

EXHIBIT 1



DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS

UKRAINE INVESTMENT POLICY REVIEW

THE LEGAL AND INSTITUTIONAL REGIME FOR INVESTMENT:
ASSESSMENT AND POLICY RECOMMENDATIONS

Executive Summary and Recommendations

March 2001

This Executive Summary and Recommendations will form part of a forthcoming OECD publication entitled Ukraine Investment Policy Review which will be

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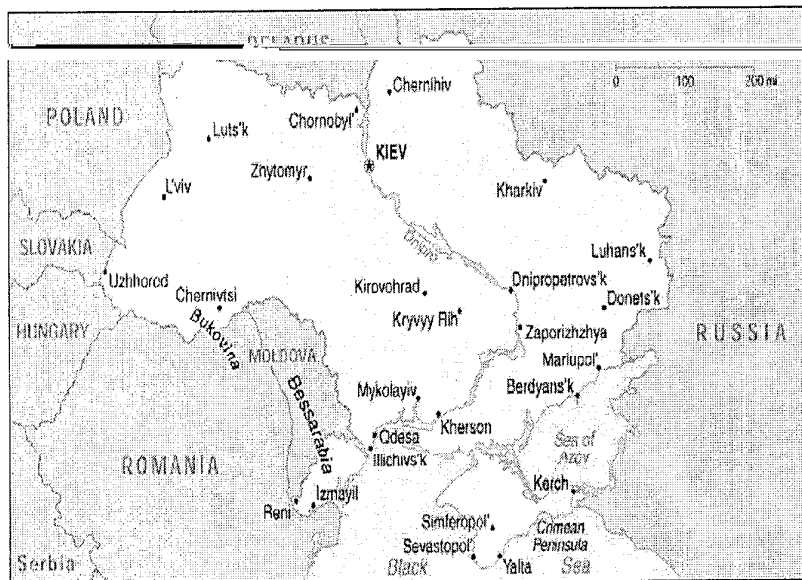


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ABBREVIATIONS

AMC	Antimonopoly Committee of Ukraine
BIS	Bank for International Settlements
BIT	Bilateral Investment Protection Treaty
BSEC	Black Sea Economic Co-operation
CEE countries	Central and Eastern European countries
CEFTA	Central European Free Trade Agreement
CIS	Commonwealth of Independent States (which includes as full or associate members all countries of the former Soviet Union, except the Baltic States)
ECT	Energy Charter Treaty of 1994
EU	European Union
FDI	Foreign Direct Investment
FIAC	Foreign Investment Advisory Council
FSTS	Ukrainian First Trading System
GATT	General Agreement on Tariffs and Trade
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
IAS	International Accounting Standards
ICSID	International Centre for Settlement of Investment Disputes
ICSID Convention	Convention on the Settlement of Investment Disputes between States and Nationals of other States
IMF	International Monetary Fund
ISO	International Standardization Organization
NADEI	National Agency for Development and European Integration of Ukraine
NBU	National Bank of Ukraine
PCA	Partnership and Co-operation Agreement between Ukraine and the European Union
PDA	Priority Development Area
Review	The Investment Policy Review for Ukraine, OECD December 2000
SEZ	Special Economic Zone
SMEs	Small and Medium-Sized Enterprises
SPF	State Property Fund
SSMSC	State Commission for Securities and Stock Market of Ukraine
TRIPS	Agreement on Trade Related Aspects of Intellectual Property Rights
UAH	Hryvnya (national currency of Ukraine since 1996)
UAS	Ukrainian Accounting Standards
USAID	United States Agency for International Development
WTO	World Trade Organisation

FOREWORD

The *Investment Policy Review of Ukraine* builds on the earlier "Investment Guide for Ukraine", published in 1993 to provide information to business operators planning activities in Ukraine. This Review, which is prepared in the framework of the OECD's Centre for Co-operation with Non-Members, is intended to advance the policy dialogue and co-operation between the OECD and Ukrainian decision-makers on investment issues. To support Ukraine's reform efforts, the Review assesses the implementation of the legal rules, with an emphasis on their practical enforcement, and identifies gaps in legislation and institutional frameworks, distilling an array of policy recommendations.

In addition to the legal and institutional setting specifically dealing with foreign investment issues, the Review encompasses salient features of the overall business environment in Ukraine, such as legislation ensuring the rule of law, contract and property protection, corporate legislation, secured lending and financial sector legislation, taxation, and, public governance, privatisation, competition and anti-corruption measures. It sets out the main impediments to investment and private sector development in Ukraine focusing on government regulations for foreign investment.

Mehmet Ogütçü co-ordinated and finalised the Review under the guidance of Rainer Geiger. Recommendations have been drafted by Juergen Voss, with the advice of Vladimir Anatoliyevitch Ignatchenko, Anatoly Doygert and Yaroslav Kinakh. Other major contributors from the OECD Secretariat included Jan Schuijjer and Fianna Jesover. The Review also benefited from comments on different chapters by Tristan Price, Eva Thiel, Frederic Wehrle, Terry Winslow, Sebastian Molineus, Elena Miteva and Marie-Laurence Guy of the OECD Secretariat, as well as editing assistance from George Williamson.

Valuable contributions are acknowledged from Victor Ivanovitch Lisitsky, State Secretary of the Cabinet of Ministers of Ukraine, from the Ministry of Economy of Ukraine, the World Bank Group, the Organisation for Security and Co-operation in Europe, the Deloitte Touche Tohmatsu USAID Commercial Law Center Project (Prof. Viktor Musiyaka and Dr. Petro Matiaszek in particular), the International Center for Policy Studies, the Ukrainian-European Policy and Legal Advice Centre, the Kiev law offices of Baker & McKenzie, Salkom, Frishberg & Partners, Proxen & Partners, Jurvneshservice, and the German Advisory Group on Economic Reforms to the Ukrainian Government. We gratefully acknowledge the support provided by the Government of Poland for investment work on Ukraine including from Marek Wejtko of the Polish Delegation to the OECD.

Several members of the Business and Industry Advisory Committee (BIAC) to the OECD including Charles Kovacs, Andrey Pleskonos, Elodie Ritzenthaler Dr. Irina Paliashvili and Ms. Liselott Agerlid took active part in its preparation. Among many others, David L. Konick, Marek Dabrowski, Philip Davies, Rudolf Mueller, Scott McLeod, Thomas Vennen and Michel Zayet provided useful inputs to the Review, particularly on recommendations. Draft of the Review was released and discussed at an OECD-Ukraine Roundtable in Kiev on 23 February 2001. Participants at the meeting called for the establishment of a joint Forum on Investment and Enterprise Development to follow up the implementation of the recommendations proposed in the Review, and develop further actions to help Ukraine improve its investment environment.

This Review, current as of March 2001, is published on the responsibility of the Secretary General of the OECD.

Eric Burgeat
Director, Centre for Co-operation with Non-Members

STATEMENT FROM THE GOVERNMENT OF UKRAINE

The Government of Ukraine is especially grateful to the Centre for Co-operation with Non-Members and the Directorate for Fiscal, Financial and Enterprise Affairs of the Organisation for Economic Co-operation and Development (OECD) for their invaluable work in preparing this Policy Review.

