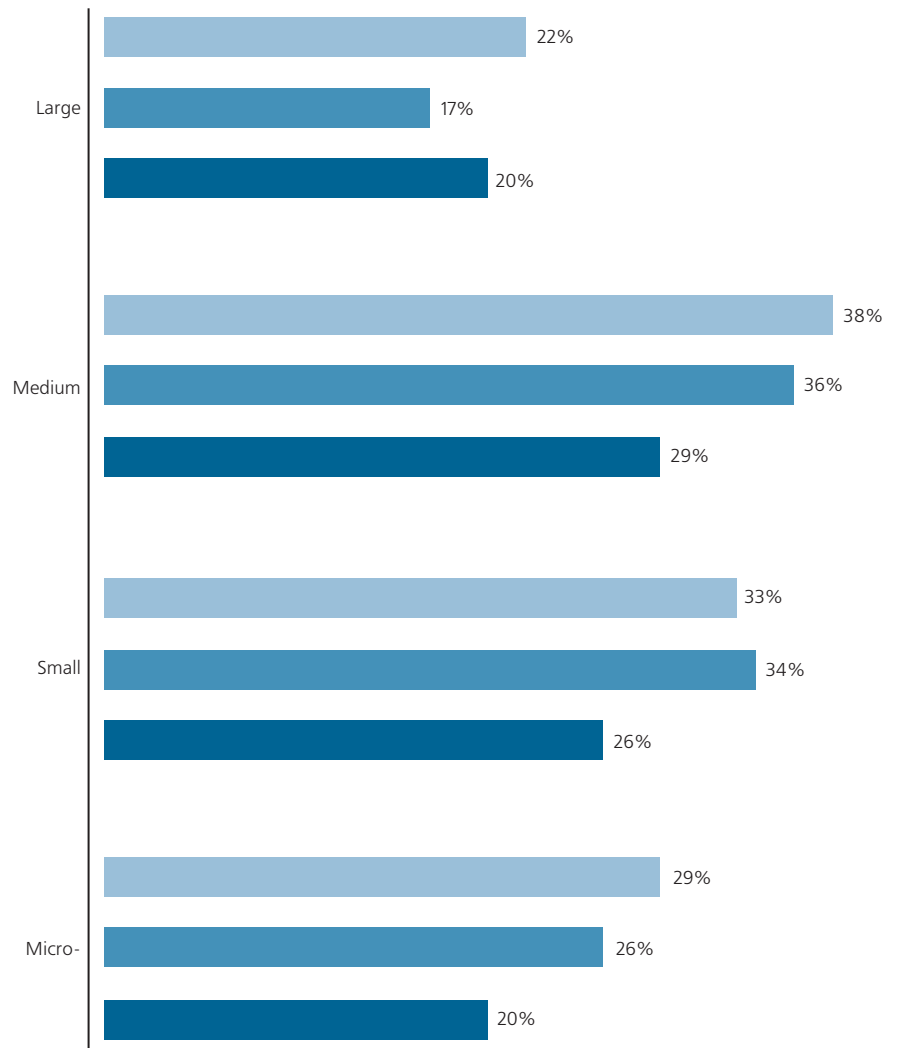


12

Respondents in large enterprises were least willing to pay extra tax to improve the business environment

% of respondents willing to pay extra tax, by firm size

- For infrastructure improvement
- To streamline government regulations
- For fair competition measures



