SigmaBleyzer

Where Opportunities Emerge.

Accelerating the Flow of International Private Capital to Ukraine

International Private Capital Task Force (IPCTF)

SigmaBleyzer

April 22, 2001

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This study was carried out by teams from SigmaBleyzer and the Thunderbird Corporate Consulting Group. The SigmaBleyzer team included Messrs/Mdmes. Michael Bleyzer, Dr. Edilberto Segura; Vadim Bodaev, Viktor Gekker, Olexander Kaptsov, Igor Krikun, Diana Smakhtina, Anatoly Solyanyk. The Thunderbird team included Messrs/Mdmes. Prof. Krishna Kumar, Prof. Charles Nelson, Alur Shashikiran, Jennifer Schnur, Peter Duffy, Richard Gottschall, Sumanth Raghavendra, Arturo Verges and Neeray Wadgwa. The study received significant inputs from the members of the Steering Committee listed in Annex 1 of this report.

Executive Summary

This study is based on benchmarking and analysis of the government policies in 5 countries with transition economies. The results of benchmarking were further augmented by the statistical analysis of government policies in 50 countries in order to arrive to stable relationships between government policy actions and foreign direct investments (FDI) flows to these countries. These relationships were then validated by several previously completed studies of transition economies conducted by reputable international agencies and private institutions. In addition, significant input was received from some of the most experienced international agencies and companies operating in Ukraine to develop an Action Plan for the country. The study makes recommendations for government policy actions, which Ukraine must undertake to sustain its pace of economic growth. Given low levels of domestic savings, the only way for Ukraine to continue to grow on a sustainable basis is to accelerate the inflows of international private equity capital to the country.

The International Private Capital Task Force (IPCTF) was created in early 2000 by an agreement between the Ukrainian Government and SigmaBleyzer. The IPCTF Steering Committee included representatives from many international agencies and businesses operating in Ukraine (see Annex 1).

The study was conducted by the team of SigmaBleyzer professionals and the Thunderbird Corporate Consulting Group. Many members of the Steering Committee provided substantial and valuable input to this study. This input has been incorporated in the report. ***Nonetheless, the views expressed in this study are those of the authors and do not necessarily coincide with those of individual members of the IPCTF Steering Committee or the organizations they represent.***

The study shows that Ukraine is receiving only a small fraction of its potential flow of international private capital. Benchmarking and statistical analyses indicate that Ukraine could increase the level of foreign direct investments from the current level of less that US$1.0 billion per year to about US$3.4 billion per year by year 2005 with the implementation of policy actions identified in the study. This level of foreign investments would have an important incremental effect on GDP growth of about 4–5% per year. The study also shows that, if Ukraine were to implement even stronger policy actions, it should be able to increase foreign direct investments to US$6.4 billion per year, by year 2005. The difference between these three possible scenarios translates into $15 billion, US$75 billion and US$100 billion, respectively, which Ukraine could receive in foreign direct investments over the next 15 years.

The study starts from the premise that macroeconomic stabilization, achieved by sound fiscal and monetary policies, is an essential pre-condition to achieve a favorable business climate and attract foreign direct investments. Within this macro framework, in order to achieve increases in international capital inflows, on the basis of statistical work, the study identified three key policy actions that had the strongest impact on foreign direct investments. These policy actions were the following:

Priority 1: Liberalize and Deregulate Business Activities

- ✓ Finalize and communicate widely the Government's De-regulation Policy, consistent with international standards, and rapidly implement it to simplify and facilitate registration of new businesses, the operations of existing businesses, and import/export of goods.

- ✓ Establish an appropriate on-going mechanism to liberalize business activities, establish deregulation priorities, and continuously review all existing and new regulatory legislation.
- ✓ Eliminate current incentives to excessive Government intervention, such as the right of some agencies to retain part of the fines they impose on businesses.

Priority 2: Provide a Stable and Predictable Legal Environment

- ✓ Create an independent and incorruptible judiciary, separate from the Executive branch.
- ✓ Pass well-conceived new laws or modify existing legislation as needed to provide a more favorable framework for business, including the civil code, the labor code, the criminal code and the tax code.
- ✓ Establish an efficient legislative process to coordinate and expedite the drafting of laws and regulations.
- ✓ Provide adequate funds from the fiscal budget for the judiciary, including resources for training and for computers with legal databases, Internet access, web sites with compilations of court decisions and academic treatises.

Priority 3: Improve Corporate and Public Governance and Eliminate Corruption

Corporate Governance:

- ✓ Demonstrate corporate financial discipline by closing 10-20 big loss-making state companies within next two years.
- ✓ Enact the Joint Stock Company Law of Ukraine to modernize Ukrainian corporate governance legislation.
- ✓ Require all companies listed in exchanges to switch over to international accounting standards and to submit annual reports.

Public Governance

- ✓ Continue public administration reform to reduce the size of state agencies, raise salaries of key civil servants, and redefine the Government's role as that of supporting — not replacing — private activities.
- ✓ Extend administrative reform to local state bodies.
- ✓ Reduce shadow economy activities by drastically cutting red tape and lowering cost of compliance with legislation in effect.

Privatization

- ✓ Secure the early approval and implementation of the Land Code to promote private ownership and registration of land.
- ✓ Encourage the independence of the State Property Fund (SPF) by passing the Law on the State Property Fund and subordinate it to the Executive branch.
- ✓ Take early actions to prepare state companies for privatization (including actions to protect minority shareholder rights and transfer social assets to local authorities) and complete expeditiously the privatization of energy sector and other major enterprises under clear and transparent procedures.

Corruption

- ✓ Implement an intensive, sustained and visible anti-corruption campaign, with a strong emphasis on corruption prevention to make corruption more difficult and more expensive to undertake, starting with key areas such as barter and the energy sector.

- ✓ Develop the legal framework needed to ensure better enforcement of anticorruption measures and impose visible, harsh, swift and certain penalties for corruption of Government officials.

- ✓ Get public support for anti-corruption programs by making people aware of their rights and the rules of the game.

Although the above priority actions would have a significant impact on the flow of foreign direct investments, in order to secure a significant and sustainable flow of investments, the study shows that all nine policy areas discussed in the report are essential. In fact, the experience of many other countries shows that only a comprehensive program addressing all nine policy areas would lead to significant and sustainable capital investments, both foreign and domestic. Details about these policy actions are presented in Annex 2.

Some of the Members of the Steering Committee are prepared to continue to advise the Government, on a permanent basis, on the matters covered in this report, if the Government were to find such support from the private sector worthwhile.

I. Introduction

1. During meetings in early 2000 between the Prime Minister of Ukraine and SigmaBleyzer, it was agreed that SigmaBleyzer would collaborate with the Government on the development of measures that could accelerate the inflow of international private capital into Ukraine.

2. The desire to accelerate the inflow of international private capital was based on the belief that over the longer term, large inflows of equity capital were needed to provide sustainable financing to develop the country's economic potential. In fact, there was recognition that there were no other options. In Ukraine, as in other former planned economies, the level of domestic savings and investment is low and not sufficient for sustainable GDP growth. Domestic savings are low due to low personal incomes, low profitability and cash flows in the corporate sector, and large numbers of barter/non-cash transactions. Given the low level of domestic savings, at this time Ukraine cannot maintain its pace of economic growth without attracting foreign investments, particularly in the form of equity capital. It is expected that, as the economy and national income grow over time, the level of domestic savings will increase. Therefore, over time, the need for direct foreign investments will decline. The speed at which this will happen will depend on the speed of implementation of policy reforms.

3. Although official lending by bilateral and multilateral institutions is necessary to maintain future financial stability — due to the large foreign debt obligations of Ukraine — official lending could not provide the large amounts of financing needed at this time for sustainable long-term economic growth.

4. Similarly, private international debt financing cannot replace equity capital. Debt financing is only a temporary solution. Additional borrowings create only short-term relief, but at the cost of increasing the burden for any future development. Therefore, they should only be looked at as "bridge" measures to get to a sustainable economic growth environment.

5. On the other hand, additional private equity investments change the fundamental nature of the economy in a very profound and healthy way. They reduce the Government's role and responsibility in the overall economy, shifting them to the private sector. They promote healthy sustainable businesses, significantly increasing the tax revenue base, and most importantly create happy, successful and prosperous taxpayers. The creation of the prosperity for the nation must be the main priority for the government, and nothing can better achieve it than private equity capital.

6. Therefore, given these other limitations, the success of Ukraine in maintaining high and sustainable growth will depend on its ability to increase the flows of international private equity capital. Without these international private capital inflows, Ukraine will not succeed over the long term.

7. To review the issues related to the attraction of foreign capital, the International Private Capital Task Force (IPCTF) was established. Its Steering Committee included representatives from private sector companies in Ukraine, international bilateral and multilateral agencies, economic NGO's, and the Government.

8. At the first meeting of the Task Force's Steering Committee that took place in June 2000, participants supported the initiative of the Task Force's work and outlined a general direction for future work. An essential part of the work was the execution of a Benchmarking and Statistical Study. SigmaBleyzer took the initiative of contracting

the services of the Thunderbird Graduate School of International Management to assist in this effort. Over the last five years, Thunderbird was ranked first in the rating of "U.S. News & World Report" magazine in the area of international business. It operates in the USA and has overseas facilities and business programs in Europe and Asia. Its staff is composed of more than 110 experts in all areas of international business. Their practical research and case studies span all dimensions of modern international corporations. Its Thunderbird Corporate Consulting Group has carried out a large number of strategic studies for some of the largest US and European corporations (IBM, General Motors, Coca-Cola and others). The Group has also carried out corporate strategy studies for a number of Ukrainian industrial sectors (ship repair, information technology, confectionery).

9. The study was conducted by the team of SigmaBleyzer professionals and Thunderbird Corporate Consulting Group. Many members of the Steering Committee provided substantial and valuable input to this study. This input has been incorporated in the report. Nonetheless, the views expressed in this study are those of the authors and do not necessarily coincide with those of individual members of the IPCTF Steering Committee or the organizations they represent.

The study was completed in December 2000 and its main findings and recommendations are contained in the remainder of this report.

II. The Flow of Foreign Direct Investment

10. During the 1990's the flow of international private capital to Emerging Markets increased significantly from an average of US$12 billion in 1984-1989 to about US$220 billion by the mid-1990s, as noted in the Table below. However, several financial crises in the last decade — including the Mexico Crisis of 1994, the Asian Crisis of 1997 and the Russian Crisis of 1998 — significantly reduced the flow of total international private capital to Emerging Economies. In fact, there was a drop of 31% in the flow of private capital in 1997, followed by a drop of 49% in 1998. Nevertheless, in spite of these crises, the flow of foreign direct investment (equity capital) has been very stable, increasing throughout the period, as noted in the Table below. It now represents the most important source of financing for Emerging Markets. The table also shows that the flows of official assistance and commercial bank lending have been quite unreliable and unstable.

Net Capital Flows to Emerging Markets (in US Dollar billions)

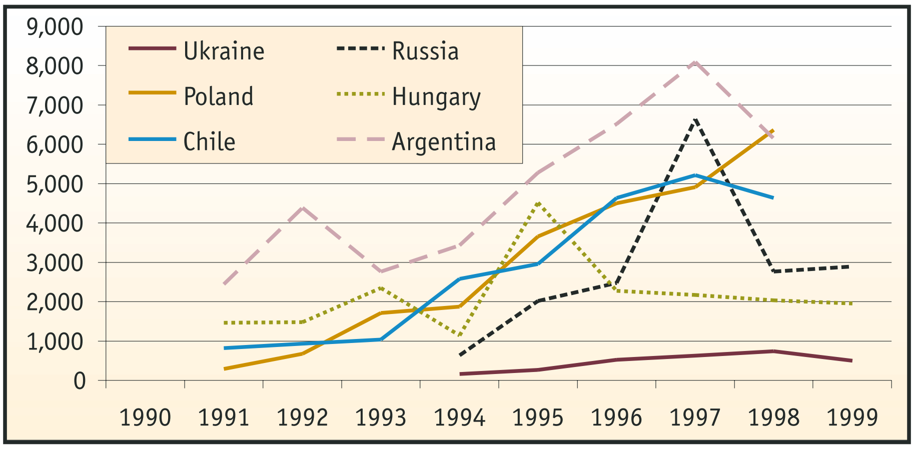
	1984-89	1994	1995	1996	1997	1998	1999	2000(e)
Total Int. Private Capital	12	136	226	215	148	75	80	71
- Foreign Direc t Investments	13	84	93	113	138	143	150	153
- Portfolio Flows	4	110	37	78	53	8	23	30
- Commercial Bank Loans	-5	-57	97	25	-44	-77	-92	-112
Official Assistance	26	4	12	1	23	45	3	1

Source: IMF, September 2000

11. As noted above, in 2000, the flow of foreign direct investment to Emerging Economies reached US$153,000 million. The largest recipients were developing countries in Latin America and East Asia. Of the total amount, Ukraine received only US$750 million, or only 0.5% (one-half of one percent) of this flow.

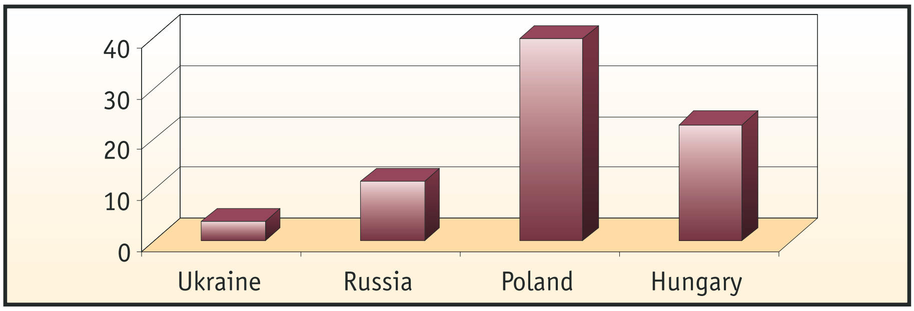
12. In fact, since independence, foreign direct investment for Ukraine has been very low compared to the flows of foreign direct investment received by other countries including Poland, Hungary, Russia, Chile, and Argentina. As shown in the chart below, in 1998, Ukraine received US$750 million in foreign direct investment, compared to the much larger amounts received by Hungary (US$2.0 billion), Poland (US$6.4 billion), Russia (US$2.8 billion), Chile (US$4.6 billion) and Argentina (US$6.1 billion).

