

Business opportunities lost . . . and found

November 2016

*Small and medium
sized enterprises from
Donbass responding
to the conflict*

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Credits

HD expresses its appreciation to the governments of Canada, Switzerland and the United Kingdom for their generous support for the conduct of this study.

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Executive summary

This study outlines how the armed conflict in the east of Ukraine has affected small and medium sized enterprises (SMEs) from Donbass. It covers those SMEs which remain in areas which aren't controlled by the Ukrainian Government and SMEs which left those areas because of the conflict. The conflict in the east has severed many economic ties, to the detriment of populations and livelihoods on both sides. However, the specific ways in which businesses have been affected and the coping strategies employed by business owners need to be understood in order to broaden the scope of conflict transformation approaches, including the use of economic measures. The study explores the reasons why SMEs chose to either remain in their areas or to leave, the status of their business and supply chains, as well as the state of the markets in which they operate. The research assessed the resilience, business optimism and political agency of the enterprises, particularly as SMEs are often considered an important constituency that naturally favours peace over conflict. However, this study revealed that this is not the case in the east of Ukraine because SMEs have not formed an organised pro-peace actor by themselves, nor have the political leaders in Ukraine or external third parties provided them with an enabling framework for engaging in conflict transformation. Nonetheless, SMEs are a critical constituency in eastern Ukraine as they are non-oligarchic, independent, entrepreneurial and a key social community which can potentially affect change in society.

Politics appear not to have played a major role in the behaviour of this business community.

The study found that SMEs from the Non-Government Controlled Areas (NGCAs) have suffered a severe reduction in their business activities as a result of military hostilities, lawlessness and 'the rule of the gun' in the rebel-held territories. Their connections with the rest of Ukraine have also been considerably disrupted.

The evidence suggests that physical insecurity, the interruption of critical supply chains, and the depletion of local markets as well as the prospects for restarting businesses elsewhere primarily influenced the decision-making of locally-founded SMEs in Donetsk and Luhansk. Neither political preferences nor prior business ties with Russia adequately

explain decisions regarding the relocation and continuity of each business. Politics appear not to have played a major role in the behaviour of this business community. The apolitical nature of these entrepreneurs is an asset in the highly polarized conflict environment as it fosters pragmatic decisions and favours middle ground solutions.

SMEs from the NGCAs – both those that stayed and those that left – demonstrate a high degree of resilience and a low degree of optimism. A sustainable ceasefire and the lifting of some elements of the economic blockade are perceived to be by far the most important conditions for the further development of SME enterprises, compared to economic incentives. This points to the habit of survival in a situation where there is little or no affirmative action or empowerment of entrepreneurs outside the big industries. Those in Luhansk which have re-orientated themselves towards Russian supply chains feel most hopeful with regard to their business development, while in Donetsk, receiving supplies from Russia is not a strong predictor for optimism about business prospects.

The distance of a business' current location from the line of contact is a good predictor for the prospects of returning to and re-starting that business in its place of origin: entrepreneurs currently residing in Mariupol and Donetsk demonstrate greater willingness to re-engage with their clients, partners and suppliers across the current line of contact, as soon as the conditions permit. They are also more interested in retaining economic connections across the line of contact than their counterparts residing in Kharkiv and Luhansk.

The temporary rules for the movement of goods, people and vehicles across the line of contact, issued by the headquarters of the Ukrainian Government's Anti-Terrorist Operation (ATO), favours big enterprises and the supplies necessary for their operation. In contrast, the formal and informal obstacles erected initially by the Ukrainian side and later by the rebel authorities makes it extremely difficult for SMEs to move small commercial cargo and this puts them in a precarious position. As a result, small businesses that were otherwise keen to retain supply chains and business ties with Ukrainian enterprises have ended up in a disadvantaged position.

In order to craft creative policies and mechanisms which strike a sensible balance between security needs and economic benefits (for both sides), decision-makers should consider regular revisions of the restrictive rules for crossing the line of contact, and other ways to maintain business connections between the two sides – including the banking system, logistics and taxation.

Introduction

This study outlines how the armed conflict in the east of Ukraine has affected small and medium sized enterprises (SMEs) from Donbass. It covers those SMEs which have remained in areas not controlled by the Ukrainian Government and SMEs which have left those areas because of the conflict. The conflict in its east has severed many economic ties, to the detriment of populations and livelihoods on both sides. However, the specific ways in which businesses have been affected and the coping strategies business owners have employed need to be understood in order to broaden the scope of conflict transformation approaches, including the use of economic measures. This study assessed the impact of the conflict (as well as the impact of policies adopted by the conflict parties) on the resilience, business optimism and political agency of the SMEs. Two categories of businesses were surveyed: those that stayed in Donetsk and Luhansk, and those that left for Kharkiv and Mariupol. This analysis contributes to the search for peace constituencies across the line of conflict and explores the niche that SMEs could occupy in conflict termination, peacebuilding and post-conflict recovery efforts.

The study focuses on the economic, social and political profile of SMEs originating from the current Non-Government Controlled Areas (NGCAs) of Donbass. Cities were selected as the basis of the analysis since SMEs tend to be predominantly concentrated in big cities.

The SME segment was selected as the focal point of the study for the following reasons:

- The SME segment is comprised of economically independent agents that are self-employed and provide employment to others. They are outside the oligarchic big businesses and public service, are not employees, and, thus, constitute a distinct social cluster of the population.
- SMEs are natural allies in reforms that introduce fair play rules, curb corruption and safeguard freedom as the necessary condition for fair competition¹.
- SMEs are usually immediately affected by the war as they are vulnerable to the external security situation and economic circumstances, and lack significant back-up resources. At the same time, SMEs are flexible and can adapt relatively easily to the changing context. Their coping strategies, aspirations and concerns are rarely the centre of attention for the designers of peace processes, yet SMEs' mode of operation – especially across conflict divides – as well as their role in the rebuilding of conflict-affected communities, offers a positive model amidst conflict.
- The Donetsk region has the highest percentage of big enterprises in Ukraine (0.4%), while the Luhansk region

shares second place with the Kiev and Dnipro regions (0.3%)². The Donetsk and Luhansk regions have an above average percentage of medium-sized businesses (6% and 6.5%, respectively), while they have a smaller than average percentage of small businesses: 93.5% and 93%³. The Donetsk and Luhansk regions are in the middle of the scale of the number of small businesses per 10,000 people in Ukraine⁴. The Donetsk region is among the leading regions in relation to the number of medium-sized businesses per 10,000 people. At the same time, the total volume of goods and services traded by the small business segment in the Donetsk region is 58 billion UAH, while in Kharkiv, where the ratio of small businesses per 10,000 people is 86, this figure is 43.8 billion UAH and in Zaporizhzhia, where there are 76 small businesses per 10,000 people, their volume of production is 21.23 billion UAH. Therefore, the numerical data on the percentage of businesses or people running their business needs to be supplemented by their relative weight in terms of regional and sectoral economic turnover, the type of products they sell, the employment options they provide, etc. Consequently, the common view that the Donetsk and Luhansk regions are not entrepreneurial needs correction. Against the background of massive job losses in the big, labour-intensive industries of the Eastern Donbass, the SME sector's prominence as an alternative employer becomes more significant. The operation of SMEs may also be an important component in the (re-)integration of internally displaced people (IDPs).

- These two regions score lowest on the 'soft factors' relating to attracting investment and the negative results of this have become increasingly visible in recent years. Low levels of business optimism and high levels of resilience seem to characterize the paradoxical SME segment in the two regions.
- As in any industrial area, a sizeable proportion of SMEs operate as part of the expanded infrastructure of big industries or are part of their supply chains for goods and services. Therefore, interdependence within the regional economy is likely to be stronger than in the regions where the production and services sectors are relatively autonomous. Analysis of the behaviour of the SME segment vis-à-vis the massive disruption of industrial production and supply chains as a result of the military conflict, tests a common assumption about the low degree of autonomy – economic and political/administrative – of SMEs in the region.

