



HOW CAN UKRAINIAN SME GROW INTO NATIONAL AND GLOBAL CHAMPIONS?

Based on the German experience

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1 Executive summary

Small and medium companies are the backbone of any national economy. An economy with a high share of strong SMEs enjoys several benefits, such as inclusive and sustainable growth and economic growth based on knowledge and innovation. SMEs are also more flexible and community-embedded.

In Germany, the development of a strong SME sector (known as the Mittelstand) leads to the appearance of ‘hidden champions’, which contribute to the economic success of the country.

In this paper, we study the key internal factors of resource management in Mittelstand companies and the policy measures that contributed to the success of the German SME sector, as well as the applicability of the German experience to the Ukrainian SME sector.

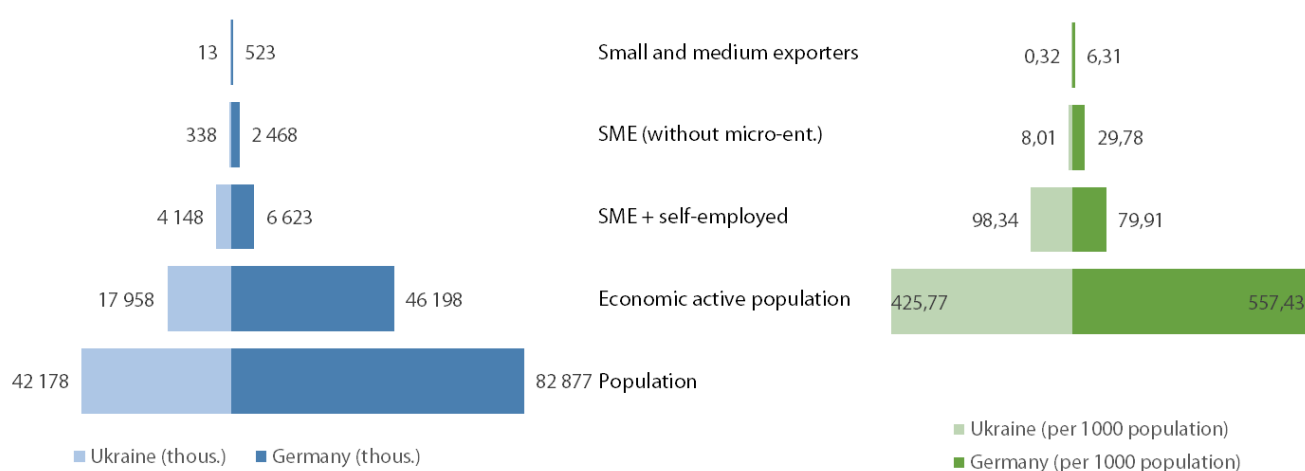
Our paper is based on desk research, previous research projects of the Institute of Economic Research (Kyiv), field visits to German SMEs and policymaking bodies, and in-depth interviews with Ukrainian and German policymakers and business.

As for Ukraine, there are general factors that need to be taken into consideration when developing strategic policy measures for SMEs, including low levels of trust and a relatively weak rule of law, and political and economic instability. These long-term circumstances have a strong impact on both public governance and business management.

To formulate policy recommendations for Ukrainian SME policy, we analysed the development of a business from being run by an individual entrepreneur to becoming an international champion. First, we compared absolute and relative numbers of population and businesses for the latest available years for both countries. The relative rate of operating businesses to 1,000 population at a certain moment of time shows both the willingness and the ability to run a business or to be an entrepreneur. Then we analysed the reasons why more businesses succeed and/or grow in Germany than in Ukraine at each level.

While the structure of small and medium enterprises and individual entrepreneurs in Ukraine is similar to that of Germany, the Ukrainian SME sector lacks capabilities and productivity that might lead it to become successful at a national or international level. Particularly, Ukraine substantially lags behind in the number of small and medium companies that are successful in international markets. Therefore, after conducting a comparative analysis of the German and Ukrainian SME sector at each size and market level, we suggest policy measures to increase the share of businesses that are able and willing to develop to the upper level, up to becoming exporters.

Figure 1. SME structure in Ukraine and Germany (latest available data)



Source: State Statistics Service of Ukraine, Federal Statistical Office of Germany, Federal Ministry of Economics and Technology of Germany



In order to build up a competitive and innovative SME sector that promotes the formation of national and international champions, the Ukrainian SME policy should be comprehensive, long-term oriented, and include the following components:

- **Support for prospective and new entrepreneurs:** Enhancing the creation and development of university technology parks and boosting the ideas of innovative start-ups by business. Creating opportunities for vulnerable groups to launch their own businesses.
- **Facilitation of legal entity creation and business expansion:** Unification of the taxation system; joint lending and consulting programmes by local authorities, banks and international financial institutions; regional innovation support centres.
- **A national focus:** Business association development as an opportunity for new business partnerships, involvement in policy development and policy dialogue; fostering digital infrastructure usage outside of big cities.
- **Help with foreign market entry:** Developing new brands; easing export-related regulation; fostering short-term mobility and foreign-language skills.

2 Introduction

Small and medium enterprises in Ukraine usually work in a very competitive environment. However, in some cases, they can face entry or development barriers artificially created by the state or existing competitors. When there are no artificial entry barriers, the only way they can get a substantial market share is through innovation and the creation of new products, processes, and services. Innovation implies more investment and better quality for the customers or consumers, so it has a positive impact on both the economy and the wellbeing of the population.

We discuss the ways in which the state and other stakeholders can help SMEs to grow into national and international champions through innovation while remaining in the competitive environment. We suggest focusing on soft incentives rather than direct state aid, as the latter risks facilitating corruption and distorting the level playing field and competition.

As we learned from the German experience, the development of small and medium-sized enterprises can also help a country solve economic and social problems, such as monopolisation, unemployment, and the underdevelopment of certain regions, all of which lead to the non-inclusive economy. Solving these problems is a way to a more inclusive and sustainable economic system.

In the next chapter, we define the categories of SMEs, German Mittelstand and hidden champions. In chapter 4, we provide an overview of German small and medium enterprises and hidden champions. Next, we discuss specific reasons for the success of the German Mittelstand. We describe specific managerial features (internal factors) and policy measures (external factors) taken in Germany to strengthen the development of its innovative and successful SMEs. Chapter 6 gives the characteristics of the SME sector of Ukraine. It is followed by the chapter aiming at identifying policy gaps in Ukraine's SME policy and recommendations on its improvement. We proceed from the hypothesis that the state SME policy should be structured according to the specific needs of the entrepreneurs and enterprises of different sizes, thus increasing the share of successful SMEs and their potential to grow in size (from micro to small, from small to medium-sized and so on) and improve performance (sales, export earnings, market position).

3 SMEs, Mittelstand and 'hidden champions': definitions

In this paper, we use three major categories: SMEs, Mittelstand and 'hidden champions'.

The main parameters by which an enterprise is defined as an SME are (1) staff headcount and (2) either turnover, income or balance sheet total. The definition is presented in Table 1.



The EU and Ukraine define SMEs slightly differently. The EU's definition¹ determines the number of employees and the turnover of the enterprise based on consolidated accounts for enterprises that are related to others. In other words, it is important to know whether an enterprise is part of a larger business group. However, the Ukrainian Commercial Code, according to which enterprises are defined as small and medium ones, does not take membership of a business group into account. Another difference between EU and Ukrainian SME statistic is the broad definition of medium-sized enterprises in Ukraine. In particular, Ukraine defines medium-sized enterprises as those with more than 250 employees, but with incomes below 50 million euro (recalculated in hryvnia), whereas the EU classifies all enterprises with more than 250 employees as large² firms.

Table 1. Definition of SMEs

Enterprise size	Staff headcount		Annual income	Annual turnover	Balance sheet total
	UA, EU	DE (IfM Bonn)	UA	DE, EU	EU
Micro	< 10	<10	≤ € 2 m	≤ € 2 m	≤ € 2 m
Small	< 50	<50	≤ € 10 m	≤ € 10 m	≤ € 10 m
Medium-sized	< 250	<500	≤ € 50 m	≤ € 50 m	≤ € 43 m

Source: Economic Code of Ukraine, EU recommendation 2003/361, IfM Bonn

German officials widely use the definition produced by the *Institut für Mittelstandsforschung* (IfM) Bonn. The maximum number of employees for medium-sized enterprises is twice as high as in the definitions above in order to reflect the German peculiarities of business structures.³

When referring to the SME sector of Ukraine or Germany, the definition of the European Commission or of SMEs by IfM Bonn will be used, respectively.

German Mittelstand

'Mittelstand' literally means 'middle group' in German⁴. In German-speaking countries, the term commonly refers to small and medium-sized enterprises. In German sources, as in the Federal Statistical Office (Destatis), the terms 'SME' and 'Mittelstand' are used interchangeably⁵. However, there are other (qualitative) criteria that would make an enterprise part of the German Mittelstand, and some publications also treat somewhat larger firms as part of the Mittelstand.

¹ Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (Text with EEA relevance) (notified under document number C(2003) 1422) [доступне за посиланням](http://data.europa.eu/eli/reco/2003/361/oj) <http://data.europa.eu/eli/reco/2003/361/oj>.

² USAID. *Official Statistics of SMEs in Ukraine: Analysis and Suggestions for Improvement*. https://dec.usaid.gov/dec/content/Detail_Presto.aspx?ctID=ODVhZjk4NWQtM2YyMi00YjRmLTkxNjktZTcxMjM2NDNmY2Uy&ID=MjM0NDM1

³ IfM Bonn. *SME-definition of IfM Bonn*. <https://en.ifm-bonn.org/definitions/sme-definition-of-ifm-bonn/>

⁴ Oxford Dictionaries. *Definition of Mittelstand in English*. <https://en.oxforddictionaries.com/definition/mittelstand>

⁵ Statistisches Bundesamt (Destatis). *The German Mittelstand in the age of globalisation*. https://www.destatis.de/EN/Publications/WirtschaftStatistik/TheGermanMittelstand_Soellner_022016.pdf



The *Institut für Mittelstandsforschung* (IfM) Bonn defines a company as belonging to German Mittelstand if “up to two individuals or their family members (directly or indirectly) hold at least 50% of the company shares and these natural persons also belong to the management of the enterprise”.⁶ That means that large enterprises can also be defined as belonging to Mittelstand, even if their employment exceeds 499 people or turnover is more than €50m. Such definitions referring to the ownership structure are also widely debated in the family business literature, which analyses research questions regarding a different kind of firm behaviour in a (often multi-generational) family-owned firms compared to public companies.⁷

Many German Mittelstand companies are a perfect example of Schumpeterian companies, creating product, process, or business model innovations. Further forms of SMEs might be classified as ‘normal’, adjusting to the market conditions, or as ‘poverty-driven’ – the result of lacking economic development, employment opportunities, and welfare state benefits.⁸

‘Hidden Champions’

The uniqueness of the German Mittelstand – apart from their tendency to be family-owned, export-oriented firms working in manufacturing – is in their ability to become ‘hidden champions’, the term associated with Prof. Hermann Simon, a German author and business leader, who first used it in 1996. According to Simon, the main traits of a ‘hidden champion’ are “tending to become world market leader in a specific niche market” and “neither seeking nor attracting publicity”. Simon argues that ‘hidden champions’ can be found not only in Germany; however, the conditions in Germany (as well as in Austria and Switzerland) have made the phenomenon of ‘hidden champions’ strongly associated with these German-speaking countries.⁹ However, they are called ‘hidden’ because most of their products are sold B2B and therefore are used in the manufacturing process or subsumed by the end product. These products are therefore invisible to final consumers.¹⁰

Professor Christoph Müller of the HBM Entrepreneurship School of the University of St. Gallen provides different criteria for ‘hidden champions’. He argues that not all the companies that proclaim themselves ‘champions’ are actually stable global market leaders. Müller uses the following criteria:

- The highest or second highest market share in the market niche;
- Annual turnover of over 50 million euros (*large enterprises by the definitions*);
- Generation of at least half of the turnover abroad;
 - Activities on at least three continents.¹¹

Prof. Müller and his team update their database of ‘hidden champions’ every year. In 2018, 461 German world market leaders remained, according to the above-mentioned criteria.¹²

⁶ IfM Bonn. *Definition "Deutscher Mittelstand"* <https://en.ifm-bonn.org/definitions/definition-deutscher-mittelstand/>

⁷ Handler, W. C. (1989). Methodological issues and considerations in studying family businesses. *Family business review*, 2(3), 257-276. Harms, H. (2014). Review of family business definitions: cluster approach and implications of heterogeneous application for family business research. *International Journal of Financial Studies*, 2(3), 280-314.

⁸ The Role of Small and Medium-sized Enterprises in Development What Can be Learned from the German Experience? Hansjörg Herr and Zeynep M. Nettekoven November 2017 <http://library.fes.de/pdf-files/iez/14056.pdf>

⁹ Simon, H., 1996. *You Don't Have to Be German to be a Hidden Champion*, s.l.: Business Strategy Review.

¹⁰ Germany Trade and Invest. *Economic Overview Germany. Issue 2018* https://www.gtai.de/GTAI/Content/EN/Invest/_SharedDocs/Downloads/GTAI/Brochures/Germany/economic-overview-germany-market-productivity-innovation-en.pdf?v=9

¹¹ Schmidt, K. *Hidden champions. Das sind Deutschlands geheime Weltmarktführer.* <https://www.wiwo.de/unternehmen/mittelstand/hannovermesse/hidden-champions-das-sind-deutschlands-geheime-weltmarktfuehrer/20883700.html>

¹² *ibid.*



4 German SME sector characteristics

Small and medium enterprises are considered the backbone of the German economy and the driver of its success.¹³ In Germany, the development of the SME sector has helped enable the appearance of ‘hidden champions’, which are already a part of the country’s brand.

