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Foreword

In 2016 Ukraine was invited to become the 47th adherent to the OECD Declaration on International Investment and Multinational Enterprises. This adherence bears witness to the determination that Ukraine holds towards its integration into the world economy and promoting responsible business conduct.

As adherent to the Declaration, Ukraine commits to providing national treatment to foreign investors and promoting responsible business conduct. In turn, it benefits from similar assurance from other adherents to treat Ukrainian investors abroad fairly and to encourage their multinational enterprises operating in Ukraine to contribute to economic, social and environmental progress. In accordance with the OECD Guidelines for Multinational Enterprises, an integral part of the OECD Declaration, Ukraine has committed to establish a National Contact Point charged with promoting principles and practices embodied in the Guidelines, handling related enquiries in the national context and supporting mediation and conciliation procedures.

The Investment Policy Review of Ukraine *was undertaken under the aegis of the OECD Investment Committee and as part of the OECD-Eurasia Competitiveness Programme. This publication draws on the report supporting the examination by the Investment Committee of Ukraine's application for adherence to the OECD Declaration. The examination of Ukraine's investment policies took place in December 2015 at the OECD headquarters in Paris in the presence of a delegation from Ukraine led by Ms. Yuliya Kovaliv, First Deputy Minister of Economic Development and Trade.*

The report was prepared by a team led by Andrea Goldstein and Frédéric Wehrlé, Senior Policy Analysts in the Investment Division of the OECD Directorate for Financial and Enterprise Affairs and including Tihana Bule, Antoine Comps and John Hauert, under the supervision of Ana Novik. It has benefited from the Investment Committee's discussions and comments from the OECD Secretariat, including the secretariats of the Anti-Corruption Network for Eastern Europe and Central Asia and the Committee on Corporate Affairs, and the Global Relations Secretariat. The team thanks Deloitte Central Europe for the data of its Central Europe Top 500 rating.

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Acronyms and abbreviations

BIT	Bilateral Investment Treaties
BMD4	Benchmark Definition of Foreign Direct Investment, 4th edition
BOC	Business Ombudsman Council
BOT	Build-Operate-Transfer
BPM6	Balance of Payments and International Investment Positions Manual, 6th edition
CEO	Chief Executive Officer
CETA	Comprehensive Economic and Trade Agreement
CIS	Commonwealth of Independent States
CIS	Commonwealth of Independent States
CISFTA	Commonwealth of Independent States Free Trade Agreement
CISFTA	CIS Free Trade Area Agreement
DCFTA	Deep and Comprehensive Free Trade Area
DGF	Deposit Guarantee Fund
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
EITI	Extractive Industries Transparency Initiative
ETF	European Training Foundation
EU	European Union
FAT	Fixed Agricultural Tax
FATS	Foreign Affiliates Statistics
FDI	Foreign Direct Investment
FET	Fair and Equitable Treatment
FIC	Chile's Foreign Investment Committee
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
GPA	WTO Agreement on Government Procurement
GVCs	Global Value Chains
IAIS	International Association of Insurance Supervisors
ICC	International Chamber of Commerce
ICT	Information and Communications Technology
IEA	International Energy Agency
IIA	International Investment Agreement

IMF	International Monetary Fund
INDC	Intended Nationally Determined Contribution
IPA	Investment Promotion Agency
ISDS	Investor-State Dispute Settlement Mechanisms
JSCs	Joint-Stock Companies
LLCs	Limited Liability Companies
M&A	Mergers & Acquisitions
MEDT	Ministry of Economic Development and Trade
MFN	Most-Favoured Nation Treatment
MNE	Multinational Enterprise
MST	International Minimum Standard of Treatment of Aliens under Customary International Law
MW	Megawatt
NAFTA	North American Free Trade Agreement
NAP	National Action Plan
NBU	National Bank of Ukraine
NCCIR	National Commission for State Regulation of Communications and Informatisation
NCP	National Contact Point for the OECD Guidelines for Multinational Enterprises
NCSREU	National Commission for State Regulation of Energy and Utilities
NDP	National Development Plan
NGO	Non-Governmental Organisation
NPL	Non-Performing Loans
NSSMC	National Securities and Stock Market Commission
NT	National Treatment
NTRC	National Transport Regulation Commission
OECD	Organisation for Economic Co-operation and Development
PDT	Priority Development Territories
PFI	OECD Policy Framework for Investment
PJSC	Public Join-Stock Company
PPP	Public Private Partnerships
PSA	Production-Sharing Agreements
RIA	Regulatory Impact Assessment
ROE	Return on Equity
SAINP	State Agency for Investment and National Projects
SASAC	People's Republic of China State-owned Assets Supervision and Administration Commission of the State Council
SCC	Stockholm Chamber of Commerce
SEZ	Special Economic Zones
SME	Small and Medium-Sized Enterprises
SOE	State-Owned Enterprise

SPE	Special Purpose Entity
SSSU	State Statistics Service of Ukraine
TWh	Terawatt
UAH	Ukrainian Hryvnia
UEFA	Union of European Football Associations
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Commission on Trade and Development
UNDP	United Nations Development Programme
UNESCO	United Nations Educational, Scientific and Cultural Organization
USD	United States Dollar
VAT	Value-Added Tax
VGIRFO	Immigration Authorities
WEF	World Economic Forum
WTO	World Trade Organization

Executive summary

The 2016 *Investment Policy Review of Ukraine* assesses the country's ability to comply with the principles of openness, transparency and non-discrimination and its policy convergence with the OECD Declaration on International Investment and Multinational Enterprises, including responsible business conduct practices, which Ukraine adhered to in 2016. It also considers the interaction and coherence of Ukraine's investment policy with other areas such as investment promotion and facilitation, infrastructure and financial development. In doing so, it evaluates progress made by Ukraine in response to the recommendations of a previous Review conducted in 2011.

In the past few years, Ukraine has made significant progress in improving its investment policy framework. Ukraine's investment legislation includes the principle of non-discrimination of foreign investment and general provisions on foreign investment protection. Over the past two years, continuous efforts have been made to simplify establishment and licensing procedures. New policies have also been enacted for the purpose of creating a more transparent and efficient environment for public procurement. Ukraine also introduced significant tax reforms in 2015 resulting in better tax transparency.

The exceptions to the National Treatment instrument notified by Ukraine are limited. Ukraine maintains exceptions to national treatment for established foreign-owned companies for access to land and forests and in the following sectors: news information agencies, television and radio broadcasting, maritime transport and cabotage, and in the area of privatisation. Overall, the country ranks rather well in the OECD *FDI Regulatory Restrictiveness Index* with a legal regime for foreign direct investment more open than the average of non-OECD countries covered by the *Index*. Ukraine nevertheless ranks above the OECD average, a score that reflects in part the fact Ukraine still applies several transectoral and sectoral restrictions on national security grounds, which qualify for measures described in the Declaration.

Ukraine has also recently undertaken important policy reforms in many of the areas covered by the OECD Guidelines for Multinational Enterprises (Guidelines). The government has developed a comprehensive framework and has ratified the main instruments relating to human rights and labour rights. A new service has been set up to ensure consumer protection. Reforms have also led to the establishment of disclosure and, in general, corporate governance

requirements, although further measures are needed to ensure corporate transparency and accountability. As an adherent to the Declaration, Ukraine has committed to further promote the Guidelines and establish a dedicated National Contact Point (NCP) in the Ministry of Economic Development and Trade to this effect. NCPs have the mandate to promote the Guidelines, and to address issues related to the observance of the Guidelines in specific instances, including receiving complaints related to the non-observance of the Guidelines by an enterprise operating in or from an adherent.

Many of these reforms illustrate willingness on the part of the Ukrainian authorities to take practical measures to improve the overall business climate and attract more foreign investment. Despite indisputable efforts by the authorities in this area, foreign investment flows to Ukraine have nevertheless proven particularly volatile in a context of an adverse geopolitical environment. In addition, investors' perception gap in evaluating the country's liberalisation achievements, combined with recurrent concerns about corruption and insufficient infrastructure development has been an important investment impediment to Ukraine.

This Review of Ukraine, which reflects an examination of the country's investment policy conducted by the OECD Investment Committee in December 2015, is based on the laws, regulations and other materials supplied by Ukraine. It is also based on information obtained by the OECD Secretariat during three technical missions to Kyiv, in May, September and November 2015, during which the Secretariat met with representatives of the Ukrainian public administration, the private sector and representatives of adherents. Ukraine will report on progress in improving its regime for FDI pursuant to the OECD National Treatment instrument and in improving the overall business environment to the Investment Committee before the end of 2017. On this occasion, Ukraine will also report on action taken to establish and build capacity of its National Contact Point.

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Assessment and recommendations

Since 2014, Ukraine has deployed significant efforts to improve its investment environment. Ukraine's post-Maidan authorities have been moving forward with a reform agenda to create a welcoming business environment. In parallel, ongoing economic and social reforms that aim to bring Ukraine closer to international standards in fields such as human rights or labour relations are important steps in shaping and strengthening the country's policy that promote sustainable development and responsible investment.

Ukraine's policy framework for investment

Since 2011, Ukraine has been wracked by a period of severe political and economic turmoil that culminated in unprecedented tensions with its Russian neighbour in 2014. The situation in the Autonomous Republic of Crimea and in Eastern Ukraine remains extremely complex, with important economic and financial implications. While external forces triggered these events, this young democracy suffers from a deeper malaise of destructive policies and corruption.

During this crisis, Ukraine has upheld the generally open stance that has characterised legislation since the country gained independence in 1991. This includes introducing the principle of non-discrimination of foreign investment and enhancing general provisions to protect it, including against nationalisation and changes in relevant legislation as well as guarantees for compensation and the repatriation of profits. Protection against expropriation is guaranteed by the Constitution and conditions and procedures are stipulated in the 1996 Foreign Investment Regimes Act as well as in legislation addressing private land, national defence-related legislation and privatisation laws.

At the same time, Ukraine still applies some restrictions on foreign investment, which qualify for the list of exceptions to national treatment and measures reported for transparency in the meaning of the OECD Declaration on International Investment and Multinational Enterprises. As a result of these statutory restrictions, Ukraine has a score on the OECD *FDI Restrictiveness Index* (a measure of statutory restrictions on foreign direct investment) higher than the OECD average, albeit lower than the average of non-OECD countries. Public monopolies still apply in some significant sectors such as energy transport, transmission of electricity, supply and distribution of water, centralised heating supply, and railways.

In the scarcely two years since a new attempt at economic reforms was launched in earnest, the reform momentum has grown stronger and Ukraine has achieved quite important progress in introducing a modern legal framework that is conducive to investment in general and foreign direct investment (FDI) in particular. The ratification of the Association Agreement with the European Union and preparation towards full implementation of its economic part – the Deep and Comprehensive Free Trade Area – in January 2016 have provided an anchor for many different measures.

New legislation aiming at simplifying business registration procedures and cleansing government procurement is in place. Ukraine has now a comprehensive framework regulating public procurement. Developed in the framework of the EU-Ukraine Association Agreement, it is largely modelled on the 2004 EU Procurement Directives and has been designed to streamline and facilitate government procurement in Ukraine. Public procurements are open to foreign and domestic economic operators on an equal basis. A dedicated web portal (*www.tender.me.gov.ua*) is run by the Ministry of Economic Development and Trade, which places advertisements about upcoming public procurement. E-procurement practices are increasingly being used and should soon be generalised.

To address corruption, in particular in the judiciary, judicial reform is underway: the powers of the Supreme Court were enhanced and new rules now apply to the selection and disciplining of judges. Ukraine has also begun to reform its independent prosecutors. To cope with commissioned tax-related criminal investigations and inspections of the target business, Ukraine established a Tax Ombudsman in 2015. In the crucial area of anti-bribery, amendments to the National Anti-Corruption Bureau of Ukraine (NABU) law were passed and a NABU director was appointed. In a major step forward towards the improvement of the investment climate in the country, a Business Ombudsman institution also became operational in 2015. It provides a platform for the business community in Ukraine to file complaints about unfair treatment by the state or municipal authorities, state-owned or controlled companies, or their officials. Since then, businesses have voiced support for the Ombudsman institution and have been encouraged that the government was addressing issues such as administrative and legal abuse by state or local agencies, repetitive tax audits or investigations, excessive fines or retaliation.

Ukraine has signed over 70 international investment agreements (bilateral investment treaties and investment provisions in free trade agreements) with partner countries. These agreements offer covered foreign investors substantive and procedural protection. The review of the investment provisions suggests that Ukraine should consider updating its international investment agreements with a view to ensuring that they well-reflect government intent and emerging trends in investment treaty policy. Ukraine ratified the 1958 Convention on the

Recognition and Enforcement of Foreign Arbitral Awards (New York Convention) in 1960 and the 1965 Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention) in 2000. Expropriation of property has been rare in Ukraine. Expropriations have primarily occurred on the territory of the Autonomous Republic of Crimea in the aftermath of its self-declared independence.

Problems in applying existing (and *a fortiori* new) laws and regulations, however, continue to plague the business environment and depress domestic and foreign investors' sentiment. Access to agricultural land is an additional issue: foreign investors are subject to a foreign ownership restriction, while the absence of a unified registration system for land and real estate imposes additional bottlenecks. Vagueness in defining the scope of "strategic" sectors closed to foreign investors or subject to authorisation procedures continues to increase legal uncertainty and discourages foreign multinationals from bringing their expertise to Ukraine. Additional obstacles to FDI include the uncertainty and duration of judiciary processes – seen by many investors as one of the most corruption prone areas in Ukraine – and persistent scepticism regarding the fight against corruption in the highest echelons of power.

The role of FDI in the economy of Ukraine

Combined with the ongoing conflict in the Donbas region, political instability, and capital-account restrictions introduced to stabilize the exchange rate, such problems make it very difficult to match the country's vast economic potential with commensurate investment. Ukraine's FDI inflows have indeed proven particularly volatile in the face of an adverse global environment for world investment. Hardly had they recovered from the global economic slowdown that FDI flows to Ukraine declined by 45% in 2013 and plummeted again by 81% in 2014. Preliminary data suggest a mild recovery in the first semester of 2015.

The round-tripping phenomenon, whereby Ukrainian investors use legal entities in offshore jurisdictions to channel local funds, which subsequently return to the local economy in the form of foreign direct investment, is widespread. Because of round-tripping, official statistics tend to overestimate genuine FDI inflows.

Financial services and manufacturing (for the most part metallurgy and food processing) together account for 53% of the total inward FDI stock, with trade and repair representing an additional 13%. Despite the country's comparative advantage in agriculture, this sector has a very modest share of the total FDI (1.3%). EU27 countries are the main source of Ukraine's FDI, representing over 75% of the total stock. The principal mode of entry is acquisition, including through privatisation deals, although the privatisation process has stalled in recent years.

There are fewer foreign-owned companies among the largest Ukrainian companies (7 out of 32 in 2014, based on Deloitte CE Top 500 rating) than in almost all of Ukraine's neighbours in Eastern Europe. Nevertheless, foreign-owned enterprises have also come to play a significant role in the economy of Ukraine. In 2012, Multinational enterprises (MNEs) from the European Union accounted for about 200 000 employees in Ukraine, while MNEs from the United States of America employed an estimated 26 000 employees. Foreign-owned enterprises dominate mobile telephony: mobile operators are currently deploying their 3G network across the country. They are also prominent players in agribusiness, consumer products, banking and retail distribution. Arcelor Mittal owns one of the largest integrated steel companies in Ukraine.

The status of infrastructure and finance

Sound infrastructure development policies ensure that scarce resources are channelled to the most promising projects. In Ukraine, insufficient investment in energy and deficient infrastructure, in particular in transport, has been increasingly hindering the country's competitiveness. The road network is one of the deadliest in Europe. In addition, while the country boasts a world-class airport in Kyiv International Airport, its railways lag behind in terms of the quality and efficiency of the network. Attempts at attracting private investment in ports and terminals have produced limited results.

The authorities recognise that much larger private sector participation is needed and are committed to address infrastructure bottlenecks. The little experience with public private partnerships (PPPs) compounds the lack of expertise in managing such complex transactions. The intricate legal framework for PPPs means that their preparation is very burdensome, with decisions from various different bodies required. On 24 November 2015, the Ukrainian Parliament adopted changes to the Law of Ukraine on PPPs as well as to some other related laws with the purpose of eliminating regulatory barriers to the development of public private partnership and encouraging investments to Ukraine.

In a similar vein, effective financial sector policies provide a stable environment that facilitates households, enterprises and entrepreneurs to realise their investment plans. Access to finance (especially access to medium and long maturities loans) remains an important obstacle to higher corporate investments and SME growth in Ukraine. Some foreign private-owned banks, traditionally the main lenders to SMEs in Ukraine, exited the market in the aftermath of the 2008-09 crises, while others have been decreasing the size of their balance sheet. The situation deteriorated dramatically in 2014, with a 31% contraction of domestic credit outstanding in real terms and a withdrawal of deposits from the banking sector. The state of the banks, especially those

owned by domestic conglomerates, remains fragile, while the stock exchange and non-bank financial institutions (dominated by insurance companies) are still at an early stage of development. The incomplete credit information system causes high transaction costs (and thus higher interest rates), while long, costly and unpredictable judicial proceedings for contract enforcement impedes the ability of banks to take security and enforce it effectively.

Ukraine is currently undertaking numerous significant reforms that could, if properly implemented, lay the conditions for a sustainable growth of the financial sector. The recapitalisation of the banking sector is under way: systematic asset quality reviews of banks have been undertaken, resulting in mandatory recapitalisation plans or resolution of establishments with insufficient capital. The current crisis episode should therefore result in a necessary consolidation of the banking system. The bank resolution framework is being strengthened and the capacities of the Deposit Guarantee Fund (DGF) reinforced. The National Bank of Ukraine (NBU) has gained new supervisory powers and will closely monitor related party lending, while new legislation toughened disclosure requirements regarding bank ownership. Finally, the new unified registry of credit history should improve Ukraine's credit information system.

Ukraine's investment regime and the OECD National Treatment instrument

The National Treatment instrument is a voluntary undertaking by adherents to the OECD Declaration on International Investment and Multinational Enterprises to accord to foreign-controlled enterprises operating on their territories treatment not less favourable than that accorded in like situations to domestic enterprises in similar activities. Adherents commit themselves to make their list of exceptions to the National Treatment instrument available to the OECD Investment Committee and the public and to review it periodically with a view to improving the effectiveness of international economic cooperation among adherents.

Two categories of restrictions apply to foreign investment activity in Ukraine. The first relates to restrictions that are applied to both established companies with foreign capital and domestic companies with no foreign ownership (i.e. non-discriminatory). The second category relates to certain restrictions applicable only to foreign investment or companies with foreign ownership (i.e. discriminatory). Ukraine's investment policy in this area follows two approaches: Ukraine applies rules on ownership that prohibit foreigners to own a company or operate in a specific sector; it also has rules on acquisition, which regulate the extent a foreigner can acquire stakes in a company operating in a given sector.

For instance, foreign companies (Ukrainian legal entities with foreign investment) are not authorised to own agricultural land and any acquisition of state and municipality land by foreign legal entities is subject to approval by the Cabinet of Ministers. The 1992 privatisation law also prohibits investment in the privatisation of state and municipal property by companies that are more than 25% equity-owned by a state (i.e. by a foreign state or by the state of Ukraine). Foreign ownership of news information agencies is limited to a maximum of 35% of the charter capital. The number of such restricted industries is nevertheless limited and is expected to decrease even further, except for those sectors that are seen by the Ukrainian authorities as national security sensitive due to the on-going tensions with the Russian Federation.

Responsible business conduct and the OECD Guidelines for Multinational Enterprises

The OECD Guidelines for Multinational Enterprises (Guidelines), which form a part of the OECD Declaration on International Investment and Multinational Enterprises, are recommendations on responsible business conduct (RBC) addressed by adherents to businesses operating in or from their jurisdictions. The Guidelines set out principles and standards in all major areas related to good business practices, including information disclosure, human rights, employment and industrial relations, environment, bribery and corruption, consumer interests, science and technology, competition, and taxation.

As adherent to the Declaration, Ukraine has committed to establish a National Contact Point (NCP) for the Guidelines as a dedicated unit within the Ministry of Economic Development and Trade (MEDT), which led Ukraine's adherence process to the OECD Declaration. The Ministry's functions are broad and include, among others, implementation of the EU-Ukraine Association Agreement, cooperation with international financial organisations, strategic planning and regulatory policy, public-private partnerships, and trade, investment, and entrepreneurship policy. In the government's view, MEDT's combined experience, breath of responsibilities, and available resources create the appropriate conditions to establish a robust, transparent and easily accessible NCP that is capable of fulfilling all of its functions effectively. The NCP will initially be staffed by two experts from MEDT that participated in all RBC-related activities organised as part of the adherence process. An action plan has been identified for the NCP's first year of functioning; actions, among others, include quarterly information and promotion activities with a wide range of stakeholders, and outline the initial procedures for how the NCP will handle specific instances.

The concept of responsible business conduct is relatively new in Ukraine. RBC-related activities so far have mostly been undertaken by the private

sector and civil society. While there is no comprehensive national strategy on RBC or public policies targeting responsible business conduct in specific sectors, the ongoing economic and social reforms that aim to bring Ukraine close to international standards in fields such as human rights or labour relations represent a positive step in shaping and strengthening Ukraine's policy framework that affects and enables RBC. Ukraine's adherence to the OECD Declaration, and, in particular, the establishment of an NCP, is an opportunity to further promote RBC principles and standards, both within the government and with the wider public and to further clarify and set out the government's expectations on responsible business conduct.

In specific areas covered by the Guidelines, corporate governance requirements in Ukraine, including on disclosure and reporting, are still evolving. The existing legislation mainly requires disclosure of financial information. Disclosure is an integral part of RBC and corporate governance. Clear and complete information on the corporation is important to a variety of users, from shareholders to workers, local communities, governments and the society at large. The government has a leading role to play in enhancing transparency and accountability in the overall market and would benefit from clarifying the requirements on disclosure, including disclosure of non-financial information.

Ukraine has undertaken concrete steps toward improving the human rights situation. It has ratified all the major international instruments on human rights, as expressed in the International Bill of Human Rights and has an established office of the Ukrainian Parliament Commissioner for Human Rights. The first-ever National Human Rights Strategy in Ukraine was approved in August 2015. Ukraine would benefit from including a section on business and human rights in the action plan to implement the Human Rights Strategy, paying particular attention to measures for ensuring the respect of human rights in Ukraine's conflict-affected regions.

Ukraine has ratified 69 ILO International Labour Standards (Conventions), eight fundamental Conventions and the four governance Conventions. It is currently in the process of introducing major changes to its existing labour legislation. Particular attention should be paid to measures that will increase the labour productivity, while ensuring that the proposed changes are in line with internationally recognised principles and standards on employment and industrial relations. Reducing informality of employment would not only bring substantial benefits to Ukraine's economy, but would also protect workers, increase labour and product market efficiency and productivity.

Strengthening environmental protection and responding to major environmental challenges in Ukraine, particularly soil erosion, agricultural run-off, and low energy efficiency, would bring immediate benefits to Ukraine.

Environmental performance in agriculture and fisheries has declined considerably in Ukraine according to the 2014 Yale Environmental Performance Index compared to 10 years ago, with a respective -22.46% and -10.47% change. Ukraine could consider harmonising its environmental policy to EU standards as part of the obligations under the EU-Ukraine Association Agreement. Strengthening disclosure requirements for environmental and climate change matters is also of relevance.

As noted above, corruption remains one of the main risks for businesses operating in Ukraine, even though a number of actions have been taken by the Ukrainian government in response to it. The Anti-Corruption Strategy of Ukraine was updated for 2014-17 and adopted as a law. The legislation on the National Anti-Corruption Bureau was passed; the President has appointed the head of the bureau and special investigators have been hired. The National Council for Anti-Corruption Policy has been established and held its first meeting, chaired by the President, in October 2015. Businesses are now able to report claims of bribery and other unfair practices by Ukraine's public agencies to the Business Ombudsman and the Tax Ombudsman. New rules aimed at preventing corruption in government purchases have also been established. These developments are encouraging and illustrate the willingness on part of the Ukrainian government to acknowledge the problem of widespread corruption and to take practical measures to address it, although many business representatives feel like not much is happening in practice. One area where future reforms could particularly focus on is strengthening the involvement by the private sector in the implementation and monitoring of efforts to promote integrity in the private sector.

Reforms have been undertaken in the area of consumer interests. The newly established State Food Safety and Consumer Protection Service, which will be directed and coordinated by the Cabinet of Ministers, will focus on food safety, consumer protection, advertising laws and regulations, sanitary legislation, plant, veterinary and agricultural certifications and market supervision. Regarding consumer protection, the service, among other things, will be able to check consumer protection compliance and impose penalties in case of violations of businesses, as well as to control advertising compliance. Future activities could involve supporting and promoting consumer education and information programmes in order to increase the capacity of the civil society to be aware of consumer rights, to monitor government policy, and to promote effective defence of consumer rights. Ukraine could make a particular effort to promote sustainable consumption.

Ukraine's innovation potential is high; however, the full potential of Ukraine's highly educated workforce is not yet fully tapped due to structural and institutional barriers that prevent Ukraine from realising its full innovative

and scientific potential. Reforms in the employment and labour market should yield positive benefits in this regard.

According to the World Economic Forum 2015/16 Global Competitiveness Index, Ukraine has one of the lowest rankings in the world on the effectiveness of anti-monopoly policy – 136 out of 140. Ensuring the impartial and transparent functioning of the Anti-Monopoly Committee of Ukraine and addressing any competition-distorting behaviours in the reform of SOEs should bring benefits to Ukraine.

Ukraine introduced significant tax reforms in 2015. As related to RBC, tax governance and tax compliance should be treated as important elements of enterprise oversight and broader risk management systems and corporate governance. Considering the size of the informal economy in Ukraine, the government should consider assessing if taxes and unified social security contributions represent excessive burdens on those in the formal sector relative to the informal sector.

The road ahead

Provided sweeping political, economic, social, and government reforms are undertaken, Ukraine has a great opportunity to achieve prosperity and fortify independence. Priorities include that financial stability be fully restored (including the unwinding of foreign exchange administrative restrictions) and that the security outlook improves. As the government seeks a new engine for economic recovery in 2016 and onwards, no effort should spared to stimulate foreign investment and attract foreign MNEs. In addition, well-targeted policy reforms can increase the quality and quantity of private investment, especially in infrastructure where it can be a significant complement to public investment. These efforts will have greater chances of succeeding if Ukraine develops a coherent view on the role of foreign investment and MNEs in its development strategy and then applies it consistently and convincingly.

In order to attract new investors, the policy and institutional framework for investment promotion needs to be consolidated. To address this, a more detailed strategy and action plan would be required. In the aftermath of the liquidation of the State Agency for Investments and National Projects, more consideration must also be given to the provision of public support to foreign and domestic investors in the form of business services and informational assistance. The government could consider setting up an agency responsible for investment promotion with a clear mandate and adequate funding. The creation of a user-friendly and regularly up-dated online portal specifically designed for potential and existing investors could help investors get information and shed some light on recent legal and regulatory changes and upcoming opportunities.

Even though the number and scope of regulatory restrictions to foreign investments is limited, the government could reconsider some of them. It is already planning to revise the 1992 Privatisation Law in order to allow foreign companies that are more than 25% equity-owned by a state to take part in privatisation of State-owned enterprises. This would open privatisation tenders to a broader scope of foreign investors in and thus allow more competition between bidders. Ukraine could also soften strict conditions on the acquisition of non-agricultural land plots outside of settlements by foreign businesses established in the country. Ukraine should consider opening some of its public monopolies (such as railways and the production of ethyl alcohol) to attract private and foreign investments in these sectors and improve productivity. Last but not least, defining clearly the scope of "strategic sectors" that may be closed to foreign investment or subject to special authorisations procedures for national security reasons would reduce any current legal uncertainty concerning foreign investment in these sectors.

Anti-corruption policies are also critical for attracting investors and for reaping the development benefits of investment. Although Ukraine has made progress in setting up a legal and institutional framework to combat corruption, enforcement is uneven. More consideration should be given to provide adequate political and financial support to the newly established anti-corruption bodies. The wish to combat corruption effectively can be fulfilled only if they have sufficient resources and are not influenced by undue considerations.

Investment treaties are another policy area to help contribute to a sound investment climate for both existing and new investors. Ukraine should consider updating its international investment agreements with a view to ensuring that they well-reflect government intent and emerging trends in investment treaty policy. As part of this strategy, Ukraine and its treaty partners should consider specifying the treaty language of key investment protection provisions, such as on expropriation, fair and equitable, and most favoured-nation treatment. With regard to investment arbitration proceedings, Ukraine and its partners should provide for adequate levels of regulation and ensure that they respect minimum standards of transparency and accountability. A first valuable step could be for Ukraine to adhere to the UN Convention on Transparency in Treaty-Based Investor-State Arbitration. The review provides useful information on the temporal validity of Ukraine's international investment agreements, which could inform the country's timetable to engage with its treaty partners.

Finally, Ukraine's newly established NCP could serve as a valuable vehicle for bringing about policy coherence on a wide range of issues that affect the quality of the investment environment, including, for example, labour relations and corporate governance. A robust NCP, one that has adequate human and financial resources to operate effectively, also has the potential to

shape the quality of incoming investments, contributing to a more stable and predictable investment environment based on a level-playing field. Should the government decide to set up an agency for investment promotion, a partnership between the NCP and this agency would ensure that investors are fully aware of Ukraine's expectations on responsible business conduct.

Box 1. **Policy recommendations**

- Define the strategic sectors in which foreign investment is prohibited or subject to specific authorisation procedures; specify relevant authorisation procedures, including the conditions/documents required for applications and the deadline for reply to applicants by the responsible authority.
- Observe the guiding principles of non-discrimination, proportionality, transparency and accountability in implementing investment measures related to national security, as expressed in the 2009 OECD Guidelines for Recipient Country Investment Policies relating to National Security and consider the formal acceptation of these recommendations.
- Clarify the notion of control of "residents from countries undertaking armed aggression against Ukraine and/or creating conditions for armed conflict or use of military force against Ukraine" in the Law "On Licensing Types of Economic Activity" (in particular, whether indirect control falls under the scope of this provision). Ensure that different licensing authorities apply this provision consistently.
- Issue the implementing legislation to mainstream electronic registration.
- Continue the process of business simplification, especially about permit procedures.
- Abolish the moratorium on agricultural land ownership and accelerate the implementation of the unified registration of land and real estate property.
- Ensure that the recommendations of the Business Ombudsman Council based on the analysis of issues that are brought to its attention are taken into account to effectively tackling concrete problems faced by new and established investors.
- Develop and publicise a detailed strategy and action plan for investment promotion and consider setting up an agency responsible for investment promotion with a clear mandate and adequate funding. This would include the creation of a user-friendly and regularly up-dated online portal specifically designed for potential and existing investors to help investors get information and to shed some light on recent legal and regulatory changes and upcoming opportunities. The role of the NCP and the expectations on responsible business conduct, as outlined in the OECD Guidelines for Multinational Enterprises, should be adequately reflected in these efforts.

Box 1. **Policy recommendations** *(cont.)*

- Ensure that the principles contained in the Instrument on International Investment Incentives and Disincentives are observed, in particular concerning the importance for adherents to evaluate the costs and benefits of incentives with a view of meeting their investment promotion objectives.
- Carry out a thorough costs-benefit analysis before reintroducing the preferential investment regimes in priority development territories and industry parks.
- Finalise refunding of VAT arrears and improve VAT administration as foreseen by the IMF agreement and the government's plan
- Develop implementing regulations to make possible the rapid and effective application of the law on public-private partnerships. Improve the regulatory framework of PPPs (Public-Private partnerships) in line with international standards to strengthen existing guarantees granted to private investors while ensuring its overall coherence.
- Strengthen the dedicated PPP unit under the Ministry of Economic Development and Trade, and give it resources to engage in technical support and capacity building of officials dealing with PPP Projects (including at the subnational level). Given the lack of practical PPP experience, focus on projects where technical and other risks are well understood, such as basic infrastructure.
- Pursue ongoing financial regulation reforms, including the reinforcement of the supervisory capacity of the NBU and the NCSSM, since new regulatory powers are to be transferred to these institutions. Strengthen corporate insolvency and credit enforcement mechanisms, in particular the enforcement of collateral by creditors.
- Establish a general credit guarantee scheme focused on SMEs and based on best practice in transition countries.

Box 2. **Recommendations on responsible business conduct**

- Consider developing a national action plan or strategy on responsible business conduct, based on the OECD Guidelines for Multinational Enterprises and in line with international good practice. Ensure, as a matter of policy coherence, that the extent of business responsibilities on environmental and social matters is considered during the ongoing reforms.
- Streamline and clarify corporate governance requirements, including also on disclosure of non-financial information.
- Consider including a section on business and human rights in the action plan to implement the National Human Rights Strategy of Ukraine, paying particular attention to measures for ensuring the respect of human rights in Ukraine's conflict-affected regions.
- Adhere to the OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas at the same time as the OECD Declaration in light of the importance of the mining sector in Ukraine.
- Finalise employment and labour market reforms, paying particular attention to measures that will reduce the rates of informal employment, skills mismatch and labour mobility.
- Strengthen environmental protection, paying particular attention to the most urgent environmental issues such as soil erosion, agricultural run-off, and low energy efficiency.
- Continue the ongoing reforms to combat corruption and consider strengthening the involvement of the private sector in the implementation and monitoring of efforts to promote integrity in the private sector as outlined in the 2014-17 Anti-Corruption Strategy of Ukraine.
- Consider introducing initiatives that promote consumer education and information programmes in order to increase the capacity of the civil society to be aware of consumer rights, to monitor government policy, and to promote effective protection of consumer rights. Particular efforts could be made to promote sustainable consumption.
- Ensure that competition-distorting behaviours are adequately addressed through impartial and transparent functioning of the Anti-Monopoly Committee of Ukraine and ongoing SOEs reforms.
- Considering the size of the informal economy in Ukraine, consider assessing if taxes and unified social security contributions represent excessive burdens on those in the formal sector relative to the informal sector.

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Chapter 1

The role of FDI and multinational enterprises in Ukraine's economic development

Attracting foreign investors has been a top priority for Ukraine's authorities, particularly since 2014. Ukraine underwent a deep recession and a sharp macroeconomic adjustment in 2014-15, in large part due to unprecedented geopolitical tensions and military conflict in the East. As a result, FDI inflows reached their lowest level in a decade in 2014, before partially recovering in 2015. Companies from the European Union (EU), the United States and Russia are major foreign investors. The FDI Stock (49% of GDP at the end of 2014) is heavily concentrated in metallurgy, finance, retail trade and other non-tradable sectors. Over the long-term, attracting more export-oriented, efficiency seeking FDI projects in a broader range of manufacturing sub-sectors would benefit both export diversification and a better integration into EU value chains.

Introduction

Ukraine has faced considerable economic challenges in recent years and been living through enormous political turbulence since the end of 2013. Social unrest, which started in Kyiv at the end of 2013, led to an overturn of the Yanukovych government. New presidential elections took place at the end of May 2014. In 2014, relations between the Russian Federation and Ukraine became extremely tense, with a new gas supply dispute between Naftogaz and Gazprom, the events regarding the Autonomous Republic of Crimea, an escalation in fighting in Ukraine's Donbas region, severe damage to industrial capacity and infrastructure in the east, and significant disruptions in bilateral trade.

Ukraine suffers from three large economic problems. First, its foreign payments are unsustainable. In 2013, the current-account deficit reached 9.2% of GDP, with foreign-currency reserves covering just over two months of imports. High debt refinancing needs weigh on the balance of payments. Second, public finances are also unsustainable; with the consolidated budget deficit (i.e. including Naftogaz) exceeding 10% of GDP in 2014 and expected to remain well above 7% in 2015 amid weakness in revenue collection, skyrocketing government-bond yields, and increased security-related spending.[1] Third, macroeconomic adjustment has been sharp. Following the National Bank of Ukraine (NBU)'s forced abandonment of the currency peg in February 2014, the Hryvnia (UAH) depreciated by around 85%. Deficit monetisation by the NBU restricts its monetary policy aimed to cut inflation. Unprecedented security challenges and uncertainty have taken a severe toll on the economy, with activity shrinking by an estimated 8.2% in 2014 and the recession continuing in the first three quarters of 2015.

Since mid-2014, successive new governments committed themselves to restore macroeconomic stability, strengthen economic governance and transparency, and generate sound and sustainable economic growth, while protecting the most vulnerable. Ukraine signed an Association Agreement (AA), including a Deep and Comprehensive Free Trade Area (DCFTA), with the European Union (EU), secured a new International Monetary Fund (IMF) programme in August and initiated structural changes in the energy and banking sectors. Most remarkably, the second government appointed in December 2014 under Prime Minister Arseniy Yatsenyuk contains three foreign nationals, who were awarded Ukrainian citizenship the same day they became ministers.[2]

With a population of around 45 million inhabitants in 2013 and an area of 603 628 km^2, Ukraine is the largest country entirely within Europe and has the lowest geographical density. Within the Commonwealth of Independent States (CIS), which in 2011 signed the CIS Free Trade Area (CISFTA) Agreement, Ukraine is the second largest economy.[3] It is ranked as a lower middle-income country according to both the World Bank and the United Nations. With a Gross Domestic Product (GDP) per capita in purchasing power parity of USD 8 665 in 2013, it is the fourth-poorest country in both Central and Eastern Europe (after Moldova, Armenia and Georgia) and the CIS.[4] This reflects the fact that Ukraine has experienced one of the weakest post-1990 growth performances among post-communist Europe transition countries.

The country has suffered from recurrent political instability, particularly since 2012, and military spending, at 2.9% of GDP in 2010-14, is relatively high and growing. Successive governments have acknowledged that FDI can play a crucial role in national development. Nonetheless, with some exceptions, mostly in agribusiness, consumer products, retail trade and financial services, few large MNEs have invested in Ukraine. In some sectors, in particular consumer products and financial services, global corporations imported international business practices and set an example for domestic investors. Failure to attract FDI in high value-added and technology-intensive sectors means that the country's exports remain relatively undiversified (Table 1.2: the number of exported products has slightly decreased between 2008 and 2013, and is lower than Poland and Turkey), a contributing factor for slow economic growth.

The country faces enormous challenges to increase participation in global value chains (GVCs), to facilitate linkages between MNEs and domestic companies, and to accelerate productivity growth. Most promises of deep economic reforms have failed to materialise. As part of the 2014 Memorandum of Economic and Financial Policies with the IMF, authorities affirm that they will continue to pursue the objectives of restructuring Naftogaz and amending relevant laws to allow FDI in companies operating in the gas transport and storage business. The international community has confirmed its commitment to help authorities and is now eagerly waiting for action. It is against this backdrop that the OECD and Ukraine are collaborating.

Recent developments of the Ukrainian economy

As highlighted by Table 1.1, the structure of the economy has been evolving over the past decade or so. In fact, in Eastern Europe Ukraine has been one of the countries most seriously hit by the global financial and economic crisis. First of all, the manufacturing sector has always been central to Ukraine's economy. It was the most important contributor to GDP during the first part of the past decade, but its share of GDP declined steadily from 23% in 2007 to 13%

Table 1.1. **Percentage of real GDP per sector (System of National Accounts 2008)**

Sector	2000	2006	2012*
Agriculture, hunting, forestry and fishing	16.35	8.26	8.97
Mining and quarrying	4.91	4.39	6.54
Manufacturing	20.37	21.40	14.14
Utilities	7.74	4.43	4.17
Electricity	6.72	3.47	3.61
Water supply	1.02	0.96	0.56
Private services	37.10	45.49	49.09
Construction	4.06	4.64	3.21
Wholesale and retail commerce	9.86	13.77	16.66
Transport, storage	10.52	8.99	8.23
Restaurants and hotels	0.55	1.08	0.91
Information and telecommunications	3.31	3.32	3.50
Financial intermediation and insurance	2.18	5.21	4.94
Real estate	4.28	5.25	6.89
Professional activities	1.58	2.21	3.41
Other business services	0.76	1.02	1.34
Public services	12.12	14.21	15.27
Public administration and compulsory social security	4.50	5.36	5.10
Education	4.80	5.30	5.95
Human health and social service activities	2.82	3.55	4.22
Arts, entertainment	0.43	0.69	0.82
Other services	0.97	1.12	1.02
GDP at basic prices	100.0	100.0	100.0

* Preliminary data.

Source: State Statistical Service of Ukraine (SSSU), *Annual National Accounts*, *https://ukrstat.org/en* (accessed on 1 August 2015).

StatLink http://dx.doi.org/10.1787/888933355851

in 2014. Manufacturing employed an estimated 12% of the labour force in 2009 (according to most recent data from the State Statistics Service of Ukraine). The crisis has had a particularly severe impact on the ferrous metal industry (i.e. cast iron, steel, and steel pipe), mineral fertilisers and sulphuric acid. Second, although Ukraine is also a major producer of grain, sunflower seeds, and beet sugar, the share of the agricultural sector in GDP has also been declining, from 17% of GDP in 2000, to 9.3% in 2012. On the other hand, this sector still employed 17.2% of the labour force in 2012. The contribution of private services, on the other hand, has risen fast, from 37.1% to 49.1% of GDP, with commerce and real estate showing remarkable dynamism (Table 1.1).

In fact, commerce has been the main driver of GDP growth during the 2000s and is now the single-largest contributor to GDP, at 16.7% in 2012.

Ukraine has opened its economy, including trade and investment liberalisation, and sought to expand and diversify its export base. Ukraine's

average tariff is comparable to other transition economies that have acceded to the WTO, and lower than the average developing country (Hoekman et al., 2014). This indicates that the present tariff policy of Ukraine does not present substantial anti-export bias and, except for a few sectors with tariff peaks, the tariff regime is not an impediment to Ukrainian development. Nonetheless, several restrictions to private investment persist in certain key sectors (see below).

Merchandise exports have grown five-fold in the 18 years to 2013,[5] and per capita trade has grown 78% since 2008, and yet Ukraine has simply maintained its global market share. A comparison of its trade profile with those of two European emerging economies of comparable size, Poland and Turkey, is illustrative (Table 1.2).

Table 1.2. **Trade profiles – Ukraine compared to Poland and Turkey**

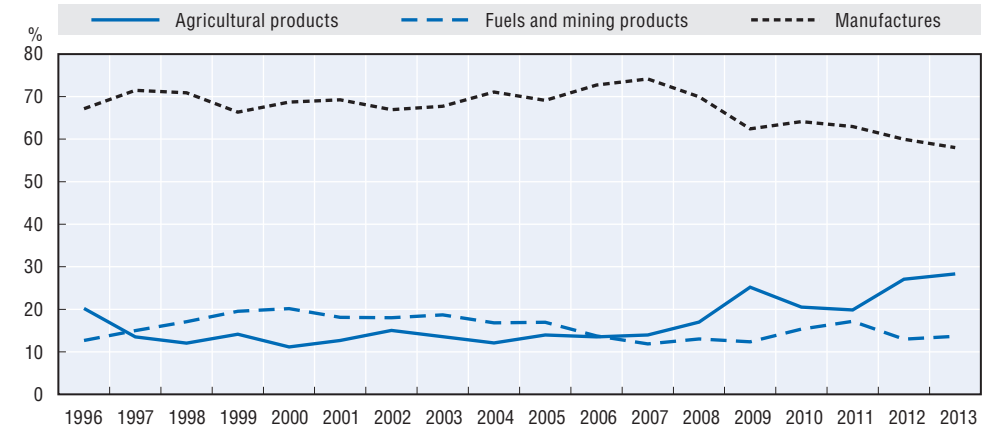
	Ukraine 2008	Ukraine 2013	Poland 2013	Turkey 2013
MERCHANDISE TRADE				
Share in world total exports	0.35	0.34	1.07	0.81
Number of exported products (at the HS6 digit level)	2 289	2 191	3 521	3 404
Number of export markets	131	102	112	115
Share in world total imports	0.43	0.41	1.09	1.33
Number of imported products (at the HS6 digit level)	3 500	3 420	4 110	3 828
Number of import markets	144	148	171	174
Trade per capita (USD, three-year average)	2 311	4 119	12 245	6 151
Breakdown in economy's total exports/by product				
Agricultural products	13.8	28.1	14.1	11.5
Fuels and mining products	11.4	13.5	9.0	8.7
Manufactures	73.6	57.4	76.7	76.1
Breakdown in economy's total exports/by partner				
Partner #1	31.5	26.5	74.3	42.3
Partner #2	22.5	23.8	5.4	7.9
Partner #3	6.2	6.0	2.9	4.6
Partner #4	3.2	4.3	2.2	3.7
Partner #5	3.1	4.3	2.0	3.3
COMMERCIAL SERVICES TRADE				
Share in world total exports	0.41	0.42	0.86	1.00
Share in world total imports	0.35	0.35	0.75	0.51
Breakdown in economy's total exports/by service item				
Transportation	44.8	41.8	30.5	28.2
Travel	33.7	26.2	28.4	60.5
Other commercial services	21.5	31.9	41.1	11.3
ECONOMIC COMPLEXITY INDEX	0.55	0.79	1.03	0.48

Source: Based on WTO, *World Integrated Trade Solution (WITS)* (database), *http://wits.worldbank.org/* (accessed on 1 December 2015); Observatory of Economic Complexity.

StatLink http://dx.doi.org/10.1787/888933355868

Primary products remain the backbone of commodity export trade. As a share of total merchandise trade, the traditional agricultural exports of wheat, barley, rapeseed and maize have more than doubled from almost 14% in 2008 to more than 28% in 2013. Fuels and mining products also saw their relative participation increase, although at a slower pace. While 73.6% of exports were industrial goods (Figure 1.1) in 2008 – more or less in line with the levels now prevailing in Poland and Turkey – their participation fell markedly to 57.4% in 2013. Most exports are destined for the European Union (EU) market, accounting for 26.5% of total exports in 2013, followed by Russia (23.8%), Turkey (6%) and the People's Republic of China (4.3%). The vast majority of imports also originate from the EU (35.1% of total imports in 2013) and Russia (30.2%) and mainly consist of manufacturing goods and energy, respectively. It is interesting to observe that the incidence of the EU as a trade destination has decreased over time (it accounted for 31.5% of exports in 2010) and is much lower than for Poland and Turkey.

Figure 1.1. **Structure of Ukrainian exports**



Source: WTO, *WTO Statistics* (database), *http://stat.wto.org/Home/WSDBHome.aspx?Language* (accessed on 1 December 2015).
StatLink http://dx.doi.org/10.1787/888933355710

Unsuccessful integration into the world economy, despite the large benefits Ukraine could derive from trade, owes a lot to insufficient export diversification. In 2012 Ukraine exported fewer products to fewer partners than in 2008; the same is true when the comparison is made with Poland and Turkey (Hoekman et al., 2014). In practice the country's full "export basket" is fairly simple: farming products (corn and soybeans) and metals (iron and steel products). The case of trade with Italy, Ukraine's biggest export market in Western Europe, is exemplary – Ukraine sells a small number of simple goods, such as metals, food, minerals, and wood, and barely any machinery and more

sophisticated manufactured goods. On the other hand, Russia buys not only metals, but also more complex manufactured goods, such as railway cars, aircraft parts, and car parts. For the country's medium-term growth prospects, improving trade links with Russia could thus help preserve and possibly upgrade these significant manufacturing sub-sectors.

Although economic integration has been central among the country's priorities in its short history as an independent nation, Ukraine has found it somewhat difficult to choose between two competing partners, the EU and the Customs Union of Russia, Belarus and Kazakhstan (RBK CU) established in the Eurasian Economic Community framework.[6] The talks on Association Agreement with the EU were launched in 1997, followed by technical negotiations of the Deep and Comprehensive FTA (DCFTA) that started in 2008 and were completed in October 2011. Parliament ratification of the agreement was delayed and in April 2014, in response to the seriousness of security, political and economic challenges, the EU unilaterally granted Ukraine preferential access to the EU market until 31 December 2015. DCFTA was finally ratified in September 2014, although the EU delayed implementing the trade accord until 31 December 2015 to guarantee Ukraine's access to the CIS market under the Ukraine-Russia bilateral preferential regime. The cooperation with the CIS countries has been also considered as a strategic priority of Ukraine. Ukraine currently has free trade status (with certain exceptions) with the members of the ECU, but significant non-tariff barriers exist.[7] The border clearance problems in August 2013 dramatically highlighted longstanding trade facilitation problems.

Research has shown that the greatest benefits from preferential trade agreements come from the deep aspects of the agreements, not from the preferential tariff liberalisation. In the case of Ukraine, the application of a supply chain-centred approach to lowering trade costs with, Belarus, Russia and Kazakhstan would be particularly useful. Indeed, lowering trade costs created by regulatory policies will generate much larger gains than changes in import tariffs (see, e.g. Movchan and Guicci, 2011).

Ukraine is not integrated in global value chains

As Ukraine has found it very difficult to attract FDI, especially in non-traditional export sectors, it is also failing to integrate its economy in GVCs where global MNEs play a crucial role. Foreign investors have so far mainly targeted the domestic market, especially non-tradable sectors such as finance, retail trade, and other services. Not only is the share of FDI in manufacturing smaller than in comparable countries like Poland and Turkey. FDI in manufacturing is also heavily concentrated in metallurgy, where the end product is sold as a commodity in global markets. Ukraine would benefit from attracting more export-oriented, efficiency seeking FDI projects in a broader range of

manufacturing sub-sectors. Given the recent depreciation of the Hryvnia and competitive labour costs, Ukraine would be well placed to attract FDI into labour-intensive sectors. In this regard, deeper integration into EU value chains (which is consistent with the DCFTA with the EU) in sectors like automotive components or ICT equipment is a valuable option (Adarov et al., 2014).

While the political and security situation has deteriorated in recent years, the problems are long-term and have to do with poor business environment, weak institutions and widespread corruption. It is not surprising that linkages between foreign direct investors and domestic companies, including service SMEs, are underdeveloped and thus depress the competitiveness of Ukraine. The temptation is always strong to overcome these problems through specific measures to promote and facilitate targeted investments, but the emphasis should rather be on improving the business environment throughout the whole spectrum of policy areas. In that regard, Ukraine could benefit from the work of the OECD on GVCs, including in the area of investment policy (Box 1.1).

Box 1.1. **Global value chains and investment policy: key OECD messages**

- Given the important role of Multinational Enterprises (MNEs) in Global value chains (GVCs), lowering investment barriers is an efficient way for a country to become integrated in GVCs. By inhibiting the efficient functioning of GVCs, impediments to cross-border investment can have negative welfare impacts beyond the home and host country.
- The current international investment regime built on thousands of bilateral and regional investment agreements does not adequately reflect the interconnected nature of economies in GVCs. Multilateral co-operation and co-ordination, such as the OECD *Policy Framework for Investment* and the OECD *Codes of Liberalisation*, are needed to maintain the open and predictable international investment climate that has supported international investment in GVCs.
- To realise the full benefits of international investment, investment promotion and facilitation policies need to focus more closely on the activities undertaken in GVCs rather than on industries. These policies must recognise that success in GVCs depends on both inward and outward investment. Governments should avoid incentive wars to attract high-value stages of a GVC and should work together to ensure that the multilateral investment system continues to support growth.
- Large MNEs, including in some cases state-owned enterprises (SOEs) are prominent players in GVCs. This has raised policy concerns, for example about the effects on competition and markets further downstream.

Box 1.1. **Global value chains and investment policy: key OECD messages** *(cont.)*

- GVCs can support the spread of principles and best practices on responsible business conduct. The OECD Guidelines for Multinational Enterprises and implementation tools such as the OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas are policy instruments for promoting responsible business in GVCs.

For further details on OECD work regarding global value chains, please refer to the 2013 OECD report "*Interconnected Economies: Benefiting from Global Value Chains*", *www.oecd.org/sti/ind/interconnected-economies-GVCs-synthesis.pdf*.

Because of these economic dynamics, Ukraine has a chequered history with regards to living standards and poverty reduction. While the poverty rate was reduced from 11.9% in 2000 to 1.9% in 2013 according to the absolute criterion (share of the population whose daily consumption is below USD 5.05 [PPP]), it hardly budged according to the relative criterion (the share of the population below the national poverty line), from 26.4% to 24.5% (UNDP, 2015).[8] In addition, almost every third family with children is poor (32.6%), as is every fifth working person (20.7%). As result of rapid economic growth, particularly prior to the global financial crisis, the poverty rate declined from 14.7% in 2006 to 3.9% in 2012. From 2007 to 2012, consumption for the bottom 40% grew by more than twice that of the rest of the population (3.9% vs. 1.5%). This reflected a higher growth in wage income than for the average of the population (24% vs. 19%), driven by improvements in the education profile of those in the bottom 40%, and a slight decrease in the share of unemployed over the period. Higher growth in social assistance receipts and child benefits also played a role. In 2014, the country was ranked 83rd out of 187 countries on the United Nations Development Programme (UNDP) Human Development Index.[9]

Public spending on education represented 6.7% of GDP in 2012, which is comparable to that of many OECD countries. The adult literacy rate was 99.7% in 2012, the youth one marginally higher at 99.8%, and the gender gap is nihil (UNESCO). According to the World Economic Forum 2015/2016 Global Competitiveness Index, Ukraine is ranked 45th out of 140 economies for the quality primary education and 46th for the quality of higher education. These figures makes Ukraine one the highest ranked countries for the quality of primary and higher education among European transition countries. The country performs much worse in terms of health, with a life expectancy of 71 years (and as low as 66 years for men) despite expenditure representing approximately 7.6% of GDP.

