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OECD Investment Policy Reviews

UKRAINE

PROGRESS IN INVESTMENT REFORM 2002

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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The OECD Centre for Co-operation with Non-Members (CCNM) promotes and co-ordinates OECD's policy dialogue and co-operation with economies outside the OECD area. The OECD currently maintains policy co-operation with approximately 70 non-Member economies.

The essence of CCNM co-operative programmes with non-Members is to make the rich and varied assets of the OECD available beyond its current Membership to interested non-Members. For example, the OECD's unique co-operative working methods that have been developed over many years; a stock of best practices across all areas of public policy experiences among Members; on-going policy dialogue among senior representatives from capitals, reinforced by reciprocal peer pressure; and the capacity to address interdisciplinary issues. All of this is supported by a rich historical database and strong analytical capacity within the Secretariat. Likewise, Member countries benefit from the exchange of experience with experts and officials from non-Member economies.

The CCNM's programmes cover the major policy areas of OECD expertise that are of mutual interest to non-Members. These include: economic monitoring, structural adjustment through sectoral policies, trade policy, international investment, financial sector reform, international taxation, environment, agriculture, labour market, education and social policy, as well as innovation and technological policy development.

FOREWORD

Ukraine's recent efforts to strengthen its laws and policies in support of investment have included intensified co-operation with the OECD on investment issues. In response to the Ukrainian Government's request, the OECD developed major policy recommendations contained in its *Investment Policy Review of Ukraine* (published in May 2001). To assist in implementing the recommendations and monitoring progress, the OECD jointly established with the Ukrainian Government the OECD-Ukraine Forum on Investment and Enterprise Development, officially launched in Kiev on 21-22 February 2002.

At the inaugural meeting of the Forum, the Ukrainian Government presented a comprehensive progress report produced by an inter-ministerial team with the assistance of the OECD Secretariat and the United States Agency for International Development (USAID). Participating government bodies included: the Ministry of Economy and European Integration; the State Tax Administration; the State Commission on Securities and Stock Markets; the Ministry of Finances; the Antimonopoly Committee; the State Property Fund; the National Bank of Ukraine; and the State Standardisation Committee.

This publication compiles the Ukrainian Government's report, the OECD assessment, business perspectives and presentations by Ukrainian and international experts. The publication addresses a broad set of issues, ranging from the general economic situation to achievements and difficulties in the fields of taxation, privatisation, finance and banking. It also reflects the Forum's discussions on the next steps for OECD-Ukraine co-operation in this field.

This progress report records the series of reforms under way and suggests measures to advance the reform process in Ukraine – a country with great assets but with considerable work still to be undertaken if it is to fully realise its potential as a destination for foreign direct investment.

The project was designed and directed by Mehmet Ögütçü, with guidance from Eric Burgeat and Rainer Geiger and assistance from Anna Stepanenko-Malan. Professor V.N. Balasubramanyam provided a careful editing of the entire text.

Edward Smiley provided technical support. Significant inputs were received from Yaroslav Kinach, Senior Advisor to the Ukrainian Prime Minister. Valuable contributions and strong support are acknowledged from Vice-Prime Minister Leonid Kozachenko, and from Volodymyr Pershin, State Secretary of the Ministry of Economy and European Integration. Thanks are due to Ihor Umansky, Ihor Kovalenko, and Alexandra Trojan of the Ministry of Economy and European Integration, for their major contributions to the Forum.

The OECD gratefully acknowledges the support provided by the Government of Switzerland for investment work on Ukraine, including from Rudolf Müller of the Federal Economic Secretariat, and by the USAID, in particular David Dod. Special thanks go to Ulrich Ernst, Iryna Krupska and Natalia Tereschenko from the Support for Economic and Fiscal Reform (DAI/USAID), who provided strong intellectual and technical support.

The views expressed in this publication do not necessary reflect those of the OECD and its member countries. It is published on the responsibility of the Secretary-General of the OECD.

Seiichi KONDO
Deputy Secretary-General

MESSAGE FROM THE PRIME MINISTER OF UKRAINE

The OECD-Ukraine Forum on Investment and Enterprise Development took place at a time of positive change in the social life of our country. In 2001 Ukraine achieved high rates of economic growth and secured a real increase in salaries and wages for the first time in ten years.

The Cabinet of Ministers of Ukraine strives to strengthen these trends and use its economic achievements to further increase the wealth of the Ukrainian people. Accomplishments of these tasks require common efforts from all branches of government, the private sector and international organisations.

The OECD Investment Policy Review, prepared at the request of our Government and published in May 2001, represented an important step in this direction. Implementation of the practical recommendations set out in the OECD Review helped improve Ukraine's investment climate and conditions for business activity.

I am confident that the outcome of the Forum, which should have a permanent status, will provide the basis for further in-depth co-operation between the OECD and Ukraine, especially in the areas of stimulating investment activity and improving the investment image of Ukraine. My Government appreciates the OECD work and looks forward to greater co-operation and dialogue.

Anatoly Kinakh
Prime Minister of Ukraine

PREFACE

The Government of Ukraine continues to support the policy of reform aimed at ensuring sustainable development of our country. Our co-operation and constant dialogue with the OECD make a significant contribution to the further development of these reforms and implementation of our joint tasks.

In this context, the presentation in May 2001 of "Ukraine Investment Policy Review" prepared by OECD turned out to be a successful result in the first stage of our co-operation. I would like to stress that Ukraine is committed to effectively implement the policy recommendations contained in this review. Moreover, the President of Ukraine has recently issued the Edict aimed at the improvement of the investment climate in Ukraine. The measures contained in the Presidential Edict are in line with our efforts to implement the OECD recommendations.

This Progress Report provides a basis for further developing and specifying the directions of our co-operation and dialogue with the OECD, including (*i*) the identification and adoption of the best international experience in the area of attracting foreign direct investment, (*ii*) improving the strategy of providing support for investment activities, and (*iii*) ensuring the consistency of our policies with regard to foreign investment with competition, taxation, corporate governance and capital markets policies. We are confident that the inauguration and further work of the OECD-Ukraine Forum on Investment and Enterprise Development will facilitate further development of our country in the future.

On behalf of the Government of Ukraine, I wish to express our gratitude and appreciation to the Organisation of Economic Co-operation and Development for the assistance provided to us in the area of investment policy and economic reform, as well as for making this Forum a success for both sides.

Ihor Umansky
Deputy State Secretary
Ministry of Economy and European Integration of Ukraine

TABLE OF CONTENTS

I. SETTING THE SCENE

OECD-UKRAINE CO-OPERATION IN THE FIELD OF INTERNATIONAL INVESTMENT

Eric Burgeat[*]

The inaugural meeting of the OECD-Ukraine Forum on Investment and Enterprise Development marked the start of the second phase of the OECD-Ukraine co-operation on investment policies. The first phase was completed in May 2001, when the OECD released the Investment Policy Review of Ukraine. In response to the request of the Ukrainian government, this Review was undertaken not as a desktop study, but in a dynamic framework as a joint exercise involving key players, domestic and international alike, on Ukraine's investment scene. It identifies the obstacles to investment and private sector development, and puts forth practical recommendations for an improved business climate.

* Director, Centre for Co-operation with Non-Members, Organisation for Economic Co-operation and Development.

The preliminary findings of the Review were discussed in February 2001 at a Kiev Roundtable. During the Roundtable, we also agreed to establish this OECD-Ukraine Forum with a view to monitoring the implementation by Ukraine of the recommendations contained in the Review and providing further practical advice and support to Ukraine on investment issues.

Increasingly, FDI has been recognised as a powerful engine and a major catalyst for achieving development, poverty-reducing growth and furthering the process of global integration. Competition for FDI is increasing worldwide. Hence, like Ukraine, many countries are intensifying their efforts to attract more FDI flows.

The vast majority of countries have liberalised considerably their rules and regulations. Efforts towards traditional liberal policies (i.e. national treatment, most-favoured-nation, investment protection treaties, and market access) are now almost taken for granted. Since its creation, the OECD has been in the forefront in developing such “rules of the game” amongst its Members and, increasingly, beyond its membership. However, while open FDI policies are necessary to attract and maximise the benefits of FDI, they are no longer a sufficient condition. We need to go beyond them. Indeed, a wide range of other policies can influence the level of foreign – but also domestic – investments, as well as the positive returns they bring to the economy. I would distinguish three types.

A first set of policies includes measures that influence the broad economic environment in which investors operate: policies that promote infrastructural and skill endowments, policies that ensure macroeconomic and political stability.

A second set of policies determine the rules of the game for businesses: strong competition policy, good corporate governance rules, a non-distortionary tax system, and adequate standards in the financial sector.

Last, but not least, a third set of policies should aim to improve the efficiency and transparency of the public administration and to fight corruption. Empirical research shows a significant correlation between the quality of governance, reduced levels of corruption and economic development indicators such as the growth rate of GDP and GDP per capita.

These and some other issues addressed by speakers and panellists during the Forum meeting are reported in this publication.

Despite the significant progress made by Ukraine towards macroeconomic and financial stability since 2000, Ukraine still has a considerable way to go to make its growth sustainable and fully realise its vast potential as a destination for FDI.

Much has been said about what needs to be done. Two main challenges have to be kept in mind. First, the emphasis in reform should be on *a web of policies* that provide a favourable environment for investment and private enterprise development in general. This requires a strong commitment to reform by all levels and sectors of government and efficient synergies between a wide range of actors. Second, an effective and timely *implementation* of reforms is a key requirement. Adopting new laws and regulations is not enough, and indeed, as noted by many at the Roundtable last year, too many laws may kill the rule of law.

The task ahead remains challenging, but let me underline that Ukraine is not alone in this endeavour. Our Member countries, multilateral organisations, the private sector and civil society at large - all of us have a shared responsibility to support Ukraine's efforts on the path of policy reforms. I trust that we can help in two main ways.

First, policy makers from many OECD countries have faced similar challenges and their experience should be able to assist Ukrainian policy makers in selecting the right policy approaches. Such exchange of policy experience is at the core of the OECD's role, and the Organisation is actively engaged in open dialogue and experience sharing with both Members of the OECD and others.

Second, we should assist Ukraine in implementing the reforms needed. The OECD cannot, however, do it all by itself. The need for co-ordination and participation of many donors and international institutions in the field of international investment is particularly important, and I am pleased to note that the World Bank, IMF, EBRD, USAID and European Commission were all represented at the Forum meeting. In this context, the OECD sees very much its role as a facilitator, focussing our own efforts on contributing to building consensus on a "roadmap for reform", monitoring and helping with implementation of reforms, and then encouraging bilateral and multilateral donors to make use of our work in targeting their own assistance programmes to Ukraine.

We believe that this Forum can indeed contribute to strengthen our sense of a shared responsibility and help to further focus the co-operation between the OECD, Ukraine and other partners on priority policy issues.

The Forum is meant to be a dynamic process in which all the stakeholders looking forward to an improved business environment are actively involved. Our aim is to engage the participants in frank and lively exchanges, without refraining from expressing praise or - positive - criticism as long as it is based on solid facts and sound analysis.

In concluding, let me recall the final statement of the Kiev Roundtable meeting last year: “Ukraine has the potential to be transformed from ‘a miracle in waiting’ to ‘a miracle in making’”. Almost one year afterwards, we have a unique opportunity to see how this transformation is being realised and how we can contribute to deepen and speed up the important process of Ukraine’s greater integration into the international community.

AN ASSESSMENT OF CHALLENGES AND POLICY REFORMS FOR IMPROVED INVESTMENT ENVIRONMENT IN UKRAINE

Mehmet Ögütçü and Anna Stepanenko-Malan[*]

Despite significant growth in foreign direct investment (FDI) flows throughout the world in the past decade, the immediate outlook for fresh inflows of investment dollars does not appear to be very optimistic. Governments all over the world continue to actively seek FDI, and the competition for attracting the "quality" FDI will likely become even more intense over the next decade. In this context, it is critically important for countries like Ukraine to create an enabling framework for investment and further advance the reform agenda with a view to retaining and attracting greater inflows of FDI. This is particularly crucial given that Ukraine needs FDI in almost every area from agriculture to telecommunications.

Although Ukraine achieved an impressive economic growth rate in 2000-2001 , as compared to previous years, largely thanks to the comprehensive reform programme launched in early 2000, the country has still a considerable way to go to be qualified as an attractive destination for FDI. The new Ukrainian government, led by Prime Minister Anatoly Kinakh, seems to have realised the importance of building investors' confidence and the need to implement the reform agenda without further delay. What needs to be done by Ukraine is crystal clear; its achievements will be judged by the vigour with which these reforms will be carried out.

The OECD's Review of Ukraine's investment policies shows the way forward through a series of practical policy recommendations. How decisively these

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recommendations will be put into practice remains a key challenge for Ukraine, and might determine its future place and orientation in the world economy.

Recent FDI Trends and Implications for Transition Economies

The fact that virtually all countries are competing to attract FDI inflows demonstrates that the opportunities for growth and development generated by FDI are now widely acknowledged. In addition to capital inflows, FDI can lead to transfers of technology and know-how, improve access to international markets, and spur competition.

However, despite its growing role in the globalisation process, FDI flows are set to decline in 2001, for the first time in a decade.[1] According to projections released just before the tragic September events in New York and Washington, world FDI flows were expected to drop by 40 % this year, to $760 billion.

FDI Trends in Transition Economies

The transition countries currently preparing for EU accession attracted the largest inflows in the period 1990-1999, with Poland, Hungary and the Czech Republic as main recipients, bringing their combined stock above $65 billion in 1999. This compares with an estimated FDI stock in the Russian Federation of $19.7 billion in 2000.[2]

On a per capita level, inflows into Estonia, Latvia and Slovenia have also been significant placing them ahead of Poland according to this indicator. The smaller CEE countries are also showing the highest share of FDI in terms of total fixed capital formation, with levels well above 20 % for the period 1996-1998. Poland and the Czech Republic range closer to 15 % in terms of this indicator, while in the Russian Federation the share of FDI in fixed capital formation remains closer to 5 % in 2000.[3]

1. Karl Sauvant (UNCTAD), Recent trends, Implications for Developing Countries and Policy Challenges, OECD Global Forum on International Investment, 26-27 November 2001, Mexico City.

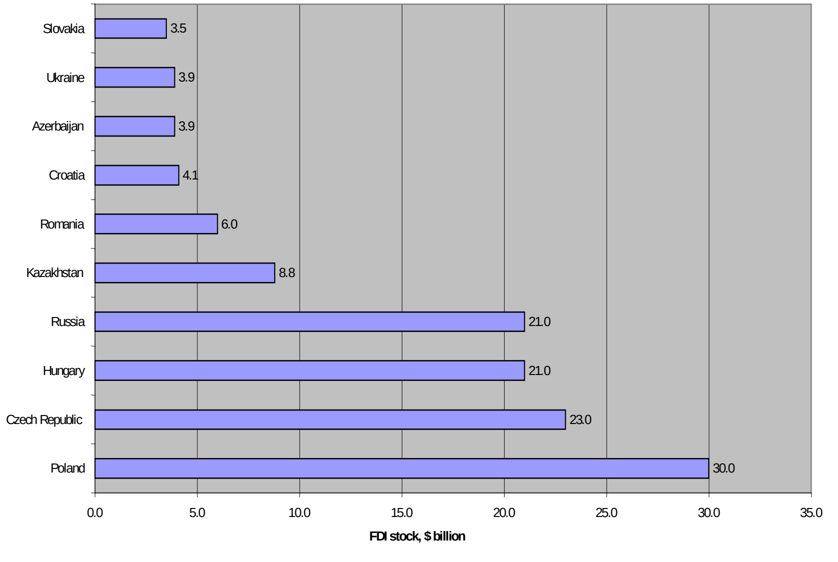
2. Evgeny Gavrilenkov, *Achievements or Missed Opportunities: Factor of Economic Growth in Russia. What lessons are relevant to Ukraine?,* Fostering Sustainable Growth in Ukraine, Physica-Verlag, 2002.

3. Eva Thiel, *The Investment Environment in Russia and Ukraine: Common Weaknesses in the Institutional and Policy Framework*, Fostering Sustainable Growth in Ukraine, Physica-Verlag, 2002.

The projected decline of FDI is likely to affect mostly developed countries, largely through the decrease in mergers and acquisitions (M&As). In the case of developing countries, where most FDI is greenfield investment, the decline is estimated to be around 6 %, from $240 billion to $225 billion. FDI inflows in Central and Eastern Europe, increased by 9 % (to $27 billion, representing 2 % of world inflows) in 2000, are expected to remain stable.[1]

An accentuation of the slow-down in the world economy may prompt some companies to relocate production resources to low-cost producing countries; in this case there may be some redistribution of FDI flows towards developing and transition economies. Under these circumstances, transition countries – a group still accounting for a relatively modest share of total world FDI stock – could use their comparative advantage to attract such relocated investment. The decline of FDI may lead governments to increase their efforts to boost FDI inflows and to try to secure greater benefits from FDI received. Hence, establishing an enabling framework in key policy areas and improving the overall business climate will become even more important in the years ahead.

Chart 1. Top Ten FDI Destinations in Central Europe, 1990-2000



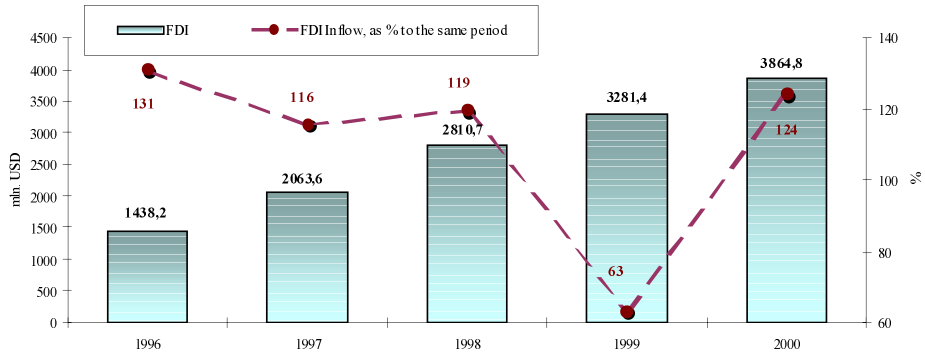
Source: OECD Investment Policy Review, Ukraine, 2001.

1. Ibid.

Foreign Direct Investment in Ukraine Today

Ukraine is one of the transition economies with potential for investment and growth, but also with huge challenges. Its large landmass, domestic market of about 50 million people, highly educated labour force, rich natural resources, and strategic location, provide a solid base for sustained economic growth and a fertile soil for investment inflows, domestic and foreign alike. Yet, despite its perceived sound fundamentals, Ukraine lags behind most Eastern European transition economies, both in terms of growth and the volume of FDI it has attracted.

FDI Inflow to Ukraine (1996-2000)



Source: OECD Investment Policy Review, Ukraine, 2001

Some projections indicate that Ukraine should raise at least an estimated US$40 billion of investment for rehabilitating its ailing infrastructure alone. FDI is urgently required in almost every area from agriculture to telecommunications. Yet, FDI inflows remain marginal. According to official Ukrainian data, as of 1 October 2001, total FDI stock Ukraine has accumulated since independence is some US$4.2 billion. This translates into about US$83 per capita, placing Ukraine the second lowest among CIS countries, ahead of only Belarus; and amounting to less than 10 % of per capita FDI to Central and Eastern European countries such as Poland and Hungary. Also, the USA invested 10 times more in the Polish economy than in that of Ukraine.[1]

1. Stefan Lutz and Oleksandr Talaverda, EERC annual conference paper, April 28-29, 2001.

The legal regime specifically addressing foreign investment is set out in both Ukraine's domestic legislation (in particular 1996 Law on the Regime of Foreign Investment amended in 1999), and in international agreements. Some national legislation, while not expressly distinguishing between domestic and foreign investment, applies in practice to foreign investment only, notably the laws on production-sharing and concession agreements.

FDI Trends in Ukraine

By origin of investment, the United States has been the dominant foreign investor ($ 590 million, which represents 18 % of all FDI), followed by the Netherlands with 9 %, the Russian Federation (9 %), Germany (7 %) and the United Kingdom (7 %).

From a sector perspective, as of January 2000, the main destination of FDI in Ukraine, was the domestic food industry (20 % of cumulative FDI), followed by domestic commercial operations (over 17 %) and mechanical engineering/metals (almost 11 %).

FDI flows into Ukraine are highly concentrated in a few regions. Kiev and its surroundings receive over one-third of all FDI; Donetsk, Zaporozhye, Poltava, Odessa and Dnipropetrovsk regions together account for another third; leaving less than one-third for the remainder of the country.

Major amendments to Ukraine's FDI legislation enacted during the past few years constitute a shift from a generous, but ineffective system, of specific incentives to a system of non-discriminatory legal conditions for all investors, including more extensive investment protection. Access for foreign investors to the Ukrainian market has also been considerably liberalised, though limitations remain in certain sectors.

Ukraine has signed a significant number of bilateral investment treaties (67 treaties, 43 of which are in force), including some with OECD Member countries. The bilateral treaties, which supersede the Ukrainian Foreign Investment Law and prevail over it in case of conflict, conform, in most cases, to international standards. In addition, Ukraine has signed several multilateral agreements related to foreign investment, such as the 1965 ICSID Convention, the 1994 Energy Charter Treaty, and the 1998 Partnership and Co-operation Agreement with the European Union.

The mechanism for implementing foreign investment regulation has also been streamlined. In 2000 the main central government agencies with FDI-related responsibilities were integrated into the Ministry of Economy and European

Integration. This concentration of FDI expertise now offers an opportunity for implementing a coherent investment strategy.

Why then, if the legal and institutional framework for foreign investment seems satisfactory, do FDI inflows still represent only a small fraction of Ukraine's potential? The answer appears to be that substantive flaws in Ukraine's general legislation, and especially the lack of transparency and legal insecurity, constitute a much more important investment barrier than some minor shortcomings in specific foreign investment regulation. Hence, to attract investment, the reforms should address structural reform and the policy deficiencies as a whole, and not be confined to the revision of foreign investment regulations alone.

Major Challenges…

In spite of recent economic growth, most international ratings and investment climate surveys place Ukraine among the least advanced transition economies with respect to its macroeconomic and microeconomic conditions. The contribution of the private sector to GDP is quite low, at about 20 % of GDP, compared to around 70 % to 80 % in Hungary, Poland and Russia.[1]

An unfavourable environment for business has contributed to substantial capital outflows, estimated to have reached around $20 billion since Ukraine's independence. Estimates on the size of the informal, "shadow", economy range from 14 % (official estimates) to a more realistic 60 % of total GDP. Persistent fiscal and current account deficits – even taking into account the fact that they have gradually decreased since 1994 – as well as high inflation – around 20 % per annum – testify of grave economic difficulties.

Effectiveness in affording property security and enforcing contractual rights also appears to be poor. Investors complain of complex and often ambiguous legislation.[2] Indeed, despite a vast body of law, Ukraine still lacks a coherent, effective and transparent legal system. To date, fundamental codifications, such as civil code, tax code, and legislation concerning the judiciary system, are pending before Parliament or the Presidency.[3] Moreover, frequent legislative

1. Sigma Bleyzer, 2001.

2. "Report on Impediments to Foreign Investment in Ukraine" carried out by the TACIS-funded Ukrainian-European Policy and Legal Advice Centre in 1999.

3. Thus, the draft Civil Code has passed three readings (September 2001) and is to be signed into law by the President.

and regulatory modifications, rather than helping to establish transparent rules, have often contributed to discretionary interpretation and unpredictable implementation.

Although the major reform programme has demonstrated some encouraging achievements, the structural reforms remain incomplete and the economic growth fragile. The most pressing economic priorities include:

- ***Accelerating privatisation*** of many large State-owned enterprises: Progress in the area of structural reform, in particular privatisation of the energy sector, has slowed down recently. Mr. Kuchma, President of the Ukraine, put a temporary moratorium on privatisation of electricity distribution companies in May 2001, although his recent Decree of December 2001 will lift this ban as of spring 2002.[1]

- ***Restructuring unwieldy governmental apparatus, and combating corruption:*** Public governance marked by bureaucratic interventionism and corruption remains one of the priorities of the reform. According to the Transparency International 2001 "Corruption Index", Ukraine ranks in 83rd position, leaving behind only 8 countries.[2]

- ***Re-organising the court system:*** A comprehensive re-organisation of the court system is required in order to improve courts' technical and financial resources, as well as the competence of judges, and to ensure effective protection of investors' rights.

- ***Streamlining the tax system:*** Taxation tops the list of investment disincentives in Ukraine. The lack of a comprehensive and coherent tax code is one of the main shortcomings of the business climate. The reduction of tax burden, in terms of both tax rates and the number of taxes, is also required.

- ***Overhauling agricultural sector:*** The new Land Code establishing private land ownership is an important step towards transforming agriculture into a market-based sector, but it requires

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1. Oxford Analytica Daily Brief, June 6, 2001, II.

2. The Index is based on 1999, 2000 and 2001 data provided by the Economist Intelligence Unit, the Global Competitiveness Report, the World Business Environment Survey and the Freedom House.

implementation of legislation relating to key issues such as land valuation, the establishment of a property registry, the creation of a mortgage bank and bankruptcy procedures.

- ***Completing reforms necessary to enter the World Trade Organisation*:** Though Ukraine has liberalised its trade regime in recent years and lowered its tariffs, considerable non-tariff barriers remain, especially the imposition of cumbersome technical standards and certification requirements. At present, Ukraine is actively seeking WTO membership but must l implement a host of reforms in order to qualify.

- Further reforms of banking and capital market systems, accounting and auditing, ensuring better protection of property rights, and completing land reform.

- Providing a foreign investor-friendly climate by liberalising capital, foreign exchange and profit expatriation controls, lifting restrictions on foreign ownership and control, and minimising red tape.

…and First Achievements

There are, however, some encouraging signs. First signs of success of a comprehensive reform programme, implemented since 1999-2001, are now becoming visible.

Significant progress could be seen in macroeconomic and financial stability during 2000-2001. Real GDP grew by 14 % in two years, inflation declined to an average 12 % in 2001 and the fiscal deficit was cut to 1.3 % of GDP. Net general government public and external debt decreased to 29 % of GDP and 23 % of exports, respectively, in 2001, down from a peak of 54 % of GDP and 63 % of exports, respectively, in 1999.[1] Added to this list are recent significant improvements in liquidity reflecting the restructuring of liabilities to the Paris Club, the settlement of natural gas arrears, and rising international reserves. Reserve coverage of the external financing gap increased to over 300 % in 2001, up from a trough of 21 % in 1998. These developments hold out hope for an economic revival.

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1. Standard & Poors' rating of 26 December 2001.

Progress has been achieved in the field of small business. There are over three million small and medium enterprises (SMEs) operating in Ukraine, which contribute to job creation,[1] although the share of SMEs in total output and total employment is not high: in 2000 it constituted 8.4 % and 8 % respectively.[2] The government needs to pay special attention to the needs of SMEs and help open avenues for SMEs to enhance linkages with foreign direct investment.

One should also acknowledge some strategically important decisions that have already been taken to provide a solid base for sustainable economic growth, such as:

- Approval, for the first time since independence, of a realistic budget for 2000; this was repeated in 2001 and 2002 and sustained by a rather tight budgetary and fiscal policy. The 2002 budget allows for a deficit of 1.7 % of GDP, or US$811 million. The budget is based on the new Budget Code (enacted in March 2001) providing for decentralisation of local public finance, which is one of the key elements of current budgetary reforms. On the negative side, due to delays in the adoption of the new Tax Code, the 2002 budget is based on the existing taxation system with its high tax burden.[3]

- Implementation of policies that have reduced the share of non-cash transactions in the economy, notably a ban on non-cash settlements with the budget.

- Amendments to the Law on electricity, which significantly restricted the scale of non-payments in the electricity market

- Approval of the 2000-2002 Privatisation Program, which sets the baseline for transparent and foreseeable sales of State property. The programme aims at privatising most of the 200 large enterprises holding over 80 % of assets in the industrial and utilities sectors. Unlike previous privatisation rounds, the 2000-

1. Mr. Carlos Pascual, the US Ambassador to Ukraine, *What can place Ukraine on a path to Sustainable Growth,* (lecture at the Kyiv-Mohyla Academy of April 25, 2001).

2. Iryna Akimova, *Performance of Small and Medium Sized Manufacturing Firms in Ukraine: Does the Quality of Governance Matter?*, Fostering Sustainable Growth in Ukraine, Physica-Verlag, 2002.

3. Oxford Analytica (http://www.oxweb.com).

2002 programme targets primarily long-term strategic investors and foreign investors in particular. To attract them, it is envisaged to re-organise enterprises earmarked for privatisation and to restructure their debt. Also, a Working Group to review such progress has been established.

- Privatisation of collective agricultural enterprises, demonopolisation of lending to the agricultural sector, and finally, adoption of the Land Code. Agriculture (13 % of GDP), the most depressed sector during the 1990s, grew by 7.6 % in real terms in 2000 and by an estimated 6.5-7.5 % in 2001. This year's bumper crop resulted in Ukraine tripling its grain exports, and contributed significantly to lowering food prices and inflation.[1]The new politically challenging and economically important Land Code was finally approved in November 2001 and came into effect on 1 January 2002. It introduces a formal mechanism for private land ownership and allows agricultural land to be bought and sold and used as collateral (effective as of 1 January 2005), which should facilitate farmers' borrowing. The pace and detail of land reform will be determined by legislation adopted to implement the land code.

- Introduction, within the framework of the administrative reform, of a new mechanism for collective decision-making that prevents the approval of decisions hindering entrepreneurial activity, and requires publication of government decisions.[2]

The Way Ahead in Reforms: Implementation is the Key

Despite recent favourable macroeconomic indicators, Ukraine has still some considerable way to go to make its growth sustainable. FDI is one but not the only mechanism to increase economic growth. As mentioned above, the emphasis in reforms should be on a web of policies that provides a favourable environment for investment and private enterprise in general.

If this is done properly and regulatory barriers are eliminated, investment flows, including FDI, will increase and the economy will prosper with complementary developments in the foreign-owned and domestic enterprises. It should be

1. Standard & Poors' *op. cit.*

2. ICPS newsletter, No. 109, 28 May 2001.

understood that if policy-makers focus solely on trying to attract FDI to the economy, which has a “hostile” business environment, by favouring foreign investors over domestic ones, the results are likely to be less positive with respect to the long-term development of the economy.

To support Ukraine’s reform efforts, the OECD and other international donors have come up with a number of policy recommendations aimed at improving the overall business environment.

The **OECD Investment Policy Review**[1] recommends, *inter alia,* that the Ukrainian authorities:

- Reorient government administration away from micro-managing the economy towards a strategic formulation of framework conditions conducive to private sector development.

- Develop a transparent, predictable, and stable process for case-by-case privatisation, and ensure that the tender commission is independent.

- Phase out non-transparent and distortive investment incentive schemes.

- Open the way to international arbitration of disputes under the foreign investment law, and establish courts of appeal for economic disputes.

- Align Ukraine’s accounting and auditing practices with international standards, in particular for publicly-traded companies and financial institutions, so as to avoid double book-keeping and attendant costs, simplify financial reporting and ensure transparency and proper performance evaluation.

- Simplify interaction between foreign investors and Ukrainian authorities by considering the creation of a "one-stop-shop" that obtains for foreign investors all required licences, approvals and permits.

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1. The executive summary and the recommendations are available at the OECD website (http://www.oecd.org/daf/investment/ukraine.htm).

Ukraine faces a choice between drastic policy and institutional reforms to further improve the environment for investment and enterprise development and a gradual but irrevocable decline of the economy. To mobilise investments now, it is necessary to strengthen investor confidence in the will and ability of Ukraine to implement reforms, persuading investors that it pays to buy into the Ukrainian economy today, when entry prices are still moderate, and reap returns tomorrow, when business conditions will be favourable.

It would not be an exaggeration to call Ukraine today a "miracle in waiting" that has all the necessary potential to become a reality.

A SYNTHESIS OF FORUM DELIBERATIONS

Jaroslav Kinach[*]

The crucial difference between this Forum and other meetings on Ukraine's investment policy and private sector development is that the Forum continued the discussions and analyses by experts which started a year ago at the initiative of the Ukrainian government, and which resulted in OECD's publication *Ukraine: Investment Policy Review* in May 2001. Indeed, the OECD has a pivotal role to play in spearheading discussions leading to reforms in these and other vital sectors in Ukraine, particularly since the OECD, unlike other international financial institutions, offers expert and professional advice without any pre-conditions.