As in almost every country, the SME sector functions as the largest employer in Germany, with a share of 60,7% of all employees (Figure 2). In terms of economic sectors, SMEs in construction and accommodation services generate the most turnover (more than 80% of the turnover in the sector in 2017), and those in energy and water supply the least (less than 10%) (Figure 3).¹⁴

Table 2. Place of SMEs in the German economy (2016)

Enterprise size	Enterprises		Persons employed		Turnover		Gross investment in tangible fixed assets		Gross value added at factor cost	
	number	%	number	%	EUR mn	%	EUR mn	%	EUR mn	%
Microenterprises	1 983 076	80,36%	5 416 503	18,62%	419 801	6,78%	36 110	15,69%	190 611	11,49%
Small enterprises	394 596	15,99%	6 742 562	23,18%	746 186	12,04%	37 607	16,34%	292 668	17,64%
Medium-sized enterprises	72 155	2,92%	5 627 840	19,35%	928 176	14,98%	33 791	14,68%	306 460	18,47%
Total SMEs	2 449 827	99,28%	17 786 905	61,15%	2 094 162	33,8%	107 508	46,72%	789 739	47,59%
Large enterprises	17 859	0,72%	11 299 510	38,85%	4 101 281	66,20%	122 606	53,28%	869 591	52,41%
Total	2 467 686	100%	29 086 415	100%	6 195 443	100%	230 114	100%	1 659 330	100%

Source: Statistisches Bundesamt (Destatis)

According to the analysis of the German Savings Banks Association, in 2015 a German medium enterprise got on average 7,3% profit margins, compared to 6,3% on average for the largest enterprises¹⁵. Some 90% of these operate in the business-to-business market, and 70 per cent are based in rural areas^{16 17}.

Figure 2. Employment proportions, 2016

Figure 3. Turnover proportions, 2016

¹³ Federal Ministry for Economic Affairs and Energy. *The German Mittelstand as a model for success* <https://www.bmwi.de/Redaktion/EN/Dossier/sme-policy.html>

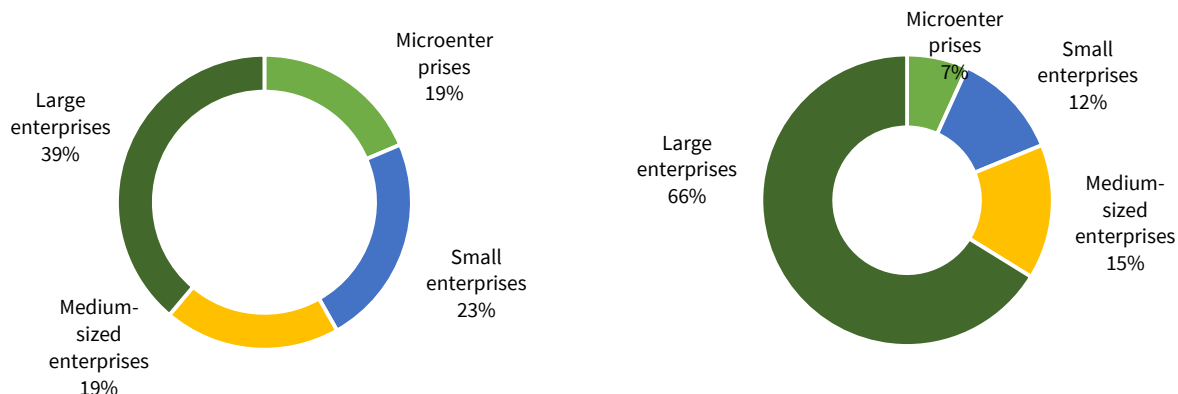
¹⁴ Statistisches Bundesamt (Destatis), *Small & medium-sized enterprises* https://www-genesis.destatis.de/genesis/online/data;sid=132F9771E62A3B4322F5EB911AF030AC.GO_2_1?operation=abrufabelleAbrufen&selectionname=48121-0001&levelindex=1&levelid=1560424359021&index=1

¹⁵ Sommer, U. *The Mighty Mittelstand* <https://global.handelsblatt.com/companies/the-mighty-mittelstand-519763>

¹⁶ The Economist. *Mittel-management*. <https://www.economist.com/business/2010/11/25/mittel-management>

¹⁷ Financial Times. *Germany’s apprenticeship scheme success may be hard to replicate*. <http://www.ft.com/content/1a82e8e0-04cf-11e7-aa5b-6bb07f5c8e12>. April 21, 2017





Source: Statistisches Bundesamt (Destatis)

Source: Statistisches Bundesamt (Destatis)

Creative industries are among the most innovative sectors in Germany. As a rule, they are concentrated in big cities, and their contribution to economic output is approaching that of traditional industrial sectors. The cultural and creative industries play a significant role in stimulating innovation in other sectors, not only in the software and games industry but also, for example, in the design industry and advertising market that support traditional industries with content, design, and client interaction.¹⁸ In 2017, gross value added in cultural and creative industries amounted at €102,4 billion, and it has been on an upward trend.

The migrant-led family business is becoming an integral part of the German SME sector. It constitutes more than 10% of the population of German businesses. Its internationalisation is not restricted to the owner's country of origin or family connections. Contrary to the widespread belief, such businesses are at least as innovative as non-migrant ones and are in fact even more likely to create a product or service innovation. The latest findings on entrepreneurial teams suggest that start-ups founded by a multi-ethnic founder team are significantly more likely to introduce innovation into the market than are mono-ethnic teams. These insights suggest that the current influx of migrants towards Germany might be an additional source of strength of its economy, as the society and the economy are growing more diverse, and diversity seems to lead to combinations of new ideas and innovation. The research also shows that migrant-led businesses often do not rely on their native area.¹⁹

About one-quarter of German exports comes from 'hidden champions' and 20% is generated by SMEs. The success of German-based SMEs lies in their internationalisation (Figure 4). According to Bruegel analysis of EFIGE firm-level survey results for seven EU-19 countries, exporting firms are more productive (1,47 times for Germany) and more profitable (2,35 times for Germany) than non-exporting ones.²⁰

Small niches, if covered by one enterprise worldwide, can generate a considerable amount of turnover.²¹ The effectiveness of 'hidden champions' innovation and R&D activities beats that of large corporations by a factor of five.²²

¹⁸ 2018 Cultural and Creative Industries Monitoring Report. Summary https://www.kultur-kreativ-wirtschaft.de/KUK/Redaktion/DE/PDF/monitoring-report-cultural-and-creative-industries-2018.pdf?__blob=publicationFile&v=3

¹⁹ Bijedić, T., Kay, R. & Schlepphorst, S., 2017. *Familienunternehmen von Migranten*. IfM-Materialien https://www.ifm-bonn.org/uploads/tx_ifmstudies/IfM-Materialien-261-2017.pdf

²⁰ Bruegel (2012). *Breaking down the barriers to firm growth in Europe: the fourth EFIGE policy report* <http://bruegel.org/wp-content/uploads/imported/publications/Blueprint-XVIII-EFIGE-web.pdf>

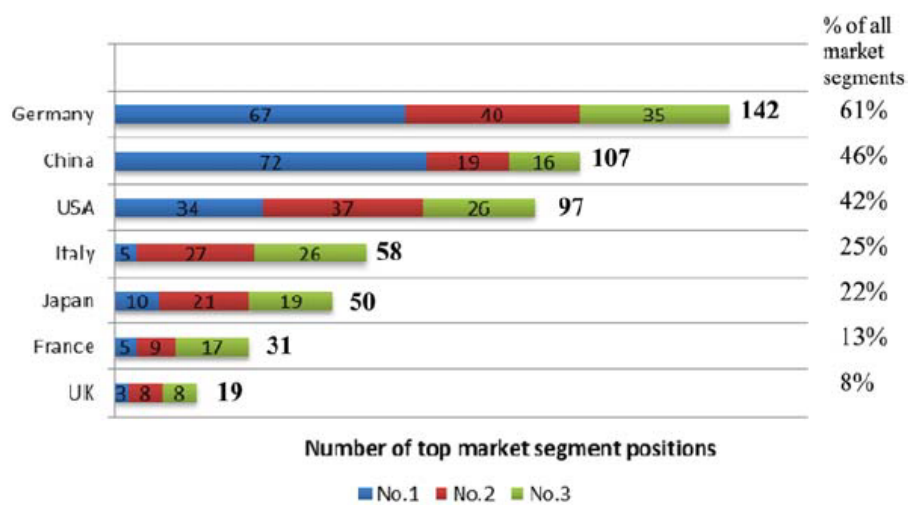
²¹ Statistisches Bundesamt (Destatis), *Small & medium-sized enterprises* https://www-https://www-genesis.destatis.de/genesis/online/data;sid=132F9771E62A3B4322F5EB911AF030AC.GO_2_1?operation=abruftabelleAbrufen&selectionname=48121-0001&levelindex=1&levelid=1560424359021&index=1



Some hidden champions own 70-100% share of their market because of their relatively small size and in-depth expertise in their fields, as well as the good protection from competitors that their constant innovation affords them. In the case of the right market strategy, it increases market risks while shrinking competition risk.²⁴

5 SME development in Germany: success factors

Figure 4. Number of world market leaders (Top-3 across each market segments)



Source: (De Massis, et al., 2017)²³

When seeking to draw international comparisons, we should keep in mind that ‘hidden champions’ are a product of successful small and medium enterprises in a suitable environment. The majority of modern German ‘hidden champions’ have a long history of growing in the nation’s heterogeneous SME sector, mostly owned and managed by the members of the same family. On the other hand, private business started to appear in Ukraine only after the country gained independence in 1991.

In light of the fact that many medium-sized Ukrainian businesses were founded in the 1990s by founders in their most productive years, one should consider and adopt a more long-term approach to these businesses. As the original founders’ generation retires, dynastic family businesses are already developing, some using a long-term approach on the model of German family firms. Therefore, it is worth looking towards potential success factors to create favourable conditions and give informed management advice to this growing and promising Ukrainian sector of SMEs and potential future hidden champions.

²² Simon H. *Hidden Champions (1): what German companies can teach you about innovation*

<http://www.whiteboardmag.com/hidden-champions-1-what-german-companies-can-teach-you-about-innovation/>

²³ De Massis, A., Audretsch, D., Uhlaner, L. & Kammerlander, N., 2017. Innovation with Limited Resources: Management Lessons from the German Mittelstand. <https://onlinelibrary.wiley.com/doi/epdf/10.1111/jpim.12373>

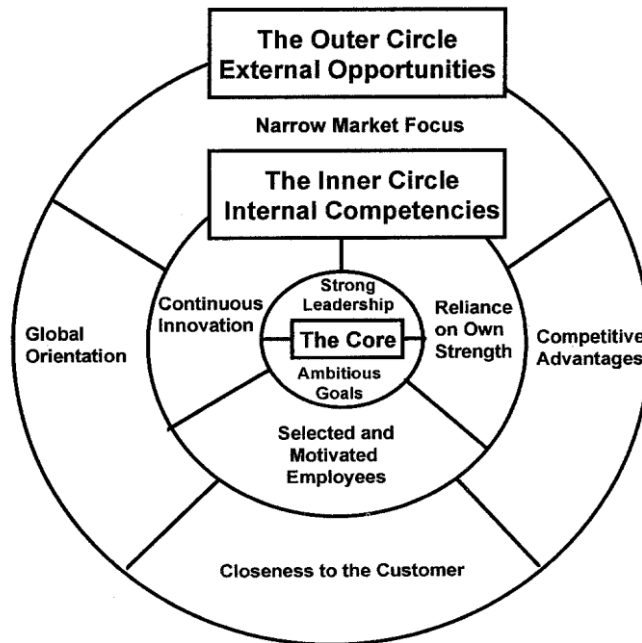
²⁴ Simon H. *Hidden Champions of the 21st Century. The Success Strategies of Unknown World Market Leaders* <https://www.deginvest.de/DEG-Englische-Dokumente/PDFs-Download-Center/Presentation-Herrmann-Simon.pdf>



5.1 Management and internal factors

Prof. Simon (1996) argues that ‘hidden champions’ both in Germany and elsewhere just apply more common sense to their business models, and “many people ... overestimate the country-specific aspects of management”. Based on his research of ‘hidden champions’ worldwide, he created a diagram of “three circles and nine lessons” (Figure 5).

Figure 5. Simon’s three circles and nine lessons of ‘hidden champions’



Source: (Simon, 1996)²⁵

Some researchers point out that skilled management is the main factor in the evolution of the Mittelstand into ‘hidden champions’. De Massis, Audretsch, Uhlaner, and Kammerlander (2017) provide the most comprehensive analysis of six key factors of resource management in Mittelstand enterprises to date.²⁶ Using their framework, we briefly explain those factors below, using both the original article and other literature in the field:

Niche focus and customer collaboration; deep integration in order to gain direct access to customers

Most of the ‘hidden champions’ export through their subsidiaries abroad, manufacture components further used in more complex aggregates, and provide after-sales service themselves instead of outsourcing non-core activities. Otherwise, they would lack not only the quality but also the innovative approach to manufacturing and services.²⁷ This is in line with the principle of maintaining control in the hands of the owner-manager.²⁸

²⁵ *ibid.*

²⁶ De Massis, A., Audretsch, D., Uhlaner, L. & Kammerlander, N., 2017. *Innovation with Limited Resources: Management Lessons from the German Mittelstand*. <https://onlinelibrary.wiley.com/doi/epdf/10.1111/jpim.12373>

²⁷ *ibid.*

²⁸ *ibid.*



Simon mentions the mental internationalisation of German entrepreneurs. Having a knowledge of foreign languages and a history of actively participating in international exchange programmes as youths (e.g. university studies) suggests that an entrepreneur will have confidence when approaching new markets.²⁹ Germany sends more students abroad than any other OECD country. Furthermore, as mentioned, accelerated migration towards Germany over the last decade is leading to an ever more diverse population and workforce. The latter then does not only lead to a more innovative population of small firms, but also to an enhanced understanding of international markets and to a broadening of horizons of the German workforce. Many German SMEs report having 50% of employees with a migration background, and most entrepreneurs see this diversity as an important resource of organisational tolerance and openness.

Preference for self-financing

Mittelstand firms are an attractive target for foreign investors.³⁰ However, the firms prefer to retain their financial independence by relying on internal financing to a large extent.

German banks are traditionally more oriented towards the long-term than their peers in other countries, especially in liberal market economies such as the UK or the US. The traditional German model of a “house bank”, which is a bank with a deep knowledge of the firm, long-standing relations with it, and a history of sticking by it even during times of crisis, might be less important than 20 or 30 years ago. However, one would assume that the strong, long-standing relations between banks and firms still play a significant role in the long-term success of the firms.