On the political front, Ukraine has found it difficult to establish a transparent and well-functioning democracy. Since 2004, successive democratically elected regimes have proven unable to complete their terms in power. It is hence one of the most politically unstable countries in Eastern Europe and the inefficiency and fragility of its institutions has hindered Ukraine's economic development. Corruption has also been a major problem for businesses in Ukraine.

On top of these factors, Ukraine is facing a number of new challenges that will negatively affect its long-run economic performance and competitiveness. First of all, although Ukraine has maintained a rather low level of income inequality (the Gini index shifted from 0.291 in 2002 to 0.248 in 2010) and 95% of the old-age population is covered by social security, fairness and unequal opportunities are considerable concerns. According to the IMF (2014), "the majority of social assistance is captured by higher-income households who consume the largest share of gas and heat. For instance, the top quintile in the income distribution gets subsidy benefits that are, as a rule, double those of the bottom quintile". High and increasing level of inter-regional inequality is another concern: the dispersion of regional GDP and household income is higher than in most OECD countries. Prior to the 2009 crisis, Kyiv saw its share of GDP grow, while GDP levels and living standards stagnated in the poorer (largely agricultural) regions (OECD, 2013).

Analysis of workplace conditions such as risk of on-the-job injury, various benefits/amenities, and insecurities with wage payments, shows that the inequalities in these conditions do exacerbate inequalities in hourly wages (Nizalova, 2014). The informal sector is relatively large in Ukraine (it was estimated to account for 23% of total employment in 2010) and its size is increasing due to the current economic downturn. Moreover, Ukraine experienced amplified criminality and violence in the 2000s and is faced with organised crime, mainly related to cigarettes, drug and human trafficking (the port of Odessa being notorious for these activities, also due to proximity with Transdniester, the pro-Russian enclave).[10]

The role of foreign direct investment in Ukraine's development

Over the past two decades, Ukraine has evolved as an investment destination. In the mid-1990s some pioneer enterprises in the light industrial sector (food processing and tobacco) established operations in the country, but the stock of foreign direct investment (FDI) in Ukraine was negligible compared to other transition economies in Central Europe (Meyer and Pind, 1999). It was not until the early 2000s – i.e. much later than in other former socialist countries – that the country began to sell off large state-owned enterprises and attract investment. Russian investors figured prominently in Ukrainian privatisation, in particular in energy and telecoms.

FDI stands out among the government's priorities and is well embedded in its current development strategy. The National Development Plan (NDP) 2011-14 has four main pillars of government actions: 1) social welfare; 2) public safety and social peace; 3) environment and land management; and 4) competitiveness and innovation. The last pillar is divided into two strategic objectives: i) increasing production through investments in human capital and infrastructure and increased efficiency; and ii) promoting sustainable growth by expanding and diversifying markets. According to the NDP, FDI has a key role to play in both strategic objectives. Recognised benefits of FDI by the government include bringing capital, creating direct jobs and contributing to increased efficiency and know-how. Particular attention is given by the government to linkages in order to strengthen small and medium-sized enterprises (SMEs).

The Ministry of Economic Development and Trade (MEDT) is in charge of defining the country's FDI policy, overseeing special incentives regimes, and co-ordinating FDI-related strategies and plans.[11] The State Agency for Investment and National Projects (SAINP), directed and coordinated by the Cabinet of Ministers, was responsible for implementing the FDI policy and managing strategic projects.[12] A department was designated for investment promotion (InvestUkraine). After the change of government in March 2014, the SAINP was liquidated and its functions have since then been passed to the MEDT.[13] The investment promotion and facilitation section of Chapter 2 provides further details.

Recent FDI trends

Statistics in Ukraine are compiled in accordance with the most recent international standards: the IMF's Balance of Payments and International Investment Positions Manual, 6th edition (BPM6) and the OECD's Benchmark Definition of Foreign Direct Investment, 4th edition (BMD4) (Box 1.2). Over the past two decades, gross annual FDI inflows to Ukraine have increased at an impressive pace, before decelerating abruptly in 2013 and in particular in 2014 when they reached their lowest level in more than a decade (Figure 1.2). Whereas in 2004 FDI inflows totalled USD 1 711 million, in 2008 it reached USD 10 700 million. Gross FDI inflows nonetheless more than halved in 2009, in the broader context of the global economic slowdown. In 2013, FDI flows to Ukraine declined again by 45%, reflecting mounting concerns about economic management and the business environment, and in 2014 plummeted by 81% in a context of political instability and escalating conflict in the Donetsk and Lughansk regions (Figure 1.2 below). FDI inflows (liabilities) recovered in 2015: they amounted to USD 3 050 million; while FDI inflows (liabilities) were only USD 847 million in 2014. This recovery of FDI inflows is largely due to the recapitalisation of foreign-owned banks, including through debt to equity conversion.

Box 1.2. **Ukraine's foreign direct investment statistics**

Statistics on Ukraine's foreign direct investment (FDI) are compiled and disseminated by both the National Bank of Ukraine (NBU) and the State Statistics Service of Ukraine (SSSU). The FDI statistics of the SSSU are compiled from data collected on quarterly and annual enterprise surveys. The SSSU currently disseminates statistics on inward and outward equity capital FDI positions by partner countries. The surveys used by SSSU have recently been revised to include information recommended in the latest international guidelines, including coverage of transactions and positions between fellow enterprises,* the identification of Special Purpose Entities (SPEs),** and identification information for the ultimate controlling investor. The first results from these revised surveys are expected to be released in 2016.

The NBU is responsible for publishing the quarterly and annual balance of payments and annual international investment position statistics. The NBU's FDI statistics are based on the FDI surveys conducted by the SSSU and on information from an International Transactions Reporting System. These data are supplemented by information on privatizations from the State Property Fund and, for debt instruments, by data from surveys that collect information on the external loans of banks and other enterprises. The NBU disseminates FDI statistics as part of Ukraine's balance of payments and international investment position statistics.

In common with other international organisations, such as the World Bank and UNCTAD, the OECD report refers to the NBU statistics for aggregate FDI flows and stocks and uses the SSSU statistics for the geographical breakdown given that such data are not systematically available in the NBU balance of payments reports.

While the NBU publishes data according to BPM6, there are some important details that are not published, including the amount of reinvested earnings and transactions and positions between fellow enterprises. The revised surveys that the SSSU has begun to use should enable the publication of this additional detail. In addition, these revised surveys should enable the SSSU to publish more detailed statistics on FDI that would be useful for globalization analysis, including supplemental presentations recommended in BMD4. First, the identification of FDI flows and positions associated with SPEs could enable SSSU to publish information on FDI flows and positions excluding SPEs, providing a much better measures of FDI into their country that is having a real impact on their economy. Second, the identification information on the ultimate controlling investor could enable the SSSU to publish statistics on inward investment in the Ukraine that identify the countries of the investors that ultimately control the investments in their country. This presentation shows the country of the direct investor who ultimately controls the investment

Box 1.2. **Ukraine's foreign direct investment statistics** *(cont.)*

and, thus, bears the risks and reaps the rewards of the investment. This presentation can result in substantial changes in the distribution of inward positions by country from the standard presentation by immediate investing country. In addition, this presentation can show inward investment controlled by investors in the reporting economy; this is inward FDI resulting from round-tripping. Round-tripping is when funds that have been channelled abroad by resident investors are returned to the domestic economy in the form of direct investment. It is of interest to know how important round-tripping is to the total inward FDI in a country because it can be argued that round-tripping is not genuine FDI into an economy.

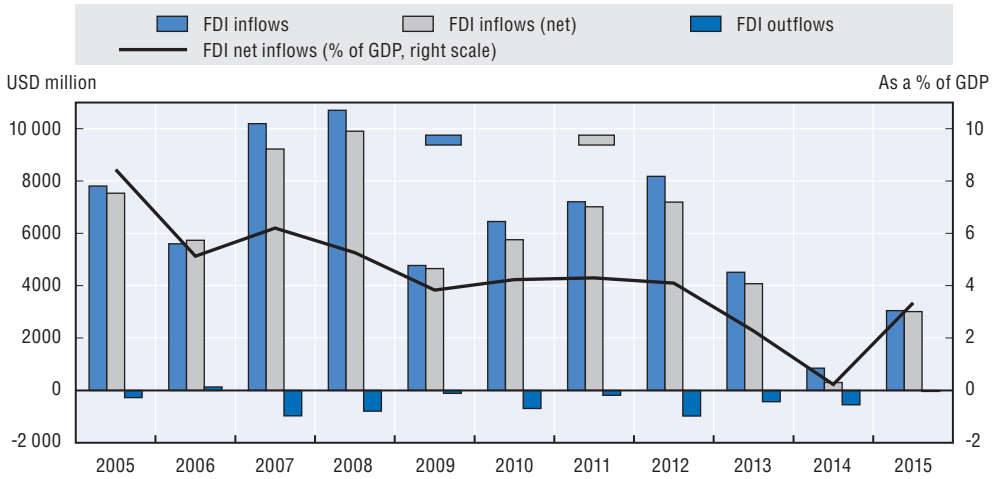
For more information on OECD statistical instruments: *www.oecd.org/investment/statistics.htm*.

* Fellow enterprises are entities that do not have a direct investment relationship themselves but that have a direct investor in common. Transactions and positions between fellow enterprises are included in FDI statistics because these transactions and positions likely resulted from the influence of the common direct investor.

** Special Purpose Entities are entities with little or no physical presence in the host economy but that provide services to the multinational enterprise, such as holding assets and liabilities and raising capital.

Figure 1.2. **FDI Inflows, outflows and net inflows (2004-15)**

USD millions (left axis) and % of GDP (right axis)



Source: Based on National Bank of Ukraine (NBU), *Balance of Payments Statistics* (database), *www.bank.gov.ua/control/en/publish/article?showHidden=1&art_id=19486397&cat_id=47388&ctime=1438695717136* (accessed on 1 March 2016); International Monetary Fund, *World Economic Outlook Database*, *www.imf.org/external/pubs/ft/weo/2015/02/weodata/index.aspx* (accessed on 1 March 2016).

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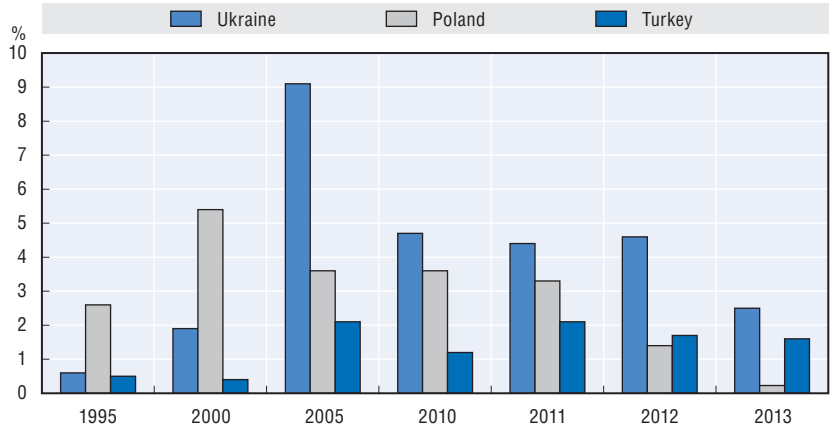
In relative terms, since 2005 FDI flows to Ukraine have performed well: in 2012 they were equal to more than 4% of GDP (Figure 1.2 above). In the 2000s, FDI inflows expressed in percentage of annual GDP have been significantly higher in Ukraine than in Poland and Turkey (see Figure 1.3 below). However, Ukraine's FDI stock *per capita* was well below the level of Poland and Turkey at the end of 2014 (Figure 1.4 below). These results, however, must be interpreted

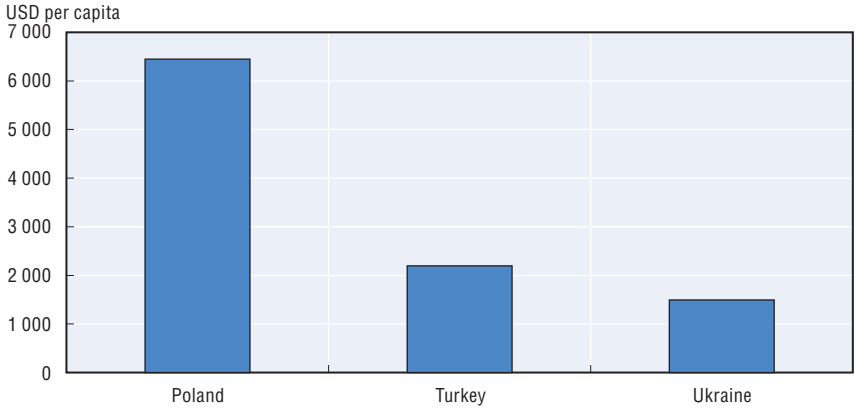
Figure 1.3. **FDI inflows (gross) as a percentage of GDP in Ukraine, Poland, and Turkey for selected years**



Source: Based on National Bank of Ukraine (NBU), *Balance of Payments Statistics* (database), *www.bank.gov.ua/control/en/publish/article?showHidden=1&art_id=19486397&cat_id=47388&ctime=1438695717136* (accessed on 1 March 2016); International Monetary Fund, *World Economic Outlook Database*, *www.imf.org/external/pubs/ft/weo/2015/02/weodata/index.aspx* (accessed on 1 March 2016).

StatLink http://dx.doi.org/10.1787/888933355730

Figure 1.4. **FDI inward stock per capita, 2014**



Source: Based on UNCTAD, WIR Annex Tables, *http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx* (accessed on 1 March 2016).

StatLink http://dx.doi.org/10.1787/888933355741

with caution, insofar as a sizeable portion of *prima facie* foreign capital may in fact correspond to round-tripping FDI: official statistics therefore overestimate the real level of inward FDI.

FDI inflows to Ukraine have been mostly composed of mergers and acquisitions (M&As, see Table 1.5 below), as Ukrainian companies were targets of significant deals from 2005 to 2011. However, Ukraine attracted remarkably little Greenfield FDI. The value of announced Greenfield projects to Ukraine has been consistently lower than in Poland and Turkey during the last 10 years (Table 1.3 below).

Table 1.3. **Value of announced Greenfield FDI projects 2004-14 (USD million)**

Year/Country	Ukraine	Poland	Turkey
2004	3 356	14 247	4 402
2005	5 814	13 882	4 922
2006	4 921	15 603	11 699
2007	7 050	18 336	15 426
2008	7 644	28 567	19 499
2009	4 463	13 804	19 619
2010	4 062	11 076	9 483
2011	2 869	10 820	11 185
2012	3 061	10 839	8 996
2013	4 669	8 848	9 714
2014	1 090	7 503	4 779

Source: UNCTAD, WIR Annex Tables, *http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx;* data from FDI markets (accessed on 1 March 2016).

StatLink http://dx.doi.org/10.1787/888933355875

FDI by country of origin

The breakdown by nationality shows a predominance of foreign investors from OECD countries, with the exception of Cyprus[14] that is by far the single largest country of origin (Figure 1.5 below), accounting for 27.7% of the inward FDI stock at October 2015. One possible explanation for such a high share of Cyprus is that some Ukrainian investors channel investments through the Cypriot banking sector to finally re-invest in Ukraine, which gives rise to "round-tripping" FDIs. Beyond Cyprus, round tripping concern other "offshore" jurisdictions, for instance the British Virgin Islands (BVI), Luxembourg and the Netherlands. Indeed, the British Virgin Islands was the seventh largest foreign investor in Ukraine (4.2% of total FDI stock) as of October 2015. However, the exact share of round tripping in bilateral FDIs between Ukraine and these jurisdictions is unknown.[15]

The high share of Cyprus in the overall inward FDI stock probably also reflects trans-shipping investments from Russian multinational enterprises

Box 1.3. **The Cyprus* – Ukraine investment relationship**

Cyprus was the largest foreign investor in Ukraine at the end of 2010, with an inward FDI position of USD 9 billion (State statistical service of Ukraine). However, according to national data accessed through Eurostat, the outward FDI position of Cyprus in Ukraine was much smaller at USD 163 million at the end of 2010 (most recent data available).

How to reconcile these two observations? Cyprus outward FDI data exclude special purpose entities (SPEs), which on the other hand account for most of Ukraine's inward FDI transactions from Cyprus.

The existence of SPEs – holding companies with little or no physical presence in the host economy – is one important factor that can distort FDI statistics. First, transactions by SPEs inflate the FDI flows into and out of the country where they are located as investment passes through via SPEs to its ultimate destination. Second, SPEs can distort the geographic distribution of FDI statistics for countries that host a significant number of them because it can appear they are receiving investment from countries whose investors are just passing capital through SPEs. Likewise, it can appear that investors from this country are investing abroad when that investment really reflects the funds that have been passed through.

Round-tripping (Ukrainian investors) or trans-shipping FDI transactions (for instance, Russian investments channelled to Ukraine through Cyprus) can have different motives, such as tax advantage or ensuring confidentiality of the ultimate controlling investor. In addition, under some existing Ukrainian investment treaties as generally interpreted, a Ukrainian national can obtain treaty coverage for an investment as "foreign" by channelling its investment in Ukraine via a subsidiary in a foreign jurisdiction (see Chapter 2, Box 2.6).

In 2012, Ukraine and Cyprus signed a new double tax treaty to replace a 30 year-old USSR-Cyprus Treaty. It created a new framework which ensures that bilateral investment benefits from a stable and favourable tax environment. Another motive may be institutional arbitrage: Cyprus gives investors access to a stable and modern legal environment under English law, where the enforcement of property rights (particularly, shareholder rights) is less uncertain than in their domestic economy (Wilson, 2015).

Kokko and Kravtsova (2012) argue that most of the round-tripping FDI in Ukraine has been directed to Eastern Ukraine. Their empirical study suggest that "round tripping" inward FDI from Cyprus and other offshore jurisdictions do not have the positive spillover effects on local firms expected from "regular" inward FDI.

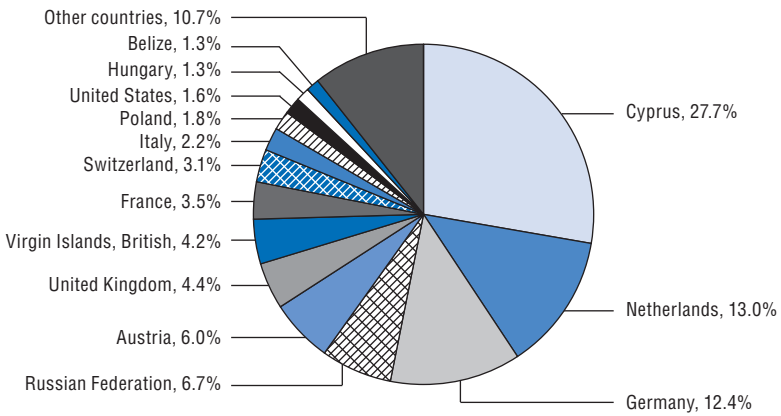
In 2012-13, Cyprus went through a dramatic sovereign and banking crisis. A haircut was imposed on deposits above EUR 100 000 in Cyprus's largest banks

Box 1.3. **The Cyprus* – Ukraine investment relationship** *(cont.)*

as part of the March 2013 bailout package. The impact on FDI flows to Ukraine is unclear. According to SSU data, the FDI stock from Cyprus grew throughout 2012 and 2013 to reach one third of the overall FDI stock at the end of 2013. The share of Cyprus in the overall FDI stock declined abruptly in 2014, which could reflect a withdrawal of capital from Ukraine by Russian and domestic investors (UNCTAD, 2015).

* Footnote by Turkey: The information in this document with reference to "Cyprus" relates to the Southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".
Footnote by all European Union member states of the OECD and the European Union: The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.

Figure 1.5. **Inward FDI stock by country of origin (October 2015)**



Source: State Statistical Service of Ukraine (SSSU), *https://ukrstat.org/en* (accessed on 8 January 2016).
StatLink http://dx.doi.org/10.1787/888933355759

(MNEs) which use Cyprus as an offshore centre (Kononov, 2012; Kuznetsov, 2011). Round-tripping is also relevant for Ukraine's exposure to claims by foreign investors under international investment agreements (see Box 1.3 above).

Kvashnin and Kuznetsov (2014) use a database based on a systematic analysis of corporate reporting (CIS and Georgia Mutual Direct Investment Monitoring Database) and business news to measure mutual FDI in the CIS and Georgia. Their data confirms that the Russian FDI stock in Ukraine is underestimated by official statistics due to trans-shipping FDI through offshore

jurisdictions (for instance, through Cyprus). According to their estimate (which only includes projects with value in excess of USD 3 3 million), at the end of 2014 the Russian FDI stock in Ukraine (USD 9.9 billion) was more than three times higher than reported by the State Statistics Service of Ukraine (USD 2.7 billion).

Although considerably lower than Cyprus, the Netherlands constitutes the second largest source of inward FDI with 13% of the overall FDI stock, and is closely followed by Germany[16] (12.4%, see Figure 1.5). All other significant investors (among which Austria, the United Kingdom, France, Italy, and Poland) are also from the European Union, with the exceptions of Switzerland (3.1%) and the United States (1.6%). While EU countries account for 77.2% of the total inward FDI stock, the EU share is likely overstated given the importance of Cyprus in the inward FDI Stock and its popularity as a flow through country with non-EU Investors. Indeed, Special Purpose Entities (SPEs) account for most of inward FDI transactions from Cyprus.

The outward FDI position of OECD countries in Ukraine, when available[17] (Table 1.4 below), is a useful complement to Ukrainian FDI statistics. As of March 2015, the OECD disseminates FDI statistics from member countries

Table 1.4. **Outward FDI stock positions of selected OECD countries excluding SPEs**

Investments excluding resident SPEs, except for Sweden, Denmark, the Netherlands and the United Kingdom (SPEs included for these countries)

Origin country	OECD BDM4 Data (Millions USD)	SSSU Data (Millions USD)
Netherlands*	12 358	5 544
Austria	2 499	3 179
Italy	1 189	1 210
France	1 011	1 741
United States	931	935
Sweden*	757	439
Hungary	542	686
Greece	530	333
United Kingdom*	489	2 768
Estonia	358	180
Poland	354	840
Denmark*	64	174
Slovenia	61	36
Czech Republic	58	83
Iceland	21	19
Norway	15	9
Korea	12	172

* Data includes FDI by Special Purpose Entities.

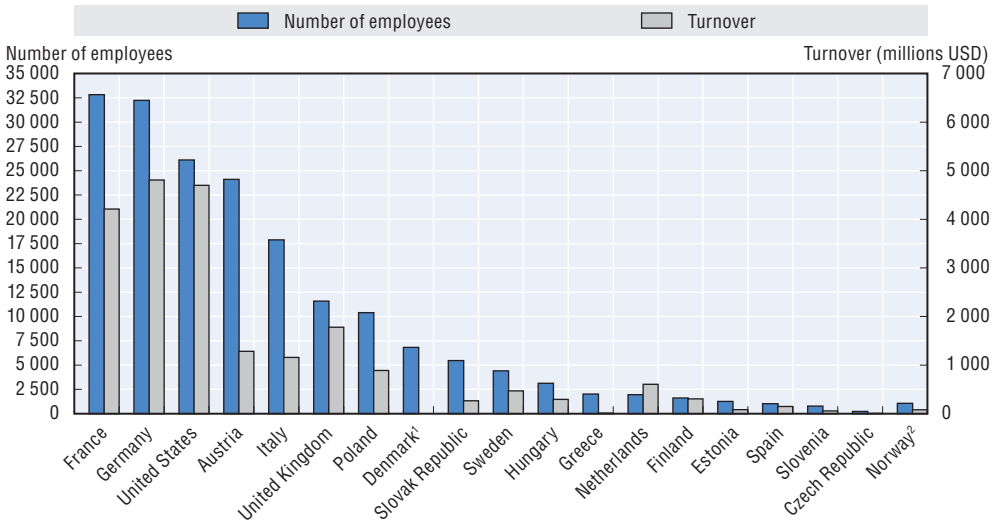
Source: OECD International Investment Statistics Database (BDM4), *http://stats.oecd.org/index.aspx* (accessed on 1 December 2015); State Statistical Service of Ukraine (2015), *https://ukrstat.org/en/operativ/operativ2015/zd/ivu/ivu_e/ivu0415_e.htm* (accessed on 1 December 2015).

StatLink *http://dx.doi.org/10.1787/888933355885*

according to the fourth edition of its Benchmark Definition of Foreign Direct investment (BMD4). For most countries, it excludes SPEs, whose role is to facilitate the internal financing of MNEs but that have little or no physical presence in an economy. Excluding such entities from FDI statistics give a much better measure of the FDI that have had a real impact on Ukraine's economy. Overall, this confirms that EU countries, along with the United States, are important foreign investors in Ukraine.

Data on the activities (employment, turnover) of foreign affiliates in partner countries (Foreign Affiliates Statistics, FATS) are available for some OECD countries (Figure 1.6 and Statistics in Annex C – Table C.1 and C.2). In 2012, MNEs from the European Union had roughly 200 000 employees in Ukraine, and MNEs from the United States had about 26 000 employees. For the purposes of comparison, Metinvest, the largest Ukrainian private conglomerate, had 104 000 employees at the end of 2012. Since 2010, the number of employees of EU affiliates has been stable, while the United States reported a 13% increase. Using cumulated turnover of affiliates rather than employment (Figure 1.6) introduces only small changes to the list of leading OECD foreign investors in Ukraine.

Figure 1.6. **Employment and turnover by foreign affiliates from OECD countries in Ukraine (2012)**



* Turnover non-available (confidential);** 2011.

Source: Eurostat, Outward FATS, main variables – NACE Rev. 2, *http://appsso.eurostat.ec.europa.eu/nui/show.do* (accessed on 1 December 2015); US Bureau of Economic Analysis; *www.bea.gov/iTable/iTable.cfm?ReqID=2&step=1#reqid=2&step=3&isuri=1&202=13&200=1&201=2* (accessed on 1 December 2015); OECD *AMNE Database*, *http://stats.oecd.org/* (accessed on 1 December 2015).

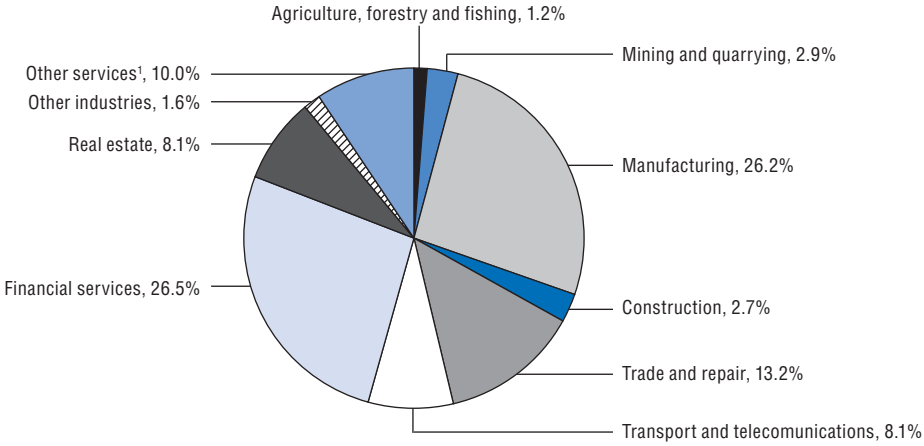
StatLink http://dx.doi.org/10.1787/888933355762

The regional distribution of the inward FDI stock is very uneven, with Kyiv accounting for 51.6% of the total, followed by Dnipropetrovsk (16.5%), and other urban centres (Donetsk, Kharkiv, Odessa and Lviv, respectively from 4.9% to 2.9%). This may reflect that many large foreign-owned corporations are incorporated in Kyiv, even though they often operate at the national level.

FDI in Ukraine by sector

As noted above, Ukraine has been rather unsuccessful in diversifying away from agri-industry and heavy industry and towards more technology-intensive activities since the 1990s. In mid-2015, the total inward stock was still dominated by financial services (26.5%) and manufacturing (26.2%, Figure 1.7), even though trade and repair now represents more than 13% of the total FDI stock. Metallurgy alone accounts for half of the total FDI stock in manufacturing and 12.2% of the overall FDI stock. The sector is central to Ukraine's economy: regardless of a decrease in steel production, Ukraine remained the 10th largest steel producer in the world in 2014.[18] Despite the country's comparative advantage in agriculture, the share of this sector in total FDI stock is very modest (1.2%), reflecting unpredictable regulatory changes in the sector and grain export restrictions (OECD, 2015b).

Figure 1.7. **Inward FDI stock by sector (October 2015)**



1. Other services are mainly business and professional services, accommodation, health and social services.
Source: Based on State Statistical Service of Ukraine (2015), *https://ukrstat.org/uk/druk/publicat/kat_u/publ10_u.htm* (accessed on 1 December 2015).

StatLink http://dx.doi.org/10.1787/888933355777

Since 2010, non-tradable services (wholesale and retail trade) and real estate have absorbed a growing share of total inward FDI flows. In contrast, the share of financial services decreased from 32% (end-2010) to 26.5% of total FDI stock (October 2015). This is primarily due to divestments by EU-based

commercial banks between 2010 and 2013. As a consequence, the share of non-Russian foreign banks in total banking assets declined from 31% (end of 2010) to slightly above 20% at the end of 2014, while the share of Russian banks (16%) increased slightly (Barisitz and Fungáčová, 2015; see also sections on the banking sector in Chapter 3).

Most FDI inflows correspond to mergers & acquisitions (M&A) in the financial sector, mining and metallurgy, telecommunications, construction materials and food processing. In 2014, the largest inward M&A deal since Maidan saw Alfa Bank (part of Russia's Alfa Group) acquire the Ukrainian assets of the Bank of Cyprus (Table 1.5 below). M&A data indeed confirm that official FDI statistics tend to underestimate Russia's presence in the Ukrainian economy, insofar as Russian investment is often channelled through SPEs domiciled in Cyprus, Luxembourg and other jurisdictions. Moreover, investments from many other countries are also understated by official FDI Statistics in Ukraine given the high share of Cyprus, the Netherlands, British Virgin Islands and Austria in the inward FDI stock. Indeed, SPEs account for a significant share of FDI from these countries.

Table 1.5. **Major foreign M&A deals in Ukraine, 2005-15**

Year	Sector	Investor	Source country	Value (USD million)
2005	Steel	Arcelor/Mittal	Luxembourg	4 800
2005	Banking	Raiffeisen International	Austria	1 028
2005	Banking	BNP Paribas	France	465
2005	Telecom	Vimpelcom[1]	Russia/Netherlands	280
2006	Banking	Credit Agricole	France	262
2006	Banking	OTP Bank	Hungary	821
2007	Agrifood	Pepsico	United States	542
2007-08	Iron ores	Evraz	Russia	2 663
2008	Banking	UniCredit	Italy	2 076
2008	Banking	Private investor	Russia	350
2008	Banking	Intesa Sanpaolo	Italy	730
2010	Telecom	Vimpelcom[1]	Russia/Netherlands	5 515
2010	Energy	TNK-BP[2]	Russia/United Kingdom	313
2011	Steel	Mechel	Russia	537
2014	Banking	Alfa Bank	Russia	276

1. Vimpelcom is a joint venture between Alfa Group (Russia) and Telenor (Norway) with headquarters in the Netherlands.
2. Russian state-owned Rosneft acquired TNK-BP in March 2013.

Source: Dealogic, *www.dealogic.com/* (accessed on 1 October 2015).

StatLink http://dx.doi.org/10.1787/888933355895

Low FDI inflows are reflected in the limited weight of foreign capital among Ukrainian companies of the annual Deloitte Central Europe "Top 500" ranking.[19] In 2014, only 7 out of the 32 (22%) Ukrainian companies in the ranking

are foreign-owned, accounting for 13% of their cumulated turnover (Table 1.6). The weight of foreign firms is much higher in almost all other Central European countries (both EU and non-EU members). For instance, among the 170 largest firms in Poland, 90 (53%) are foreign- owned, accounting for 43% of the cumulated turnover of the 170 largest firms.

Table 1.6. **Ownership of Ukraine's largest companies by turnover (USD million)**

	2012		2013		2014	
Status	Turnover *(share of total)*	Number	Turnover *(share of total)*	Number	Turnover *(share of total)*	Number
Local	59 679 *(53%)*	28	63 714 *(54%)*	28	42 612 *(55%)*	18
State-owned	37 059 *(33%)*	9	32 399 *(28%)*	7	25 504 *(33%)*	7
Foreign	15 356 *(14%)*	14	21 274 *(18%)*	18	9 870 *(13%)*	7
TOTAL	112 095	51	117 386	53	77 985	32

Source: Based on Deloitte CE Top 500 Ranking, *http://www2.deloitte.com/global/en/pages/about-deloitte/articles/central-europe-top500.html*.

StatLink http://dx.doi.org/10.1787/888933355907

One exception is mobile telephony, which is dominated by foreign operators: they include Kyivstar (a subsidiary of Norway's Telenor and Russia's Alfa Group) and MTS Ukraine (fully owned by Russia's Mobile TeleSystems). In June 2015, Turkcell (Turkey) announced a USD 100 billion investment into the third-largest mobile phone operator in Ukraine, giving him full control over the company. Foreign companies are also prominent players in Agribusiness (Cargill, Bunge, Louis Dreyfus), Food processing and Consumer products (JTI, Phillip Morris, Nestle, Procter & Gamble). Despite a recent reflux, foreign presence is also significant in the financial sector (see chapter 4 for more details). In retail, international players such as Metro Group, Auchan, Rewe Group (Billa) and Spar compete with local companies ATB Market and Fozzy Group that lead the market in terms of gross sales. Foreign presence is more modest in the manufacturing sector, even though steelmakers Evraz (a Russian Steel multinational) and Arcelor Mittal are among the largest companies in Ukraine.

Notes

1. See World Bank (2015), *Ukraine – Economic Update*, 29 April 2015, *www.worldbank.org/content/dam/Worldbank/document/eca/ukraine/ua-macro-april-2015-en.pdf*.
2. Natalia Jaresko, a U.S. citizen, became finance minister; Lithuanian Aivaras Abromavicius economy minister; and Aleksandre Kvitashvili of Georgia minister of health care.
3. The Commonwealth of Independent States is a regional organisation set up during the breakup of the Soviet Union by former Soviet Republics.

4. World Bank Development Indicators.
5. Whereas in 1996, Ukraine's total merchandise exports amounted to USD 14 232 million, in 2013, they reached USD 62 679 million.
6. The Eurasian Economic Community was terminated from 1 January 2015 in connection with the launch of the Eurasian Economic Union.
7. Russia has threatened to extend its food ban to Ukraine and to end the CIS preferential trade regime for Ukraine in case the country implements DCFTA with the EU.
8. The criterion of relative poverty, as determined by the Poverty Reduction Strategy, is equal to 75% of median level of expenditures, while for absolute poverty it is the minimum subsistence level defined by the national law.
9. The Human Development Index takes into account not only the standard of living but also social indicators, notably education and health.
10. Mikheil Saakashvili, a former President of Georgia, was appointed the new governor of Odessa in May 2015.
11. Jaanika Merilo, a member of the Estonian parliament of Ukrainian origin, was appointed the government advisor on foreign investment in January 2015.
12. Its main elements, as set out in 2011, included: implementation of the one-stop shop, creation of Project Marketplace as database of investment opportunities, and active promotion of the most significant projects, both of local and industries scope.
13. Resolution No. 442 of the Cabinet of Ministers "On Optimization of Central Executive Authorities" (10 September 2014) also liquidated the State Service for Personal Data Protection, the State Service for Combating HIV/AIDS and Other Socially Dangerous Diseases, the State Agency for Tourism and Resorts, the State Assay Service, the State Inspection for Price Control, the State Agricultural Inspectorate, and the State Environmental Investment Agency. The State Service for Food Safety and Consumer Protection, the State Service of Geodesy, Cartography and Cadastre, the State Service for Transportation Safety, the State Service for Medical Products and Drug Control, the State Service for Labour, the State Inspectorate for Energy Supervision were created as a result of reorganisation by merger. The State Agency for Restoration of Donbass was created separately.
14. Footnote by Turkey: The information in this document with reference to "Cyprus" relates to the Southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".

    Footnote by all European Union member states of the OECD and the European Union: The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.
15. Ukrainian investors also channel foreign direct investments to third countries ("genuine outward FDI") through the jurisdictions mentioned in this chapter. Conversely, some genuine foreign direct investors also channel their investments into Ukraine through these jurisdictions.
16. The high share of Germany mainly reflects the fact that the largest foreign investor in Ukraine, Arcelor Mittal, controls its Ukrainian affiliate (ArcelorMittal Kryvyi Rih) through a German entity.

17. BMD4 data is not yet available for several significant OECD investors in Ukraine, among which Germany.
18. *World steel in figures 2015*, Worldsteel Association.
19. Deloitte Central Europe Top 500 is a ranking of the 500 largest non-financial companies in Central Europe, excluding Russia and Belarus. The ranking is based on revenues reported by a particular legal entity operating in Central Europe. For more information: *http://www2.deloitte.com/global/en/pages/about-deloitte/articles/central-europe-top500-2014.html*.

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Chapter 2

The policy framework for investment in Ukraine

During 2014-15 Ukraine deployed significant efforts to improve its investment environment. The ratification of the Association Agreement with the European Union and the entry into force of its economic part in January 2016 have provided an anchor for many reforms. Recent initiatives have focused on reducing administrative burdens and improving public procurement. The government has also introduced significant tax reforms, resulting in better tax transparency, and made headway on reducing bribery and other forms of pressure on businesses with the establishment of a Business Ombudsman institution. Corruption nevertheless remains a serious challenge, and investors still complain about inadequate enforcement of anti-corruption legislation. Problems in applying laws and regulations continue to plague the business environment and public consultation mechanisms are not yet fully satisfactory. The overall policy and institutional framework for investment promotion and facilitation needs to be consolidated.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

This chapter focuses on a range of policies having an impact on Ukraine's investment environment, in particular investment policy, access to property, investment promotion and protection, privatisation, and international agreements. The analysis is based on the OECD Policy Framework for Investment (PFI). The PFI explores various policy domains, which influence countries' investment climate (see Box 2.1) and analyse their contribution, interaction and coherence in support of a sound investment environment. Based on the areas of the PFI selected by the authorities.

Box 2.1. **The Policy Framework for Investment**

The Policy Framework for Investment (PFI) is the most comprehensive and systematic approach for improving investment conditions ever developed. It helps governments mobilise private investment that supports steady economic growth and sustainable development, and thus contribute to the prosperity of countries and their citizens and the fight against poverty.

In response to new forces reshaping the global investment landscape and the numerous lessons learnt through its use over the years, the PFI has been updated to reflect new global economic fundamentals and to incorporate feedback from the international investment policy community. The update took place with the active participation of emerging and developing countries through an inclusive process led by an international task force co-chaired by Finland and Myanmar. A series of offline and online public consultations were held to gather comments from interested stakeholders. The updated PFI was endorsed on 3 June 2015 at the OECD Ministerial Council Meeting.

The 2015 update of the PFI looks at 12 different policy areas affecting investment: investment policy, investment promotion and facilitation, competition, trade, taxation, corporate governance, finance, infrastructure, developing human resources, policies to promote responsible business conduct and investment in support of green growth, and lastly broader issues of public governance. These policy areas are widely recognised as underpinning a healthy environment for all investors, from small- and medium-sized firms to multinational enterprises. However, while the PFI looks at policies from an investor perspective, its aim is to maximise the broader development impact from investment and not simply to raise corporate profitability.

Box 2.1. **The Policy Framework for Investment** *(cont.)*

The PFI is neither prescriptive nor binding. It emphasises the fundamental principles of rule of law, transparency, non-discrimination and the protection of property rights but leaves for the country concerned the choice of policies, based on its economic circumstances and institutional capabilities. It helps governments to design and implement policy reforms to create a truly attractive, robust and competitive environment for domestic and foreign investment.

By encouraging a structured process for formulating and implementing policies at all levels of government, the PFI can be used in various ways and purposes by different constituencies, including for self-evaluation and reform design by governments and peer reviews in regional or multilateral discussions.

For more information, see: *www.oecd.org/investment/pfi.htm*.

Overview of national investment-related legislation

Ukraine has an open and transparent legal regime for foreign investment that is broadly consistent with international norms. The Civil Code and the Commercial Code establish the principle of freedom of contract allowing the parties to select the type of contract appropriate to their situation.[1] Either most businesses are incorporated as joint – stock companies (JSCs) or limited liability companies (LLCs). Article 13 of the Constitution enshrines the principle of State protection of rights for property and economic activity for all subjects, which are equal before the law; it also clarifies that property entails responsibility. The 2003 Commercial Code covers definitions of enterprises with foreign investments (Art. 116), foreign enterprises (Art. 117), and foreign investors (Art. 390); types (Art. 391) and forms (Art. 392) of foreign investments; the obligation to register (Art. 395); and the guarantees to foreign investors in case of termination of investment activities (Art. 399).

According to the Law of Ukraine "On the Regime of Foreign Investments" all investment, profits, legitimate interests and rights of foreign investors in the whole of Ukrainian territory enjoy the following protection and guarantees:

- Protection against changes in foreign investment legislation for a period of 10 years after their introduction (Article 8 of the Commercial Code).
- Protection against nationalisation, with the exception of emergency measures (e.g. national disasters or epidemics) and only if based on the decision of the Cabinet of Ministers of Ukraine. In case of nationalisation, a foreign investor must be compensated in the currency in which the investment was made or in any other currency acceptable for the investor. Decisions on requisition of foreign investment and compensation may be appealed in the courts (Article 9).

- Guarantee for compensation and reimbursement of losses resulting from the action, the omission of the action or the improper performance by the state or municipal bodies (Article 10).
- Guarantee in the event of the termination of investment activity to remit the revenues and withdraw the investment without paying export duties within six months after the termination of the investment activity (Article 11).
- Guarantee of repatriation of profits after the payment of taxes, duties and other mandatory payments (Article 12).

To qualify for these guarantees, foreign investors have to register (Article 13). The registration is linked to the investor, not to the company, and any ownership change must be accompanied by re-registration of the concerned entity.

Establishment procedures and permits – complex but progressively simplified

For their establishment, domestic and foreign investors remain subject to the same requirements, consisting of two or three steps, i.e. obtaining state registration, business permits and, for activities concerned, licensing. A foreign legal entity is required to present an additional document to confirm its registration in the country of residence, i.e. an extract from the trade, banking or judicial registry.[2] The law also sets up the timeframe for this procedure (one working day) and the amount of the fees (UAH 170 or USD 8).[3] The registration is carried out by some 680 registration offices operating as "single window" facilities and certificates do not expire. Companies, except single tax payer companies, with an annual turnover (excluding VAT) lower than UAH 300 000 (USD 14 086) are exempted from the obligation to obtain a VAT number.[4] The number of permits was reduced from 143 to 85 in 2014.[5]

Law No. 191-VIII "On Amendments to Certain Legislative Acts of Ukraine on Simplification of the business environment (deregulation)" and Law No. 222-VIII "On Licensing of Certain Types of Business Activity" have been two of the most notable reform provisions since former Ukrainian President V. Yanukovych's departure in February 2014. Adopted on 2 March 2015 and effective since 28 June 2015, Law No. 191-VIII cuts the number of licensing and approving procedures,[6] eliminates permit centres (replaced by administrative service centres as a single window[7]), reduces the authorities' influence on business activity, enhances investor protection, and improves the funding mechanism for the State Registration Service. The Housing Code was amended, simplifying the rules to re-equip and redevelop residential and commercial property, if such works do not interfere with the supporting structures and/or engineering systems for general use.

The Law No.191-VIII also aims at simplifying permit procedures in town planning, by authorizing village, settlement and municipal councils to i) grant, receive

and register the documents required for conducting preparatory and construction works; ii) perform architectural and building inspections and iii) commission the objects.[8] The Law also abolishes mandatory state registration of franchise agreements.[9] With regard to scrap metal regulation the Law only introduces changes to the administrative and criminal liability, as more consequential proposals to abolish licensing, allocation of quotas for export and registration of export contracts were amended in the Parliament. Finally, the Law No. 191-VIII removed some ambiguities in the Code of Criminal Procedure that allowed the seizure of telecommunication equipment within criminal proceedings.[10]

In addition, the new legislation improves the system of electronic document flow between the United State Register of Legal Entities and Individual Entrepreneurs (maintained by the Ministry of Justice) and other state authorities.[11] The right to obtain extracts, excerpts and statements (both in paper and in electronic forms) from the Register with respect to any business entity is granted to any person for a small fee (except for the state and municipal authorities).[12] Information from the Register can be accessed via the official website of the Ministry of Justice. Previously, such information had to be published in official printed media.[13]

Adopted on 21 April 2015, Law No. 344 "On Amendments to Article 69 of the Tax Code of Ukraine regarding Simplification of Doing Business" requires banks to immediately notify the tax authorities on opening a bank account, entitles taxpayers to start expense transactions via their bank account from the date the bank notifies the tax authorities without needing to wait for any confirmation in reply from the tax authorities (unless registration is denied), and foresees a reduction of the term for value added tax registration from three business days to just one.

The Cabinet of Ministers also adopted an "Action plan for business deregulation" which contains 131 tasks to reduce the burden on businesses in different branches (agrifood, agriculture, construction…), diminish the number of entities controlling businesses and make business regulations more transparent and predictable. This comprehensive action plan also includes inspections by controlling entities, the reform of customs administration and a harmonisation of technical standards with EU Norms. The government plans to implement all these 131 tasks by the end of 2017. As of January 2016, Ukraine completed 37 tasks (i.e. relevant pieces of legislation adopted), while normative acts necessary to complete 23 other tasks were pending adoption in Parliament.

Efforts to reduce administrative burden are producing results and should be pursued

The 2000 Law on licensing initially listed 76 different activities subject to mandatory licensing, reduced to 30 in the new legislation of 2015.[14] The

government plans to reduce further the number of activities subject to licensing. The main innovation of this 2015 Law on Licensing is that licensing authorities will incorporate the details of all licenses into the United State Register of Legal Entities and Individual Entrepreneurs (available online, see above). The development of the necessary IT Infrastructure is at its final stage, while the Cabinet of Ministers is currently approving implementation Decrees detailing new approval procedures for obtaining licenses.

Ukraine has successfully carried out important business reforms, especially with respect to establishment procedures, as testified by its improving distance to frontier score on the indicator "Starting a business" in the World Bank *Doing Business* report (World Bank, 2016). The "distance to frontier" score is a tool to assess the absolute distance to best regulatory practices (on a scale from zero to 100) and its evolution over time. In the case of the indicator "Starting a business", it has improved from 69.8 in 2010 to 93.9 in 2016 (reflecting data from July 2015). Chapter 2 provides a detailed analysis of Ukraine's results in the World Bank's *Doing business 2016* ranking and accompanying report.

The government is also working on improving the *ex-ante* regulatory impact assessment (RIA) of draft business regulations (i.e. assessment of regulatory impact before adoption and implementation). Amendments to the current methodology[15] will strengthen the standards for RIA by introducing mandatory cost-benefit analysis and specific SME-tests, in accordance with EU Standards in this field.

In 2015, the government set up the Better Regulation Delivery Office, financed under a three-year EU programme starting in 2016. The office is a non-government entity employing around 70 experts (lawyers, business analysts and experts on the DCFTA, the EU-Ukraine free trade agreement) to analyse the vast number of existing business-related norms and regulations. It will systematically analyse the regulatory environment for each sector, with a focus on issues relevant to SMEs, build coherent sector-specific "regulation trees" and make relevant recommendations (including new draft legislation or recommend to abolish existing norms).

The main problems remain an inadequate enforcement of existing legislation due to delays in the adoption of implementing regulations and often insufficient administrative and technical capacities of responsible executive agencies. The involvement of various agencies and interlocutors at different governmental levels and the lack of harmonisation in procedures inevitably leave room for discretion with an inherent risk of corruption. Some progress has been achieved since 2011 with the opportunity to file documents with the United State Register of Legal Entities and Individual Entrepreneurs in electronic form.[16]

Improving the quality of the public service is a key step to ensure expedient and efficient enforcement of business-related laws and regulations. In this regard, Ukraine's Parliament adopted in December 2015 a new law on public service.[17] Experts from the OECD/SIGMA Programme (a joint EU-OECD initiative) provided methodological support and recommendations throughout the drafting of the Civil service law. It increases public sector wages and introduces systematic competitive recruitment procedures and a transparent remuneration system, including a bonus based on individual performance. The Law also defines public service as a politically neutral professional body and limits the political activity of top public servants, while clearly distinguishing public servants from political appointees (subject to the spoils system, e.g. cabinet positions) or contractors in charge of support functions. The government plans to reduce significantly the number of public servants (around 300 000 as of January 2016) in the next two years.

Problems persist with ownership registration for land and other forms of property

Ukraine, possibly more than other transition economies, has found it complex to establish a formal ownership registration for land and other forms of property. As highlighted in the companion study on the Policy Framework for Investment in Agriculture in Ukraine, many property titles have not been formalised and the unified property and land cadastre is not yet operational. In addition, foreign individuals and foreign legal entities are not authorised to own either agricultural land or forests and purchase of publicly-owned land is possible but subject to complex procedures and requires consent by relevant ministries or the Parliament.[18] The risk of misappropriations and fraudulent transactions remains high, courts are swamped with disputes, and investment, in particular from foreign multinationals, is discouraged.

There has been some major progress in recent years, however. Under the indicator "Registering property", Ukraine's distance to frontier in the 2016 World Bank *Doing Business* database (69.5) has improved compared to 2011 (51.3). However, there is still room for improvement: for instance, registering property in Ukraine requires more procedures (7, compared to 5 on average in Europe and Central Asia) and entails slightly longer delays (23 days against 22 in the region) than in the "Europe and Central Asia" regional grouping.[19] Therefore, Ukraine's performance on this indicator lags behind the average for Europe and Central Asia (75.3).

The 2015 Law on Business Deregulation also addresses several issues arising in agricultural land use. In particular, the Act significantly reduces the number of essential clauses in land lease agreements, directly authorizes the owners of land plots designated for subsistence farming to lease these land parcels to legal entities for commercial farming without any permitting

procedures, and lifts or loosens special requirements governing crops use and rotation. A less positive amendment to the Land Code and the Act On Land Lease introduces a minimum seven-year term of agricultural land lease (this provision also covers subsistent farming), which may potentially result in higher transaction costs and risks.[20] The Law further expressly allows leasing out of agricultural land designated for private farming to companies for commercial agriculture, with no requirement to change the designation. Finally, products that are already certified in the European Union will receive a Ukrainian certificate without any additional procedure.

Enforcement of contracts is affected by the poor state of the judiciary

According to the 2016 World Bank *Doing Business* database, under the indicator "Enforcing contracts", Ukraine's distance to frontier is 57.1 and has worsened compared to 2010 (67.2). Moreover, Ukraine's performance on this indicator lags behind the average for Europe and Central Asia (66.4). Therefore, there is room for improvement in terms of the number of procedures, time and cost involved in payment disputes. Discussions with foreign investors in Ukraine confirm that they often do not see local courts as a viable option for the resolution of contract disputes. The judiciary – in principle the institution of choice for enforcing contracts – is not trusted by companies: courts in Ukraine are perceived as corrupt.[21] Moreover, legal instruments have often proved ineffective in protecting the rights of minority shareholders, in particular to prevent profit-skimming or assets-stripping by controlling shareholders. The situation is projected to improve following the reduction of the minimum quorum for general shareholders' meetings of joint stock companies (with or without state shareholding) and limited liability companies to be competent, from at least 60% to 50%+1 vote of the entire stock.[22] This novelty will help resolve the "deadlocks" arising in the companies where minority shareholders (holding in total over 40% votes) could block the decision-making process merely by ignoring the general shareholders' meetings.[23] Another notable provision of the Law is introduction of a simplified procedure of recovery of dividends that were approved at the general shareholders' meeting but which were not paid within 6 months after the respective decision had been passed. Such dividends now will be recoverable by aggrieved shareholders extra-judicially, as "undisputed" accounts payable, through the execution certificate by a notary, and without recourse to courts.

In what is the first step in an expected major overhaul of the judicial system, new rules enhance the powers of the Supreme Court, extend the grounds for review of Cassation court decisions, and improve the selection and disciplining of judges.[24] The law also tightens the professional requirements for judicial appointments.[25] The law also amends the rules on professional misconduct by judges. Professional misconduct now encompasses

groundless refusal of access to justice, unmotivated rejection of parties' arguments in a court decision, failure to notify the law enforcement authorities of influence on the judge by outside persons, etc.[26] While the new rules may delay consideration of court cases, they provide parties with more procedural tools to deal with an inconsistent or prejudiced approach by lower courts through revision by the Supreme Court.[27] In addition, reflecting the influence of young reformers in post-Maidan Ukraine, civil society groups may now videotape judicial proceedings.

