

A terra incognita of Ukrainian business: What do we know about medium-sized industrial enterprises?

- **Most Ukrainian industrial MEs (medium-sized enterprises) originated as a result of privatisation and downsizing of former state enterprises.**
- **Contrary to their western counterparts, Ukrainian MEs are mainly represented by joint-stock companies (JSCs) with a high potential for corporate governance problems.**
- **Small businesses (SEs) do not represent a significant source of medium-sized sector development due to problems with incentives and opportunities for growth.**
- **Half of the SEs consider that losing their tax privileges and simplified accounting are disincentives for growing beyond their size group.**
- **19% of the MEs consider using simplified taxation schemes in their growth plans.**
- **ME investment activity is rather low and they consider a lack of profits to be an impediment to investment more often than do the SE and LE (large enterprise) groups.**
- **The share of profitable firms is lowest among MEs.**
- **The ME restructuring activities and their dynamics of performance show a "staying-in-the-middle" approach.**
- **MEs report a lower level of security of property rights than do SEs and LEs.**
- **The larger the firm the more it believes it to be important for business success to maintain informal relations with representatives of the public authorities.**
- **MEs consider uncertainty of corruption outcomes more likely than do the other size groups.**
- **In 2003, MEs have the lowest share of firms with tax arrears compared to SEs and LEs.**

A panel of 300 manufacturing firms is used to monitor their managers' perceptions about markets, the business climate, investment activity and the performance of their firms.

In this issue: Results of special surveys conducted in February and July 2003

New: Profile of Industrial Medium-Sized Enterprises.

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Why medium-sized enterprises are important.

In Europe 1.9% of all businesses are medium-sized enterprises (with 51-250 employees) employing 15.4% of the available workforce and generating 20.2% of the total turnover. Private companies of medium size play an important role in manufacturing industries.

European MEs serve both the domestic and international markets and are considered the backbone of the economy. Compared to SEs, MEs have a much higher rate of survival, better access to external finance, and the advantage of economies of scale. Compared to LEs, MEs are, on the average, more customer-oriented and flexible in adjusting to changes in demand and in the business environment. This shows up in the dynamics of their performance results. With regards to employment, MEs play a stabilizing role over each business cycle: During an economic upswing they offer lower average wages and demonstrate lower rates of employment growth. However, during a recession they are more reluctant to shed personnel.

What is medium-sized business in Ukraine?

Authors:
Irina Akimova
Oksana Kuziakiv

Institute for Economic Research
and Policy Consulting
Reytarska St. 8/5-A, 01034 Kyiv
Tel. (+38044) 228-6342
Fax (+38044) 228-6336
E-mail: institute@ier.kiev.ua
<http://www.ier.kiev.ua>

Ukrainian medium-sized businesses: A profile

Definition of medium-sized enterprises and markets served by MEs

Ukrainian legislation does not provide a precise definition of medium-sized businesses. The new Commercial Code defines small businesses as entities with less than 50 employees, and large enterprises as firms with more than 1000 employees. Consequently, all firms employing 51 to 1000 people would fall into the category of "medium-sized businesses". However, this definition is ambiguous and also does not agree with the standard international approach. Most European countries set the upper employment limit for MEs at the level of 250 employees, while the USA extends it up to 500 employees. In our survey, we used the EU definition and defined enterprises with 51 to 250 employees as medium-sized, as compared to large firms with more than 250 and small firms with less than 50 employees.

In our sample, 41.5% of all firms are medium-sized. The highest concentration of MEs is in food processing (31.6% of the total number of MEs). 84.2% of MEs produce final goods (15.8% produce intermediary products). More than half of the MEs (54.4%) work with products of mass consumption, another 40.4% target special groups of customers, and 5.3% work on individual orders.

Geography of sales: MEs operate mainly in the domestic markets. On the average, about 91.2% of their goods are sold within Ukraine. In this respect, MEs are more like SEs (with 96.2% of sales on domestic markets) than large enterprises (with 68.1%). However, MEs are more oriented towards serving the whole national market than SEs, which offer almost 70.0% of their goods on local or regional markets. ME production for export is quite low for both CIS and European countries (5.0% and 3.1% respectively).