Foreign direct investment — Selected Countries



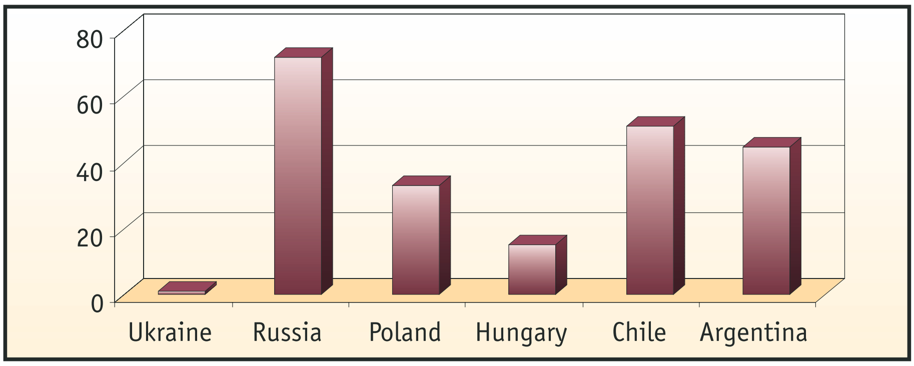
13. In terms of cumulative flows of foreign capital since independence in 1991, the table below shows a similar but more striking situation for the economies in transition. For example, Ukraine was able to get only 10% of the amount received by Poland.

Cumulative FDI Inflow Since 1991



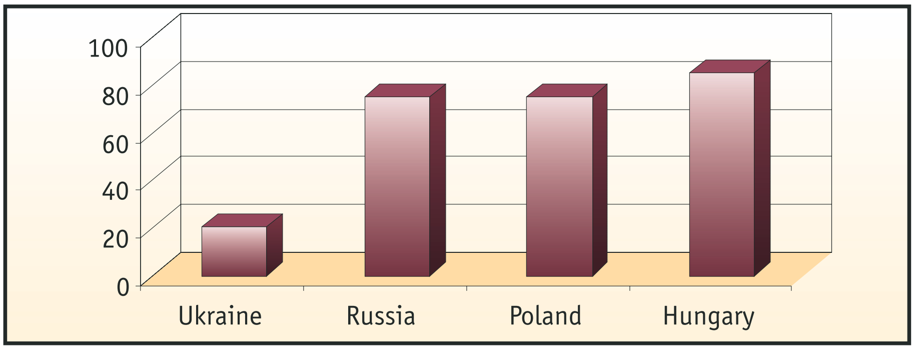
14. As a result of low foreign and domestic capital, the equity market value of the stock exchange in Ukraine is quite low, as indicated in the chart below. The total capitalization of the equity market in Ukraine is a US$1.2 billion equivalent. This represents 0.05% (1/20 of 1%) of the equity capitalization of all Emerging Markets (which reached US$2,300 billion in 1999) and 0.005% (1/200 of 1%) of the World's equity capitalization of US$23,000 billion. The comparison with benchmarked countries is given below:

Equity Market Value



15. Another indicator of the low level of private investment in Ukraine, including domestic and foreign investment, is the contribution of the private sector to Gross Domestic Product. As noted in the chart below, such contribution in Ukraine is quite low, at about 20% of GDP, compared to around 70% to 80% in Hungary, Poland and Russia.

Private Sector Contribution to GDP 1999

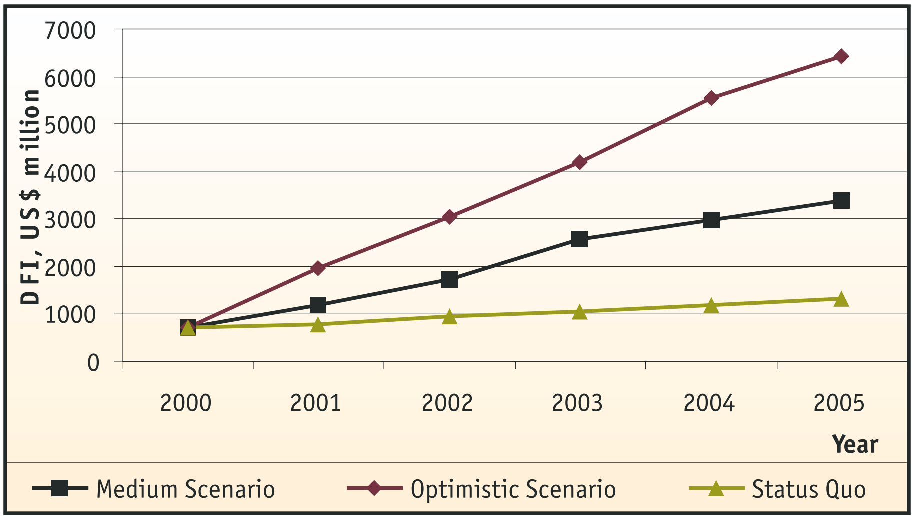


16. All the above tables show that Ukraine has ample room to expand its flow of international private capital. It has not tapped even a small percentage of its potential. The present study will show that the economic recession of Ukraine and the lack of foreign direct investment since independence cannot be attributed only to macro-economic factors. To a large extent, the lack of sustainable growth and international capital is due to exceptionally difficult conditions for business activities in Ukraine. These poor business conditions are the main drivers that deter foreign investors.

III. Possible Scenarios of Foreign Direct Investment for Ukraine

17. Based on the forecasting model developed in this Study, for the next few years Ukraine has three likely scenarios for its level of foreign direct investment depending on the depth of economic policy reforms aimed at improving the business climate in Ukraine. The continuation of the current policies would mean a Status Quo. That is, Ukraine would continue to receive around US$1 billion per year in foreign direct investment during the next five years. On the other hand, under an optimistic, aggressive reform program that would significantly improve the business climate in the country, Ukraine would be able to increase the flow of foreign direct investment to a level of about US$6.5 billion per year, in five years. Under a middle scenario, Ukraine may be able to increase the flow of foreign direct investment by year 2005 to about US$3.4 billion per year.

18. The possible evolution of foreign direct investment under these three scenarios is given in the chart below.



19. The flow of foreign direct investment will have a multiplier effect on GDP growth. Under the Middle Scenario, the incremental foreign direct investment would generate an incremental GDP growth of 4.8% per year.

20. The discussion in this section illustrates that Ukraine would be able to reap significant economic benefits from a policy that would accelerate the flow of foreign direct investment. For this purpose, an environment must be created where private foreign capital is allowed and welcomed to work effectively in the country. The measures to achieve these objectives will be discussed in the next section of this report.

IV. Increasing the Flow of Foreign Direct Investment to Ukraine

21. Ukraine must compete for investment dollars on global capital markets. While there is a lot of investment capital available in the world, the country must provide the upside revenue potential commensurate with the underlying risk in order to attract investment.

22. An appropriate balance of risk and reward must be present to attract private capital. Today, Ukraine is viewed as too high of a risk as compared to the potential reward. The Government must work on both sides of the equation simultaneously – reducing risk and increasing potential reward.

23. Reducing risk is a long-term process, but the signals should be loud and clear: the country is on a decisive and irreversible course towards a competitive free-market-based economy. To achieve this goal, the country is actively pursuing economic reforms, including securing internal and external economic stability, providing a stable and predictable legal system, developing a private-land-ownership-based agricultural sector, pursuing liberalization and deregulation of business activities, and eliminating barriers to market entry and market exit. In addition, the progress of reforms should be clearly visible and constantly improving.

24. In order to increase potential rewards from equity capital, there are many variables to consider. They include creating a favorable tax environment, facilitating the growth of internal markets and competitive export-oriented business, permitting the realization of potential higher revenues and profits, providing logistical advantages, and facilitating the potential for integration into global supply chains.

25. In order to attract foreign equity, Ukraine must be seen as a modern country, which understands its strengths and weaknesses, and therefore its role in the global economy. It should be seen as hip, cool, even irreverent – a fast growing economy that nobody can stop, instead of an old bureaucracy with heavy vested interests. A dynamic image must be created for this new Ukrainian economy. This represents a fundamental transition and creates a marketing challenge, but both can be managed and other countries have done it successfully in the past. A key signal for this is the speed of change that is taking place in the country. Indeed, change attracts private capital! Once capital markets perceive that a radical positive change is taking place, they reward it quickly and dramatically. More investment is made every day on the basis of the potential of tomorrow, rather than in the current business per se. But this potential must be seen, understood and accepted by the market, and this process always starts with a perceived change in the status quo.

26. In order to create the conditions to attract private foreign equity capital, the Government must define and implement the concrete Government measures that are needed to improve the business climate in the country. Based on the pre-condition that a sound macroeconomic stabilization framework must be in place, additional measures should aim at improving “Transparency”, encouraging “Simplicity” and facilitating “Predictability” in business activities in Ukraine, as noted below:

“**Transparency**” is like “clear air” for private equity capital investment. At this stage of development, only large globally diversified investors would invest in equities in Ukraine. There are many of these investors, and they control an enormous amount of free capital reserves that would be more than sufficient to cover all of the Ukrainian investment needs for years to come. However, with their size comes sophistication and experience. All of these investors have had experience investing in liquid, efficient markets with great transparency, and in more "murky" markets. They all know from experience that real returns on their investments can only be made when transparency arrives to a market place. Unfortunately, in Ukraine today, many decisions and business activities are made in a non-transparent manner. Furthermore, a lot of the information available to investors on business opportunities in the country is not clear and not consistent with international standards.

"**Simplicity**" is also vital to the investment process. There is nothing more damaging to a foreign investor than a cumbersome, complicated, difficult-to-understand investment and business environment. The more difficult it is to register, set up and operate a business in the country, to transfer funds in and out of the country, and to participate in various privatization and other investment processes, the more negative an adjustment the investor has to make to his perceived risk / reward ratio.

"**Predictability**" is a third important consideration for investors. All successful business people or investment professionals all over the world pride themselves on their ability to understand and then manage and control risk. They must be able to predict, at least in their minds, what the consequences of certain actions by them and their competitors will be. For this purpose the "rules of the game" should be clear and stable.

27. This Report will identify and prioritize the concrete measures that are needed to improve Transparency, Simplicity and Predictability.

V. Study Methodology

28. The methodology used in the Benchmarking and Statistical Study was as follows:

- ✓ It compared and benchmarked the current status of key economic factors — called "drivers" — that influence the flows of private capital with the situation in other countries, including Argentina, Chile, Poland, Hungary and Russia. This Benchmarking Analysis assigned values to the policy actions of a number of countries — policy actions that could explain the differences in capital flows to these countries.
- ✓ For a larger group of 50 countries, the study quantified the individual contributions of these "drivers" to the actual flow of foreign direct investment into these countries. It then established the relationship between policy actions and foreign direct investment and their relative importance for success.
- ✓ The study developed a mathematical model to estimate the flow of international private capital that Ukraine would be able to obtain over time if it were to implement policies carried out by the most successful benchmarked countries.
- ✓ The Study then made recommendations as to the top priority actions for Ukraine, based on international experience.

VI. Benchmarking Analysis

29. A team of consultants from the Thunderbird Corporate Consulting Group visited a number of countries to assess concrete economic policy actions that affect foreign investment and to compare these policy actions with Ukraine's actions. The following countries were visited: Argentina, Chile, Hungary, Poland, and Russia.

Policies Affecting Business Climate

30. The study starts from the premise that macroeconomic stabilization, achieved by sound fiscal and monetary policies, is an essential pre-condition to achieve a favorable business climate and attract foreign direct investments. Within this macro framework, in order to achieve increases in international capital inflows, the study identified the following nine key "policy actions" or "drivers" that generate foreign investment:

1. Liberalize and Deregulate Business Activities
2. Provide a Stable and Predictable Legal Environment
3. Enhance Governance & Reform Public Administration
4. Remove International Capital & Foreign Trade Restrictions
5. Facilitate Financing of Businesses by the Financial Sector
6. Eliminate Corruption
7. Reduce Political Risks (non-economic country risks)
8. Expand Country Promotion
9. Rationalize Investment Incentives

31. Scores were assigned to these nine individual policy actions in all benchmarked countries, based on Thunderbird's research and research done by others. To minimize subjectivity in assigning values to these factors, and to further ratify and validate the accuracy of the estimations, the Thunderbird team reviewed research carried out by prestigious institutions. Furthermore, data was aggregated from multiple sources to eliminate evaluator bias. Values (ratings, scores etc.) for individual line items were normalized using a scale of 1.0 to 100.0 with higher scores indicating a better item score.

32. The results of the Benchmarking Analysis are given in the tables below (numbers in red represent best-in-class scores).

