

Enterprise Survey: Business Climate and Investment in 1999-2002

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NO SIGNIFICANT IMPROVEMENT?

BUSINESS CLIMATE CONTINUES TO BE UNFAVORABLE. NO SIGNIFICANT CHANGES ARE RECORDED IN 1999- 2002:

- More than three quarters of managers perceive property rights as insecure;
- 86% of managers perceive regulations as unclear;
- "Time tax" is more than 13% of working time;
- About 70% of firms pay bribes to get "things done";
- Unpredictability of bribe's size is high and increases over time;
- About 25% of the firms are unsure about corruption outcome;
- Implicit corruption increases over time;
- Firms continue to avoid about 25% of taxes;
- Competitive pressure from domestic and foreign producers to raise;
- Budget constraints become harder;
- Tolerance of tax arrears remains high;
- Most significant improvement in performance results is recorded for 2001;
- Investment activity is growing slowly;
- Profit remains the main source of investment, though the role of banks loans is increasing;
- Almost 2/3 of the firms perceive current period of time to be unfavorable for investment;
- Only about 15% of the firms have implemented strategic restructuring measures;

SMALL ENTERPRISES VS LARGE FIRMS:

- Lower perceptions of ability of judicial system to enforce commercial contracts;
- Lower level of state interference;
- Higher perceptions and better dynamic concerning clarity / predictability of regulations;
- Lower absolute level and better dynamics of "time tax";
- Higher exposure to corruption and higher average size of bribes;
- Higher uncertainty of corruption outcome;
- Lower importance of informal relations with representatives of state authorities;
- Lower level of state subsidization;
- Harder budget constraints;
- Lower investment activity.

A panel of 300 manufacturing firms is used to monitor managers' perceptions of the changes in business climate and investment activity of the firms 1999-2002.

In this issue: results of a special survey conducted in February 2003

New: 1. small firms vs large firms: comparative analysis;

2. dynamics of explicit and implicit corruption in Ukraine.

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Business environment

Security of property rights: are assessed across two indicators: 1) ability of judicial system to ensure enforcement of commercial contracts; 2) ability of judicial system to protect personal security and security of business entities against criminality

Business environment in Ukraine is perceived as extremely insecure. Only 23.1% of respondents believe that judicial system is able to enforce their contract rights, and only 12.5% of managers think that judicial system is able to protect effectively their business entities and personal security against criminality. It is alarming that no improvement is recorded since 1999, when respective numbers constituted 24.2% and 12.3%. There are significant differences across the firms of different size. Small enterprises report ability of judicial system to enforce their contracts less often than large firms. However, perceptions of managers of small firms concerning protection against criminality are a bit better than that for large firms.

Regulatory burden: We investigate regulatory burden across the following indicators¹: 1) level of indirect state interference, 2) predictability and clarity of regulations, and 3) time tax.

DIRECT STATE INTERFERENCE IN OPERATING ACTIVITY OF THE FIRMS. The level of state interference is rather low and has slightly reduced over time. In 1999, 49.3% of the firms reported no state interference into operational decisions, while for 2002 the respective number constitutes 52.2%. The level of state interference is slightly higher for large enterprises.

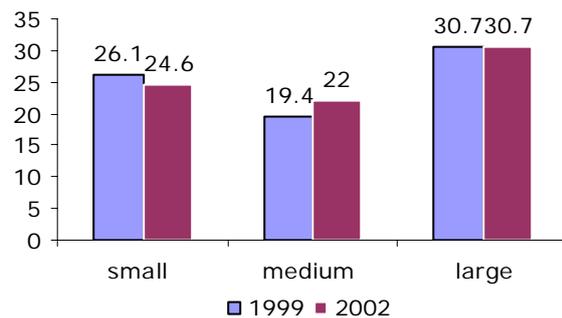
PREDICTABILITY AND CLARITY OF REGULATIONS. Predictably and clarity of regulations is very low. Almost 90% of respondents believe that legislations are inconsistent and unpredictable (90.2% in 1999 and 86.8 % in 2002, respectively), and no significant progress is recorded. The larger the size of the firm, the lower the perceptions concerning clarity of regulations.

In 1999-2002, the most significant improvement is recorded for small enterprises: the share of SEs perceiving regulations as unpredictable has decreased from 86.0% in 1999 to 79.0% in 2002.

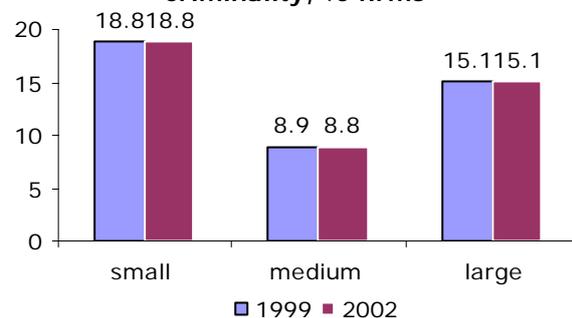
TIME TAX .In 2002, managers spent about 13.2 % of their time dealing with the state officials. No significant changes are observed over time (respective indicator for 1999 is 13.5). The larger the size of the firms, the higher the "time tax".