Long-run mindset

The long-run mentality of Mittelstand companies is reflected in the following:

- A more conservative attitude towards growth, which can be seen in the firms’ tendency to give up growth opportunities rather than risk the survival of the firm;
- building long-term relationships with various stakeholders including suppliers, customers, peers in the industry and, probably most important, employees: the most successful German firms work successfully with unions, invest in skills and personal growth of their employees, and have very low turnover rates. This results in a high identification with the firm among employees and a highly skilled and collaborative workforce that identifies its own success with the success of the whole organisation;
- the desire to build a legacy for the future generations of the owning-management family.³¹

Superior employee relations

As already mentioned, employee-employer relationships are long-term oriented and both parties try to create win-win situations. For example, employees’ self-governed bodies can be included in the decision-making process. The specific legislation on codetermination by employees provides an opportunity to create ‘works councils’. These councils represent employees at the workplace and have substantial power, extending to veto power on some issues. They are shop-floor organisations and supplement trade unions.

³²

²⁹ Simon, H., 2012. Hidden Champions (1): what German companies can teach you about innovation. <http://www.whiteboardmag.com/hidden-champions-1-what-german-companies-can-teach-you-about-innovation/>

³⁰ Ramthun, C. *Bundesregierung verbietet erstmals Firmenverkauf an Chinesen* <https://www.wiwo.de/politik/deutschland/leifeld-metal-spinning-bundesregierung-verbietet-erstmal-firmenverkauf-an-chinesen/22846694.html?share=fb>

³¹ De Massis, A., Audretsch, D., Uhlaner, L. & Kammerlander, N., 2017. *Innovation with Limited Resources: Management Lessons from the German Mittelstand*. <https://onlinelibrary.wiley.com/doi/epdf/10.1111/jpim.12373>

³² L. Fulton (2015) *Worker representation in Europe*. Labour Research Department and ETUI. <https://www.worker-participation.eu/National-Industrial-Relations/Countries/Germany/Workplace-Representation/#note2>



Work councils help protect the rights of employees from the employer. At the same time, German employer and employee associations also pursue collaborative strategies, as they closely work together for the success of the firm, and the industry is aware that collaboration will lead to superior results for all parties involved, while unilateral deception will hurt all parties in the long run. This collaborative approach resulted in the employees taking voluntary wage cuts to save the firms during the 2009 crisis. When the economy eventually started to take off again and losses were compensated, many firms voluntarily raised wages again to compensate their employees for previous losses, though they were under no obligation to do so. Both sides were aware of the long-term benefits of their collaboration for all partners involved.

German vocational training is often referred to as “a unique dual system of apprenticeship”.³³ It was introduced in 1969 by the Vocational Training Act, which was amended in 2005. It was meant to build cooperation between the companies and national and federal governmental bodies, with the objective of providing young people with adequate training to prepare them for a future occupation in industries.³⁴ The German system of vocational training is now frequently regarded as a role model for many other countries in the world and is widely seen as an important part of the success story of the German economy and especially its SMEs. The vocational training system is organized by the chambers and thereby self-organized by the firms and supported by the government. Vocational training takes place partly on the job in the companies and partly in VET schools.

Community embeddedness

Localisation in small local communities provides the following opportunities for business:

- maintaining the employee base³⁵;
- partnerships with local research and educational institutions³⁶;
- greater social responsibility³⁷;

For the economy as a whole, the distribution of successful firms countrywide (Figure 6), rather than concentration in industrial centres, leads to the sustainable development of provincial areas.³⁸ One can easily see that the most successful areas in breeding hidden champions are the west and the south of Germany. The federal states east of the former border between former two German states contain considerably less fewer champions. However, the fact that there are quite a few of them suggests that it is possible, with a concentrated and long-term approach, to develop conditions favourable for hidden champions even in a formerly socialist state.

Figure 6. The localisation of ‘hidden champions’ across Germany

³³ Simon, H. *Why Germany Still Has So Many Middle-Class Manufacturing Jobs*. 2 May 2017 <https://hbr.org/2017/05/why-germany-still-has-so-many-middle-class-manufacturing-jobs>.

³⁴ Federal Ministry of Education and Research. *The German Vocational Training System* <https://www.bmbf.de/en/the-german-vocational-training-system-2129.html>

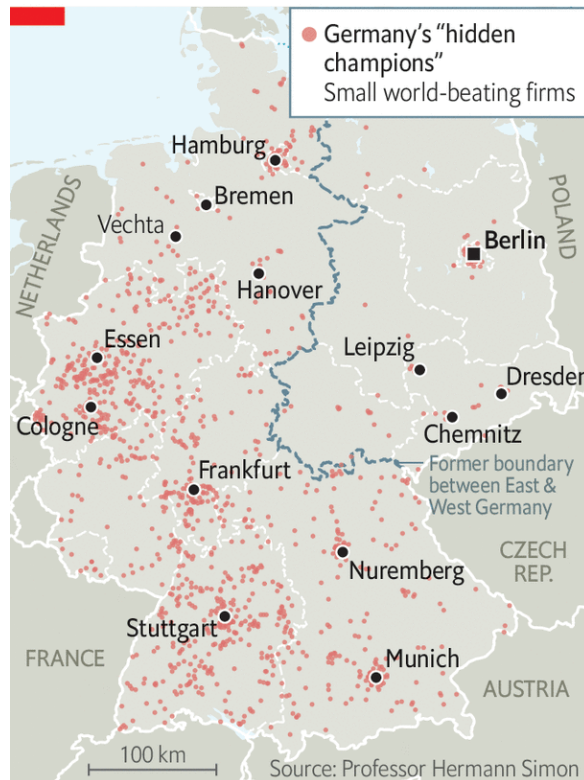
³⁵ DZ Bank Group, 2012. *Confidence in the German Mittelstand*. http://www.geschaeftsbericht.dzbank.de/2012/gb/files/pdf/en/DZBANK_Group_AR2012_Magazine-Confidence-in-the-german-Mittelstand.pdf

³⁶ Weber, W. W., 2016. *Germany’s Midsize Manufacturers Outperform Its Industrial Giants*. <https://hbr.org/2016/08/germanys-midsize-manufacturers-outperform-its-industrial-giants>

³⁷ Cruz, C., Larraza-Kintana, M., Garcés-Galdeano, L. & Berrone, P., 2014. *Are family firms really more socially responsible?*. *Entrepreneurship Theory and Practice*, 38(6) <https://academic.elsevier.com/bsbs/bsbs/2014/2454/18917/FamilyFirms.pdf?sequence=1&isAllowed=y>

³⁸ The Economist, 2019. *Why Germany has no gilet jaunes protesters* <https://www.economist.com/europe/2019/02/09/why-germany-has-no-gilet-jaunes-protesters>





Source: (The Economist, 2019)³⁹

5.2 Policy and external factors

Some of the traits mentioned above (links with research institutions, training system) are part of German government programmes. However, in our opinion, they can be developed elsewhere to some extent. Certainly, the German model of a *Mittelstand* economy cannot be copied on a 1:1 base for a country such as Ukraine. However, the experience with countries such as Poland suggests that it is possible to learn from best practices from abroad and then to carefully adjust the models to the national and regional context.

For Germans, the *Mittelstand* is more an idea than just a business model. Robert Wardrop of Cambridge's Judge Business School surveyed Germans about their views of big companies, big commercial banks, small co-operative or savings banks, and *Mittelstand* firms. The *Mittelstand* was by far the most popular, with the least variation in attitudes.⁴⁰ So the *Mittelstand* in Germany is not only a statistical reality, but rather a concept deeply embedded into the mindsets of the German population. The German population's sound scepticism of large conglomerates and big firms led to a *Mittelstand* policy that is very supportive of the broadly diversified German *Mittelstand*.

Box 1. German SME policy areas

There are 10 focal areas of German Economic ministry's SME policy. Below we list the most important of them for the purpose of this paper:

- Strengthening the financing of start-ups and growth
- Securing skilled labour, bringing refugees into vocational training and work

³⁹ Ibid.

⁴⁰ Smith Business Insight. *The Mittelstand Way To Social Impact*
https://smith.queensu.ca/insight/articles/the_mittelstand_way_to_social_impact



-
- Pressing ahead with efforts for better regulation and less red tape
 - Harnessing and shaping digitalisation
 - Boosting innovation
 - Using the opportunities created by globalisation
 - Strengthening SMEs in less-favoured areas
 - Supporting the development of new fields of a business deriving from the energy transition

Source: The German Mittelstand as a model for success. <https://www.bmwi.de/Redaktion/EN/Dossier/sme-policy.html>

Box 2. Policy Recommendations by the B20 SME Cross-thematic Group

B20 is an organisation representing the business of G20 countries. In 2017, the experts of G20 countries lead by Germany developed three policy recommendations containing nine policy actions aiming to boost the small and medium enterprises performance.

Among them, the most important to the purpose of this paper are:

- to provide greater inclusion of SMEs into trade agreements and global value chains through inclusion of their needs to the agreements and trade capacity building
- to reduce regulatory borders for digital trade
- to provide better Internet access and digital infrastructure outside the industrial centres and create Innovation Hubs
- to improve financial market infrastructure for SMEs
- to boost financial literacy of SMEs and raise their awareness of various financial instruments

Source: B20 SME Cross-thematic Group. Think Big for Small. Policy paper 2017.

https://www.b20germany.org/fileadmin/user_upload/documents/B20/B20_CTG_SMES_Final_Policy_Paper_2017-04-11.pdf⁴²

Throughout large parts of its history, Germany consisted of many small independent states, which meant that it was important to be able to act on international markets at an early stage of operation.⁴¹ Some regions of Germany have a long tradition of specialising in certain areas of manufacturing. Therefore, the relevant skills of local workers have been highly developed over generations.

⁴¹ Simon, H. *Why Germany Still Has So Many Middle-Class Manufacturing Jobs*

<https://hbr.org/2017/05/why-germany-still-has-so-many-middle-class-manufacturing-jobs>

⁴² B20 SME Cross-thematic Group. Think Big for Small. Policy paper 2017.

https://www.b20germany.org/fileadmin/user_upload/documents/B20/B20_CTG_SMES_Final_Policy_Paper_2017-04-11.pdf



Self-governed business associations

IfM Bonn, in its study, argues that the state governments in German (the Länder) still play an inefficient role.⁴³ However, in Germany, horizontal networks between politicians, businesses, their associations and the civil society are established and managed at an advanced level, especially compared with less sophisticated economies like Ukraine. There are many specialized entities that manage to respond to the needs of SMEs very well: from Chambers of Industry and Commerce to the German Confederation of Skilled Crafts, to specialized education and research organisations and various sectoral business associations, etc. These associations are self-governed, meaning their members (i.e. the businesses) have the key decision-making power. Therefore, these associations are strong power brokers between the interests of businesses, politics, and the greater society. One has to understand these associations as service providers for firms as well as a way for member firms to articulate their needs.

Box 3. Chambers of Industry and Commerce (the case of IHK Rhein-Neckar)

The Chambers of Industry and Commerce (*Industrie- und Handelskammern - IHK*) are regional branches of the Association of German Chamber (DIHK). The participation in a local IHK is compulsory for local business in commerce and industry, while skilled crafts are organised in a separate chamber.

There are 79 local divisions of DIHK in Germany; they are related to districts, cities and other small areas. They operate at the principles of self-governance and self-financing. IHK acts as both a service provider for SMEs and a policy contributor for the state.

The Chamber of Industry and Commerce in Rhein-Neckar has ca. 75,000 members, who vote for a plenum every five years. Currently the plenum consists of 85 entrepreneurs. A variety of committees are elected by and subordinate to the plenum. The voting principle is “one company – one vote” regardless of size or any other characteristic, meaning that SMEs as a whole are more influential by virtue of outnumbering large companies such as SAP, Bosh or Daimler.

All the member enterprises are committed for payment. A basic membership fee varies from 35 euros to 4,000 euros (for companies with more than 27.5 million euros turnover or more than 500 employees). Another part of a membership fee is the percentage of turnover (turnover information is given by financial authorities) defined by plenum. Therefore, small and medium enterprises can afford membership in Chambers.

One of the best-known ways of supplementing a state service is a commitment for dual vocational training, thanks to which generations of young people have gotten a start in professional life.

Source: <https://www.rhein-neckar.ihk24.de44>, <https://www.dihk.de/en/45>

Consultancy and support for entrepreneurs is also provided by the *Senior Experten Service (SES)*. This non-commercial organisation unites highly experienced retired experts (former German businesspersons) with their younger peers from the same field of activities in Germany as well as in transition economies. SES activities abroad are financed by the Federal Ministry of Economic Affairs and Energy (BMWi).⁴⁶

⁴³ IfM Bonn. *Mittelstand policies in practice – Business framework policy or funding policy?*

https://en.ifm-bonn.org/uploads/tx_ifmstudies/Executive_Summary-IfM-Materialie-251_2017.pdf

⁴⁴ IHK Rhein-Neckar <https://www.rhein-neckar.ihk24.de>

⁴⁵ Deutscher Industrie- und Handelskammertag <https://www.dihk.de/en/>

⁴⁶ Senior Experten Service (SES). *About us*. <https://www.ses-bonn.de/en/about-us.html>



The German chamber system also provides support for exporting companies. Regular presentations and workshops inform German businesses about export to many countries. Specialized consultants assist SMEs with exports and inform about laws and regulations and tariff barriers, among others. As an example, DIHK e.V. (the German association of chambers of industry and commerce), SES (Senior Experten Service) and IPD (Import Promotion Desk) have cooperation agreements with the UCCI (Ukrainian Chamber of Commerce and Industry). Some regional CCI have separate agreements with German and European bodies. These partnerships aim to strengthen international ties and improve Ukrainian businesses' network capacity in terms of expertise, trade, cooperation etc. ⁴⁷

Support for clusters

There are several cluster support programmes for specific sectors or technologies at the national (e.g. "Go-cluster") as well as on the state level (e.g. Baden-Württemberg's ClusterAgentur BW programme). The "Go-cluster" programme of the German Ministry for Economic Affairs and Energy is aimed at supporting collaboration between groups of various actors: large corporations, SMEs, research institutes including universities, and local and regional governmental actors. They are supported not only by funding for common R&D projects but also by guiding cluster management: consulting, training, and network opportunities. The primary areas for funding among industrial sectors are high-tech and renewable energy. ⁴⁸

Although the government supports cluster programs, they are essentially bottom-up initiatives of the main local actors (business, academia, research entities, and local government etc.). That means that local actors can form clusters and apply for funding. The actors of a cluster must also come up with a plan for the cluster's development. In many programs, they have to bring in significant own resources in order to assure ownership.

