

Enterprise Survey: Business Climate and Investment in 2005-2006

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ONE STEP FORWARD, TWO STEPS BACKWARD?

THE IMPROVEMENT OF BUSINESS CLIMATE SLOWED DOWN IN 2006 AFTER ITS ACCELERATION IN 2005

- ANNUAL INDICATOR OF BUSINESS ENVIRONMENT BURDEN has increased to 51.0 in 2006 from 47.5 in 2005;
- The number of managers perceive property rights to be insecure has increased;
- The share of managers consider regulations unclear: remains at level of 2005: 79.8%;
- The "time tax has decreased from 14.8% to 11.2% of working time;
- The share of respondents reported the bribe to be a common instrument to get "things done" has decreased from 76.8% in 2004 to 34.0% in 2005
- In 2006 share of all firms pay bribes to get "things done increased again and reached to 55.1%";
- In 2006 the average size of bribes has grown again and reached an average 3.4% of annual sale
- The amount of the bribes increase over time and became more stable again in 2006;
- About 63.5% of all firms are unsure about the efficacy of corruption;
- 72,0% of surveyed managers are sure that "friendly relations" with state need to get success in business;
- After significant increase in 2005, the rate of tax compliance has decreased again in 2006;
- Competitive pressures from domestic and foreign producers are seen to be weaker over time;
- The investment activity is growing slowly;
- Profits remain the main source of investment, though the role of banks loans is increasing;
- Almost 2/3 of the firms consider the present to be an unfavorable time for investment;
- Insufficient profits and too high cost capital are the most frequently reported obstacles to invest;
- Investment plans of firms are sensible to changes in political situation.

Small and medium enterprises vs. large firms:

- Smaller firms believe the judicial system to be less able to enforce commercial contracts;
- Medium firms experience more state interference;
- The clarity and predictability of regulations are seen to be less onerous by small enterprises;
- Smaller firms experience a lower absolute level of the "time tax";

Smaller firms experience more exposure to corruption and a higher average size of bribes.

A panel of 300 manufacturing firms is used to monitor managers' perceptions of the changes in business climate and investment activity of the firms 2005-2006.

In this issue: We present the results of the fourths annual survey of business opinions dedicated to the quality of the business climate. Managers of the industrial enterprises gave their assessments, perceptions and anticipations regarding different aspects of the business environment and performance of their enterprises in 2005-2006

New: 1. *Small firms vs. medium firms vs. large firms: A comparative analysis.*

2. *The dynamics of explicit and implicit corruption in Ukraine.*

3. *Annual Indicator of Business Environment Burden*

Authors:
Oksana Kuziakiv
Mykhaylo Maximov

Institute for Economic Research
and Policy Consulting
Reytarska St. 8/5-A, 01034 Kyiv
Tel. (+38044) 278-6342
Fax (+38044) 278-6336
E-mail: institute@ier.kiev.ua
<http://www.ier.kiev.ua>

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.

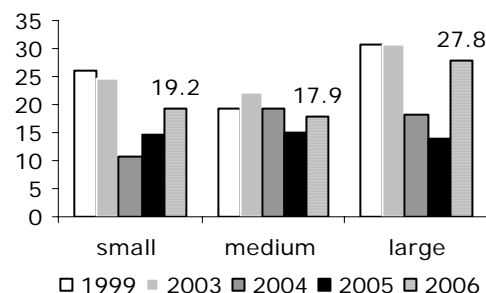
Business environment continue to be perceived as extremely insecure. But according to managers there are some improvements in 2006 comparing to 2005. The share of managers that believe in the ability of the judicial system to enforce their contract rights has increased from 14.7% in 2005 to 20.5% in 2006. Next improvement is recorded for business opinions about ability of judicial system to protect personal security of businessman. General level of this trust has not changed since 2002 and varied in 2002 to 2005 from 11 to 12.5%. In 2006 the share of managers who trust the judicial system in protecting their business entities and ensuring their personal security increased in two times and reached to 23.7%! While this level of trust is still low but the tendency perceived to be very encouraging. Improvement of the both indicators is recorded for all size groups. But most significant growth is observed in large size group. In 2006 vs. 2005 and 2004 large business perceive themselves more secure in terms the both (1) security of the contract right and (2) personal security because of increase their trust in the ability of the judicial system to enforce their contract rights and protecting their business entities against criminality.

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.

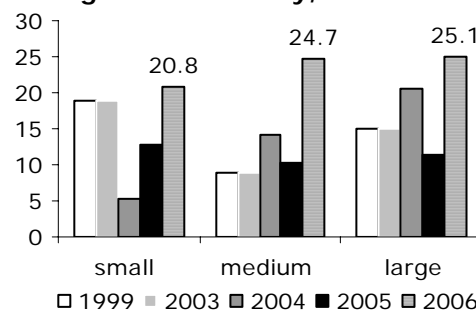
DIRECT STATE INTERFERENCE IN OPERATING ACTIVITY OF THE FIRMS. The level of state interference is rather low, however after decreasing in 2005, it has slightly increased again in 2006. In 2006, 80.9% of firms reported no or infrequent state interference, while for 2005 the respective indicator constituted 85.7%. The most significant increase in the level of state interference is observed in the small-size group of enterprises. At the same time the large firms reported about decrease in level of state interference.