Benchmarking Results

UKRAINE	RUSSIA	POLAND	HUNGARY	CHILE	ARGENTINA
Business Liberalization Score					
18	49	87	80	**89**	62
Legal Environment Score					
17	61	**99**	93	89	65
Governance and Privatization Score					
29	30	**89**	82	80	65
International Capital Controls and Foreign Trade Score					
63	45	78	79	**84**	69
Financial Sector Score					
10	39	62	68	**74**	39
Corruption Score					
15	21	41	52	**74**	35
Political Risk Score					
65	49	**83**	82	71	75
Governmental Business Promotion Score					
20	30	80	**100**	90	75
Tax and Investment Incentives Score					
31	48	78	**82**	63	70

33. The tables above show that compared to the benchmarked countries, Ukraine's policy framework is weak in most areas. The weakest areas are those relating to the Financial Sector (13% of best-in-class), Legal Environment (17% of best-in-class), Corruption (20% of best-in-class), and Business Liberalization (23% of best-in-class). On the other hand, Ukraine's policy framework is less weak in Political Risk (78% of best-in-class) and International Capital Controls (80% of best-in-class).

34. The above analysis says nothing about the effects that the individual deficiencies in the policy environment have on the flows of foreign direct investment. The potential effects of these nine policy factors in the flows of foreign direct investment will be analyzed in the next section.

VII. Statistical Analysis

35. The objective of the statistical analysis was to determine the 'relationship' between capital inflows and actionable policy actions in a cross-section of countries. Several statistical tests were run to establish this relationship, ranging from simple correlation models to multiple regression techniques to structured equation modeling.

36. In the statistical analysis carried out by SigmaBleyzer staff, the scores on the nine policy actions were statistically tested against the capital inflows in 50 countries to arrive at the coefficients of a "formula" for FDI. The coefficients of the multiple regression are the relative weights of the nine factors in explaining FDI.

37. The following countries were included in the SigmaBleyzer statistical study: Angola, Argentina, Armenia, Azerbaijan, Belarus, Bolivia, Botswana, Bulgaria, Burkina Faso, Cameroon, Chile, Colombia, Costa Rica, Croatia, the Czech Republic, Ecuador, Egypt, El Salvador, Estonia, Ethiopia, Ghana, Hungary, India, Indonesia, Jordan, Kazakhstan, Kenya, Lithuania, Malawi, Moldova, Morocco, Mozambique, Nigeria, Peru, Philippines, Poland, Romania, Russia, Senegal, Slovak Republic, South Africa, Tanzania, Tunisia, Turkey, Uganda, Ukraine, Venezuela, Vietnam, Zambia, and Zimbabwe.

38. The results of the multiple regression analysis indicated that four "drivers" were the most significant in explaining the flow of foreign direct investment into the above 50 countries.

39. Three "drivers' had a strong positive impact on foreign direct investment. These three "drivers" were as follows:

- ✓ Liberalization of Business Activities (including domestic and trade liberalization.)
- ✓ Adequacy of the Legal Environment (Law and Order).
- ✓ Governance and Accountability of Public Administration.

40. The fourth significant "driver" had a negative impact on foreign direct investment. This driver was the level of Investment Incentives. This is a plausible result because a high level of investment incentives is used by many poor performing countries in lieu of a free and competitive business environment. The level of ad hoc investment incentives cannot outweigh the other negative factors.

41. Other "drivers" — including Financial Sector, Political Risk, International Capital Controls, Corruption, and Government Promotion — were not statistically significant in the regressions. But this does not mean that they are not important. Their lack of statistical significance may be explained by multicollinearity problems, since these factors were highly correlated to the other significant factors. In fact, Corruption was 82% correlated to Public Governance; Removal of Capital and Trade Restrictions was 79% correlated to Liberalization; Financial Sector Reform was 70% correlated to Liberalization; and Political Risk was 71% correlated to Governance.

42. The results of the multiple regression analysis, using a two-year average for foreign direct investment, are as follows:

Multiple Regression Analysis

	Standardized Coefficients Beta	t-values	Signif. Level	Standard Error of Beta
Business Liberalization	1.140	3.09	0.003	0.368
Legal Environment	0.646	1.99	0.053	0.325
Governance/Pub Adm	0.719	1.87	0.067	0.384
Investment Incentives	-1.863	-4.54	0.001	0.409

R	R Square	Adjusted R Square	p-value
0.779	0.607	0.574	<0.00000

43. The above results indicate that Business Liberalization, Legal Environment and Governance/Public Administration had strong positive effects on the flow of foreign direct investment among the sample of 50 countries. Investment incentives, on the other hand, were significant, but with a negative statistical impact. As noted earlier, this suggest that poorly performing countries that use Investment Incentives will not be able to increase the flow of international capital. These policy variables explained about 60% of the variations in FDI in the sample of 50 countries. The regression p-value of less than 0.00000 indicates that the significance level of this relationship is almost 100%. The statistical significance of these variables is very high: 99% for Investment Incentives, 99% for Business Liberalization, 95% for Legal Environment, and 93% for Governance/Public Administration. The contribution of Investment Incentives was significant and negative.

44. The Thunderbird Corporate Consulting Group ran similar regressions, but for a smaller group of 23 countries, including: Argentina, Bangladesh, Bulgaria, Chile, Colombia, the Czech Republic, Egypt, Hungary, Indonesia, Kenya, Nigeria, Pakistan, Peru, Poland, Romania, Russia, South Africa, Sri Lanka, Thailand, Ukraine, Venezuela, Zambia, and Zimbabwe.

45. In this second set of regression analyses, four major Government policies (Liberalization of Business, Legal Environment, Financial Sector and Governance/Privatization) were aggregated into a single index called "Major Government Policy". The other variables included Political Risk, Corruption, Capital and Foreign Trade Restrictions, and Tax and Investment Incentives.

46. The results of this regressions was as follows:

Multiple Regression Analysis — Coefficients

	Standardized Coefficients	t - values	Signif. level	95% Confidence Interval for E	
	Beta			Lower Bound	Upper Bound
(Constant)		-2.071	0.059	-6.649	0.14
Mj Gov Policies	1.778	2.859	0.013	0.008	0.061
Polit Risk	0.760	1.448	0.171	-0.012	0.059
Corruption	0.422	1.213	0.247	-0.01	0.034
Cap/TF Rt	0.272	0.967	0.351	-0.02	0.053
Tax/Inv Inc	-0.036	-0.165	0.872	-0.008	0.07

Model	R	R Square	Adjusted R Square	Std. Error of Est.
1	0.715	0.511	0.323	0.350

47. The results of this second analysis show similar conclusions to the first analysis performed by SigmaBleyzer: for the sampled countries, Major Government Policies had the most significant effect on the amounts of foreign direct investment received by the countries, with a significance level of 94%. Corruption and Political Risks followed

in significance at around the 75% and 83% level of significance, respectively. As was the case with the first set of regressions, Investment Incentives also had a negative coefficient, though at a lower level of significance.

Statistical Research Done by Others

(a) Study Done by Morgan Stanley Dean Witter

48. A USAID-funded regression study of 67 emerging economies was made by Morgan Stanley Dean Witter in July 1998 (titled ***"Foreign Direct Investment and its Determinants in Emerging Economies."***) The main findings of the study were as follows:

Finding 1: Foreign investment inflows are influenced very little by generic variables such as: location, proximity to financial centers, total population, and size of the country. These variables show little significance throughout the regressions.

Finding 2: On the other hand, foreign investments are heavily influenced by the countries' policies and institutions.

Finding 3: The above means that even though initial, country-inherent conditions may play a certain role, they can be overcome by sound policies and their thorough implementation.

Finding 4: Economic policies allowing for free open markets, investment and trade are key determinants of FDI inflows (Economic Openness had the highest coefficient value).

Finding 5: The key determinants of "Economic Openness" were:

- ✓ Little Government interference in markets, that is, "free" markets with minimum directive regulation.
- ✓ Open import and export regimes.
- ✓ An exchange rate that reflects a currency's true value, with no controls on currency exchange.

49. The statistical results of this USAID/Morgan Stanley study is as follows:

Morgan Stanley Model

	Standardized Coefficients	t
	Beta	
(Constant)	0.898	-2.105
Econ.Openness	0.789	3.052
Corruption	0.171	1.926
Tax on Pvt. Sector	-0.061	-3.101
Credit Availability	0.007	1.969
Adjusted R-square	0.38	

(b) Study Done by the International Center for Policy Studies

50. Another important study was carried out by Ukraine's International Center for Policy Studies in June 2000 (titled ***"Foreign Direct Investment in Ukraine, Policy Study No. 11"***). This study carried out a survey of 65 foreign companies with representation in Ukraine. These companies had committed over US$2 billion of FDI in Ukraine, representing about 2/3 of Ukraine's total FDI stock. They were asked to identify the major deterrents to foreign investment in Ukraine, to estimate the importance of privatization for FDIs, and to indicate their motives for investing in Ukraine.

51. The Survey's result confirmed that the main reason for Ukraine's poor performance in attracting foreign capital was its inferior investment climate. The main conclusions were as follows:

Major Deterrents for FDI.

The survey ranked the major deterrents to FDI in Ukraine in the following order, descending in significance:

- ✓ Instability and exorbitance of the Government's regulations
- ✓ Ambiguity of the legal system
- ✓ Uncertainty of the economic environment
- ✓ Corruption
- ✓ High Tax burden
- ✓ Problems establishing clear ownership conditions
- ✓ Depressed disposable income levels
- ✓ Difficulty negotiating with Government authorities
- ✓ Volatility of the political environment
- ✓ Lack of physical infrastructure

Recommended Policies.

The respondents to the Survey suggested the following policy agenda to improve Ukraine's business climate and attract foreign direct investment:

- ✓ Liberalization of controls on capital, foreign exchange and profit repatriation
- ✓ Lifting of restrictions on foreign ownership and control
- ✓ Minimization of red tape
- ✓ Reduction of tax rates and number of taxes.

Importance of Privatization.

The surveyed companies indicated that they had invested in Ukraine mostly through greenfield projects or joint ventures with private companies. Privatization had not been important in their investment decisions. Nevertheless, 95% of the companies felt that proper privatization policies could significantly improve the business climate in the country.

Investment Motives.

The most important motive for investment in Ukraine was new market opportunity. Most investors were attracted to Ukraine by its extensive market of 50 million people. This factor was well ahead of others, including cheap labor. Ukraine's lower wage rates were offset by Ukraine's lower labor productivity, inferior management and regulatory burdens. All these factors made labor costs higher. It is also interesting to note that tax/investment incentives, available qualified labor, and existing production capacities were regarded as unimportant.

(c) Study Done by the European Bank for Reconstruction and Development (EBRD)

52. In connection with the ***"Transition Report 1999"*** prepared by the EBRD (Transition Report 9, November 1999), the EBRD carried out a ***"Business Environment and Enterprise Performance Survey"***. This survey contains indicators of the problems accountable for the rather negative perception of Ukraine's investment climate. For the survey, the managers of over 3,000 enterprises in twenty Central European, East European and CIS countries were asked to assess the business/investment climate in their respective countries. Questions focused on macroeconomic conditions (policy instability, inflation, exchange rate), microeconomic conditions (business regulations and taxation, and access to finance), law and order (functioning of the judiciary, corruption, and crime), and the physical infrastructure.

53. Out of the 20 countries surveyed by the EBRD, Ukraine occupied the 16th place. And on microeconomic conditions alone, Ukraine scored lowest of all the 20 countries. Ukraine was also at to the bottom (ahead only of Moldova) with respect to its effectiveness in affording security of property and contract rights.

(d) Study Done by the German Advisory Group

54. In 1999, the German Advisory Group to the Ukrainian Government carried out a survey of 20 foreign companies with operations in Ukraine to find out the most important impediments for investing in Ukraine (Siedenberg, Hoffmann (eds.), ***"Ukraine at the Crossroad"***, New York 1999.) The study also ranks them to define the importance of their disincentive potential. The following were the main deterrents to investments, in order of importance:

1. Legal Uncertainty was rated as the first and foremost impediment.
2. Government's failure to abide by its commitments.
3. Government control and remnants of command economy.
4. Lack of support from authorities.
5. Corruption.
7. Long processes for obtaining necessary permits.

55. Each of these four studies validates the results from our own primary analysis and statistical tests. In fact, their results are fairly consistent with the result of this study. How these findings are used to predict foreign direct investments to Ukraine is presented in the next section.

VIII. Formula to Predict Foreign Direct Investment

56. The Benchmarking Analysis and the Statistical Analysis were used to construct an economic mathematical model that would explain changes over time in the flows of international capital to Ukraine as a function of two factors:

(i) the value of nine policy actions or drivers discussed earlier; and

(ii) the changes in the importance of these policy actions over time, that is, the changes in the values of the coefficients of the regression over time.

57. The economic-mathematical model is explained in detail in Annex 3 and summarized in this section.

58. Foreign direct investment flows [$FDI(t)$] for each year [t] are calculated by the following formula:

$$FDI(t) = \sum C_k(I_k(t)) \times I_k(t)$$

Where: $I_k(t)$ are the values of the nine Indexes of policy actions at time t; and
$C_k(I_k(t))$ are the regression coefficients for the nine indexes.

59. The values of the regression coefficients [$C_k(I_k(t))$] are not constant, but they change depending on the value of the Index per se [$I_k(t)$]. Therefore the model is non-linear and more realistic. In fact, we can expect that the importance of a particular policy action (such as Liberalization) would not be constant, but would evolve over time, as this policy action evolves.

