

UKRAINE - Priority Economic Reforms

A. REFORMED PUBLIC ADMINISTRATION AS A CORNER STONE OF SUCCESSFUL ECONOMIC REFORMS

The newly formed government must start with reforming itself into an administration that is capable of designing and implementing economic policy efficiently.

Ukraine's current government structure retains many of the problems inherited from the former Soviet Union, including cumbersome decision-making, bureaucracy, and unclear responsibilities among government agencies. The existing system of developing, passing and implementing economic policies stalls implementation of economic reforms that would improve the country's business environment.

Without transforming the way government agencies presently work, it is likely that numerous obstacles to investment listed below in this paper will be removed very slowly or will be quickly reversed or substituted by new regulations. On the contrary, if well done, public administration reform will stimulate fast implementation of other reforms, make the public sector less prone to corruption and red-tape, and improve the country's image, thereby putting the country on a different path, on an accelerated course to attract investment and faster development and growth. Public administration will become a facilitator rather than an obstacle to implementation of other economic reforms.

The reform of public administration is an undoubtedly ambitious task that will require strong will, a long time and consolidation of various forces. But this is the key reform that is absolutely necessary to facilitate and make possible the implementation of all other economic and social reforms needed to revive investment in the country.

Moreover, with changes to the Constitution that give more chances for the new Cabinet of Ministers to find support in Parliament and to stay in office longer than its predecessors it is now unique time to embark on public administration reform.

The limited success of previous governments to implement economic reforms that could improve the country's business environment and investment climate was primarily due to the dysfunctionality of the existing system of developing, passing and implementing economic policies. A legacy of the communist past, Ukraine's current government structure is plagued with corruption, bureaucracy, and vested interests. Decision-making is quite cumbersome, with unclear responsibilities among government agencies. Even minor decisions require a large number of consultations and approvals. Due to low salaries, public servants are faced with the difficult choice

between doing their job impartially, and surviving on rather low official salaries, or engaging in corrupt activities. The public sector has become a bottleneck to the country's development, particularly by delaying the implementation of economic reforms.

The success of public administration reform will require perseverance of the top officials and strong support on the part of the business community and civil society. If both sides comprehend the benefits of efficient, transparent and uncorrupted government, strong ties prevailing between political factions and local business community will facilitate rather than impede implementation of the reform.

Some Ukrainian corporations have already realized the benefits of transparency while materializing their ambitions to enter international markets. Local businesses are now on the verge of welcoming the creation of a level playing field, in which neither they nor their competitors will be able to operate under specifically designed privileges, in which both they and their competitors will be protected from unequal treatment, and in which no resources will be wasted for lobbying. At this point, a strong strategic vision of the Ukrainian government on improving its capacity to implement economic reforms necessary to create a level playing field will be particularly welcomed.

The reform of public administration is a lengthy process with many stages. The government should start the reform by approving a plan of action for implementing the concept of administrative reform. The plan of action should take into account the experiences of other countries, which shows that a comprehensive and drastic reform of public administration has a better chance of succeeding than piecemeal or incremental reform. A number of countries have experienced success in reforming their public administration (such as Canada, New Zealand, Poland, 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.

The reform agenda should include the following components:

1. Redefine the Role of the Government to Support Private Sector Activities

As a first initial step to reform the public sector, there is a need to clearly define the main objectives and role of the government. The role of the government will not be to compete with the private sector in revenue generating activities, but to support the private sector by creating a friendly environment for its activities. The government role shall be based on the premise that productive and revenue generating activities will be carried out essentially by the private sector in a free and competitive market environment. The government will deliver essential services that are not normally provided by the private sector, such as: infrastructure services, non-commercial activities in education, health and environment, protection of the poor, market-oriented regulations of trade, communications, labour and other private sector activities, law enforcement, foreign affairs, national security and defence, and similar non-commercial activities.

This clear definition of the role of the government should discourage some of the recent previous government “initiatives” such as the creation of new state enterprises to “complement” the private sector in such markets as oil refining, titanium production, grain distribution, etc. It would also discourage excessive intervention on the part of the government in business affairs. Some aspects of this intervention (such as price controls) interfere with free market pricing and destroy business confidence, which discourages investment.