The ways SMEs from the NGCAs were affected by the conflict, the response options which were available to them, and the choices made by SMEs are analysed in this study.

The research process

Taking an analytical, as opposed to a legalistic, approach to business activities, including illicit ones, allowed this study to elicit the economic rationale of business operations in the conflict context and the areas where political obstacles become economic burdens or economic opportunities. In this study, no assumptions were made about the dynamic of the businesses which were studied.

The research process involved several different elements:

- Analysis of the ways in which SMEs from the NGCAs were affected by the conflict during its different phases, including by the policies and behaviour adopted by the conflict parties.
- An assessment of the relative weight of the political, business and personal factors that determined business choices (in relation to the type of activity undertaken, the location of the business, the market, the supply chain, etc.) in response to the conflict during its different phases.
- An assessment of social optimism, resilience and the agency of SMEs from the NGCAs vis-à-vis the conflict.

Methodology

Field research was carried out from May to September 2015 in Donetsk, Luhansk, Kharkiv and Mariupol. A triangulation strategy (measuring parameters of the phenomenon under study by several methodologies) enabled the study to increase the rigour of the process and the data was collected by face-to-face and telephone surveys (that were agreed upon in advance with the interlocutors), focus group discussions, and in-depth interviews.

The choices made with regard to the methodology used were defined by the specific demands of data collection in difficult contexts:

- In an environment of military hostilities, intimidation, surveillance and high emotions, data collection methods have to minimize risks for researchers and respondents. Therefore, presence in the field is discreet, low key, and human sources of data are kept confidential.
- Surveys that require probability samples of over 1000 respondents in order to meet the standard of the commonly accepted 5% margin of error are not useful in such contexts. This is because they unjustifiably increase risks and costs since many interviewers need to be involved, which makes the process of data collection visible, hence,

vulnerable. With a large number of field researchers, verifying the accuracy of their performance becomes difficult. It is next-to-impossible to create a random sample using lists of telephone numbers or addresses because people change their place of residence, do not pick up their telephone when receiving a call from an unknown number, or the lists are not accessible at all. Surveying people by telephone or on the street is also risky.

- Qualitative data, and qualitative methods of analysis, are preferred in this study because of the greater reliability and validity of the data. The downside of qualitative methods is low levels of representativeness. However, if the purpose of the study is to infer tendencies in relation to ‘why people think/act this way’ rather than figures such as ‘what is the percentage of the people that think/act this way in the population’, qualitative methods are an optimal choice⁵.

The sample of respondents consisted of entrepreneurs from the NGCAs who had either left for Kharkiv and Mariupol or stayed in Donetsk and Luhansk. A ‘Snowball’ technique was used to construct the sample (this is a non-probability sampling technique when a subject in the study is asked to help identify other subjects of the same type – businesspeople in this case). This technique is particularly useful where it is difficult to locate people to form a sample. Using this technique, the sample was composed as follows:

- 76 entrepreneurs were surveyed in Kharkiv, 68 in Mariupol, 57 in Donetsk and 50 in Luhansk.
- 2 focus groups were run in Kharkiv (with 7 and 6 people, respectively) and 1 focus group was run in Mariupol (with 8 people).
- In-depth interviews were carried out in Donetsk (8) and Luhansk (6).

Results and analysis

1. Business size and sector – and the decision to leave or stay

A majority of the SMEs which moved from the current NGCAs to Kharkiv and Mariupol were involved in the production and industry sector in comparison with the businesses which stayed in Donetsk and Luhansk (Fig. 1, 2, 3, 4). These businesses are likely to have been most affected by war and interrupted supply because:

Production and industrial cycles are sensitive to the availability of raw materials, spare parts and other components which are more difficult to replace compared to goods for retail trade or services.

Equipment is vital for the production and industry sector. Businesses have lost workshop space and lost, or suffered damage to, equipment in some areas due to shelling and interruptions in the power supply in the areas of the anti-terrorist operation (ATO).

As a rule, production and industrial businesses have more significant cash flow, upscale office space, equipment and vehicles in comparison with small retailers and service providers. Hence, they were likely to be primary targets for looting (including of expensive equipment) and production space takeover by rebels and Russian military. This may have led to the termination of business activities.

2. Markets – and the decision to leave or stay

As part of the study, businesses were asked to indicate which markets they operated in from a choice of several different categories: local (current NGCAs); current NGCAs and other regions of Ukraine; current NGCAs, Russia and the Commonwealth of Independent States (CIS); and Russia and the CIS. The “Other” category was used for businesses which had markets that did not fit into any of these categories.

- SMEs from the current NGCAs tended to cater predominantly for the local market (Fig. 5, 6). The percentages of businesses who have moved from the NGCAs to Kharkiv and Mariupol that used to orientate themselves exclusively toward markets elsewhere in Ukraine has not exceeded 10% in either case (Fig. 7, 8). This is a tendency in Ukraine, in general⁶.

