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UKRAINE: Removing Barriers to Foreign Investments

Increasing foreign direct investments is now important for Ukraine not only to revive economic growth, but also because it may be a key financing source for possible current account and fiscal deficits that are likely to emerge in the near future.

1. Recognized Barriers to Foreign Investments

It is widely recognized that the following issues are indeed important concerns about the business environment in the country today:

- (a) **Possible Fiscal Deficits and Inflationary Pressures.** 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. Many investors believe that the current targeted fiscal budget deficit of 1.86% may be difficult to achieve as budget revenues may not increase by the amount of 50% needed to achieve this result. As a result, it is feared that inflation could be above the 9.8% target. In addition, continuous large fiscal deficits are bound to generate current account deficits.
- (b) **Uncertainties in the Legal Environment and 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. Furthermore, there are still a number of key business-related laws that are pending approval (such as the draft Joint Stock Companies Law, the Administrative Court Procedures, etc).
- (c) **Excessive Administrative Interventions on Business Activities.** A number of existing regulations discourage investments, including NBU Resolution 482 (which requires the opening of multiple bank accounts and multiple foreign exchange conversions), Article 65 of the State Budget (which mandates profit confiscations of companies with state shares), etc. 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. Some other interventions, such as government interventions in pricing decisions, make business activities more unpredictable.
- (d) **Uncertainties on Privatization Policy.** The privatization process is stalled because of unresolved disputes on past privatizations and lack of a clear privatization strategy. Unless promptly resolved, these issues are likely to hinder foreign investments for future privatizations.
- (e) **Uncertainties on Exchange Rates.** There 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. Furthermore,

there are uncertainties as to whether the NBU has the tools to carry out successfully an alternative monetary policy, such as targeting inflation.

- (f) **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 fear however that these important government goals may be delayed by the inability of government agencies to act promptly.

2. Possible Solutions to the above Barriers to FDI.

Potential solutions to the above problems can be divided into three categories, as follows:

I. Administrative Decisions and Policy Measures

The government is planning a number of Administrative Decisions and Policy Changes that aim at addressing the above barriers to foreign direct investments. These are needed and necessary. However, these plans have not yet translated into implementable actions. In fact, despite good intentions, many of these decisions and policy changes may not be executed in a sound and sustainable manner due to the inability of the state apparatus to carry out their proper implementation.

Furthermore, lack of institutional capacity may result on policy implementation that may be contradictory and confusing. The long-lasting and successful implementation of required policy changes requires an institutional capacity that is now lacking in the country.

Regarding the fiscal budget deficit, the government is taking some measures to reduce the potential fiscal deficit, including elimination of tax exemptions and privileges, further formalization of the shadow economy, increases in excise taxes, etc. The remaining deficit is expected to be financed by privatization receipts and borrowings. These measures are necessary, but are unlikely to be sufficient to bring sustainable fiscal budget equilibrium over the long term. Over the long term, the government will need to carry out a comprehensive audit of the public sector, as discussed in section B below.

II. Institutional Strengthening.

The successful and long-lasting implementation of administrative decisions and policy changes will require a more fundamental strengthening of the state apparatus (that is a fundamental **reform of public administration**, including a re-definition of the roles and functions of the government and its modus operandi). This will be a time-consuming process; but international experience suggests that without it, policy changes may not be implemented and if implemented, they may be reversed soon thereafter.

The objective of public administration reform should be to redefine the role of the government to support the private sector, secure the provision of sound and efficient government services without corruption, and effectively implement economic measures and reforms to deal with emerging economic problems. Although Ukraine has made some progress towards the development of a better public administration system, the agenda for public administration reform is still large. The

public sector continues to be a bottleneck to the country's development. 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 up to five 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.

III. Open Communications and Transparency.

While implementing the above policy changes and institutional strengthening, 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 once a week in a specified evening of the week so that the population would look forward to them.

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.

3. Proposed Action Plan

(a) Increase Confidence.

Arrange immediately for a Senior Government official to offer Press Conferences 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.

(b) Start immediately a review of all constraints to FDI's.

This could be done by re-defining and staffing a small Foreign Investment Agency reporting to a high level authority. This agency should prepare a detailed Plan of Action which would identify the main constraints, the measures needed, the responsible government agency and the deadlines for execution. The Agency should also take other steps to promote FDI for the country. For example, a major international conference on FDI could be organized in Kiev or a key European country (Germany, UK) as soon as possible. It should be followed by visits to a number of countries in America, Europe and Asia to seek foreign direct investments from large key enterprises with ongoing plans to establish operations in this part of the world.

(c) Contract International Experts to Develop a Program for Public Administration Reform.

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.

- (d) Enact Pending Legislation and Provide Stability to the Legal Environment.** The government should appoint a Task Force to monitor and encouraging the processing and the enacting of draft laws and amendments that are now pending in the Rada, including the Join Stock Companies law, 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 be ensuring consistency of new laws with the existing laws, better defining processes and responsibilities for drafting and reviewing new laws, and required reform of the judiciary system to give it more autonomy and adequate financing and training.

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.