Expropriation has been rare

Whenever a government exercises its legitimate right of expropriation, there is a need for compensation. The compensation must be fair and adequate and paid promptly. In addition, the government decision to expropriate land or other property ought to be motivated by a public purpose, observe due process of law, and be non-discriminatory and guided by transparent rules. As expropriation is perceived as a major political risk for an investor, clear provisions regarding expropriation are needed and constitute an investment guarantee. In international investment law (see the following section on IIAs), the concept of expropriation typically includes indirect expropriation (i.e. situations where a state interferes in the use of a property or in the enjoyment of its benefits even where the property is not seized and the legal title to property is not affected). In domestic legal systems, state interference with property rights that does not constitute a direct expropriation is often not addressed under the concept of expropriation.

In Ukraine, protection against expropriation is guaranteed by the Constitution. Conditions and procedures for expropriation are also stipulated in the 1996 Foreign Investment Regimes Act as well as in legislation addressing private land, in national defence-related legislation and in privatisation laws. Most of Ukraine's investment partners are also protected by provisions under international investment agreements (IIAs and investment provisions of FTAs).

Article 41 of Ukraine's Constitution (as amended) guarantees private property rights and stipulates that no one can be deprived of his/her property, except in cases where "social necessity" (public interest) has been demonstrated and "on the condition of advance and complete compensation of their value". Article 41 further states that confiscation of property may be applied only pursuant to a court decision in the extent and by the procedure established by law. Under the 1996 Law of Ukraine on "Regime of Foreign Investments" (as amended), a qualified foreign investor is provided guarantees against nationalisation, except in cases of emergency measures in the event of natural disaster, accidents, epidemics or epizootics.[28] There is no discrimination between foreign and national investors as regards expropriation,

as the principle is embodied in Article 7 of the law. All expenses and losses incurred by the foreign investor are to be compensated on the basis of the current market prices and/or a substantiated evaluation, certified by an auditor or auditing company. Compensation paid to the foreign investor is to be prompt, adequate and efficient.[29] The right to recourse for administrative decisions and judicial actions regarding an expropriation is guaranteed.

Other legal expropriation of property is regulated by the law on the alienation of land plots and property for public needs, the law on the legal regime of emergency state, and the law on the legal regime of martial law. The law on the alienation of land lots governs the procedure, rights and obligations to be fulfilled for the expropriation of land plots and other immovable properties owned by individuals or legal entities for public use or to satisfy public requirements.[30] In addition to providing for a clear definition of public needs, the law includes a list of possible reasons for expropriation for such public needs (e.g. national security and defence; construction, modernisation and maintenance of line facilities and properties for transport and energy supply infrastructure; accommodation and maintenance of facilities connected with mining operations), fair-price fixing mechanisms, modalities of compensation and rules for appeals. Pursuant to the law, in the event of expropriation of a land plot and other immovable properties for public needs, the owner(s) of such property may receive compensation in monetary form or may acquire ownership of a similar land plot or item of real estate, the value of which will be taken into account during calculation of the repurchase price. In case of disagreement over the calculated repurchase value, the owner may bring the issue to court. Compensation shall be paid after the relevant decision of the competent authorities and before the issuance of property title document for the new owner.[31]

As in many other countries, Ukraine's legislation also provides protection to investors in case of emergency situations. Private property may be legally expropriated for defence or emergency purposes with mandatory substantiated evaluation and compensation.[32] For example, Article 15 of the Law On the Legal Regime of Martial Law ("The Content of Measures Introduced under the Legal Regime of Martial Law") provides that, where Martial Law is effective, the Military Command is empowered to "temporarily expropriate (for defence needs) the property and assets of. (…) enterprises, institutions and organisations (both publicly and privately owned)". Article 15 clarifies that "the procedures for the introduction of restrictions on the rights and legitimate interests of legal entities under Martial Law are pre-determined by the Laws of Ukraine". According to Article 25 of the Law "On the Legal Regime of a State of Emergency", "legal entities, whose property and resources were used for the prevention or elimination of situations that brought about the introduction of a state of emergency, shall be fully reimbursed according to the procedures specified by law".

While Ukraine's legal framework on expropriation does not contain provisions on indirect expropriation, most IIAs surveyed for the present review cover both direct and indirect expropriation (see Section on IIAs below). The absence of provisions on indirect expropriation in domestic law, however, does not mean that investors have no recourse against state interference with property rights that does not involve a formal transfer of title. Administrative law remedies in domestic law, such as judicial review of administrative decisions, are typically available to investors who seek redress against government action. Contrary to investment law remedies, where investors are usually paid compensation when they prevail against the state, advanced systems of domestic administrative law often grant primary remedies, such as annulling the illegal administrative decision or prohibiting or requiring specified government action (Gaukrodger and Gordon, 2012: 26).

Expropriation of property in Ukraine has been rare. According to the US Department of State (2013), one case of expropriation occurred in 2008 when a Production Sharing Agreement with an investor was cancelled by the authorities for exploring oil and gas in the Black Sea (US State Department, 2013). Another case occurred in early 2015, when Ukraine's Supreme Court approved the expropriation of a controlling stake by a Russian company in an aluminium plant, because of unpaid debts.[33] Ukrainian Law allows the government of Ukraine, with court permission, to revoke ownership when owners of privatized enterprises fail to complete payment of an enterprise or to otherwise implement the purchase agreement.

Following the events regarding the Autonomous Republic of Crimea in the spring of 2014, a major issue for business active in Crimea has become expropriation as the result of the adoption by the Crimean parliament of a law "On Redistribution of Strategic Facilities in Crimea" in July 2014. Enforcement of the legislation has reportedly affected many businesses in addition to state-owned enterprises and property: from March to December 2014, around 4 000 enterprises, organisations, and agencies had their real estate and other assets expropriated according to Ukraine's Justice Ministry.[34] In August 2015, Ukraine's prosecuting authorities suggested that the value of the property expropriated was more than UAH 50 billion (USD 2.3 billion).[35] Several UNCITRAL cases have been brought by Ukrainian investors against the Russian Federation based on the Ukraine-Russia IIA, alleging violations of the treaty by Russia against Ukrainian investments established in the Autonomous Republic of Crimea (see section on IIAs below).

State-owned enterprise reform is a priority, privatisation programme gaining new momentum

State-owned Enterprises (SOEs) control a significant share of the Ukrainian economy; the State is considered the largest enterprise owner in Ukraine,

employing around 1 million people (Ministry of Economic Development and Trade, 2015a). SOEs, defined as entities in which the share of the State exceeds 50%, are present in most sectors of the economy and include (2015 estimate) 3 350 companies, of which 1 833 are operational: total revenue was USD 17.3 billion in 2014 (Ministry of Economic Development and Trade, 2015b). The top 100 SOEs account for 92% of the revenues, but a little over half are losing money.[36] The first annual review of Top 100 SOEs, published by the Ministry of Economic Development and Trade (2014) which is supervising the ongoing SOE reform, highlights that the main challenges for the SOE sector are inefficiency, governance, transparency and accountability.

The State Property Fund has the right to be represented on the supervisory boards of joint-stock companies with the State's share exceeding 25%. Corporate governance of SOEs is generally not good: for example, out of the 100 largest SOEs, 82 are organised as "unitary enterprises" (a form of corporation without full legal personality which, among other things, do not have ownership of all their assets) and do not have boards of directors. The quality of information is also poor: less than 5% of SOEs are audited according to internationally recognised standards. The SOE Reform Action Plan aims at raising transparency and accountability, improving corporate governance, setting clear objectives, and preparing the privatisation list.

Changes have been introduced to improve governance of SOEs based on the 2015 OECD Guidelines on Corporate Governance of State-Owned Enterprises (OECD SOE Guidelines), which are being used as a framework for reform. These include:[37]

- *Strategic management and planning*: Ordinance 662-r of the Cabinet of Minister "On approval of the Strategy on improving the effectiveness of the entities in the public sector" was approved on 27 May 2015. Guidelines on strategic planning and management were developed and sent to enterprises in June 2015.
- *Mandatory audits*: Decree "On certain issues related to financial audit of SOEs" approved; requiring 146 largest SOEs to complete audits by an independent qualified audit firm, the first time such audits have ever been required. The audits of 10 large SOEs have already been completed, while other audits are being undertaken.
- *Boards of directors:* Amendments to legislation on appointment of independent members of the board of directors of especially important enterprises have been drafted and agreed by the Cabinet of Ministers and relevant ministries, and have been submitted to Verhovna Rada for approval.
- *Qualified executive management:* A process to appoint qualified executives has been ongoing. The procedures for competitive selection of key executives was agreed on in February 2015. Following the results of and experience

with the first round of competition, the procedures were amended by the relevant Ministries, agreed to, and approved by the Cabinet of Ministers of Ukraine in August 2015. A Nomination Committee has been established and its procedures approved through a Decree "On approval of principles of Nomination Committee".[38] The Ukrainian authorities have reported that the committee consists of 10 members, including five ministries and representatives of the business community and international financial institutions. CEOs for four SOEs (Ukrgasbank, Ukrgasdobycha, Ukrnafta, and Food and Grain Corporation of Ukraine) have already been appointed by the Committee, and short-listed candidates for four other SOEs were being assessed by the Committee in early 2016. Nine SOEs were running the internal nomination procedures, while positions in four more SOEs remained to be filled and responsible ministries had to approve selection criteria and start the selection process.

- *Corporatisation*: The legislation on the corporatisation process of SOEs (except fiscal enterprises) has been changed. Decree "On adoption of transformation process of state unitary commercial enterprise into joint stock company (Draft Resolution of the Cabinet of Ministers "On approval of the transformation of state unitary commercial enterprise into a corporation") has been developed and agreed with responsible ministries, and approved by the Cabinet of Ministers. At the beginning of 2016, the Ministry of Economic Development and trade was preparing a list of SOEs to be corporatized and defining relevant timelines.
- *National Holding Company*: The shareholder function of strategic SOEs (i.e. not intended for privatisation) will be transferred from Ministries to a national holding company. The key objective of the holding would be to manage SOEs professionally, in line with the OECD SOE Guidelines, while increasing SOE efficiency and return on assets. This would separate the State's ownership function and regulatory functions (Ministry of Economic Development and Trade, 2015c).

Of particular note is the ongoing reform of Naftogaz, which is the largest company in Ukraine and effectively controls the entire Ukrainian oil and gas sector. A large majority (76 %) of combined net losses of the top 100 SOEs in 2014 were losses by Naftogaz. Naftogaz is also the largest holder of debt among all SOEs (Ministry of Economic Development and Trade, 2015d). Naftogaz corporate restructuring action plan, which was designed by the EBRD and based on the OECD SOE Guidelines, includes the creation of a supervisory board of independent and qualified directors, the introduction of internal audit, compliance, anti-corruption and risk management functions and an ownership and governance structure in line with the OECD SOE Guidelines. The government has agreed on the plan, and conditional upon the reform, EBRD provided a USD 300 million loan to finance purchases of gas for the

winter heating period.[39] On 5 December, the government adopted Naftogaz's new by-laws, which includes a supervisory board of 5 Directors, among which 3 will be independent Directors. The shareholder function of Naftogaz has been transferred to the Ministry of Economy and Trade.[40]

Regarding privatisation, Resolution "On Conducting a Transparent and Competitive Privatization in 2015-16"[41] lists 345 SOEs subject to privatisation in 2015-2016, which is the largest in recent years. The list includes, in particular:

- 78.29% stake in Centrenergo, one of the major power generating companies, and several large combined heat and power generating companies;
- a 50% stake in Azovmash PJSC, one of the largest heavy machinery manufacturers;
- Odessa Port Plant, one of the largest chemical producers, and majority shareholdings in other chemical companies (Sumykhimprom and Svema);
- Various agri-business concerns such as "Horse-breeding of Ukraine" (approximately 40 000 hectares of land), a poultry farm, a greenhouse plant, a sugar mill, and a sugar supply company;
- In the trading sector – 50% of shares in "Ukrnaftoproduct";
- In banking, the Ukrainian Bank for Reconstruction and Development and 51% of the shares in Spetseksimstrah.

The list also includes some SOEs that had previously not been subject to privatization, such as 13 seaports, the Ukrainian Danube Shipping Company, the Black Sea General Shipping Agency "Inflot", and a number of mines and quarries. Additionally, the government has reported that a list of companies (913 companies) excluded from privatisation has also been created and submitted to the Parliament for approval[42] as an amendment to the "Law on the list of state property excluded from privatization".[43] Alternative draft laws have been developed for companies engaged in alcohol production and maritime transportation and submitted to the Parliament for approval.

The privatisation programme will be open to all domestic and foreign investors, except to those that are more than 25% equity owned by a state (i.e. any state, a foreign state or the state of Ukraine) as under Ukraine's current legislation such investors are barred from taking part in privatisation of state or communal property in Ukraine. However, the government is preparing amendments to the Privatisation Law in order to limit the scope of this restriction to Ukrainian SOEs. If these amendment are adopted, foreign SOEs (or foreign companies where a state owns more than 25 % of the share capital) would thus be allowed to take part in privatisations. This would open privatisation tenders to a broader scope of foreign investors in key sectors (like electricity generation) and allow more competition between bidders. Legal

entities and citizens from an Aggressor-State,[44] as well as their Ukrainian affiliates, would nevertheless be prohibited to take part in the privatisation process.[45]

The State Property Fund of Ukraine is responsible for putting the companies and assets up for sale via open competitive auctions. The terms of privatisation of G group companies[46] and energy sector companies are determined by in a Resolution of the Cabinet of Ministers and subject to reinforced disclosure requirements prior to privatisation auctions. Because of delays in the process, most privatisations are now planned in 2016. The State Property Fund of Ukraine plans to hire privatisation advisors among leading investment banks to provide technical assistance in the privatisation of certain large SOEs. In October 2015, the Fund concluded a contract with an international investment Bank to provide technical assistance in the privatisation of the Odessa Port Plant.[47]

New policies are being enacted for the purpose of creating a more transparent and efficient environment for public procurement

Public procurement represents an important share of Ukraine's economy. In 2013, the aggregate value of public procurement amounted approximately to 13% of the country's GDP. During the first nine months of 2014, public procurement amounted to UAH 93 billion (USD 4.37 billion) for a total of almost 55 000 contracts (OECD, 2015).

Increased corruption in public procurement characterized the years after the 2004 "Orange Revolution". Legislation on public procurement was amended many times in recent years, but these amendments had a minimal effect on the levels of corruption. Furthermore, the 2012 amendments eradicated transparency in public bids, allowing for the embezzlement of state funds.[48] In 2014, the Minister of Justice noted that experts had estimated that abuse in tenders for public procurement in the previous four years led to a reduction of the country's GDP by 6-7%.[49]

In response to the corruption challenges in public procurements, and with the view to improving the business environment in Ukraine, a number of actions have been taken. On 20 April 2014, a new version of the Law on Public Procurement, designed to facilitate and streamline the government procurement procedures in Ukraine, came into force.[50] The law was developed in the framework of the EU-Ukraine Association Agreement and is thus largely modelled on the 2004 EU Procurement Directives. Amended several times since then, the Law contains several provisions aimed at upholding the principles of transparency and procedural fairness. Efficiency, equal opportunity, fair competition and corruption prevention are principles governing procurement proceedings expressly stated in Article 3 of the law.

The law also refers explicitly to the principle of non-discrimination, stating that domestic and foreign bidders shall participate in the procurement procedures on an equal basis and that the procuring entity may not set discriminatory requirements for bidders,[51] unless the bidders are registered offshore.[52]

As compared to previous legislation dating back to 2010,[53] the law has broadened the scope of application and reduced the number of exemptions from the public procurement regulations. In 2013, only 35% of public procurement by value used competitive methods (World Bank, 2014). The law has cancelled 30 exemptions from the scope of public procurement, reducing their number to categories usually found in international procurement practices (Yaremenko and Shatkovskiy, 2014). New financial thresholds that make a public tender mandatory also apply. Since September 2015, all government procurement of goods and services valued more than UAH 200 000 (USD 9 200) and works (such as construction works) valued at more than UAH 1.5 million (USD 75 000) must be procured through competitive tenders.[54] Besides requiring open public tenders for all purchases above certain threshold amounts purchasers, the law also limits sole-source procurements.

This process has gone hand in hand with the availability of appeal mechanisms for better oversight of procurement processes. The Public Procurement Law adopted in June 2010 assigned the function of the appeal authority for considering claims of tender participants to the Antimonopoly Committee of Ukraine. This arrangement has been preserved in the 2014 Public Procurement Law, which specifies the appeal procedure in the case of complaints.[55] The public procurement proceedings may also be appealed before a court. The 2014 Law has also preserved the function of monitoring body to the Ministry of Economic Development and Trade (MEDT).[56] Its role includes issuing opinions on compliance of the procurement procedure with the requirements of the legislation; making recommendations to the procuring entities regarding correction and prevention of violations detected in the course of monitoring, including cancellation of the procedure; and the possibility to submit materials to law enforcement authorities about such violations. All opinions issued by MEDT are accessible on the Ministry's website. In addition, reflecting the influence of young reformers in post-Maidan Ukraine, journalists and civil society groups may now attend bid openings and videotape the proceedings. In order to enhance transparency further, the government now regularly publishes information about procurements made by state-owned enterprises.[57]

The government has also been increasing efforts to render electronic public bidding proceedings and make them accessible through the web, in order to increase efficiency and transparency. Announcements of upcoming calls for bids in relation to the major part of public procurements are now

made available on the official national web-portal on public procurements of the Ministry of Economy: *www.tender.me.gov.ua*.[58] Announcements of tenders the value of which exceeds EUR 200 000 for goods, EUR 300 000 for services and EUR 500 000 for works are made in both English and Ukrainian languages, whereas announcements of tenders below such values are made in Ukrainian only. Registration is free. Furthermore, the law requires annual procurement plans of contracting authorities to be published on the website of the Ministry of Economic Development and Trade and within a strict deadline – no longer than five days from the date of their approval. This provision aims at increasing accessibility of information about planned public procurement to potential bidders.

The 2014 Public Procurement Law also provides for an option to carry out procurement procedures in electronic format, paving the way for the introduction of e-procurement in the near future. In late 2014, the government embarked on a pilot project on electronic state procurement to test a basic e-procurement platform (called "ProZorro") for low value tenders with several public entities.[59] The ProZorro platform has been designed by NGOs (including Transparency International Ukraine) with the support of the government and commercial electronic tender platforms. It aims at ensuring transparency in public procurement, improving business confidence and eliminating corruption. Electronic procurement also simplifies access of SMEs to public tenders, can reduce budget expenditures and may ensure greater public control over the auction process.

The first purchases conducted under this new system have involved the ministries of Justice, Defence, Economic Development and Trade, Infrastructure, Health, and the State Affairs Department, as well as the National Bank of Ukraine, Energoatom, and the Kyiv City State Administration. State-owned enterprises (SOEs) affiliated to these Ministries (for instance, SOEs affiliated to the Ministry of Infrastructure, such as the Railways administration, Ports and airports, etc.) are also encouraged to use the ProZorro e-procurement platform. This pilot project should lead to broad scale introduction of e-procurement for the entire public sector in the near future, as required by the EU.[60] In this respect, the Ukrainian authorities developed in the second half of the year a new law "On Public Procurement" according to which all public procurements would be carried out through electronic means. In December 2015, the authorities were reviewing the draft.

Although the results of the introduction of the above-mentioned changes in the legislation are yet to be seen, they represent a substantial progress with respect to openness, transparency and procedural fairness. Institutions such as the Council of Europe, the European Union and the World Bank have welcomed the new legislation,[61] which has been seen as bringing greater alignment with good international practices in public procurement, in

particular through limiting the cases for exception to categories commonly found in international procurement practices. To assist in meeting the commitments under the OECD Declaration on International Investment and Multinational Enterprises, Ukraine should continue is efforts to simplify and make more transparent public procurement proceedings, including through e-registration.

Ukraine has also been negotiating its accession to the WTO Agreement on Government Procurement (GPA). Ukraine became observer to the GPA in February 2009 and submitted its first offer to accede in March 2014. Ukraine submitted a second offer in October 2014 and the Committee on Government Procurement provided positive comments on Ukraine's GPA accession bid in February 2015. In summer 2015, a final offer of Ukraine was circulated among Parties.[62] Based on further amendments to the public procurement law, the WTO's Committee on Government Procurement agreed to invite Ukraine to join the GPA on 11 November 2015.

International investment agreements

International investment agreements (IIAs or investment treaties) are an important element of Ukraine's investment policy framework.[63] As of January 2016, Ukraine had 72 investment treaties in force.[64] More than half of the agreements were ratified in the 1992-2000 period, immediately after Ukraine gained independence.

Ukraine's bilateral IIAs typically contain substantive investment protection provisions, such as protection against expropriation without compensation and against discrimination, and they give covered investors access to investor-State dispute settlement mechanisms (ISDS) to enforce those provisions (see Box 2.3 on common features of IIAs).

Ukraine is also a party to several multilateral investment agreements. In particular, Ukraine ratified the Energy Charter Treaty in 1998. It offers protection for covered investments "associated with an Economic Activity in the Energy Sector".[65] The Ukrainian free trade agreement with the European Free Trade Association, which entered into force in June 2012, also contains an investment chapter and offers protection in the country's investment relations with Iceland, Liechtenstein, Norway and Switzerland. Finally, in the 2014 EU-Ukraine Association Agreement, the parties agreed to review the agreement with a view to "including investment protection provisions and investor-to-state dispute settlement procedures".[66] The sections below give an overview of selected provisions in Ukrainian IIAs based on a sample of publicly available treaties.[67] Ukraine's legal and institutional framework for the settlement of disputes between the state and foreign investors is also presented.

The review of the substantive and procedural provisions suggests that Ukraine should consider updating its investment treaties with a view to ensuring that they well-reflect government intent and emerging trends in investment treaty policy. In addition to reflecting the suggested changes in their future agreements, Ukraine might, together with its treaty partners, also wish to consider changes to its existing treaties. Table 2.3 below gives some useful information on the temporal validity of investment treaties in this regard, which could inform Ukraine's timetable to engage with its treaty partners.

Further specification of investment protection provisions would help to better reflect government intent

International practice shows that investment protection standards in IIAs have been typically relatively vague, especially in older treaties. This gives investment arbitrators broad discretion to interpret and thereby determine the scope of protection they provide. In general, Ukrainian IIAs follow this older tradition.

Recently, however, many countries have taken a more active role in managing their investment treaty policy. As part of this strategy, they have included more specific language on core protection standards, such as expropriation, fair and equitable treatment and most-favoured nation treatment. Since Ukraine has not been an active treaty negotiator in recent years, many of these innovations are not reflected in Ukraine's investment treaties. While recent Ukrainian treaties contain more specific language on fair and equitable treatment and most-favoured nation treatment provisions, the provisions on expropriation remain relatively vague.

Box 2.3. **Common features of international investment agreements**

IIAs, entered into between two or more countries, typically offer covered foreign investors substantive and procedural protection. They provide additional protection to covered foreign investors beyond that provided to all investors and or to foreign investors specifically in national legal frameworks.

Substantive protections generally include protection against expropriation without compensation and against discrimination, by for example guaranteeing that covered foreign investors will be treated no less favourably than investors from the host state (national treatment, or NT) or third states (most-favoured nation treatment, or MFN). Particularly important for policy considerations are guarantees of fair and equitable (FET) treatment or treatment, which can be equated (or not) with the international minimum standard of treatment of aliens under customary international law (MST). The

Box 2.3. **Common features of international investment agreements** *(cont.)*

FET provision has been the provision most frequently invoked by foreign investors in recent years (UNCTAD, 2012). Additional clauses in IIAs can facilitate the transfer of profits, or limit or exclude certain performance requirements, such as local content rules.

IIAs can also foster liberalisation of investment by including commitments to open sectors to more foreign investment (market access) or give prospective covered foreign investors certain rights with regard to their efforts to make investments.

IIAs usually provide for procedural venues to enforce the host state's obligations under the substantive standards. Today, most IIAs give investors themselves the right to bring claims against the host state before international arbitration tribunals for an alleged breach of the IIA – the so-called investor-state dispute settlement mechanism (ISDS) (Pohl et al., 2012; Gaukrodger and Gordon, 2012). The number of ISDS claims under IIAs has risen significantly in recent years and that there are currently over 600 known claims (UNCTAD, 2015). Precise numbers of the cases are difficult to establish because of the confidentiality of certain arbitral proceedings.

Direct and indirect expropriation

Most Ukrainian IIAs require host states not to expropriate unless the measures are taken in the public interest, on a non-discriminatory basis and under due process of law, with prompt, adequate and effective compensation.[68] The relevant provisions typically address the determination and modalities of payment of compensation as well. Ukrainian treaties distinguish and cover both direct and indirect expropriation.[69] These involve different policy considerations. Direct expropriation generally refers to an actual taking of legal title to property or a physical seizure of property by a government. As a result, the host state is enriched by and the investor is deprived of the value of the expropriated property. Indirect expropriation is a more complex and sensitive issue. Regulatory action or other behaviour by a government can sometimes have a dramatic effect on an investment, without involving a formal transfer of title or outright seizure. At the same time, provisions on indirect expropriation can affect the host state's policy space because regulatory action can give rise to claims for compensation. Because most policy issues relating to expropriation arise with regard to indirect expropriation, this section focuses on Ukraine's policy in that area.

Most Ukrainian IIAs explicitly cover indirect expropriation, but none of the treaties clarifies the circumstances under which regulatory measures do

not amount to expropriation and where therefore no compensation has to be paid.[70] This gives arbitrators discretion to draw the line between indirect expropriations that entitle the covered investor to compensation, and legitimate regulation that has a significant economic impact on the investor without obligating the government to pay compensation. Under treaties that refer only generally to indirect expropriation, ISDS tribunals have used varying approaches to determining whether an indirect expropriation has occurred (UNCTAD, 2012).

Ambiguity entails risks for Ukraine and does not facilitate predictability for investors. In the context of intense world competition for attracting FDI, Ukraine's on-going efforts to improve the business climate should take more into account the need to review treaty language in order to better reflect Ukrainian government intent and the evolving treaty policy of international partners. The recent experience of Ukraine's treaty partners could be useful in this regard. A growing number of treaties provide that except in rare circumstances, non-discriminatory regulatory actions that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations or can only do so in "rare circumstances".[71] These provisions clarify the limits on claims for indirect expropriation, but do not address liability under other treaty provisions and in particular the fair and equitable treatment provision for the same measure.

Fair and equitable treatment and the international minimum standard of treatment of aliens

The fair and equitable treatment (FET) standard is another standard at the centre of international investment protection. It is also at the centre of investment treaty claims. Since the early 2000s, investors have invoked the standard in virtually every investment treaty claim, including claims against Ukraine (Bonnitcha, 2012; see also Table 2.1 below on cases against Ukraine). Most Ukrainian IIAs grant covered investors fair and equitable treatment.[72] These treaties often merely state that foreign investors shall be accorded fair and equitable treatment without providing further specification.[73] Provisions providing generally for fair and equitable treatment have been considered or applied by tribunals in a broad range of claims.[74]

There is a growing trend to define fair and equitable treatment provisions, both in Ukraine and internationally. The Ukrainian treaties with Japan, the US, and Canada link the fair and equitable treatment standard to international law.[75] Other countries in the Americas and Asia have done so as well. In their subsequent treaty practice, the United States and Canada have further clarified the scope of the fair and equitable treatment provision by linking it to the minimum standard of treatment under customary international

Table 2.1. **ISDS cases against Ukraine**

ICSID Cases					
Year	Case number	Claimant	Sector	IIA	Status
2015	ARB/15/33	Gilward Investments B.V.		Unknown	Pending
2015	ARB/15/9	Poltava Gas B.V. and Poltava Petroleum Company	Exploration and production of oil and natural gas	Ukraine-Netherlands IIA (1994)	Settlement
2014	ARB/14/17	Krederi Ltd.	Real estate and land development	Ukraine-United Kingdom IIA (1994)	Pending
2014	ARB/14/9	City-State N.V., Praktyka Asset Management Company LLC, Crystal-Invest LLC and Prodiz LLC	Banking instrument	Ukraine-Netherlands IIA (1994)	Pending
2009	ARB/09/11	Global Trading Resource Corp. and Globex International, Inc.	Poultry products	Ukraine-United States IIA (1994)	Declined jurisdiction
2008	ARB/08/16	GEA Group Aktiengesellschaft	Petrochemical industry	Ukraine-Germany IIA (1993)	Claims dismissed
2008	ARB/08/11	Bosh International, Inc. and B&P, LTD Foreign Investments Enterprise	Hotel development project	Ukraine-United States IIA (1994)	Claims dismissed
2008	ARB/08/8	Inmaris Perestroika Sailing Maritime Services GmbH and others	Maritime operations	Ukraine-Germany IIA (1993)	EUR 3 million
2007	ARB/07/16	Alpha Projektholding GmbH	Hotel development project	Ukraine-Austria IIA (1996)	USD 3 million plus interest
2006	ARB/06/18	Joseph C. Lemire	Radio broadcasting enterprise	Ukraine-United States IIA (1994)	USD 8.7
2004	ARB/04/2	Western NIS Enterprise Fund	Sunflower oil joint venture	Ukraine-United States IIA (1994)	Settlement
2002	ARB/02/18	Tokios Tokelės	Printing enterprise	Ukraine-Lithuania IIA (1994)	Claims dismissed
2000	ARB/00/9	Generation Ukraine Inc.	Construction of an office building	Ukraine-United States IIA (1994)	Claims dismissed
1998	ARB(AF)/98/1	Joseph C. Lemire	Radio broadcasting enterprise	Ukraine-United States IIA (1994)	Settlement

Table 2.1. **ISDS cases against Ukraine** *(cont.)*

Non-ICSID cases					
	Arbitration rules/institution	Claimant	Sector	IIA	Status
2015	SCC	Littop Enterprises Limited, Bridgemont Ventures Limited and Bordo Management Limited		Energy Charter Treaty	Pending (involving a shareholder claim)[1]
2015	SCC	JKX Oil & Gas, Poltava Gas, Poltava Petroleum Company	Electricity, gas, steam and air conditioning supply	Energy Charter Treaty	Unclear – apparently, emergency award has been rendered, with further ECT and Ukraine-United Kingdom and Ukraine-Netherlands IIA proceedings under way[2]
2008	UNCITRAL[3]	OJSC Tatneft	Oil	Ukraine-Russia IIA	USD 112 million plus interest
2007	UNCITRAL	Laskaridis Shipping Co. LTD, Lavinia Corporation, A.K.Laskaridis and P.K.Laskaridis		Ukraine-Greece IIA	Settlement (2012)
2008	SCC	Remington Worldwide Limited	Equipment for a nuclear power plant	Energy Charter Treaty	USD 4.5 million (2011)
2005	SCC (Case No. 080/2005)	Limited Liability Company Amto	Bankruptcy proceedings against a nuclear power company	Energy Charter Treaty	Claims dismissed

1. IAReporter (2015), "Arbitrator selection under way in $5 billion Energy Charter Treaty claim at Stockholm Chamber", 8 October 2015.
2. IAReporter (2015), "Investor takes emergency arbitrator award under Energy Charter Treaty to a Ukraine court and obtains enforcement of tax-freeze holdings", 29 June 2015.
3. IAReporter (2014), "After $112 million arbitration loss to Russian oil company, Ukraine looks to set-aside award", 27 August 2014.

Source: OECD, based on information retrieved from the ICSID website, *www.italaw.com, www.iareporter.com, and www.arbitration.kiev.ua/.*

law (see also Box 2.4).[76] The EU and other countries have more recently developed another approach to defining and limiting the FET provision by explicitly listing the content of the protection that the standard confers upon covered investors (see Box 2.4).

Box 2.4. **Two approaches to specifying and limiting the FET provision**

In addition to the language already reflected in Ukraine's treaties, two important approaches to further specifying the scope of fair and equitable treatment have emerged:

- Limitation to the minimum standard of treatment under customary international law (MST): This approach has been used in a number of major recent treaties in Asia and the Americas. A FET provision limited to MST has been repeatedly interpreted under NAFTA. It has been interpreted more narrowly than FET provisions under other treaties and NAFTA governments have had much greater success than other governments in defending FET claims (UNCTAD, 2012: 61).
- Defined lists of elements of FET: The European Union's Comprehensive Economic and Trade Agreement (CETA) with Canada contains a defined list of elements of the FET provision. Article X.9 of the draft text from 2014 lists the elements that can constitute a breach of the standard, namely denial of justice, fundamental breach of due process, targeted discrimination on manifestly wrongful grounds, and abusive treatment of investors. While it is a closed list, this approach is broader than some interpretations of MST. Under the CETA draft, the parties may agree to add further elements to the list. The article also provides that the tribunal "may take into account" specific representations that created legitimate expectations.

Both options are more specific than the broad language of treaties that only refer to "fair and equitable" treatment. This does not mean, however, that issues of interpretation might not arise. The specific content of the minimum standard of treatment, for example, is subject to important debates as are a number of elements in the list in CETA.

Most-favoured nation treatment

Virtually all investment treaties entered into by Ukraine contain most-favoured nation (MFN) treatment provisions which guarantee that covered investors will not be treated less favourably than those of third states. Similarly to the other investment treaty provisions reviewed above, the Ukrainian IIAs typically use general language to accord MFN treatment to foreign investors.

The meaning of general wording in an MFN clause has been subject to doctrinal and arbitral debates. With respect to investment protection granted

to nationals of third states in investment treaties, one important element is the question of whether the MFN provision only applies to substantive protection provisions – such as the indirect expropriation or FET provisions discussed above – or also to procedural aspects, and notably the ISDS mechanism (Dolzer and Schreuer, 2012).

On this particular question, Ukraine's investment treaties with Japan and the United Arab Emirates explicitly exclude the application of the MFN provisions to ISDS provisions in other treaties.[77] This treaty also specifies that, in general, "[m]easures that have to be taken for reasons of public security and order, public health or morality shall not be deemed "treatment less favourable" within the meaning of this Article".[78]

More specific language in investment protection provisions would lead to increased predictability and thereby benefit both investors and governments. The specifications also reflect policy choices. In some cases, the specifications may affect the degree of protection for covered foreign investors. Policy-makers need to carefully consider the costs and benefits of these choices, and their potential impact on foreign investors, domestic investors, as well as the host state's legitimate regulatory interests and exposure to investment claims.

Box 2.5. **Public scrutiny of international investment agreements**

Recently, IIAs have come under increasing scrutiny by a variety of stakeholders, including civil society and academia, but also contracting parties to IIAs themselves. Critics argue that international investment agreements unduly restrict governments' "right to regulate" and that arbitral proceedings are subject to important flaws. In this process, a number of core assumptions have been challenged. Econometric studies, for example, have failed to demonstrate conclusively that IIAs actually lead to increased FDI flows – a policy goal commonly associated with the investment protection regime (Sauvant and Sachs, 2009). Furthermore, while it has been contended that IIAs advance the international rule of law and good governance in host states by providing mechanisms to hold governments accountable, critics argue that its opaque legal proceedings and potential conflicts of interest of arbitrators are contrary to rule of law standards (Van Harten, 2008). Moreover, the availability of international investment arbitration to investors has been seen by some as an instrument that could circumvent, and thereby weaken domestic legal and governance institutions instead of strengthening them (Ginsburg, 2005).

Treatment of domestic and foreign investors

Ukraine should seek to guarantee a sound investment climate for both domestic and foreign investors. Parts of Ukraine's legal framework applicable

to investment protection, such as its constitutional provision on expropriation, apply to both domestic and foreign investors. Ukrainian law also contains many provisions that exclusively cover only some foreign investors, such as IIAs, or only foreign but not domestic investors, such as the Foreign Investment Regimes Act. Ukraine should consider whether distortions to efficient investment decisions may occur because of more favourable regulatory conditions for certain investors based on nationality. At the same time, many governments see the value or the need to provide certain extra incentives and guarantees to attract foreign investment in a highly competitive market for that investment. The balance between these interests is a delicate one and may evolve over time.

Ukraine's international investment agreements are starting to be used by policy-makers to foster investment liberalisation, sustainable development goals, and responsible business conduct

Investment treaties have been commonly seen as instruments to protect foreign investors. Newer treaties, both in Ukraine and internationally, show that they can also be used to foster liberalisation of investment activity, and to advance sustainable development and responsible business conduct goals.

Investment treaties as a tool to liberalise investment policy

While econometric studies have failed to establish a clear link between investment protection and FDI flows, they show that investment treaties might lead to more FDI flows when they facilitate investment, for example by reducing barriers and restrictions to foreign investments (Berger et al., 2013). Overall, provisions that seek to foster liberalisation remain the exception in the Ukrainian treaties. Some treaties, however, do grant so-called "pre-establishment" most favoured-nation and national treatment to covered investors prior to their establishment, i.e. while they are seeking to make an investment. The Ukrainian investment treaty with Canada, for example, provides that the parties shall permit the establishment of a new business enterprise on a basis no less favourable than that which is accorded to its own and third state investors.[79] Provisions of this type are typically accompanied by lists of exclusions, known as negative lists. Ukraine's on-going efforts aimed at facilitating the establishment of foreign investment could be an opportunity for policy-makers to consider a more widespread inclusion of such liberalisation provisions into new or existing treaties.

Sustainable development and responsible business conduct considerations

A new emphasis in recent treaty making has been on sustainable development and responsible business conduct considerations. While specific

investor obligations are so far not encountered in treaty practice, treaties often make investment protection conditional on compliance with host state law. The Ukrainian IIAs use different ways to ensure that only investments that do not violate host state law are covered. These include making legality a condition for application of the treaties or by defining covered investments as those made in accordance with host state law.[80] Such requirements serve as a filter mechanism and can potentially incentivise investors to be more mindful of obligations that they have under host state law. The 2015 Ukraine-Japan treaty requires compliance with host state as well as home state law.[81]

Other Ukrainian IIA clauses address sustainable development considerations more generally or focus on the rights of the government with regard to such considerations. The underlying free trade agreement of the investment chapter between Ukraine and the EFTA states provides that the parties shall review the entire agreement within three years after its entry into force "in light of developments in the field of trade and sustainable development".[82] Some Ukrainian treaties specify that the host country's policy space in particular areas shall not be affected by the investment protection provisions. Similar to specification of treaty language of the indirect expropriation provision discussed above, a few treaties include general exceptions clauses. Article XVII of the Ukraine-Canada IIA refers to environmental measures to protect human, animal or plant life or health or relating to the conservation of living or non-living exhaustible natural resources that a government shall not be prevented from taking.[83] The EU-Ukraine Association Agreement does not yet contain investment protection provisions but it provides for their negotiation. In light of the Association Agreement's explicit references to responsible business conduct and the "right to regulate",[84] and the EU's emerging investment treaty policy, it can be expected that future investment protection provisions in this Agreement will be subject to such considerations as well.

These clauses aim at specifying the policy space of the host states and at ensuring that government will not be liable to pay compensation when its pursues policy goals and regulates investor behaviour in specific areas.

Another set of clauses imposes obligations relating to sustainable development considerations on the governments themselves. In the Ukraine-Japan IIA, for example, both countries provide that they should not "encourage investment … by relaxing its health, safety or environmental measures, or by lowering its labour standards".[85] The enforcement of these clauses, however, is subject to state-to-state dispute settlement mechanisms, and practice suggests that contracting parties have rarely sought to enforce this type of commitment.[86]

Ukraine's legal framework for investor-state dispute settlement

Like many other adherents to the OECD Declaration on International Investment and Multinational Enterprises, Ukraine has been facing investment claims. Since 1998, Ukraine has been a respondent in 20 known investment claims, several of which are still pending (see Table 2.1). Such claims can be costly for the authorities to defend, even if no damages are accorded to the investors.

All of these claims have been brought under treaty clauses providing for investor-state arbitration. Starting in the 1990s, direct venues for covered investors to bring claims – ISDS mechanisms – have become a frequent feature of international investment agreements, both in Ukraine and internationally. OECD research (2012) shows that around 96% of global IIA stock provide access to ISDS (Pohl et al., 2012). All of the bilateral investment treaties to which Ukraine is a party, as well as the Energy Charter Treaty, contain ISDS provisions. The investment chapter of the multilateral free trade agreement with the EFTA countries does not give investors access to arbitral remedies; the agreement is subject to state to state dispute settlement. The investment chapter states that covered investors shall be granted national and most-favoured nation treatment with respect to the jurisdiction of its courts as well as its administrative tribunals and agencies.[87]

The main benefit commonly advanced for ISDS is that it provides a forum to settle disputes that is independent from both the host state and the investor, although this view has been challenged by some groups and commentators in recent years.[88] Issues raised in the debate include among other things the characteristics of the pool of investment arbitrators, conflicts of interest, and lack of transparency (Gaukrodger and Gordon, 2012). Some jurisdictions have therefore been actively considering changes to the prevailing ISDS model. In September 2015, the EU Commission announced a proposal on a new Investment Court System for all its on-going and future investment negotiations.[89] Accordingly, the proposal is likely to form the basis for future negotiations on an investment dispute settlement mechanism under the EU-Ukraine Association Agreement as well.

For Ukraine, like other countries, it is important to manage exposure to potential claims and to prevent them as far as possible. As discussed later in the section of the review addressing investment promotion and facilitation, Ukraine has established the Business Ombudsman Council (BOC), which has been construed as the first point of contact for companies seeking redress against unfair treatment (Wehrlé, 2015). Such forms of dispute prevention mechanisms are important tools to manage the exposure of governments to investors' claims because they can reduce the likelihood of formal investment treaty claims arising. Several case studies published by the BOC suggest that investors have successfully sought redress through the Ombudsman without having to resort to arbitration (BOC, 2015).

A low level of regulation of ISDS proceedings is still a predominant feature in Ukrainian investment agreements

The experience of Ukraine shows that not all arising disputes can be prevented by such mechanisms. Investment policy-makers therefore need to ensure that ISDS proceedings are properly regulated. OECD research suggests that ISDS mechanisms in investment treaties are typically subject to only low levels of regulation (Pohl et al., 2012: 39). Some issues are addressed by the arbitration rules, but as rules designed for commercial disputes between private parties, they may need adjustment in light of the nature of investment claims. Other issues remain unregulated if the treaties refrain from doing so. The available data suggest that Ukrainian IIAs do not provide a high level of regulation and remain even below the average level of regulation found in the global treaty stock.[90]

Few agreements in Ukraine, for example, specify for how long after the alleged violation of the IIA the covered investor can bring a claim. A few recent treaties provide for a three-year period.[91] Most agreements in Ukraine, however, follow the international practice providing that the parties must engage in amicable efforts to resolve a dispute, often subject to so-called "cooling-off" periods. For Ukraine, these periods typically vary between three and six months. In some cases, Ukrainian treaties require investors to exhaust local remedies before having access to investment arbitration. Ukrainian treaties also do not expressly address the issue of shareholder claims for reflective loss (see Box 2.6) or the early dismissal of frivolous claims. As part of the government's drive to improve the country's business climate, Ukraine could consider assessing whether this low level of regulation of ISDS proceedings appropriately reflects its treaty policy objectives.

Box 2.6. **Claims for reflective loss**

Many ISDS claims today are by foreign shareholders for reflective loss (see Table 2.1). Many Ukrainian IIAs generally do not expressly address the issue of claims by shareholders' reflective loss. (Shareholders' reflective loss is incurred as a result of injury to "their" company, typically a loss in value of the shares; it is generally contrasted with direct injury to shareholder rights, such as interference with shareholder voting rights.) Advanced systems of corporate law generally bar individual shareholder claims for reflective loss. Only the directly-injured company can recover the loss.

In ISDS claims brought under typical bilateral investment treaties (BITs) that – like the Ukrainian treaties – do not expressly address the issue of reflective loss, arbitrators have consistently permitted shareholders to claim for reflective loss. Outcomes for shareholders thus differ under advanced systems of corporate law and typical BITs (Gaukrodger, 2013: 32-51).

Box 2.6. **Claims for reflective loss** *(cont.)*

Extensive analysis and discussion of shareholder claims for reflective loss at the OECD have demonstrated that the availability of reflective loss claims raises a broad range of policy issues for governments.[92] These include the risk of multiple claims and inconsistent decisions arising out of a single injury, exposure to double recovery, the impact on predictability, hindering settlement, facilitating treaty shopping by investors, and upsetting the hierarchy of claims against corporate assets under corporate law so that a claimant gets better treatment than under normal legal principles.[93] To date, no strong arguments have been identified to explain the different approach taken in investment treaties as opposed to advanced corporate law. It is widely recognised by governments that the issue merits further attention.[94] Ukraine could consider addressing the issue of reflective loss expressly, for example through clarifications to treaty language.

Arbitral proceedings and enforcement of awards

Since investment arbitration claims are not brought before public courts but administered by arbitral tribunals, these proceedings need to be regulated and the decisions and awards enforced. The international community has developed specific institutions and rules to guarantee the effectiveness of arbitral justice. Ukraine has adhered to two of the most important conventions for investment arbitration: the 1965 Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention) and the 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards, also known as the "New York Convention".

The New York Convention addresses the recognition and enforcement of awards. For investors it is important to know that awards can and will be enforced, and the New York Convention is likely to increase investor confidence in this regard. The national courts of contracting parties to the New York Convention must generally recognise arbitration awards rendered in other contracting parties, subject to narrow exceptions set out in the Convention, and enforce the awards in accordance with their rules of procedure. Since Ukraine is a contracting party to the New York Convention, investors that have prevailed in arbitral proceedings against Ukraine know the conditions under which the awards will be recognised and enforced in Ukraine. The New York Convention also facilitates the recognition and enforcement of Ukrainian awards in third countries that are party to it.

The ICSID Convention addresses both the arbitral proceedings and the enforcement of awards rendered under these proceedings. ICSID proceedings follow the rules established under the ICSID regime, which governs questions

such as the applicable law, the constitution of the tribunal, and the powers of the arbitrators.[95] Importantly, the recognition and enforcement of awards rendered under this regime is solely governed by the ICSID Convention itself – the ICSID regime is largely self-contained in this respect. The awards cannot be reviewed by national courts of the country in which their enforcement is sought. While a Ukrainian court could refuse the enforcement of an award for reasons of public policy under the New York Convention, enforcement of an ICSID award cannot be refused on grounds of public policy. However, the ICSID rules on enforcement only apply to ICSID awards.

ICSID has been a prominent forum to hear investment claims against Ukraine: 14 of the 20 claims against it were brought under the ICSID regime. However, not all investor-state disputes are administered under ICSID. Frequently, Ukrainian IIAs give investors the choice between multiple arbitration rules and/or arbitration institutions to settle their disputes with the host state. Most offer the choice between proceedings under the auspices of ICSID and *ad hoc* proceedings under the UNCITRAL arbitration rules. Others also allow investors to bring claims under the arbitration rules of the International Chamber of Commerce (ICC), the Stockholm Chamber of Commerce (SCC) or rules as agreed on by the parties.[96] Awards under these arbitration rules fall outside of the scope of the ICSID Convention; their enforcement is generally sought using the New York Convention.

Giving investors the choice between various arbitration rules or arbitration institutions may affect important aspects of the arbitral proceedings. For example, it can affect the appointment of the chair of the arbitration tribunal, which is often considered to be one of the most important steps in an arbitration proceeding. Arbitration rules typically allow the parties (or the party-appointed arbitrators) to agree on a chair. However, in the event that no agreement can be reached, different arbitration rules designate different bodies as the default appointing authority for the chair. Typically, in private arbitral institutions that primarily administer commercial arbitration cases between business entities, such as the ICC or SCC, the appointing authority is itself composed of persons nominated by business interests.

Allowing covered investors to choose among different arbitration rules and fora may give the investor influence over the identity of the default appointing authority and thus potentially a degree of influence over the selection of a default chair; this can in turn affect the negotiating environment for the selection of an agreed chair. A number of recent treaties have addressed this concern by defining a single appointing authority regardless of the arbitration rules selected by the investor (Gaukrodger and Gordon, 2012; OECD, 2012).[97]

Box 2.7. **Transparency of arbitral proceedings**

The lack of transparency of arbitral proceedings features high on the list of concerns regarding the IIA regime. Investor-state proceedings usually involve issues of public interest: it is at stake when the investor challenges regulatory measures ostensibly or actually taken in the public interest, or when the host state, i.e. the taxpayer, has to pay compensation. Transparency of arbitral proceedings is an important means to shed light on these questions and how they are dealt with. In general, the argument in favour of confidentiality is less convincing than in private proceedings, between two companies, for example.

Beyond regulations in IIAs, regulations on transparency are sometimes provided by arbitration rules. More important consequences on the transparency of arbitral proceedings are to be expected from the UNCITRAL Rules on Transparency in Treaty-based Investor-State Arbitration, which came into effect in 2014. Under the Rules, basic information about the dispute has to be made public through UNCITRAL's Transparency Registry; written submissions by the disputing parties, non-disputing parties and third parties have to be made publicly available; the oral hearings are open to the public and transcripts of those hearings have to be made publicly available; finally, all orders, decisions and awards are made publicly available. The requirements are subject to certain requirements regarding confidential and protected information.

In principle, the Rules apply to any UNCITRAL arbitration under an IIA that was concluded on or after 1 April 2014. (This is not the case when contracting parties to the IIA exclude the application of the Rules; or when the IIA allows excluding the application and both disputing parties agree to do so). For IIAs concluded before that date, the Rules only apply if the disputing parties agree to the application, or the contracting parties provide for their application on or after 1 April 2014. By signing and ratifying the UN Convention on Transparency in Treaty-Based Investor-State Arbitration, open for signature since 17 March 2015, a country makes the Rules applicable to its IIAs concluded before 1 April 2014.

ISDS practice – defensive and offensive use of Ukrainian treaties

It is difficult to establish a precise number and status of investment claims by foreign investors against Ukraine due to the confidentiality of certain ISDS proceedings (see Box 2.7 on Transparency). The ICSID website indicates that there have been 14 ICSID cases against Ukraine,[98] three of which are still pending. Three of the cases were settled; in four the investor's claims were dismissed; in one the tribunal declined jurisdiction. Investors were awarded damages in three cases (USD 3 million, USD 8.7 million, EUR 3 million respectively). For the non-ICSID cases that were reported, the outcomes are similarly divided: in one case, the claims were dismissed; in another case, the

parties settled; in two cases the investors were awarded damages (USD 4.5 million, and USD 112 million plus interest respectively) and two more known cases are still pending, with an emergency arbitrator award already rendered in one of them.[99] The pending and concluded cases against Ukraine do not show a unique pattern: claims have been brought in different sectors and based on different investment agreements, with the Energy Charter Treaty and the investment treaties with the Netherlands and the United States being the most-invoked agreements.[100]

With regards to cases brought by Ukrainian investors against foreign states (see Table 2.2), there are two known cases in which Ukrainian state-owned enterprises have brought claims against the Republic of Moldova, invoking the Energy Charter Treaty. In a first case, under the UNCITRAL rules, damages were awarded. In the second case, under the Arbitration Institute of the Stockholm Chamber of Commerce rules, the tribunal declined jurisdiction. In addition, a Ukrainian investor issued a notice of intent of arbitration in 2013, referring to the Ukraine-Belarus IIA, but it appears that no claim has been filed so far. More recently, there have been reports about several UNCITRAL cases brought by Ukrainian investors against the Russian Federation based on the Ukraine-Russia IIA, alleging violations of the treaty by the Russian Federation against Ukrainian investments established in the Autonomous Republic of Crimea.[101]

Table 2.2. **ISDS cases by Ukrainian investors against their host states**

Arbitration rules/institution	Claimant	Sector	IIA	Status
UNCITRAL	Energoalians	Energy	ECT (Republic of Moldova)	Damages awarded[1]
SCC	Energorynok	Electricity, gas, steam and air conditioning supply	ECT (Republic of Moldova)	Declined jurisdiction
UNCITRAL	Several cases have reportedly been initiated in the context of the events regarding the Autonomous Republic of Crimea and Sevastopol City.	Ukraine-Russia IIA		
ICSID – only the notice of dispute is available.[2]	Mr. Gennady Mykhailenko		Ukraine-Belarus and Switzerland-Belarus IIA are mentioned in the notice	It appears that no claim has ever been filed after

1. IAReporter (2014), "In previously undocumented Energy Charter Treaty arbitral ruling, a divided tribunal awards $49 million in dispute over electricity supply debts", 3 May 2014.
2. Award published by IAReporter, *www.iareporter.com/downloads/20131113*.

Source: OECD, based on information retrieved from the ICSID website, *www.italaw.com*, *www.iareporter.com, and www.arbitration.kiev.ua/*.

Decisions about review and possible renegotiation of existing investment treaties should take account of their temporal validity

Review and renegotiation of investment treaties takes time. It may be more easily conducted without the time pressure of either an imminent tacit renewal for an extended period or its denunciation with the attendant publicity. Ukraine should accordingly monitor the temporal validity of its treaties in order to allow it sufficient time to approach treaty partners where appropriate. Ukraine's treaties have varying duration and different mechanisms for renewal and termination. Bilateral investment treaties generally contain, in the final provisions, the definition of an initial validity period; at the end of this period, treaties are often extended tacitly either for an indefinite period or for another fixed term. Denunciation is possible at certain points in time, but requires an advance notice. Most treaties define an additional period during which the treaty has effect for existing investments following termination (Pohl, 2013).

