OECD-UKRAINE ROUNDTABLE ON INVESTMENT POLICY REVIEW

KIEV, 23 FEBRUARY 2001

SUMMARY REPORT

Overview

1. At the request of the government of Ukraine, the OECD has carried out a major policy review of Ukraine's legal and institutional investment regime. The Review was released and discussed at a Roundtable meeting on 23 February 2001, co-organised by the OECD and Ukraine. It identifies the obstacles to investment and private sector development, and puts forth concrete, practical recommendations for an improved business climate. The Review was undertaken not as a desktop study, but in a dynamic framework as a joint exercise involving almost all key players, domestic and international alike, on Ukraine's investment scene.

2. The concluding statement of the Kiev Roundtable meeting was: "Ukraine has the potential to be transformed from 'a miracle in waiting' to 'a miracle in making'" in recognition of this nation's rich human and natural resource endowment, as well as strategic location. Senior Ukrainian government officials supported the Review's recommendations and pledged strong support to implementing them, which they indicated were in conformity with the government's strategic objectives for 2001 and beyond.

3. The key issue that arose throughout the 23 February discussions and thereafter remains: who would be charged and empowered to implement these recommendations. Timing is of critical importance: when the implementation would commence and what timelines and identified benchmarks would be set out to track performance. It was strongly recommended to establish an Ukrainian inter-ministerial/departmental team to develop a strategy to begin implementing the recommendations and rectifying the shortcomings identified in the Review.

4. This team would also be the interface of the Ukrainian government with the OECD-Ukraine Forum on Investment and Enterprise Development established at the Roundtable (see attached the terms of reference for the Forum). The Forum is expected to develop dialogue and synergies among government officials, the private sector, bilateral and multilateral co-operation programmes, and above all, help identify the fundamentals of a forward-looking investment policy.

5. The OECD team held a series of bilateral meetings with the State Secretary of the Cabinet of Ministers Viktor Lisitsky, the Acting Minister of Economy Victor M. Kalnyk, and the Chairman of the Constitutional Court Victor E. Skomorokha, prior to, and during, the Roundtable on how best the OECD-Ukraine co-operation could be furthered and the practical ways of pushing forward the implementation of the concrete recommendations contained in the OECD Review. In addition to investment matters, other areas of OECD-Ukraine co-operation were also discussed during the bilateral meetings including the organisation of an economic policy seminar on Ukraine this summer in Paris and an activity on Ukraine's

agricultural policy reform. The Ukrainian side also stressed that the energy sector reform was among its high priorities this year, an area which might of interest to the IEA.

Need for Investment and Change

6. Ukraine is a potentially attractive place to invest. The failure to attract foreign investment, the staggering capital flight, the collapse of the formal economy and the relative growth of the "shadow" economy are in sharp contrast to certain strong endowments of Ukraine. The country possesses a large amount of unused or underused physical and human capital (98.6 per cent literacy rate), substantial reserves of idle savings, a large domestic market of about 50 million people (among the largest in Europe), rich natural resources, and a strategic location at the crossroads of Central Europe, Russia, Central Asia and the Middle East, all of which provide a solid base for sustainable economic growth.

7. Ukraine's investment needs are huge, as large parts of the capital stock have in fact no longer been maintained or replaced during the last decade, not to speak of expansion. There is certainly also an important need for renewal of the general infrastructure. Investments needed for rehabilitating the ailing infrastructure alone are estimated to exceed $40 billion. According to official Ukrainian data, as of early January 2001, the cumulative FDI inflows into Ukraine since 1991 approached $3.9 billion. On a per capita basis, FDI is among the lowest in the region – $79 per capita, placing Ukraine as the second lowest among Commonwealth of Independent States (CIS), ahead of Belarus only, and with less than 10 per cent of the FDI that has flowed to Poland or Hungary.

8. The unfavourable business environment has contributed to substantial capital outflows, estimated to reach around $20 billion since independence at a time when Ukraine badly needs resources for domestic investment. President Leonid Kuchma has proposed a new law in September 2000, which would grant amnesty to "shadow" capital, allowing Ukrainians to legalise any hidden assets. They would simply have to declare the account to the tax authorities, transfer it from any foreign bank to a Ukrainian bank, and pay a 10 per cent tax on it.