Changes of regulatory burden are summarized in a star diagram where axis represent three indicators, namely:

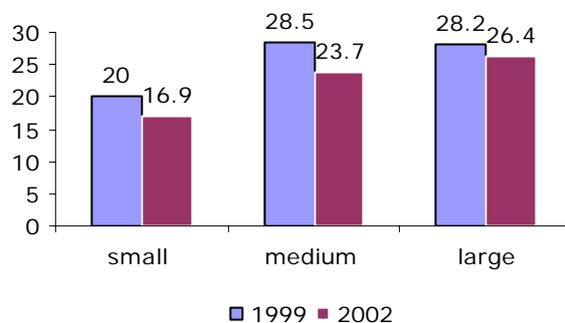
Judicial system is able to enforce contract rights , % firms



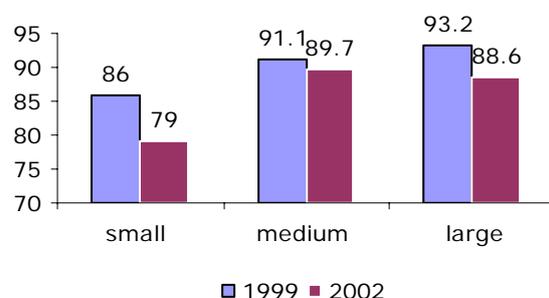
Judicial system is able to protect business entities against criminality, % firms



Direct state interference, % firms

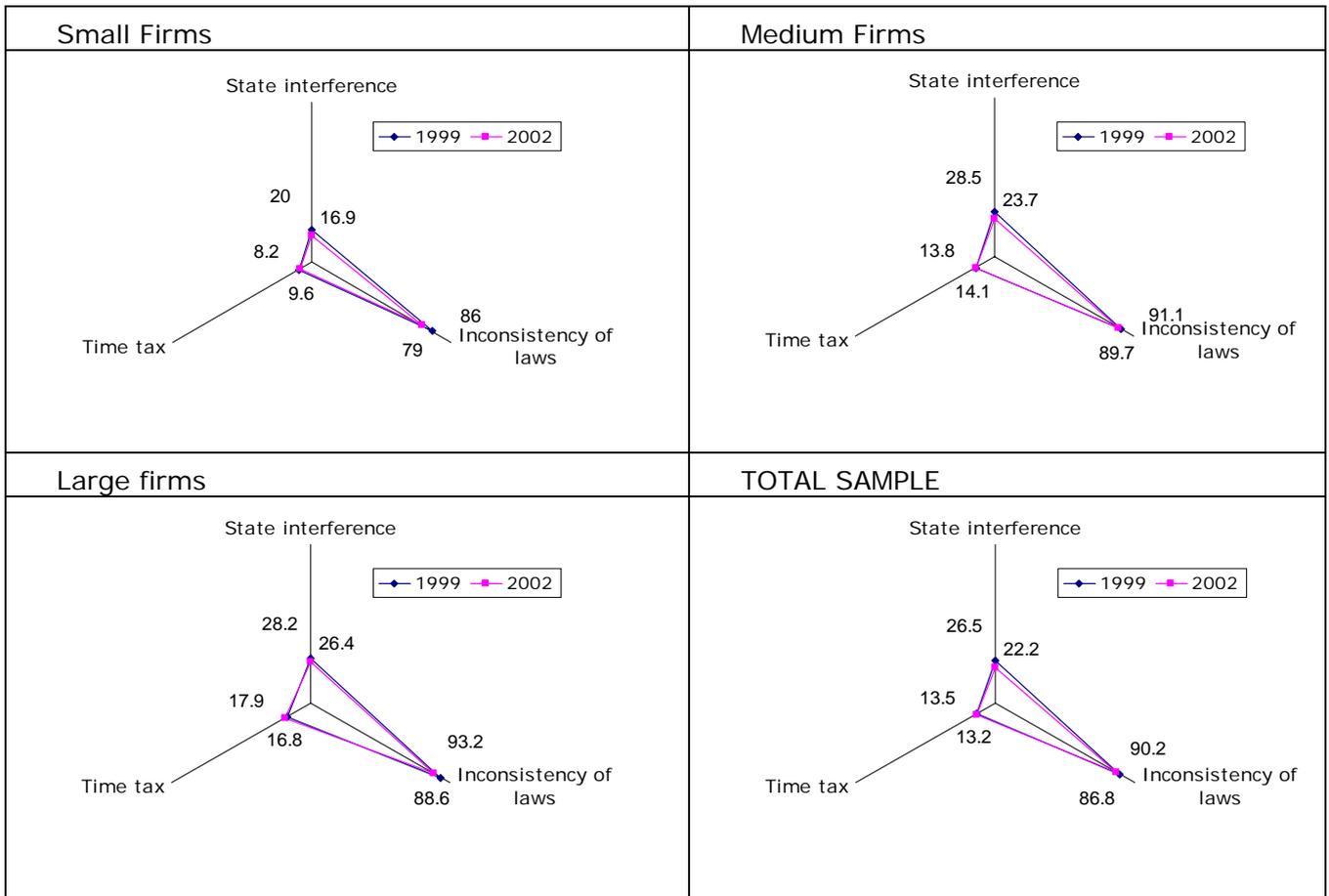


Unpredictability of regulations, % firms



¹ In our survey, we have abstained from looking at the changes in registration procedures and quantity of regular/irregular controls by regulatory bodies, since progress in this area is well recorded by other analysts.