Table 2.3 shows for each of Ukraine's treaties the dates of signature and entry into force and key characteristics of their temporal validity (fixed term validity or open-ended validity; indefinite extension or renewal for fixed terms). Treaties that renew for fixed terms require more monitoring, as they limit the possibilities to update or unilaterally end the agreement. For all treaties, Table 2.3 also shows additional information such as the approximate date when the current period to give notice of denunciation ends (i.e. the last notice date before tacit renewal) and the approximate first date when the treaty could cease to be in force.[102]

Table 2.3. **Ukrainian international investment agreements and their temporal validity**

Treaty partner	Date of signature	Date of entry into force	Definition of temporal validity	Last notice date before tacit renewal (approximate date)	Treaty will be in force at least until (approximate date)
Bilateral agreements					
Albania	25-10-2002	18-02-2004	renewal for fixed terms	18-08-2017	17-02-2018
Argentina	09-08-1995	06-05-1997	indefinite extension	–	11-12-2016
Armenia	07-10-1994	07-03-1996	indefinite extension	–	11-12-2016
Austria	08-11-1996	01-12-1997	indefinite extension	–	11-12-2016
Azerbaijan	24-03-1997	09-12-1997	indefinite extension	–	11-12-2016
Belarus	14-12-1995	11-06-1997	open-ended	–	11-12-2016
Belgium/Luxembourg	20-05-1996	27-01-2001	renewal for fixed terms	28-07-2020	27-01-2021
Bosnia and Herzegovina	13-03-2002	22-01-2004	*	**	**
Brunei Darussalam	18-06-2004	26-04-2006	indefinite extension	25-04-2016	26-04-2017
Bulgaria	08-12-1994	10-12-1995	indefinite extension	–	11-12-2016
Canada	24-10-1994	24-06-1995	open-ended	–	11-12-2016
Chile	30-10-1995	29-08-1997	indefinite extension	–	11-12-2016
China	31-10-1992	30-05-1993	indefinite extension	–	11-12-2016

Table 2.3. **Ukrainian international investment agreements and their temporal validity** *(cont.)*

Treaty partner	Date of signature	Date of entry into force	Definition of temporal validity	Last notice date before tacit renewal (approximate date)	Treaty will be in force at least until (approximate date)
Democratic Republic of the Congo	11-10-2000	17-11-2010	renewal for fixed terms	16-11-2019	16-11-2020
Croatia	15-12-1997	16-05-2001	indefinite extension	–	11-12-2016
Cuba	20-05-1995	04-12-1996	renewal for fixed terms	04-06-2016	04-12-2016
Czech Republic	17-03-1994	02-11-1995	*	**	**
Denmark	23-10-1992	29-04-1994	indefinite extension	–	11-12-2016
Egypt	21-12-1992	10-10-1993	indefinite extension	–	11-12-2016
Equatorial Guinea	15-12-2005	19-09-2008	*	**	**
Estonia	15-02-1995	05-07-1995	indefinite extension	–	11-12-2016
Finland	14-05-1992	30-01-1994	indefinite extension	no action required	expired or otherwise terminated
Finland	07-10-2004	07-12-2005	indefinite extension	07-12-2025	08-12-2026
France	03-05-1994	26-01-1996	indefinite extension	–	11-12-2016
FYROM	02-03-1998	25-03-2000	renewal for fixed terms	25-03-2019	25-03-2020
Gambia	12-07-2001	19-01-2006	*	**	**
Georgia	09-01-1995	18-12-1996	renewal for fixed terms	18-06-2016	18-12-2016
Germany	15-02-1993	29-06-1996	indefinite extension	–	11-12-2016
Greece	01-09-1994	04-12-1996	indefinite extension	–	11-12-2016
Hungary	11-10-1994	03-12-1996	*	**	**
India	01-12-2001	12-08-2003	indefinite extension	–	11-12-2016
Indonesia	11-04-1996	22-06-1997	renewal for fixed terms	21-06-2016	22-06-2017
Iran	22-05-1996	05-07-2003	*	**	**
Israel	16-06-1994		indefinite extension	not applicable	not applicable
Israel	24-11-2010	20-11-2012	indefinite extension	20-11-2022	21-11-2023
Italy	02-05-1995	12-09-1997	fixed term validity	no action required	expired or otherwise terminated
Japan	05-02-2015	not yet in force	indefinite extension		
Jordan	30-11-2005	17-04-2007	renewal for fixed terms	15-04-2016	16-04-2017
Kazakhstan	17-09-1994	04-08-1995	*	**	**
Korea	16-12-1996	03-11-1997	indefinite extension	–	11-06-2016
Kuwait	12-01-2002	11-06-2003	renewal for fixed terms	09-06-2032	10-06-2033
Kyrgyzstan	23-02-1993	not yet in force	indefinite extension		
Latvia	24-07-1997	30-12-1997	indefinite extension	–	11-12-2016
Lebanon	25-03-1996	26-05-2000	indefinite extension	–	11-12-2016
Libya	23-01-2001	23-04-2003	renewal for fixed terms	22-04-2022	23-04-2023
Lithuania	08-02-1994	27-02-1995	indefinite extension	–	11-12-2016
Moldova	29-08-1995	27-05-1996	renewal for fixed terms	25-11-2025	27-05-2026
Mongolia	05-11-1992	05-11-1992	indefinite extension	–	11-12-2016
Morocco	24-12-2001	25-04-2009	renewal for fixed terms	24-10-2018	25-04-2019
Netherlands	14-07-1994	01-06-1997	renewal for fixed terms	30-11-2021	01-06-2022
Oman	14-01-2002	06-02-2003	renewal for fixed terms	05-02-2022	06-02-2023
Panama	04-11-2003	13-06-2007	renewal for fixed terms	11-06-2016	12-06-2017

Table 2.3. **Ukrainian international investment agreements and their temporal validity** *(cont.)*

Treaty partner	Date of signature	Date of entry into force	Definition of temporal validity	Last notice date before tacit renewal (approximate date)	Treaty will be in force at least until (approximate date)
Poland	12-01-1993	14-09-1993	renewal for fixed terms	13-09-2017	14-09-2018
Portugal	25-10-2000	18-07-2003	renewal for fixed terms	16-07-2017	17-07-2018
Russian Federation	17-11-1998	27-01-2000	renewal for fixed terms	26-01-2019	27-01-2020
San Marino	13-01-2006	15-10-2008	renewal for fixed terms	15-04-2018	15-10-2018
Saudi Arabia	09-04-2008	18-02-2009	indefinite extension	18-02-2019	19-02-2020
Serbia	09-01-2001	14-08-2001	renewal for fixed terms	13-08-2020	14-08-2021
Singapore	18-09-2006	14-07-2007	indefinite extension	12-07-2021	13-07-2022
Slovak Republic	26-02-2007	20-08-2009	*	**	**
Slovenia	30-03-1999	01-06-2000	renewal for fixed terms	01-06-2019	01-06-2020
Spain	26-02-1998	13-03-2000	indefinite extension	–	11-12-2016
Sweden	15-08-1995	01-03-1997	*	**	**
Switzerland	20-04-1995	21-01-1997	renewal for fixed terms	22-07-2016	21-01-2017
Syria	21-04-2002	16-03-2003	indefinite extension	–	11-12-2016
Tajikistan	06-07-2001	27-05-2003	renewal for fixed terms	25-05-2017	26-05-2018
Turkey	27-11-1996	21-05-1998	indefinite extension	–	11-12-2016
Turkmenistan	29-01-1998	28-09-1999	renewal for fixed terms	27-09-2018	28-09-2019
United Arab Emirates	21-01-2003	28-02-2004	renewal for fixed terms	27-02-2023	28-02-2024
United Kingdom	10-02-1993	10-02-1993	indefinite extension	–	11-12-2016
United States	04-03-1994	16-11-1996	indefinite extension	–	11-12-2016
Uzbekistan	20-02-1993	26-05-1994	indefinite extension	–	11-12-2016
Viet Nam	08-06-1994	08-12-1994	indefinite extension	–	11-12-2016
Yemen	19-02-2001	07-02-2002	*	**	**
Multilateral agreements					
Energy Charter Treaty	17-12-1994	27-01-1999***	indefinite extension	–	11-12-2016
EFTA FTA	24-06-2010	01-06-2012	indefinite extension		11-06-2016

* Uncertain
*** Date cannot be determined with certainty
*** Entry into force for Ukraine

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The temporal validity of Ukraine's treaties can also inform discussions on possible joint interpretations of treaty provisions with treaty partners. Joint interpretations can be issued at any time and can be a simpler and faster device than renegotiation to address some aspects of treaty policy providing that the existing treaty text allows sufficient scope to achieve the jointly-desired interpretation. This may often be the case in older treaties with vague provisions. Discussions and exchanges of views with treaty partners about proposed joint interpretations in advance of treaty renewal dates can also help inform future negotiations and decisions about treaties.

Investment promotion and facilitation

Persistent political and macroeconomic instability have endangered promotion activities

Attracting FDI and invigorating investment promotion activities through various means, including by enhancing deregulation and liberalisation of entrepreneurial activities, improving corporate rights and bankruptcy procedures, facilitating privatisation and developing infrastructures, have long been core government's objectives. Nonetheless, neither the *Programme for the Development of Investment Activity for 2002-2010* agreed in 2001[103] nor the December 2008 *Programme Counteracting the Effect of the World Financial and Economic Crisis on Continued Development,* and the September 2010 *Concept of the State Specific Economic Programme of Investment Activity Development in 2011-2015*[104] have been effective in this regard. Persistent political and macroeconomic instability have endangered promotion activities.

In the past, the authorities addressed investment promotion largely through fragmented, piecemeal efforts. For example, the Law No. 5205-VI of 6 September 2012 "On Stimulation of Investment Activity in the Priority Sectors of the Economy to Create New Jobs" sought to provide state support for investment activities in some priority sectors through budget funds and exemption from the import duty and VAT deferral. Ukraine parliament also passed in 2012 the Law on Industrial Parks.[105] The law was enacted with the intent of increasing the investment attractiveness of Ukraine, creating new jobs, stimulating the economic development, and developing infrastructure for the market and industry.

Institutional framework for investment promotion

On the promotion side, a potential investor looking for information on Ukraine is not confronted with a wealth of helpful resources. Ukraine's underperformance has contrasted with its potential competitors among the countries of Europe and Central Asia as most of them, especially in Central and Eastern Europe, have considerably improved their investment promotion activities in recent years (OECD, 2011).

Probably the most important weakness of Ukraine's investment promotion activities has been frequent changes in the institutional and organisational structure, which led in the past to the multiplication of agencies with often unclearly delimited and overlapping responsibilities. After several institutional changes in the 2000s, in 2010, the authorities took a new overhaul of the institutional framework for investment promotion with the declared aim to streamline and rationalise the country's activities in this area. Under a Decree of the President of Ukraine, the State Agency for Investment and National Projects (SAINP) of Ukraine became responsible for the promotion of foreign investment

in Ukraine.[106] In parallel, under the principle of "One Window" established by Law No. 2623-VI of 21 October 2010, a "single window" facility for foreign investors called InvestUkraine was created to assist them in their establishment.[107] The Law introduced regional centres of investment and development ("Investment Centres") as state authorities in charge of a one-window system of preparation and implementation of investment projects in Ukraine. In particular, investors could submit any requests in connection with their investment projects to the regional centres. The relevant regional centre had to provide the investor with an action plan and documents necessary for implementation of the investment project.

SAINP was liquidated in 2014 and its functions were passed to the Ministry of Economic Development and Trade. Since then Ukraine has lacked a properly structured, funded and staffed agency for investment promotion. Furthermore, although the government has been committed to attracting foreign investment, government-led initiatives specifically focusing on investment promotion have been very sporadic. Until recently information exchange with investors had primarily taken place in the context of events sponsored by private organisations, such as the Ukrainian Investment Dialogue, a private sector-led initiative launched in 2014 with the support of the Ministry of Foreign Affairs and some other public organisations.[108] Since mid-2015, there have been increasing efforts to inform foreign investors about investment opportunities in the framework of investment forums outside of Ukraine sponsored by the Ukrainian government and foreign countries. Three such fora were held in 2015: the US-Ukraine Investment and Business Forum in Washington, DC, in July 2015; the German-Ukrainian Investment and Business Forum, held in Berlin in October 2015; and the French-Ukrainian Investment and Business Forum held in Paris in November 2015. In these forums, Ukrainian government officials presented the reforms agenda and its implementation, plans for improving the business and investment climate and opportunities for conducting business in Ukraine.

While the later initiatives bear witness to the growing attention the authorities are giving to the need to publicize Ukraine's attractiveness, government promotional initiatives require strengthening. Ukraine has yet to adopt a comprehensive foreign investment promotion programme. Local state authorities and self-government authorities have been more proactive by setting up regional investment agencies in territorial-administrative units. Several of them have been operating user-friendly and frequently updated investor portals that list current projects, highlight assistance available to potential investors, including navigating bureaucratic hurdles, and that provide advertising for specific regions or cities. These efforts nevertheless remain too fragmented. More consideration must be given to the provision of public support to foreign investors in the form of business services and informational assistance.

Frequent changes in the organisation structures and shifting in responsibilities also usually do not facilitate transparency and accessibility of the country's foreign investment promotion activities, especially for new foreign investors unfamiliar with local economic and legal environment, though this category of investors is in principle the main target group of investment promotion agencies. The efficiency and relevance of new agencies involved in investment promotion will mainly depend on financial and human resources made available to them. In the context of intense world competition for attracting FDI, the ongoing reform of Ukraine's investment promotion activities has to focus on key functions in this area, notably developing an updated information service to prospective investors both on-line and in response to their direct inquiries and providing an active support in foreign investors' establishment and operations in the country. The recent experience of Chile can be useful in this regard.

The Ukrainian government recently outlined key priority sectors relevant to its investment promotion activities: Agribusiness (with an emphasis on agro-processing), the IT Sector (the government hopes that other IT companies will emulate Samsung, which is upgrading its R&D Centre in Ukraine) and transport infrastructure (Ministry of Economic Development and Trade, 2015e).

Box 2.8. **Reforming an investment promotion agency – the case of Chile**

Chile relies strongly on FDI and, thanks to an open investment regime and a robust regulatory and institutional environment, boasts one of the highest ratios of FDI to GDP in the OECD. There are no prior-approval or screening requirements for FDI, and foreigners are legally granted the same treatment as nationals. To remain competitive vis-à-vis competitors that are sharpening their investment promotion, Chile has recently decided to update the investment policy and institutional framework. The Framework Law for Foreign Investment is designed to support Chile's further integration in global value chains (GVCs) through more and better FDI.

Against this background, in 2014 the OECD worked in partnership with Chile's Foreign Investment Committee (FIC) to turn it into a modern IPA, develop a well-crafted investment promotion strategy and provide concrete recommendations on the way forward. The OECD Investment Committee and OECD IPAs held a peer review of the FIC on 2 December 2014, in Paris.

The report recommends adopting a pro-active and carefully targeted investment promotion, while also ensuring a careful calibration of policies and implementation to avoid duplication of tasks. In particular, responsibilities should be clearly assigned for country-image building, investment generation,

Box 2.8. **Reforming an investment promotion agency – the case of Chile** *(cont.)*

linkage promotion and policy advocacy. For the FIC to play a more pro-active role in defining Chile's strategic policy orientation towards FDI it must transition from a regulatory body to an entity capable of developing its own vision in terms of target markets and priority sectors. It must also gain a strong institutional position with a legally defined mandate and clearly stipulated core functions. Ideally the FIC should have direct reporting lines to the Minister of Economy. The OECD stresses the necessity of guaranteeing that the FIC has sufficient room to manoeuvre to execute its services in the way investors expect and in line with the government's priorities.

On the other hand, successful investment promotion and facilitation cannot be undertaken in isolation by one agency alone, but relies on a dynamic investment ecosystem consisting of local industry clusters, multinational enterprises (MNEs), well-coordinated public policies and agencies, including in the area of research and development and innovation, and a well-functioning international network.

Furthermore, the resources and skills needed to carry-out new investment promotion and facilitation tasks will require the relevant agencies to focus more on policies to attract foreign investments with potentially strong spill-over effects, and to strengthen the linkages of these investments with the domestic economy. These investment-targeting policies can be useful to enhance the absorptive capacity of the domestic economy, but any new programmes that target specific sectors and firms should carefully balance costs and benefits, to avoid the pitfalls of special incentive schemes for foreign investment.

Dialogue with investors

Investment promotion agencies or dedicated bodies can play an important role in facilitating communication and consultation with investors, and in providing an effective channel to relay investors' concerns to relevant governmental agencies, thus potentially influencing government activities, decisions, and regulations having an impact on the investment climate.

Prior to 2014, dialogue with investors was largely formalistic and ineffective (OECD, 2014). There were various mechanisms for involving entrepreneurs, business associations and industry representatives in the decision-making process, such as the Council of Local and Foreign Investors and the State Administration for Entrepreneurship and Regulatory Policy, but their activities did not have a significant impact on policy-making in the country.[109] Since the Maidan events, as part of the government's drive to improve the country's business climate, Ukraine has been stepping up its efforts to enhance

dialogue with investors and a central element of this campaign has been the establishment of a Business Ombudsman institution.[110]

The Business Ombudsman Council (BOC) is a key element in an Anti-Corruption Initiative agreed among the Ukrainian government, international organisations, including the EBRD and the OECD, and a number of Ukrainian business associations (Wehrlé, 2015). It allows businesses to report claims of corruption and unfair practices against companies such as repetitive tax audits or investigations, excessive inspection fees, threats, retaliation or other business abuse by Ukraine's public agencies. The Ombudsman's role is to look into whether an administrative decision has been taken place in accordance with the regulations in force. It does not constitute a judicial body; instead, it offers a simplified, faster way to settle issues, while still recognizing the right of companies to take their grievances to courts or use other procedures. One of the strengths of the Business Ombudsman institution is its power to initiate a dialogue with managers of the public agency about which the complaint is made to obtain a speedy response to resolve issues. The mechanism also encompasses an advisory role for government. The Ombudsman has the power to report publicly on the systematic causes of the unfair treatment of business. It is also empowered to make proposals to the government on how to improve the business climate in Ukraine, including proposals to amend legislation and regulations.

The establishment of the Business Ombudsman institution holds great promise for improvement of Ukraine's business climate and is expected to yield tangible results. During the third quarter of 2015, the newly established institution processed 197 complaints: a 14% increase from the 172 complaints submitted in the first reporting quarter (second quarter of 2015).[111] Forty cases were successfully investigated, with a direct financial impact of more than UAH 115 million (Business Ombudsman Council, 2015b). From May to November 2015, government agencies most subject to complaints were the State Fiscal Service of Ukraine (42% of complaints), followed by criminal law enforcement agencies (12%), municipal administrations (councils) (9%), and the Ministry of Internal Affairs (Business Ombudsman Council, 2015a). Most complaints received by the Business Ombudsman were made in relation to taxation (VAT refund delays, refusal of VAT taxpayer registration, excessive tax inspections), non-enforcement of court rulings by local and central government officials, baseless criminal investigations and unfair regulatory compliance in the area of export-import operations. On average the review and resolution of cases was completed within 4 weeks (see Box 2.9 on matters addressed and solved by the Business Ombudsman Council).

Apart from the establishment of the Business Ombudsman, the authorities have made further efforts to institutionalize public-private consultations within the framework of the National Investment Council. The

Box 2.9. **Addressing problems faced by businesses: The Business Ombudsman Council of Ukraine in practice**

Case 1: Law enforcement authorities pressuring a foreign-owned company through baseless criminal proceedings

An international company established in Ukraine complained that its premises had been searched, its employees summoned for interrogation, and corporate documents had been seized as part of an ongoing criminal investigation. The criminal investigation into the company's activities was launched for alleged VAT avoidance. In their complaint to the Business Ombudsman institution, the company's officers said that the investigation had been launched to exercise pressure on the company, citing court rulings in its favour.

After the company's complaint had passed the first filter and being evaluated by the Council's experts, the Council met with representatives of the Ministry of Interior and the investigator in charge of the case to address the complainant's concerns. Based on this meeting and a review of relevant legislation, the experts came to the conclusion that the investigators' actions were excessive and likely intended to put pressure on the company and its management. With the inputs of the experts, the Business Ombudsman Council presented a set of observations to the Ministry of Interior's Main Investigative Bureau, including the legal requirement for the investigators to strictly abide by the Criminal Procedural Code. These observations resulted in the issuance of formal letter of apology to the complainant by the Bureau and a commitment to abstain from such incidents in the future. The resolution of the case was completed within 4 weeks.

Case 2: Illegal actions by the Regional State Tax Inspection

A complaint was lodged against Ukraine's Regional State Inspection for groundlessly depriving the complainant's ability to register its tax invoices electronically. The Business Ombudsman's secretariat called the Anti-Corruption Bureau of the State Fiscal Service, inquiring about the situation. Because of this action, the complainant's issue was resolved within two days. Specifically, the complainant's ability to conduct normal business operations and to file tax invoices electronically was restored.

Source: Business Ombudsman Council, *Quarterly Report April-June 2015*.

Council was established at the end of 2014 in replacement of the former Council of Local and Foreign Investors with the declared aim to offer a platform that will promote the interaction between the government and investors.[112] A consultative and advisory body chaired by the President and composed of representatives of domestic and foreign entities involved in investment activities as well as of business associations, audit and legal

companies and financial institutions, the Council aims at serving as a high-level policy dialogue to involve investors in the reform and decision-making process. In the absence of implementing regulations, it nevertheless remains to be seen the extent to which the Council will be able to accomplish its role in advising the President on how to improve the investment climate in the country, intensify the development of the investment potential of Ukraine, increase the volume of foreign investments, and ensure the protection of the investors' rights. As noted above, in the past similar bodies did not have a significant impact on the policy-making process.

In the interim, the main venue for public-private dialogue beyond the Ombudsman Council remains public hearings and public consultations on draft regulations and laws. Draft laws (including those that are foreign and domestic investment-related) are usually discussed during parliamentary hearings organised by the profile committees of Ukraine's parliament, where representatives of the business sector may be invited to participate depending on the subject matter. To that end, parliamentary committees have established websites that are kept up to date and invite the public to comment on specific drafts. Pursuant to the law, stakeholders are also given an opportunity to comment on new draft legislation initiated by relevant ministries and agencies prior to its submission for consideration to the Cabinet of Ministers and the Verkhovna Rada of Ukraine.[113] Announcements of public discussions are posted on the relevant agencies' website, as well as on the government's portal. Consultations also take place in the framework of working groups established by ministries that bring together Ukrainian public officials and industry representatives. Since the political changes in March 2014, business representatives have cited an unprecedented amount of cooperation and communication between the Ukrainian government and the private sector through government established working groups.

Private sector influence on regulatory decisions could nevertheless be further increased. Developing additional tools to ensure the broader participation of the private sector in creating a relevant legal environment for business should be a priority for improving Ukraine's competiveness. The activity of the newly established National Investment Council under the leadership of Ukraine's President needs to ensure that consultations take place on a regular basis, discussion topics are submitted early enough for private sector representatives to provide comments, and alternative proposals, comments and recommendations directed at eliminating barriers for business are taken into consideration. Information on the outcomes of the Council's activity should be provided as well, as this knowledge can contribute towards greater trust among investors in this type of institution. This information could typically be published in a yearly or quarterly report, as it is in the case with the Business Ombudsman.

Investment incentives and the tax system

The OECD Declaration on International Investment includes the Instrument on International Investment Incentives and Disincentives, which encourages adherents to ensure that incentives as well as disincentives are as transparent as possible so that their scale and purpose may be easily determined. The Instrument also provides for consultations and review procedures among adherent countries to facilitate international cooperation in this area. The OECD *Policy Framework for Investment* also encourages countries to evaluate the costs and benefits of incentives, in particular the use of tax incentives together with the level of tax burden they impose on businesses with a view of meeting its investment promotion objectives. The OECD *Checklist for Foreign Direct Investment Incentive Policies* also helps raise awareness of decision-makers in assessing the usefulness and relevance of investment incentives. In addition, the OECD Tax and Development Programme developed the *Principles to Enhance the Transparency and Governance of Tax Incentives for Investment in Developing Countries* to promote the management and administration of tax incentives for investment in a transparent, consistent manner, limit discretion and increase accountability.

Inventory of incentive regimes

The Tax Code of Ukraine, adopted on 2 December 2010 (as amended), and the Customs Code of Ukraine, adopted on 13 March 2013 (as amended), primarily govern the Ukrainian tax incentives regime.[114] Over the past two years, the Ukrainian authorities have considerably reduced the number of tax incentives available to investors with the view of simplifying Ukrainian tax administration to ease the conditions of doing business in Ukraine, and of raising revenue to finance government expenses. Below is a brief overview of the most significant tax incentive regimes currently existing in Ukraine. They can be categorized as follows: general incentives, sectoral incentives, special tax regimes, and regional incentives.

Until recently, subject to certain limitations and eligibility criteria, tax "holidays" and incentives favoured certain prioritized sectors of Ukraine's economy, including the production of IT goods; manufacturing of certain consumer goods (the so-called "light industry"); ship- and aircraft-building industries; production of machinery for the agricultural industry; three to five star hotels; power generation from renewable sources; and investments resulting in job creation in qualifying industries, including high- tech, eco-friendly, and manufacturing and export-oriented industries.

Effective 1 January 2015, new legislation has cancelled tax incentives in the following areas: production of IT goods[115]; extraction and use of gas (methane) and of coal deposits; bio-energy fuel, electric and heat energy

generated from bio-energy fuel, and domestic equipment powered with bio-energy power production; "light industry"; ship-building and aircraft industries; machinery construction for the agricultural industry; operations on medicines and medical products supplies; hotels; and investments in qualifying large investment projects (those resulting in job creation) in qualifying industries.[116]

As a result of these recent legislative changes, Ukraine now provides for much more limited tax "holidays" and incentives. Specifically, under the Customs Code of Ukraine, enterprises with foreign investments are exempted from paying import duties on in-kind contributions made by foreign investors into the charter capital (except for goods for sale or use for purposes not directly related to business activities). Foreign investors can also benefit from specific tax provisions made available to small and medium enterprises. This category of enterprises (which includes legal entities with annual revenue of up to UAH 20 million [about USD 809 000]) is subject to the simplified taxation system, paying a single tax not including other taxes such as corporate income tax, land tax, duty for special use of natural resources, communal taxes and duty for obligatory state pension insurance.[117] This preferential taxation system associated with the possibility of simplified accounting and reporting has sought to promote the development of SMEs in Ukraine.[118] Ukraine also offers depreciation rates for fixed assets, including buildings and constructions for both foreign and domestic investors.[119] Foreign investors, like domestic ones, can also benefit from total exemption from VAT that applies to the publishing industry (production and trade of locally produced books, newspapers and magazines).[120] The cinematography industry (production, distribution, sale of Ukrainian movies and foreign movies dubbed in Ukrainian or with subtitles in Ukrainian) is also exempt from VAT until 1 January 2016.[121]

In addition, tax is not levied on income of foreign investor withheld at source in Ukraine received under production sharing agreement ("PSA") with the Ukrainian authorities, which is paid by its permanent establishment. Funds/property transferred by non-resident investor of Ukraine to its permanent establishment aimed at financing activity under PSA in accordance with agenda and budget costs are not subject to corporate income tax. In 2013, the government also adopted regulations that offer preferential tax treatment for development of the depleted fields and reserves of oil and gas that are difficult to access. The tax rate for such projects is 2% and, since 2015, applies to companies with a state share of 25% or more.

Ukrainian tax legislation also allows agriculture companies to take advantage of a special VAT regime until 1 January 2018, according to which VAT collected from them is not payable to the government, but should instead be retained by these companies and transferred to special bank accounts of agricultural producers. These funds may only be used for the business

purposes of agricultural producers.[122] The law also allows them to choose between the general system of taxation and the Fixed Agricultural Tax (FAT), a special tax regime according to which qualified agriculture companies whose activities for 75% consist of agricultural production may choose to pay FAT in the form of single tax payment instead of corporate income tax, land tax, charge for special use of water, and special taxes for certain types of activities. The amount of FAT paid is calculated based on the size and type of land plot. In addition to this, based on the applicable Ukrainian tax laws, the local authorities may grant privileges regarding land tax.[123] As an incentive to investments in green energy, a reduced land tax rate also applies to renewable energy sources producers until 31 December 2015. Pursuant to this preferential regime, investors pay only 25% of the land tax.[124]

Local governments are also entitled to grant tax privileges in order to stimulate certain projects. Pursuant to the Tax Code of Ukraine, they may:[125]

- Establish exemptions from the tax on real property, other than land, as provided in paragraph 266.4.2 article 266 of the Tax Code;
- Establish exemptions of tax on real property, other than land, as provided in paragraph 266.4.2 article 266 of the Tax Code;
- regulate rates of the land tax within the maximum defined in paragraph 284.1 article 284 of the Tax Code;

Also, the fourth paragraph of Article 40 of the Law of Ukraine "On regulation of urban development" provides exemption from payment for participation in local infrastructure development for the following buildings: schools, cultural and sports centres, medical and recreational facilities; social and affordable housing; objects, built as the result of investment tenders or auctions; objects if they contain objects of social infrastructure; objects built to replace those that are damaged or destroyed due to human actions or natural disasters; engineering facilities, transport infrastructure, energy, communications and road facilities (except of road service); objects within industrial parks constructed by the founders of industrial parks, industrial park management companies, members of industrial parks.

Special economic zones

In 1998-2000 Ukraine established a specific customs and tax regime for Special Economic Zones (SEZs) and the priority development territories (PDTs) under the Law "On Special (Free) Economic Zones", adopted in 1997, and other legislation.[126] A total of 12 SEZs and 9 PDTs, reportedly covering more than 10% of the whole area of Ukraine, were created. Given the very poor record of accomplishment of these incentives – in terms of tax avoidance and evasion[127] and corruption,[128] a 2005 law abolished both the customs regulations and the special tax regime granted to these zones.[129] As a result, all existing projects

were cancelled either after the expiration of their contracts or at the initiative of investors.

In 2010, the government announced its intention to re-establish SEZs and PDTs as they were prior to the 2005 law but a draft law on the subject never went forward. The SEZ debate in Ukraine received new impetus in 2014 when a free economic zone was established in the territory of the Autonomous Republic of Crimea and Sevastopol City.[130] Pursuant to the Law of Ukraine on SEZ, the free economic zone of Crimea will be valid for 10 full calendar years (i.e. until 27 September 2024) and governed by a so-called Management Company which will be state property. The SEZ grants foreign and domestic companies registered in the Autonomous Republic of Crimea tax breaks for their investments in the country, including full exemption from corporate income tax, individual income tax, VAT, excise tax, environmental tax, the obligatory state pension insurance, and exemptions from fees for land, the transport of oil and oil products through main pipelines, and for transit transport of natural gaz. The provisions of double taxation treaties are not applicable to incomes of such legal entities and individuals registered in the SEZ. No exemption applies to the obligation to pay local taxes.[131] Customs duties also apply to the supply of goods and provision of services from Crimea to the mainland Ukraine and vice-versa.[132]

As of January 2016, against the background of the law of Russia "On Admission of the Republic of Crimea and Establishment of the New Federal Subjects of the Russian Federation" adopted on 20 March 2014, the fact that Russian legislation was *de facto* applied in Crimea, and of the parallel establishment by Russia of a special economic zone in Crimea to encourage investment in priority sectors such as tourism, recreation, spa and curative industries,[133] the impact of Ukraine's law on Crimea's SEZ was unclear. Furthermore, a number of countries recognising Crimea as an integral part of Ukraine had taken measures aimed at prohibiting new investments by persons or entities under their jurisdiction, thus making unlikely foreign investors investing or operating on the territory of Crimea and Sevastopol City.[134] In practice, as of January 2016, due to increased legal uncertainty, a growing number of businesses were switching legal jurisdictions, with their Crimean affiliates starting operating as part of Russia's market.

Industrial parks

In June 2012, Ukraine established industrial parks with the intent of increasing the investment attractiveness, creating new jobs, stimulating economic development and developing infrastructure for the market and industry.[135] In the framework of this new instrument, foreign and domestic investors were to benefit from tax incentives and ready infrastructure with a view to reducing operating costs and cutting the time it takes projects to reach

the market. The proposed tax benefits included duty-free import of equipment not produced in Ukraine. In practice, although 12 industrial parks were registered with the national authorities after the Law's adoption, given the existence of administrative barriers and insufficient support from the central authorities, as of January 2016 only four of them were operational.[136] In an effort to address many of the omissions left by the 2012 Law and to streamline the procedures for industrial parks development and management, Ukraine's parliament adopted amendments to the Law and other relevant laws (land code, Law on land lease) in November 2015.[137] These amendments also exonerate industrial park's management companies from rents on leasing state or communal land for the first 3 years of industrial park's operations.

Industrial parks can be used to accelerate economic development. When properly designed, the parks have the potential to become growth hubs, creating high growth territories that drive national economic development. Integrated with area education and training institutions, the parks can support start-ups, new enterprise incubation, the development of knowledge-based businesses, and offer an environment where local and multinational enterprises can interact with each other for mutual benefit. International experience points to a number of good practice examples that Ukraine could follow in connection with any decision to revamp its legislation. The design and establishment of industrial parks should nevertheless be subject to rigorous *ex ante* and *ex post* cost-benefit analysis (OECD, 2014).

Evaluation of the cost of investment incentives

Tax expenditures – the revenue loss attributable to investment incentives and special exemptions – have translated into less money available to the government for other public expenditures. Amid renewed crisis, falling tax revenues, including revenue losses from the East, and rising debt, Ukraine has been facing serious fiscal consolidation needs. Over the past five years, the government primarily relied on generous tax incentives and holidays to stimulate private investment, often at the expense of much needed general government revenues. The large number of exemptions also seriously compromised fiscal transparency in Ukraine.

The Ministry of Finance publicly released tax expenditures reports aimed at evaluating the costs and benefits of existing incentives in the past.[138] In 2011, the losses of budget revenue due to tax incentives were 25.9% of consolidated budget.[139] Since 2014, the Ministry has issued quarterly reports on tax expenditures to the IMF. Although most recent data are not publicly available, the overall size of tax expenditures has been a concern for the current government, especially when considering the low tax revenue collection figures, with the tax revenue to GDP ratio recorded at 18.3% in 2012.[140] Ensuring Ukraine's macroeconomic stability has become a major priority for the

Ukrainian authorities to guarantee that the investor-friendly framework conditions are in place. To that end, the health of public finances, including stabilisation of the country's public sector debt and fiscal consolidation, has been high on the agenda of Ukrainian policy-makers. As noted above, a number of measures aiming at expanding the tax base through elimination of the most ineffective tax exemptions and privileges in order to increase tax revenues have been undertaken during the past two years. In February 2015, pursuant to the conditionalities attached to the IMF loans, the government further committed to eliminate tax exemptions.[141]

To assist in meeting the commitments under the instrument on International Investment Incentives and Disincentives, Ukraine is invited to use the OECD Checklist for Foreign Direct Investment Incentive Policies which is based on good practices in in this area, as well as the OECD Principles to enhance the transparency and governance of tax incentives for investment in developing countries. Both instruments encourage governments to promote the management and administration of incentives in a transparent and consistent manner and to set up a mechanism to assess incentives through costs-benefits analysis. Engagement with the Committee of Fiscal Affairs to conduct analyses of tax policy for investment would also be beneficial; in particular, the OECD Tax and Development Programme can provide assistance in comprehensive analysis of tax incentives for investment.

VAT refund

While the timely payment of VAT refunds is a legal obligation of the state, the enormous accumulation of arrears to domestic and foreign-owned companies has plagued the Ukrainian economy. In April 2010, the amount of VAT subject to refund was equal to UAH 28.4 billion (USD 1.3 billion), which corresponded to 2.6% of GDP.[142] Five years later, as of December 2015, the amount of non-refunded VAT was approximately UAH 15 billion.[143] Primarily affected have been export-oriented companies, which can claim VAT paid on inputs, while their exports are zero-rated. Within the export sectors, agriculture has been the hardest hit in both absolute and relative terms.

Tackling this problem figured prominently in the Program of Economic Reform 2010-14 and in the IMF-Ukraine agreement reached in July 2010. The objective of redeeming all export VAT-refund arrears by end-2011 was not met, however. In July 2013, VAT arrears amounted to UAH 4.5 billion (USD 200 000), while UAH 11 billion (USD 500 000) worth of refunds were being disputed in courts; automatic VAT refund payments were UAH 24.2 billion (USD 1.1 billion) in 2013, which was 4.5% more than in 2012, and 52.2% more than in 2011. In the meantime, VAT refunds were still doled out manually and bribes continued to be solicited to obtain refunds.[144] As a result, fraud reportedly cost the government upwards of approximately UAH 24.19 billion (USD 1.13 billion) in 2014.[145]

Since February 2015, pursuant to the Law of Ukraine "On Amendments to the Tax Code of Ukraine and Certain Legislative Acts of Ukraine on Tax Reform" of 28 December 2014, all VAT payers in Ukraine have been required to use special VAT accounts for VAT payment purposes and soon VAT reporting will be made electronically only as foreseen by the law.[146] Taxpayers will not be able to make any transfers from their VAT accounts to the state budget.[147] The VAT tax base of the purchased goods or services cannot be lower than their purchase price, tax base of the produced goods or services should be at the level of the production costs at least, the tax base of the non-current assets should be at their book value as of the last reporting date or higher. The new law provides for automatic and non-automatic VAT refund. Since 1 July 2015, VAT refund does not require any tax audit or inspection.

Ongoing tax reforms

The VAT-related measures are part of an ambitious tax reform package seeking to reduce the share of taxes in business costs and ease tax related management for enterprises. The government's strategy is bearing fruits: According to the 2016 World Bank *Doing Business* database, under the indicator "Paying taxes", Ukraine's distance to frontier (a useful tool in assessing the absolute distance to best regulatory practices and its evolution over time, on a 0 to 100 scale) has improved from 18 in 2010 to 70.7 in 2016. The business community has been actively involved in discussions regarding a comprehensive tax reform.

While postponing a systemic overhaul of the tax system to 2016, Parliament adopted significant changes to the tax code in December 2015 (together with the preliminary 2016 budget). The tax code, as amended, substantially reduces the tax burden on labour: the single social security contribution levied on wages decreases from the previous 41 % (on average) to 22 %, while the small contribution paid by employees (previously 3.6 %) is abolished. Parliament also introduced a flat personal income tax at 18 %, while increasing excise duties on fuel, spirits, alcohol and tobacco. By doing so, the government and Parliament have hoped that cutting tax rates on labour would shrink the informal economy (notably under-reporting of tax and employment), improve tax compliance and thus bolster fiscal revenues. However, World Bank experts have pinpointed that coordinated reforms to improve the inefficient tax administration, broaden the tax base and fight corruption are indispensable to deliver results over time.[148] Therefore, the short-term effect of the reduction of the burden on labour might be limited.

On 25 February 2015, in order to stabilise its balance of payment, Ukraine also introduced temporary import duties[149] of 5 % to 10 % on most import items (except for a few "essential articles" entailing natural gas, coal, petroleum products and other energy commodities and certain medicines). As

prescribed by the IMF Program, these temporary import duties have been removed in January 2016. This move is expected to lower the cost of key inputs and thus likely enhance the attractiveness of Ukraine to foreign investors.

Benchmarking Ukraine's business environment

A realistic assessment of relative FDI attractiveness requires considering a broader assessment of the business climate than regulatory restrictions and constraints. The World Bank's *Doing Business* indicators (World Bank, 2016) regularly measure particular time and costs required to comply with basic establishment and business-related procedures. According to the 2015 survey ("*Doing Business 2016*"), Ukraine came at 83rd out of 189 countries, which is an improvement from 87th in the previous year. The average distance to frontier (as indicated above, the distance to frontier is the absolute distance to the best regulatory practices) across all indicators has constantly improved since 2010. The average distance to frontier went up from 39.7 in 2010 to 63 in 2016 (Figure 2.1), meaning that Ukrainian business regulations got closer to the best regulatory practices over time.

Figure 2.1. **Distance to frontier: Significant progress**

Measures the gap between Ukraine's performance and the best performance since 2005

* 2016 ranking reflects data as of June 2015.

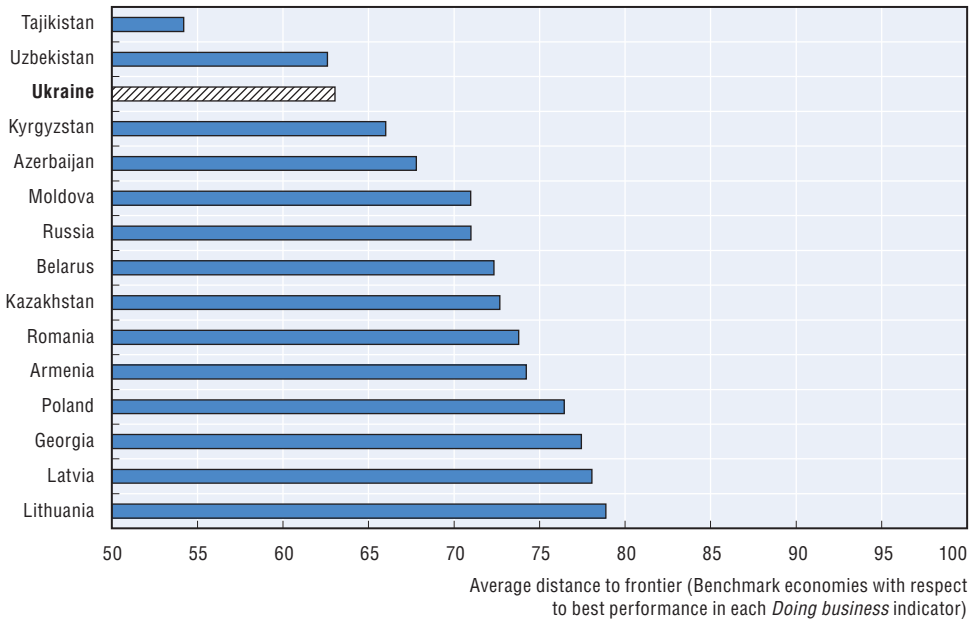
Source: World Bank (2016), *Doing business*, *www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB16-Chapters/DB16-Mini-Book.pdf*.

StatLink http://dx.doi.org/10.1787/888933355786

Despite this progress, Ukraine continues to rank poorly in a group of 15 countries from the former Soviet Union and Central and Eastern Europe (Figure 2.2). Indeed, the *Doing business 2016* ranking suggests that the gap between Ukraine's performance and the best business regulations at any point in time is still larger than for most of its neighbours. However, some improvements in business regulations detailed in this chapter are not yet factored in *Doing business 2016* as the survey reflects data as of June 2015.

Figure 2.2. **Average distance to frontier: A regional benchmark**

Average distance to frontier across 10 Doing business indicators



Source: World Bank (2016), *Doing business*, *www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB16-Chapters/DB16-Mini-Book.pdf*.

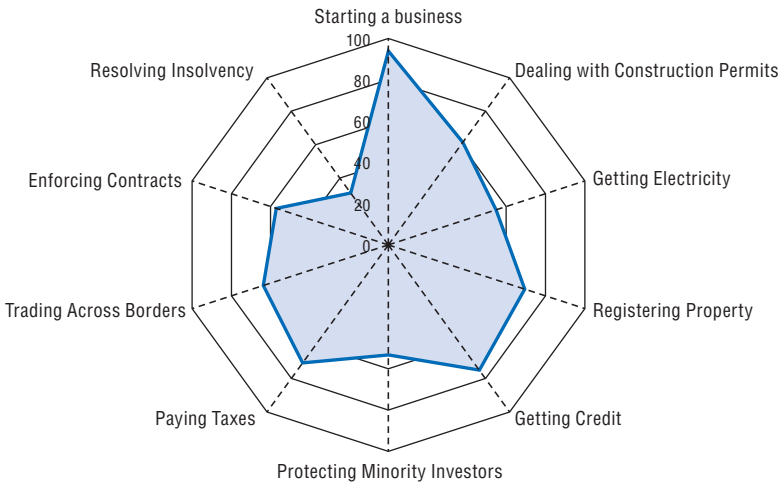
StatLink http://dx.doi.org/10.1787/888933355798

Figure 2.3 measures the gap between the Ukrainian performance and against the best performance observed on each of the indicators across all economies in the *Doing Business* sample since 2005. An economy's distance to frontier is reflected on a scale from zero to 100, where zero represents the lowest performance and 100 represents the frontier (World Bank, 2016). Figure 2.3 suggests that Ukraine in now very close to the frontier regarding business registration procedures ("Starting a business": distance to frontier: 93.9). Indeed, a dramatic improvement was registered in 2016 concerning this indicator (Ukraine's rank improved from 70th to 30th last year). However, Ukraine is still very far from best regulatory practices regarding other key indicators such as "Resolving insolvency" (assessing bankruptcy system and procedures, distance to frontier: 31), "Getting electricity" (distance to frontier: 54.9), "Protecting minority investors" (assessing the protection of minority shareholders in the corporate governance framework, distance to frontier: 53.3) and "Enforcing contracts" (assessing commercial dispute resolution through courts, distance to frontier: 57.1).

The government is undertaking significant reforms in the areas covered by the indicators "Protecting minority investors", "Resolving insolvency" and

Figure 2.3. **Ukraine: Distance to frontier across indicators (*Doing business 2016*)**

Benchmark economies with respect to best performance in each doing business indicators



Source: World Bank (2016), *Doing business*, *www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB16-Chapters/DB16-Mini-Book.pdf*.

StatLink http://dx.doi.org/10.1787/888933355804

"Enforcing contracts". As detailed in Chapter 3 of this report, the authorities introduced tighter regulations regarding related-party lending and the credit information system is being strengthened (Unified credit registry). Efforts are also ongoing to improve the corporate insolvency (the gap to best regulatory practices is the largest across all indicators regarding "Resolving insolvency") and credit enforcement regime. Judicial and corporate governance reforms covered in Chapter 2 (section on "Enforcement of contracts despite a poor state of the judiciary") will also help address issues regarding commercial disputes ("Enforcing contracts") and the rights of minority shareholders.

However, these developments and on-going reforms aimed at further improving Ukraine's business environment represent only a small part of a larger picture. Feedback from domestic and foreign enterprises indicates that the overall business environment in Ukraine continues to be critically weakened by corruption and weak rule of law. In late 2015, out of 99 companies surveyed by the American Chamber of Commerce of Ukraine, 73% of respondents said that they do not believe that corruption in Ukraine has fallen since March 2014. 88% of them said that they continue to face corruption while carrying out business activities (91% in 2014).[150]

The survey conducted by the American Chamber of Commerce shows that bribe solicitation by public officials continue to pose constant challenges for

many companies if they wish to access to certain services or public procurement, obtain licences, get VAT refunds that they are legally entitled to or protect themselves from illegal actions. For example, reportedly, corruption would be pervasive throughout the entire energy industry sector, from getting the licence to securing the tariff to keeping the licence each year. As a result, the majority (82%) of members of the American Chamber of Commerce believed that the fight against corruption was a top priority for Ukraine to address.

Notes

1. The contracts between domestic and foreign companies have to be drafted in Ukrainian and in one language used by the foreign party. The absence of the bi-lingual form of foreign contracts can justify their invalidation by courts. A representative office of a foreign company is not considered as a legal entity and should be registered with the Ministry of Economy, tax authorities and the Statistics Committee. It can be exempted from corporate profit tax if provided so by international double taxation treaties concluded by Ukraine.
2. Law No. 755-IV "On State Registration of Legal Entities and Individual Entrepreneurs" (15 May 2003).
3. All USD Conversions in this Review are based on the official NBU Exchange rate as of 19.10.2015 (1 USD/UAH 21.297).
4. Tax Code of Ukraine No. 2755-VI (2 December 2012).
5. Law No. 1193-VII "On Introducing Amendments to Certain Legislative Acts of Ukraine with Regard to Reduction of the Number of Permits" (9 April 2014).
6. The Act cancelled licenses in 20 fields of business activities. For instance, security guard activities, creating forms for securities, conducting land evaluation works and land tenders, collecting and using information that includes credit history, sales of liquid fuel made from biomass and biogas, sales of pesticide and agricultural chemicals, etc.
7. The businesses can choose between obtaining licenses and permits either directly through a competent authority, or through the centres of administrative services. The list of such licenses and permits will be approved by the Cabinet of Ministers.
8. Prior to the Act, the State Architectural and Construction Inspectorate and its regional departments performed these functions.
9. In the past, the standard practice was not to register franchise agreements, which negatively affected the parties to such agreements (for instance when the tax authorities refused to assign royalties paid by Ukrainian franchisees to deductible expenses without due registration of franchise agreements). Foreign franchisors considered the registration requirement with no transparent registration procedure in place to be a burdensome ambiguity.
10. Ukrainian IT business has long complained that authorities seized computer equipment (servers) during investigation of copyright infringement, distribution of pornography, etc. Despite the need for only a few gigabytes the authorities seized all servers, which literally paralyzed business activities. The 2015 bill replaces seizure of servers with copying of information. The temporary seizure of the computer equipment is limited to instances where: 1) it is necessary for the

investigation of physical properties, which are relevant for criminal proceeding, and 2) there is a court order. However, the notion of "relevant for criminal proceedings" is rather ambiguous and still leaves discretion.

11. When obtained in electronic form from the Register, extracts ("виписка"), excerpts ("витяг") and statements ("довідка") on business entities will enjoy equal legal force with the respective documents obtained in a paper form.

12. The fees vary from 19 UAH to 46 UAH (or USD 0.89 to USD 2.2) depending on the type and the form of the document requested.

13. In addition to the above, the Parliament of Ukraine is currently considering draft law envisaging mitigation of risks related to performance of registration formalities based on forged documents. Draft law No. 1475 (16 December 2015) contemplates performance of registration formalities (e.g. altering charter or changing management of a legal entity) based on the originals of the respective corporate decision (current version of the Law on State Registration provides for the possibility of performing such registration formalities also based on copies of such documents).

14. Law No. 222-VIII "On Licensing of Certain Types of Business Activity" (2 March 2015), Article 7.

15. Currently the methodology for regulatory impact assessment of business regulations is defined by Resolution 308 of the Cabinet of Ministers (adopted on 11.03.204), as amended.

16. See Law "On Amendments to the Law of Ukraine 'On State Registration of Legal Entities and Individual Entrepreneurs of Ukraine on Electronic Registration'" (14 August 2011) and Order of Ministry of Justice No. 997/19735 "On Approval of Procedure of Application and Electronic Documents Flow to the State Registrar" (23 August 2011).

17. Law No. 889-VIII "*On Civil Service*" (10 December 2015).

18. After the repeated rejection by the Parliament of the draft laws on the land market and the land cadastre, the moratorium on sales of agricultural land to foreigners was extended in 2009 and continued to apply in 2015. Law No. 11315 "On Introduction of Changes into Land Code of Ukraine".

19. Before the 2015 changes, land lease agreements were concluded on the basis of a standard form containing 15 essential provisions and five mandatory integral annexes.

20. Previously, there was no minimum duration for land leases (while the maximum duration remains 50 years).

21. The majority (95%) of members of the American Chamber of Commerce in Ukraine believe that judicial corruption is the most widespread in Ukraine, next to illegal tax pressure (unjustified additional sanctions) for bribery purpose: Report by the Anti-Corruption Working Group of the American Chamber of Commerce of Ukraine (November 2015).

22. Law No. 272-VIII "On Amending the Joint Stock Companies Law" (19 March 2015); Law No. 816-VIII "On amendment to Article 60 of the Law 'On Companies' (24 November 2015)".

23. This has been the case for instance at Ukrnafta, where Ukraine's pre-eminent oligarch, Ihor Kolomoisky, owned 43% with the state holding another 51%.

24. Law No. 1656 "On Ensuring the Right to a Fair Trial" (April 2015). The new grounds for review include inconsistent application of procedural rules by the cassation

courts preventing further consideration of cases, lower courts not properly applying the rules on jurisdiction, as well as incompatibility of a cassation court's decision with the legal positions of the Supreme Court. Legal positions endorsed by the Supreme Court are binding for all public bodies including lower courts, which can however deviate from those positions on reasonable grounds.

25. Judges are appointed for an initial five-year term by the President upon the recommendations of the High Council of Justice of Ukraine. The High Qualification Commission of Judges is responsible for the initial selection of candidates.

26. Only licensed attorneys admitted to the Bar can now file complaints against unlawful actions of a judge on behalf of a legal entity. Disciplinary cases concerning judges of the local and appellate courts will be considered by the High Qualification Commission of Judges and the High Council of Justice will consider those involving judges of the higher courts and the Supreme Court. The Law also extends the range of disciplinary sanctions applicable to judges, which now include a warning, reprimand, temporary removal from office (up to six months), transfer of a judge to a court of lower instance or the High Council of Justice filing a motion on complete removal from office (in cases of violation of the judicial oath).

