THE
BLEYZER
FOUNDATION

SigmaBleyzer

Ukrainian Odyssey: Improving its Investment Climate

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Investment Climate

Overview

Countries create wealth and prosperity through wise and ingenious management of national resources. The fundamental role of the government is to create a political and economic environment that enables the private sector to achieve this objective. What makes it achievable is the freedom to invest in open and competitive markets.

Accordingly, an investment friendly environment is a key prerequisite to sustain economic performance in a country with a fledgling market economy. Above all, growing private investments have a strong positive impact on the country’s long-term competitiveness. More importantly, these benefits extend far beyond straightforward capital accumulation. Growing total factor productivity and better efficiency brought by knowledge and technology spillovers, superior managerial and information processing skills are principle factors that enhance the value of investments in capital-scarce economies. Foreign direct investments play a key role in this process by increasing the degree of integration into the global economy, improving the international competitiveness of recipient countries and stimulating R&D activities. All told, policies and reforms establishing institutions and regulations that initiate and advance favorable developments in the investment climate are priorities on the economic development agenda. Only successful implementation of these efforts will put emerging market economies on the path to higher living standards and sustainable economic growth.

The dominant share of foreign direct investments (FDI) in the international investment positions of Central and Eastern European countries is a new feature for these economies. Therefore, besides significant technology spillovers, these investments create a mechanism for effective global risk-sharing as the returns on FDI are not fixed and are conditional on overall economic performance. This makes the government a passionate and caring stakeholder in the country’s future, as stable and good economic performance enhances the trust of foreign and domestic businesses, prompting more investments. Higher levels of investments, in turn, create national wealth, which boosts public support for market and investment friendly transformations.

SigmaBleyzer has been extensively monitoring developing transition economies to identify target reform areas with the highest potential for improving the business environment and attracting foreign direct investment. This research effort is a part of and is based on a comprehensive study that reviewed 100 countries around the world and carried out econometric analyses to identify the policy measures that have the greatest impact on the flow of FDI. Our benchmarking, statistical analyses and business surveys indicated that a significant portion of the variations in foreign direct investments can be explained by nine economic policy drivers. The key investment drivers are presented below in the order of current priority for Ukraine:

1. **Public governance** includes policies and actions to increase the capacity of public administration to implement economic reforms and to improve the efficiency of the system;
2. **Macroeconomic stability**, which includes policies and actions that ensure stable domestic prices and foreign exchange, as prerequisites to minimize economic risks for investors;

3. Policies to create a **stable and predictable legal environment** with well-defined "rules of the game" for all businesses, without discrimination or preferential treatment and with the capacity to enforce business contracts;
4. **Business liberalization and deregulation policies** to permit firms to operate freely in a competitive environment by removing barriers to market entry, barriers to operations and barriers to exit;
5. Policies to develop sound **corporate governance** that would guide the activities of business in the best interest of their shareholders, protecting ownership rights;
6. Policies to **liberalize foreign trade and international capital movements** to facilitate the exports and imports of goods and the transfer of capital internationally with a view to increase economic competitiveness and efficiency;
7. Policies to create a **healthy financial sector** capable of meeting the financing needs of growing businesses;
8. Actions to **minimize corruption** and protect businesses from abuse of power by government officials;
9. Actions to minimize the effects of **political uncertainties** on business activities and promote **country image** and inform investors about business opportunities.

How to Implement Reforms

Every time I've ever introduced a reform in government, I wish in retrospect I had gone further.
Tony Blair[1]

Without exaggeration, successful implementation of economic reforms is the ultimate culmination of a well-designed policy-making process. Indeed, governments of developed countries have been polishing their skills of executing effective policy decisions in the economic domain for years. Yet, regardless of the crowds of international and local policy advisors flooding the hapless governments of developing countries, the track record of good policy accomplishments remains rather modest. Admittedly, many of these governments know perfectly well what has to be reformed. However, they fail to put these policies into practice with worrying regularity. Equally important, reform progress tends to be frustratingly uneven across various policy areas. Some reforms, such as foreign trade liberalization, went relatively painlessly, while other reforms, most notably judicial reform and reform of public administration, triggered perpetual political stalemates.

Essentially, many governments still fail to understand that strengthening policy implementation capacity is as important as developing good public policies. This means that the feasibility of public policies is not thoroughly scrutinized, while existing institutional and political environments are ill-prepared to pursue a meaningful reform agenda. Nevertheless, even with weak public institutions, a structured and consistent approach toward policy implementation can

[1] 27 September 2005, at Labour conference, http://news.bbc.co.uk/1/hi/uk_politics/3750847.stm

unlock the reform process. In particular, the following key components of policy implementation must be accurately and comprehensively evaluated:

- **The government must clearly define current social or economic problems.** Economic and institutional troubles impose an enormous burden on societies. The government must build a strong capacity to estimate the costs of its inaction and develop skills to detect potential challenges in advance. Furthermore, the public should be duly and honestly informed about these issues. For example, current challenges to macroeconomic stability are clearly detectable: rising inflation, the widening current account deficit, the budget gap and growing public debt, while the social costs of macroeconomic instability are obvious and substantial. The institutional environment presents a more difficult challenge. The public may become accustomed to the poor quality of public administration or the judiciary. Thus, it may be difficult to communicate the need for reform to a broader audience. On the positive side, better accountability of public institutions will help to uncover public dissatisfaction with this *status quo* and build a healthy reform momentum. Free mass media, an open civil society and access of NGOs to government information will certainly bring more transparency to the public sector.
- **Once problematic areas are identified, the government must develop feasible solutions.** At this stage the government sets measurable targets and defines what should be done to achieve them. More importantly, a good solution will both outline desirable policies and provide the government with meaningful checkpoints to track whether implemented measures yield expected results. For example, macroeconomic stabilization assumes maintaining inflation below a certain level. If consumer prices deviate from this target, macroeconomic policies must be revised. In the case of judicial reform, policy success is more difficult to measure. This may put off implementation of desirable policies. However, a feasible solution is to incorporate a good incentive package into this reform. In essence, this package assumes that budgets of reformed institutions are linked to their performance, measured with a set of criteria (e.g., judicial case load, reduction of paperwork, average time spent on application processing, etc.). Equally important, outcomes of institutional reforms must be regularly analyzed and honestly disclosed to the public. This will help to select a better policy alternative or adjust current policies, and will considerably reduce opposition to reforms. And finally, in many cases a good solution may require that the government simply stop doing the things it has been doing.
- **A through understanding of the current problem and its solution will help the government identify opponents to reforms.** Governments often encounter resistance when they attempt to implement economic reforms. However, if policy solutions are clearly defined, it is possible to identify opposition groups. Alas, inert administrative bureaucracy may frequently become a major stumbling block in the policy implementation process, especially taking into account that bureaucracy plays a key role in executing government policies. A good solution is to negotiate problematic issues with opposition to minimize the worries of all affected stakeholders and build support for reforms. Needless to say, the transparency and achievability of policy solutions visibly helps to ease hostility toward reforms.
- **Finally, the government must build a solid constituency for economic and institutional reforms.** This process relies on accurate evaluation and distribution of the costs and benefits of reforms. Indeed, benefits of many reforms are dispersed across the population, while costs are concentrated in specific sectors or are borne by narrow

interest groups. However, the general public as a group rarely enjoys much political clout. As a result, the atomization of losses may help to organize effective opposition groups to delay policy implementation. This challenge raises two issues. First, the government must **correctly estimate expected outcomes** of public policies. A particular solution to country's problems generates various short and long-term costs and benefits. Furthermore, benefits may not be observed unless reforms are launched, while costs are usually known with reliable accuracy. All of this raises uncertainty about the general success of reforms and individual outcomes for specific political and economic groups. Thus, a good solution to the country's problems should equip the government with a wide set of measurable success criteria. Unless benefits of reforms are measurable and tangible, policy-makers will fail to find sufficient support for broad and prompt action. Second, whenever possible, a reform should be designed to allow for **compensation to losers**. Indeed, performance-based budgeting or salary increases may considerably ease the opposition of insiders. On the contrary, a failure to link performance to financing of reforms will almost certainly result in the same weak institutions, albeit at a greater cost. Finally, since some reforms draw little opposition, it may be feasible to bundle them with more challenging policy measures. This may help to neutralize some resistance and will ensure the required support for the entire reform package.

Securing strong political support for economic reforms is essential, as failed attempts to implement necessary policies will make it more difficult to launch these reforms again in the future. Worse, if vital reforms are delayed, economic problems and institutional flaws will deepen, while the future reform process will become even more costly and difficult to execute. All told, policy implementation relies on an integrated approach to pressing economic and social challenges, rather than on a long list of detached, palliative and incomplete policy measures. Indisputably, good public governance is at the heart of all public policy decisions. Thus, the first priority of the Ukrainian government is to fix its ailing public administration system to enable an effective and productive policy-making process.

Driver 1: Macroeconomic stability

The basis for sound macroeconomic performance and sustainable economic growth is macroeconomic stability. A sound macroeconomic framework involves multiple dimensions, including price and exchange rate stability, prudent fiscal and monetary policies, a well-functioning real economy, sustainable debt ratios, and a healthy domestic financial and non-financial private sector. Above all, investors need stable prices and currencies to perform an informative and meaningful profitability appraisal of various investment projects. Stable prices and currency help to minimize business risks, reduce the rate of return required by investors and visibly facilitate long-term business planning. All of this will increase the range of projects that could be attractive to international investors. Therefore, stable and predictable inflation and exchange rates are necessary preconditions to encourage investments and enhance private sector confidence in the country. The key determinants of macroeconomic stability are sound fiscal and monetary policies, which are achieved through the government's ability to maintain control over the fiscal budget balance on the one hand, as well as control over the money supply on the other.

Over the last several years, Ukraine has achieved strong economic performance, supported by benign external conditions, macroeconomic stability and accelerated structural reforms. Indeed, notwithstanding a recent escalation of political uncertainties[2], the real economy demonstrated remarkable resilience in the volatile political environment. Without exaggeration, this strength of the private sector was backed by fundamental improvements of macroeconomic management. In particular, fiscal authorities managed to maintain budget discipline despite frequent elections. Relatively low budget deficits and reasonable levels of public debt were, by and large, reinforced by buoyant fiscal revenues driven by growing economy and better administration of taxation and customs. On the monetary side, the central bank maintained the de facto exchange rate peg, which helped to expand foreign exchange reserves on the back of robust foreign capital inflows. Needless to say, this choice for the foreign exchange regime continues to be justified by deeply entrenched expectations that forex stability is a good barometer for overall economic health. As a result, regular foreign exchange interventions visibly limited the capacity of the central bank to conduct autonomous monetary policy. Although the monetary authority consistently employed moderate monetary tightening through partial sterilizations of market liquidity and more strict reserve requirements on commercial banks, brisk credit growth remains a key contributor to mounting demand pressures. Still, a combination of the stronger private sector (supported by the developed banking system) and better macroeconomic policies (backed by progress with structural reforms) helped to balance and manage most of the major risks to macroeconomic stability.

However, the latest macroeconomic trends revealed that these policy achievements are still rather fragile and reversible. Above all, visibly accelerated inflation has been a major headache for the government for months. Admittedly, Ukraine has recently been hit by several adverse commodity price shocks, which resulted in dearer foods and energy for consumers. These one-off supply side shocks (including hikes of natural gas prices in 2006 and 2007, record high crude

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[2] Starting 2005, the average government tenure declined by nearly two times from about 20 months in 2000-2004.

oil prices as well as tighter supply conditions at global agricultural markets) pushed consumer inflation above 10% in the last quarter of 2006. Meanwhile, demand pressures were considerably fanned by rapidly growing incomes and booming domestic credit.

This unfortunate confluence of supply and demand inflationary pressures puts the government's macroeconomic management to a real test. Obviously, previous efforts to improve the macroeconomic framework yielded good results. However, these efforts were still lacking in sufficient scale and systemic approach, as stark economic performance boosted government complacency about the sustainability of country's macroeconomic stability. As a result, macroeconomic policies were frequently tilted toward palliative, after the fact and rather passive and inconsistent responses. Evidently, until now these policy reactions were adequate to manage the economy under relatively benign global conditions. Indeed, foreign exchange stability, which underpins the credibility of the central bank, was resolutely maintained, while resilient foreign capital inflows lifted the central bank's forex reserves to record high levels. Furthermore, the widening current account gap was fully covered with foreign direct investments. More importantly, the modest exposure of the domestic banking sector to international credit markets helped to avoid current account financing risks caused by the global financial crisis. On top of that, the fixed exchange rate effectively shielded domestic exporters from international competition.

Nevertheless, efforts to strengthen the overall institutional capacity of fiscal and monetary policies lacked momentum. As a result, persistent economic rigidities, embedded in a tightly managed exchange rate regime and widespread administration of various tariffs and prices, entail the possibility of excessive accumulation of risks to macroeconomic stability. This means that unanticipated adverse external disturbances may trigger a sharp and painful adjustment of macroeconomic fundamentals. Thus, to enhance the flexibility of the macroeconomic environment, the government has to advance reforms in several areas: (i) achieve prudent, disciplined and efficient utilization of public funds, (ii) improve the competitiveness of the public and private sectors to allow for market-based determination of prices and tariffs and (iii) promote credibility of the monetary authority.

There are many reasons to be optimistic that the government is pursuing this agenda. First, the Ministries of Economy and Finance jointly with the National Bank of Ukraine (NBU) have recently developed a program to maintain price stability in 2008. Its key short-term provision is to put a ceiling on budget expenditure at 26.1% of GDP in 2008. The budget deficit is to be capped at 1.2-1.5% of GDP, while all budget revenues in excess of the projected amount will be channeled to reduce this gap. Better administration of taxes and custom duties may considerably facilitate this task.[3] Indeed, in the first quarter of 2008, state budget revenues surged by 43% yoy (nearly $600 million above target) driven by custom revenues, which surged 78% yoy. Medium-term actions, in turn, will focus on the improvement of the budgeting process (including adjustments of custom tariffs and tax preferences), better public debt management and improved analytical capacity of the government to produce more accurate and realistic forecasts of

[3] For example, the State Customs Administration of Ukraine is notorious for corruption. However, when the new government reshuffled top customs managers, overall operational efficiency tended to improve.

macroeconomic fundamentals. Special emphasis is put on the development of transparent and efficient channels of communication between fiscal and monetary authorities. This will improve overall government cooperation on macroeconomic policies and facilitate a prompt and coordinated response to economic challenges. In addition, the government intends to implement short-term supply side strategies through more prudent management of state reserves of staple commodities and supply interventions on the domestic food market. In the medium term, enthusiastic support of transparency and competition on local markets will be enforced. Better regulation of the housing sector and natural monopolies are to be enacted. Finally, several provisions will attempt to promote higher productivity in agriculture and advance overall energy efficiency.