60. For a given year (such as year 2002), a sample formula is given in the table below:

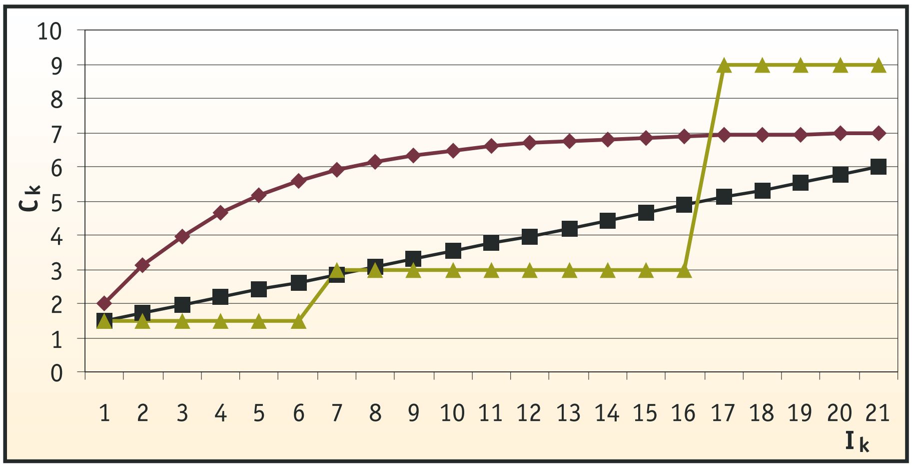
	Cap/TF R	Polit Rsk	Corrup	Govt Pol	Tax/In Inc	Prom Eff
(IF) Value	62	85	34	42	48	62
(THEN) Coefficient	2	2	10	10	4	6

Formula: 2(Cap/FT)+2(Polit Rk)+10(Corru)+10(Govt Pol)+4(Tax/Inv In)+6(Prom Eff)

FDI Value for 2002 ($m): 1618

61. As indicated above, for other years, the values of the coefficients will change. The model tested various assumptions regarding the relationship between the coefficients C_k and indices $I_k(t)$. In one scenario, it is assumed that while the value of a policy action [$I_k(t)$] grows, that growth will also make its overall importance in defining FGI [i.e., the value of the coefficient $C_k(I_k(t))$] to grow as indicated in the chart below. Thus, we model the multiplicative impact of a factor's growth on investment flows and take into account time dependences.

$C_k(I_k)$



62. The values for the index coefficients $[C_k(I_k(t))]$ are calculated with the help of the benchmarking and statistical analysis discussed in the previous section and further regressions of the coefficients vis-a-vis the indices.

63. In order to estimate foreign direct investment to Ukraine, we first had to estimate the value of the Indices for policy action $[I_k(t)]$ over time. These values will depend on the depth of implementation of policy measures. We assumed the following three scenarios for implementation of policy measures:

Status-Quo Scenario: Continuation of current policies.

Middle Scenario: Implementation of policy actions to reduce 50% of the policy level differential in five years with the Best-in-Class country identified in the Benchmarking analysis (e.g., Chile on Liberalization, Financial Sector Reform, Anticorruption and International Controls; Poland on Legal Framework, Governance, and Political Risk; and Hungary on Government Promotion and Taxation). In fifteen years, this policy differential would be reduced further as described in Annex 3 and noted in the table below.

Optimistic Scenario: Implementation of stronger policy actions to reduce 80% of the policy differential with the Best-in-Class in five years.

64. The evolution of the Policy Indices for the Middle Scenario for a period of 15 years is presented in the table below.

Evolution of Policy Action Indexes - Middle Scenario

Index	Year		Growth Rate, %	
	2000 E	2015 E	2001-2015	Average Annual
Liberalization and De-regulation of Business Activities	18.1	87.6	384%	11%
Legal Environment Index	16.8	96.6	475%	12%
Governance & Public Administration Index	28.6	89.1	211%	8%
International Capital and Foreign Restrictions Index	63.0	92.8	47%	3%
Financial Sector Index	10.8	72.1	567%	13%
Anticorruption Index	15.0	72.6	384%	11%
Political Risk Index	65.0	92.3	42%	2%
Government Business Promotion Index	20.0	82.0	310%	10%
Investment Incentives Index	31.0	83.7	170%	7%
Major Combined Index	24.8	85.0	342%	9%

IX. Estimating Foreign Direct Investment into Ukraine

65. Using the above formula, and assuming different scenarios for the depth and speed of improvement in the key "drivers" for foreign investment, the Study reached the following conclusions:

- ✓ If Ukraine were to continue its current policies - status-quo scenario - the level of capital inflows will not increase significantly from its current level– except for ad-hoc flows related to large privatizations. By year 2005, FDI would reach about US$1.3 billion per year.
- ✓ Under the middle scenario, if Ukraine were to take policy actions to reduce 50% of the policy level differential with the Best-in-Class in five years, Ukraine would increase foreign direct investment to about US$3.4 billion per year by 2005, an increase of 150% over the status-quo scenario.
- ✓ Under an optimistic scenario, with stronger policy actions to reduce 80% of the policy differential with the Best-in-Class in five years, the level of foreign direct investment into Ukraine could increase to US$6.4 billion per year.
- ✓ Liberalization of Business Activities, followed by improvements in the Legal Framework and improvements in Governance were the three most important policy actions that the country could take to increase capital inflows today. If reforms in only these three areas were to be undertaken, their implementation would increase capital flows to US$2.5 billion in five years, or by 92% compared to the status-quo scenario.
- ✓ However, in order to get more significant increases on capital flows over the next five years (i.e., between US$3.4 billion to US$6.4 billion per year), actions on all nine factors are required.

66. The detailed forecasts of foreign direct investment into Ukraine for the different scenarios are given in Annex 3. Concrete Policy Actions to achieve these higher scenarios are presented in Annex 2 of this report.

X. Proposed Action Plan for Ukraine

67. Based on extensive discussions with the members of the Steering Committee of the Task Force on International Private Capital, the study proposes an Action Plan necessary to achieve a high level of foreign direct investment into Ukraine. This Action Plan is presented in Annex 2.

68. The members of the Steering Committee were also asked to prioritize the main actions that the Government should take to attract increased flows of international private capital. The main priorities indicated by members of the Steering Committee were very similar to the priorities derived form the statistical analysis of the Study. In addition to a sound macroeconomic framework consistent with adequate fiscal and monetary policies, the study team proposes the main priorities as follows:

Priority 1: Liberalize and Deregulate Business Activities.

- ✓ Finalize and communicate widely the Government's De-regulation Policy, consistent with international standards, and rapidly implement it to simplify and facilitate registration of new businesses, the operations of existing businesses, and import/export of goods.
- ✓ Establish an appropriate on-going mechanism to liberalize business activities, establish deregulation priorities, and continuously review all existing and new regulatory legislation.
- ✓ Eliminate current incentives to excessive Government intervention, such as the right of some agencies to retain part of the fines they impose on businesses.

Priority 2: Provide a Stable and Predictable Legal Environment.

- ✓ Create an independent and incorruptible judiciary, separate from the Executive branch.
- ✓ Pass well-conceived new laws or modify existing legislation as needed to provide a more favorable framework for business, including the civil code, the labor code, the criminal code and the tax code.
- ✓ Establish an efficient legislative process to coordinate and expedite the drafting of laws and regulations.
- ✓ Provide adequate funds from the fiscal budget for the judiciary, including resources for training and for computers with legal databases, internet access, web sites with compilations of court decisions and academic treatises.

Priority 3: Improve Corporate and Public Governance and Eliminate Corruption

Corporate Governance:

- ✓ Demonstrate corporate financial discipline by closing 10–20 big loss-making state companies within next two years.
- ✓ Enact the Joint Stock Company Law of Ukraine to modernize Ukrainian corporate governance legislation.
- ✓ Require all companies listed in exchanges to switch over to international accounting standards and to submit annual reports.

Public Governance

- ✓ Continue public administration reform to reduce the size of state agencies, raise salaries of key civil servants, and redefine the Government's role as that of supporting — not replacing — private activities.
- ✓ Extend administrative reform to local state bodies.
- ✓ Reduce shadow economy activities by drastically cutting red tape and lowering cost of compliance with legislation in effect.

Privatization

- ✓ Secure the early approval and implementation of the Land Code to promote private ownership and registration of land.
- ✓ Encourage the independence of the State Property Fund (SPF) by passing the Law on the State Property Fund and subordinate it to the Executive branch.
- ✓ Take early actions to prepare state companies for privatization (including actions to protect minority shareholder rights and transfer social assets to local authorities) and complete expeditiously the privatization of energy sector and other major enterprises under clear and transparent procedures.

Corruption

- ✓ Implement an intensive, sustained and visible anti-corruption campaign, with a strong emphasis on corruption prevention to make corruption more difficult and more expensive to undertake, starting with key areas such as barter and the energy sector.
- ✓ Develop the legal framework needed to ensure better enforcement of anticorruption measures and impose visible, harsh, swift and certain penalties for corruption of Government officials.
- ✓ Get public support for anti-corruption programs by making people aware of their rights and the rules of the game.

69. Members of the Steering Committee felt that if the above measures were to be implemented swiftly, the investment climate in Ukraine would improve significantly. Foreign as well as domestic investment, would come to Ukraine at an accelerated pace, providing for employment opportunities and a sustainable rate of growth for the Economy.

70. Several Members of the Steering Committee expressed their willingness to continue to advise the Government, on a permanent basis, on the matters covered in this report, if the Government were to find such support from the private sector worthwhile.

ANNEX 1

Members of the Steering Committee
of the
International Private Capital Task Force

Western Members of the Steering Committee

Private Enterprises

1.	SigmaBleyzer	Michael Bleyzer, President Edilberto Segura, Kiev Director
2.	AGCO Corp.	Gordon Graham, General Manager
3.	American Chamber of Commerce	Jorge Zukoski, Executive Director
4.	CityBank	Witold Zielinski , President
5.	Coca Cola	Garry Wilson, General Manager Elias Ashkar, Region General Manager
6.	Commerzbank, AG	Olaf Letzel, Head
7.	Credit Lyonnais	Jacques Mounier, President
8.	Du Pont de Nemour	Peter Gill, General Manager
9.	Financial Markets International	Hugh Patton, Director
10.	Leo Burnett	Francois Demers, Managing Director
11.	PricewaterhouseCoopers	Gerry Parfitt, Senior Partner Jorge E. Intrigo, Parner

Multilateral and Bilateral Agencies

1.	European Bank	Andrew Seton, Country Director
2.	European Commission	Andre Van Haeverbeke, Ambassador
3.	Harvard Institute for Int. Devel’t	Janusz Szyrmer, Director
4.	International Finance Corporation	Alyona Voloshina, Resident Represnt.
5.	International Monetary Fund	Henry Ghesquiere, Sr. Resident Repr. David Orsmond, Resident Reprsentat.
6.	Internat’l Center for Policy Studies	Vera Nanivska, Director
7.	US Agency for Internat’l Devel’t	Chistopher Crowley, Director
8.	US Embassy	Kenneth Fairfax, Economic Counselor
9.	World Bank	Gregory Jedrzejczak, Mission Chief

ANNEX 2

Detailed Measures under the
Proposed Action Plan
to Attract International Capital
to Ukraine

(Recommendations made
by the Members of the Task Force)

Specific Measures to Attract International Capital

I. Liberalization & Deregulation of Business Activity

1. Finalize and communicate widely the Government's De-regulation Policy, reconfirming to companies that they are allowed to operate in a market economy with more freedom and less interference from government agencies.

2. Establish an appropriate on-going mechanism to liberalize business activities, establish deregulation priorities, and continuously review all existing and new regulatory legislation. This body should have the final responsibility to review and introduce new licensing and business regulations.

3. Adopt licensing and other Government controls requirements that conform to European Union and international standards. This should simplify business licensing to facilitate and reduce the amount of time required to: (i) complete business registration to start a new business, (ii) operate a business and (iii) import/export goods, as follows:

(i) Start a business registration system based on a one-stop process. Show that the government is trying to focus only on those areas where it has a public duty to ensure adequate standards (e.g. health and safety). Consider moving to a system of license issuance without preliminary business inspections. Ensure that local registration offices comply with national company registration requirements in terms of time, cost and documentary burden.

(ii) Implement the following deregulation measures for ongoing businesses:

- ✓ Reduce the number of bodies that have the power to inspect businesses.
- ✓ Reduce the number of individual business inspections by government agencies and coordinate inspections among agencies.
- ✓ Limit or eliminate unplanned business inspections (to cover all inspecting agencies). If an unplanned business inspection is required then this should only be done with a court order.
- ✓ Take strong measures to stop the arbitrary practice of state bodies to close businesses unless there is a direct threat to safety, health or the environment. Even then only with a court order.
- ✓ Remove constraints to the purchase and leasing of commercial premises, land and housing.
- ✓ Reduce the number of planning regulations developers have to meet for refurbishment of new buildings (related to property development, especially in Kiev, where signals that are given to foreign investors are strongest).
- ✓ Move towards a level business playing field by eliminating distortions caused by preferential access to land, state contracts, infrastructure, and credit.

(iii) Streamline customs service for imports and exports:

- ✓ Develop a custom code and other trade laws in line with international standards.

- ✓ Consider partial (or full) privatization of customs service.
- ✓ Consider contracting out the customs function to a reliable international pre-shipment inspection firm to improve service and reduce corruption (as in Indonesia).
- ✓ Streamline product certification and ensure effective oversight over certification laboratories to eliminate corruption and unnecessary delays. Move towards recognizing international certification standards (e.g. European Union, World Trade Organization).

4. Eliminate incentives to excessive Government intervention, such as:

- ✓ Disallowing all regulatory agencies from keeping any part of the fines they collect,
- ✓ Not allowing implementing agencies such as the State Tax Authority, SCS, to get too independent or fund itself. Get their reporting lines under the control of the Government and Ministry of Finance.

II. Legal Environment

1. Create an independent and incorruptible judiciary. In order to achieve this, it is necessary to:

- ✓ Provide adequate funds from the fiscal budget to support the work of courts and independent judges (in 1999 only 50% of the funding required was supplied by the government).
- ✓ Increase resources for the judiciary, where funds are needed for computers with legal databases and Internet access, web sites with compilations of court decisions, academic treatises, judicial training on issues associated with modern commercial transactions, etc.