PREDICTABILITY AND CLARITY OF REGULATIONS. Predictably and clarity of regulations is constantly low. But there were some improvements in 2005 comparing to 2004. The share of respondents perceived legislation as inconsistent and unpredictable decreased from 93.8% in 2004 to 79.2% in 2005. But in 2006 no changes are recorded: 79.8% of respondents perceive legislation as inconsistent and unpredictable. The different tendencies are recorded for different size groups. In the small business sector the share of firms that consider regulations as unclear and unpredictable has declined two years in row. There are no changes in the medium-size group. And after decrease in 2005 the share of the large

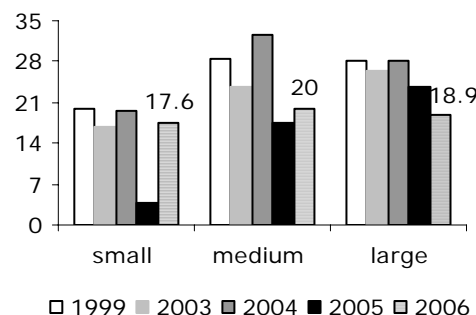
Judicial system is able to enforce contract rights, % firms



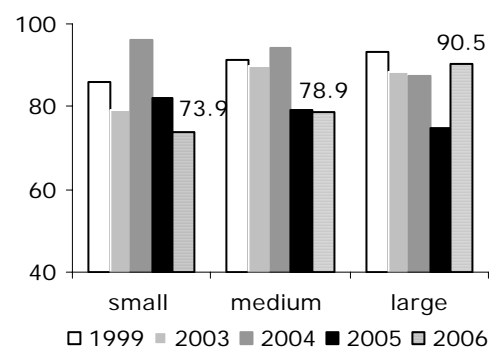
Judicial system is able to protect business entities against criminality, % firms



Direct state interference, % firms



Unpredictability of regulations, % firms



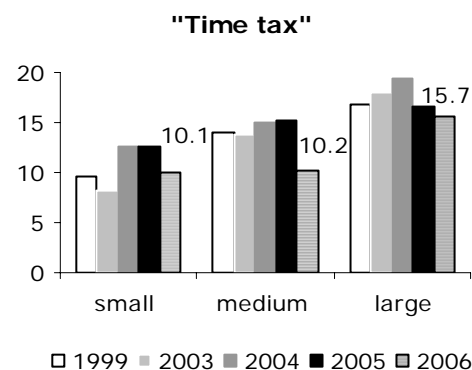
¹ In our survey, we have abstained from looking at the changes in registration procedures and quantity of regular/irregular controls by regulatory bodies, since progress in this area is well recorded by other analysts.

firms that considers regulations as unclear and unpredictable grew again and reached 90.5 %.

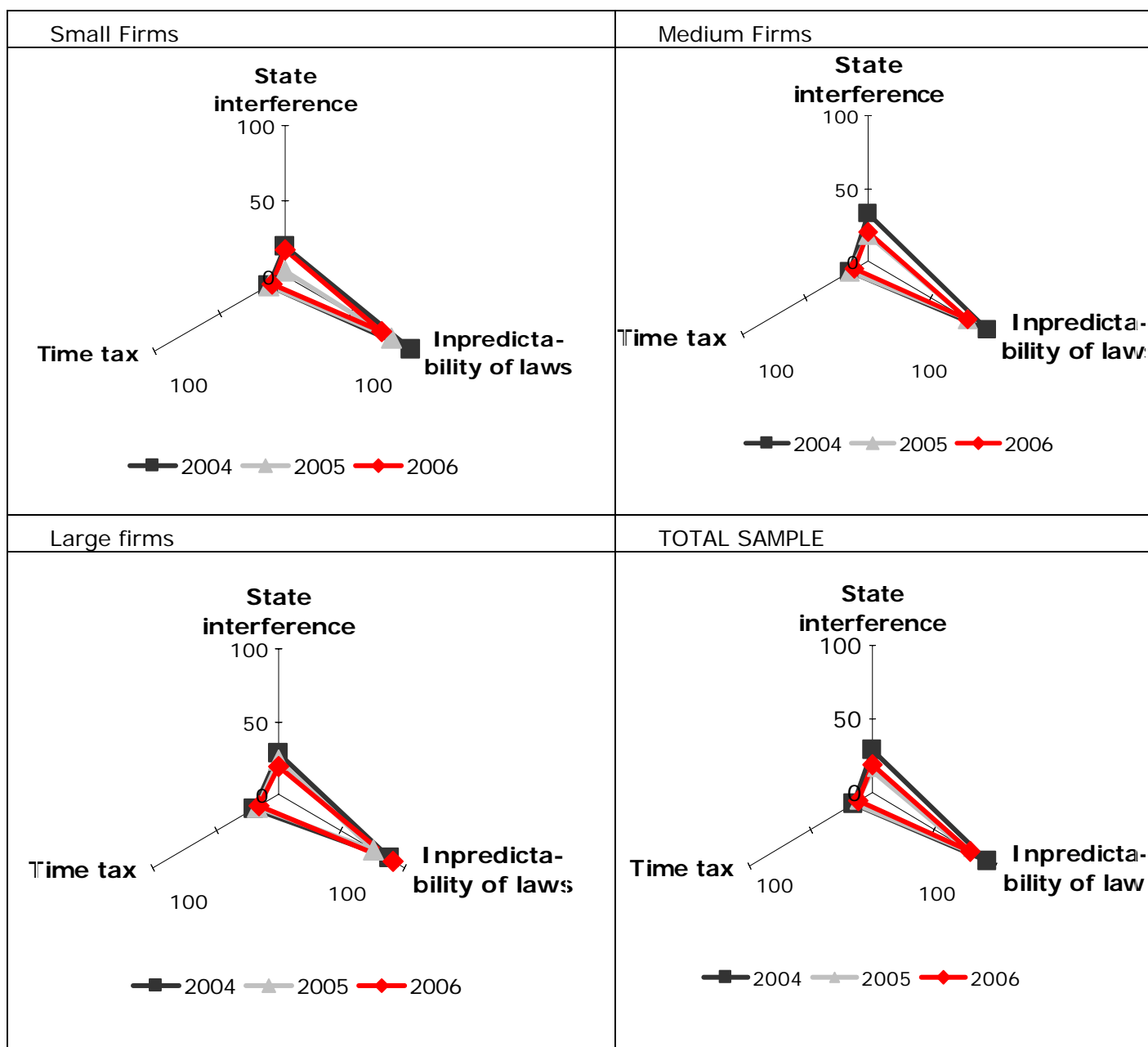
TIME TAX . In 2006, managers spent about 11.2% of their time dealing with the state officials. Compared to 2005, time tax has decreased by 3.6 percentage points. It is observed for all size groups. But the most significant decline (from 15.2% to 10.2) is recorded for medium enterprises.