2. Increase Public Transparency and Access to Government Information

As a second step in the reform of the public sector, the government should quickly make government information more transparent and available to the public, except for information, which is sensitive for national security reasons. This can be achieved by expeditiously passing legislation on Free Access to Government Information on any non-national security matter. Public procurement procedures should also be made more transparent.

Improving information transparency and openness will also be an important weapon to combat corruption, which is a major cause of irregularities in public sector behaviour. Information disclosure should also aim at building popular support -- among businesses, unions, students, the press, and the civil service -- for policy reform and for the role of the Government.

3. Undertake Functional, Operational and Civil Service Reviews

As a third step, there should be a comprehensive review of the public sector activities should be performed at the third step. A complete “audit” of all public sector functions, operations and activities shall be carried out in order to identify functions or programs that do not serve the public interest and to detect areas where responsibilities overlap. Unnecessary or irrelevant functions of the central government should be eliminated; others should be transferred to the private sector; and others should be decentralized to local authorities.

The review shall also analyse the day-to-day activity of state agencies and the qualifications of government staff in order to streamline the decision-making process, which is currently burdensome and time-consuming, and upgrade the quality of civil service. In general, the comprehensive review can be performed in three stages:

- The objective of the functional review would be to identify the central government’s core roles and responsibilities and allocate resources to priority areas in order to provide effective, affordable government. This will include (i) establishing information exchange and interaction between secretariats of the President of Ukraine and the Cabinet of Ministers of Ukraine with further minimization of duplication of functions (ii) organizing ministries along “functional” lines rather than by branch or sector, (ii) consolidating and reducing

the number of ministries and state agencies to minimize duplication, avoid overlapping responsibilities and introduce a system of clear accountability, (iv) clear differentiating functions of regular civil servants and politicians with their aids hired as the patronage service (v) streamlining the current collective process for decision making that requires multiple signatures for most matters by transferring most decision-making power to single line ministries, etc.

- Once the functional reviews have been completed and new organizational set ups established, operational reviews of all ministries and government agencies should be undertaken to simplify their modus operandi, including improvements in internal processes, practices and procedures. In particular, the review would eliminate un-necessary regulations and licenses of business activities. In order to increase the effectiveness of the government decision-making process, policy formulation and analysis should be separated from policy implementation.
- Civil service review would aim to upgrade the quality of personnel. This can be achieved through differentiating between regular civil servants and politicians with their aids hired as the patronage service, reducing the number of civil servants while increasing the salaries of the remaining staff, introducing effective training programs in order to bring civil servants' qualifications closer to EU standards and introducing a system of incentives discussed in below more in more details. These measures should make civil servants less prone to selfseeking (corrupt) behaviour.

4. Introduce Effective “Incentives” and “Control” system

The core of the public administration reform is the creation of an enabling institutional environment in the public sector based on “incentives” and “control” system that would lead public servants to carry out government functions in an effective manner. The “incentives” and “control” system for the public sector should be designed in the image and likeness of the system that naturally works in the private sector. In the private sector free prices and free trade allow firms to seek profits, thus creating an incentive for businesses. Control is performed by the presence of competition: those that do not improve their efficiency and seek continuous improvements to satisfy their clients will be tossed out of the market through bankruptcy. A similar system should be introduced in the public sector in the process of implementing a comprehensive public administration reform.

International experience suggests that an effective way to introduce an incentives system is to develop the concept of “programs” (or “projects”) accompanied by the performance-based budgeting, management and reporting. The most important characteristic of a program is its emphasis on the desired output rather than on the logic of production. As long as the objective of the program together with the actions and resources necessary to achieve this objective are clearly defined, it will be possible to undertake the cost-benefits analysis of the program and to evaluate the rationality of its implementation. Apart from this, it will be possible to define, measure, and monitor performance indicators and assess performance of the agency,

department, or team of public servants responsible for its implementation. This will allow introducing the performance-based budgeting, management and reporting as the backbone of public administration functioning.

Within the described framework, adequate compensation of state servants linked to performance will be the main ingredient of the incentive system. To motivate performance, a key measure will be to link a substantial part of the compensation (about 20%-30% for most personnel) to the achievement of objectives of the program or a part thereof. As for now, the salaries of civil servants not only fail to reflect individual performance but also are formed in an opaque manner with high emphasis given to bonuses and pay increments as compared to the base salary. Non-monetary incentives should also be enhanced; in particular, the perceived stature and professionalism of government employment should be strengthened by involving employees in setting objectives and working out programs, and by providing them with sufficient autonomy and accountability to produce the expected outcomes.