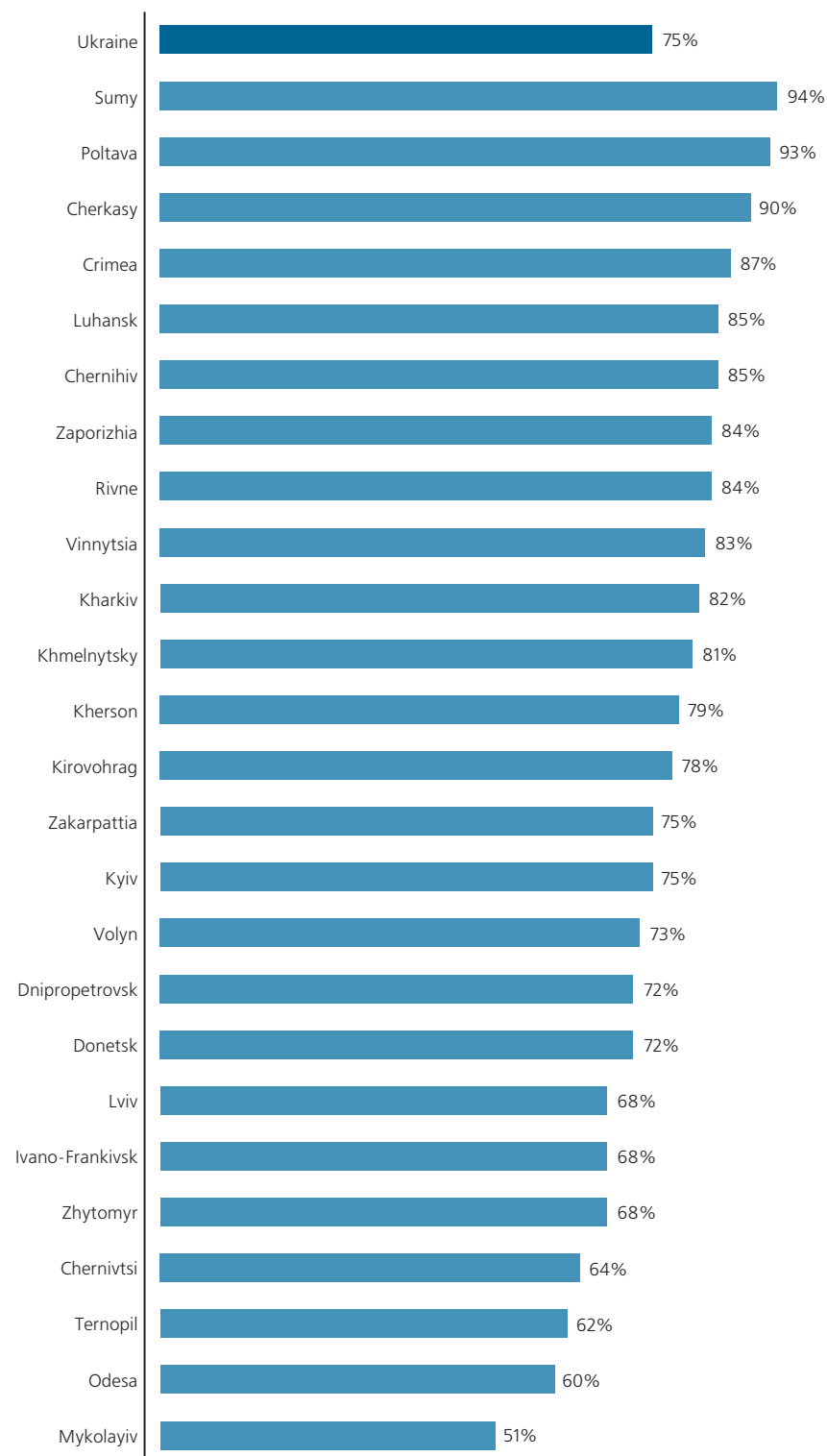
Taxation



13

Over 90% of respondents in Sumy and Poltava cited taxation as a serious obstacle to doing business