The *Investment Policy Review* synthesises practical advice and recommendations which, when implemented, will lead to improvements in Ukraine's investment climate and also facilitate business formation and private sector growth. Both are critical to Ukraine's economic development and growth, and these factors will contribute significantly to its prosperity.

Ukraine's transition from a centrally planned to a market economy has been difficult and complex. An efficient market economy requires appropriate institutional, legal and regulatory conditions. An open market economy also requires a government that understands its role, which is essentially to protect the national interest via legislative and regulatory mechanisms, rather than active involvement and interference in the marketplace.

While these concepts are fundamental and self-evident to many westerners, they are not as easily understood, let alone accepted, by officials in the executive and legislative branches of power in most countries comprising the Former Soviet Union (FSU). These concepts and recommendations are in fact opposite (and alien) to what the previous regime represented, namely, control of all economic and most social activities. Accordingly, modifying attitudes and motivating officials to establish the 'rules of the game' and apply these fairly to all is an

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equally important dimension in creating an attractive investment climate and appropriate conditions for business to flourish. As one observer noted at the Forum, laws and regulations are important, but too many of them will inevitably create more problems than solutions.

This Forum was important not only because it provided another opportunity for experts from the OECD and its member countries, as well as members from the Ukrainian business community, but also to assess improvements and shortcomings in the legislative and regulatory environment over the last year. This meeting also provided government officials with an important opportunity to debate these and other issues openly and frankly, and in the context of improving attitudes and modifying administrative behaviour, there is no replacement for an active, face to face, discussion.

The Forum comprised three key sessions. In the first session, senior government officials presented a general, but comprehensive, overview of the economic situation in Ukraine during the last two years, and a detailed report on the implementation status of OECD recommendations contained in the *Investment Policy Review*. A panel of experts from the IMF, World Bank, the local business community and other resident advisors and economists presented their views of these developments. All acknowledged that economic growth in Ukraine was indeed the highest among transition countries and that structural and administrative reforms were underway.

However, they also agreed that there were still many opportunities for improvement in terms of structural and administrative reforms in various sectors of the economy, and that existing institutional, legal and regulatory frameworks were either lacking or were ineffective in supporting a vibrant open market economy. In this context, taxation merited special attention inasmuch as the government and parliament are drafting a new Tax Code that would streamline tax law and regulations, including administration thereof, as well as align tax policies with international practice.

Two interesting comments highlighted the discussion in this session: first, that Ukraine should benchmark its economic performance against its neighbours and other countries that it wishes to emulate in order to assess its performance and potential. And, secondly, that Foreign Direct Investment (FDI), which is one of the lowest in *per capita* terms in the region, is a good litmus test of how foreign investors view Ukraine. All speakers acknowledged the need for more FDI. And many reasons for shortcomings in attracting FDI were again recited, although these have been extensively described in the *Investment Policy Review.*

The second session was more focused on topics of special interest to investors and businessmen. On the issue of Privatisation, a succinct overview of the process and its critical components was described. It was also acknowledged that substantial progress has been made in the privatisation process, as witnessed by several successful large- scale privatisations in 2000/01. The Forum also heard about the challenges faced by owners of a recently privatised major electricity distributor. Their experience in Ukraine was markedly different from similar privatisations in neighbouring countries. Again, we heard about administrative intrusion in the electricity market place, and the need to establish fair "rules of the game" and apply them without exception and consistently.

An insight was also offered into the fragile, and yet undeveloped, capital and securities market in Ukraine. The absence of a functioning and effective capital market in Ukraine is a serious and major drawback in Ukraine's economic development. Themes of good corporate governance, respect for minority shareholder rights, financial reporting according to international accounting standards and other desirable issues were discussed, and it was encouraging to hear from the authorities present that these shortcomings were recognized and that appropriate legislative and regulatory changes were imminent.

The banking sector was also examined in view of its critical importance in supporting enterprise development. It was noted that despite a large number of banks, (over 150 registered), the top ten banks represented over 70% of all bank activities, and that bank loans represented less than 15% of GDP, an insignificant level of financing in the economy. The ineffectiveness of the banking system in intermediating between savers and users of financial capital was examined and traditional themes of trust, integrity and reliability were highlighted. Again, notwithstanding the shortcomings in this important sector, major improvements in regulatory and legislative areas were identified, and new bank supervisory and monitoring standards were being developed and implemented.

The third and closing session focused on the near term and next steps. Officials provided an outline of priority areas requiring attention, and it was not a coincidence that many initiatives had already been launched to address areas of concern identified by the many speakers. The government, it was noted, would continue with reforms to improve the welfare of its citizens, modernise its extensive industrial base and elimination of barriers to investment and business formation and growth. It was also made clear that the government required professional assistance and advice from the international and bilateral communities. And in this regard, the OECD could also play a pivotal role in co-ordinating and encouraging technical assistance from its member countries.

Overall, the participants in the Forum were pleased that progress was being made in many areas of the economy. However, there was also a feeling that more extensive reforms were needed, including an accelerated tempo, if Ukraine is to take its rightful place in the region and globalized economy.

II. PROGRESS REPORT BY THE GOVERNMENT OF UKRAINE

ACTIONS TAKEN TOWARDS IMPLEMENTATION OF OECD RECOMMENDATIONS

Report Prepared by the Government of Ukraine[*]

Introduction

Ukraine is currently going through an extremely crucial phase in its economic and political development. The destiny of market-oriented reforms aimed at improving the country's business environment is important for Ukraine, but also for its economic partners. Ukraine is a country with a large economic and human potential capable of progressing rapidly, given the strong political will to implement the necessary reforms.

The OECD Investment Policy Review, prepared at the request of the Government of Ukraine, contains a number of practical recommendations with regard to our country's economic and political progress. The developments that have taken place since the publication of the Review and the progress that we have been able to make are outlined in the report below, which reflects input from all relevant government departments.

I. Foreign Investment

1. Investment Protection

Recommendations:

- Review the need for of the frequent provisos in favour of generally applicable Ukrainian legislation and delete these provisos wherever feasible. Especially the proviso with respect to national

* The following government bodies participated in the preparation of this report, under co-ordination of the Ministry of Economy and European Integration: State Tax Administration; State Commission on Securities and Stock Markets; Ministry of Finances; Antimonopoly Committee; State Property Fund; National Bank of Ukraine; and State Standardisation Committee.

treatment, which is inconsistent with the treaty framework, should be either deleted or at least replaced by a list of exceptions from this principle, to be attached to the Foreign Investment Law.

– Extend the protection of expropriation and nationalisation to indirect and creeping expropriation.

Actions:

⇒ The Law of Ukraine "On Investment Activities" grants equitable regime to investors, including foreign investors. This form of the statute aims at preventing a possibility of applying measures of a discriminatory nature.

The list of exceptions mentioned in Article 17 of the Law "On Investment Activities" is being reviewed and will be submitted for consideration of interested parties following its amendment.

⇒ With respect to protection for foreign investors against creeping expropriation, Clause 2, Article 19 of the Law of Ukraine "On Investment Activities" stipulates: "Investments may not be nationalised, requisitioned or subjected to actions similar in their consequences without compensation." It should be understood that expropriation, including creeping expropriation, is an action similar in its consequences to nationalisation and requisition.

⇒ On March 16, 2000, the Verkhovna Rada of Ukraine ratified the Convention on the Settlement of Investment Disputes between States and Nationals of other States.

Ukraine, therefore, has access to the authoritative international mechanism for reviewing and settling investment disputes founded under this Convention, specifically the International Centre for Settlement of Investment Disputes (ICSID).

Rigorous ethical and professional requirements for Mediators and Arbitrators included in the ICSID Lists, and provisions regarding the representation of the principal existing world legal systems and main forms of economic activities (Article 14) ensure a high level of legal analysis of disputed situations, and comprehensive and relevant decisions by the ICSID.

Article 26 of the Convention stipulates: "Any negotiating State has the right to demand precedence of the national administrative or judicial means of settling disputes as a condition for submitting a dispute for arbitration pursuant to this Convention.” This provision of the Convention allows the national administrative and judicial systems to prove their effectiveness in settling investment disputes between the State and foreign national. This efficiency is inversely proportional to the number of disputes involving this State submitted to ICSID.

As of today, one case involving Ukraine, Joseph Lemire vs. Ukraine, is being considered by the ICSID. In order to speed up the case and due to the absence of serious contradictions, the parties in the case issued an Appeal for Conciliation Procedure pursuant to Article 28 of the Convention; in this case, the dispute is settled in accordance with the Conciliatory Procedure as per Section 3 Chapter III of the Convention.

2. *Investment Liberalisation*

Recommendations:

- It is recommended that the remaining cases of foreign investor discrimination (limitations remaining in certain sectors, notably insurance, television and broadcasting) be reviewed with a view to eliminating them wherever feasible.

Actions:

⇒ On October 4, 2001, the Verkhovna Rada of Ukraine adopted a new version of the Law of Ukraine “On Insurance” effective as of November 7, 2001 (hereinafter referred to as Law).

The Law completely removes limitations on the interest share of a foreign founder in establishing as an insurer, which could not exceed 49 % earlier, and sets forth identical requirements with regard to authorised capital both for domestic insurers and those established with the participation of foreign founders.

According to Article 2 of the Law, recognised as insurers are financial institutions established as economic companies pursuant to the Law of Ukraine “On Economic Companies” and those that have been licensed, in accordance with the established procedure, for pursuing insurance activities. Insurance activities in Ukraine are carried out exclusively by insurers that are resident in Ukraine.

The Cabinet of Ministers of Ukraine issued Resolution No.98 dated February 2, 2001 to approve the Program for Development of Insurance Market in Ukraine for 2001-2004 (hereinafter referred to as Program).

The Program aims, among other things, at removing administrative barriers to entry into specific insurance markets, and at creating equitable conditions for all insurers based on the principle of open competition. The State guarantees to all insured and insurers (domestic and foreign) free choice of types of insurance and equal opportunities in conducting business, creates conducive conditions for development or insurance with the aim of providing for implementation of the right to effective insurance protection and free choice of insurer.

⇒ In order to remove obstacles to attracting foreign investment for development of the telecommunications sector, the Law of Ukraine "On Specifics of Privatisation of Open Joint Stock Company "Ukrtelekom" of July 13, 2000, has amended the Law of Ukraine "On Telecommunications", which has lifted the restrictions on the share of foreign capital in authorised funds of telecommunications joint ventures, as well as broadcasting support companies.

⇒ The Law of Ukraine "On Television and Radio Broadcasting" regulates the establishment and operation of television and radio broadcasting organisations with foreign investment. Implementation of information policies in the area of television and radio broadcasting rests with the State Committee for Information Policy, Television, and Radio Broadcasting.

3. Incentives and Privileges

Recommendations:

- Phase out all remaining incentive schemes to the extent that they distinguish between foreign and domestic investors. Once granted, however, privileges should be maintained for the entire time period initially agreed upon.

Actions:

⇒ As indicated above (see Clause 1 of Section I), according to the Law of Ukraine "On Foreign Investment Regime", the national regime does not make distinctions in the status of national and foreign investors.

4. Special Economic Zones

Recommendations:

– Review the concept of Special Economic Zones (SEZs) with a view to abandoning plans for the creation of new zones and to the phasing out of existing SEZs. Incentives already granted to enterprises in the zone shall be honoured, however, to avoid undermining investor confidence in the stability of investment conditions.

Actions:

⇒ Since August 1999, the Cabinet of Ministers of Ukraine has not authorised the establishment of new SEZs.

⇒ To implement the OECD recommendations with regard to reviewing the concept of Special Economic Zones, the Government passed a decision (Resolution No.184 of the Cabinet of Ministers of Ukraine of February 28, 2001) to carry out a comprehensive analysis of SEZs performance results.

Pursuant to a decision of the Governmental Economic Development Committee of August 31, 2001, it is planned to review the performance results of Special Economic Zones of Investment Activities in May 2002 and make decision on their further operation.

⇒ According to the legislation in force, the State guarantees stability of the legal regime to investors and subjects of entrepreneurial activities operating in a Special Economic Zone, in case of change in Ukrainian laws on taxation and customs issues.

Pursuant to Ukrainian legislation, the State guarantees preservation within the full scope of all property and non-property rights to investors and subjects of entrepreneurial activities operating within SEZ if such SEZ is liquidated.

Any disputes between SEZ management agencies, subjects of entrepreneurial activities operating within SEZ, investors, and the liquidation commission, which could emerge in connection with liquidation of a zone are settled by Ukrainian courts. Disputes involving a foreign subject of entrepreneurial activities are considered by courts to be agreed by the parties, including foreign courts.

Following ratification by the Verkhovna Rada of Ukraine of the Convention on the Settlement of Investment Disputes between States and Nationals of other States on March 16, 2000, a foreign investor can appeal to the International Centre for Settlement of Investment Disputes in Washington, D.C.

5. Foreign Investment Institutions

Recommendations:

- Ukrainian investment institutions should coherently and consistently implement an investment promotion strategy. Such a strategy would include the following tasks:
- developing a coherent investment promotion strategy to which all Ukrainian authorities subscribe;
- simplifying interaction between foreign investors and Ukrainian authorities by considering the creation, for instance, of a “one-stop shop” that obtains for foreign investors all required licenses, approvals and permits from the authorities in charge;
- assisting foreign investors in case of difficulties with Ukrainian authorities;
- facilitating a continuous and systematic policy dialogue between foreign investors in Ukraine and investment policy-makers;
- enhancing both Ukraine's image abroad as an attractive investment location and the image of foreign investment in Ukraine as an agent of growth;
- promoting abroad investment projects in Ukraine;
- promoting linkages between foreign investors and domestic suppliers.

Actions:

⇒ On December 28, 2001, the Government adopted a Program for Development of Investment Activities and set up a working group to develop a plan of actions for implementing the program.

⇒ On June 12, 2001, the President of Ukraine issued Edict No. 512/2001 “On Measures to Improve the Investment Environment in Ukraine”, instructing the Government to develop a Program to promote the "Investment Image of Ukraine."

The Program concentrates on taking steps with a view to publicising widely Ukraine's achievements in creating a favourable investment environments and highlighting the Government's actions towards overcoming barriers and obstacles to invigorating investment activities in Ukraine.

The Program is expected to help create an attractive investment image of Ukraine worldwide.

⇒ A key component of Program implementation involves setting up a permanent Co-ordinating Group for stepping up investment activities (hereinafter referred to as the Group), with participation of central government officials.

The Group is to become a "one-stop shop" performing the functions of facilitating solution of problems, protecting investors, intensifying investment activities, supporting investors making investments in sectors of priority significance for Ukraine.

6. Improving the Effectiveness of the Foreign Investment Advisory Council

Recommendations:

- It is recommended to create a permanent working body to prepare and provide follow-up to Council meetings. Such a body could be composed of the top aides of Ukrainian Council members and the chief resident representatives of international Council members.
- Invite into the Council membership representatives of business associations so as to address the particular interests and problems of small and medium-sized enterprises.

Actions:

⇒ The Foreign Investment Advisory Council, attached to the President of Ukraine, has established permanent working groups in the following areas: reforming property relations and eliminating administrative barriers; power industry; industrial policy; oil and gas sector; financial policies; telecommunications.

These working groups provide ongoing support to the activities of the Foreign Investment Advisory Council in between its meetings and develop actions to improve the investment environment in Ukraine.

7. Improving the Effectiveness of the Chamber of Independent Experts

Recommendations:

- create specialised panels, notably on tax and customs issues;
- extend the Chamber's jurisdiction to enterprises with foreign shareholders (rather than just foreign shareholders in such enterprises); and
- appoint individual experts as mediators of evolving disputes before constituting formal panels.

Actions:

⇒ The Chamber of Independent Experts on Foreign Investments attached to the President of Ukraine (hereinafter referred to as Chamber) was established pursuant to Decree No.200/97 of the President of Ukraine dated March 3, 1997, "On the Chamber of Independent Experts on Foreign Investments."

The establishment of the Chamber was connected with expanding activities of foreign investors in Ukraine and, consequently, with a significant increase of discrepancies emerging between foreign investors and State agencies and local government. Its creation was also prompted by the need to involve leading scholars and lawyers, including practising lawyers, both Ukrainian and foreign, in the process of improving Ukrainian investment laws.

Unfortunately, however, the organisational and logistical support to Chamber operations was not entirely satisfactory, which has lead to insufficient awareness of foreign investors about the Chamber's activities and the effectiveness of case arbitration was inadequate.

There were certain difficulties in the process of implementing Chamber decisions. Following case examination and taking a decision, the Chamber should have had certain mechanisms for interaction with central government agencies for them to take appropriate actions. Besides, the Chamber’s activities could have been more effective, had it become an addressee of requests for examination of investment disputes not just to foreign investors, but also for enterprises with foreign investments.

⇒ For these reasons, the last case was submitted for consideration of the Chamber nearly a year and a half ago and de facto the Chamber’s activities have been suspended since that time. In view of these developments and due to the fact that Ukrainian legislation on investments has been significantly improved with the adoption of the Civil, Land, Customs, and Economic Codes, which in a comprehensive manner regulate the issues of economic and other types of activities in the territory of Ukraine, the Presidential Edict No.1071/2001 “On Liquidation of Certain Advisory, Consultative, and Other Bodies” dated November 13, 2001, liquidated the Chamber of Independent Experts.

II. Rule of Law

1. Substantive Law

Recommendations:

- Adopt the pending draft Civil Code as soon as possible; and during the period prior to adoption of the code, base new legislation on the pertinent provisions of the draft Civil Code.

Actions:

⇒ The Verkhovna Rada of Ukraine approved the Civil Code of Ukraine on November 29, 2001.

2. Strengthening the Judiciary

Recommendations:

- Strengthen the role of the judicial system and, in particular, improve the competency of judges in commercial disputes;
- proceed as expeditiously as possible with the reorganisation of the court system and the adoption of new rules of procedure.
- establish courts of appeal for economic disputes;

– explore the feasibility of some specialisation of judges by creating either specialised courts or specialised chambers within the courts. Such specialisation should especially be considered with respect to intellectual property, taxation and bankruptcy cases; and
– create an effective system of preliminary protection of creditors' rights and preliminary protection against illegal action or inaction of state authorities.

Actions:

⇒ First of all, it should be noted that the court system dating back to the Soviet period has been transformed pursuant to requirements of Article 125 of Ukrainian Constitution into a system of courts of general jurisdiction. Adoption by the Verkhovna Rada of Ukraine of a number of Laws of Ukraine on June 21, 2001, constituting the so-called “small legal reform” represents a significant achievement in implementing the judiciary reform.

In addition, appropriate changes have been made in the Code of Civil Procedure of Ukraine, Code of Economic Procedure of Ukraine, and Code of Criminal Procedure of Ukraine, which bring the rules of procedure in line with the Ukrainian Constitutions and amendments introduced to the Law of Ukraine “On Judicial System”.

⇒ The Verkhovna Rada of Ukraine is now considering a draft Law of Ukraine “On Judicial System” approved in the first reading (Reg.No.5185-D), which comprehensively addresses the global issues of implementing judicial and legal reform in Ukraine.

A full-fledged functioning of a new judicial system requires reforming the codes of procedure. Reforming the codes of procedure should conform to the systematic principle, which provides for a well considered concept of the law and intrinsic consistency of rules and institutions.

The Verkhovna Rada of Ukraine is also currently considering a draft Code of Civil Procedure of Ukraine (letter No.29-100/4 of the Cabinet of Ministers of Ukraine dated January 10, 2002).

Also, submitted for consideration of the Verkhovna Rada of Ukraine is a draft Code of Criminal Procedure (Registration Number 7431 dated June 23, 2001).

⇒ Pursuant to Law of Ukraine “On Introducing Changes to the Law of Ukraine “On Judicial System of Ukraine”, the system of Ukrainian courts of general jurisdiction is represented by local courts, courts of appeal, higher specialised courts, and the Supreme Court of Ukraine. Such a judiciary reform would allow continuing work on building a judicial system.

Introduction of appeal and cassation reconsideration of court decisions represents an important step. These forms of reconsideration of court decisions have replaced an obsolete system of revision of court decisions by means of cassation and oversight.

⇒ In accordance with Article 124, part 2, of the Ukrainian Constitution, the jurisdiction of courts embraces all legal relationships in the State, including economic legal relations. The jurisdiction of courts over civil and commercial disputes is stipulated in the Code of Civil Procedure of Ukraine and Code of Economic Procedure of Ukraine. For instance, according to Article 24 of the Code of Civil Procedure of Ukraine, courts have jurisdiction over:

- cases of disputes emerging from civil, family, labour, and co-operative legal relations if a private individual is at least one of the parties in the dispute, except for the cases when settlement of such disputes is transferred by law into jurisdiction of other bodies;
- cases that arise from administrative-legal relations as listed in Article 236 of this Code;
- cases of separate jurisdiction as listed in Article 254 of this Code. Courts also have jurisdiction over other cases referred by law into their competence. Courts also consider cases involving foreign nationals, persons without citizenship, foreign enterprises and organisations.

⇒ Regarding jurisdiction of economic courts, according to Article 12 of the Code of Economic Procedure of Ukraine, the economic courts have jurisdiction over:

- cases of disputes that arise when concluding, amending, terminating, and implementing economic agreements and on other grounds, as well as on disputes on recognising acts as invalid on the grounds stipulated by law, except: disputes arising when agreeing standards and technical specifications; disputes on establishing prices of products/goods, as well as tariffs for services/work of these prices and tariffs, in accordance with the law, cannot be set by agreement of the parties; and other disputes, which are referred to jurisdiction of other bodies in accordance with Ukrainian law, intergovernmental agreements and treaties;

– bankruptcy proceedings;

– cases filed by offices of the Antimonopoly Committee of Ukraine and Accounting Chamber on matters referred by legislative acts into their competence.

⇒ A dispute subject to jurisdiction of economic courts can be submitted by the parties for consideration of the court of arbitration, except for the disputes on recognising acts as invalid, as well as disputes arising from concluding, amending, terminating, and implementing economic agreements related to satisfying State needs.

⇒ It should also be noted that according to Article 12, Part 1, of the Ukrainian Code of Economic Procedure, economic courts have jurisdiction over cases involving disputes on recognising acts as invalid on the grounds stipulated by legislation, except for the cases established by law.

⇒ Courts of appeal function in the Autonomous Republic of the Crimea, oblasts, and cities of Kyiv and Sevastopol. Courts of appeal act as courts of appellate instance with regard to decisions of local courts, as courts of first instance for administrative, criminal, and civil cases referred into their jurisdiction by law, as well as reconsider cases due to newly revealed circumstances.

⇒ In connection with formation of the above system of courts of general jurisdiction and according to the changes introduced to the Law of Ukraine “On the Court of Arbitration”, the system of courts of arbitration has been transformed into a three-tier system of specialised economic courts made up of local economic courts, economic courts of appeal, and High Economic Court of Ukraine.

Therefore, the above laws define the concept and system of local, appeal, and cassation courts, delineate their powers and competence with regard to considering cases in the first instance, and as appeal or cassation reconsideration of court decisions.

Chapter 31-A of the Ukrainian Code of Civil Procedure stipulates the procedure for considering by court of complaints of citizens against decisions, actions or inaction of State agencies, legal persons or officials in the area of management activities.

⇒ According to the Law of Ukraine "On Economic Courts", the High Economic Court is a specialised court, which performs administration of justice in economic relations.

It should also be noted that according to provisions of the Law of Ukraine "On Introducing Changes and Addenda to the Law of Ukraine "On Judicial System of Ukraine" and Law of Ukraine "On Introducing Changes to the Law of Ukraine "On the Court of Arbitration", specialised panels can only be set up at economic courts.

⇒ The Edict of the President of Ukraine "On Establishing Special Panels for Considering Bankruptcy Cases with Courts of Arbitration of Ukraine" No.333/98 dated April 21, 1998, introduces special panels for considering bankruptcy cases within courts of arbitration of the Autonomous Republic of Crimea, oblasts, cities of Kyiv and Sevastopol with the view of improving effectiveness of court proceeding of bankruptcy cases.

⇒ According to Order No.19 of July 26, 2001, of the Supreme Economic Court of Ukraine, the following entities have been established:

- panel of judges of the High Economic Court of Ukraine for considering cases related to protection of intellectual property rights, with the composition of its personnel approved;
- panel for considering cases related to protection of intellectual property rights within local courts and courts of appeal.

⇒ The Ministry of Justice of Ukraine has prepared a draft Law of Ukraine "On Administrative Courts," which was submitted to the Cabinet of Ministers of Ukraine on December 19, 2001.

The draft Law of Ukraine establishes the system of administrative courts aimed at assuring the appropriate protection of rights and freedoms of citizens through consideration of cases ensuing from administrative legal relations.

⇒ Twelve laws of Ukraine providing for changes in the judicial system became effective in July 2001: Laws of Ukraine "On Introducing Changes to the Law of Ukraine "On Judicial System of Ukraine", "On Introducing Changes to the Law of Ukraine "On Prosecutor's Office", "On Introducing Changes to the Code of Criminal Procedure of Ukraine", "On Introducing Changes to the Law of Ukraine "On Status of Judges", "On Introducing Changes to the Law of Ukraine "On Self-governing Bodies of Judges", "On Introducing Changes to the

Law of Ukraine “On Qualification Commissions, Qualification Attestation, and Disciplinary Responsibility of Ukrainian Judges”, “On Introducing Changes to Laws of Ukraine “On Operative and Investigative Activities”, “On the Militia”, “On Pre-trial Incarceration”, “On Administrative Supervision of Persons Released from Penitentiary Institutions”, “On Introducing Changes to the Law of Ukraine “On the Court of Arbitration”, “On Introducing Changes to the Code of Arbitration Procedure of Ukraine”, “On Introducing Changes to the Code of Civil Procedure of Ukraine".

⇒ In addition, based on two alternative drafts submitted by people’s deputies, a new Law of Ukraine “On Judicial System” is currently being prepared. This draft law is included in the number of urgent bills for consideration of the Verkhovna Rada of Ukraine. The Verkhovna Rada of Ukraine considers the draft laws designated by President of Ukraine as urgent on a priority basis.

III. Company Law

Recommendations:

- Develop entirely new legislation for various types of businesses based on relevant provisions of the draft Civil Code. Before preparing drafts, a decision should be taken as to whether all types of businesses should be covered in one comprehensive codification or whether separate laws should be envisaged for different types;
- strengthen shareholders' protection through appropriate provisions on management responsibilities, equal treatment of shareholders as well as provisions against conflicts of interest on the part of corporate managers, supervisors and majority shareholders;
- develop rules concerning fiduciary duties of corporate officials;
- review restrictions on corporate finance in the light of international practice;
- create a company register in line with common practice in western market economies.

Actions:

⇒ Development of new legislation for various types of businesses based on relevant provisions of the Civil Code would be possible after enacting the new Civil Code.

At this moment, the main laws of general action, which regulate activities of economic subjects, are represented by the Laws of Ukraine "On Enterprises in Ukraine", "On Entrepreneurship", "On Economic Companies", "On Property", "On Foreign Economic Activities", "On State Support of Small Business", "On the National Program for Support of Small Business in Ukraine" (according to the Law "On the National Program for Support of Small Business in Ukraine", the State Committee for Support of Entrepreneurship has developed, within its terms of reference, the Measures for Implementing the National Program for the Year 2002 approved by resolution No.463-p of the Cabinet of Ministers of Ukraine dated September 26, 2001), "On Licensing of Certain Types of Economic Activities", and others.

In addition, there are laws regulating certain sectors and types of activities, namely: "On Power Industry", "On Oil and Gas", "On Banks and Banking", "On State Regulation of Securities Market in Ukraine", "On Metal Scrap", "On Insurance", "On Credit Unions", "On State Regulation of the Production and Trade in Ethyl, Brandy, and Fruit Alcohol, Alcoholic Beverages and Tobacco Products", etc.

It is desirable that alongside with general laws specialised laws are used, which would account for the specifics of certain types of economic activities.

⇒ Collaboration between the State Commission on Securities and Stock Markets (SCSSM) and international donor organisations, including OECD, USAID, TACIS, and others has resulted in producing a number of normative documents of the Commission aimed at settling the problems related to corporate governance and strengthening the protection of shareholder (investor) rights. The most important of these are Regulations on the Procedure for Increasing/Decreasing the Authorised Fund Amount of Joint Stock Company approved by SCSSM decision No.158 of October 16, 2000, draft Law of Ukraine "On Joint Stock Companies", numerous decisions and clarifications.

The priority tasks, which could be considered as short-term operational strategy of the SCSSM in the area of corporate governance consist in eliminating the legislative lacunae, still remaining in corporate law, as well as implementing a package of measures towards introducing and developing generally acceptable principles of corporate governance, namely:

- improving the legislative base, which regulates corporate relations, primarily, through approval by the Verkhovna Rada of the Law of Ukraine “On Joint Stock Companies,” and drafting a new version of the Law of Ukraine “On Securities and Stock Market”;
- developing national standards of corporate governance/Corporate Governance Code;
- development of recommended internal documents of joint stock companies (Regulations on General Meeting of Company Shareholders, Regulations on Officials of Governing Bodies, Regulations of the Board of Directors, Regulations of the Auditing Commission, Regulations of the Supervisory Council, Statute of Joint Stock Company, Regulations on Calculation and Payment of Dividend);
- conducting educational events and introducing training programs on corporate governance.

IV. Taxation

Recommendations:

- Move ahead with the process of adopting the Tax Code, which should have the following parameters:
- improve the language of the Draft to eliminate numerous inconsistencies and ambiguities;
- follow international standards concerning the deductibility of business expenses, the determination of depreciation allowances, and the rules of accounting for income and expenses;
- rationalise the system of penalties so that the amount of the penalty bears a closer correspondence to the gravity of the taxpayer's violation;
- prior to the adoption of a new Tax Code no new legislation should be enacted that would increase the tax liability of enterprises or investors;

- establish tax ombudsman offices staffed with tax experts who would provide assistance to businesses in filing their tax declarations and in resolving problems that businesses may encounter in their dealings with the tax authorities; and
- tax authorities should also be authorised to issue written interpretations of the law to taxpayers, which would be binding on the tax authorities.

Actions:

⇒ The Verkhovna Rada passed the Tax Code in the second reading in November 2001 (Resolution No.2827-III of the Verkhovna Rada of Ukraine dated November 29, 2001). It should be noted that it is the first time that such a comprehensive document on taxation issues is ever created in Ukraine.

⇒ Finalising of the draft Tax Code is in progress, taking into account the requirements with regard to alleviating tax burden, expanding the tax base, improving the practices of tax administration and providing incentives for innovative investment activities, and including measures toward implementation of tax reform.

- in order to clearly define the types of financial aid, the draft clarifies the terms of “repayable” and “non-repayable” financial aid, as well as regulates the procedure of taxation for these types of aid;
- the criteria have been clarified with regard to referring capital assets to fixes assets, for which the taxpayer charges depreciation;
- the procedure has been settled for including an excise tax and rental payments, which pass in transit and do not affect the amount of taxed profits, into the gross revenue and total costs of payers of taxes on profit;
- the terms are finalised for including the costs related to professional training and retraining of personnel into total costs;
- the procedure is being specified for including expenditures related to voluntary life insurance of private persons into total costs;
- expenditures have been specified related to payment or accrual of interest on debt obligations, which payers of tax on profit have the right to refer to total costs;

- special procedure has been established for referring contributions for social actions to total costs;
- when preparing the draft Tax Code for consideration in the third reading and in order to bring the tax accounting closer to international rules (standards) of accounting, a new definition was introduced for the moment of emergence of gross revenues and total costs, and taxation of barter transactions based on general principles.

⇒ The level of penalties would be determined depending on the nature of violation both in absolute amount, and based on tax-free minimum personal incomes, and as a percentage of the unpaid tax liability amount.

⇒ According to the requirements of Sub-clause 2, Clause 4, Abstract of the Minutes of a Meeting of the Government Economic Development Committee of June 23, 2000, ministries and other executive agencies have been directed to abstain from initiating any changes in tax legislation before the Tax Code is approved by the Verkhovna Rada of Ukraine.