To introduce a control mechanism similar to one that operates in the private sector a set of laws and regulations will be needed. These regulations should allow for the “competitive” environment for public agencies, their behaviour, and the way of conducting business. Greater competition can be achieved by establishing more than one government agency for providing a particular service (e.g., competition between district Sanitation and Epidemiology Stations, regional Scientific and Technical Centres for Labour Protection). Importantly, departments that provide such public services should not act as the authorities that establish rules or control their execution. Competition over funding among such providers will keep them under continuous pressure to seek more efficient and effective ways of reaching the defined objectives. The control mechanism should also include measures to improve information for accountability. Public institutions normally are not subject to the test of the marketplace to evaluate performance and ensure accountability. In the absence of a market test, transparency and openness of information and public processes are the best ways to ensure accountability.

5. Coordination of specialized government institutions responsible for promotion of investment activity in Ukraine

The mission of the state investment policy is not only to create a favourable investment climate but also attract investors, encourage their business activity and provide post-investment services. The experience of many transitional economies demonstrates an importance of creating a country’s positive image, providing objective information about its economic capabilities as well as analytical, legal and organizational support to potential investors.

Up till now, Ukraine had no specialized institutions specializing in these issues. Last year, however, the State Centre for Foreign Investment Promotion within the Ministry of Economy, the State Agency for Investment and Innovation, and the National Council for Investment and Innovation under the President of Ukraine were established, and the Foreign Investment Advisory Council intensified its activities.

These developments testify the fact that improvement of the investment climate has been a priority of the government economic policy. However, having several institutions that deal with similar issues could disorient potential investors. Their respective functions and responsibilities should therefore be clearly distinguished.

B. OTHER KEY ECONOMIC REFORMS TO IMPROVE THE INVESTMENT CLIMATE

Along with the comprehensive public administration reform there is a number of another key measures that can substantially improve the investment climate in the country. It is very important to emphasize here that even promising initiatives aimed at improving the business environment may fail, if the incentives system of public servants is not changed, as is the case, for example, with the recent attempts by Ukrainian authorities to deregulate business activity. Thus, it is extremely important to undertake a comprehensive approach to reforms, recognizing that the key measures to improve the investment climate should be performed hand in hand with the reform of public administration.

1. Improve the Predictability and Stability of the Legal Framework

Establishing a transparent, stable and fair national legal system is essential to attracting stable flow of foreign investment in Ukraine.

The lack of a stable and predictable legal environment increases the cost and risk of doing business in Ukraine. The deficiencies of the legal framework create obstacles to foreign firms that already started their businesses in Ukraine and strongly discourage those willing to come. The major points of concern are not only multitudinous ambiguities and inconsistencies in the existing legislative acts, but also radical changes in the legislation that could appear overnight, poor implementation of adopted laws into practice and ineffective law enforcement, the latter stemming from weak and corrupted judiciary.

There are three major areas of concern, the improvement of which will make the overall legislative environment much healthier:

1. Inconsistencies in current legislation

There is a tremendous number of ambiguities, inconsistencies and explicit contradictions in the current legislation. The most glaring example is the presence conflicts between provisions of the Commercial and Civil Codes, the two legislative acts that constitute a basis of the whole legal system. Although adopted only a few years ago, the Commercial Code embodies concepts that contradict the principles of a market-economy. The major problems with the Code are described in detail in Section IV of this report. The conflicts and inconsistencies between the two Codes are so numerous that it hardly possible to bring them into compliance with each other

through adopting amendments. Hence, removal of the uncertainty generated by the conflicting Codes would be possible only by eliminating the Commercial Code and passing some of its provisions to the Civil Code and other respective legislative acts. There are plenty of other problems with the existing legislation, remains a substantial impediment to investment, although improvement has been achieved in some spheres. The ambiguous definitions and conflicting provisions in certain spheres still create an uncertainty and increase the costs and risks of doing business.