The main characteristics of a successful cluster are:

- Bottom-up approaches: Cluster participants form clusters themselves based on their own interests. In many programs, they must themselves provide significant own resources in order to assure ownership;
- Sustainability: the actors have to build partnerships based on mutual long-term relations rather than short-term funding programs;
- Co-funding: cluster operations need to be funded from various own sources;
- Objective-based performance: the cluster roadmap should refer to the KPIs of regional and national strategies;
- Realistic goals: the cluster activities should rely on the available resources and competitive advantages of the environment of the cluster.

Knowledge and Technology Transfer between Science and Business

The pre-phase of business-university partnership building starts with their intervention into the studying process. The agreements between companies and universities are usually initiated by companies, and their success also mainly depends on a company's commitment. ⁴⁹ Collaborations between universities and businesses can often involve students. Having a small student group work on a specific case over a few months is "affordable consulting" for a small or medium-sized enterprise: no remuneration is paid.

⁴⁷ International Projects. *Ukrainian Chamber of Commerce and Industry* <https://ucco.org.ua/en/international-projects>

⁴⁸ Ekert, S., Schüren, V. & Bode, A., 2016. *Evaluation of „go-cluster“ – A programme of the Federal Ministry for Economic Affairs and Energy (BMWi)*

https://www.bmwi.de/Redaktion/EN/Publikationen/evaluation-of-go-cluster-english.pdf?__blob=publicationFile&v=4

⁴⁹ According to professor Selenthin from the University of Applied Science in Koblenz



However, other resources, such as time and human resources, should be spent to introduce the problem and to organise their work. If the problem is solved, no further obligations apply for both sides; however, if the company is satisfied with the result, it can possibly make a donation to a university or reward the students.

Box 4. University technology parks

German universities also contribute to the development of SMEs. A good example of such a contribution is the launch of start-up incubators in some German universities. For instance, the Gründungsbüro in the Koblenz University of Applied Sciences provides a range of free services to all current and former students and staff interested in starting a business. Such services include consultations and advice on business planning and financing, organizing events such as a seminar series on various topics related to starting a business, as well as networking events with other start-ups from other universities in the region and alumni of the programme and offering free office space for a period of up to four months.

The Gründungsbüro also collaborates with other organisations, ranging from private companies, such as ones from the finance industry (e.g. the Debeka Group), to other start-up incubators, such as the Technology Center Koblenz and the Founder Week Germany. This approach has produced a number of successful enterprises, which operate in various industries, including technology, food, online marketplaces, marketing, education, and many others.

Technology parks usually have a group of local advisors (representatives of the university, local government, and business side as well (chambers of commerce). These experts decide who will have the right to move in and be promoted.

Source: Gründungsbüro, Hochschule Koblenz <https://www.hs-koblenz.de/en/forschung-transfer/gruendungsbuero/>⁵⁰

⁵⁰ Gründungsbüro, Hochschule Koblenz <https://www.hs-koblenz.de/en/forschung-transfer/gruendungsbuero/>



Box 5. Case studies: medical and textile clusters in Mannheim

According to Dr Elmar Bourdon from Medical Technology Cluster Mannheim, the key for success in cluster management is organisational integration, both of the authorities at local, regional and national levels (while arranging funding and legal support) as well as of the partners. It is even more important in case of field-specific clusters. The cluster management should have the relevant background knowledge to provide consulting and advocacy services for the residents of the clusters (companies, start-ups, academia etc.), i.e. experience in the industry and management experience rather than being government bureaucrats.

Mannheim Medical Technology Cluster

Medical technology was defined as one of the key industries in the region of Mannheim due to the availability of a qualified workforce based at local medical universities and relevant research facilities. The whole medical technology industry is relatively small, employing 210, 000 people in Germany. 92% of all medical technology businesses have fewer than 250 employees. All of them ought to be innovative and highly specialized.

Mannheim Medical Technology Cluster was created in 2015 as a response to the following problems:

- Intensive M&A process between large companies and the Mittelstand;
- Lack of venture capital in the industry due to long product development cycles and a generally low endowment of VC funds in Germany;
- Need for integration of production and clinical studies;
- Requirement of product certification before medical usage.

The start-ups located in Cubex (the name of the start-up centre in the cluster) are usually not spinoffs from the universities (unlike individual researchers that work there). The cluster itself is owned by the city of Mannheim, and the mayor is in the supervisory board.

Textilerei Fashion Center Mannheim

Small businesses here have the possibility to work as a part of a cluster. As for Textilerei Fashion Center, the participation fee is 5% of turnover. Currently such businesses as fashion designers, advertisers, photographers are located there.

They are also supported by the means of:

- Consulting & training / qualification
- Seminars & workshops
- Access to high quality industrial machinery park
- Cheap rental rates
- Sales promotion
- Marketing & PR

Source: <http://www.medtech-mannheim.de/>; <https://textilerei.de/>⁵¹

Support for innovations diffusion

There are already many digital production and distribution solutions in use; however, they are implemented mostly in large companies and are not affordable for the SME sector. In addition, the fact that they connected to specific technologies means they are hardly transferable. Therefore, German ministries are providing a different kind of support programs for digitalisation of Mittelstand companies. There are programmes for the digitalisation of the skilled crafts sector, for the digitalisation of vocational training, and Industry 4.0 applications with to a focus on usability in Mittelstand software companies.

⁵¹ Modezentrum Mannheim <https://textilerei.de/>, <http://www.medtech-mannheim.de/>



Box 6. German Mittelstand 4.0 Agencies

To bring SMEs into the age of industry 4.0, the German government established four Mittelstand 4.0 Agencies that promote the diffusion of digital innovations and their availability for SMEs.

These agencies pass on their expertise to Mittelstand 4.0 Competence Centres and use multipliers to share it with companies.

- The Mittelstand 4.0 Agency for the Cloud provides support on the application and growing use of cloud computing technologies.
- The Mittelstand 4.0 Agency for Processes offers help with the use of digital process and resource management.
- The Mittelstand 4.0 Agency for Communication supports innovation management and helps raise the use of digital communication processes.
- The Mittelstand 4.0 Agency for Trade answers questions on new technologies in digital trade, such as eBilling, and on production-related trade.

Currently, there are 23 Mittelstand 4.0 Competence Centres around the country.

Source: Mittelstand Digital. <https://www.mittelstand-digital.de/MD/Navigation/DE/Home/home.html>⁵²

Provision of insurance for exporters

The most prominent instrument to reduce the risk of German exporters are the Hermes guarantees offered by the Federal Government. They provide insurance for claims to payments abroad for German enterprises that export to developing and emerging countries, protecting them in the event of non-payment. The Hermes guarantees complement the offer of private insurance companies, which mostly focus on export credit guarantees for less risky target countries. Moreover, both large and small enterprises investing in emerging and developing countries may apply for investment guarantees from the Federal Government to reduce political risks.⁵³

The Federal Ministry for Economic Affairs and Energy also supports SMEs' exports by helping them enter into or develop new foreign markets in fields such as energy or environmental technologies. The ministry provides guarantees and export credit subsidies, as well as assisting German companies in foreign market activities.⁵⁴

The various support measures offered by the BMWi have been efficiently coordinated and bundled together under the new umbrella initiative "Mittelstand Global" (Global SMEs). Under this programme, there are also initiatives aimed at key sectors where Germany is especially strong, such as the "healthcare export initiative", the "civil security technologies and services export initiative", and the "environmental technologies export initiative".⁵⁵

Additional Government SMEs funding

SMEs can apply for technology-specific subsidies or credit within the framework of specific government programmes, for instance for bioengineering or energy supply technology. Additionally, SMEs can establish collaborations with research institutes.

⁵² Mittelstand Digital. <https://www.mittelstand-digital.de/MD/Navigation/DE/Home/home.html>

⁵³ Agaportal.de *Foreign Trade and Investment Promotion Scheme*
<https://www.agaportal.de/en/was-ist-auslandsgeschaeftsabsicherung>

⁵⁴ Herr, H., Nettekoven, Z. M. *The Role of Small and Medium-sized Enterprises in Development*
<http://library.fes.de/pdf-files/iez/14056.pdf>

⁵⁵ Federal Ministry for Economic Affairs and Energy. *Export initiatives: Finding new markets.*
<https://www.bmw.de/Redaktion/EN/Dossier/export-initiatives.html>



SME support programmes within Germany are very specific and demand significant contributions from the SMEs as well. This co-financing requirement makes the projects less risky and more sustainable.

There is also funding provided to SMEs in a wide range of technological advancement areas and in a variety of types of supported projects. Funding goes to collaborative projects, individual projects with research institutes, and investment loans for innovations. Furthermore, funding is given to research centres for collaborative projects with SMEs.

SMEs can rely on strong apprenticeship support in the form of substantial public co-funding (55.75% of the country's apprenticeship expenses).⁵⁶ With this support, SME provides training for four in five apprentices in Germany.⁵⁷ Moreover, in addition to these government funds, the German development bank, KfW, is in charge of giving low-interest rate loans to SMEs via local banks for innovation projects.⁵⁸

Intellectual property rights protection

Another external contributor to German companies' high ability to innovate is a high level of intellectual property rights protection. This is one reason why companies of German origin prefer to locate their R&D departments together with the headquarters in the home country even though production lines can be moved overseas.

In order to compare German and Ukraine intellectual property rights protection, we used the International Property Rights Index (IPRI) as the flagship publication of the Property Rights Alliance, an American advocacy organisation (Figure 7). Covering 127 countries, it is the world's only index entirely dedicated to the measurement of intellectual and physical property rights. IPRI reports on property rights systems affecting 98 per cent of world GDP and 93 per cent of the world population and is a tool for policymakers, business communities, and civic activists.⁵⁹

Interestingly, the IPRI includes such general components as judicial independence, rule of law, political stability, and ease of access to loans. One can see that even though patent protection is now relatively advanced in Ukraine, the Ukrainian institutional system still underperforms on a variety of dimensions. Especially in the fields such as copyright piracy, judicial independence, or property rights protection, there is still a need for further reform in Ukraine.

⁵⁶ Müller, N., Wenzelmann, F., Jansen, A. *Financing of vocational education and training in Germany* <https://www.bibb.de/en/41380.php>

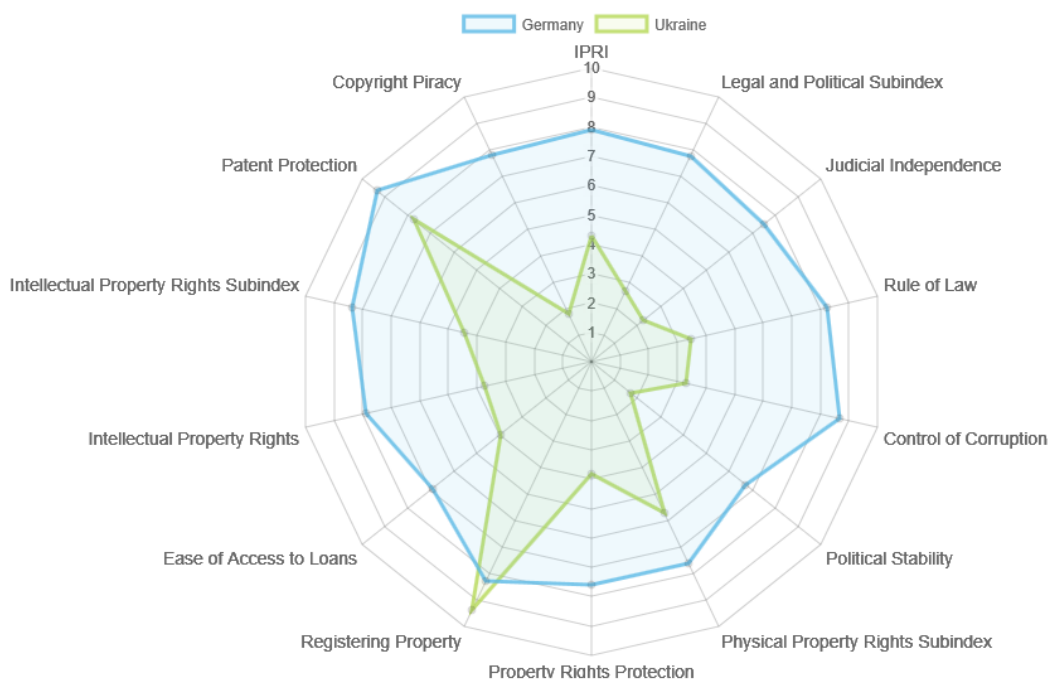
⁵⁷ Federal Ministry for Economic Affairs and Energy. *SME Policy* <https://www.bmwi.de/Redaktion/EN/Dossier/sme-policy.html>

⁵⁸ Belitz, H., Eickelpasch, A. & Lejpras, A., 2013. *Innovation Policy for SMEs Proves Successful*. http://www.diw.de/documents/publikationen/73/diw_01.c.419114.de/diw_econ_bull_2013-04-3.pdf

⁵⁹ Property Rights Alliance. *About*. <http://www.propertyrightsalliance.org/about/>



Figure 7. International Property Rights Index, overall score, 2018



Source: <https://www.internationalpropertyrightsindex.org/compare/country?id=10,42> 60

5.3 Possible challenges for Germany's Mittelstand model

Researchers point to some present and future challenges for the German model of SMEs and family business.