V. Property Protection and Secured Lending

1. Ownership System

Recommendations:

- Proceed with the adoption of a new land code that would liberalise private ownership of land for all purposes. Foreigners should be able to own land on the same conditions as Ukrainian citizens.

Actions:

⇒ On October 25, 2001, the Verkhovna Rada of Ukraine adopted a new Land Code of Ukraine (which became effective on January 1, 2002). This document allows finally securing ownership of land, introducing market mechanisms for management of land resources, establishing realistic prices for land, and untangling the problem of a socially equitable division of land among the population.

Approval of the Land Code of Ukraine is a logical continuation of positive trends in the development of country’s economy and the course of reform. The Land Code of Ukraine is based on the principle of precedence of private land ownership, protection of rights and legitimate interests of landowners.

⇒ A significant feature of the market orientation of the Land Code of Ukraine consists in recognising the possibility of obtaining the right of private ownership of land by private persons (citizens of Ukraine, foreign nationals, and persons without citizenship) and legal persons, territorial communities, the State, foreign states on the grounds, in the cases, and with due account for the limitations set forth by the Code.

⇒ These provisions reaffirm an important constitutional principle to the effect that foreign nationals and persons without citizenship legally residing in Ukraine should enjoy the same rights and freedoms as Ukrainian citizens.

Even so, one of the restrictions with regard to transferring land plots into ownership is contained in Article 22 of the Land Code of Ukraine, whose part four stipulates that agricultural land cannot be transferred into ownership of foreign citizens, persons without citizenship, foreign legal persons, and foreign states. Change in the purpose of land is only allowed according to the procedure stipulated by Article 20 of the Land Code of Ukraine.

2. Intellectual Property Protection

Recommendations:

- Enhance investigative powers and administrative capacities of enforcement authorities;
- increase fines for intellectual property violations;
- increase the compensation to infringed parties;
- authorise the preliminary seizure of unauthorised products by the courts; and
- develop specialised expertise within the court system, possibly by creating a special chamber for intellectual and industrial property violations.

Actions:

⇒ Articles 176, 177 of the Ukrainian Criminal Code provide for establishing liability for violation of copyright and allied rights and establishing liability for violating the rights of industrial property. According to parts one and two of Article 112, the cases involving offences falling under Article 176 and Article 177 of the Ukrainian Criminal Code are subject to investigation by investigating agencies of internal affairs, and should such an act be committed by an official, using his/her official capacity with regard to subordinate, this offence should be investigated by investigator of the Prosecutor's Office.

With regard to a person guilty of offences stipulated in Article 176 and Article 177 of the Ukrainian Criminal Code, a court might impose a penalty, in particular, of a fine at the amount of 100 to 1000 tax-exempt minimum personal incomes.

⇒ It should also be noted that the Law of Ukraine "On Introducing Changes to Certain Legislative Acts of Ukraine with Regard to Strengthening Liability for Violation of Intellectual Property Rights" No.2362-III dated April 5, 2001, amended Article 512 of the Ukrainian Code of Administrative Offences towards raising the amount of fine for violating intellectual property rights.

⇒ The grounds and procedure for conducting a pre-trial arrest of unlicensed products have been stipulated by Article 53 of the Law of Ukraine "On Copyright and Allied Rights".

According to part two of the said article, if there are sufficient data on committing such violation of copyright and/or allied rights, which entail criminal liability under law, the agency of inquiry, investigation or a court are obliged to take action to assure search and seizure of:

- copies of products (including computer software and databases), recorded performances, phonograms, video recordings, broadcasting programs, which are assumed to be infringing articles, as well as the means of defeating technical copyright protection systems;
- materials and equipment intended for their manufacture and reproduction;
- documents, invoices, and other articles, which could serve as proof of illegal actions.

⇒ On January 30, 2002 the President of Ukraine signed the Decree on Urgent Activities to Increase the Copyright Protection in the Process of Production, Export, Import and Distribution of Laser Compact Discs.

4. Loan Guarantees

Recommendations:

- Create the legal framework for an active loan market and reduce the government budget deficit.

Activities:

⇒ National Bank of Ukraine has already developed a number of documents to develop mortgage-lending system in Ukraine.

First of all, the Draft Law of Ukraine On Mortgage Lending and Factoring Transactions with Mortgage Liabilities submitted to Verkhovna Rada for review, deserves attention. The Draft Law has an objective to regulate legal relationships concerning the alienation by the mortgagee of debtors' liabilities that occurred with regard to mortgage loans, the payments on which should be protected from an inflation-associated devaluation, while the mortgages should be able to freely alienate the liabilities on them.

In addition, in compliance with an assignment of the Cabinet of Ministers of Ukraine (CMU) the National Bank of Ukraine developed a Draft Law On Specific Features of the Establishment and Operations of Mortgage Institutions in Ukraine.

⇒ The National Bank of Ukraine has also developed a Draft Structure for the Draft Law On Land Evaluation, the development of which was envisaged by the Land Code of Ukraine and by the Resolution of the CMU dated 10.01.2002 No. 6.

⇒ Currently a Draft Decree of the President of Ukraine On Measures to Develop the Mortgage Market in Ukraine is being developed at the National Bank of Ukraine, as well as proposals for a Draft Law On Mortgage.

VI. Financial sector

1. Banking activities

Recommendations:

- Consider confining the “Council of the NBU” to an advisory role in order to dispel doubts about the NBU’s independence;
- Proceed with the adoption of the law on banks and banking but review the remaining restrictions on foreign bank operations in favour of a national treatment policy.
- Require audits in accordance with International Auditing Standards for all banks.
- Enact legislation on the bankruptcy of banks providing effective protection of depositors.
- Reconsider plans of introducing a national deposit insurance system.
- Restructure the Savings Bank.
- Liquidate unhealthy banks.

Actions:

⇒ Most transition economies have central bank councils, the functions of which are limited to counselling on monetary and credit policy, or have an advisory character. In Ukraine, the NBU Council has a wide range of responsibilities established by Article 9 of the law “On the National Bank of Ukraine;” exercising these responsibilities may contradict NBU activities in the operational regulation of monetary and credit market, although it often comes too late.

Taking these aspects into account, we consider that it would be expedient to initiate amendments to the applicable law “On the National Bank of Ukraine,” with a view to limiting the role of the NBU Council to an advisory one.

⇒ In December 2000, a new law “On Banks and Banking Activities” was adopted. The law established some additional requirements to the creation of banks with foreign capital, as well as specific features of the registration of banks with foreign capital. The provisions of this law do not envisage any limitations to the participation of foreign capital in the banking system of Ukraine.

The National Bank of Ukraine is developing a Draft Law ‘On Changes to the Law on Banks and Banking Activities’ as a legislative initiative; these changes would, for instance, include the following provisions: to cancel requirements to obtain preliminary allowance in order to set up a bank with foreign capital, and to amend the law with specific provisions with regard to the registration procedure for the affiliated branches of the foreign banks.

⇒ To date, Ukrainian audit companies and auditors execute the audit of the banks in accordance with the National Audit Norms, approved by the decision of the Audit Chamber of Ukraine as of 18.12.98 No. 73, that were developed on the basis of International Audit Standards.

⇒ According to the Law On Banks and Banking Activities, the supervisory responsibilities of the National Bank of Ukraine should be applied not only to the banks, but also to the entities that have a direct relationship to the bank activities as affiliated branches and subsidiaries of the banks or foreign banks institutions in Ukraine. Such approach has the aim to prevent a negative influence on the financial performance of the bank and to create guarantees for the protection of the interests of the bank clients.

On September 20, 2001, the Verkhovna Rada passed the Law On the Guarantee Fund for the Deposits of Individuals establishing the procedures to reimburse depositors of the banks, which participate in the Fund. The law establishes that the Fund shall guarantee to all depositors of the banks, which participate in the Fund, that their deposits, including interest, will be reimbursed in the amount of deposits on the day of occurrence of deposit inaccessibility, but not more than UAH 1,200 per deposits in each of such banks.

⇒ A comprehensive program to restructure the Savings Bank of Ukraine is being developed in cooperation with the International Monetary Fund within the Extended Fund Facility (EFF) program, and with the World Bank taking into consideration the conclusions of the inspection held in 2001. The program will envisage specific measures to improve the Savings Bank operations in accordance with all prudential NBU requirements.

In order to ensure the financial stability of the Savings Bank and to protect the interests of its depositors and creditors, on April 13, 2001 the National Bank of Ukraine signed a written agreement with the Savings Bank, according to which the Saving Bank undertook to implement a whole range of measures in 2001 to facilitate the stable banking activity, rule out the violations of banking legislation and adhere to the regulatory and legal acts of the NBU and to the internal regulations of the Savings Bank.

During 2001, on a monthly basis, the National Bank of Ukraine monitored the adherence to the provisions of the said agreement, in particular, compliance with the economic standards, norms of compulsory reserves, reserve forming to cover possible expenditures of the active transactions, etc. In addition, the NBU reviewed on a monthly basis how the Savings Bank adhered to the schedule of indebtedness for the organisations of fuel and energy complex (FEC). The amounts of indebtedness of FEC enterprises before the Savings Bank are gradually decreasing.

The issue of the allocation of UAH 87.1 million from the State Budget to replenish the Savings Bank capital on an irrevocable basis has also been positively resolved.

In compliance with the assignment of the President of Ukraine as of 25.12.2001, the National Bank of Ukraine together with the Cabinet of Ministers of Ukraine elaborated the issue of the Savings Bank activities and sent a letter to the President of Ukraine with the proposals to determine the terms and approaches to solve the problems of the Savings Bank.

In the end of the last year a routine annual comprehensive inspection of the Savings Bank was completed and its findings were discussed at the meeting of the NBU Commission on Supervision and Regulation of Bank Activities. These findings are now being studied in detail.

⇒ As of 01.01.2002 thirty five commercial banks were undergoing a liquidation process; 17 of these banks were being liquidated by the decision of the National Bank of Ukraine, 15 banks – by the decision of economic courts and 3 banks – by the decision of the shareholders' meetings.

Since the beginning of 2001 several banks were excluded from the State Registry of the Banks; six of them were excluded due to the completion of a liquidation process, and three banks – due to reorganisation, as they were affiliated with other banks.

⇒ In order to increase the efficiency of liquidation procedures and to discuss the current situation in the banks under liquidation, a series of consultations was held with the representatives of liquidation commissions and territorial divisions of the National Bank of Ukraine.

2. *Capital Market*

Recommendations:

- Develop legislation to define clearly the fiduciary duties of financial intermediaries (especially investment funds, investment companies and securities traders) and ensure proper enforcement of these duties.
- Strengthen the self-regulatory system of securities traders with a view to raising professional standards.
- Consider reducing the number of trading systems to consolidate the market.

Actions:

⇒ The "General Approaches to the Development of Stock Market in Ukraine in 2001-2005, were approved by the Decree of the President of Ukraine No. 198/2001 as of March 28, 2001. Item 20.21 of the Measures to Implement these General Approaches envisages "approval of the requirements to the professional associations of the stock market participants as to the self-regulated organisations" and "a gradual transfer of the part of responsibilities for the pre-license activities, training, re-training and initial certification of the specialists to self-regulated organisations with a simultaneous strengthening of control over their activities".

⇒ It is considered expedient that the task of determining the fiduciary obligations and to ensure a proper compliance with these obligations should be transferred to the self-regulated organisations of the professional stock market participants, as well as the function to organise respective divisions (for instance, courts of arbitration, etc.), which would facilitate the proper compliance with the obligations based on the mutual trust.

⇒ There are no current plans to consolidate trading systems.

3. *Accounting and Auditing*

Recommendations:

- Align speedily Ukrainian accounting and auditing standards with international practice, in particular for publicly traded companies and financial institutions (reference points are the International Accounting Standards, as developed by the International Accounting Standards Committee, and International Standards of Auditing, as developed by the International Federation of Accountants).

- Modify the Ukrainian commercial chart of accounts to facilitate the application of internationally recognized accounting standards. (“Companies are still required to produce two separate sets of accounts, one for tax purposes, the other for financial reporting.”)
- Ensure that financial statements are tax neutral and use a reconciliation statement to link tax computation to such financial statements.
- Implement effectively the existing 1998 Presidential Edict and the October 2000 Law “On Small and Medium-Sized Enterprises” for a simplified reporting system for SMEs.

Actions:

⇒ According to the Law of Ukraine “On Accounting and Financial Reporting in Ukraine,” which establishes the legal foundation for the regulation, organisation and keeping of accounting and financial reports in Ukraine; and to the resolution of the Cabinet of Ministers of October 28, 1998 No. 1706, “On Approval of the Program to Reform the Accounting System in Conformance with International Standards,” financial records of economic entities shall be maintained on the basis of the national accounting standards that are co-ordinated with international accounting standards (IAS). The Ministry of Finance has approved 25 provisions (standards) of accounting, taking into consideration the economic and legal environment in Ukraine; in general these standards are consistent with IAS.

⇒ On September 30, 1998 the Ministry of Finance of Ukraine issued Instruction No. 196, which approves the “Provisions for Simplified Accounting Method for Small Businesses,” that are recognized as subjects of small entrepreneurship in accordance with the applicable legislation; the Provisions came into force in the beginning of 1999.

⇒ Instruction No. 39 of the Ministry of Finance of February 25, 2000 approves a shortened financial reporting for small businesses, while the Instruction on “Procedures to Introduce the Chart of Accounts” also envisages the shortened correspondence of entries in the accounting registries of such subjects.

VII. Trade and Currency Regimes

Recommendations:

- Adopt and implement international trade policy disciplines and commitments, which would facilitate Ukraine's accession to the World Trade Organisation;
- Remove remaining non-tariff trade barriers and, especially, bring the country's technical standards and certification procedures in conformity with international practice; and
- Review the suitability of currency regulations, notably the exports proceeds surrender requirement.

Actions:

⇒ In order to bring the national legislation in correspondence with the requirements of GATT/WTO system, Ukraine developed the Schedule of Introduction of Priority Draft Legislation that included 20 draft laws, including such important acts as Customs and Tax Codes, Laws on Insurance Services, on Copyright, on the Regulation of Agricultural Production, and sent this document to the Working Group member-countries on the admittance of Ukraine to WTO.

⇒ To date, the Verkhovna Rada of Ukraine passed 16 of 20 draft laws of the Schedule, including the Customs Code. The legal environment has been significantly changed in such important sphere of trade relations as trade aspects of copyright. Verkhovna Rada of Ukraine passed 7 laws that bring the national copyright protection system in conformity to international requirements.

⇒ On January 30, 2002 the President of Ukraine signed the Decree on Urgent Activities to Increase the Copyright Protection in the Process of Production, Export, Import and Distribution of Laser Compact Discs.

⇒ On September 5, 2001, and Edict of the President of Ukraine on "Additional Activities to Facilitate the Entry of Ukraine to WTO" became effective, which envisaged the implementation by the Government and certain bodies of executive power of a range of political and organisational activities aimed at an urgent completion of negotiations about the admittance of Ukraine to WTO.

In compliance with the Presidential Decree, the government developed the Program of Activities to Complete the Entry of Ukraine to WTO, which presents a comprehensive plan for the central executive government to efficiently prepare and conduct negotiations about the entry of Ukraine to WTO in order to complete the process as soon as possible.

⇒ In order to reduce the non-tariff barriers to trade, to create favourable conditions for economic growth and to protect Ukrainian citizens from low quality and unsafe products, the national system of technical regulation is being reformed.

The priority area in the reform of the technical regulation system is its adaptation and convergence to the European practice in accordance with article 51 and 56 of the Agreement on Partnership and Cooperation between Ukraine and EU (APC) and with the requirements of GATT/WTO.

⇒ On June 20, 2001 the laws On Standardisation, On Accrediting of the Bodies Assessing Conformity, and On Confirmation of Conformity became effective.

The adopted laws in the sphere of technical regulation correspond to the objectives to reform the national economy and have been developed in an absolute accordance with the requirements of the Agreement on Technical Barriers in Trade (TBT) of WTO.

Adoption of these laws corresponds to the needs and requirements of Ukrainian industry, of the trade partners and ensures the recognition of the national technical regulation system, the elimination of technical barriers in international trade, mutual simplification of the products access to the market.

⇒ Agreements were signed to develop 11 normative and legal acts (technical regulations) on the basis of the New Approach European directives. State Standardisation Committee determined the methodology for the development of technical regulations on confirmation of conformity on the basis of the New Approach European directives; the respective recommendations were given to the managers of organisations involved in the development of the technical regulations. In accordance with the Provision on Working Groups to develop draft normative and legal acts of Ukraine taking into account the main provisions of EU Legislation, approved by the resolution of the 5th session of Inter-sectoral Council for the Co-ordination of Ukrainian legislation with the EU legislation (ICC), the State Standardisation Committee issued an instruction as 19.11.01 No. 551, to create the working groups in order to develop and follow up the legislative process of the above technical regulations.

Heads of the working groups were assigned. Working groups' composition was formed with the consideration of ICC recommendation. By 01.02.01 the first versions of technical regulations on the confirmation of conformity had been developed on the basis of the New Approach directives, including Modules to Assess Conformity and Rules to Mark and Use the National Conformity Sign.

⇒ Harmonisation of standards occurs in accordance with the Standardisation Plan for 2001, approved by Resolution No. 277-p of the Cabinet of Ministers of 11.07.01. It envisages the development of over 1,300 national standards that would introduce international standards. By year-end 2001, 293 standards had been approved. The Standardisation Plan for 2002 is being developed.

⇒ According to Edict No. 797 of the President of Ukraine of 05.09.01 it is planned to introduce at least 500 standards co-ordinated with the international and European ones on an annual basis.

VIII. Privatisation and Enterprise Reorganisation

1. Privatisation

Recommendations:

- Expand the list of privatisable large-scale enterprises, especially extending privatisation to energy and telecommunications (taking into account developments in OECD market economies);
- Develop a transparent, predictable, methodical and stable process for case-by-case privatisation;
- Establish clear qualification requirements for the selection of privatisation advisers;
- Announce publicly the planned privatisations well in advance, and provide full information on the financial situation of the enterprises concerned;
- Offer equal participation conditions for all parties concerned that cannot be changed after such an announcement;
- Ensure that the tender commission be independent with no interference in the commission's activity unless otherwise stipulated by current legislation;
- Ensure that there must be no investment request prior to the sale.

Actions:

⇒ The privatisation of the electric power sector is under way. In 2001, controlling stakes of 6 power companies were successfully sold. Currently, the State Property Fund has submitted to the Cabinet of Ministers the refined plans for the placement of controlling stakes of 9 power companies, the sales of which is planned to be completed in the current year. It is also planned to complete privatisation of those power companies, in which the state does not have majority ownership. At the same time, opportunities for further privatisation of heat supply and energy-generating companies are being considered.

⇒ Current plans call for the completion of a privileged subscription to the shares of Open Joint-Stock Company "Ukrtelecom" by February 1, 2002.

⇒ The Law of Ukraine "On the State Privatisation Program for 2000 – 2003" established transparent privatisation procedures, including privatisation of strategically important enterprises. The State Property Fund of Ukraine (SPFU) is developing and publishing the schedules of share sales, unfinished construction objects, and so on.

⇒ In order to consolidate efforts of government institutions, private sector and international organisations with regard to further improvement of the privatisation process in Ukraine through the analysis of the process and through the development of recommendations based on the best international practice and Ukrainian privatisation experience, an Advisory Group on Privatisation was established.

On the basis of the Group's meetings, the criteria for transparent privatisation that correspond to the best international practice were determined:

- Public announcement of the auction, which should contain clear and complete information about the auction conditions;
- Equal conditions for all interested parties;
- Majority shareholding should be offered for sale at the privatisation auction;
- Price offered by a buyer is the only criterion to make decision about the winner; there should not be investment demands before the sales;
- In cases when advisors are invited to assist in privatisation process, they should meet clear qualification requirements;

- After the auction announcement, the auction procedures and conditions of privatisation cannot be changed;
- Tender commission should be independent; any interference in the commission activities is prohibited;
- Free access to a company being privatised should be ensured, including site visits to the enterprise, cooperation with its management, obtaining of financial and operational information about the company.

It should be noted that the above criteria correspond to the OECD recommendations.

The Advisory Group on privatisation is permanently analysing the conformity of privatisation transaction to the transparency criteria. The last meeting of the Group concluded that most privatisation transactions of 2001 were in line with these criteria.

⇒ Qualification conditions for the privatisation advisors have been developed and set forth by the SPFU.

⇒ Information about the scheduled auctions is published in the mass media in the legally established terms. Financial information about the auctioned object is provided in sufficient amounts. When strategic enterprises are offered for bids, an investor can obtain more detailed information about the financial status of the object that is being privatised. Procedures of information provision and its volume correspond to international standards.

⇒ The conditions of sale of an object to be privatised are not subject to change.

⇒ Tender commissions are independent according to the Law of Ukraine. There are no exclusions from this provision.

⇒ According to the Law of Ukraine “On the State Privatisation Program for 2000 – 2003,” the auction conditions at which shares are sold do not envisage demand for the buyers to make investments as a precondition of a contract.

2. *Legislation on Bankruptcy*

Recommendations:

- Simplify the initiation of bankruptcy proceedings to the extent possible by all parties and, in particular, lift the requirement that creditors must have their claims confirmed by a court decision before filing for bankruptcy, even if their claims are undisputed or otherwise obvious.
- Launch comprehensive training programmes for bankruptcy judges and trustees in bankruptcy.
- Enhance the abilities of bankruptcy judges in handling intricate business processes and protecting creditor and shareholder interests, perhaps by creating a centralised pool o specialised bankruptcy judges and assigning complex bankruptcy / reorganisation cases to them.

Actions:

⇒ Procedures to initiate bankruptcy case have been maximally simplified for all parties. In case of cancellation of the requirement that the creditors should have a court confirmation of their demands, economic courts will be overloaded trying to recognise the irrefutability of the creditors' demands due to the objections of the debtors.

⇒ Conditions and procedures of the restoration of solvency of a subject of entrepreneurial activities, or its recognition as a bankrupt and initiation of a liquidation procedure, of the full or partial satisfaction of the creditors' demands, are established by the Law of Ukraine as of 30.06.99 "On Making Changes to the Law 'On Bankruptcy", in which the latter law is stated in the following wording: "Law of Ukraine on Restoration of Solvency of a Debtor, or on Recognising as Debtor".

This law defines the creditor as a physical or legal entity that has legally and documentarily confirmed financial claims to the debtor, as well as the state tax institutions and other governmental institutions that exercise control over the correct and timely payment of taxes and dues (compulsory payments).

⇒ On January 10, 2002 the Verkhovna Rada of Ukraine adopted the first reading of the draft law "On Making Changes to Some Laws of Ukraine" developed by the Ministry of Economy and European Integration of Ukraine together with the interested ministries and institutions. This draft law envisaged that during the review of a bankruptcy case of an especially hazardous enterprise, or natural monopoly, the chairman or deputy chairman of an economic court can appoint two additional judges to the court composition and appoint one of them to be the chairman.

IX. Public Governance

Recommendations:

- Reorient government bureaucracy from micro-management of the economy to the strategic formulation of framework conditions conducive to private sector development;
- Restructure government bureaucracy with a view to enhancing efficiency, transparency, accountability, predictability and integrity;
- Develop the legal system and, above all, put in place an institutional infrastructure with a view to ensuring effective and consistent protection of contracts and property rights as well as protection of business operators against the misuse of power on the part of public authorities;
- Enforce hard budget constraints, in both the public and private sectors;
- Continue with deregulating business activities, with a particular view to fostering SMEs;
- Carry out and expand the envisaged privatisation of large state enterprises; and
- Consider making greater use of the Antimonopoly Committee for advice on the impact on Ukrainian consumers from existing and proposed subsidies and regulatory policies, including those relating to privatisation and regulation of enterprises with some "natural monopoly" component.

Actions:

⇒ The President of Ukraine issued the following relevant Edicts: 'On the System of Central Executive Government Bodies, No. 1572', 'On Changes in the Structure of Central Executive Government Bodies, No. 1573', On the Composition of the Cabinet of Ministers of Ukraine, No. 1574' of December 15, 1999; 'On Strategy to Reform the System of Public Service, No. 599' of April 14, 2000; and 'On the Next Steps to Further Implement the Administrative Reform, No. 345' of May 29, 2001.

⇒ A draft Law on "Strengthening of the Guarantees to Protect the Rights and Legal Interests of the Subjects of Economic Activity" is now under consideration of Verkhovna Rada of Ukraine, its aim being the provision of appropriate legal protection of rights and legal interests of the individuals and legal entities – subjects of economic activity – from illegal decisions or actions, or inactivity of the state and local authorities and their officials.

⇒ A draft Law "On Changes and Amendments to the Legislative Acts of Ukraine as for Increased Responsibility of Governmental Officials in the Process of Inspections of the Subjects of Economic Activity" has been developed.

⇒ A Concept of performance of economic activity by executive bodies has been developed. The Concept determines the necessity for regulation, the principles of implementing and stages of reforming of business activity by executive bodies as for the provision of paid services to the subjects of business activities and to the population, and will facilitate the creation of the efficient system of public administration and to the improvement of services provided by the executive bodies.

⇒ Instruction of the Cabinet of Ministers of Ukraine as of 26.09.01 No. 463-p approved the "Measures to Implement the National Program to Support Development of Small Businesses in Ukraine for 2002", that included the development of normative and regulatory acts on the increase of personal responsibility of the executive power and local self-government officials for the decisions that worsen conditions for business activities, or for a coerced attraction of finances of businesses to any undertakings, including to the funds, the establishment of which has not been envisaged by the Ukrainian legislation, or if the donation of funds into them is voluntary. The above activities envisage public discussion of the draft regulations, which may significantly influence the market environment, or affect the rights and legal interests of the businessmen.

⇒ According to the adopted Law "On Licensing of the Certain Kinds of Economic Activities," uniform standard license is the only document allowing performance of certain kinds of activities. The Law determines the kinds of economic activities that are subject to licensing, regulates governmental control over the licensing process and responsibility of the subjects of economic activities and licensing bodies for the violations of the licensing legislation.

⇒ Privatisation of the energy sector is under way.

⇒ On January 11, 2001 the Verkhovna Rada of Ukraine passes the Law "On Protection of Economic Competition," which establishes the legal grounds for support and protection of the economic competition, the limitations of monopoly in business activities, and which is aimed at the provision of an efficient functioning of the Ukrainian economy on the basis of the competition relationships development. The Law will become effective on March 2, 2002.

⇒ In compliance with the provisions of article 44 of the Law On Protection of Economic Competition, currently a Draft Law "On Provision of Evidence in Cases Reviewed by the Bodies of Antimonopoly Committee of Ukraine" is being developed.

⇒ Draft Concept of the Competition Procedure Code of Ukraine has been developed and submitted to the Cabinet of Ministers of Ukraine for review. The Concept objective is to determine the basic procedure principles regarding the examination by the Committee of the cases related to co-ordinated actions and concentration of business entities, and actions aimed to disclose, terminate and prevent the violations of the competition legislation, to call the violators to account, as well as to execute, appeal, check and review the decisions made by the Committee bodies.

⇒ The Antimonopoly Committee took part in the development of proposals on the need to set up the National Commissions in the transportation and communication industries. This would have a positive effect due to the renunciation of sectoral approaches to the formation of prices and tariffs for the services in transport and communications spheres.

⇒ In order to improve the tariff policy for natural monopolies, new normative documents were adopted that determine the procedures to form prices and tariffs of the natural monopoly entities, and to set up cost and revenue standards. Also, the new regulatory acts were passed on the paid services that can be provided by budget funded institutions and organisations administered by the State Water Industry Committee; as well as a number of changes and amendments to the methodology to calculate retail tariffs on electric energy, as well as on the transportation of passengers, luggage and commodities by the railroads.

⇒ In order to improve the governmental regulation of prices on the monopolised markets of compulsory security services, the Ministry of the Interior of Ukraine, in cooperation with the Ministry of Economy and European Integration of Ukraine, issued a joint instruction, co-ordinated by the Antimonopoly Committee, that approves the Methodology to Determine Prices on the Services for the Protection of Objects that Are Subject to Compulsory Protection by the divisions of State Security Service at the Ministry of the Interior of Ukraine.

⇒ Provisions of the Decrees by the President of Ukraine 'On Activities to Provide Support and Further Development of Business Activity' and 'On Activities to Develop Co-operative Movement and to Strengthen its Role in the Reforming of the Economy of Ukraine' are aimed at the realisation of constitutional rights of the citizens to carry out business activity and at the development of the co-operative sector of economy. The Law "On Credit Unions" was adopted and draft legislation "On Co-operatives" was submitted for consideration to Verkhovna Rada of Ukraine to implement provisions of the mentioned Decrees.

⇒ The State Committee on Entrepreneurship has developed the Draft Law "On Basic Principles of Control over the Activities of Business Entities in Ukraine."

⇒ The Law "On Financial Services and State Regulation of the Financial Services Market" was adopted to create the legal basis for the protection of interests of the financial services' consumers, for the legal support to the activities and for the development of the competitive financial services market in Ukraine.

⇒ Introduction of the above mentioned measures and realisation of activities of the National Program to Support the Development of Small Businesses for 2001, and of the regional programs on small businesses development for 2001-2002 facilitated the removal of bureaucratic obstacles to the organisation of businesses, made crediting conditions much easier and reduced taxes. According to the State Statistics Committee, there were 227,000 small businesses (excluding agricultural enterprises and banks) on October 1, 2001, employing some 1.7 million people. These figures represented an increase of 17,000 enterprises during the first 9 months of 2001, and of 84,300 employed persons.

⇒ Central and local executive bodies created working groups to revise their own decisions and to bring them into conformity with the market relations in order to decrease administrative interference into business activity and to comply with Instruction No. 1090/1 of the Cabinet of Ministers of 26.01.2000.

As a result of revision of their own normative and legislative acts during 2000-2001, central and local executive bodies revealed 385 normative and legislative acts that did not correspond to the market relations demands. Out of that number, 325 acts, that is, 84.4 % of the total, were cancelled or substantively changed, and only 60 of them remained unchanged.

⇒ In order to reduce the number of government bodies that are entitled to inspect the activities of business entities, to set up the clear regulation of rights and competencies of the controlling bodies that are responsible for the execution of inspections, the State Committee on Entrepreneurship developed the Draft Law "On Basic Principles of Control over the Activities of Business Entities in Ukraine;" currently this Law is undergoing co-ordination in the interested bodies of central executive power.

X. Deterrence of corruption

Recommendations:

- Carry out administrative law reforms introducing clear, simple and publicly available rules governing public administration and reducing officials' discretionary powers to the extent possible (The pending work on a law on administrative procedures plays a central role in this context);
- Advance public sector reorganisation to increase transparency and accountability of officials. In this context, the powers of the State Auditing Chamber should be strengthened, and the office of an Ombudsman for Public Service Integrity could be established, possibly associated with the State Auditing Chamber;
- Introduce judicial reforms designed to enhance judicial review of misuses of power. In addition to the envisaged creation of an administrative court system, remedies for private parties could be strengthened to assert rules of fair play, including actions by non-governmental groups and associations;
- Promote civil service reform to afford public servants an adequate remuneration and a clear career track that motivates professional behaviour;

– Intensify privatisation to remove opportunities for misallocation of public resources. Extend privatisation to the provision of infrastructure and public services wherever feasible with a view to introducing competition between public and private providers;

– Introduce measures to encourage cash transactions instead of barter trade;

– Introduce a system of codes of ethics for certain professions (e.g. legal, accounting professions) and business sectors (e.g. financial intermediaries) creating peer pressures against illicit conduct;

– Participate in efforts to combat bribery of foreign public officials in international business transactions in accordance with the 1997 OECD Convention.

Actions:

⇒ The main areas for the development and reform of administrative legislation are envisaged in the Draft Reform Concept, which is now being discussed at the Verkhovna Rada of Ukraine.

⇒ According to Section III of the Administrative Reform Concept, the main attention will be focused on the legislative solution of the issues in the system of mutual relationships and in the structure "government bodies system – government body – government official". This envisages implementation of the Laws 'On the Cabinet of Ministers of Ukraine', 'On Ministries and Other Central Executive Bodies', 'On Local Public Administrations', as well as of the regulatory acts on the distribution of authorities of local public administrations and local self-governments based on the functional analysis of the competences and responsibilities of these bodies.