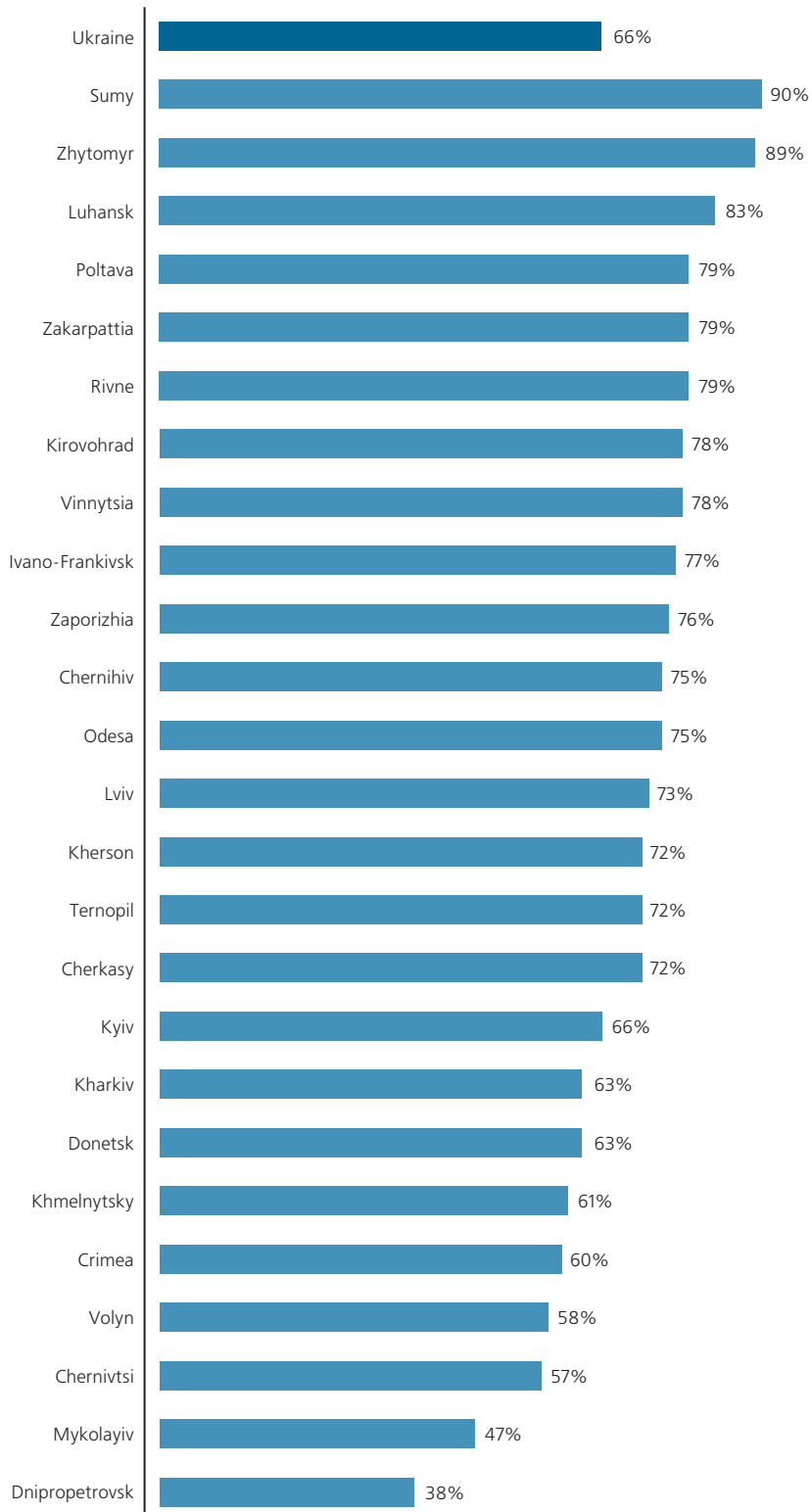
% of respondents, by region





Taxation procedures were rated most complicated in Sumy and Zhytomyr and least complicated in Dnipropetrovsk

