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A Contribution to WDR 2005 on Investment Climate, Growth and Poverty

Investment Climate Reform in Ukraine

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Key Messages

1. Estimates of cost of the poor investment climate in Ukraine suggest that the regulatory burden on business takes 14% of a manager's time each month. This varies from region to region – from 9% to 19%.
2. Whilst it is clearly important that the national legal and regulatory framework should be sound, there is evidence from Ukraine that it is possible for improvements to be made to the climate for investment at the regional and local level, and for this to lead to relatively large increases in economic growth. There is also evidence that changes in regional leaders can lead to such gains being quickly lost – so policy needs to be consistently implemented over a long period of time.
3. A strong leader is always required to force through reform to the investment climate and to brush aside local objections.

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Introduction

1. Productive investment by new and existing businesses plays a critical role in growth and development. The level of that investment is influenced by a range of government policies, regulations and institutions that shape the opportunities, costs and incentives faced by firms and entrepreneurs.

2. Ukraine has the second largest landmass in Europe and a population of 48 million. The present administrative structure of the country comprises of 24 regions (Oblasts), two Oblast level cities and one autonomous republic, Crimea. Oblast Administrations are headed by Governors, appointed (and dismissed) by the President; they are essentially regional replications of Central Government.

3. Since 1991, the country has suffered economic and social collapse on a scale rarely experienced anywhere else in the world in peacetime. GDP totalled almost $50 billion (approximately one tenth of Russia) in 2002, having grown by 9 per cent in the year 2001. Real GDP growth in the first nine months of 2002 was 9.1 per cent. However, estimated GDP for 2002 will be only 65% of the 1990 figure. GNP per capita was estimated at $735 in 2002.

4. However, these official figures may overstate the fall in output; the informal economy has been expanding beyond the reach of government regulations, taxes or statistics. The Ministry of Economy & European Integration itself now estimates that 60 per cent of actual total GDP comes from the informal economy – it could be higher.

5. The development of the private sector, particularly new SMEs, has been much slower in Ukraine than in neighbouring Central European countries. It is estimated that there are only 5 active SMEs per 1,000 population compared to 10 in Russia and 35 in Poland. A recent USAID survey estimated that there were a total of 3.1 million businesses and self employed people, including 1,185,000 being self employed.

6. The Government of Ukraine (GoU) estimates that in 2001 there were 300 (registered) small firms per 10,000 persons in Ukraine compared to between 650 and 700 in Great Britain, Italy and Germany. The figure rises to more than 500 if the informal estimates of the self-employed are included.

7. In 1997, the GOU created the State Committee for the Development of Enterprise, re-created as the State Committee for Regulatory Policy and Entrepreneurship (SCORPE) in 2000. Its role is to formulate and implement state policy on entrepreneurship development and support and to remove legal and administrative hurdles to business investment and growth. SMEs in Ukraine operate within a legal and regulatory framework which includes a mixture of new and old laws and Presidential decrees attempting to provide an environment to encourage SME growth.

Regulatory Best Practice Criteria

8. DFID commissioned a study of the links between regulation and SME development in 10 countries in 2002 which has become something of a model for subsequent DFID work on improvements of the investment climate.[1] The following table measures Ukraine in terms of the Bannock Study criteria:

MACHINERY	
One Lead Ministry for PSD	Yes (1)
Also responsible for deregulation	Yes (1)
Extensive consultation with private sector	Yes
SME Act	Yes 2001
Decentralised policy implementation	Yes
Monitoring of policy results	No (2)
Policy formalisation & execution capacity	Yes but often weak (2)
Macro-economic reforms	Yes (3)
Reduction in cost of business registration and licensing	Yes
Effective rule of law	Depends who you are
Collateral recovery possible	In principle, yes
Title to land ownership/use	In principle
Employment law simplification	No

MACHINERY (continued)	
Taxes lowered, simplification	Yes
Removal of barriers to finance provision	Yes
Extensive privatisation	Yes (3)
Simplified foreign trade procedures	No
Inward Investment facilitation	No (4)
Delivery of regulatory services, e.g. One-Stop-Shops	Yes (5)
Effective regulatory enforcement	No (6)

<u>Notes to the Table:</u>

(1). SCORPE is not a Ministry as such but a State Committee which reports to the Ministry of Economy and European Integration.

(2). Capacity for effective development, implementation and monitoring of policies for SME development varies widely, but in many of the 27 Oblast level bodies, it is very weak and, at best, staffed by bureaucrats from the Soviet time.

(3). Macro-economic reforms and privatisation have proceeded, especially since 1999, but there are extensive, and often hidden, linkages between state power and the privatised industries, and such industries, especially those perceived to be of strategic national importance (including coal, steel, metals, electricity, telephones) remain under tight state (central) control. Businesses in these and other sectors can be heavily subsidised, often via the non recovery of unpaid bills and taxes to the state sector.