⇒ The Law of Ukraine "On Local Public Administrations" has already been adopted.

⇒ The foundation for the legislative regulation in the sphere of public administration will be laid by the Law "On the Cabinet of Ministers of Ukraine" passed by the Verkhovna Rada on January 17, 2002. This law is being considered by the President of Ukraine.

⇒ The Cabinet of Ministers is now reviewing the Draft Code of General Administrative Procedures in Ukraine.

This Code establishes the principles of legal regulation of the procedures to develop, adopt or appeal against the individual administrative acts of the central executive bodies, local self-governments and their officials with regard to the realisation of rights, freedoms and legal interests of physical and legal entities. The Code norms are aimed at the improvement of mutual relations of the authorised bodies and officials with the population, at the limitation of the manifestations of bureaucracy and self-will on the part of government officials.

⇒ The creation of an efficient system of government control in the sphere of executive power activities is very important for the legal support to administrative reform. The Law of Ukraine on State Control over the Activities of Executive Bodies and Their Officials that is now being developed by a working group will facilitate the achievement of the above objective.

INVESTOR FRIENDLY TAX LEGISLATION

Ivan Yakushik[*]

Overview

Ukraine has made its choice with regard to its future socio-economic development. This is a choice in favour of Europe and the Ukrainian Government is determined to adapt the country's legislative system to the standards of the European Union. The main guidelines for the tax policy are intended to stimulate the accumulation of capital, investment activities, innovative activities, improve competitiveness of domestic producers, create favourable conditions for development of private enterprise, and reduce the size of the illegal "shadow" economy.

Unified Tax System

The Ukrainian Ministry of Finance, acting within its terms of reference, aims to implement a unified tax policy, whose main objective for the immediate future is to attract foreign and domestic investments. Let me highlight the fundamental tenets of our tax policy as it relates to foreign investment.

International experience is replete with evidence that the appeal of the tax legislation from the point of view of attracting investment depends, primarily, on its stability. That is why our government pays special attention to adopting the Tax Code of Ukraine, which should serve as guarantor of tax legislation stability in the State. The issue of adopting the Tax Code remains the priority on the government agenda and we anticipate the problem to be resolved this autumn.

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The second important aspect in stimulating inflow of investments to Ukraine is to provide a moderate tax burden. In this respect, it is anticipated to prepare and introduce changes to the existing tax legislation in order to significantly reduce the tax rates in the first half of 2002. A draft Law of Ukraine “On Personal Income Tax” has already been prepared, which, instead of the existing five income tax rates of 10-15-20-30-40%, proposes to introduce the lower rates of 10-15-25%. Also, the income range taxed at 10 % is significantly expanded.

We believe that easing of tax burden on private individuals will help promote private savings, which can be used in the country’s domestic market, giving an additional impetus to development of processing industries and, in the final account, will give an additional incentive to investing in Ukraine. In addition, reduced tax burden on personal incomes of individuals will reduce the size of unreported incomes and increase savings.

The rate of tax on profits is expected to decrease from 30% to 25 %, that of value-added tax will be reduced from 20% to 17 % with simultaneous abolishing of tax privileges. Tax on dividends will be set at 15 %. We hope that these changes would be incorporated in the Ukrainian State Budget for the year 2003. The same positions will be preserved in the Draft Tax Code, where, in addition to the above, it is expected to reduce the list of the effective taxes and fees and leave only those, which are economically justified and whose collection is not excessively complex. This will also contribute to alleviation of the tax burden.

In order to attract investments to Ukraine, special (free) economic zones of various functional types have been created: free customs zones and ports, export zones, transit zones, technological parks, “technopolices”, integrated production zones, tourist zones. Currently, there are 11 special economic zones in Ukraine, nine territories of priority development, and three technological parks, which enjoy substantial tax remissions. The Draft Tax Code also maintains this approach and the free economic zones, which provide for maximum efficiency, will be preserved until 2004-2006.

Tax privileges conducive to attracting investment in Ukraine and those in effect today, will be preserved in the Draft Tax Code. The most important among these include exemptions from the tax on profits and value-added tax for international technical and humanitarian assistance and direct investments.

The Law of Ukraine “On Production-Sharing Agreements” has been adopted in Ukraine. This Law provides numerous tax incentives to investors exploiting mineral deposits in Ukraine. This Law has been taken into account in the Draft Tax Code and special tax regime for investors preserved.

We also believe that establishment of transparent, democratic rules for administration of taxes is one of the most important factors in attracting investment. Ukraine has progressed significantly on this road with the passing of the Law of Ukraine “On the Procedure for Repaying Debt Obligations of Taxpayers before Budgets and State Special-purpose Funds”. The law abolishes “kartoteka”, cancels the procedure of mandatory collection from debtor taxpayers, unifies the terms for submitting tax returns, introduces the process of tax appeals and tax compromise.

III. ASSESSMENT OF UKRAINE’S POLICY REFORMS

MACROECONOMIC SITUATION AND OUTLOOK

Ricardo Giucci and Veronika Movchan[*]

Macroeconomic Situation

Ukraine's macroeconomic performance in 2001 was impressive and can be summarised thus: high growth; external stability; low inflation; and low fiscal deficit.

High growth **-** Economic growth in 2001 amounted to 9 %. Investment in fixed capital grew by 17.2% (Figure 1), accounting for almost one half of the total real GDP growth.[1] Contrary to the widely held view, net exports did not make a sizeable contribution to growth in 2001.

The largely investment-led growth was facilitated by increased credits, extended to enterprises by commercial banks. Outstanding credits grew by 46% in 2001. This lending activity was in turn made possible by an increase in deposits by 37%.

External stability **-** Both exports and imports grew significantly in dollar terms in 2001 (Figure 2). According to the State Committee of Statistics, the growth rate of merchandise exports was 11.6%, while imports increased by 13%. This rise is smaller in real terms, because of the real appreciation of the Hrivna relative to the US dollar in 2001.

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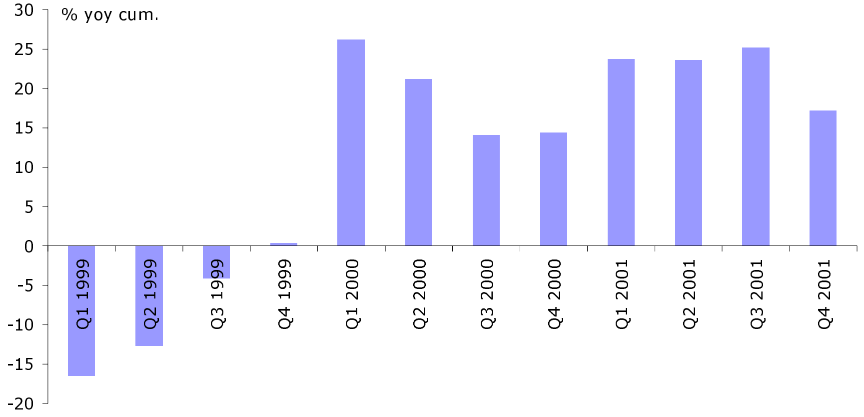
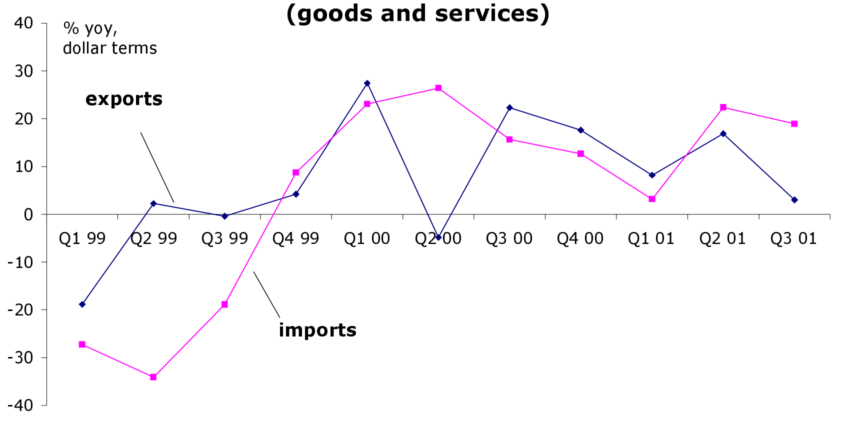
1 Exact figures on the contributions to real growth by private consumption, investment, government expenditures and net exports are not presented because of statistical discrepancies.

Figure 1. Investments in Fixed Capital



Source: State Committee of Statistics

Figure 2. Dynamics of Exports and Imports (goods and services)

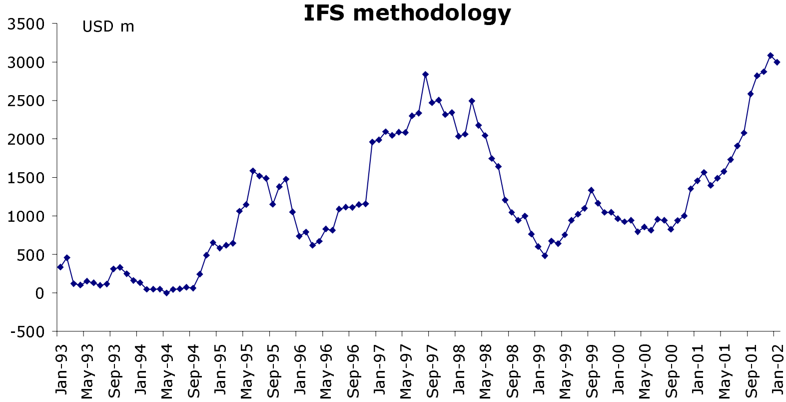


Source: National Bank of Ukraine, own calculations

The merchandise trade balance posted a surplus of $ 490 million[1], which helped the National Bank of Ukraine (NBU) to replenish its gross reserves of foreign exchange (Figure 3) and to keep the external value of its currency stable. An appreciation of 2.6% relative to the US dollar took place in 2001.

1 Source: State Committee of Statistics.

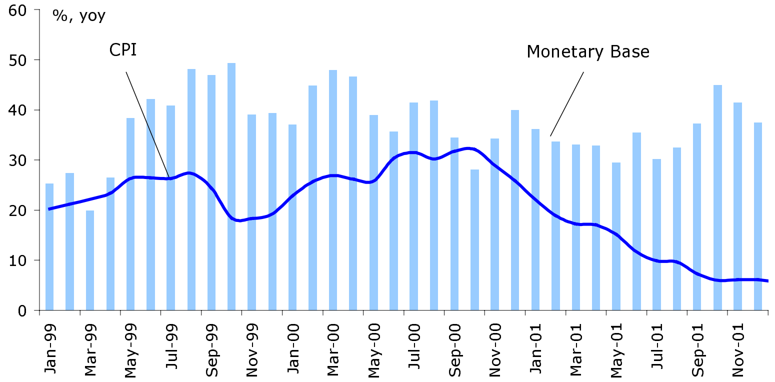
Figure 3. Total International Reserves minus Gold, IFS methodology



Source: International Financial Statistics (IFS), National Bank of Ukraine

Low inflation **-** The net purchases of foreign exchange by the NBU in 2001 resulted in a significant expansion of the monetary base (37.4%). Thanks to high economic growth and further monetisation of the economy, this monetary expansion did not produce a high rate of inflation, as was the case in 2000 (Figure 4). The inflation rate (CPI) came down from 25.8% in 2000 to 6.1% in 2001.

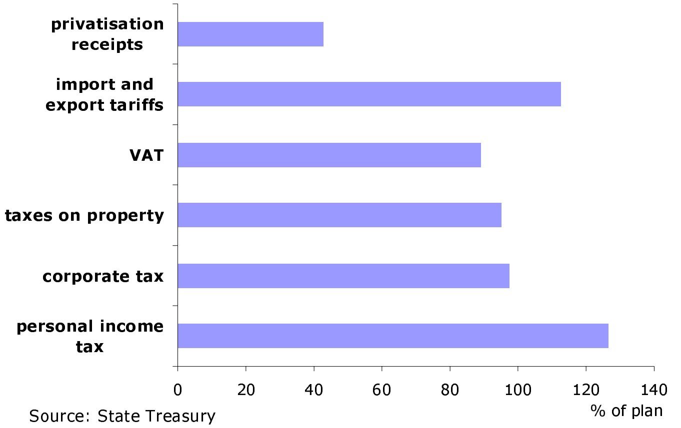
Figure 4. Monetary Base and Price Developments



Source: State Committee of Statistics, National Bank of Ukraine

Low fiscal deficit **-** According to preliminary figures, the consolidated fiscal deficit amounted to 0.5% of GDP in 2001. Thus, the goal of a zero budget deficit was almost achieved. But behind this apparent success lie a number of serious fiscal problems. In spite of higher than expected economic growth, corporate income revenues were under-executed, partly because of significant tax write-offs and restructuring. VAT revenues were also under-performing, despite a considerable build-up of state debt to exporters and other enterprises for VAT refunding. Privatisation receipts were also significantly under-performing. These shortfalls were partially compensated by a considerable over-execution of personal income taxes as well as import and export tariffs (Figure 5).

Figure 5. Consolidated Budget Execution in 2001



Source: State Treasury

Macroeconomic Outlook

Economic growth **-** The Ukrainian economy is expected to significantly slow down in 2002. The government forecast of 6% used in the budget 2002 should be seen as optimistic. One major factor in the slowdown will be the recession in the world economy. In particular, the expected slowdown in the Russian economy, which takes 23% of Ukrainian exports, might negatively affect growth in Ukraine.

Turning to internal factors, structural reforms slowed down in the second half of 2001 and are not expected to increase significantly in the first half of 2002. A further bottleneck for economic growth is the rather poor state of infrastructure in Ukraine. A substantial inflow of FDI into this sector would facilitate sustainable growth in Ukraine. But the low level of financial intermediation by commercial banks also remains a brake on further economic growth.

The first signs of a slowdown of the Ukrainian economy have already appeared. In January 2002, economic growth and industrial output decelerated to 3.2% and 1.7%, respectively. The Ukrainian policy makers are well advised to resume reforms as soon as possible. Especially they should ensure investment in infrastructure and further growth in financial intermediation by commercial banks.

External position **-** The maintenance of external stability should be a major priority for Ukrainian economic policy. For this purpose, a number of measures should be taken.

Exports constituted about 57% of GDP in 2001 and were by far the main source of foreign exchange in Ukraine. The stability of exports is crucial for growth and for the external stability of the country. Unfortunately, Ukrainian exports are quite sensitive to trade disputes: metallurgy accounts for 41% and agriculture for 11% of exports. Thus, Ukraine should strive to defend itself in case of trade conflicts. The most urgent step in that direction is to become a member of the World Trade Organisation (WTO). In the medium-run, building a more solid institutional basis for the economic relationship with the European Union should be a major goal.

The role of the National Bank in maintaining external stability has to be emphasized. At present, lacking sufficient capital inflows, current account surpluses are necessary to service the foreign debt of the country. Thus, the NBU should avoid an unsustainable real appreciation of the Hrivna, which would in turn hurt net exports. It should be noted that the positive effect of a real devaluation on the trade balance only shows up after two to three quarters.

Inflation **-** The annual inflation rate (CPI) in January 2002 was 5.6%. Thus, the decelaration of inflation of 2001 seems to continue. For a projection of price development this year, several factors should be taken into account.

On the one hand, the net purchases of foreign exchange by the National Bank should be significantly lower this year than in 2001. As a consequence, the National Bank will be in a better position to control money creation and keep inflation at a low level. On the other hand, the expected slowdown in economic activity and in the speed of monetisation means that the inflationary pressure of a given money expansion will be that much more intense. Furthermore, some administered prices, such as community services, are expected to rise. The net effect of all these factors should be slightly inflationary. But as long as the inflation rate remains in the single digit realm, its negative effects on the economy will not be significant.

This projection for the inflation rate assumes, that the Finance Ministry fully complies with its financial obligations vis-a-vis the National Bank. Should this assumption turn out to be wrong, than a significant increase in money supply and inflation would result. Keeping inflation low is a joint task of the National Bank and the Finance Ministry.

Public finance - Public finance remains the most critical aspect of Ukrainian policy. There are many potential reasons for a considerable rise in the public deficit. The rather optimistic forecast of 6% real growth used in the budget 2002 is one major risk for lower than expected revenues. Furthermore, the continuation of tax write-offs and restructuring could make public finance less transparent, intensify rent-seeking activities, and reduce the ability of the government to execute planned revenues. The extension of the state subsidisation of enterprises, including the experiment in the ore mining and metallurgy complex, is also a serious threat for the fiscal soundness. The same applies to the extension of social privileges in the 2002 budget.

A failure to privatise Ukrtelecom and the energy distributing companies (oblenergos) would not only have a negative impact on investment and growth, but also on public finances. Thus, a successful and speedy privatisation of these enterprises should be a political priority for this year. Also the problem of VAT refunding should be solved fairly and quickly.

Conclusions

The performance of the Ukrainian economy in 2001 was positive, combining high growth, external stability, low inflation and low fiscal deficit. But the inability of the central government to meet several revenue targets in spite of a much higher than expected economic growth revealed significant structural problems in fiscal policy. These problems will become more apparent in 2002, because of the expected slowdown in economic activity. A solution to these problems is urgently needed. A substantial fiscal deficit would put an end to the combination of internal and external stability, enjoyed by Ukraine for the last two years. We are confident that a workable solution can be found, with the government setting and sticking to realistic targets.

INVESTMENT PROSPECTS IN UKRAINE

Lorenzo Figliuoli and Maxim Kryshko[*]

Overview

Investment in Ukraine is projected to be an important factor in both short-term growth in 2002 and of sustained long-term growth over the next five years.

In the last few years, investment prospects have indisputably improved. In real terms, gross investment grew 14.4 % in 2000 and 17.2 % in 2001. This recent positive investment growth, however, may be insufficient to expand the capital stock of the economy.

The reasons behind this shortcoming are clear. Despite the fact that capacity usage in the Ukrainian industry is well below 100 %:

- production assets are often worn-out and technologically obsolete; and
- net investment was negative in 2000 and remained almost nil in 2001, which implies that capital consumption is relatively high.

Sources of Investment

In 2001, investment activity exhibited positive real growth almost everywhere in Ukraine, with the cities of Kiev, Sumy, the region of Odessa, and most of the Western Ukrainian regions (Volyn', Zakarpattya, Rivne, Chernivtsi) being the leaders. However, this incipient geographical diversification remained modest

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in absolute terms. Total investment remained heavily concentrated in the traditional industrial areas (including the city of Kiev). Indeed, around 40 % of investment spending is concentrated chiefly in Kiev and two major industrial cities (Donetsk and Dniepropetrovsk). Specifically, the city of Kiev attracted about 18 % of total national investment, which was spent mostly on reconstructing the central railway station and building (or renovating) metro stations and urban squares or streets.

Two thirds of the investment realised in 2001 was financed by own funds of the enterprises, although this source of funds has gradually diminished over time (in 1997, this source represented three quarters of the total). The second most important source of investment financing was constituted by bank credits, the share of which has grown considerably over the last three years and reached 14 % of the total in 2001. This trend follows from the greater magnetisation of the Ukrainian economy, introduction of market forces in the agricultural sector, and the reduction of barter trade in economic transactions. In line with recent levels, about 11 % of investments were financed by the state budget (either central or local authorities).

It should also be noted that, as regards sectoral allocation, capital outlays were directed toward transportation (23 %), manufacturing industry (19.8 % - mostly, food and metals), extracting industry (15%), and residential construction (14%).

A regrettable finding is that the share of foreign direct investment (FDI) in total investment, as well as the per capita level of FDI, remains quite modest, compared with that in other Central and Eastern European transition countries. In order to transform successfully to a market economy and to secure stable long-term growth, FDI is very important, well beyond its direct, immediate impact on the amount of capital spending in a given country. It promotes technological spillovers and helps enhance management practices throughout the economy. The recent privatisation of the first batch of oblenergos in April 2001 is a positive step in this direction.

Positive Developments

Among recent positive signs that appear to support an improved investment climate in Ukraine, we can enumerate the following:

- The exchange rate of the Hryvna remained stable throughout 2001. This development consolidated market expectations and, against the backdrop of continuing growth and improved consumer confidence, facilitated the importation and installation of new equipment.

- Long-term credits from the banks grew rapidly, while the share of bad loans shrank.

- The annual report of Moody's for the year 2001 sent promising signals to investors by acknowledging the strong positive growth of exports, domestic demand and investment in Ukraine, noting the favourable external debt conditions, as well as commending its cautious monetary and fiscal policies. As a result, Moody's upgraded the ratings of Ukraine's sovereign debt and of FX deposits to "B2"and "B3" respectively, and announced a stable forecast for future ratings.

- The Presidential Decree "On Measures to Improve the Investment Climate in Ukraine" (July 2001) provided a solid foundation to further enhance the investment climate in Ukraine, and to identify and overcome existing difficulties in this area.

What Needs to be Done?

The elements of progress listed above provide evidence of a potentially attractive investment environment in Ukraine. However, we believe these developments and the efforts of the government would be much more effective and purposeful, if the authorities of Ukraine would:

- **Continue privatisation** (including "UkrTelecom" and the oblenergos) in a transparent and competitive way.

- **Introduce a "one-stop" window** for all legal and regulatory requirements, particularly to promote FDI. This will help: (i) simplify operations, reporting and control; (ii) reduce costs (and also stem the burden of corruption); and (iii) improve regulatory efficiency.

- **Strengthen capital adequacy and Central Bank supervision** of the banking system. Strong and healthy commercial banks will permit to narrow interest spreads and fees, and thus promote further investment and growth.

- **Safeguard stable and predictable "rules of the game,"** including in tax policy and tax administration.

- **Promote greater transparency** in public decision-making and broaden the practice of public hearings before adopting vital regulatory decisions.

- **Implement tax reform**, simplifying the system, eliminating privileges, reducing rates, and ensuring a level playing field. We are convinced that the efforts of the Ukrainian authorities to speed up parliamentary passage of the long-awaited Tax Code are an important step toward improving the investment environment. Bringing the widely dispersed tax legislation of Ukraine into a single comprehensive document, which is to embody internationally accepted principles of good tax design, would minimise efficiency losses and likely confer the required stability to the tax system, greatly stimulating domestic and foreign investment. In particular, the elimination of arrears on VAT refunds will eliminate a major obstacle to exports.

- However, in order to preserve macroeconomic stability, that is still fragile and very sensitive to domestic and external shocks, the provisions of the new Tax Code need to be carefully balanced. Reduction of the tax rates is welcome, provided it is accompanied by the cancellation of the numerous tax exemptions and special treatments, which have eroded substantially the tax base in the last few years. This is an area well within the core mandate of the IMF, and will be at the centre of the future co-operation between the Fund and the authorities.

INVESTMENT AND COMPETITIVENESS: A STRATEGIC MANAGEMENT PERSPECTIVE FOR UKRAINE

Ulrich F. W. Ernst[*]

Introduction

Ukraine's economic resurgence over the last two years has been accompanied by some recovery in gross investment. Increased investment levels are critical to continue and expand economic growth. At the same time, gains in investment levels must be accompanied by gains in investment productivity, as measured by value added per unit of capital, or by the economy-wide equivalent of "shareholder value", which describes the ability of assets to generate an income stream over time.

The key to raising investment productivity is the ability to compete in increasingly global markets, both at home and abroad, and to build competitive advantage in key sectors. In fact, the need to innovate constantly in order to achieve and sustain a competitive position is the central challenge to managers of individual companies as well as to local, regional and national economies. Fostering the emergence of competitive firms and sectors is becoming a key challenge of structural economic policy. This challenge is universal, but assumes even greater importance in countries that are not performing up to their real potential. For Ukraine, a Presidential Edict (19 November 2001) has underlined this crucial role of competitiveness as a guiding principle for economic development policies.

I argue here that the most effective approach to designing and implementing investment policies to help companies, sectors and clusters build competitive

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advantage draws on strategic management principles. Reduced to basic principles, strategic management (unfortunately in many respects a "buzzword," which again should not detract from its importance) defines a systematic approach to articulating and pursuing goals or directions when many stakeholders are involved. It emphasises participation by all stakeholders in establishing goals and priorities, in defining measurable objectives and benchmarks, in forging a strategy and mobilising needed resources to reach these objectives, in carrying out the activities, and in monitoring achievements and revising and adjusting goals, objectives and strategic activities as needed. In the present context, the goal is of course an improved investment climate and a more competitive Ukrainian economy, with objectives and benchmarks being defined in terms of both "hard" (observations) and "soft" (perceptions) indicators.

Levels of Competitiveness

Many observers, including Michael Porter and Paul Krugman, have pointed out that only firms, not nations, compete.[1] Ultimately, it is up to the management of each firm to ensure competitiveness and gain competitive advantage through continuing innovation. However, success in the quest for competitive performance depends also on forces in the firm's environment. Understanding competitiveness at the firm, or micro level, therefore requires a broader view, taking into consideration both economy-wide factors at the macro level, and forces that shape the firm's immediate environment at the intermediate, or meso level.

A firm forms part of a value chain. For example, the food processing value chain includes soil preparation, cultivation, harvest, post-harvest handling (storage and transport), processing, packaging, marketing, and consumption.[2] Even "vertically integrated" operations usually link into other activities, for example, through their use of social or physical infrastructure services, How successful individual firms are in achieving competitive performance depends, therefore, not only on their own ability to innovate, but also on the performance of both upstream and

1. Even so, Porter's work actually seems to assign greater weight to country competitiveness, thereby blurring this distinction. His 1990 book on the determinants of the competitive performance of industry clusters is entitled *The competitive advantage of nations (emphasis added)*; he also has taken a leading role in ranking the competitiveness of countries in the Global competitiveness report issued by the World Economic Forum.

2. In most industries, the value chain should also include the post-consumer phase, that is, disposal or recycling.

downstream links of their respective chains. These linkages, which are not captured in the traditional concept of an economic sector, have become a major focus of development policies in many countries. The industrial clusters defined by these linkages are critical to understanding and promoting competitiveness and building competitive advantage in an economy.

Both the macro and meso level perspectives on competitiveness are critical to effective policies to promote growth and development. At the macro level, policies focus on the creation of an attractive investment climate, especially for small and medium-sized enterprises, to spur innovation and competitive performance. At the meso level, focused policies and effective private-public sector partnerships promote innovation and facilitate competitive performance.

Macro Level: The Investment Climate

While there may be agreement at one level that firms, not nations, compete, there appears to be a growing interest in assessing the competitiveness of countries. Several sources are compiling country rankings or "benchmarkings" on the basis of indicators that describe the investment climate and the competitive performance of the economy as a whole. These rankings can be of great help to the policy maker, since they in effect provide a ready tool for the strategic management approach to investment and competitiveness policies. These rankings, and in particular the indicators they use, can be used for:

- Tracking the position of the country vis-à-vis competitors: it is important to know where the country is seen in a global context, even if there is disagreement about some of the measures – in particular any "soft" criteria or perceptions;

- Setting priorities: by understanding the relative strengths and weaknesses of the country's investment climate, as seen by outsiders, better targeting of policies can leverage strengths and mitigate weaknesses more effectively;

- Keeping score: using indicators related to country competitiveness rankings, it becomes easier to assess the effectiveness of policy initiatives in improving the overall investment climate;

- Making the case: understanding the perceived strengths and weaknesses of the country as seen by outsiders can provide valuable guidance in designing more effective outreach and information strategies.

The attempts to compare macro level competitiveness across countries – competitiveness competitions – include initiatives like the World Competitiveness Yearbook (WCY) or the Global Competitiveness Report of the World Economic Forum (WEF). The WCY, for example, uses 286 criteria (118 "hard" criteria used in rankings, 62 "hard" criteria used for background information, and 106 criteria from survey data) to rank 49 countries, including 30 OECD members and 19 newly emerging and transition economies. The rankings do not include Ukraine.

The competitiveness factors comprise several groups: economic performance (68 criteria), government efficiency (84), business efficiency (60), and infrastructure (74). The Global Competitiveness Report covers a broader range of countries (75 in its 2001 edition), including Ukraine (ranked No. 69 in growth competitiveness and No. 60 in current competitiveness for the year 2000). Table 1 shows these rankings for the 75 countries included in the Global Competitiveness Report. Other studies have used smaller sets of criteria to establish competitiveness benchmarks for a range of countries.

A related example are the international business environment rankings carried out by the Economist Intelligence Unit (EIU), using a model that "seeks to measure the quality or attractiveness of the business environment and its key components by using quantitative data, business surveys and expert assessments. The EIU used this model recently to assess business environments in 27 transition economies, including Ukraine, both retrospectively for the period 1996-2000, and prospectively for the period 2001-2005. The prospective ratings served as a basis for projecting foreign direct investment (FDI) inflows.

As it turns out, while the rankings for Ukraine are somewhat sobering, there is some encouraging news: the country occupies only rank 19 (out of 27) for the period 2001-2005, but it shows the best relative improvement in the EIU's business environment score from 1996-2000, after the special case of the Federal Republic of Yugoslavia. This relative improvement is projected to raise foreign direct investment from a paltry $12 per capita for 1996-2000 to $21 for 2001-2005, which amounts to less than 20 % of the projected average for the 27 countries. In fact, only the Kyrgyz Republic, Tajikistan and Uzbekistan are projected to have lower per-capita FDI over the period 2001-2005 than Ukraine.

Table 1: Country rankings by growth competitiveness (GCI) and current competitiveness (CCI)

	GCI ranking	CCI ranking		GCI ranking	CCI ranking
Finland	1	1	China	39	47
United States	2	2	Slovak Republic	40	39
Canada	3	11	Poland	41	41
Singapore	4	10	Mexico	42	51
Australia	5	9	Lithuania	43	49
Norway	6	19	Brazil	44	30
Taiwan	7	21	Jordan	45	44
Netherlands	8	3	Uruguay	46	46
Sweden	9	6	Latvia	47	42
New Zealand	10	20	Philippines	48	54
Ireland	11	22	Argentina	49	53
United Kingdom	12	7	Dominican Republic	50	59
Hong Kong SAR	13	18	Egypt	51	45
Denmark	14	8	Jamaica	52	40
Switzerland	15	5	Panama	53	48
Iceland	16	16	Turkey	54	33
Germany	17	4	Peru	55	63
Austria	18	13	Romania	56	61
Belgium	19	14	India	57	36
France	20	12	El Salvador	58	64
Japan	21	15	Bulgaria	59	68
Spain	22	23	Vietnam	60	62
Korea	23	28	Sri Lanka	61	57
Israel	24	17	Venezuela	62	66
Portugal	25	31	Russia	63	58
Italy	26	24	Indonesia	64	55
Chile	27	29	Colombia	65	56
Hungary	28	26	Guatemala	66	69
Estonia	29	27	Bolivia	67	75
Malaysia	30	37	Ecuador	68	72
Slovenia	31	32	Ukraine	69	60
Mauritius	32	52	Honduras	70	74
Thailand	33	38	Bangladesh	71	73
South Africa	34	25	Paraguay	72	70
Costa Rica	35	50	Nicaragua	73	71
Greece	36	43	Nigeria	74	67
Czech Republic	37	35	Zimbabwe	75	65
Trinidad and Tobago	38	34			

Source: Global Competitiveness Report 2001. The GCI is a combination of “hard” and “soft” (perceptions from a survey of 4,600 executives in 75 countries) criteria; the CCI is based entirely on the survey of perceptions.

Table 2: EIU ratings of business environment

	2001-05	1996-2000	% change
Estonia	7.40	6.86	7.9%
Hungary	7.26	6.42	13.1%
Poland	7.07	6.22	13.7%
Czech Republic	7.01	6.18	13.4%
Slovenia	6.96	6.08	14.5%
Lithuania	6.95	5.74	21.1%
Latvia	6.88	5.87	17.2%
Slovakia	6.57	5.46	20.3%
Croatia	6.33	5.23	21.0%
Bulgaria	5.94	4.03	47.4%
Kazakhstan	5.59	4.30	30.0%
Russia	5.49	4.12	33.3%
Armenia	5.34	4.50	18.7%
Azerbaijan	5.28	4.35	21.4%
Romania	5.24	4.10	27.8%
Yugoslavia, FR	5.23	2.79	87.5%
Macedonia	5.21	4.47	16.6%
Albania	5.09	4.01	26.9%
Ukraine	4.95	3.27	51.4%
Georgia	4.87	4.01	21.4%
Moldova	4.78	4.04	18.3%
Kyrgyz Republic	4.77	3.75	27.2%
Bosnia & Herzegovina	4.66	3.98	17.1%
Belarus	4.16	3.91	6.4%
Tajikistan	3.55	2.81	26.3%
Turkmenistan	3.46	3.05	13.4%
Uzbekistan	3.18	2.80	13.6%

Source: Economist Intelligence Unit, as reported in Transition, Oct/Nov/Dec 2001.