Unlike other analyses of the difficulties and shortcomings in Ukraine's investment climate and business conditions, this Investment Policy Review identifies key issues and offers very practical suggestions for modifying and improving our legal and regulatory environment in order to attract further investments and provide for an attractive environment for business. We will introduce measures to implement these policy recommendations.

Our government is well aware of the importance of encouraging the development and growth of the private sector in our economy. We also recognise that foreign direct investment plays a particularly significant role in accelerating the growth and development of our economy. Accordingly, the recommendations herein, together with the broad range of policy reforms we are implementing to restructure our economy, are invaluable and useful tools to guide us during this transition process.

In a broader context, we look forward to more extensive and deeper co-operation with the OECD. The OECD has a unique ability to harness and convey practical and policy experience of its Member countries; Ukraine needs and wants such experience. We therefore look forward to the newly created OECD-Ukraine Forum on Investment and Enterprise Development as our first and formal step in building a closer relationship with the OECD, and learning from the experience of its Member countries.

Victor Lysytsky
State Secretary
of the Cabinet of the Government of Ukraine

INTRODUCTION

The present OECD Review has been carried out at the request of the Government of Ukraine – not as a desktop study, but in a dynamic framework as a joint exercise involving almost all key players, domestic and international alike, on Ukraine’s investment scene. It identifies the obstacles to investment and private sector development, and puts forth concrete, practical recommendations for an improved business climate. This version of the Review incorporates comments and suggestions received during and after the Roundtable meeting on 23 February 2001, co-organised by the OECD and Ukraine, with the support of the Deloitte Touche Tohmatsu USAID Commercial Law Center Project based in Kiev.

The concluding statement of the Kiev Roundtable meeting was: “Ukraine has the potential to be transformed from ‘a miracle in waiting’ to ‘a miracle in making’” in recognition of this nation’s rich human and natural resource endowment, as well as strategic location. Senior government officials supported the Review’s recommendations and pledged strong support to implementing them in conformity with the government’s strategic objectives for 2001 and beyond.

The most pressing economic problems currently facing Ukraine are of a structural nature: slow privatisation; little industrial restructuring; an unwieldy governmental apparatus; a narrow tax base; over-regulation; significant levels of corruption; and a largely unreformed agricultural sector. These factors have resulted in pushing over half of the economy to operate in the informal, or “shadow”, sector. While foreign assistance is crucial in this period of economic transition, official flows of assistance in the longer term could be dwarfed by private capital inflows if Ukraine creates a more conducive environment for private sector development.

Ukraine is a potentially attractive place to invest. The failure to attract foreign investment, the staggering ~~gap between the formal economy and the relative growth of the “shadow” economy~~ are in sharp contrast to certain strong endowments of Ukraine. The country possesses a large amount of unused or underused physical and human capital (98.6 per cent literacy rate), substantial reserves of idle savings, a large domestic market of about 50 million people (among the largest in Europe), rich natural resources, and a strategic location at the crossroads of Central Europe, Russia, Central Asia and the Middle East, all of which provide a solid base for sustainable economic growth.

Hence, the relative economic decline of Ukraine cannot be attributed merely to economic fundamentals, but is mainly due to difficult conditions for business activity in Ukraine that deter investors, foreign and domestic alike, drive Ukrainian entrepreneurs underground and encourage domestic capital to flee the country. In fact, virtually all international ratings and investment climate surveys place Ukraine among the least advanced transition economies. In particular, Ukraine has lagged behind other Eastern and Central European countries in attracting FDI flows.

From a sector perspective, as of January 2000, the main destination of FDI in Ukraine, was the domestic food industry (20 per cent of cumulative FDI), followed by domestic trade operations (over 17 per cent) and mechanical engineering/metals (almost 11 per cent). By origin of investment, the United States has been the dominant foreign investor. United States companies have made investments valued at some \$590 million, representing 18 per cent of all FDI made in Ukraine. The United States is followed by the

Netherlands with 9 per cent, the Russian Federation (9 per cent), Germany (7 per cent) and the United Kingdom (7 per cent).

Ukraine's investment needs are huge, as large parts of the capital stock have in fact no longer been maintained or replaced during the last decade, not to speak of enlargement. There is certainly also an important need for renewal of the general infrastructure. Investments needed for rehabilitating the ailing infrastructure alone are estimated to exceed \$40 billion. According to official Ukrainian data, as of early January 2001, the cumulative FDI inflows into Ukraine since 1991 approached \$3.9 billion.¹ On a per capita basis, foreign direct investment is among the lowest in the region – \$79 per capita, placing Ukraine as the second lowest among Commonwealth of Independent States (CIS), ahead of Belarus only, and with less than 10 per cent of the FDI that has flowed to Poland or Hungary. The hostile business environment has contributed to substantial capital outflows, estimated to exceed \$10 to \$20 billion since independence at a time when Ukraine badly needs resources for domestic investment. President Leonid Kuchma has proposed a new law in September 2000, which would grant amnesty to “shadow” capital, allowing Ukrainians to legalise any hidden assets. They would simply have to declare the account to the tax authorities, transfer it from any foreign bank to a Ukrainian bank, and pay a 10 per cent tax on it.

The transition process in Ukraine has been difficult, burdened as the country is with the economic structure it inherited from its Soviet past, the uncertainties and a complex political constellation. Starting in late 1996, Ukraine's Government initiated a comprehensive legislative programme to remove structural obstacles to economic growth. It included tax reduction, regulatory reform, budget cuts and pension reform. Indeed, bold and extensive economic reforms are vital, not least to ensure the sharp increase in foreign investment, which the country needs. High and seemingly arbitrarily applied taxes have scared investors off. Privatisation – an important vehicle for foreign investment and economic reform in many countries – has been slow and has suffered setbacks, such as in agriculture. Rules prejudicial to foreign investment in privatised industries continue to apply.

Many difficulties stem from a bureaucracy, which is well entrenched and still extensive, and still operates with a mindset reflecting the FSU legacy of control and strict regulation, as well as from complex and often ambiguous legislation. Administrative reforms have been slow, and not sufficiently deep and extensive. And the legislative and regulatory changes have not been oriented towards establishing explicit and transparent rules of the game. This, of course, invites inconsistent interpretation and unpredictable application of laws and regulations, with the added problem of corruption.

Major amendments of Ukraine's FDI legislation have been enacted during the past few years. These changes have been fundamental, since they constituted a shift from a generous, but ineffective system of specific incentives to a system of non-discriminatory legal conditions for all investors, including more extensive investment protection. Ukraine has also signed a significant number of bilateral investment treaties, including those with some OECD Member countries. These legislative steps lend further credence to the notion that incentives, however generous, can be no substitute for those factors that really attract foreign investors: a promising market, transparent and non-discriminatory legislation, effective investment protection and sound economic policies. Given the massive need of foreign investment for industrial restructuring, a rapid improvement of Ukraine's investment climate is indeed urgent.