2. Pass well-conceived new laws or modify existing legislation as needed to provide a stable legal framework for businesses. Codes should set the framework for any special legislation needed by a modern economy on banks, joint stock companies, investment institutions, securities and stock markets, etc. There should not be special regulations for individual investors but improvement of the general legal and investment climate. This legislation should include:

- ✓ New civil code.
- ✓ New labor code that allows restructuring of enterprises.
- ✓ New criminal code.
- ✓ New tax code.

3. Establish an efficient legislative process to expedite the above work and coordinate the preparation and drafting of new laws and regulations. In general, drafting and passing modern commercial laws and codes is uncoordinated and is occurring way too slowly in Ukraine, thereby holding up reforms. Have public hearings with inter-

ested groups as part of the legislative process. At the very least, publish all drafts of legislation in order to stimulate debate.

4. Make the Civil Courts more efficient and enhance commercial courts for settling disputes and enforcing contracts. In order to achieve these results, the government must:

- ✓ Improve the mechanisms for the enforcement of court decisions.
- ✓ Implement a compulsory retraining of judges and court officials.
- ✓ Ensure that private business has the voice in the court system equal to the state.
- ✓ Ensure that any and all penalties against the state are effectively levied.

5. Empower the Courts to deal with jurisprudence. For this purpose, the Judiciary should have its own independent budget. Separate the judicial and executive branches (while legally they are separate, in terms of day-to-day operations the executive still decides on office space, communication, staffing, etc.) This is especially obvious at the local level, when executive officials can influence the Judiciary. Do not allow executive agencies to perform jurisprudence (today, for instance, Tax authorities effectively carry out jurisprudence).

6. Improve the regulations and implementation of the new Bankruptcy Law to make it more effective.

7. Abolish the practice of backdating any legal decisions. Ukraine is known for passing legal acts that come into effect a couple of months prior to the date of the passage of the law.

8. Review existing legislation from the point of view of consistency among different legal documents. There is a need to harmonize the existing body of Ukrainian law to eliminate inconstancies. There is also a need to implement a permanent program to update basic Ukrainian laws and codes regulating business.

III. Corporate and Public Governance and Privatization

III (A) Corporate Governance

1. Demonstrate corporate financial discipline by closing 10-20 big loss-making state companies within the next two years. This should send a strong signal that financial performance in a market environment is the only criterion for survival in the long term. For this purpose, remove soft budget constraints caused by tax and energy arrears, remove entirely mutual debt settlement and offsets (accepting cash only), and enforce bankruptcy procedures.

2. Enact the Joint Stock Company Law of Ukraine. The current company law of Ukraine does not reflect the progress of market changes taking place. The 26 articles of the existing law “On Business Associations” regulating the activity of joint stock

companies do not adequately regulate matters such as minority shareholder rights or board responsibility and remedies. A draft law is presently in the Cabinet of Ministers and is to be passed on to Parliament in the near future.

3. On the above draft Joint Stock Company Law , the following changes should be made:

- ✓ It should include a provision clearly stating that individual shareholders should not draft orders, instructions, or any other similar documents relating to the company's activity, particularly those dealing with the appointment or dismissal of officials. In particular, the Law should state that Government agencies (such as the State Property Fund, Ministries, former Agency on Corporate Rights Management, etc.) authorized by the state to manage state shares should observe the Company's statutory norms and rules. In addition, they should implement state policy exclusively by voting by state shares at the Company's General Meetings or by taking appropriate decisions at Supervisory Board Meetings.
- ✓ The Joint Stock Company Law should have provisions to require shareholders that own 25% or more of the stock to take part or send representatives to the General Meetings of Shareholders. This requirement is necessary in order to avoid the cases when the work of the Company is blocked by the non-appearance of the shareholder at the shareholders' meetings.
- ✓ The Government should abandon the practice of requiring the obligatory creation of Dividend Funds in all Companies in which the state has shares.
- ✓ The Government agencies that represent the state at the Shareholders Generals Meetings should be restricted from making proposals as well as pass decisions regarding mandatory deductions of funds and their allocation to other Government funds. For example, in the past, some Government agencies holding majority control in a company to be privatized included into the company's Statute mandatory deductions of part of the company revenue contributing it to the Innovation Fund. After privatization, this provision could be cancelled by the new shareholders if more than 75% of the shareholders would oppose it. However, given that the Government would often own at least a 25% stake, the provision would remain in effect for an extended period of time.
- ✓ In order to ensure the rights of the shareholders that are in minority, the mechanism of cumulative voting should be implemented when the managing directors of the Company are elected.

4. Amend the Labor Code to allow managers and workers to be laid off more easily.

5. Draft and officially issue a "Corporate Governance Code," (as is being done in Russia now) a set of specific voluntary principles to which companies are encouraged to comply. It should include topics such as the limit of the role of Board members in day-to-day matters/management.

6. Encourage the creation of non-government institutions to improve corporate governance, such as:

- ✓ Shareholder associations. These are needed to protect shareholders' rights, encourage shareholder activism, facilitate the lawsuit process, and engage in raising public awareness. This would contribute to shifting the balance away from dominant shareholders and managers that systematically abuse these rights.

- ✓ Private rating agency for corporate governance. This will bring transparency, highlighting good and poor governance in companies.
- ✓ Association of issuers to protect issuers' rights.

7. Implement a comprehensive corporate governance training program. This is needed to improve corporate governance knowledge. Special attention should be paid to the implementation of a training program designed for different categories of target recipients:

- ✓ Supervisory Board members.
- ✓ Investors and shareholders.
- ✓ Managers of Joint Stock Companies.
- ✓ Public officials/employees.
- ✓ Judges from arbitration courts and courts of general jurisdiction.

III (B) Public Governance

8. Public Administration Reform of state agencies needs to continue, giving special attention to the following:

- ✓ Define and widely disseminate the role of the Government as that of supporting - and not replacing - private sector business activities.
- ✓ Reduce the number of separate Government agencies that have the power to interfere in private business.
- ✓ Reduce the number of central bodies that are members of the Cabinet of Ministers.
- ✓ Continue the reorganization of the Apparat (infrastructure) of the Cabinet of Ministers to delegate decision-making to line ministries. Focus the Apparat on developing overall strategies and on exercising ex-post control to stop line ministries and central state bodies from issuing decrees, instructions, and rules by fiat.
- ✓ Improve policy-making capacity and efficiency of line ministries, with clear functions and roles that support, rather than replace, private sector activities.
- ✓ Raise the salaries of key civil servants to attract quality staff and make them less susceptible to corruption.

9. Administrative reform should be extended to local "oblast" state bodies, including:

- ✓ Mechanisms to ensure the compliance by local officials with the requirements of national legislation.

- ✓ Adoption of clear and enforceable rules to limit the power of state officials to monitor and interfere with local business.
- ✓ Introduce more transparency in decision making at the oblast, region and town levels.
- ✓ Publish clear and transparent accounts of local government's finances.
- ✓ Develop mechanisms to ensure that entrepreneurs have proper recourse against local officials.

10. Reduce shadow economy activities by drastically reducing red tape and lowering the cost of compliance with legislation in effect. Eliminate all backdated laws and regulations, allowing sufficient time for businesses to adapt to changes in legislation. Increase the cost of non-compliance through a more effective use of the courts.

III (C) Privatization

11. Secure the early approval and determined implementation of the Land Code to promote private ownership of land, the development of a land market, the implementation of a mortgage law, and the development of a clear system for registering titles to fixed assets. This reform is crucial in developing social attitudes towards privatization, as well as an important step towards making mortgage-based financing possible for Ukraine's sector of greatest competitive advantage-agriculture.

12. The Law "On the State Property Fund" should be approved as soon as possible. The State Property Fund (SPF) has been functioning without any law regulating its activity for nine years and this should not continue. The Law should indicate the status and the authority of the State Property Fund and should subordinate it to the Executive branch. In addition, it should prohibit any interference into SPF activities relating to its concrete privatization procedures.

13. The privatization procedures and provisions regarding competitions, tenders and bids should be revised. These amendments should be aimed at removing current shortcomings that have already resulted and might lead to the following conflict situations in the future:

- ✓ The role of the Tender Commission should be reduced to simply stating the facts on the availability and number of proposals made by participants. In addition the Tender Commission should perform just supplementary functions like organizational, preliminary and technical ones. The Tender Commission should not vote on privatization, since in all cases the winner is decided by the SPF, which must defend its actions in a court of law and which signs the purchase/sale Contract.
- ✓ In order to accelerate the assessment on whether or not the participants meet the requirements of antimonopoly legislation, it is necessary to introduce separate procedures by antimonopoly committee bodies for consideration of privatization cases. This procedure should not envisage payment fees for the applications and should stipulate that the permission (or refusal) should be given before the review of the individual privatization proposals.
- ✓ The right to cancel or halt competitions should not be vested in the government or privatization bodies if even only one participant of this competition meets all competition's requirements and complies with its rules. The right to cancel a competition should remain within the authority of the courts.

14. Complete the privatization of virtually all medium and large enterprises — including the sale of "golden" shares and "blocking" minority positions in all areas including energy, telecom and the agro-industry — through transparent processes consistent with international standards. This should be done with commitment to "letting go," that is, fully privatizing companies as quickly as reasonably possible. Abandon incremental privatization.

15. In the privatization process, prepare companies for privatization, including:

- ✓ Having the State Property Fund put adequate protections for non-government private shareholders (including cumulative voting provisions) into the charters of companies undergoing privatization. Also, initiate legislation to protect other minority shareholder rights, including restrictions on insider dealing.
- ✓ Transferring social assets to local authorities from enterprises to accelerate privatization and facilitate enterprise restructuring.
- ✓ Disclosing the nature of ownership.
- ✓ Disclosing to what extent the enterprise management has ownership rights in the companies with which this enterprise has business relations. Even the slightest suspicion about a possible conflict of interests is enough to demand the sale of these ownership rights.

16. The privatization should be carried out under clear and transparent procedures, which would include the following:

- ✓ Be prepared to accept a higher percentage of foreign shareholding than 49% in more cases. There should not be indiscriminant disqualification of foreign investors to drive down prices.
- ✓ Abolish the minimum share price requirement.
- ✓ Remove certain attached conditions (i.e.: profile preservation, retention of employees, investment obligations, etc.) that reduce the attractiveness of companies offered for privatization as well as the price investors are willing to pay.

IV. International Capital and Foreign Trade Restrictions

1. Liberalize foreign exchange transactions, including the following:

- ✓ Amend the Decree of the Cabinet of Ministers "On the System of Currency Regulation and Currency Control" to cancel the requirement regarding proof of initial internal transfer of funds in order to buy hard currency for its export from the country.
- ✓ Cancel the requirement that a foreigner that acquired securities abroad cannot sell them on the Ukrainian market unless there is documented proof confirming that the initial buyer imported dollars into the country and that income tax was paid.
- ✓ Eliminate all restrictions concerning the use of foreign exchange gained as a result of foreign trade transactions or spent for needs of foreign trade.

- ✓ Remove deadlines for pre-payment of exports and the receipt of imported goods.

- ✓ Improve licensing procedures and registration of foreign loans.
2.Cancel all restrictions on the purchase of securities in foreign currency by residents by amending the above-mentioned Cabinet of Ministers decree "On the System of Currency Regulation and Currency Control" as well as the law "On the Procedure of Making Settlements in Foreign Currency".

3. Reduce restrictions to Imports, as follows:

- ✓ Reduce import duties to levels consistent with international agreements on tariff reductions under the WTO. Reduce high and variable tariff rates to levels more consistent with average tariffs. Remove most import tariff exemptions, and raise exceptionally low rates closer to the average level. Alternatively, consider the enactment of a unified customs duty for all categories of imported goods, for example, 10% no matter what type of goods or their country of origin.

- ✓ Eliminate the critical import list.

- ✓ Tighten customs procedures for dealing with illegal imports (these imports can represent a relatively high share of the market in some sectors, for example agribusiness and branches of manufacturing, which given the scale of import duties paid by law abiding companies results in unfair competition).

4. Remove restrictions to Exports:

- ✓ Ukraine badly needs foreign exchange from exports. Virtually all remaining barriers to export such as quotas, export duties, existing indicative prices, advance deposits, and foreign exchange surrender requirements should be abolished, the only exception being unfortunate cases where the EU and other countries impose export quotas on Ukrainian industries to protect their own high-cost producers.

- ✓ Remove the 23 percent duty sunflower and other oil seed exports, and in general avoid using export duties to control production and distribution in the economy.

5. Accelerate accession to the World Trade Organization. Complete process of accession to the WTO as quickly as possible, thus allowing Ukraine to participate fully on a stable basis in world trade and receive the privileges pertaining to WTO membership.

6. The Customs service should be comprehensively reformed. Introduce the system of pre-inspection of imports by international certified companies. Allow the mutual recognition of international certification standards and procedures and the right to have all export (custom) procedures completed within 24 hours. Customs officers should take personal responsibility in the most severe cases if they violate these instructions. Ensure the free and smooth flow of goods across the borders between oblasts.

7. Develop more modern and consistent procedures for certification requirements and standards of products (which in general apply to imported goods and goods produced domestically). This should focus on the procedures at the State Committee for Standardization (SCS). Agree to recognize certain foreign product certification stan-

dards and stop subjecting products meeting those standards to inspection in Ukraine. (The SCS is often reluctant to recognize product certificates issued outside of Ukraine. Current procedures tend to result in lengthy delays and high fees to obtain the necessary certification, even for companies with an international reputation. There are, in practice, a large number of certification agencies under the general supervision of the SCS leading to problems of differing interpretations, or at the very least companies having to secure numerous certificates to meet the requirements of the different agencies with responsibilities in this field).

