Ukraine- Economic Development, Reforms, and Investment Climate

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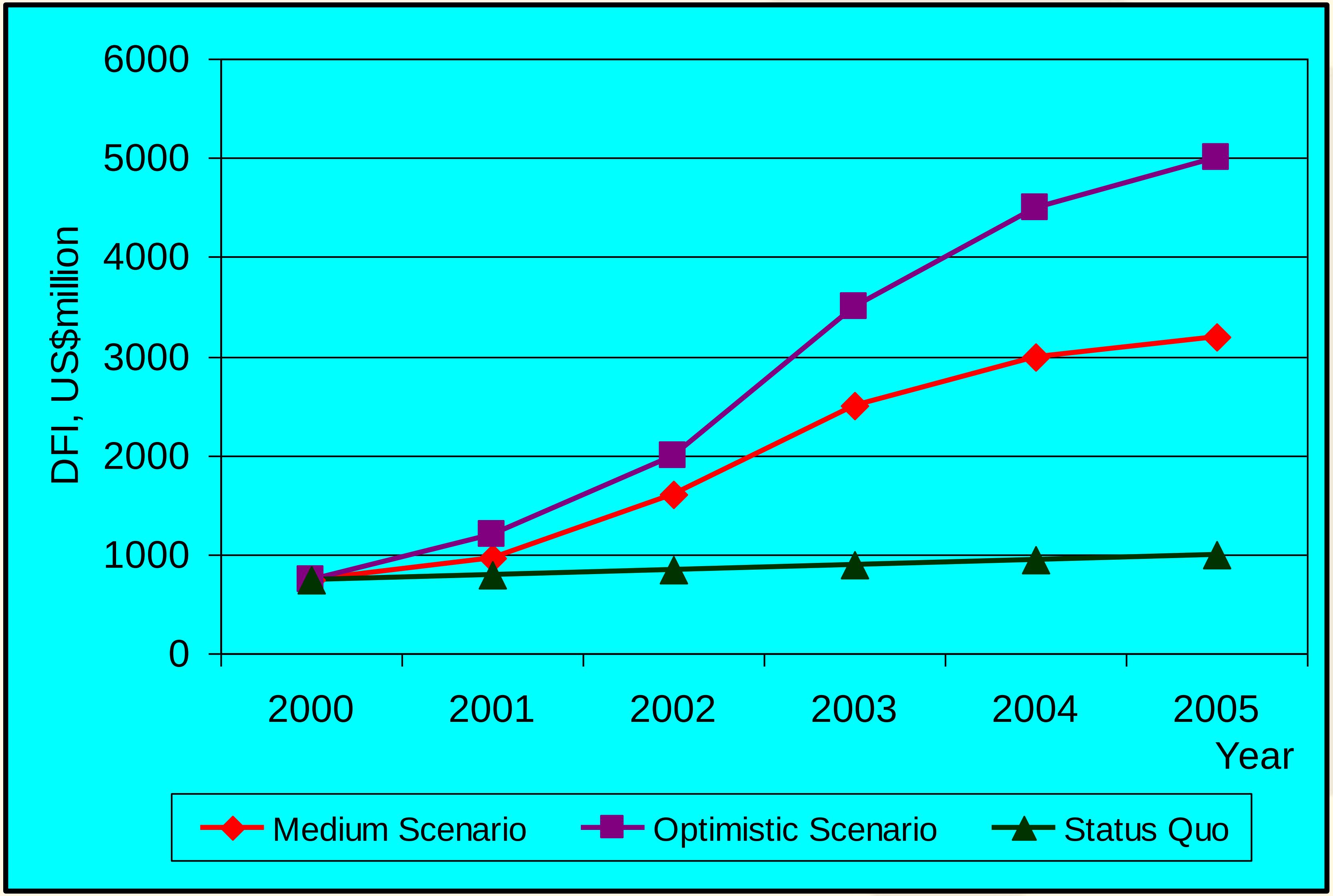
Identifying Investment Drivers

- In 1999, SigmaBleyzer launched its first effort to identify best practices in government policies to improve the investment climate, attract private capital, and spur economic growth.
- To supervise this effort, the International Private Capital Task Force (IPCTF) was established in 1999, which included the heads of large international companies and international agencies.
- Thunderbird Corporate Consulting Group was retained to build an econometric model of a transition economy, based on the key investment drivers identified through benchmarking of selected countries and statistical analysis of over 100 countries.
- Since 2000 SigmaBleyzer/The Bleyzer Foundation have continued developing the IPCTF framework, with the initial hiring of graduating Oxford MBAs and periodic investment surveys carried out in collaboration with the US Ukraine Business Council.