To maximise Ukraine's potential for foreign investors, it is clear that the government needs to swiftly proceed with more privatisation in a transparent and non-discriminatory fashion, develop a business climate conducive to the rapid expansion of foreign trade, limit tariff and non-tariff barriers, ensure fair access to the Ukrainian market for foreign firms and foster a meaningful dialogue with businesses on key policy issues. The Review, reflecting the expertise and recommendations of the OECD Secretariat, Member countries, other international organisations, the international business community, many

Ukrainian officials and business executives, forms a solid basis for further follow-up and monitoring of policy reforms in Ukraine.

The key issue that arose throughout the 23 February discussions remains: who will be charged and empowered to implement these recommendations. Timing was of critical importance: when will the implementation commence and what timelines and identified benchmarks would be to track performance. It was strongly recommended to establish an inter-ministerial/department team to develop a strategy to begin implementing the recommendations and rectifying the shortcomings identified in the Review. This team would also be the interface of the Ukrainian government with the OECD-Ukraine Forum on Investment and Enterprise Development, established during the Roundtable. The Forum will help develop dialogue and synergies among government officials, the private sector, bilateral and multilateral co-operation programmes, and above all, help identify the fundamentals of a forward-looking investment policy.

EXECUTIVE SUMMARY AND RECOMMENDATIONS

Overview

1. Ukraine is the only eastern European transition economy that experienced a decline until last year

average wages to 51 per cent of pre-independence levels. More than half of the population reportedly lives below the poverty line.

2. The virtual collapse of the formal economy came hand-in-glove with a steady increase of the shadow economy. The causes of the rapid development of the shadow economy in Ukraine are closely related to the dissolution of the old political and economic systems and, subsequently, to delayed economic reforms. The official estimates of the shadow economy by *Derzhcomstat* claim that its share is roughly 13-14 per cent of official GDP. It should be stressed that this amount is included in official estimates. However, more realistic estimates range between 50 and 70 per cent of official GDP in 2000. While the shadow economy somewhat compensates for the decline of the formal economy, it also increases distortions in the Ukrainian economy, with allegations of corruption pervading all layers of the state.

3. Business operators in Ukraine still face an omnipresent bureaucracy, over-regulation, corruption, considerable legal uncertainty and stifling tax and customs structures. Fiscal deficits and arrears remain huge, both with respect to the government and among enterprises. As a result, private lending is only available on short term and at exorbitant rates. While most small and medium-sized enterprises have been privatised, more than 200 large enterprises accounting for some 70 per cent of industrial output are still controlled by the state. The parallel operation of state and private enterprises in the Ukrainian market distorts competition. After hyperinflation in 1993, inflation rates now cluster around 20 per cent per annum. Trade tariffs have been liberalised but considerable non-tariff barriers remain.

4. After almost ten years of independence, reforms to establish a market economy under the rule of law are still in an embryonic state. This is largely due to the paralysis, which existed until the end of 1999 between a reform-oriented President and a Parliament with a reform-sceptical majority. Subsequent to the re-election of President Leonid Kuchma in November 1999, a referendum on amendments to the Constitution strengthening the presidency, and parliamentary by-elections in spring 2000, a new, albeit fragile, majority has been formed in Parliament (*Verkhovna Rada*) in support of market-oriented reforms. For the first time, the political constellation appears to be conducive to adopting reform legislation.

5. In the first half of 2000, a comprehensive reform programme was launched and first achievements can be seen, notably the adoption of a relatively balanced budget (with a deficit of some 1.5-2.0 per cent of GDP) and the successful renegotiation of Ukraine's external debt. While still incomplete and debatable in detail, the pending reforms do go in the right direction and, if implemented, will

Government predicts a real GDP growth of at least 4 per cent in 2001. Thus there now appears to be an

opportunity for economic reversal. Whether it will materialise or not will depend in large measure on whether the reform process will be carried forward decisively.

6. Despite the difficulties of moving ahead simultaneously on a myriad of issues, reforms must be pursued as an integrated process, since success depends on the interaction of reform measures in the various areas. Implementation of the necessary reform agenda takes time. To mobilise investments now, it is necessary to market the reform programme and build investor confidence in its decisive implementation, persuading investors that it pays to buy into the Ukrainian economy today (when entry prices are still moderate) and reap returns tomorrow (when business conditions will be favourable).

Foreign Investment Regime

7. Rules for foreign investments as distinguished from domestic are found in both domestic legislation and international treaties of Ukraine; they govern both the admission of foreign investments (pre-establishment treatment) and their protection once admitted (post-establishment treatment). Some legislation also, while not expressly distinguishing between domestic and foreign investment, in practice applies to foreign investment only, notably the laws on production-sharing and concession agreements. Foreign investments are furthermore subject to particular administrative procedures (registration and dispute settlement). In several cases, legislation applicable in principle to both domestic and foreign investment alike includes provisions that apply to foreign investment only.

Investment Protection

8. The basic rules on the (post-establishment) treatment of foreign investments are set out in the "Law on the Regime of Foreign Investment" of March 1996. This law has several shortcomings; it is in particular flawed by a total of 27 provisos giving precedence to domestic legislation. In particular, a proviso limits the principle of national treatment. In theory, the Law protects foreign investors against discrimination vis-à-vis domestic investors – but only to the extent that no discriminatory provision is found in generally applicable legislation.

9. The shortcomings of investment protection under domestic legislation are, however, largely remedied by the considerable and still expanding network of international treaties of Ukraine applying to international investments. Ukraine has concluded some 67 bilateral investment protection treaties ("BITs"), 43 of which are in force. In most cases these treaties conform to international standards. In addition, Ukraine has signed several multilateral agreements related to foreign investment, especially the ICSID Convention of 1965 (ratified on 16 March 2000), the 1994 Energy Charter Treaty, and the 1998 Partnership and Co-operation Agreement with the European Union. These treaties are integral parts of the Ukrainian legal system, directly applicable and prevailing over domestic legislation in case of conflict.

10. While the legal protection can thus be considered as adequate for most foreign investments (i.e. investments from countries with which Ukraine has a BIT), it is nevertheless proposed to align the Foreign Investment Law with the protection provided by the treaty framework. More specifically, it is recommended to:

- review the necessity of the frequent provisos in favour of generally applicable Ukrainian legislation and delete these provisos wherever feasible. Especially the proviso with respect to national treatment, which is inconsistent with the treaty framework, should be either deleted or at least replaced by a list of exceptions from this principle, to be attached to the Foreign Investment Law;

- extend the protection of expropriation and nationalisation to indirect and creeping expropriation; and
- upon ratification of the ICSID Convention, open the way to international arbitration for disputes arising under the foreign investment law, preferably by providing access to ICSID. (Such "ICSID clauses" are now included in the investment laws of more than 30 countries).

Investment Liberalisation

numerous restrictions, it has been consistently... sectors, notably insurance, television and broadcasting. In the telecommunications sector, the most serious limitation applicable to foreign investors, namely the restriction on the allowed share of foreign investment in each telecommunication company, was lifted in August 2000 by the Law on "Specifics of Privatisation of Open Joint Stock Company 'Uktelecom'". Foreign investors are still not allowed to own land, and they have been able to participate in privatisations in a few cases only.