Origins of the industrial medium-sized enterprises in Ukraine

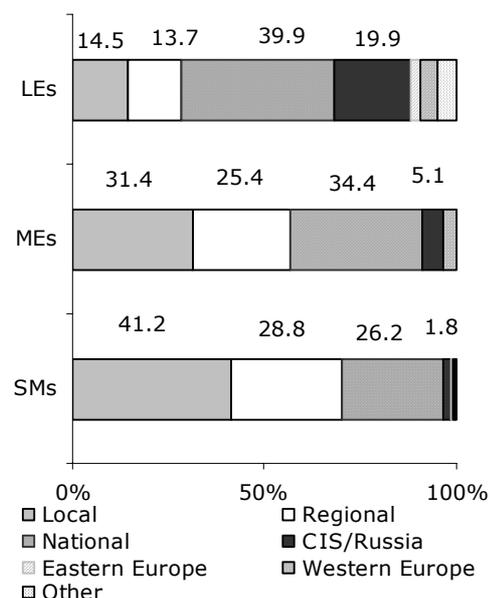
In developed economies, medium-sized firms typically originated as private start-ups, a considerable part having grown out of small businesses. In transition countries like Ukraine, *MEs normally originated as a result of the privatisation of former State owned enterprises (SOEs)*.

In our sample, 8.5% of the MEs are state-owned companies, 88% are privatised enterprises, and only 3.5% represent private start-ups. Among the privatised MEs, 93.8% of the firms had been privatised as a unit; the remaining 6.2% were split-offs from large enterprises. 57.8% of the privatised companies belonged to the medium-sized group before privatisation, while 42.2% of the firms resulted from a considerable downsizing of former large enterprises during and after privatisation. In general, the process of post-privatisation downsizing affected the vast majority of MEs (80.8%). Their average employment dropped from 452 people in the year of foundation to 213 in 1999, and further to 131 in 2003. The downsizing tendency seems to have come to an end now: By 2006 the average ME size is expected to increase to 142 employees.

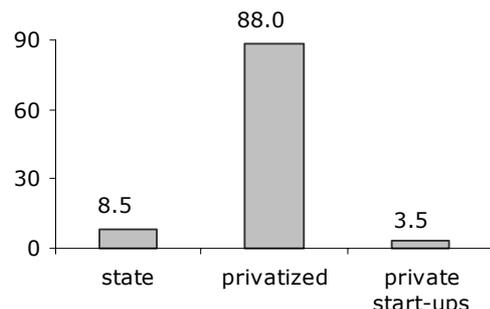
We use the EU definition of medium-sized enterprises...

... and define Ukrainian enterprises with 51-250 employees as medium-sized.

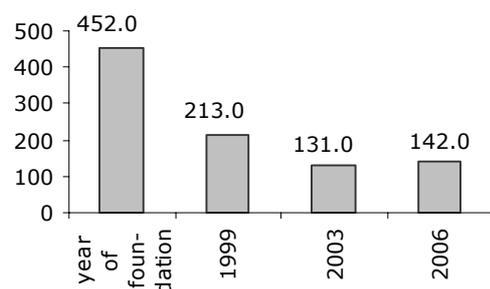
Market shares for different size enterprises, %



Type of ownership for MEs, %



An average number of employees for MEs, %



Ownership structure

In Western Europe, MEs are characterized not only by size, but also by ownership structure: They are typically owned by a small number of individuals (often members of one or two families) who actively participate in the companies' managements. This encourages entrepreneurship and avoids certain corporate governance problems, which publicly owned joint-stock companies usually experience.

In Ukraine, on the contrary, most industrial MEs are joint-stock companies with a rather dispersed ownership structure. In our sample, joint-stock companies account for 65.5% of the total number of MEs (including 46.2% open and 19.3% closed JSCs), while individual proprietorships and partnerships account for only 11.8% of the MEs.

This means that *the average industrial ME faces all the typical corporate governance problems.*

Do changes in the ownership structure of MEs move in the direction of the western type, i.e. to enterprises with fewer owners? Our data suggests a rather negative answer.

MEs are still heavily dominated by insiders (see Table 1), who control almost two-thirds of the equity. Though managerial shareholdings have been slowly increasing, they are still too small even for exercising a blocking power, and almost 40% of the shares are dispersed among non-managerial employees. At the same time, concentration of ownership in the hands of outsiders (mainly Ukrainian companies) is ongoing, while no significant (dominant) outside ownership has as yet developed.