Succession problem

One risk facing the German Mittelstand is that ageing companies' owners and managers do not have a vision for their businesses. Around 33% of CEOs are above 54, and almost half of those senior business leaders (roughly 46,000) do not have a successor, according to the Association of German Chambers of Industry and Commerce⁶¹. The issue is likely to get more acute because by 2030, when almost half of the people living in Germany are expected to be 50 or older.⁶²

The succession problem can be expected to become more relevant in the following years in Ukraine, given the fact that private businesses were only built up in post-Soviet times. Many of these early entrepreneurs, who were in their best years in the 1990s, are now ageing. Therefore, a keen understanding of the challenges in the succession process from one generation towards the next is necessary for the future of the nascent sector of Ukrainian family firms.

Prejudice for vocational training

⁶⁰ International Property Rights Index 2018 <https://www.internationalpropertyrightsindex.org/compare/country?id=10,42>

⁶¹ Deutscher Industrie- und Handelskammertag eV. *Für Unternehmensnachfolge genug Zeit einplanen* <https://www.dihk.de/themenfelder/gruendung-foerderung/news?m=2018-13-20-evers-nachfolge>

⁶² Reuters Staff. *Ageing Mittelstand bosses seen as threat to German economic vitality* <https://www.reuters.com/article/germany-mittelstand-investment/ageing-mittelstand-bosses-seen-as-threat-to-german-economic-vitality-idUSL5N0ZT3HX20150731>



The German apprenticeship system is not without its own flaws. About a quarter of young people entering training courses only qualify for “prevocational” training, a fall-back that leaves many unprepared for anything other than unskilled, unstable, poorly paid jobs.⁶³

Germany’s labour market values workers trained for specific occupations. Most positions, from electricians to nursery-school teachers, require standard training and certification. This is not the case in many of the countries eager to copy Germany’s dual-education success. While the relative lack of dependence on qualifications in other countries makes mid-career moves easier, argues Prof Solga, that fluidity could undermine the status and usefulness of youth apprenticeship schemes.⁶⁴

Therefore, the apprenticeship scheme has to be constantly updated and improved. Indeed, the chamber of commerce and the chamber of the skilled crafts that organize the training are constantly arguing for improving it and adapting it to the changing world.

6 Ukraine: SME sector characteristics

The SME sector statistics review presented below is based on the existing Ukrainian approaches to the definition of SMEs and ways to collect information about the SME sector. Both are very well described in the IER/USAID LEV Policy Paper “Official Statistics of SMEs in Ukraine: analysis and suggestions for improvement”. The authors draw attention to the key issue of difference in the definition of medium and small enterprises in Ukraine and the EU. In particular, the EU definition determines the number of employees and the turnover of the enterprise based on consolidated accounts for enterprises that are related to others, in other words, it is important to know whether an enterprise is part of any business group or not. On the other hand, the Ukrainian Commercial Code, according to which enterprises are defined as small and medium ones, does not take membership of a business group into account.

6.1 Number of SMEs

In 2017, there were 1.8 million SMEs (15,000 medium; 323 small; 1.467 millions individual entrepreneurs) and only 399 big enterprises in Ukraine.⁶⁵ The number of SMEs decreased by 3.2% (about 60,000 entities) in comparison with 2016. As a result, the number of SMEs per 1,000 inhabitants decreased from 43.7 in 2016 to 42.5 in 2017 (See Figure 8). This took place primarily because of a decline in individual entrepreneurship, which constitutes the major part (81.3%) of the SME sector in this dimension. The number of individual businesses decreased by 5.9%. At the same time, the number of micro, small (without micro-) and medium enterprises grew by 12.3%, 10.9%, and 0.7% respectively.

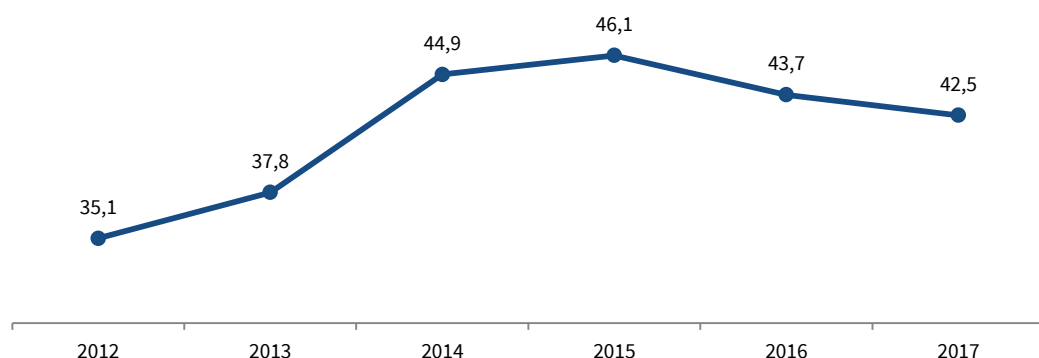
Figure 8. SMEs' number per 1000 population (2012-2017)

⁶³ Jacobs, R., 2017. *Germany’s apprenticeship scheme success may be hard to replicate*. Financial Times, 21 April 2017. <https://www.ft.com/content/1a82e8e0-04cf-11e7-aa5b-6bb07f5c8e12>

⁶⁴ Ibid.

⁶⁵ Taking into account only headcount criterion (250 and more employed people), the number of big enterprises is a few times higher. For example, in 2016 it was more than 2.7 thousand.





Source: State Statistics Service of Ukraine, 2018.⁶⁶

In 2017, only 18.7% SMEs were functioning as legal entities and the others were individual entrepreneurs. This figure was 2.3 percentage points higher than in 2016, when its value was the lowest in recent years. Individual entrepreneurship has become a popular way to minimize tax payments.

The Verkhovna Rada, the Ukrainian parliament, adopted amendments to the Law on Collection and Registration of the Single Contribution for Mandatory State Social Insurance (signed by the President in December 2016), which introduced new requirements for individual entrepreneurs. Today they are obligated to pay Unified Social Insurance Contribution even if their business is not active. This contributed to a decline in their number in late 2016 and early 2017. More than 200 thousand individual business entities were closed in the first months of 2017. According to ABCA 2016, 12.5% of individual entrepreneurs were planning to register their business as a legal entity (13.3% - ABCA 2015)⁶⁷.

It should be emphasized that more than one-quarter of legal entities are registered in the capital of Ukraine (Kyiv). However, many of these enterprises are merely registered in Kyiv, but in fact own and operate businesses in all regions of Ukraine. Besides, many small and medium enterprises are located in the Dnipropetrovsk, Kharkiv, Kyiv, Lviv, and Odessa regions. In some regions (e.g., Chernivtsi, Ternopil, Kherson) there are only a few big enterprises and, consequently, the SME sector plays the main role in their business sector.

Table 3. SME sector in 2017

	Absolute figures			Relative figures		
	Number, thous.	Employment, thous. people employed	Turnover, UAH bn	Share in the total number	Share in total employment	Share in total turnover
Micro enterprises	278.1	714.6	497.8	15.4%	8.8%	6.0%
Small enterprises (without micro)	44.8	944.3	984.2	2.5%	11.6%	11.8%
Medium enterprises	14.9	2 593.1	3 296.4	0.8%	31.9%	39.7%

⁶⁶ State Statistics Service of Ukraine, 2018 <http://www.ukrstat.gov.ua/>

⁶⁷ ABCA (Annual Business Climate Assessment) – was an annual small and medium-sized business survey conducted by the Institute for Economic Research and Policy consulting within USAID LEV Program.



Individual entrepreneurs	1 466.8	2 328.1	604.3	81.3%	28.6%	7.3%
SMEs	1 804.7	6 580.1	5 382.8	99.98%	80.8%	64.8%
Big enterprises	0.4	1 560.9	2 929.5	0.02%	19.2%	35.2%
Total	1 805.1	8 141	8 312.3	100.0%	100.0%	100.0%

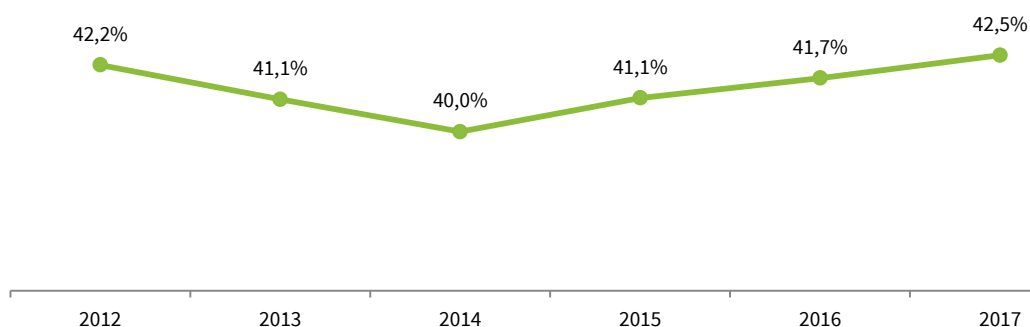
Source: State Statistics Service of Ukraine, 2018.⁶⁸

6.2 Employment

In 2017, there were circa 6.580 Mn people employed in the SME sector, including 2.593 Mn at medium-sized enterprises, 1.659 Mn at small enterprises (including micro), and 2.328 Mn at individual entrepreneurship entities (see Table 5). In comparison with 2016, employment in SMEs has grown by 0.9% (58 thousand people employed). The source of growth came from an employment increase at small (including micro) enterprises (4.2%) and individual entities (0.9%). However, medium enterprises employed 1.1% less people than in 2016.

2017 was the second year in a row in which SMEs employment grew, after declining every year from 2012-2015. In 2016, the growth indicator was about at the same level (0.8%). According to the ABCA 2016 survey, one-third of Ukrainian SMEs were reducing the number of workers in 2015-2016. However, 45% of SMEs did not change the number of employed people and 22% increased it.

Figure 9. Share of SMEs in total employment (2012-2017)



As of today, the SME sector is the major employer in Ukraine. SMEs provided about 80.8% of all jobs in entrepreneurial entities in 2017 (circa 0.4 percentage point higher than in 2016). In 2017, the total number of people employed at business entities also increased (by circa 0.4%) due to the growth of SMEs employment. However, employment in big enterprises decreased by 1.6%. This change also increased the share of SMEs. Small and medium-sized enterprises have also contributed to general employment. In 2017, the SME sector accounted for 42.5% employed people of working age (41.7% in 2016), exceeding the figure of 2012 (see Figure 9).

⁶⁸ State Statistics Service of Ukraine, 2018 <http://www.ukrstat.gov.ua/>

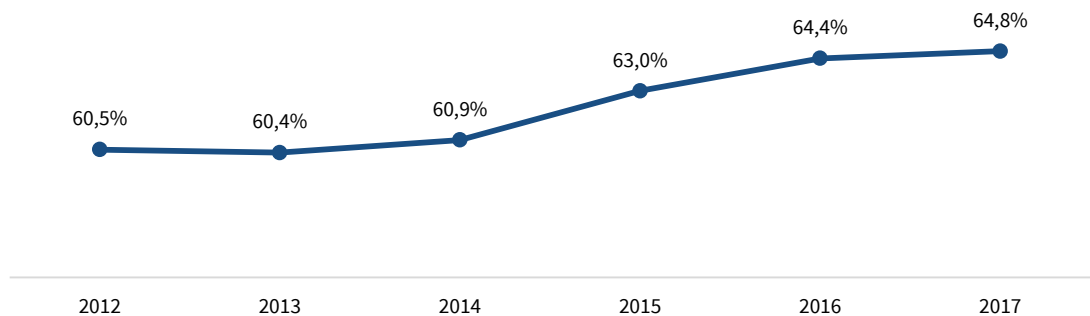


6.3 Turnover

In 2017, the annual turnover of the sector reached UAH 5,383 bn. Taking into account inflation, turnover volume increased by 8.5% in comparison with 2016. Such growth was produced by entities of all sizes and legal forms. However, medium enterprises, which accounted for 61.2% of the sector’s turnover, made the major contribution. The same situation was in 2016 when real growth of turnover made 8.6%. The data for 2017 prove that the SME sector has probably recovered and is continuing its growth.

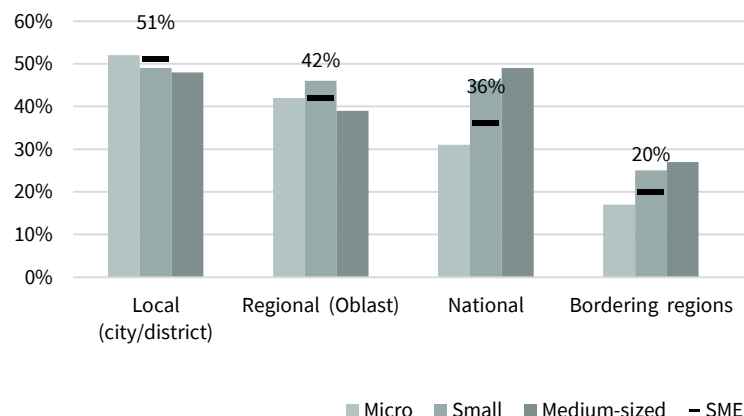
In 2017, SMEs accounted for 64.8% of the total turnover of economic entities in Ukraine. The same figure was 0.4 percentage points lower in 2016 (see Figure 10). Just as with employment, SMEs have also increased their role in terms of sales of goods and services over the past few years.

Figure 10. Share of SMEs in total turnover of economic entities (2012-2017)



A lack of demand has recently become one of the main problems of Ukrainian business. According to ABCA 2016, 58.5% of SMEs experienced a low demand for their products and services in 2016. However, only 38.5% of respondents mentioned this issue in 2015. At the same time, in 2016 50.3% of SMEs operated only at the regional (local) market (52.8% in 2015). According to the survey, 46% of SMEs were planning in 2016 to expand their markets (domestic and foreign), compared to only 43.3% in 2015). In particular, 21% of all entrepreneurs wanted to find customers in the EU or other countries (only 16.9% in 2015).

Figure 10. SMEs operating markets (2016)



In this context, Ukrainian business statistics lacked data on export activities of the SME sector, and surveys remained one of the main information sources in the field. However, in 2018 the State Statistics Service of Ukraine published export data by a number of companies for the first time. According to this dataset, in 2016 there were 21,319 exporting companies. About two-thirds of them (13,413 or 62.9%) had fewer than 250 employees. However, they accounted only for 28.3% of Ukraine’s exports (USD 10.3 bn). Besides,



there were also 5,740 individual entrepreneurs-exporters, but they accounted only for 1% (USD 357 mn) of total exports. In comparison, in 2015 the share of enterprises with zero to 249 employees and individual businesses was almost at the same level (28.3% and 0.8% respectively).