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

- % 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



Picture 1. Regulatory burden: summary





The square of a triangle reflects the overall regulatory burden, which in 2005 has decreased both for the whole sample and different size-groups and in 2006 has increased again (picture 1). This conclusion is confirmed by the results of IER Quarterly Surveys: during 2004-2006, the share of firms that consider unfriendly regulatory climate as an important impediment to growth has been declining from 44.2% (Q4 2003) to 11.4% (Q3 2005) and then has been growing to 21.3 (Q1 2006).

Corruption: The level of corruption is monitored across the following indicators:

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

ABSOLUTE LEVEL OF CORRUPTION. The level of corruption in Ukraine is high and continues to increase. Respondents have been asked weather it is common for the firms like theirs to pay bribes in order "to get things done". The results are striking: the share of respondents reported the bribe to be a common instrument for "smoothing" dealings with public officials has decreased from 76.8% in 2004 to 34.0 in 2005 and then has increased to 55.1%! The growth is recorded for small and medium firms.

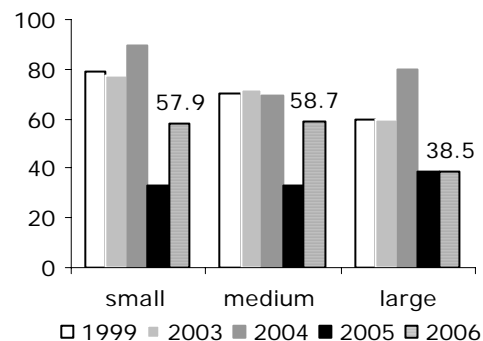
Small and medium firms continue to be exposed to bribes to a larger extent then the others: 57.9% of small and 58.7% of medium enterprises report paying bribes compared to 38.5% of large-sized firms.

In 2006 the average size of bribes has grown again and reached 3.4% of annual sale. The first time the average size of bribes increased dramatically in 2004: it grew from 1.9% of annual sales in 2003 to 6.5% in 2004. In 2005 significant decrease in the indicator was recorded (from 6.5% to 1.4%). This indicator varies across the enterprises of different size. Small and medium size firms face a higher "bribe tax" than large enterprises.

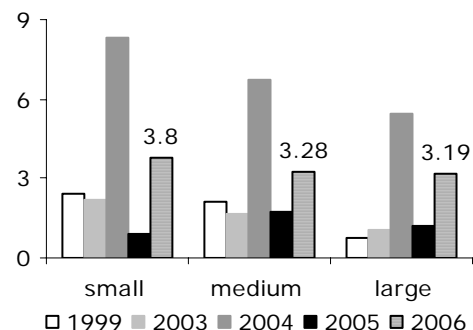
UNPREDICTABILITY AND INSTABILITY OF BRIBES. In 2006 vs. 2005 the bribe tax" becomes more stable. The level of corruption-induced uncertainty has a tendency to decrease: the share of managers reported that the size of a "bribe tax" is unstable and/ or unpredictable has dropped from 86.6% in 2005 to 79.8% in 2006. The most predictable and stable size of "bribe tax" was in 2004: only 43.0% of respondents reported about unpredictably of bribe size. The most predictable size of the bribe is for small enterprises.

UNCERTAINTY OF CORRUPTION OUTCOME (impossibility of bribe-givers to ensure corruption outcome). This indicator has increased over time. The share of our respondents who are completely unsure whether after paying bribe required "services" would be delivered as has been agreed before have risen from 25.0% in 2003 to 29.6% in 2004 and to 65.8% in 2005. In 2006 there are no significant changes comparing to 2005: 63.5% of respondents are unsure whether after paying bribe required "services" would be delivered as has been agreed before. The lowest level of such kind uncertainty is recorded for large firms.

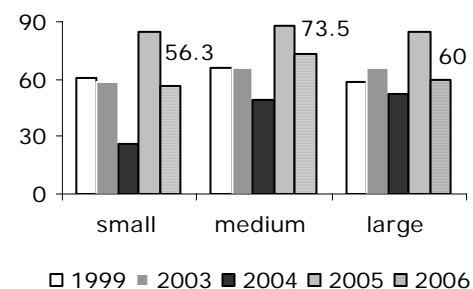
Absolute level of corruption, % firms



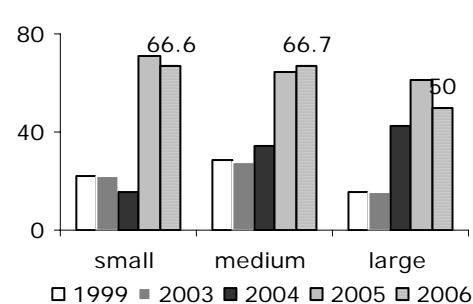
"Bribe tax" as percentage of annual sale, mean value



Unpredictability of bribes, % firms



Uncertainty of corruption outcome, % firms



INFORMAL RELATIONS WITH STATE AUTHORITIES (IMPLICIT CORRUPTION). In 2006 importance of informal relation have remained at the same level as in 2005. 72% of surveyed managers consider having informal relations with the representatives of public authorities to be important for their business success. In 2005 the respective indicators decreased comparing to 2004 was at 73.2% level. Such changes of indicator were observed for all size groups. In terms of absolute value the importance of informal relations continues to be slight higher for large and medium firms (80.0% and 70.6%) than for small ones (68.2%).

The importance of informal relations varies across different types of public authorities. State tax administration continues to be the most frequently reported among the important subjects of informal relations during all period of observations. Decreased in 2005 the importance of informal relations with STA for the enterprises has increased in 2006 again. The rating of other "important friends" of the successful businesses has significantly changes in 2005 and 2006:

- In 2005 oblast authorities and central government became more "important friends" comparing to 2004 (respectively +24.1% and +15.4). At the same time the importance of informal relations with police has decreased (-13.3).
- In 2006 the importance of informal relations with central government increased again (+7.9%). Also "friends" from city (district) authorities are perceived to be more important than in 2005 (+2.5). At the same time the importance of informal relation with oblast level authorities has decreased (-12.4).