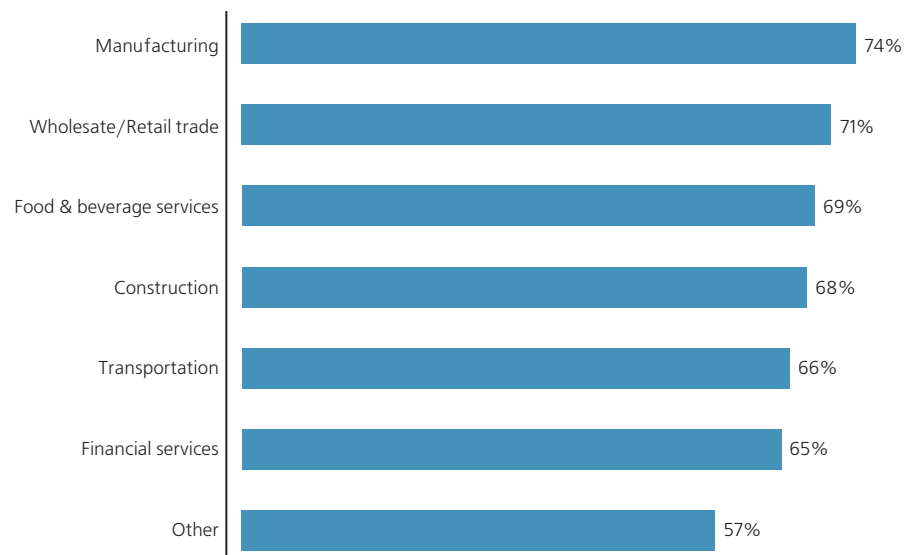
% of respondents, by region



15

Taxation procedures were rated most complicated by respondents in the manufacturing sector

% of respondents, by business sector



16

The majority of respondents in all firm size categories considered taxation procedures complicated

% of respondents, by firm size



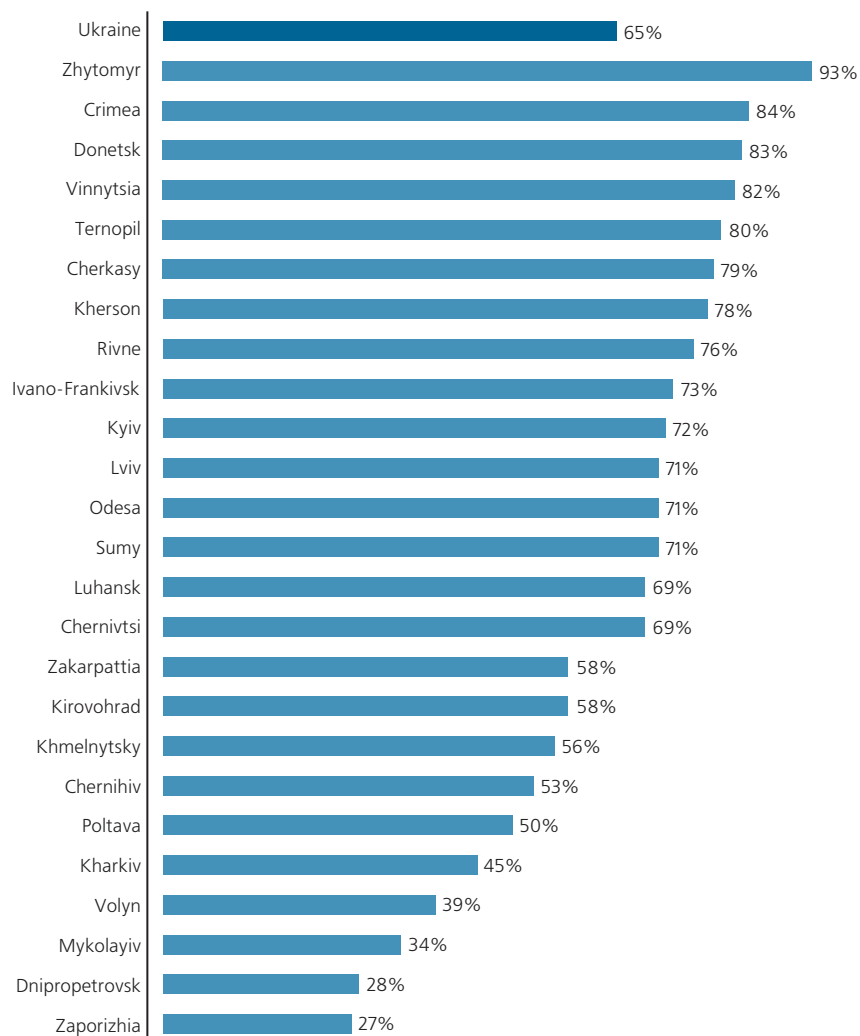
Permits



17

Permit procedures were perceived as most complicated in Zhytomyr

% of respondents obtaining permits in 2004 who perceived the procedures as difficult, by region



18

The larger the company, the more complicated the permit procedures were perceived to be