9. Major amendments of Ukraine's FDI legislation have been enacted during the past few years. These changes have been fundamental, since they constituted a shift from a generous, but ineffective, system of specific incentives to a system of non-discriminatory legal conditions for all investors, including more extensive investment protection. Ukraine has also signed a significant number of bilateral investment treaties, including those with some OECD Member countries. These legislative steps lend further credence to the notion that incentives, however generous, can be no substitute for those factors that really attract foreign investors: a promising market, transparent and non-discriminatory legislation, effective investment protection and sound economic policies.

10. Both during the bilateral meetings with senior Ukrainian government leaders and at the roundtable discussions, the Review was described as the most comprehensive assessment to date of the current situation in Ukraine with regard to the investment climate, business conditions, as well as the legal landscape. It is critically important to encourage the Ukrainian government to form an inter-ministerial/departmental team to develop a strategy to begin implementing the recommendations and rectifying the shortcomings identified in the Review. Otherwise, several speakers warned that the Review would be yet another document that may gather dust on the shelf.

Public Information

11. With a view to promoting wider distribution of the Review's recommendations and to triggering positive action on the part of the Ukrainian government, the Secretariat made the Review available to a broad audience in Ukraine, including senior government officials, members of the Verkhovna Rada (Parliament), the business community as well as all OECD diplomatic missions, NGOs and technical assistance organisations such as TACIS and USAID based in Kiev. Accordingly, the Review was translated into Ukrainian, with the support of the USAID Deloitte Touche Tohmatsu Commercial Law Center Project. The final version, which now incorporates all comments and suggestions made during and after the 23 February Roundtable, would also be distributed to key stakeholders.

12. The Secretariat organised a public press conference in Kiev to publicise the Review. Praising its value for potential investors, the Ukrainian Ministry of Foreign Affairs requested permission to distribute copies of the Review to its diplomatic missions abroad. The Review would also be separately released to the OECD press in Paris in March.

Roundtable Deliberations

13. Some selected highlights from discussions in the Kiev Roundtable include the following notes:

- Deliberations highlighted that many difficulties stem from a bureaucracy, which is well entrenched and still extensive, and still operates with a mindset reflecting the FSU legacy of control and strict regulation. Investors also complain of complex and often ambiguous legislation. Administrative reforms have been slow, and not sufficiently deep and extensive. And the legislative and regulatory changes have not been oriented towards establishing explicit and transparent rules of the game.

- Many speakers alluded to what the OECD Review termed as "*Much Legislation, Little System*": this heading represented a good description of prevailing legal and regulatory quagmire in Ukraine. They indicated that the inconsistent and unclear regime gives rise to unpredictable administration and interpretation, which in turn invites corrupt practices and behaviour, both in civil service and elsewhere. A senior business executive pleaded that the international community should not press for more legislation in Ukraine.

- It was pointed out that Verkhovna Rada (Parliament) passed a Law on Banks and Banking Activity, which President Kuchma signed into law in January 2001. The Law has established clear rules for all banks and banking activities, in particular eliminating discrimination against foreign banks. Of the 156 banks operating as of 1 October 2000, there are only two state-owned banks and three formerly state-owned banks. The new minimum statutory capital requirements to open a bank, according to the new law, are 3 million Euro for regional banks and 5 million Euro for nation-wide banks. The minimum total capital requirements for existing banks are also the same amounts.

- In addition, it was mentioned that a law on Deposit Guarantee Fund passed first reading in Verkhovna Rada. While this deposit insurance law only covers the equivalent of 500 hryvnya ($1=5.4Hr), there is a move to improve the draft law and raise the maximum deposit insurance to 1000 Hr. This Law is particularly important to build confidence in the banking sector, which would then, hopefully, attract more deposits from the shadow economy, provide liquidity to the banks, and especially additional funding resources (medium to long term) for financing industry and the general economy.