Figure 1. Business profile: Donetsk sample

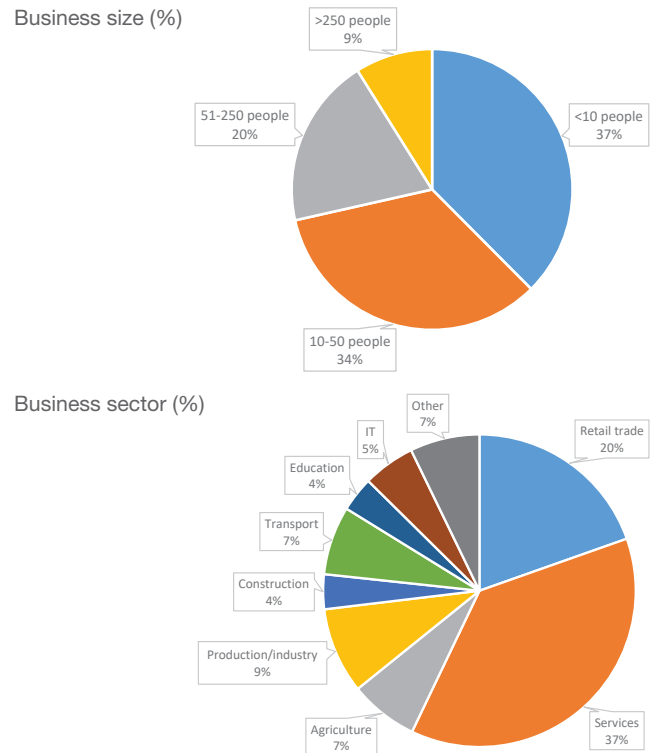


Figure 2. Business profile: Luhansk sample

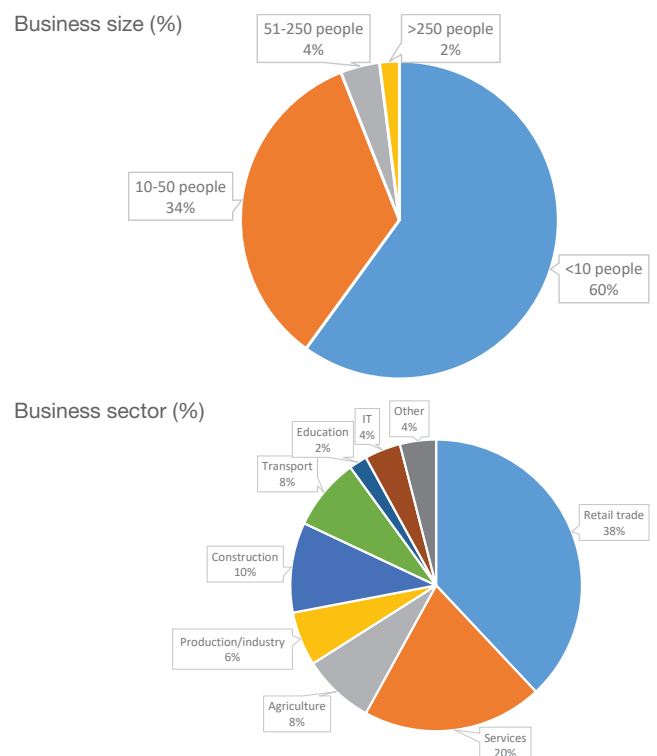


Figure 3. Business profile: Kharkiv sample

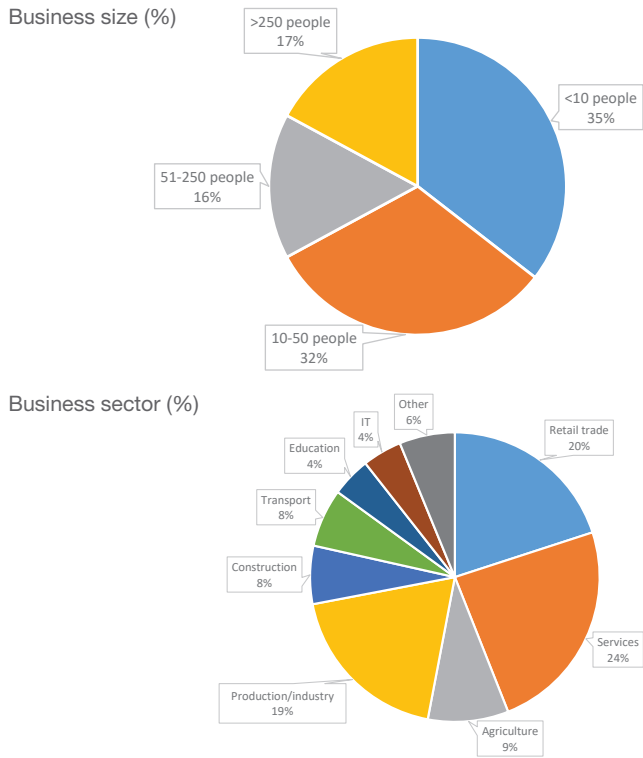


Figure 4. Business profile: Mariupol sample

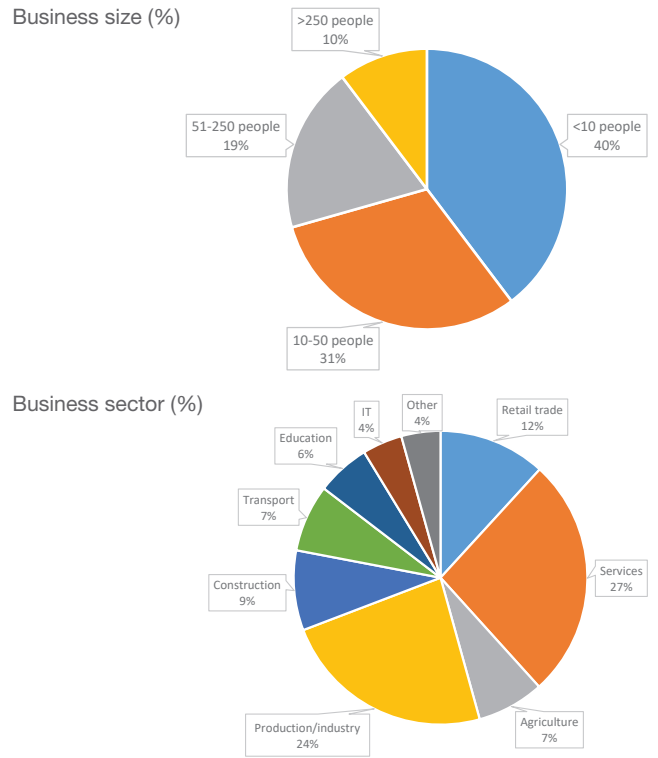


Figure 5. Markets for businesses (%) before the conflict, Donetsk and Luhansk samples

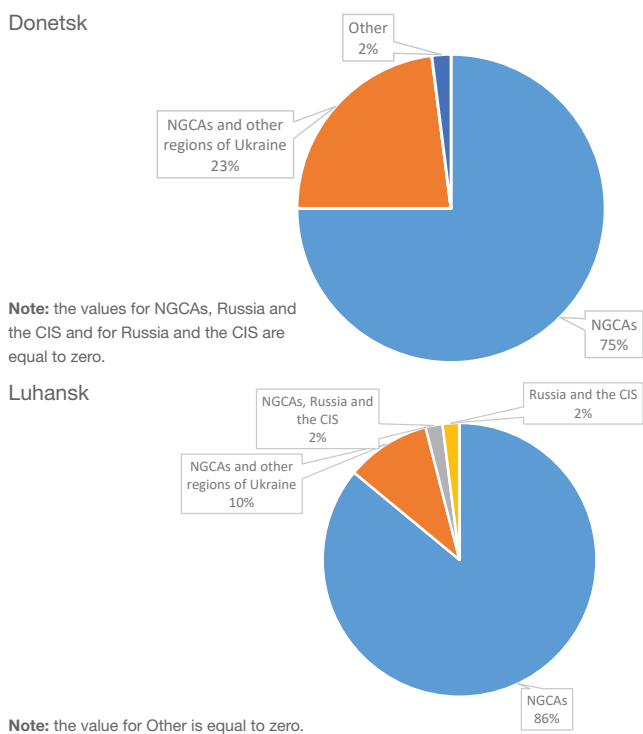


Figure 6. Markets for businesses (%) before the conflict, Kharkiv and Mariupol samples

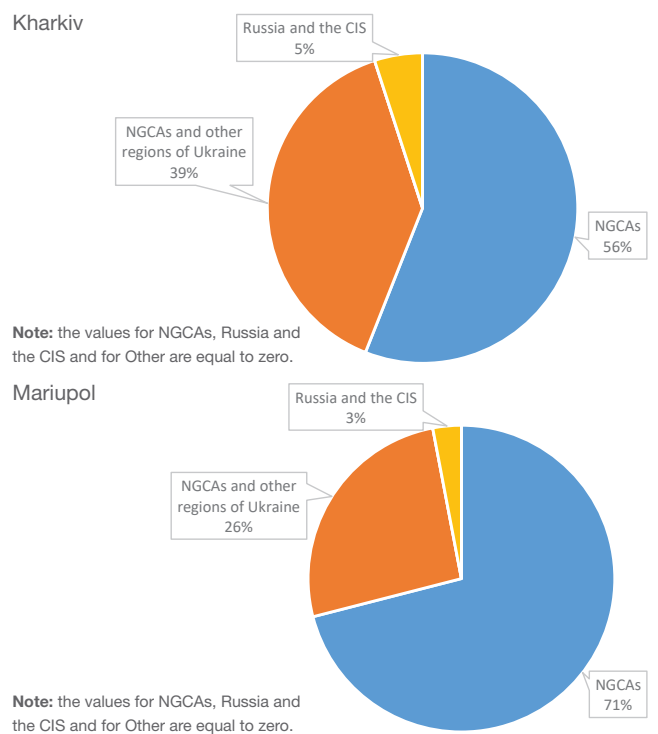
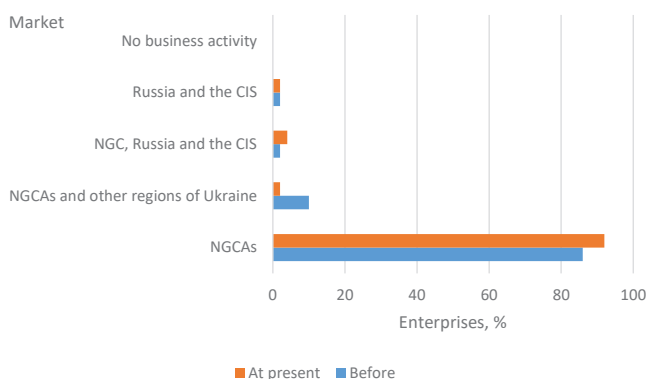