Picture 1. Regulatory burden: summary



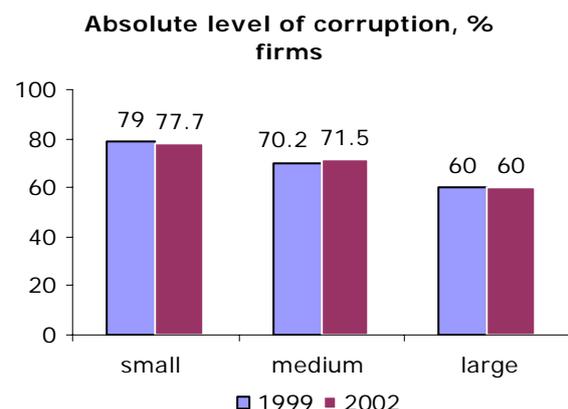
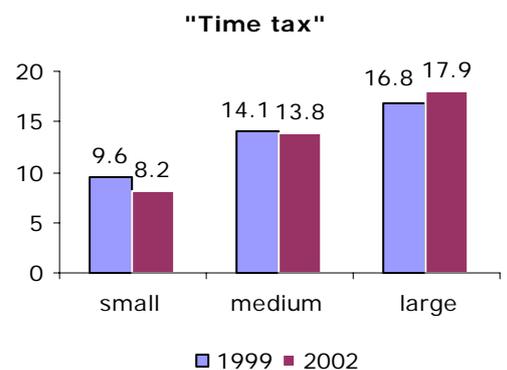
- % of the firms that report state interference in operational activity,
- % of firms that consider business legislation to be unclear and unpredictable,
- % of managers' time spent on dealing with state officials

The square of a triangle reflects overall regulatory burden. No significant changes in the level of regulatory burden have been observed during 1999-2002 (picture 1). Differences in squares of triangles across size groups indicate that small firms face lower regulatory burden than medium and large ones.

Corruption: Changes in corruption are investigated across the following indicators:

- Absolute level of corruption;
- Uncertainty of corruption outcome;
- Unpredictability and instability of bribes;
- Informal relations with the authorities.

ABSOLUTE LEVEL OF CORRUPTION. The level of corruption in Ukraine continues to be high and so far has not undergone significant changes. Respondents have been asked whether it is common for the firms like theirs to pay bribes in order "to get things done". The results are striking: almost 70% of the respondents (69.3 in 1999, and 69.9% in 2002) report that bribe is a common instrument for "smoothing" dealings with public officials concerning business activities of the firm!





Small firms are exposed to bribes more often than the others: 79.0% of them report bribes as common instrument, while respective indicator for large firms constitutes 60%.

The average size of bribes also remains rather stable: it constitutes 1.7% in 1999 and 1.9% in 2002. This indicator varies across the enterprises of different size. Small and medium size firms face a higher "bribe tax" relative to large enterprises, and moreover, it is growing over time.

UNPREDICTABILITY AND INSTABILITY OF BRIBES. The level of corruption-induced uncertainty is very high and has a tendency to increase: about two-thirds of the managers report that the size of a "bribe tax" is unstable and/ or unpredictable (63.5% in 1999, and 64.8% in 2002, respectively).

UNCERTAINTY OF CORRUPTION OUTCOME (impossibility of bribe-givers to ensure corruption outcome). A quarter of our respondents (25.0% in 2002 and 25.3% in 1999 respectively) are completely unsure whether after paying bribe required "services" would be delivered as has been agreed before. Another 25% of managers are only more-or-less sure about corruption outcome. No significant changes are recorded in 1999-2002.

INFORMAL RELATIONS WITH STATE AUTHORITIES (IMPLICIT CORRUPTION). In 2002 50.0% of surveyed managers consider having informal relations with the representatives of public authorities to be important for their business success. The importance of informal relations is higher for large and medium firms.

The importance of informal relations varies across different types of public authorities. State tax administration is most frequently reported among the important subjects of informal relations (52.4% of the firms). Representatives of local (oblast and city) authorities are ranking second (42.1% and 45.3% of respondents, respectively) while central government is at the end of the list of "important friends"(33.6%).

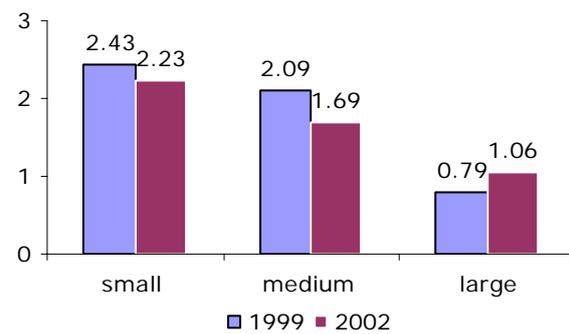
The share of firms that consider having informal relations with central government as "very important" is higher for large enterprises (34% of the firms) than SMEs (16.9% for small enterprises, and 26.2% for medium ones, respectively).