- It is also worth noting that the government recently created a Co-ordinating Council on Financial Sector Policy, comprising all Ministers and heads of national and State Committees dealing with Economy, Finance, Taxation, Capital Markets to develop coherent national policies on financial institutions and services. This was considered commendable and advisable under prevailing circumstances when there has been a paucity of credit and investment resources, especially from abroad.

- With respect to relations with the IMF, it was noted that the EFF has been renewed and in fact one *tranche* of about $245 million was disbursed in December 2000. Both the World Bank and the IMF are generally satisfied with improvements on the economic front, but are pressing for more structural and systemic reforms. This is holding up the 2nd disbursement of the EFF since recommencement.

- Breakthroughs in certification reform occurred during 2000 with a change in the management of Derzhkomstandart and its subordination to the Ministry of Economy. The new Derzhkomstandart chairman supports reform efforts targeted at adopting technical regulations system compatible with EU requirements. The certification reform involves the codification of three new laws on Accreditation, Standardisation and Certification that are being drafted jointly with the State Standardisation Committee.

- On Accounting and Auditing, it was pointed out that speedy convergence of UAS and IAS was needed to avoid double book-keeping and attendant costs, and especially to simplify financial reporting to facilitate transparent reporting for capital market purposes as well as for the proper analysis (of enterprises) by financiers. Presumably, speedy IAS accounting would also facilitate quicker adaptation to the EU rules.

- The application of *tax law and regulations* is problematic because a hierarchy of tax rulings and interpretation is not necessarily recognised, leading to conflicts between local and central officials. *Kartoteka*, while suspended, is still applied. Regrettably, in virtually all cases of tax dispute, the burden of proof is on the taxpayer and not official making the ruling. In the same context, the system victimises businesses and businessmen since they are considered guilty unless an arbitration court rules otherwise. This means that businesses may be closed and/or made inoperative pending court hearings and proceedings. It was indicated that most of the problems could be avoided if there were more frequent and more extensive consultations between tax authorities and taxpayers, and especially accountants and auditors prior to enacting tax laws and regulations.

- The national co-ordinator for Ukraine's Anti-Corruption NGO "Freedom of Choice" emphasised the importance of a free and independent press in helping to combat corruption and its role in fostering transparency within the government and in the private sector. He characterised the corruption as a key deterrent to FDI flows.

- Speakers from OECD Member countries shared best practices in Policy Reform and Transition on financial markets and taxation, foreign investment policies and investment promotion agencies, as well as other international organisations, bilateral donors active in Ukraine.

- The Roundtable also provided an opportunity to introduce to senior Ukrainian officials OECD's codes, declaration and guidelines on international investment-related matters, as well as the newly created Global Forum on International Investment.

Possible Follow-up Actions

14. To maximise Ukraine's potential for foreign investors, it is clear that the government needs to swiftly proceed with more privatisation in a transparent and non-discriminatory fashion, develop a business climate conducive to the rapid expansion of foreign trade, limit tariff and non-tariff barriers, ensure fair access to the Ukrainian market for foreign firms and foster a meaningful dialogue with businesses on key policy issues. It was concluded that the Review, reflecting the expertise and recommendations of the OECD Secretariat, Member countries, other international organisations, the international business community, many Ukrainian government and business executives, would form a solid basis for further follow-up and monitoring of policy reforms in Ukraine.

15. The Ukrainian Ministry of Economy singled out one particular recommendation (establishing a Ukrainian Investment Promotion Agency) for immediate action. The government is now reviewing the concept and a favourable Cabinet decision is expected to be made shortly for the creation of such an Agency. The OECD has been asked to provide policy advice on best practices in this field. In addition, several other proposals were tabled as a follow-up including: (i) helping the codification of investment-related laws in a consistent, coherent and transparent manner; (ii) assisting Ukraine to be associated with OECD's international investment instruments and related OECD activities through the Global Forum on International Investment, and (iii) launching an activity on the root causes of corruption and bribery and adhering to relevant OECD instruments.

16. The OECD-Ukraine Forum on Investment and Enterprise Development (see para.4) would be the primary vehicle for pursuing the follow-up activities in co-operation with the Government of Ukraine, the private sector, foreign and domestic alike, bilateral and multilateral donors active in Ukraine.