A SWOT Analysis for Competitiveness Rankings

Overall country rankings on competitiveness show average scores across a wide range of indicators. By digging a little deeper to understand the makeup of overall competitiveness rankings, Ukrainian policy makers can develop a better sense of policies priorities. In a strategic management context, the data on the country’s relative position for the different indicators used provide a basis for an analysis of strengths, weaknesses, opportunities and threats (SWOT).

In addition to the overall rankings in terms of current and growth competitiveness, the Global Competitiveness Report presents component indices that summarise subsets of indicators. Its growth competitiveness index incorporates indices for technology, public institutions and the macroeconomic environment. Not surprisingly, Ukraine is doing better on the technology index, where it ranks 63rd, than on public institutions or macroeconomic environment, where it ranks 71st and 73rd, respectively, producing the overall rank of 69th.[1] It is likely that the gains in overall economic performance in 2001 would improve rankings with respect to macroeconomic environment. In the case of the current competitiveness index, the two component indices reported, "company operations and strategy" and "quality of the national business environment," are close together for a 62nd and 60th rank, respectively, yielding an overall rank of 60th.

In a very basic sense, policy priorities aim at building on strengths and mitigating weaknesses. But policies also need to take into account specific opportunities and threats. With respect to threats, the fact that Ukraine ranks significantly higher on current competitiveness than on growth competitiveness raises concerns for the future.

Disaggregating the more favourable score in the area of technology, for example, shows more specific threats that can undermine future performance. Ukraine ranks relatively high on measures such as the level of new technology development, quality of research institutions and their activities, and quality of exact science education. However, it scores low on factors shaping prospects for building on these strengths, such as the extent of the "brain drain," procedures for licensing new technologies, level of intellectual property protection, or potential for investing in education and research activities. For example, any strategy stressing technological innovation as a key to growth places a premium on effectively protecting intellectual property rights – aside from obligations under, say, WTO accession standards.

Conversely, the individual indicators can also serve as a guide for identifying or clarifying opportunities. Real gains in terms of building competitive advantage in Ukraine's economy require a clear sense of priorities, both with respect to macro level measures and with respect to industrial clusters or value chains. Obviously, clusters that take advantage of strengths (and are capable of reinforcing those strengths) or are less affected by particular weaknesses in the business environment should become a particular focus of strategic management approaches to improving investment climate and performance.

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1. Differences in component indices can be even more pronounced. Korea, for example, ranks 9th in technology and 8th with respect to the macroeconomic environment, but 44th for its public institutions, for an overall rank of 23rd.

Strategic Elements

An effective competitiveness strategy needs to combine macro-level efforts to improve the investment climate with initiatives aimed at building competitiveness in key industrial clusters. Efforts at the macro level can draw on the types of country competitiveness rankings discussed as both a handy scorecard for monitoring and a tool for strategic analysis. Complementing these with cluster-oriented development policies demands new tools for analysis and innovative approaches to economic policy making that cross traditional sectoral and administrative boundaries. The concept of an industrial cluster is central to such approaches.

The intellectual roots of the industrial cluster concept extend across several academic disciplines. Business economics, especially Michael Porter's work, has stressed that local factors matter greatly in establishing and maintaining competitive advantage in the global economy. Geographic proximity of competitors and complementors remains an important element. Mainstream economics has contributed a new body of growth theory built around models of increasing returns. Paul Krugman's work on trade and geography has highlighted the importance of economic clustering as a source of increasing returns. Related econometric studies have shown that innovative activity tends to cluster as a result of knowledge spillovers.

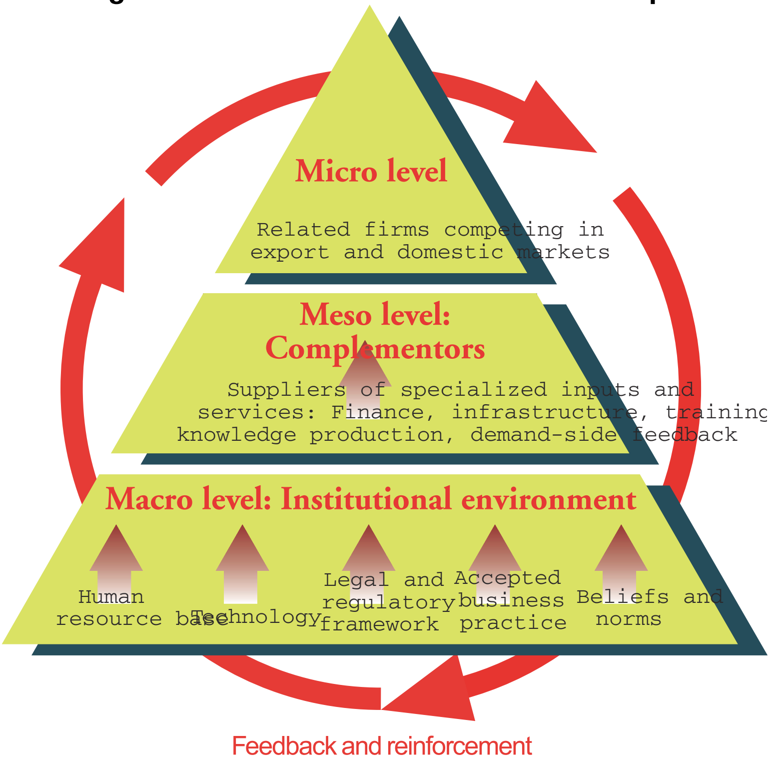
Regional science has of course long been interested in clusters as networks of innovation, as evidenced by the growth pole literature of the 1960s and 1970s. This interest has been rekindled by the recent industrial district literature — to some extent harking back to Marshall's analysis of industrial districts in 1890 - which focused initially on Italy and then on many other countries in Europe and elsewhere. Finally, the literature concerned with technological development has focused not only on the individual firm, but has also stressed the importance of interactions with customers, complementors (suppliers) and competitors, where competition does not exclude strategic, tactical or incidental co-operation. Both innovation and diffusion depend on networks of institutions that often define regional systems.

While geographic proximity matters because it facilitates both cooperation and competition, cluster-based policies operate at different levels. A 1998 OECD report summarising the experience with cluster-based policies focuses on the role of clusters as mechanisms of innovation and knowledge mobilisation:

… networks of production of strongly interdependent firms (including specialised suppliers), knowledge producing agents (universities, research institutes, engineering companies), bridging institutions (brokers, consultants) and customers, linked to each other in a value adding production chain. The cluster approach focuses on the linkages and interdependence between actors in the network of production when producing products and services and creating innovations.[1]

Figure 1 illustrates the concept of a cluster, with a focus on the regional dimension, and stressing exports. "Leading firms," however, can also compete in domestic markets with imports.

Figure 1: Illustration of the cluster concept[2]



1. Roelandt, Theo J.A. and Pim den Hertog (eds.), *Cluster analysis and cluster-based policy in OECD-countries. Various approaches, early results and policy implications*. The Hague/Utrecht, May 1998, p. 5.

2. This illustration borrows from a similar pyramid focusing on regional clusters copyrighted by the Economic Competitiveness Group.

The experience of OECD countries and others with cluster-based policies demonstrates that these approaches can successfully target increased competitiveness at different levels of aggregation. Countries in Europe, for example, have pursued policies that revolve around “mega clusters” like services (Netherlands) or forestry and telecommunications (Finland). At the same time, local and regional institutions have adopted cluster-based approaches to promote regional development.

Whatever the scale, successful cluster-based policies share certain features. The most important element is the creation of a focused public-private partnership. Such a partnership, in whatever institutional form, needs to work diligently to understand both strengths and weaknesses in the respective value chain, and to commit to a joint strategy to leverage strengths and address weaknesses. Such a public-private partnership has to transcend the traditional thinking of seeking advantages for a particular sector through direct and indirect subsidies. For the government, cluster-oriented competitiveness policies are not designed to achieve artificial and transitory cost advantages, but to complement efforts by the private sector to improve performance in key markets. Such policies focus on improving social capital and physical infrastructure in ways that support a clearly articulated strategy for building competitive advantage.

A focus on industrial clusters also provides specific strategic guidance across the full range of policy making. For example, it can serve to build a sound strategic context for privatisation policies, initiating a shift away from the traditional focus on individual transactions. Cluster-based approaches would view the enterprise to be privatised in the context of the value chain(s) to which it belongs, and formulate strategies accordingly.

Finally, cluster-based approaches need to be understood as real alternatives to traditional industrial policies. Their basic rationale is to complement special efforts and initiatives in flexible and coherent manner. Adopting such policies recognises both the dismal track record of governments in betting on industrial winners, and the need for clear criteria in making choices. Government policies simply cannot be neutral with respect to their impact on industrial (and geographic) clusters. Not making choices is therefore making choices – with unintended consequences.[1]

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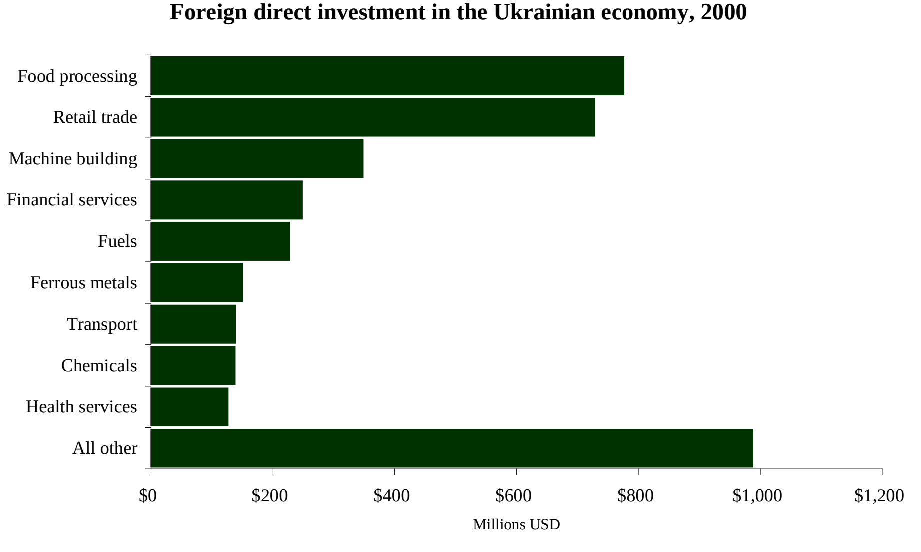
1. Michael Fairbanks and Stace Lindsay, *Plowing the sea*. Boston, 1997.

Cluster Criteria

The selection of industrial clusters as focal points for development policies is a complex process. Ultimately, it needs to be demand-driven, if it is to be an effective public-private partnership, but both intuition and analytical approaches can provide some direction. Intuition, based on a general knowledge of the economy and investment and performance trends, can be valuable. For example, in the case of Ukraine, virtually anyone familiar with economic trends and prospects is likely to cite the food processing cluster as a likely candidate for cluster-based development policies. Both investment trends, in particular foreign direct investment, and relative performance in terms of output growth patterns, provide some support for this view. But these points should be seen as strictly indicative. There are many factors that have shaped the performance of this cluster, including levels of protection inconsistent with an open economy. For articulating an effective strategy, the notion of food processing as a mega cluster will need to be broken down further to focus on individual value chains.

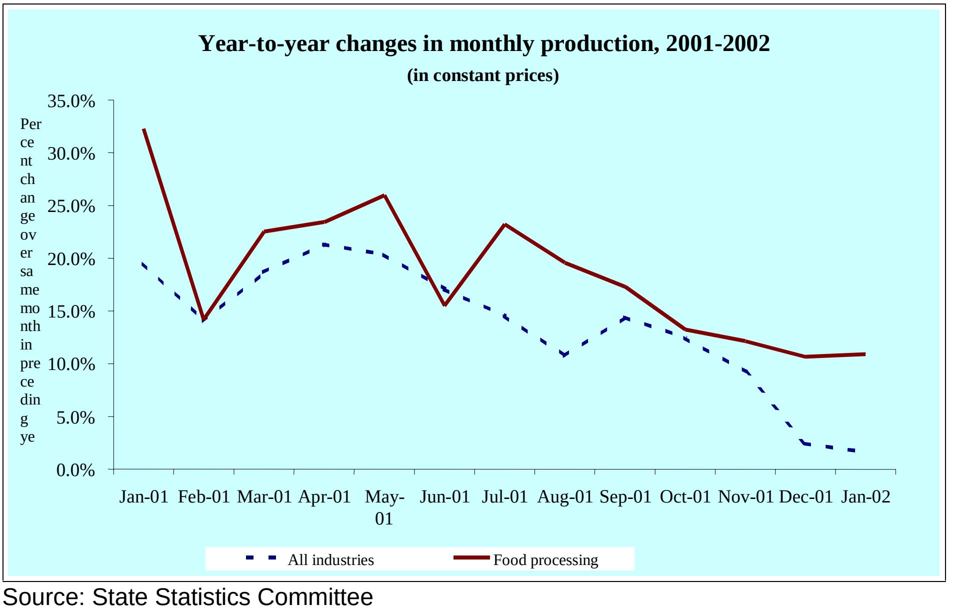
Other sectors generally thought to have competitive potential include pharmaceuticals, information technology and software development, and tourism. These indications may warrant further exploration, especially a more intense dialogue with the private sector, to gauge the suitability of these clusters as focal points for development policy.

Figure 2: Food processing is the prime target for FDI …



A more systematic approach to the initial assessment of competitive potential focuses on prospects in export markets. It is encapsulated in the “competitive analysis of nations (CAN)” method developed by the UN Economic Commission for Latin America and the World Bank. The method involves an adaptation of the venerable market positions analysis matrix (the “Boston matrix”), which combines market growth rate and relative market share (relative to the largest competitor) to define opportunities and threats. The CAN looks at the growth rate for various products in key export markets and links it to such measures as the exporting industry’s growth in market share. Applying a variant of this approach to the relative performance of Ukrainian exports to the European Union, for example, suggests additional clusters for further exploration, such as wood products or leather goods.

Figure 3: … and it outperformed other industries



Source: State Statistics Committee

Outlook

While the competitiveness challenge looms large, a careful assessment of the situation and prospects at both the macro and the meso level can help in identifying priorities. A clear sense of priorities as the basis for building consensus is the precondition for a strategic management approach to improving Ukraine’s investment climate and building competitive advantage in the economy.

To be effective, a strategy involves choices, especially in a complex environment like the Ukrainian economy. The SWOT analysis of Ukraine's relative position on the basis of competitiveness rankings, in terms of both statistical descriptors and perceptions in the global business community, can provide a useful perspective in this process. A dispassionate assessment of the strengths and weaknesses in the country's investment climate is needed to answer the question of what to do first. Improving the investment climate across the board will take time. A focused approach built around selected clusters that offer competitive opportunities and can demonstrate the real commitment of the private sector can yield real achievements within a shorter timeframe, and thereby send a powerful message to the international investors community.

TWO YEARS OF ECONOMIC GROWTH: MORE QUESTIONS THAN ANSWERS

Alexander Paskhaver[*]

Are the Recent Two-Year Economic Growth Statistics Realistic?

There has undoubtedly been some growth in Ukraine's economy.However, I would advise some caution and care in analysing the quality and size of growth estimates.

Value and Physical Volume Growth

On the basis of the government's 2001 Statistical Bulletin, growth rate of the value and physical volumes of the most important products in six industrial sectors (the share of which in the overall industrial production amounts to 60 %) have been compiled in a simplistic manner. On the basis of rough estimates, in four out of six sectors (i.e. food industry, textile/apparel, chemistry and metallurgy) value and physical volume growth rate estimates were quite close. In two sectors, the scenario was as follows: as regards extraction of fuels, increment of production in comparable prices of 2001/2000 was 4.8%; in physical volumes (simple average for coal, gas, oil) it was 0.3%. Building materials, respectively, 11.4% – in value and –1% in physical volumes (simple average of increment for 9 products).

It should be emphasised that these are rough and ready estimates . However, it might be useful for the government to have a more precise assessment and check the accuracy of physical volume part of its value indicators, as well as comparable prices and computation procedures.

* Center for Economic Development, Kiev.

Real Growth or Getting out of the "Shade"

First comparison: More than 15% of GDP growth over the recent two years was achieved without any increment of the production of electricity (1999 – 172.1 billion kW/ hour; 2001 – 172 billion kW/hour). Data on energy consumption is available only for 2000. With 5.9 % growth of GDP, electricity consumption has reduced by 1.5 %, or in broader terms consumption of all energy resources for production needs to be reduced by 1.4 %.

Second comparison: 29 % growth of industrial production over a two- year period and almost 21% growth of agricultural production have resulted in a mere 2.6% increase in freight-ton-miles.

Third comparison: The only available data refers to 2000: 6% GDP growth occurred accompanied by a decrease of employment by 0.5 million people or by 2.3%; in industry, 13.2% growth coincided with a decrease of employment by 0.4 million people or by 6.8%.

It goes without saying that the squeezing of the "shadow" economy will result in a growth of the legal economy. But the question is whether the economic behaviour in the coming years could be forecast if implications of this process are not accounted for properly. Does the government consider this factor and if yes, then in what way?

Similar questions could be raised with regard to the data on domestic market growth and population income. The changes in the value need to be monitored via indirect indicators of physical volume.

Internal Reserves or New Capacities

Has there been any real structural reform going on over the last couple of years? The answer is yes, if the judgement is to be made using the striking difference in the growth rates in extraction and various processing industries.

If the judgement is to be made on the basis of the indicators of production capacities upgrading, then this data is not all that clear. On the one hand, investments have been channelled into production. Moreover, capital investment growth rate over the last two years has been 2.2 times higher than the GDP growth rate. They basically went into reconstruction. The share of capital investments into the new enterprises declined from 53.9% in 1985 down to 24.4% in 2000, in other words, they experienced a twofold decrease.

On the other hand, disposal and PP&E upgrading ratios in 2000 were 2.5 times lower than in 1991 although 1991, as we remember, was far from being a year of aggressive reconstruction.

Non-Capital Factors

Considering a lag between the time when the capital is invested and when the impact of these investments could be experienced, accretion to the capital investments works to a considerable measure for the future. Real economic growth during last two years seems to be rooted mainly in the low capital intensive factors of an adaptive nature. Primarily, it is the adaptation of the population as a whole, businesses and managers to the new social and economic roles. For the social indicators (such as mortality including that caused by unnatural reasons), life expectancy, crime, relative number of day time students, and so on) 1995 was crucial; for economic indicators they were years 1997-1998, when plummeting of the most important of them was rapidly terminated.

It should be emphasized that it is not the reality that changed, just the opposite is the case: red tape was continuously increasing its pressure on the business community. However, there was nothing unusual about the situation, and a new pattern of behaviour has consequently been elaborated. After two or three years of mass and small-scale privatisation following year 1998, the new owners have begun seeking new markets, modifying their products, and better organising their businesses. These improvements also coincided with a number of favourable external circumstances, which contributed to the overall economic growth.

It is natural that non-capital factors of growth come into play prior to the significant investments being made and this way stimulate them.

However, these adaptation factors will very soon deteriorate unless new and strong signals – incentives are sent by the government. The latter should regularly produce such stimulating signals for the economy, for instance, by tightening tax burden, protecting ownership rights, and enhancing deregulation. A strategy of the signals' optimal sequence and their concentration has to be developed.

Need for Strong Signals-Incentives from the Government

One such signal is, in my opinion, of the utmost importance. I am talking about unpredictability of what the government is doing in the economy. It means that under identical business situations one could expect that the government could make different decisions, which are impossible to predict. I would dare to pronounce a provocative thesis: predictable corruption is acceptable in business, unpredictable corruption will paralyse it. Doesn't it explain the uniqueness of this very situation when foreign capital does not flow into the fast growing economy?

Ill-thought, so-called "exclusive" interference into the business processes not only reduces the flow of investments; all operating capital will also depreciate as a consequence of the growing risks.

Consistent adherence of the government to the rules it has once established and, consequently, reduction of political risks paving the way to the greater values of national wealth (which from the economic perspective is on par with its accumulation), these are the issues to be addressed. Circulation of more costly components of the national wealth such as means of production, land, mineral resources, housing will immediately lead to higher incomes of all subjects of economic activities. A rent component of taxes will also grow allowing for less pressure on the income and labour. Reduction of political risks appears to be a one-time resource we are crying for in Ukraine.

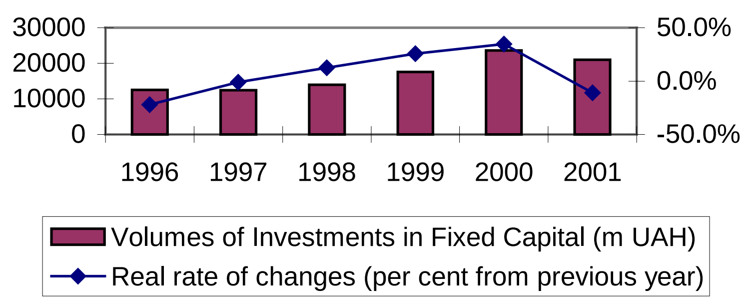
LATEST IMPROVEMENTS IN THE INVESTMENT ENVIRONMENT AND SOME VIEWS ON THE NEED FOR REGIONAL MONITORING OF THE INVESTMENT CLIMATE

Todor Balabanov[*]

Macroeconomic Considerations Relevant to the Investment Environment

It has been frequently said that if the domestic investments are low then the country cannot expect foreigners to put their money in the economy. Figure 1 depicts both a substantial growth rate of the domestic investment in long term assets and the volume of investment. Over the last three years domestically generated investment reached $ 14 billion or more than three times total Foreign Direct Investment (FDI) of $ 4.2 billion.

Figure 1. Investment in long term assets and their growth rates

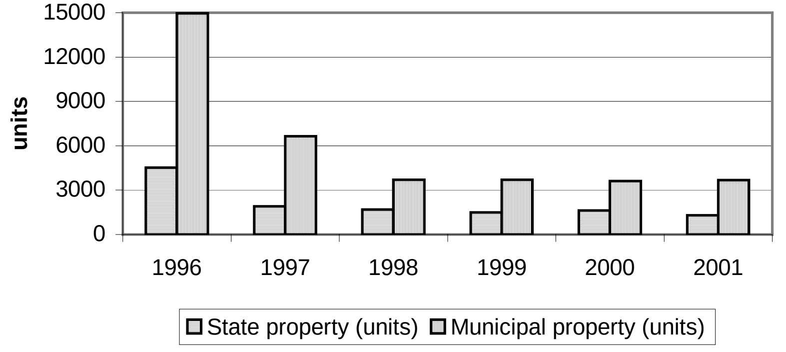


Source: Basic Indices of Economic and Social Development of Ukraine, February 2002

* Institute for Advanced Studies, Austria. This paper benefited from the inputs and comment provided by the Ukrainian Embassy in Vienna. Kevin J. Daly from Standart&Poor's kindly permitted to use the latest credit rating analysis for this presentation.

Another favourable indicator is the steady pace of privatisation by the State and Municipal Property Funds. After the initial outburst of privatisation activities in 1996 and 1997 the level of the privatised units by both Funds stabilised during 1998-2001.

Figure 2. Privatisation by the State and the Municipal property Funds



Source: Basic Indices of Economic and Social Development of Ukraine, February 2002

Other positive trends can be seen in Figure 3, namely, for the last two years GDP was increasing at the rate of 6% to 9% per year and the state budget showed surpluses for the two subsequent years.

To illustrate the sources of growth: for the period January-November 2001 industrial production increased by 16.1 % (by 12.2 % in 2000), including processing industry – by 19.6 %, mining industry – by 4.1 %, production and distribution of electric power, gas and water – by 2.4 %. The volumes of production of processing industry comprised 72.8 % of total industrial production. For the same period the highest rates of growth, compared with respective period of last year, were achieved in production of oil products and coke (by 57.1 %); wood and timber (by 25.9 %); engineering (by 21.7 %); pulp and paper industry, and printing and publishing (by 20.5 %).

Certainly the restrictive budgetary policy exacts a price, namely, arrears and non payments, e.g., the biggest share of debit indebtedness falls on enterprises of collective (54.7 %) and state (except municipal) (37.9 %) property forms as well as the biggest share of credit indebtedness – 57.7 % and 34.6 % respectively. As per November 2001 the arrears of payments remain significant: the total share of delayed debit indebtedness made up 41 %, credit indebtedness – 40.5 %.

On a positive note the stability of the country's currency the Hrivna (UAH) has been demonstrated by UAH´s improving position at the currency markets – now one US dollar buys 5.3 UAH – the lowest level since several months, namely, the UAH has achieved stability in nominal terms.

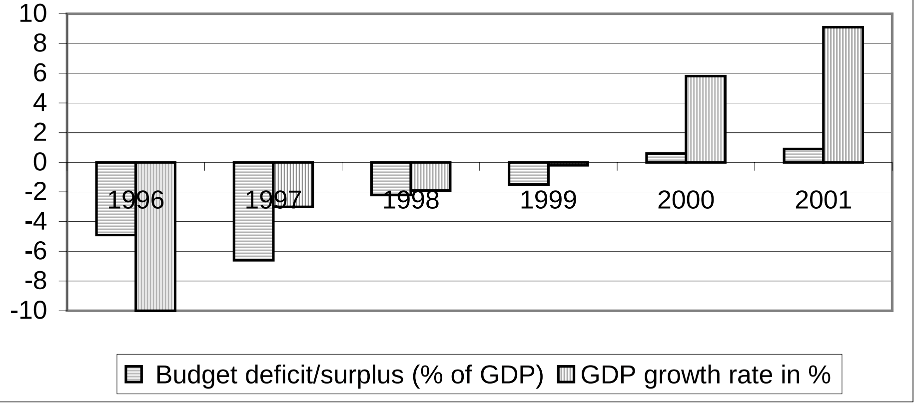
Inflation was also very low: for the period January - November 2001 the CPI was at 103.9 % while for the 2000 the CPI was 123.3 %.

Hence, vastly improved fiscal management and performance have been key achievements.

Overall, however, fiscal flexibility is low. Sustainable progress requires effective and timely implementation of the legislated Tax Code.

Debt burden indicators improved significantly in 2001, reflecting higher growth and revenue and successful debt rescheduling.

Figure 3. GDP Growth Rate and Budget Balance



Source: Basic Indices of Economic and Social Development of Ukraine, February 2002

There is also dynamism in Foreign Economic Activities, e.g., for the first 10 months of 2001 the turnover of goods and services increased by 12.2% compared with 10 months of last year and reached $ 26.8 billion. Exports of goods and services increased by 11.8 % (18.9 % last year) and imports increased by 12.6 % (21.1 % last year).

For the year 2001 the positive foreign trade balance in goods amounted to $ 632.5 million as against $ 421.8 million for the period January-November 2000.

Foreign Direct Investment

By the end of October 2001, total volume of direct foreign investment in Ukraine amounted to $ 4.194 billion, that is $ 85 per inhabitant. For the first 10 months of 2001 the total volume of registered FDI amounted to $ 529.4 million, that is by 10 % less than for the year 2000.

Table 1. Principle Source Countries of Foreign Investment

Country	**%**
United States of America	16.8
Cyprus (probably Russian and/or Ukrainian indirect investment)	9.5
The Netherlands	8.8
United Kingdom	8.7
Russian Federation	7
Germany	6.3
Virgin Islands	5.8
Switzerland	4.5
Republic of Korea	4.1
Austria	3.3
Total	71.5 %

Table 2. Sectoral Distribution of Foreign Investment

Sector	**%**
Food processing	19.5
Wholesale and commercial intermediation	14
Engineering	8
Financial activities	8
Transports	7
Chemical and oil industries	5.4
Real estate transactions	4
Oil products and nuclear fuel, production of coke	4
Metallurgy and metal processing	3.9

Ukraine's very strong growth recovery during 2000-2001 will be hard tested in 2002, given the global slowdown, an appreciating Hrivna, and possible protectionist measures by Russia.

Expansion has been driven, to a large extent, by strong exports (60% of GDP). Russia is Ukraine's largest single trading partner, accounting for 25% of exports and 40% of imports as well as for a lion's share of foreign direct and portfolio investment. The Russian companies now have almost total control over Ukraine's aluminium and oil refining sectors and an increasing presence in its metallurgy and machinery sectors.

Ukraine's growth over the next two years will, therefore, be strongly correlated with that of Russia and its exchange rate policy. Standard & Poor's growth projection for Russia in 2002 (2.5 - 3%) implies that growth in Ukraine ie to be constrained to 3.5 - 4% in 2002, somewhat lower than either official or IMF projections. Domestic demand will become a major source of growth. Downside risks to this scenario are various, including possible Russian quotas on Ukrainian goods and lower world price for steel and chemicals (the country's main exports). If oil prices continue to decline, Russia might be hard pressed to abandon its strong rouble policy, with dire consequences for Ukraine.

Looking beyond 2002, growth in Russia and helpful external conditions will, needless to say, continue to matter. Increasingly, however, structural reform - including industrial restructuring, privatisation, reform of the agricultural sector, and strengthened financial conditions - will be crucial. Structural reform implemented in 1999-2001 has permitted an impressive growth rate over the past two years. An assault on barter transactions and inter-enterprise arrears within the state's productive sector, repayment of wage and pension arrears and legislative improvement all supported expansion of the real economy. In particular, long-overdue reform in the agricultural sector began to bear fruit, with farmers allowed to own shares in de-collectivised farms beginning in 1999. Finances available to farmers tripled in 2001 compared to 2000, reflecting de-facto privatisation of agricultural land. The new Land Code, approved in November 2001, allows agricultural land to be bought and sold, with land used as collateral (effective as of 2005), which should facilitate farmers' borrowing.

In summary, it appears that a critical mass of restructuring sufficient to support a modest 3 - 4% GDP growth over the next two years has occurred in Ukraine. The contribution of the dynamic private-sector, accounting for about 65% of GDP, has been increasingly important. It is conceivable that less harassment, better taxation administration, and a cut in barter transactions have all helped to reduce the shadow economy (still estimated at about 50%) and brought some Ukrainian capital back into the country.

Over a longer-term, Ukraine's growth potential will crucially depend upon continued reform and its effective implementation. Comprehensive bankruptcy, corporate governance, and securities laws are yet to be implemented. The financial system, as in Russia, is extremely weak. A substantial part of the country's industrial base is obsolete, and the energy sector is extremely inefficient. A number of state regulatory bodies are still lucrative and therefore subject to corruption, and red tape and bureaucracy remain a formidable obstacle to an efficiently functioning market economy.

Ukraine has also one of the world's smallest banking and monetary systems, unable to provide the productive sector with the credit and other financial support services necessary to ensure sustainable long-term growth. The system suffers from a high degree of politicisation, overt favouring of selected banks, and protects both depositors and shareholders from the consequences of failures. The recent bankruptcy of Ukraine's most problem-ridden and politically supported large bank may be a welcome step.

Overall, Ukraine's financial system is seriously inadequate relative to the requirements of the economy, particularly given the country's massive need for infusion of capital.

Mass privatisation, and the so-called shadow privatisation process, created powerful economic groups that continue to exert pressure through a variety of corrupt practices and benefit from large quasi-rent activities generated by key industries (metals, chemicals, gas). As a result, various favours (such as tax exemptions and the discretionary application of regulatory requirements) have been prevalent, with all their dire consequences for the country's fiscal position. While there has been tremendous improvement in the fiscal sphere over the past two years, in some other areas political influence has continued to be damagingly strong.

On the positive side, the transparency of privatisation has increased since mid-2000, when, for the first time since independence, all political participants agreed to accelerate the privatisation of large-state owed companies to strategic investors, with the assistance of Western firms and for cash. (The three-year program (2000-2002) has a US$ 2.75 billion target.) While actual privatisation receipts were close to their 2000 targets, in 2001 they were just above half of what was planned (i.e., UAH 3 billion (US$ 500 million).