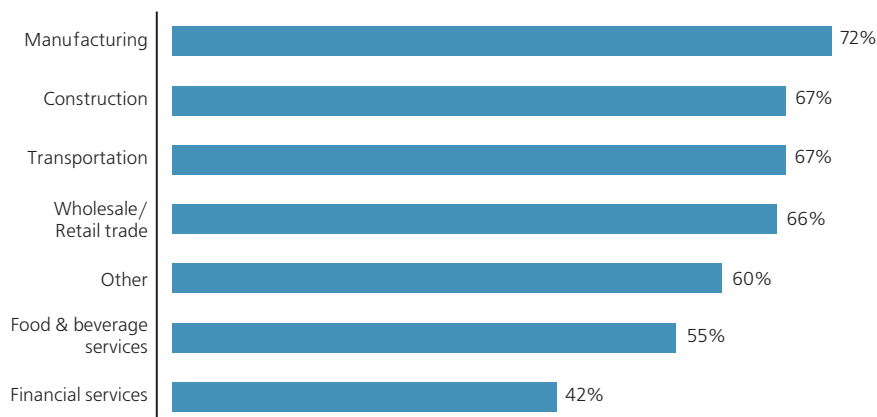
% of respondents obtaining permits in 2004 who perceived the procedures as difficult, by firm size



19

Respondents in the manufacturing sector were most likely to perceive permit procedures as complicated

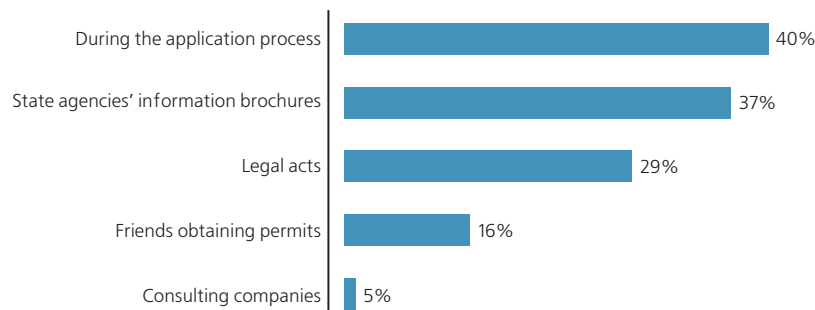
% of respondents obtaining permits in 2004 who perceived the procedures as difficult, by business sector



20

Forty percent of respondents obtained information about permit procedures during the application process

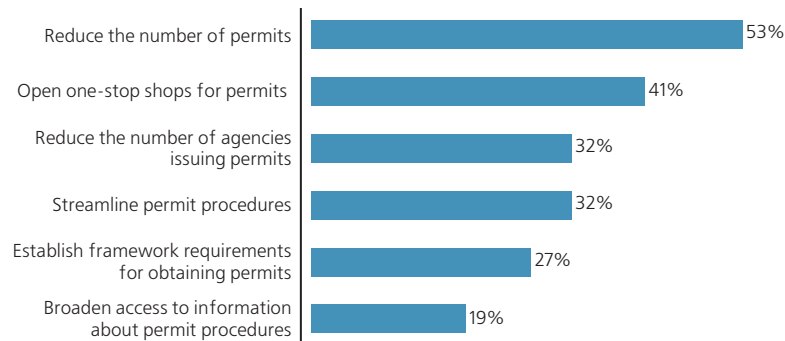
% of respondents obtaining permits in 2004



21

More than half of respondents stated that reducing the number of permits would improve the permit process

