

# Institutional Reforms is Key Driver of Investment Attractiveness Improvement in Ukraine

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*Ukraine is at vital crossroad, the current political situation is perhaps an ideal for the implementation of reforms. EuroMaidan resulted in a change of political regime. The change in power brought about a government far more dedicated to the creation of an environment favourable to business. Corruption, violation of property rights and excessive business regulation are key problems in the Ukrainian business environment. Today Ukraine is in a situation in which it has never been. On the one hand, it is in deep economic crisis and there is urgent need to reform and rebuild key state institutions. On the other hand, the war in the East requires resources, and mobilizes the forces of society. The military operations in the east, the military invasion and aggression of the Russian Federation have left a significant mark on the processes taking place in the country, including reform of the business environment. In this situation implementation of institutional reforms such as reform of tax system, deregulation and trade and labour liberalization is in key priority for future development of country.*

## INVESTMENT CLIMATE, IMPEDIMENT TO BUSINESS GROWTH AND EXPECTED REFORMS

According to the 2015 Index of Economic Freedom provided by The Wall Street Journal and The Heritage Foundation, Ukraine's economy holds the 162<sup>nd</sup> position in the 2015 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 were the most problematic for the country during last years. In 2015 the index score has dropped, reflecting declines in eight of the 10 economic freedoms with especially deteriorations in property rights, the management of government spending, and investment freedom. The investment regime remains closed, with foreign investment competing with large state-owned enterprises. A rigid labor market and bureaucratic business regulations inhibit the development of a dynamic private sector<sup>1</sup>.

Low demand and an unstable political situation (a broad category including the armed conflict in Eastern Ukraine as well as political destabilization) are two top obstacles for business in February 2015<sup>2</sup>. With a backdrop of these impediments, the most expected reforms are establishing equal rules and conditions for all business, and efficient law enforcement. A simplification in the procedures of tax administrations, an abolishment of newly introduced VAT accounts and a decrease in the rate of single social contributions are also among the most expected measures in economic reform. It is important to mention that in the current geopolitical situation, due to Russian military aggression against Ukraine, the priority of business regarding reforms has changed. Thus according to the IER Survey<sup>3</sup> in August of 2014 among the top reforms expected by businesses non-economical or regulatory measures are prominent. First place is given to the successful completion of military operations in the ATO area (76.9% of respondents). Parliamentary

elections (41.0%) and corruption (40.1%) hold the 2<sup>nd</sup> and 3<sup>rd</sup> places on the list of priority measures. Fourth place was given to greater government transparency (26.3%). Fifth place was a reduction of the tax burden (24.4%). 23.7% and 21.8% of respondents respectively expect an increase in transparency of government procurement and improvement of the regulatory environment. Approximately twenty percent support such activities as judicial reform (19.9%) and simplification of the tax administration (19.6%).

## TAX REFORM

High tax burden is key problem of Ukrainian business environment since getting independence in 1991. Current principles of the tax system in Ukraine are defined in the 2010 Tax Code of Ukraine, with amendments, adopted during consecutive years. Tax reforms were important part of the agenda each of the Government in the country. Unfortunately implementation gap was the main impediment of changes.

There are 23 taxes and contributions, 18 of which are national and 5 local. The main taxes in Ukraine are the following: Corporate Income Tax (2.7% of GDP); Value-Added Tax (10% of GDP); Personal Income Tax (5.3% of GDP), Single Social tax which is going to social security fund. Other principal taxes include land tax, royalties for the extraction of oil, natural gas and gas condensate, single tax, environmental tax. Ukrainian employers are liable to pay social security contributions and personal income tax on behalf of their Ukrainian and foreign national employees.