Without a doubt, the government of Ukraine is embarking on a bold, Herculean effort. On top of that, these policies are most likely to dampen inflation in the medium or long-term, while their short term costs may be substantial. And historically, fragmented and short-lived Ukrainian governments have proven to be ill-fitted to push a meaningful long-term strategy. On the positive side, this program, despite its shortcomings, is a good attempt to streamline government actions on macroeconomic stability, and it is an explicit signal about the authorities' resolute commitment to control inflation. Furthermore, increasing concern over inflation helps to consolidate authorities' efforts across all jurisdictions and political factions. This may ensure that the government is guaranteed sufficient stability to enact necessary anti-inflationary policies.

On the monetary side, the government has proposed to gradually shift toward inflation targeting and introduce greater flexibility on the forex market. Indeed, inflation targeting is an excellent tool to strengthen the credibility of the central bank by improving its capacity to shape inflation expectations. The experience of many emerging economies, most notably Latin American countries, suggests that a credible inflation targeting regime considerably reinforces control over inflation and helps to contain inflation expectations. Many countries that successfully implemented this strategy saw their inflation rates falling below double digit rates to steady and comfortable levels. However, it is worth mentioning that inflation targeting requires a high level of technical and procedural sophistication and yields visible results in the long-term. Unless the NBU noticeably enhances its autonomy and analytical capacity, the outcome of inflation targeting risks falling below expectations.

At present, the NBU is following moderate monetary tightening by increasing monetary policy rates on the one hand but continuing to maintain the exchange rate peg on the other hand. This will most likely encourage higher inflows of foreign capital (especially on the back of widening international interest rate differentials due to the accommodative monetary policy of the major world central banks), which will be accumulated in the forex reserves of the NBU and, consequently, will help to increase money supply. Needless to say, a central bank that sticks to a fixed exchange rate regime has to sacrifice most of its control over the money supply, providing relatively free cross-boarder capital movements. Restricting foreign capital flows is not an appealing option either, as the Ukrainian economy still needs foreign investments to grow. Not surprisingly, the NBU is considering loosening its grip on the foreign exchange market.[4]

[4] The NBU is currently considering widening its foreign exchange band and revising the official forex rate. This decision to introduce greater flexibility to the country's forex market is expected to be made in May.

Admittedly, this may help to reduce exchange rate pass-through for prices of imports, as the national currency is expected to appreciate in the short-term. However, with the current account deficit already at 4.2% of GDP in 2007, a stronger hryvnia may keep Ukrainian exports tame and will fan demand for imports, dragging the current account balance deeper into negative territory. Still, the NBU seems to accept that these short-term costs of a more flexible exchange rate are justified by a more effective monetary policy. Thus, efforts to liberalize the forex market should gradually gain momentum. On top of that, greater flexibility of the exchange rate regime will help to achieve smoother correction of external imbalances in the future.

Obviously, an investment hungry economy like Ukraine needs to import modern technology and capital goods to support sustainable gains in productivity and competitiveness. Since most Ukrainian exports are low value added products and commodities, the widening of the trade in goods deficit is normal during phases of intense economic development. As a result, the current account deficit per ser is not a major threat. After all, Ukraine's peers in Eastern Europe have been running current account deficits in excess of 10% of GDP for years. A more important question is whether this current account gap is sustainable, which implies that external debt to GDP ratios (both in the private and public sectors) are stable, while the current account gap is financed with long-term foreign capital inflows.

Ukraine's balance of payments does imply that the current account deficit is still a moderate risk to macroeconomic stability. First, the inflows of foreign direct investments have been consistently covering the current account deficit. This means that imports are driven by booming investment demand. Second, a recent widening of the trade in goods deficit is attributed to unprecedented price hikes of imported natural gas as well as growing prices of other energy resources. On the positive side, higher energy prices will encourage the public and private sectors to adopt a more meaningful energy saving agenda. Indeed, Ukraine is notorious for its uneconomical use of energy, especially in the public housing sector, where even unsophisticated energy saving investments may generate visible efficiency gains. As a result, the economy will benefit from lower demand for imported energy and improved energy security. Meanwhile, imports of consumer durable and non-durable goods were fueled by rising household incomes and booming consumer credit. Indeed, last year the external debt of the banking sector more than doubled, prompting brisk expansion of domestic credit. This trend raises concerns over the disproportionate impact of booming external borrowing on consumer demand, which tends to fan inflationary pressures and widen the current account deficit. The NBU is aware of this issue and is attempting to address it by imposing stricter requirements on external liabilities of commercial banks. All told, greater foreign exchange flexibility will almost certainly entail additional pressures on the current account balance in the sort-term. In the medium term, these pressures can be effectively balanced with more prudent regulations of the financial sector and supply-side structural reforms. In summary, short-term costs should not deter the government and the NBU from establishing a sustainable framework to manage external and internal economic risks.

Finally, macroeconomic stability indispensably relies on a well-functioning real economy. A country where inadequate investment demand is a binding constraint due to low investment returns will inevitably see its savings absorbed by higher inflation and imports. On top of that, in this environment foreign capital inflows will mostly boost consumption (by strengthening the real exchange rate), while their impact on investment and growth may be negligible. Therefore, it is crucial for the government of Ukraine to push a more comprehensive reform agenda that stimulates domestic supply through consistent improvements in the business and investment climate.

The latest supply and demand side developments are clear symptoms of the inadequate availability of good instruments in the government's toolbox of monetary and fiscal policies. However, things are changing, as authorities are willing to strengthen their macroeconomic management with a more systematic and coordinated approach. A broad understanding appears to be emerging that credible and independent monetary policy as well as prudent fiscal policy must be reinforced with structural and institutional reforms that support private sector development and generate productivity and employment gains. With luck, more mature and responsible politicians can accumulate the necessary political will and consensus to implement this reform program.

Public Policy Recommendations

The social costs of soaring inflation are devastating. Worse, these costs tend to be disproportionably distributed across society with low income groups feeling the largest impact of higher food and energy prices. Furthermore, persistently high inflation becomes deeply entrenched in inflation expectations, which makes stabilization policies even more difficult to implement. On the positive side, macroeconomic stabilization policies are pretty straightforward. Fiscal discipline and monetary tightening usually do the trick. However, an unavoidable tradeoff between economic growth and inflation frequently cools enthusiasm for policy tightening, especially if governments are motivated by short-term considerations or face approaching national elections.

The Ukrainian government finds itself in a very delicate situation. On the one hand, restricting aggregate demand is the only solution to curb inflation given the pronounced supply constraints in the short-term. On the other hand, the government is tempted to continue fiscal loosening to support its constituencies and maintain the credibility of its political program. True, Ukraine's real sector is flawed by many supply-side deficiencies, which adds more fuel to inflationary pressures. However, policies targeting the expansion of domestic supply yield benefits in the medium or long-term, while their implementation is costly. On top of that, current political situation is hardly favorable for allocating public funds to large-scale strategic policy reforms. Thus, the government must resolutely commit to fiscal and monetary tightening. Otherwise, inflation risks getting out of control, while public tolerance of the macroeconomic situation will plunge below a comfortable level.

- **The budget should be brought into balance.** The state budget balance does not necessarily imply extremely restrictive income policies. The government has to cut its discretionary spending, while public pensions, wages and social benefits must grow much slower (at rates consistent with single-digit inflation) or should be frozen altogether. Additional budget revenues, including privatization revenues, should be used to fix the budget gap. More importantly, a shift in policy priorities (due to the evolving political conjuncture) results in increasing spending on new policy programs (for example, the restitution of lost savings). This spending must be offset with equivalent cuts (or elimination) of other budgetary programs. Otherwise, higher public spending will continue to feed inflation pressures. Finally, heavy subsidies to households and other sectors must be stopped. Social protection programs should more precisely target the poor, while broad and unjustified grants, distorting the consumption behavior of households, must be eliminated.

- **The fiscal framework must be strengthened.** Timely and adequate response of macroeconomic policies relies on the developed fiscal capacity of the government. This includes a sustainable and growing tax base, strong analytic capacity and regular and accurate development and public disclosure of medium and long-term macroeconomic strategies. A good fiscal framework implies that tinkering with tariffs and export quotas makes little sense as well. Although adjustment of tariffs and quotas may bring some short-term relief in terms of cheaper imports and increased domestic supply, it has negative and unavoidable long-term consequences. Above all, it exacerbates uncertainty for local businesses, which leads to suboptimal investment decisions and impairs their competitiveness. Needless to say, only a stable and predictable fiscal environment will encourage businesses to invest in domestic production capacity (which will increase supply in the long-term). Equally important, accountable and economical utilization of public funds is essential to curb spending and improve efficiency of the public sector. All told, policies that strengthen the fiscal framework and integrate automatic policy stabilizers will make the government more flexible and responsive to macroeconomic shocks.
- **The central bank must gain more control over monetary policy.** This means a more flexible exchange rate policy and tighter control over domestic credit. The foreign exchange rate peg is a serious constraint on the ability of the central bank to execute independent and meaningful monetary tightening. Thus, it has to be replaced with a more flexible foreign exchange regime. Admittedly, tighter monetary policy and flexible exchange rates will certainly bring more volatility into the country's financial sector. However, a change in the forex regime is indispensable for a prompt monetary policy shift to inflation targeting.
- **The central bank has to shift toward inflation targeting.** International evidence suggests that inflation targeting is a very effective monetary policy regime that can influence inflation expectations. Thus, the NBU has to advance its analytic and procedural capacity to apply this policy. Furthermore, the NBU must be empowered with real autonomy to conduct monetary policy and should be granted an unambiguous price stability mandate. All of this will help to improve the credibility of the central bank and create functioning transmission mechanisms with meaningful policy response lags.
- **Supply-side structural rigidities must be eased.** More pronounced short-term constraints on domestic supply make inflation-growth tradeoff more painful. Indeed, excess demand tends to be absorbed through higher prices and imports if the domestic investment climate is weak. Thus, the government must support its monetary and fiscal policies with a comprehensive package of structural reforms that improve the investment and business climate. However, these reforms are costly and may yield few immediate tangible benefits, which may put-off their execution. Thus, strong leadership and political stability are essential to build needed reform momentum. Finally, neither structural transformation nor fiscal and monetary policies can guarantee sustainable macroeconomic stability if these policy actions are implemented in isolation. Thus, macroeconomic stabilization must be an integral program that addresses many policy issues. Equally important, a temptation to avoid short-term costs of tighter fiscal and monetary policies by advertising bold structural initiatives is not a feasible option. These

structural reforms are very unlikely to produce desired short-term outcomes. Thus, public enthusiasm for these policies will fade rather rapidly on the back of worsening macroeconomic conditions. On the contrary, a resolute commitment to responsible fiscal and tight monetary policies will certainly bring inflation back to comfortable levels in the short-term. Improving the macroeconomic outlook will, in turn, earn the government public support for vital structural reforms.

Driver 2: Public Governance and Reform of Public Administration.

The driver includes policies and actions to improve the capacity of the country's public administration design and implement economic reforms and to modernize and increase the efficiency of the public administration system. The reform of public administration is the key reform that is needed to facilitate and make possible the implementation of all other reforms. If well done, this reform will put the country on a different path, on an accelerated course to faster development and growth.

The second element of Public Governance is the transfer of revenue generating activities that do not involve a "public good" to the private sector. The objective of privatization-related policies is to improve the efficiency of resource use through private ownership, minimize the possibilities of undue market power by the authorities, and concentrate government resources on public goods. Key elements here include sound legislation to ensure a competitive privatization process, an independent agency in charge of privatization, along with private ownership of land.

Public Governance

Public governance in Ukraine still remains hostage to institutional pathologies acquired during the “communist era”, including vast, inefficient and inflexible public administration.[5] On top of that, past efforts to rationalize public administration regularly failed to follow a coherent and structured policy agenda. Adopted measures were frequently palliative, inconsistent and heavily distorted with vested interests and creeping corruption. As a result, Ukraine's present-day public institutions are still reminiscent of the former soviet administration. Above all, the administrative system lacks unambiguous separation between political and administrative functions, which delays the development of autonomous and productively functioning administrative bureaucracy. Regulatory policy is complex, nontransparent and inflexible. Policy-making tends to be fragmented and uncoordinated and lacks transparency and accountability. Even minor decisions require a large number of intergovernmental consultations and approvals. More important, the strategic and management framework of policy-making remains weak. Policy-makers, preoccupied with narrow short-term issues, have little incentives to pursue meaningful long-term development goals.

Uncompetitive wages in the public sector distort incentives as well. Civil servants are regularly confronted with a tradeoff between impartial and professional execution of their duties and involvement in various corrupt activities. Excessive, costly and time-consuming regulatory procedures encourage state officials to charge hapless businesses for various informal favors. This creates a complex informal network of private middlemen and nourishes corruption. As a result, despite trivial salaries, government occupations are notorious for their capacity to generate handsome illegal incomes. Worse, informal personal networks became a fundamental component of the state administration at virtually every level.

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[5] Extensive coverage of this issue is presented in our report on public administration reform in Ukraine. The Bleyzer Foundation (2008), *Public Administration Reform in Ukraine*.

Ukraine's public administration has now become a perpetual bottleneck blocking the country's economic development. Moreover, the over-regulated private sector and delayed implementation of key economic and structural reforms have materialized as two alarming symptoms of the government's consistent failure to promote and enhance a business friendly and liberalized market environment.

Indeed, the quality of public governance in Ukraine is below 60% of over 200 countries rated by the World Bank. As a result, the government still has a long way to go to achieve the performance of public administration comparable to Ukraine's regional peers, let alone that of developed market economies. Admittedly, weak public administration puts a huge strain on Ukraine's competitiveness on global markets.[6] Thus, it is essential to accelerate public administration reform. Otherwise, Ukraine will continue to lose its competitive edge despite vast indigenous economic advantages.

