

Investment Climate in Ukraine: Mixed Results of Reforms in 2010-2013

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Foreign direct investment (FDI) has a significant potential to be a motor for economic growth of the country, making an important contribution to GDP growth and improvement of global competitiveness of the country. It has a special importance and stronger impacts on economic development of emerging economies that have a shortage of own resources for funding the economic growth. Ukraine significantly underutilizes the potential positive effects from inward FDI increase. FDI per capita indicator in Ukraine – being in 2012 about USD 1600 – is extremely low compared to the majority of transition/emerging countries, including the Central Europe and the CIS. Adverse investment climate characterized by weak institutions, high level of state capture, and administrative corruption and, as result, high country risks was one of the major reason for low FDI inflow in the country. Regulatory reform is proven tool for removing the barriers to investment. During last years Ukraine has made an attempt to reform regulatory issues area. Reforms included implementation of competitive tax rates and some regulatory changes such as introduction a new Tax Code, Customs

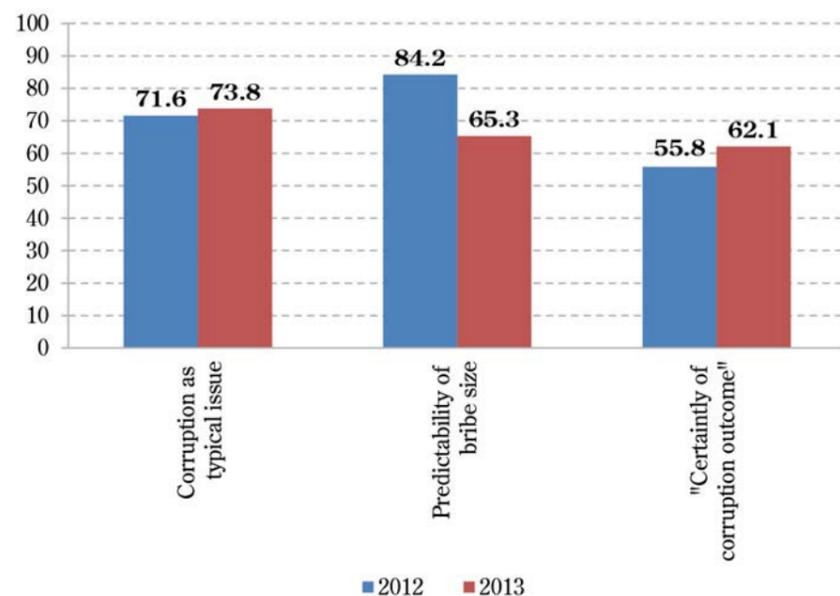
Code, decrease in numbers of permits in some areas etc. Despite these efforts the achieved result is mixed. It is reported by assessments of domestic institutions as well as international ratings.

According to the 2013 Index of Economic Freedom provided by The Wall Street Journal and The Heritage Foundation, Ukraine's economy holds the 161st position in the 2013 Index among 185 countries of the world, meaning economic freedom keeps to be severely repressed in the country. Rule of law measured in this Index by level of property right protection and freedom of corruption is the most problematic for the country. The authors of report mentioned that the reforms have failed to spur broad-based economic development due to poor policies and weak institutional structures throughout the economy associated with corruption, poorly administered laws and contract enforcement, weakly protection of property rights. At the same time the positive movement is also recorded: despite the low level of economic freedom, Ukraine has stability on open markets during last two years, particularly

on trade freedom with a score of 84.4 out of 100 (100 meaning complete freedom), while the potential benefits of trade freedom are undermined by institutional controls on capital and investment¹.

According to the quarterly survey of business managers of the Institute for Economic Research and Policy Consulting, Kyiv-based independent policy think tank, in 2013 enterprise managers traditionally keep on evaluating investment climate as very risky: the share of managers who consider present time to be favorable for investment was 1.3%, 57.1% of respondents perceive current conditions to be unfavorable for investment, 32.3% consider that present conditions are sufficient. Among the main obstacles, that impeded managers in planning investments in 2013, top three positions were occupied by insufficient income (55.5%), high cost of capital (28.2%) and fear of defaults (20.1%). Business environment continue to be perceived as extremely insecure. The share of managers that believe in the ability