8. Eliminate restrictions on foreign direct investment in certain sectors — insurance, publishing, broadcasting and telecom. Remove impediments for the return of Ukrainian funds to the country.

V. Financial Sector

V (A) Banking sub sector

1. Pass required regulations on the recently approved law "On Banks and Banking Activity", including a requirement that bank employees and controlling shareholders adhere to specified standards of integrity and fiduciary responsibility.

2. Improve commercial bank supervision and prudential regulation.

✓ Bring supervision of commercial banks up to international standards.

✓ Strictly enforce requirements regarding minimum capitalization (seeking to vastly expand the capitalization of the banking system), capital/asset ratios, loan classification and provisioning, and lending to related parties. Lax application of these requirements undermines confidence in the banking system with negative effects on foreign investment.

✓ Complete the development of the early warning system — with sensitivity analysis capabilities — to identify banks at risk.

✓ Complete the preparations of contingency plans for dealing with possible troubled banks, including bankruptcy procedures with an efficient enforcement mechanism.

✓ Initiate the closure or merger of any bank not showing any real prospects for recovery out of the seven large banks that signed Commitment Letters with the NBU.

✓ Carry out the restructuring of commercial banks that are now in financial difficulties, but have prospects for recovery restructuring or writing-off bad loans within a set period of time. Otherwise, debt-equity swaps or bankruptcy procedures should be used.

3. Improve the independence of the banking sector as follows:

✓ The Government should sell shares in commercial banks that it holds today.

- ✓ Under no circumstances grant any Government guarantees to commercial banks for foreign credit lines.

- ✓ Reduce the amount of government debt that commercial banks are obliged to hold, thereby lowering interest rates and freeing bank capital for investment.

- ✓ The Government should abstain from placing political pressure on commercial banks to lend to specific sectors or enterprises.

- ✓ Ensure the independence of the NBU by ensuring that its Governor be the Head of the 15 member Board and that the Board makes only recommendations, not decisions.

- ✓ Ensure separation of responsibilities in commercial banks by establishing that their Boards of Directors are in charge of strategy, and prevented from day-to-day lending/borrowing decisions. The President and/or Board members should be prevented from having operational functions and/or offices at the bank.

- ✓ The financial statements of commercial banks should be systematically audited by one of the big five international auditing firms. The audit should include a statement about undue influence of third parties on the business of the bank.

- ✓ Accounting should be in strict conformity with International Accounting Standards.

- ✓ Develop arbitration possibilities to serve as the referee for the banking sector when the NBU and/or the banks consider that they have been improperly dealt with.

4. Abolish the "Kartoteka" and replace it with normal court-based lien and bankruptcy procedures. The State Tax Authority should no longer have the unilateral right to freeze and seize bank accounts of companies for alleged tax arrears without prior substantiation of the claim and an opportunity for the company to seek protection in the courts. The Government cannot take money out of bank accounts without due process. Also, reduce and control the requirement for banks to report on client bank accounts.

5. Take the following measures to encourage the growth of bank assets (Hryvna lending) by minimizing lending risks as follows:

- ✓ Develop a "loan" and "pledge" database, which should be accessible by all banks, including information on existing lines of credit, outstanding balances, and liens for all bank debtors.

- ✓ Enhance the legal environment for Secured Transactions by simplifying procedures for registration of liens and other security, permitting the unrestricted possibility of pledges over assets, permitting the possibility of pledges for a fluctuating pool of accounts receivable for working capital financing, improving the protection of bona fide acquirers (including those acquiring in the ordinary course of business), and improving enforcement procedures by easing repossession from delinquent borrowers (including housing and land - which would help allow mortgage lending to develop).

6. Facilitate the growth of bank deposits and other liabilities through the following actions:

- ✓ Facilitate the development of current accounts with checking privileges, and an ATM system.
- ✓ Encourage entrepreneurs to make payments on bank accounts above a minimum level, though allowing the use of cash in transactions.
- ✓ Encourage shops in Ukraine to accept card payments above a minimum amount.
- ✓ Encourage consumers to pay utilities via banks.
- ✓ Introduce inflation-related banking instruments/liabilities.
- ✓ Introduce a modern deposit insurance scheme, increasing its current limit of UAH 500 and ensuring that insurance fees are invested by an independent body (which could issue marketable instruments).
- ✓ 7.Restructure the Savings Bank in order to improve solvency and profitability.
- ✓ Develop criteria for the successful work of its branches and their employees.
- ✓ The network of Savings banks should be used to provide consulting services to individual depositors, and to small and medium sized business.
- ✓ Establish close cooperation with foreign organizations that allows the transfer of “know- how” in relevant areas.
- ✓ Close branches that do not meet new requirements.

V (B) Securities and Stock Markets

8. Strengthen Securities and Stock Market State Commission mandates in security-related activities of all financial institutions.

9. Secure agreements relating to the separation of mandates between the Security Commission, the Stock Market and the NBU regarding their scope and rules for the regulation of banks.

10. Accelerate the adoption of the Law “On the Institutions of Joint Investments” that would speed up the flow of funds for small investors.

11. Promote secondary market activities for securities by increasing various types of securities and their derivatives including Treasury Bills.

12. Make adjustments to the Law “On the National Depositary System and Peculiarities of Electronic Circulation of Securities in Ukraine” in the following sections:

- ✓ clarify the function and mandate of the National Depositary;
- ✓ expand the mandate of non-banking clearing depositaries.

13. Provide self-regulating organizations with real power of authority to enable them to become true centers of professional regulation of security market participants.

14. Implement special procedures to tax operations with securities.

15. Introduce separate procedures for the registration of security issuance during the reorganization of companies when a private placement of securities takes place.

V (C) Pension System

16. Enact legislation increasing the retirement age to correct financial imbalances of the pension system and to better target benefits.

17. To supplement the "Pay-As-You-Go" state pension system, gradually introduce a regulated mandatory component to the pension system with a fully funded element, based on capitalizable individual accounts managed by private pension funds. The first step is to finalize and pass the draft pension laws currently being developed.

18. Finance from the state fiscal budget the contributions to fund pensions for the elderly. The rates of pension contributions for the younger generation should not be affected. Therefore, the current part of these contributions, nearly 2% of the current rate of pension contributions, should enter the personal savings account of these individuals.

V (D) Financial Sector Infrastructure

19. Accelerate implementation of the Accounting and Auditing Reform:

- ✓ Complete the work of bringing the National Accounting Standards (NAS) closer to International Accounting Standards (IAS).
- ✓ Require that all companies whose shares are listed on a stock exchange or trading and information system file annual reports in accordance with IAS, not NAS, by 2003.
- ✓ Expand efforts to widely disseminate the new accounting and auditing standards in the business community.

20. Encourage competition and efficiency in the financial sector by facilitating the expansion of foreign banks and the formation of non-bank financial institutions, such as investment funds, factoring companies, leasing companies, credit unions, venture capital funds, etc. For this:

- ✓ Liberalize the rules regulating foreign banks.
- ✓ Finalize and pass the law "On Investment Institutions".
- ✓ Pass prudential rules concerning the activities of non-bank financial institutions and improve supervision over their activities.

VI. Corruption

VI (I). Corruption Prevention

1. Undertake corruption prevention measures to reduce opportunities for corruption and to make corruption more difficult to undertake, starting with key areas such as barter and energy. Prevention would involve:

- ✓ Fund the Judiciary and independent agencies (such as the SPF and various sector Regulatory bodies) to ensure they can be run by professionals capable of earning public confidence in their integrity. This will help guarantee that the STA and STC do not have incentives to "look after themselves" and that they are run by the promoters of key reform-policies.
- ✓ Reduce the frequency and intrusiveness of contacts between the private sector and bureaucrats with discretionary power by deregulating the economy - simplify rules and regulations, and lower the number of inspections and the number of required licenses and registrations.
- ✓ Reduce the number of activities that are subject to the discretion of public officials through either eliminating (or privatizing) public activities or subjecting them to competition and market forces.
- ✓ Eliminate Government discretion by eliminating "exemptions" to laws and regulations and making laws more precise.
- ✓ Simplify over-complex, non-transparent tax system provisions that allows for free interpretation by tax inspectors that may lead to corruption.
- ✓ Introduce open and competitive procedures for public procurement and bidding for public works.
- ✓ Reduce the size of the Government and refocus its role to minimize opportunities for improper interventions and corruption.
- ✓ Reform the Civil Service to make it more professional, including (i) increasing salaries of key government officials to make them less susceptible to corruption; and (ii) mandate public servants to declare their income/assets.

VI (B) Enforcement of Anti-corruption

2. Develop the legal framework to ensure the enforcement of anticorruption measures. This would require the government to:

- ✓ Improve contract enforcement and legal protections for property so that parties have an incentive to move into the formal sector in order to enjoy these protections.
- ✓ Impose harsh, swift and certain penalties for official corruption, including legislation that facilitates the confiscation of the proceeds of crime.
- ✓ Develop adequate avenues for "appeals" of Government decisions, including a system for review of tax decisions.
- ✓ Develop effective channels for complaints of Government actions.

- ✓ Increase the probability of detection and punishment of official corruption through special investigative units comprised of auditors, lawyers, investigators, IT experts, and other strong "watchdog" agencies.

- ✓ Improve the court system (Judiciary) to expedite the processing and resolution of cases.

- ✓ Strengthen Enforcement agencies, such as FBI equivalents.

VI (C) Public Awareness

3. Make people aware of their rights and the rules of the game. For this:

- ✓ Initiate a public education campaign to develop a culture of zero tolerance of corruption so that people are taught the real cost of corruption to society (e. g., it has been estimated that the wealth of the average citizen can be doubled by eradicating corruption).

- ✓ Increase the transparency of Government actions through clear and simple laws.

- ✓ Launch Government-wide ethics guidelines, as well as integrity pledges and personal financial disclosure by top officials.

- ✓ Improve Government Information Systems at all levels to keep the Government and the public informed of payments, expenditures, subsidies, etc.

- ✓ Widely publish Government rules, such as Tax Bulletins, customs regulations, quality certifications, etc.

- ✓ Enlist the support of the Press and NGOs in dealing with corruption.

- ✓ Use surveys of opinions to widely disseminate concerns on corruption.

VII. Political Risks

1. The Government of Ukraine should give demonstration in its public statements that it understands the importance that foreign investors place on expropriation. This includes "creeping expropriation" as opposed to the fear of an outright re-nationalization of assets.

2. Bring tax collectors and local authorities under the control of the central administration. From the point of view of foreign investors, the Tax collectors and local authorities do not frequently respond to orders from the center.

3. Government enterprises competing with private businesses in the same sector should not get preferential treatment.

VIII. Country Promotion

1. Announce everywhere in the domestic and international press, the Government's policy and commitment to implement strong market-oriented policies; and then actually follow through. Officials must convince investors that things have changed.

2. The Government should be vocal in supporting foreign investment. It needs to change the attitude of officials at central and local levels towards foreign investors. It needs to encourage a long view rather than short-term exploitation. It needs to speak out clearly in favor of investors who bring the prospects of new jobs, investment in modernization and a culture of paying taxes voluntarily. It should implement a top-down championing of the benefits of foreign investment, particularly by inaugurating a major Public Relations campaign by the Presidential administration and the Central Government targeted at central and local officials.

3. All Ukrainian embassies abroad should have their commercial section strengthened, and go on sales drives in each country to promote better dissemination of Ukrainian business opportunities.

4. The Government should go on worldwide sales drives on Privatization.

5. The Government should operate on the principle that the best type of government promotion is to leave the private sector alone. Unless there is an overwhelming need to interfere or legislate in the affairs of private business, government needs to abstain.

6. Consider the utilization of a private investment promotion agency to promote the country abroad.

IX. Corporate Taxes and Investment Incentives

IX (A) Investment Incentives

1. The Ukrainian Government should not be offering any new "special" investment incentives for particular sectors or companies. A level playing field should be the goal. This requires taxes and investment incentives that are stable, simple, and predictable. Investment incentives are ineffective because, in Ukraine, investors believe that: (i) they will not enjoy the investment benefits as promised - the law may change at any time, and that (ii) these benefits are not to attract legitimate foreign investment, but just to help the oligarchs who have the influence to create these incentive plans for their own benefit, thereby increasing their monopoly position.

2. Reduce existing incentives and other privileges related to 'special economic zones' as well as for producers of some goods and services, which distorts the incentive framework.

IX (B) Corporate Taxes

3. Speed up enactment of the new Tax Code that would envisage the following:

- ✓ Reduce the total fiscal burden on enterprises by reducing the number of taxes, duties, fees, fines and other contributions to which enterprises are subject.
- ✓ Broaden the tax base by eliminating tax privileges.

4. Improve the Value Added Tax system by the following actions:

- ✓ Operate the VAT system on international standards in terms of accrual accounting and auditing procedures for tax debate claims. Move and keep the VAT on an accrual basis, preferably without the dual accounting system required under current transitional arrangements.
- ✓ The VAT on coal, gas, and electricity consumption should be taxed at the normal VAT rate; the agricultural sector should not be exempted any longer.
- ✓ Treat VAT refunds as a major priority in 2001. VAT payments are made immediately but there are long delays in refunds (for overpayments), with the problem accentuated in periods when inflation is high, which lowers the value of the late payment made in Hryvna. Ensure that the budget has the funding for this at the level where it is required. Ensure that responsibility for refunds does not devolve to local authorities that do not have the money.
- ✓ VAT should not be applied to enterprises on their in-kind capital contributions made in the form of equipment (Although the tax law states that capital contributions made in the form of equipment are not subject to VAT, there is some experience of tax inspectors applying VAT, with only a promise of a rebate at some point in the future).
- ✓ Alter the basis for charging VAT on leased, imported equipment (Someone who purchasers a piece of equipment is subject to VAT at double the normal rate if they lease as oppose to buying the item).

