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CHALLENGES AND POLICY REFORMS FOR IMPROVED INVESTMENT ENVIRONMENT IN UKRAINE

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Despite significant growth in foreign direct investment (FDI) flows throughout the world in the past decade, the immediate outlook for fresh inflows of investment dollars does not appear to be very optimistic. Governments all over the world continue to actively seek FDI, and the competition for attracting the “quality” FDI will likely become even more intense over the next decade. In this context, it is critically important for countries like Ukraine to create an enabling framework for investment and further advance the reform agenda with a view to retaining and attracting greater inflows of FDI. This is particularly crucial given that Ukraine needs FDI in almost every area from agriculture to telecommunications.

Although Ukraine achieved economic growth in 2000-2001 for the first time since 1991, largely thanks to the comprehensive reform programme launched in early 2000, the country has still some considerable way to go to be qualified as an attractive destination for FDI. The new Ukrainian government, led by Prime Minister Anatoly Kinakh, seems to have realised the importance of building investors’ confidence and the need to implement the reform agenda without further delay. What needs to be done by Ukraine are crystal clear; its achievements will be judged by the vigour with which these reforms will be carried out.

The OECD’s review of Ukraine’s investment policies, conducted at the request of the Ukrainian government and published in May 2001, shows the way forward through a series of practical policy recommendations. How decisively these recommendations will be put into practice remains a key challenge for Ukraine, and might determine its future place and orientation in the world economy.

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Recent FDI Trends and implications for Transition economies

The fact that virtually all countries are competing to attract FDI inflows demonstrates that the opportunities generated by FDI are now widely acknowledged. In addition to capital inflows, FDI can lead to transfers of technology and know-how, improve access to international markets, and spur competition.

However, despite its growing role in the globalisation process, FDI flows are set to decline in 2001, for the first time in a decade.² According to projections released just before the tragic September events in New York and Washington, world FDI flows were expected to drop by 40 per cent this year, to \$760 billion.

The decline of FDI is likely to affect mostly developed countries, largely through the decrease in mergers and acquisitions (M&As). In the case of developing countries, where most FDI is greenfield investment, the decline reaches an estimated 6 per cent, from \$240 billion to \$225 billion. FDI inflows in Central and Eastern Europe, increased by 9 per cent (to \$27 billion, representing 2 per cent of world inflows) in 2000, are expected to remain stable.³

FDI TRENDS IN TRANSITION ECONOMIES

The transition countries currently preparing for EU accession have attracted the largest inflows in the period 1990-1999, with Poland, Hungary and the Czech Republic as main recipients, bringing their combined stock above \$65 billion in 1999. This compares to an estimated FDI stock in the Russian Federation of \$19.7 billion in 2000.⁴

On a per capita level, inflows into Estonia, Latvia and Slovenia have also been significant placing them ahead Poland according to this indicator. The smaller CEE countries are also showing the highest share of FDI in terms of total fixed capital formation, with levels well above 20 per cent for the period 1996-1998. Poland and the Czech Republic range closer to 15 per cent in terms of this indicator, while in the Russian Federation the share of FDI in fixed capital formation remains closer to 5 per cent in 2000.⁵

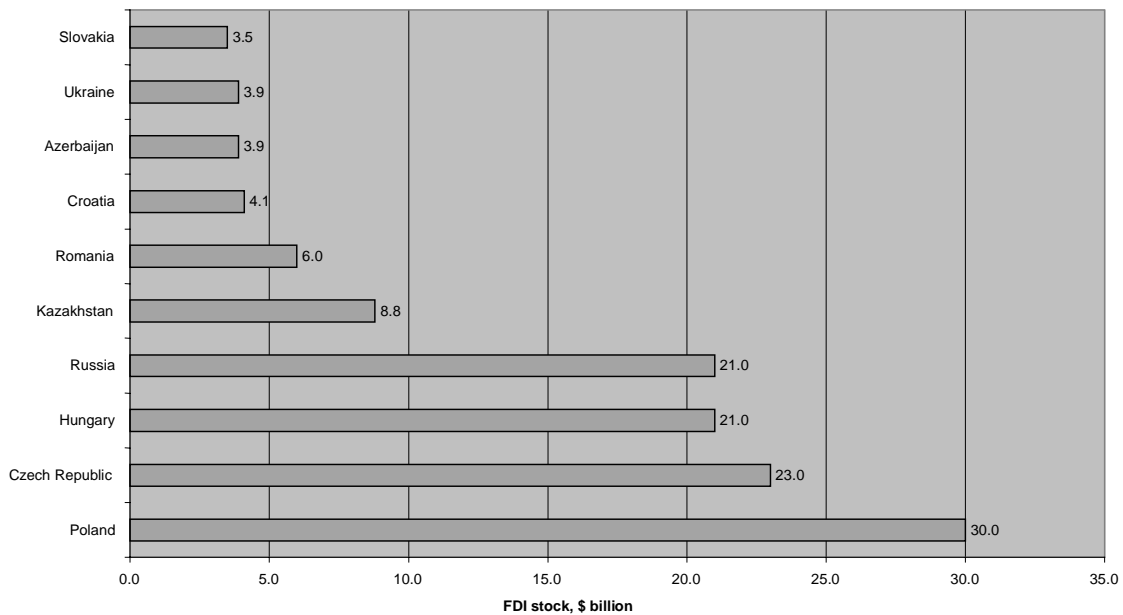
2. Karl Sauvant (UNCTAD), Recent trends, Implications for Developing Countries and Policy Challenges, OECD Global Forum on International Investment, 26-27 November 2001, Mexico City.