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

	Informal relations						Change of representative of public authorities					
	1999	2003	2004	2005	2006	2006 vs. 2005	1999	2003	2004	2005	2006	2006 vs. 2005
STA	50.8	52.4	74.5	59.1	64.1	+5.0	35.9	42.4	44.1	34.5	45.8	+11.3
Police	36.8	39.6	66.2	52.9	52.9	0.0	24.4	29.1	40.1	30	38.8	+8.8
City (district) authorities	43.4	45.3	57.9	56.9	59.4	+2.5	33.9	40.9	39.9	35.7	47.2	+11.5
Oblast authorities	41	42.1	34.4	58.5	46.1	-12.4	32.7	35.6	21.9	37.8	35.5	-2.3
Central Government	31.1	33.6	28.6	44	51.9	+7.9	24.3	28.8	19.6	23.8	42.7	+18.9
Total	50	50	78.9	73.2	72	-1.2	60.3	55.3	48.5	40.2	46.9	+6.7

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

Importance of informal relations with state authorities for the business success varies across size groups of enterprises. The larger enterprise is, the more important informal relations for success in business. For small and medium firms STA and city (district) authorities are the most "important friends" (respectively 61.4% and 60.4; 61.9% and 57.3% in 2006). List of "important friends" for large enterprises are headed by STA and central government (71.4% and 68.6% in 2006).

In the previous years our results concerning importance of informal relations with public authorities are supported by the

Importance of informal relations, % firms

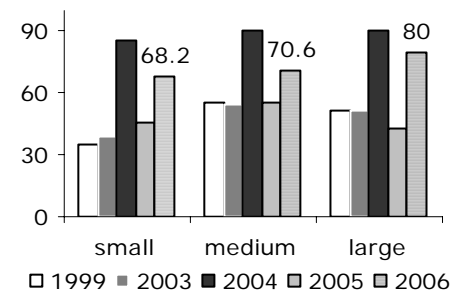


Table 2. Importance of informal relations with state authorities for the business success across different size groups, % of managers in 2006*

	Small	Medium	Large
STA	61.4	61.9	71.4
Police	56.1	51.7	55.9
City (district) authorities	60.4	57.3	62.8
Oblast authorities	38.5	46.3	47
Central Government	43.6	48.8	68.6
Total	68.2	70.6	80.0

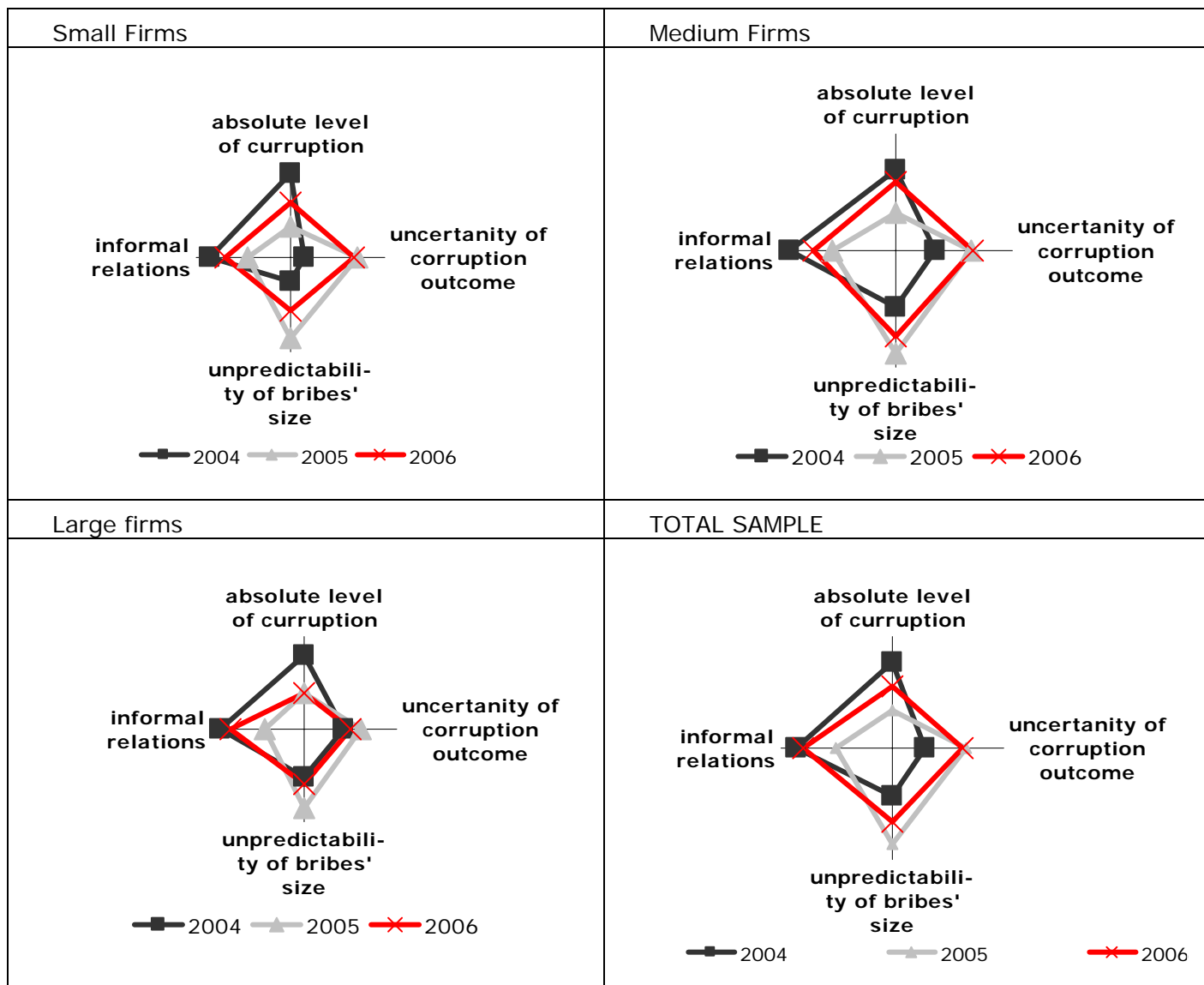
evidence of the impact of change in public officials on business performance of the firms. In 2006, about 46.9% of the managers (vs 40.2% in 2005 and 48.5% in 2004) perceive changes of representatives of public authorities to have a significant impact on business success of their firms. The lowest level of this indicator is recorded for small firms. Again, importance of changes in STA and city (district) authorities is reported more often than for other public offices. And again the most significant increase of importance in 2006 vs. 2005 is observed for central government.