12. It is recommended that the remaining cases of foreign investor discrimination be reviewed with a view to eliminating them wherever feasible.

Incentives and Privileges

13. While the first generation of post-independence legislation provided generous incentives to foreign investments (especially tax holidays), most of them have been phased out since 1996. An exemption from import duties and import taxes of capital goods imported as contributions in kind into the charter fund of a foreign investment enterprise is the most important remaining privilege of foreign investors. The stated policy of Ukraine is now in favour of creating "level playing fields" where all investors in the Ukrainian market are treated equally, regardless of their origin.

14. This policy must be applauded, because no distinction in the treatment of domestic and foreign investors is justified. International experience suggests that investment incentives tend to mobilise less additional investment than governments usually expect. Frequently, they distort competition between domestic and foreign-owned enterprises as well as among foreign investors. They tend to foster corruption, especially if granted on a case-by-case basis. As a rule, the economic costs associated with incentives exceed the gains from mobilising additional investment. It is therefore advisable to phase out all remaining incentive schemes to the extent that they distinguish between foreign and domestic investors. Once granted, however, privileges should be maintained for the entire time period initially established; a retroactive repeal is likely to undermine confidence in the reliability of investment conditions.

Special Economic Zones

15. Some 21 special economic zones ("SEZs") or priority development areas ("PDAs") have been set up to encourage investment in less developed regions. Investors, domestic and foreign, in such zones are granted considerable fiscal benefits. Admission to these zones is usually limited to large investments; and enterprises within the zones are subject to tight state regulation and control. As a result of criticism from the IMF and the EU, the creation of new zones has been suspended until 2003.

16. The present regime of highly regulated SEZs relying on fiscal privileges to attract investments appears to do more harm than good to economic recovery. The mobilisation of investment into some SEZs might come at the expense of investment which otherwise would have taken place elsewhere in Ukraine. In this case, budgetary costs have been incurred through granting fiscal privileges without adding value to Ukraine's economy. More important than the direct fiscal costs are the indirect economic costs as a result of distorted competition.

17. The focus of SEZs on large investors, together with non-transparent administrative procedures, prevents competition within the SEZs; and the privileges granted to quasi-monopolists within the zones distorts competition to the detriment of enterprises outside the zones. It is therefore advisable to review the concept of SEZs with a view to abandoning plans for the creation of new zones and to phasing out of existing ones. Incentives already granted to enterprises in the zone should be honoured, however, to avoid undermining investor confidence in the stability of investment conditions.

Foreign Investment Institutions

18. While the legal framework for FDI appears to be compatible with that in eastern European transition economies, implementing institutions in Ukraine are widely rated as ineffective. Until the end of 1999, relevant responsibilities were dispersed among several institutions on the central, provincial (*oblast*) and local levels, without clear demarcation lines and accountabilities. To correct this, in early 2000 four central government agencies with FDI-related responsibilities were integrated into the Ministry of Economy and one agency was abolished. This concentration of FDI expertise now offers an opportunity for a coherent and consistently implemented investment promotion strategy.

19. Such a strategy would include the following tasks:

- developing a coherent investment promotion strategy to which all Ukrainian authorities subscribe;
- simplifying interaction between foreign investors and Ukrainian authorities by considering the creation, for instance, of a "one-stop shop" that obtains for foreign investors all required licenses, approvals and permits from the authorities in charge;
- assisting foreign investors in case of difficulties with Ukrainian authorities;
- facilitating an ongoing and systematic policy dialogue between foreign investors in Ukraine and investment policy-makers;
- enhancing both Ukraine's image abroad as an attractive investment location and the image of foreign investment in Ukraine as an agent of growth;
- promoting abroad investment projects in Ukraine; and
- promoting linkages between foreign investors and domestic suppliers.

20. In many transition economies, investment promotion agencies have been created to carry out the above-mentioned functions. These agencies should ideally:

- have an autonomous status detached from government bureaucracy;

- have a managerial structure similar to a private corporation, typically with a managing board comprising representatives of both public and private sectors;
- adopt a remuneration and incentive system competitive with the private sector;
- focus solely on investment promotion;
- enjoy the support of, and have direct access to, the political leadership; and
- derive their status and powers directly from enabling legislation, most suitably from the

21. While such agencies reportedly operate successfully in some transition economies (e.g. Poland, Hungary, and Bulgaria), the creation of such an agency in Ukraine might:

- be very difficult to implement in practice because there are separate laws regulating various types of business activity and requiring certain types of permits or licenses within certain sectors;³
- lead to increased government bureaucracy;
- run counter to the aim of concentrating investment promotion responsibilities in one institution (i.e. the Ministry of Economy); and
- stifle local initiatives if the agency attempts to exercise control over them.

22. Indeed, there was a prototype of “one-stop-agency” (not actually issuing permits and licenses, but facilitating this process) before in Ukraine, the National Agency for Reconstruction and Development, but it was not able to achieve much progress in encouraging foreign investment. The Government is now reviewing the concept and requested OECD’s assistance to benefit the experience of successful agencies with a view to determining how investment promotion activities could best be organised in the Ukrainian context.

23. In April 1997 a Foreign Investment Advisory Council (FIAC) was established under the chairmanship of the President of Ukraine as a forum for an ongoing policy dialogue between the chief Ukrainian economic policy-makers and senior foreign executives of large multinational enterprises. Thus far the Council has met three times; and some of its recommendations have been implemented.

24. To strengthen the effectiveness of the Council, it is recommended to create a permanent working body to prepare and provide follow-up to Council meetings. Such a body could comprise the top aides of Ukrainian Council members and the chief resident representatives of international Council members. It is furthermore proposed to invite into the Council membership some representatives of business associations so as to address the particular interests and problems of small and medium-sized enterprises (“SMEs”).

25. Also in 1997 a Chamber of Independent Experts was created to arbitrate disputes between foreign investors and Ukrainian authorities. While its conclusions are not binding on the parties, they are submitted directly to the President of Ukraine for a final decision. Thus far, the Chamber has considered some 10 cases and in most instances its findings were voluntarily agreed by the parties.

26. The Chamber provides some protection against state authorities, especially insofar as no administrative courts have been created (see below). Its credibility depends on the attention that the

President of Ukraine gives to its conclusions. To enhance the Chamber's effectiveness, it could be considered to:

- create specialised panels, notably on tax and customs issues;
- extend the Chamber's jurisdiction to enterprises with foreign shareholders (rather than just foreign shareholders in such enterprises); and
- appoint individual experts as mediators of evolving disputes before constituting formal panels.

Rule of Law System

Substantive law

27. One of the most important issues to improve foreign investment is the reliability of the administrative and judicial system. The lack of a strong tradition of independence and impartiality within the judiciary makes it even more important that the basic structures of the judicial system be strengthened to ensure a strong judicial power that would provide an effective and full guarantee to the protection of fundamental rights and freedoms.