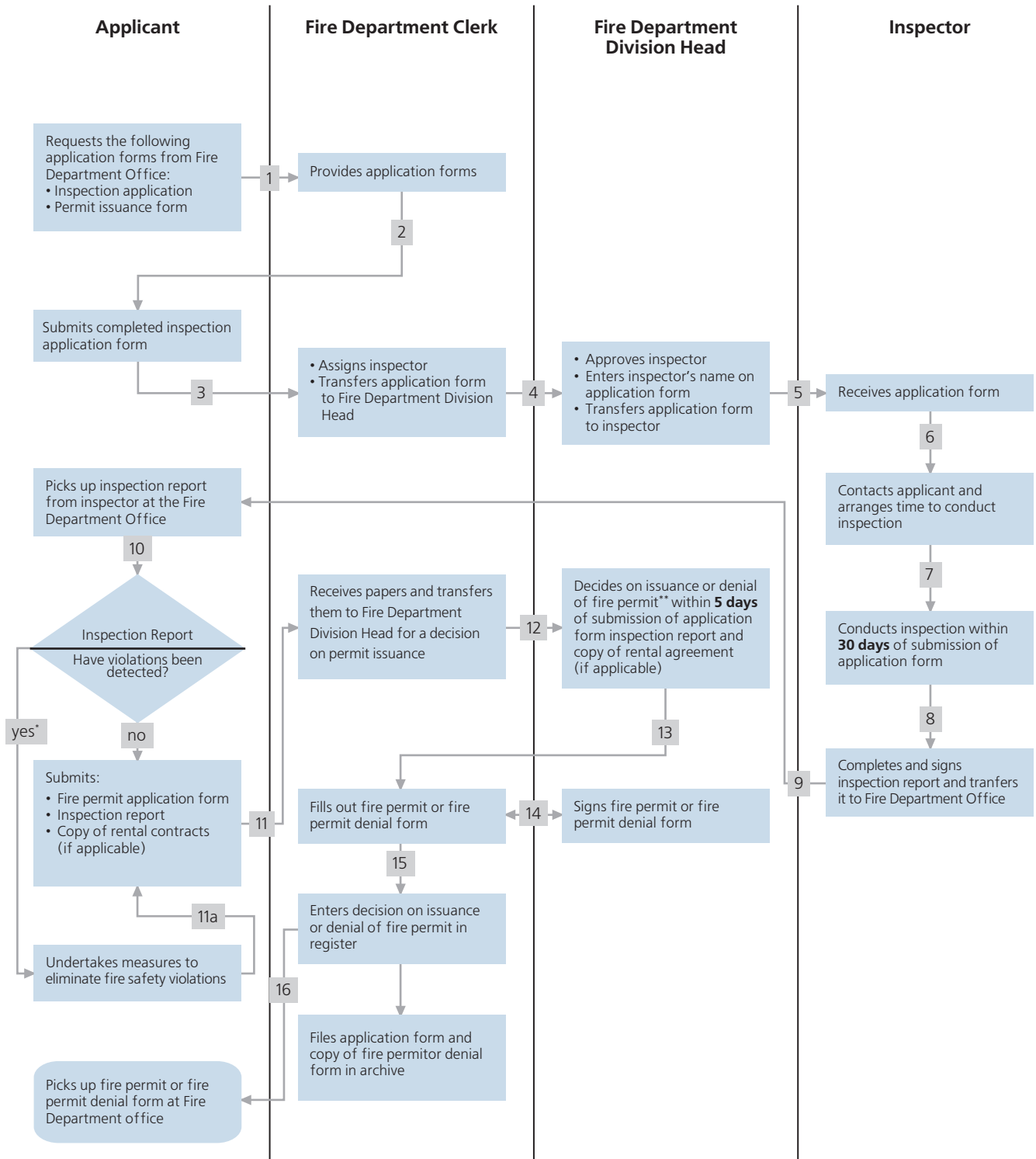
% of respondents obtaining permits in 2004





22

Fire Department permit issuance process map



* Where the fire permit is denied, the entrepreneur is required to eliminate fire safety violations and reapply for the permit. In such cases, there are 25 steps in process; otherwise, there are 16.
 ** Owing to fire safety regulations, the majority of fire permits issued are temporary.

