May 2005

THE BLEYZER FOUNDATION

UKRAINE: Short- and Medium-Term Economic Reforms

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Ukraine must implement expeditiously urgent economic reforms to accelerate economic growth and improve the quality of life of its population. For this purpose, Ukraine needs to increase the level of investments, both domestic and foreign. Increasing the level of foreign direct investments is also important for Ukraine not only to revive economic growth, but because it may be a key financing source for possible fiscal deficits in the near future.

A comprehensive study of SigmaBleyzer[1] identified the most important measures that a government can take to improve the business environment and attract foreign direct investments. The study reviewed 50 countries across the world and carried out statistical analyses to identify the policy measures that could have the greatest impact on the flows of FDIs. Through benchmarking, it also identified best practices in economic reforms in a number of successful developing countries. Also, a model was built to predict the flows of foreign direct investments that the country could receive based on the implementation of these key "policy" investment drivers. The study concluded that "first generation" reforms — macroeconomic stabilization, achieved by sound fiscal and monetary policies — are essential pre-conditions to achieving a favorable business climate and attracting foreign direct investments. But they are not sufficient to improve the business environment and achieve increases in international capital inflows. Within this macroeconomic framework, a number of "second generation" reforms are needed. Our benchmarking, statistical analyses and business surveys indicated that a significant portion of the variations in foreign direct investments in the group of 50 developing countries could be explained by nine economic policy drivers. Furthermore, studies showed that whereas there was a high correlation between the nine policy drivers and the flows of FDIs, there was also a low correlation between FDI flows and the "natural characteristics" of a country (e.g., geographical location, country size, population, etc.)

These key investment drivers were the following:

(i) Macroeconomic stability
(ii) Business liberalization and de-regulation policies
(iii) Stable and predictable legal environment
(iv) Corporate and Public Governance
(v) Liberalization of foreign trade and international capital movements
(vi) Healthy financial sector
(vii) Corruption minimization
(viii) Reducing political uncertainties
(ix) Expand country promotion and image building activities

[1] For more details see "Accelerating the Flow of International Private Capital to Ukraine" at www.sigmableyzer.com

In 1999, SigmaBleyzer initiated the International Private Capital Task Force (IPCTF) in Ukraine. Its objective was to benchmark transition economies to identify best practices in government policies that improve the investment climate and attract private capital. An Action Plan was developed and presented to the Ukrainian government which identified the economic policy actions necessary to improve the investment and business climate in Ukraine, attract additional flows of private capital to the country; support economic growth, and improve the quality of life for their citizens. In 2001, this effort was expanded to all countries of the FSU, and IPCTF ratings for all 15 countries of the FSU were developed. They are available from SigmaBleyzer and The Bleyzer Foundation.

The Bleyzer Foundation was established in 2001 in order to promote the IPCTF framework and help countries implement the policies necessary to successfully complete transitions to market economy.

The Foundation's Managing Director is Mr. Victor Gekker, who is supported by a team of economists and business analysts. The Advisory Board of The Bleyzer Foundation is chaired by Dr. Edilberto Segura and provides advice and guidance to the activities of the Foundation.

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Below we propose the economic reforms needed to accelerate investments, both domestic and foreign. These measures are divided into short-term (with quick payout) and long-term (needed to ensure sustainable investment inflow and economic growth in the future). All of the measures listed below are grouped in the order of the current priorities facing Ukraine.

1. Quick Payout Reforms to Attract Foreign Investments

The policy measures that may bring fast results in attracting inward investment into the country may be divided into the following groups.

The first group includes across-the-board measures that are equally important to all non-resident businessmen regardless the size and timing of their investments already made or just to be into Ukraine. These measures are necessary to improve the overall business environment in the country and will be beneficial for both resident and non-resident entrepreneurs that are already operating in the market.

The second group includes measures that should be implemented in order to attract large foreign investors to set up business in Ukraine.

The third group includes measures that should be implemented in order to attract small & medium foreign investors to Ukraine.