6.4 Sectoral dimension

In 2017 (see Table 6), the highest number of SMEs operated in the wholesale retail and trade sectors (circa 834 thous. entities or 46.4%). Besides retail and trade, many SMEs belonged to information and communication (circa 147,000 or 8.1%), industrial production (circa 127,000 or 6.8%), and professional, scientific, and technical activities (124,000 or 6.9%). However, the sectoral distribution of SMEs' employment and turnover is partially confidential according to Ukrainian legislation. Therefore, comprehensive statistics of the sectoral dimension are entirely available only for small entities. However, the detailed picture of small business generally reflects the sectoral development of SMEs in Ukraine.

In 2017, the highest number of **small** enterprises (about 86,600 or 26.8%) also operated in the wholesale retail and trade sectors (see Table 3). This sector was the main employer (about 370,000 people employed or 22.3%) and had the biggest volume of sales (UAH 723.2 bn or 48.8%). In the same year, the agricultural sector ranked second in a number of entities (44,700 enterprises or 14.8%), but third in employment (229,700 or 13.8%) and turnover (UAH 177.5 bn or 12%). The industrial sector was placed only third in terms of number of entities (37,100 enterprises) but provided the second highest number of jobs (about 204,300 or 17.7%) and also demonstrated the second biggest turnover (UAH 188.4 bn or 12.7%).

Table 4. Small business statistics: number of small enterprises, employment and turnover (2017)

Type of activity	Number		Employment		Turnover	
	Thous. enterprises	Share %	Thous. people employed	Share %	UAH bn	Share %
Total	322.9	100.0	1658.9	100.0%	1482.0	100.0%
Wholesale and retail trade; repair of motor vehicles and motorcycles	86.6	26.8%	369.4	22.3%	723.2	48.8%
Agriculture, forestry and fishing	47.7	14.8%	229.7	13.8%	177.5	12.0%
Industry	37.1	11.5%	294.3	17.7%	188.4	12.7%
Real estate activities	33.7	10.4%	123.8	7.5%	60.3	4.1%
Professional, scientific and technical activities	26.9	8.3%	106.0	6.4%	45.2	3.0%
Construction	26.7	8.3%	149.7	9.0%	110.3	7.4%
Administrative and support service activities	15.1	4.7%	91.9	5.5%	29.4	2.0%
Transportation and storage	14.1	4.4%	92.9	5.6%	66.6	4.5%
Information and communication	13.1	4.1%	66.0	4.0%	41.0	2.8%
Accommodation and food service activities	7.0	2.2%	42.8	2.6%	9.3	0.6%
Human health and social work activities	4.0	1.2%	37.2	2.2%	5.1	0.3%
Financial and insurance activities	3.7	1.2%	17.9	1.1%	18.8	1.3%



Other services	3.4	1.0%	15.3	0.9%	3.0	0.2%
Education	2.0	0.6%	12.2	0.7%	1.7	0.1%
Arts, entertainment and recreation	1.8	0.6%	9.8	0.6%	2.5	0.2%

Source: State Statistics Service of Ukraine, 2018⁶⁹

6.5 Involvement in networks and bottom-up organisations

Chambers and business associations are bottom-up structures, through which SMEs can have an impact on policy decisions. However, only 15% of SME are members of at least one business association.⁷⁰ The Chamber of Commerce and Industry of Ukraine (UCCI) and its 25 regional subsidiaries act according to a specific law of Ukraine.⁷¹ Thus, the UCCI system enjoys a privileged position, being the only subject regulated by the law. The institution issues the following documents:

- expert conclusions on legislation project acts
- force-majeure certificates
- certificates of the non-state register of entrepreneurs that are reliable partners etc.

Around 8,000 enterprises are members of UCCI, while 20 industry-specific committees create the framework of the Chamber. In view of the approximately 3 million enterprises officially involved in the German DIHK, entrepreneurs' level involvement of chambers and business associations in the two countries is not comparable. The financing structure is also different. In 2016, the UCCI's annual income mostly consisted of service fees, whereas membership fees were only 1,51% of the budget.

However, there are other business associations that are influential on the national scale. For example, there is the Ukrainian Business Council (UBC), the European Business Association (EBA), and the Union of Ukrainian Entrepreneurs (SUP), as well as approximately 60 industrial and regional associations created on a voluntary basis.⁷²

7 SME development in Ukraine: current policy

7.1 External political and economic factors

Having analysed the strong German SME sector (Mittelstand) and the 'hidden champions' phenomena (as well as the factors that determined their success) and the current Ukrainian situation, we came to the following conclusions:

A higher share of strong small and medium enterprises can contribute to an economy in positive ways, such as:

- higher inclusiveness and stability of the economy (for example, The Economist compared the French and German economy and came to the conclusion that the strong German Mittelstand prevented the marginalisation of small towns)⁷³
- economic growth based on a broad and inclusive approach of knowledge-based innovations

⁶⁹ State Statistics Service of Ukraine, 2018 <http://www.ukrstat.gov.ua/>

⁷⁰ ABCA 2016-2017 http://www.ier.com.ua/en/sme_development/InfoFigureics_LEV?pid=6086%5C

⁷¹ Law of Ukraine *On Chambers of Commerce and Industry in Ukraine* <https://zakon2.rada.gov.ua/laws/show/671/97-%D0%92%D0%A0?lang=en>

⁷² Annual Report 2016. Ukrainian Chamber of Commerce and Industry. <https://drive.google.com/file/d/0B4e0RVTixtZUZndaU80U056cmM/view>

⁷³ The Economist, 2019. *Why Germany has no gilet jaunes protesters* <https://www.economist.com/europe/2019/02/09/why-germany-has-no-gilet-jaunes-protesters>



As for Ukraine, there are general factors that need to be taken into consideration while developing strategic policy measures for SMEs. They are long-term circumstances with an impact on both state governance and business management.

Low level of trust in society. There is strong evidence that the level of trust in society corresponds to the level of GDP per capita. The share of people agreeing that “all people should be trusted” is twice as high in Germany as in Ukraine (2014 data). We believe that low level of trust hinders the development of SMEs by adding to uncertainty among stakeholders, making it less likely that a person or group will launch a business and innovate. The dense networks of collaboration that constitute the German Mittelstand, in particular, might be more difficult to establish in Ukraine, a country with a low level of generalized trust.

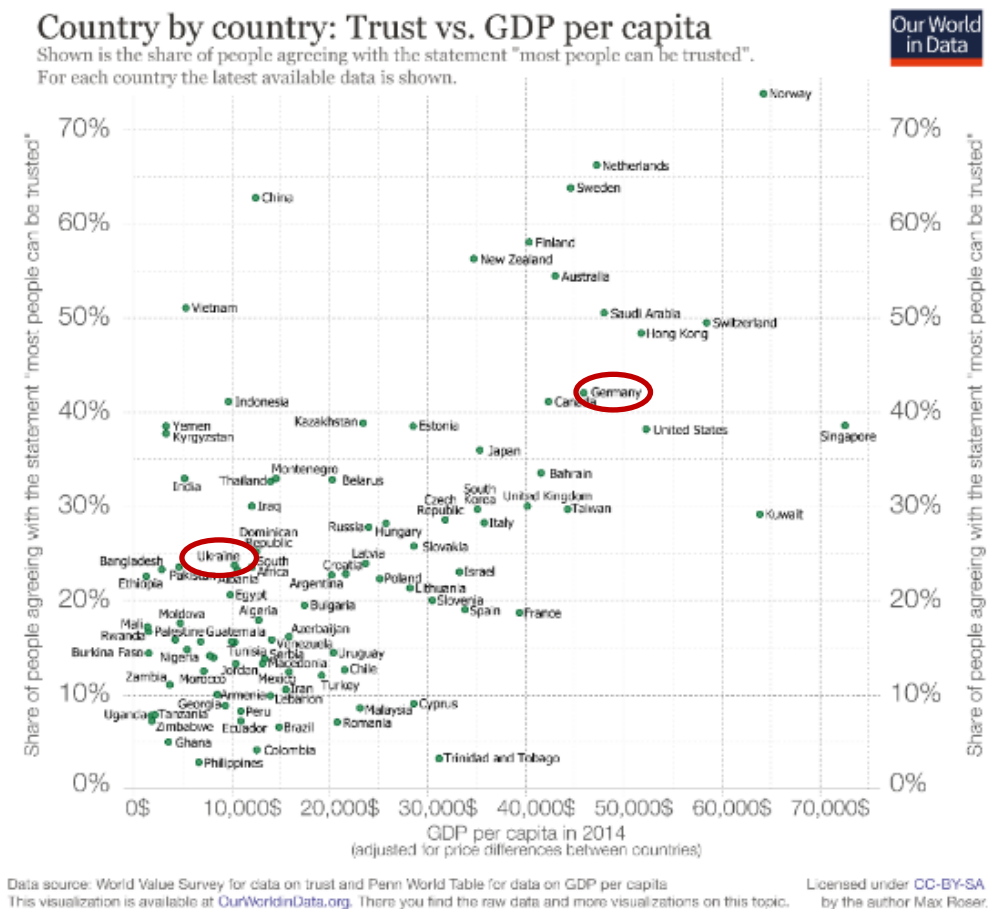


Figure 12. Trust vs. GDP per capita

Weak rule of law. The state agencies, in general, enjoy a low level of public trust (e.g. only 9.1% of the population trust public functionaries), which is grounded on weak rule of law⁷⁴. It causes:

- an inability to protect the rights of ownership of assets, profit and intellectual property
- the low level of trust in the justice system and law enforcement agencies

⁷⁴ Hromadskiy prostir *Level of trust in public institutions and electoral orientation of Ukrainian citizens – research.*
<https://www.prostir.ua/?news=riven-doviry-do-suspilnyh-institutiv-ta-elektoralni-orijentatsiji-hromadyan-ukrajiny-doslidzhennya>



- a high risk of state capture by crony capital and monopolies that distort the level playing field
- a high level of corruption

Thus, any government initiative to provide financial means of support for SMEs may be viewed with distrust by potential beneficiaries, as they might not trust that funds will be allocated fairly. Funds allocation may involve corruption. This might also lead to a low level of demand for government funding and support for SMEs.

Political and economic instability is another factor that keeps business from planning for the long-term, as there is a high risk of unexpected changes in taxation, regulation, and foreign trade policies due to changes in politics and interests of large business lobbies. Political uncertainty was proven to affect technological innovation more than the type of policy itself.⁷⁵ This also means that when political influence on economic decisions is high, technological innovation tends to slow down.

7.2 Existing SME policy overview

In 2015, the MEDT designed a draft SME Development Strategy that was under discussion for three months. During January-March 2016, the government had several presentations and public discussions about the strategy with executive authorities, business associations, business support organisations and research institutions, representatives of international and donor organisations, and SMEs. After improvements to the strategy, it was adopted on 24 May 2017.⁷⁶

The vision of the SME Strategy 2017-20 is to create favourable conditions for opening, operating, and growing businesses and strengthening the SME sector. General targets of the SME Strategy include:

- improving Ukraine's position to get it into the top-20 of the World Bank "Doing Business" ranking;
- Increasing the share of innovative enterprises from 14.6 per cent (2014) to 20 per cent;
- Increasing in the share of markets with a competitive structure from 42.7 per cent (2015) to 49.5 per cent.

It is important to know that SME support policies emerge continuously. Several new policies were launched in 2018⁷⁷. For example:

- The Ukrainian National Start-up Fund with 50 mn UAH (1.56 mn EUR) of potential grants to start-ups. It will invest from \$25,000 to \$75,000 in UAH and search for external investments.
- The Ukrainian Inventors Support Fund with 100 mn UAH of support for innovative enterprises. The criteria for the state support are novelty, social or market expediency, the term of implementation, etc. At the first stage after the contest, the inventors are supported by the means of services (business planning, laboratory tests, patent application, etc.) paid by the state (up to 500 thous. UAH). At the second stage, the winners are further supported by 2 mn UAH. The fund provider, the State Finance institution for innovations (SFII), has the opportunity to invest up to 10% of its own financial resources.⁷⁸
- An SME development office of the Ministry of Economic Affairs that will deal with:
- analysing the needs of SMEs and providing recommendations to the Government;
- credit guarantee mechanisms;

⁷⁵ Bhattacharya, Utpal, et al. "What Affects Innovation More: Policy or Policy Uncertainty?" *Journal of Financial and Quantitative Analysis*, vol. 52, no. 5, 2017, pp. 1869–1901. <https://www.cambridge.org/core/journals/journal-of-financial-and-quantitative-analysis/article/what-affects-innovation-more-policy-or-policy-uncertainty/FB21593CFF8551F9204850EFA896658B>

⁷⁶ EU4Business. *Investing in SMEs in the Eastern Partnership. Country report Ukraine*. http://www.eu4business.eu/files/medias/country_report_ukraine.pdf

⁷⁷ All of the mentioned are brand new initiatives; therefore there is still no evidence on the impact of such funds.