Thus, there is an urgent need to review the existing legislation and eliminate gaps, inconsistencies and ambiguities. To do this the government should appoint a Task Force of qualified legal experts. Undoubtedly, the revision may take years given the number of laws passed by the Rada, Resolutions of the Cabinet of Ministers, Presidential Decrees and regulations issued by other state authorities. This process can be more efficient if the Task Force concentrates on a set of issues that create the largest problem for local and foreign businesses and tackles them first. Flaws in Ukraine's legislation discussed throughout this paper may perfectly serves as basis for compiling a list of priority assignments for the Task Force.

2. Procedure of drafting laws

The presence of a large number of deficiencies in the legislation signals that Ukraine has serious problems with the way it enacts laws. Eliminating existing inconsistencies in the laws will be only a short-term relief, if the system of drafting laws is not reformed. As a matter of fact, the laws are often amended and changed many times as a result of shifts in the political situation in the country or at the behest of certain business groups with very little or no attention paid to how well these changes interact or how badly they contradict to the existing legislation. Such legislative instability often creates a great deal of uncertainty among local and foreign businesses alike. On top of this, little effort is made to secure proper implementation of the laws and other regulations. Insufficient level of analysis on the resources redistribution caused by the law (workload, finance, etc.) and lack of attention to potential difficulties with interpreting and using the law by judges and lawyers are at the root of this problem.

As a short-term solution to this problem, the government should appoint a Task Force that will be responsible for:

- ensuring consistency of new laws with the existing laws,
- better defining processes and responsibilities for drafting and reviewing new laws and regulations,
- ensuring that enough effort is made to secure proper implementation of the laws.

3. Weak judiciary

The judiciary is a key element to ensure protections of investors' rights provided in certain laws. Despite the enactment of the *Law of Ukraine On the Judiciary*, the judiciary in Ukraine is still weak and lacks independence, remaining a major stumbling block in establishing proper legislative framework. Another serious

concern is poor enforcement of court decisions.

Extremely low financing of the courts leaves judges vulnerable to demands from different government bodies, local authorities, and even utilities suppliers. As a consequence of continued under-financing, courts are largely understaffed. This situation has made the judiciary system desperate for new employees, and has resulted in under-qualified personnel being hired to fill the vacant positions. Also, the judges are often insufficiently qualified to resolve some modern issues in corporate law, taxation, bankruptcy, and intellectual property.

Measures should be announced to strengthen the Judiciary, including the development of concrete action plans. In particular, the government should provide adequate funds to the Judiciary to raise salaries, train judges, encourage systematization and improvement of quality of recommendations of the higher courts, develop legal data bases, and facilitate court actions. It is also important that starting from the state level a respective culture to perceive the court as a powerful, just and absolutely independent institution is being formed.

2. Continue Regulatory Reform and Liberalization of Business Activities

The existing regulatory environment for business is a significant barrier for local and foreign firms.

Although in 2005 Ukrainian authorities made noticeable progress in addressing the issue of reforming the regulatory environment for business, more work needs to be done. There is often poor law enforcement and disinterest on the part of local authorities in altering the current regulatory framework. This corroborates the necessity of changing the incentives system of public servants, who currently find it more attractive to keep the numerous permits in place rather than abolishing them. Notwithstanding the success of the steps taken during the past year, efforts to liberalize business activity by implementing regulatory reform should be continued, since streamlining the procedures of starting and finishing business, reducing number of licenses and permits, making the system of inspections clear, simple and transparent are among of the key conditions for attracting foreign investors. What happened with the promising 2005 initiatives?

In 2005, Ukrainian authorities undertook two important steps aimed at improving business environment. First, the *Law on Business Permit System* that sets forth fundamental principles of state policy in the sphere of business permitting was adopted by the Verkhovna Rada. The law simplifies the permitting procedure, prescribes the administrative liability of government officials for breaking the procedure and introduces European principles of issuing permit documents. Another initiative was an accelerated review of regulatory acts at the local and national level to ensure that they were business friendly and consistent with the *Law of Ukraine on Fundamentals of the State Regulatory Policy in the Sphere of Economic Activity*, the so called “quick deregulation initiative”. It aimed at revising over a short-period of time all existing documents that regulate business activity with the purpose to abolish

unnecessary acts and bring the rest into conformity with the principles of the state regulatory policy.