3. Ibid.

4. Evgeny Gavrilin, *Achievements or Missed Opportunities: Factor of Economic Growth in Russia. What lessons are relevant to Ukraine?*, Fostering Sustainable Growth in Ukraine, Physica-Verlag, 2002.

5. Eva Thiel, *The Investment Environment in Russia and Ukraine: Common Weaknesses in the Institutional and Policy Framework*, Fostering Sustainable Growth in Ukraine, Physica-Verlag, 2002.

Top Ten FDI Destinations in Central Europe, 1990-2000



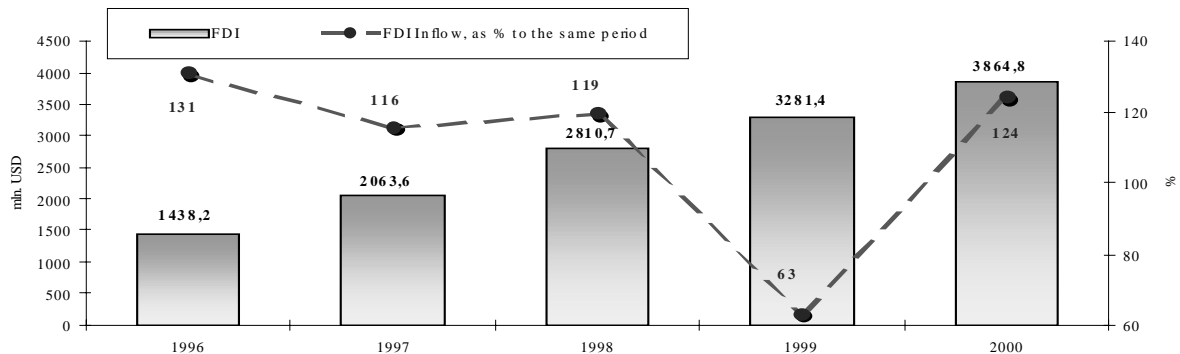
Source: OECD Investment Policy Review, Ukraine, 2001.

An accentuation of the slow-down in the world economy would likely prompt some companies to relocate production resources to low-cost producing countries; in this case there may be some redistribution of FDI flows towards developing and transition economies. Under these circumstances, transition countries – a group still accounting for a relatively modest share of total world FDI stock – could use their comparative advantages to attract redistributed investment. The decline of FDI may lead governments to increase their efforts to boost FDI inflows and to try to secure greater benefits from FDI received. Hence, establishing an enabling framework in key policy areas and improving the overall business climate will become even more important in the years ahead.

Foreign Direct Investment in Ukraine today

Ukraine is among the transition economies with great economic potential and investment needs, but also with huge challenges. Its large landmass, domestic market of about 50 million people, highly educated labour force, rich natural resources, and strategic location, provide a solid base for Ukraine's sustainable economic growth and a fertile soil for investment inflows, domestic and foreign alike. Yet, despite its perceived sound fundamentals, Ukraine lags behind most Eastern European transition economies.