Corruption indicators, % respondents



Source: IER Business Survey

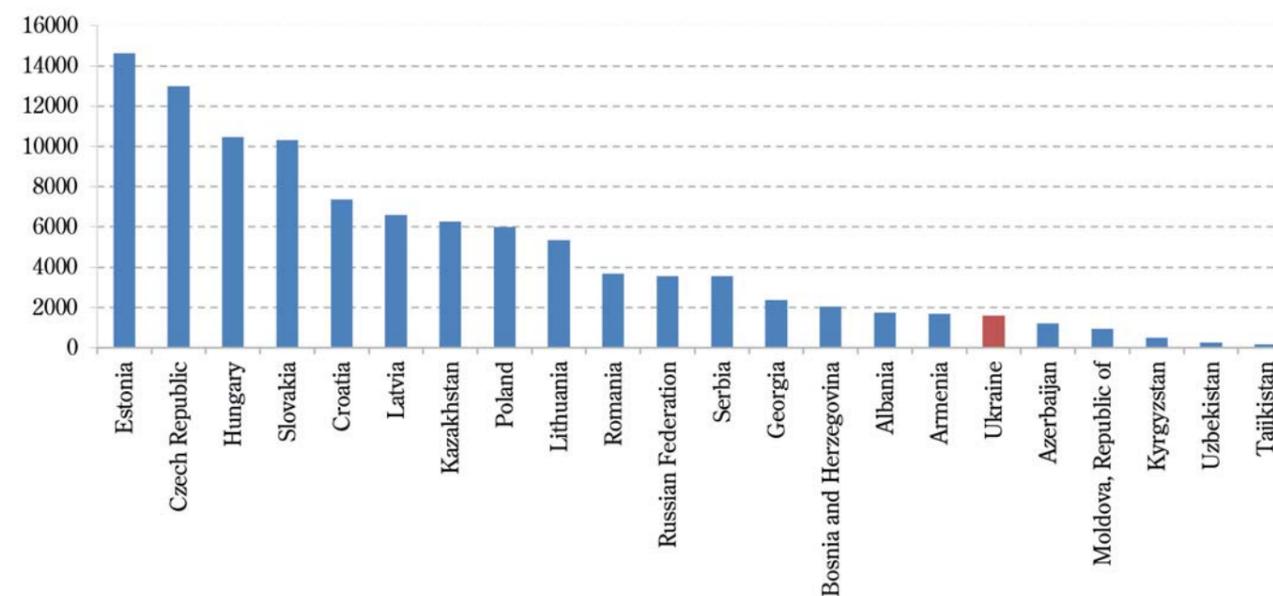
¹ See <http://www.heritage.org/index/country/ukraine>

of the judicial system to enforce their contract rights has decreed from 33% in 2012 to 28.2% in 2013. Only 1 out of 5 respondents trust the judicial system in protecting their business entities and ensuring their personal security, this indicator decreased at 10-years-ago level. The level of corruption in Ukraine perceived to be high. Respondents have been asked whether it is common for the firms like theirs to pay bribes in order "to get things done". The results are striking: the share of respondents reported the bribe to be a common instrument for "smoothing" dealings with public officials constants 73.8% in 2013. During decade of IER's observation on this indicator only during the two post "orange revolution" years the significant drop has been recorded (34.0% in 2005 and 55.1% in 2006), the rest of time the indicator has been about 70 and more percents. 62.1% of respondents are completely sure that after paying bribe required "services" would be delivered as has been agreed before and 65.3% of respondents more or less aware about size of bribe. When considering corruption in Ukraine, the role of informal relations with state officials should be taken into account. Business believe it important to establish strong working relations with those state bodies that have a say in enacting and enforcing business-

related rules and procedures. 50% of respondents consider having informal relation with representative of public authorities to be important to success their business. In 2013 44% of respondents consider having informal relation with State Tax Administration (STA) officials as a "very important" or "important" for their business, followed by the police and other authorities. IER Business Survey also shows that large companies tend to have closer relations with state bodies than SME and think that they are more important for get success. For small and medium firms STA and municipal authorities are the most "important friends", list of "important friends" for large enterprises are headed by STA and central government. When talking about corruption phenomena as part of unfavorable investment climate in the country it is important to remember that corruption is perceived to be a part of everyday life and people as well as businessmen tend to consider it as normal practice. IER Business Survey indicates that despite the pervasiveness of bribing among business, corruption is not even among 10 obstacles to business growth. Corruption has become such common practice that Ukrainian business no longer considers it an issue. This is unfortunate but should by no means be seen as a reason for do nothing in this area.

Based on IER Business Survey results assessment of the overall business conditions in Ukraine during 2012 and 2013 fluctuated but predominantly was pessimistic: the number of enterprises' managers that reported an improvement of business environment remained lower than the number of those, who pointed to the worsening of business climate in the country. Similar tendency is recorded by EBA Investment Attractiveness Index: at the end of 2012 70% of respondents saw a downward trend in investment attractiveness, as no positive changes have taken place and Ukraine's business climate was assessed at 2.12 points out of 5 - the lowest score for four years.² According to recent July 2013 IER Business Survey the quality of business climate remains low: 23.3% of respondents consider business climate to be poor one. Moreover within next half a year the respondents are expecting the further decline of the quality of business climate due to excessive regulations and lack of finance. The share of managers, according to whom the unfriendly regulatory climate is a significant obstacle to business growth, has increased severely in July 2013 compared to April 2013 (from 46.7% to 55.6%). It has happened due to dramatically growth of such component of this complex indicator as "High regulatory burden" (from