28. There exists a vast body of law in Ukraine, but a coherent, effective and transparent legal system is still lacking. As a result, business operators spend considerable resources on complying with a myriad of legal regulations, but still face uncertainties and inadequate protection of their property rights and contracts. Three main reasons account for the inadequacy of the legal system in Ukraine:

- Soviet law is still in force unless it has been repealed or superseded by post-independence Ukrainian legislation. Furthermore, the quality of new post-independence legislation in Ukraine is in some cases not better than the Soviet legislation. Among many reasons for the sometimes poor quality of current legislation is often incompetent legislative drafting, absence of co-ordination among various executive bodies responsible for legislative drafting, and absence of co-ordination within the Supreme *Rada* (Parliament).
- Many laws simply state general principles to be specified in secondary legislation and administrative instructions, and the latter are normally not publicly available.
- Most post-independence legislation has been adopted piecemeal to transform specific policy measures into law, without due regard to the coherence of the legal system. Gaps and inconsistencies among individual clauses are the consequence.

29. Thus far, only one major system-building codification has been adopted: the Constitution of June 1996. All other fundamental codifications are still pending in Parliament or even still under preparation, including:

- comprehensive civil code awaiting adoption since its introduction nine years ago (at present the Soviet civil code of 1963 is still in force);
- comprehensive tax code;
- law on the judiciary system;

- law on administrative procedures; and
 - new rules of civil, administrative and, possibly, commercial procedure.
30. The civil code, inspired by the German and Dutch civil codes, is designed to set out the basic concepts and terminology for the entire private law system. It is therefore recommended to:
- adopt the pending draft civil code as soon as possible; and
 - during the period prior to adoption of the code, base specific legislation (e.g. company legislation, secured transactions) on the pertinent provisions of the draft civil code.

Judiciary

31. The court system comprises the constitutional court, the “courts of general jurisdiction” and the “*arbitrazh* courts”. The latter are in charge of “economic” disputes, i.e. disputes between enterprises, between enterprises and state authorities, and bankruptcy cases. Judicial protection against state authorities was introduced in 1996. While there are three levels of general courts (first instance, appeals, Supreme Court), there are only two levels of *arbitrazh* courts (first instance and Supreme Court).
32. Effective court protection requires improvements with respect to:
- technical and financial resources of the courts; and
 - competency of judges, especially in economic matters.
33. Until recently, the execution of court decisions involved overly lengthy procedures, and one third of awards was reportedly not executed at all. In 1998 a new enforcement system was set up under the Ministry of Justice.
34. At present, legislation for a comprehensive reorganisation of the court system is pending in Parliament. According to the Constitution, the new system must be in place by June 2001.
35. It is recommended to:
- strengthen the institutional capacity of the judiciary and in particular enhance the competency of judges on commercial issues;
 - proceed as expeditiously as possible with the reorganisation of the court system and the adoption of new rules of procedure;
 - establish courts of appeal for economic disputes;
 - explore the feasibility of some specialisation of judges by creating either specialised courts or specialised chambers within the courts. Such specialisation should especially be considered with respect to intellectual property, taxation and bankruptcy cases; and
 - create an effective system of preliminary protection of creditors’ rights and preliminary protection against illegal action or inaction of state authorities.

Company Law

36. Business enterprises are regulated by two 1991 laws, namely the Law on Enterprises and the Law on Companies. Progressive when adopted, this legislation contains major weaknesses relating to:

- protection of (minority) shareholders against insider dealing, asset stripping, profit skimming, share dilution, and other malpractices;
- unnecessary restrictions imposed on corporate finance;
- lack of transparency (no company register).

37. A new draft law on joint stock companies, which takes into account the draft model law for CIS countries and "General Principles of Company Law in Transition Economies",⁴ is expected to be submitted to Parliament shortly.

38. Ukraine's present company legislation appears to be inadequate by international standards; and the duality of the Law on Enterprises and the Law on Companies creates unnecessary complexity and confusion. It is recommended to develop entirely new legislation for various types of businesses based on relevant provisions of the draft civil code. Before preparing drafts, a decision should be taken as to whether all types of businesses should be covered in one comprehensive codification or whether separate laws should be envisaged for different types. Proper consideration should be given to the above-mentioned draft on joint stock companies.

39. The new legislation should in particular strengthen shareholders' protection through appropriate provisions on management responsibilities, equal treatment of shareholders as well as provisions against conflicts of interest on the part of corporate managers, supervisors and majority shareholders (insider dealing and insider trading). Rules concerning fiduciary duties of corporate officials should also be developed. The restrictions on corporate finance should be reviewed in the light of international practice.

40. The OECD Principles of Corporate Governance³ could provide an appropriate starting point for developing modern Ukrainian company legislation. In addition, the draft CIS model laws on joint stock companies and limited liability companies, as well as the "General Principles of Company Law in Transition Economies", could be taken into consideration.

41. It is furthermore recommended to create a company register in line with common practice in western market economies. The register could be based on the First European Community Company Law Directive.

Taxation

deductibility of bad debts, and the deductibility of business expenses (even though tax rates as such are relatively moderate);

- the ambiguity and inconsistency of tax legislation, which prevents taxpayers from fully complying with the law and also results in costly and needless disputes between taxpayers and tax authorities.
- burdensome compliance requirements, including the quarterly filing of profit tax declarations and the monthly computation of profit by enterprises.
- the number of taxes, as there exist over 30 different types of taxes, of which six account for more than 80 per cent of state revenues;
- frequent changes in tax legislation and reporting requirements;
- arbitrary and opaque tax administration, especially the imposition of fines disproportionate to the gravity of the violation.

Nevertheless, improvements in the tax system in recent years must be recognised, notably:

- the right of tax authorities to retain 30 per cent of all fines collected was repealed in 1999;
- in early 2001 the power of tax authorities to unilaterally withdraw amounts from a taxpayer's bank account in order to pay taxes (*kartoteka*) was abolished and was replaced by a system that generally requires the tax authorities to notify taxpayers of taxes that are due and that provides taxpayers the opportunity to appeal tax determinations to a court and to arrange for the deferred payment of taxes; and
- double taxation agreements were concluded with some 30 countries.

43. In the summer of 2000 Parliament approved in the first reading a new tax code which would consolidate all Ukrainian taxes in a single document, decrease the number of taxes, reduce the rates for the VAT, enterprise profit tax, and personal income tax, reduce the reporting burden for enterprises, and codify simplified taxation procedures for SMEs.

44. The adoption of a tax code that is comprehensive, coherent, and consistent with international standards would significantly improve the tax system in Ukraine and would facilitate investment in Ukraine. The decrease in the number of taxes, the reduction in the reporting burden for enterprises and the simplified procedures for SMEs would also contribute to a more favourable investment environment in Ukraine. However, to address the main points of criticism of the present tax system, it is important that the tax code be amended to:

- improve the language of the law to eliminate numerous inconsistencies and ambiguities;
- follow international standards concerning the deductibility of business expenses, the determination of depreciation allowances, and the rules of accounting for income and expenses; and
- rationalise the system of penalties so that the amount of the penalty bears a closer correspondence to the gravity of the taxpayer's violation.