Table 1. Importance of informal relations with state authorities and for the business success, %*

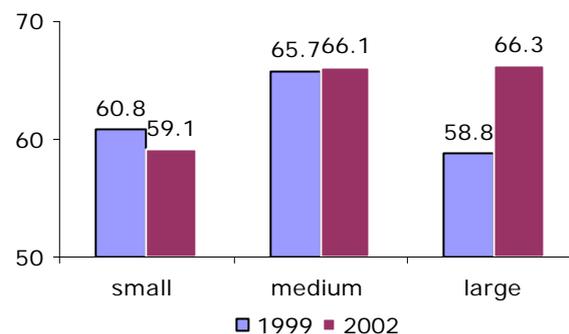
	Informal relations		Change of representative of public authorities	
	1999	2002	1999	2002
STA	50.8	52.4	35.9	42.4
City (district) administration	43.4	45.3	33.9	40.9
Oblast administration	41.0	42.1	32.7	35.6
Police	36.8	39.6	24.4	29.1
Central Government	31.1	33.6	24.3	28.8

*% of managers that assess relations as important and very important

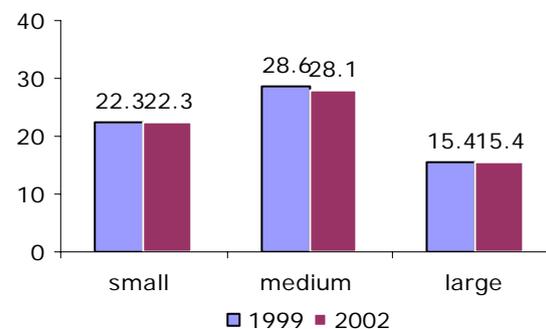
"Bribe tax" as percentage of annual sales, mean values



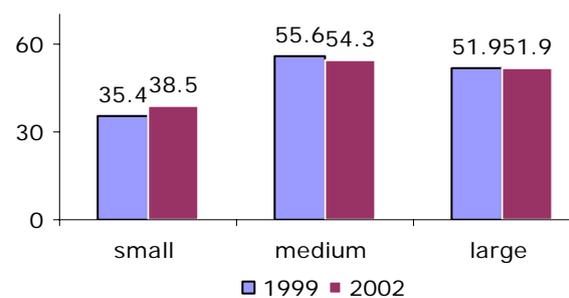
Unpredictability of bribes, % firms



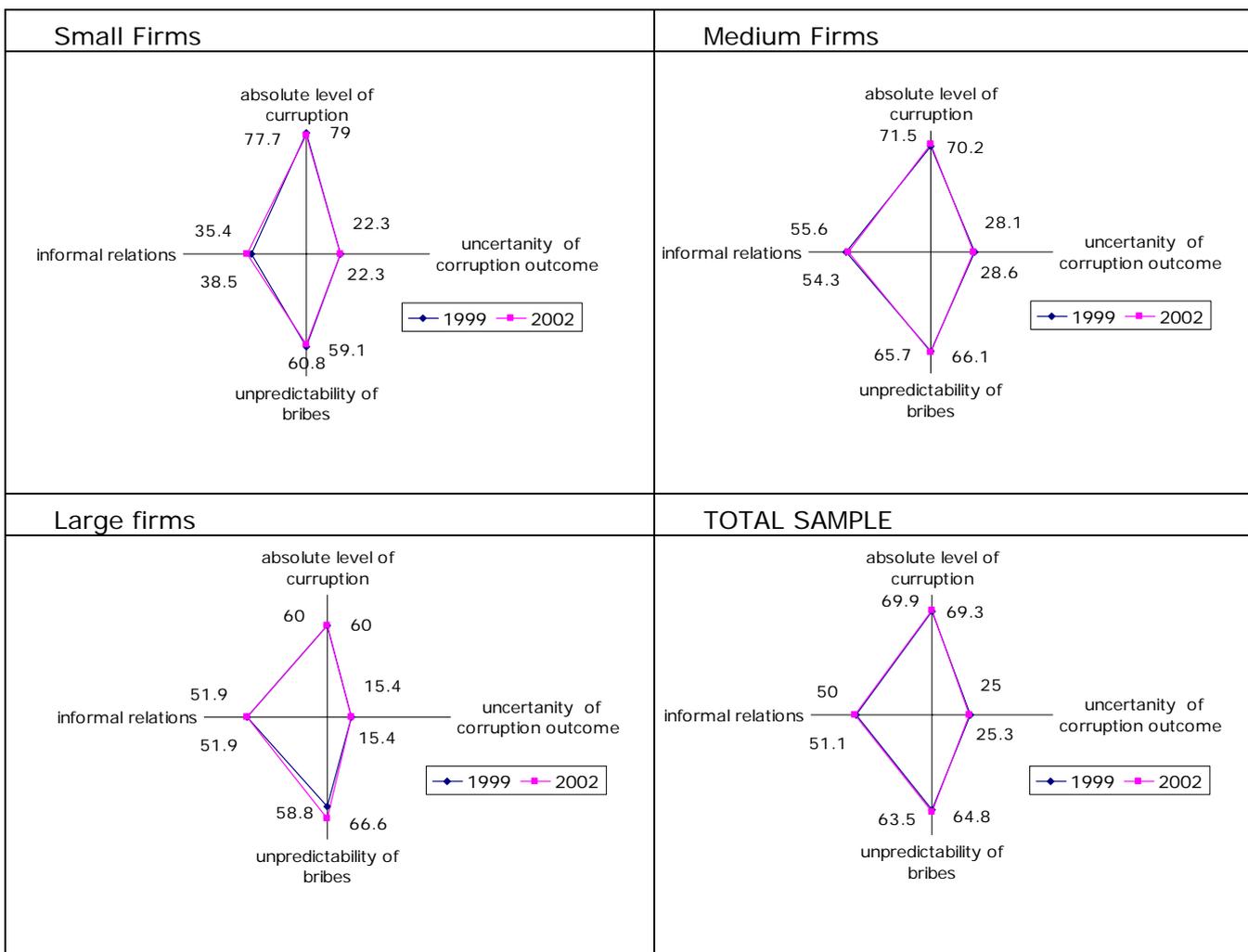
Uncertainty of corruption outcome, % firms