(4). National and regional promotion to attract FDI does exist but very much on the basis of a supply side approach, emphasising what investment opportunities the country wants to sell, and not attractions from the point of view of the foreign investor.

(5). Such services do exist but are not implemented comprehensively across the country and rarely include effective rationalisation of services.

(6). See main body of case study for elaboration of this point. Effective and consistent enforcement rare, and influenced by rent-seeking behaviour by officials.

Investment Climate Reform in Ukraine

9. Business in Ukraine is negatively affected by an unfavourable business environment, characterised by a labyrinth of regulations, complex requirements for all businesses to get licences and permissions and the ability of many state bodies to arrive at a business, unannounced, for inspections to confirm compliance. Import and export of goods is very difficult and can be expensive. All this is founded on an ever-changing legal basis, which many, especially outside Kyiv, are not up to date with.

10. The Government of Ukraine started work to improve the climate for business in 1997, with the establishment of SCORPE. This was done in part by GoU, concerned about the falling GDP and the increasingly poor comparison with business performance in Poland. The GoU was stimulated and supported by donors, particularly:

(i). IFC from 1998 – via an annual series of surveys of the business environment, attempting to show the sheer complexity of the regulatory climate for business in Ukraine, especially SMEs[2]. The surveys also provided a useful role in showing the marked regional variations in the business climate from Oblast to Oblast;

(ii). DFID from 1998 with support for SCORPE, to develop the institution into a more powerful body to support SME growth and to push for deregulation at the national level. This project support has now continued at the regional level via projects in Donetsk, Lviv and Luhansk – specifically providing advice to the Oblast State Administrations on how to improve the enabling environment for business;

(iii). World Bank, which initially launched the Private Sector Development (PSD) Loan programme via a Japanese grant funded pilot programme in four Oblasts in the west of Ukraine in 1999, specifically focusing on the improvement of a number of indicators reflecting the enabling environment, The Loan has now been approved and is likely to become operational from April 2004 in six Oblasts. DFID has launched a separate but parallel programme of support for the Bank's loan;

(iv). The PSD Loan includes a Cost of Doing Business Survey, launched in July 2003, but planned as a bi-annual measure of the change in the regulatory climate at the oblast level;

(v). USAID, initially from 1996 via the Newbiznet programme, which, in its latter stages focused on the development of business associations as pressure groups for change at the regional, and particularly local, level, and from 2000 via the BIZPRO programme, which has continued the work with administrations at the regional and local level in eight focal oblasts, largely in the west of the country;

11. Much of the work of SCORPE over the last six years has focused on ensuring new laws are "business-friendly" and in getting the eventual approval of new laws on registration and on licensing, which will be law from 2004. A Single Unified Tax has been introduced, which sets a standard rate of tax for small firms, covering VAT, profit taxes, local taxes etc.[3]

12. More success has been had at the regional and local level. In a handful of regional examples, administrations have created formal or informal "one-stop-shops".[4] Sometimes these just deal with the registration process, sometimes they act as a true single point of contact for all business problems, for example in Ivano Frankivsk. DFID is strengthening the capacity of Chambers of Commerce in two locations to provide such a pressure group on behalf of business.

13. USAID in particular reports success from many of its 32 focal rayons and municipalities (local level administrations) – in some increases in budget receipts have reached hundreds of per cent, largely from a relaxation on permits for local businesses – taxis, kiosks etc. Much of this is based on legitimisation of activities from the grey economy. General economic growth has also increased.

14. Recent DFID project research from Donetsk suggests that the introduction of such one-stop-shops may have increased business registrations by up to 30%.[5]

15. All agree that the biggest issue for the regulatory environment for Ukrainian businesses is its unpredictability. Regulations are often confusing or unclear, many

regulatory activities lack a comprehensive legislative basis, information is lacking and procedures are unnecessarily complex. In addition, of course, Ukraine has a legal system, which still reinforces the privileges of the strong rather than protecting the weak.

16. The lack of clear and accurate information for business on the current state of the law assists corrupt officials. A simple, but important policy has been to develop intermediaries such as the Chambers of Commerce, to provide such good information, often via hot-lines, which the USAID projects have introduced.

17. IFC have attempted to cost this regulatory burden on business, by means of an Enterprise Manager Time Tax, calculating the amount of a manager's time in a Ukrainian business dealing with these regulatory bodies. In 2002 this was 14%, an improvement on 2001 and 2000 when it was 16%. This equates to 6 hours in any 40 hour week, and can also be seen as time that is not available for the manager to maximise the growth of the business. This time tax varies across the country from 19% in the worst to 9% in the best oblasts.

18. One of the biggest burdens reported by the surveys is inspections, which are often, of course, a vehicle for petty corruption on the part of state officials. In 2002, the average Ukrainian business was inspected 14 times, a figure which has remained static since 1999, although in 1998 and 1997 it was 22 and 30 inspections respectively. Regional variations for 2002 range from 23 in Donetsk to 7 in Zaporizhie and Chernivtsi. The Luhansk Chamber, for example, has started a system whereby a business requests a visiting inspector to sign a formal document to state that the visit is authorised. This has led to over 50% of inspectors leaving without signing.