FDI Inflow to Ukraine (1996-2000)



Source: OECD Investment Policy Review, Ukraine, 2001

Some projections indicate that Ukraine should raise at least an estimated US\$40 billion of investment for rehabilitating its ailing infrastructure alone. FDI is urgently required in almost every area from agriculture to telecommunications. Yet, FDI inflows remain marginal. According to official Ukrainian data, as of 1 October 2001, total FDI stock in Ukraine has accumulated to some US\$4.2 billion since its independence. This translates into about US\$83 per capita, placing Ukraine the second lowest among CIS countries, ahead of Belarus only; and amounting to less than 10 per cent of per capita FDI to Central and Eastern European countries such as Poland and Hungary. Another example is that the USA invested 10 times more in the Polish economy than in that of Ukraine.⁶

FDI TRENDS IN UKRAINE

- By origin of investment, the United States has been the dominant foreign investor (18 per cent of all FDI), followed by the Netherlands with 9 per cent, the Russian Federation (9 per cent), Germany (7 per cent) and the United Kingdom (7 per cent).
- From a sector perspective, as of January 2000, the main destination of FDI in Ukraine, was the domestic food industry (20 per cent of cumulative FDI), followed by domestic commercial operations (over 17 per cent) and mechanical engineering/metals (almost 11 per cent).
- FDI flow in Ukraine is highly concentrated in a few regions. Kiev and its surroundings receive over one-third of all FDI; Donetsk, Zaporozhye, Poltava, Odessa and Dnipropetrovsk regions together account for another third; leaving less than one-third for the remainder of the country.

6. Stefan Lutz and Oleksandr Talaverda, EERC annual conference paper, April 28-29, 2001.

The legal regime specifically addressing foreign investment is set out in both Ukraine's domestic legislation (in particular 1996 Law on the Regime of Foreign Investment amended in 1999), and in international agreements. Some national legislation, while not expressly distinguishing between domestic and foreign investment, applies in practice to foreign investment only, notably the laws on production-sharing and concession agreements.

Major amendments of Ukraine's FDI legislation enacted during the past few years constitute 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. Access for foreign investors to the Ukrainian market has also been considerably liberalised, though limitations remain in certain sectors.

Ukraine has signed a significant number of bilateral investment treaties (67 treaties, 43 of which are in force), including some with OECD Member countries. The bilateral treaties, which supersede the Ukrainian Foreign Investment Law and prevail over it in case of conflict, conform, in most cases, to international standards. In addition, Ukraine has signed several multilateral agreements related to foreign investment, such as the 1965 ICSID Convention, the 1994 Energy Charter Treaty, and the 1998 Partnership and Co-operation Agreement with the European Union.

The mechanism of implementing foreign investment regulation has also been streamlined. In 2000 the main central government agencies with FDI-related responsibilities were integrated into the Ministry of Economy and European Integration. This concentration of FDI expertise now offers an opportunity for a coherent and consistently implemented investment strategy.

Why, if the legal and institutional framework for foreign investment seems satisfactory, do FDI inflows still represent only a small fraction of Ukraine's potential? The answer would be that substantive flaws in Ukraine's general legislation, and especially the lack of transparency and legal insecurity, constitute a much more important investment barrier than some insignificant lags in specific foreign investment regulation. Hence, to attract investment, the reforms should address the shortages in structural reform and the policy deficiencies as a whole, and not be limited to the revision of foreign investment regulations.

Major challenges...

In spite of recent economic growth, most international ratings and investment climate surveys place Ukraine among the least advanced transition economies with respect to its macroeconomic and microeconomic conditions. The contribution of the private sector to GDP is quite low, at about 20 per cent of GDP, compared to around 70 per cent to 80 per cent in Hungary, Poland and Russia.⁷

An unfavourable environment for business has contributed to substantial capital outflows, estimated to have reached around \$20 billion since Ukraine's independence. Estimates for the informal, "shadow", economy range from 14 per cent (official estimates) to a more realistic 60 per cent of total GDP. Persistent fiscal and current account deficits – even taking into account the fact that they have gradually decreased since 1994 – as well as high inflation – around 20 per cent per annum – testify of economic difficulties.

Effectiveness in affording property security and enforcing contractual rights is also questioned. Investors complain of complex and often ambiguous legislation.⁸ Indeed, despite a vast body of law, Ukraine is still lacking a coherent, effective and transparent legal system. Thus far, fundamental codifications, such as

7. Sigma Bleyzer, 2001.

8. "Report on Impediments to Foreign Investment in Ukraine" carried out by the TACIS-funded Ukrainian-European Policy and Legal Advice Centre in 1999.

civil code, tax code, and legislation concerning the judiciary system, are pending before Parliament or the Presidency.⁹ Moreover, frequent legislative and regulatory modifications, rather than helping to establish transparent rules, have often contributed to discretionary interpretation and unpredictable implementation.