Now the tax reform is among key reforms for Ukraine. Yatsenyuk Government has an ambition aiming to decrease the number of taxes from 23 to 9. The Government also plans to unite the tax reporting with accounting and harmonize it according to International standards of financial reporting. Another change is to introduce the new system of VAT administration. The following issues are in the agenda of Yatsenyuk Government: simplification of the reporting and introduction of e-reporting in full scale, especially for SME usage. The aim of these planned changes is to increase cost effectiveness of tax administration. Legalization of salary is expected to happen using two ways. The first is reduction of the rate of Single social tax from 41%<sup>4</sup> to 15%, and the second, increase of sanctions, including administrative and criminal ones, against "out of pocket" salary payment. The last but not least, is reduction of tax pressure on small and medium business (SME) via decreasing the rate of single tax and forbidden of inspections for SME during 2015-2016.

## FOREIGN TRADE LIBERALIZATION AND CUSTOMS REFORM

In mid-2012 the new Customs Code has been enforced. According the Code there should be significant reduction in duration of customs clearance and number of documents, implementation of electronic declaration, streamlined customs valuations etc. Despite progressive Custom Code no significant changes were recorded. The custom procedures were

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very costly for business in term of time and money. In Trading across Borders in World Bank 2015 Doing Business, Ukraine's rank is 154 out of 185<sup>5</sup>. Doing Business recorded that 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 2.455, in case of export they take 29 days and costs are USD 1.880. 8 documents are needed by the trader to import the goods across Ukrainian border, for exporting goods 9 documents are demanded.

Trade facilitation is a one of key measure for liberalization of foreign trade in Ukraine, especially in the field of efficiency of customs procedures and control. The most demanded measures are simplification of customs procedures, straggle against corruption on customs, and reform of customs service itself. The reforms should ensure "one-stop shop" for the clearance of cargos and reduce power of other authorities except Customs to intervene operations. Moreover, further regulatory changes are advocated by business associations, e.g. unification of transit documents, establishment of "single windows".

Customs reform and integration into the EU customs community is one out of 64 priority reforms of presented by National Council for Reforms as Strategy 2020<sup>6</sup>. In short terms prospective, the Government and non-government actors' priorities of reforms states anticorruption measures as priority for improving situation in this area. According to recently adopted by Government Action plan of deregulations of business activities and simplify regulations, the number of mandatory documents required for the implementation of administrative procedures during import/export will reduce from current numbers to 3-4 documents<sup>7</sup> during 2015 year.

## DEREGULATION

Deregulation and simplification of doing business is also among top priorities of reforms for all of key stakeholders in Ukraine. Deregulation and entrepreneurship development is one out of eight immediate reforms according to National Council for Reforms as Strategy 2020<sup>8</sup>.

According to National Council of reforms<sup>9</sup> under the Strategy 2020 the following measures for deregulation and simplifications of business procedures should be implemented: simplification of business registration; namely decrease time on business registration to 2 days, harmonization norms in constructions with EU legislation, decentralizing of construction, deregulation of land usage, fixing property rights problems, harmonized trademarks and licensing issues with international standards.

According to the Government program<sup>10</sup> the main idea of deregulation is to reduce interaction between business and state. Particularly, it is expected to drop the number of inspection from 56 to 28; the number of state bodies' functions related to business regulation should decrease from 1032 to 680. In addition, it is expected to short cut the list of business activities that required licenses. Important issue is change of the system of standards. According Association Agreement with EU, Ukraine will adopted 1500 national standards harmonized with EU ones and repeal standards of former USSR that still in Ukraine. Development of e-database with full text of standards (about 28,000) is among measure aimed at deregulations.

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

<sup>2</sup> IER Survey, February 2015 [http://www.ier.com.ua/en/proekt\\_dilova\\_dumka/](http://www.ier.com.ua/en/proekt_dilova_dumka/)

<sup>3</sup> IER Survey, August 2014, <http://www.laender-analysen.de/ukraine/pdf/UkraineAnalysen136.pdf> (in German) or <http://www.ier.com.ua/ua/publications/articles/?pid=4595> (in Ukrainian)

<sup>4</sup> The is an average weighted rate of this tax, see page below.