Since 1999 the importance of having informal relations with public officials has increased in general and across all types of public authorities. Also the survey's findings allow stating: the larger size of business is the closer informal relations with more number of state bodies should be established. The "boom" of importance of informal relations was observed in 2004. In 2005 we recorded the tendency of decreasing the importance of informal relations. Unfortunately in 2006 it has not continued: not only no changes but also deteriorations of some indicators have been recorded in 2006 vs. 2005.

Table 3. Importance of change of representative of public authorities, % of managers in 2006*

	Small	Medium	Large
STA	51.2	40.2	53.1
Police	44.2	34.9	41.9
City (district) authorities	48.9	45.4	50.1
Oblast authorities	34.1	32.5	45.1
Central Government	35.9	40.7	56.7
Total	46.6	44.3	56.8

Picture 2. Corruption burden: summary



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 informal relations with at least one authority.

Star chart shows tendency to deteriorate on the overall level of corruption during in 2006 after its slight improvement in 2005 (picture 2):

- In 2005 the absolute level of corruptions and importance of informal relations with the representatives of state bodies for business successes have decreased, corruption became high-risky for enterprises (unpredictability of bribes size and uncertainty about outcome)
- In 2006 the absolute level of corruptions and importance of informal relations with the representatives of state bodies for business successes have increased again. Size of bribe becomes more stable again. At the same time the uncertainty of corruption outcome remain such high as in 2005.

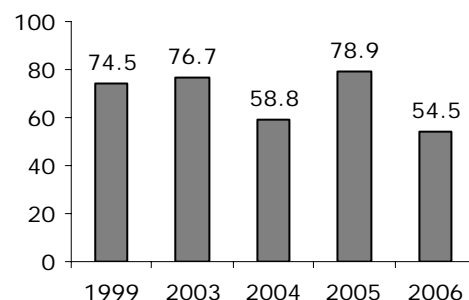
Tax compliance. The respondents were asked to estimate the percentage of taxes that, according to their knowledge, are actually paid by the firms of the same size in their industry relative to the total amount of taxes due to payment in case of full compliance. It is observed the deterioration of this indicator in 2006 vs. 2005. Thus, the average level of tax compliance has decreased from 78.9%% in 2005 to 54.5% in 2006. If in 2005, 12.8% of the enterprises reported paying less than 50% of the official amount of taxes that in 2006 already 48% support such opinion. At the same time the share of the respondents considered tax payment rate to be more than 90% dropped to 27.5% from 56.8.0% in 2005. We should mention that business perceptions about tax compliance rate in 2006 are even poorer than in 2004 (respective rate was 58.8%).

Managers of the small firms reported a lower level of tax compliance than medium and large enterprises.

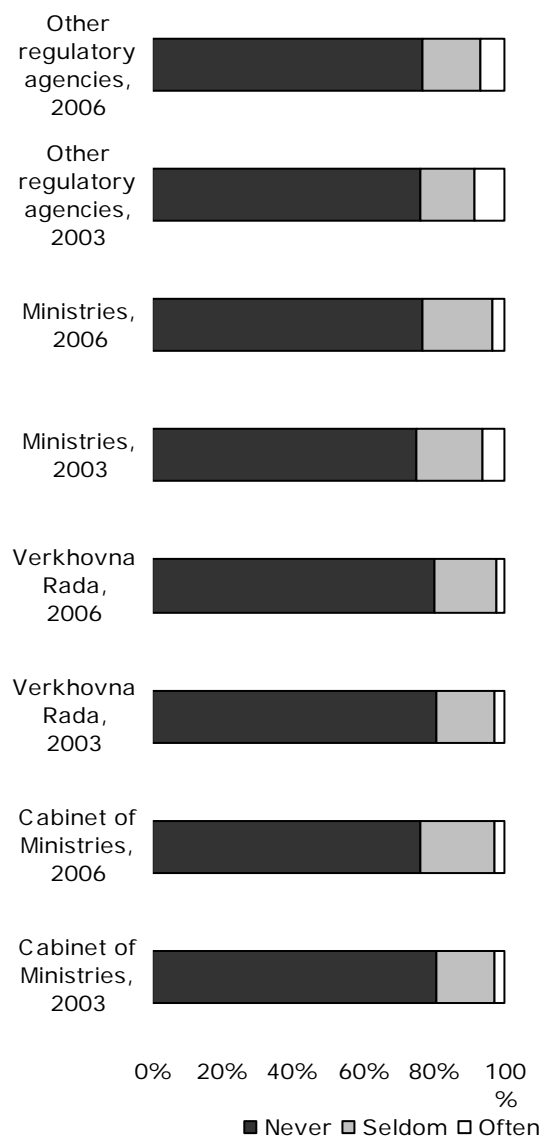
State influence. In 2006 about one third of the enterprises reported having some influence on the decisions of government authorities that are important for business activities of their firms. No significant change is recorded during all period of observations (1999-2006). Frequency of state influence slightly varies across the types of government bodies showing no significant changes during the last four years. No significant changes are observed across different size groups.

Competition: In 2006 managers perceive that the level of competition is lower than in 2005 and 2004. In the 2nd quarter of 2006 37.6% of the firms report strong competitive pressure from Ukrainian competitors in the main markets. 19.5% and 17.4% of the firms inform about strong completeive pressure from respectively CIS countries and foreign countries producers. The respective indicators for the 2nd quarter of 2005 were 39.9%, 12.1% and 15.9%. And for the 2nd quarter of 2004 they were 57.2%, 21.3% and 20.8%. Thus in 2006 vs. two previous years managers

Rates of tax compliance, mean value



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



perceive weaker competitive pressure from the both domestic and foreign competitors.

Competitive pressure from Ukrainian producers in 2004-2005 seemed to be higher for small firms, while pressure from foreign producers seems to be higher for large enterprises. But in 2006 situation changed: competitive pressure for small firms was lower than for large and medium.