The *Law on Business Permit System* is being implemented very slowly. Most strikingly, government agencies are not complying with the law thereby stalling its implementation. National and local authorities seem unwilling to prepare supplementary documents stipulated by the Law regarding, for example, reduction of the number and costs of paid services provided by state agencies or cancellation of normative acts that establish necessity to receive permits that are not stipulated by the laws of Ukraine.

The Cabinet of Ministers of Ukraine was supposed to conduct legislative monitoring in order to determine the expediency to require certain permits and submit to the Verkhovna Rada bills on abolition of inexpedient permits 6 months after the publication of the *Law of Ukraine On Business Permit System* but has not yet done it. Furthermore, bills on amendments to the Laws of Ukraine *On Fire Safety*, *On Veterinary Medicine*, *On Ensuring Sanitary and Epidemiological Welfare of Population*, *On Labour Protection*, and other branch laws that establish permits had to be submitted to Verkhovna Rada by April 5, 2006 to ensure implementation of the *Law of Ukraine On Business Permit System*.

Today the responsible committee of the Verkhovna Rada prepared a *Bill On Amendments to Certain Legislative Acts of Ukraine with regard to Compliance with the Law of Ukraine on Business Permit System* that stipulates amendments to the laws of Ukraine *On Fire Safety*, *On Veterinary Medicine*, *On Ensuring Sanitary and Epidemiological Welfare of Population*, *On Labour Protection*, *On Safety and Quality of Foodstuffs*, and the Decree of the Cabinet of Ministers of Ukraine *On Local Taxes and Duties*, which significantly improves starting new business conditions, particularly stipulating application of self-declaration principle for large number of business entities. We recommend to the President of Ukraine and to the Cabinet of Ministers of Ukraine to define this bill as expedient and urgent.

Besides, as a result of the first phase of quick deregulation initiative undertaken in 2005, 9,340 regulations were reviewed and 5,184 (55.5%) were found to be inconsistent with the *Law of Ukraine on Fundamentals of the State Regulatory Policy in the Sphere of Economic Activity* and 4,940 of them were amended or repealed by December 31, 2005. In addition, 66 Presidential Decrees were found to be inconsistent with principles of state regulatory policy and, though nothing has been done to date, all of them should be repealed. At the municipal level (local selfgovernment bodies), 5,386 local regulations were reviewed and authorities have repealed or amended 1,358 of the 1,750 (32.5%) identified as inconsistent with principles of state regulatory policy. This effort was a positive step to clearing away Ukraine's regulatory underbrush.

The President and Government of Ukraine adopted several documents which established deadlines for a second phase of quick deregulation (Presidential Decrees No. 901/205 dated 06/01/05, No. 1648/2005 dated 11/24/2005, and Resolution of the

Cabinet of Ministers No. 391-r dated 09/08/2005). The second phase is sector-oriented to allow for identification and elimination or amendment of those problematic laws and regulations which continue to impede business growth in specific sectors and in the economy as a whole. Experience from countries which have successfully reformed their regulatory environment supports the importance of the second phase for the creation of a significantly better business environment. Unfortunately, authorities are not properly following through on what could be a very important milestone on Ukraine's road to creating a more competitive business environment.

We encourage the government to effectively implement:

- The *Law of Ukraine on Fundamentals of the State Regulatory Policy in the Sphere of Economic Activity*;
- The *Law On Business Permit System*;
- The second phase of the quick deregulation strategy.

There are many other issues except for those already attempted to be tackled by the government that impede investment in Ukraine. Future initiatives in the sphere of business deregulation should touch upon:

• **Licensing**

Although the overall level of legal support of licensing is on an appropriate level, the major problems in this sphere are related to unclear procedures while applying for necessary licenses, a large number of the documents required for submissions, and frequent changes in the respective legislations. All these problems create misunderstandings among the private businesses.

• **Inspections**

Inspections are one of the main regulatory obstacles for business development in Ukraine. The annual number of inspections conducted throughout the country by different controlling bodies exceeds 1.5 million. More than 91,000 of state employed workers are constantly working in the sphere of inspections, which costs the government around UAH 637 million. According to a recent study, 57% of the private businesses in the country believe that the procedures for fulfilling inspections are unclear, complicated, and non-transparent.