FDI For Ukraine- Possible Scenarios in 1999



Factors Affecting Investment Climate

- Ukraine's Investment Climate is driven by its ability to provide domestic and international companies with (a) minimum business risks and uncertainties and (b) opportunities to expand profitable businesses.
- Based on its studies and international experience, The Bleyzer Foundation defined nine factors or investment drivers covering these two categories.

A. Minimize Business Risks

1. Public Governance and Administration.
2. Legal and Judiciary Environment.
3. Anti-Corruption
4. Corporate Governance.
5. Political Risks and Country Image.

B. Opportunities to Expand Businesses by Removing Obstacles to Profitability:

6. Macroeconomic Stability.
7. Business Deregulation.
8. Cross-border Trade and Capital Movements.
9. Financial Sector.

Key Pending Reforms

Successive governments have taken steps to improve several of these drivers. But three key drivers not properly addressed are the following:

1. **Public Governance and Administration Reform**.
   - Current plans to reduce the size of the central government and decentralize will not be sufficient to improve governance.
   - International experience shows that a pre-condition for successful public reform is reaching a national consensus about the functions and role of the government: to support, not to compete with the private sector.
   - Reaching a national consensus requires broad national consultations on Constitutional changes to be followed by a national referendum.
   - Ideally, the central government should only be responsible for policy formulation, with implementation of government services and provision of public goods decentralized to local authorities.
   - Following changes in the Constitution, there will be a need to carry out reviews of government functions and programs across agencies, with a view to eliminate overlaps and those in conflict with the Constitution.

Key Pending Reforms

- This should be followed up by functional reviews within each agency to decentralize functions related to delivery of government services.
- Without deep horizontal and vertical functional changes, there will be conflictive and overlapping roles between the center and lower levels that will lead to chaos.
- Following these functional reviews, there is a need to improve government operations and procedures at all levels in order to deregulate, and to improve transparency, predictability and efficiency.
- Only when the role of the government has been redefined, the country should address the question of changes in the **Tax Code** and need to increase government revenues. International experience show that the above public reform will reduce expenditures to financeable levels particularly since the level of government revenues and taxes are already quite high (at 42% of GDP, compared to about 35% in most Eastern European and many OECD countries). Otherwise, taxes will just finance functions that the government should not be doing in the first place.

Key Pending Reforms

2. **Anti-Corruption.**

- There have been lots of talk about the need to address corruption.
- But efforts have been ad hoc, without a proper framework to be effective.
- Anti-corruption must have three elements:
  - (1) **Preventive measures** to reduce opportunities for corruption and make corruption more expensive;
  - (2) **Enforcement** of anti-corruption measures; and
  - (3) **Public support** elicited by greater transparency.

Very little has been done about **preventive measures** to minimize opportunities for corruption. Preventive measures require:

- – a more drastic reduction in the size of the government's bureaucracy in all ministries and agencies to minimize interference with businesses.
- – a total revamping of the court system and the separation of almost all prosecutors, judges and court officials, the majority of whom are corrupt.
- – a much deeper de-regulation to eliminate licenses and other opportunities by government officials to ask for bribes.

Key Pending Reforms

- the elimination of multiple prices, tariffs and rates which provide too much discretion to officials.
- elimination of all product subsidies, such as energy subsidies to eliminate re-commercialization at higher prices.
- the privatization of state enterprises whose managers are likely to seek rents for themselves.

Enforcement requires the insulation of the new anticorruption agencies from political pressures. The President should have nothing to do with the operations of these agencies or the appointment of officials. Otherwise, political interference will pop in. Furthermore, there must be an immediate increase in the number of corrupt oligarchs and corrupt officials that are put in jail. Otherwise, enforcement will have no credibility.

Public support requires a much better publication of government actions and much better transparency of government activities.

Key Pending Reforms

3. Political Risk.

- This investment driver needs to be addressed given the military situation in the East and South of Ukraine.
- There is a risk that pro-Russian sentiments in these regions may be further increased due to a great extend by disillusionment with the current pro-Western government that has done little for these populations in practical terms: There is still significant un-repaired damage to infrastructure, schools, health facilities, potable water, utilities, etc.
- This risk of disturbances and social tensions highlights the importance of implementing the concept of a comprehensive and large **Social Investment Fun**d in these regions, as outlined in the paper produced by SigmaBleyzer some months ago.
- International experience shows that the social investments are very effective in building confidence in the country and minimizing political risks.

Annex: Action Plan Driver 1

A. Minimize Business Risks

1. Public Governance and Administration. Efficiency of public administration, with capacity to resolve issues promptly, provide needed services/public goods, and with minimum interferences in business decisions.