Based on the above analysis Standard & Poor´s recently (26-Dec-2001**)** assigned to Ukraine a Stable B rating. An even higher rating is constrained by:

- Major political distortions, which are being eliminated only very slowly. As a result, the country continues to endure a highly centralised decision making process and is yet to develop democratic cultural and political institutions.

- Shallow institutional and legal systems, including lax enforcement that continues to foster powerful vested interests and widespread political patronage and corruption.
- A weak economic structure, including the challenges of downsizing and privatising politically sensitive large mining and heavy industry as well as restructuring and privatising an inefficient energy sector.
- A recent track record of local currency and foreign currency debt defaults and rescheduling with both official and commercial creditors.

Latest developments

Admittedly, the Ukrainian government is very much aware of the shortcomings of the investment climate in the country. In order to ensure a workable approach to creation of friendly investment environment in Ukraine and stimulate investment activity, the President of Ukraine decreed the ratification of a “Program on Development of Investment Activity in Ukraine in 2002-2010”.

The Program should be introduce a coherent set of measures aimed at further improvement of the investment climate in Ukraine, namely: further deregulate and liberalise business activities, complete the creation of a stable and predictable legal environment, ensure transparency of the procedure of the decision-making process of central and regional executive bodies, improve the mechanisms of corporate rights management, improve effectiveness of bankruptcy procedures, rationalise and increase transparency of tax administration procedures, improve and increase the effectiveness of public governance, further strengthen the banking system of Ukraine, encourage implementation of the judicial reform and ensure unconditional execution of court decisions.

The intentions are quite in line with the OECD recommendations but, as is well known, the devil hides in the implementation.

Let us just take the last part of the envisaged set of measures, namely, to complete the creation of a stable and predictable legal environment and the intention to encourage implementation of the judicial reform and ensure unconditional execution of court decisions. These are certainly very complex issues and I do believe that for a real efficiency improvement of this “third power" of the governance structure, beyond the political determination to support the full independence of the legislative branch, there should be a extensive know-how transfer from the OECD member states, combined with financial assistance for a broad range of measures ranging from the creation of computerised networks to the initial direct financing of courts and judges. This ambitious project tentatively called "Support to the Reform and the Restructuring of the Ukrainian Juridical System and Law Enforcement Agencies" should go together with the introduction of an extensive monitoring of the law enforcement practices.

A related development may be the largely overdue improvements in the Corporate governance practices. To my mind, first it makes sense for the Government to approve the proposed Code of Corporate Conduct. The implementation of the principles included in the Code will have to be entrusted to a specialised self-financing institution, similar to the Russian Institute of Directors (http://www.rid.ru/) which, beside keeping track of the corporate governance index (based of methodology currently under development by Standard & Poor´s), should offer a Program of Education tentatively called "Corporate Director" for the Members of the Boards of Directors and the Top Managers. This program should be designed to assist in the transformation of the board of directors into an effective organ of control and governance and, thus, enhance the effectiveness of the operation of the company as a whole. The target groups for training would include: executive/non-executive board members, company managers, representatives of the central and regional authorities in the boards, major shareholders.

Some recommendations

I do believe that the key recommendation should be to establish a permanent monitoring of the main facets of the process of improving the investment environment in Ukraine. This can include monitoring of the Law Enforcement and Corporate Governance practices but also bringing to the public attention regional ratings of these parameters, e.g. in the form of corporate governance indexes.[1]

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1 References: Decree of the President of Ukraine On Measures to Improve the Investment Climate in Ukraine, 12 July 2001, Kyiv; International Trade Club in Ukraine, Information catalogue N 1 (January, 2002), Development of Economy of Ukraine over 11 Months of 2001 and Macroeconomic Indices Forecast for 2001-2002; Basic Indices of Economic and Social Development of Ukraine, State Committee for Statistics, February 2002; Investment Climate in Ukraine, International Trade Club in Ukraine, January 2002.

SEVEN YEARS OF REFORM: WHAT HAVE WE LEARNED?

*Serhiy Moskvin**

What was written seven years ago:

" Normal investment activities are impossible without the stock market" - this is the opinion expressed by Serhiy Moskvin, Deputy Head of Foreign Investment Division of Agency for International Co-operation and Investments ("Delovye novosti" May 31, 1994).

The current situation in Ukraine is not favourable for foreign investments, which is in large measure due to economic and political developments in the following fields: political situation, legal guarantees, hard-currency regime, foreign trade regime, taxation, and privatisation.

What is written today:

Currently, assessment by experts of Ukraine's investment climate is not favourable. According to "Euromoney" magazine analysing investment attractiveness in 169 countries, the degree of risk in capital investments to Ukraine is constantly increasing. As of March 2000 in terms of reliability index Ukraine was in the 149th place, whereas in 1994 it was ranked 122nd.

Senior executives of foreign companies doing business in Ukraine have identified the following factors, which have a negative impact on Ukraine's investment climate: unstable legislation, corruption, and excessive government's interference into entrepreneurial activities. Positive changes are

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as follows: stabilised economy and political situation, improved qualifications of the staff, and development of the private sector.

Why are we the way we are…

Ukrainian enterprises did not experience any competition in the past. Now they are facing competition with the world's leading producers of various goods and services. Most of Ukrainian producers are unable to meet world competition due to the lack of efficiency in the following three areas:

- Technology- it is much easier to export raw materials, have it processed and bring it back as a ready made product instead of setting up the production process in Ukraine;
- Restructuring - a lot of existing production capacity will never be used in the future, and those required to service internal market are absent;
- Management –old organisational structures of enterprises have proved ill-equipped to function in the market environment.

Substantial reduction of domestic production and total drying up of investments in the real economy proved to be a logical consequence of the above-mentioned circumstances. Growth of domestic investments has begun only in 2000.

What we understood:

- Freedom is the price to be paid for investments
- Investments cause redistribution of ownership rights
- Redistribution of ownership rights leads to redistribution of power

Which investor is better: Ukrainian or foreign?

Portfolio foreign investments have a major drawback: in times of financial crises foreign portfolio investors desinvest capital rapidly, leaving domestic investors behind to deal with the problem of the lost money on their own.

Not all foreign investments are genuine foreign investment. Much of it may be Ukrainian capital finding its way back to Ukraine in the guise of foreign capital.

Many domestic investors may be operating in Ukraine's shadow economy. We should not forget the average investor – Ukrainian citizens who are actually hiding their savings. It is the average investor who is able to boost the economy if the government authorities and banking system succeed in winning his/her confidence.

Is all what they say about us is true?

Unstable political situation **-** Ukraine's choice of democracy is the cause of its unstable political situation for several years. An autocratic regime is always more stable and (if there is a wish) it may provide a favourable investment climate. In spite of many obstacles Ukraine has evolved into a State, which in itself is a miracle. Born out of a political compromise Ukraine's Constitution is naturally imperfect. Competition between political forces is a regular phenomenon testifying to competitive environment in politics. Such competition promotes future stability, which is a pre-requisite for economic growth. A strong President, well-structured Parliament and sound Government –all constitute a precondition for political stability.

Business interests of the State and corruption **-** Was a different course of development possible in the new country with primary capital formed on account of cheap resources owned either by the government or some unidentified entities? Officials are not willing to live on miserable salaries when they are in position to exercise control over huge volumes of funds. They are looking for more or less legal means to ensure their children's future. They insure their risks by acquiring more power. Businessmen who started their careers in different types of co-operatives are seeking seats in the Parliament. Bureaucrats used to allocating resources under socialism are founding their own private firms.

The rules of the game were developed by interest groups not on the basis of the world experience. None of the world's countries has experienced this. Foreigners who took the trouble to learn these rules have succeeded. However, things are changing rapidly, and developments should be watched closely. The level of corruption in Ukraine is considerably overstated. And corruption is a consequence of both the supply and demand for bribes.

Lack of legislative clarity about investment conditions **-** Some experts believe that Ukrainian laws are passed by certain outsiders and not by the 450 members of Parliament, each of whom has his/her own opinion on the draft law. Don't forget that ten years ago Ukraine did not have any legislation at all. Creation of a post-socialist economy was something like a *terra incognita*. 1992 saw the passage of law on foreign investments with special tax privileges granted to joint venture enterprises, which was a drain on the budget and was eventually annulled in 2002.

It is the democratic law making process that poses problems. Mistakes are inevitable. Legislative development is moving ahead. The Law “On the Joint Investment Institutes” and the changes introduced into the system of taxation of corporate and share investment funds have moved funds into tax-free zones.

***Tax rates* -** No one will claim the Ukrainian tax rates are low; but European rates are even higher. Tax rates are not an issue (it is hard to believe that lowering them will make everybody pay the taxes). The core issue is that investments are being taxed according to the Law “On Enterprise Profit Tax”. As a result, investments are either not undertaken or are hidden. Progressive taxation scale is applied to natural persons. Salaries are also taxed. For this reason, a lot of them are paid below the counter, and not accounted for in official payrolls. The budget is being enriched by the value-added tax. The conclusion is that tax reform should not center on lowering tax rates and the passage of Tax Code, but rather it should aim at improving the investment climate.

What are we “poor” at doing?

First of all, to attain steady economic growth, domestic investments and savings should reach 17-25% of GDP. Currently, it is 6-9 %. Such a level of investments is a pre-requisite for improving the investment climate. Secondly, Ukraine’s economic growth should be fuelled primarily by domestic investments, and foreign investments should only follow the investment activities with domestic capital. Finally, absolute amounts of investment per se do not guarantee successful economic growth. Structure of the economy, investment efficiency, management quality, also play a crucial role.

Laws, decrees, resolutions and instructions may only impact a certain aspect of investment process but they may not induce people invest their money if they are not willing to do so; stimulate domestic investors to enter the open economy and exit from the hidden economy; and teach managers to work if they are not able to do so.

Recommendations

Let me briefly discuss my suggestions on how to increase investment flows in Ukraine:

- ***Political and economic stability*****:** Encourage who are thinking of how to improve business climate. The more centrist deputies we have the easier it will be to pass the required laws and place professional, competent people in the government.
- ***Privatisation***: Privatisation should be completed by 2003.
- ***Liberalisation***: Adjust to the current state of the market and do not demand from the authorities more than they are able to give.
- ***Corporate Governance***: Analyse the composition of shareholders in Ukraine's 35,260 joint stock companies. Determine how they differ from the stockholders in other countries, and then judge which system of corporate governance suits them.
- ***Foreign Capital***: Do not give any unnecessary privileges to foreign capital, for it is already competing with national capital.

IV. BUSINESS AS PART OF THE SOLUTION

PRIVATISATION: LESSONS FOR UKRAINE

Helen Kryshtalowych[*]

This paper examines how other countries, as compared to Ukraine, have privatised their large industrial and infrastructure sectors. Drawing on these examples, it outlines the fundamental elements of a successful privatisation programme. The challenge is to design a privatisation process that results in the greatest possible value for the shares that are sold.

2002: A First and Critical Step - Identify The Goals of the Proposed Privatisations

As a first and critical step, Ukraine must specifically define the goals that it seeks to achieve through privatisation of its industrial and infrastructure sectors, as well as the natural monopolies in the energy and telecommunications sectors, and it must formulate standards by which it will measure the success of the privatisation programme.

There will Be Both Immediate and Long-Term Goals of Privatisation

Short-Term Goals of Privatisation are as follows**:**

- Ukraine will want to ensure the safe, efficient, and reliable operation of privatised assets especially in energy and telecom sectors.
- Ukraine will want to attract capital and expertise from strategic investors with the technical and financial ability to invest in large industries and utilities.
- And, Ukraine will want to obtain the highest possible price for the assets.

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Long-Term Goals of Privatisation

Let us examine some important long-term goals:

- CEER and CIS Governments use large-scale industrial and infrastructure privatisations as key to building international investment reputation. Large-scale privatisations generally attract the greatest international attention:
  - Purchase price and investment amounts are very large;
  - Bidders are major global companies whose activities draw attention;
  - Sectors remain closely associated with modernisation, change and economic growth.
- Ukraine will want to enhance its attractiveness as a country in which to make further investments, specifically, for the construction of new facilities and rehabilitation of old facilities.
- Ukraine will want to position itself to become a full participant in broader markets, such as the EU markets.
- Ukraine will want to position itself as both a reliable local supplier, and exporter.
- As another long-term goal, Ukraine will want to create confidence in the absolute integrity of its privatisation process.

In establishing its goals, Ukraine must be aware that it is competing for private investment. Foreign investors interested in emerging markets now have a wealth of attractive investment opportunities outside of Ukraine. Further, the recession in Europe and the U.S. is likely to affect short term investment decisions. Energy and telecom present special problems but also unique opportunities. In sum, Ukraine's privatisation process must be competitive or rational investors will invest elsewhere.

Elements Common to Successful Privatisations

Five Issues Best Addressed Before Privatisation.

Successful privatisations have taught us that there are five issues that should be addressed prior to privatisation. These are: regulatory issues; labour issues;

valuation of assets; long-term supply contracts and debt obligations; and environmental liabilities.

As we learned from last years oblenergo sales, regulatory issues are the most important. The regulatory system must:

- Establish prices that enable investors to recover their costs and earn a profit, and
- Protect consumers, so that they do not lose faith in the privatisation process.

Various state bodies and generation and distribution companies in Ukraine are currently debating how to organise the sale of electricity on the wholesale market. The debate about how to buy electricity (directly from generation companies or through a wholesale market or both) and the uncertainty related thereto affected the oblenergo privatisations and will certainly affect future sales. Whichever way the current debate is resolved, these regulatory issues are best resolved before privatisation. Negotiating regulatory conditions with individual investors is not a desirable part of any privatisation process.

Hungary and Ukraine's experience illustrates this point. In 1993, Hungary's first privatisation attempts failed because the proper regulatory and pricing regime was not in place. Ukraine's oblenergo privatisations were affected by the last minute decisions on regulatory issues and did not ultimately bring in the large number of potential bidders nor the prices expected.

Labour, Valuation, Debt and Environmental Issues.

The other four issues, - labour issues, valuation issues, issues of long-term supply contracts and debt, and environmental pollution issues also must be clearly resolved prior to privatisation.

Labour concerns - Labour concerns will be minimised by strengthening the safety net with retraining programs.

Valuation - Valuation of an asset by an independent auditor helps to establish a benchmark against which to evaluate bids. However, establishing a minimum bid price generally tends to drive down the price. (A bottom price brings down the top price.) Ultimately, if the sale is competitive, the market will establish the market value of an asset. Strategic investors need the time and full information to make their own valuation assessments.

***Debt and Long-Term Supply Contracts* -** Debt and long-term supply contracts that are no longer economically feasible will affect privatisation, unless public policy on how to deal with them is adopted prior to privatisation. Some countries write off debt in the process of privatisation. The debt restructuring agreements offered to investors in the oblenergo privatisations were very helpful to the process.

***Environmental Issues* -** Significant environmental liabilities will drive down the price. Thus, environmental clean-up prior to privatisation will improve the attractiveness of an asset.

In this regard, there are clear lessons to be learned from the privatisation experiences of Tunisia, Venezuela, New Zealand, Japan, Hungary, and Ukraine.

Creating and Maintaining Investor Confidence in the Integrity of the Process

The government must create and maintain investor confidence in the integrity of the privatisation process. It is essential to recognise that the process itself will affect the price.

Establish and Publish Good, Rational, Clear and Specific Rules For the Process That are Free From Political Interference.

The criteria to evaluate bids must be clearly stated. If price is the determining factor, this must be very clear. If other criteria will be used, the weight given to each factor should be published before the bid proposals are submitted. I will return to the relative merits of the evaluation standards later in the paper. My first point on process may be an obvious one, but it bears emphasising: Investor confidence in the privatisation process depends upon the creation and advance publication of detailed, clearly defined, rational privatisation procedures.

Ukraine enacted new and detailed regulations on privatising the electricity sector. The new regulations were a significant improvement leading to a selection process that was both literally and figuratively transparent. This is a model that should be built upon as it instilled confidence in the fairness of the selection process.

Even if there is no manipulation or favouritism, the mere perception that these are possible will undermine the bidders’ confidence in the integrity of the process.

It should be noted that the electricity sector rules were specifically applicable to those privatisations. Other privatisations are currently subject to other regulations, which are not as transparent.

Adhere to the Published Rules and Procedures.

Detailed rules published in advance will of course mean nothing if potential bidders do not believe that those rules will be followed. Strict adherence to the rules increases investor confidence in the process only if the rules are clear and evenly applied. Mexico does this very well.

Bidder confidence is also bolstered when bidders know that they can appeal the bid award. Because there is a perception that Ukrainian arbitration courts may be manipulated, foreign arbitration of appeals should be permitted.

Establish a Commercially Reasonable Bid Process.

The concept here is straightforward: Investors are likely to pay more for assets whose value they have had the opportunity to assess, and they will pay less for assets about which they know relatively little. This is a key requirement.

First, potential bidders must have a reasonable amount of time to conduct due diligence in order to value the assets for themselves. Second, they must have adequate time to prepare a meaningful and competitive bid proposal. A central criticism of Hungary's energy privatisation was that it did not grant sufficient time for thorough due diligence. Ukraine's process in the oblenergo privatisations arguably provided sufficient time.

The real problem, however, was having real access to reliable information. A major issue in Ukrainian privatisations is the fact that the seller, SPF, does not control disclosure of information. Thus, SPF is usually also unwilling to give appropriate representations and warranties which will protect investors in cases where they relied on incorrect information provided by the companies. Moreover, SPF is usually unwilling (and legally not capable of) contractually binding itself to certain government guarantees. Thus, in case of large scale industrial privatisations, complete government support is essential. The other lessons from the oblenergo privatisations are that strong local financial and industrial interests do not always allow the Government to behave consistently.

There must be full disclosure to bidders of all information, which might effect the value of the investment. Company management needs to support the privatisation process.

Balanced against the need for adequate time to examine an asset is the need to maintain the momentum of privatisation. If the waiting period is too long, business may suffer as management waits for the change in ownership.

Establish Rigorous Financial and Operational Qualifications For Bidders.

If the government's long-term privatisation goals are those I identified earlier, it will want to attract bidders with the expertise and the resources to pursue these goals through good times and bad. Tender regulations and rules should establish specific, clear technical and financial requirements for bidders, which will permit disqualification of bidders that lack such expertise and resources. The rules were clear in the oblenergo privatisations.

Maintain Bidding Transparency.

Lack of transparency will lead to an outcry over unfairness that can threaten not only privatisation, but reform in general. Competitive bidding ensures transparency. The perception of transparency is enhanced by the full disclosure of the winners, and the reasons for their selection.

Standards for Selecting the Winning Bid.

The determination of the appropriate standard or standards for selecting the winning bid is often the most disputed and controversial element.

Many analysts favour a multi-factor standard for selecting the winning bid. Other analysts argue that the selection standard should be based on one factor only: price. This is the factor utilised in the oblenergo privatisations and applauded by the investment community.

When a multi-factor standard is employed, each bid is evaluated on the basis of the bidder's experience and qualifications, proposed business plan, and willingness to make future investments. One problem with the multi-factor approach which is found in Ukraine's general regulations (applicable to current large scale privatisation) is that it does not specify what the bidder receives in return for its future investments (not clear whether additional shares are available for the investment; and the liability for taxes on the investment are bad potential consequences). Another problem is that investors are forced to make investment promises that will be hard to keep even if made in good faith.

When bids are evaluated based in part on bidders' investment projections, bidders have the perverse incentive to inflate those projections. When they win, the bidders then try to renegotiate. A better strategy is to establish a regulatory regime that gives the new owners the proper investment incentives.

Using the price-only system makes the selection process simple and more transparent.

Hungary has successfully employed the single-factor, highest-bid criteria, giving little or no weight to bidders' proposed business plans. To date, Hungary's power sector privatisations have earned it over US$1.5 billion.

Issue is Negotiating Control of the Enterprise

The tension between government and investors.

In any privatisation, there arises a fundamental tension between the government and the investors. The government wishes to maintain control, while the potential investors wish to obtain control. In Ukraine, Russia and many Newly Independent States, governments have been reluctant to relinquish their control, and have offered potential investors only minority ownership interests. Latin American countries, on the other hand, have tended to transfer majority or total ownership and control of an enterprise for a limited term, at the end of which ownership reverts to the government. This can be done through concession, leasing or other contractual arrangements.

Deciding how much to sell.

Bidders need assurance that the winning investor will acquire sufficient control to manage the company to profitability. From the bidder's point of view, earnings must not be threatened by unexpected costs, changing tariffs, disruptions of customer collections, or government intervention.

Where the government retains a majority stake, it retains the ability to interfere with company operations.

Hungary was successful in giving investor's management control even where they held minority stakes. This is an option permitted by Ukrainian law and regulations by way of Share Management Agreements, which permit the investor to manage some portion of the state-owned shares. However, current regulations and model contracts do not give any real meaningful control over the State-Owned shares. This should be changed.

As noted, Ukraine has not addressed the problems that will arise when the government maintains a stake of 26 % or 51 % but at the same time requires additional investments, investments for which no new shares will be issued.

Conclusion

In conclusion, to conduct a successful privatisation, Ukraine must:

- Identify its privatisation goals;
- Create the proper regulatory framework;
- Create and maintain investor confidence in the integrity of the privatisation process;
- Establish clear standards for selecting the winning bid; and
- Determine the degree of control to be granted to the new owner.

PRIVATISATION IN UKRAINE: AES CASE

Mikhail Malyovaniy[*]

This paper aims to give an overview of challenges and obstacles faced by AES Corporation (AES) involved in the privatisation process of Ukraine's electricity sector since 1998.[1]

Development of privatisation conditions in 1999-2000

In 1999-2000 progress was achieved on the utmost importance of attracting strategic investors into Ukraine. Investors were given the opportunity to acquire controlling stock and the Government appointed an Advisor for tender projects. Conditions of preliminary information were developed and oriented towards the strategic investor. At the same time, the Government adopted amendments to the Law on Electric Power engineering, which improved the discipline of payments in the Electric Power Market and introduced the notion of "Industrial Investor".

Oblenergoes' privatisation process

Taking into consideration these and other factors reflecting positive macroeconomic changes in Ukraine, and believing that there is no other

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* Director of AES Corporation Representative Office in Ukraine.

1 AES Corporation is a global electric power company having more than 160 businesses in more than 20 countries around the world, including distribution networks in the countries of the former Soviet Union. In 1998, AES Representative Office was set up in Kiev. The Kiev Office carried out monitoring of the privatisation process's development, contributing to the advance of privatisation ideas and using accumulated international experience of AES on this field. Substantial preparatory work was performed together with well-known legal and audit companies.

alternative to a market economy in Ukraine, the AES Representative Office took the decision to participate in the tender sale of six oblenergo. Besides AES, such companies as EDF, Union Fenoza and Power Company from Slovakia, and Kansai Electric (Japan) took part in the tender. In September 2000 these companies started to work with the Advisor (Credit Swiss First Boston Bank) on privatisation issues.

Alongside with a "due diligence" study, the work began on drafting, with the Advisor's assistance, the following documents: stock purchase agreement; debt restructuring agreement; new tariff methodology; agreement on purchase of electric power from the electric power market.

Due to a heavy workload on such a "brand new" issue, the Government decided to postpone the tender for one month. In April 2001 tenders were carried out and the award was given to AES for two of oblenergos (Kievoblenergo and Rovnooblenergo).

After signing the Purchase-Sale Agreement, payment and transfer of 75% of stock, AES started to fulfil its contractual obligations, such as:

- Ensuring 100 % payment for purchase of electric power on the Electric Power Market;
- Elaborating of the Investment program, to be approved by an appropriate regulating body; and
- Preservation of working places in the privatised companies within one-year period, and others.

Today AES has fulfilled all these obligations. There is no indebtedness on salaries and payment of taxes. The Investment program was presented on the due date.

In addition, restructuring of the management structure is under way. The main goal is to increase managing ability, reduce the management hierarchy to four levels at the first stage, and delegate decision-making to lower levels of management. In order to adapt to Western systems of management, professional psychologists have been invited to carry out special support training. A special Program has been adopted, which includes payment of allowances for those who take an independent decision to leave the company. With a view to fulfilling the Investment program, the Company has announced tenders to replace the capital stock.

Problems of Electric Power Market

Having limited practical experience in the context of Ukraine's "Wholesale Energy Market", AES, as well as other companies, face the following problems:

- Series of cross-debts among market participants;
- Current payment for electric power difficulties;
- Administrative interference in economic activities by state structures;
- Imperfect system of tariffs and pricing for electric power products;
- Limited "solvent" demand;
- High level of losses (including theft of electric power); and
- Imperfection of contractual relations in electric power market.

AES has been striving to find a compromise settlement of problems, although some of them have quite a long history and can not be solved by half measures. This is particularly so in the case of non-payment for supplied electric power. In this case we have to resort to extreme measures and disconnect customers that do not pay for supplied electric power (defined as a "goods" by the Law on Electric Power) and keep on accumulating debts.

However, the response of local administrative bodies is not very constructive to these measures. They carry out various inspections in the companies, checking all types of activities starting from fire protection measures to targeted spending of budget funds, from examination of the network condition to monitoring of prices for electric power, execution of license activity, reporting, information etc. Although the inspections do not reveal any violations, they divert employees from their activity, and finally the companies incur losses. These inspections are gross violations of the Company's rights.

Conclusion

Privatisation process is quite painful. It usually means changes in existing structure of property and staffing. Taking such complex decisions is usually linked with in-depth analysis of the condition of the enterprise, the branch and the economy as a whole.

There is no other alternative but privatisation for Ukrainian power engineering today. Therefore, decisions and programs must be purposefully executed. It would be expedient, if at this stage, the state prepares the way for rendering post-privatisation support to private companies working in the power-engineering sector.

The Government must not pursue its policy at the economic and operational level for those economic subjects in the process of privatisation in different sectors of the economy.

This can be done by adopting legislative and regulatory decisions through independent bodies, which promote already working businesses in Ukraine and, at the same time, signalling improvements of the investment climate to those, who are about to participate by monitoring the aspects related to this climate.

In conclusion, it should be said that if today one hears about the administrative interference in the activity of the enterprises, this means that investors are already working in the country.

RISKS AND OPPORTUNITIES ON UKRAINE'S STOCK MARKET

Serhiy Oksanych[*]

This paper highlights the principal characteristics of the Ukrainian stock market today, discussing opportunities it offers both to strategic investors and venture capitalists, and obstacles to its development.

In 2001, total trading volume in all financial instruments amounted to UAH 8.7 billion, 72 % of which was traded on the PFTS (First Securities Trading System). This volume is 4.3 times higher than in the year 2000. But this increase was achieved mainly due to the fact that government bonds were allowed to be traded on the PFTS. Only about a quarter of this volume was brought by corporate stocks and bonds, while the other three-quarters were generated by government bonds.

PFTS index fell 23% in 2001 after a spectacular increase of 42% in the year 2000. Standard & Poors, which uses PFTS figures, placed Ukraine third in terms of capitalisation among the so called Frontier Markets after Romania and Slovenia, and showed its capitalisation as just $ 1.6 billion, a quite miserable figure. But investors should understand that organised market figures are just a small fraction of the total market figures as many of the actual trades are done over the counter and never get reported through organised markets. So the real market capitalisation should be a lot higher.

Most of the issues that are used to calculate major market indices have become illiquid and hence the prices have become depressed with indices following the downward trend. How can this be explained if general economic growth figures were last year the best ever over the whole history of independent Ukraine and probably the best in Europe? Unfortunately, I will not discover America if I say that the answer lies in just two words – CORPORATE GOVERNANCE. This implies:

* President, KINTO, Investment & Securities.

- Transparency of Ownership
- Concentration and Influence of Ownership
- Regularity of and access to the shareholders meetings
- Shareholder meeting procedures
- Equality of ownership rights
- Public disclosure standards
- Timing of, and access to, public disclosure
- Independence of auditor
- Board composition
- Influence of board

Unfortunately, during 10 years that Kinto has worked on this market, we have seen, to put it mildly, irregularities in all aspects of corporate governance.

Another reason for the secondary market to become depressed was very high concentration of ownership in many of the companies that once were leaders of the stock market. Once a shareholder or a group of affiliated shareholders reach 51%, let alone 60% or 75%, the secondary market plunges below any reasonable levels. In fact, the secondary market with such levels of ownership concentration is alive only while there are groups of larger foreign or domestic shareholders competing for complete control. Clearly, this is closely connected to the aspects of corporate governance and minority shareholder rights.

However, I believe that today's depressed state of the secondary market for portfolio investments, and also quite low price levels for second- and third-tier companies offer great opportunities for both real **strategic investors** for these middle companies and a new wave of **venture capitalists** willing to invest in the so called "special situations".

There are a lot of mid-cap companies that still do not have a single owner and shares in which are vastly dispersed among employees, and many privatisation voucher investment funds. At the same time, privatisation is not over yet, and the government disposes of its sizeable stakes in such companies through tenders or auctions. And there is still room for both venture capitalists and strategic investors to capitalise on the discrepancy between economic growth (e.g. 18.2% in food industry, 18.2% in light industry, and 28% in wood-processing industry) and depressed stock prices. For a "special situations" venture capitalist an estimated time horizon is 1.5 to 3 years.

Speaking of strategic investors, we believe the following sectors to have bright prospects:

- Energy generating and distributing companies (taking into account the forthcoming privatisation of 12 energy distributing companies in 2002);
- Telecommunications: mobile connection (privatisation of UMC); local telephony projects, CDMA/TDMA; data transmission, IP-telephony; cable TV;
- Manufacturing and processing of agricultural products: cereals; vegetables and fruits; flax manufacture and processing; manufacture of ecologically safe agricultural products;
- Construction materials: building and front bricks; building ceramics; light concrete; stone quarrying; heat insulation materials; roofing materials;
- Certain machine building industries: agricultural machinery; machinery intended for the needs of energy industry (turbines, «Turboatom», Kharkiv, «Zarya», Mykolayiv); machine-tools construction; bearing manufacture; ship building industry (in an outlook); cable manufacture;
- Pharmaceuticals - manufacture of import substitutes and other medicines under license in the future;
- Separate industries of the food sector: canned fruits and vegetables; confectionery; alcohol drinks and alcohol-free beverages; dairy; semi finished food products;
- Separate sectors of light industry: leather processing; shoe industry; clothing industry;
- Wood and timber processing industries, furniture manufacture (production of import substituting goods);
- Cellulose and paper industry (manufacture of import substitutes);
- Retail trade development (construction of supermarkets and shopping malls to replace the “bazaars”).

Hence, the Ukraine’s stock market offers huge opportunities to investors. However, strategic investors still have little confidence in this market. Consequently, to attract investment it would require improving the corporate governance standards and shareholders’ rights’ protection, which continue to constitute a major problem.

DEVELOPING THE BANKING SYSTEM

Jacques Mounier[*]

This paper discusses banking in Ukraine as seen from the viewpoint of a foreign banker working in Ukraine since 1993[1].

Overview

About 150 banks are still operational in Ukraine, which is 50 banks less than two years ago and ±10% of the number of banks that are still operational in Russia. From a balance sheet standpoint, the first 10 banks represent 50% of the assets of the banking sector.

Banks in Ukraine are not really a significant factor for the economy of today: loans, as compared to the official GDP of about $ 40 billion, represent 15 to 20% of this amount. Thus, the first *raison d'être* of banks is not fulfilled, i.e. banks do not intermediate deposits into loans, in a significant way.

Banks, except foreign ones, have virtually no access to foreign currencies funding: if a bank ranked 10th in Ukraine from an assets point of view is able today to obtain $ 2 million of clean lines from western banks (i.e. non-cash covered lines), this is to be considered as a success for that bank.

The local currency money market is still in its infancy: there is not yet a liquidity instrument like T-bills that can be used, rates in UAH are still volatile, the money market is a recent phenomenon. But payment services offered by banks in Ukraine are excellent: I discovered in this country the best clearing system I have experienced in my 30 years career.

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* Credit Lyonnais Bank Ukraine.

1 Credit Lyonnais Bank Ukraine, was the first western owned bank to come to Ukraine in 1993 and has been operational in this country for 8 years now. Banking by Credit Lyonnais Bank in Ukraine is mostly service-driven processing 2500 transactions per day, the majority of which is automated.

And technically Ukraine is almost ready to be involved in modern/western banking: the staff of the National Bank of Ukraine (NBU) is skilled, banks in general usually have good systems, a credit culture has arisen. Altogether, Ukraine's banking system is in a much better shape today than a few years ago.