Figure 7. Markets for businesses (%) before the conflict and at present, Donetsk sample



Figure 8. Markets for businesses (%) before the conflict and at present, Luhansk sample



- Trading with both local and national Ukrainian markets is a stronger predictor for the decision to leave the area: 39% of those who left for Kharkiv had previously had their markets within the area of their residence as well as elsewhere in Ukraine, while only 10% of those who stayed in Luhansk had catered for the Ukrainian market. Businesses that used to cater to a diversity of markets are likely to have greater competitive capacity, a broader network of contacts, and be known to clients outside their area of residence – hence having a greater chance of re-establishing their business activities in a new location.
- No businesses among those surveyed in Luhansk and Donetsk used to be orientated toward the Russian market, while those businesses that left for Mariupol and Kharkiv had previously had customers in Russia. Thus, having prior business ties with Russia does not explain the decision to stay or leave. A broader geography of business ties is characteristic of the businesses that decided to leave for Kharkiv and Mariupol

- Those businesses which have stayed in Luhansk are currently orientating themselves exclusively toward the local market, while about 10% of the businesses that stayed in Donetsk and continue to operate are still serving markets in Ukraine which are outside their area of residence, although this figure has halved in comparison with the time before the conflict (Fig. 7, 8).
- The Russian market is still only a small part of the range of markets catered for by the businesses which have stayed in Donetsk and Luhansk.

3. Changes in supply chains

As part of the study, businesses were asked to identify their sources of supplies from a choice of several different categories: from Ukraine directly or via a third party; from Russia directly or via a third party; from other countries directly or via a third party; multiple sources including Ukraine (“Mixed + Ukraine”); and multiple sources not including Ukraine (“Mixed – Ukraine”). For businesses that did not require any supplies, the “No supply” category was used. An “Other” category was used for businesses that had a source of supply that did not fit into any of these categories. A “No business activity” category was used for the businesses that stopped their business operation.

- Before the conflict, supplies from the rest of Ukraine constituted 44% to 60% of direct supplies to SMEs in the current NGCAs, while another 5% to 30% of enterprises were receiving supplies from Ukraine via third parties and as part of mixed supply chains. Thus, Ukraine was the dominant source of supplies to all the SMEs surveyed (Fig. 9, 10, 11, 12).

Figure 9. Supply chains (%) before the conflict and at present, Donetsk sample

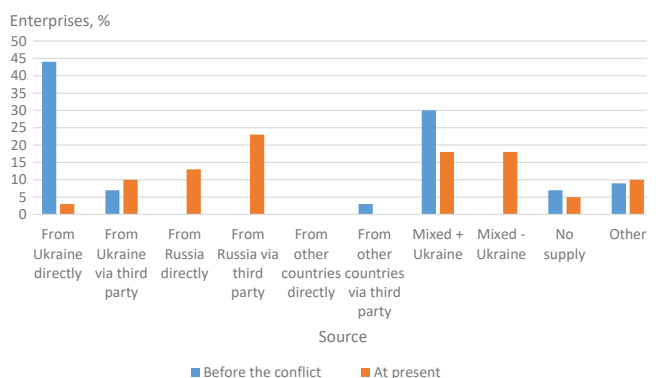


Figure 10. Supply chains (%) before the conflict and at present, Luhansk sample

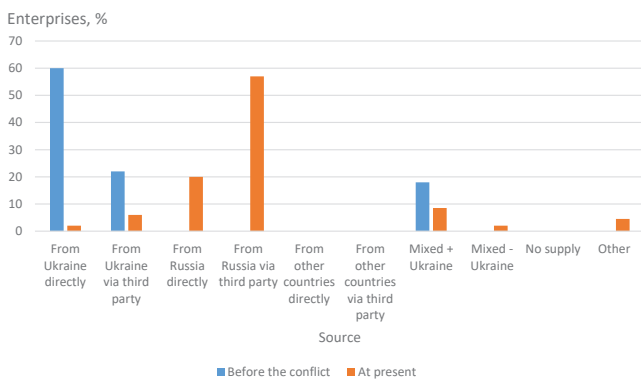


Figure 11. Supply chains (%) before the conflict and at present, Kharkiv sample

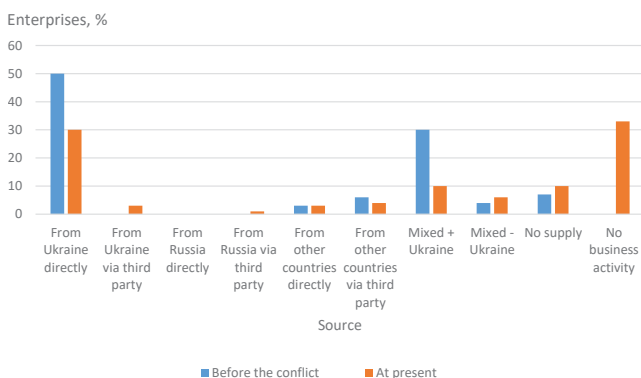
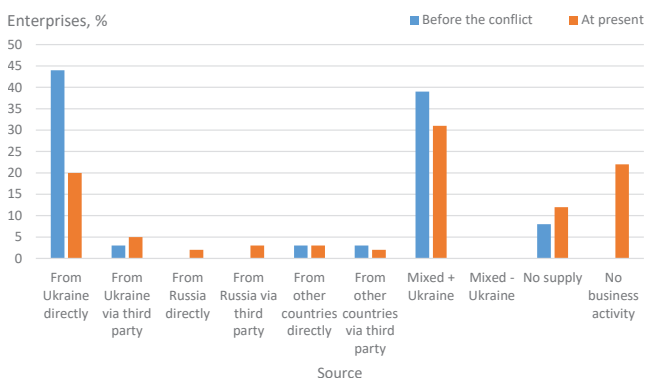


Figure 12. Supply chains (%) before the conflict and at present, Mariupol sample



- At present, less than 2% of supplies reach SMEs in Donetsk and Luhansk directly from Ukraine, while the share of supplies directly and via a third party from Russia has grown from zero to 70% for Luhansk and to 35 % for Donetsk SMEs (Fig. 9, 10). Ukrainian supplies still find

their way to the NGCAs, but via third parties (including via corruption and other intermediary schemes to pass through the Ukrainian checkpoints) and as part of mixed supply sources. At the time of the field research, it was by and large Ukrainian checkpoints that were named by the respondents as posing most difficulties for the passage of goods, most notably by introducing “passing fees”. The checkpoints of the self-styled Donetsk People’s Republic (DPR) and Luhansk People’s Republic (LPR) republics were reported as being relatively unproblematic. The situation changed in December 2015 after the introduction of a ban on Ukrainian goods by the rebel authorities⁷). Nearly complete reorientation of SMEs toward Russian suppliers is most apparent in Luhansk. For SMEs that resettled in Mariupol and Kharkiv, about 50% of supplies for the 70 to 80% of operational businesses come from the rest of Ukraine, both exclusively and in combination with other supply chains. Virtually no supplies come from Russia.