Inspections



23

Maintaining an inspection log was most prevalent among medium-sized enterprises

% of respondents who kept an inspection log, by firm size



24

Maintaining an inspection log was most prevalent among companies in the food and beverage services sector

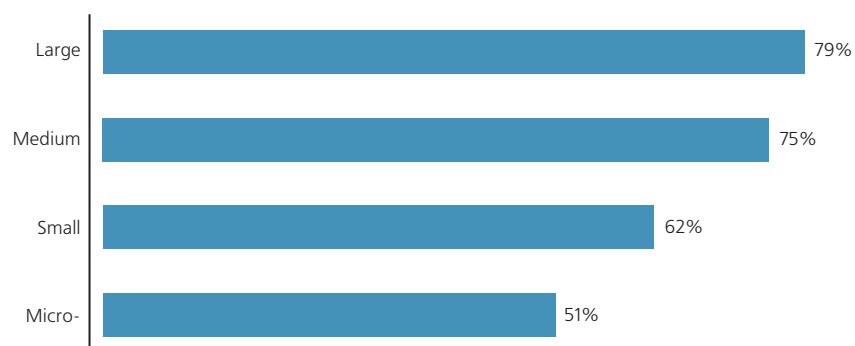
% of respondents who kept an inspection log, by business sector



25

Large enterprises were most likely to have been inspected in 2004

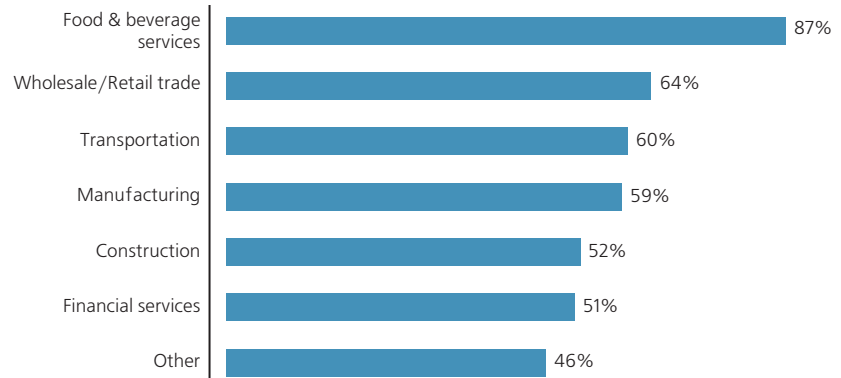
% of respondents inspected in 2004, by firm size



26

Enterprises in the food and beverage services sector were most likely to have been inspected in 2004

% of respondents inspected in 2004, by business sector



27

Large firms were least likely to have made unofficial payments in 2004

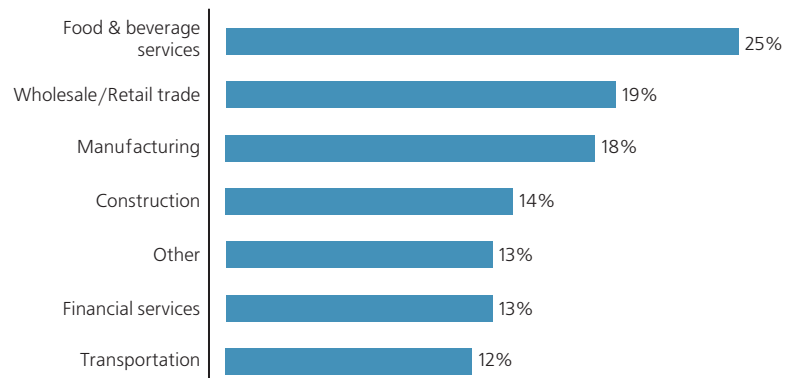
% of respondents who made unofficial payments during inspections, by firm size



28

Firms in the food and beverage services sector were most likely to have made unofficial payments in 2004

% of respondents who made unofficial payments during inspections, by business sector



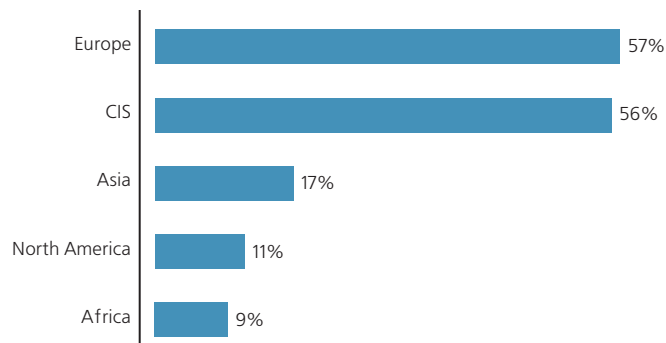
Regulation of exports



29

Countries in Europe and the CIS were most attractive for local exporters in 2004

% of respondents planning to enter the given market in 2005-2006

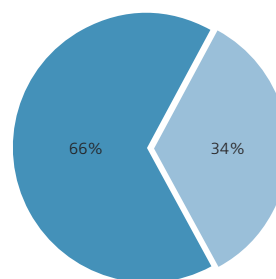


30

Most exporters did not make exclusivity agreements with importers in the countries to which they exported in 2004