Why are we where we are today?

The population in Ukraine has not yet developed confidence in banks: today it deposits approximately $ 2 billion in banks, half of it in domestic currency. If such an amount has doubled over the last two years, which is obviously a success, it is still far from the level that should have been reached: +/- $ 10 billion equivalent in a country that has a GDP of +/- $ 40 billion officially and probably $ 60 billion unofficially.

Banking is based on trust and building such trust requires discipline, long-term commitment of all the participants, and no accidents! The international banking community does not yet have enough confidence in Ukrainian banks, which are still much too small and, therefore, fragile. Those 150 banks have ± $ 1,5 billion of capital, i.e. $ 10 million on average per bank, the quality of the assets is even harder to assess than in our western world, the way provisions are constituted is also difficult to understand and seems to be very much tax-oriented.

The money market instruments, as well as the capacity of the NBU to monitor the money market are not yet developed sufficiently: lack of confidence in the Government of Ukraine, so far, has prevented the T-bill market from developing as it should. In addition, the NBU, even if it controls the liquidity of the UAH market much better today, it is far from smooth and predictable.

What could be the next steps for the development of the banking system in Ukraine?

Increasing protection of lenders to banks is the first important step. If insurance on deposits exists already, it could be developed further. For instance, one could imagine mutualising such an insurance to a certain extent: it would force participating banks to be very strict on the membership of such a deposit insurance system, and thus, eliminate a significant number of small banks.

A second way is to ensure the development of infrastructure, mostly regulatory and legal, which would help to better protect the interests of the banks when lending: pledges, development of mortgages, development of a true loan database. On the latter, the NBU has, against our will, developed a loan database, which we consider to be useless: it would be useful if and only if banks had no choice, but to declare credit lines that they have granted to a given corporation, for instance, above UAH 1 million (i.e. Euro 200 000), declare also the utilisation of such lines, and if every participating bank could have access to such a database and could discover for a given corporation what are the lines granted and used, at a given time, how it changed overtime, the whole operation conducted on an anonymous basis (i.e. it would be impossible to know who among the banks opened a credit line and at which bank lines are being used).

The third way is to develop the T-bill market. This is linked to the development of trust of all the participants in the Government of Ukraine: the Ministry of Finance knows this perfectly well and is about to issue T-bills to be subscribed by the population, and is committed to honouring its signature!

Improving the rule of law – this is mentioned by every corporation working in Ukraine. We all know that, unfortunately, one has no choice in Ukraine when one disagrees with an administration, but to sue it. And those administrations will tell you bluntly: "If we want your company to lose in Court, you know that we will succeed…" The task is first and foremost to make the judiciary system fully independent of any power base in Ukraine.

Development of the investors' market should be facilitated. The first step, as everybody knows, is to empower regulators that will regulate and control the insurance market, the funds, as well as the non-banking sector (leasing). The insurance market for instance, is almost absent in Ukraine, the amount of "true" premium is less than $ 100 million per year (i.e. virtually nobody and nothing is insured in Ukraine). One of the first steps is probably to increase the minimum capital required for an insurance company from Euro 1 million to Euro 5 or 10 million. The second step is to force reinsurance to be subscribed to by only highly-rated companies in Ukraine, if any, and in the west, via investment grade rated companies. This would put an end to the fake insurance business in Ukraine.

A brake has to be put on tax evasion and tax games that are channelled by banks or used by those banks. A few examples:

An individual in Ukraine that has received interest from a bank is not obliged to declare those revenues. Therefore a significant number of banks pays interest rates that are much above market rates (up to 1000%!), interest rates that are tax deductible (provided that those banks are profitable). Many banks pay their staff to a large extent in this fashion, and provide revenues to selected friends.

Provisioning of assets can be tax deductible, based on rules that are rather opaque. And there is no certainty that Tax Administration and/or the National Bank of Ukraine are capable of checking the relevance of those provisions.

Fees paid abroad for guarantees received, guarantees probably backed by deposits that came from Ukraine, are sometimes in the ± 10% per annum range and are tax deductible for the companies that are being lent to.

Reinforcement of the NBU independence is also needed. Although the NBU is a well-organised and respectable institution it can hardly resist some requests. Just to quote one: in 2000 it had no choice but to print ± $ 1,5 billion equivalent of UAH in order to finance the 2000 Government of Ukraine funding needs, that the Government had not been able to finance in any other manner that year.

Long term? What could happen?

It is likely that, as in the neighbouring western countries, western capital will take-over the majority of the local banking system. There is clearly an issue for the banking system in Ukraine, one of not being capable of intermediating deposits into loans in a more relevant way: is this the only reason that will engender the taking-over of banks by foreign capital?

Is western capital interested today in taking-over Ukrainian banks? Apparently, western investors are not. But, based on the changes that have taken place since the last three years, one could expect such an interest to develop in a few years, some western banks may then be interested in taking-over networks.

Should Ukraine resist such a possible future? The well-being of the country should be paramount when such a decision would have to be made by the authorities. I have heard that a 15% limit exists: i.e. some bankers and administrations in Ukraine mention that foreign owned capital in the banking system in Ukraine should not exceed 15%. By foreign owned capital one should understand capital from Cyprus, Russia, the USA, Western Europe… We heard Mr Kroytuk, Vice Governor of the National Bank of Ukraine, tell us, that such a limit does not exist . Anyway, if it did, it would be discriminatory.

To conclude, I truly believe that it is up to the Ukrainian authorities to decide on the future of the banking system and, therefore, on the best way to make such a banking system operational and first and foremost much more useful for the development of Ukraine.

CO-ORDINATING EFFORTS WITH BUSINESS IN UKRAINE

Allard Touwen[*]

Overview

Many changes and radically new processes need to be introduced in Ukraine in order to make the transition from a planned-economy as smooth as possible towards a market economy. The governments, previous ones and the present one are taking various initiatives to make real changes. However it is not only a matter of passing laws and legislations, but it also entails a change of thinking, a change of mentality to make these steps into the transition. No government will have an easy task to implement changes but only the most democratic one that fosters communication and dialogue with the people and the business communities will be successful.

Government should ask itself with any new law and/or legislation the main question: Are we reducing government involvement/hindrance in business operations or not? If so let us redo our work!

The government of Mr. Yushchenko and the prevailing one under the premiership of Mr. Kinakh have been productive in introducing new legislation and have introduced changes in many fields of governmental disciplines. Obviously one should not expect miracles, however some very good macro-economic parameters can be recorded.

The major reforms in agriculture, energy, transportation, financial and infrastructural sectors need more attention and funding. Moreover, the support from European countries sharing their great experience with Ukraine would be very helpful but requires an open-mind and willingness to change from the Ukrainian side. Why should we invent the wheel that is working smoothly in other countries?

The social reforms and the status of the pensioners, almost 30% of the total population, need special attention.

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* President, European Business Association in Ukraine.

Priority Areas for Action

We could make a long list of both areas, which require attention and achievements. It must be clear to the real observer of the development of Ukraine that the list of achievements is impressive, however the listing of areas of attention is much longer. In order not to get lost or side-tracked in the forest of problems we would like to focus our attention on the following:

- Financial sector needs cleaning-up. Within the financial sector the banking sector should be the first to clean-up; there are more than 150 banks, of which over 30% is in bad shape and needs early attention. With interest rates coming down local lending should be stimulated but needs protection by legislation. Especially the Small & Medium Enterprises, the so-called SMEs need more support because these enterprises will provide employment and are the real engine of sustained growth of the economy. Role of Central Bank is encouraging and it should endeavour to make further progress.

- Slow progress of privatisations. Many companies have been privatised and a lot of them are still in dire-straits, however some 4000 companies are still on the list. There are three words to master privatisation: speed, clarity and transparency.

- Transition to a market economy is a process; it is not just copying and adopting EU legislation but needs unambiguous and consistent implementation.

- Level playing field for foreign and local investors; VAT issues. "All people are equal but some are more equal" is the fashion in Ukraine but is in need of change. No favours or incentives should be given to some because in the end it hampers stable and predictable growth.

- Bureau***crazy*****,** corruption and tax evasion makes the transactional cost too high. Bureau***crazy*** is not a misspelling of the word but the bureaucracy viz. the enormous number of papers to be processed not for the sake of business but to drive you crazy**.**

- Taxes are in general not too high but the huge disparity between payers and non-payers makes the costing of products & services much too high. In this case one could say "bad habits drive out good habits". Under the Tax system there are now 22 different central taxes and 16 types of local taxes (e.g. advertisement, parking etc); 6 (six) of these 38 taxes generate more than 80 % of the state revenues. Simplification of the Tax system should be one of the priorities.

- Powers that be in the country should step-up their foreign and domestic PR and practice communication/dialogue. The image of Ukraine in the country and also outside is at a very low level and needs urgent attention. Elections do allow the political powers to practice dialogue and communication with people, however entry into EU and WTO are not on the agenda. In order to boost the image of Ukraine a strong united campaign is needed to tell the outside world that Ukraine offers a good opportunity for doing business. Government should improve its communication with the business circles.

- WTO process & accession to EU. Entry into WTO and EU is a long process and needs not only planning but also action.

How did we do in 2001?

On the positive side: macro-economic data; stability of Hryvna; positive trade balance though slipping; rising GDP - 9%; lower inflation (6%); rising reserves at NBU; and constructive criticism from WB, IMF and EBRD.

On the negative side: banking system is appalling; privatisation is too slow; budget deficit for 2002 not realistic; management problem (who is the boss); and “Ukraine Ltd” did a bad job in attracting FDI (shareholders are dissatisfied because the management did a bad sales job).

Instead of asking why investment, including FDI, is not coming let us do benchmarking that will give the best picture of how attractive we are.

Role of European Business Association in Ukraine

With the European Union (EU) expanding east-wards and approaching the Ukrainian borders in the nearest future, there is more and more interest in developing contacts between Ukraine, the EU and individual European countries. Our aim is on the one hand to help Ukraine through the transition period with all its obvious obstacles and on the other hand to facilitate and support our European investors/members in getting the solutions and not the problems highlighted. We needed to formalise our business contacts. With the help of the EU delegation the EBA was established in 1999. It has grown in 2001 from 120 to 190 members.

We like to be a forum for discussion and resolutions of problems and obstacles that our businesses are confronted with. The EBA tries to provide help and give advice to our Western partners in co-ordinating efforts aimed at legislative changes, administrative reforms and an improvement of the general investment climate in Ukraine. In order to pursue our intentions we offer:

- Collective Advocacy of members' interests; recent example is the VAT issues.
- Regular information support through our monthly meetings and our Website (www.eba.com.ua).
- A voice in EU policy-making process through strong relations with EC delegation and EU members' embassies.
- Networking opportunities.

Conclusion

Ukraine has embarked on its route to market economy and there is no turning back. Many obstacles are visible and some even not yet but the direction is clear. It depends on those in power in the country and the business community to increase the speed, clarity and transparency and foster growth and happiness for all Ukrainians. We want to be part of the solution by contributing to make this happen. You can count on us.

V. THE WAY AHEAD: OECD COUNTRIES PERSPECTIVE

GOOD GOVERNANCE IS CRUCIAL

Rudolf Müller[*]

Overview

The OECD Investment Policy Review of Ukraine, for which we met exactly one year ago, reveals itself to be a happy initiative. We all agreed, and among us several representatives of the private sector, that the analysis of the Ukrainian Investment Policy submitted by the OECD Secretariat was accurate and that its practical recommendations should be implemented. The creation of an OECD-Ukraine Investment Forum had then been decided, and we now celebrate its inaugural meeting. For me it is obvious that there is already considerable progress to be recorded.

Before discussing this progress in more detail, I would like to emphasise our support for the Forum and its continuation. This inaugural meeting is a well prepared one and organised to our entire satisfaction. We have been able, these two days, to engage in productive and interesting discussions. It would make sense to continue our discussions on an annual basis. If I might make a suggestion, it would be to strengthen the participation of the private sector of Ukraine as well as of the home countries of foreign investors.

We do not doubt that the economic situation in Ukraine has improved. Not only do the statistics show economic growth but, looking around, we observe a lot of construction and other investment activity, and we feel a certain entrepreneurial dynamism emerging from within the domestic economy. That is exactly what we were calling for, twelve months ago. We clearly said that the multiplication of small and medium-size Ukrainian entrepreneurs, their investment activity and, hence, their visible belief in the future of the Ukrainian economy would be important signals to foreign investors that the potential of the Ukrainian economy has started to materialise. Let us hope that this enhanced activity in domestic investment is sustainable.

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* State Secretariat for Economic Affairs, Switzerland.

Whatever we may think of the detail, the Ukrainian authorities have given a serious response to the OECD recommendations that were presented and unanimously welcomed a year ago. They presented to us a document of 26 pages entitled "Actions taken by the Government of Ukraine towards implementation of OECD recommendations". We haven't heard of any Forum participant complaining that important recommendations had been omitted or unanswered. Nor was it said that the measures listed and described by the Ukrainian authorities were not in the right direction. This document is a commitment of the Ukrainian authorities to accomplish far-reaching progress in the investment conditions in Ukraine. Its drafting must have provoked many discussions and resulted in a widened awareness of the problems and opportunities for Ukraine. This alone is already an invaluable step ahead.

Elements of Good Governance

However, we also are conscious and stated it a year ago, that a series of new laws or changes in existing laws, as indicated in the mentioned document, might be a necessary but not yet a sufficient condition for tangible improvements. Implementation and application in everyday life, and especially the spirit in which it is undertaken, is crucial. This has, in the case of Ukraine as everywhere, very much to do with Good Governance. Good Governance is now recognized as a crucial pre-requisite for well functioning markets and, hence, for attractive investment conditions and a sustainable allocation of investment capital.

Good Governance means:

- Rule of law;
- that people in charge of Government separate governmental from private affairs;
- that a judicial system with competent and independent judges is in place and enforces the law;
- that the system of laws is of a non-contradictory nature and designed with clarity;
- that new laws or other parts of the legal system are not put into effect retroactively, and that no firm or citizen should suffer disadvantages because of retroactive implementation of new rules;
- that the Government fights corruption.

Good Governance is very much about transparent policies. All companies should be able, on an equal footing, to know the conditions in which they operate and to prepare themselves sufficiently in advance, when changes are upcoming.

Good Governance also includes sound democratic principles in the political life of a country. Not only should elections be fair and the rules of public life shaped and decided by the representatives of the people. But modern democracies also consult with the private sector before taking important decisions relevant to the economy. Good consultation procedures ensure laws consistent with practical life and compatible with the needs and possibilities of the firms and the economy in general.

Pressure for Good Governance is a result of globalisation as investors compare conditions on a worldwide scale and demand a level playing field. Ukraine now definitely is part of the world economy and has the chance of reaping the benefits of globalisation. When arriving in Kiev, I met with several of the Swiss investors in Ukraine. They emphasized the significant potential of the Ukrainian economy. But they also were of the opinion that there still is considerable progress to be made with regard to Good Governance and transparent conditions for investors.

Of course, all this cannot be done within a few months or even a few years. Mr. Bezrouchenko, Deputy State Secretary of the Ministry of Economy and European Integration of Ukraine, just said that in the field of privatisation a lot has already been accomplished within a short time. We presume that the pace at which these measures have been taken would not be possible in each and every OECD member country. Clearly, the will exists with Ukrainian authorities to make further progress in the field of Good Governance and in economic policy. We must hope that they will succeed.

The Glass is Half Full

Because there will be further challenges to be addressed. As one of the Swiss investors put it, when asked what he wished for in Ukrainian economic policy, education should become a matter of concern in the not so distant future. A well-educated labour force will need further attention. In order to maintain a well-educated labour force, investment in human capital is necessary. In that sense, I might come back to the picture I alluded to yesterday: In Ukrainian economic policy, the glass is not half empty; it is half full. Progress has been made, but there still is important work to be done.

STRATEGY TO IMPROVE THE UKRAINIAN INVESTMENT ENVIRONMENT *

*David Dod***

Key Elements for Reform

Since 1995, USAID has substantial programs of assistance to Ukraine in three broad areas that are crucial for improving the climate for investment by enterprises: reform of the financial sector and of commercial law; reform in the design and implementation of budget and tax policy; and restructuring, privatization, and market-reform of the electric power sector.

Since 1999, we have seen very substantial improvements in all three areas, as indicated in the following survey of the goals of the relavant USAID programs. Of significance for investors, we have seen in this period a great improvement in macroeconomic stability. The government has established a high degree of control over the level of government spending and the fiscal deficit and, with sound monetary policy, has reduced inflation to just 6% in 2001. In addition, many important legal processes have been put in place to clarify the rights of investors and creditors, to protect businesses against arbitrary attacks by tax and regulatory authorities and to reduce rent-seeking behaviour by government officials. In response to such developments, gross fixed investment in Ukraine increased substantially in 2000/01- although this mainly reflected the growing confidence of domestic rather than foreign investors.

For 2002, one might single out a few key elements for reform action taken by the Government of Ukraine that are especially timely and important for further improvement in the investment climate:

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* Presentation and background description of USAID activities related to the OECD-Ukraine Forum on Investment and Enterprise Development, Kiev, Ukraine, February 21-22, 2002. Opinions expressed in this presentation do not necessarily represent the views of USAID or the U.S. Government.

** USAID Regional Mission for Ukraine, Belarus and Moldova.

- Enactment of the Civil Code. This should be the fundamental body of law for commercial relations in a market economy. The Government should reject the Economic Code - which was also passed by the outgoing Parliament but which retains non-market principles and conflicts in many ways with the new Civil Code.
- Passage and enactment of the Joint Stock Company Law, crucial to development and enforcement of improved corporate governance in Ukraine. The past influence of special interests in the Parliament must be overcome, so that this Law can be approved and enacted.
- Improved financial discipline and realistic tariffs in the power sector. The national government must become more consistent and proactive in leading this process. This will require political courage to facilitate cut-offs of non-paying customers, to allow tariffs for distribution and generating companies to rise to levels that will attract serious strategic investors, and to move much more quickly to a restructuring of debts of the energy sector companies so that they will be saleable to strategic investors.

Development of the Financial and Commercial Legal Sectors

USAID's program to promote reform of the financial sector and of commercial law in Ukraine includes four principal areas of technical assistance:

- Establishment and implementation of a sound, market-oriented commercial legal framework;
- A strong legal and regulatory system governing the safety and efficiency of banks and non-bank financial intermediaries;
- Adoption and effective implementation of international accounting and auditing standards;
- Improved corporate governance.

The commercial law component made important contributions recently to several important legislative successes - including the development of the Law on Banks and Banking of 2001 and Parliament's passage in November of the Civil Code to replace Ukraine's patchwork of ad hoc and Soviet-era laws governing business relations. New areas of emphasis in 2002 will include: resubmission of the Civil Code, to conform to changes requested in the President's veto message of February 2002; revision and amendment of a large number of other laws and regulations to conform with the final Civil Code; reform of currently ineffective mechanisms for enforcing court decisions; passage of the joint-stock company law; and passage of a new mortgage law. The USAID-sponsored Commercial Law Center will be the main implementer of this program.

A second element of USAID's commercial law program since 1998 has been to assist Ukrainian government agencies and business associations to roll back excessive burdens of regulation and inspection that have created a breeding ground for corruption and inhibit business operations. Until 2000, the primary emphasis was on assisting legal and administrative reforms on licensing, standards, and inspections at the national level - such as the Law On Licensing of 2000, which reduced by nearly half the types of business activities that require a license and reduced by 60 % the costs for obtaining a business license. In 2001-02, the USAID program emphasis has shifted to emphasise reforms at the municipal level in areas of greatest concern to entrepreneurs - notably, through transparent, competitive processes to make business sites available and to award concessions for local services.

The financial sector regulatory component will continue USAID's work since 1995 to help improve the soundness and growth prospects of Ukraine's financial intermediaries. The program will continue to assist development of the National Bank of Ukraine's (NBU's) bank supervision capabilities toward a Western standard of excellence. A second planned area of activity in 2002 or 2003 is assistance for the establishment by Ukraine of basic regulations, licensing, and inspection procedures of a strong, independent regulatory body for Nonbank Financial Institutions that has been proposed to be formed in 2002.

The accounting component of the program will continue USAID's multi-year effort to assist adoption of - and a system of practical implementation, monitoring, and enforcement for - international standards in accounting and auditing. This effort requires further development of the legal and regulatory framework to comply with those standards. Education activities will be continued and certification programs will be developed to produce professionals capable of ensuring the accuracy of financial statements for banks and non financial enterprises - enabling investors and creditors to make better informed decisions.

In the field of corporate governance, USAID's approach will be to address a broad audience of private companies and associations, regulatory agencies, and judges - to help them understand thoroughly the inter-relationships between financial disclosure, shareholder rights and protection, and corporate governance practices to assist anti-corruption and fraud prevention. That understanding is essential to achieve fundamental change in attitude toward markets, commercial behaviour, property rights, and combating financial fraud.

Performance and Projected Results

Important objectives of the financial institutions component of the USAID program over the next few years will include further improvement of Ukraine's financial intermediaries - to increase public confidence in the safety of these institutions and to mobilise external finance to meet the credit needs of Ukrainian enterprises. Recent tendencies are encouraging. Partly as a result of recent improvements in the banking system, depositor confidence in Ukraine has now lifted public deposits in banks from 11.5 % (mid-1998) to 17.5 % of GDP (autumn 2001).

Many Ukrainian private companies have performed poorly in their concern for shareholders' rights, in maintaining accurate and honest accounts, and in disclosure of reliable financial information to prospective lenders and new shareholders. In recent years, USAID projects have sought to remedy these conditions primarily through training and certification efforts focused on the accounting and auditing professions and through selective initiatives to improve corporate governance.

By 2004, under the commercial law component of the program, USAID's goal is that the Commercial Law Center (which has been operating since the fall of 2000) will become a legally independent and largely self-sustaining institution. Its work will include continuation of the development of legal infrastructure and marketplace laws and rules and a program of training public and private sector officials in the resolution of commercial disputes. As an example, CLC will continue to assist through training and implementation appropriate of Ukraine's modern Bankruptcy Law - with its emphasis on restructuring rather than liquidating of insolvent but viable enterprises. Since the law became effective in 2000, USAID-trained arbitration managers have restructured more than 50 enterprises, employing about 30,000 workers.

Economic and Fiscal Reform Activities

USAID's umbrella program of Support for Economic and Fiscal Reform in Ukraine includes four substantive areas of technical assistance, with a focus on capacity building of Ukrainian counterpart – namely:

- Macroeconomic and Structural Policy Assistance;
- Tax Reform;
- Budget Reform; and
- Fiscal Analysis for the Parliament.

During 2002-03 USAID intends to strengthen the institutional capacity of Ukrainian counterparts to develop, implement, and monitor effectively short-term economic and fiscal policies that promote growth and efficiency in the private economy, including an emphasis on:

- implementation of the Budget Code;
- development and implementation of the Tax Code; and
- the use of program budgeting.

Technical assistance is being provided to both national and local public authorities, including the Ministry of Economy and European Integration, the Ministry of Finance, and the State Tax Administration of Ukraine, as well as non-governmental organisations involved in economic and fiscal policy reform. Assistance will include expertise of expatriate advisors and local professionals, both on a long-term and short-term basis; information systems support; and internal and external training programs (including training of local trainers), seminars and conferences, internships, mentoring, and study tours.

Performance and Projected Results

The U.S. government has provided a substantial level of technical assistance since 1995 to Ukrainian agencies that formulate and administer the national budget and tax programs. During this time, we have seen dramatic improvement in the Ukrainian government's overall management of its economic and fiscal policies. Cumulatively, the government has reduced the cost of government from about 42% of GDP in 1996 to around 35% in 2001 while the budget deficit has been reduced from about 5% of GDP in 1996 to a more sustainable 1.7%. As a result, it has been possible to reduce the tax burden on business, to ease barriers to business development in the private sector, and to stimulate increased investment in the domestic economy.

Since 1996, the State Budget has become a comprehensive and transparent policy document, one that is better able to reflect GOU priorities while using fewer resources. This has helped promote economic growth by lowering inflation and interest rates and making increased volume of resources available for private investment. Moreover, budget execution has shown an important and dramatic shift to a cash basis - as the amount of offsets was reduced from about 50% of revenues/expenditures a few years ago to just a few % in 2001. The GOU has now paid off all pension arrears and most wage arrears in the public sector and has been able to begin increasing wages and pensions.

In tax policy and administration, USAID advisors have assisted in the development of a European-style value added tax (VAT) and an enterprise profit tax (EPT) which have provided the GOU with a sizeable and stable source of revenue for the State Budget. The EPT is now based on profit instead of gross revenues, and the VAT is based on value-added instead of turnover. For small businesses, Ukraine has also introduced a unified tax that further reduces their tax burden, as well as reducing the number of taxes they must pay. Meanwhile, Ukrainian payroll taxes have been cut from 52% to 38% - which should broaden the base and workers' eligibility for social insurance.

In recent years, tax administration has improved. Senior tax officials demonstrate increased understanding and promotion of voluntary compliance, in tax administration processes, accounting and auditing. Moreover, amendments to tax laws have simplified and improved tax administration, as well as promoted the modernisation of the STS. One significant result has been the improvement in administration of the personal income tax (PIT) and increased compliance rates.

During 2002-03, the objectives of the current USAID fiscal program are designed to increase the capacity of the Government of Ukraine (GOU):

- to produce short- and medium-term economic and fiscal forecasts;
- to ensure that major macroeconomic indicators such as the budget deficit and tax burden are maintained at levels that will facilitate further rapid growth of the private economy; and
- to implement program budgeting and multi-year budgeting as tools to make transparent decisions, to meet constituents' priorities, and to use scarce resources more efficiently.

For example, in the latter area, the GOU budget implementation process is expected to lead to more realistic and sustainable budget choices in promoting poverty reduction, health and education objectives.

The USAID fiscal program also intends to contribute to structural reforms led by the Ministry of Economy that will improve the efficiency of the economy by increasing transparency, competitiveness, and openness of the enterprise sector.

Privatisation and Market Reform of the Power Sector

The USAID objective is to promote a commercially operated, profitable, and efficient/ environmentally sound energy sector. Since 1999, our program focus has been on the electric power complex, where prospects for reform and restructuring have been much more promising than elsewhere - e.g., the coal sector.

Technical assistance is provided mainly for the following areas:

- energy sector legislation - to strengthen the capabilities of Parliament's Energy Committee and to promote laws that will increase the independence of the energy regulator and will provide the basis for a competitive energy market development;
- electricity market development and regulation – through assistance to the National Energy Regulatory Commission (NERC) and the Energomarket Enterprise;
- privatisation by Ukraine of electricity distribution and, prospectively, thermal generating companies;
- direct U.S.-Ukraine energy utility partnerships, including a new partnership for Energoatom (Nuclear Generating Company).

The thrust of the USAID program in recent years has been to assist with:

- improving the design, operation and regulation of the energy market; and
- sale of electric power companies to foreign strategic investors.

Privatisation is not an end in itself, but rather a vital step towards mobilising new private capital and managerial skills from abroad that will better ensure future investment in the sector. Creating multiple distribution and generating companies will also facilitate development of a decentralised, competitive and efficient electricity market. To attract such private investors, the market is evolving to allow incentives for full cost recovery – and to phase out the pattern of heavy subsidisation of power to Ukrainian consumers that was inherited from the Soviet era and that has led to highly wasteful uses of energy.

Because of the high cost of such subsidies, reform of the power sector has been a priority for USAID, the international financial institutions (EBRD, IBRD), and the European Union. For 2002, the Government of Ukraine is developing new devices that the donors feel will help to ensure continued, successful privatisation of the next 12 electric distribution companies (including several of the very largest ones) that are now listed for sale to foreign strategic investors. These devices are expected to include:

- a restructuring of long-overdue debts of the energy sector companies – which have led to their harassment by creditors, threatened to strip essential company assets, and (if not reduce) who have prevent the sale of most of the companies;
- a Partial Risk Guarantee insurance program which would enable foreign buyers to purchase from the World Bank and the EBRD insurance against non-fulfilment of terms of the sale;
- Increased Ukrainian Government efforts to facilitate cut-offs of electricity to non-paying customers and the collection of unpaid bills by customers (such as budget organisations and politically protected companies) who consume, but do not pay for, over 20 % of the total electricity delivered to end-users in Ukraine.

For 2003, USAID will also consider assisting the Government with its proposed privatisation of the fossil-fuel electric generating companies – which account for about half of the electric power produced in Ukraine.

Performance and Results:

Ukraine is ahead of Russia in the transition from a monolithic, inefficient, state electricity monopoly towards a market system. Following the unsatisfactory results from Ukraine's sale in 1998 of seven electricity distribution companies to undercapitalised portfolio investors, Ukraine has changed its approach towards attracting foreign strategic investors, in order to upgrade management and to attract follow-on investment that will be needed in the future. In April 2001, drawing on USAID and other donor assistance, Ukraine sold majority stakes of six other distribution companies to foreign strategic investors – following a competitive, transparent approach that many consider a model for future privatisations by the State Property Fund.

An important precondition for the sale of the companies, that the Government implemented in 2000, was a new system of cash collections and settlements for electricity – in place of a bizarre system of barter, offsets, and other non-cash settlements that previously had hidden enormous problems of non-payment and corruption in the sector. In operation, however, the settlement system, however created new problems – including political diversion of funds to meet ad hoc investment, debt payments, and other state enterprise expenses that reduce payments received by other companies that actually provided the electricity. Thus, further reform of the settlement system will be needed in the future.

Another critical element in the power-company privatisations of 2001, which raised $155 million in budget revenue, was a new tariff methodology by NERC that should enable the investors to earn a reasonable return, without resorting to unethical practices. In December 2001, NERC approved new tariffs for four of the six distribution companies that had been privatised.

However, in comparison with other energy-importing countries in Eastern Europe and in the former the Soviet states, Ukraine still has the lowest tariffs for industrial and residential power consumers of any major country in the region. As indicated in the EBRD's recent Transition Report for 2001, such tariffs in Ukraine are only one-third to one-half the level of tariffs in the other energy importers of Eastern Europe. Thus, the Ukrainian Government has not yet demonstrated clear political will to phase out the indirect Soviet-era subsidies. In addition, Parliament has not yet developed and passed appropriate energy legislation to encourage the evolution of a western-type market, which in the longer term would encourage competition and a more efficient tariff structure. In the opinion of most experts, the Wholesale Electricity Market Law passed by the Parliament in July 2001 is fundamentally flawed and should not be revived and made effective in April 2002, as is now intended. USAID intends to continue to assist the Government and the Parliament to develop an improved law and to help implement an efficient market mechanism.

In line with positive statements by official Ukrainian participants in the OECD-Ukraine Forum on Investment and Enterprise Development, USAID believes that it is now reasonable to expect that, by 2005, all 27 electric distribution and the four fossil-fuel generating companies in Ukraine will be privately owned. In that new environment, lengthy power shortages, which now occur frequently in many parts of Ukraine should be eliminated. However, there are strong political forces that represent heavy industry in Ukraine and which may seek to block such privatisations, in order to retain the large energy subsidies that they obtain from the present system.

INVESTMENT CLIMATE: SHORT TERM AND LONG TERM PERSPECTIVES

Klaus Zillikens[*]

The secret of learning is repetition. The reasons for the poor investment climate in Ukraine are known; they have been highlighted during this conference again.

As regards ways and means to improve the investment climate, one should caution against a technocratic approach. A measure here and a measure there can be helpful, but do not really change the overall climate, nor do they influence concrete investment decisions. Let us have no illusions in this regard.

Investment climate depends on broad parameters. The rule of law has been mentioned. Over the last year, there has been no improvement in this field, this is at least my impression.

Another important parameter: state interference. There continues to be a culture of control and interference in business affairs, particularly at the grass roots level. It will take time to change this culture. And I doubt that it can be changed from within the state apparatus. I rather believe that only the emerging market environment in Ukraine and its protagonists, more western-oriented entrepreneurs and more demanding and more affluent clients and consumers, will eventually change this culture.

When it comes to government programs regarding the investment climate in Ukraine, my expectations are therefore modest. As someone who speaks a lot with German businessmen, I would just like to appeal to state officials and politicians: do not stand in the way of investment. And do not make things worse.