27. As noted earlier, litigation in Ukrainian courts has been seen by foreign investors as lacking the objectivity that an investor desires. As a matter of practice, Ukrainian courts tend to apply Ukrainian domestic laws even if they fall short of standards and rules provided by international treaties. Therefore, the national courts are often not the last resort in settlement of investment disputes.

28. Article 9 of the Law of Ukraine "On the Regime of Foreign Investments" No. 93/96-BP of 19 March 1996.

29. Article 10 of the Law "On the Regime of Foreign Investments".

30. Law No. 1565-VI of 17 December 2009 "On Alienation of Private Land Plots and Real Estate Facilities Located on Them for Public Needs or Due to Public Necessity".

31. Resolution of the Cabinet of Ministers of Ukraine No. 284 dated April 19, 1993 "On the Procedure of Determination of and Compensation for Losses to Owners of Land and Land Users".

32. Law No. 1550-III "On the Legal Regime of a State of Emergency" (as amended) (16 March 2000) and Law No. 1647-III "On the Legal Regime of Martial Law" (as amended) (6 April 2000).

33. See Reuters, "Kiev says will take over Rusal's stake in ZALK aluminium complex", 12 March 2015, *www.reuters.com/article/2015/03/12/ukraine-crisis-rusal-idUSL5N0WE3PN20150312*.

34. The Associated Press, "Change of leadership in Crimea means property grab", 2 December 2014, *www.dailymail.co.uk/wires/ap/article-2857238/Change-leadership-Crimea-means-property-grab.html*.

35. *Ukraine Today,* "Ukraine reports 50 bln losses due to 'nationalisation' in Crimea", 15-24 August 2015, *http://uatoday.tv/news/ukraine-reports-50-bln-losses-due-to-nationalisation-in-crimea-478774.html*.

36. See interview in BNE, "Ukraine economy minister tightens grip on state companies", 14 May 2015, *www.bne.eu/content/story/interview-ukraine-economy-minister-tightens-grip-state-companies*.

37. As reflected on the government website outlining reforms (*http://reforms.in.ua/en/reforms/state-owned-enterprise-governance-reform*) and as reported to the OECD.

38. Order No. 157 of the Minister for Economic Development and Trade (23 February 2015).
39. *www.ebrd.com/news/2015/ebrd-ukraine-agree-naftogaz-reform-sign-us-300-million-loan-for-winter-gas-purchases.html*.
40. Resolution of the Cabinet of Ministers No. 1002 (adopted 5 December 2015).
41. Resolution of the Cabinet of Ministers No. 271 (adopted on 12 May 2015), as amended.
42. Draft Law No. 1567 (deposed on 22 December 2014).
43. Law No. 847-XIV (7 July 1999), as amended.
44. An "Aggressor-State" is a state that undertook an armed aggression against Ukraine and occupied a part of Ukrainian territory. In January 2015, the Ukrainian Parliament recognized the Russian Federation as an Aggressor-state (Parliamentary Resolution No. 129-XIX adopted on 27 January 2015).
45. In November 2015, the Parliament was discussing Government Draft Law No. 2319a amending the Privatisation Law in order to adjust it to international standards and make the privatisations more transparent. If adopted, this draft law would exclude legal entities and citizens from an Aggressor-State, as well as their Ukrainian affiliates from privatizations.
46. The G Group of state-owned companies, as defined by the 1992 Law "On Privatisation of State Property" (Law No. 2544-XII of 4 March 1992), comprises enterprises "*of strategic importance for the economy and national security*" (according to a list established by the Cabinet of Ministers), enterprises of the defence sector and enterprises with dominant market positions.
47. Press release of the State Property Fund of Ukraine (10 October 2015).
48. Law of Ukraine No. 5044-VI dated 4 July 2012 "On Amendments to Certain Regulations on Public Procurement in Ukraine". See: *Policy Brief*, National Institute of Strategic Studies, 2014, "On fighting corruption in public procurement in Ukraine", *www.niss.gov.ua/articles/1486*.
49. Unian News Agency Report dated 9 September 2014. Earlier that year, Ukrainian Prime Minister Yatsenyuk noted that 40% t of the EUR 20 billion spent annually on public procurement had stayed in the "corrupt pockets of the people who carry out these purchase", 10 April 2014, *www.reuters.com/article/2014/04/10/us-ukraine-crisis-imf-idUSBREA390R520140410*.
50. Law No. 1197-VII "On Public Procurement" (20 April 2014).
51. Article 5 of Law No. 1197-VII.
52. The law forbids participation by firms registered offshore. See Article 17.2.3 of Law No. 1197-VII.
53. Law No. 2289-VI "On Public Procurements" adopted by Parliament on 1 June 2010.
54. Article 2 of Law No. 1197-VII as amended on 15 September 2015; these thresholds are to be reviewed every 12 months. Higher thresholds apply to the procurement of goods, services or works by natural monopolies and other similar public sector entities. Previously, pursuant to an amendment made in 2012 to the 2010 law "On Public Procurements", no tender was required for public companies when procurement contracts were not funded from the state budget of Ukraine.
55. Article 8 of Law No. 1197-VII.
56. The procedure of conducting monitoring is established by the Order of MEDT No. 155 of 19 November 2011 "On Public Procurement Monitoring".

57. Centre for Transport Strategies, "Ukraine's Infrastructure Ministry Discloses Information About Procurements By 58 State Companies From 2012 To March 2015", 28 August 2015, *http://en.cfts.org.ua/news/ukraines_infrastructure_ministry_discloses_information_about_procurements_by_58_state_companies_from_2012_to_march_2015*.

58. Law No. 1197-VII has in particular introduced mandatory publication of procurement information by publicly-owned companies (enterprises with 50% or more state or municipal ownership) on the Ministry's web portal.

59. During this pilot phase, tenders will be limited to UAH 100 000 (USD 4 695) for goods and UAH 1 million (USD 46 953) for services. For further details regarding the ProZorro e-procurement platform, please refer to: *http://prozorro.org/en/faq/*.

60. See reports in Unian News Agency, "Abromavicius expects state procurement law to be passed in June as prerequisite for EU aid", 27 May 2015, *www.unian.info/economics/1082608-abromavicius-expects-state-procurement-law-to-be-passed-in-june-as-prerequisite-for-eu-aid.html*.

61. See for instance Council of Europe, *Joint First and Second Evaluation Round: Fifth Addendum to the Compliance Report on Ukraine*, 10 July 2015, *www.coe.int/t/dghl/monitoring/greco/evaluations/round2/GrecoRC1&2(2009)1_FifthAdd_Ukraine_EN.pdf*; EU Delegation to Ukraine, 2 December 2014, *http://euukrainecoop.com/2014/12/02/eu-procurement/*; "World Bank Statement on Amendments to Ukraine's Public Procurement Law", 10 April 2014, *www.worldbank.org/en/news/press-release/2014/04/10/world-bank-statement-on-amendments-to-ukraine-public-procurement-law*.

62. World Trade Organization, "Committee on Government Procurement moves ahead on multiple accessions", 11 February 2015, *www.wto.org/english/news_e/news15_e/gpro_11feb15_e.htm*; European Bank for Reconstruction and Development, EBRD GPA Technical Cooperation Facility, 27 May 2015, *http://ukraine.ppl.ebrd.com/gpa_deliverables.php*.

63. IIAs herein refer to stand-alone investment treaties like bilateral investment treaties (BITs) and investment chapters in broader agreements such as free trade agreements (FTAs).

64. Ukraine has concluded 74 bilateral investment treaties, 70 of which were in force in November 2015. Earlier treaties with Finland and Israel were terminated and replaced by new ones. The remaining treaties were signed but do not appear to be in force yet, among them the most recent IIA, signed with Japan in early 2015. IIA databases of OECD, UNCTAD, the Ukrainian Arbitration Association, the website *http://arbitration.kiev.ua* and the official Ukrainian government repository show discrepancies regarding the number of Ukrainian IIAs signed and in force.

65. Energy Charter Treaty, Art. 10.

66. EU-Ukraine Association Agreement, Art. 89(2).

67. UNCTAD, OECD, Ukrainian Arbitration Association.

68. The Ukrainian investment treaty with the United Arab Emirates differs by providing additional criteria for the lawfulness of expropriations, such as the non-violation of contractual stabilisation commitments (Ukraine-United Arab Emirates IIA, Art. 6.1.).

69. E.g. Ukraine-Chile IIA, Art. 6(1), referring to measures "depriving, directly or indirectly, an investor of the other contracting Party of an investment…".

70. In Ukrainian treaties, the concept of indirect expropriation is referred to in general terms, e.g. "Neither Contracting Party shall take any measures depriving, directly or indirectly…" (Ukraine-Netherlands IIA, Art. 6); "Investments or returns of investors

of either Contracting Party shall not be nationalized, expropriated or subjected to measures having an effect equivalent to nationalization or expropriation (hereinafter referred to as "expropriation"…)" (Ukraine-Canada IIA, Art. VIII(1)).

71. US Model BIT 2012 Annex B(4)(b): "Except in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations."; Comprehensive Economic and Trade Agreement (CETA) draft between the European Union and Canada, Annex X.11(3): "For greater certainty, except in the rare circumstance where the impact of the measure or series of measures is so severe in light of its purpose that it appears manifestly excessive, non-discriminatory measures of a Party that are designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriations."; ASEAN Comprehensive Investment Agreement (ACIA) Annex 2, para. 4: "Non-discriminatory measures of a Member State that are designed and applied to protect legitimate public welfare objectives, such as public health, safety and the environment, do not constitute an expropriation of the type referred to in sub-paragraph 2(b)."

72. Some Ukrainian investment treaties do not contain any language on fair and equitable treatment at all or refer to it only in the preamble. See Ukraine-Russia IIA; Ukraine-Croatia IIA; Ukraine-Turkey IIA, Preamble: "Agreeing that fair and equitable treatment of investment is desirable in order to maintain a stable framework for investment and maximum effective utilization of economic resources".

73. Ukraine-United Arab Emirates IIA, Art. 2.3.: "Each Contracting State shall at all times ensure fair and equitable treatment to the investments of investors of the other Contracting State."; Ukraine-Belgium Luxembourg IIA, Art. 3.1.: "Tous les investissements, directs ou indirects, effectués par des investisseurs de l'une des Parties contractantes, jouissent, sur le territoire de l'autre Partie contractante, d'un traitement juste et équitable" ; Ukraine-Croatia IIA, Art. Ukraine-Germany IIA, Art. 2: "Sie wird Kapitalanlagen in jedem Fall gerecht und billig behandeln"; Ukraine-Portugal IIA, Art. 2.1.: "Em qualquer caso, concederão aos investimentos tratamento justo e equitativo."; Ukraine-Argentina IIA, Art. 3.1.: "Cada Parte Contratante asegurará en todo momento un tratamiento justo y equitativo a las inversiones."

74. Claims have related to the stability of the legal framework, the protection of covered foreign investors' "legitimate expectations", compliance with contractual obligations, the transparency of the legal framework and regulatory measures, arbitrary government action, denial of justice, procedural propriety and due process, good faith, and freedom from coercion and harassment (Dolzer and Schreuer, 2012: 145 ff.).

75. The Ukraine-Canada IIA states that governments shall accord fair and equitable treatment "in accordance with principles of international law" (Ukraine-Canada IIA, Art. II.2). Similarly, the 2015 agreement with Japan, which has yet to enter into force, states that investors shall be accorded treatment "in accordance with international law, including fair and equitable treatment…" (Ukraine-Japan IIA, Art. 6.1.). The Agreement with the United States provides that investors shall be accorded "fair and equitable treatment […] and shall in no case be accorded treatment less than that required by international law." (Ukraine-USA IIA, Art. 2.3.).

76. See NAFTA Free Trade Commission: Notes of interpretation of certain Chapter 11 provisions, 31 July 2001, *www.sice.oas.org/tpd/nafta/Commission/CH11understanding_e.asp*, and US model BIT, Art. 5(2).

77. Ukraine-United Arab Emirates IIA, Protocol, Art. 5: "With respect to Article 3 – It is agreed by both contracting parties that the most favourable treatment shall not apply to any investment disputes"; Ukraine-Japan IIA, signed in 2015, Art. 5(4).

78. Ukraine-United Arab Emirates IIA, Protocol, Art. 2.

79. Ukraine-Canada IIA, Art. II(3)(a) and (b); Ukraine-Finland IIA, Art. 2(3), limited to MFN.

80. Ukraine-Chile IIA, Art. 2; Ukraine-Finland IIA, Art. 1(1). Several issues regarding these types of clauses are unclear, among them i) whether it is necessary to provide for a legality requirement or whether it also applies when it is absent from the treaty language, ii) whether the requirement only applies to the time the investment is made or also to its execution; and iii) whether and which are *de minimis* thresholds to find that an investment is not covered because it violated the (host) state laws.

81. Ukraine-Japan IIA, Note, Art. 1(1): "It is confirmed that nothing in the Agreement shall apply to investments made by investors of a Contracting Party in violation of the applicable laws and regulations of either or both of the Contracting Parties."

82. Ukraine-EFTA FTA, Art. 10.4.

83. Ukraine-Canada IIA, Art. XVII(3): "Provided that such measures are not applied in an arbitrary or unjustifiable manner, or do not constitute a disguised restriction on international trade or investment, nothing in this Agreement shall be construed to prevent a Contracting Party from adopting or maintaining measures, including environmental measures: a) necessary to ensure compliance with laws and regulations that are not inconsistent with the provisions of this Agreement; b) necessary to protect human, animal or plant life or health; or e) relating to the conservation of living or non-living exhaustible natural resources."

84. See Chapter 5 of this review on responsible business conduct and the OECD Guidelines for Multinational Enterprises and references in the Association Agreement, e.g. Art. 290 on the "right to regulate" and Art. 422 on responsible business practices, referring explicitly to the OECD Guidelines.

85. Ukraine-Japan IIA, Art. 25. Similar clauses have emerged more broadly in more recent treaty practice.

86. United States Government Accountability Office (2009), "Four Free Trade Agreements GAO Have Reviewed Have Resulted in Commercial Benefits, but Challenges on Labor and Environment Remain", *www.gao.gov/assets/300/292204.pdf*. In 2014, the United States has brought a claim against Guatemala for an alleged breach of obligations regarding labor rights under CAFTA-DR.

87. Ukraine-EFTA IIA, Art. 4.6.

88. OECD (2015), *Conference on Investment Treaties: Policy Goals and Public Support*, 16 March 2015, *www.oecd.org/investment/investment-policy/2015-conference-investment-treaties.htm*.

89. EU Commission, Press release, 16 September 2015, *http://europa.eu/rapid/press-release_IP-15-5651_en.htm*.

90. For the purposes of this analysis, the focus is on investment treaties between Ukraine and participants of the OECD's Freedom of Investment Roundtable.

91. Ukraine-Japan IIA, Art. 18(6); Ukraine-Canada IIA, Art. XIII(12)(a)(iv).

92. Cf. Eilís Ferran, Summary of FOI Roundtable 19, pp. 18-19. In addition to shareholders, creditors can also suffer reflective loss and may be able to file claims for such loss under some treaties. Summary available at: *www.oecd.org/investment/investment-policy/19thFOIroundtableSummary.pdf*.

93. Summary of FOI Roundtable 19, pp. 18-19.

94. Summary of FOI Roundtable 19, pp. 18-19.

95. Unless otherwise agreed by the parties, the ICSID Arbitration Rules apply to ICSID proceedings pursuant to Art. 44 ICSID Convention.

96. Ukraine-United Kingdom IIA, Art. 8(2) allows the investors to choose between all options listed in this paragraph and to submit the claim to an "international arbitrator or ad hoc arbitration tribunal to be appointed by a special agreement."

97. This approach is followed in the CETA draft from 2014, Chapter 10, Section 6, Art. 25.

98. The earliest case (ARB(AF)/98/1) was administered by the Additional Facility of ICSID, which is open to disputes where at least one party is a contracting party to the ICSID Convention. Arbitral proceedings and awards administered under the Additional Facility do not fall under the scope of the ICSID Convention.

99. IAReporter (2015), "Investor takes emergency arbitrator award under Energy Charter Treaty to a Ukraine court and obtains enforcement of tax-freeze holdings", 29 June 2015.

100. In addition to cases brought on the basis of IIAs, several contract disputes against Ukraine are pending before arbitral tribunals, see IAReporter, "Ukraine: Updates on arbitrator resignations, costs-order collections, and other recent arbitral developments", 8 October 2015.

101. IAReporter (2015), "First UNCITRAL arbitral tribunal is finalized to hear claim that Russia is liable for harm befalling investments in annexed Crimean peninsula", 14 July 2015; IAReporter (2015), "A second UNCITRAL arbitral tribunal is constituted to hear Crimea claims against Russia, as tribunal selection begins in three further cases", 14 July 2015.

102. This information is provided as a matter of general analysis and should not be relied on with regard to individual treaties. Recourse should be had to the precise treaty text in each case. The dates do not take into consideration the possibility of an agreement by the treaty partners to amend and/or terminate the treaty. The reference date for the calculation is 11 December 2015. The calculation is also approximate due to the different length of months and years.

103. Regulation of the Cabinet of Ministers of Ukraine No. 180 (28 December 2001).

104. Resolution of the Cabinet of Ministers Resolution No. 1900-p (29 September 2010).

105. Law of Ukraine No. 5018-VI on Industrial Parks of 21 June 2012.

106. Decree of the President of Ukraine of 12 May 2011 No. 583/2011 on the State Agency for Investment and National Projects of Ukraine.

107. Law No. 2623-VI of 21 October 2010 "On Preparation and Implementation of Investment Projects under the One Window Principle".

108. "International project Ukrainian Investment dialogue can help Ukraine to attract investment", 26 November 2014, *http://lifeinua.info/international-project-ukrainian-investment-dialogue-can-help-ukraine-attract-investment/*; "International investment project Ukrainian Investment Dialog 2015", Ukraine's Ministry of Foreign Affairs website, 16 March 2015, *http://chicago.mfa.gov.ua/en/news/notes/3667-mizhnarodnij-investicijno-komunikacijnij-projekt-ukrainian-investment-dialog-2015*.

109. An example of lack of proper consultations with business was the drafting of the new Tax Code in 2010, which resulted in public protests from companies and

business associations. See OECD (2015), *Anti-Corruption Reforms in Ukraine: Round 3 Monitoring of the Istanbul Anti-Corruption Action Plan*, Anti-Corruption Network for Eastern Europe and Central Asia, Paris, p.177.

110. Decree of the Government No. 691 dated 26 November 2014 "On the Establishment of the Business Ombudsman Council".

111. The Business Ombudsman Council for Ukraine began operations in May 2015.

112. President official website, "President has established the National Investment Council", 25 December 2015, *www.president.gov.ua/en/news/glava-derzhavi-stvoriv-nacionalnu-investicijnu-radu-34447*.

113. Resolution of the Cabinet of Ministers of Ukraine No. 996 dated 3 November 2010 "On Ensuring Citizen Participation in State Policy Formation and Implementation".

114. Tax Code of Ukraine of December 2, 2010 (Law No. 2755-VI). In 2014 and 2015, several new laws introduced significant amendments to the Ukrainian Tax Code.

115. The 5% profit tax rate for IT industry that applied until January 2015 has been cancelled. The standard rate – 18% – now applies.

116. Under previous legislation, Ukraine provided a 0% corporate profit tax (CPT) rate on income derived from investment projects resulting in job creation in qualifying industries. These priority industries were set out in the Law of Ukraine of 2012 "On Stimulation of Investment Activity in Priority Sectors of the Economy for the Creation of New Work Places" and included certain sectors in the agro-complex, machine-building complex, transportation infrastructure and tourism, recreation and processing industries, and communal and housing services. The incentives were granted for both newly created businesses in Ukraine and for restructuring/modernisation of existing enterprises.

117. Specific types of business activities are prohibited under this tax regime, including exploration, production or sale of precious metals and communication services.

118. According to a 2012 OECD study, the contribution of Ukraine's SMEs to the economy decreased between 2007 and 2010. Employment decreased particularly in medium-sized enterprises, approximately 10% each year; in terms of turnover, the share of the SME sector dropped from 60.7% in 2007 to 51.2% in 2010: *SME Policy Index: Eastern Partner Countries 2012 – Progress in the Implementation of the Small Business Act for Europe* (OECD Publishing, 2012).

119. A fixed asset with a cost exceeding 2 500 UAH (USD 117.4) and useful economic life exceeding one year is allocated to one of 16 classes of fixed assets. Each fixed asset is depreciated. The minimum statutory periods vary from 2 years (for computers and similar electronic devices) to 20 years (for property).

120. Tax code of Ukraine (Law No. 2755-VI adopted on 2 December, 2010; as amended), Article 197.1.25.

121. Tax code of Ukraine (op. cit.), Chapter XX (Concluding statements), para. 2.12 and 2.13. Ukrainian movies are movies produced in Ukraine and whose original version is in Ukrainian.

122. At the time of writing, the authorities were working on a reform plan aimed at bringing the preferential VAT treatment of this sector closer to the general VAT regime pursuant to the Memorandum on Economic and Financial Policies agreed by the Ukrainian government with the International Monetary Fund (IMF) in February 2015. According to this agreement, the beneficial VAT taxation regime applied to the agricultural sector would be abolished in 2016 (see IMF, "Ukraine:

Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding", 27 February 2015, C:\Users\wehrle_f\AppData\Local\Microsoft\Windows\Temporary Internet Files\Content.Outlook\KE4E6SH1\Information Note to EU business operating and\or investing in Crimea\Sevastopol).

123. For example, under current legislation, renewable energy sources producer pay only 25% of the land tax.

124. The Land tax is usually 1% of the normative pecuniary valuation of land.

125. Source: Ministry of Economic Development and Trade, November 2015.

126. For example, the Law No. 1276-XIV "On the Special Regime of Investment Activities in the Priority Development Territories in Zhytomyr Oblast" (3 December 1999).

127. The Ministry of Finance estimated that the tax expenditures on SEZs and PDTs, i.e. the revenue loss attributable to investment incentives and special exemptions, at 10.5 billion UAH during 1997-2005. Against this, the total revenues generated by SEZs and PDTs projects, including payroll taxes, amounted to only 5.5 billion UAH: *OECD Economic Surveys: Ukraine 2007* (OECD Publishing, 2007), p. 81.

128. See work by Violeta Skrypnykova, "Channels of Corruption in Establishment of Special Economic Zones of Ukraine", MA Thesis, Kyiv School of Economics, 2013.

129. Law No. 2505 "On the Introduction of Amendments to the Law of Ukraine on the State Budget of Ukraine for 2005 and Some Other Legislative Acts of Ukraine" (25 March 2005).

130. Law No. 1636-VII "On Establishment of the Free Economic Zone of Crimea and Special Aspects of Economic Activity in the Temporarily Occupied Territory of Ukraine" (12 August 2014). The law entered into force on 27 September 2014.

131. The law foresees the possibility for the Management Company of the SEZ to abolish such taxes.

132. Under the law, any supply of goods and/or provision of services from the mainland through the administrative borders of the FEZ (or vice versa) shall be treated as import/export operations and shall be subject to the applicable duties and measures.

133. Federal Law No. 377-FZ of 29 November 2014. The related tax package entered into force on 1 January 2015. Investors who will invest in Crimea more than 100 million roubles over three years will be granted a tax relief.

134. For example, the EU Council adopted on 25 June 2014 a decision (No. 2014/386/CFSP) and a Regulation (No. 692/2014) that prohibit the import to the European Union of goods originating in Crimea, unless a certificate of origin issued by Ukraine's authorities accompanies them. On 30 July, the Council adopted a Decision (2014/507/CFSP) and a Regulation (825/2014) amending the previous Council Decision and Regulation to prohibit investment in Crimea in infrastructure projects in the sectors of transport, energy and telecommunications as well as trade in certain goods with Crimea. See European Commission, *Information Note to EU business operating and/or investing in Crimea/Sevastopol* (SWD[2014] 300 final/3, 10 June 2015). Similarly, American companies have been prohibited from participating in certain transactions in Crimea, which is subject to sanctions under Executive Order 13685 dated 19 December 2014.

135. Law of Ukraine No. 5018-VI of June 21, 2012 "On Industrial Parks".

136. Press release of the Ministry of Economy and Trade (25 November 2015): "The Parliament supported industrial parks 'development and Public-Private

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137. Law of Ukraine No. 818-VIII "On amendments to certain normative acts to lift existing obstacles to the development of a network of industrial parks in Ukraine" (24 November 2015).

138. Ministry of Revenue and Duties of Ukraine (2012), *Information about revenue losses due to tax benefits in the first half of 2012* [Informatsiya pro vtraty bjudgetu vnaslidok podatkovyh pil"g za pershe pivrichja 2012 roku].

139. See Olena Liakhovets, "Tax Incentives Effectiveness for the Innovation Activity of Industrial Enterprises in Ukraine", *Economics & Sociology*, Vol. 7, No 1, 2014, pp. 72-84.

140. *World Bank data: Tax revenue (% of GDP)*.

141. IMF, "Ukraine: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding", 27 February 2015, *www.imf.org/external/np/loi/2015/ukr/022715.pdf*.

142. Berlin Economics (2010), "VAT Refund Arrears in Ukraine: Analysis and Recommendations on How to Solve the Problem, With a Special Focus on Agriculture", *www.berlin-economics.com/download/policypapers/VAT Refund Arreas UKR BE_en.pdf*.

143. Source: Ukraine's Ministry of Finance.

144. See *Kyiv Post*, "US prosecutors expose Ukraine's corruption in VAT-refund payments", 26 December 2013, *www.kyivpost.com/content/business/us-prosecutors-expose-ukraines-corruption-in-vat-refund-payments-2-334308.html*.

145. Speech of Ukrainian Finance Minister Natalie Jaresko at the Chatham House on 24 March 2015.

146. The law has abolished paper invoices and requires the use of electronic VAT invoices. It is now mandatory to register electronic VAT invoices with the Unified Register of Tax Invoices when the turnover from taxable operations for the preceding 12 months exceeds UAH 1 million (USD 50 000). In the past, this threshold was set at UAH 300 000 (USD 14 086).

147. The new rules would also apply to agricultural VAT tax payers. In 2016-17, supply of grains of commodity items 1001-1008 (save for commodity item 1006 and commodity sub-category 1008 10 00 00) and of industrial crops of commodity items 1205 and 1206 (per the UCGFEA) will be VAT-exempt (except for supply of such grains and industrial crops by producers and companies, which purchased such grains and industrial crops from producers). Unlike previous years, this exemption will not apply to exports by producers of such grains and industrial crops grown on agricultural land which is owned, or perpetually used, or leased.

148. See "Ukraine's tax reform must be equitable, affordable" by Mr Qimiao Fan (World Bank country Director for Ukraine), Opinion Column, *Kiyv Post*, 4 December 2015, *www.worldbank.org/en/news/opinion/2015/12/04/ukraines-tax-reform-must-be-equitable-affordable*.

149. These temporary import duties fall under Article 12 of the 1994 General Agreement on Tariffs and Trade "Restrictions to Safeguard the Balance of Payments".

150. 2015 Report by the Anti-Corruption Working Group of the American Chamber of Commerce of Ukraine (Kyiv, November 2015)

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Chapter 3

Infrastructure, financial development and natural resources in Ukraine

Given the state budget constraints and substantial investments required to modernise and expand existing infrastructure capacity, more private sector participation is necessary. However, despite a modernisation of Public Private Partnership (PPP) legislation in 2015, the use of PPPs is at an early stage in Ukraine. Among infrastructure sectors, electricity is the most advanced in regulatory reform, with full-scale liberalisation of the market scheduled in 2017. Significant private (foreign and domestic) investments in the sector are expected as major power plants are slated for privatisations. The banking sector is going through an unprecedented consolidation (54 banks, accounting for one fifth of banking assets, were classified as insolvent since January 2014). Remaining banks are being recapitalised and the regulatory framework is being strengthened.

Sound infrastructure development policies ensure that scarce resources are channelled to the most promising projects and address bottlenecks that limit private investment. Ukraine's infrastructure, especially in transport, has been deteriorating following a long period of underinvestment and insufficient maintenance. High freight railway and port tariffs and the lack of reliability of transport services have seriously handicapped private sector development, especially for export-oriented firms. Ukraine has one of the lowest road network densities in Europe and a large part of the existing road network is obsolete and does not comply with European standards. The country also does not have adequate warehousing and storage facilities, which is partly due to the difficulties to acquire land and construction permits.

Little progress with regard to concessions, but reform ongoing

The Ministry of Infrastructure of Ukraine defines infrastructure concessions as contractual arrangements through which a private entity obtains the right from a government agency to provide a service under market conditions, using a public-sector asset. The arrangement allows asset ownership to remain in public hands, while the private operator is taking responsibility for new investments in addition to operation and maintenance.

Various governments have regarded concessions as one of the most attractive ways to implement large-scale, long-term infrastructure projects. For instance, Build-Operate-Transfer[1] (BOT) agreements can be a valuable tool for modernising or extending transport infrastructure. Public-Private Partnerships (PPPs) can be a way to attract much-needed investment into local utilities (usually owned and managed by local governments and municipalities). However, the use of PPPs is at an early stage in Ukraine. As mentioned in Chapter 3 (Measures reported for transparency, section Concessions), the legislative framework refers to multiple legislative acts, including the 1999 Law On Concession[2] and the 2010 Law On Public-Private Partnership.[3]

Nevertheless, sector-specific legislation exists. It includes the Motorway Concession Law,[4] the Law On the Peculiarities of Concessions in the Energy Sector,[5] the Law On the Peculiarities of Concessions of Municipal Property in Heating, Water collection and Distribution,[6] and various regulations and ministerial resolutions. These multiple normative acts are contradictory in specific cases. In addition, under the PPP Law, the preparation of PPPs involves several different bodies since various decisions and approvals of responsible

authorities at the local or state level are required. Because of this complexity, the existing PPP-type projects refer to the less-restrictive 1999 Law On Concession rather than to the framework of the 2010 PPP Law (International Finance Corporation, 2015). However, few international investors have translated a general interest in Ukrainian infrastructure into concrete actions (one exception is the German Port logistics group HHLA, see below section on "Transport and communications").

The Parliament adopted a reform of the regulatory framework of PPPs in November 2015.[7] This legislation substantially amends the previous PPP framework. Its aim is to simplify the procedures during PPP implementation,[8] strengthen guarantees granted to private investors and modernise the PPP framework in line with international standards. Several provisions might make Ukrainian PPPs more attractive to foreign investors, such as the possibility to resort to international arbitration in case of PPP-related disputes, or the simplified foreign exchange regime for PPP participants. Other planned improvements to the PPP framework include amendments to the Budget code in order to introduce a mechanism of long-term budgetary commitments under PPP agreements and a revision of the methodology to calibrate concession payments drawing on international experience.

PPPs are long-term undertakings whose successful implementation greatly depends on the government's success in improving the overall business climate and reducing legal, institutional and policy uncertainty. The development of PPPs is also sensitive to the regulation of specific sectors: for instance, in the field of local utilities, the development of PPPs relies on assurances at the national level about the direction of tariff policies, since the National Commission for State Regulation of Energy and Utilities (rather than local PPP partners, such as subnational governments) regulates tariffs. Moreover, successful PPPs involving subnational governments would require considerable capacity building (OECD, 2014).

The 2013 OECD Territorial review of Ukraine (OECD, 2014) identified specific steps that the authorities can take to foster the development of effective forms of PPPs:

- Strengthen the dedicated PPP unit under the Ministry of Economic Development and Trade. Such units exist in most OECD countries to ensure that the skills needed to handle third party-provision of public goods and services are clustered together within the government. The unit typically provides policy guidance, technical support and capacity-building. Given the need for capacity-building at the subnational level, programmes to train local and regional officials in PPP-relevant subjects (project finance, appraisal methodologies, etc.) could be established.

- All national, regional and municipal PPP projects – including those in the planning phase – should be made as transparent as possible. A database of PPP projects should be maintained and be publicly accessible over the internet.
- The review advises caution in rolling out PPP projects. At first, pilot projects should be undertaken and evaluated. Given the lack of practical PPP experience, it suggests to focus on projects where technical and other risks are relatively well understood, such as basic infrastructure.

Box 3.1. **Key challenges for developing Public-Private Partnerships**

PPPs are complex instruments, which require a number of capacities to be present in government. These involve setting up a robust system of assessing value for money using a prudent public sector comparator and transparent and consistent guidelines regarding non-quantifiable elements in the value for money judgement. The public authorities must also be able to classify, measure, and allocate risk to the party best able to manage it and to adhere to sound accounting and budgeting practices.

The starting point for assessing the desirability of a PPP is the public sector comparator, a comparison of the net present cost of bids for the PPP project against the most efficient form of delivery according to a traditionally procured public-sector reference project. The comparator takes into account the risks that are transferable to a probable private party, and those risks that will be retained by the government. Thus, the public sector comparator serves as a hypothetical risk-adjusted cost of public delivery of the project. The risk here is of manipulation in favour of PPPs, not least because much depends on the discount rate chosen or on the value attributed to a risk transferred. The evaluation, moreover, encompasses qualitative aspects that involve an element of judgement on the part of government. The question is what the government judges to be an optimal combination of quantity, quality, features and price (i.e. cost), expected (sometimes, but not always, calculated) over the whole of the project's lifetime. It ultimately depends, then, on a combination of factors working together, such as risk transfer, output-based specifications, performance measurement and incentives, competition in and for the market, private sector management expertise and the benefits for end users and society as a whole.

The second challenge is risk management. To ensure that the private partner operates efficiently and in the public interest, a sufficient, but also appropriate, amount of risk needs to be transferred. In principle, risk should be carried by the party best able to manage it. In this context, "best" means the party able to manage the risk at least cost. This may mean the party best able to prevent a risk from materialising (*ex ante* risk management) or the party best able to deal with the results of realised risk (ex post risk management). However, not all risks can be managed and cases may exist where one or more parties to a contract are unable to manage a risk. To those parties, such unmanageable risks are exogenous risks (an example is uninsurable force majeure risk that affects all parties, while political and taxation risk is exogenous to the private party and endogenous to government).

Box 3.1. **Key challenges for developing Public-Private Partnerships** *(cont.)*

The third key issue is affordability. A project is affordable if government expenditure associated with a project (whether or not it is a PPP) can be accommodated within the intertemporal budget constraint of the government. A PPP can make a project affordable if it results in increased efficiency that causes a project that did not fit into an intertemporal budget constraint of the government under traditional public procurement to do so with a PPP. It can be tempting to ignore the affordability issue where PPPs are off budget, but this is very unwise. Using PPPs also reduces spending flexibility, and thus potentially allocative efficiency, as spending is locked in for a number of years. Given that capital spending in national budgets are often accounted for as expenditure only when the investment outlay actually occurs, taking the PPP route allows a government to initiate the same amount of investments in one year while recording less expenditure for that same year. However, the obligation to pay over time will increase expenditures in the future, reducing the scope for new investment in coming years. Government spending might also be affected if the government provides implicit or explicit guarantees to the PPP project and thus incurs contingent liabilities. The system of government budgeting and accounting should provide a clear, transparent and true record of all PPP activities in such a way that there is no incentive take the PPP route based on its accounting treatment.

In some cases, PPPs may be used to circumvent spending ceilings and fiscal rules. There are those that argue that this need not be a problem and that PPPs should be used to invest in times of fiscal restraint. The fiscal constraint argument for public-private partnerships is driven by pressures for governments to reduce public spending to meet political, legislated and/or treaty mandated fiscal targets. In parallel with this, many governments face an infrastructure deficit stemming from a variety of factors including a perceived bias against budgeting for capital expenditures in cash-based budgetary systems. However, when responding to fiscal constraints, governments should not ignore efficiency and affordability considerations. PPPs may also create future fiscal consequences if they violate the budgetary principle of unity, i.e. that all revenues and expenditures should be included in the budget at the same time. Potential projects should be compared against other competing projects and not considered in isolation to avoid giving priority to the consideration and approval of lower value projects.

Source: OECD (2014), *OECD Territorial Reviews: Ukraine 2013*, OECD Publishing, *http://dx.doi.org/10.1787/9789264204836-en*.

Attracting investment in infrastructure is one of Ukraine's key priorities but there are still legislative and other regulatory constraints on private sector participation

The State program document "Ukraine 2020: Strategy for national modernisation" identifies investment in infrastructure as one of the main policy directions of the Ukraine government. The issue is nevertheless complicated by the fact that infrastructure is often state-owned and requires

substantial public investment. The authorities recognise that given budgetary constraints in the public sector, large-scale private sector participation is necessary to modernise and expand existing infrastructure capacity. The government is committed to address legislative and regulatory bottlenecks in the area of infrastructure concessions.

At the same time, from 2016 onwards the government will introduce a new mechanism to select and assess public investment projects. An interdepartmental commission (composed of government representatives and MPs from the Parliament's budget committee) will be in charge of selecting public investment projects. For the first time in Ukraine, this mechanism will provide for an *ex ante* economic assessment of public investment projects based on cost benefit analysis and monitoring of the implementation of these projects. Depending on actual implementation, such mechanism may improve the selection of public investment projects in infrastructure.

Electricity generation, transmission and distribution

The electricity system suffers from various fragilities, including outdated thermal production facilities (only utilising 38% of their capacities), poor transmission lines, dependence on coal and nuclear (that contribute more than 80% of the total electricity generation of around 180 TWh), and few funds for maintenance and improvements. Despite receiving some of the highest subsidies in Europe, the share of renewable energy plants (below 10 MW) is currently at around 7% of total generation. The stagnation is due to several legislative barriers, such as a problematic local content requirement, a restrictive definition of biomass and unbalanced tariffs for various types of renewables, etc.[9]

Ukraine was the first country of the former Soviet Union to undergo extensive electricity sector reforms back in the mid-1990s: the government privatised some thermal generation and distribution companies in 1995, followed in 1999 and 2002 by the sale of controlling (50%) and blocking (25%) shareholdings in the Ukrainian energy distribution companies to private investors through open tenders.[10] This allowed the creation of the largest private energy holding of Ukraine DTEK,[11] a vertically integrated holding that controls several regional thermal electricity generation companies. In May 2015, several power plants and equity stakes in major electricity producers, including one of the largest thermal electricity producer Centrenergo, were slated for privatisation.[12]

A great deal of investment will be required for the electricity sector to support robust national economic growth going forward – but policy uncertainty and low tariffs for households (cross-subsidised by high industrial tariffs) threaten this goal. Investment in energy projects with private

participation in 2010-12 equalled USD 1 811 million, compared with USD 16 827 million in Turkey.[13]

The 2013 Electricity Market Law has been designed to further liberalise markets, creating the conditions for bilateral contracts and wholesale exchanges that would allow customers to choose their suppliers.[14] Different markets would operate depending on the customers (bilateral "over-the-counter" contracts, "day-ahead spot", the balancing market, the ancillary services market, and the retail market).[15] Before the full-scale liberalised electricity market becomes operational (on 1 July 2017), the electricity market will operate as the existing "Single Buyer" market, retail market and ancillary services market.

The success of the transition hinges on establishing and/or reorganising the entities that would be in charge of developing and implementing mechanisms for launching the market, such as the Market Operator, System Operator, Cost Imbalance Allocation Fund and others; and achieving legal and organisational unbundling (separation) of distribution activities from activities related to production, transmission and supply of electricity. No attempt was made, however, to create real, workable competition: the five large thermal generation companies created by the original reforms all remain either state-owned or controlled by the private holding DTEK, and the electricity generating companies using nuclear and hydroelectric technologies, respectively Energoatom and Ukrhydroenergo, are state-owned.[16] Moreover, the law prohibits any privatisation of nuclear and hydropower power plants.[17] Energoatom (which accounts for half of overall electricity production) and Ukrhydroenergo are on the list of strategic enterprises under Ukrainian government control[18] ("State assets of strategic importance for the economy and national security").

The National Commission for State Regulation of Energy and Utilities (NCSREU) was instituted in August 2014 following the dissolution of the National Commission of Ukraine for Electric Energy Regulation and the National Commission of Ukraine for State Regulation of Utility Services. NCSREU is an independent state collegial body that reports to Parliament and is controlled by the President. In addition to the powers of the two previously existing agencies, NCSREU gained new ones regarding implementation of interim emergency measures.[19]

Natural gas

Despite its untapped conventional and unconventional gas resources, Ukraine has experienced stagnating production in recent years.[20] While the International Energy Agency considers that the country has potential to meet its gas consumption with domestic production by 2030 (IEA, 2012), dependency

on Russian imports remains a heavy burden. The so-called "winter package" signed on 30 October 2014 ensured that Ukraine could purchase natural gas from Russia.[21]

Upon becoming a member of the European Energy Community, Ukraine undertook to unbundle transport, production and sale of energy resources. Under new legislation voted in April 2015, state gas conglomerate Naftogaz will be unbundled into separate production, transit, storage, and supply businesses.[22] The Law provides free access to the Ukrainian gas transport system by any eligible party, secures non-discriminatory access to the gas market by all gas producers including biogas and gas from biomass, and allows gas consumers freedom of suppliers' choice. Small distribution system operators which have less than 100 000 consumers will be exempt from the unbundling requirements. The law also allows open market access for traders. Various changes to the current feed-in tariff regime were made in mid-2015.[23]

The trunk pipeline transport system (Ukrtransgaz), a key conduit for Russian gas supplies to European markets, is excluded from privatisation.[24] According to a report prepared by Ukrtransgaz analysts based on publicly available data, during 1996-2014 the Ukrainian gas transport system experienced 7.77 times fewer major disruptions per 1 000 km than the Russian one.[25] In line with the Joint Declaration of March 2009 between the Ukraine, the EU, EIB, EBRD and World Bank, the EIB and EBRD signed in December 2014 the first two loans of EUR 150 million each for the upgrading of the main East-West pipeline. As regards to energy security, new interconnection points in the Slovak Republic and Poland have been operational since 2014, thus providing crucial additional supplies to Ukraine in addition to gas from Russia.

Transport and communications

Transport infrastructure is an additional bottleneck for improving aggregate productivity and regional competitiveness. The network consists of 22 thousand km of railways; 170 thousand km of roads; 2.2 thousand km of inland waterways; 13 seaports, four fishing ports and 11 river terminals; 21 airports (of which two state and 14 communal). The 2012 UEFA European Championship, which was co-hosted by Poland and Ukraine, triggered reconstruction works at Kyiv and Lviv airports, while new ones were built from scratch in Donetsk and Kharkiv. Nonetheless, according to the World Economic Forum 2015/16 Global Competitiveness Index, whereas Ukraine is ranked 54st out of 140 economies for electricity and telephone infrastructure, it is ranked 91th in its sub-index for transport infrastructure.

The World Bank's Logistics Performance Index is a benchmarking tool in the area of trade logistics that allows for comparisons across 160 countries. Based on quantitative data and feedbacks from operators around the world, it

demonstrates comparative performance (on a scale from 1 to 5) on six key dimensions of trade logistics.[26] According to the index database, Ukraine's overall rank has improved from 102nd in 2010 to 61st in 2014, an impressive gain in just four years. Ukraine has improved substantially in several key areas of logistics necessary for trade, including in the ease of arranging competitively priced shipments, competence and quality of logistics services such as transport operators, and the ability to track and trace consignments (Figure 3.1).

Figure 3.1. **Ukraine's score across the six dimensions of the Logistics Performance Index (2014)**

Dotted line: 2010 score

Source: World Bank, *Logistics Performance Index database* (International LPI), 2014, *http://lpi.worldbank.org/* (accessed on 1 December 2015).

StatLink http://dx.doi.org/10.1787/888933355817

However, as visible on Figure 3.1, infrastructure and customs are the lowest-scoring components of Ukraine's Logistics Performance Index. This suggests that investments in the maintenance and extension of transport infrastructure would substantially improve trade logistics. Similarly, an improvement of the efficiency and transparency of the State Customs service could positively affect trade logistics. Along this line, the government is preparing a reform of the State Customs Service, including a pilot project to delegate the management of certain regional customs departments to foreign companies specialised in customs management. On 4 November 2015, the Ukrainian Parliament also adopted a simplification of export-import procedures that should decrease the regulatory burden on businesses involved in international trade.[27]

The country's reliance on agriculture and heavy industry translates into far more transport movements and volumes relative to its GDP than any other country in Europe (World Bank, 2014). This implies that transport costs make up a much larger part of the final price of many goods. Less than 10% of freight traffic (in ton kilometres) is by road, while rail and pipelines account almost equally for most freight volume. However, this is changing quickly. Due to steadily increasing commercial and passenger traffic, some strategic sections of the road network are functioning at peak capacities. Yet, substantial portions of the network need upgrading to European technical and safety standards, such as intersection improvements, road markings, and pedestrian facilities. Ukraine's road safety record remains one of the worst in Europe in terms of road accidents and fatalities (above 20 traffic deaths per year per 100 000 people, compared to less than five in most EU countries).

Pursuant to the Plan on Priority Measures for European Integration of Ukraine, the Transport Strategy was approved in 2010.[28] It aims at enhancing economic and social development through efficient (minimum cost), effective (maximum benefit) and sustainable (minimum environmental impact) transport; supporting balanced regional development; facilitating European integration; and enhancing the transit capacity of Ukraine. Proposed priority areas included rationalisation and rehabilitation of existing transport infrastructure; enhancement of Ukraine's participation in Pan-European corridors; clarifying public service obligations; ensuring inter-modal competition; and institutional coordination to guarantee traffic safety, reliability and environmental protection. The Transport Strategy is now the key strategic document regulating the development of the transport industry until 2020. It sets out long- and medium-term perspectives, key challenges, objectives, principles and priorities of the development of the transport system of Ukraine with due consideration of the needs and interests of the economy and society.

The government reckons that 97% of roads are in poor condition.[29] The State Road Agency of Ukraine (Ukravtodor) has been reformed and is pursuing public-private partnerships and concessions in order to quicken the development of modern highways and rehabilitate key national roads that are part of Trans-European networks. This is expected to lessen the burden on the national budget, both during construction and operation of the toll road. The State Road Agency also aims at introducing weight control systems in order to improve the roads durability along with international standards.

Rail transport is a state monopoly and the reform process has been very slow. In 2012, a law stipulated the transfer of all assets from the State Administration of Railways Transport ("Ukrzaliznytsya") and other state-owned enterprises related to railways to a new Joint-Stock company (still called Ukrzaliznytsya).[30] However, results proved very limited in practice.[31]

In June 2015, the Ministry of Infrastructure published on its website for debate a draft railroad law. It includes several fundamental measures to comply with European Union directives. In particular, it provides for equal access to infrastructures for private locomotive traction; differentiation of infrastructural, investment, locomotive, and railcar components in the tariffs; and establishment of the National Transport Regulation Commission (NTRC) under the control of the Cabinet of Ministers. As a result, a holding company is being established on the bases of Ukrainian Railways PJSC,[32] with companies divided along the lines of business (infrastructure operator, freight, passenger, etc.). The infrastructure will remain in public ownership, and the state carrier will have the same rights as private ones. The development and modernisation of railway infrastructure will be carried out on a contractual basis between the infrastructure branch of Ukrainian Railways PJSC and the Ministry of Infrastructure.[33] International experience shows the importance of separating the carrier and infrastructure operator functions of the state-owned incumbent, while ensuring that its public service obligations are funded adequately.

Ukrainian railways face huge financing needs to renovate rail infrastructure and rolling stock. The Ministry of Infrastructure is examining different options, including a joint venture with a private Ukrainian rail car company. It recognises that the railways must optimise costs through divestment of non-core assets and human resources reform. Another strategic goal is to simplify the freight tariff system (in the past, revenues from freight traffic partly compensated below-cost passenger tariffs) using a transparent cost-plus method.

In the field of air traffic and airports, Ukraine signed an open-sky agreement with the United States in July 2015 and started negotiations on a comprehensive EU-Ukraine aviation agreement. As a result, Ukraine would join the European Common Aviation Area[34] and gradually harmonise its civil aviation regulations with EU standards. This would liberalise the aviation market between Ukraine and the EU and open the market for new players (including low-costs). Another priority of Ukraine is the attraction of private investments to improve airport infrastructure and the reconstruction of regional airports.

Seaports and infrastructure facilities have always been state-owned and operated, with commercial and management problems that have resulted in huge losses.[35] The Law on Sea Ports (in effect since summer 2013) aims to reform the sector by separating the commercial activities of ports from strategic infrastructure facilities (such as aquatic areas, most hydraulic facilities, moorage walls, etc.) and administrative functions, that are to remain in state ownership and under the operational control of the Seaports Administration (a newly-established state department).[36] Private investment in seaport

infrastructure facilities is possible under concession agreements, joint operation agreements, lease agreements or other types of investment agreements. The separation of commercial activity from administrative regulation introduces a level playing field between state and private stevedoring companies. For instance, the government recently introduced a uniform tariff for all operators to provide equal access to seaports' infrastructure.

The Strategy for Ukrainian Sea Ports Development until 2038 recognises the critical role of private investors,[37] including in the provision of cargo handling services. In 2012, the government added 18 seaports to the "List of state-owned property that may be subject to concession".[38]

Recently completed, launched and contemplated investment projects in Ukrainian ports include:

- In autumn 2012 Cargill signed a protocol of intent with Yuzhnyi seaport to build a USD 90 million complex for storage and trans-shipment of grains and oilseed; the deal was stopped on 8 June 2015 when a court decided to return the land plot where the complex was to be constructed to insolvent Delta Bank.
- In April 2014, the first stage of new container terminal in the Quarantine Mole of Odessa was commissioned and handled its first vessel in test mode. Construction started in April 2010 and the terminal will be jointly operated with Hamburg Port Consulting.
- In February 2015 American private equity investment firm Siguler Guff & Company indirectly acquired 50% of the shares in the private enterprise Illichivsk Container Terminal. The investor intends to develop production volumes of the terminal and increase container capacity of Illichivsk seaport.
- In June 2015, Soufflet Group signed an MoU to invest up to USD 100 million in Illichivsk port infrastructure.
- Arcelor Mittal signed an MoU to invest in Oktyabrsk port.

Ukraine joined the 2000 European Agreement concerning the International Carriage of Dangerous Goods by Inland Waterways in November 2009. Cabotage (i.e. between Ukrainian ports, including as part of international transport) is reserved to vessels under the Ukrainian flag.[39] However, if there is a permit issued by the State Inspectorate of Safety at Maritime and River Transport, it is possible to sail under the flag of another country. The entry of passenger-carrying crafts, sport boats, wind-driven ships and yachts is permitted under the flag of their country.[40] According to Article 32 of the Merchant Marine code, only vessels owned by Ukrainian citizens or by a Ukrainian legal entity whose shareholders are all Ukrainian citizens can fly the Ukrainian flag. Foreign vessels hired by Ukrainian citizens under a bareboat charter arrangement can fly the Ukrainian flag for the duration of the arrangement.

Privatisation is expected in 2015 for the Airline Company "Horlytsya" and Aviation Enterprise "Universal Avia". According to the European Commission, air transport of passengers and cargo between Ukraine and the EU has been growing steadily in recent years.[41] The lifting of limitations to weekly flights between Ukraine and the EU and the signing of the comprehensive EU-Ukraine aviation agreement would strengthen air transport connections, allow reciprocal majority ownership, and benefit users. To attain these objectives, Ukraine would have to align its legislation with EU aviation standards and enforce EU requirements in areas such as aviation safety, air traffic management, environment, economic regulation, competition, consumer protection and social aspects. The agreement, similar to those that the EU has already signed with the Western Balkans, Morocco, Georgia, Jordan, Moldova, and Israel, was initialled in November 2013.

Telecommunications

Ukraine's telecom liberalisation has been limited (fixed-line services remain a monopoly) and relatively slow: the privatisation of Ukrtelecom was launched in 2000,[42] operational activities and the regulatory function were separated in 2005, and the sell-off was only completed in 2011. Trimob LLC, a subsidiary of Ukrtelecom, has long held the only 3G license, with service limited to a few largest cities and consumers mainly using low-tech 2G technology. In February 2015, three 3G licenses were auctioned to MTS, Kyivstar, and Astelit (operating under "the life:)" trademark). These operators are now expanding their 3G network across the country. Lack of available spectrum has prevented the awarding of 4G licenses.[43]

The legislation includes regulatory principles such as universal service, independence of the regulatory authority, transparency, interconnection, and fair competition. It provides for market opening in three areas: mobile services, internet services, and private networks. This allows telecommunications services providers, on a non-discriminatory basis, to effectively compete to directly supply services to customers. There are no foreign ownership limits or restrictions on types of services for operators, but the operating license strictly determines types of services that the operator can provide.[44]

Through the Ukraine-European Union Association Agreement, Ukraine is expected to ensure a competitive market, transparent functioning of competent state agencies, protection of market players against discrimination, and effective allocation and use of frequencies and national numbering resources. In addition, Ukraine has to ensure that relevant national laws and regulations in the telecom sector, among others, are gradually made compatible with the existing EU laws and regulations. The Coalition Agreement adopted after the parliamentary elections in October 2014 includes commitments to ensure the launch of telecommunication networks of the 4th and 5th generations in 2015.