- Redefine the role of the government based on national consensus
- Eliminate conflictive government roles and functions and transfer service delivery and policy implementation to decentralized bodies
- Improve government processes and procedures
- Privatize state enterprises that may be interfering in the market place
- Improve the stability/transparency of government policies
- Facilitate access to government officials to address problems
- Improve the professionalism and competence of Government officials
- Improve the adequacy and reduce the cost of transport infrastructure
- Ensure the timely and easy provision of utilities
- Improve the adequacy/cost of communications and IT

Annex: Action Plan Driver 2

2. Legal and Judiciary Environment. Adequacy and predictability in the Legal Environment, including the Judiciary, to protect companies' property ownership rights, and have fair and just settlements of disputes.

- Improve the predictability/adequacies of business laws
- Improve the protection of physical property rights
- Improve the protection of intellectual property rights
- Deal energetically with arbitrary, unfair and partiality of courts
- Avoid lengthy/costly settlement of contract disputes
- Improve the effectiveness of legal enforcement of judicial decisions

Annex: Action Plan Driver 3

3. Anti-Corruption. Combating energetically administrative and private corruption (including prevention, enforcement and public support) to minimize seizure of company's funds and arbitrary administrative decisions on company matters.

- Undertake corruption prevention measures to reduce opportunities for corruption while making it more costly
- Eliminate administrative corruption by Government officials who require extra payments and bribes.
- Ensure that the anti-corruption agency is fully independent
- Deal energetically with corruption in the Judiciary and Courts to eliminate biased settlements
- Deal with private business corruption and corporate raiding
- Improve the adequate anti-corruption enforcement & support
- Deal with cases of vandalism, crime and public/business safety

Annex: Action Plan Driver 4

4. Political Risks and Country Image. Reduced Political Risks to minimize sudden changes in business conditions, and improve Country Image to attract capital and facilitate exit operations

- Improve the stability of the political system, without excessive rotation of officials
- Reduce the prospects of social unrests due to war or to highly uneven income distribution, particularly by implementing a broad Social Investment Fund that would satisfy the needs of vulnerable local communities
- Minimize the risk of expropriations/nationalizations
- Improve the country’s image that hampers doing business

Annex: Action Plan Driver 5

5. Corporate Governance. Efficiency of Corporate Governance, to ensure that shareholders rights are not violated by their own company's management or boards. Adequacy of legislation on Corporate Governance.

- For listed enterprises, improve the disclose of major board decisions and directors' liability for them
- Improve the transparency of information to public
- Avoid difficulties in suing management/board
- Improve regulations regarding corporate governance laws/regulations
- Address unethical behaviour of firms

Annex: Action Plan Driver 6

B. Opportunities to Expand Businesses by Removing Obstacles to Profitability:

6. Macroeconomic Stability. Consistent macroeconomic stability minimizes capital and operating losses caused by fluctuations in exchange rates and domestic prices. This requires sound fiscal and monetary policies, without excessive tax costs.

- Reduce excessive domestic price inflation
- Reduce excessive FX Hryvnia devaluation
- Improve prospects for future inflation/ devaluation
- Reduce the current high level of government expenditures (42% of GDP) to comparable levels in Eastern Europe (about 35% of GDP)
- Consistent with reductions in government expenditures, reduce excessive business & payroll taxes to improve competitiveness
- Simplify cumbersome tax administration and compliance

Annex: Action Plan Driver 7

7. Business Deregulation. Ability to operate without excessive government regulations which increase costs and reduces profits. This requires liberalization of business to enhance market competition and provide freedom to start up, operate, or close a firm.

- Simplify cumbersome regulations to start and register a firm and to obtain construction and other licenses
- Reduce excessive regulations for business operations, including excessive government agency inspections/controls
- Facilitate the processes of bankruptcy and closing a business
- Eliminate unfair market competition principally by government-supported firms
- Increase the availability of qualified labour at low wage costs
- Facilitate the processes of hiring or firing workers

Annex: Action Plan Driver 8

8. Cross-border Trade and Capital Movements. Ability to export goods easily and to import equipment and raw materials freely. Ability to invest easily in the country with minimum impediments and repatriate capital and profits freely.

- Reduce excessive documentation, time and cost to export freely with adequate institutional support
- Reduce excessive/costly import tariffs and barriers
- Simplify and reduce costs of customs procedures
- Facilitate the movement of funds in and out of the country
- Simplify the procedures to obtain foreign exchange

Annex: Action Plan Driver 9

9. Financial Sector. Ability to secure reasonable domestic financing that may be needed for working capital, trade and long term investments. This requires major improvements in the banking sector and capital market institutions and instruments.

- Eliminate difficulties in obtaining working capital financing
- Eliminate difficulties in securing long term loans
- Reduce excessively high interest rates
- Improve the ability of capital markets to issue short and long term securities