Importance of informal relations, % firms



Picture 2. Corruption burden: summary



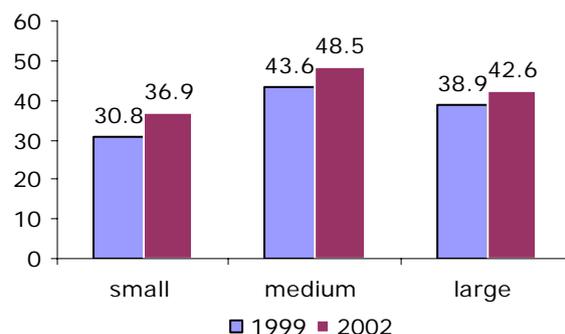
Our results concerning importance of informal relations with public authorities are supported by the evidence of the impact of change in public officials on business performance of the firms. In 2002, about 44.7% of the managers (vs 39.6% in 1999) perceive changes of representatives of public authorities to have a significant impact on business success of their firms. The lowest level of this indicator is recorded for small firms. Again, importance of changes in STA and city administration is reported more often than for other public offices.

Since 1999 the importance of having informal relations with public officials has increased in general and across all types of public authorities. Similar tendency is recorded with respect to the impact of change in the representatives of public authorities on the business success of the firms. This implies that corruption is increasing both in its explicit and implicit forms.

The overall picture of corruption is presented in the star chart where axes reflect the following indicators:

- % of firms that admit paying bribes ,
- % of firms that are unsure about the outcome of bribe,
- % of firms that consider bribe sum unstable,
- % of firms that admit importance of IR with at least one authority.

Importance of change of representative, % firms





Star chart shows no improvement on the overall level of corruption during 1999-2002 (picture 2).

Tax compliance. The respondents were asked to estimate the percentage of taxes that, according to their knowledge, are actually paid by the firms of the same size in their industry relative to the total amount of taxes due to payment in case of full compliance. In 2002, 23.6% of the enterprises reported paying less than 50% of the official amount of taxes. Another 10.4% of the firms reported tax payment rate of about 50-90%. And 66.0% of the respondents considered tax payment rate to be more than 90%. The average level of tax compliance has slightly increased from 74.5% in 1999 to 76.7% in 2002.

Managers of the medium firms reported a lower level of tax compliance than small and large enterprises. While small enterprises demonstrate the most significant improvement in tax compliance during 1999-2002.

State influence: In 2002 about one third of the enterprises reported having some influence on the decisions of government authorities that are important for business activities of their firms. No change is recorded since 1999. Frequency of state influence slightly varies across the types of government bodies showing no significant changes during the last three years. No significant changes are observed across different size groups.

Competition: A vast majority of the firms (82.5%) reports moderate or strong competitive pressure in the main markets in 2002. While pressure from Ukrainian competitors is perceived to be strong by 37.9% of the firms, the respective indicator for foreign competitors is lower (16,2% for CIS countries firms, 15.6% for other foreign countries).

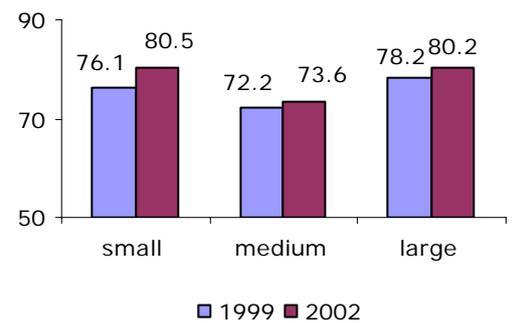
Strong competitive pressure is reflected in high elasticity of demand. 52.0% of managers report that in case product price increases by 10%, most of their consumers will switch to competitors, another 25.8% of the firms believe that consumers might significantly reduce volume of purchases.

Competitive pressure from Ukrainian producers seems to be higher for small firms, while pressure from foreign producers seems to be higher for large enterprises (see Table 2)

Even the firms that hold monopolistic position in Ukrainian market with respect to at least one of their products (21.5% of total sample) face competition with domestic producers, though to a less extent than non-monopolists. At the same time, monopolists report high competitive pressure from foreign producers more often than non-monopolists (see table)

Since 1999, the level of competition in Ukrainian industrial sector seems to increase. It is indirectly indicated by an increase in the share of firms perceiving competitive pressure as an important obstacle for their business activity from 13.2 in 1999 to 38.1 in 2002. The most significant increase in perceptions concerning competitive pressure as impediment to growth is recorded for small firms (from 29.8% in 1999 to 45.5% in 2002). The respective share for MEs constitute 26.1% and 36.7%, and for LEs — 26.2% to 35.1%.