World Bank Governance Indicators

	Ukraine							Russia	Poland	New Zealand
	1996	2000	2002	2003	2004	2005	2006	2006	2006	2006
Voice and Accountability										
Estimate (-2.5 to + 2.5)	-0.46	-0.43	-0.68	-0.59	-0.61	-0.26	-0.11	-0.87	0.95	1.62
Percentile Rank (0-100)*	36.1	33.8	27.5	31.9	31.9	40.1	45.7	24	76.9	97.1
Political Stability										
Estimate (-2.5 to + 2.5)	-0.45	-0.7	-0.06	-0.14	-0.32	-0.39	-0.27	-0.74	0.22	1.27
Percentile Rank (0-100)	30.2	24.5	41.5	40.6	35.8	32.1	37	23.6	54.3	93.8
Government Effectiveness										
Estimate (-2.5 to + 2.5)	-0.87	-0.76	-0.73	-0.58	-0.63	-0.42	-0.57	-0.43	0.49	1.94
Percentile Rank (0-100)	18.1	20.6	23.4	33.5	33	40.2	33.2	37.9	69.2	96.2
Regulatory Quality										
Estimate (-2.5 to + 2.5)	-0.63	-1.28	-0.66	-0.62	-0.48	-0.26	-0.47	-0.45	0.64	1.68
Percentile Rank (0-100)	24	10.8	26.1	27.1	35	47	32.7	33.7	69.3	96.6
Rule of Law										
Estimate (-2.5 to + 2.5)	-0.73	-0.8	-0.87	-0.84	-0.83	-0.6	-0.72	-0.91	0.25	1.93
Percentile Rank (0-100)	28.2	23.6	22.1	23.1	22.6	34.8	27.1	19	59	97.6
Control of Corruption										
Estimate (-2.5 to + 2.5)	-0.79	-1.03	-1.01	-0.94	-0.96	-0.63	-0.67	-0.76	0.14	2.38
Percentile Rank (0-100)	23.9	13.2	14.2	16.7	15.7	34.5	27.7	24.3	60.2	98.5

** Percentage of countries, where a governance indicator is below the level observed for a selected country*
Source: World Bank, Governance Matters 2007, Worldwide Governance Indicators 1996-2006

Notwithstanding the obvious improvements in 1996-2005, the quality of public governance in Ukraine deteriorated across virtually all governance indicators in 2006. Interestingly, the correlation between voice and accountability and government effectiveness indicators is weak. If data for 2005 and 2006 is excluded, this correlation becomes strong and negative. Such a relationship implies that a more transparent and open public sector creates an institutional environment where flaws and deficiencies of the public administration can be detected much better. Indeed, over the last several years, Ukraine has achieved unparalleled levels of political

[6] Global Competitiveness Report 2007-2008 ranked Ukraine 75 out of 131 countries rated. According to this report, the quality of institutions, ranked as low as 115 out of 131, is a major setback for economic growth and development.

freedom.[7] The liberal political environment, in turn, triggered heated debates on the rationalization of public governance. True, a more polarized political environment paralyzes the capacity of policy-makers to build consensus on public administration reforms. However, improved political accountability allows voters to exercise more influence over public policies. This means that public pressure on the government to enhance the quality of public administration and public services delivery has already reached a critical point to prevent any further deterioration of government effectiveness. In this environment, all political factions are eager to agree that good administration and governance is the only cure for Ukraine's ailing public sector.

Public Administration Reform

The ability of the central and local governments to execute prudent economic policies and programs relies heavily on the overall functional and operational efficiency of the entire administrative system. Building the institutional capacity of the Ukrainian government is a basic step to facilitate policy making and reduce the risks of improper implementation of social and economic strategies of the country. For this reason, public administration reform in Ukraine is indispensable for the success of all essential economic and social reforms. As long as various administrative inefficiencies continue to persist, the impact of good public policies on economic development will be of limited magnitude.

The concept of public administration reform in Ukraine, approved back in 1998, was a significant step toward the launch of the government's restructuring. However, the implementation of this concept was below expectations. Uneven progress of various components of this reform, a narrow focus on mere rebranding or liquidation of selected ministries or state departments, lack of a thorough functional review, frequent reshuffling of top officials responsible for public administration reform and numerous amendments to the relevant legislation have postponed the development of a comprehensive long-term reform strategy. The duplication and overlapping of many functions and responsibilities within the government were inevitable outcomes. As a result, public administration reform did not evolve along well-defined and stable policy guidelines but mostly represented continuing and rather erratic reorganization of state administration.

The slow progress of public administration reform is obviously rooted in the inadequate extensiveness and transparency of legislation governing the responsibilities and functions of various executive authorities. Alas, lingering constitutional limbo and continuous rivalry and bickering over control of executive functions still leave many legislative controversies unresolved. However, there are signs that this political stalemate will eventually be broken. Various political groups are attempting to conceive a power-sharing agreement, which is to be implemented through constitutional amendments. Meanwhile, the legislature, although prone to inertness due to the thin and fragmented parliamentary majority and strong opposition, appears to

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[7] The Freedom House named Ukraine a free country in 2006 and a country with a partially free press in 2005. In addition, according to Reporters Without Boarders, Ukraine moved from 138th position in the Press Freedom Index in 2004 to 92nd in 2007. Furthermore, Ukraine has the best rankings in terms of civil liberties and political rights across the CIS region (excluding the Baltic States).

be willing to compromise on the division of executive power. Above all, the approaching presidential elections will most certainly prompt policy-makers to resolve these issues.

Still, several important steps have been recently taken to accelerate public administration reform. In November 2006, a coordination council on the **functional review** of the central and local executive authorities under the Cabinet of Ministers was established. However, the internal capacity of various state institutions to proceed with the functional review is worryingly weak. In particular, the Department of the Civil Service of Ukraine (DCSU) delayed the release of the official methodology on the functional review until January 2007, which implies that the role of the DCSU in administering this review is rather nominal. Furthermore, many of the state agencies are not ready to administer functional reviews. Working groups on the functional review have not yet been formed by all central executive authorities, while the coordination council on this review lacks the initiative and authority to speed up and monitor the process. More importantly, the official methodology insufficiently incorporates the best international practices on functional reviews. As a result, the functional review in Ukraine may be merely narrowed to an inventory of currently performed functions with little attention paid to overall improvement of government machinery. In summary, the functional review still lacks strong centralized supervision, while the methodology and procedures for this review are being drafted at a snail's pace as there is no clear assignment of responsibility for this process within the government.

Operational efficiency of the government has been steadily improving. Thanks to the adoption of the Budget Code and some progress in rationalizing administrative management, public finance in Ukraine gained in transparency and accountability. On top of that, efforts were made to simplify and streamline administration of taxation and customs. The government visibly narrowed tax and custom privileges, curtailed tax exemptions and carried out several deregulation initiatives. All of this helped to broaden the tax base and ensured steady growth of fiscal revenues. Indeed, acceptable levels of public debt and budget deficit are eloquent evidence of better public finance management. Meanwhile, budget expenditures continue to increase and remain unreasonably high. Worse, utilization of public funds is plagued by colossal deficiencies, including excessive subsidies to agriculture and energy sectors as well as flaws in the pension and social security systems. More importantly, public spending is oriented toward current consumption, while public investments are still low. As a result, the burden disproportionably falls on local governments, which fail to deliver high quality services due to a lack of capital spending on dilapidated regional public infrastructure.

Regretfully, **decentralization reform** continues to lack substance and vigor. True, intergovernmental financial relations are now more transparent and better controlled. Equally important, the decentralization of political and administrative powers between the central and local governments has been gradually advancing. However, the fiscal autonomy of local self-governance has not been meaningfully strengthened. Despite the fact that the central government managed to achieve more even distribution of public funds across Ukrainian regions, transfers from the central budget account for nearly half of total budget revenues of local governments.[8] All told, local governments are frequently locked in expenditure programs delegated by the central government. This insufficient expenditure and revenue autonomy leaves little room to address the pressing needs of local communities.

Slow progress with decentralization has an impact on the quality of **civil service** as well. Regional executive offices are, by and large, mere copies of Kyiv-based government agencies. As a result, despite the declining size of the civil service at the central level, the regional network of central executive agencies has visibly expanded.[9] In turn, the inflated size of public administration at the local level delays relocation of functions from central to sub-national governments and leads to functional overlapping and execution of many unnecessary operations. However, the sheer size of Ukrainian bureaucracy is not a problem per ser, as the government employs 277,000 civil servants or only about 1.3% of total employment in the economy. Millions of people employed in healthcare, education, social protection, etc., are on public payroll as well without holding civil servant status. For example, in 2006 the government employed almost three extra workers per each civil servant just to run public administration.[10] This means that the involvement of the private sector in public services delivery is relatively modest as outsourcing and privatization of non-core in-house public services and commercial activities are still rare. As a result, the quality of public governance remains low due to weak competition and inefficient management in the public sector.

On the positive side, salaries of civil servants have noticeably increased,[11] which implies that the current incentive structure in public administration enhances moral. However, higher remunerations and better security of civil service employment do not necessarily improve efficiency. Performance of civil service depends on overall quality and integrity of human resource management in public administration. Unfortunately, until now there has been scant evidence of performance-related pay and promotion policies for government employees. Civil service in Ukraine eschews competition, demands personal loyalty and shies away from impartial and fair judgment of employee performance and selection by merit.

Indeed, a cautious attitude toward market-type governance is typical in Ukraine’s public administration. The government continues to put undue emphasis on administrative functions, while market-type management processes are still slow to penetrate public administration. As a result, the public sector has limited options to partner with private contractors in service delivery. Public service delivery, thus, remains inefficient and costly due to the unjustifiably low level of competition in the public sector. Although isolated experiments with outsourcing in the public

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[8] Transfers from the state budget to local budgets constituted only 18.3% of local budget revenues in 1998, while this number swelled to 45% in 2006. Furthermore, the ratio of transfers received by local budgets from the state budget to GDP increased from 2.3% in 1998 to 6.5% in 2006.

[9] In 1995-2007, employment in the Kyiv-based central government shrank by 1.5%, while employment at the regional offices of these agencies almost doubled.

[10] According to the State Statistical Committee of Ukraine, the government employed 1,034,000 people to run public administration in 2006.

[11] In 2007, wages of civil servants averaged $392 or 46% above the national average.

sector yielded encouraging results,[12] the legal framework on **public procurement** is worryingly weak. Above all, it fails to structure public-private sector interactions on the basis of non-discrimination, competition, equal access to information and tenders, accountability and transparency. These challenges call for a public governance culture that treats the private sector as a partner that provides valuable services to the government. Needless to say, private contractors (either through a partnership with the government or independently) are often better equipped to supply the public with goods and services that are currently delivered by the state. The government, in turn, must enforce market enabling regulations, build strong policy-making capacity and resolutely support competition in the private sector.

In summary, a comprehensive and shared vision for the role and function of the government is a key prerequisite for productive public administration reform in Ukraine. All authorities that have a stake in this reform and are affected by the government's restructuring must achieve a formal agreement on the implementation of the reform by adhering to common goals and objectives. Most importantly, the government must understand that public administration reform is indispensable to push forward any meaningful development agenda in Ukraine.

A concluding remark on **privatization** is necessary. Up until now, privatization of large state-owned companies was postponed due to lingering management uncertainties at the State Property Fund, while the legislature consistently stymied proposals to unlock this stalemate. Another set of problems lies in the still imperfect privatization methods eroded by fraud, corruption and vested interests inherent in deals involving lucrative stakes of state property. Privatization methods, albeit relying on competitive bidding and non-discrimination, are vulnerable to various manipulations as it is possible to screen out unwelcome bidders. Furthermore, obscure ownership structures help several related companies to participate in privatization auctions, which violates the utmost principle of competitive bidding. Finally, intentions to encourage enterprise restructuring in the public sector coexist with the insistent temptation to use privatization as a way to repair the holes in the government's coffers. Nevertheless, there is a reason to be cheerful as the current government has already earned excellent credit for selling mammoth state companies through transparent and competitive auctions.[13] Furthermore, the government now approaches privatization in a more consistent and strategic way and attempts to select buyers with the best credentials to run privatized companies. A list of companies to be privatized during this budget year was approved and is publicly available. This further improves transparency of the privatization process and facilitates the involvement of all interested buyers.

Public Policy Recommendations

Institutionalization of good values, principles and processes of public governance is a central component of public administration reform. The government should implement legislative initiatives that establish logically structured and coherent organization of state power across all

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[12] A recent pilot project undertaken by the Ministry of Defense of Ukraine, which introduced competitive tenders for the supply of catering services to the Ukrainian army, indicates that the involvement of private suppliers can noticeably improve the quality of services as well as save budget resources previously spent on in-house provision of these services.

[13] In October 2005, Ukraine's largest steel mill, Kryvorizhstal, was sold to Mittal Steel for nearly $5 billion.

jurisdictions. Various government agencies and departments must build the capacity to materialize this framework through their internal organizational structures and interrelations with other state agencies and the private sector. This effort relies on the ability to design and enforce coherent formal codes of behavior as a system of regulations and procedures of day-to-day public-policy making and execution. Individual state agencies play a fundamental role in enforcing and disseminating this code of values across the entire organism of public administration. Even if the institutional fabric of the country is properly defined, the failure to internalize good governance principles by the bureaucracy of the atomic administrative units will impede complete and efficient execution of public administration reform and will continue to damage implementation of all other reforms.

Finally, the ability to ensure sufficient support for public administration reform crucially depends on the degree of citizens' participation in policy making. The limited impact of citizens on public policy reduces public trust in the government and its leadership. Therefore, a legal basis of public administration reform must shape public institutions that facilitate representative democracy and expand social inclusion of the population. Such a legal system requires an adequate distribution of authority and responsibilities at different levels of government and must establish a high degree of public sector accountability.

How to build support for public administration reform:

- **Authorities should maintain strong leadership through their commitment to proceed with public administration reform.** Without such leadership, it would be impossible to consolidate the efforts of all parties involved in the reform as well as shape and achieve common targets. For this reason, public administration reform must be prioritized as a key item on the government's agenda.
- **An independent and competent state agency with a broad mandate to monitor, control, revise and execute public administration reform must be established.** The design of public administration reform has to reflect the current public governance and offer a feasible solution to existing problems. In addition, it is necessary to develop measurable performance targets[14] against which the result of this reform can be assessed.
- **A detailed and feasible plan of action for public administration reform must be enacted.** This plan should be designed as a broad policy instrument (based on a thorough feasibility study) rather than a mere statement of intentions. Existing institutional and procedural weaknesses and obstacles that may put off the execution of this reform must be fixed.