Large enterprises seem to be more dynamic with respect to changes in the ownership structure than MEs: Insider shareholdings in LEs are considerably lower (41.6% vs. 58.5% in MEs), and dispersed employee ownership is nearly half as large (23.3% vs. 38% in MEs). Concentrated outside ownership is growing mainly due to an increase in the shareholdings of Ukrainian companies and individual owners. Foreign equity, on the average, is still very small (about 3%)¹.

What kind of changes in the concentration of ownership are expected within the ME group between 2004 and 2006?

More than a quarter of the respondents expect an increase in managerial ownership. At the same time, about 22% of the respondents expect greater ownership concentration in the hands of Ukrainian companies and individual outside owners.

Over the short run, the development of small groups of dominant owners in the medium-sized sector seems unlikely.

The ownership structure in partnerships is absolutely clear: On the average, there are 2 partners, who run the ME. The situation has not changed significantly between 1999 and 2003.

Table 1. The distribution of ownership in medium-sized joint-stock companies, mean

	1999	2002
Non-managerial employees	44.9	38.0
Managers	18.0	20.5
Insiders	62.9	58.5
State	4.7	2.4
Ukrainian physical entities	10.1	14.0
Ukrainian legal entities	21.5	25.1
Foreign legal entities	0.0	0.0
Foreign physical entities	0.7	0.0
Outsiders	32.3	39.1

Table 2. The distribution of ownership in large joint-stock companies, mean

	1999	2002
Non-managerial employees	30.5	23.3
Managers	16.3	18.3
Insiders	46.8	41.6
State	15.5	14.1
Ukrainian physical entities	11.6	12.6
Ukrainian legal entities	23.8	28.0
Foreign legal entities	2.3	3.7
Foreign physical entities	0	0
Outsiders	37.7	44.3

Table 3. Respondents' perceptions about ownership concentration in 2004 to 2006 (ME businesses), % of respondents

	Increase
Managers	26.7
Ukrainian physical entities	8.2
Ukrainian legal entities	14.1
Foreign physical entities	2.9
Foreign legal entities	3.0

¹ Enterprises owned by foreigners are represented in our sample, but an average share cannot be statistically recognized.

Sources of the medium-sized sector development

In developed economies, growing small businesses are an important source of medium-sized sector development. In Ukraine however, small businesses do not seem to have the same potential. Between 1999 and 2002, less than 1% of the small firms in our sample entered the ME group. The situation is not going to change significantly in the next 3 years: Though 45.2% of all small enterprises plan to increase their employment levels in 2004-2006, only 4.8% of SEs expect to exceed the 50-employees benchmark.

This means that medium-sized businesses in Ukraine will be mainly represented by privatised former SOEs for the foreseeable future.

What prevents SEs from growing? There are problems both with *opportunities* and with *incentives* for growth. Regarding growth opportunities, the main impediment for entering the ME sector is the lack of internal and external sources for financing investments. *At the same time, more than half of the SEs consider the loss of tax privileges and of the simplified accounting standards as disincentive for growth.* Therefore, if necessary 22% of the SEs would open new small subsidiaries, which are eligible for simplified taxation, rather than entering the ME group.

MEs also use simplified taxation schemes to minimize their tax load: 57.5% of the MEs admitted that splitting-off scheme is used in their industries in order to benefit from the tax advantages provided for SEs. About 12% of the MEs report that they actively use the simplified taxation system for their own departments and affiliations, and 19% of the MEs intend to use this practice (i.e. by opening SE affiliations) in the future.

What advantages do small businesses expect from becoming medium-sized? According to the opinion of SE managers, the main advantages are related to economies of scale (lower unit costs) and superior investment opportunities (53.2% of SEs), including better access to bank loans (48.5%).

Do the expectations of SE managers agree with the perceptions of ME managers concerning their own advantages? Yes, with respect to economies of scale and access to bank credits. No, with respect to investment opportunities! While 53% of the SEs expect the MEs to have better investment opportunities, only 32% of MEs consider this to be so.

Investment, restructuring activity and performance results: MEs stay in the middle.