Although the major reform programme has demonstrated some encouraging achievements, the structural reforms remain uncompleted and the economic growth fragile. The most pressing economic priorities include:

- **Accelerating privatisation** of many large State-owned enterprises: Progress in the area of structural reform, in particular privatisation of the energy sector, has slowed down recently. Mr. Kuchma, President of the Ukraine, put a temporary moratorium on privatisation of electricity distribution companies in May 2001, although his recent Decree of December 2001 will lift this ban as of spring 2002.¹⁰
- **Restructuring unwieldy governmental apparatus, and combating corruption:** Public governance marked by bureaucratic interventionism and corruption remains one of the priorities of the reform. According to the Transparency International 2001 “Corruption Index”, Ukraine ranks in 83rd position, leaving behind only 8 countries.¹¹
- **Re-organising the court system:** A comprehensive re-organisation of the court system is required in order to improve courts’ technical and financial resources, as well as the competency of judges, and to insure effective protection of investors’ rights.
- **Streamlining the tax system:** Taxation tops the list of investment disincentives in Ukraine. The lack of a comprehensive and coherent tax code is one of the main shortcomings of the business climate. The reduction of tax burden, in terms of both tax rates and the number of taxes, is also required.
- **Overhauling agricultural sector:** The new Land Code entrenching private land ownership is an important step towards transforming agriculture into a market-based sector, but it requires implementation legislation regarding key issues such as land valuation, the establishment of a property registry, the creation of a mortgage bank and bankruptcy procedures.
- **Completing reforms necessary to enter the World Trade Organisation:** Though Ukraine has liberalised its trade regime in recent years and lowered its tariffs, considerable non-tariff barriers remain, especially through the imposition of cumbersome technical standards and certification requirements. At present, Ukraine is actively seeking WTO membership but must still implement a host of reforms in order to qualify.
- **Further reforms of banking and capital market systems, accounting and auditing, insuring better protection of property rights, and completing the land reform.**

9. Thus, the draft Civil Code has passed three readings (September 2001) and is to be signed into law by the President.

10. Oxford Analytica Daily Brief, June 6, 2001, II.

11. The Index is based on 1999, 2000 and 2001 data provided by the Economist Intelligence Unit, the Global Competitiveness Report, the World Business Environment Survey and the Freedom House.

- **Providing a foreign investor-friendly climate by liberalising capital, foreign exchange and profit expatriation controls, lifting restrictions on foreign ownership and control, and minimising red tape.**

...and first achievements

There are, however, some encouraging signs. First achievements of a comprehensive reform programme, implemented since 1999-2001, are now becoming visible.

Significant progress could be seen toward macroeconomic and financial stability during 2000-2001. Real GDP grew by 14 per cent in two years, inflation declined to an average 12 per cent in 2001 and the fiscal deficit was cut to 1.3 per cent of GDP. Net general government public and external debt decreased to 29 per cent of GDP and 23 per cent of exports, respectively, in 2001, down from a peak of 54 per cent of GDP and 63 per cent of exports, respectively, in 1999.¹² Added to this list are recent significant improvement in liquidity reflecting the restructuring of liabilities to the Paris Club, the settlement of natural gas arrears, and rising international reserves. Reserve coverage of the external financing gap increased to over 300 per cent in 2001, up from a trough of 21 per cent in 1998. These figures hold out hope for an economic reversal.

Progress has been achieved in the field of small business. There are over three million small and medium enterprises (SMEs) operating in Ukraine in a rather effective way, which contribute to job creation,¹³ although the share of SMEs in total employment is not high: in 2000 it constituted 8.4 per cent and 8 per cent respectively.¹⁴ The government needs to pay special attention to the needs of SMEs and help open avenues for SMEs to enhance linkages with foreign direct investment.

One should also acknowledge some strategically important decisions that have already been taken to provide a solid base for sustainable economic growth, such as:

- Approval, for the first time since independence, of a realistic budget for 2000; this was repeated in 2001 and 2002 and buoyed by rather tight budgetary and fiscal policy. The adopted 2002 budget allows for a deficit of 1.7 per cent of GDP, or US\$811 million. The budget is based on the new Budget Code (enacted in March 2001) providing for decentralisation of local public finance, which is one of the key elements of current budgetary reforms. On the negative side, due to delays in the adoption of the new Tax Code, the 2002 budget is based on the existing taxation system with its high tax burden.¹⁵
- Implementation of policies that have reduced the share of non-cash transactions in the economy, notably a ban on non-cash settlements with the budget.
- Amendments to the Law on electricity, which significantly restricted the scale of non-payments in the electricity market

12. Standard & Poors' rating of 26 December 2001.

13. Mr. Carlos Pascual, the US Ambassador to Ukraine, *What can place Ukraine on a path to Sustainable Growth*, (lecture at the Kyiv-Mohyla Academy of April 25, 2001).