[14] For example, reducing the share of budget funds spent on public administration or cutting the size of civil service employment could be straightforward and practical goals of the reform. The set of performance measures to evaluate the quality of public administration is rather extensive. The perception of the quality of public services supplied by the government to the final consumer is one of the possibilities. Furthermore, regular surveys that monitor the professional level of civil servants and the ability to draft, review and implement key legislation within a reasonable period of time should not be ignored when the impact of public administration reform on policy making capacity is estimated. At the same time, it should be acknowledged that the capacity of the Ukrainian government to undertake sophisticated performance measurement of the quality of public administration requires significant modernization as well.

- **The action plan on public administration reform should represent a well-structured and detailed list of activities and measures to be implemented, including specification of clear-cut targets, timing, deadlines, and the distribution of responsibilities between all involved state agencies.** All stakeholders must understand their roles and responsibilities during every phase of the reform. This allocation of responsibilities and roles should reflect internal capacities and resources of every involved party to which specific duties are to be assigned.
- **The role of government and the scale of the public sector must be clearly defined.** Activities of the state should be restricted to non-commercial activities. The government should clearly demarcate the boundaries of its core activities and firmly commit to market oriented policies and business regulations that enable private-sector led growth unconstrained by wasteful competition with the state.
- **Public administration reform must be supported with broad rationalization of legislation.** The legitimacy of the government should be underpinned by coherent and transparent laws on the structure of state institutions.
- **The institutional framework of public administration reform must be properly shaped.** The revision and modernization of state roles and functions should be maintained on a regular basis through the application of innovative technologies and modern managerial skills in the public sector. The government should create and support educational and research networks, facilities and institutions that actively encourage the diffusion and utilization of this knowledge within state institutions and advance civil service and its human capital capacities.

How to perform a meaningful functional review:

- **A functional review of the government must rely on a clear and common vision of state functions in the modern market economy.** This functional review must adopt a critical and comprehensive agenda that prioritizes (i) effective execution of core government functions and (ii) efficient utilization of public resources that are often rather unproductively allocated to operations where state involvement is poorly justified.
- **A functional review must rely on good methodological procedures, which can detect current problems and offer effective solutions.** Essentially, each function performed by state agencies must pass six fundamental tests: whether this function (1) serves public interests, (2) should be performed by the government, (3) can be transferred to local governments, (4) can be outsourced or privatized, (5) whether and how the function can be rationalized, (6) whether the government can afford to persue this function. Results of these tests must be consolidated in a meaningful and informative way to assist the government with public administration reform.
- **Based on the results of the functional review, the government should prepare a detailed plan of reorganization of the public sector in Ukraine**. More importantly, privatization, outsourcing and partnership with the private sector should be considered as principal options to boost public sector efficiency, reduce costs and improve the quality

of public services delivery.[15] All necessary regulatory procedures and laws should be properly developed and enforced to make these options feasible at all levels of the government.

How to improve efficiency of the public sector (operational review):

- **The government has to review the modus operandi of each public institution and prepare recommendations on streamlining their operational systems.** This includes the evaluation of compensation and efficiency of government employees, while the performance of the private sector may be used as a good benchmark.
- **The accountability of public services delivery must be considerably strengthened.** The government should develop and enforce modern quality standards and ethical codes while all parties involved in service delivery must adhere to these rules. Furthermore, user charges for public services must be transparently set on a competitive basis rather than heavily regulated by the state. Competition is a key driver forcing producers to increase efficiency and improve the quality of their products and services. Therefore, all government actions that damage market competition must be avoided.
- **It is necessary to ensure that privatization, outsourcing and partnership with the private sector are organized through strictly competitive procurement procedures.** The government must adopt a transparent and unbiased approach to the selection of private contractors and place efficiency and quality considerations at the top of its list of requirements.
- **A good balance should be maintained between centralized control over the utilization of budget funds and openness of the public sector to private contractors.** Effective cooperation with the private sector relies on the flexibility of all levels of the government to select private partners and negotiate contract terms. Therefore, the government should alleviate the excessive bureaucratic burden on state procurement procedures as well as expand the mandate of local authorities to engage private contractors in public services delivery.
- **Civil service reform must be accelerated.** In essence, this reform aims to upgrade the quality of human resource management in the public, including merit-based hiring procedures, performance-based payment and promotion and enforcement of codes of ethics.
- **The number of civil servants and public sector employment must be reduced.** Quality should prevail over quantity. On top of that, a smaller civil service will save budget funds and will make it affordable to boost good work morale and professional skills through higher salaries and personnel training. Furthermore, the reduced size of public sector employment will help to slash supervision and administrative expenses and will open more opportunities for independent and creative approaches to policy development and implantation.

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[15] For example, many workers employed by the government perform standardized blue-color commercial services (for example, catering, maintenance and cleaning, laundry, etc.). Outsourcing such services is a straightforward, feasible and efficient option since there are many private businesses in Ukraine that can serve this market competitively.

<u>*How to advance with decentralization reform:*</u>

- Decentralization should become a policy vehicle to expand the capacity of local governments to implement policy measures, effectively targeting issues specific to local communities. **Deadweight losses incurred through lengthy bureaucratic approval procedures and administration of cumbersome inter-governmental communication must be minimized. As a result, higher flexibility of local governments to implement local policy initiatives will improve the wellbeing of local communities and reduce the costs of doing business through better quality of public services delivery.**
- Successful decentralization assumes a transfer of vital public services to the lower levels of government. **The principle rationale behind this transfer is superior knowledge and competence of sub-national governments to utilize local public resources optimally when addressing the needs of final consumers of public services. A thorough identification of functions that can be performed by sub-national governments is a necessary prerequisite at this stage of the reform. It is critical to evaluate whether local governments have sufficient policy-making and implementation expertise as well as strong revenue capacity to execute and finance transferred and assigned functions.**
- A transfer of economically feasible functions to sub-national governments will improve cost recovery as the inclination of users to pay for public services increases when services are managed closest to final consumers. **This is particularly the case for the most basic services, such as water, sanitation, education and healthcare. Thus, it is fundamental to build a strong culture of users being charged for public facilities and utilities at the local level. For this reason, local authorities must be equipped with fair and market-based mechanisms of tariff-setting for local public utility services. If local consumers are uncertain about quality and costs of such services, sub-national governments will fail to promote a customer-friendly image and gain the trust of local users.**
- **Vertical fiscal imbalances, which arise when local governments lack the resources to finance social programs that have been assigned to them by the central government, or which they have adopted for themselves under the local legislation, should be fixed.**
- **The central government should implement policy measures that improve nation-wide tax compliance and expand the tax base at the local level.** Furthermore, full cost recovery of public services delivered by local governments must be supported.

Driver 3: Stability and Predictability of the Legal Environment

This driver includes policies and actions to enact and implement stable and predictable laws and regulations that would support and encourage private businesses in a free market. It calls not only for solid legislation and its effective implementation, but also for a transparent judiciary and recognition of international contracts and agreements.

Since 2005, Ukraine has gone through two parliamentary elections, two coalition breakups, was governed by four governments and plunged deep into a constitutional limbo. Yet, in spite of the bumpy political landscape, the real economy remained on firm footing. Several explanations are possible for this puzzling resilience. Over the last decade, the private sector gained sufficient strength, sophistication and experience to survive in the capricious political climate. Equally important, macroeconomic stability, market entry of many foreign investors and an unprecedented development of the financial system helped to reduce the dependence of local private businesses on state backing. As a result, instead of fighting for political patronage and preferential access to budget funds, many private companies preferred to compete in the rising market economy, financing their expansion strategies through the growing private banking system. On top of that, political competition in Ukraine has visibly improved since the last presidential election. Although greater political rivalry came at the cost of higher uncertainty, these costs were compensated for by better opportunities for balanced distribution of power across all jurisdictions and political groups. Indeed, for the first time since independence Ukraine obtained all preconditions for the existence of a genuine and effective opposition faction in the parliament. This brought more transparency, accountability and openness to public institutions. In summary, a combination of better market and political competition helped to neutralize most new political risks.

Although the private sector managed to shrug off recent political turmoil, many fundamental reforms of legislation and judiciary lost momentum. Indeed, while the legal environment remained relatively stable on the back of the stalled legislative process, deep and coherent rationalization of the country's body of law was virtually phased out. However, it would be an egregious error to assume that the quality of the Ukrainian legal environment has been regressing. On the contrary, several important legislative efforts were successfully finalized (for example, the government and the parliament secured Ukraine's WTO membership), while many other initiatives are under way, including constitutional process and streamlining of core legislation on the distribution of executive power.

Obviously, the quality and course of legislative changes are as essential as the stability of the legal environment, i.e. the frequency of these changes. A good legal environment allows the private sector to anticipate that pending and future legislative transformations will attempt to improve the quality of the business climate, reduce the regulatory burden and minimize state interventions in the business activities. Admittedly, the Ukrainian government and legislature became more vocal and thoughtful in debating these issues. Needless to say, this came as a result of a more liberal and transparent political environment. However, higher political competition, albeit indispensable for the development of functioning democratic institutions, exacerbated fragmentation and instability of the government in the short-term. As a result, the law-making process still lacks clear and coherent long-term guidelines. Legislative amendments are frequently driven by urgent considerations and carry a substantial risk of being revoked or reversed by succeeding governments. This means that a general trend toward a more market-friendly legal environment is suppressed by insufficient predictability of legislation. More importantly, frequent and inconsistent legislative changes tend to dent regulatory compliance, which, in turn, increases the costs of enforcement and damages the rule of law. Although, more transparent and better public administration as well as several episodic deregulation initiatives helped to improve overall tax compliance, the judicial system is still deficient in providing cost-effective property rights protection and enforcement of contracts. Riddled with corruption, Ukrainian courts get entangled in legislative controversies and consistently fail to serve as reliable institutions to settle commercial and civil disputes.

In summary, the inadequate quality of the legal environment calls for a comprehensive reform program, including streamlining of core legislation and regulatory policies and maintenance of an impartial, fair and independent judiciary. On the positive side, this program offers considerable synergies, which will help to build strong reform momentum. In particular, clear and simple legislation and regulations will slash enforcement costs and improve compliance. Meanwhile, elimination of conflicting legal provisions will help to achieve consistency in judicial decision-making, improving overall predictability of the legal environment.

Legislation

Essentially, Ukrainian legislation is still alarmingly detached from the interests of the business community. Many laws contain provisions that are relics of the Soviet past. As a result, undue emphasis is put on inflexible administrative and restraining procedures, while insufficient attention is given to good governance, market-oriented regulations and trust-based and incentive-based compliance. This visibly reduces responsiveness of the legal environment to growing needs of the emerging market economy. Private businesses that demand low-cost, efficient and reliable protection of property rights and contract enforcement risk losing their competitiveness as legislators hesitantly incorporate market-centered provisions into the country's body of law.

Legal confusion embedded in the Civil Code and the Commercial Code (key laws governing commercial activities) is a characteristic example of weaknesses spoiling the contract environment. Since their adoption at the beginning of 2004, both codes have been repeatedly amended and corrected. However, these transformations accomplished little in shaping a logical and structured legal base for business activities. Instead, the deep-rooted overlap and duplication of legal spheres of these two codes still impose excessive and rigid formal requirements on the private sector. In fact, flagrant deficiency of the Commercial Code has swelled to an extent that justifies its complete abolishment as the only reasonable solution. In particular, the Commercial Code fails to provide for a clear and unambiguous regulation of ownership rights, poorly structures property transactions, establishes prohibitively burdensome regulations and justifies excessive interventions into internal affairs of private businesses.

By and large, the meager quality of Ukrainian legislation is a product of an inferior law-making process. For years, the legislature lacked experience, openness, independence and political will in drafting market-friendly legislation, and was rotted by corruption and vested interests. Until recently, broad public consultations on legislative proposals were largely ignored. Furthermore, frequent earmarking or appropriation of budget funds to please constituencies has materialized as a driving force of legal transformations. Expert decision-making continues to play a secondary role in policy-making. Not surprisingly, existing legislation is a convoluted collection of many redundant, overlapping, inconsistent and excessively restrictive laws and provisions.

One of the most serious gaps in the country's legal environment is the absence of a law on joint stock companies. Alas, successive drafts of this law have been stalled in the parliament for years. Currently, a legal framework of businesses is governed by the company law, which was approved nearly two decades ago. However, despite many new amendments, this piece of legislation mostly demarcates a set of permitted legal business structures, while little attention is paid to creating incentives for good corporate governance and corporate responsibility. Indeed, Ukraine's business environment is plagued by the chronic incapacity of legislature to establish good corporate governance standards. True, weak corporate governance has evolved under the pressure of many factors. Excessive and frequent state interventions, nontransparent and insecure property rights, corruption, massive perversion of vested interests and a crippled judiciary – all of these both visibly deterred the development of a business-enabling legal environment and shifted most of property transactions into the informal domain. Obviously, the weak legal environment failed to ensure necessary conditions for the harmonious growth of the private sector. Worse, gaps in the current legislation and collisions of legal norms helped business predators, frequently backed by political insiders, to unlawfully cease control of others' property and assets. As a result, illegal corporate takeovers or "raidering" risk emerging as a fatal malaise, further weakening the already shaky health of Ukraine's investment climate.

Admittedly, the picture is far from all bleak. Above all, the growing economy and the entrance of many foreign investors improve market competition and increase demand for modern and business-friendly legislation. The business community is gradually gaining more political clout to steer the government and legislature in the direction of necessary legal reforms. On top of that, public opinion on the quality of the business climate has become much more vocal during the past several years. The government, in turn, tends to be more receptive to the needs of the private sector and has considerably expanded the scale of public consultations in its law-drafting process. Equally important, Ukraine's WTO membership and ongoing efforts to strengthen economic cooperation with the European Union is a powerful impetus for broad rationalization of national legislation. Indeed, international experience suggests that countries with an aspiration to pursue international economic integration managed to secure national consensus on vital legal reforms. Ukraine's path to WTO membership is a good example. Despite being backed by different and rival political factions, several consecutive Ukrainian governments managed to guide the country to this common goal. All told, more open and transparent public institutions, strict international guidelines (accepted by Ukraine as a member of the WTO and transmitted through Ukraine's commitment to join a free trade agreement with the EU) as well as better market competition and a more sophisticated private sector are set to improve the quality of the legal environment in Ukraine.