Rates of tax compliance, mean values



How often can your firm influence the decision of the government authority, % of respondents

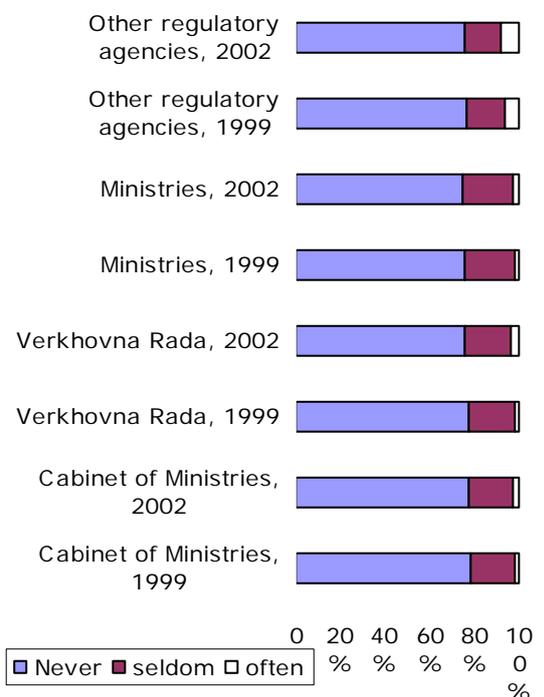


Table 2. % of enterprises reporting strong competitive pressure

	Small	Medium	Large
Ukrainian competitors	46.6	36.4	35.1
CIS competitors	11.9	12.7	31.5
Other foreign competitors	10.2	17.6	17.0

Table 3. % of enterprises reporting strong competitive pressure, % of sub-sample

	Monopolist	Non-monopolist
Ukrainian competitors	23.5	43.1
CIS competitors	28.6	14.3
Other foreign competitors	25.0	13.9

Hardness of budget constraints

STATE SUBSIDIES AND TAX ARREARS: In 1999-2002, direct subsidization played a minor role as an instrument of state support. Only 5.2% of surveyed firms reported receiving direct state subsidies. The latter were mainly concentrated at the large enterprises. While among SMEs only 4.6% of the firms have received state subsidies, the respective number for large enterprises is twice as high and constitutes 9.4%.

At the same time, toleration of tax arrears has become an important source of soft budget constraints. Almost a half of surveyed firms (42.9%) reports having tax arrears in 1999-2002.

The share of the debtors increases along the size groups: it constitutes 25.0%, 46.5% and 53.7% for small, medium and large firms, respectively. Two thirds of tax "debtors" (59.5%) have been partly relieved from fulfilling their tax obligations. Almost three quarters of tax "debtors" (70.2%) have experience to restructuring of tax arrears. As a rule, writing-off and restructuring of tax arrears was combined (in 74.4% of cases).

However, there is some evidence of hardening budget constraints in Ukrainian industry. We asked managers whether they can rely on the support of central/local government or commercial partners in case there is a threat of bankruptcy 82.9% of the managers do not expect any support from outside. Only 4.6% of all respondents expect support from the central government in the form of direct subsidies or writing-off of tax arrears, and another 2.3% of managers rely on the support of local authorities. The larger the size of the firms, the higher the expectations concerning support from central government (this indicator equals 1.6%, 3.8%, and 9.1%, for small, medium, and large firms respectively)

INTER-ENTERPRISE ARREARS, BARTER, STATE ORDER: In 1999-2002, the average size of overdue payables and receivables measured as percentage of annual sales has gone down (from 13.6 to 8.1, and from 15.8 to 9.2 respectively). It is interesting that the share of firms that have overdue payables and receivables has also decreased (from 72.3% to 58.3% with respect to overdue payables, and from 76.2% to 63.6% with respect to overdue receivables). This implies differentiation of the firms into two groups: viable firms which succeeded in eliminating inter-enterprise arrears, and less viable ones, in which average size of overdue payables/receivables has even increased.

Arrear for communal services has also slightly decreased and in 2002 constitute only 1.0 % of annual sales (compared to 2.8 % in 1999).

The most dramatic reduction is recorded for barter operations: In 2002, its average size has gone down by 5 times compared to 1999 (from 18.7 to 3.7), while the number of firms without barter has doubled.

No significant changes have occurred with respect to state order. Its share in annual sales remains quite low (4.1% in 1999 and 3.6% in 2002, respectively).

Table 4. Tolerance of tax arrears across the firms of different size, % of the firms with tax arrears

	Tax arrears restructured	Tax arrears written-off
Total sample:	70.2	59.5
Small	75.0	65.5
Medium	67.6	54.3
Large	74.1	72.0

Table 5. Inter-enterprise arrears, barter, state order

	1999		2002	
	0% of total sales, % of firms	An average level, mean	0% of total sales, % of firms	An average level, mean
State orders	85.1	4.1	83.9	3.6
Arrears for communal services	78.2	2.8	89.7	1.0
Barter	34.3	18.7	66.4	3.7
Overdue payables	27.7	13.6	41.7	8.1
Overdue receivables	23.8	15.8	36.4	9.2

Table 6. An average % in total sales inter-enterprise arrears, barter, state order, mean value

	1999		
	Small	Medium	Large
State orders	1.8	4.7	5.4
Arrears for communal services	2.3	2.1	5.3
Barter	13.8	19.1	23.6
Overdue payables	11.0	12.7	19.6
Overdue receivables	13.0	16.4	17.8
	2002		
	Small	Medium	Large
State orders	1.8	4.8	2.2
Arrears for communal services	0.4	0.7	2.9
Barter	1.5	3.6	6.4
Overdue payables	5.0	7.9	12.3
Overdue receivables	5.7	9.7	12.1



Small firms have lower absolute size and better dynamics of communal arrears, barter, and overdue payables/receivables than large enterprises.