14. Iryna Akimova, *Performance of Small and Medium Sized Manufacturing Firms in Ukraine: Does the Quality of Governance Matter?*, Fostering Sustainable Growth in Ukraine, Physica-Verlag, 2002.

15. Oxford Analytica (<http://www.oxweb.com>).

- Approval of the 2000-2002 Privatisation Program, which sets the baseline for transparent and foreseeable sales of State property. The programme aims at privatising most of some 200 large enterprises holding over 80 per cent of assets in the industrial and utilities sectors. Unlike previous privatisation rounds, the 2000-2002 programme targets primarily long-term strategic investors and foreign investors in particular. To attract them, it is envisaged to re-organise enterprises earmarked for privatisation and to restructure their debt. Moreover, a Working Group to review such progress has been established.
- Privatisation of collective agricultural enterprises, demonopolisation of lending to the agricultural sector, and finally, adoption of the Land Code. Agriculture (13 per cent of GDP), the most depressed sector during the 1990s, grew by 7.6 per cent in real terms in 2000 and by an estimated 6.5-7.5 per cent in 2001. This year's bumper crop resulted in Ukraine tripling its grain exports, and contributed significantly to lowering food prices and inflation.¹⁶ The new politically challenging and economically important Land Code was finally approved in November 2001 and came to the effect on 1 January 2002. It introduces a formal mechanism for private land ownership and allows agricultural land to be bought and sold and used as collateral (effective as of 1 January 2005), which should facilitate farmers' borrowing. The pace and detail of land reform will be determined by legislation adopted to implement the land code.
- Introduction, within the framework of the administrative reform, of a new mechanism for collective decision-making that prevents the approval of decisions hindering entrepreneurial activity, and requires publication of government decisions.¹⁷

The way ahead in reforms: implementation is key

Despite recent favorable macroeconomic indicators, Ukraine has still some considerable way to go to make its growth sustainable. FDI is one but not the only mechanism to increase economic growth. As mentioned above, the emphasis in reforms should be on a web of policies that provides a favorable environment for investment and private enterprise in general.

If this is done properly and regulatory barriers are eliminated, investment flows, including FDI, will increase and the economy will prosper with complementary developments in the foreign-owned and domestic enterprises. It should be understood that if policy-makers focus solely on trying to attract FDI to the economy, which has a “hostile” business environment, by privileging foreign investors over domestic ones, the results are likely to be less favorable with respect to the long-term development of the economy.

To support Ukraine's reform efforts, the OECD and other international donors have come up with a number of policy recommendations aimed at improving the overall business environment.

The **OECD Investment Policy Review**¹⁸ published in May 2001 recommends, *inter alia*, that the Ukrainian authorities:

16. Standard & Poors' *op. cit.*

17. ICPS newsletter, No. 109, 28 May 2001.

18. The executive summary and the recommendations are available at the OECD website (<http://www.oecd.org/daf/investment/ukraine.htm>).

- Reorient government administration away from micro-managing the economy and in favour of the strategic formulation of framework conditions conducive to private sector development.
- Develop a transparent, predictable, and stable process for case-by-case privatisation, and ensure that the tender commission is independent.
- Phase out non-transparent and distortive investment incentive schemes.
- Open the way to international arbitration of disputes under the foreign investment law, and establish courts of appeal for economic disputes.
- Align Ukraine’s accounting and auditing practices with international standards, in particular for publicly-traded companies and financial institutions, so as to avoid double book-keeping and attendant costs, simplify financial reporting and ensure transparency and proper performance evaluation.
- Simplify interaction between foreign investors and Ukrainian authorities by considering the creation of a "one-stop-shop" that obtains for foreign investors all required licences, approvals and permits.

Ukraine is facing the choice either to go forward with drastic policy and institutional reforms to further improve the environment for investment and enterprise development or to face “sustainable” decline. To mobilise investments now, it is necessary to strengthen investor confidence in the reform’s decisive implementation, persuading investors that it pays to buy into the Ukrainian economy today, when entry prices are still moderate, and reap returns tomorrow, when business conditions will be favourable.

It would not be an exaggeration to call Ukraine today a “miracle in waiting” that has all the necessary potential to become a reality.