45. It is recommended that prior to the adoption of a new tax code no new legislation should be enacted that would increase the tax liability of enterprises or investors.

46. It is further recommended to establish tax ombudsman offices staffed with tax experts who would provide assistance to businesses in filing their tax declarations and in resolving problems that businesses may encounter in their dealings with the tax authorities. Tax authorities should also be authorised to issue written interpretations of the law to taxpayers, which would be binding on the tax authorities.

Property Protection and Secured Lending

Ownership system

47. Even though in principle recognised by the Ukrainian Constitution, private ownership of land is in practice still restricted to plots for residence and agricultural subsistence. For business purposes, land can only be leased (for a maximum period of 98 years). Under the 1992 Land Code, foreigners are expressly prohibited from owning land. However, in April 2000 the Cabinet approved a new draft land code for submission to Parliament. This draft envisages private ownership of land for both industrial and agricultural purposes, and it would allow foreigners to acquire non-arable land in urban areas for industrial purposes (thus limiting the discrimination against foreigners to agricultural plot ownership).

48. It is recommended to proceed with the adoption of a new land code that would liberalise private ownership of land for all purposes. Foreigners should be able to own land on the same conditions as Ukrainian citizens (“National Treatment”).

Intellectual Property Protection

49. In theory, intellectual property rights are protected in Ukraine under both domestic legislation and pertinent international treaties to which Ukraine has acceded, particularly for industrial property protection (patents, trademarks, etc) and, to some extent, authors’ rights. In practice, however, infringements abound, with a piracy rate for computer software estimated at some 95 per cent of the output.

50. The protection of intellectual property needs to be enhanced in accordance with the WTO “Agreement on Trade Related Aspects of Intellectual Property Rights” (TRIPS); notably, enforcement needs to be strengthened urgently. To this end, it is recommended to:

- enhance investigative powers and administrative capacities of enforcement authorities;
- increase fines for intellectual property violations;
- increase the compensation to infringed parties;
- authorise the preliminary seizure of unauthorised products by the courts; and
- develop specialised expertise within the court system, possibly by creating a special chamber for intellectual and industrial property violations.

Secured lending

51. While the legislation on pledging securities is fairly appropriate and a state-of-the-art “securities pledge registry” was created in 1999, adequate legislation and a title registry for mortgages are still unachieved. Thus, mortgage-based lending remains underdeveloped and local currency credits in spring

2000 ran at some 50 per cent interest and were usually available for short term only (up to one year). The adoption of relevant legislation has hitherto fallen prey to the controversy on private land ownership. At present, two interconnected draft bills pending in Parliament would create a mortgage system and a title registry for real property.

52. Recognition of private land ownership and development of a mortgage and title registration system for real assets are essential to developing a functioning commercial credit system in Ukraine. Pending efforts in this direction therefore deserve support. The successful creation of the pledge register for securities demonstrates that a similar system should be feasible for real property.

53. Creation of such a system would provide the basis for mortgage banking that could facilitate both corporate financing and financing of private housing. It could in particular foster long-term lending and drive interest rates down. Foreign investors would be able to leverage their capital transfers to Ukraine by raising additional domestic funds and would thus find investment conditions in Ukraine more attractive.

54. To achieve these results, however, the present "crowding out" of private borrowing by the public treasury must be ended. The creation of the legal underpinnings for a functioning credit market must go hand in hand with a reduction of the government deficit. The reduction of the deficit in the budget for 2000 marks a promising step in this direction.

Financial Sector

55. The government recently created a Co-ordinating Council on Financial Sector Policy, comprising all Ministers and heads of national and State Committees dealing with Economy, Finance, Taxation, Capital Markets to develop coherent national policies on financial institutions and services. This was considered commendable and advisable under prevailing circumstances when there has been a paucity of credit and investment resources, especially from abroad.

56. Ukraine's banking system and capital market are both still in an embryonic stage. Nevertheless, reforms aimed at the creation of a viable banking system and capital market are proceeding, some with noticeable success.

Banking

57. Ukraine has a two-tier banking system, which distinguishes Central Bank activity from commercial bank functions.

58. Central Bank functions – monetary policy and banking supervision – are vested in the National Bank of Ukraine (the "NBU"). The NBU has been relatively successful in approaching monetary stability and has recently tightened banking supervision in line with international (BIS) standards. The Law on the NBU of May 1999, while stating the NBU's independence, created a "Council of the NBU" comprised of representatives of political constituencies and endowed with policy-making powers. Amendments were made in July 2000 to the NBU Law, which weakened the authority of the Council over the NBU.

59. At present of the 156 banks operating in Ukraine there are only two state-owned banks and three formerly state-owned banks, with the state-owned banks accounting for about half of total turnover. While marginally effective in facilitating payments, they play only a modest role as intermediaries of savings. Confidence in the banking sector has been eroded by several failures. In January 2001, a Law on "Banks and Banking" entered into force. The Law has established clear rules for all banks and banking activities,

in particular eliminating discrimination of foreign banks. Legislation on bankruptcy proceedings for insolvent banks is under preparation.

60. In March 2001, only six foreign banks were operating in Ukraine. Since 1997, restrictions on foreign banks were mostly lifted, even though some still remain and have even been reconfirmed in the above-mentioned bill.

61. It is recommended to:

- consider confining the "Council of the NBU" to an advisory role in order to dispel doubts about the NBU's independence;
- proceed with the adoption of the law on banks and banking but review the remaining restrictions on foreign bank operations in favour of a national treatment policy;
- require audits in accordance with International Auditing Standards for all banks;
- enact legislation on the bankruptcy of banks providing effective protection of depositors;
- reconsider, for this purpose, plans of introducing a national deposit insurance system (The Law on Deposit Guarantee Fund recently passed first reading in Parliament);
- restructure the Savings Bank; and
- liquidate unhealthy banks.

Capital Market

62. Two market systems exist in Ukraine – traditional stock exchanges (with the Ukrainian Stock Exchange as the largest) and an alternative trading system called the "Ukrainian First Stock Trading System". Operated by the association of licensed Ukrainian securities traders, the latter provides an electronic trading information network similar to the U.S. NASDAQ. Established in July 1996, it accounts for almost 90 per cent of the entire Ukrainian securities market. State oversight of the capital market is exercised by the State Commission for Securities and Stock Markets created in 1995.

63. While progress has been achieved in developing a functioning capital market (especially with the creation of the First Stock Trading System), further legislation will be needed to clearly define the fiduciary duties of financial intermediaries (especially investment funds, investment companies and securities traders) and to ensure proper enforcement of these duties. The self-regulatory system of ~~traders should be strengthened with a view to raising professional standards. The number of~~

Accounting and Auditing

64. In August 1999, the previous Soviet-style accounting system was replaced by a system of "Ukrainian Accounting Standards" (UAS), which are not supposed to contradict international standards. The UAS are not yet fully developed, however, and enterprises with foreign investments usually still have to operate with two accounting systems, at considerable expense and complexity in the application of double taxation issues. Only banks are required since January 1998 to report under accounting standards

issued by the National Bank of Ukraine, which are largely consistent with international accounting standards. Companies are still required to produce two separate sets of accounts, one for tax purposes, the other for financial reporting.