In summary, there is critical momentum for Ukraine to advance with legal reforms. After all, Ukraine is an open economy, which will inevitably see its international competitiveness deteriorating unless deficiencies in its legislation are promptly removed. Although at present the legislative process mostly revolves around the political bickering over the division of executive power, other important legal transformations are steadily gaining momentum. In particular, the parliament is attempting to strengthen the legal framework of privatization, land reform, the budgeting process and public procurements. Drafts of the law on joint stock companies and the tax code were developed; regretfully, the legislature still lacks the political consensus to accelerate the adoption of this legislation. Finally, it appears that incremental amendments to existing legislation continue to serves as the preferred vehicle for legal changes. Needless to say, with a narrow parliamentary majority, this may be more practical compared to a broad and comprehensive redrafting of legislation. However, the government can no longer afford to compromise on each and every political issue at the expense of solid and integral legal reforms.

The Judiciary

A functioning judiciary is a product of a reliable and good legal environment. However, existing contradictions and incompleteness of Ukrainian laws as well as weak administration of courts result in conflicting and unpredictable decisions and are sources of inefficiency and judicial corruption. Although Ukrainian judges are granted independence, in reality they may frequently experience unprecedented pressure from various political factions. As a result, the judiciary consistently fails to function as an efficient and low-cost mechanism to settle commercial and civil disputes. All of this has been steadily eroding public trust in the Ukrainian court system[16] which, in turn, damages transparency and accountability of the judiciary. Indeed, settling disputes in the Ukrainian courts is commonly perceived as a costly process with a highly uncertain outcome. According to the World Bank's *Ease of Doing Business* rankings[17], it takes up to a year and about 30 procedures to enforce a contract in Ukraine. Although this procedural burden is below OECD and regional averages, the financial costs of enforcing contracts in Ukraine tend to be significantly higher. This implies that administrative efficiency of courts remains low. All told, bringing a case to court appears to be the least preferable option to settle disputes. Worse, conflicting and imperfect legislative provisions and a weak judiciary are frequently abused to inflict damages on business competitors.

All of this comes as an inevitable outcome of the insufficient independence of Ukrainian courts. As Ukraine entered the period of political limbo in sharing executive power, various conflicting political and business groups gained stronger leverage in influencing court decisions. The beleaguered judicial system, entangled in legislative ambiguity and inconsistencies, lacked the autonomy to neutralize these pressures. Not surprisingly, the World Bank's rule of law indicator has recently reversed course, following a period of steady gains.[18] However, this trend should be treated with caution. Above all, improved accountability and transparency of public institutions helped to bring to light the extent of weakness of the legal environment in Ukraine. As a matter of fact, the capacity of Ukrainian courts to support the rule of law was as strongly damaged by

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[16] According to a public opinion poll (conducted by the Kyiv International Institute of Sociology in 2007) 49%, 42.9% and 22.8% of Ukrainians believed that judges, prosecutors and notaries respectively are corrupt. Meanwhile, less than 21% of Ukrainians claimed that courts and law-enforcement agencies could protect their rights. This finding is rather disturbing as it, by and large, reveals lack of public awareness about ways to enforce citizens' rights within the boundaries of the country's legal system. Ironically, as government continues to invest little into raising this awareness, public trust in the judiciary process is set to plunge even deeper, eroding faith in the rule of law. Indeed, according to the EBRD-World Bank *Business Environment and Enterprise Performance Surveys*, Ukrainian companies find it more difficult to obtain information on laws than businesses in peer countries. Worse, less than 25% of Ukrainian businesses believed that the court system is fair and impartial, while more than one third claimed that the judicial system is an obstacle to doing business.

[17] World Bank, *Doing Business 2008*.

[18] World Bank (2007), *Governance Matters VI: Governance Indicators for 1996–2006.*

poor legislation as by the weak administration of the judiciary. On the positive side, thanks to a more liberal political environment, many crying deficiencies of the court system were brought to the surface. Thus, the government is now able to contemplate the complete menu of problems and challenges inherent in the national judicial system. Certainly, this will help to design a more comprehensive reform agenda as well as build powerful momentum to implement judicial reform.

Alas, the Ukrainian court system remains hostage to weak and impractical administrative procedures. As the economy grows in scale and sophistication, courts find themselves overloaded with cases. In 2007, the judicial caseload of local courts of general jurisdiction increased by 16% to 160 cases per judge. This intensifies time pressure on judges and frequently leads to insufficient and inadequate handling of cases. As a result, a combination of higher caseload and excessive complexity of laws results in greater likelihood of appeal of judgments. Indeed, the monthly caseload of courts of appeal grew by 16.5% to 11.3 cases per judge in 2007. Courts of appeal, in turn, still lack competence, resources and motivation to give proper consideration to every complaint. Apparently, the incentive to revoke decisions of these courts by appealing to courts of higher jurisdiction remains substantial. All told, judicial settlement of disputes may become prohibitively costly and time-consuming.

On the positive side, the judicial process has been steadily moving toward better disclosure of information and accountability. An online database of court decisions was created and is publicly accessible. Furthermore, several other unified registries are functioning as well, including an online database on companies under bankruptcy, real estate and land registry, registry of notaries and mortgaged property registry. These resources help judges to deliver balanced and consistent decisions and facilitate access to consolidated legal information. Still, the accessibility and functionality of these registries still has to be improved through the enforcement of common standards of storing and processing legal information within the court system. Admittedly, at the end of February 2008, the Council of Ukrainian Judges approved a program to unify information systems of the Ukrainian judiciary. This program envisions the creation of a standardized information handling network within courts of all jurisdictions. Provided that the government allocates sufficient resources and technical expertise to this project, it will visibly improve transparency and accountability of courts and will ensure expedient and consistent case handling.

Finally, insufficient financing of courts continues to be the Achilles' heel of the judiciary. The lowest base salary of a judge[19] is still marginally below the average wage in Kyiv[20], despite being eight times higher than the minimum wage[21]. True, during the past several years, salaries of judges tended to grow fast as the government revised bonuses, minimum wage levels and multiples for judges. However, at the same time, earning opportunities in the private sector increased even faster. This means that skilled workers tended to migrate to the private sector to earn higher wages, while more affluent private businesses bid up the price of a "favorable" decision, raising returns on judicial corruption. On top of that, funding of judicial infrastructure and auxiliary personnel is still insufficient. Public servants, who assist judges and manage court

[19] Bonuses and raises for tenure and professional qualifications may add up to 40% of the base salary.
[20] About $545 per month in February 2008.
[21] This is currently fixed at around $66 per month.

administration, may earn wages below competitive levels. This erodes work morale and damages independence and efficiency of the court system. Yet, notwithstanding all of these negative trends, recent rises of wages and pensions of judges have been gradually tilting the incentive balance toward a more fair and impartial judicial process.

A judicial system capable of maintaining the rule of law is a building block of democratic and market enabling public governance. Recent developments do indicate that Ukraine is moving in that direction. The country's legal environment is steadily absorbing international standards while courts and judges attempt to be more accountable, efficient and independent. Equally important, the judiciary is evolving toward better division in terms of courts' specialization. In particular, thanks to the creation of regional administrative courts[22], other courts were considerably relieved of administrative cases. More narrow specialization of judges will, in turn, help to polish quality and expediency of case handling. Administration of courts is getting better as well. Recent amendments and refinements of the country's procedural codes enhanced efficiency and transparency of the judicial process. Still, many modifications are mostly episodic and fail to encompass the depth of required legal rationalization to achieve irreversible and meaningful improvements. Needless to say, the snail's pace of these reforms must be abandoned. The government should embark on a comprehensive and expedient program of legal and judicial reforms.

Public Policy Recommendations

Judicial reform is commonly perceived as the most thorny of policy issues. Furthermore, many citizens only episodically participate in the judicial system, which limits public awareness about the weaknesses of the judiciary. In turn, political and business insiders are interested in preserving the *status quo* as they frequently use deficiencies of the legal environment to their benefit. On top of that, difficulties related to measuring performance of the court system may prevent good evaluation of the performance of judicial reform. Therefore, the government should develop a set of meaningful performance measures and establish a strong link between performance and rewards within the system.

Finally, legal reforms should primarily focus on strengthening law-drafting capacity. Expert decision making, which relies on broad public consultations with the private sector, must replace the current emphasis on balancing interests of various political factions, which overburdens this process with excessive and lengthy intergovernmental consultations and widens the gap between adopted laws and needs of the broader business community.

- **Legislation governing commercial activities must be aligned to the needs of the local business community**. Ideally, this requires the elimination of the Commercial Code and adoption of a good law on joint stock companies. Other laws and regulations must be revised to eliminate unjustified restrictions and interventions in the private sector.

- **The government needs to strengthen regulatory quality management.** Ukrainian legislation is famous for imposing excessive compliance costs on private businesses.

[22] Regional administrative courts and administrative courts of appeal started to function in 2007. These courts resolve disputes between the private sector and central and local governments.

Obsolete and rudimentary laws and regulations that damage market competition and allow for state interventions must be promptly eliminated. Meanwhile, rationalization of the country's body of law must be performed as a continuous and systematic process, rather than as episodic and narrow deregulation initiatives.

- **Ukrainian legislation should incorporate best international legal practices.** This is the only way to sustain the country's international competitiveness in the long-term.
- **Fairness, transparency and accountability of the judicial system must be advanced.** Reform of the judicial system should be implemented as a far-reaching policy initiative that attempts to fix major weaknesses of the Ukrainian court system. In particular, budgets of the judiciary should be increased, while a strong link between funding and performance must be established. Administration of courts must be strengthened with merit-based human resource management and investments into personnel training and court infrastructure. Equally important, various procedural codes should be improved to allow for impartial allocation of cases to courts and judges and proper handling of cases. Finally, legislative gaps that prevent judges from delivering consistent decisions and facilitate equivocal interpretation of laws must be eliminated. This requires more narrow specialization of courts and a prompt adjustment of legislation to ongoing economic and social transformations.
- **Judicial corruption must be relentlessly fought.** Judicial reform will accomplish little if the government ignores the issue of corruption in courts. Admittedly, a more transparent judiciary and better performance measurement will help to detect corruption more easily. In addition, the government should establish an independent agency with a strong mandate to punish corruption in courts, as the judicial system may have little incentive to prosecute insiders. More important, judicial corruption is a result of complex and convoluted laws and regulations. Once the legal environment is simplified and streamlined, the private sector will find it less costly to enforce contracts without paying bribes to judges. On top of that, the government must raise public awareness on the ways to protect their rights in a lawful manner. This will improve accountability and efficiency of the judicial system.

Driver 4: Liberalization and Deregulation of Business Activities

This driver includes government policies and actions that reduce government interventions, enabling private businesses to operate freely and make profits in a competitive environment. Favorable conditions must be created for the three major components of business activities: entry, operations and exit.

In 2005-2007, Ukraine made certain improvements in liberalization and deregulation of business activity. In particular:

- Regulatory acts governing local private businesses were revised. 5,184 regulatory acts out of 9,340 total were recognized as inconsistent with the defined principals of the effective state regulatory policy and were abolished;
- Law-drafting procedures were visibly strengthened. Above all, new regulations are required to pass regulatory impact assessment (RIA), which should improve the business friendly features of legislation. As a result, as of the beginning of 2007, 95% of the regulatory acts were supplemented by RIA;
- A system of "one-stop-shop registration" was broadly introduced. As of January 2007, this system was in place in all 677 state registry offices. Due to this simplification, registration procedures are fulfilled in 2-3 days compared with 2-3 weeks under the old system. Up to 10,000 registration actions are currently performed by such offices on a daily basis;
- Integration of the United State Register of Legal Entities and Individual Entrepreneurs of Ukraine[23] (USR) into the European Business Register (EBR) was initiated and all necessary agreements on the development of this partnership were signed;
- Reforms of the Ukrainian permission system were advanced. A new amendment to the law on business registration, which integrates European principles for issuing permits based on the self-declaration approach, was enacted. Still, reform of the permit system is still in process since as it requires introduction of the correspondingchanges in more than 100 laws and legal acts concerning business regulation. However, the first results of the reform are very encouraging. For instance, as a result of its introduction, businesses were able to decrease the time needed to get permits by almost 3 times in 2007 compared to 2005.

Ukraine continues to suffer from the poor implementation of public policy decisions, which became a systematic problem rather than an isolated issue affecting only regulatory policy. Although the Ukrainian government undertook significant efforts to improve the country's regulatory environment, some of them were not properly implemented and some were just declared.

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[23] Starting in mid April 2008, Ukrainian companies can submit electronic financial statements to the USR using its on-line service.

The World Bank's *Doing Business 2008* report places Ukraine in 139th position in terms of ease of doing business among 178 countries, which is exactly the same position Ukraine held in last year's report. The rankings are based on 10 business indicators: time required to start a business, dealing with licenses, employment of workers, registration of property, obtaining credit, protection of investors, payment of taxes, trading across borders, enforcement of contracts, and closing of businesses.

Procedures and time required to **start a business in Ukraine** have been relaxed over the last three years. At present, the number of procedures in Ukraine is mostly on par with peer emerging markets in the region. For instance, it takes on average 10 procedures and 17 days to open a new business in the Czech Republic, in Poland – 10 procedures and 32 days, in Bulgaria – 9 procedures and 32 days, in Slovenia – 9 procedures and 60 days, and in Russia – 8 procedures and 29 days.

Starting a Business in Ukraine

	2005	2006	2007
Procedures (number)	15	10	10
Time (days)	34	33	27
Cost (% of income per capita)	10.6	9.2	7.8
Min. capital (% of income per capita)	183	198.8	203.1

Source: World Bank, Doing Business.

The existing system of **licensing** in Ukraine remains one of the weakest elements of the entire regulatory system governing business activities in the country. Article 9 of the Law on Licensing of Some Types of Economic Activities defines 74 types of economic activities for which obtaining a license is a must. Moreover, the Decree of the Cabinet of Ministries of Ukraine #1698 set a list of 36 government bodies that have the right to issue licenses to domestic businesses. Alas, lack of transparency and simplicity in licensing procedures was a major institutional weakness, which put Ukraine in 174th position of 178 countries rated by the World Bank in terms of dealing with licenses. Apparently, among CIS and Eastern European countries, only Russia scored below Ukraine with respect to the quality of business licensing.