19. The four World Bank PSD Loan pilot Oblasts have shown marked improvements in their regulatory environments between 1999 and 2002 – one reducing the number of inspections from 21 to 9, another from 17 to 10.

20. A further problem for business is the interference of the state in the day to day workings of individual enterprises. This can take the form of:

(i). Unfair competition from a subsidised state-owned enterprise (SOE)6;
(ii). Interference, or even closure, of a business by state institutions and inspection bodies who are controlled by competitors;
(iii). Pressure on local businesses from regional and local state administrations to deliver services on their behalf for nothing – for example, on restaurants to host functions for visiting dignitaries, or on bus companies to run school transport. It is, of course, unwise to refuse.

21. Much of the problem should be seen in its historical context. Public officials have been corrupt in Ukraine since the Seventeenth Century and Ukrainians do not necessarily expect anything less. The corruption and rent seeking behaviour which is at the heart of the problems with the enabling environment is stable and the "tariffs" are well-known. Some of it is coercive, but most is collusive. Many Ukrainian entrepreneurs take the view that if they have to pay bribes, they will not pay taxes – more than 60% of the economic activity is in the shadow economy, compared to less than 10% in the UK or US. For poverty reduction, of course, this absence of tax payments into a state budget, which can be used for redistribution, is disastrous.

Policy Conclusions

22. The following policy conclusions can be drawn from this case study:

(i). The biggest problem of the regulatory environment for Ukrainian businesses is its unpredictability. The lack of clear information on the current status of the law, on the ground, is a major problem.
(ii). Whilst it is clearly important that the national legal and regulatory framework should be sound, there is evidence from Ukraine – especially from the pilot work for the World Bank PSD Loan - that it is possible, on the ground, for marked improvements to be made to the enabling environment7 and for this to lead to relatively large increases in economic growth There is also evidence that changes in regional leaders can lead to such gains being quickly lost – so policy needs to be consistently implemented over a long period of time.
(iii). In this regard, a strong regional or local leader is always required, to force through reform and to brush aside – even bully – objectors. Such persons

have to take a medium-term view that the tax income which will result from economic growth in three to five years time is worth upsetting people now. They are, unfortunately, rare. Further, evidence now exists that the departure of such people can put reforms into reverse.

(iv). The problems with the enabling environment affect Foreign Direct Investment (FDI) and local investment similarly. The risk of expropriation is the same. It is common in many countries that foreign investors are protected and nurtured after the first wave of investment, as the goal of any FDI policy is to receive second and even third waves and for the investor to start sourcing locally. It is striking in Ukraine that such protection on the ground is absent. Large foreign investors suffer the same problems from corrupt and rent seeking officials – often worse as they are larger.

(v). It is really important that state officials at the national and regional levels properly understand the real nature of SME development and the high levels of entry of businesses into and exit of businesses from trading – the so-called “churn” factor.8 It is essential that policy allows firms to start easily and stop trading easily, either as a result of bankruptcy or for other reasons.9

(vi). Anti-competitive pressure via local and regional authorities which are “in the pocket” of certain factions is a major problem for Ukrainian business. It is essential therefore that the enabling environment reforms are tackled comprehensively – as governance and enterprise issues – and that the issue is seen as a long-term one. Such behaviour can be placed in the historical context of the development of capitalism in many countries.

(vii). Donor work on improving the climate for investment has been important for Ukrainian authorities, in particular by explaining what the problem is, by offering successful case studies as role models from relevant countries and detailing policy options to assist in making improvements. Again this has been most successful at the regional and local level. These donor interventions have been co-ordinated to a limited extent, for example DFID supporting the World Bank PSD Loan.

Notes

[1] Indigenous Private Sector Development and Regulation in Africa and Central Europe: A 10 Country Study : Bannock, Gamser, Juhlin and McCann for DFID (2002)

[2] For example, the time taken to register a new business, the number of bodies able to physically inspect a business

[3] As this report was written, however, it was announced that this tax was being withdrawn

[4] Or “One Window” in Ukrainian

[5] The system only allows registrations either where the firm operates or the registering person lives.

[6] In Ukraine, many SOEs continue to receive large subsidies in the form of unpaid taxes.

[7] Whilst this is of course difficult to measure objectively, local investment and job creation have increased at the local level in a number of examples by between 15% and 35% in the 18 to 24 months following the introduction of improvements to the business climate. Some evidence from Donetsk also suggests increases in new business registrations of more than 30% following simplification of the procedure.

[8] In the UK in 2001, for example, the increase in the stock of businesses of 100,000 masked new starts of 750,000 and the exits of 650,000.

[9] Only 15% of businesses in Britain are forced to cease to trade – the rest exit the market voluntarily.