Executive Summary and Policy Recommendations

The 2011 OECD *Investment Policy Review of Ukraine* assesses the country's ability to comply with the principles of liberalisation, transparency and non-discrimination and to bring its investment policy closer to recognised international standards such as the OECD Declaration on International Investment and Multinational Enterprises (MNEs). Based on the OECD Policy Framework for Investment, the *Review* considers the interaction and coherence of investment policy with other areas such as investment facilitation, trade and competition policy as well as responsible business conduct practices critical for enhancing the investment climate. It also highlights specific challenges faced by Ukraine to attract investment in support of energy efficiency. The *Review* shows that Ukraine has made progress in developing a legal framework for attracting foreign direct investment (FDI), but implementation problems continue to affect domestic and foreign investors alike and prevent the country from mobilising private investment commensurate with its economic potential and investment needs.

In line with recent world investment trends, Ukraine's FDI inflows declined considerably in 2009 and picked up in 2010 but remain below pre-crisis levels. Financial services and manufacturing together absorb 62% of the total inward FDI stock. EU27 countries are the main source of Ukraine's FDI, representing over 75% of the total stock. Foreign investors have participated in a number of privatisation deals, in particular in the metallurgical sector in 2005, but the privatisation process has stalled in recent years. The 2010 governmental reform programme stresses the contribution of foreign investment not only as a source of external financing but also as a market transformation and competition-enhancing tool and encourages increased participation of foreign investors in the revamped privatisation process.

Since its initiation in 1991, Ukraine's legislation has embodied the principle of non-discrimination of foreign investment and general provisions on foreign investment protection, including against nationalisation and changes in relevant legislation as well as guarantees for compensation and the repatriation of profits. Since the dismantling in April 2010 of temporary financial crisis-related measures applied specifically to foreign investment, all categories of investment are now subject to the same establishment procedures, notably state registration, business permits and, for the activities concerned, licensing. The current legal framework thus provides for national treatment for firms' establishment but in practice new foreign investors, who are less familiar with local practices than incumbent firms, have been discouraged by complex, protracted and costly procedures and resulting regulatory uncertainty. The government's recent efforts to streamline administrative procedures (for example in the area of licensing) should be pursued.

Ukraine applies several trans-sectoral 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*. The trans-sectoral restrictions concern the prohibition of FDI in unspecified strategic sectors and territories in cases where foreign capital would lead to Ukraine's "critical dependence on the business cycles of international markets" or "jeopardise its economic independence". According to the 1992 privatisation law, legal entities in which more than 25% of equity is owned by a state cannot participate in the privatisation of state and municipal property. Defining clearly the scope of "strategic" sectors closed to foreign investors or subject to authorisation procedures would considerably reduce any current legal uncertainty concerning foreign investment in these sectors. More generally, while safeguarding its essential national security interests the country's policy should be designed and implemented to ensure the smallest possible impact on investment flows and be guided by the principles of non-discrimination, proportionality, transparency and accountability as recommended in the OECD *Guidelines for Recipient Country Investment Policies relating to National Security* adopted by the OECD Council in May 2009.

Despite the possibility of short- and long-term land leasing, the moratorium on foreign ownership of agricultural land, prolonged until 2012 is perceived by foreign investors as a significant limitation on their activities especially given additional bottlenecks such as the absence of a unified registration system for land and real estate. As part of its WTO accession commitments, Ukraine has opened a number of sectors to foreign investment, including transport, telecommunications and banking. Several remaining restrictions, notably on providing insurance services by direct branches of foreign insurance companies and a 30% limit on foreign ownership in the wholesale trade of books, magazines and newspapers, have to be eliminated within 5 years after the country's WTO accession, *i.e.* by May 2013.

Among other measures which qualify for the list of measures reported for transparency under the OECD *Declaration on International Investment and Multinational Enterprises*, Ukraine would notify a significant number of public monopolies, specifically in energy transport, distribution and transmission of electricity, railways and local telephone communications. Taking into account the existing statutory FDI restrictions, Ukraine's score under the OECD FDI Restrictiveness Index is higher than the OECD members' average but lower than the average of non-OECD countries covered by the FDI Index. Ukraine's relatively favourable performance with respect to formal FDI restrictions captured by the OECD FDI Index contrasts with a poor perception of its investment climate in most international comparisons, which assess actual implementation of existing laws and regulations.

Based on the OECD *Policy Framework for Investment*, which evaluates various policies relevant for the country's investment climate, Ukraine has made progress in several important areas such as investment facilitation and promotion, trade and competition policies, but more remains to be done to create a favourable investment environment. General transparency in terms of access to investment-related information has improved, but public consultations and public-private dialogue though referred to in the law have not yet been generalised. Investment policy implementation continues to suffer from a lack of regulatory transparency due to frequent changes in legislation, the complexity of existing measures and the absence of, or the delays in issuing, implementing regulations. This shortcoming allows too much room for administrative discretion and hence the possibility of corruption. Protection of intellectual property rights is probably one of the most critical areas where the gap between national legislation – generally in line with internationals standards – and its inadequate enforcement in practice is particularly harmful to foreign investment. Ukraine's investment promotion activities have been subject to frequent reorganisations resulting in the multiplication of various agencies with often overlapping responsibilities. It is essential that the new State Agency for Investments and National Projects, created at the end of 2010, and the restructured Council of Local and Foreign Investors become efficient tools for enhancing policy implementation in close association with the investment community.

The OECD *Declaration on International Investment and MNEs* includes the Instrument on Investment Incentives and Disincentives, which encourages adherent countries to make such measures transparent so that their scale and purpose can be easily determined. After its unsuccessful experience with Special Economic Zones (SEZs), Ukraine has abolished the differentiated tax and customs regime applied in SEZs in 2005 but is now considering reintroducing a preferential investment regime in selected areas. The government's commitment gradually to reimburse export VAT-refund arrears, which have constituted one of the major disincentives to firms' operations and investment, is part of an ambitious tax reform package aimed at reducing the weight of taxes in business costs and improving tax management.