1.1. Across-the-Board Measures to Facilitate Foreign Investments

1.1.1. Perform Quick Deregulation and Liberalization of Business Activities (via implementation of the idea of the "regulatory guillotine mechanism"). The business environment can be markedly improved by quick deregulation through the adoption by the government of a regulatory guillotine process. The regulatory guillotine is a means of rapidly reviewing a large number of regulations, and eliminating those that are no longer needed without the need for lengthy and costly legal action on each regulation. It is clear, decisive, and fast. It can be used to create a comprehensive and central regulatory registry with positive security. Results could be achieved within a short period of time as the "guillotine date" may be set on September 30, 2005. In general, the guillotine works like this:

- The government instructs all government agencies to establish lists of their regulations by a certain date;
- As the lists are prepared (involving consultation with the private sector and oversight from a central body), unnecessary, outdated, and illegal rules are identified, and excluded from the list;

- A centralized list is created by adding all the ministries' lists together. When the deadline is reached, any regulation not on the list is automatically cancelled without further legal action (the guillotine drops);
- The list becomes a comprehensive registry of all regulations in force, and is recognized in law as the legal database of regulations for purposes of compliance;
- In the future, all new regulations and changes are entered in the registry within one day of adoption and/or publication. The registry should have legal security — no regulation not in the registry can be enforced against a business. A guillotine has been used successfully in a number of countries such as Sweden, Taiwan, Mexico, and Moldova to "clean the dirty pool" of existing regulations. The guillotine is effective because it places the burden on the regulatory agency (generally answerable to a ministry in Ukraine) to justify which current regulations should be retained, not which ones should be eliminated. Ukraine could implement any scope of guillotine it chooses through amending the current Law on Regulatory Policy in the Sphere of Economic Activity (RPL).

1.1.2. Eliminate Other Excessive Administrative Interventions on Business Activities. Excessive interventions of the government on businesses discourage investments as they make business activities more unpredictable. Some of these interventions — such as price controls — interfere with free market pricing and destroys business confidence. Others discourages investments, including NBU Resolution #482 (which requires the opening of multiple bank accounts and multiple foreign exchange conversions), and Article 65 of the State Budget (which mandates profit confiscations of companies with state shares). Furthermore, there are still a large number of inspections that companies need to deal with in the normal course of business. It is still cumbersome to register a new business in many areas of the country.

1.1.3. Enact Pending Legislation and Provide Stability to the Legal Environment. The government should appoint a Task Force to monitor and accelerate the processing and the enacting of draft laws and amendments that are now pending in the Rada, including the Join Stock Companies law (in a form that complies with OECD Corporate Governance Principles), the Administrative Court Procedure Code, the removal of conflicts between the Civil and Commercial Codes, and the removal of the recent extension of the Land Sale Moratorium. This Task Force should also provide recommendations to secure the stability and predictability of the legal environment, particularly by (i) ensuring consistency of new laws with the existing laws, (ii) better defining processes and responsibilities for drafting and reviewing new laws, and (iii) defining the required reform of the judiciary system to give it more autonomy and adequate financing and training.

1.1.4. Improve the Country's Image through Public Communications, Openness and Transparency. The government can increase confidence by making more periodic and regular communications with the population. Starting immediately, the new leaders should communicate directly to the country about the actions that the government is taking and the results achieved. These communications should be at least once a week in a specified evening of the week so that the population would look forward to them. Press Conferences should also be scheduled on a regular, periodic and predictable manner, such as on a given time on a specific day of the week. TV, radio and newspapers should be encouraged to attend these Press Conferences. In addition, Senior Government Official should participate in large Regional Seminars in the Oblasts to maintain a direct dialogue with public and obtain feedback about their views and concerns. Confidence can also be enhanced by increased transparency. For this purpose, the government should expeditiously pass legislation on "Free Access to Government Information" on any non-national security matter. Transparency in business should be improved by requiring all companies filing tax returns to prepare financial statements based on international accounting standards.