The recent law No 2899 on the removal of tax privileges for foreign companies is such an example. There is nothing wrong with equal opportunities for foreign and domestic companies. But you cannot take privileges away from one day to

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* Counsellor, German Embassy in Ukraine.

the next or even do this retroactively. A lot of foreign companies have built their business plans and calculations on these privileges. What are they going to do now? And what are they going to tell other companies about the investment climate in Ukraine?

Another appeal I would have is: consult the business community. Talk to those concerned, before you take decisions. Be responsive to problems when they occur. And try to solve disputes quickly and in a fair manner. There is nothing worse for the investment climate than these lingering disputes and court-cases, which often are dragged on for months and even years. Every Embassy representative here, I am sure, could give you one or two examples. The damage these cases cause is much bigger than it may seem on the surface.

So, in a nutshell, I think there is a short term and a long-term perspective. Short term: let us be pragmatic and implement whatever improvements can be implemented, thus preventing things getting from bad to worse. Long term: let us work together to foster the economic recovery of Ukraine. I am optimistic that this recovery, the chances it offers for investment and the market culture and mentality it creates will eventually create an attractive investment climate in Ukraine.[1]

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1 The Program of Technical Assistance Measures provided by Germany is appended (Annex 2).

OECD PERSPECTIVE AND FOLLOW-UP ACTIONS

*Rainer Geiger**

Why was the forum a success?

The most important achievement of the Forum was to get different parts of the Ukrainian government work as an inter-ministerial team to produce a Progress Report with the assistance of the OECD Secretariat and the USAID. The government departments involved in the preparation process and represented at the Forum at deputy minister level include the Ministry of Economy and European Integration, State Tax Administration, State Commission on Securities and Stock Markets, Ministry of Finances, Antimonopoly Committee, State Property Fund, National Bank of Ukraine, and State Standardisation Committee, despite the fact that most of senior officials had to go on a hastily arranged mission to Washington for talks with the IMF.

The meeting was a good example of the OECD approach to peer review as applied to non-Member countries. It is based on a diagnosis of the challenges, development of policy recommendations, monitoring their implementation and fostering capacity building.

Achievements and challenges: a mixed story

Volodymyr Pershin, State Secretary of the Ministry of Economy and European Integration Issues, outlined the list of key achievements in 2001 and early 2002 including in particular macro-economic indicators (i.e. high growth, external stability, low inflation and fiscal deficit), formulation of a ten-year strategic development plan, adoption of Land Code, further improvement in the transparency of privatisation procedures, removal of limitations on foreign investors in insurance and telecommunications, liquidation of bankrupt banks, reduced barter transactions that may reduce the size of the shadow economy.

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* Deputy Director Directorate for Financial, Fiscal and Enterprise Affaires, OECD.

According to official Ukrainian data, as of end 2001, cumulative foreign direct investment (FDI) inflows into Ukraine amounted to about $4.5 billion. Per capita FDI is still one of the lowest in the region. Ukraine's FDI stock corresponds to an insignificant share (6 %) of total investment capital. Participants underlined the vast economic potential of Ukraine, which can be unleashed if reform measures are swiftly and efficiently implemented and investor confidence is restored. Positive macro-economic environment, if sustained, is likely to promote greater inflows of FDI in the years ahead.

Participants welcomed the progress made on economic reforms and the efforts by the Government of Ukraine to improve the business environment for investors, domestic and foreign alike, and called on the Ukrainian leadership to implement the decisions and build the capacity needed to effectively carry out the legislation and policies, in close dialogue with business, non-governmental organisations and other constituencies.

Some private sector interventions highlighted the range of difficulties that investors, both domestic and foreign, still face. Participants drew attention to slow progress made with privatisation, need for financial sector reforms to provide access to finance in particular for small and medium size enterprises (SMEs), consistent and timely implementation of legislation, clarity in taxation, and simplification of administrative procedures. Corruption was cited as a major deterrent to investors increasing transaction costs and distorting competition.

Other participants stressed the need for the government of Ukraine to consult major stakeholders including in particular the private sector on investment related decisions and cited examples of retroactive and unexpected moves, which create unpredictability for investors.

There was a call for action to create a level playing field for domestic and foreign-controlled enterprises and to increase support to SMEs and backward regions. Investors were invited to make use of competitive opportunities particularly in sectors such as agro-industry and machine-building, where Ukraine possesses strong competitive strengths.

Follow-up actions

Subject to the mobilisation of the necessary funding, Ukrainian authorities and the OECD agreed to hold the Forum annually as a platform to assess the progress and identify the next stages of action in investment and enterprise development; ensure effective government-business dialogue on major issues; and achieve synergies with bilateral and multilateral donors supporting

Ukraine's reform efforts through capacity building projects. At each annual meeting of the Forum, a comprehensive report on improvement of investment climate – similar to the one prepared by the Government of Ukraine for this Forum – will be presented.

The Forum will also contribute to the Black Sea Investment Initiative, launched this year by the OECD and the Business Council of the Black Sea Economic Co-operation (BSEC) of which Ukraine currently holds the chairmanship. Ukraine will take part in the investment policy peer reviews of other BSEC countries to share its experience.

The co-chairs of the Forum highlighted the following areas of possible co-operation for further action:

- Continuing work on good governance to improve the general investment environment
- Promoting Ukraine as a destination for investors as Ukraine comes closer to OECD best practices
- Mobilising foreign investment for Ukraine's regional development
- Fostering enterprise development, with a focus on removing administrative barriers
- Improving tax administration, design of corporate taxes and incentives
- Follow up work on corporate governance (a seminar with Ukraine on the margins of the OECD Eurasian Corporate Governance Roundtable will be held in Kyiv on 17-18 April 2002) and competition policy

ANNEXES

ANNEX 1

PROGRAM FOR DEVELOPMENT OF INVESTMENT ACTIVITIES FOR 2002 - 2010*

An urgent task for the State is to activate investment activities and increase investment volumes significantly. Increasing attraction of investments is a priority for the activities of the state authorities.

This Program is based on provisions of the Presidential Messages to the Verkhovna Rada of Ukraine entitled: "Ukraine: Progress in the 21st Century. Strategy of Economic and Social Development for 2000 - 2004" and "On Internal and External Situation of Ukraine in 2000", the Edicts of the President of Ukraine of February 22, 2001, No. 108 "On Additional Measures to Increase Investments in the Economy of Ukraine" and of July 12, 2001, No. 512 "On Measures for Improvement of the Investment Environment in Ukraine", the Concept for Regulation of Investment Activities under Market Transformation of the Economy approved by the Resolution of the Cabinet of Ministers of Ukraine of June 1, 1995, No. 384.

I. Current Status of Investment Activities

Economic transformation has enlivened of investment activities. Since 1998, investment growth has outpaced the growth of GDP and industrial production.

The 1999 Programme of privatisation the stimulus given to the development of small businesses played a positive role in the growth of investments in the Ukrainian economy. Other factors were: reduction of the tax burden on manufacturers; introduction of the flat-rate agricultural tax; creation of the network of special economic zones and territories with special investment regimes; and reduction of non-monetary settlements and payments.

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* Approved by the Resolution of the Cabinet of Ministers of Ukraine of December 28, 2001, No. 1801. An edited version of the program is presented here.

As a result, the volume of investments in fixed capital in 2000 reached Hr 23,630,000,000, which is 1.9 times more than that achieved in 1997 (at comparable prices - by 18.5 %).

Foreign investments in Ukraine are not significant.As of October 1, 2001, it was $ 4,194,000,000, or only $ 85 per capita. In general, foreign investments came from 112 countries. The principal investors are the USA (16.8%), Cyprus (9.5%), the Netherlands (8.8%), Great Britain (8.7%), Russia (7%) and Germany (6.3%).

The food industry and agricultural processing, wholesale trading and mediation, financial activities, machine-building, chemical and petrochemical industry, metallurgy and metal works, coke production, oil processing and nuclear fuel production, science and technologies, innovation activities and tourism (hotel infrastructure development) are the principal recipients.

The 1998 crisis in the world financial and stock markets affected the Ukrainian securities market as well, which resulted in a slowdown of the market infrastructure development.

II. Problems Associated with Investment Activation

Activation of investments requires:

- reduction of state regulation of entrepreneurial activities and stability of legislation;
- elimination of ambiguous interpretation of regulatory acts and completion of judicial reforms;
- improvement of regulations governing ownership rights;
- completion of administrative reforms, improved publicity and transparency of decision-making by state authorities, elimination of circumlocution and corruption;
- introduction of efficient methods of corporate management;
- support of capital market development, primarily, banking, stock and insurance markets;
- reduction of tax burden;
- stability of the political environment;

III. Goal and Objectives of the Program

The goal of the Program is to create a favourable investment environment and develop infrastructure for investment activities in order to ensure stable economic growth and improvement of living standards.

The main objectives of the Program for the promotion of a favourable investment environment for the private non-borrowed capital are as follows:

- deregulation of entrepreneurial activities and business liberalisation;
- A stable regulatory basis in accordance with the principle of equality for all investors;
- transparency of decision-making procedures by central and local executive authorities;
- improvement of mechanisms for the exercise of corporate rights, including those belonging to the State, protection of the rights of small shareholders;
- enhancement of efficiency of bankruptcy procedures;
- support of further reform of the tax system, including reduction of tax burden, optimisation and transparency of tax administration, protection of the taxpayers' rights;
- further administrative reform in order to improve and increase efficiency of State administration, elimination of circumlocution and corruption;
- strengthening the banking system of Ukraine, , introduction of hypothecation mechanisms;
- enlivening investment activities in special economic zones;
- support of judicial reform and enforcement of court judgements;
- creation of additional incentives for attraction of investments into priority sectors in Ukraine's economy.

Program objectives in the area of development of the State investment activities:

- elimination of structural distortions in the economy of Ukraine through acceleration of the development of consumer and services sectors;
- extension and modernisation of the transport infrastructure, particularly, the gas transportation system; creation of conditions for the extension of transit transportation; creation of a national network of international transportation corridors with investments for development of the transport infrastructure and roads using concession and leasing mechanisms;
- support of increasing investments in the area of communications and telecommunications services;
- stimulation of investments in scientific, technological and innovation activities.

IV. Role of the State in Investment Activities

A crucial task of the state policy in the area of investment activities is the creation of a level playing field for business and investment in the economy of Ukraine for business entities with differing forms of ownership; and improvement of the structure of investments.

The state policy will be focused on:

- acceleration of economic growth based on domestic investment and the market mechanism;
- introduction of open consultations between executive authorities and business entities, dissemination of information on economic situation, internal and external markets, conjuncture processes, and the regulatory mechanisms;
- significant reduction of the shadow sector of the national economy;
- creation of a level playing field for activities of business entities irrespective of the forms of ownership and origins of capital;
- formation of an efficient competitive environment;
- strengthening of the stock market, development of institutions for joint investments, insurance and pension funds, the market of

corporate securities, and integration into international capital markets;

- creation of additional economic incentives for attraction of investments in priority sectors of the economy;
- creation of efficient system for the protection of intellectual property.

V. Program Directions

Deregulation of Entrepreneurial Activities, Liberalisation of Business and Creation of an Efficient Competitive Environment

The state economic policy is aimed at the creation of a favourable environment for business development, elimination of circumlocution and corruption, reduction of the shadow sector, as the prerequisite for:

- implementation of the uniform state regulatory policy in the area of entrepreneurial activities aimed at achieving the optimal level of state regulation, setting legal grounds for the state support of small businesses, and regulation of licensing procedures;
- revision of regulatory acts on entrepreneurial activities in specific sectors of the economy in order to increase efficiency and competitiveness of business entities;
- improvement and simplification of the system for registration of enterprises;
- improvement of the procedure for implementation of investment projects;
- creation of a system for monitoring of business activities;
- introduction of a mechanism for policing violation of the provisions of investment agreements (contracts);
- co-ordination of external trade and competition policy in order to ensure competitive conditions for domestic business entities on external markets;
- promoting international cooperation in the area of competition policy to delimit threats to competition resulting from measures taken outside of the country.

Formation of the Regulatory Basis

Formulation of legislation that would promote the market economy is crucial for improvement of the investment climate in Ukraine.

This requires:

- promotion of inter-state agreements for support and protection of investments, prevention of double taxation, exchange of information on regulatory acts in the area of investment activities, formation of a stable legislative basis and conditions for entrepreneurial activities;
- extension of cooperation with the International Monetary Fund, World Bank and the European Bank for Reconstruction and Development with regard to financial aid to Ukraine, and measures supporting Ukraine's membership of the WTO.

For gradual adaptation of national legislation to the legislation of the European Union and WTO requirements, regulatory acts should be adopted to promote:

- further reform of the tax system;
- formation of the regulatory basis to support functioning of the stock market;
- protection of personal insurance payments and pension contributions.

Reform of the Tax System

A strategic goal of tax policy is to create a stable tax system to ensure sufficient revenues at all levels, efficient functioning of the economy, creation of conditions for further integration of Ukraine into the world economy.

The main objectives of tax reform are:

- reduction of tax burden through cutting the list of taxes and duties (mandatory payments), reduction of tax pressure on wages fund in order to form joint social funds and transition to personal insurance schemes;
- extension of the taxation base through cancellation of exemptions that are not related to innovation or investment activities; introduction of a mechanism for claiming tax exemptions by the taxpayers; introduction of taxation on immovable property;

- stimulation of innovation/investment activities of enterprises with an efficient tax policy designed to support renovation of fixed assets and development of small business;
- growth of revenues from taxes and duties (mandatory payments);
- prevention of double taxation of non-resident taxpayers.

Ensuring Transparency of Decision-Making Procedures of Executive Authorities

Creation of a transparent procedure for implementation of investment projects funded from the State and local budgets, as well as the ones that essentially impact the livelihood and activities of the population, requires:

- public discussion of draft regulatory acts aimed at development of entrepreneurial activities, creation of public boards and entrepreneurs' councils with executive authority, consultations with entrepreneurial entities, non-government organisations, scientists and other specialists on the efficiency of regulatory acts;
- participation in international activities in order to present investment opportunities in Ukraine; publicity for priority investment projects through foreign mass media and the Internet; active use of exhibitions.

Development of Corporate Management

Development of corporate management will be aimed at improvement of the investment environment, provision for efficient activities of joint-stock companies including:

- gradual harmonisation of the regulatory and legislative acts on corporate management based on legislation in the European Union;
- improvement of corporate management standards;
- definition and differentiation of powers of executive authorities in the area of corporate relations;
- development and introduction of rules for corporate management on the basis of generally accepted principles of efficient corporate management.

In the area of management of state corporate rights, research will be done on:

- estimation of the optimal size and structure of the state corporate sector;
- improvement of state policies towards enterprises owned by the state;
- ensuring efficient management.

Improvement of Investment Environment in the Process of Privatisation

State policy in the area of privatisation will be aimed at:

- replacement of the fiscal model of privatisation with investment and innovation models; privatisation of large enterprises and monopolies in accordance with specific plans for the sale of control stock to industrial investors;
- technical and technological renewal of enterprises funded by revenues from privatisation.

Improvement of the privatisation process envisages:

- extension of the group of enterprises to be privatised, reduction of the list of enterprises, privatisation of which is prohibited;
- increase of investment attractiveness and competitiveness of enterprises in the process of their pre-privatisation preparation, restructuring of enterprise, and separation of the social infrastructure objects;
- introduction of a modern mechanism for property assessment;
- enhancement of transparency during sale of privatisation objects on a competitive basis;
- prevention of unjustified changes in the lists of objects, schedules and terms of their sale after official approval and publicising of the relevant information, diversification of powers of the state executive authorities for sale of entities to be privatised;
- Institution of measures for promotion of efficient investments in privatised enterprises.

Improvement and Promotion of Efficiency of the State Administration

Administrative reform envisions improvement of the structure of executive authorities, differentiation and balancing of powers and responsibilities of executive authorities and local governments.

One of the most important components of administrative reforms is the reform of public service, which envisions the establishment of a professional, politically neutral and authoritative public service.

This requires the following measures:

- development of proper transparent procedures for hiring public servants;
- introduction of uniform procedures for open competition, secondment and examination;
- creation of an independent commission for employment of senior civil servants (Categories 1 – 2);
- prevention of corruption;
- periodical rotation of staff in the civil service.

Stimulation of Long-Term Lending

Improvement of the investment environment in the country depends on the presence of an efficient banking system, particularly, enlargement of the scope of long-term credit for the real sector, and growth of personal savings.

The main reasons why banks are not willing to provide long-term loans to business entities is the high level of credit risks, insolvency of most borrowers, lack of reliable guarantees of repayment and liquid collateral, and an inefficient system of taxation.

The following measures should be taken to stimulate long-term credit:

- introduce a mechanism for the protection of creditors' rights and a transparent procedure for sale of pledged property;
- ensure mobilisation of bank capital through increased capitalisation and solvency of the banks, introduction of procedures for reorganisation and liquidation of unstable banks;

- stimulate growth of personal savings;
- create a specialised financial institution for long- and medium-term funding of priority investment projects;
- introduce a mechanism for hypothecation; and
- stimulate inflow of foreign capital in the banking sector.

Development of Stock Market

The main tasks in the area of stock market development are:

- favourable taxation policy on the stock market of Ukraine;
- creation of conditions for increased capitalisation and liquidity of the stock market;
- extension of cooperation with the Organisation for Economic Cooperation and Development, International Organisation of Commissions for Securities and other international organisations on introduction of international standards of information disclosure;
- simplification of procedures for settlements under agreements involving securities with non-residents;
- improvement of the accounting system, settlements and reports of stock market participants;
- ensuring transparency in activities of joint investment institutions;
- measures to concentrate trade on organised markets in accordance with international standards;
- increased efficiency in activities of the National Depository System in order to ensure protection of rights of security holders and regulation of settlements on transactions with securities;
- development of mechanisms for insurance of stock market participants.

Creation of a System for Investment of Pension Funds

Creation of an efficient system for investment of pension funds is aimed at:

- identification of areas for investment of pension funds;
- according priority to the economic interests of pension fund depositors in the process of investment;
- creation of a system for investment of pension funds with guaranteed income;
- establishment of criteria for selection of banks and non-banking financial institutions for investment of pension funds.

Development of Special (Free) Economic Zones with Special Investment Regimes in Depressed Territories

Introduction of a special investment regime in territories with unfavourable social, economic and environmental conditions is aimed at: stimulating investments in priority sectors in order to preserve existing jobs and create new ones, introduce new technologies, develop external economic relations, increase production of high quality goods and services, create modern production, transportation and marketing infrastructure.

An important area of investment policy is the creation of industrial parks for development of high technology products.

For further activation of investment processes in special (free) economic zones and territories with special investment regimes, it is necessary to:

- develop and implement strategic development programs for each special (free) economic zone or territory where a special investment regime is established;
- stimulate investments in priority sectors of the economy, support introduction of new technologies for manufacturing of goods competitive on external markets by optimising of priority economic activities.

State support to overcome the depressed situation of some territories should be exercised as a set of actions that envisage:

- support of new producs, implementation of new technological processes and creation of safe conditions for life and activities of the population;
- ensuring structural rebuilding of the national economy and regional development, involvement of investments in priority sectors of the economy;
- development of social infrastructure;
- involvement of investments in the sphere of production and creation of new jobs;
- measures taken by executive authorities and local self-governments to develop small business and support employment;
- targeted funding of programs for retraining and professional training of the population;
- involvement of international technical assistance for the solution of social and economic problems of the depressed territories, training and retraining of specialists in the issues of investment activities and entrepreneurial development;
- development of proposals to introduce preferential regimes for taxation of income received as a result of investment projects.

Investment Activities of the State

Elimination of Structural Deformation in the Economy

A key issue in the country's development is maintaining its pace of economic growth. Investment policy is aimed at formation of a rational economic structure.

In the process of structural changes, following changes are expected in the economy:

- changes in capital investments through reorientation of investments into high technology and science intensive sectors, state support of high technology production and development of small and medium business at the cost of compensation of partial loans from the State Budget;

- extension of the rights of business entities in formation and utilisation of their amortisation charges;
- state investments for renewal of fixed assets in priority sectors of the economy;
- innovative investments in enterprises with the funds received from privatisation of state-owned entitiess;
- introduction of resource- and energy-saving technologies and equipment;
- deepening of market reforms, formation of competitive environment and enforcement of private ownership, reform of agricultural relationships;
- extension of the internal market, strengthening of the market infrastructure, implementation of regional programs for efficient functioning of markets, development of the utility services for the population, provision of a wide range of tourist services;
- protection of domestic manufacturers, where justified on economic grounds;
-

Development of the Internal Market Infrastructure

The priority areas for extension and modernisation of the transport infrastructure include:

- involvement of investment capital and loans of domestic and foreign financial organisations;
- construction and reconstruction of roads;
- competitive selection of investment projects based on the payback criteria and tender selection of implementers;
- creation of a network of leasing companies for renewal of sea and river fleet, domestic aviation, railroad and river transport.

Improvement of the national communication network and telecommunications envisages structural reformation in order to extend communication services and improve their quality; development and modernisation of zonal and local networks on the basis of modern technologies.

Activation of investments in the area of communications will be supported by the following priority activities:

- continuation of reform in the telecommunications sector;
- efficient use of investments, accelerated development of the most productive segments in the communications market, introduction of new network technologies;
- formation of legal grounds for regulatory policies;
- regulation of settlements for electric communication services to budget institutions;
- improvement of tariff regulation;
- reorganisation of sector systems of standardisation and certification. Their adaptation to international standards.

Special attention will be paid to development of hotels and tourism.

Involvement of Investments in Scientific, Technical and Innovation Activities

In order to stimulate involvement of domestic and foreign investments in scientific, technical and innovation activities, the following measures should be taken:

- creation of a system for preferential refunding of commercial banks that provide preferential loans for implementation of investment projects on development and installation of highly technological equipment and other innovation products;
- extension of preferential crediting against collateral of property;
- creation of share investment funds for implementation of large innovation projects;
- extension of credit to innovative enterprises through leasing, factoring and other operations.

Creation of Highly Productive Jobs

A component of investment policy is the acceleration of job creation, specifically on the job markets of mono-functional cities and coal-mining areas, as well as employment of rural population.

Solution of the employment problem requires:

- ongoing work on restructuring of state enterprises through investments for entrepreneurial development in the production sphere, modernisation of outdated jobs and creation of new highly productive jobs, efficient functioning of enterprises during the post-privatisation period;
- introduction of favourable investment regimes for job-creating enterprises, including those for the population categories that are not competitive on the job market;
- state support of the regions where the situation on the job market is critical through establishment of special regimes for privatisation, investments and crediting; development and implementation of mechanisms for involvement of funds from foreign crediting lines and international technical assistance.

The State as a subject of investment activities will ensure:

- concentration and direction of state investment resources for development of the market infrastructure, support of scientific, technological and innovation policies;
- enhancement of competitiveness of domestic goods, overcoming resource waste and production renewal;
- Application research to facilitate entering world markets;
- creation and implementation of modern information technologies;
- introduction of the mixed funding for highly efficient investment and innovation projects;
- target loans for implementation of investment projects, partial compensation of the interests at the cost of the State Budget;
- extension of the state participation in international investment projects.

VI. Stages of the Program Implementation

At the first stage (2002 - 2004), attention will be paid primarily to liberalisation of entrepreneurial activities, creation of a legal environment, harmonisation of national legislation with European and world legislation, ensuring of political stability, extension of internal buying and consumption demand, activation of investment and innovation, reduction of tax burdens, stimulation of economic growth, attraction of foreign capital, informing business circles of Ukraine and other countries of particular opportunities of investment involvement and the most attractive opportunities for them.

At the second stage (2005 - 2010), it is envisaged to continue optimisation of the economy structure and industrial production, efficient use of energy and physical resources, rehabilitation of the economic environment, development of export of science-intensive, high-technology production with a high degree of processing, strengthening of the stock market, development of joint investment institutions, insurance and pension funds; the market for corporate securities, its integration to international capital markets; realisation of competitive advantages of the national economy sectors; presentation of investment projects, domestic goods and services on international exhibitions and fairs.

VII. Expected Results of the Program Implementation

Implementation of the Program will ensure creation of a favourable investment environment in Ukraine, improve its attractiveness for foreign investors.

Creation of joint investment institutions will provide proper conditions for investors' activities. A transparent system will be created for exercising the rights of all investors through improvement of corporate management systems.

Increase use of investment resources will be achieved, particularly, through efficient use of state investments, increased volumes of long-term credit to the real sector of the economy, and foreign investments.

Inflow of direct foreign investments during the period by 2010 is expected to amount to nearly ten billion US dollars.

A comprehensive approach to formation of a favourable investment climate in Ukraine, activation of investments will make it possible to reach in 2005 the forecast volume of investments in the fixed capital (capital investments) at the cost of all funding sources in the amount of Hr 55.8 billion (15% of GDP) compared to Hr 23.6 billion actually invested in the economy in 2002 (13.7%).

By 2010, the volume of investments will grow to Hr 122.1 billion (18.8% of GDP).

Development of non-banking financial institutions, systems for insurance of investments, introduction of hypothecation credit mechanisms are aimed at increasing flow of personal savings into investments in fixed capital by a factor of 7 compared to the year 2001.

VIII. Mechanism for Management and Control of the Program Implementation

Co-ordination of activities aimed at the Program implementation, monitoring, analysis and promotion of investment experience through mass media will be undertaken by a standing work group consisting of representatives of ministries and other interested central executive authorities, institutions and organisations.

The Ministry of Economy and European Integration shall exercise control over the Program implementation. The Ministry shall inform the Cabinet of Ministers of Ukraine twice a year of the situation and proposals on adjustment if necessary.

ANNEX 2

TRANSFORM-PROGRAM UKRAINE 2001

German Embassy, Kiev, Ukraine
Coordination Unit for Technical Assistance

Governmental and Legal Advise				
German Advisory Group / Institut for Economic Research and Policy Advice	Advise from long and short-term experts; macroeconomic stabilisation; public finances, structural reforms, energy and agriculture Establishment of an Economic Research Institute and training of young researchers. Advice on administrative reform, training of young civil servents.	11/94 - 12/03	Government, Ministry of Economy, Presidential Office, National Bank of Ukraine, Ministry of Finance	Federal Ministry of Economy (BMWi)/ Kreditanstalt für Wiederaufbau (KfW)/ Deutsche Bank Research, Deutsches Institut für Wirtschaftsforschung (DIW), Osteuropa Institut (OEI); Agrar Institute of University of Göttingen
Policy advice on privatisation	High-level advice; close cooperation with German Advisory Group	1998-2002	Government, Parliament, State Property Fund	Ministry of Finance (BMF)/ GTZ/Dr. Bonnenberg
Cooperation of German and Ukrainian legal institutions	Cooperation between legal institutions.Reform of civil, trade and economic law, justice reform	1996 – 2002	Ministry of Justice, Parliament, Higher Court, Higher Arbitration Court, Constitutional Court, National Law Academy of Kharkiv	BMJ/ IRZ

SME sector				
Micro Finance Bank	Set-up a bank for SME in cooperation with EBRD, IFC, Western Enterprise Fund, DOEN and IMI	2000 – open	Micro Finance Bank	BMWi/ KfW/IPC
German-Ukrainian Fund for SME	Micro and small loan program to support small and medium sized enterprises and strengthening of the Ukrainian banking system	1996 – 2003	National Bank, AVAL-Bank, AGIO-Bank, VA-Bank, Kiev-Privatbank, Privatbank	BMWi/KfW/Internationale Projekt Consult (IPC)
Technical assistance for small and medium sized private companies	Economic and technical advise for SME in Kiev, Cherkasy and Poltava, training of Ukrainian consultants, political advice on central and regional level on issues of SME	12/97 – 2002	State Committee for Enterprise Development, International Consulting and Information ICI, POLARR, INCONSULT, different enterprises	BMWi/KfW/ Planungs-Engineering-Management (PEM), HLT
Center for clothing industry	Advise on restructuring, cooperation and export, training for Ukrainian clothing manufactures. Establishment of an Association of Ukrainian Clothing Manufactures	1996 – 2003	Different enterprises, Kiev university of light industry; Association of Ukrainian Clothing Manufactures	BMWi/KfW/ International Market Development GmbH (I.M.D.)

SME sector				
German-Ukrainian bakery center	Set-up and equip of training center with a training bakery; training of students and teachers; support of start-ups, finance	1998-2003	Vocational School # 4 in Poltava, INTERCHLIB Poltava	BMWi/KfW/ GfS Gesellschaft für Strukturentwicklung e.V.
German-Ukrainian meat processing center	Set-up and equip of training center with a training butcher shop; training of students and teachers; support of start-ups	2000-2003	Kiev University for food processing, Vocational School for meet processing professions	BMWi/KfW/GfS
German-Ukrainian dairy processing center	Set-up and equip of training center with a training dairy-shop; training of students and teachers, restructuring advice	2000-2003	Poltava Tecknicum, University of Agriculture, varies dairy factories	BMWi/KfW/GfS
German-Ukrainian center for construction	Training and advise for Ukrainian SME's in construction sector	1998-2003	State University of Construction and Architecture of Kiev	BMWi/KfW/CIM/ German construction companies
Certification center; restructuring of the Ukrainian system of standardisation	Advise on certification and accreditation	01/97 – 2002	Dershstandard, Association of quality	BMWi/KfW/BAM, VDE, CIM
Support for the economic administration of Ternopol	Regional economic development	2000-2002	Ternopol regional administration	BMZ/GTZ/Syseca

Financial sector				
Advice on stock exchange regulation	Advice of Stock Exchange Committee, Currency Exchange, Stock Exchange Institute and the Parliament	1996 - 2002	Stock Exchange Committee of Ukraine, Ukrainian Interbank Currency Exchange, Stock Exchange Institute and the Parliament	BMF/KfW/ Fördergesellschaft für Börsen- und Kapitalmärkte in Mittel- und Osteuropa (FBF)
Ukrainian savings bank	Advice/training of Oschtschadny Bank	1997-2002	Oshadny Bank	BMF/KfW/SIK

Training and education				
Ukrainian management initiative	Internships for up to 150 young Ukrainian managers in German companies	2001-2004	Ministry of Economy	BMWi/KfW / Carl Duisberg Gesellschaft (CDG)
Trainee program for prospective managers	Internships for 6 months in German companies	1993 – 2002	“Grand” institute for training and education	Ministry of Foreign Affairs (AA)/ CDG
Training of managers and specialists to realise the Partnership and Cooperation Agreement between the EU and Ukraine	Training of specialists of the Ministry of economy and other ministries combined with short practical internships in Germany	1996-2002	Ministry of Economy	AA/DCG, co-financing by Worldbank

Training and education				
Advanced training courses for executive officers in economic administrative authorities	Professional support for the Ukrainian Academy of Diplomacy in the field of training	1996 – 2002	Academy of Diplomacy	AA/CDG
Improvement of management training	Strengthening of capacity of Center Rynok , advise for 6 companies	1999-2002	Rynok Institute	AA/CDG/Bonner Akademie
Establishing of training bank	Development of a model education and advanced training courses for banking professionals, support to establish a training bank	1999-2002	National Bank, Rynok Institute, Ukrainian Banking Association	BMBF/BIBB/Educational Academy of Berlin-Brandenburg
Model-center for hotel and restaurant business in Kiev	Establish of a training restaurant, improvement of practical training	1997-2002	Ministry of Education, Professional School for Hotels and Restaurants in Kiev	BMBF/BiBB/ Gesellschaft für Weiterbildung und Unternehmensberatung Ost mbH (GWU)

Agricultural sector				
German-Ukrainian Agrarian Development and Investment Project	Restructuring of agri businesses via 3 competence centers in Kiev, Cherkasy and Vinniza	1999-2002	Ministry of Agriculture, cooperative organisations	BML/GfA/ ADT/BMZ/ CIM
Training of agricultural specialists in Germany (internships)	Internships in Germany for agricultural students and young farmers.	1997-2002	Ministry of Agriculture, Farmers Association	BML/ German Farmers Association (DBV)

Other projects				
Integrated experts/CIM	Long-term experts in different sectors	1993-2002	Various	BMZ/GTZ/ CIM
Short-term expert fund	Support of diverse measures to support TRANSFORM-projects	1998-2002	Various	BMWi/KfW /various
Science cooperation	Scope of actions will be decided bilaterally by the responsible ministries	1998-2001	Various	BMBF/various
Study and Professionals Fund	Development of projects and time-limited separate projects	2000-2002	Various	BMZ/GTZ

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