⁷⁸ <https://www.sfii.gov.ua>



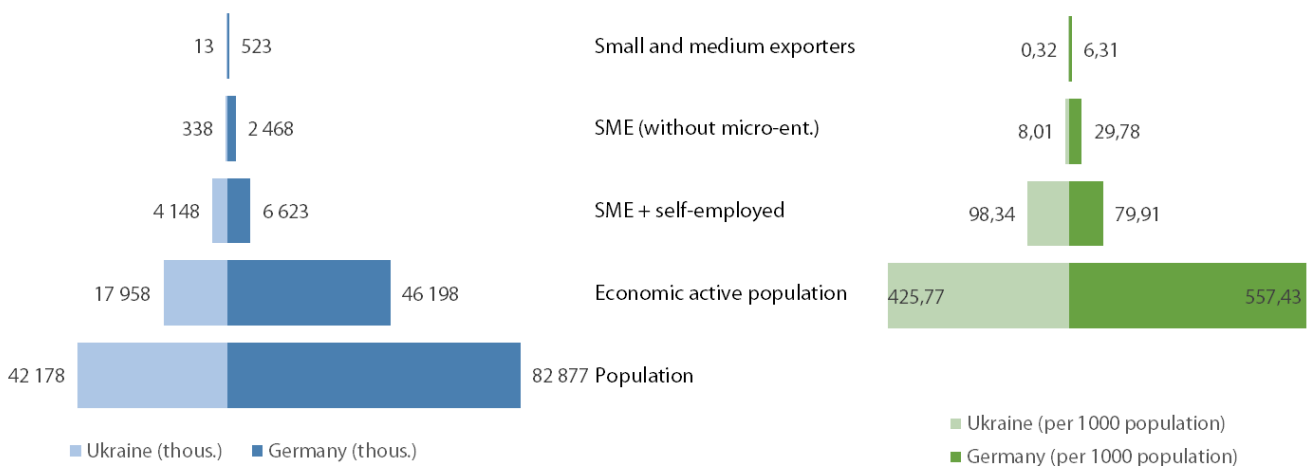
- the creation of an integrated official information resource, in order to provide access to all the relevant information;
- organisational integration of the activities of the authorities involved in the implementation of SME development programs;
- supporting the local authorities in establishing centres of entrepreneurship support at the regional and local levels.
- The creation of different forms of clusters (by private investors and local authorities), including industrial parks, technology parks, and scientific parks. (However these still look like local initiatives not coordinated at the national level.)
- An innovation development council, a consultative and advisory body created under the Cabinet of Ministers of Ukraine in October 2017.

8 Recommendations for Ukraine SME policy

When describing German SME policy, we used the structure of internal and external factors influencing SME development in this country. In this subchapter, however, we suggest differentiating the policy solutions by the size and market position of beneficiaries. This approach will lead to greater organisational cooperation between national and local authorities and donors. The suggested policies will result in more enterprises being willing and able to advance to the next level (for instance, from individual micro-enterprise to small enterprise; from the national market leader to the exporter, etc.). Figure 13 (also present in the Executive Summary) shows that Ukraine’s SME sector lags behind Germany not only in absolute but also in relative numbers, especially for small and medium exporters (whereas for SMEs and self-employed persons the relative numbers for Ukraine are in fact higher than in Germany).

It is complicated to measure success and sustainability for the whole sector due to inadequacy and/or unavailability of data. Therefore, the policy options suggested below should aim at gradually increasing the number of enterprises able to survive and willing to develop further.

Figure 13. SME structure in Germany and Ukraine



Source: State Statistics Service of Ukraine, Federal Statistical Office of Germany, Federal Ministry of Economics and Technology of Germany



8.1 From a student to an entrepreneur

At the moment, there is no general system of supporting potential entrepreneurs in Ukraine. Potential entrepreneurs do, though, have the option to apply for a grant from the State Employment Service to establish their own business (if a person is unable to find employment for a month).⁷⁹ And technology transfer activities and academic entrepreneurship are present at higher educational institutions; however, experts evaluate their activities as insufficient to meet the challenges of the market.

From the German experience, we can see that one of the main components of promoting entrepreneurship is the creation of clusters. These are platforms for the cooperation of local players – e.g., universities, small and large companies, business angels, start-ups, local authorities. Localisation is an important principle of a cluster; however, the organisational integration and existence of horizontal links between all parties are also essential.

There are several forms of SME clusters, namely private and municipal incubators, innovation parks at universities and industrial parks. There are 16 innovation parks registered and coordinated by the Ministry of Education. However, they themselves are not active due to their dependence on the universities and lack of in-house operational and managing personnel – thus they exist as the subsidiaries of the universities – while local authorities tend to be more concerned with the development of industrial parks – as the latter can attract a higher amount of investments in a shorter period of time.

According to a survey conducted by the Ministry of Education and Science of Ukraine in October 2018, Ukrainian universities and scientific institutions are not active enough in technology transfer and academic entrepreneurship. Among 284 higher educational and scientific institutions surveyed, 86% (or 243 institutions) declared themselves active in the commercialisation of inventions and cooperation with businesses. However, only 10% were engaged in international technology transfer networks. The majority of them had a special department to deal with the issues, employing six employees on average. 165 institutions (or 58%) declared they were cooperating with small and medium enterprises; almost the same number cooperate with big companies.⁸⁰ Interestingly, when asked about the lack of capability and qualification in the field, only half of the institutions acknowledge the need for professionals. The greatest shortcoming in this regard is the deficit of intellectual property specialists, PR, sales and marketing professionals. This may be an indication of the lack of incentives for the institutions themselves to commercialise the inventions and cooperate with business by the means of clustering.⁸¹

Box 8. Science Park DonNU-Podillia (case study)

The concept of science parks is underappreciated in Ukraine. The responsible policymaking body (the ministry of education and science) does not support their creation (according to the representatives of such parks interviewed by CES). According to the Ministry's web page, there are 25 of them. However, the vast majority of them do not even have active web sites. The example of Science park DonNU-Podillia is an exception: the park was created in 2016 after the university was evacuated from temporarily occupied Donetsk to Vinnytsia. Nowadays the science park tries to attract partners and funding according to four core specialisations: smart heating systems, agriculture, rural development, and water pollution control.

The creation of the science park DonNU-Podillia faced the following problems:

⁷⁹ State Employment Service of Ukraine. *Як започаткувати власний бізнес за сприяння державної служби зайнятості*. <https://www.dcz.gov.ua/publikaciya/yak-zapochatkuvaty-vlasnyy-biznes-za-spryannya-derzhavnoyi-sluzhby-zaynyatosti-0>

⁸⁰ The figures include 41 institution of National Academy of Sciences and 40 institutions of National Academy of Agrisciences, all of which declared engagement in technology transfer and cooperation with busoness

⁸¹ Analysis of the activities of technology transfer offices as to the prospects for applying the results of their activities to small and medium-sized enterprises <https://mon.gov.ua/storage/app/media/innovatsii-transfer-tehnologiy/diyalnosti-ofisiv-z-transferu-tehnologiy-shchodo-perspektiv-zastosuvannya-rezultativ-ikh-diyalnosti-subektami-malogo-i-serednogo-pidpriemnitstva.pdf>



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- complicated registration process;
 - lack of funding coordination by the national and local authorities;
 - lack of skilled science park managers (consultants) that could be engaged and employed full-time.

The dependence on the central policymaking body (Ministry of Education and Science) is seen as a negative factor.

Source: <http://spark.donnu.edu.ua>⁸²

We suggest allocating public funding to the creation of new innovative companies and the necessary supporting infrastructure. To start the process of infrastructure creation, it is necessary to "revitalise" the present scientific parks and to combine them in the form of academic-business clusters. For their part, industrial parks, as a separate organisational and legal form, should apply business logic, choosing the appropriate form of cooperation with such clusters.

A good first step could be the liberalisation of existing legislation on science parks, specifically:

- providing clusters with autonomy for universities in decision-making;
- developing transparent mechanisms for the distribution of public funding and attracting private investment;
- providing independent advisory support financed by the Ministry of Economic Development and the Ministry of Education and Science to all the stakeholders: local government, universities, business, industrial parks, foreign investors, etc.
- only supporting clusters that are bottom-up initiatives of firms, universities and local government, and who have transparent, horizontal governance processes.

The basis of any park should be horizontal links and organisational integration between local stakeholders, rather than the receipt of privileges from the state. Applications from promising candidates can be encouraged by open calls with clear criteria for potential recipients, which should be reviewed by independent (including international) experts. The clusters that receive funding could receive it in the form of support for the introduction of cluster management (responsible only to the cluster participants, but not to the government), and for other horizontal bodies for steering the cluster.

The responsibilities in the field of innovations' support policies should be clearly divided between the Ministry of Education and Science (MES) and the Ministry of Economic Development (MEDT) as follows:

- MES has to create an innovative environment in the educational and scientific institutions
- MEDT has to provide the conditions for academic entrepreneurship and commercialisation of inventions
- Universities should be the institutions to coordinate both approaches
- Technology parks are to be the product of cooperation of regional or local authorities, business associations and universities in the framework of state innovation policy

⁸² Ukrainian Science park «DonNU-Podillya» <http://spark.donnu.edu.ua>



8.2 From an individual entrepreneur to a company

From private entrepreneurs to legal entities

The taxation system's inherent differentiation between individual entrepreneurs (simplified taxation system) and legal enterprises (limited liability companies) is a barrier to growth. However, together with a moratorium on inspections by the controlling bodies, a simplified taxation system creates a favourable environment to start a business. Entrepreneurs have the option of keeping business operations below the limit of UAH 5 Mn on turnover in order to comply with the rules of the simplified taxation system and to avoid exposure to the hardships of the general taxation system, primarily – permanent “talks” with tax authorities. Thus, transitioning from being an individual entrepreneur to a legal enterprise is seen as a psychological, financial, and organisational barrier for business to grow and develop and thereby potentially become exporters. Making this transition easier would be a further incentive for micro to small and medium-sized businesses to grow bigger.

Bankruptcy procedures ought to be simplified too, and its perception needs to be changed from negative (as a failure to succeed in business) to neutral (as a chance to change a vector of entrepreneurship and as a learning experience for companies).

Compensating for financial scarcity

To help start-ups and small enterprises overcome financial scarcity, different programmes are possible. When provided by the state authorities, any kind of financial support can be considered state aid; thus a competition authority should approve the validity of each case.

One way to mitigate the risks of bad governance and inappropriate use of taxpayer resources is to attract funding from international financial institutions. They usually provide loans through local actors. For example, the EBRD supports local commercial banks, which in turn provide loans to SMEs and municipalities.⁸³

To minimise corruption risks while funding support programmes for SMEs (be it micro-grants, institutional or organisational support), we suggest the following measures:

- to open the database of the beneficiaries of public funds;
- to assure that the fund allocation process is not influenced by politicians and public officials (e.g. by creating independent supervisory boards with a high level of integrity and ensuring their rotation mechanisms).

Special programmes of state-owned banks that aim at SME (e.g. KUB by state-owned Privatbank⁸⁴ or “Buduy Svoje” by state-owned Oschadbank⁸⁵) combine money lending with consulting and mentoring programmes in the spheres of marketing, management, communications and human resources management, finance, and law.

Venture capital is another possible source of funding that is not enough developed in Ukraine. However, the demand for it is limited by the absence of corresponding legislation and because it is common to register product start-ups in other jurisdictions due to the weak rule of law in Ukraine.

Innovation support

Some policy measures to promote innovativeness among SMEs are:

- Local innovation support centres that would help innovative solutions to be implemented at enterprises situated far from industrial centres.

⁸³ EBRD. *Loans*. <https://www.ebrd.com/work-with-us/project-finance/loans.html>

⁸⁴ Business Incubator «Cube» <https://inkubator.pb.ua/>

⁸⁵ Portal «Buduy svoe» <https://buduysvoe.com/>



- R&D vouchers or innovation vouchers are non-refundable financial aid provided to companies for the development and implementation of product or process innovations. The model for such a vouchers programme is the climate innovation vouchers programme jointly implemented by EBRD, Ukrainian NGO Greencubator, and EU Neighbourhood Investment Facility.⁸⁶

Existing and new state-supported innovations funds should have regular compulsory supervision by international peers. Thus, all the important documentation has to be published in English.

Policymakers and the civil society should be aware that the measures mentioned above would have a long-term effect, rather than creating short-term successes. Entrepreneurship and innovation policy, as with almost all sustainable economic development policies, is a long-term policy.

The World Intellectual property organisation (WIPO) provides the opportunity to create Technology and innovation support centres (TISCs) in developing countries. It aims to provide access to high-quality information on patents, technology information and industrial property legislation and consulting. TISCs can be established through national focal points jointly with WIPO by a number of local actors (universities, technology parks, local governments, chambers of commerce etc.).⁸⁷ One was established in Kyiv in November 2018 at UNIT.city.⁸⁸

8.3 From a local SME to a national champion

Networking for production output increase and fostering policy dialogue

According to ABCA 2016, lack of demand is the most important obstacle for SME business development.⁸⁹ At the same time, according to the most recent analysis of the National Bank of Ukraine, the most important obstacles for businesses to increase their production output are high energy prices and high prices for raw materials (for more than 40% of respondents).⁹⁰ That is where the strong formalized lobby of small and medium business in a form of associations might be important, as it enables the businesses to effectively advocate their interests in relations with monopolistic suppliers of raw materials and energy as well as lobby for other policy measures. Business associations also create networking opportunities that make it easier to create partnerships and enter new regional markets, thus increasing the demand for SME products and services.

Even though the membership in the German Chamber of Industry and Commerce is compulsory for local businesses, we do not consider replicating this policy for Ukraine's Chamber of Commerce and Industry. In the Ukrainian context, the better option would be to allow the various self-organised business associations to compete fairly to attract members—by offering different services and protections of members' rights. This could enhance their service orientation and orientation towards the needs of members. The latter is deeply ingrained in the German chamber system through a complex system of self-governing bodies, which cannot readily be replicated in another context.

Self-governed business organisations where the quantity of SMEs prevails can represent both individual industries as well as the SME sector in general (at the national or regional level). Some other possible areas for the cooperation of such associations with the government and local authorities that can compensate for small businesses' personnel and organisational shortcomings include:

⁸⁶ Innovation Vouchers <http://innovoucher.com.ua/about-us/?lang=en>

⁸⁷ Technology and Innovation Support Centers <https://www.wipo.int/tisc/en/>

⁸⁸ Technology and innovation support centre http://tisc.org.ua/en/home?language_content_entity=en

⁸⁹ The Institute for Economic Research and Policy Consulting. *Annual Business Climate Assessment (ABCA) 2016/2017* http://www.ier.com.ua/en/sme_development/InfoFigureics_LEV?pid=6086

⁹⁰ National Bank of Ukraine. *Business expectations of Ukrainian enterprises* (1 quarter of 2019) <https://bank.gov.ua/doccatalog/document?id=92021349>



- An improvement of the Ukrainian system of vocational training towards the needs of the labour markets by including business associations in the continuous process of upgrading old and creating new professions.
- Joint apprenticeship schemes for students of technical universities and professional schools with the ministry of education and science
- Joint educational programmes for students willing to master a technical profession (using the German experience of a cooperative university (Duale Hochschule).
- Peer-to-peer lending. Around 37.6% of Ukrainian enterprises plan to receive loans.⁹¹ In the interviews with the business owners, they emphasized the lack of working capital during the period of transition from establishing their company to consolidating their market position and signing first long-term large-scale agreements. Considering the German experience of enterprises issuing small bonds⁹², the associations can consider applying the same model for their new members.