5. Improve the Corporate income tax.

- ✓ Introduce a flat corporate income tax rate.
- ✓ Eliminate the existing exemptions to income taxes, such as the privileges for agriculture, car producers, agricultural machinery, TV-sets, etc.
- ✓ Improve the current depreciation ratio rule and any charge on depreciation.
- ✓ Introduce a symmetric treatment of foreign exchange losses and profits.
- ✓ Introduce a new system under which losses at the initial stage can be compensated by future profits, thus reducing the tax burden

6. Alter the tax treatment of unrealized foreign exchange gains on equity investment made in enterprises in hard currency (which includes financial institutions, given that in these cases the investment must be made in hard currency). The tax penalizes companies by imposing a tax on a nominal profit.

7. Aim for much more stability in the tax regime. The enactment of a rational Tax Code should, for instance, be accompanied with a moratorium of 5 years during which it would not be modified.

8. Improve Tax Administration by putting into effect international standards for tax collection.

- ✓ Change the reporting line of the State Tax Administration to make the STA report to the Ministry of Finance. The concept of a self-financing and autonomous tax inspection service that reports not to the Ministry of Finance but to higher authorities, is proving unhelpful both to the volumes of tax collected and the image of the country.
- ✓ Change the objectives of tax collectors away from trying to maximize revenues into the objective of monitoring adherence to well grounded legislation.
- ✓ Foster voluntary tax compliance to reduce tax evasion and promote a compliance-based revenue administration equipped with business processes, skills, management systems, and operational tools.

ANNEX 3

Economic-Mathematical Modeling of International Private Capital Flows to Ukraine

Introduction

The essential condition for structural reconstruction and sustained economic growth in Ukraine is a substantial increase of investment flows and improvement of their efficiency.

It is not a new challenge for the economy of Ukraine. Last year the need to increase investment flows was discussed during the development of Government's economic strategies, implementation of various programs, preparation of the State Budget, etc. Decline of the investment activity became the most painful consequence of the economic crisis in Ukraine (for 9 years of transition, 1992-2000, investments in fixed assets in Ukraine had fallen almost 5 times, significantly outpacing the rate of GDP decline).

The investment crisis in Ukraine has a number of reasons. But, at the current stage of economic transformation in Ukraine the major complexity of the investment process is, most of all, the limited amount of national savings and the inability of private investors to fully compensate the lack of capital investment to support the economic growth.

Therefore, one of the important factors to help with the investment crisis is attracting foreign capital. As we know, this capital inflow is insignificant in terms of Ukrainian demand and international standards, and it does not match major indicators of the economy of Ukraine: country size, production volumes, national market potential, natural resources and qualified employees.

To attract international capital inflows to the Ukrainian economy the country will need to develop a favorable investment climate, a renewal of foreign investors' trust in Ukraine, the improvement of its image in the world financial markets, the development of a system that attracts foreign entrepreneurs, and the adoption of international standards for investment cooperation. The IPCTF project was initiated to address some of these issues.

An essential part of this project is the development of the tool kit for the Government of Ukraine that allows it to analyze the experience of other countries. It includes economic-mathematical modeling and forecasting, and scientific foundation that provides estimates of specific impact of various government policy actions. It also gives the Government the opportunity to focus on the most effective measures for international capital attraction.

1. General Description of the Economic-Mathematical Model

1.1 The model is based on the relationships that explain the impact of foreign direct investment on the economy of Ukraine using the following 9 groups of drivers:

- ✓ Liberalize and Deregulate Business Activities
- ✓ Provide a Stable and Predictable Legal Environment
- ✓ Enhance Governance & Reform Public Administration

- ✓ Remove International Capital & Foreign Trade Restrictions
- ✓ Facilitate Financing of Businesses by the Financial Sector
- ✓ Eliminate Corruption
- ✓ Reduce Political Risks
- ✓ Expand Country Promotion
- ✓ Rationalize Investment Incentives

1.2 Each of the above-mentioned drivers was estimated with the help of index $I_k(t)$ (k=1,…,9), that changes with the lapse of time t.

1.3 Each of 9 indexes Ik(t) is within boundaries [0;100], therefore

$$0 \le I_k(t) \le 100, (k = 1, \ldots, 9)$$

1.4 Initial index values for 2000 are calculated on the basis of expert estimates for six countries that were included in the benchmarking study. To carry out these calculations we used over 70 different quantitative and qualitative indicators (factors) that influence (are related to) investment flows in the country. On the basis of the benchmarking study, the country that enjoys the maximal index value is defined as the Best-in-Class Country. Along with above-mentioned 9 indexes we calculate the Major Combined Index that explains the combined impact of all drivers. In Table 1 you can find data that indicates initial factor values. This data allows qualifying and quantifying the group of factors that explain the attraction of foreign capital in Ukraine compared to other countries.

Table 1. The Benchmarking Study: Initial Values of the Aggregated Indices

Index	Country						Best in Class (BC)		Maximum
	Ukraine	Russia	Poland	Hungary	Chile	Argentina	Score	Country	
International Capital and Foreign Restrictions Index	63	45	79	79	**84**	69	84	Chile	100
Political Risk Index	65	49	**83**	82	71	75	83	Poland	100
Anticorruption Index	15	21	41	52	**74**	35	74	Chile	100
Governance & Public Administration Index	28.6	29.8	**88.3**	81.9	79.9	64.7	88.3	Poland	100
Financial Sector Index	10.8	39.2	62.8	68.4	**74.4**	38.4	74.4	Chile	100
Legal Environment Index	16.8	61.8	**99.1**	92.9	89.3	65	99.1	Poland	100
Liberalization and De-regulation of Business Activities	18.1	49	87.4	80.1	**89.3**	62	89.3	Chile	100
Investment Incentives Index	31	48	78	**82**	63	70	82	Hungary	100
Government Business Promotion Index	20	30	80	**100**	90	75	100	Hungary	100
Major Combined Index	24.8	39.5	75.6	78.6	78.9	59.6	85.6		

1.5 Foreign direct investment flows $FDI(t)$ for each year t are calculated by formula:

$$FDI(t) = \sum C_k(I_k(t)) \times I_k(t),$$

and $C_k(I_k(t))$ — regression coefficients, that is the important feature of the model, are not constants, but they depend on the index value $I_k(t)$. Therefore the model is substantially non-linear.

1.6 In the model we used various assumptions regarding relationships between coefficients Ck and indices $I_k(t)$. We presume that while $I_k(t)$ grows it will make $C_k(I_k(t))$ grow too. Thus, we model the multiplicative impact of the factor's growth on the investment flows, and take into account time dependence.

1.7 The calculations of $C_k(I_k(t))$ are implemented with the help of mathematical statistics methods.

1.8 The state policy for attraction and effective use of international private capital in the economy of Ukraine directly influences the index $I_k(t)$. According to 9 drivers model includes 9 blocks respectively, that formalizes and forecasts the impact of various state policy elements on the indices.

1.9 Each of the 9 blocks includes short-, mid- and long-term forecasts of indices.

1.10 Index forecasting can proceed in two modes: general expert estimation of state policy on the set of drivers; and analysis and forecasting of the impact of certain measures that are taken to improve state policy.

1.11 Each of the 9 blocks, in order to forecast index $I_k(t)$, includes 3 scenarios: base, optimistic, and pessimistic. Therefore the model is able to review 3^9 alternatives (or a total of 19,683 possibilities) of further development of the situation.

1.12 For every scenario in the model we calculate:

- ✓ FDI forecasts in the economy of Ukraine for each year in the period, and for the period in whole (for 2001–2005, 2006–2010, and 2011–2015 year-to-year.)
- ✓ The set of indicators for the analysis of the various government policy impacts (specific measures) on FDI flows. Thus, the model can provide economic validation of certain government policies, laws, acts, etc.
- ✓ The set of indicators to define priorities for state policy in order to attract international private capital. The model may be further developed by the inclusion of optimization elements.
- ✓ The set of indicators for comparative analysis of the investment process in Ukraine with the respective situation in other countries. These indicators are very important if we take into account tough competition on international capital markets.

1.13 An additional part of the model is the possibility to carry out decision-risk analysis with the help of the latest analysis tools, like Tornado-diagrams, S-curves, etc.

1.14 The model is built using the latest methods and approaches regarding forecasting, decision-making analysis, mathematical statistics, operation research, etc. The model consists of blocks and includes over 100 tables, 30 diagrams and other elements, that present information in a comfortable way, allowing the use of various functions (analysis, forecasting, economic grounding of decisions made, etc.) and at the different level of preparations of management decisions.

2. Forecast of Foreign Direct Investment Flows to Ukraine: *Base Scenario*

2.1 According to the base scenario forecast in 2001-2005, the government will implement a well-balanced policy for foreign investment attraction and clear orientation on the major international economic and political demands regarding international capital inflow. This scenario assumes that Ukraine will be able to close the gap in all factors (comparing to the Best in Class Countries) by 50% on average. In Table 2 you can find forecast values of indices.

Table 2. Most Likely Scenario

Index	2000 E	2001 E	2002 E	2003 E	2004 E	2005 E
International Capital and Foreign Restrictions	63.0	66.6	69.8	72.7	75.3	77.8
Political Risk Index	65.0	68.2	71.0	73.6	76.0	78.2
Anticorruption Index	15.0	23.4	30.8	37.3	43.1	48.3
Governance & Public Administration Index	28.6	37.3	44.9	51.6	57.6	63.0
Financial Sector Index	10.8	19.8	27.7	34.7	40.9	46.4
Legal Environment Index	16.8	28.4	38.7	47.8	55.9	63.0
Liberalization and Deregulation of Business	18.1	28.2	37.1	45.0	52.0	58.3
Investment Incentives Index	31.0	38.4	45.0	50.8	56.0	60.7
Government Business Promotion Index	20.0	30.4	39.4	47.2	54.1	60.0
Major Combined Index	**24.8**	**34.7**	**42.8**	**49.7**	**55.7**	**60.9**

2.2 A major change in the policy regarding international capital attraction will result in substantial foreign investment inflows to Ukraine. According to the forecasts for the base scenario, the expected annual amount of foreign direct investment will reach ***$3.4 billion*** in 2005, and will be 4.7 times higher compared to 2000 (see Fig. 1). In sum, for 2001–2005, the Ukrainian economy could attract approximately ***$11.8 billion*** of foreign direct investment.

2.3 According to the base scenario forecast in 2006–2010 and 2006–2015, we will see a further improvement of the investment climate in Ukraine, and a gradual approach to the positions of Best in Class Countries. The gap in indices (compared to Best in Class Countries) will be reduced by another 40% in 2006–2010, and by 25% in 2011–2015.

2.4 Forecasts indicate that the annual amount of foreign investment, according to the base scenario, will be $6.5 billion in 2010, and for 5 years it will be higher by 82% then in 2005. In whole, for 2006-2010, the Ukrainian economy can expect about $27 billion of foreign direct investment. The long-term forecast for 2011–2015 is the following: the annual amount of foreign direct investment will reach $7.6 billion in 2015; and in whole for 2006-2010, the economy of Ukraine should expect about $35 billion in foreign direct investment (see Fig.2).

Fig. 1.
Foreign direct investment flows in Ukraine.
Most Likely Scenario

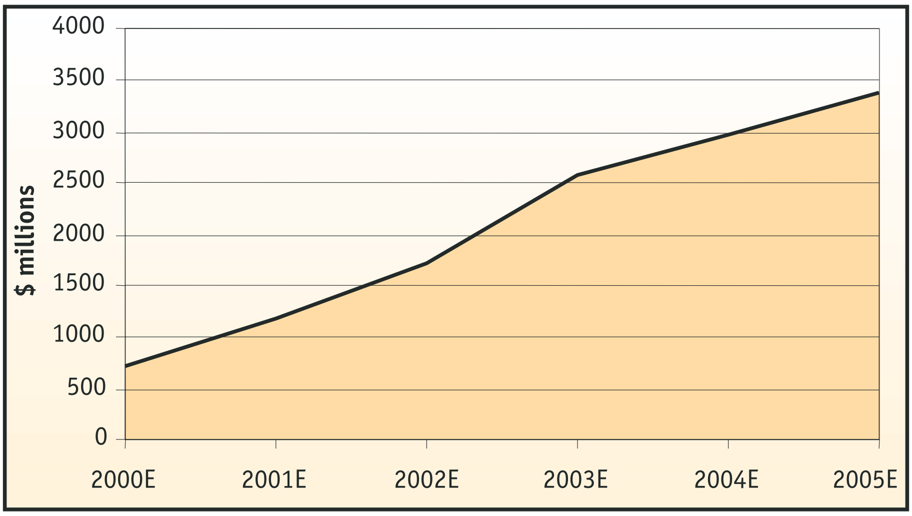
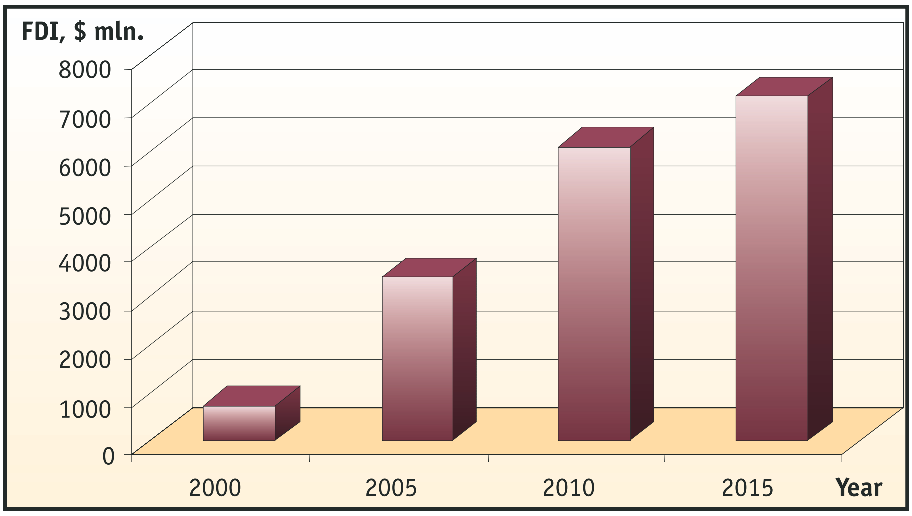


Fig.2.
Long-Term Forecast of FDI Flows to Ukraine.
Most Likely Scenario



2.5 The Major Combined Index, which explains all indices that have an impact on the forming of the investment climate and foreign direct investment flows to the economy of Ukraine, will grow (in complex) from 25 units in 2000 to 86 units in 2015, according to forecasts. This represents an 8.5% annual rate of decrease of the lag between Ukraine and the Best in Class Countries regarding investment climate.