Another ambitious initiative taken by the new parliamentary majority is the implementation of nationwide broadband Internet. The government is planning to introduce spectrum reframing, technological neutrality implementation, and mobile number portability.

The main regulator – the National Commission for State Regulation of Communications and Informatisation (NCCIR), established in January 2005 – is responsible for issuing licences and the allocation of radio frequencies, and for regulating IT and postal services.

The Law "On amendments to certain acts of Ukraine regarding delineation of the State bodies' powers in sectors of natural monopolies and in communications sector in part of provisions regarding analysis of telecommunications services markets" came into force in December 2012. It aims at helping NCCIR in its analysis of relevant markets, identification of operators holding significant market power, and designation of efficient remedies. The elaboration of other new regulations and methodologies is in progress. Several draft regulations have been issued, covering the joint use of infrastructure of telecommunications networks, identification and analysis of relevant markets of electronic communications services, and license terms for using radio frequency resources. In addition, the draft Law on "Amendments to the Laws of Ukraine on providing measures to ensure the transparency of media ownership and implementation of the state policy principles in the field of television and radio broadcasting" aims at alignment with the EU's Audiovisual Media Services Directive and the additional definitions in the European Convention on Transfrontier Television, as per the commitments made by Ukraine under the Association Agreement.[45]

Financial sector development

Banking is the backbone of the Ukrainian financial sector, accounting for 95% of total assets in 2012. Non-bank financial institutions on the other hand are relatively underdeveloped, with insurance companies representing 4.5% of financial sector assets in 2012. Micro finance is extended through local credit unions, while factoring and particularly leasing services are mostly offered by large banks and companies affiliated with them. Compared to its peers in Eastern Europe and the Caucasus, the leasing sector is well-developed in Ukraine (the cumulated value of new leasing contracts amounted to approximately 2% of GDP in 2013). However, in 2014 the leasing market shrank and registered a 78% year-on-year decrease in the amounts of new leasing contracts (EBRD et al., 2015).

An important development is the planned consolidation of State Regulation of Financial services (through the liquidation of the Commission for Regulation of Financial Services Markets). According to Draft law 2414,[46]

still under discussion in Parliament, only two entities will be responsible for the control and supervision of the financial sector: the National Bank of Ukraine (NBU) and the National Securities and Stock Market Commission (NSSMC). After adoption of Draft Law 2414, the NBU would regulate insurance companies, credit unions and leasing companies, while the regulation of private pension funds would be transferred to the NCSSM.

Banking

The banking sector has been plagued by different problems in recent years, which have not impeded its rapid development but have exposed its underlying fragility (Barisitz and Fungáčová, 2015). Considering its lower middle-income status, Ukraine has a rather high bank-assets-to-GDP ratio (86% in 2014) which suggests overleveraging (Raiffeisen Research, 2015). Following a prolonged boom, credit institutions were hit by the 2008-09 crisis and again in 2014 from geopolitical tensions, deep recession and the plunge of the Hryvnia. The exchange rate risk is in fact high: in July 2015, an estimated 53% of all credits were denominated in foreign currency.[47] Lack of trust in banks translated in a 37.7% fall in deposits in real terms in 2014.[48] Household deposits suffered an even deeper contraction, falling by 46% in 2014, partly due to limited trust in the Deposit Guarantee Fund (DGF), with a delay of several months. Deposits' loss accounted for about 15% of total banking sector assets. According to NBU data, the first semester of 2015 saw a further erosion of bank deposits, especially those in foreign-currency.

Among 163 banks registered in Ukraine at the end of 2014, PrivatBank (the largest) and two state-owned banks (the Ukrainian Export-Import Bank: Ukreximbank and the State Saving Bank: Oschadsbank) represented 35% of total assets (USD 68 billion). However, the Ukrainian banking sector is rather fragmented compared to peers in Eastern Europe.[49] A large number of credit institutions are so-called "pocket banks" or "agent banks", i.e. extended financial departments of domestic financial and industrial groups. They tend to distribute credit mainly within their groups, thanks to lax supervision over related party transactions and opaque ownership structures.

Since Ukraine's WTO accession, foreign credit institutions have the same rights and obligations as Ukrainian banks.[50] Ukraine benefited from an influx of foreign capital into its banking sector before the 2008-09 crisis. Private foreign banks (many of them from the European Union) introduced higher service standards and more diversified products (World Bank and International Finance Corporation, 2014). In the aftermath of the 2008-09 crisis, some foreign banks exited the market[51]; other institutions engaged in deleveraging and are still decreasing the size of their balance sheets. As a result, the share of private foreign banks in total banking sector assets fell from 33% in 2010 to 21% in 2014 (Figure 3.2 below). In contrast to other foreign banks, Russian banks (all of them

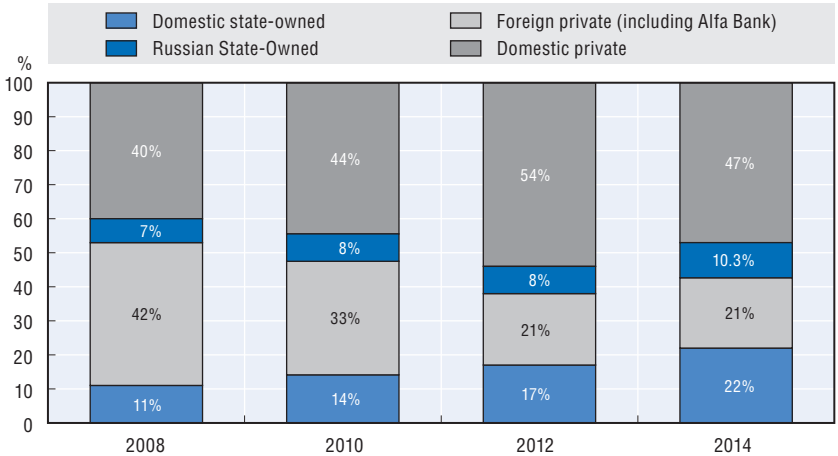
Table 3.1. **Ukraine: Structure of the banking sector**

	End-2012	End-2013	End-2014	Mid-2015
Number of banks	176	180	163	137
Among which: foreign-invested	*53*	*49*	*51*	*38*
Among which: fully foreign-owned	*22*	*19*	*19*	*17*
Among which: under liquidation or administration	…	0	16	11

Source: National Bank of Ukraine, Key performance indicators of banks, *www.bank.gov.ua/control/en/publish/article?art_id=37942&cat_id=37937* (accessed on 1 December 2015), IMF, First Review Under the Extended Arrangement, *www.imf.org/external/pubs/cat/longres.aspx?sk=43152.0* (accessed on 1 December 2015).

StatLink http://dx.doi.org/10.1787/888933355923

Figure 3.2. **Ownership structure of the banking sector**



Source: Based on Raiffeisen Research (2015), *Central and Eastern Europe banking sector report*, Vienna, *www.rbinternational.com/eBusiness/services/resources/media/829189266947841370829189181316930732_829602947997338151_829603177241218127-1078945710712239641-1-2-EN.pdf*; World Bank and International Finance Corporation (2014), World Bank and International Finance Corporation (2014), *Ukraine – Opportunities and challenges for private sector development*, Washington, *wwwds.worldbank.org/external/default/WDSContentServer/-WDSP/IB/2014/01/13/000456288_20140113092348/Rendered/PDF/ACS47780revised0ESW00OUO090.pdf*.

StatLink http://dx.doi.org/10.1787/888933355823

state-owned, except for Alfa Bank) stabilised their share of the Ukrainian banking market (13% of total assets in 2014, up from 12% in 2010). Because of market consolidation, the number of foreign banks has been decreasing along with the overall number of banks (see Table 3.1 above).

Short maturity is a problem that reflects the lack of stable local currency funding. In 2014, half of local currency corporate loans was extended for less than one year, and only 12% had maturities of five years or more. Even though corporate loans dominate the loan portfolio of the Ukrainian banking system, large businesses can also access long-term funding on foreign markets. An additional problem is insufficient information regarding borrower's

creditworthiness: Despite recent progress, Ukraine's credit information system remains incomplete and fragmented. Judicial proceedings for contract enforcement are long, costly and unpredictable. Because of this risky lending environment, borrowers face higher interest rates and banks adopt very conservative credit allocation patterns (World Bank and International Finance Corporation, 2014).

In 2012, Ukraine had the highest share (76%) of companies reporting credit constraints in Eastern Europe and the Caucasus, up from only 50% in 2008.[52] This deterioration reflects the degradation of financing conditions over the period. In 2013, only 19% of firms used bank credits, ten percentage points lower than in the Eastern Europe and Caucasus region (EBRD et al., 2015).

The credit constraint seems particularly stringent for SMEs: SME loans financing dropped by an estimated 30-40% since 2012. Firm-level data from the business environment and enterprise performance survey[53] (BEEPS V) suggest that access to credit is particularly problematic for medium-size enterprises (from 50 to 250 employees). High rates on non-performing loans (NPLs) among SMEs have triggered stricter bank filters. High interest rates are a major obstacle to access to bank finance: in 2013, 36% of firms who did not apply for a loan reported it as the main obstacle, the highest level in the Eastern Europe and Caucasus region. SMEs do not make use of government support for SME bank financing (interest rate subsidies or partial compensation of loan payments) outside of the agricultural sector. Even in Agriculture, the amounts provided are relatively small (EBRD et al., 2015). Box 3.2 provides for a brief comparative assessment of legal, regulatory and policy aspects of access to finance by SMEs.

The government's microloan entity, the Ukrainian Fund for Entrepreneurship Support, is an instrument to facilitate access to finance by SMEs. However, it did not provide any financing in 2014 and is currently being audited. The establishment of a general credit guarantee scheme with private sector participation is currently under consideration (EBRD et al., 2015).

Non-performing loans (NPLs) have become an almost unsurmountable problem. According to the NBU definition (which includes doubtful and loss loans, as recorded in the balance sheets), NPLs as a share of total loans increased from 12.9% at end-2013 to 24.1% in May 2015. The IMF also includes substandard loans (most of them in foreign currency) and shows a similar trend although at higher levels (from 23.5% at end-2013 to 44.3% in May 2015). Profitability has suffered dramatically: according to IMF estimates, the return on equity (ROE) of the overall banking system is -30.5% in 2014 (IMF, 2015). The situation worsened in 2015: in the first four months, Ukrainian banks (mostly those in liquidation or under administration) reported losses of UAH 83 billion or USD 3.9 billion (versus UAH 53 billion or USD 2.5 billion in 2014 and profits of UAH 1 billion or USD 47 million in 2013).[54]

Box 3.2. **Legal and regulatory framework of access to finance: highlights from the SME Policy Index: Eastern Partner Countries 2016**

The SME Policy Index: Eastern Partner Countries 2016 – *Assessing the Implementation of the Small Business Act for Europe*, includes a comparative assessment of legal, regulatory and policy aspects of access to finance by SMEs (Dimension 6 of the Index), such as the protection of creditor's rights and the framework for taking collateral. A legal and regulatory framework that enables the collection and distribution of credit information on borrowers (through functioning credit information reporting systems) and ensures the ability of banks to take security and enforce it effectively (functioning registries for security interests, etc.) can play an important role in decreasing lending risks.

Even though there is still much room for progress, the Index report acknowledges some regulatory improvements in recent years:

- Since the establishment of a unified cadastre (land registry) in 2012, its geographical coverage and online availability have been continuously improved, though neither are fully comprehensive at this point in time. Moreover, the current moratorium on the sale of agricultural land means that this type of land cannot be used as collateral. Regarding security interests, the Ukrainian State Register of Encumbrances over Movable Property does register movable assets, but is neither regulated nor fully accessible online for the general public.
- The coverage of private credit information bureaus has significantly increased over the past three years. In 2012, 17% of the adult population was covered, while in 2015 coverage is up to 48%, with a legally secured right to access one's credit history once a year for free. Ukraine does not have a public information bureau (credit registry), even though the NBU plans to create one in 2016 (see below).

The report also points out two persisting challenges:

- Despite the existing legal framework for protecting secured creditors, enforcement of collateral through the court system is slow and inefficient, in part due to corruption. A 2013 legal provision allows secured creditors to be paid out of queue, though in practice only 8.6% of creditors' claims were met in 2014 (8.9% in 2012).
- Regarding banking regulations, while capital adequacy rules have been largely implemented, most other Basel II recommendations have not. Since 2012, the legal framework on capital markets remains unchanged, as well as the number of listed companies on the main stock exchanges.

The table below provides the assessment of policy dimensions relevant for the legal and regulatory dimensions of access to finance for SMEs. Indicators are structured around five levels of policy reforms, with 1 being the weakest and 5 being the strongest. They measure both the regulatory framework in place and its effective implementation.

Box 3.2. **Legal and regulatory framework of access to finance: highlights from the SME Policy Index: Eastern Partner Countries 2016** *(cont.)*

Score for the legal and regulatory framework of access to finance (sub-dimension 6.1)

	Armenia	Azerbaijan	Belarus	Georgia	Moldova	**Ukraine**
Creditor rights	4.15	2.95	2.91	4.64	4.52	**3.85**
Register*	4.50	2.83	3.00	4.90	4.60	**3.49**
Credit information bureau	4.54	4.05	4.53	4.42	3.78	**4.31**
Banking regulations	3.50	2.00	3.50	4.00	2.00	**3.50**
Stock market**	3.01	2.89	2.97	3.06	2.53	**3.00**
Weighted average	***4.08***	***3.05***	***3.41***	***4.34***	***3.73***	***3.70***

* Measures both land registry (land cadastre) and security interests registry.
** Based on existing stock exchange metrics and the legal framework for stock markets.
Source: OECD work based on EBRD, ETF, EU and OECD (2015), SME Policy Index: Eastern Partner Countries 2016. *Assessing the Implementation of the Small Business Act for Europe*, OECD Publishing, *Forthcoming*. Chapter 6 (Access to finance for SMEs) and Chapter 16 (Country profile: Ukraine).

Degrading asset quality and the liquidity crunch due to deposit outflows have combined to cause the number of insolvent banks to reach record levels. Since January 2014, the NBU has classified 54 banks (out of 180 registered banks at that time, see Table 3.1 above) as insolvent, accounting for more than one fifth of the system's total assets. In 2014, despite massive liquidity support to solvent banks by the NBU, total credit outstanding contracted by 31% in real terms (Barisitz and Fungáčová, 2015).[55] With more banks expected to exit the market, the current crisis episode should result in some consolidation of the banking system.

In the framework of the IMF arrangement under the *Extend Fund Facility* (further "IMF Program"), Ukraine is undertaking significant financial sector reforms:

- **Bank recapitalisation and statutory capital requirements.** As part of Ukraine's IMF program, diagnostic studies and asset quality reviews ("stress-tests") of banks were undertaken in 2014. As a result, 13 banks raised their capital by UAH 45.6 billion or USD 2.1 billion (2.3% of GDP), while five did not and were subsequently dismantled (IMF, 2015). Indeed, the recent Bank restructuring law requires banks to carry out capitalisation and/or restructuring to ensure compliance with the capital adequacy requirements resulting from these diagnostics. A new wave of diagnostic studies is underway concerning the largest 20 banks, which have to submit credible recapitalisation plans detailing capital injections up to 2018. In the case of foreign-owned banks, recapitalisation by their owners is expected, with possible involvement of international financial institutions. Furthermore, the NBU increased the minimal statutory capital requirement

for banks to UAH 500 million or USD 23 million (a fourfold increase from the previous level) and set up a compulsory schedule (until 2024) for credit institutions to progressively increase their statutory capital.

- **Bank resolution and deposit insurance.** Since January 2014, the financial resources of the Deposit Guarantee Fund (DGF) have come under pressure, obliging the government to provide extensive financial support.[56] With assistance from the World Bank, Ukraine drafted and adopted new legislation to enhance its deposit guarantee and bank resolution frameworks, and to strengthen the DGF's capacities.[57] It aims at improving asset recovery from failed banks: for instance, the timeframe to complete bank liquidation has been increased from three to five years, while the period of administration will be reduced to one month in 2016. Finally, bank managers will face criminal responsibility in case of fraud regarding depositors' database. Overall, this enhanced framework, provided full implementation, is expected to facilitate the clean-up of the banking sector from insolvent banks and to speed up depositor pay out (IMF, 2015).
- **Reform of the National Bank of Ukraine.** In June 2015, Parliament adopted amendments to the NBU law in order to improve its governance and strengthen its financial autonomy from the executive.[58] For instance, as of 2016 the preservation of a minimal level of reserves will be prioritised over profit transfers to the government. The government also plans to enhance the supervisory capacity of the NBU through new discretionary powers in the field of bank regulation (IMF, 2015).
- **Unified credit registry.** The establishment of a unified credit registry at the NBU was being discussed in Parliament in October 2015.[59] It would likely significantly improve Ukraine's credit information system,[60] since the transfer of information by banks would be mandatory and the registry would thus cover 100% of legal entities and individuals. The unified registry would also strengthen the supervision capacity of the NBU, by providing the regulator with exhaustive data on the concentration of credit risks and related party lending. International organisations have been advocating for the creation of such a unified registry of credit history (see, for instance, World Bank and International Finance Corporation, 2014).
- **NPL Resolution Framework.** In the framework of the IMF programme, the government is also committed to strengthen the corporate insolvency and credit enforcement regimes and to remove tax impediments to insolvency and debt restructuring activities. A coordinated out-of-court restructuring arrangement for corporate debt is also being designed (IMF, 2015). These reforms are essential to facilitate the resolution of NPLs, since exposure from the 2008-09 crisis is still burdening banks due to insufficient write-offs (Raiffeisen Research, 2015).

- **Related-party lending and ownership disclosure.** New banking regulations introduced in 2015 aim at making the shareholding structure more transparent and enhance the liability of related persons.[61] The law expands the list of persons related to a bank, sets out new rules and restrictions on transactions with related persons, and increases civil, administrative and criminal liability of persons related to a bank. Banks will have to unwind above-the-limit loans to related parties. A review process of related party lending has also started, supported by independent accounting firms, and a dedicated unit is being created within the NBU to identify and monitor loans to related parties in all banks. The new regulatory framework also requires banks to disclose key stakeholders (defined as any individual owning shares in a legal entity or any person holding 2% or more of the shares in a legal entity with the peculiarities as set forth by the article 2 of the Law of Ukraine "On Banks and Banking") in their ownership chain.

Despite this ongoing progress in financial sector reform, the Parliament adopted in July a controversial law on mandatory conversion of retail foreign-exchange loans that could entail substantial losses for banks (IMF, 2015).[62] However, this legislation has not come into force and may face subsequent revision.

Insurance

The insurance market in Ukraine, despite a few years of rapid development up to 2008, is significantly behind other Eastern European markets in terms of size.[63] Gross insurance assets accounted for only 4.5% of GDP in 2014. While risk insurance has been dynamic, driven by motor and property insurance, life insurance is still in its infancy (it represents 8% of the 2014 gross collected premiums). Like their banking counterparts, Ukrainian insurance companies suffered from the economic downturn in 2014, which led to a decline of collected gross premiums (-6.6%) in a context of growing claims and degrading asset liquidity. In particular, since bank deposits account for more than 20% of insurers' assets, the rise of bank insolvencies in 2014 exposed insurers to increased liquidity risks.

Insurance activities are subject to licensing and regulated by the 1996 Law "On Insurance",[64] which stipulates that insurance services can be provided by a Ukrainian legal entity in the form of a joint-stock company, a general partnership, a limited partnership or an additional responsibility company.[65] Such legal entity must have registered with the State Register of Financial Institutions and obtained an insurance license. The National Commission for the regulation of financial services (hereafter–the National Commission), which is the regulator of the insurance market in Ukraine, delivers insurance licenses.

The charter capital of an insurer must be at least equal to the Hryvnia equivalent of EUR 1 million (USD 1.13 million). The requirement is higher regarding life insurers, whose charter capital must be higher than EUR 10 million (USD 11.3 million).[66] Upon registration, an insurer must comply with various requirements regarding the existence of qualified staff, adequate office premises and technical equipment. The regulator imposes additional conditions regarding the qualifications of key personnel (general manager, deputy general manager, chief accountant and actuary) and key documents, for instance a bank or auditor certificate confirming the amount of paid capital. In addition, insurance companies must register their insurance conditions (description of all their insurance products) and any amendments thereto with the regulator. The National Commission monitors the financial situation of insurers through compulsory quarterly financial reporting and is authorised to carry out on-site inspections in order to ensure compliance with prudential solvency and integrity requirements. All these regulations apply irrespective of the national origin of investors.

There is full competition between national and foreign enterprises, subject to the fulfilment of the applicable legal requirements on a non-discriminatory basis. From May 2013 onwards, Ukrainian legislation allows non-resident insurers to set up branches in Ukraine: the licensing conditions and procedures are similar to those for resident insurers[67] (a guarantee deposit in a resident Ukrainian bank replaces the charter capital). Under certain conditions,[68] direct insurance from abroad is authorised concerning reinsurance transactions, as well as in the fields of overseas transport, commercial aviation and space shifts, and freight and cargo.

The number of market participants has been slowly decreasing for several years, as the result of the withdrawal of insurance licenses. At the end of March 2015, 385 insurance companies operated in Ukraine (330 in risk insurance and only 55 in life insurance). The small life insurance market, where the largest 10 companies accounted for more than 90% of overall gross premiums in 2014, is much more concentrated than the risk insurance market.

Foreign insurers, many of them from the European Union and Russia, are well represented in the Ukrainian insurance market. Several multinational insurance groups such as the Vienna insurance group, Axa, Allianz and UNIQA operate in the country. Out of the 15 largest insurers by gross premiums collected in 2014, eight are affiliates of foreign insurance companies.[69]

The relatively poor institutional and regulatory framework is one of the key constraints weighing on the development of the insurance sector and other non-bank financial institutions. Despite recent improvements, such as new requirements regarding the risk management system of insurers, the quality of insurance legislation and supervision remains inadequate (EBRD, 2011). The

lack of capacity of the National Commission to enforce sound prudential rules is widely acknowledged (World Bank and International Finance Corporation, 2014). A moratorium on inspections of SMEs currently prevents the National Commission from carrying out on-site inspections of many insurance companies.

To address these issues, the regulatory framework of the insurance market will be significantly amended. A new law on insurance[70] is being prepared and should be adopted by the end of 2015. The draft law draws upon relevant EU norms[71] and IAIS (International Association of Insurance supervisors) standards and principles to modernise insurance market regulations. Its implementation should significantly improve supervision and strengthen prudential and transparency requirements (for instance, solvency requirements will depend on asset quality). The draft law also gives new powers to the insurance regulator to safeguard the interest of policyholders of financially weak insurance companies. Moreover, upon adoption by Parliament of Draft Law 2414,[72] the National Commission will transfer most of its attributions to the National Bank of Ukraine (already in charge of banking supervision). The purpose of this reform is to strengthen supervision and enforcement of prudential rules and avoid regulatory fragmentation. The NBU will then become the regulator of the insurance market.

Other financial intermediaries such as credit unions, private pension funds, and investment companies are less developed. With a rapidly aging population, a comprehensive reform is being considered (adoption in Parliament is expected by December 2015) to strengthen the financial viability of the pension system. It combines adjustments to the existing mandatory pay-as-you-go system ("the first pillar") to reduce its structural deficit and the introduction of a second, mandatory and fully-funded pension pillar in 2017 (IMF, 2015). A third pillar, based on voluntary contributions to insurance companies or private pension funds, already exists, although the volume of contributions is insignificant.

Natural resources

Despite being one of the world's leading producers of manganese ore, titanium ores, and titanium sponge, Ukraine has failed to remain competitive in metallurgy because of high energy requirements, insufficient new investments, and the often differing interests of the government and the owners of privately owned industrial facilities (Safirova, 2012). The subsoil remains the exclusive property of the State and an authorisation is mandatory for its use.[73] The subsoil rights have to be granted on a competitive basis, i.e. through tenders or auctions; but an applicant has to obtain the approval of the corresponding local elected body, usually at the oblast level, before being allowed to participate in an

auction. The corresponding elected bodies customarily consider such petitions during their biannual sessions, a procedure which significantly slows the government's ability to conduct auctions. To simplify the process, in August 2012 the central government proposed to delegate the issuance of approvals to local governments, which can process the approvals more quickly. To implement those changes, the Ukraine Parliament would need to approve relevant amendments to the Mining Code and the Code on Regional and Local Administrations. Special licenses are usually required for mineral resources that have been determined to be of national importance.

A new version of the Code was approved by Cabinet in April 2014. Its purpose, as mentioned in the explanatory note, is to modernise and harmonise all subsoil legislation, modify the right to use subsoil, and reduce the number of approvals and other bureaucratic procedures, in particular for water use. It also states that the subsoil use agreement should contain all the technical, economic, social, environmental and other obligations of the parties and permit to transfer subsoil use rights, terms and conditions for subsoil production and distribution.

The Law on Production-Sharing Agreements (PSAs) was promulgated in 1999. PSAs benefits include: freedom of contract and extension of rights of a subsoil user; prolongation of subsoil use term, non-interrupted special permits for exploration and production; government assistance in obtaining permits; pricing and disposal of hydrocarbons; investment protection and dispute resolution in international arbitration. According to the Tax Code, parties to a PSA are exempt from paying taxes other than corporate profits tax, value-added tax, personal income tax, a single charge for mandatory state social security in respect of Ukrainian employees and foreign individuals employed in Ukraine, state charges and duties for receipt of state services (if any) and charges for subsoil use.

The PSA Law also established the PSA Interagency Commission comprised of "the central body of executive power in the sphere of geological study and rational use of subsoil", which at present is the State Service for Geology and Subsoil of Ukraine ("Derzhgeonadra") and the Ministry of Ecology and Natural Resources ("Ministry of Ecology"). An ExxonMobil-led consortium concluded the only PSA agreement so far to tap a Black Sea natural gas field. Internal coordination was also weakened by the decision to abolish the Commission in December 2012. The Law "On Amendments to the Law of Ukraine 'On Production-Sharing Agreements Concerning the State Regulation of the Conclusion and Performance of the Agreements'" restored the PSA Commission as the government institution formally responsible for all PSA issues.[74]

Since July 2013, Ukraine has also been a candidate country for the Extractive Industries Transparency Initiative (EITI). A new law was approved in

2015 to introduce European financial reporting standards in this regard.[75] Subsoil users are now expected to disclose information on taxes and royalties paid and on commercial activities related to mining operations in Ukraine. According to the Law, the Cabinet of Ministers must develop the relevant procedure before 12 September 2015. The government should consider adhering to the OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas.

Notes

1. In the Build-Operate-Transfer Model (BOP), the private partner may design, build and operate an asset before transferring it back to the government when the operating contract ends, or at some other pre-specified time. See OECD (2011).
2. Law No. 997-XIV "On Concessions" (16 July 1999).
3. Law No. 2404-VI "On Public-Private Partnership" (1 July 2010).
4. Law No. 662-IV "On Concessions for Construction and Operation of Motor Roads" (3 April 2003).
5. Law No. 3687-VI "On the Peculiarities of Concessions of municipal property in heating, water collection and distribution" (8 July 2011), as amended.
6. Law No. 2624-VI "On the Peculiarities of Concessions of municipal property in heating, water collection and distribution" (21 November 2010).
7. The Parliament adopted Draft law No. 1058 "On Amendments to some Legislative Acts of Ukraine on the removal of regulatory barriers for development of public-private partnership in Ukraine and stimulation investment" (27 November 2014) on 24 November 2015.
8. For instance, the acquisitions of goods and services as part of PPP arrangements would no longer be subject to public procurement procedures.
9. At around 23 EUR cents per kWh, the average price received by renewable energy producers is around eight times higher than the non-renewable wholesale price. Solar power producers receive the largest subsidy at around 47 EUR cents per kWh. See Differ (2012).
10. In April 2015 the Ukraine prosecutor's office announced it would seek to cancel what it described as three "rigged" privatisations of electricity utilities conducted under the regime of Viktor Yanukovych.
11. DTEK, whose power stations generate around 25% the national electricity production, is owned by the Ukrainian magnate Rinat Akhmetov (holding "System Capital Management").
12. Resolution No. 271 "On Conducting a Transparent and Competitive Privatization in 2015" (12 May 2015).
13. See World Bank, Private Participation in Infrastructure Project Database, *http://ppi.worldbank.org*, accessed 1 July 2015.
14. Law No. 663 "On Basic Principles of the Electricity Market Functioning" (24 October 2013).

15. The balancing market serves to increase or decrease the load so as to ensure secure and reliable operation of the energy system; the ancillary market serves to maintain reserve capacity, frequency and quality of electricity supply as well as to ensure security and reliability of the energy system.
16. See Russell Pittman (2015), "Restructuring Ukraine's Electricity Sector: What Are We Trying to Accomplish?", *Vox Ukraine*, 7 February.
17. Law No. 2544-XII "On Privatisation of State Property" of 4 March 1992, Article 5.
18. Resolution No. 83/2015 of the Cabinet of Ministers (4 March 2015).
19. Governmental Order No. 915-r.
20. In 2000-13, the CAGR for production was 0.2%, while that for the production/consumption ratio was 3.3%, the second-highest in Europe after Bulgaria [see ENI (2014), *World Oil and Gas Review*].
21. Naftogaz has paid USD3.1 billion to Gazprom with regard to the November/December 2013 and April – June 2014 invoices, leaving the final clearance of accounts to the Stockholm arbitration procedure.
22. Law No. 2250 "On Natural Gas Market" (9 May 2015). The Energy Community Secretariat assisted in preparing the initial draft that mainly reflects the Third Energy Package requirements.
23. Law No. 2010-d "On Introduction of Changes to Certain Laws of Ukraine with respect to Securing Competitive Conditions for the Production of Electricity from Alternative Energy Sources" (19 May 2015).
24. The relatively small section of the Ukraine Power System – Burstyn Island – is synchronized with EU's ENTSO-E which is separated from the rest of the transmission system of Ukraine that operates in synchronous parallel mode with the United Power System (UPS) of the Russian Federation.
25. See Press release of Naftogaz Ukraine (18 June 2014), *Data shows Ukraine's gas transit system is almost 8 times more reliable than Russia's*, *www.naftogaz.com/www/3/nakweben.nsf/0/-98A90DDFBDED941BC2257CFB0069E841*.
26. For further details and the complete database, please refer to the LPI Index webpage, available at: *http://lpi.worldbank.org/international/global*.
27. See Draft Law No. 69 (20 November 2015).
28. The Ministry of Transport and Communication solicited inputs from the general public, the Association of Taxi Dispatchers and Drivers, and numerous non-government organisations, including the Kyiv Cyclists' Association.
29. Source: Minister of Infrastructure of Ukraine, as quoted by RBC Ukraine.
30. Law 4442-VI "On the Specifics of Establishment of Public Joint Stock Company of Public Railway Transport" (23 February 2012) and Law 5099-VI "On Amendments to the Law of Ukraine 'On Railroad Transport'" (5 July 2015).
31. Ukrzaliznytsia Joint-Stock Company reportedly lost UAH 9.3 billion (USD 440 million) in 2014, primarily on account of tariffs raises that were insufficient to balance the increase in the prices of energy and other inputs. Further losses amounting to UAH 1 billion (USD 50 million) resulted from the lack of compensation for transportation of government-subsidized passengers. Capital expenditures are far from sufficient to maintain the network and the equipment. See Centre for Transport Strategies, "*Interview with the New Acting Head of Ukrzaliznytsia: Private Traction Will Emerge Whether We Desire it or Not*", 21 August 2015, *http://en.cfts.org.ua/*

articles/interview_with_the_new_acting_head_of_ukrzaliznytsia_private_traction_will_emerge_whether_we_desire_it_or_not.

32. In September 2015, the Cabinet of Ministers published the charter of the new railways holding company. See Resolution of the Cabinet of Ministers No. 735 (2 September 2015).

33. For more details, see "Why the American Model is Unacceptable for the Ukrainian Railway Reform", Svitlana Zabolotska, *Vox Ukraine*. Available at *http://voxukraine.org/2015/09/14/why-the-american-model-is-unacceptable-for-the-ukrainian-railway-reform-eng/*.

34. The European Common Aviation Area (CAA) is an arrangement to allow gradual market opening between the EU and its neighbours, which is intrinsically linked with regulatory convergence through the gradual implementation of EU aviation rules. Western Balkan Countries, Georgia, Israel, Jordan, Moldova and Morocco have already joined the CAA. For further details: *http://ec.europa.eu/transport/modes/air/international_aviation/external_aviation_policy/neighbourhood_en.htm*.

35. During the Soviet period, the Ukrainian Soviet Republic accessed the Black and Azov Sea routes through its seaports, which were strategic territories subject to a special regime controlled directly from Moscow.

36. Law No. 4709-VI "On Sea Ports of Ukraine" (17 May 2012).

37. Resolution of the Cabinet of Ministers (11 July 2013).

38. Resolution of the Cabinet of Ministers (24 November 2012).

39. Merchant Marine Code of Ukraine, Article 131 (4 July 2013).

40. Resolution No. 155 "On opening river ports for the call of foreign non-military vessels" (29 February 2012).

41. European Commission - Fact Sheet, "European Commission support for Ukraine" (27 April 2015).

42. See Law No. 1869 "On Particularities of Privatization of the Open Joint Stock Company Ukrtelecom" (13 July 2000), which offered investors up to 43% stock. The law was terminated on 5 July 2005 and just three weeks later, on 25 July 2005, Ukrtelecom once again appeared on the priority list of enterprises slated for privatization.

43. The spectrum required for offering 4G services is currently only available to state security and defence authorities – so-called "special users."

44. Among the major private ISPs are Volia, Triolan, Vega and Datagroup, all of them Ukrainian-owned.

45. No. 1831 (29 May 2015). For a thorough analysis, see Council of Europe (2015), Opinion of DGI (Directorate of Information Society and Action Against Crime, Information Society Department, Media and Internet Governance Division), DGI(2015)15.

46. Draft law No. 2414a registered on July 20, 2015, accessed on 2 September 2015. The President of Ukraine introduced this draft law.

47. NBU Data. The share of foreign currency was 34% at the end of 2013 and went up because of the fall of the hryvnia.

48. Figures are exchange-rate adjusted to account for the depreciation of the hryvnia (Barisitz and Fungáčová, 2015, p. 11).

49. Even though the current crisis is causing overall market consolidation, the share of the five largest banks amounted to only 43% of total assets at the end of 2014 (Raiffeisen Research, 2015).

50. NBU permission is still required for establishing a commercial bank with foreign participation or for converting an existing commercial bank into a bank with foreign participation.

51. In 2012-13, Commerzbank (Germany), Swedbank and SEB (Sweden), and Erste (Austria) sold their subsidiaries to Ukrainian investors.

52. Credit constrained firms reported needing a bank loan, but either decided not to apply for one or had their loan application rejected. The Eastern Europe and Caucasus region comprises Ukraine, Moldova, Belarus, Georgia, Armenia and Azerbaijan.

53. Data from BEEPS V (2011-2014), the fifth wave of the Business Environment and Enterprise Performance Survey, administered by the EBRD and the World Bank (dataset available at *http://ebrd-beeps.com/*).

54. "Lack of confidence in Ukraine's economy hinders banks", *Oxford Analytica Daily Brief*, 1 June 2015.

55. Exchange rate adjusted.

56. In 2014 alone, the government borrowed UAH 10 billion or USD 470 million (0.6% of GDP) to support the DGF and secure pay-outs to insured depositors. According to its Deputy Director, the DGF managed UAH 320 billion (USD 15 billion) in assets from failed banks in July 2015.

57. Notably Law No. 629-XIX "On Amendments to Certain Legislative Acts regarding the improvement of the deposit guarantee system for individuals and dissolving insolvent banks" (16 July 2015).

58. Law No. 541-VIII "On Amendments to Certain Legislative Acts regarding the enhancement of the institutional capacity of the National Bank of Ukraine" (18 June 2015).

59. Draft law No. 3111 registered on 16 September 2015, accessed on 7 October 2015.

60. Up to now, banks rely on several credit history bureaus with partial coverage, and banks report data on borrowers to them on a voluntary basis. This creates high risks and high transaction costs, passed along to borrowers in the form of higher interest rates and rejections of good quality credit applications by banks.

61. Law No. 218-VIII "On Amendments to Certain Legislative Acts of Ukraine Regarding Responsibility of Persons Related to a Bank" (2 March 2015).

62. Draft law No. 1558-1 "On the restructuration of foreign-exchange loans", adopted by the Ukrainian parliament on 2nd July, 2015, requires banks to convert retail foreign-exchange loans into hryvnia at the exchange rate applicable when the loan was issued. As of January 2016, the President has still not signed the bill into law.

63. The 2015 Deloitte rating of the top 50 insurance companies (ranked by gross premiums collected in 2014) in Central Europe does not include any Ukrainian company, reflecting both market fragmentation and the small size of the Ukrainian insurance market. See Deloitte (2015).

64. Law No. 85/96 "On Insurance" (7 March 1996, as amended).

65. The draft Law "On Insurance" discussed in Parliament at the end of 2015 would require all insurance companies to register as joint-stock companies, which are

subject to higher transparency requirements (publication of financial accounts and of the identity of large shareholders).

66. The Insurance Law No. 85/96 of 7 March 1996, as ammended sets minimum capital requirements denominated in euros.

67. A foreign insurer must also respect additional conditions to open a branch in Ukraine: for instance, its country of registration must have signed a double taxation treaty with Ukraine and its financial solvency rating must satisfy a minimal threshold defined by the National Commission.

68. In addition to the conditions mentioned in the above footnote, this direct access to the Ukrainian market pertains to WTO members only (this restriction does not exist for reinsurance).

69. OECD Elaboration based on the data published by the Ukrainian specialised review "Insurance Top".

70. Draft law No. 1797-1 registered on 6 February 2015, accessed on 2 September 2015.

71. The draft law aims at meeting the requirement of the EU Solvency 2 Directive (Directive 2009/138/EC of the European Parliament and the Council of 25 November 2009).

72. Draft law No. 2414a registered on 20 July 2015.

73. Code No. 132/94 "On the Subsoil" (27 July 1994).

74. Law No. 331-VII (21 July 2013).

75. Law No. 2591 "On Amendments to Certain Legislative Acts of Ukraine concerning the strengthening of the Extractive Industries Transparency in Ukraine" (16 June 2015).

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Chapter 4

Ukraine and the OECD National Treatment instrument

Ukraine's legislation embodies the principle of non-discrimination of foreign investment. Ukraine has no institutionalised general screening mechanism for foreign investment but still applies several transectoral and sectoral restrictions on foreign investment which qualify for the list of exceptions to national treatment and measures reported for transparency in the meaning of the OECD Declaration on International Investment and Multinational Enterprises. In particular, Ukraine maintains exceptions to national treatment for established foreign-owned enterprises for access to land and forests and in sectors such as news information agencies, television and radio broadcasting, maritime and air transport, as well as for certain types of investment in privatisations.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

This chapter examines Ukraine's investment regime in light of the National Treatment instrument, the first element of the OECD Declaration on International Investment and Multinational Enterprises (Box 4.1). Ukraine's framework regarding responsible business conduct as covered by the OECD Guidelines for Multinational Enterprises, an integral part of the Declaration, is analysed in Chapter 5.

Box 4.1. **The Declaration on International Investment and Multinational Enterprises**

Adopted in 1976, the Declaration is a policy commitment by adherents to provide an open and transparent environment for international investment and to encourage the positive contribution multinational enterprises can make to economic and social progress.

The Declaration consists of four elements (each underpinned by a decision of the OECD Council on follow-up procedures):

- ***National Treatment:*** A voluntary undertaking by adherents to accord to foreign-controlled enterprises on their territories treatment no less favourable than that accorded to domestic enterprises in the same situations.
- ***The Guidelines for Multinational Enterprises:*** Recommendations on responsible business conduct addressed by governments to multinational enterprises operating in or from adherents. The Guidelines were updated in 2011.
- ***Conflicting requirements:*** Adherents agree to co-operate so as to avoid or minimise the imposition of conflicting requirements on multinational enterprises.
- ***International investment incentives and disincentives:*** Adherents recognise the need to give due weight to the interest of other adherents affected by laws and practices in this field; they need to strengthen international co-operation in this area and endeavour to make measures as transparent as possible.

All 34 OECD member countries have adhered to the Declaration, as have twelve non-member countries: Argentina (22 April 1997), Brazil (14 November 1997), Colombia (8 December 2011), Egypt (11 July 2007), Latvia (9 January 2004), Lithuania (20 September 2001), Morocco (23 November 2009), Peru (25 July 2008), Romania (20 April 2005), Tunisia (25 May 2012), Costa Rica (30 September 2013) and Jordan (28 November 2013).

National treatment is the commitment by an adherent to the Declaration on International Investment and Multinational Enterprises to treat enterprises operating on its territory, but controlled by the nationals of another country,

no less favourably than domestic enterprises in like circumstances. The National Treatment instrument consists of two elements: a declaration of principle, which forms part of the Declaration, and a procedural OECD Council Decision which obliges adherents to notify their exceptions to national treatment and establishes follow-up procedures in the OECD to deal with such exceptions. The Decision comprises an annex that lists exceptions to national treatment, as notified by each adherent and accepted by the OECD Council. The Investment Committee periodically examines the exceptions. To ensure transparency, adherents to the Declaration also undertake to report any measures that, while not representing exceptions to national treatment, have an impact on it. The lists of these exceptions and measures are published and regularly updated.

National treatment has become a well-established principle among adherents. Exceptions are typically limited to certain sectors, such as mining, transport, fisheries, broadcasting and telecommunications. Exceptions are reduced in scope or eliminated among adherents to the Declaration as a result of unilateral measures by the countries themselves, or as a result of peer reviews.

The aim of this chapter is to assess and present the exceptions to the OECD National Treatment instrument notified by Ukraine and measures notified by Ukraine for transparency as defined by the OECD Declaration on International Investment and Multinational Enterprises. The latter measures include various restrictions based on national security considerations, others measures reported for transparency as well as public and private monopolies and concessions.

Exceptions to the National Treatment instrument

The assessment and presentation of Ukraine's exceptions to the National Treatment instrument reflects the Ukrainian authorities' written responses to a general questionnaire and clarification requests, as well as a review of a broad range of domestic laws and regulations documented by the Ukrainian authorities and independent analyses conducted by the Secretariat.

The review also draws on other instruments – in particular Ukraine's commitments under the Deep and Comprehensive Free Trade Area (DCFTA), the Energy Community Treaty and the Schedule of Specific Commitments on Services within the General Agreement on Trade in Services (GATS) of the World Trade Organisation (WTO) – as complementary sources of information for discussion with the authorities and validation of Ukraine's list of exceptions to the OECD National Treatment instrument presented in Annex A. However, the OECD instrument follows a "negative-list approach" to notifying restrictions and discourages listing "precautionary" exceptions (i.e. not

reflecting applied restrictions). Therefore, the lists of exceptions under these various instruments are not necessarily the same. Only measures concerning legal entities are reported for the purpose of the OECD National Treatment instrument, and thus any measure that may also apply to natural persons is not reflected, neither in this Chapter nor in the list.

Exceptions at national level

Ukraine maintains exceptions to national treatment at national level for established foreign-owned enterprises regarding access to privatisations; access to agricultural land and forestry; access to public procurement; news agencies; and maritime transportation. An exception to national treatment in the field of international air transport will enter in force in July 2016. In compliance with WTO commitments, Ukraine dismantled restrictions regarding the publishing industry (production and distribution of books, newspapers and magazines) in May 2013.

Investment by established foreign-controlled enterprises

Privatisations. The 1992 privatisation law prohibits investment in the privatisation of state and municipal property by companies that are more than 25% equity-owned by a state,[1] including by foreign states. Based on this provision, many top European telecom companies that had to various degrees expressed interest in the fixed-line telecommunication incumbent Ukrtelecom – including Deutsche Telekom and Norway's Telenor – were barred from participating in bids for privatisation in 2010. There are, however, no restrictions on the resale of privatised shares by residents to non-residents or established foreign-controlled enterprises on the secondary market.

Access to agricultural land and forestry. According to the Land Code, foreign individuals, foreign legal entities and subsidiaries of foreign companies (Ukrainian legal entities with foreign investment) are not allowed to own agricultural land but they may acquire non-agricultural land plots only if they already own, buy or will build real estate on such land (OECD, 2015). For instance, they can own non-agricultural land for purposes related to agriculture, such as agro-processing located further away from the growing area, but only as an adjunct to purchasing non-movable assets located on said land. This discourages investment as the purchase of or building a factory creates a right to own land, and not the other way around. If non-agricultural land plots become agricultural land, foreign legal entities and fully owned subsidiaries of foreign companies would have to sell them within one year.

If foreigners, a foreign legal entity or subsidiaries of foreign companies (joint-ventures with participation of foreigners and foreign legal entities) wish to purchase state-owned non-agricultural land, a complicated process is

prescribed in the Land Code[2] and requires ultimate consent by the Cabinet of Ministers in addition to prior approval by relevant Ministries (this process does not exist for sales of private non-agricultural land).

Only Ukrainian citizens and legal entities can own forests. Foreign legal entities and subsidiaries of foreign companies (Ukrainian legal entities with foreign investment) are not authorised to own forests. In practice, forests are state-owned: the State Forestry Agency manages 68% of forests, with the remaining 32% spread across approximately 50 public agencies, local municipalities, and educational organisations (OECD, 2015).

Access to government purchasing. Ukraine's framework regulating public procurement is open to foreign and domestic economic operators on an equal basis, unless bidders are from off-shore zones (e.g. the Bahamas, Belize, the British Islands, the Cayman Islands, etc.), as defined by Ordinance No. 143-p of the Cabinet of Ministers (23 February 2011). Details of the grounds for rejecting foreign companies registered in off-shore zones are provided for in Article 17 of the 2014 Law on Public Procurement. Specifically, according to paragraph 3 of alinea 2 of this Article, participation by firms registered offshore is forbidden. Reportedly, this provision has been enacted for the purpose of targeting companies that in this way avoid taxes and should be deemed as such having outstanding tax liabilities, which prevent them from becoming parties to public contracts. As such, this provision most likely refers to off-shore companies established by Ukrainians; however the way it has been drafted allows for a broader interpretation and rejecting any foreign companies that may be suspected in taking advantage of low taxation countries.

Media and news agencies. The Law "On Television and Radio Broadcasting"[3] forbids foreign legal entities, individual entrepreneurs or any non-resident registered in offshore zones (as defined by the Cabinet of Ministers) from setting up or being shareholders or co-founder of TV channels, radio broadcasting companies, or television and radio content providers. The national television and radio broadcasting council of Ukraine ensure that broadcasting organisations comply with legislative requirements, include requirements regarding foreign investments in their share capital.

According to the Law "On news agencies",[4] news agencies can be created only by Ukrainian citizens and Ukrainian legal entities. Foreigners and foreign legal entities can be co-founders of news agencies (with Ukrainian citizens or legal entities), but the share of foreign ownership is limited to 35% of the charter capital. Foreign news agencies can set up representative offices in Ukraine.

There are no ownership restrictions on foreign ownership or investments in the telecoms and internet sectors.

Domestic and international air transportation. Foreign airlines can set up affiliates in Ukraine and operate domestic flights under certain conditions (including reciprocity conditions) defined by the international agreements that Ukraine concluded in the sphere of civil aviation. Several affiliates of foreign airlines have been operating domestic flights in recent years.[5] However, a recent regulation of the civil aviation authority stipulates that, as of July 2016, licences for international regular and charter air routes will be reserved to airlines that are directly or indirectly majority-owned (more than 50% of the share capital) by Ukrainian citizens or the Ukrainian state.[6] This restriction is not applicable to licenses for international air routes granted by foreign civil aviation authorities under Ukraine's international civil aviation agreements. According to Ukrainian civil aviation authorities, this restriction is required to harmonise Ukraine's civil aviation rules with EU Standards, in the perspective of the conclusion of a comprehensive EU-Ukraine aviation agreement. Chapter 3 gives more details on this agreement, which is still being negotiated.

Cabotage. Cabotage transportation (i.e. between Ukrainian ports, including as part of international transportation) is reserved to vessels under the Ukrainian flag.[7] However, if there is a permit issued by the State Inspectorate of Safety at Maritime and River Transport, it is possible to sail under the flag of another country. The right to fly the Ukrainian flag belong to ships owned by Ukrainian citizens or Ukrainian legal entities whose shareholders are all Ukrainian citizens. It also belongs to ships that Ukrainian citizens rent under a bareboat charter arrangement.

Measures reported by Ukraine under the National Treatment instrument for transparency

Policies established for safeguarding national security and public order, as well as restrictions in relation to corporate organisation and key personnel must be reported under the OECD National Treatment instrument under transparency measures. Monopolies and concessions must also be reported under transparency measures.

Measures at the level of national government

Measures based on public order and essential security reasons

The OECD Investment Instruments recognise that policies for safeguarding national security and public order are an important part of investment policies in many countries. OECD instruments that grant an exemption from obligations regarding national treatment include the National Treatment instrument and Article 3 of the Codes of Liberalisation of Capital Movements. Countries that

adhere to the OECD Declaration on International Investment and Multinational Enterprises nevertheless commit to report their investment policies related to national security. The policies are recorded in the List of measures reported for transparency by country of the National Treatment instrument.

Concerns with national security. Since the last review of Ukraine in 2011, the country has amended its policies in this area or introduced new legislation to address national security concerns in the context of foreign investment. This policy-making activity has been in part driven by a re-evaluation of what national security encompasses and in which ways it can be threatened, as demonstrated by the adoption of a new *Strategy of National Security of Ukraine* in 2015.[8] Pursuant to the strategy, "limitations aimed at preventing the penetration of capital from the Aggressor-state[9] in strategic sectors of the economy" are necessary in order to ensure the economic security of Ukraine.[10]

Ukraine has defined circumstances under which a national security exception can be invoked in its Law "On Fundamentals of National Security of Ukraine".[11]Although the list of "potential and real economic threats to the national security of Ukraine" (Article 7) is rather broad, the factors the regulatory or legislative authorities may proceed from to ban or scrutinize foreign investment shed some light on what is to be covered under the Ukrainian concept of threats to national security:

- An increase in the share of foreign capital in strategic sectors[12] of the Ukrainian economy such that it jeopardises Ukraine's economic independence;
- Critical dependence of the national economy on the business cycles of international markets and a low rate of expansion of the internal market;
- A significant reduction in GDP, investments and research activities in key sectors of scientific and technological development;
- The weakening of state regulation and control regarding the economy;
- The instability of regulations in the economic sphere, including the government's fiscal policy as well as the absence of an effective programme for the prevention of financial crises and the increase of credit risks;
- The critical state of basic production assets in the leading industrial sectors, in the agro-industrial complex and regarding technical maintenance of nuclear power installations;
- Insufficient economic growth and the structural misbalances in the economy;
- An exports structure composed mainly of raw materials and containing few high added value products;
- The high level of internal and external government debt;
- Inadequate anti-trust policy and inadequate regulation of local monopolies that prevent the creation of a competitive economic environment;

- The critical situation regarding the population's supply of food;
- The ineffective use of fuel and energy resources, an insufficient diversification for their supply and the absence of an effective energy-saving strategy;
- The "Black" or "Shadow Economy";
- A predisposition at the top level of the public service to favour individual, corporate and regional economic interests over national priorities.

Although this list may been seen as giving broad discretion to Ukrainian authorities in deciding whether a particular foreign investment threatens national security, Ukraine has, in general, maintained an open policy towards foreign investment, including in sectors that are often considered as national security sensitive. If some strategic sectors are barred to investment, such prohibition most often applies equally to domestic and foreign investors.[13] Furthermore, the 2015 *Strategy of National Security of Ukraine,*[14] while considering that "limitations aimed at preventing the penetration of capital from an "Agressor-state"[15] in strategic sectors of the economy" are necessary in order to ensure Ukraine's economic security, also recognizes "foreign investments in key sectors of the economy, including energy and transports" as a key contribution to it. Contrarily to previous versions, the 2015 *Strategy* contains no general mention to "foreign investments in strategic sectors" as a potential threat to national security.

National security grounded approaches to foreign investments. Ukraine's response to national security concerns stemming from foreign investment has taken two distinct forms: partial or total prohibitions of foreign investment in specified sectors and sector-specific licensing provisions.