Investment: The investment activities of MEs between 1999 and 2002 were rather low. More MEs made investments than did SEs, but compared to the LEs they made significantly fewer (see Table 7). For example, in 2002, 30.8% of the MEs reported investments, while the figures for LEs and SEs are 43.8% and 23.4% respectively. The same tendency applies for 2003, too. The difference between MEs and SEs increased because many fewer SE group firms reported investments.

In terms of investment volume measured as a percentage of total revenues, MEs were the worst performers during 1999 to 2002. In 2003, the investment ratio for the MEs is expected to be higher than for the SEs, mainly due to a

Table 4. Impediments for small businesses to grow into MEs

	% of SEs
Lack of resources for investment	65.6
Loosing of tax privileges	58.2
Assess to / cost of bank credits	57.4
Higher accounting requirements	55.2
Lack of demand	53.2
Expected decreased quality of goods (increased unit cost)	37.3
Additional licenses	26.8
Low level of security of property rights	22.4
Increasing need for market information	7.5

Table 5. Advantages of being medium-sized: perceptions of SE managers

	% of SEs
Lower unit costs	54.3
Better investment opportunities	53.2
Better access to bank credits	48.5
Better possibility to lobby group interests	27.9
Higher level of state tolerance	23.3
Better access to market information and market research	22.2
Higher security of property rights	21.0

Table 6. Advantages of being medium-sized: perceptions of ME managers

	% of MEs
Lower unit costs	63.5
Better access to loans	57.7
Higher security of property rights	35.8
Higher level of state tolerance	34.8
Better access to market information and market research	32.9
Better investment opportunities	32.2
Better possibility to lobby for group interests	32.2



reduction in the respective indicator for the SEs (see Table 8). The slow down of investment activity among the SEs observed between 1999 and 2003 again confirms that the SEs are not going to be a source of medium sector development in Ukraine in the near future.

What restricts ME investment? MEs, like enterprises of the other size groups, mention insufficient profit as the first item in the list of barriers to investment. However, MEs report this barrier more often than do LEs, and in 2002 - even more frequently than SEs.

Table 9. Barriers to investment for the three size groups, % of the firms

	Small		Medium		Large	
	1999	2002	1999	2002	1999	2002
Insufficient profit	84.1	63.5	79.8	76.4	68.9	68.1
Insufficient demand	29.5	46.0	18.2	34.0	13.5	29.7
High cost of capital	27.3	42.9	31.9	28.3	36.5	26.4
Difficult access to loans	13.6	20.6	16.2	11.3	13.5	16.5
Unclear legislations	31.8	11.1	23.2	15.1	21.6	18.7
Foreign competition	9.1	4.8	10.1	16.0	5.4	18.7
Frequent changes in legislations	34.1	1.6	37.4	14.2	43.2	22.0

Are the profits of MEs lower than those of the other size groups? In 1999, the MEs had the lowest share of profitable enterprises: 46.4% of the firms vs. 54.1% for the SEs and 55.2% for the LEs. Though in 2002, the situation had improved, the share of profitable firms among MEs remained the lowest: 54.5% vs. 61.7% for SEs and 56.5% for LEs. Our respondents were asked to assess their level of profitability compared to the average in their industries. In 1999, this index of relative profitability (the difference between the percentage of firms with a higher than average profitability and the percentage of firms with a lower than average profitability in the industry) was the lowest for MEs. In 2002, MEs ranked second due a significant drop in the index of relative profitability for the SEs.

Performance: Table 11 presents the indexes of performance for enterprises of the different size groups for 1999 to 2002 using five performance measures. MEs stood "in the middle" for all performance measures except for profitability, showing better performance dynamics than the SEs and, at the same time, being inferior to the LEs. The dynamics of ME profitability have been worsening since 1999, and in 2001 and 2002 were inferior even to the SEs.

Table 11. Indexes of performance between 1999 and 2002.