Ukraine's accession to the WTO in May 2008 has enhanced trade policy transparency and predictability. The country has concluded a number of free trade agreements, mainly with the countries of the former Soviet Union. Efforts to streamline border procedures and trade facilitation measures should be intensified, especially the introduction of electronic customs documents and procedures as well as the adoption of international technical standards and conformity certification procedures. In the area of competition policy, Ukraine has gradually put in place an appropriate legal and institutional framework but the development of a competitive environment remains constrained by the size of the public sector, particularly the large number of public monopolies operated by state-owned enterprises, the scope of price controls and the pervasive system of licensing and business permits, which prevent the entry of new firms.

Public policies promoting principles for responsible business conduct, such as those embodied in the OECD *Guidelines for MNEs*, contribute to attracting investment in support of sustainable development. But, in many relevant areas, both public awareness and responsible business practices, such as compliance with, and reporting on, environmental performance and management, are still less common in Ukraine than in other emerging economies. Corruption remains the key investment impediment and the main reason for the country's poor ranking in available international business surveys. Recent delays in adopting new anti-corruption legislation cast doubts on the authorities' willingness to deal with this issue.

Ukraine faces specific challenges in attracting energy investment required to reduce its currently high energy intensity, increase its energy production and upgrade its deteriorating energy infrastructure. Energy efficiency efforts and investment have been hampered by distortions in energy price setting and the energy market structure, dominated by state-owned firms. The June 2010 government economic reform programme addressed these critical issues and set objectives for accelerating the privatisation process in the energy sector and for gradually adjusting energy prices to the market level. Given that public financing will be unable by itself to cover the huge needs for energy efficiency investment, implementing these reforms without delays is essential in order to attract private, including foreign, investment.

Although for the near future, energy efficiency remains the main focus of Ukraine's energy policy, the importance of developing renewable energy resources should not be underestimated, particularly when there are synergies between energy efficiency and environment-friendly energy production and technologies, for example in the case of heat production based on biomass and waste. Ukraine has developed a basic policy framework in support of environmentally friendly energy resources and technologies, but in the absence of energy price reforms the incentives for such investment have been limited. The government has an important role to play in promoting both public awareness and corporate initiatives aimed at improving the measurement and reporting of environment performance. Foreign investment and international assistance could be a potential source of "greening" effects, both directly through transfers of more energy-efficient and environmentally friendly technologies and indirectly by facilitating spillovers to domestic firms through best practices in environmentally friendly production, technologies and management.

Policy recommendations of the *Review* (see Boxes below) focus on specific aspects of investment policy. Although necessary macroeconomic reforms are not expressly addressed here, they remain a prerequisite for putting the country firmly on the map of foreign investors, especially given the current risk-averse behaviour of most investors. To encourage capital inflows, the country has to stabilise its public finance deficit and reform its fiscal system to support public and private investment, particularly in infrastructure. Proposed investment policy recommendations thus have to be a part of broader reforms which target public and private investment, including foreign capital, and which remove entry and exit barriers for all categories of firms. The following recommendations are divided into three categories: *i)* general investment policy recommendations; *ii)* recommendations for improving the investment climate, and *iii)* recommendations related to energy efficiency investment.

Box 1. **General investment 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.
- Specify clearly the conditions for foreign participation in the privatisation process in the new law on privatisation currently under preparation and avoid leaving room for administrative discretion in selecting those sectors and firms excluded from privatisation.
- 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.
- Make sure that the new law on investment currently in preparation confirms the non-discrimination principle for foreign investment.
- Implement e-registration and continue to simplify business permit procedures, including applying the "declarative principle" as foreseen by the law.
- Abolish the moratorium on agricultural land ownership in 2012 as currently foreseen and accelerate the implementation of the unified registration of land and real estate property.
- Remove remaining foreign investment and trade restrictions in line with WTO commitments.
- Develop implementing regulations to make possible the rapid and effective application of the law on public-private partnerships.

Box 2. **Recommendations for improving the investment climate**

- Develop public-private consultations on business-related legislation and regulations with the business community, including foreign investors, notably within the new Council of Local and Foreign Investors.
- Take into account the interests and concerns of foreign investors in small and medium-sized enterprises, which are particularly affected by frequent legislative and regulatory changes and related regulatory uncertainty.
- Consider setting up an ombudsman office to tackle concrete problems faced by new and established foreign investors in Ukraine.
- Ensure that the State Agency for Investments and National Projects established in December 2010 fulfils its main tasks in line with the planned schedule, notably the creation of the single window facility for foreign investors before 2012.
- Finalise refunding of VAT arrears and improve VAT administration as foreseen by the IMF agreement and the government's plan.
- Carry out a thorough costs-benefit analysis before reintroducing the preferential investment regimes in special economic zones and priority development territories.

Box 3. **Recommendations related to energy efficiency investment**

- Comply with the objectives and the planned schedule set up for the energy sector in the 2010 Government Economic Reform Programme, namely phasing out of all energy tariff subsidies before the end of 2012, launching privatisation in the energy sector, unbundling of *Naftogaz* activities and ensuring the independence of the energy regulatory agency.
- Implement the new gas law allowing access to pipelines by other operators.
- Put in place a transparent and predictable legal and regulatory framework to mobilise investment in energy efficiency and renewable energy resources financed by international programmes and through the development of private-public partnerships.
- Promote public awareness and corporate initiatives aimed at improving the measurement and reporting of energy efficiency and environment performance.

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