The system of inspections existing in Ukraine does not fulfil its main function of preventing abuses of law and mainly serves a punitive function. This practice, on the one hand, helps to increase revenues of government agencies, and, on the other hand, negatively affects private businesses. There is a clear need that a new approach to inspections should be developed. It should address several important issues: In order to solve the aforementioned problems it is expedient to finish up and pass to the Verkhovna Rada the bill On State Supervision and Control and Protection of Entrepreneurs Rights discussed within the State Committee for Regulatory Policy and

Entrepreneurship and the Entrepreneurs' Council under the Cabinet of Ministers of Ukraine. The bill should include the following provisions:

1. Implementation of risk management, according to which scheduling actions of state control and supervision is made with account to type and nature of business activity, results of previous inspections, level of hazard to life and health of population as well as to the environment resulting from business activity.

2. Detailed rules of the procedure of state supervision and control should include the following conditions:

- State supervision and control should be conducted by officials accordingly to the check lists done by each agency of state supervision and control for each group of business entities, taking into consideration hazard for life and health of population as well as for the environment resulting from business activity. A check list should be provided to an entrepreneur along with notification of the forthcoming action of state supervision and control.
- Conducting state supervision and control on the basis of state identification document for officials who conduct state supervision and control.
- The right of an entrepreneur to have a journal of actions of state supervision and control along with the liability of government officials to make records on actions of state supervision and control.
- The right of government officials to carry out state supervision and control should be conditional on written notification of entrepreneur about it.

3. Conducting state supervision and control in the form of scheduled, unscheduled and repeating measures (inspections, investigations, audits.)

4. The time limits of conducting state supervision should be determined depending on the type of supervision (scheduled, unscheduled or repeating) and the size of the inspected business.

5. Damage caused to an enterprise by illegal actions of government officials must be reimbursed on the ground of court decision and at the expense of the state budget funds.

6. State supervision and control authorities must publish schedules of measures to be taken and amendments to them. State supervision and control authorities must consult entrepreneurs on a free of charge basis upon receipt of a written request on the issues of state supervision and control.

3. Improve Corporate Governance and Protect Shareholders Rights

Inefficient corporate governance legislation and especially poor protection of shareholders rights discourage foreign firms from investing in Ukraine.

Over recent years the Ukrainian authorities have been actively introducing new rules to regulate the creation and operation of joint stock companies. However, the country

still suffers from many serious problems in the area of corporate governance, mainly due to inefficient legislation. Loopholes in current legislation allow for the non-disclosure of information, insider trading, asset stripping, dilution of shares, and voting fraud, to name a few. Also, the issue of minority shareholders' rights is not sufficiently regulated, which virtually allows majority stake holders to exercise unlimited control over the company with no regard to other owners' needs.

A straightforward and efficient solution to many corporate government problems would be the enactment of the Joint Stock Company Law that complies with international standards. In particular, the Law should include provisions that would (i) either clearly state the differences between closed and opened companies or eliminate the distinction; (ii) define the role and responsibilities of the board of directors; (iii) introduce cumulative voting; (iv) facilitate the settlement of shareholders disputes; (v) improve protection of minority shareholders; (vi) define the rights and obligations of common and preferred stock shareholders; and (vii) define clear requirements on disclosure of information. The bill that incorporates many of these principles has been approved by the Cabinet of Ministers at the end of 2005, but failed to pass the Verkhovna Rada. Thus, the important task of the new Parliament and Government will be to accelerate enactment of the Joint Stock Company Law in a form that complies with international standards.

Non-transparency of joint stock companies is an important impediment for foreign investors. To acquire a part of a company and invest in its assets, foreign firms need to know how healthy the company is, who the owners and majors customers/suppliers are, and what the financial position of the company is. All this information is rarely publicly available and cannot be found out easily. Adjustment of the Ukrainian accounting standards to international standards and enactment of stringent rules for ownership structure disclosure will increase transparency of private businesses.

4. Continue Liberalization of Cross-border Movements of Goods and Capital

Liberal trade regime and soft capital control will attract efficiency-seeking investors, who will start-up production in Ukraine to sell output outside as well as inside the country.

Although Ukraine has one of the largest domestic markets in the region, the size of the market in terms of purchasing power is still far below that of the EU. At the same time, relatively low wages (compared to the EU standards) and qualified labour make the country very attractive for efficiency-seeking investors, those who wish to start-up production in Ukraine in order to sell output internationally. However, these investors are discouraged by the opaque and often corrupt customs procedures and strict capital controls that nullify all the efficiency of low production costs.