	1999 vs. 1998			2001 vs. 2000			2002 vs. 2001		
	Small	Medium	Large	Small	Medium	Large	Small	Medium	Large
Profitability	-19.0	+5.0	-5.0	+3.0	+2.0	+14.0	+2.0	-2.0	+9.0
Sales	-5.0	+17.0	+24.0	+14.0	+21.0	+45.0	+3.0	+8.0	+14.0
Labour productivity	-3.0	+9.0	+18.0	+15.0	+21.0	+47.0	+3.0	+7.0	+17.0
Investment	-9.0	-6.0	+9.0	-4.0	-6.0	+31.0	-14.0	-10.0	+20.0
Capacity utilizations	-6.0	+10.0	+13.0	+8.0	+16.0	+41.0	-8.0	+2.0	+11.0

Table 7. Investment by the different size groups, % of the enterprises

	1999	2002	2003
Small	20.3	23.4	20.3
Medium	25.2	30.8	34.6
Large	37.5	43.8	45.2

Table 8. Investment as % of total revenues for the different size groups, mean

	1999	2002	2003
Small	15.9	11.6	9.9
Medium	8.2	9.0	11.9
Large	12.3	14.9	16.1

Table 10. Self-assessed relative profitability of the firms in 1999 and 2002 (% of firms)

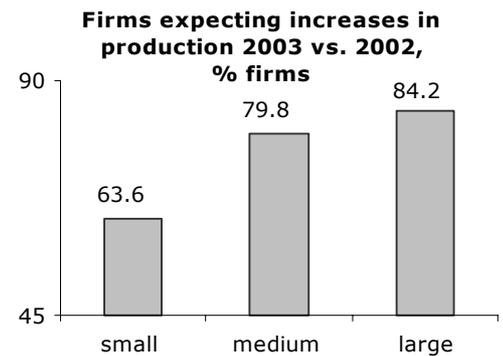
Level of profitability compared to the industry average

	1999	Small	Medium	Large
Lower		41.5	47.6	42.6
Same		43.4	42.9	31.1
Higher		15.1	9.5	26.2
Index 1999	-26.4		-38.1	-16.4
	2002	Small	Medium	Large
Lower		54.2	43.8	35.9
Same		29.1	39.3	32.8
Higher		16.3	16.9	31.2
Index 2002	-37.9		-26.9	-4.7

Growth expectations for the MEs are similar to those of the large enterprises. The share of firms expecting an increase in production in 2003 vs. 2002 is 80% both for the ME and LE groups, while the respective indicator for the SEs is 60%. This situation is not expected to change significantly over the next three years. Between 2004 and 2006, 89.2% of the medium-sized firms and 89.3% of large firms plan growth. For small firms the respective figure is 81.8%.

Restructuring activities: This middle-of-the-road *behaviour of the MEs is also observed with respect to restructuring activities* (Table 12). MEs are more active than SEs and less active than LEs across almost all restructuring measures. Entering new markets constitutes the only exception: MEs demonstrate the lowest activity in searching for new markets across all size-groups.

Table 12. Percentage of the firms reporting restructuring activities.



	Small		Medium		Large	
	Before 2000	After 2000	Before 2000	After 2000	Before 2000	After 2000
Buying new equipment/technology	33.3	41.5	38.4	49.0	51.9	65.9
International certification for products	19.6	21.5	23.3	35.3	40.5	55.3
Major product innovations	31.4	35.4	41.9	51.0	49.4	62.4
Minor product innovations	45.1	47.7	44.2	55.9	48.1	57.6
Entering new markets	49.0	55.4	34.9	54.9	51.9	64.7
Development of new distribution channels	27.5	26.2	31.4	40.2	43.0	54.1
Increased advertising	19.6	36.9	15.1	48.0	25.3	44.7
Changing the organizational structure of the firm	21.6	18.5	22.1	27.5	31.6	43.5
Audit of the firm according to international standards	3.9	3.1	10.5	14.7	13.9	27.1

Security of property rights and relations with public authorities

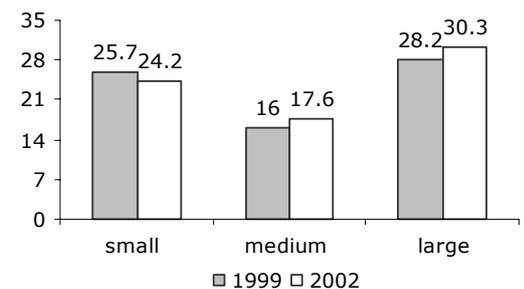
Security of property rights: The Ukrainian business environment is perceived as extremely insecure. Only 23.1% of the respondents believe that the judicial system is able to enforce their contract rights, and only 12.5% of the managers think that the judicial system is able to provide efficient protection against criminality. *Compared to the other size groups, MEs see themselves the most insecure: the share of ME managers trusting in the abilities of the judicial system is nearly half of that in the LE and SE groups!*

Informal relations with state authorities (implicit corruption). In 2002 more than half of all surveyed managers considered having informal relations with representatives of the public authorities as an important factor for business success. In addition, almost half of the respondents believe changes in public authority executives to have significant impacts on their firms' performances.