- Entrepreneurs in Luhansk and Donetsk state that Ukrainian suppliers and supplies are still preferred over those from Russia because of a better price-quality combination and the proven reliability of partners. However, economic blockades (most of the respondents imply economic blockades by the Ukrainian side, but some also mentioned the improvised ban on Ukrainian supplies in the self-proclaimed republics and harassment of the entrepreneurs that were found selling Ukrainian brands⁸) increased risks associated with smuggling supplies from Ukraine to such an extent that importing Russian supplies became a better alternative. High checkpoint “passing fees”, intimidation and the unpredictable behaviour of the guards were named among the factors that affected the decision by the businesses in Donetsk and Luhansk to substitute Ukrainian suppliers with Russian ones. For most, this is an unfortunate decision. They look forward to the restoration of normal – “just like before the war” – business relations with Ukrainian partners.
- Another important factor which prohibits sustaining business relations with Ukrainian partners is the lack of legal possibilities for formalizing trade in goods and services between businesses registered in the self-proclaimed republics, where registration is imposed by the authorities and Ukrainian enterprises. Few can afford registration in both places (and, hence, double taxation). Some micro businesses continue to operate outside any legal field, just like in the 1990s, however more visible businesses cannot run the risk of being prosecuted by the

new authorities. Cases of torture, extortion and other types of arm-twisting tactics applied to the reluctant enterprise owners are too well known.

- Financial transactions have also become complicated as businesspeople based in Luhansk and Donetsk can do bank transfers or card payments to their Ukrainian clients or suppliers only in the territories under Ukraine's control. Frequent travel across the line of contact is an increasingly expensive and time-consuming exercise. Some do not feel secure when crossing checkpoints on either side.
- Due to the artificially-inflated exchange rate of the Ukrainian Hryvna in the NGCAs, purchasing Ukrainian supplies has become more expensive for businesses that operate in the Ruble financial space compared to purchasing supplies from Russia.
- Importantly, no cases of Ukrainian business partners having violated contracts (mostly verbal and based on trust exclusively) or having not fulfilled their obligations under the force majeure premise were reported by the respondents.
- Entrepreneurs that have left for Mariupol and Kharkiv retain their Ukrainian suppliers, while they have not acquired any Russian ones. The decline in the direct supplies from other regions of Ukraine is likely to be related to the suspension of business activities by 20% to 30% of the internally displaced entrepreneurs surveyed.

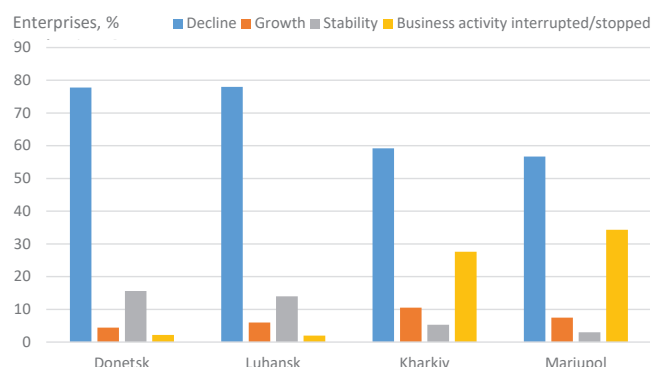
Changes in supply chains: getting across the line of contact

- Some businesses left behind in the NGCAs continue to receive Ukrainian supplies (goods, raw materials) across checkpoints. The smuggling of commercial goods disguised as goods for personal use or as humanitarian aid is a popular tactic that may still require paying bribes at checkpoints.
- Marked goods made in Ukraine are not welcome in the self-proclaimed republics and business people can be prosecuted for spreading Ukrainian "propaganda".
- Heavy or bulky cargo is impossible to get across the line of contact without high bribes as the movement of transport across the line of contact is prohibited. People can cross on foot or in their private cars.
- A new class of 'middlemen' has emerged who help with commercial cargo and cash transfers across the line of contact.

4. The business dynamic since the beginning of the conflict

- Overwhelmingly, SMEs have experienced a decline in their business activities since the beginning of the conflict (Fig. 13).
- Approximately 30% of those who have left for Kharkiv and Mariupol stopped their business activities, while nearly all respondents in Donetsk and Luhansk have retained their business, although 80% of the respondents stated that they had experienced a decline in their business activities. Some of the Donetsk and Luhansk businesses started to gradually regain their pre-conflict positions. In order to remain afloat in the hope that the economic situation would improve, all had to set higher prices (but had to balance that with the sharply reduced purchasing power of the population); go for inexpensive goods, spare parts and raw materials; and opt for zero profit.
- There is a marginally higher percentage of growing businesses among those who relocated to Kharkiv and Mariupol compared to those who had stayed in Luhansk and Donetsk. This may be explained by better conditions for business outside the area of conflict and fighting, as well as the specifics of the businesses that were easy to relocate or which were not heavily dependent on the market and supplies inside the conflict area. Some growth was detected in the NGCAs, mostly due to the exodus of competitors in certain sectors.
- The survey respondent commentaries, focus groups and interviews indicate a timeline of the changing business dynamics in the areas where there has been armed confrontation. Entrepreneurs who had decided to leave mention June and July 2014 as the definitive moment: looting and extortion were at their most intense, and businesses

Figure 13. The business dynamic since the beginning of the conflict



that had competitive office space, competitive locations and car pools as well as businesses run by individuals with clear pro-Ukrainian positions were among the first targets. The events that convinced some to leave and evacuate their businesses included the following:

- When all the delivery and post services had been looted and this virtually stopped their operations.
- When there were no more possibilities for bringing goods and raw materials in from the Ukrainian territory.
- When reserves had been depleted at the end of July 2014 and there was nothing left to be sold.
- When customers could no longer pay for any products beyond bare necessities.
- When shelling began and people around were getting killed.
- When they had personal experience of extortion and physical assault by rebels and Russian military.
- When staff were leaving as well. Some enterprises had to completely re-recruit and train new staff.

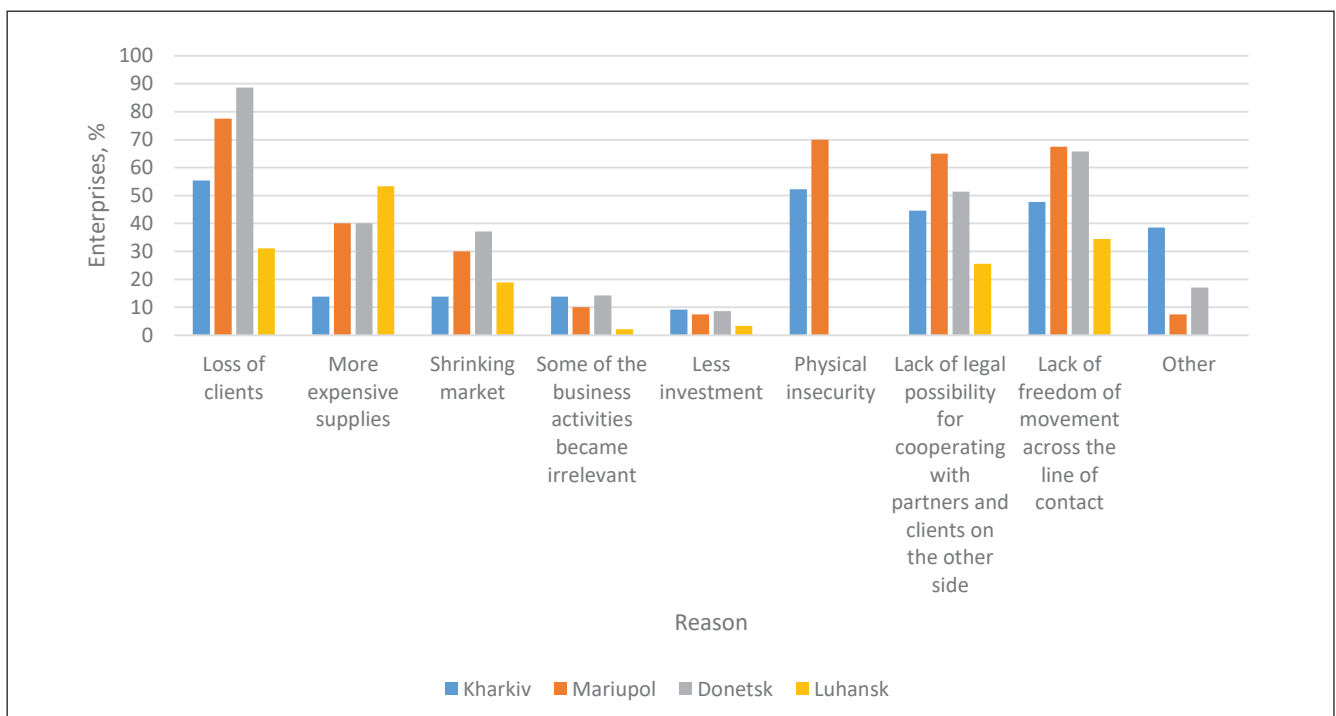
Thus, physical insecurity, the interruption of critical supply chains, and the depletion of local markets as well as the pros-