2.6 According to the forecasts of the base scenario, for the entire 15 years (2001–2015), the Ukrainian economy should receive ***$75 billion*** in foreign direct investment.

3. Forecast of Foreign Direct Investment Flows to Ukraine: *Optimistic Scenario*

3.1 According to the optimistic scenario forecast in 2001–2005, which provided substantial improvement of the investment climate in the country, integration of the Ukrainian economy into the world economy, active and well thought-out internal and external policies regarding foreign investment attraction, and clear orientation on the major international economic and political demands regarding international capital inflows, Ukraine will be able to decrease the gap in all factors (compared to the Best-in-Class Countries) by 80% on average. In Table 2 you can find forecast values of indices.

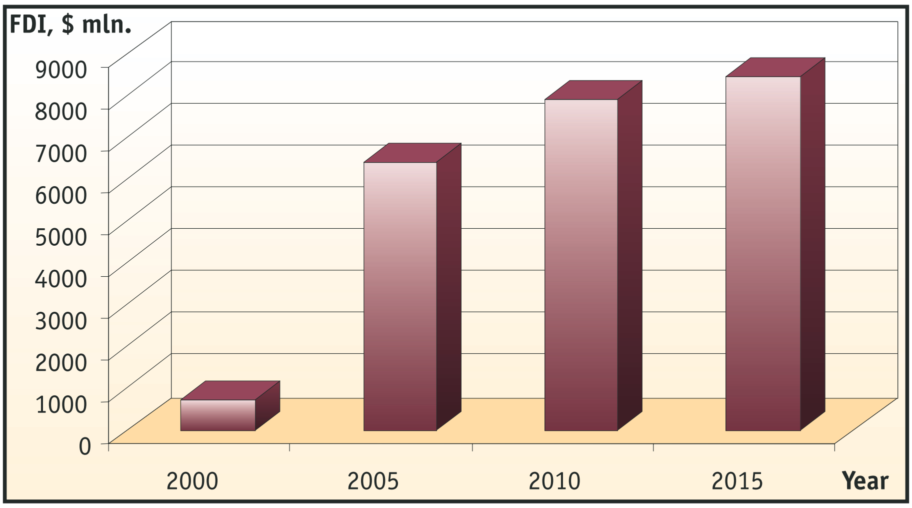
3.2 Such changes, according to forecasts for the optimistic scenario, will allow Ukraine to attract ***$6.4 billion*** in annual foreign direct investment in 2005 (8.9 times higher compared to 2000). Therefore, according to the optimistic scenario, annual investment will grow by ***50%*** per year on average. For the entire 2001–2005 period, the Ukrainian economy can expect approximately ***$22.8 billion*** in foreign direct investment.

3.3 According to the optimistic scenario forecast in 2006–2010 and 2011–2015, we will see further improvement in the investment climate of Ukraine and a gradual approach to the positions of Best in Class Countries. At the same time, growth rates for international capital flows will be lower compared to 2001–2005. The gap in indices (compared to the Best in Class Countries) will be reduced by another 50% in 2006–2010, and by 25% in 2011–2015.

3.4 Forecasts indicate that annual amount of foreign investment, according to the optimistic scenario, will be ***$7.9 billion*** in 2010, and for 5 years it will become higher by 23% then in 2005. For the 2006–2010 period, the Ukrainian economy should expect about ***$35 billion*** of foreign direct investment. The long-term forecast for 2011–2015 is the following: annual foreign direct investment will reach ***$8.5 billion*** in 2015; and for 2011–2015, the economy of Ukraine should expect about ***$41.1 billion*** in foreign direct investment.

3.5 The whole picture of foreign direct investment flows to the economy of Ukraine according to the optimistic scenario can be seen in Fig. 3.

Fig. 3.
Long-Term Forecast of FDI Flows to Ukraine.
Optimistic Scenario



3.6 According to the optimistic scenario, the Major Combined Index, which explains all indices that have an impact on the forming of the investment climate and foreign direct investment flows to the economy of Ukraine, will grow (in complex) from 25 units in 2000 to 94 units in 2015. It represents a 9.1% annual rate of decreasing of the lag between Ukraine and the Best in Class Countries regarding investment climate.

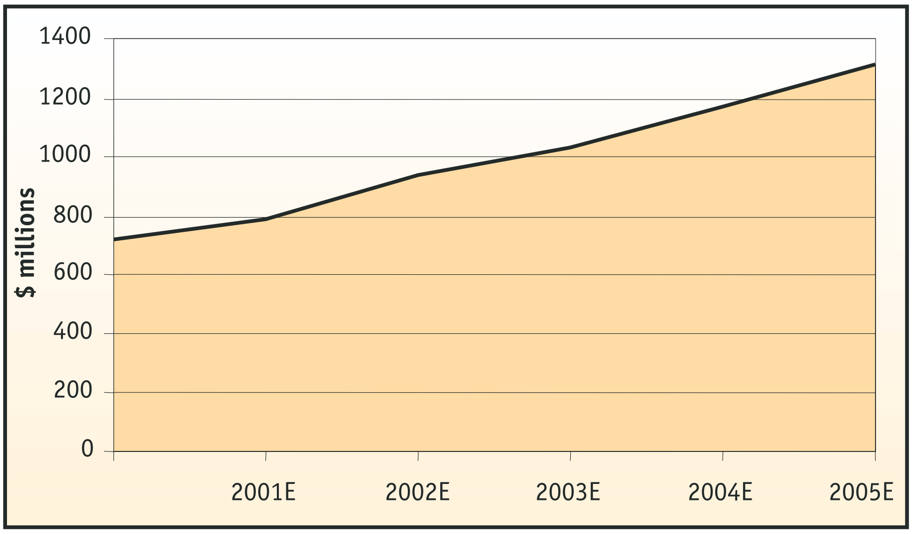
3.7 According to the forecasts of the optimistic scenario, for the 15-year period (2001–2015), the Ukrainian economy should receive ***$98 billion*** in foreign direct investment.

4. Forecast of Foreign Direct Investment Flows to Ukraine: *Pessimistic Scenario*

4.1 According to the pessimistic scenario forecast in 2001-2005, the investment climate will not change substantially. We presume that in 5 years, Ukraine will be able to decrease the gap in all factors (comparing to the Best in Class Countries) by 10% on average.

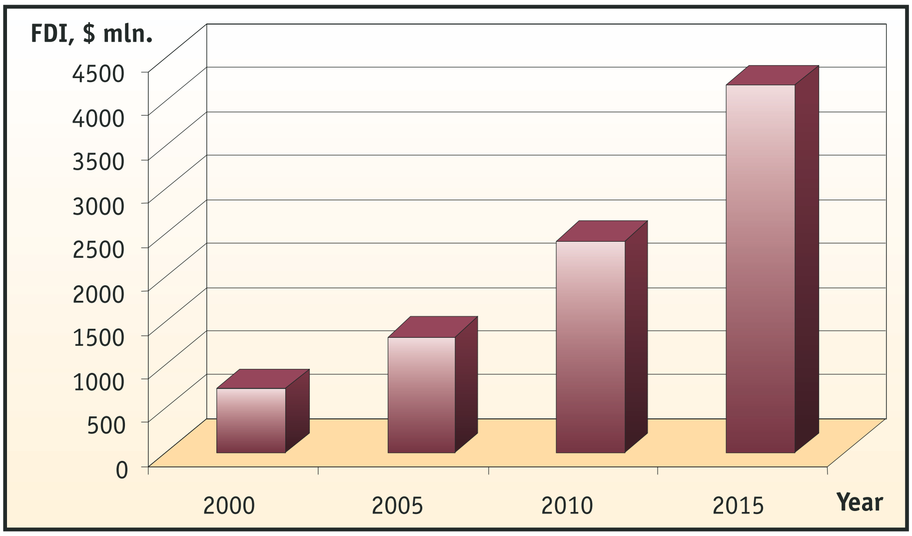
4.2 Such inactive policy, according to the forecasts for the pessimistic scenario, will allow Ukraine to attract ***$1.3 billion*** in foreign direct investment in 2005 (see Fig. 4). In whole, for 2001-2005, the Ukrainian economy should expect approximately ***$5.2 billion*** in foreign direct investment (about ***$1 billion*** per year).

Fig. 4.
Foreign direct investment flows to Ukraine.
Pessimistic Scenario



4.3 According to the pessimistic scenario forecast in 2006–2010 and 2011–2015 we will see an insignificant improvement in government policy regarding the attraction and effective use of international capital. Growth rates for international capital flows will be higher compared to 2001–2005. We predict that the gap in indices (compared to the Best-in-Class Countries) will be reduced by 15% in 2006–2010, and by 25% in 2011–2015.

Fig. 5.
Long-Term Forecast of FDI Flows to Ukraine.
Pessimistic Scenario



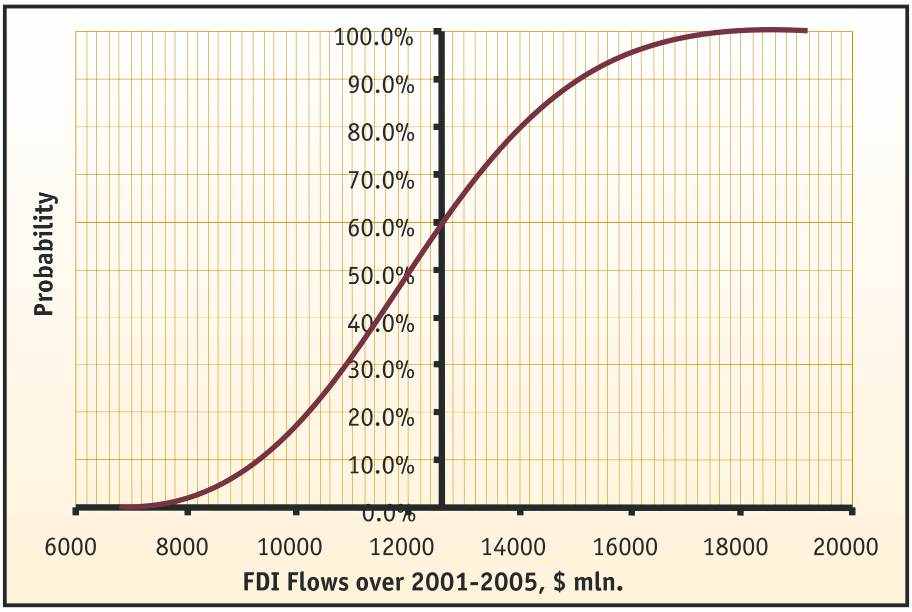
4.4 Forecasts indicate that annual foreign investment, according to the pessimistic scenario, will be $2.4 billion in 2010, and for 5 years it will be twice as high (see Fig. 5). Overall, for 2006-2010, the Ukrainian economy should expect about $9.9 billion in foreign direct investment. The long-term forecast for 2011-2015 is the following: annual foreign direct investment should reach $4.5 billion in 2015; and for the period 2006-2010, the economy of Ukraine should expect about $17.0 billion in foreign direct investment.

4.5 According to the forecasts of the pessimistic scenario, for 15 years (2001-2015), the Ukrainian economy should expect $32 billion in foreign direct investment.

5. Statistical Estimations of Foreign Direct Investment Flows to Ukraine

5.1 An incremental part of the optional forecasting of the foreign direct investment in the economy of Ukraine is the statistical estimation of obtained results. In Fig. 6 you can see the ***S-Curve*** that allows us to statistically estimate obtained forecasts.

Fig. 6. S-Curve



5.2 To build the ***S-Curve*** we have to review (to model) the 39 alternatives indicated earlier (the possibilities for each of the 9 groups of factors that have an impact on the foreign investment flows was reviewed based on the base, optimistic and pessimistic scenarios). Therefore, the ***S-curve*** includes all possible events for foreign direct investment flows in the economy of Ukraine.

5.3 On the basis of the ***S-Curve*** we obtained the following statistical estimations of the foreign direct investment flows into the economy of Ukraine (Fig. 6).

- ✓ With a probability of 100%, the total amount of foreign direct investment to Ukraine will exceed \$6.5 billion for 2001–2005.
- ✓ With a probability of 75%, the total amount of foreign direct investment to Ukraine will exceed \$10.8 billion for 2001–2005
- ✓ With a probability of 50%, the total amount of foreign direct investment to Ukraine will exceed \$12 billion for 2001–2005.
- ✓ With a probability of 25%, the total amount of foreign direct investment to Ukraine will exceed \$14 billion for 2001–2005.
- ✓ With a probability of 100%, the total amount of foreign direct investment to Ukraine will not exceed \$19 billion for 2001–2005.

Other statistical estimations can be defined on the basis of ***S-Curve*** directly.