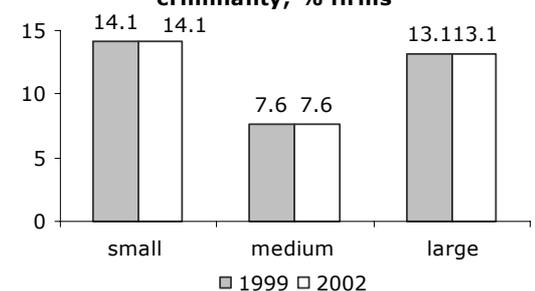
Both indicators of implicit corruption are the highest for large firms. *MEs are again in the middle:* they report the importance of informal relations and of public authority personnel changes more frequently than the SEs, but less often than the LEs.

The importance of informal relations depends on the type of the public authority involved. The state tax administration is

Judicial system is able to enforce contract rights, % firms



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





most frequently reported among the subjects of informal relations. Representatives of local (oblast and city) authorities are ranking second, while the central government is at the bottom of the list of "important friends".

Here, again MEs are in the middle: both indicators of informal relations are higher for the MEs than for the SEs, but lower than for large firms.

Table 13. The importance of informal relations with state authorities for business success, %*

	Informal relations			Change of public authority executives		
	Small	Medium	Large	Small	Medium	Large
State tax administration	50.0	55.5	60.9	41.7	44.1	49.2
City (district) administration	45.9	47.3	49.2	41.0	44.1	41.2
Oblast administration	36.1	45.6	52.2	28.8	41.0	42.7
Police	34.5	40.0	50.7	24.6	27.9	41.2
Central government	24.6	32.6	48.6	24.6	27.2	38.8

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

Corruption: MEs² rank between small and large enterprises across almost all indicators of explicit corruption³. MEs pay bribes in "order to get things done" less frequently than do SEs, but more often than LEs. The share of "bribers" in ME group has not changed significantly over time and in 2002 was 67.5%. At the same time, the average size of bribes for MEs has decreased (from 1.89% to 1.79% of total sales) and *at present is slightly lower than for the other size groups.*

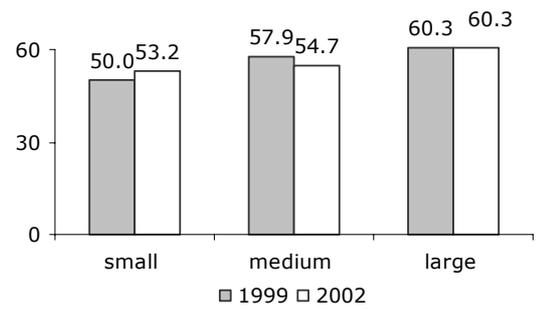
On the other hand, *the level of corruption-induced uncertainty for MEs is slightly higher than for the other size groups.* 25.1% of ME managers are unsure whether the agreed-to "services" will be delivered after paying a bribe.

Tax evasion. The respondents were asked to estimate the percentage of taxes that, according to their knowledge, are actually paid by firms of the same size in their industry relative to the total amount of taxes due to be paid for full compliance. In 2002 on the average, *MEs avoided 24.1% of their tax obligations, which did not differ significantly from SEs and LEs.*

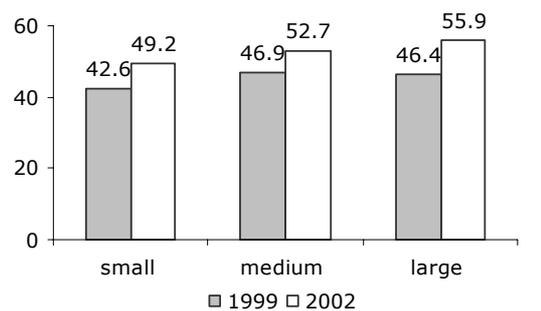
Tax arrears. At the same time, *MEs demonstrated the highest rates of reduction in tax arrears.* Since 1999, the share of firms with tax arrears among MEs has dropped by 36% compared to 24.4% for SEs and 33.6% for LEs.