Total or partial prohibitions of foreign investment in specific sectors. Ukraine retains prohibitions of any foreign investment on national security grounds in the manufacturing of weapons and in space facilities,[16] as well as for certain categories of investors in TV and radiobroadcasting. With regards to the latter sector of activities, legal entities and residents, as well Ukrainian legal entities whose shareholders or ultimate beneficiaries are residents from an "Aggressor-State", are forbidden from setting up or being shareholders of any TV or radio broadcasting company, or of any television and radio content provider.[17]

As noted above, the 1992 privatisation law also prohibits investment in the privatisation of state and municipal property by companies that are more than 25% equity-owned by a foreign state but there is no indication in the legislation that this restriction aim at managing risks related to national security. However, the government is preparing amendments to the Privatisation Law in order to limit the scope of this restriction to Ukrainian SOEs. If these amendment are adopted, foreign SOEs (or foreign companies

where a state owns more than 25% of the share capital) would thus be allowed to take part in privatisations. By contrast, the government introduced a draft law prohibiting legal entities and citizens from the Aggressor-State, as well as Ukrainian legal entities whose shareholders or ultimate beneficiaries are residents from the Aggressor-State, from taking part in the privatisation programme.[18]

Legal entities and residents, as well Ukrainian legal entities whose shareholders or ultimate beneficiaries are residents from the Aggressor-State, are forbidden from setting up or being shareholders of any TV or radio broadcasting company, or of any television and radio content provider.[19]

Sector-specific licensing provisions. Under the Law of Ukraine "On Licensing Types of Economic Activity"[20] (hereinafter – the "licensing Law"), 30 economic sectors require prior government authorization (i.e. an activity licence), which can be denied on national security grounds. The essence of this approval process can be summarised as follows: entities "under the control of residents from countries undertaking armed aggression against Ukraine and/or creating conditions for armed conflict or use of military force against Ukraine" are not entitled to an activity license in these sectors.[21] The licensing authority is usually a government agency in charge of sector-specific regulation (often named "National Commission"). This provision applies to all of the 30 economic activities subject to licensing, except for banking activity and activity in the areas of television and radio broadcasting, production and trade of alcoholic beverages and tobacco products.[22] The basis for refusing to grant a license is documentary evidence of control of "residents from countries undertaking armed aggression against Ukraine and/or creating conditions for armed conflict or use of military force against Ukraine" (hereinafter "residents from countries undertaking armed aggression against Ukraine, etc."), to be established by licensing authorities. The licensing law, under the same provision, also provides the grounds for cancellation of existing licenses held by such entities.

The licensing law gives an extensive but rather vague definition of control, which includes "decisive influence" over a business entity, and does not define a precise shareholding threshold or clarification regarding the exact interpretation of control in the context of the licensing law. As a result, regulatory authorities have applied the law unevenly. For example, on 24 June, 2015 the National Securities and the Stock Market Commission (NSSMC) cancelled the brokering licenses of 7 market participants with Russian capital (among which the banks Sberbank and VTB) on the basis of documentary evidence of control of "residents from countries undertaking armed aggression against Ukraine, etc."[23] It did not however cancel the brokering license of Alfa Bank Ukraine, which belongs to Russian Alfa Group but is

formally controlled by a Special Purpose Entity (SPE) based in Cyprus.* On 6 October 2015, the NCSSM cancelled the license of PFTS, one of the largest stock exchanges in the country; because of documentary evidence of control of "residents from countries undertaking armed aggression against Ukraine, etc." (Moscow Stock Exchange had a majority stake in PFTS). This suggests that some licensing authorities may have adopted a formal definition of "Aggressor control", i.e. direct control by a foreign entity or individual.

Other measures

Professional and other services. Ukraine's legislation imposes a Ukrainian nationality requirement for notary services.[24] As this measure concerns natural persons, it is not taken into account in the list of measures qualifying for exceptions to national treatment in the meaning of the OECD Declaration on International Investment and Multinational Enterprises given that the scope of the OECD National Treatment instrument covers legal entities only.

The director of primary and secondary education institutions, both public and private, shall be a citizen of Ukraine, having a degree in Pedagogy and not less than three years of experience in teaching.[25] The same requirement applies to all pre-school and non-school education institutions (public or private alike).[26] The heads of State or municipal higher education institutions shall be Ukrainian citizens.[27]

Repatriation of foreign investment. Article 397 of the Economic Code of Ukraine and Article 12 of the Law of Ukraine "On the Foreign Investment Regime" guarantee free transfer of returns, profits and others funds received by foreign investors as a result of foreign investment. In addition, in accordance with Article 5 of the Order of the Cabinet of Ministers of Ukraine "On the system of foreign exchange regulation and foreign exchange control", there is no obligation to secure authorization in order to repatriate foreign investment, or profits and other funds earned as a result of investment. In addition, in the territory of Ukraine, a foreign investor may invest funds from investment accounts opened with authorized banks both in authorized foreign currencies and in Hryvnia.[28]

* Footnote by Turkey: The information in this document with reference to "Cyprus" relates to the Southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".
Footnote by all European Union member states of the OECD and the European Union: The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.

In recent years, as Ukraine faced negative and unpredictable external conditions, the National Bank of Ukraine (NBU) adopted a range of temporary capital control measures to address external imbalances, to tame panic in the foreign exchange market, and to stabilize disorderly market developments. In 2009-10, foreign investors were obliged to route their monetary contribution in foreign currency exclusively through "investment accounts" opened with Ukrainian banks.[29] In March 2015, currency controls were tightened by broadening and extending prohibition of certain foreign currency transactions.[30] Banks are subject to the obligation to monitor foreign currency purchase transactions on a daily basis and service only those that have an express legal basis. The NBU is granted the right to suspend any transaction suspected by the NBU of being illegal and to request additional documents regarding such transactions. At the same time, in September 2015 and in December 2015, the NBU slightly relaxed some of its previously introduced restrictions, in particular:

- The cap on daily cash withdrawal from foreign exchange accounts have been raised to UAH 20 000 (about USD 939) from UAH 15 000 (USD 704).
- The prohibition for Ukrainian banks to purchase foreign exchange funds upon instructions of their clients (other than private individuals) if such clients already hold FX funds in a Ukrainian bank account has been relaxed for certain non-convertible currencies (Egyptian pound, etc.).
- In December 2015, the NBU relaxed the 75 % mandatory sale (surrender requirement) of foreign currency in the case a resident borrower uses it to fulfil its obligation under an import contract involving a foreign export credit agency.

These changes should not influence significantly the foreign currency market (for a detailed analysis, see UkrSibbank Research, 2015).

Several temporary capital control measures introduced in 2015 directly impact foreign direct investors established in Ukraine, including the prohibition of the following foreign-exchange transactions:

- Transfers of dividends to foreign investors;
- Repatriation of the proceeds from the sale of a security, except in the case of a debt security sold on a stock exchange (NBU verifications required in this case) or in the case of government bonds;
- Repatriation of the proceeds from the sale of corporate rights (other than shares), from the decrease of the charter capital or the withdrawal of a foreign shareholder in a company;
- Prepayments under foreign loans, including if repayments are shifted to earlier dates.[31]

The National Bank of Ukraine has been considering further liberalization steps conditional upon sustained improvements on the foreign exchange market and of the general economic situation.[32]

Sectors subject to public/private/mixed monopolies or concessions

Monopolies and concessions must be reported under the OECD National Treatment instrument under transparency measures. Monopolies can take two forms: i) a public monopoly, run by the state or managed by local governments, and ii) a monopoly exercised under an exclusive licence granted to a private operator.

Monopolies. The Ukrainian legislation defines a natural monopoly as an activity in which the absence of competition is beneficial to the market due to specific features of production, and products cannot be replaced by equivalent substitutes.[33] The law classifies the following activities as natural monopolies (Article 5):

- Transport of oil and oil products by oil pipelines;
- Transport of natural gas and oil gas by pipelines;
- Distribution of natural gas by pipelines;
- Storage of natural gas beyond certain volumes defined by the Ukrainian legislation;
- Transport of other products by pipelines;
- Transmission and distribution of electricity;
- The use of railway lines, dispatcher services, railway stations and other rail infrastructure;
- Air traffic control;
- Centralised supply and distribution of water;
- Centralised heating supply;
- Specialised services in ports and airports, as determined by the Cabinet of Ministers;
- Burial of domestic waste.

The law also defines "adjacent markets" as markets closely related to natural monopolies, since market participants directly rely on products produced or sold by natural monopolies for their own activities. The law classifies the following activities as "adjacent markets" (Article 6):

- Supply of any product transported by pipelines, including natural gas;
- Domestic and international transport of passengers and cargo by rail, air, sea or rivers;

- Production and supply of electricity;
- Processing of domestic waste;
- Sale of natural gas beyond certain volumes defined by the Ukrainian legislation.

According to the law, natural monopoly can be state-owned or private entities, provided that they comply with applicable regulations.

Natural monopoly activities and activities on "adjacent markets" (as defined above) are subject to licensing. The Licensing authorities can be either National Commissions (sector-specific regulators) or Ministries. In the case of regional or local monopolies, local governments are entitled to regulate them and act as licensing authorities. In practice, one prominent licensing authority is the National Commission for State Regulation of Energy and Utilities, in charge of the regulation of the power sector (electricity, natural gas, heating supply), along with centralised supply and distribution of water and domestic waste.[34] The Ministry of infrastructure is the Licensing authority and regulator in the field of transport and transport infrastructure (including ports and airports). According to the law (Articles 8 and 14), licensing authorities of natural monopolies enjoy wide regulatory powers, among which the fixation of tariffs and the regulation of consumer's access to the products of natural monopoly, and the determination of compulsory quality standards. The law stipulates that regulatory procedures should be transparent and open.

The Antimonopoly Committee of Ukraine maintains an overall record of natural monopolies.[35] According to this record, as of January 2016, 6 natural monopolies (all state-owned) operated at the national level:

- Air traffic control services: state enterprise Ukraerorukh (report to the Ministry of Infrastructure);
- Railways, dispatcher services, railway stations and other rail infrastructure: state administration of Ukraine's railway transport Ukrzalinitsya;
- Transport of natural gas by pipelines: national shareholding company Naftogaz represented by its subsidiary Ukrtransgas;
- Transport of oil and oil products by major pipelines: national shareholding company Naftogaz represented by the open joint stock company Ukrtransnafta;
- Transmission of electricity via national and international electricity grids: state enterprise National Energy Company Ukrenergo.

In Ukraine, the production of ethyl alcohol is a state monopoly.[36] The State-owned holding *Ukrspirt* was created in 2010 to reunite 40 state-owned ethyl alcohol factories. Although it is not on the list of the SOEs subject to privatization in 2015,[37] the government signalled recently introduced a draft law[38] that would allow a partial or total privatisation of Ukrspirt in the future.

According to the Law "On Postal services",[39] the national state-owned operator "Ukrpochta" has an exclusive right to the publication and distribution of stamps and the conveyance of ordinary postcards and ordinary letters up to 50 kilogrammes. The handling of parcels and letters of more than 50 kilogrammes is thus open to the private sector. It is subject to a licensing system and tariff regulation by the National Commission for State Regulation of Communications and Informatisation (NCCIR). This tariff regulation is limited to universal postal service obligations (which extends to letters and parcels up to 10 kilogrammes).[40]

In addition, a list of "State assets of strategic importance for the economy and national security" sets forth the strategic enterprises under Ukrainian government control. In 2015, under this list, the number of strategic state-owned enterprises was reduced to 309.[41] This list is to be updated and might be reduced further in the future. It comprises strategic state-owned enterprises in the energetic sector (such as Naftogaz and Energoatom), transport infrastructures such as the Kyiv International Airport and key commercial ports, aerospace and rocket companies in the defence sector, etc. The Prime Minister announced that these strategic state-owned enterprises would not be part of the privatisation program.

Concessions. Ukraine's legislation on concessions entails multiple normative acts, which makes the Public private partnerships (PPPs) framework relatively complex. The Law "On Public-Private Partnership" stipulates that foreign investors can participate in public-private partnerships, defined as co-operation between the State of Ukraine and territorial communities and, on the other side, private businesses or individual entrepreneurs.[42] Such co-operation can take the form of a concession, production sharing agreement or joint activities. The law defines general principles of PPP projects, in particular a fair allocation of risks and access to land plots. Public private partnership agreements are concluded for a period of five to 50 years. Under the law, PPPs are possible in the following economic sectors:

- Exploration, prospecting of mineral deposits and production thereof;
- Heat production, transport and supply, and natural gas distribution and supply;
- Construction and/or operation of highways, roads, railroads, runways at airports, bridges, overhead roads, tunnels and subways, river and sea ports and infrastructures thereof;
- Machine building;
- Water collection, purification and distribution;
- Health care;
- Tourism, leisure, recreation, culture and sports;

- Support of operation of irrigation and land improvement systems;
- Waste treatment and management;
- Electric power production, distribution and supply;
- Property management.

The 1999 law "on Concessions" refers to a narrower definition of PPP as "the transfer for a defined period of time by a public entity (state or territorial) of the right to create or/and operate an object to private investors on the basis of a concession agreement".[43] The Law defines key legal principles applicable to concessions, as well as conditions of and procedure for conducting concession tenders. It stipulates that individuals and business entities, both resident and non-resident, can bid for concessions and establishes the possibility to lease state and municipal property for up to fifty years for the purpose of concession arrangements. In addition to the economic sectors mentioned above,[44] state or municipal assets are eligible for concession agreement in the following sectors:

- Urban public transport and municipal parking services;
- Telecommunications;
- Postal services;
- Public catering;
- Construction of residential real estate;
- Funeral services.

The regulatory framework and recent developments of PPPs in Ukraine is detailed further in Chapter 3 (Infrastructures and Financial Sector Development).

Corporate organisation and key personnel

The Ukrainian legal framework contains few corporate organisation requirements. They are applied on a non-discriminatory basis to foreign and domestic investors. For instance, local incorporation is required to provide road (freight and passenger) transport services.

Rules on hiring and employing foreign citizens and stateless persons are broadly in line with international practices.[45] While a company established in Ukraine is free to define the number of its staff (Ukrainian and/or foreign individuals) and the qualifications required from them, in the case of a foreign company's representative office the number of foreign employees must be predetermined in the official registration application and then be included in the registration certificate. Any company wishing to employ a foreign national must obtain a work permit for him/her. To obtain a work permit, an employer should present supporting evidence that there are no local employees able to perform the work proposed to foreigners. The commission considering the

applications consists of representatives of the Ministry of Interior, the State Security Service, the State Tax Service and the Ministry of Labour. Work permits are issued by the relevant regional employment centres within 30 calendar days from the date of the submission of the application. State fees for issuing a work permit amount to the equivalent of four minimum monthly wages.

While the formalities necessary to obtain visa, temporary stay and work permits are not mentioned by foreign business as a major barrier to investment in Ukraine, in practice some difficulties persist. Procedures are complex (some 10-12 documents) and administrative officers sometime give different interpretations to registration requirements. This applies in particular to work at the representative offices of banks. Insofar as such offices should be registered with the National Bank of Ukraine (NBU) instead of the MEDT and no legislation exists concerning the procedure of accrediting a foreign national with the NBU, there is uncertainty regarding what concerned staff should do. More generally, registration with the immigration authorities (VGIRFO) and obtaining a temporary residence permit is considered a lengthy and sometime difficult process, despite the 2009 introduction of new electronic entry/exit control database. On 11 February 2015, Resolution No. 42 "On certain business deregulation matters" came into effect. The Resolution has simplified the procedure to issue and renew work permits by 1) extending the list of appropriate and justifiable grounds for recruiting foreign labour;[46] 2) waiving the 15-day labour market search requirement for additional categories of applicants; 3) changing time limits for renewal filings and reducing the maximum amount of time allowed to issue, or to renew, a Work Permit;[47] and 4) establishing that a Work Permit can be prolonged an unlimited number of times.

Following the suspension of the provisions of the 1997 Agreement between the Government of Ukraine and the Government of the Russian Federation on visa free travel for citizens of Ukraine and the Russian Federation, a special regime applies since 1 March 2015. Citizens of the Russian Federation are now able to enter, exit, transit, stay and travel within Ukraine only on the basis of passports valid for international travel. The suspension is introduced for an unlimited period, until the government of Ukraine decides that there is no need to ensure state security, preserve public order or protect the health of citizens anymore.

Rationale for the existing restrictions and plans for phasing them out

The Ukrainian authorities consider some restrictions as necessary to balance the needs and interests of consumers, users and suppliers of public services, guarantee standards of quality, quantity, opportunity, stability and reliability in their provision, enhance cost-oriented tariffs and pricing, and

promote local investment projects. Other restrictions seek to endorse the state's ownership, use and supervision of the national patrimony, including assets of public domain, as well as its right to demand liability from economic activities that have a bearing on matters of public interest.

Lastly, some restrictions are designed to keep certain strategic sectors of economic, social or cultural interest within the scope of the state's control. While provisions that regulate investment to safeguard national security are a legitimate component of investment policies, they should be designed so as to achieve their goals with the smallest possible impact on investment flows. Ukraine should consider revising its relevant legislation in line with the generally accepted principles of non-discrimination, transparency of policies and predictability of outcomes, proportionality of measures and accountability of implementing authorities. This also means that investment restrictions should be narrowly focused on concerns related to national security. These principles are drawn from the OECD Guidelines for Recipient Country Investment Policies relating to National Security adopted by the OECD Council in May 2009 (see OECD, 2009).

Ukraine's position under the instrument of the OECD Declaration on Investment Incentives and Disincentives

The instrument on Incentives and Disincentives to Investment is an integral part of the Declaration on International Investment and Multinational Enterprises. It encourages adherents to ensure that incentives as well as disincentives are as transparent as possible, so that their scale and purpose can be easily determined. Secondly, the instrument provides for consultations and review procedures to make co-operation between adherents more effective.

A number of measures aiming at expanding the tax base through elimination of the most ineffective tax exemptions and privileges have been undertaken by Ukraine during the past two years. In February 2015, pursuant to the conditionality attached to the IMF loans, the government further committed to eliminate tax exemptions on the basis of further evaluations of costs and benefits of existing investment incentives. Reforms undertaken in Ukraine have resulted in a simplified and more transparent tax system. Ukraine, in undertaking to pursue its efforts to make its investment regime more transparent and to conduct further evaluation of costs and benefits of existing investment incentives, should be able to fulfil its commitments under this instrument (see sections on Investment incentives and the tax system in Chapter 2).

Ukraine's position under the instrument of the OECD Declaration on Conflicting Requirements

The instrument on Conflicting Requirements, which is also an integral part of the OECD Declaration on International Investment and Multinational Enterprises, provides that adherents should co-operate with a view to avoiding or minimising the imposition of conflicting requirements on multinational enterprises. By adopting an approach based on co-operation, adherents agree to hold consultations on potential problems and to give due consideration to the interests of other countries in the regulation of their economic affairs.

In undertaking to pursue efforts to make its investment regime more transparent and uniform, the government is committed to address any conflicting requirements stemming from Ukrainian laws and regulations that may be brought to its attention by multinational enterprises.

Ukraine's FDI Restrictiveness Index

The *FDI Restrictiveness Index* (FDI Index), developed by the OECD, seeks to gauge the restrictiveness of a country's FDI rules in 22 sectors taking into account four types of measures: equity restrictions, screening and approval requirements, restrictions on key personnel, and other operational restrictions such as for instance restrictions on branching (see Box 4.2). The FDI Index is currently available for 58 countries, including all OECD and G20 countries, and for eight years: 1997, 2003, 2006-14. It constitutes one component of indicators used for the OECD's *Going for Growth* policy recommendations. It is also used on a stand-alone basis to assess the restrictiveness of FDI policies in reviews of candidates for OECD accession and in OECD Investment Policy Reviews, including reviews of new adherent countries to the OECD Declaration on International Investment and Multinational Enterprises.

Box 4.2. **Calculating the OECD FDI *Regulatory Restrictiveness Index***

The OECD *FDI Restrictiveness Index* covers 22 sectors, including agriculture, mining, electricity, manufacturing and main services (transports, construction, distribution, communications, real estate, financial and professional services).

For each sector, the scoring is based on the following elements:

1. The level of foreign equity ownership permitted;
2. The screening and approval procedures applied to inward foreign direct investment;
3. Restrictions on key foreign personnel; and
4. Other restrictions such as on land ownership, corporate organisation (e.g. branching).

Box 4.2. **Calculating the OECD FDI *Regulatory Restrictiveness Index*** *(cont.)*

Restrictions are evaluated on a 0 to 1 scale: "0" corresponds to the absence of restrictions and "1" indicates a sector totally closed to FDI. The overall restrictiveness index is the weighted average of individual sectoral indexes.

The measures taken into account by the index are limited to statutory regulatory restrictions on FDI (as reflected in the countries' lists of exceptions to the National Treatment instrument and measures notified for transparency) without assessing their actual enforcement. The discriminatory nature of measures, i.e. when they apply to foreign investors only, is the central criterion for scoring a measure. State ownership and state monopolies to the extent they are not discriminatory towards foreigners are not scored. Incorporation requirements, as they restrict FDI in the form of branching, are also taken into account although they are not covered and, thereby, listed as an exception in the National Treatment instrument.

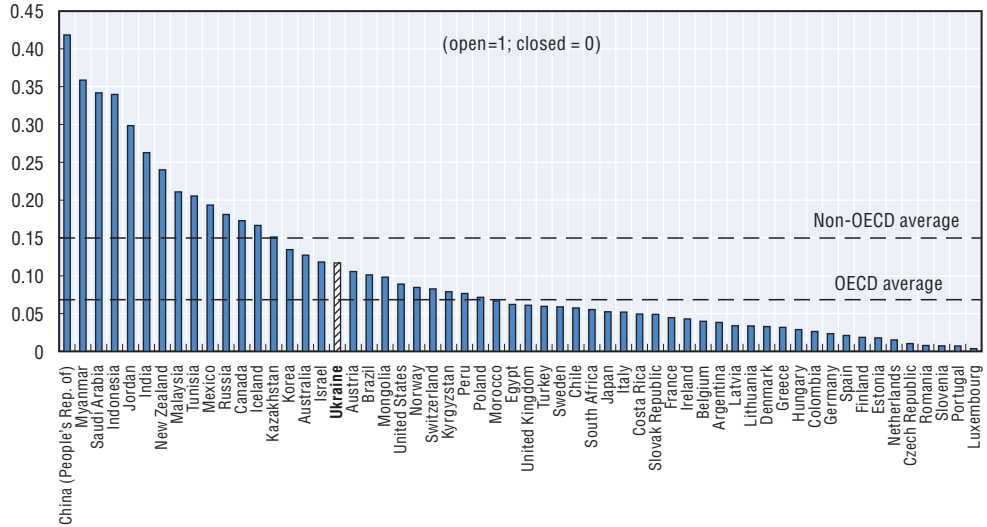
For the latest scores: *www.oecd.org/investment/fdiindex.htm* and for a presentation of the methodology, see OECD Working Paper on International Investment No. 2010/3 OECD's *FDI Restrictiveness Index*: 2010 Update available at *www.oecd.org/daf/inv/investment-policy/WP-2010_3.pdf*.

The FDI Index does not provide a full measure of a country's investment climate as it does not score the actual implementation of formal restrictions and does not take into account other aspects of the investment regulatory framework, such as the nature of corporate governance, the extent of state ownership, and institutional and informal restrictions which may also impinge on the FDI climate. Nonetheless, FDI rules are a critical determinant of a country's attractiveness to foreign investors and the FDI index, used in combination with other indicators measuring various aspects of the FDI climate, contributes to assess countries' international investment policies and explain variations among countries in attracting FDI.

With the total score of 0.117, Ukraine ranks above the OECD average (0.068) and below the average of non-OECD countries (0.151) (see Figure 4.1 below). Its score reflects the remaining restrictions on the level of foreign equity regarding information agencies and the restrictions on foreign ownership of non-agricultural land plots outside of settlements. It also reflects a number of operational restrictions, notably in agriculture (agricultural land ownership not allowed for subsidiaries of foreign companies), forestry (subsidiaries of foreign companies cannot own forests) and regarding cabotage (maritime transport). Finally, it takes into account an incorporation requirement concerning road (freight and passenger) transport. In line with the *FDI Restrictiveness Index* methodology, Ukraine's current prohibition of foreign investment in unspecified "strategic sectors" (see Annex A) is taken into account and considered as an equivalent of general screening and approval procedures.

Figure 4.1. **2015 FDI Indices by country**

The Index reflects regulatory restrictions in Ukraine as of October 2015
(for all other countries, as of December 2014)

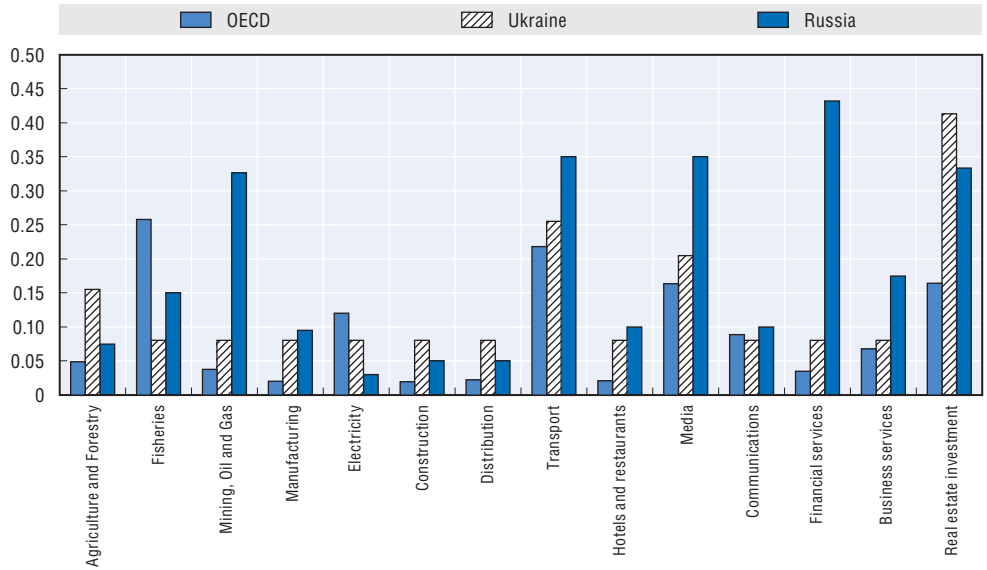


Source: OECD, *Regulatory Restrictiveness Index (database), www.oecd.org/investment/fdiindex.htm.*

StatLink http://dx.doi.org/10.1787/888933355834

Figure 4.2. **Ukraine's regulatory restrictiveness index by sector (2015)**

The Index reflects regulatory restrictions in Ukraine as of October 2015
(for all other countries, as of December 2014)



Source: OECD, *Regulatory Restrictiveness Index* (database), *www.oecd.org/investment/fdiindex.htm.*

StatLink http://dx.doi.org/10.1787/888933355846

Figure 4.2 above provides the details of Ukraine's *FDI Restrictiveness Index* by sector, as well as comparison with the average restrictiveness level by sector in OECD countries and in Russia. This allows a meaningful comparison of the restrictiveness of Ukraine's FDI regulations across sectors. As compared to OECD countries, the most severe statutory restrictions to FDI in Ukraine pertain to real estate investments (restrictions on the acquisition of non-agricultural land plots outside of settlements by subsidiaries of foreign companies), as well as Agriculture and forestry (agricultural land ownership and forest ownership not allowed for subsidiaries of foreign companies). Except in these two sectors, the FDI Regime in Ukraine is generally less restrictive than in Russia. Restrictions on foreign investments in unspecified "strategic sectors" affect all sectors (considered as an equivalent of general screening and approval procedures).

Since the first Investment Policy Review of Ukraine in 2011, the country dismantled three statutory restrictions to foreign investments. This positively affected the *FDI Regulatory Restrictiveness Index*, which decreased from 0.144 in 2011 to 0.117 in 2015 (reflecting a lower degree of restrictiveness to foreign investments). Ukraine dismantled the following statutory restrictions:

- Ukraine lifted a sectorial equity restriction in publishing (wholesale of books, newspapers, magazines) in May 2013. Previously, foreign ownership was limited to 30 % of the charter capital.
- Ukraine lifted a restriction on branching (incorporation requirement) in insurance services in May 2013, allowing foreign insurances to open branches in the country.
- Up to July 2012, foreign investors required a special permit from the Cabinet of Minister to take part in privatisations and, in some cases (G group of strategic enterprises), parliamentary approval. This requirement opened room for non-transparent privatisation deals (OECD, 2011, p. 37). In 2012, amendments to the 1992 Law "On Privatisation" ensured equal access of foreign and domestic investors to privatisations tenders. Foreign investors no longer require special permits or approvals to take part in privatisation tenders.

Notes

1. Law No. 2544-XII "On Privatisation of State Property" of 4 March 1992, Article 8.
2. Land Code of Ukraine, Article 129.
3. Law of Ukraine on Television and Radio Broadcasting No. 3759-12 of 21 December 1993 as amended in October 2015 (Article 12).
4. Law No. 74/95-BP "On Information Agencies" (28 February 1995), as amended. Article 9.
5. Notably Wizz Air (Hungary), UTair (Russia) and Atlasjet (Turkey).

6. See Order No. 686 of the Civil Aviation Authority (*Gosaviaslujba*), adopted on 24th November 2014 (Registration No. 1440/26217).
7. Merchant Marine Code of Ukraine, Article 131 (4 July 2013).
8. Strategy of National Security of Ukraine, as approved by Presidential Decree No. 287/2015 (26 May 2015).
9. An Aggressor-State is a state that undertook an armed aggression against Ukraine and occupied a part of Ukrainian territory. In January 2015, the Ukrainian Parliament recognized Russia as an Aggressor-state (Parliamentary Resolution No. 129-XIX adopted on 27 January 2015).
10. One example of restriction based on the notion of Aggressor-state – although outside the scope of this review – is the Law "On Cinematography", which forbids the diffusion on any Ukrainian television channel of movies "produced by persons or legal entities from an Aggressor-State" after the 1st of January 2014. In practice, this restriction applies to all Russian movies produced after this date. The law contains restrictions on the diffusion of earlier films from an Aggressor-state based on specific conditions (for instance, if they justify the occupation of Ukrainian territory).
11. Law No. 964-IV "On Fundamentals of National Security of Ukraine" (19 June 2003), see Philipp Fluri, Marcin Koziel, and Andrii Yermolaiev (eds.) (2013), *The Security Sector Legislation of Ukraine*, Second Edition, Center for Army, Conversion and Disarmament Studies, Kyiv, translated by the Geneva Centre for the Democratic Control of Armed Forces.
12. There is no such list of "strategic sectors" in the Ukrainian legal framework.
13. For example, the Cabinet of Ministers maintains a list of state-owned enterprises "of strategic importance for the economy and national security" (see Sectors subject to public/private/mixed monopolies or concessions below).
14. See *Strategy of National Security of Ukraine,* as established by Order 287/2015 of the President of Ukraine (26 May 2015).
15. An Aggressor-State is a state that undertook an armed aggression against Ukraine and occupied a part of Ukrainian territory. In January 2015, the Ukrainian Parliament recognized the Russian Federation as an Aggressor-state (Parliamentary Resolution No. 129-XIX adopted on 27 January 2015).
16. This is a consequence of Parliament Resolution No. 35/1992 "On the property right of specific items", which forbids foreign legal entities to own weapons, ammunitions and missile or space facilities.
17. Article 12 of the Law of Ukraine on Television and Radio Broadcasting No. 3759-XII of 21 December 1993 (as amended).
18. Draft Law No. 2319a introduced by the Cabinet of Ministers (registration date 09.07.2015).
19. Article 12 of the Law of Ukraine on Television and Radio Broadcasting No. 3759-XII of 21 December 1993 (as amended).
20. Law No. 222-VIII "On Licensing of Certain Types of Business Activity" (2 March 2015), Articles 6 and 8.
21. The absence of control of "residents from countries undertaking armed aggression against Ukraine and/or creating conditions for armed conflict or use of military force against Ukraine" is a compulsory requirement for license applicants to

obtain a license in one of the 30 economic activities subject to licensing. See Law No. 222-VIII, op. cit., Article 6 and 9.

22. Separate pieces of legislation are applicable to the licensing of banking activities, television and radio broadcasting and the production and trade of alcoholic beverages and tobacco products. The Law No. 3759-XII "on Television and Radio Broadcasting" also contains ownership restrictions regarding "*residents from countries undertaking armed aggression against Ukraine, etc.*" (see above).

23. The Ukrainian parliament recognized Russia as an Aggressor-state in January 2015: Parliamentary Resolution No. 129-XIX "On the recognition of the Russian Federation as an Aggressor state" (27 January 2015).

24. Law No. 3425-XII "On Notariat" (2 September 1993), Article 3.

25. Law No. 2628-III "On Pre-School Education" (11 July 2001), Article 31; Law No. 651-XIV "On General Secondary Education" (13 May 1999), Article 24.

26. Law No. 1841-III "On Off the School Education" (22 June 2000), Article 21.

27. Law No. 1556-VII "On Higher Education" (1 July 2014), Article 42.

28. The first group of the Classifier of Foreign Currencies and Banking Metals covers hard currencies widely used for international operations (United States dollar, British pound, euro, Japanese yen etc.).

29. Law No. 1533-VI "On Amending Certain Laws of Ukraine to Prevent Negative Consequences of the Financial Crisis" (23 June 2009) and "Amendments to Legal Acts of Ukraine to Stimulate Foreign Investment and Crediting" (27 April 2010).

30. NBU Resolution No. 160 "On Regulating the Situation in the Monetary and Foreign Currency Markets of Ukraine" (initially in effect until 3 June 2015, later extended on 4 December 2015 until 4 March 2016 through NBU Resolution No. 863).

31. This may affect foreign MNEs established in Ukraine if the parent company abroad extended a loan to its Ukrainian subsidiary.

32. See for instance NBU Presentation "Ukraine: Macroeconomic and Policy Outlook" by the NBU Deputy Governor at the American Chamber of Commerce (16 September 2015) and NBU official policy declarations.

33. Law No. 1682-III "On Natural Monopolies" (20 April 2000) as amended, Article 1.

34. Most of the natural monopolies at the regional level pertain to centralised heating supply, water supply and gas and electricity distribution. Accordingly, the National commission for State Regulation in the Energy and Utilities Sectors has offices in all of Ukraine's regions.

35. The record is accessible on the website of the Antimonopoly Committee, *www.amc.gov.ua/amku/control/main/uk/publish/article/94020*.

36. Law No. 481/95 "On the State Regulation of Production and Circulation of Ethyl Alcohol, Cognac and Fruit Alcohols, Alcoholic Beverages and Tobacco Products" (19 December 1995), Article 2.

37. Resolution No. 271 "On Conducting a Transparent and Competitive Privatization in 2015" adopted on 12 May 2015.

38. Draft law No. 2519 "On Amending Certain Laws Regarding Assets of the Agro-industrial Complex" (25 August 2015).

39. Law No. 2759-III "On Postal service" (4 December 2001), Article 15.

40. Universal postal service obligations are defined in Resolution No. 295 (11 April 2012) of the Cabinet of Ministers.

41. Resolution No. 83/2015 of the Cabinet of Ministers (4 March 2015). The previous list of "state assets of strategic importance for the economy and national security" comprised around 1500 state-owned enterprises.

42. Law No. 2404-VI "On Public-Private Partnership" (1 July 2010).

43. Law No. 997-XIV "On Concessions" (16 July 1999).

44. The list of sectors eligible for PPPs in the laws "On Public-Private Partnership" (Article 4) and "On Concessions" (Article 3) overlap for most sectors, even though the last is more precise and refers to sector-specific pieces of legislation.

45. See Resolution No. 322 of 8 April 2009 "On Approval of the Procedure of the Issuance, Extension and Annulment of Work Permits for Foreign Citizens and Stateless Persons", which came into effect on 14 May 2009.

46. According to the Resolution, appropriate and justifiable to hire a foreign national or stateless person who holds a degree from any of the top 100 universities included in any one of the following world rankings: 1) *Times Higher Education*; 2) Shanghai Jiao Tong University; 3) QS World University Rankings by Faculty; or 4) Webometrics Ranking of World Universities. Also, it will be considered appropriate and justified to employ a company shareholder for a managerial position, a manager or employee with occupation code 2131.2, 2132.2 or 3121 (such codes include database administrator, software development engineer, or technician programmer) if a company operates in the software industry, or to recruit a foreign national for a job where his/her major role will be to create copyrighted work.

47. The Resolution requires that the application for renewal of the Work Permit be filed at least 20 days (compared to 30 days) in advance of the Work Permit's expiration date. Also, now the employment center is required to take a decision on whether or not to issue/renew the Work Permit within seven business days (compared to 15 business days prior requirement), and to convey its decision, including by email, to the employer within two business days. The employers, in turn, shall submit a copy of the employment agreement or contract with the respective foreign national to the employment centre within seven business days (compared to three business days) from the execution date of such agreement or contract.

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Chapter 5

Supporting responsible business conduct and the OECD Guidelines for Multinational Enterprises in Ukraine

Responsible business conduct (RBC) is recognised as an important part of the investment climate and is increasingly integrated within public policies aimed at attracting better investment and enhancing sustainable development. RBC-related activities in Ukraine so far have mostly been undertaken by the private sector and civil society. While there is no comprehensive national or sectoral strategy on RBC, the ongoing economic and social reforms that aim to bring Ukraine close to international standards in fields such as human rights or labour relations represent a positive step in shaping and strengthening Ukraine's policy framework that affects and enables RBC. Ukraine's adherence to the Declaration, and, in particular, the establishment of a National Contact Point for the OECD Guidelines for Multinational Enterprises, is an opportunity to further promote RBC principles and standards, both within the government and with the wider public, and to further clarify and set out the government's expectations on RBC.

This chapter reviews Ukraine's policies for enabling responsible business conduct and the planned institutional arrangements for establishing a National Contact Point for the OECD Guidelines for Multinational Enterprises (Guidelines), a commitment by each country that adheres to the OECD Declaration on International Investment and Multinational Enterprises (Declaration). The Guidelines are one of four instruments of the Declaration.

The Guidelines are a set of government-backed recommendations on responsible business conduct (RBC). Addressed by businesses operating in or from their jurisdictions, the Guidelines set out principles and standards in all major areas related to RBC, including information disclosure, human rights, employment and industrial relations, environment, bribery and corruption, consumer interests, science and technology, competition, and taxation. Their purpose is to ensure that business operations are in harmony with government policies, to strengthen the basis of mutual confidence between businesses and the societies in which they operate, to improve foreign investment climate and to enhance the contribution of the private sector to sustainable development. The Guidelines, together with the UN Guiding Principles on Business and Human Rights (UN Guiding Principles) and core ILO Conventions, are one of the major international instruments on RBC.

A precise definition of a multinational enterprise is not required for the purpose of the Guidelines. These enterprises operate in all sectors of the economy; their ownership may be private, state or mixed; and they comprise all entities within the enterprise, i.e. parent companies and/or local entities. The Guidelines do not aim to introduce differences of treatment between multinational and domestic enterprises – they reflect good practice for all – and accordingly, multinational and domestic enterprises are subject to the same expectations wherever the Guidelines are relevant to both. Adherents wish to encourage the widest possible observance of the Guidelines to the fullest extent possible, including among small- and medium-sized enterprises even while acknowledging that these businesses may not have the same capacities as larger enterprises.

Understanding responsible business conduct

Responsible business conduct is a key element of a healthy business environment – one that attracts quality investment, minimises risks for businesses, ensures stakeholder rights are respected and ultimately leads to

broader value creation. Irresponsible business practices erode the overall quality of the investment and business environment; can result in large losses for businesses, environmental degradation, and poor conditions; and, in the most serious of cases, such as the April 2013 collapse of the Rana Plaza factory in Bangladesh, in loss of human life.

All businesses – regardless of their legal status, size, ownership structure or sector – should behave responsibly. As set out in the internationally recognised principles and standards on RBC, such as the Guidelines and the UN Guiding Principles, this entails making a positive contribution to economic, environmental, and social progress of the countries in which they operate, while at the same time avoiding and addressing adverse impacts of business activities. RBC principles and standards emphasise the integration and consideration of environmental and social issues into core business operations. A key element of RBC is risk-based due diligence, a process through which businesses identify, prevent and mitigate actual and potential adverse impacts, and account for how these impacts are addressed. RBC expectations extend to business activities throughout the entire supply chain and linked to business operations, products or services by a business relationship.

Furthermore, while it is the role of business to act responsibly, governments have a primary duty to protect public interest and ensure that stakeholder rights are respected – they have an important role to play in enabling RBC. This entails establishing and enforcing an adequate legal framework that protects the public interest and underpins RBC, while monitoring business performance and compliance with the law. It entails setting and communicating clear expectations on RBC and providing guidance on what those expectations mean; encouraging and engaging industry and stakeholders in collective initiatives and providing recognition and incentives to businesses that exemplify good practice. It also entails ensuring alignment of all policies relevant to RBC, as well as collaboration with foreign governments to establish international policy coherence on RBC. Collaboration on the Guidelines is an example. Finally, it also entails ensuring that RBC principles and standards are observed in the context of the government's role as an economic actor. Not only is this in the public interest, it also enhances the government's legitimacy in making recommendations on RBC to businesses. The OECD Policy Framework for Investment and the chapter on enabling RBC is a useful reference for governments for designing and implementing a strong RBC policy framework (OECD, 2015a).

Understanding the OECD Guidelines for Multinational Enterprises

Countries that adhere to the Declaration use the Guidelines for several policy purposes, at both national and international level. The Guidelines

provide a comprehensive and clear guidance on the expected behaviours of businesses operating in or from jurisdictions of adherents; help protect public interest and stakeholder rights; and promote a more open, transparent, and better business and investment climate. Because of their breadth and scope, the Guidelines can also be useful for framing and strengthening the links between policy areas that govern business conduct, such as, for example, corporate governance and risk management for environmental and social issues. Therefore, the Guidelines can be used to promote policy coherence and a whole-of-government approach to policies that concern business behaviours.

Furthermore, the Guidelines also contribute to improved accountability in case of issues that can arise from their non-observance. Each country that adheres to the Declaration commits to set up a National Contact Point (NCP) for the Guidelines to further their effectiveness by undertaking promotional activities, handling inquiries, and contributing to the resolution of issues that arise if the Guidelines are not observed by businesses in specific instances. NCPs are expected to operate according to the core criteria of visibility, accessibility, transparency and accountability in order to promote functional equivalence.

Box 5.1. **International convergence and coherence on RBC expectations**

The consensus built around the 2011 update of the OECD Guidelines for Multinational Enterprises and the unanimous endorsement of the UN Guiding Principles on Business and Human Rights by the UN Human Rights Council has brought about international convergence and coherence on what responsible business conduct entails. The result has been a clearer understanding of the baseline standards for how businesses should understand and address the risks related to the actual and potential impacts of their operations, and how governments should support and promote responsible business practices. This common understanding has contributed to creating a more predictable business environment.

This coherence is echoed in other international standards, including the ISO 26000 Guidance on Social Responsibility, the IFC Performance Standards, and the OECD Recommendation on Common Approaches for Officially Supported Export Credits and Environmental and Social Due Diligence, as well as, increasingly, regional and country strategies. For example, the European Union Corporate Social Responsibility Strategy and the United States National Action Plan on Responsible Business Conduct are based on the Guidelines and the UN Guiding Principles. Many countries are also developing National Action Plans to ensure that the recommendations from governments on responsible business conduct are actually implemented on the ground. Finally, more and more countries are using responsible business conduct principles and standards to frame domestic law. For example, the United States Dodd-Frank

Box 5.1. **International convergence and coherence on RBC expectations** *(cont.)*

Act specifically addresses due diligence for human rights along the minerals supply chain and requires companies to report on whether they source certain minerals (tin, tantalum, tungsten and gold) from conflict areas. Another notable development is the 2015 G7 Leaders' commitment to support responsible supply chains and improve access to remedy.

NCPs provide one of the few government-based, non-judicial grievance mechanisms with such an effective and broad application. NCPs offer, and with the agreement of the parties involved, facilitate access to consensual and non-adversarial means, such as conciliation or mediation, to resolve issues that arise if the Guidelines are not observed. This problem solving focus of NCPs allows the involved parties to exercise a better level of control over the process of reaching an agreement than more formal processes in which a third unrelated party makes a final binding decision. This can often be a significantly more expeditious and cost saving alternative to more formal procedures, and, in cases where there are no reliable procedures available, can often be the only venue available.

NCPs also have an important promotion and stakeholder engagement function. NCPs are expected to develop and maintain relations with representatives of the business community, worker organisations and other interested parties that are able to contribute to the effective functioning of the Guidelines. NCPs are expected to make the Guidelines known and available by appropriate means, to raise awareness about them and their implementation procedures, including also with prospective investors (outward and inward).

Furthermore governments that adhere to the Declaration have also agreed to help businesses, through a multi-stakeholder process and in co-operation with the NCPs, identify and respond to risks of adverse impacts associated with particular products, regions, sectors or industries. Guidance on due diligence is currently being developed for the extractives, agriculture, garment and footwear, and financial sectors.

Box 5.2. **How responsible agricultural supply chains can contribute to sustainable development**

Investing in agriculture is one of the most effective strategies for economic growth and poverty reduction in rural areas. GDP growth originating in agriculture is at least twice as effective in reducing poverty as GDP growth originating outside agriculture (World Bank, 2008). However, agri-business investments can also have adverse social and environmental impacts,

Box 5.2. **How responsible agricultural supply chains can contribute to sustainable development** *(cont.)*

particularly in countries with weak governance frameworks. Conflicts between investors and affected stakeholders can lead to social polarisation and political instability, and translate into reputational, operational and, thus, financial risks for investors. For instance, if land tenure rights are not well defined and protected, small land tenure rights holders may enter into unfair contracts with large agri-business investors that have higher bargaining power.

Businesses have a key role to play in ensuring that their operations do not have adverse impacts and benefit local communities and host countries. Their observance of responsible business conduct standards, as outlined in the forthcoming FAO-OECD guidance for responsible agricultural supply chains that aims to aid the implementation of the Guidelines, can ensure that they contribute to sustainable development. The guidance calls on companies to:

- Ensure that their operations contribute to food security and nutrition and sustainable and inclusive rural development;
- Continuously assess and address the actual and potential impacts of their operations, processes, goods and services over their full life-cycle;
- Disclose timely and accurate information related to risk factors and their responses to particular environmental, social and human rights impacts;
- Respect human rights and core labour standards and strive to increase employment opportunities;
- Establish and maintain an appropriate environmental and social management system and continuously improve their environmental performance; and
- Prevent and abstain from any form of corruption and fraudulent practices.

As highlighted in the companion study to this review, the Review of Agricultural Investment Policies of Ukraine, and in addition to the issues discussed throughout this review, the most urgent policy issues to be addressed in order to ensure that agriculture contributes to food security, poverty reduction and economic growth in Ukraine include defining the conditions for removing the moratorium on the sales of agricultural land, while ensuring that it benefits most land tenure rights holders, as well as strengthening the implementation of the environmental legislation, in particular to reduce soil erosion and water pollution (OECD, 2015d).

Ukraine's National Contact Point

Ukraine, like any country that adheres to the Declaration, has committed to establish a National Contact Point for the Guidelines. According to a plan developed by the authorities in December 2015, the NCP will be established as

a dedicated unit within the Ministry of Economic Development and Trade (MEDT). The NCP organisation and operation will be added to MEDT functions through a revision of the Regulation of the Ministry of Economic Development and Trade (Cabinet of Ministers of Ukraine Resolution of 20 August 2014 No. 459), expected to be completed within a month of adherence.[1]

The NCP will be staffed by two MEDT experts, while the flexibility to add more staff and resources as necessary will be retained in the NCP bylaws. The government has defined key NCP functions as following:

- promotion of RBC principles and standards in Ukraine;
- development of measures to implement RBC principles and standards;
- contribution to the resolution of issues raised within the scope of the Guidelines;
- establishment of a dialogue between public authorities, business representatives and relevant parties;
- facilitation of cooperation and consultation within government authorities, local authorities, employers, trade unions and business associations, and other non-governmental organisations on RBC issues.

An advisory and oversight board is not envisioned for the NCP at this time, although the option to establish either in the future will be retained in the NCP bylaws. The NCP will liaise with other Ministries and stakeholders as a matter of its regular functioning.

The government has set out an action plan for the first year of NCP functioning. The planned actions include information and promotion activities, including establishment of an NCP website, development of materials in Ukrainian, and quarterly meetings and workshops with stakeholders and relevant government authorities. It also includes an outline of procedures for the submitting specific instances to the NCP.

General policies for promoting responsible business conduct in Ukraine

Awareness of RBC principles and standards is not yet widespread in Ukraine. No comprehensive national strategy or policy has been adopted nor is there a dedicated body or a representative within government responsible for coordinating RBC activities. However, ongoing economic and social reforms that aim to bring Ukraine close to international standards in fields such as human rights or labour relations represent a positive step in shaping and strengthening Ukraine's policy framework that impacts and enables RBC. Ukraine's adherence to the Declaration, and, in particular, the establishment of an NCP for the Guidelines, will be an opportunity to further promote RBC principles and standards, both within the government and with the wider public; to further clarify and set out the exact expectations on RBC; and to

meet obligations under its existing international agreements, such as the EU-Ukraine Association Agreement.

RBC-related activities in Ukraine so far have mostly been undertaken by the private sector and civil society. The largest grouping of businesses with interest in RBC is the UN Global Compact Network of Ukraine. Established in 2006, the network currently has 162 active participants, although that number does not solely include businesses; 45% of participants are classified as local NGOs, for example, organisations or associations that deal with thematic issues like environment or youth issues (UN Global Compact, 2015). Another relevant organisation is CSR Ukraine, an association of 38 member companies, which serves as a knowledge hub on RBC and focuses on project implementation, research and analysis. CSR Ukraine is a board member of the UN Global Compact and a local partner of CSR Europe and the World Business Council on Sustainable Development (CSR Ukraine, 2015a). The EU Economic Chamber of Trade, Commerce and Industry advertises a social responsibility initiative, though projects listed under the initiative seem to focus largely on philanthropic efforts (EU Chamber, 2015). The American Chamber of Commerce of Ukraine has also established a CSR Club, which is aimed at sharing and promoting best CSR practices among its members. As reported to the OECD, the Club held its first meeting in October 2015, with planned monthly meetings.

From 2009-11, UN Global Compact and CSR Ukraine spearheaded an initiative to develop a corporate responsibility strategy for Ukraine, under the auspices of the Parliamentary Committee on Industrial Policy and Entrepreneurship. The document was publicly discussed and handed over to the Presidential Administration for endorsement at the end of 2011; however, this initiative has been put on hold (UN Global Compact, 2015).

The government of Ukraine could consider building on these efforts and working with stakeholders to develop a National Action Plan (NAP) on RBC, in line with international good practice and based on the Guidelines. The UN has strongly encouraged all States to develop a NAP as part of the State responsibility to disseminate and implement the UN Guiding Principles. A number of OECD governments, notably the United States, have decided to broaden these efforts and include all RBC issues, based on the Guidelines, in their NAPs. Considering the alignment between the UN Guiding Principles and the Guidelines, this approach is complementary with UN recommendations and efforts. The UN Working Group on Business and Human Rights has set up a dedicated webpage on NAPs to provide easy access to existing plans, as well as key public information and analysis on the various stages of NAP development, implementation and follow up (UN OHCHR, 2015b).

The process of developing a NAP would be a good way for the government to engage with stakeholders and the wider public on a range of issues related

to RBC, to promote the Guidelines, as well as policy coherence and alignment on RBC. The NCP, in coordination with relevant government and other stakeholders, could lead the process. The process of developing the NAP would also be a good way for the government to understand and eventually remove barriers that influence RBC uptake by businesses, as well as to facilitate collective initiatives, in the government's role as a convener, to promote RBC among industry and other stakeholders.

Additionally, the NAP would be a useful mechanism to demonstrate the economic and social reforms the government has undertaken or plans to undertake in areas related to RBC. For example, the NAP could serve to fulfil the commitments made by Ukraine in the EU-Ukraine Association Agreement. Article 422 of the agreement specifically mentions that Ukraine and EU will "promote corporate social responsibility and accountability and encourage responsible business practices," and cites the Guidelines by name. Furthermore, Chapter 13 of the Agreement on Trade and Sustainable Development includes Articles 291-292, which address effective implementation of internationally recognised labour and environmental standards and agreements; and Article 293, which relates to, in addition to the implementation of core labour standards and decent work, trade favouring sustainable development, facilitating and promoting trade and foreign direct investment in sustainable goods, services and technologies, and facilitating trade in products that contribute to sustainable development and respect corporate social responsibility and accountability principles. The Chapter provides for a monitoring mechanism and strong involvement of civil society in reviewing the contributions of these provisions to sustainable development (EU, 2014a).

The Association Agreement also contains references to corporate governance reforms in Articles 387-388. RBC and corporate governance are intrinsically linked as, on the one hand, RBC impacts the company's decision-making processes, risk management, disclosure and transparency, and relationships with investors and stakeholders; and, on the other hand, the actual process of undertaking due diligence is closely related to the corporate governance framework and the relationships between company management, board, shareholders and other stakeholders. The Agreement in particular refers to developing corporate governance policy in Ukraine in line with international standards, as well as a gradual approximation to the EU rules and recommendations in this area. The G20/OECD Principles of Corporate Governance, one of the main standards listed in the Association Agreement for these purposes, reflect the expectations set out in the Guidelines, including, among others, the expectation that the corporate governance framework recognises the rights of stakeholders and encourages active co-operation with them; ensures timely and accurate disclosure on all material matters regarding the corporation; and reflects high ethical standards (G20/OECD, 2015).