Annual indicator of business environment burden. Due to summary the main dimensions of business environment we develop the ANNUAL INDICATOR OF BUSINESS ENVIRONMENT BURDEN². It is an arithmetic mean of the following indicator:

- % of the firms that consider low ability of judicial system to ensure enforcement of commercial contracts and protect security of business entities against criminality,
- % 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
- overall corruption indicator³

The overall picture of business environment is presented in the star chart where axes reflect the abovementioned indicators. We can see improvement 4 out of 5 indicators in 2005 vs. 2004. In 2006 only 2 out of 5 indicators have improved, 2 indicators have deteriorated and one has remained at the level of 2005. As result the ANNUAL INDICATOR OF BUSINESS ENVIRONMENT BURDEN has increased to 51.0 in 2006 from 47.5 in 2005 indicating the deceleration of business environment improvement.

Picture 3. Business environment burden: summary

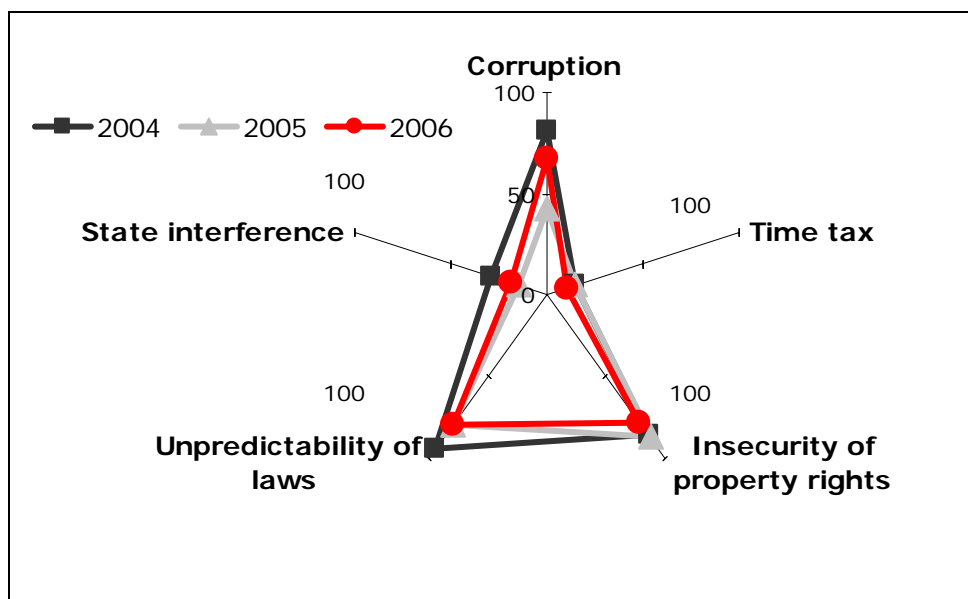


Table 5. Change of business environment burden

	2005 vs. 2004	2006 vs. 2005
Corruption	-	+
Time tax	-	-
Insecurity of property rights	=	+
Unpredictability of laws	-	=
State interference	-	+

- — decrease of burden
- = — no change of burden
- + — increase of burden

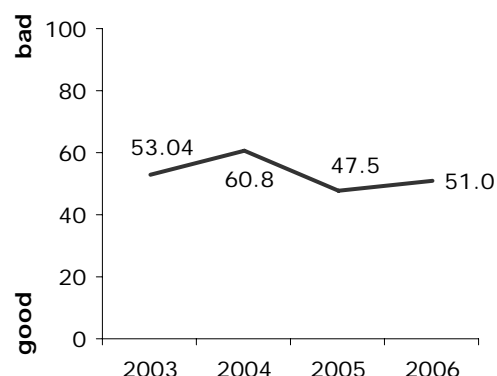
² The value of ANNUAL INDICATOR OF BUSINESS ENVIRONMENT BURDEN varies from 1 to 100. 1 – favorable environment, 100 – poor environment.

³ Overall corruption indicator is calculated as arithmetic mean of % of firms that admit paying bribes and % of firms that admit importance of informal relations with at least one authority

Table 4. % of enterprises reporting strong competitive pressure

	Small 05/06	Medium 05/06	Large 05/06
Ukrainian competitors	43.2/34.6	39.6/38.8	34.9/38.2
CIS competitors	5.4/15.8	13.4/20.0	19.0/22.6
Other foreign competitors	8.2/5.9	17.3/18.5	23.8/27.6

Annual Indicator of Business Environment Burden





Investment, performance

Performance: During 1999-2004, the share of profitable firms in our sample has increased from 50.6% to 60.8%. In 2005 it reached 63.4%. It has happened due to an increase in the respective shares within all of size groups. But the less progress was recorded for medium firms.

For the majority profitable firms the final results in 2005 were insignificantly better than in 2004. 40.9% of profitable firms informed that profit didn't increased comparing to 2004. While 30.7% of firms got profit that were higher than in 2004. And profit of 28.5% profitable firms has decreased.

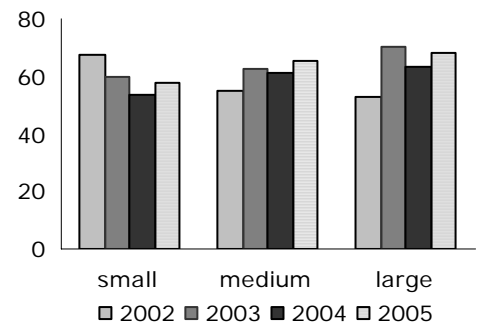
This assessment varies across size-groups. The small firms informed about increase in profit in 2005 more often than others (29.8 vs. 25% and 25%).

Managers were asked to estimate change in performance of their firms in 2004-2005 (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.

The overall improvement of performance results, i.e. positive balance percentages, is observed during the whole period except for investment. At the same time, the most significant improvement in performance results has been recorded in 2003. The 2005 results were not so positive. Beside traditionally negative balance percentages for investment, the negative balance percentages for profitability have been observed also.