The **permission system** in Ukraine has been steadily streamlined as well. A historical overview shows that more than 60 types of business activities were subject to permission in 2005. Moreover, within these activities there were 1,200 specific types of activities for which a state permit was a must. The issuing of specific permits was regulated by more than 60 laws and almost 100 decrees issued by the Cabinet of Ministers of Ukraine. The Law on Permission System in Business Activity was enacted at the beginning of 2006. Admittedly, this law provides for one-stop-shop permit centers. These centers save time for entrepreneurs and companies starting business activities or renewing permits. It is important that the Law imposes common procedures for granting permits by both central and local governments. However, the detailed provisions of the Law may not ensure the same approach to different economic activities. Although implementation of this law yielded positive results, the number of permits needed for conducting a business in Ukraine is still significant. On top of that, these permits must comply with existing EU standards.

Among the most popular types of permits issued by these one-stop-shops are those related to retail trade, construction, and placement of outdoor advertisements. In 2007, the number of permits was reduced to around 100 and procedures for their issuing were significantly simplified. However, the law remained unclear about the description of documents that had be submitted by applicants to one-stop-shops, which frequently led to equivocal interpretations and put an undue paperwork burden on businesses, especially at the regional level. To avoid this situation, a new amendment to this law was introduced in 2007, which was submitted to the Parliament for approval and is still under the consideration of the profile parliamentary committee.

Inspections are still a serious obstacle for private sector development in Ukraine. Their excessive number diverts significant resources from both the state and businesses. According to IFC research, around 95% of all business in Ukraine were inspected by different state regulators in 2006 compared with 66% in Belarus and 32% in Georgia.[24] Currently, there are around 40 different government controlling bodies in Ukraine, and their quantity has been constantly changing. Worse, the current system of state inspections does not prevent abuses of law, which is its main declared function.

Closing a business in Ukraine is not an obstacle for the country's further development. The average duration of a business liquidation process for limited liability companies does not exceed 2.9 years in Ukraine, which is a good achievement compared with other countries of Central and Eastern Europe, where, this indicator is significantly higher on average.

Public Policy Recommendations:

- **Introduce a transparent and simple system of issuing permits to businesses.** Simplify the existing permission system in Ukraine by making it more transparent; eliminate any possible abuses of powers while issuing permits through the introduction of a "silent approval procedure" into the Law on Permission System in Business Activity.
- **Relax business licensing procedures.** Prevent any possible abuses of power by introducing a special amendment to the Law on Licensing of Some Types of Economic Activities, which will prohibit expansion of the already extensive list of activities that require obtaining a license.
- **Simplify regulatory procedures applied by state controlling bodies during business liquidation**. Promptly introduce all necessary amendments to the Civil Code and the Law on State Registration of Enterprises and Private Entrepreneurs.
- **Reduce the overall tax burden.** Accelerate the adoption of the new Tax Code, which should reduce the tax burden for businesses and minimize compliance cost. More importantly, this Code should serve as a single, transparent and accessible source of information for all taxes and payments that are levied on businesses operating in the country.
- **Launch meaningful regulatory reform.** The government must create an independent state agency on regulatory reform with a broad mandate to manage regulatory policies, issue guidelines for drafting effective regulations and monitor the regulatory impact on

[24] International Finance Corporation, Ukraine SME Policy Development Project

the business environment. The primary objective of this agency is to maintain a national registry of regulatory procedures and check whether existing and new regulations contribute to a high quality and simple regulatory environment.

- **Create an electronic, free and publicly accessible national registry of business regulations.** Above all, this registry must contain regulations that promote market competition and contribute to a transparent and simple regulatory environment, while obsolete and ineffective regulatory acts must be eliminated. To assemble such a registry, the government must screen all current regulatory procedures against a set of quality criteria within a tight deadline. Regulations that either do not pass efficiency tests or are not submitted for this revision must be automatically abolished.
- **An administrative simplification agency must be created to rationalize and simplify administrative services delivered by the government to businesses**. This agency should develop and enforce standards of administrative simplification that must be adopted across all jurisdictions. In addition, the agency should support a prompt shift toward electronic administration of state permits and licenses. For this purpose, it is necessary to develop common standards of e-government and ensure strict compliance with them. Finally, this agency should also promote the provision of auxiliary consulting and advisory services to citizens and continuously seek to simplify the regulatory environment through process re-engineering and new tools for regulatory management. As a result, if the regulatory reform agency focuses on the development of good and market-friendly regulations, the administrative simplification agency ensures that implementation and enforcement of these regulations imposes minimal compliance and administrative costs on businesses and the government respectively.

Driver 5: Corporate Governance

The objective of corporate governance policies is to institute laws and regulations as well as appropriate rules, relationships, systems and procedures that support effective distribution of rights and responsibilities among different participants in the company (managers, board members, shareholders and others). The ultimate purpose of corporate governance reforms is to improve the financial performance of companies and guide their activities in the best interest of the shareholders, protecting ownership rights. Key features of effective corporate governancet include disclosure of information about corporations, shareholders' rights protection, equitable treatment of shareholders, use of transparent and standardized accounting practices, and enhanced responsibility and monitoring of the board .

Corporate governance is a complex system of formal rules and procedures as well as private business cultures. In a modern market economy where corporate ownership is dispersed among many institutional and private investors, this system guarantees protection of shareholders and creditors against fraudulent and rent-seeking behavior of managers and outsiders. The effectiveness of this protection involves multiple dimensions and relies as much on the adherence to good corporate governance standards as on the ability to enforce these rules through a functioning judicial system. Essentially, strong public institutions and the rule of law are key fundamentals to maintain investor and property rights protection at an adequate level. Otherwise, weak corporate governance leads to mediocre, insecure and unpredictable returns and depresses investments of foreign and local investors.

Admittedly, the quality of corporate governance in Ukraine visibly varies across sectors. Mammoth state-owned enterprises[25] (SOE) remain nontransparent, lack independence and are prone to bad business strategies. Yet on the positive side, state regulators are present on boards of many SOE, which reduces the risk of rent-seeking behavior.[26] Equally important, many SOE are being groomed for privatization by foreign investors, who require better disclosure and sound management. All told, corporate governance in the public sector is not universally poor. Furthermore, the government has managed to strengthen its supervision over the business performance of SOE during the last several years.[27]

In the private sector, consumer goods producers and providers of financial and telecommunication services tend to outperform metals, mining and energy sectors. This means

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[25] Such as fixed-line telecommunication monopoly Ukrtelecom, national oil and gas company Naftogas, as well as state-owned banks.

[26] Management of state-owned and state-controlled enterprises is still a muddy business in Ukraine. Essentially, both the government and the State Property Fund of Ukraine (SPFU) share responsibilities in managing state stakes in commercial activities. In 2006, a law on state property management was approved. Although, this law refined jurisdictions of various government agencies in state property management, a proposal of the law on the SPFU is stalled in the parliament. This legislative vacuum has recently sharpened the conflict within the executive branch over the control of the SPFU. Needless to say, this new source of uncertainty adds little to better corporate governance in the public sector.

[27] State-controlled enterprises are required to prepare financial plans to be approved by the government. Admittedly, these financial plans only remotely reflect conventional business plans, as they are perceived as a mere formality rather than a business development strategy. However, they do impose better discipline on management since a failure to meet performance targets can frequently result in job loss.

that good corporate governance brings the highest rewards for companies and investors when the business environment is competitive and is populated by foreign players (retail, food processing and banking sectors are typical examples). In sectors dominated by large resource-based oligopolies, where private ownership is usually highly concentrated and was created through privatization to local players, corporate governance remains rather opaque. Ownership structures are not accurately and completely disclosed and are difficult to track due to a complex network of intermediary holding entities.

However, it bears emphasizing that this situation is poised to change for the better. First, local companies are hungry for funds to invest in business development. Successful fund-raising either through IPO or issue of corporate bonds requires transparent and accountable corporate cultures. Furthermore, intense competition with regional peers will prompt Ukrainian companies to accelerate corporate governance restructuring. Indeed, funds raised by CIS companies through IPO are estimated at $22 billion and $34.3 billion in 2006 and 2007 respectively.[28] Yet, with only $1.1 billion in 2007, Ukraine is dwarfed by the aggressive IPO issues of Russian companies, which raised nearly $30 billion.[29] Second, the global wave of consolidations in the mining industry will force Ukrainian mining companies to team up with foreign partners. Good corporate governance is one of the key requirements to pursue corporate mergers on acceptable terms. And finally, there is no place for clandestine business cultures in an open, democratic market economy, especially if a single business entity enjoys disproportionate political and economic clout. Mature civil society demands as much accountability and responsibility from public institutions as from private businesses. Thus, survival instincts will urge large Ukrainian companies to improve disclosure, refine ownership structures and put more emphasis on social responsibility. There are many signs that corporate governance in Ukraine is evolving in that direction. The role of the government is to support this process with solid and modern legislation and ensure that rights of creditors and minority shareholders are not abused.

The government faces a rocky road along the path to better protection of investors, as much effort must be made to improve legislation and strengthen enforcement. Although basic corporate laws and regulations were adopted, Ukraine still lacks a coherent and consolidated legal framework on corporate governance. Many issues remain controversial or are left unregulated; disclosure and compliance with rules is discrete and frequently ignored. Not surprisingly, adoption of a good joint-stock company law is commonly perceived as the most important action to improve corporate governance in Ukraine. This means that the extensiveness and depth of state regulations on disclosure, reporting, accounting standards, rights of minority shareholders and rights of creditors as well as effective enforcement of compliance with these rules are crucial to maintain high quality corporate governance.

Public Policy Recommendations

- **A law on joint stock companies must be at last adopted.** This law should comply with best international practices, honor international standards and provide effective protection to minority shareholders and creditors.

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[28] The PBN Company, *IPO Pioneers: An analysis and review of 33 Initial Public Offerings in 2007*.

[29] Notwithstanding its distorted law enforcement and corruption, Russia is commonly praised for one of the best corporate legal frameworks in the CIS region. This may serve as an additional explanation for a bias of foreign investors toward Russian companies.

- **Compliance with international accounting standards must be scrupulously enforced.** Disclosure of financial information and ownership must provide clear and valid information on companies.
- **Judicial corruption must be stopped.** The rule of law is a key prerequisite to improve the quality of corporate governance. As long as courts fail to protect property and investor rights, good corporate governance will offer few advantages for domestic businesses.
- **The government should adopt market-friendly regulatory policies**. An excessive regulatory burden pushes private businesses into the shadow economy, where openness and transparency is hardly a virtue.
- **Institutions supporting market competition must be strengthened.** Good corporate governance may expose companies to the predatory behavior of rival companies if market competition is not rigorously enforced. Furthermore, companies abusing their market experience little competitive pressure to strengthen corporate cultures. Thus, the government must clearly understand that market competition is the sole force behind corporate governance innovations. If competition remains weak, the quality of corporate governance will almost certainly continue to decline.
- **Finally, broad reforms to improve the investment climate have to be implemented.** Superior corporate governance adds a lot of value to a company's assets. However, a poor investment climate does not allow domestic companies to capitalize on good corporate governance, which in turn suppresses efforts to improve corporate and managerial practices.

Driver 6: Liberalization of Foreign Trade and Capital Movements

This driver includes policies and actions to facilitate the export and import of goods and transfer of capital internationally. This includes the following actions: removal of restrictions to both exports and imports (including non-tariff restrictions), streamlining customs procedures and certification requirements, and liberalizing the foreign exchange regime.

Ukraine's aspiration to integrate into the European economy, proclaimed as one of the country's key priorities, has been already actively supported by the governments for almost half a decade. This has led to substantial positive developments in the area of foreign trade liberalization and capital movements.

In 2007-2008, Ukrainian authorities undertook much effort in facilitating foreign trade relations, simplifying customs procedures, fighting corruption at customs, bringing local trade legislation in line with World Trade Organization (WTO) requirements. One of the iconic achievements in this direction was Ukraine's membership in the WTO. Ukraine was on a long road before securing this membership, as negotiations on accession to the WTO continued for almost 15 years. On April 10th, 2008, the country's Parliament ratified the protocol on accession to the World Trade Organization.

For Ukraine, membership in the WTO is of special importance. The country is deeply integrated into global markets. In 2007, the ratio of exports to GDP stood at 45%, while the ratio of imports to GDP was even higher, reaching more than 50%. Notwithstanding this high level of trade integration, Ukraine has a rather narrow structure of its international trade. As a result, the country remains vulnerable to external market conditions and is exposed to risks that may arise from significant worsening of its terms of trade. Yet on the positive side, since nearly 85% of its international trade is with WTO member states, Ukraine's membership in this organization helps to mitigate this exposure.

In particular, major benefits from this membership are:

- Better access for Ukrainian companies to other markets, which is even more important for exporters.

- A clear and straightforward path to resolve any possible disputes through the WTO mechanisms of dispute settlements.

- Admittedly, all WTO decisions are approved by consensus. Thus Ukrainian companies will be able to enjoy increased bargaining power in the international arena. The principle of non-discrimination built into the WTO agreements should ensure that.

- Ukrainian businesses, importing inputs for their production, will able to reduce production costs due to lower trade barriers.

- Growing openness of the Ukrainian economy should encourage competition on domestic markets, which will stimulate productivity and efficiency gains in the Ukrainian private sector, and will consequently ensure sustainability of economic growth.

- The Ukrainian government will be better equipped to defend itself against lobbying efforts from narrow interest groups. Moreover, it is a “warranty” for businesses that the country’s new liberal international trade regime is irreversible, which means greater certainty and clarity about trade conditions and rules.

The current Ukrainian-EU relations reflect ongoing internal transformations in the EU, stemming from the present wave of enlargement. The Ukrainian government isn’t pushing for the country’s immediate acceptance as an EU member. Moreover, Ukraine and the EU are building their relations on a framework of concrete practical agreements, which cover a broad spectrum of economic issues. Ukraine is lobbying to enhance its cooperation with EU-member states through (i) integration into the EU market, and (ii) gaining access to sector-specific programs.