Investment & restructuring activities, performance

Performance: During 1999-2002, the share of profitable firms in our sample has increased from 50.6% to 57.7%. This has happened due to an increase in the respective shares within the groups of small and medium sized firms, while large enterprises have shown no changes.

Managers were asked to estimate change in performance of their firms in 2000-2002 (using previous year as a basis for comparison) across the following indicators: 1) profitability, 2) sales volume, 3) labor productivity (sales per employee), 4) investment (as percentage of annual sales), and 5) capacity utilization.

Table 7. Changes in performance results during 1999-2002, % of the enterprises

	1999 vs 1998				2001 vs 2000				2002 vs 2001			
	Up	The same	Down	Balance ²	Up	The same	Down	Balance	Up	The same	Down	Balance
Profitability	22.7	49.5	27.8	-5.1	28.7	49.8	21.5	7.2	30.9	39.3	29.8	1.1
Sales	36.8	37.9	25.4	11.4	48.5	31.0	20.4	28.1	40.5	27.7	31.8	8.7
Labor Productivity	31.1	44.2	24.7	6.4	44.0	39.2	16.8	27.2	36.5	35.7	27.8	8.7
Investment	18.7	62.7	18.7	0.0	21.5	64.6	13.8	7.7	20.7	57.2	21.8	-1.1
Capacity utilizations	30.9	42.8	26.4	4.5	41.3	39.0	19.7	21.6	33.3	36.7	30.0	3.3

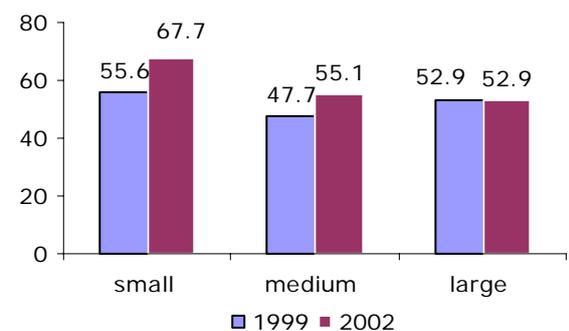
Table 8. Changes in performance results during 1999-2002, balance %

	1999 vs 1998			2001 vs 2000			2002 vs 2001		
	Small	Medium	Large	Small	Medium	Large	Small	Medium	Large
Profitability	-18.0	3.0	-13.0	8.0	8.0	6.0	2.0	3.0	0.0
Sales	3.0	19.0	7.0	25.0	25.0	43.0	5.0	8.0	15.0
Labor Productivity	-2.0	10.0	6.0	16.0	26.0	44.0	2.0	9.0	17.0
Investment	0.0	-2.0	5.0	2.0	4.0	26.0	-6.0	5.0	15.0
Capacity utilizations	-6.0	11.0	0.0	11.0	22.0	34.0	-8.0	7.0	6.0

The overall improvement of performance results, i.e. positive balance percentages, is observed during the whole period except for profitability and investment. At the same time, the most significant improvement in performance results has been recorded in 2001, while in 2002 the progress has slowed down. It is reflected in the lower values of balance percentages across all performance indicators in 2002 compared to 2001

For small firms balance percentages are lower across all indicators except for profitability.

Share of profitable firms, % firms



² *Balance is the difference between "up" and "down" shares. We calculate balance percentages, i.e. differences between the share of the firms that improved performance and the share of enterprises that reported worsening performance results. Interpretations of the balance percents are similar to those of indices of change in the regular QES bulletin.



Level of investment: The share of firms in total sample that reported investment remains rather low, though it has grown from 28.0% in 1999 to 33.9% in 2002. This positive tendency seems to continue: 35.0% of the firms have investment plans also for 2003.

The average level of investment measured as percentage of annual sales has been increasing from 14.9% in 1999 to 15.9% in 2002. In 2003, it is expected to increase up to 18.3%. Among the firms that reported investment in 2002, 67.8% had investment activity also in 1999, and 83.9% are going to invest in 2003.

Sources and purposes of investment. Profit and depreciation remain the main sources of investment covering more than 90% of its total volume. Profit re-investment rate has risen from 41.2% in 1999 to 50.7% in 2002. The highest increase is recorded for small firms. At the same time, the role of bank loans has started to increase: it has gone up from 2.8% of total investment volume in 1999 to 3.7% in 2002, and is expected to reach 7.2% in 2003.

Investment is mainly directed into buying new equipment (about 95% of "investing" firms), while investment in building new production and social facilities remains low.

Obstacles to investment. Managers' perceptions reflect high risks associated with investment climate. 64.5% of surveyed managers consider current period of time to be unfavorable for investment, another 34.7% of the respondents assess it as "more-or-less favorable", and only 0.8% of managers believe that it is good time to invest. No significant improvement in perceptions of investment climate has been recorded.