pects for restarting businesses elsewhere were the defining factors in the decision-making of locally-founded SMEs in Donetsk and Luhansk. It is important to note that branches of Ukrainian business chains, especially of West Ukrainian origin, found themselves in an extremely hostile environment and left because of political and security considerations or were pushed out, while their businesses were expropriated and rebranded by the new local masters⁹. The turning point for the service and retail businesses was when pension and public sector salary payments resumed in the NGCAs around December 2014¹⁰.

Reasons for the decline in business

- Physical insecurity featured prominently as the reason to leave among those entrepreneurs who ended up in Mariupol and Kharkiv. For those who stayed in Donetsk and Luhansk, physical security appeared to be less of a concern (Fig. 14).
- Loss of clients was the major reason for the decline of businesses, particularly for the businesses that stayed in Donetsk, possibly as it had the highest outflow of people who also had the greatest pre-conflict purchasing power.

Figure 14. Reasons for the decline in business



- Entrepreneurs currently residing in Mariupol and in Donetsk appear most inclined to retain economic connections across the dividing line: they see the lack of legal possibilities for continuing business co-operation and restricted freedom of movement as detrimental to their business activities and prospects. Entrepreneurs residing in Kharkiv and Luhansk are less dependent on economic connections with the other side.

Businesspeople from the NGCAs of Donbass in Mariupol and Kharkiv: torn between the two territories

- Businesspeople who moved to Mariupol and Kharkiv partly or fully retain their business means (equipment, storage, office, workshops), business connections, staff and clients in the NGCAs. This trend is more prominent in Mariupol than Kharkiv.
- Some evacuated their equipment, documentation and other necessary means, either fully or partly.
- Many suffered the loss of their entire business, either through extortion or due to destruction during the war. Some were tortured and harassed.

Figure 15. Current location of business (%) of businesspeople who moved to Mariupol and Kharkiv

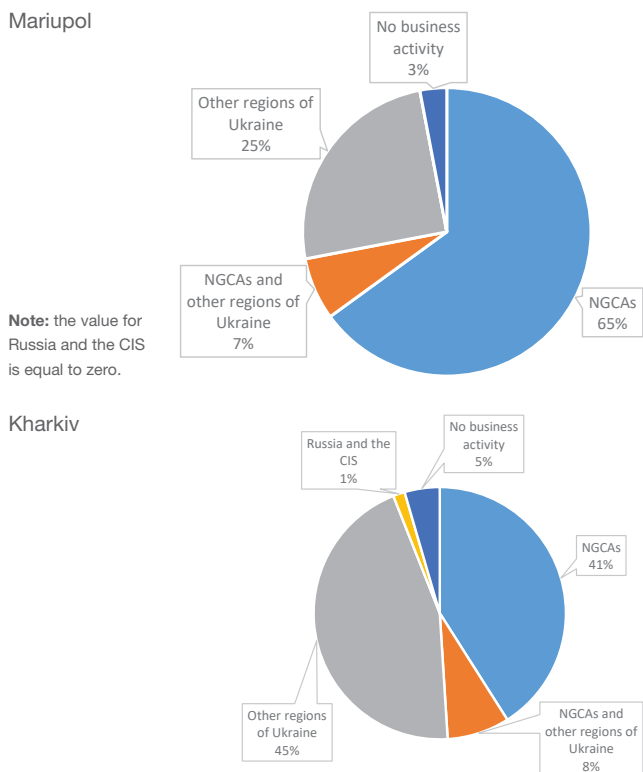


Figure 16. Elements of businesses left behind in the NGCAs (%) of businesspeople who moved to Kharkiv and Mariupol

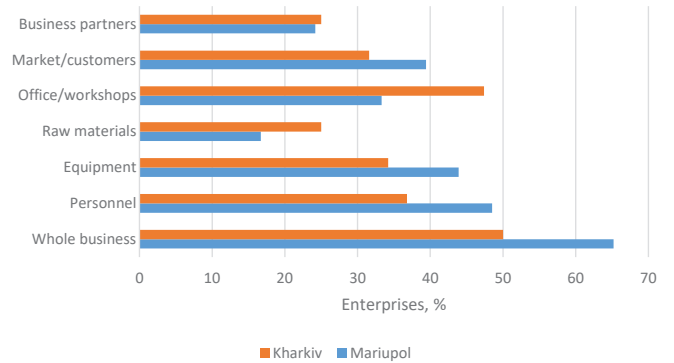


Figure 17. Business prospects in the NGCAs (%) for businesspeople who moved to Kharkiv and Mariupol

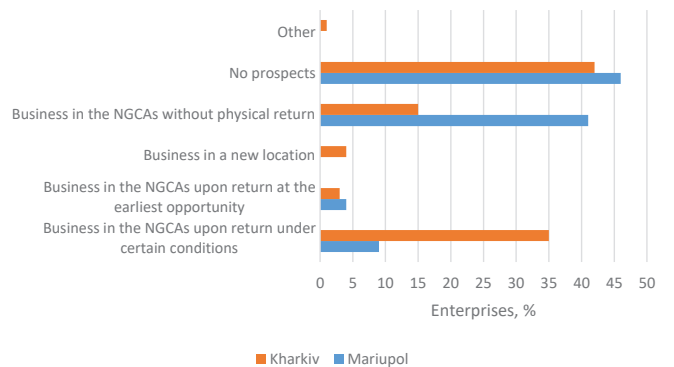
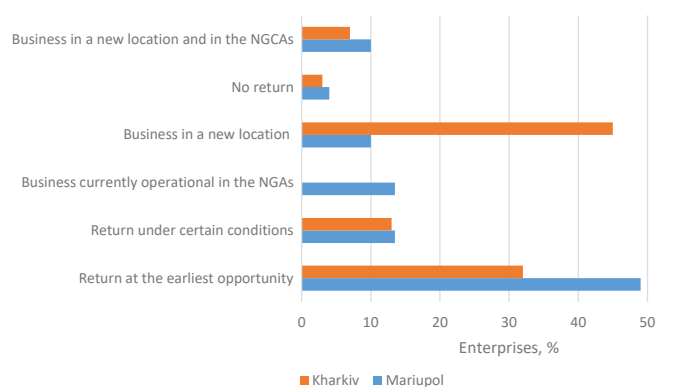


Figure 18. Business prospects in a new location (%) for businesspeople who moved to Kharkiv and Mariupol

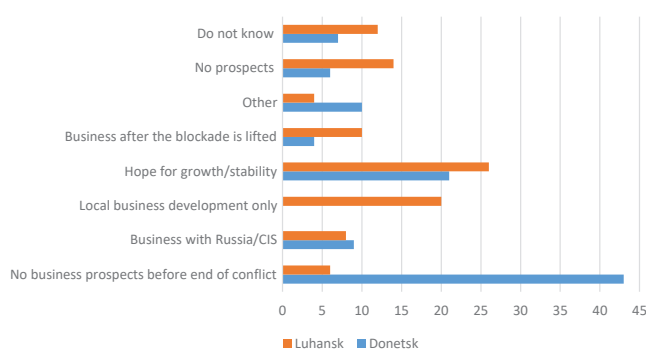


- Nearly half of the businesspeople who relocated to Mariupol and to Kharkiv do not see any prospects for resuming business in the NGCAs (Fig. 17).
- IDP business communities in Mariupol and Kharkiv demonstrate sharp differences with respect to the question of returning home versus starting new businesses and new

lives in a new location (Fig. 17, 18). Those residing in Mariupol are clearly willing to go back or to resume business activities from a distance at the earliest opportunity. Meanwhile a significant number of them are ready to adopt strategies to keep their business in the NGCAs afloat while they are away.