% of respondents exporting

- Did not make exclusivity agreement
- Made exclusivity agreement



31

Respondents with micro- and small businesses were most likely to make unofficial payments to Customs officials

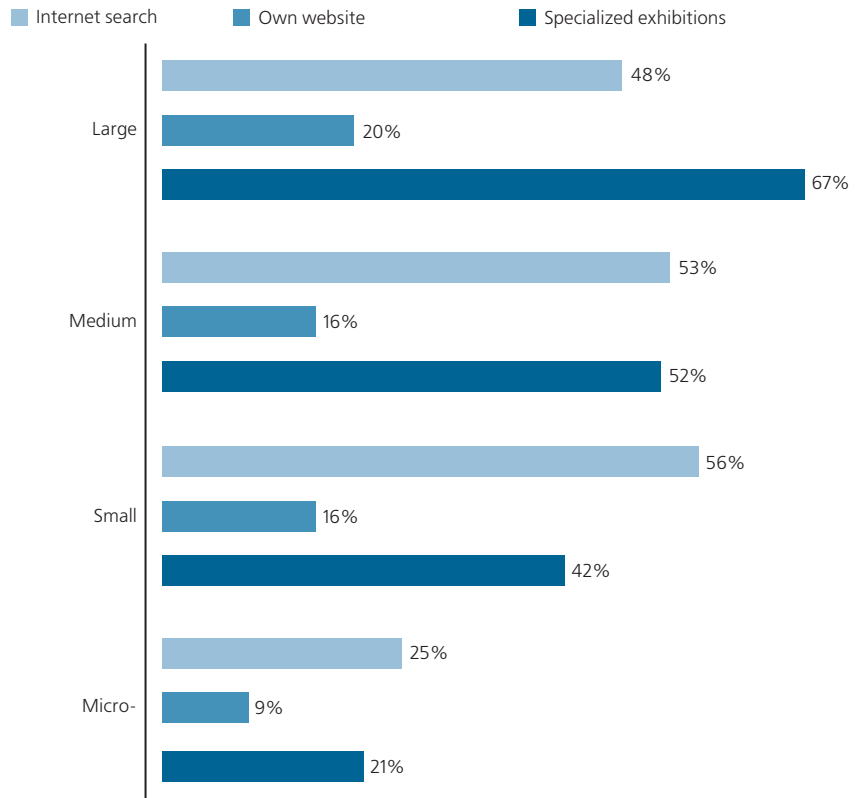
% of respondents reporting that firms similar to theirs always or almost always made unofficial payments to avoid problems



32

Micro-businesses were the least active in searching for partners abroad in 2004

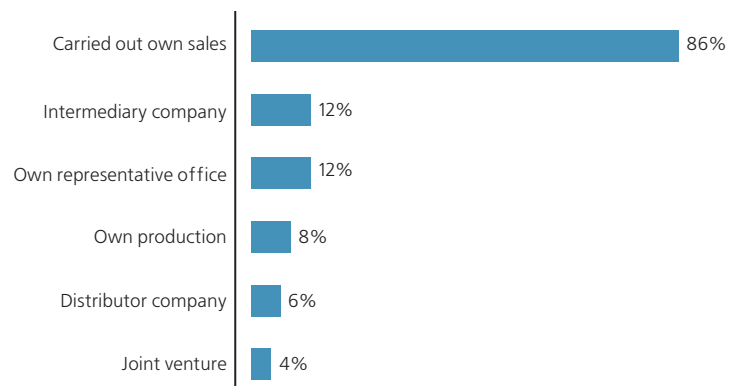
% of respondents exporting, by firm size



33

The majority of exporters carry out sales to foreign buyers themselves in 2004

% of respondents exporting, by sales agency



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