65. Even though large international accounting firms are present in Ukraine, only individual auditors, foreign and local alike, licensed by the Audit Chamber of Ukraine, may conduct and sign compulsory audit reports. As most Ukrainian auditors do not use International Standards of Auditing, audited financial statements have limited international credibility.

66. It is recommended to:

- align speedily Ukrainian accounting and auditing standards with international practice, in particular for publicly traded companies and financial institutions (reference points are the International Accounting Standards, as developed by the International Accounting Standards Committee, and International Standards of Auditing, as developed by the International Federation of Accountants);
- modify the Ukrainian commercial chart of accounts to facilitate the application of internationally recognised accounting standards;
- ensure that financial statements are tax neutral and use a reconciliation statement to link tax computation to such financial statements; and
- implement effectively the existing 1998 Presidential Decree and the October 2000 Law on SMEs for a simplified reporting system for SMEs.

Interdependencies

67. It should finally be emphasised that the development of the financial sector depends largely on progress in related reform areas such as:

- privatisation, where progress on large scale privatisation would increase the volume of tradable securities;
- corporate governance, where the adequate protection of minority shareholders is *conditio sine qua non* for building investor confidence in securities markets;
- taxation, where the tax implications of secondary market transactions (capital gains) need to be clarified;
- bankruptcy, where adequate protection of investors in case of bankruptcies of custodians and financial intermediaries must be provided; and
- currency regulations, where clarifications are outstanding as to whether and to what extent currency regulations apply to the purchase of Ukrainian securities by foreign residents.

Trade and Currency Regimes

68. While Ukraine has liberalised in recent years its trade regime and lowered its tariffs, considerable non-tariff barriers remain, especially through the imposition of cumbersome technical standards and certification requirements.

69. Ukraine has concluded bilateral free trade agreements with almost all CIS countries and the three Baltic countries; it is also a partner in the 1995 CIS Free Trade Agreement. Even though not (yet) a member of the WTO, Ukraine has already subscribed to most WTO disciplines in relation to the EU under its 1998 Partnership and Co-operation Agreement with the latter (although Ukraine has not bound its tariffs vis-à-vis the EU). At present, Ukraine actively pursues WTO membership, but must still implement a host of reforms to qualify. Following WTO accession, Ukraine intends to form a free trade area with the EU (feasibility studies under way) and to join the Central European Free Trade Agreement (CEFTA). Ukraine is moreover an active member of the Black Sea Economic Co-operation, which is envisaged to be developed into a free trade area among Black Sea countries.

70. Ukraine's currency regime has been largely liberalised in recent years. The *hryvnya*, the national currency, is convertible in accordance with Article VIII of the IMF Agreement. Its rate is determined freely on the Ukrainian Interbank Currency Market. Foreign investors are guaranteed the free transfer of dividends and other investment proceeds. In response to the 1998 Russian financial crisis, some regulations were introduced, notably a requirement to surrender 50 per cent of export proceeds to the NBU.

71. It is recommended that Ukraine:

- adopt and implement international trade policy disciplines and commitments, which would facilitate its accession to the World Trade Organisation;
- remove remaining non-tariff trade barriers and, especially, bring its technical standards and certification procedures into conformity with international practice; and
- review the suitability of its currency regulations, notably the exports proceeds surrender requirement.

Privatisation and Enterprise Reorganisation

72. By the end of 1998, some 80-90 per cent of state-owned enterprises had been privatised, mainly through management/employee buyout schemes and voucher/mass privatisation programmes. Foreign investors were involved in only a few cases. However, some 200 large enterprises holding over 80 per cent of assets in the industrial and utilities sectors remain state-owned. These enterprises are at the core of the government's privatisation programme for 2000-2002, even though several enterprises are "reserved" for continued state ownership. Unlike previous privatisation rounds, the 2000-2002 programme targets primarily long-term strategic investors and foreign investors in particular. To attract them, it is envisaged to reorganise enterprises earmarked for privatisation and to restructure their debt.

73. The objectives and tenets of the 2000-2002 programme are commendable. To achieve them, it is recommended to:⁶

- expand the list of privatisable large-scale enterprises, especially extending privatisation to energy and telecommunications (taking into account developments in OECD market economies);

- develop a transparent, predictable, methodical and stable process for case-by-case privatisation;
- establish clear qualification requirements for the selection of privatisation advisers;
- announce publicly the planned privatisations well in advance, and provide full information on the financial situation of the enterprises concerned;
- offer equal participation conditions for all parties concerned that cannot be changed after such an announcement;
- ensure that the tender commission should be independent with no interference in the commission's activity unless otherwise stipulated by the current legislation; and
- ensure that there must be no investment requests prior to the sale.

Bankruptcy Legislation

74. Privatisation of Ukrainian state enterprises regularly presupposes their reorganisation and the liquidation of pre-existing debt. With a view to facilitating this process, a new bankruptcy law entered into force in January 2000 allowing debtors to initiate bankruptcy/reorganisation procedures and making reorganisation the first choice, with liquidation the last resort. Effective bankruptcy proceedings are also urgently needed to enforce payment discipline and impose hard budget constraints on enterprise management.

75. While the new law marks considerable progress, its effectiveness is hampered by remaining rigidities regarding the initiation of proceedings and, especially, by lack of expertise on the part of courts entrusted with the administration of proceedings. It is recommended to:

- simplify the initiation of bankruptcy proceedings to the extent possible by all parties and, in particular, lift the requirement that creditors must have their claims confirmed by a court decision before filing for bankruptcy, even if their claims are undisputed or otherwise obvious;
- launch comprehensive training programmes for bankruptcy judges and trustees in bankruptcy; and
- enhance the abilities of bankruptcy judges in handling intricate business processes and protecting creditor and shareholder interests, perhaps by creating a centralised pool of specialised bankruptcy judges and assigning complex bankruptcy/ reorganisation cases to them.

Public Governance

Structural deficiencies and pending reform programme

76. Public governance is still marked by especially high "state capture" (i.e. undue influence of vested interests on government), bureaucratic interventionism, time tax on enterprises for interacting with authorities and bribery costs (the latter estimated at some 6.5 per cent of enterprise revenues). A bloated

bureaucracy with broad discretionary powers and non-transparent accountability, an under-trained and highly volatile civil service, and a still embryonic "civil society" have fostered Ukraine's development towards "crony capitalism". To rectify this situation, the government, with parliamentary endorsement, adopted in spring 2000 a five-year programme aimed at developing human resources, alleviating poverty, increasing competitiveness of the Ukrainian economy, protecting human rights and freedoms, and promoting Ukraine's integration into the European Union.

77. As a first step in the implementation of this programme, the government has started to downsize the government apparatus and refocus it from micro-managing the economy towards creating and ensuring framework conditions for market operations. It has also taken initiatives to reduce barter settlements in transactions involving the public sector.