- The option of continuing their business in the NGCAs without physical return – as a temporary solution – is popular among businesspeople residing in Mariupol (Fig. 17). This mode of operation is risky, but the pay-back is much better compared to profits made outside the NGCAs. Due to the difference in the course of the Ukrainian Hryvna in the GCAs and NGCAs, and 2-3 fold increase in prices in the NGCAs, business owners in Mariupol benefit from the status quo. They appear to be more flexible and willing to take risks than their Kharkiv colleagues who would often only consider the resumption of business activities in the NGCAs if the necessary conditions are in place.
- The business climate in their host community is also an important factor which shapes an individual entrepreneur's choice to stay in the new location or to return home. According to the IDP businesspeople in Mariupol, the business community is hostile toward them, the rules for doing business are of the 'survival of the fittest' type, and the law is not respected. On the contrary, IDP entrepreneurs in Kharkiv appreciate the welcoming spirit of their fellow businesspeople, as well as the assistance available to businesses in the form of advice, training or financial help. The Kharkiv business community demonstrated understanding of the hardship faced by the IDP businesses and was supportive (with lowered rents, making concessions on payment delays, etc.)
- IDP businesspeople in Mariupol who have not yet managed to resume their business activities are the most likely of all not to see business prospects in the NGCAs. This result may seem not to be in line with the previous finding that those with no currently operational business are more likely to return home at the earliest opportunity. The discrepancy may be due to differences in the time horizons, with the 'earliest opportunity' being a more distant moment in time than prospects for doing business in the NGCAs at present. This may also be due to the concept of return as a psychological phenomenon, a goal that may be unattainable today, but the teleology is defining the choices made at present. Resumption of

Figure 19. Business prospects in the NGCAs (%), Donetsk and Luhansk samples



business activities is a specific set of acts and conditions that is assessed pragmatically.

- In the case of Kharkiv-based businesspeople, the results of co-variance of the current type of supply chain and the prospects for the resumption of business in the NGCAs are in line with the findings of previous studies: the option of return for those who continue to receive supplies directly from other regions of Ukraine is not excluded, but it is conditional.

Businesspeople from the NGCAs of Donbass in Donetsk and Luhansk: business prospects in the NGCAs

- A sustainable ceasefire is the most important condition for the resumption of business in Donetsk. The lack of a sustainable ceasefire is an overwhelming burden for the Donetsk SME segment.
- The remaining threat of the resumption of armed hostilities does not appear to be a significant impediment for SMEs in Luhansk. The economic blockade is seen as a more detrimental condition.
- Luhansk entrepreneurs are hopeful and concentrate on the development of local business.
- Those in Luhansk who have reorientated themselves towards Russian supply chains feel most hopeful.
- In Donetsk, those who have suspended business activities tend not to see prospects for business development in the absence of the sustainable cessation of armed hostilities.
- In Donetsk, receiving supplies from Russia is not a strong predictor for feeling hopeful.

5. Optimism

- The Donetsk SME community is least optimistic about their current and future business. This may have to do with the fact that the once well-off city has experienced destruction on the greatest scale as well as a more dramatic relative decline in living and business standards (Fig. 20, 21).
- SMEs which left for Mariupol are the most optimistic among the selected sample. This tendency may be explained by the high share of entrepreneurs that manage to benefit from their ‘dual’ status and keep doing business on both sides (Fig. 20, 21).
- Economic incentives – in the form of favourable tax policies, access to bank loans, etc. – do not seem to be considered an important condition for improving the business environment. This may be due to the long disillusionment of the business community and their habit of relying on their own means. In their view, the best the state could do is not to interfere (Fig. 22).

Figure 20. Reasons for staying in business

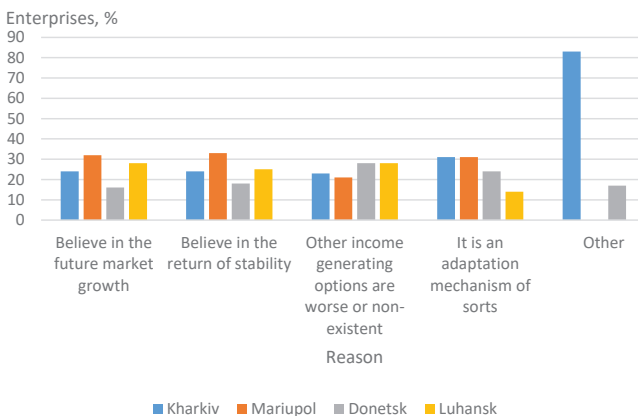


Figure 21. Reasons for staying in business, by location

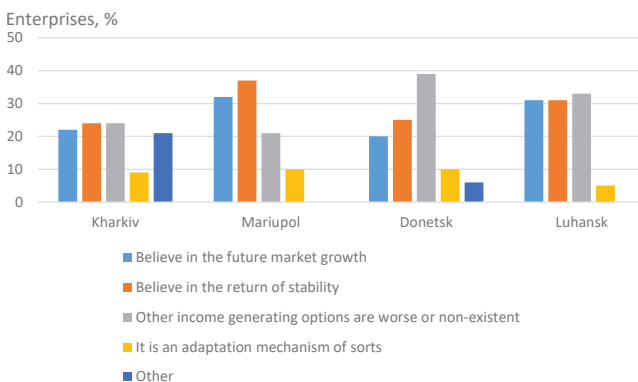
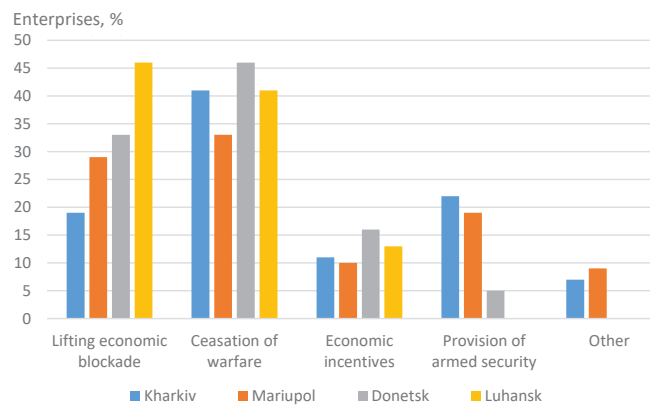


Figure 22. Conditions for the improvement of the business environment



- A ceasefire is the most urgent condition for the Donetsk business community, while reviving the – still preferred – commercial links with Ukraine appears to be an important condition for Luhansk SMEs.
- The Donetsk and Luhansk regions scored lowest on business optimism¹¹ with respect to the business environment in the two regions. However, the tendency to rely exclusively on their own funds for business development is prominent across Ukraine: only 22% were planning to get a bank loan as opposed to the 82.7% of those who had decided to invest their own funds to ensure their business growth in the next 5 years¹².
- IDP businesspeople in Kharkiv are least inclined to see economic blockades as a major obstacle to the improvement of the business environment. This could be explained by the presence among this group of the greatest share of those who have decided to start a new business in a new place, hence they do not associate their business future with the NGCAs (Fig. 18).