In 2003, the share of firms with tax arrears among MEs is the lowest, constituting 20.5%, while the respective indicators for SEs and LEs are 25.6% and 34.5%.

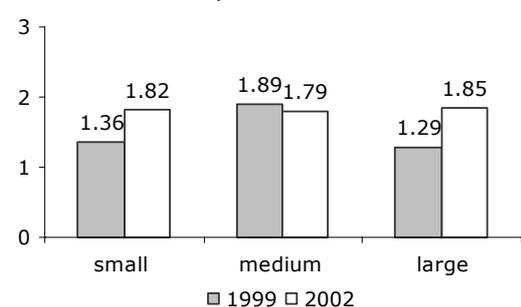
Importance of informal relations, % firms



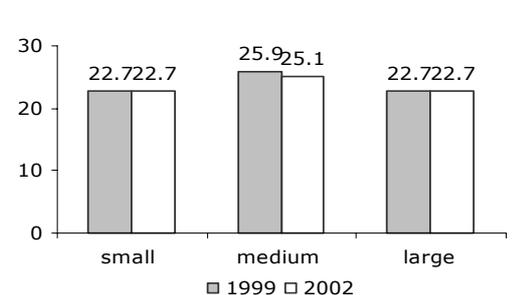
Importance of change of public authority executives, % firms



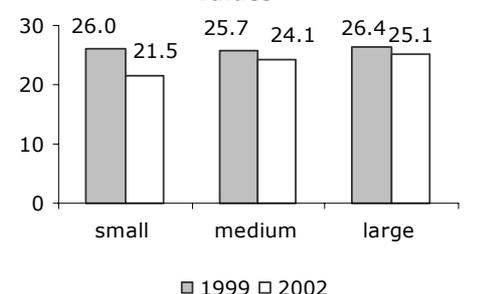
"Bribe tax" as percentage of annual sales, mean values



Uncertainty of corruption outcome, % firms



Rates of tax evasion, mean values



² MEs defined according to the USA definition were described in the "QES. Special Issue #1 (1) April 2003".

³ For a detailed explanation of the Corruption Indicators used see "QES. Special Issue #1 (1) April 2003".



Table 14. Tolerance of tax arrears for firms of different sizes, % of the firms with tax arrears

	Tax arrears restructured	Tax arrears written-off
Small	72.0	56.0
Medium	68.9	52.3
Large	67.6	63.6

Interestingly, this cannot be explained by a higher level of state tolerance. Just the contrary, *MEs experienced write-offs of tax arrears less often than did enterprises of the other size groups* (see Table 14).

Sample description

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

The surveyed enterprises are located in the Kyivska, Lvivska, Kharkivska and Odeska oblasts. About 2/3 of the firms are located in the oblast centres, and 1/3 of the firms in local settlements. The average size of the enterprises measured by the number of employees is 437. We distinguish between three groups of enterprises: small (less than 50 employees), medium-sized (51-250 employees), and large ones (more than 250 employees).

The sample consists of state (13.5%), privatised (77.7%), and *de novo* private firms (8.9%).

Notes:

- LEs Large enterprises
- MEs Medium-sized enterprises
- SEs Small enterprises

Firms with tax arrears , % firms

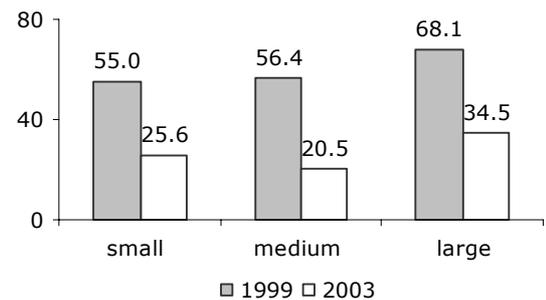


Table 15. Sample description

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	27.7
Medium	41.5
Large	30.9

Regions, %

Lviv	26.6
Kyiv	33.0
Kharkiv	31.9
Odessa	8.5