Following accession to the WTO, the EU and Ukraine entered a new phase in the international integration process – negotiations on a Free Trade Agreement (FTA). The Ukrainian economy is deeply integrated into the European economy. In 2007, 36.6% of the country’s imports were originated in EU states. On the other side, 28.3% of Ukrainian exports were directed to the EU. Imports from the EU are mainly represented by high value added products, including machinery, equipment and transportation vehicles, while Ukraine’s exports to the EU are relatively low value added goods dominated by metals and steel. In turn, Ukraine is important to European businesses as (i) a market for European products, (ii) a supplier of inputs and raw materials for European companies and (iii) an attractive destination for European investments.

As of January 2008, more than 77% of the FDI stock in Ukraine came from EU countries, with the most significant amounts from Germany and Cyprus – both countries have equal shares and are responsible for more than half of Ukraine’s FDI stock originating from the EU. The second tier of FDI investors to Ukraine are represented by businesses from the Netherlands, Austria, the UK, France and Sweden, which in total contribute 37% to FDI stock from the EU region. The neighboring Russian Federation and Poland are in the third tier, with a 5% and 2.3% share of the total FDI stock in Ukraine.

Although the level of economic cooperation between the EU and Ukraine has been constantly growing, these economic relations can be further strengthened by signing a free trade agreement. The new agreement will ensure free trade in all goods by liberalizing all tariffs, which will support free and effective access to Ukrainian markets without discrimination for EU businesses and vice versa. An FTA should help to utilize large potential for more extensive economic cooperation between the EU and Ukraine, which is still hampered by some distortions.

The agenda for FTA negotiations with the EU will include the following key issues:

(i) Further liberalization of the tariff regime in a framework of bilateral relations, which should go deeper than general WTO rules;

(ii) Elimination of all hidden non-tariff barriers to trade such as restrictive import license schemes and technical certificates (GOST) dealing with quality of products, which are not in line with current European standards;
(iii) Non-discriminatory policy, which treats domestic and European businesses equally and is based on principles of market competition;
(iv) Non-preferential treatment of European companies in Ukraine and Ukrainian companies in the EU on all issues related to public procurements, which should rely on the rigorous enforcement of transparency and accountability;
(v) Support of transparency and good governance, which should ensure predictability of the business environment in Ukraine for European businesses operating in the country. This should include the ratification by the Ukrainian legislature of the Convention on Anti-Bribery that exists in OECD countries.

Ukraine has advanced significantly in liberalizing capital movements. Still, the government realizes that free capital movement, on the one hand, helps to attract strategic investors while, possibly provoking speculative capital flows on the other hand. Striving to discourage hot-money inflows that could destabilize the foreign exchange market and exhaust foreign exchange reserves, the NBU introduced rules on short-term borrowing from abroad. In particular, commercial banks are required to reserve 5% of a foreign loan amount, if this loan is disbursed for less than 180 days. This constraint was designed as a specifically targeted measure to increase costs of short-term cross-border capital flows. Thus, it may help to discourage speculative capital inflows without exerting negative impacts on long-term strategic investments.

Public Policy Recommendations:

- **Ensure fast-track negotiations with the EU on an FTA.** Prepare in advance all propositions from the Ukrainian side on (1) desirable depth of trade liberalization, (2) changes in the existing Ukrainian legislation on issues concerning technical barriers to trade, including amendments to the “GOST” system and (3) a comprehensive and feasible plan for increasing transparency in public procurements. On top of that, ratification of the OECD Convention on Anti-Bribery by Ukraine must be accelerated.
- **Corruption at customs must be stopped.** Customs procedures and administrative formalities should be further streamlined to ensure expedient processing of imported and exported goods and avoid opportunities for rent-seeking behavior. Launch a program to “Stop Corruption at Customs” by granting full access of businesses experiencing regulatory abuses to the “National anti-corruption call center”, which will proceed with all complaints based on the existing Criminal Law.
- **Closely monitor current trends on international financial markets to forestall possible negative consequences on the financial stability of Ukraine.** Establish a competent working group on financial stability. This group will be responsible for advising government authorities on issues of financial stability and optimal levels of financial market regulations.

Driver 7: Financial Sector Development

This driver includes policies and actions to develop a healthy financial sector capable of meeting the financing needs of growing businesses. To achieve this, a country needs an independent central bank capable of effective bank supervision, a large number of private commercial banks (including foreign ones), functioning lending and deposit markets with liberalized interest rates, along with a developed stock market and an effective insurance system in place.

Banking sector

Over the last five years, the Ukrainian banking system has undergone unprecedented development as the ratio of bank assets to GDP grew from 30% at the end of 2002 to 84% at the beginning of 2008. There are several factors behind this phenomenal growth. First, booming demand for credit by households and the corporate sector prompted banks to expand their credit portfolios. Falling nominal and real interest rates and improving economic prospects made credit more affordable for a wide range of consumers and private businesses.[30] In addition, status-conscious consumers saw their real income soaring, which pushed them on shopping sprees for durable goods and real estate. Although households remain net creditors to the banking sector, the ratio of credit to households to household deposits narrowed from less than 20% in 2002 to 97% in the first quarter of 2008. Meanwhile, the share of credit issued to households in the total credit portfolio of banks jumped from less than 9% in 2002 to over 36% at the end of the first quarter of 2008. Businesses kept up with households as well. In 2002, only 5.3% of fixed capital investments were financed by borrowing, while this funding source accounted for over 16% of capital spending in 2007.

Second, plentiful global liquidity flooded the domestic banking sector with cheap foreign borrowing. Astonishingly, for the past three years the stock of external debt of the banking sector more than doubled every 12 months, increasing from a trivial $1.75 billion at the beginning of 2004 to nearly $31 billion at the end of 2007. Although Ukrainian banks had a relatively strong deposit base to fund credit portfolios, foreign borrowing helped them to grow even faster. Finally, Ukraine witnessed unparalleled entry of leading European financial groups[31] in recent years, lured by growing opportunities in retail and mortgage banking. Equally important, Ukrainian banks acquired by foreign investors saw their credit ratings being upgraded or put on a positive revision by major international rating agencies. As a result, their access to international credit markets was further eased. Indeed, in the aftermath of the global liquidity crisis, Ukrainian

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[30] In 2002, nominal interest rates on credit issued to households and the corporate sector stood at 18.6% and 18.4% respectively, while at the end of 2007 they declined to 13.3% and 15.7%. Taking into account that CPI inflation in January-December 2007 reached 12.8% (0.8% in January-December 2002), real interest rates on bank loans plunged even deeper - from 17.8% to 0.5% for business entities and from 17.6% to 2.9% for households.

[31] For example, at the beginning of 2008, a 60% +1 share of Forum bank was bought by German Commerzbank. Italy-based UniCredit group recently finalized a purchase of a 94.2% stake in Ukrsotsbank – the fourth-largest bank in Ukraine. In 2007, TAS-Kommerzbank was acquired by Swedbank. In 2006, BNP Paribas finalized its acquisition of a 51% stake in the fifth-largest bank –UkrSibbank. Raiffeisen International Group owns more than 95% of the Raiffeisen Bank Aval – the second-largest bank in Ukraine. At present, foreign banks control nearly 45% of Ukrainian banking assets as most of the largest and solvent banks have recently been acquired by foreigners.

banks managed to raise $1.8 billion in syndicated loans, including $795 million in January-April 2008 or 6.7% more than in the same period of 2007.[32]

Banking System Statistics

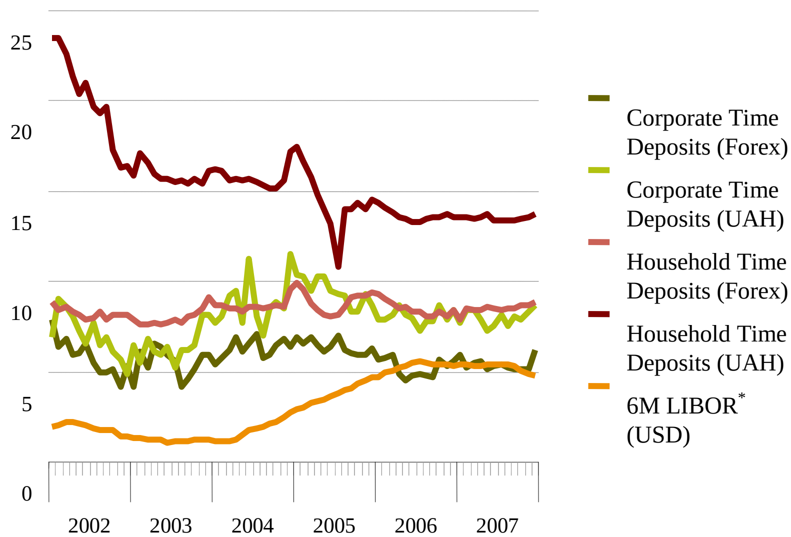
	Banking system *% to GDP*		Top 10 banks[*] *% of banking system*	
	2002	**2007**	**2002**	**2007**
Assets	30.0	84.1	54.1	49.7
Credit portfolio	20.7	60.3	52.9	53.0
Houshold deposits	8.5	23.3	65.2	54.5
Corporate deposits	8.7	21.4	54.5	45.0
Net income	0.3	0.9	46.2	64.2
Equity capital	2.7	6.0	27.2	31.7
Gross revenues	4.6	5.3	56.3	54.2
HHI[**]	*0.0494*	*0.0445*		
ROA	1%	1.1%	0.9%	1.4%
ROE	11.4%	15.4%	19.4%	31.2%

[*] by the size of assets
[**] Herfindahl-Hirschman Index, based on shares of gross revenues
Source: National Bank of Ukraine

Notwithstanding its rapid growth, the composition of the banking system has not radically changed. Leading banks preserved and strengthened their market positions, while about 50% of all bank assets remain in the hands of the top ten banks. However, the Herfindahl-Hirschman Index[33] (HHI) for the banking sector, calculated based on each bank's share of total revenues of the banking system, posted a marginal drop in 2002-2007. This may be interpreted as a sign of better competition in the banking industry. Financial performance[34] of banks, both for the entire system and the top ten banks, has improved as well, albeit with a considerable variance across banks.[35] True, better operational efficiency improved returns on assets and capital.[36] In addition, banks were able to finance their credit portfolios with foreign loans, which typically were less expensive than domestic deposits. Domestic interest rates on corporate and household deposits tended to decline as well. All told, more available and affordable funding sources helped banks to earn record high profits, which surged to $1.3 billion in 2007.

[32] Source: http://loans.cbonds.info/
[33] The HHI is a common measure of market concentration. It is calculated by squaring the market share of each firm competing in the market and is used by antitrust authorities to judge the degree of market competition. According to the US Department of Justice, markets are considered to be moderately concentrated if this index falls in the 0.1-0.18 range. Values in excess of 0.18 signal a concentration of market power.
[34] Measured either with a return on assets (ROA) or a return on equity (ROE).
[35] For the first tier banks (17 largest banks), ROA ranges from 0.1% to 2.7%, while ROE ranges from 1.8% to over 100%.
[36] Admittedly, banks have been expanding their credit portfolios more aggressively. The banks' credit to assets ratio grew from 69% in 2002 to 75% in the first quarter of 2008. Although this helped to earn higher interest margins, a concentration of assets in loans may have increased banks' vulnerability to liquidity risks.

Annual Interest Rates on Time Deposits in Ukraine



* Interest rates on syndicated loans, raised by Ukrainian banks, are usually linked

Source: National Bank of Ukraine, British Bankers' Association

In summary, the banking system of Ukraine is hardly a binding constraint for economic development. Banks' corporate governance is rather strong due to the presence of many foreign lending institutions and active participation of domestic banks on international credit markets. Indeed, many local banks are rated by international rating agencies, which require accurate and regular disclosure of financial statements as well as compliance with international reporting and risk-management standards. Additionally, Ukrainian banks have managed to shrug off the ongoing global credit crunch. This may imply that the banking sector is structurally solid, while its financial stability is underpinned by the presence of large international banks. Furthermore, local banks did not see their external funding sources drying up in the aftermath of the global liquidity crisis and continued to raise funds through syndicated loans. However, widening spreads on Ukraine's external debt[37] and forthcoming repayments of foreign loans[38] could still spell liquidity trouble for the domestic banking system.

Ukrainian banks have recently increased their reliance on wholesale funding, which pushed banks' credit to deposit ratio to 140% in the first quarter of 2008 from about 120% at the end of 2002. On the positive side, the large share of banks' foreign debt (about 50%)[39] comes in the form of loans by parent institutions. Since refinancing and repayment of such loans can be arranged on favorable terms, the growing external liabilities of Ukrainian foreign-owned banks do not create a material threat for the system's liquidity. Still, recent unprecedented growth of credit portfolios, funded by external borrowing, is hardly sustainable in an environment of tight

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[37] Emerging Markets Bond Index Plus (EMBI+) spread for Ukraine more than doubled in the first quarter of 2008, growing to 297 basis points (bps) at the beginning of May 2008 compared to 126 bps a year ago.

[38] Standard & Poor's estimates that Ukrainian banks will have to repay $12 billion in 2008. However, a relatively deep penetration of foreign banks in the Ukrainian banking sector helps to ease foreign debt rollover risks.

[39] Standard & Poor's (2008), *Liquidity Tension at Kazakh, Russian, and Ukrainian Banks Looks Manageable, but Highlights Inherent Structural Vulnerabilities*.

global liquidity. Thus, banks will almost certainly see their businesses expanding at a slower rate in the medium-term. A deceleration of credit may unearth yet another potential vulnerability of the banking sector – the weak quality of banks' credit portfolios. Indeed, as banks rushed to expand their retail and mortgage business, lending standards became more lax. True, households and the corporate sector are in healthy shape and are unlikely to default on their loans on a massive scale, especially taken into account that real interest rates are close to zero or negative. On top of that, real estate prices remain resilient to downward pressures, largely thanks to supply-side rigidities, which support the value of banks' collateral pools. All told, Ukrainian banks still have sufficient time to adjust their risk and liquidity management to an environment of more sustainable credit growth.