The government should ensure, as a matter of policy coherence, that corporate governance reforms adequately address, describe and reflect the extent of corporate responsibilities related to environmental and social matters. These expectations should also be integrated in the ongoing state-owned enterprises (SOEs) reforms. As the OECD Policy Framework for Investment recommends, governments should lead by example and model RBC principles and standards in their own practices, i.e. as employers, business partners, through procurement and contracting practices, and in commercial activities. This includes the activities of SOEs.

SOEs control a significant share of the Ukrainian economy; the State is considered the largest employer in Ukraine, employing around 1 million people (Ukraine, 2015a). A recent report by MEDT, which is supervising the SOE reform, highlights that the main challenges for the SOE sector are inefficiency, governance, transparency and accountability (Ukraine, 2014). The 2015 OECD Guidelines on Corporate Governance of State-Owned Enterprises (SOE Guidelines) are used as a framework for SOE reform in Ukraine. SOE Guidelines recommend that the state ownership policy fully recognise SOE responsibilities towards stakeholders and request that SOEs report on their relations with stakeholders, as well as to make clear any expectations the state has in respect of responsible business conduct by SOEs (OECD, 2015b: V). The SOE Guidelines further recommend (and rely on the Board of Directors to executive management) extensive measures to report on foreseeable risks, including in the areas human rights, labour, the environment, and risks related to corruption and taxation.

It is important for the expectations established by the government in this regard to be publicly disclosed and mechanisms for implementation of these expectations to be clearly established. It should be noted that recommendations and requirements for SOEs to integrate RBC in their decision-making and report on these efforts is not solely a development in OECD countries. For example, the People's Republic of China State-owned Assets Supervision and Administration Commission of the State Council (SASAC), which supervises and manages the state-owned assets of the enterprises under the supervision of the Chinese Central Government, has issued the Guidelines to the State-owned Enterprises Directly under the Central Government on Fulfilling Corporate Social Responsibilities since 2008 (SASAC, 2008).

Finally, there are no public policies in place targeting responsible business conduct in specific sectors. However, in light of the importance of the mining sector in the country, as discussed in Chapter 3, the government should adhere to the OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas at the same time as the Declaration.

In summary, although general awareness of RBC principles and standards is not yet wide-spread in Ukraine, the government is undertaking extensive economic and social reforms that can have a significant impact on business behaviours and that can be used as an opportunity to enable RBC. Ukraine's adherence to the Declaration and the establishment of the NCP will be a further opportunity to promote RBC principles and standards, to clarify and set out the government's expectations on RBC, and to integrate them into the government's own economic activities.

Policies in specific areas covered by the OECD Guidelines for Multinational Enterprises

In addition to general recommendations on RBC, the Guidelines include specific recommendations to enterprises in the areas of information disclosure, human rights, employment and industrial relations, environment, bribery and corruption, consumer interests, science and technology, competition, and taxation.

Disclosure

Disclosure is an integral part of RBC and corporate governance. Clear and complete corporate information is important to a variety of users, from shareholders to workers, local communities, governments and the society at large. The Guidelines call for timely and accurate disclosure on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company. The Guidelines also encourage disclosure in areas where reporting standards are still evolving such as, for example, social, environmental and risk reporting. These expectations align with the expectations set out in the G20/OECD Principles of Corporate Governance as well. Many businesses already provide information on a broader set of topics than financial performance and consider disclosure of non-financial information a method by which they can demonstrate a commitment to socially acceptable practices. Additionally, the process of gathering and thinking through data pieces needed for effective non-financial disclosure is not only relevant for communication and reporting, but also serves as invaluable input for strategic planning, decision-making, and risk management.

Corporate governance requirements, including on disclosure and reporting, are still evolving in Ukraine. Out of 140 examined economies in the World Economic Forum (WEF) 2015/2016 Global Competitiveness Index, Ukraine ranks fairly low in areas related to corporate governance, for example, strength of auditing and reporting standards (124), efficacy of corporate boards (125), protection of minority shareholders' interests (134), and ethical behaviours of firms (76). These rankings are based on the WEF's executive opinion survey and

the World Bank's/IFC Doing Business indicators. Ukraine is, however, introducing reforms that impact corporate governance, as already discussed elsewhere in this report. This notably includes the new amendments to the Joint Stock Companies Law No. 272-VIII, as well Law No. 289-VIII On Amendments to Certain Legislative Acts of Ukraine Regarding Protection of Investors' Rights, which has introduced changes in derivative action rules, corporate governance, interested party transactions and dividend payments (KPMG, 2015).

The existing legislation specifically related to disclosure mainly concerns disclosure of financial information. There are no disclosure requirements related to company anti-bribery programmes. Companies listed on a stock exchange must publish on their website quarterly and annual audited financial information, as well a separate audit report that includes auditor opinion, information on the issuance of securities and on shareholder meetings, as well as on any deals with affiliated parties. The 2011 Law on Accounting and Financial Reporting requires companies to prepare and publish financial statements in accordance with International Financial Reporting Standards (IFRS, 2015).

Another relevant legislation concerns the extractive industry, where subsoil users are expected to disclose information on taxes and royalties paid and on commercial activities related to mining operations in Ukraine – see Chapter 3 for more information. A 2014 Law No. 1701-VII On Amending Certain Legislative Acts Related to Identification of Ultimate Beneficiaries of Legal Entities and Public Officials requires companies to identify their ultimate beneficiaries, including founders, and maintain and update records on this information. This information should be disclosed to the State Register of Legal Entities and Individual Entrepreneurs at the stage of incorporation of a company and updated on a regular basis.

Disclosure requirements for listed companies include stock ownership by executives and board members, as well as their remuneration package. Any significant changes in shareholder structure must also be published. In 2014, the National Securities and Stock Market Commission (NSSMC) adopted new principles of corporate governance, which recommended that companies go beyond disclosure required by Ukrainian law. For example, the principles recommend that listed companies disclose information on issues such as human resources policy or environmental impact. However, as these recommendations are not legal obligations, companies can treat them as examples of good practice put forward by the regulator. The Ukrainian Exchange, main exchange in Ukraine, does not have specific disclosure requirements among conditions for companies to list on the exchange.

Few large Ukrainian companies are actually listed on a stock exchange and many adopt the legal form of a limited liability company, thus, avoiding

any disclosure requirements. Some large companies have minimal financial disclosure requirements because they are issuers of international corporate bonds (often issued by Special Purpose entities in off-shore jurisdictions)[2] which are not subject to Ukrainian legislation.

A 2015 survey of the largest 500 companies in Central Europe, based on the consolidated company revenues for the prior fiscal year, shows that 90 companies in the region are measuring their environmental, social and economic impacts, with 21 of them based in Ukraine (Deloitte, 2015). Considering the size of the Ukrainian economy, these relatively low numbers indicate that more efforts should be made to encourage companies to be more transparent in general, but also to disclose information on non-financial issues. This could be done by promoting disclosure of information based on the Guidelines disclosure chapter, or through supporting dedicated campaigns and targeted programs, including support for multi-stakeholder initiatives, such as the Global Reporting Initiative or the Integrated Reporting Framework. The government has a leading role to play in these efforts, particularly in terms of clarifying the requirements in this area.

In 2014, the EU issued a Directive (2014/95/EU) for the European Economic Area on disclosure of non-financial and diversity information, amending the 2013 Accounting Directive (2013/34/EU). This is a significant development for corporate governance practice in the EU. The new Directive requires companies of a certain size to disclose in their management reports information on policies, risks and outcomes related to environmental matters, social and employee aspects, respect for human rights, anticorruption and bribery issues, and diversity in their board of directors, aiming to provide investors and other stakeholders with a more comprehensive picture of company performance (EU, 2014b). Article 9 of the Directive states that business could rely on the Guidelines framework to meet these requirements. Ukraine should consider adopting a similar measure as a way to meet its commitments under the corporate governance provisions in the Association Agreement discussed above, which envision a gradual approximation to the EU rules and recommendations in the area of corporate governance, as well as a way of encouraging non-financial disclosure with the business community and promoting the Guidelines.

Human rights

As recognised by the Guidelines and the UN Guiding Principles, states have a primary duty to protect human rights. However, businesses are expected to respect human rights independently of the state ability and/or willingness to fulfil its human rights obligations. Failure either to enforce relevant domestic laws or to implement international human rights obligations, or the fact that

the state may act contrary to those laws and obligations, does not diminish obligation of businesses to respect human rights (OECD, 2011a; UN, 2011).

Ukraine has ratified all major instruments on internationally recognised human rights,[3] as expressed in the International Bill of Human Rights, consisting of the Universal Declaration of Human Rights and the main instruments through which it has been codified: the International Covenant on Civil and Political Rights and the International Covenant on Economic, Social and Cultural Rights (UN OHCHR, 2015a). Ukraine has also ratified 69 ILO International Labour Standards (Conventions), including the eight fundamental Conventions (ILO, 2015).

Ukraine has established an office of the Ukrainian Parliament Commissioner for Human Rights in order to ensure observance of constitutional human and citizen rights and freedoms. Article 55 of the Constitution allows citizens to appeal to the Commissioner in case of rights infringements. This provision provides for the basic legal mechanism to protect human and citizen rights (UPCHR, 2011).

Furthermore, the first-ever National Human Rights Strategy (Strategy) in Ukraine was approved on 25 August 2015 by Presidential Decree No. 501/2015 pursuant to Article 102 of the Constitution. The Strategy was developed under the auspices of the Ministries of Justice and Foreign Affairs over a year-long process that involved the government, Ukrainian Parliament Commissioner for Human Rights, civil society, and relevant international organisations (Ukraine, 2015b). The Strategy calls on joint action by all these actors at all stages of development, implementation, monitoring and control of the Strategy to ensure its effective implementation. A relevant initiative in this context is the 2015-17 joint plan by Ukraine and Council of Europe that makes fund available to address human rights, democratic governance, reform of the judiciary, economic crime, constitutional reform and functioning of democratic institutions in Ukraine (Council of Europe, 2015).

The purpose of the Strategy is to improve the observance and enforcement of human rights in Ukraine. The Strategy sets out goals and expected outcomes in 24 strategic areas along the whole spectrum of human rights, including preventing and investigating torture and ill-treatment; preventing and combating discrimination, including ensuring equal rights for women, minorities and indigenous peoples; combating gender-based and domestic violence, human trafficking and slavery; ensuring the right to life, privacy, a fair trial, freedom of expression and access to information; ensuring the right to work and freedom of peaceful assembly and association; supporting human rights in the Donetsk and Luhansk regions; safeguarding the rights of internally displaced persons; ensuring the right to health care and education; and raising awareness of human rights.

The implementation of the Strategy has been tasked to the Cabinet of Ministers. An action plan to implement the Strategy by 2020, to allocate funds for its financing; and to annually report on its implementation was expected to be adopted by the Cabinet in early 2016. A working group, led by the Ministries of Justice and Foreign Affairs, was established in September 2015 to lead these efforts. The working group will be divided into six thematic sub-groups responsible for different areas: personal (civic) rights; political rights; socio-economic and other rights; preventing and countering discrimination, gender equality; right to education and increasing awareness on human rights; and new challenges (DHRP, 2015b).

These developments represent a positive step toward improving the human rights situation in Ukraine. Human rights in the context of business activities are addressed in the Strategy in the section on ensuring the right to work and social security, which aims to create conditions for decent living standards and appropriate social security of citizens. Expected outcomes in this regard include a safe and healthy working environment, guaranteed protection of labour rights, strengthened social responsibility of business and improved conditions for corporate social responsibility. Businesses can nevertheless have an impact on virtually the entire spectrum of internationally recognised human rights, not just labour rights. Ukraine could consider in the action plan for implementing the Strategy the full extent of actual and potential impacts on human rights by businesses. Ukraine could consider adding a dedicated section to the action plan on this matter, particularly considering its future obligations under the Guidelines. The role of the NCP in resolving business and human rights issues should be appropriately highlighted.

Furthermore, special attention to ensuring business respect for human rights in Ukraine's conflict-affected regions due to an increased risk of gross human rights abuses by businesses in conflict times is warranted. These measures should be considered in addition to State obligations under international criminal law and international humanitarian law in situations of armed conflict. The UN Guiding Principles and the OECD Risk Awareness Tool for Multinational Enterprises in Weak Governance Zones, a complement to the Guidelines, are useful references in this regard. A comprehensive list of useful references can be found in the 2015 overview of key standards that can help business operate responsibly in conflict-affected and fragile environments published by the International Dialogue on Peacebuilding and Statebuilding.

According to the UN Guiding Principle 7, such measures entail engaging with businesses at the earliest stage possible to help them do appropriate due diligence; providing adequate assistance to assess and address the heightened risks of abuses, paying special attention to both gender-based and sexual violence; denying access to public support and services for businesses involved

with gross human rights abuses and refusing to cooperate in addressing the situation; and ensuring that current policies, legislation, regulations and enforcement measures are effective in addressing the risk of business involvement in gross human rights abuses. This may include civil, administrative or criminal liability for businesses that commit or contribute to gross human rights abuses. In cases of multinational enterprises, home governments also have a role to play, both in assisting the multinational enterprises, and also the host government. Home governments should foster close cooperation with their development assistance agencies, foreign and trade ministries, and export finance institutions; develop early-warning indicators to catch potential human rights abuses; and attach appropriate consequences to failures by businesses to cooperate in these contexts (UN, 2011: 8-10).

The EIRIS Foundation, a UK charity working in the area of responsible investment, recently catalogued business operations in the Crimea region. The database includes 27 publicly-listed businesses (i.e. with stocks and/or bonds) that are open for business in Crimea, 20 that have closed due to international sanctions, and 25 that have been nationalised since the conflict has started. The European Union (9) and Russia (8), followed by the United States (5), have the largest numbers of open businesses in Crimea (EIRIS Foundation, 2015; CSRWire, 2015).

CSR Ukraine has also made efforts to discuss the most appropriate and effective ways to conduct business during conflict times. Around 60 businesses and NGOs met in June 2015 at an event hosted by CSR Ukraine and Kyiv Mohyla Business School to seek joint solutions. The result of the meeting was a joint set of 33 recommendations, covering corporate governance, human resources practices and social investment (CSR Ukraine, 2015b).

It is worth highlighting that the expectation that businesses will respect human rights does not apply only to businesses that are operating directly in the conflict-affected zones and which may, therefore, have higher risks of causing adverse impacts. These expectations also apply to businesses that may not have a direct presence in the conflict-affected zones, but might cause or contribute to adverse impacts in these zones through their own activities or that may use suppliers that do have a direct presence in these zones. Contributing to an adverse impact should be interpreted as a substantial contribution, meaning an activity that causes, facilitates or incentivises another entity to cause an adverse impact and does not include minor or trivial contributions. Furthermore, under the Guidelines, businesses are expected to seek to prevent or mitigate an adverse impact even when they have not contributed to that impact, but when the impact is nevertheless directly linked to their operations, products or services by a business relationship. The Guidelines invite businesses to, where practicable, encourage their partners to apply RBC principles and standards. The term 'business relationship' includes

relationships with business partners, entities in the supply chain and any other non-State or State entities directly linked to its business operations, products or services.

Employment and industrial relations

Ukraine's labour market is characterised by an aging population, prevalence of informal employment, and outdated labour legislation. The World Bank projects that the Ukraine's workforce will shrink by over 15% between 2012 and 2035 if age and gender-specific workforce participation rates stay as they are today (World Bank, 2015a). There is an urgent need to introduce reforms that address the underlying structural and institutional causes that are shaping this labour market profile. This entails increasing labour productivity through improving labour market flexibility, lowering the rates of informal employment, and introducing measures to address unemployment, such as addressing skills mismatch and increasing labour mobility.

According to the Ministry of Social Policy, which has the main responsibility for implementing state labour and employment policies, the current unemployment rate in Ukraine is at 11% (1.8-1.9 million people) (RBC UA, 2015). The numbers related to the size of the informal economy are even more striking. The World Bank estimates that in 2012 informal employment constituted 22.9% of total employment, which translates to 4.6 million people being employed in the informal economy. Recent numbers are likely to be even higher considering that the size of the informal economy in 2013, as reported by MEDT, was 35% of Ukraine's economy; whereas 2015 estimates are closer to 50%, according to the Ministry of Social Policy. This represents a record high and translates to around 200 billion UAH (USD 9.39 billion) being paid in informal wages (RBC UA, 2015; USUBC, 2015). An oft-cited underlying reason for these practices has been a largely ineffective tax system that incentivises informal employment. Corporate taxes generally amount to 52.9% of profits, with 43.08% going toward unified social security contributions (World Bank, 2014). See the below section on Taxation for more information.

Furthermore, 23.4%, or 879 complaints, of the total complaints received by the Ukrainian Parliament Commissioner for Human Rights in 2013 were related to employment issues, and in particular to the right to formal employment and unemployment benefits. In light of these numbers, the Commissioner has recommended to speed up legislative efforts to address wages and labour relations, and, in particular, to introduce a reduction of the tax burden on the payroll and to strengthen employer liabilities for informal employment (UPCHR, 2014).

Ukraine is currently in the process of introducing major changes to its existing labour legislation. In addition to Ukraine's Constitution, which

defines human and labour rights in general terms, the main legal basis for employer-employee relationship has been the 1972 Labour Code. On 12 November 2015, the Ukrainian Parliament adopted amendments to the Code that explicitly prohibit discrimination based on sexual orientation.[4]

Considering that the 1972 Labour Code has not undergone any other major amendments since 1972, it can hardly be considered sufficient for Ukraine's current needs. As such, the Ministry of Social Policy launched a review process in 2014. A draft was developed over the following year in consultation with experts, including the ILO, and presented to the Parliamentary Committee on Social Affairs, which has approved and passed it to the plenary session for discussion as of the writing of this report.

Proposed legislative changes, among others, include increased annual leave; requirements for personal employment contracts rather than collective agreements; measures to protect company proprietary and trade secrets; the ability to monitor employees by video; detailed descriptions of labour relations and acceptable workplace conditions; establishment of tribunal procedures in case of illegal firings; provisions on acceptable practices in case of mergers or divisions of legal entities; clarification related to the right of repatriation in case of postings abroad; inclusion of provisions allowing termination in case of emergencies; and introduction of additional protections for pregnant women, including no probation periods (Today UA, 2015).

The reactions to these proposed changes have been mixed. The largest trade union in Ukraine, the Federation of Trade Unions of Ukraine (FTU), has generally supported the changes, while the smaller independent trade union, the Confederation of Free Trade Unions of Ukraine (KPVU), has been more critical. Notably, KPVU is concerned that new law would expand the rights of the employer too much, for example, by giving the employer the right to determine internal work regulations, which could be used to suppress collective bargaining power. KPVU has also raised concerns about the provisions that would allow monitoring and surveillance of employees (Today UA, 2015). KPVU has advocated that the 1972 Labour Code be modified, rather than completely overhauled. Legal experts, however, have pointed out that the old Code, although indeed more favourable to employees, is only so on paper, as it imposed strong constraints on employers that in fact favour informal employment.

Furthermore, Ukraine also has a specific Law on Trade Unions, Their Rights and Guarantees of Activities. The proposed draft Law No. 2983 On State Registration of Legal Entities, Individual Entrepreneurs and Community Groups, which the Ukrainian Parliament approved at a first hearing in July 2015, would amend the law on trade unions. International trade unions and their local affiliates, notably the KPVU, have expressed strong concerns that the proposed law violates ILO Conventions by introducing strict procedures for

registration of trade unions and their associations by public authorities, by weakening their autonomy, and by depriving them of the protection from external interference, including that from public authorities (Industri-all, 2015; Ukraine Solidarity Campaign, 2015).

Ukraine should ensure that changes in labour legislation are in line with internationally recognised principles and standards. Ukraine has been a member state of the ILO since 1954, and as mentioned in the previous section, it has ratified 69 ILO International Labour Standards (Conventions), including the eight fundamental Conventions and the four governance Conventions (ILO, 2015). Particular attention should be paid to adopting measures that would reduce informality of employment, as this would not only bring substantial benefits to Ukraine's economy, but would also protect workers, increase labour and product market efficiency and productivity.

Finally, the Ministry of Social Policy has also put forth a proposal to reform the current State Employment Service and create a new National Employment Agency in 2016. This reform is aimed at changing the functional responsibilities of the agency to improve labour market flexibility (through, for example, providing services aimed at re-training and re-qualification of job-seekers) and to provide an intermediary platform between job-seekers and employers (RBC UA, 2015). UNDP and ILO have announced that they will provide technical support for this reform by conducting a functional analysis of the employment service, and based on the results, developing a reform plan. Broad support will include facilitating and improving coordination between local authorities and the private sector by providing support for the establishment of Territorial Employment Pacts (TEPs), support for restructuring vocational training, and support for greater policy coherence involving employment policy (UNDP, 2015).

Ukraine could consider making a particular effort to promote the good offices envisioned as part of the mandate of the NCP for the Guidelines as one of the available non-judicial mechanisms for resolving issues related to employment and labour relations. The Guidelines are a useful framework for determining the extent of enterprise responsibilities in this regard. This is not only related to respecting fundamental labour rights, but also includes principles of equality of opportunity and treatment in employment and non-discrimination; provision of best possible wages, benefits and conditions of work; as well as provision of training with a view to improving skill levels, in co-operation with worker representatives and, where appropriate, relevant governmental authorities.

Environment

The Guidelines call on enterprises to take due account of the need to protect the environment, public health and safety, and generally to conduct

their activities in a manner contributing to the wider goal of sustainable development. This entails sound environmental management that aims to control both direct and indirect environmental impacts; establishing and maintaining appropriate environmental management systems; improving environmental performance; being transparent about the environmental impacts and risks, including also reporting and communicating with outside stakeholders; being proactive in avoiding environmental damage; working to improve the level of environmental performance in all parts of their operations, even where this may not be formally required; and training and education of their employees with regard to environmental matters.[5]

Ukraine ranks 95 out of 178 in the Yale Environmental Performance Index (2014), with an assessed 5.44% positive change in environmental performance compared to 10 years ago. A notable positive change has been in improving air quality at 10.25%. However, environmental performance in agriculture and fisheries has declined considerably compared to 10 years ago, with a respective -22.46% and -10.47% change. Chapter 7 of the companion to this investment policy review, the Review of Agricultural Investment Policies of Ukraine (Agricultural Review), extensively covers major environmental challenges in Ukraine and the existing environmental policy landscape.

As outlined in the Agricultural Review, environmental policy is characterised by a top-down approach and an array of non-streamlined legislation. Ukraine will have to harmonise the environmental policy to the EU standards as part of the obligations under the Association Agreement. Reforms have been started. The main regulatory framework for environmental protection includes:

- 1991 Law on Environmental Protection, which refers to a number of key principles and contains provisions on the authority and obligations of different governmental bodies, as well as enforcement mechanisms and administrative, civil and criminal responsibility for environmental violations;
- 1995 Law on Environmental Expertise, which requires environmental impact assessments for all draft proposals with potential negative environmental impacts and introduces the principle of public participation, hearings and comments on laws (OECD, 2011b);
- 2010 Law on Fundamentals (strategy) of the State Environmental Policy up to 2020, the current guiding document of environmental legislation, covering nearly all aspects of environmental protection. While not superseding the legislation dealing with land, water, and air pollution, the document presents the first attempt to define a coherent environmental strategy (Bigdan, 2013).

Ukraine should consider strengthening environmental protection and responding to the major environmental challenges, particularly soil erosion, agricultural run-off, and low energy efficiency, as outlined in the Agricultural

Review. This would entail greater responsibility of the private sector for environmental outcomes; support for environmentally friendly technologies; stronger land tenure rights; and increased consideration of climate change mitigation and adaptation (OECD, 2015d). For example, the private sector could take an active role in designing and implementing industry-wide environmental standards. Foreign investors could help raise environmental standards by introducing advanced technology and supporting technology transfer. Enterprises could also invest in training and education of their employees. Although this recommendation of the Guidelines does not solely apply to environmental matters, environmental matters, especially directly related to human health and safety, are of particular importance.

Finally, as discussed in the section on Disclosure, Ukraine should consider strengthening disclosure requirements and rules, including on environmental and climate change matters. Particularly related to climate change, increased transparency and disclosure would be a concrete contribution to the implementation and the actions outlined in Ukraine's new climate action plan (Intended Nationally Determined Contribution – INDC), which was submitted in September 2015 to the UN Framework Convention on Climate Change (UNFCCC, 2015). Corporate climate change reporting is relevant for design and implementation of long-term actions aimed at reducing greenhouse gas emissions. A majority of G20 countries have some kind of mandatory corporate reporting scheme in place or in preparation that requires disclosure of some climate change related information. As new OECD research shows, this information can be used for multiple policy purposes, from informing consumer decisions to assessing performance against policy objectives, investment analysis and risk analysis. Companies themselves also use the information to increase awareness of climate related risks and opportunities, streamline processes, reduce costs and improve efficiency and mitigation or reversal of negative climate impacts (OECD, 2015e).

Combating bribery, bribe solicitation and extortion

The Guidelines recognise the important role of the private sector in combating bribery and corruption. Enterprises should not, directly or indirectly, offer, promise, give, or demand a bribe or other undue advantage to obtain or retain business or other improper advantage, and should also resist the solicitation of bribes and extortion.

As discussed earlier in this Report, corruption remains one of the main risks for businesses operating in Ukraine. The country ranked 142 out of 175 in the 2014 Transparency International Corruption Perceptions Index. Corruption is cited as the most problematic factor for doing business in the World Economic Forum 2015/16 Global Competitiveness Index, even above political instability. According to a survey by the American Chamber of Commerce in

Ukraine, 97% of members say that the number one issue in Ukraine remains corruption (UT, 2015).

A number of actions have been taken by the Ukrainian government in response to corruption challenges. The Anti-Corruption Strategy of Ukraine was updated for 2014-17 through a consultative process, and, for the first time, adopted as a law. The legislation on the National Anti-Corruption Bureau was passed; the President has appointed the head of the bureau and special investigators have been hired. The National Council for Anti-Corruption Policy has been established and held its first meeting, chaired by the President, in October 2015 (Ukraine, 2015c). In November 2015, the Parliament adopted a legislative package aimed at improving procedures for recovery of misappropriated assets. It includes the Law setting up the National Asset Recovery and Management Agency (Agency). The Ukrainian government benefited from technical assistance from the OECD Anti-corruption Project for Ukraine in drafting the legislation.[6] The package also includes amendments to the criminal procedures regarding asset seizures and to the criminal code concerning special third party confiscations. As introduced by the government, this package aimed to improve Ukraine's track record on asset recovery, which is a cornerstone of anti-corruption policies. However, amendments introduced in the Parliament have limited the Agency's functions of active management of the seized assets and restrained the provisions on seizure and confiscation as compared to the original draft law (EU, 2015a).

Furthermore, as discussed in Chapter 2, the Business Ombudsman institution was agreed on and businesses are now able to report claims of corruption and unfair practices by Ukraine's public agencies. Ukraine has also enacted new policies with the aim of creating a more transparent and efficient environment for public procurement as part of its overall efforts to combat corruption. Last but not least, ongoing efforts to reform the public service as described earlier in this Review are key to the success of current anticorruption efforts.

These developments are encouraging and illustrate the willingness on part of the Ukrainian government to acknowledge the problem of widespread corruption and to take practical measures to address it. One area where future reforms could particularly focus on is strengthening the involvement by the private sector in the implementation and monitoring of efforts to promote integrity in the private sector as outlined in the 2014-2017 Anti-Corruption Strategy of Ukraine (OECD, 2015c). This should entail further simplification of business regulations to reduce opportunities for corruption and eliminating corruption schemes affecting business, taking into consideration the particular risk areas that are evident from the cases submitted to the Business Ombudsman. As related to public procurement, it could also entail arranging regular trainings for the private sector and the procuring entities on public

procurement procedures and prevention of corruption, at both national and local levels. Ukraine could also consider placing restrictions on participation in public procurement for companies involved in corruption offences. The same could be done for other public resources (OECD, 2015c). Finally, introduction of responsibility of legal persons for corruption, if enforced, can be a powerful incentive for self-regulation by the private sector (OECD, 2015c).

Ukraine could also consider introducing legislation to provide protection to whistle-blowers, as suggested by businesses in the 2015 survey on corruption undertaken by the American Chamber of Commerce of Ukraine. Guidelines include a recommendation for enterprises themselves to introduce safeguards in their own policies to protect bona fide whistle-blowing activities, including protection of employees who, in the absence of timely remedial action or in the face of reasonable risk of negative employment action, report practices that contravene the law to the competent public authorities.

Box 5.3. **Promoting integrity in the private sector – anti-corruption strategy of Ukraine**

Section 6 of the 2014-17 Anti-Corruption Strategy of Ukraine identifies the main problems related to the private sector as the "merger of business and government", illicit lobbying of business interests, complicated procedures for business regulations, corruption in control authorities and in the judicial system. The section includes several measures to reduce corruption risks for the private sector, including the following:

- Simplification of business regulations and promoting free market competition;
- Preventing corruption in public administration and the judiciary, law enforcement and state control bodies;
- Debarment of companies involved in corruption offences from the use of public resource such as public procurement, state loans, subsidies, and tax benefits;
- Establishing obligations for external and internal auditors to report about corruption offences;
- Raising awareness of companies about the law on liability of legal entities for corruption offences and enforcing this law in practice;
- Disclosure of beneficiary owners of companies through the Unified state registry of legal entities and individual entrepreneurs;
- Establishing the office of business Ombudsman who would represent the interests of business community in the government;
- Engaging representatives of business community into development of strategy to promote the implementation of anti-corruption standards in private sector

Box 5.3. **Promoting integrity in the private sector – anti-corruption strategy of Ukraine** *(cont.)*

(OECD recommendations on best practices of internal control, ethics and observance of the law and Business principles of Transparency International to combat corruption) and facilitate the development of self-regulation in private sector;

- Ensuring access of entrepreneurs to necessary information, in particular about administrative procedures, rights and responsibilities of entrepreneurs;
- Running pilot projects on "integrity pacts" in infrastructure projects or other projects entailing significant budget expenses through creating trilateral (government – business – civil society) mechanism of control over planning and implementation of such projects.

Source: OECD (2015c) *Anti-Corruption Reforms in Ukraine: Round 3 Monitoring of the Istanbul Anti-Corruption Action Plan.*

Consumer interests

On 2 September 2015, the Ukrainian Cabinet of Ministers approved a regulation "On State Service of Ukraine for Food Safety and Consumer Protection, pursuant to the reforms started in September 2014 On Optimizing the System of Central State Executive Authorities that reorganised and consolidated several state service agencies. The newly established State Food Safety and Consumer Protection Service, which will be directed and coordinated by the Cabinet of Ministers, will focus on food safety, compliance with consumer protection and advertising laws and regulations, sanitary legislation, plant, veterinary and agricultural certifications and issues, as well as market supervision. Regarding consumer protection, the service, among other things, will be able to check consumer protection compliance and impose penalties in case of violations of businesses, as well as to control advertising compliance (Arzinger, 2015).

The Guidelines recommend that enterprises act in accordance with fair business, marketing and advertising practices and take all reasonable steps to ensure the quality and reliability of the goods and services that they provide when dealing with consumers. This includes co-operating fully with public authorities to prevent and combat deceptive marketing practices and to diminish or prevent serious threats to public health and safety or to the environment deriving from the consumption, use or disposal of their goods and services. It also includes supporting efforts to promote consumer education in order to improve the ability of consumers to make informed decisions, better understand the economic, environmental and social impact of those decisions, and support sustainable consumption.

Ukraine could consider supporting and promoting consumer education and information programmes in order to increase the capacity of the civil society to be aware of consumer rights, to monitor government policy, and to promote effective defence of consumer rights. Ukraine could make a particular effort to promote sustainable consumption. This may be an efficient strategy for reaching both economic and environmental objectives, as increased demand for sustainable products would lead to increased supply and investments into sustainable products. One area of particular interest for Ukraine could be organic agriculture in light of the increasing demand for organic products from European countries and from the United States of America (OECD, 2015d).

Science and technology

The chapter on science and technology of the Guidelines aims to promote, within the limits of economic feasibility, competitiveness concerns and other considerations, the diffusion by multinational enterprises of the fruits of research and development activities among the countries where they operate, contributing therefore to the innovative capacities of host countries. Intellectual property rights are of relevance in this regard.

Ukraine's innovation potential is high. According to the 2015/2016 World Economic Forum Global Competitiveness Report, Ukraine ranks 54 out of 140 economies in overall innovation factors. The quality of primary (45) and higher education (54), in particular math and science (38) contributes to this factor. The country's capacity for innovation (52), quality of scientific research institutions (43), availability of scientists and engineers (29) shape the overall innovation potential. Education of the workforce and work ethic are least two problematic factors cited for doing business in Ukraine. At the same time, the country ranks fairly low in the factors determining technological readiness (86), in particular in availability of latest technologies (96), firm-level technology absorption (100), and FDI and technology transfer (117). Additionally, the country's capacity to retain (114) and attract (97) talent is low, although quite improved since the 2014/15 ranking which were, respectively, 132 and 130.

These numbers paint a picture of a highly educated workforce, whose potential is not yet fully tapped due to structural and institutional barriers that prevent Ukraine from realising its full innovative and scientific potential. This can have detrimental effects on the overall productivity and potential of the economy. Perhaps the most urgent policy area for reform that would enable enterprises to positively contribute to Ukraine's scientific and technological potential is employment and labour. Of particular relevance in this regard is the need to address skills mismatch and mobility in the labour market. The labour market is characterised by sharp shortages of some skilled

workers and an excess supply of others. There is a marked education-job mismatch, which, coupled with underinvestment, lack of modernisation in the primary sectors, and outdated corporate governance and management styles, has led to a low aggregate productivity of the economy that is unable to absorb all of its available talent (Aleksynska, 2015).

Ukraine's focus on bridging this skills gap and involving businesses, including foreign ones, in developing and adjusting training and learning opportunities to the market needs would be a worthwhile effort. The government could consider incentivising firms to provide on-the-job training and learning opportunities, as well as providing apprenticeships, traineeships and internships. The Guidelines call on enterprises to encourage local capacity building and human capital formation, in particular by creating employment opportunities and facilitating training opportunities for employees with a view to improving skills levels. Enterprises are encouraged to invest, to the greatest extent practicable, in training and lifelong learning while ensuring equal opportunities to training for women and other vulnerable groups, such as youth, low-skilled people, people with disabilities, migrants, older workers, and indigenous peoples (OECD, 2011a; Aleksynska, 2015).

Furthermore, Ukraine could pursue opportunities for Ukrainian researchers, businesses and innovators to participate in science and technology programmes of other countries. The renewal of the EU-Ukraine agreement on scientific and technological co-operation in March of 2015 is a good example of such an initiative. Under the agreement, Ukrainian entities, including businesses, will be able to fully participate in Horizon 2020, EU's research and innovation funding programme, on equal terms with EU Member States and other associated countries. The agreement gives Ukraine access to the entire research and innovation value chain, from basic research to close-to-market activities. For example, this agreement will allow Ukraine to be able to host European Research Council grants, as well as to apply for financial support for innovative SMEs (EU, 2015b).

Competition

The goal of competition policy is to promote market conditions in which the nature, quality, and price of goods and services are determined by competitive market forces. This benefits consumers and the economy as a whole, as well as enterprises through allowing them to respond efficiently to consumer demand. The Guidelines recognise the importance of compliance with competition laws and regulations by domestic and foreign businesses.[7] Enterprises are expected to carry out their activities in a manner consistent with all applicable laws and regulations and to refrain from entering into or carrying out anti-competitive agreements among competitors. An important aspect of enterprises responsibilities in this regard is co-operation with

competition authorities and promotion of awareness and training among employees on the importance of compliance, particularly among senior management.

According to the WEF 2015/16 Global Competitiveness Index, Ukraine has one of the lowest rankings in the world on the effectiveness of anti-monopoly policy – 136 out of 140. The Anti-Monopoly Committee of Ukraine was heavily criticised in 2014 by government officials and business representatives alike for failures to implement competition and consumer protection measures under the 2002 Law On Protection of Economic Competition (US Dept. of State, 2015).

Although the government has fully implemented the OECD recommendation to raise the capacity of the Committee to provide an impartial and effective protection of the rights and legitimate interests of persons taking part in public procurement, business associations interviewed during an OECD on-site visit to Kyiv in November 2014 noted that the Committee has contradictory practices in determining fines for anti-competitive practices (OECD, 2015c). In response to these widely-voiced concerns, the Committee published recommendations on calculating the fines in mid-September 2015 (Sayenko Kharenko, 2015).

Finally, another area that Ukraine may wish to pay greater attention to in terms of competition-distorting behaviours is the reform of SOEs. Of particular relevance in this regard is the 2014 Law No. 1555-VII On State Aid to Business Entities, which will come into force on 2 August 2017. The Law aims to systemise the allocation of state aid to business entities, and in particular, to improve management of the state funds allocated to and to minimise a negative impact of the state aid on the competitiveness of Ukraine's economy (Ukraine, 2014). As underlined in the Guidelines on Corporate Governance of State-owned Enterprises and the OECD Principles of Regulatory Reform, full administrative separation of responsibilities for ownership and market regulation is a fundamental prerequisite for creating a level playing field for SOEs and private companies and for avoiding distortion of competition. In general, SOEs should not be exempt from the application of general laws and regulations (OECD, 2015b).

Taxation

Ukraine introduced significant tax reforms in 2015 as summarised in Chapter 2 of this report. As related to RBC, tax governance and tax compliance should be treated as important elements of enterprise oversight and broader risk management systems and corporate governance. A comprehensive risk management strategy that includes tax not only allows the enterprise to act as a good corporate citizen but also to effectively manage tax risk, which can serve to avoid major financial, regulatory and reputation risk for an enterprise.

The Guidelines call on enterprises to comply with both the letter and spirit of the tax laws and regulations of the countries in which they operate and make timely payments of their tax liabilities.

Corporate boards, in particular, have a role to play. The Guidelines recommend that boards should adopt tax risk management strategies to ensure that the risks associated with taxation are fully identified and evaluated. This entails proactively developing appropriate tax policy principles, as well as establishing internal tax control systems so that management actions are consistent with board views on tax risk. Businesses are also expected to co-operate with tax authorities and provide information that is required by law to ensure an effective and equitable application of the tax laws. This also includes co-operation by multinational enterprises as related to transfer pricing and the arm's length principle.

Considering the size of the informal economy in Ukraine, the government could consider assessing if taxes and unified social security contributions represent excessive burdens on those in the formal sector relative to the informal sector. As discussed in the section on Employment and Industrial Relations, taxes on enterprises generally amount to 52.9% of profits, with 43.08% going toward single social security contribution (World Bank, 2014). Although this rate is only slightly above European averages, the distribution of the burden between employees and employers is different; employers bear the bulk of these contributions in Ukraine, providing strong incentives to under-report wages and employment (World Bank, 2015b). Ukraine therefore amended its tax code in December 2015 to reduce the single social security contribution (see section on "ongoing tax reforms" in Chapter 2). However, it is too early to assess the impact of this measure as of the writing of this report.

Furthermore, some governments provide incentives to encourage businesses to uptake responsible business practices, including financial incentives such as credits for demonstrated commitment to RBC in government contracting, procurement processes, investment or tax incentives (e.g. to encourage businesses to, for example, invest in low-carbon technologies, or to pursue a social objective). However, such financial incentives, and, in particular tax incentives, need to be considered in the context of the overall tax system and taking into account their full costs and benefits. Such incentives could be an appropriate step once the baseline reforms establishing a functioning and effective tax system have been completed.

Notes

1. In the government's view, MEDT's combined experience, breath of responsibilities, and available resources create the appropriate conditions to establish a robust, transparent and easily accessible NCP that is capable of fulfilling all of its functions effectively. The Ministry's functions are broad and include, among others, implementation of the EU-Ukraine Association Agreement, cooperation with international financial organisations, strategic planning and regulatory policy, public-private partnerships, and trade, investment, and entrepreneurship policy.
2. For instance, the international bonds of Metinvest, the largest company in Ukraine, are issued by Metinvest B.V, a Dutch legal entity. See *www.metinvestholding.com/en/investors/bonds/ebonds2016*.
3. Except for the *International Convention on the Protection of the Rights of All Migrant Workers and Members of Their Families*.
4. Law No. 785-VIII "*On amendments to the Labour code regarding harmonizing anti-discriminatory legislation with EU Standards*" (12 November 2015).
5. See Chapter V of the Guidelines for a full list of measures recommended in this area.
6. See also sections 2.4-2.5-2.6 "Sanctions, confiscation, immunities, and statute of limitations" in OECD, 2015 for broader OECD recommendations on this issues.
7. The term competition law in the Guidelines is used to refer to laws, including both antitrust and antimonopoly laws, that variously prohibit: a) anti-competitive agreements; b) the abuse of market power or of dominance; c) the acquisition of market power or dominance by means other than efficient performance; or d) the substantial lessening of competition or the significant impeding of effective competition through mergers or acquisitions.

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Annex A

Ukraine's exceptions to national treatment in the meaning of the OECD Declaration on International Investment and Multinational Enterprises

A. Exceptions at the national level

I. Investment by established foreign-controlled enterprises

- *Agricultural land*: Foreign legal entities and subsidiaries of foreign companies (Ukrainian legal entities with foreign investment) are not authorised to own agricultural land. However, they can lease agricultural land for up to up to 50 years. Outside of settlements, they can only acquire ownership titles to non-agricultural land plots in case of a purchase of real estate objects located on such land plots.
- *Source*: Law No. 2768-III: Land Code of Ukraine of 25 October 2001 (Articles 81 and 82).
- *Purchase of state-owned land*: The purchase of state and municipal land by foreign legal entities or by joint ventures with participation of foreigners and foreign legal entities is subject to a specific screening procedure. Foreign legal entities must have a representation office in Ukraine. The purchase requires the approval of the Cabinet of Ministers. In the case of state-owned land, the approval of the Ukrainian Parliament (*Verkhovna Rada*) is also required.
- *Source*: Law No. 2768-III: Land Code of Ukraine of 25 October 2001 (Article 129).
- *Forestry:* Forests can be owned only by Ukrainian citizens and legal entities. Foreign legal entities and subsidiaries of foreign companies (Ukrainian legal entities with foreign investment) are not authorised to own forests.
- *Source*: Law No. 3852-XII: Forest Code of Ukraine of 21 January 1994 (Article 13).
- *News information agencies:* Foreign ownership is limited to 35% of the charter capital.

- *Source*: Law No. 74/95-BP "On Information Agencies" of 28 February 1995 as amended (Article 9).
- *Privatisations*: The privatisation programme is open to domestic and foreign investors, except those in which more than 25% of equity is owned by a state (i. e. by a foreign state or by the state of Ukraine) as such investors are barred from participating in the privatisation of state and communal property.
- *Source:* Law No. 2544-XII "On Privatisation of State Property" of 4 March 1992 (Article 8).
- *Air transport*: As of July 2016, licences to operate Ukrainian international air routes rights will only be granted to companies controlled by Ukrainian investors (50 % ownership or more). There are no restrictions concerning domestic air routes rights.
- *Source*: Order No. 686 of the Civil Aviation Authority (*Derjaviaslujba*), adopted on 24th November 2014 (Registration No. 1440/26217).
- *Maritime transport:* Cabotage (i.e. transport of cargo between Ukrainian ports, including as part of international transportation) is reserved to vessels under Ukrainian flags, unless a special permit is issued by the State Inspectorate for Maritime and Inland Water Transport Safety. According to Article 32 of the Merchant Marine code, only vessels owned by Ukrainian citizens or by a Ukrainian legal entity whose shareholders are all Ukrainian citizens can fly the Ukrainian flag. Foreign vessels hired by Ukrainian citizens under a bareboat charter arrangement can fly the Ukrainian flag for the duration of the arrangement.
- *Source*: Merchant Marine code of Ukraine, Articles 32 and 131 (4 July 2013).
- *Television and radio broadcasting:* The Law "On Television and Radio Broadcasting" forbids foreign legal entities, individual entrepreneurs or any non-resident registered in offshore zones (as defined by the Cabinet of Ministers) from setting up, acting as co-founders or being shareholders of TV channels, radio broadcasting companies, or television and radio content providers.
- *Source*: Article 12 of the Law of Ukraine on Television and Radio Broadcasting No. 3759-XII of 21 December 1993 (as amended).

II. Official aids and subsidies

- None

III. Tax obligations

- None

IV. Government purchasing

- Participation by firms registered offshore (as defined by Ordinance N° 143-p of the Cabinet of Ministers dated 23 February 2011) into public procurement biddings is forbidden.
- *Source:* Law No. 1197-VII "On Public Procurement" (20 April 2014), Article 17.

V. Access to local financing

- None

B. Exceptions at the territorial subdivisions

- None

ANNEX B

Measures notified by Ukraine for transparency in the meaning of the OECD Declaration on International Investment and Multinational Enterprises

A. Measures reported for transparency at the level of national government

I. Measures based on public order and essential security considerations

a. Investments by established foreign-controlled enterprises

Trans-sectoral:

Unspecified restrictions exist on foreign direct investment in sectors of strategic importance for national security reasons. The commercial code stipulates that "Ukrainian affiliates wholly owned by foreigners or foreign legal entities cannot be created in sectors of strategic importance for the State Security. These sectors are to be defined by law" Moreover, the law "On the fundamentals of National Security of Ukraine" stipulates that "An increase in the share of foreign capital in strategic sectors of the Ukrainian economy such that it jeopardises Ukraine's economic independence" can be a "real or potential threat to national security". As of January 2016, there is no definition of such sectors of strategic importance to national security where foreign investments would be prohibited or restricted.

Source: Commercial Code, Art. 117.2; Law No. 964-IV "On the Fundamentals of National Security of Ukraine" of 22 July 2003 as amended (Article 7).

Weapons, ammunition and space facilities:

Weapons and ammunition production for military use by foreign-controlled companies is prohibited as well as ownership of space facilities.

Source: Parliament Resolution No. 35/1992 "On the property right of specific items", which forbids foreign legal entities to own weapons, ammunitions and missile or space facilities.

Activities affecting public order, public security and national defence interests:

Ukraine state can apply sanctions against foreign legal entities or Ukrainian legal entities which are under control of a foreign legal entity or natural person (non-resident, foreigner, persons without citizenship), who carry out terrorist activities.

Source: Law No. 1644-VII "On sanctions" of 14 August 2014; President's Decree No. 549 "On decision of National security and defence council of Ukraine of 02.09.2015" "On application of personal special economic and other actions (sanctions)" of 16 September 2015.

Currently sanctions towards the legal entities – residents of the Russian Federation are applied in various spheres of economic activity. Among them:

Television and radio broadcasting:

Legal entities and residents, as well Ukrainian legal entities whose shareholders or ultimate beneficiaries are residents from the Aggressor-State, are forbidden from setting up or being shareholders of any TV or radio broadcasting company, or of any television and radio content provider.

Source: Article 12 of the Law of Ukraine on Television and Radio Broadcasting No. 3759-XII of 21 December 1993 (as amended).

Licensing (30 economic sectors subject to compulsory licensing as defined by Article 7 of the Law "On Licensing of Certain Types of Business Activity"): Entities "under the control of residents from countries undertaking armed aggression against Ukraine and/or creating conditions for armed conflict or use of military force against Ukraine" are not entitled to an activity license. Applicants to a new license must demonstrate the absence of control "of residents from countries undertaking armed aggression against Ukraine and/or creating conditions for armed conflict or use of military force against Ukraine" to the licensing authority. Documentary evidence of such control, as established by licensing authorities, causes the withdrawal of existing licenses.

Source: Articles 6, 9 and 16 of the Law No. 222-VIII "On Licensing of Certain Types of Business Activity" (2 March 2015).

NB. In January 2015, the Ukrainian Parliament recognized the Russian Federation as an Aggressor-state (Parliamentary Resolution No. 129-XIX adopted on 27 January 2015).

II. Other measures reported for transparency

a. Corporate organisation and key personnel

Road transport: Local incorporation is required for road (freight and passenger) transport.

Source: Schedule of Specific Commitments on Trade in Services attached to the Protocol of Accession of Ukraine to WTO. Attached to Law No. 250-VI "On Ratification of the Protocol on Ukraine's Accession to the WTO" of 10 April 2008.

Education services (Primary and secondary, higher education, non-school education establishments): The head of primary and secondary schools, as well as preschools, should be a Ukrainian citizen with a degree in pedagogy and no less than three years of teaching experience. The same requirement applies to all non-school education institutions. The head of any higher education institution should speak fluent Ukrainian and be an academic with at least 10 years of experience in academic teaching positions. The head of a state or municipal higher education institutions shall be a Ukrainian citizen.

Sources: Law No. 1556-VII "On Higher Education" of 1 July 2014 (Article 42); Law No. 651-XIV "On General Secondary Education" of 13 May 1999 (Article 24); Law No. 1841-III "On Off the School Education" of 22 June 2000 (Article 21); Law No. 2628-III "On Pre-School Education" of 11 July 2001 (Article 31).

b. Temporary capital controls (non-exhaustive, selected measures with direct impact on foreign investors established in Ukraine).

Banks are subject to the obligation to monitor foreign currency purchase transactions on a daily basis and service only those that have an express legal basis. The NBU has the right to suspend any transaction it suspects of being illegal and request additional documents regarding any transaction.

The following foreign-exchange transactions are prohibited:

- Transfers of dividends abroad to foreign investors;
- Repatriation of the proceeds from the sale of a security, except in the case of a debt security sold on a stock exchange (NBU verifications required in this case) or in the case of government bonds;
- Repatriation of the proceeds from the sale of corporate rights (other than shares), from the decrease of the charter capital or the withdrawal of a foreign shareholder in a company;
- Premature repayment of loans in a foreign currency under agreements with non-residents, including repayments rescheduled for earlier dates as compared to the original payment schedule.

Source: NBU Resolution No. 863 "*On Resolving the Situation in the Money and Foreign Exchange Markets of Ukraine*" (4 December 2015).

B. Measures reported for transparency by territorial subdivisions

- None

C. Private or mixed monopolies

At the national level

I. Public monopolies

- *Transport of oil and oil products by major pipelines*
- *Transport of natural gas by pipelines*
- *Transmission of electricity via national and international electricity grids*
- *Use of railway lines, dispatcher services and other railway infrastructure*
- *Air traffic control services*
- *Centralised supply and distribution of water*
- *Centralised heating supply*
- *Specialised services in ports and airports, as determined by the Cabinet of Ministers*
- *Burial of domestic waste*
- *Publication and distribution of stamps, conveyance of ordinary postcards and letters up to 50 kilogrammes*
- *Production of ethyl alcohol*
- *Sources*: Law No. 1682-III "On natural monopolies" (20 April 2000), as amended (Article 5). Law 2759-III "On postal services" (4 December 2001), as amended (Article 15). Law No. 481/95 "On the state regulation of Production and Circulation of Ethyl Alcohol, Cognac and Fruit Alcohols, Alcoholic Beverages and Tobacco Products" (19 December 1995)", (Article 2).

II. Private monopolies

- None.

III. Concessions

- Concessions are authorized by the Ukrainian legislation in the following sectors:
  - Exploration, prospecting of mineral deposits and production thereof;
  - Heat production, transport and supply, and natural gas distribution and supply;
  - Construction and/or operation of highways, roads, railroads, runways at airports, bridges, overhead roads, tunnels and subways, river and sea ports and infrastructures thereof;
  - Machine building;

- Water collection, purification and distribution;
- Health care;
- Tourism, leisure, recreation, culture and sports;
- Support of operation of irrigation and land improvement systems;
- Waste treatment and management;
- Electric power production, distribution and supply;
- Property management;
- Urban public transport and municipal parking services;
- Telecommunications;
- Postal services;
- Public catering;
- Construction of residential real estate;
- Funeral services.

- *Sources*: Article 4 of the Law No. 2404-VI "On Public-Private Partnership" (1 July 2010), as amended. Article 3 of the Law No. 997-XIV "On Concessions" (16 July 1999), as amended.

ANNEX C

Statistics

Table C.1. **Estimated turnover of OECD affiliates in Ukraine (2012)**
USD Millions, Data available for EU countries and the USA

European Union (27 countries)	21 414
Germany	4 809
United States	4 700
France	4 212
United Kingdom	1 779
Austria	1 284
Italy	1 158
Poland	890
Netherlands	605
Sweden	470
Finland	306
Hungary	294
Slovak Republic	265
Spain	148
Estonia	82
Norway	81
Slovenia	58
Belgium	46
Greece	13
Czech Republic	6

Source: Eurostat, US Bureau of Economic Analysis.

StatLink http://dx.doi.org/10.1787/888933355937

Table C.2. **Estimated number of employees of OECD affiliates in Ukraine (2012)**

Data available for EU Countries and the USA

European Union (27 countries)	198 483
France	32 820
Germany	32 233
United States	26 100
Austria	24 111
Italy	17 890
United Kingdom	11 586
Poland	10 391
Denmark*	6 822
Slovak Republic	5 458
Sweden	4 402
Hungary	3 132
Greece	2 014
Netherlands	1 960
Finland	1 610
Estonia	1 267
Spain	1 031
Slovenia	782
Czech Republic	230
Norway**	1 069

* 2011.

Source: Eurostat, US Bureau of Economic Analysis.

StatLink http://dx.doi.org/10.1787/888933355946

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