SMEs have slightly improved their perceptions of investment climate (the share of firms considering it as unfavorable has gone down from 77.5% in 1999 to 70.0% in 2002 for small firms, and from 70.7% to 62.7% for medium ones). Large enterprises have worsened their perceptions of investment climate (respective share are 52.5% and 63.3%).

Managers have been asked to report three main impediments to their investment plans. In 1999, the most frequently reported obstacles included low profit (74.9%), frequent changes of legislations (34.7%) and high cost of capital (32.0%). In 2002, the ranking has been changed. While low profits continue heading the list, the significance of regulatory impediments has decreased, while low demand now ranks second.

Dynamics of obstacles to investment differs across the size groups. In 2002, small firms report high cost of capital and fear of indebtedness almost twice more frequently comparing to 1999, while respective indicators for large firms tend to decrease. At the same time, small firms have improved their perceptions concerning stability of regulations dramatically, while the progress for large firms is less significant.

Restructuring activities of the firms follow the pattern of investment. Managers have been asked about the measures of so-called hard strategic restructuring used before and after 1999.

Table 9. Investment across different size group, % of the enterprises

	1999	2002	2003
Small	20.3	32.8	35.9
Medium	27.3	30.6	31.2
Large	39.6	45.3	45.3

Table 10. Investment indicators

	1999	2002	2003 (expected)
Total investment (% by gross revenue)	14.9	15.9	18.3
<i>Sources of investment (% by total sum):</i>			
Profits and depreciation	96.8	94.6	91.8
Ukrainian banks loans	2.8	3.7	7.2
State funds	0.0	0.5	0.0
Issuing shares	0.4	1.2	1.0
<i>Type of investments (% of the enterprises that invested)</i>			
Buying new equipments and technology	95.7	96.5	94.9
Building production premises	14.3	17.6	16.7
Building non-production premises	8.5	5.9	5.1

Table 11. Barriers to investment, % of respondents

	Q4 99	Q4 02	04 02 vs Q99
Insufficient profits	74.9	70.4	-4.5
Insufficient demand	20.6	35.4	14.8
Too high cost of capital	32.0	31.2	-0.8
Fear of indebtedness	19.6	19.6	0.0
Difficult in obtaining loans	14.1	15.4	1.3
Unclear legislations	21.6	15.4	-6.2
Foreign competition	9.3	14.2	4.9
Frequent changes in legislations	34.7	13.8	-20.9
Unstable political situation		10.4	



Table 12. Barriers to investment across different size groups, % of respondents

	Small		Medium		Large	
	Q4 99	Q4 02	Q4 99	Q4 02	Q4 99	Q4 02
Insufficient profit	84.1	63.5	76.7	75.7	72.1	63.3
Insufficient demand	29.5	46.0	16.3	31.8	16.3	32.7
High cost of capital	27.3	42.9	31.8	27.0	39.5	28.6
Fear of indebtedness	11.4	23.8	17.8	18.2	30.2	18.4
Difficult access to loans	13.6	20.6	16.3	12.8	11.6	16.3
Unclear legislations	31.8	11.1	23.3	16.2	20.9	18.4
Foreign competition	9.1	4.8	9.3	16.9	4.7	18.4
Frequent changes in legislations	34.1	1.6	37.2	14.2	46.5	28.6
Unstable political situation		9.5		8.8		16.3

General level of strategic restructuring is rather low and does not show significant improvement: only 16.3% of the firms in 1999-2002 reported buying new equipment, and 11.3% of the firms have made significant product innovations.

In addition, we have looked at the changes in top-management of the firms in 1999-2002. 28.8% of enterprises report change of general manager. In 55.3 % of the cases new managers come from outside, while in 44.7% of the cases they represent insiders.

Sample description

The sample is based on the panel used for Quarterly Enterprise Survey and includes 300 enterprises located in four regions of Ukraine. Response rate is 94.0%. The structure of the sample reflects the structure of the panel.

The surveyed enterprises are located in Kyivska, Lvivska, Kharkivska and Odeska oblasts. About 2/3 of the firms are from oblast centers, 1/3 of the firms — from local settlements. The average size of enterprises measured by number of employees is 437. We distinguish between 3 groups of enterprises: small (less than 50 employees), medium-sized (51-500 employees), and large ones (more than 500 employees)

The sample consists of state (15.6%), privatized (75.9%), and *de novo* private firms (8.5%).

Table 13. Measures of hard strategic restructuring, % of the enterprises

	Purchase of new equipment		Significant product innovations	
	Before 1999	After 1999	Before 1999	After 1999
Small	6.2	15.4	7.7	9.2
Medium	20.9	16.6	11.0	9.8
Large	18.5	16.7	7.4	18.5
Total sample	17	16.3	9.6	11.3

Table 14. Sample description

Industries, %	
Heavy industry	11.5
Machine building	25.3
Wood processing	7.6
Construction materials	8.7
Light industry	12.5
Food processing	22.9
Printing	8.7
Other	2.8
Size (number of employees), %	
Small	23.0
Medium	58.0
Large	19.0
Regions, %	
Lviv	26.0
Kyiv	33.7
Kharkiv	31.3
Odesa	9.0