There are many currency regulations and customs procedures that hinder development of foreign businesses. It shall be recognized here that Ukraine introduced strict capital control in order avoid capital flight that could endanger the economic stability of the country. This policy is by no means challenged in this

report, as it is considered fully rational. However, the point of concern is that some regulations are phrased in an imprecise way and could be interpreted so broadly as to have a negative effect on all transactions including those that are not related to currency outflows. Thus, there is room for fine-tuning current regulations so that they would continue to prevent capital flight, but would not discourage foreign investors.

Apart from amending the regulatory acts, there is a list of other measures that should be undertaken in order to attract efficiency-seeking investors:

- To promote establishing a Free Trade Area with the EU. Elimination of trade barriers with the largest trade partner will promote Ukraine's exports and attract investors from European countries
- To ensure entry into the WTO as soon as possible; for this, enact necessary pending legislation and sign protocols on mutual market access with the remaining countries in order to pave the way for WTO entry
- To continue streamlining customs procedures and formalities to ensure prompt consideration and to avoid opportunities for self-seeking conduct
- To soften export restrictions; in particular, eliminate corruption and rentseeking activities in VAT reimbursement and ensure timely and accurate refund of VAT to exporters
- To eliminate import non-tariff import restrictions that often function through licensing, standards and certifications, sluggish performance of government agencies, etc.
- To ease and to gradually transit to a voluntary the system of certification and standardization to acknowledge international standards and certificates for quality, safety, etc.

5. Strengthen the Financial Sector

Easy access to bank credits and other sources of financing is essential for small and medium-size investors.

One of the most important things for small and medium investors to set up and develop business is an easy access to financing. At the current stage of development, bank crediting is the most widespread source of firms' financing in Ukraine, but it cannot satisfy the existing need in loanable funds due to high interest rates and short maturity. Other alternatives for raising capital, such as issue of corporate bonds or public offerings, are rare due to the underdevelopment of financial markets. Although the Ukrainian banking system is well-developed, it cannot satisfy the existing demand for loanable funds due to high interest rates and short maturity of the disbursed loans. In addition, the stability of the sector is undermined by insufficient capitalization, high share of non-performing loans, and intensive related-party lending

the latter related to non-disclosure of banks' owners.

Other sources of financing business are rarely available due to lack of institutions that accumulate "long-term" money. Typically, insurance companies (especially involved in life-insurance) and pension funds are those financial intermediaries that gather domestic savings and provide them to firms in exchange of corporate bonds or stocks. Yet, in Ukraine's realities insurance companies are often used as tax shelters or means of transferring money abroad. The private pension funds, introduced in 2003 in a framework of pension system reform, remain largely unknown to the public and too weak to attract substantial savings. At the same time, the state Accumulation Pension Fund envisaged by the reform to accumulate pension contribution paid by employees and to invest them into assets has not been introduced yet.

The key steps to improving firms' access to financing will be (i) to strengthen the banking sector and (ii) promote development of non-bank financial institutions.

In particular, for strengthening banking sector it is recommended to:

- To encourage the participation of foreign banks to promote competition that will force domestic banks to reduce interest rates and consolidate
- To amend the *Law of Ukraine On Banks and Banking Activity dated December 7, 2000, No. 2121-III* to require every bank to disclose its beneficial ownership with strong penalties in case of non-compliance
- To enact stringent rules for related-party lending
- To increase capital and capital adequacy requirement along with introducing more rigorous definition of capital.

To promote development of non-bank financial institutions it is recommended to:

- To more tightly regulate insurance companies
- To harmonise insurance legislation with EU standards
- To enact necessary legislation to introduce the Accumulation Pension Fund, envisaged by the pension reform
- To more actively disseminate information on pension reform, including nonstate pension funds as existent distrust to non-state pension funds is closely related to the lack of understanding on how these organizations operate.

Urgency of leasing as an investment mechanism

Economic and social growth of Ukraine in many respects depends on investments in fixed assets. Investments in fixed assets will renovate equipment and technologies of the national companies in all fields of economy, ensure competitiveness of their products, contribute to the development of small and medium business, creation of new jobs, and improve of the living standards of the population.