1.1.5. Clarify the Government's Policy on Privatization. The privatization process is stalled because of unresolved disputes on past privatizations and lack of a clear privatization strategy. There is a need to make a clear and concise public statement about the government's privatization strategy and policy. Unless promptly resolved, these issues are likely to hinder foreign investments for future privatizations.

1.1.6. Create Investment Promotion Agency. The government should immediately set up and staff a small Foreign Investment Agency that would promote Ukraine as an investment location, facilitate entry of large multinational companies and small & medium investors into Ukrainian market, and identify policy barriers to investments that the government should remove. The Agency may begin its work as a small team of highly skilled professionals that will coordinate the existing government capacities in investment promotion and later on a separately funded unit may be created. A cost- effective way of expanding investment promotion activities abroad is for the agency to involve embassies and consulates overseas. Many countries employ their diplomatic service for investment promotion purpose after a specific training performed for diplomatic staff in investment promotion and investor targeting. Also, a major international conference on FDI could be organized in Kiev or a key European country (Germany, UK) as soon as possible.

1.2 Additional Measures to Attract Large Investors

In order to attract major transnational corporations (TNCs) it is necessary develop a comprehensive investor targeting strategy that may employ a combination of a top-down approach (identifying large foreign investors) and bottom-up approach (offering opportunities in Ukraine).

1.2.1. Identify Transnational Corporations that are Planning Greenfield Projects in the Region. The strategy should include a through identification of large transnational companies that are currently considering or planning major investments in Central and Easter Europe, with a view to attract them to Ukraine. Special promotional campaigns should be elaborated for each targeted company to be followed by visits to the countries of origin to meet with key people of these specific TNC by high-ranked Ukrainian officials. To identify large potential investors, some countries have found it useful to use their existing network of embassies. In particular, such strategy was used by Israel's Investment Promotion Center (that had only 10 people of staff) over more than a decade.

1.2.2. Prepare a General Promotional Campaign to Induce Investors to Consider Ukraine as a Suitable Investment Location. A special program should be developed with an objective to reach un-identified investment decision-makers in TNCs and inform them of the unique opportunities in Ukraine. The campaign should explain why Ukraine is a better location than other economies in the region. The program should include specific promotion materials about the country, in-depth research analyzing the sector opportunities existing in the country in comparison with other countries in the region, prepare articles for international publications, arrange visits and meetings of government officials with representatives of TNCs to initiate the first visit of the country.

1.2.2. Identify Specific Sectors in Ukraine that could be of Interest to Large Investors. The Investment Promotion Agency should prepare or coordinate the preparation of in-depth sector reports that identify the existing investment niches or advantages in Ukraine. For instance, among Ukraine's advantages are its rich agricultural land that favors agro-industries; educated and low cost labor; location at strategic crossroads, large and rapidly growing domestic market. Investors need reliable and detailed information about the country and its opportunities. The list of specific sectors that may be targeted include high-tech (software development, bio-technology, telecommunications, agro-technology), agri-business, food processing, consumer services etc.

1.3 Additional Measures to Attract Small and Medium Investors

Unlike large TNCs, which have access to capital relatively easily and have a wide-ranging marketing network at their disposal, small & medium investors are interested in easy access to bank financing and to reliable information about the country.

1.3.1 Facilitate Access to Bank Credit. One of the most important things for small and medium investors to set up and develop business is an easy access to bank credits. At the current stage of development, Ukrainian banking system could not satisfy existing demand for loanable funds due to prohibitively high interest rates and poor system of credit risks assessment. Small and medium investors could not wait until the banking system will be developed enough to satisfy the investment needs of their growing businesses. Therefore, it is necessary for the government to launch a lending program aiming at provision medium and long debt financing for foreign equity investors that would be planning to come to Ukraine. For the implementation of this program the government should negotiate with international agencies (such as IFC and the European Bank) to provide large lines of credit to support potential foreign investors. Such lines of credit could be provided through a state-owned bank (for instance, UkrEximbank) or through a group of creditworthy commercial banks.