To accelerate participation and networking culture among Ukrainian businesses, bottom-up initiatives should be supported. Changing the perception of business by citizens and of state agencies by the business can help emerging small and medium enterprises to overcome financial scarcity. This can be done by developing the tools to connect small businesses with small-scale investors to ensure the former have enough working capital to cover the costs. Moreover, this approach might also lead to common investment into shared facilities such as research facilities or common marketing in the process of internationalising.

Box 7. Regional bottom-up network initiatives (NGO “Teple Misto” case study)

Yurii Fyliuk is a social entrepreneur (NGO “Teple Misto” (Ukr. for *warm city*), Ivano-Frankivsk) and the co-founder of several social projects. The most famous ones are the social restaurants called Urban Space 100 and Urban Space 500 (in Yuri’s hometown Ivano-Frankivsk and in Kyiv respectively). The concept was to promote cooperation by co-investing (500 people invested 1,000\$ each to create a restaurant in Kyiv) and by creating a space where active citizens can meet to discuss ideas and organise events supported organisationally and financially (according to principles of social entrepreneurship, a share of income is spent on social initiatives).

Promprylad.Renovation is a well-known example of organisational integration at a local level. It is a former factory in the city centre of Ivano-Frankivsk (37,000 square meters), which is now being revitalised and rented to businesses and social initiatives in four different sectors - education, art, new economy, and urbanism. The project has just started and, in the process of a full rollout, it will multiply its space and lead to deep integration of the cluster.

Such bottom-up initiatives with the energy of well-connected leaders, which already gathered significant resources seems to be worth supporting.

Source: <http://warm.if.ua>⁹³

⁹¹ National Bank of Ukraine. *Business expectations of Ukrainian enterprises IV quarter of 2018*. <https://bank.gov.ua/doccatalog/document?id=85931490>

⁹² The Economist, 2014. *Home Is Where the Capital Is*. <https://www.economist.com/news/finance-and-economics/21621907-germans-have-such-faith-their-industrialists-they-are-bankrolling-them-home>

⁹³ Platform «Teple Misto» <http://warm.if.ua>



In the process of financial decentralisation (launched in 2014), more instruments to support business creation and development (both financial and organisational) became available to the local authorities, rather than the central government. Creating a framework or platform for the local authorities to compete can contribute to business climate improvement. Although some rankings and KPIs already exist (for example, the *Regional Doing Business* by BRDO⁹⁴ and *Transparent Cities*⁹⁵), they have to be further developed.

8.4 From a successful SME to an international champion

The 20 largest exporters account for one-third of Ukrainian exports. All of them are major players in their markets. Most of them are in the financial-industrial groups (FIGs), such as Istvan, Glenkor, ISD, MHP, SCM, Privat, Nibulon, etc.⁹⁶

Most of the twenty exporters belong to the traditional industrial and agricultural east and south of Ukraine, as well as to the capital city of Kyiv. The main export products are carbon steel rolled products and agricultural products including oil and grain. However, some major exporters sell processed products, e.g. pneumatic rubber tires. Motor Sich has exported turbojets, turbo-propellers and other gas turbines, as well as control or measuring apparatuses.

Building a strong company brand

Ukrainian companies have two options: to develop innovative solutions (products or services) and monetise them by attracting foreign large-scale investors, or to build their own brand. We distinguished two major concepts of export-oriented small and medium-sized businesses in Ukraine:

1. Outsourcing. The model means integration with the business process of a major foreign company (or companies). It is well developed in the IT-sector. However, outsourcing can be more complicated for traditional industries, i.e. enterprises working with raw materials supplied by their customers. Such a business model is highly dependent on the demand of their customers (which are suppliers at the same time), although it can be profitable due to the low cost of resource and ease of scaling up. The core value is a cheap workforce that can perform simple orders.
2. Building a brand. Another way is developing a company's own brand. In this case, the unique brand is created and seeks its value added. In comparison to the previous concept, brand building allows more independence, but also more resource scarcity. The core advantage of this strategy is a high added value created by the business and the possibility to grow from a local to a global champion.

Foreign currency regulations

Ukrainian currency legislation is being transformed after the new law on currency was adopted in order to implement the Association Agreement with the EU. It lifted a number of currency restrictions for individuals and companies, especially exporting ones.⁹⁷

- Currency supervision of the residents' compliance with the settlement deadlines was revoked (unless the amount exceeds 150,000 UAH; with minor exceptions).

⁹⁴ Regional Doing Business in Ukraine <http://rdb.brdo.com.ua/>

⁹⁵ Transparency ranking of 100 largest cities in Ukraine <https://transparentcities.in.ua/en/>

⁹⁶ YouControl. *Metal or corn, Switzerland or Russia: trade of TOP 20 Ukrainian exporters* <https://youcontrol.com.ua/news/metal-chy-kukurudza-shveytsariia-chy-rf-torhivlia-top-20-ukrayinskykh-eksporteriv/?fbclid=IwAR31hiFPVa-Hq7Ug1HgQuXjHyQPAo87sBtAhZMtB3IX0xdG18XJSVCG-GcA>

⁹⁷ The process is monitored actively by Centre for Economic Strategy.

Centre for Economic Strategy. *Foreign exchange liberalisation and introduction of a common EU financial market: performance monitoring.* <https://ces.org.ua/fx-and-eu/>



- The settlement period for foreign economic contracts was extended from 180 to 365 days.
- The limit on the mandatory sale of foreign exchange earnings was reduced from 50% to 30%.
- Individuals and companies are now permitted to accumulate foreign currency on the residents' accounts for the purpose of the future debt repayment to a foreign creditor.
- Opening bank accounts abroad and foreign currency transfers to such accounts is now permitted within the limit of 2 mn EUR annually. The reporting on such accounts was minimized.

According to the last point, Ukrainian exporters are now allowed to receive payments in hard currency for the goods and services sold abroad, to accumulate them at a foreign account, and to spend this foreign currency during the 365 days of allowed term.

The freely convertible hryvnia will facilitate the simplification of foreign trade and Ukrainian companies' access to trade finance instruments.

The positive impact of access to services of European banks can be one of the drivers of the revival of exports and trade and economic growth in general.

Export support

Ukraine's start-ups and exporters can specialise on some new niches, e.g. food processing, food technologies, and unmanned aerial vehicles for the military use and purposes of agriculture. However, the most promising sector for Ukrainian start-ups might be new services and products in the field of information technology and the internet of things. Even though the interviewed representatives of small and medium businesses do not consider it crucial to have financial export support, central, regional and local governments can and should think about promoting favourable conditions for this promising sector. This can be done by further improving education in this field, both quantitatively and qualitatively, and thereby securing the constant supply of a well-educated labour force for the sector. Furthermore, since many potential customers of the sector are international companies, the English abilities especially (but not only) of IT graduates should be further improved, e.g. by teaching more subjects in English in universities.

Current policy measures include the development of export strategies and a web site of the Export promotion office⁹⁸ dedicated to Ukrainian export support. The Ministry of Foreign Affairs has its Council of Ukrainian exporters and investors, consisting of 28 business associations and 55 enterprises⁹⁹.

The Export Promotion Office started in 2015 as a voluntary initiative. Afterwards, it was supported by donors (WNISEF, EDGE (Canada), EBRD inter alia). Starting from December 2018, it became a state institution and owns a network of 72 consultants providing their service in 42 countries. However, the scale of operation remains small as only 244 companies received their service in 2018¹⁰⁰.

Export insurance coverage can be provided by the state-owned export-credit agency, private entities (as Euler Hermes in Germany) or combined. However, such policy measures should consider a possibly high burden on public funds and corruption risks.

9 Main conclusions and recommendations

The German Mittelstand model is popular among developing countries seeking to develop a strong and competitive SME sector. So-called hidden champions, widely known in German-speaking countries, constitute a major share at their markets due to their in-depth expertise, constant stream of innovation, and long-term policy and business planning.

⁹⁸ State Export Support <http://www.ukrexporth.gov.ua/eng/>

⁹⁹ *Exporters and investors council under the MFA of Ukraine* <https://rei.mfa.gov.ua/en/about-council/council-members>

¹⁰⁰ Export Promotion Office. *Report August - December 2018*. https://epo.org.ua/wp-content/plugins/pdfjs-viewer-shortcode/pdfjs/web/viewer.php?file=https%3A%2F%2Fepo.org.ua%2Fwp-content%2Fuploads%2FPDF%2FEPO_Report_UA_w.pdf



SMEs also play a substantial role in the Ukrainian economy. Although the proportions of small and medium enterprises in total (including self-employed) are comparable in both countries analysed, the Ukrainian SME sector is skewed towards microbusinesses, with fewer mid-size enterprises and fewer SME exporters.

In Germany, the Mittelstand sector has the following peculiarities:

- The majority of the Mittelstand operates in B2B markets; more than half of the firms are based in rural areas; and their turnover is largest in the construction and accommodation sectors.
- Organisational integration of various actors involved at all the stages of SME policy planning and implementation leads to a synergetic effect of clusters creation, management systems, public support schemes, etc.
- A unique system of dual vocational training involving public assistance for in-house vocational training organically combined with theoretical education.
- Long-standing relations between stakeholders, resulting in a strong position of bottom-up initiatives and horizontal networks (Chambers of Commerce and Trade, Confederation of Skilled Crafts, etc.), which are mostly supported legislatively but have their roots in self-organisation through German history.
- Long-lasting mentorship traditions that include senior experts supporting businesses, managers consulting vocational students, businesses intervening in the educational process, etc.
- Several sources of innovativeness, including in-house R&D, technology transfer schemes based on cluster policy, and a high level of property rights protection.
- Characteristics that promote internationalisation, such as short-term labour forces and educational mobility and the migration background of owners and management.

By analysing statistics and open source information and interviewing small and middle business owners in Ukraine and Germany, we identified the following problems in the Ukrainian SME sector:

- The majority of SME sector turnover consists of trade, and the SMEs tend to locate in big cities.
- There is a low share of small and medium companies (excluding microenterprises).
- There is a lack of demand – often indicated as an obstacle in surveys and interviews – and the SMEs tend to limit their geographical presence to local markets.
- Currency regulation is a barrier to foreign trade, as indicated in interviews and surveys.
- Academic entrepreneurship and technology transfer are not used to their full potential in traditional forms of university technology or science parks.
- Intellectual property rights protection has yet to improve, especially in the fields of copyright policy and registering property.

The ultimate goal of Ukrainian SME policy should be to develop national and international champions through competition and innovation. As the German experience shows, such champions may arise organically if the state addresses the wide range of barriers hindering the growth of domestic businesses from micro to small and medium enterprises at each stage of business development.

Creating an ecosystem for business development should be considered an integrated and comprehensive policy. In the long term, those businesses may become national and international champions in their respective niches, contributing to a more sustainable and knowledge-based economy-

At the same time, Ukraine should use soft incentives to achieve the same effect as initiatives that are grounded in German legislation, for example, on the compulsory membership in the Chambers of Industry and Commerce or obligatory establishment of works councils at enterprises. For if state officials would better coordinate their policies with the representatives of business associations, more SMEs would be eager to join such associations.

Below we summarize our recommendations for policy interventions at each stage of business development.

For prospective and new entrepreneurs:



- Development of a sustainable policy framework by the Ministry of Education and Science and the Ministry of Economic Development and Trade to revitalize the existing innovation and science parks at universities and create new ones.
- Giving reformed university clusters the necessary level of autonomy and freedom to engage with possible stakeholders.
- Funding the introduction of dedicated cluster management and part-time involvement of academics.
- Funding advisory support for clusters.
- Support for clusters based on the principles of co-funding, sustainability, objective-based performance, and realistic goals.
- Boosting the ideas of innovative and competitive start-ups among students by encouraging businesses to intervene into the study process, especially in technical fields.
- Implementing programs encouraging Ukrainian labour migrants and other vulnerable population groups to launch their own businesses.

For business entity creation:

- Unification of the taxation system framework, simplifying the transition from being a micro- to a small enterprise, including the change of legal form.
- Microgrants and microloans should be distributed by local authorities and Ukrainian banks in cooperation with international financial institutions in order to minimize the risk of inappropriate funding allocation.
- Combining lending with consulting or mentoring programmes to mitigate the risks of not returning loans.
- Innovation support centres for SMEs could be established in Ukrainian regions by the ministerial SME development office, in cooperation with the World Intellectual Property Organisation and local stakeholders and using the best practices of the German Mittelstand Agency 4.0. The focus should be on less economically developed regions or settlement types.

For growing to the national level and expanding the market:

- Enhancing cooperation and networking possibilities for SMEs (business associations, work councils, technology parks, etc.) for exploring new business opportunities, giving them not only consultancy but also a co-determination power in the policymaking process.
- Boosting digital infrastructure usage and providing better digital infrastructure outside of big cities.
- Compensating for personnel scarcity and skills mismatches, e.g. introducing joint vocational training schemes with technical universities with the support of business associations.
- Sharing information on best practices of business support mechanisms at local and regional levels in order to make better use of the powers and financial resources granted to local authorities as part of decentralisation.

For foreign market entry:

- Encouraging a company to develop its own brand rather than become an outsourcing unit when entering external markets.
- Encouraging expansion abroad via establishing subsidiaries while retaining headquarters, R&D, and production in Ukraine.
- Further foreign currency liberalisation measures to ease export operations.
- Securing the constant supply of labour force and managers with a migration background and foreign language skills by encouraging short-term educational and labour mobility.

Developing a competitive SME sector based on the Mittelstand role model could help Ukraine solve economic and social problems, such as monopolisation, unemployment, and the underdevelopment of certain regions. This would pave the way for more inclusive and sustainable economic growth in the country.