<sup>5</sup> <http://www.doingbusiness.org/data/exploreconomies/ukraine#trading-across-borders>

<sup>6</sup> <http://reforms.in.ua/2020/Strategy2020updEN.pdf>

<sup>7</sup> Item 105, <http://reforms.in.ua/2020/Strategy2020updEN.pdf>

<sup>8</sup> <http://reforms.in.ua/2020/Strategy2020updEN.pdf>

<sup>9</sup> <http://reforms.in.ua/2020/Strategy2020updEN.pdf>

<sup>10</sup> Program of Cabinet of Ministers of Ukraine [http://www.kmu.gov.ua/document/247814370/Program\\_fine.pdf](http://www.kmu.gov.ua/document/247814370/Program_fine.pdf)

Government's recently adopted Action Plan of deregulation of business activities and simplifying regulation bases<sup>11</sup> consists in 176 actions for 2015 year. Among the most urgent actions that should be implemented in the first quarter of 2015 are:

1. the improvement of procedures related to permits, namely by introducing the procedure of issuing permits using telecommunications ("electronic summation") and reducing the number of documents that entity must submit documents to obtain permits;
2. deregulation of food prices;
3. abolition of licensing of export and import of discs for laser reading systems as well as licensing of other 19 type of business activities and 28 type permits;
4. facilitation of the public procurement process, namely introducing participants who are declaring procurement procedures with all necessary information and checking this information without user involvement;
5. determination of the list of administrative services and corresponding fees.

In the first quarter of 2015 is expected that the "Strategy of Development of Technical Regulation 2020" will be approved. This document is an essential for implementation of Association Agreement between Ukraine and EU and aims to improve business environment.

Improving position of Ukraine in World Bank Doing Business rating is one of the indicators of reforms' success. That is why the special part of Action plan is devoted directly to improving situation in area measured by Doing Business. It covers such measures as new business registration, simplification of procedures for obtaining permits on construction, including reducing the period of issue technical conditions of 15 working days to 10 working days, simplification of procedures of property registration, improving of investor protection, simplification of procedures for accession to power lines, simplification of procedures for contract enforcement through the courts, and improving resolution of insolvency.

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The reform on deregulation area has already actively started. For example, at the beginning of April of 2015, the President of Ukraine signed the Law "On amendments to some legislative acts of Ukraine on deregulation of business (deregulation)." The main purpose of this law is the deregulation of economic activities, which should enable Ukraine to increase in the rating Doing Business. Also the deregulation legislation of Ukraine will be brought into line with EU legislation. In particular according to this Law responsibilities of public servant for improper perform duties on licensing has increased. Also there will be reduction the numbers and improving quality of regulatory procedures of the business activities.

The reform has a chance to get success in short term prospective due to government, business, and non-governmental actors declared a more or less consensus position on needs and tools of the reform on area of deregulation and business development.

#### **ROLE OF THE BUSINESS AND NON-GOVERNMENTAL ACTORS ON SETTING REFORM AGENDA**

It important to mention that the first time in Ukrainian history, the Government is intensively pressured by society to conduct reforms. Demand for reforms in Ukraine is driven by civil society and business. Namely these actors were the main pushing powers towards reforms in 2013 which led to Maidan. And now public activists who

represent civil society and business are an important part of the reform process. The agenda of reforms proposed by non-governmental actors usually include deregulation in order to improve the business environment, particularly reducing the number of regulatory acts regarding business, increasing the efficiency of state regulations, decreasing expenditures on public servants dealing with regulations, tax reforms, and ensuring the security of property rights. Special attention is paid to DCFTA implementation efforts and measures aimed at expanding Ukrainian business activity in EU markets.

Business is also an important player in setting the reform agenda. Business associations try to bring business interests into the reform process. Active associations in this regard are international ones. At the same time the role of local business associations, and small and medium sized businesses, are also important.

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<sup>11</sup> <http://reforms.in.ua/initsiatyvy/7-2-Deregulation-initiatives-plan-2015-02-12.pdf>

<sup>12</sup> [http://www.kmu.gov.ua/document/247814370/Program\\_fine.pdf](http://www.kmu.gov.ua/document/247814370/Program_fine.pdf)