1.3.2. Provide Reliable Information About the Business Environment. Small and medium investors find difficult to obtain information about a country. This information includes data about the country, the economy, pertinent business laws, licensing and registration requirements, etc. An Investment Promotion Agency may perform this task via maintaining an Internet Home Page, preparing leaflets, brochures and articles in international periodicals, holding lectures and organizing seminars for prospective investors.

2. Long-Term Measures to Eliminate Barriers to FDI

In addition to short-term measures listed above, the following long-term reform measures are needed to attract foreign direct investments to Ukraine:

2.1 Sustainable Fiscal Deficits and Low Inflation in the Long-Term.

Fiscal deficits are of concern to investors because it is normally the main cause of inflationary pressures. High inflation discourages investments because it makes sales, cost and profits more uncertain and difficult to predict. For these reason, investors will require a much higher rate of return limiting the number of possible investments. A country experiencing high economic growth may afford fiscal deficit in excess of 2% — 3% of GDP but this may be done only in a few years. Otherwise public debt will increase, inflationary pressures would emerge and the economy would slow-down.

To address fiscal deficit concerns in 2005, the government took the correct measures to reduce the potential fiscal gaps, including elimination of tax exemptions and privileges, further formalization of the shadow economy, increases in excise taxes, dealing with corruption, etc. Nevertheless, the remaining fiscal deficit may still be large (the IMF and other institutions such as JP Morgan have estimated that the deficit could be as large as 4% to 5% of GDP). This remaining deficit will need to be financed either by debt or FDIs. But these solutions are unlikely to be satisfactory over the long term. Over the long term, the government will need to carry out a comprehensive audit of the public sector expenditures on order to make them compatible with a "reasonable" level of taxation and revenues. This audit should be made within the context of the execution of public administration reform, as noted below.

2.2 Implementing Fundamental Public Administration Reform

A reform of public administration sector is necessary to bring government expenditures more in line with revenues. Countries such as Canada found that only through a comprehensive public administration reform, fiscal budget deficits were brought under control. For 10 years, from 1985 to 1995, Canada tried to reduce fiscal deficits by adding some taxes and making budget cuts to individual ministries. But this just produced general unhappiness as the ministries had to provide the same function just with less money. The answer was in actually eliminating from the government a large number of unnecessary functions and transferring to the private sector or local authorities other functions. This was done by the execution of a comprehensive "audit" of government functions and activities. The government became smaller but stronger and more efficient in the areas that mattered most.

Public administration reform is also needed to ensure the successful and long-lasting implementation of administrative decisions and policy changes. Today, the inadequate government apparatus is one of the main constraints to the implementation of economic and social reforms. International experience suggests that without it, policy changes may not be implemented and if implemented, they may be reversed soon thereafter.

Public administration reform will include a re-definition of the roles and functions of the government, an improvement in its modus operandi, and a modernization of its civil service. In fact, the objective of public administration reform should be to redefine the role of the government to support the private sector. Un-necessary functions would be eliminated, saving budget resources. Other functions could be transferred to local administrations which may be given the possibility of raising their own budget funds. Other functions could be outsourced or commissioned to the private sector.

The reform should also recognize that in Ukraine, the size of the Central Government is small in terms of numbers of people. But there are an excessive number of central public agencies with unclear roles and overlapping responsibilities. There is therefore a need to define clearly the role of the Government at all levels. This role should change from excessive intervention in productive and semi-commercial activities to a role compatible with a market economy, particularly improving the environment for private sector investors and producers. According to the European Commission's annual study of civil service capacities in various states, with continuous progress, it will take Ukraine several years to meet European standards in public administration.

The government should start the reform by approving a plan of action for the implementation of the concept of administrative reform. The plan of action should take into account the experiences of other countries, which show that a comprehensive and drastic reform of public administration has a better chance of succeeding than piecemeal or incremental reform. The Plan of Action would contain the elements described in the Attachment to this note and should state specific timing to complete the Reform steps. A number of countries have a successful experience in reforming their public administration (such as Canada, New Zealand, and Ireland). Official bilateral contacts should be used to identify the possibility that those former government officials in countries such as Canada could be seconded to the Ukrainian government to provide guidance and experience in reforming the state administration.