FDI inward stock per capita, by economy 2012



Source: UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics), author's calculations

² See <http://indices.eba.com.ua/en/ii/wave17.html>

33.5% in April to 43.8% in July), two others components of indicator remains without significant changes: "Corruption" is slightly grew from 6.6% to 7.3% and the impediment "Frequent changes of economic legislation" slightly drop from 17.2% to 15.3%. Totally, according to the results of July 2013 survey low demand (56.9%), unfavorable regulatory climate (55.6%), lack of finance (liquidity problems) (54.0%), excessive taxation (47.3%), high interest rates (42.2%) and large competitive pressure (35.5%) were named as major impediments of business development.

At least at the first glance, the results of the World Bank Doing Business 2014 rating are very encouraging for Ukraine and are in contradiction of studies presented above. In previous year Doing Business 2013 Rating Ukraine³, were recognized among ten countries as one of the most improved in easiness for doing business due to implemented regulatory reforms on starting a business, registering property and paying taxes, nevertheless Ukraine's overall rank was still low – 137 out of 185 economies. In this year the country has made the greatest improvement in its ranking in the Doing Business 2014: it has jumped by 28 positions from the 140th place to the 112th among the 189 nations improving ranking in eight out of ten areas. Ukraine's rapid advancement in the rating in 2014 happened mostly due to simplification of procedures for obtaining construction permits. It took 544 days and required 29 procedures to obtain these permits five years ago. The number of procedures shrank to 10, and the time needed to complete

them shortened to 73 days. As a result, in terms of "Dealing with Construction Permits", Ukraine has risen from number 186 in the 2013 ranking to the 41st place in the 2014 report. Another area of significant improvement is Registering Property, here the progress has been recorded by decrease in number of procedures from 10 to 8, shortened time from 70 to 45 days as well as reduction of costs. On the other hand, Ukraine's rating on a number of topics remained very low. Despite new progressive Custom Code has been in power more than year no significant changes are recorded in Trading Across Borders area, Ukraine's rank is 148 out of 185. Doing Business recorded import procedures, which include document preparation, customs clearance and technical control, ports and terminal handling, inland transportation and handling, take 28 days and cost USD 2.505, in case of export it takes 29 days in value of USD 1.930. It is worth noted that 8 documents are needed by the trader to import the goods across Ukrainian border, for exporting goods 6 documents are demanded. Documents preparation for goods is the lengthiest part in import procedures, while cargo handling and transportation is the most costly part. Despite the reduction of the amount of time business spends to pay taxes from 491 to 390 hours just over the last year, Ukraine had improved in the rankings in terms of "Paying Taxes" only from 168 to 164. Ukraine's 128th place in "Protecting Investors" reflects the problems with investor protection. Long delays and high costs of resolving insolvency are not conducive to doing business in Ukraine, which resulted in Ukraine's 162nd position in this area.

In this respect is important to mention that improvement in Doing Business rating as well as other international ratings became a state policy priority. However, the Government focused on achieving progress in indicators that are easiest to improve and impact overall rating the most. But taking into account that Doing Business rating is combination of ten topics, the rapid rise has happened only in a few areas and it does not necessarily mean improvement of overall investment climate in the country. This year a ranking implies that such approach seems not to care much about overall business climate in Ukraine. Implementation regulatory reforms on starting a business, simplification of procedures for obtaining construction permits and registering property have been recognized on rating positions. At the same time reforms in paying taxes and custom regulations did not effected on rate of the country. The improvement position of the country recorded in Doing Business 2014 was not supported by results of business opinions surveys. FDI indicators remained at low level. There were no changes in such fundamental issues for attracting foreign inventors as securing property rights and protection of investors. Last but not least 78.1% of respondents IER Business Surveys consider that the decrease of payroll on wages would be the most important governmental steps in order to improve business conditions in the country and 43.9% of respondents believe that equal business conditions for all business entities is in key importance to create a favorable business climate in the country.

Table Importance of informal relations with state authorities for business success*

	2008	2009	2010	2011	2012	2013
STA	17.2	18.2	29.3	22.7	48.6	44.7
Police	16.2	17.2	25.1	19.6	40.5	39.5
Municipal authorities	15.5	17.2	27	20.7	38.1	36.9
Oblast authorities	12.7	14.3	26.1	21.4	36	38.7
Central Government	13.1	14.4	24.7	19.8	33.5	38.9
Total	18.5	20.4	29.5	27.4	52.2	49.7

* Percent of respondents that assess relations as "important" and "very important"

³ See <http://www.doingbusiness.org/reports/global-reports/doing-business-2013>