Table 6. Changes in performance results during 1999-2005, % of the enterprises

Share of profitable firms, % firms



	1999 vs 1998				2001 vs 2000				2002 vs 2001			
	Up	The same	Down	Balance ⁴	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
	2003 vs 2002				2004 vs 2003				2005 vs 2004			
	Up	The same	Down	Balance	Up	The same	Down	Balance	Up	The same	Down	Balance
Profitability	36.8	33.1	30.1	6.6	31.9	36.3	31.9	0.0	26.3	38.5	35.1	-8.8
Sales	50.2	22.1	27.7	22.5	48.0	25.3	26.7	11.3	44.9	26.3	28.8	16.1
Labor Productivity	43.4	35.7	21.0	22.4	45.4	29.7	24.9	20.5	41.2	34.3	24.5	16.7
Investment	32.6	27.3	40.1	-7.4	24.5	40.8	34.7	-10.2	19.3	54.5	26.2	-6.9
Capacity utilizations	40.7	34.4	24.8	15.9	42.5	32.6	34.7	7.8	41.5	34.6	23.9	17.6

⁴ 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



Table 7. Changes in performance results during 2002-2005, balance %

	2002 vs 2001			2003 vs 2002			2003 vs 2004			2005 vs 2004		
	Small	Medium	Large	Small	Medium	Large	Small	Medium	Large	Small	Medium	Large
Profitability	2.0	3.0	0.0	13.0	1.0	13.0	-3.0	0.0	7.0	11.0	-2.0	-3.0
Sales	5.0	8.0	15.0	18.0	21.0	33.0	18.0	15.0	46.0	27.0	31.0	47.0
Labor Productivity	2.0	9.0	17.0	16.0	19.0	43.0	21.0	13.0	46.0	29.0	26.0	44.0
Investment	-6.0	5.0	15.0	-17.0	-8.0	10.0	-20.0	-9.0	5.0	-9.0	1.0	31.0
Capacity utilizations	-8.0	7.0	6.0	9.0	15.0	30.0	15.0	13.0	36.0	17.0	31.0	47.0

Performance results vary across size groups of enterprises. In 2006 balance percentages for small firms are lower across all indicators except for profitability. For large enterprises balance percentages are higher than for other size groups. Situation with medium enterprises is unstable. There are situations when balance percentage is lower than for small enterprises, but never higher than large enterprises.

Level of investment: The share of firms in total sample that reported investment continues to grow: from 28.0% in 1999 to 46.6% in 2005. The year 2004 was characterized by some decrease in the level of investments, although enterprises had ambitious investment plans: in the beginning of 2004 57% of surveyed firms were going to invest. At the end of 2004 only 38.9% of surveys firms reported about investment. But in 2005 the share of firms reported investment increased.

The investment activity in 2005 was greater than the managers expected. In January 2005 40,5% of enterprises planned investment during 2005, and in a year, in January 2006 46.6% of enterprises reported about investments in 2005. This situation is opposite to 2004, when investment plans were much greater than the real level of investments.

The level of investment activity varies across different size groups of enterprises. The lowest investment activity is observed for small firms, the highest for large ones. Investment activity of the medium size firms is in middle of small and large enterprises. But it is important to mention that significant acceleration of investment activity of the medium size firms was recorded in 2005.

In 2006 business expectations toward investment are slight more optimistic than in 2005: 46.6% of managers expect to invest in 2006 vs. 40.5% in 2005. But enterprises are still careful in their expectations and do not plan acceleration of investment activity significantly: the level of expected investment in 2006 is closer to level of observed investment in 2005.

Sources and purposes of investment. Profit and depreciation remain the main sources of investment covering about 80% of its total volume. But we can see the strong tendency of decrease of profit as a source of investment. And in the same time loans of Ukrainian banks become more and

performance results. Interpretations of the balance percents are similar to those of indices of change in the regular QES bulletin.

Investment activity, % firms

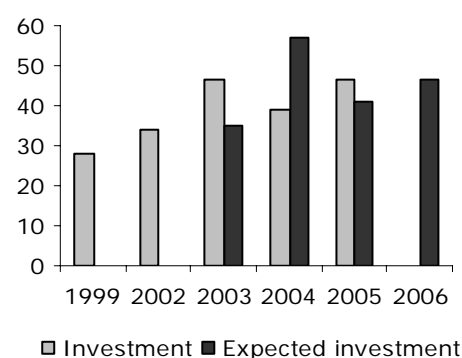


Table 8. Investment across different size group, % of the enterprises

	2003	2004	2005	2006 (exp)
Small	32.4	25	32.5	35
Medium	47.7	28.8	47.1	45.1
Large	63.8	65.1	70.5	72.7

Table 9. Investment indicators

	2003	2004 (exp)	2004
<i>Sources of investment (% by total sum):</i>			
Profits and depreciation	96.8	82,2	85,4
Ukrainian banks loans	2.8	14,1	12,9
State funds	0.0	0,5	0,33
Issuing shares	0.4	1	1,3
<i>Sources of investment (% by total sum):</i>			
	2005 (exp)	2005	2006 (exp)
Profits and depreciation	80,4	78	74,9
Ukrainian banks loans	7,2	14	11,4
State funds	0	1,1	1,7
Issuing shares	0,7	1,6	1,6

more significant as an investment source (from 3.7% in 2002 to 14% in 2005).

The main purposes of investment are replacement of depreciated (59.3%) and outdated equipment (42.2%). Such purposes as widening the range of produced goods (38.5%) and increasing of the output of current goods (35.6%) are also significant.

It is important to mention such purposes as replacement of depreciated and outdated equipment. It is not accidental that these purposes take leading places in our list. During past years we observed rise of such impediment to business activity as "outdated technology". For the end of the year 2005 20% of managers named this impediment as significant. In the present economic conditions the modernization of the equipment and implementation of new technologies is crucial for continue of economic growth and getting new quality of growth in Ukraine. The possibilities for the stirring up the economic growth lies in the scope of development the enterprises oriented at the domestic consumer. Among those sectors are the machinery, construction, and food industry. Also it is without questions that equipment and technology modernization is critical point to make Ukrainian products more competitive on the international and domestic markets.