2.3 Strengthen Monetary and Foreign Exchange Rates Policies.

The recent change in monetary policy — under which the NBU is no longer targeting foreign exchange stability — may be necessary to control inflationary pressures. However, an alternative monetary policy has not been clearly enunciated. If the policy were to be to move towards inflation targeting, the NBU will need to develop the capacity to perform open market operations, including the capacity to predict the statistical relationship between changes in the holdings of securities, money supply and inflation. The development of this capacity should be a priority task.

2.4 Trade Liberalization.

Ukraine is still a country with cumbersome policies and procedures for international trade. It needs to promptly achieve market-economy status in the US and the EU, achieve membership in the WTO and secure Free Trade Agreements with other regions. There are fears however that these important government goals may be delayed by lack of prompt actions.

2.5 Uncertainties in the Legal Environment and the Enforcement of Business Contracts.

The lack of a stable and predictable legal environment increases the cost and risk of doing business in Ukraine. Current legal uncertainties are of major concern to investors. Despite the enactment of the Law on the Judiciary, the Judiciary is still weak and its lack of independence makes its judgments more unpredictable. There is a need to develop a comprehensive program to strengthen the Judiciary and provide it with real autonomy.

ATTACHMENT: Modernization of Public Administration

A reform program to modernize public Administration should contain the following elements:

(A) Redefine the Role of the Government. A broad national consensus should be sought about the desirability to limit the role of the government to non-commercial activities and the provision of necessary "public" goods (goods that would not normally be undertaken by the private sector due to externalities) and market-oriented regulatory services. The main objective of the government should be to support private-sector led growth, not compete with the private sector.

(B) Undertake Functional Reviews. Based on a clear definition of the role of the government, there should be a "comprehensive audit" to review the roles, structure and decision making of each government department with a view to (a) eliminate current overlap of responsibilities, (b) devolve functions of policy implementation to line ministries, and (c) introduce a system of clear accountability. The functional review would also identify those public services that could be eliminated, subcontracted to the private sector, or decentralized to the Oblast or Rayon level.

(C) Undertake Operational Reviews. Once the functional reviews have been completed, operational reviews of all ministries and government agencies should be undertaken to simplify their internal decision-making processes, practices and procedures. The review would eliminate un-necessary regulations and licenses of business activities. Policy formulation and analysis should be separated from policy implementation so as to increase the effectiveness of the government decision-making process. Legislation and clear procedures should be established to improve transparency of government information. Continue improving procurement procedures to make them more competitive and transparent.

(D) Carry out a Civil Service Review. The aim of Civil Service Review is to upgrade the quality of government staff, including a clear certification system for personnel hiring, a clear linking of payment and advancement to good performance and fair but strict dismissal rules for civil servants. It would include the following: (a) introduce system of incentives for civil servants (review system of benefits to link it to performance); (b) a reduction in the number of civil servants while increasing the salaries of the remaining staff this should make civil servants less prone to rent-seeking (corrupt) behavior; (c) definition of the roles and process for monitoring performance for each operational unit and staff; (d) delegation of authority to managers to empower them; (e) introduction of effective training programs in order to increase civil servants' qualifications to EU standards; and (f) adoption of legal regulations and policy statements in order to improve management efficiency of enterprises in which the state is still a shareholder.

(E) Delegate More Power to Local Authorities. The objective of decentralization should be to bring decision-makers into closer contact with the intended beneficiaries who can exercise more direct control over performance. Functional reviews of central agencies should identify those public goods and services, provision of which may be decentralized to the regional and rayon levels. However, decentralization is one of the institutional reforms that may have the highest potential for failure. That is why, in order to succeed, decentralization should include: (a) a precise and clear definition of the functions, authorities and responsibilities transferred to local levels; (b) a clear identification of the local entities at the lowest possible level that would receive the delegated functions; and (c) the mechanisms to provide adequate financing, technical assistance, and management training to enable local agencies to effectively assume their new responsibilities.

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