International practice has proven that leasing is an effective investment mechanism and an important component of the economic and investment policy of the state. Its share in the investments into fixed assets comprises approximately 30 per cent in well-developed market economies and 10–15 per cent in other countries demonstrating high growth indicators (in Ukraine it is only 1,2 per cent). In the Eastern European countries demonstrating high growth indicators (Estonia, Czech

Republic, Hungary, Poland), the share of annual leasing market volume within GDP amounts to 2–5% (in Ukraine – only 0.25%).

As of beginning of the 21st century, the obsolescence of fixed assets of the Ukrainian companies carrying out different types of economic activity reached critical level, thus causing a drop of economic and social indicators of the country's development, a decrease of domestic products' competitiveness, an increase of technological and ecological risks, an increase of energy intensity and material intensity of production, as well as deepening of social problems.

During the last decade, the obsolescence rate of the fixed assets of the Ukrainian companies in general, as well as in individual economic activity areas, had been constantly growing. Fixed asset renovation process is extremely unsatisfactory. Volume of fixed assets that were withdrawn as a result of physical and moral deterioration exceeds volume of new fixed assets which started to get used. According to expert evaluations, the obsolescence of fixed assets' active elements, in other words, machinery, equipment and vehicles, amounts to 80-90 per cent.

In order to restore the value of currently existing fixed assets, the Ukrainian economy needs at least UAH 563 billion (106 billion USD) worth of investments. Taking into account that the country needs not only repaired, but also new fixed assets, which would allow to provide users with new equipment and technologies and add new highly productive units to the currently existing fleet of machinery, equipment and transport, the aforementioned amount of investments needs to be increased several times.

The potential demand for leasing services in Ukraine presently comprises at least UAH 85 billion. In the meanwhile, as of beginning of the year 2005, the leasing market volume in Ukraine reached somewhat more than UAH 1 billion. At the end of March 2006 the State Commission for Regulation Financial Services Market adopted the Program for the Development of Leasing in Ukraine in 2006-2010. At the moment it is waiting for approval in the Cabinet of Ministers of Ukraine.

There are such key factors that restrain the development of leasing in Ukraine shown in the Program:

- Imperfect legal framework:
 - Conflicts among individual legal acts regulating leasing activities;
 - Ambiguity in the interpretation of individual provisions of normative and legal acts as regards leasing transactions;
 - Unregulated components of leasing activities, in particular, secondary leasing issues, return of leased objects to the lessor, relations among lease participants if a leased object is damaged etc.; and
 - Unstable legislation that creates additional risks for leasing which, by its essence, is a long-term transaction.
- Insufficient integration into the international legal framework relating to leasing:
 - The National Accounting Standards related to leasing do not fully comply with

the international standards; there are no methodological recommendations with regard to the majority of the National Accounting Standards; and
- Ukraine is not a participant to a number of leasing-related international conventions.

- Unfavourable tax climate:
 - Discriminatory tax treatment in the VAT taxation of the lessors' interest and commission under financial leasing (as compared to banks);
 - Absence of accepted tax depreciation for the leased assets belonging to production fixed assets (the third group of fixed assets);
 - Unreasonable payment of the tax (15%) on an entire lease instalment going to a non-resident under international financial leasing; and
 - Impossibility of including all funds spent on lease assets' insurance into total costs.
 - Limited ability to attract funds for financing leasing operations; a non-perfect structure of the sources of leasing operations' financing.
 - Insufficient financial resistance of lessors.
 - Insufficient development and limited use of the leasing market infrastructure (a credit history bureau, a registry of the encumbrances to movable property, a registry of the encumbrances to real estate, and mechanisms for financial risks' insurance etc.).
 - Lack of qualified personnel in the area of leasing, and a low level of leasing awareness among the representatives of the small and medium business.
- The goal of the Program is to create conditions for the development of leasing as an efficient mechanism of investments into fixed assets' renovation in Ukraine. And the Program envisages the following actions to be done to achieve the goal:
- Improving civil and financial legislation on leasing issues, integrating the national legislation into the international one.
 - Improving the structure of the sources of leasing transactions' financing; creating conditions for implementation of the mechanism for refinancing leasing transactions' portfolio.
 - Creating conditions to ensure an increase of lessors' financial resistance and capitalization, as well as an implementation of the modern risk-management systems by leasing companies.
 - Developing the leasing market infrastructure and promoting its use by the market participants.