Obstacles to investment. In spite of growth of investment activity managers perceived investment environment to be high risky. The percentage of those managers who considered current time to be good for investment was just 1.1. It had been worse only in 2003 (0.8%). 59.0% of surveyed managers consider current period of time to be unfavorable for investment; another 39.9% of the respondents assess it as "more-or-less favorable". No significant improvement in perceptions of investment climate has been recorded: the respective shares for 2005 are 54.0%, 44.7% and 1.4%.

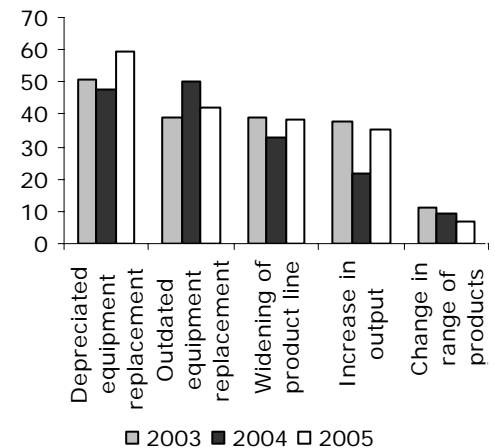
Managers have been asked to report three main impediments to their investment plans. During 2001-2006, the most frequently reported obstacles included low profit. The level of this obstacle varied through this period from 74.9% in 2001 to 83.1% in 2004 (the highest point) to 69.7% in 2006 (the lowest point). Importance of this impediment has decreased on 12.4 points comparing to the previous year.

The changes recorded for obstacle "high cost of capital" during whole period of observation is worthy of notice. After decreasing from 32% in 2001 to 16.2% (the lowest point) in 2005 it grew to 42.5% in 2006. In 2006 vs. 2005 the level of this obstacle has increased more than two times and it became second in our list!

Comparing to 2005 the importance of 4 out of 9 impediments have decreased. Beside insufficient profit they are namely insufficient demand, fear of indebtedness and foreign competition. Rest of 5 impediments has increased in their importance. Managers became to perceive high cost of capital, difficult access to loans, unclear legislations and unstable political situation as more important barriers to investment than in past.

Dynamics of obstacles to investment differs across the size groups. For example importance of high cost of capital has

Purposes of investment, % of firms



Is it favourable time for investment?, % firms

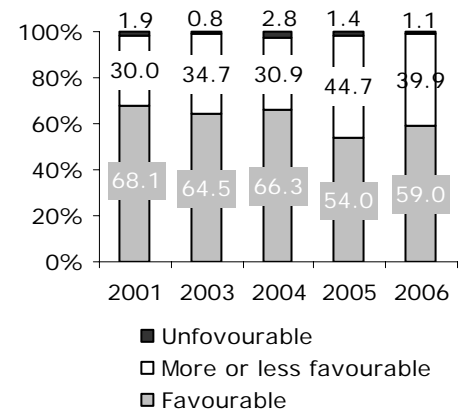


Table 10. Barriers to investment, % of respondents

	Q1 03	Q1 04	Q1 05	Q1 06	Q1 06 to Q1 05
Insufficient profits	70.4	83.1	82.1	69.7	-12.4
Insufficient demand	35.4	15.7	17.9	12.7	-5.2
Too high cost of capital	31.2	28.8	16.2	42.5	+26.3
Fear of indebtedness	19.6	24.3	17.0	12.3	-4.7
Difficult in obtaining loans	15.4	13.1	10.9	14.5	-2.2
Unclear legislations	15.4	21.7	3.5	8.8	+5.3
Foreign competition	14.2	12.7	10.5	10.1	-0.4
Frequent changes in legislations	13.8	15.4	6.6	10.1	+3.5
Unstable political situation	10.4	15.4	9.2	14.5	+5.3



increased for all enterprises, but in different range. The smaller firms the more important impediment “high cost of capital”. It is might explained by different accessibility of capital for different size groups. All firms need to long-term resources but small firms have much lower access to long-term resources than others.

Table 11. Barriers to investment across different size groups, % of respondents.

	Small			Medium			Large		
	Q4 03	Q4 04	Q4 05	Q4 03	Q4 04	Q4 05	Q4 03	Q4 04	Q4 05
Insufficient profit	87.5	78.3	78.7	81.2	84.6	67.7	85.6	79.5	62.5
Insufficient demand	18.1	21.7	19.7	15.4	18.5	11	13	10.3	7.5
High cost of capital	22.2	16.7	47.5	28.9	16.2	41.7	39.1	15.4	37.5
Fear of indebtedness	25	23.3	13.1	26.8	17.7	11.8	15.2	5.1	12.5
Difficult access to loans	15.3	11.7	23	13.4	10	12.6	8.7	12.8	7.5
Unclear legislations	15.3	1.7	3.3	22.8	3.8	11.8	28.3	5.1	7.5
Foreign competition	12.5	10	4.9	13.4	11.5	11.8	10.9	7.7	12.5
Frequent changes in legislations	9.7	1.7	6.6	16.8	7.7	9.4	19.6	10.3	17.5
Unstable political situation	16.7	1.7	14.8	12.1	13.1	15	26.1	7.7	12.5

The investment plans of firms are sensible to changes in political situation. This barrier keeps 3rd place in the list of barriers for medium firms, 4th place — for large firms and 5th — for the small ones. At the same time the small firms are the most sensible to changes in political situation. After significant decrease in the beginning of 2005 importance of this barrier for small firms in the beginning of 2006 increased again dramatically: 16.7% (2004), 1.7% (2005) and 14.8% (2006).

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 93.0%. 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 (15.4%), privatized (76.0%), and *de novo* private firms (8.6%).

Table 12. Sample description

Industries, %	
Heavy industry	9.7
Machine building	27.6
Wood processing	7.2
Construction materials	7.9
Light industry	12.5
Food processing	23.7
Printing	7.9
Other	3.6
Size (number of employees), %	
Small	27.2
Medium	55.9
Large	16.8
Regions, %	
Lviv	26.9
Kyiv	33.3
Kharkiv	32.3
Odessa	7.5