The role of regulators is fundamental to ignite this adjustment. Indeed, global financial turmoil prompted a revision and streamlining of banking regulations in many developed and developing countries. At present, the National Bank of Ukraine (NBU) is the principle banking sector watchdog in Ukraine. To its advantage, the domestic banking sector still lags behind many countries in scale and sophistication and mostly focuses on a plain vanilla version of corporate and retail lending. Thus, the NBU may simply focus on the enforcement of sound liquidity and risk management in the banking sector. However, if this financial minimalism of the banking sector facilitates bank supervision by the NBU, it risks becoming a constraint for economic development in the long-term. Above all, lack of innovation in the banking sector depresses returns on private capital and prevents effective hedging of financial risks. This means that the NBU should develop a balanced regulatory framework that strengthens financial stability through more prudent banking regulations on the one hand, and encourages harmonious integration of financial innovations into the country's financial system on the other.

Non-banking Financial Sector

Notwithstanding its recent outstanding growth, the Ukrainian non-banking financial sector remains in its infancy. Its infrastructure is poorly developed, and there is a virtual absence of a consolidated and coherent body of laws regulating non-banking financial institutions. The Ukrainian stock market (PFTS is a leading player) offers a rather modest menu of liquid shares, while its dynamics rarely reflect the fundamentals of listed companies. As a result, the PFTS is extremely vulnerable to speculative volatility that may be generated by a single large market maker. Regretfully, while many successful emerging markets, including BRIC and Eastern European countries, can boast of mature local stock exchange platforms that are routinely used by domestic companies to raise funds, Ukraine's leading companies prefer to list on the London, Frankfurt or Warsaw stock exchanges.[40]

Essentially, non-banking financial sector lacks momentum in Ukraine due to the prevailing legislative flaw, including imperfect regulations of public companies, shallow legal treatment of non-banking financial institutions and weak enforcement of corporate governance standards. Furthermore, lack of large local institutional investors (mostly due to the trivial size of the

[40] In 2007, Ukrainian real estate developer TMM raised $105 million on the Frankfurt Stock Exchange, Dragon-Capital (an investment bank) and Ferrexpo (an iron oar mining company) raised $208 million and $400 million respectively on the London Stock Exchange, while Kernel (an agribusiness company) raised $212 million on the Warsaw Stock Exchnage.

private pension system and stalled pension reform) is a significant obstacle to the development of the local stock exchange. True, ongoing proliferation of personal investment funds (PIF) means that Ukrainians are increasingly willing to diversify their savings, while the asset management industry appears to be gradually gaining strength. However, until now the non-banking financial system has had limited capacity to match investors with local entrepreneurs and businesses.

A functioning non-banking financial sector is crucial to guarantee efficient and productive allocation of capital in a market economy. Equally important, it enables savers and investors to diversify their wealth and provides private businesses with alternative sources of funding. However, a sophisticated stock exchange market is unimaginable without market-friendly regulations, good public institutions, protection of property and investors' rights, a fair and impartial judicial system and strong rule of law. Indeed, the state of the country's stock exchange may rather accurately signal the government's score on key market reforms. Needless to say, if the government continues to invest little into these reforms, the economy will grow at a suboptimal level.

Public Policy Recommendations

- **Banking regulations must not deter financial innovations.** Banking supervision must be revised to account for an ongoing transition of banks' business models. This transition involves a moderation of high double-digit expansion of credit portfolios to more sustainable long-term growth. Risk and liquidity management in the banking sector must be accordingly adjusted. The government, through financial supervision and prudent regulations, must insure that this correction of business models does not unfold into panic mode and poses little threat to the country's financial stability. At the same time, banking regulations must not put an undue burden on the banking system, while market competition and liberalization should be supported. This will help to encourage financial innovations in the banking sector.
- **Financial supervision authorities should play a larger role in maintaining financial stability.** At present, the role of the NBU and other regulatory bodies is biased toward administrative functions. This means that their flexibility to forestall financial turbulence remains week. Thus, a more solid and integral framework on financial supervision must be established. In essence, this means that more efforts and analytical capacity should be allocated to financial monitoring and policies that create a balanced, liquid and solvent financial system.
- **The legal framework of the non-banking financial sector should be upgraded.** Above all, this involves a good law on joint stock companies, effective enforcement of corporate governance and reliable protection of property and investors' rights. On top of that, the government should actively support domestic institutional investors, who are important to the growth of the stock exchange and asset management industry. Meaningful pension reform, which provides for an enhanced role of the private pension system, is one of the fundamental policies to develop this industry. Without strong local institutional investors, the public is unable to diversify savings and has a narrow menu of profitable investment options. This certainly puts a visible drag on Ukraine's long-term wealth creation capacity.

Driver 8: Corruption Level

This driver includes policies and actions to minimize corruption and protect businesses from abuse of power by government officials. Key measures here range from creating the legal framework to ensure better enforcement of anticorruption measures to measures to prevent corruption and raise public awareness of the problem.

Corruption in Ukraine still remains one of the most significant obstacles threatening the country's economic growth. In 2005-2007 after the new President of Ukraine was elected, several strong measures to combat corruption were announced. Nevertheless, a coherent and comprehensive national policy against corruption is still not in place.

Corruption practices are widespread in the country, which was reflected in the latest corruption perception index issued by Transparency International. The latest report, issued by this institution in 2007, places Ukraine in 118th position out of 179 countries, which may imply some worsening in the situation compared to 2006 when it was ranked 99th out of 163 countries. Ukraine's original score was reduced from 2.8 out of 10 (which is awarded to a corruption-free country) in 2006 to 2.7 points. The comparison of Ukraine with other Eastern European and Central Asian states shows that Ukraine is practically in the middle, holding the 12th position out of 20 countries in the region. Although the performance of Ukraine in fighting corruption is poor, it is still better than in its close counterparts such as Russia, Kazakhstan and Belarus, which are far behind Ukraine. Russia, which comes close to Ukraine in terms of corruption, is in 143d place.

The main sources of corruption in Ukraine that affect domestic businesses are:

- **Excessive Regulation of the Economy.** There is excessive regulation by the state of commercial activities, which yields many opportunities for corrupt behavior.
- **Excessive Executive Control.** The executive branch exercises control and influence over the judicial branch, reducing its independence and its capacity to provide equal and fair justice to all citizens. The legislative branch conducts minimal oversight of executive power.
- **Business-Government Ties.** There are strong ties between political and economic groups in Ukraine. Many political leaders have vested business interests. And business leaders seek to enhance their wealth through close connections with government bureaucracy. Despite the goals of the Orange Revolution, vested interests – both political and economic – do not want to see these relationships fade.
- **The low level of accountability** of the government to the general public and business associations to control potential abuses of powers.
- **Weak transparency** of the executive bodies responsible for conducting **regulatory policy.**

The most recent EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS) places corruption among the top five most significant problems for Ukraine out of the

21 most serious obstacles for further business development in the country.[41] Failure to fight corruption stems from the enormous resistance of many government agencies, whose administrative practices are designed in a way that justifies regulation of almost every aspect of business activity by law. The business regulatory is too complicated framework in many cases and lacks transparency. It creates opportunities for broad and equivocal interpretation of many regulatory and administrative procedures. Moreover, many regulations remain detached from market principles, which leads to excessive state interventions in the private sector.

By and large, the Ukrainian business community is aware of key laws shaping business regulations and private sector interactions with the government. The most significant outcome in raising this awareness was accomplished once the government established advisory and expert committees under almost all line ministries and committees. These committees provide the general public with an opportunity to be involved in the process of evaluation of a new legislative proposal on regulatory policies. However, efforts to review and abolish those obsolete legal norms, which are inconsistent with a market friendly environment, remain insufficient. The business community still has relatively little knowledge of the specific agency regulations that are vital for their routine business operations.

Public Policy Recommendations:

- **Improve transparency of the decision making process.** Accelerate implementation of public administration reform with an emphasis on good governance and market-friendly regulatory policy management. Additionally, the parliament should pass a new law on public procurements, which should ensure transparent and equal access of all market players to public procurement procedures. E-governance in all government agencies and institutions should be introduced. In essence, it should be used as an electronic platform for exchanging information, providing services and transacting with citizens, businesses, and other arms of government. The e-governance initiative will certainly bring more transparency to the decision making process, help to decrease corruption, improve efficiency, convenience, and better accessibility of public services.
- **Strengthen accountability of the government.** Reinforce the supervisory and analytical capacities of the Main Control and Revision Office of Ukraine to enable it to (i) inspect the efficiency of public funds spent by all executive bodies and (ii) verify whether these expenditure programs are justified by and comply with legitimate priorities of all agencies. This office should also be responsible for the evaluation of all aspects of public procurement, including the transparency of the process, free access and competition. Support development of business associations advocating business interests, government transparency and accountability.
- **Reduce corruption in the legislature.** Draft, approve, and implement specific laws aiming to regulate lobbying activities and reduce opportunities to influence parliament members, or any other corrupt practices that might influence the

[41] The EBRD-World Bank, *Ukraine: BEEPS-at-a-Glance*
http://siteresources.worldbank.org/INTECAREGTOPANTCOR/Resources/BAAGREV20060208Ukraine.pdf

legislative process. Introduce transparent regulations and controls for further privatization of state-owned and municipal properties.

Driver 9: Country Promotion and Political Risk

This driver includes policies and actions to minimize the effects of political uncertainties on business activities. This is achieved through effective functioning of the authorities unimpeded by vested interests, elimination of power abuses by the authorities, and minimizing the risks of civil disturbances that may affect businesses.

The driver also includes policies and actions to promote the country and improve its image as perceived by foreign and domestic investors. Key measures include the government's consistent and detailed action plan on country promotion, support to current investors in resolving problem issues, and the country's active position internationally.

Due to Ukraine's location between Russia and the enlarged EU, the country finds itself in the middle of increasing pressures from both sides. Admittedly, all recent Ukrainian governments have attempted to pursue a balanced foreign policy agenda by declaring that closer cooperation with the EU (albeit under the condition of good neighbor policy with the Russian Federation) is their top priority. The national body politic, in turn, substantially gained from a more open, plural and tolerant society. Indeed, over the last several years, Ukraine has been steadily moving towards a mature and stable democracy. Furthermore, there is strong will in Ukraine to become a member of the European Union, which is unimaginable without high-quality public institutions endorsing civil liberties and protecting human rights. The Ukrainian government is committed to democratic values as well. All political parties presented in the newly elected Parliament incessantly boast that a democratic society is their ultimate policy goal, including strong rule of law, openness and high living standards.

Still, the new government (which was approved in December 2007), which relies on a ruling coalition with a thin majority, leaves room for certain level of political tension and some instability. Another source of political risk is the uncomfortable balance of power between the president and a heterogeneous coalition drawn primarily from groups of his allies who tend to oppose some of his initiatives. Furthermore, constitutional amendments, many of which are still under consideration, shift power from the presidency to the parliament, which adds to the risk of an inter-institutional struggle and periodic political paralysis.

The last few years have been marked with the rise of local oligarchs, who started to play critical roles in policy-making at all levels of government through extensive lobbying. The activities of these vested interest groups often explain the sluggishness of reforms, the reluctance to adopt progressive legislation, etc. It remains a challenge for the authorities to set aside such demands and continue building a strong economy and civil society. This effort may be supported by the fact that several of these vested interest groups are now in the process of seeking "legitimization".

In general, Ukraine remains a rather stable country without serious risks of civil conflicts, violence, or extensive political tensions. Even though some uncertainties persist, it is increasingly unlikely that Ukraine will reverse course from its determination to build a strong market economy.

The comparison of Ukraine with other transition countries shows that it suffers from a high level of political risk. This is mostly explained by political uncertainty, which exists in the country due to the great fragmentation of political parties in Parliament and due to the upcoming 2009 presidential election. However, the level of political risk in the country should be substantially reduced after the implementation of constitutional reform and once presidential elections are over.

The Ukrainian government has a very clear understanding that improving the country's image is an important challenge. Having made considerable progress in advancing economic and social policies, Ukraine may still receive undeservedly low credit and international recognition of its achievements. Realizing this, Ukrainian authorities have started to pay more attention to this issue. In addition to organizing a State Investment Promotion Agency "InvestUkraine" under the State Committee on Investments and Innovation Policy, an Investment Council was created in 2008 with the responsibility of improving the country's image and promoting Ukraine in the international arena.

Ukraine's attractiveness for the international investment community is based on a number of features, including:

- One of the largest Eastern European markets with 47 million consumers;
- A highly competitive, well-educated, skilled labour force;
- Strategic location at the crossroads of East-West and North-South trade routes;
- Great potential for export oriented companies and multinationals, supplying the European Union and Russia.

At present, the recognition of Ukraine's political and economic achievements by the investor community is reflected in the dynamics of the country's sovereign ratings assigned by leading international rating agencies. Currently, Moody's grades Ukraine at B1 level with a positive outlook. More distinctly, Fitch upgraded the country's long-term rating from B+ to BB- with a positive outlook. An improvement in sovereign ratings was also made by Standard & Poor's, which increased long-term ratings from BB- to BB. However, S&P recently changed its stable outlook to negative due to some political tensions in the country and their possible negative effect on structural reforms.

Overall, despite some political and economic policy setbacks that negatively affected Ukraine's image in the past, the country managed to prove with progress in economic, social and political reforms that it has great potential and belongs among the world's most attractive emerging markets. Ukraine has performed very well compared to other countries of the region, including those which already joined the EU. Recent accession to the WTO and initiation of negotiations with the European Union on a Free Trade Agreement should also further improve the country's image as a reliable partner and attractive destination for investment.

Public Policy Recommendations

- **Strive for government stability.** Further promote civil society and democratic institutions development through nation-wide education and NGO sector involvement in the public decision-making process. Incorporate experts' views while developing policy measures. Increase transparency and accountability of the government through public debates and private public partnership. Improve accountability of political parties and their promises made during the election campaign.

- **Finalizing constitutional reform.** Introduce to the broad public the final concept of constitutional reform with necessary justification of the selected way and its further immediate implementation.
- **Ensure effective cooperation with the business community.** Continue dialogue with variety of business associations, including those who represent interests of foreign investors, on developing and further implementation of effective policies aiming to improve the country's business environment. Use expertise of businesses while making government decisions related to the country's economic policies through introduction of business experts and practitioners into expert councils of line ministries.
- **Promote the positive image of Ukraine in the international arena.** Ensure active participation of government officials at international events aiming to attract additional investors to the country by providing them with a necessary budget. Initiate a global media campaign to improve the country's image and circulate knowledge of Ukraine.