6. Political preferences and agency

Eliciting the general political beliefs and preferences of the entrepreneurs from Donbass was not part of this research. However, their deliberations about political power and authorities vis-à-vis the hopes and concerns of the business community were solicited.

Overall, the SME community from the Donbass area is apolitical and does not claim to be a change agent. Throughout the phase of mounting tensions, the strategy of the business community in the areas of conflict was to wait and adjust.

None of the respondents was an active participant in the protests or counter-protests on either side. The President of Ukraine, leaders of the self-proclaimed republics, and occasionally the President of Russia were named as the ones who should make peace, open borders and normalize the situation.

The specifics of the political-territorial arrangements seem to be secondary to the more immediate modus operandi preferred that implies free movement of goods and people, and the cessation of armed hostilities – “back to normal”.

Respondents in Luhansk and Donetsk demonstrate a pallet of ideas on the current and future political course, ranging from reintegration into Ukraine to various degrees of autonomy and independence. However, business relations with Ukrainian partners are unanimously considered to be natural and preferential.

Economic obstacles for SME trade including limited access to banking and restricted movement introduced by the Ukrainian government are unanimously considered to be detrimental to business development within the NGCAs and to economic connectivity across the line of contact

Conclusions

- SMEs from the current NGCAs have suffered a severe reduction in their business activities as a result of military hostilities, lawlessness and ‘the rule of the gun’ in the rebel-held territories, as well as a disruption of connections with the rest of Ukraine.
- The temporary rules for the movement of goods, people and vehicles across the line of contact, issued by the headquarters of the ATO, favours big enterprises and the supplies necessary for their operation in order to keep large numbers of people employed on both sides of the divide¹³. Their cargo is moved across the line of contact by rail. However, insurmountable obstacles erected by the Ukrainian side, both formally and informally, on the movement of small commercial cargo puts SMEs in a precarious position. As a result, small businesses that were voluntarily, and driven by their business interests, keen to retain connections with their fellow Ukrainian suppliers and clients ended up in a disadvantaged position since rail transport was too expensive and slow for their types of cargo compared to big businesses. Dominant military security logic and the influence of proponents of cutting off the rebel-held territories seem to have overridden the political logic of retaining not only humanitarian but also pragmatic business connections with the population on the rebel-held side.
- No references to the humanitarian-logistical centres which had been set up by the Ukrainian side to facilitate the movement of goods were made by any of the respondents. Instead, all complained about the arbitrariness and corruption at checkpoints. Several possible explanations for why the services of the structures established to facilitate the movement of small cargo were not in demand can be offered: information about the centres has not reached entrepreneurs; the centres were not helpful for taking perishable goods across the line of contact as the procedures for doing so may have been lengthy; the centres were set up in locations that were not easy to reach for the majority of the crossers, etc. However additional research is needed to test these hypotheses. These centres need to be reconsidered in order to ensure both security and the flow of trade.
- SMEs from the NGCAs – both those that stayed and those that left – demonstrate a high degree of resilience and a low degree of optimism. This is a paradox among Donbass SMEs. It is likely that it points to the persistent lack of affirmative action and empowerment of entrepreneurs outside the big industries on the one hand, and their great potential to become leaders (particularly in industry-linked businesses including research and innovation as well as other sectors where scientific and technical capital could be acclaimed) on the other.
- SMEs from the NGCAs have been making their decisions regarding the location of their businesses as well as adjustments in their markets and supply chains based predominantly on business calculations apart from the basic physical security considerations. Politics appears to have not played a major role in the behaviour of this business community. The apolitical nature of small and medium sized entrepreneurs is an asset in the highly polarized conflict environment as it fosters pragmatic decisions and favours middle ground solutions.
- SMEs from the NGCAs who left the area of fighting are ready to return and restart their businesses with the condition that the situation is secure and under clear and enabling rules of commerce. Regular revisions of the restrictive rules for crossing the line of contact and other ways to maintain business connections between the two sides – including in the banking system, logistics and taxation – are necessary in order to craft creative policies and mechanisms which foster balance between security and the economic connections between SMEs.

Endnotes

- 1 European Bank for Reconstruction and Development (EBRD), for example, places special emphasis on the importance of support for SMEs as reform agents. See <http://www.ebrd.com/what-we-do/sectors-and-topics/why-small-businesses-matter.htm>
- 2 Enterprise size here is defined according to the following standards: micro = 0–10 employees, small = 10–50, medium = 51–250, big = over 250, see Neighborhood SME Financing: Ukraine, European Investment Bank, February 2016.
- 3 *Рейтинг інвестиційної привабливості регіонів України 2014, Підготовлено Київським міжнародним інститутом соціології у партнерстві з Інститутом економічних досліджень та політичних консультаційна замовлення Державного агентства з інвестицій та управління національними проектами України, Київ 2014* [Kiev International Sociology Institute and Institute for Economic Research and Political Consulting, Investment attractiveness rating of the regions of Ukraine, Kiev, 2014].
- 4 *Рейтинг інвестиційної привабливості регіонів України 2014, Підготовлено Київським міжнародним інститутом соціології у партнерстві з Інститутом економічних досліджень та політичних консультаційна замовлення Державного агентства з інвестицій та управління національними проектами України, Київ 2014* [Kiev International Sociology Institute and Institute for Economic Research and Political Consulting, Investment attractiveness rating of the regions of Ukraine, Kiev, 2014].
- 5 There are statistical methods for small samples as well but for this exploratory study qualitative analysis methods sufficed.
- 6 Activity of Small Business Entities, 2012, Statistical publication, (Kiev: State Statistics Service of Ukraine, Kiev2013) available at www.ukrstat.gov.ua
- 7 <http://sovminlnr.su/akt/06.01.2016/7.pdf>
- 8 The formal ban on Ukrainian food stuffs and excisable goods had not been introduced in the Luhansk People's Republic before December 2015, while there was no official ban in the Donetsk People's Republic.
- 9 For example, the Lviv Chocolate Workshop chain, ATB supermarkets and others.
- 10 Pensioners and employees of big enterprises had to travel to the Government Controlled Areas (GCAs) to get their Ukrainian pensions. Russia transferred finances to the self-proclaimed governments for social payments, however their exact volume and periodicity is hard to verify.
- 11 *Рейтинг інвестиційної привабливості регіонів України 2014, Підготовлено Київським міжнародним інститутом соціології у партнерстві з Інститутом економічних досліджень та політичних консультаційна замовлення Державного агентства з інвестицій та управління національними проектами України, Київ 2014* [Kiev International Sociology Institute and Institute of Economic Research and Political Consulting, Investment attractiveness rating of the regions of Ukraine, (Kiev: 2014)].
- 12 *Рейтинг інвестиційної привабливості регіонів України 2014, Підготовлено Київським міжнародним інститутом соціології у партнерстві з Інститутом економічних досліджень та політичних консультаційна замовлення Державного агентства з інвестицій та управління національними проектами України, Київ 2014* [Kiev International Sociology Institute and Institute of Economic Research and Political Consulting, Investment attractiveness rating of the regions of Ukraine, (Kiev: 2014)].
- 13 *ТИМЧАСОВИЙ ПОРЯДОК контролю за переміщенням осіб, транспортних засобів та вантажів (товарів) через лінію зіткнення у межах Донецької та Луганської областей* [Temporary rules of the control of the crossing of the line of contact within the limits of the Donetsk and Luhansk regions by persons, vehicles and cargo (goods)] and the Annexes 4 and 5, 12.06.2015, 24.06.2016.] available at <http://sfs.gov.ua/diyalnist-/zakonodavstvo-pro-diyalnis/nakazi-pro-diyalnist/63768.html>