78. Through the creation of the State Committee for Regulatory Policy and Entrepreneurial Activity (SCRPEA) and its significant strengthening in 2000, the government is actively and systematically proceeding with deregulation efforts, as well as "filtering" proposed new regulations. For instance, between 1 January and 31 December 2000, the SCRPEA reviewed and made decisions to revoke or amend 136 existing regulations. On a cumulative basis, 71% of all cases SCRPEA was successful in challenging regulations (69 regulations have been fully deregulated or repealed, 27 regulations have been partially deregulated or amended. In the current quarter, 52% of draft regulations reviewed were not approved by SCRPEA and returned to the promulgating agency for further work and amendment.

Business regulations

79. Until 1997, excessive licensing requirements, together with lengthy and cumbersome procedures, constituted formidable business entry barriers, especially for SMEs. A reduction of these requirements and simplification of procedures in 1997-98 brought significant progress, even though remarkable differences in the time required to complete registration among regions suggest that further improvements are possible.

80. Also, until 1997, business operations were interrupted and sometimes definitely frustrated by frequent inspections by tax and other authorities. In response to a presidential decree restraining authorities' inspection rights, both the number and duration of inspections of SMEs fell sharply in 1998. However, it increased again slightly in 1999 (albeit not to previous levels).

81. The new law On Licensing Certain Types of Entrepreneurial Activity was passed by Parliament in final reading on 1 June 2000 and signed by the President on 2 July 2000. The new law eliminates satisfying technical requirements as a pre-condition to issuance of a license, and all procedures are more clear and transparent. According to the new law all licensing requirements (specific regulations) must pass regulatory expertise in SCRPEA before adopted. Adoption of the new Law reduced the number of activities to be licensed from 100+ (including sub-activities) to 60. Such activities as beer brewing, auditing, practice of law, general tourist and recreation business and others were eliminated. No new activities were added."

82. A Presidential Decree of 22 January 2000 on "Introduction of a Uniform State Regulatory Policy in the Sphere of Entrepreneurship" states that establishing a uniform state policy favouring entrepreneurship is one of the primary objectives of the government, and sets forth five principles for regulatory policy:

- i) demonstration of necessity for government regulation
- ii) demonstration that proposed regulations will achieve the desired result

- iii) consistency and co-ordination of regulations
- iv) publicity and public input in the regulatory process, and
- v) transparency

Competition

83. Ukraine has relatively advanced competition/antimonopoly legislation enforced by the Antimonopoly Commission and the *arbitrazh* courts. Nevertheless, competition remains distorted due to the subsidisation of preferred enterprises and a significant shadow economy.

84. While previously high direct subsidies (15 per cent of GDP in 1991) have come down to acceptable levels (2.2 per cent of GDP in 1998), indirect subsidies in the form of tax preferences, selective non-enforcement of arrears on taxes, social security and other fiscal charges (such arrears amounting to 12.7 per cent in 1998), tax write-offs and tax restructuring, targeted credits and government guarantees, and the granting of monopoly rights exceed international levels by far. To an increasing extent, tax and customs privileges granted to enterprises in special economic zones also distort competition.

85. The system of Government guarantees for credits obtained in hard currency from foreign lenders by Ukrainian companies needs to be eliminated as soon as possible. This system encourages serious corruption, causes unfair competition and already resulted in tremendous losses for the state budget since most of the companies failed to repay their credits and the Government had to pay them out of the state budget.

86. Subsidisation practices are not transparent, giving rise to concerns about excessive bureaucracy and corruption. Steps have been taken, however, to drastically reduce subsidies. Thus, in May 2000 the tax privileges of some 150 state enterprises were annulled.

87. Competition is highly distorted by the shadow economy (some 50-70 per cent of GDP) since enterprises in the shadow enjoy *de facto* exemption from taxation, social contributions and government

Recommendations

88. While public governance in Ukraine is still regarded as problematic, decisive reforms are pending and have already shown results in some areas. The reform agenda included in the government's present five-year programme merits support. To create an investor-friendly climate, reforms must:

- reorient government bureaucracy from micro-managing the economy to the strategic formulation of framework conditions conducive to private sector development;
- restructure government bureaucracy with a view to enhancing efficiency, transparency, accountability, predictability and integrity;
- develop the legal system and, above all, put in place an institutional infrastructure with a view to ensuring effective and consistent protection of contracts and property rights as well as protection of business operators against the misuse of power on the part of public authorities;

- enforce hard budget constraints, in both the public and private sectors;
- continue with deregulating business activities, with a particular view to fostering SMEs,⁷ and
- carry out and expand the envisaged privatisation of large state enterprises.

89. Competition /antimonopoly law and policy are vital to promoting investment and to the entire reform process. It is therefore encouraging that the Antimonopoly Committee (AMC) has not been subjected to the downsizing process. Indeed, OECD studies indicate that competition/antimonopoly authorities have been important not only through their law enforcement activities but also as advocates of the kind of market-oriented regulatory reform that is needed in Ukraine. It is recommended that Ukraine consider making greater use of the AMC for advice on the harm to Ukrainian consumers from existing and proposed subsidies and regulatory policies, including those relating to privatisation and regulation of enterprises with some “natural monopoly” component.

90. With a particular view to curbing corrupt practices, a government programme on building integrity of the public service is recommended. As corruption is rooted in structural deficiencies of the organisation of the Ukrainian state, such a programme cannot be successful if it focuses just on detecting and punishing wrongdoing. Rather, comprehensive reforms of the public sector are required to change incentives, capacities and attitudes of public officials. Such a programme should encompass:

- administrative law reforms introducing clear, simple and publicly available rules governing public administration and reducing officials’ discretionary powers to the extent possible. The pending work on a law on administrative procedures plays a central role in this context;
- public sector reorganisation to increase transparency and accountability of officials. In this context, the powers of the State Auditing Chamber should be strengthened, and the office of an Ombudsman for Public Service Integrity could be established, possibly associated with the State Auditing Chamber;
- judicial reforms designed to enhance judicial review of misuses of power. In addition to the envisaged creation of an administrative court system, remedies for private parties could be strengthened to assert rules of fair play, including actions by non-governmental groups and associations;
- civil service reform to afford public servants an adequate remuneration and a clear career track that motivates professional behaviour;
- privatisation to remove opportunities for misallocation of public resources. It is in particular recommended to extend privatisation to the provision of infrastructure and public services wherever feasible with a view to introducing competition between public and private providers;
- measures to encourage cash transactions instead of barter trade; and
- introducing a system of codes of ethics for certain professions (e.g. legal, accounting professions) and business sectors (e.g. financial intermediaries) creating peer pressures against illicit conduct.

91. A free and independent press is important in helping to combat corruption and in fostering transparency within the government and in the private sector. It is finally recommended that Ukraine

participate in efforts to combat bribery of foreign public officials in international business transactions in accordance with the 1997 OECD Convention.

NOTES

1. The Central Europe Annual 2001, Business Central Europe, January, 2001, p. 54.
2. "President Kuchma expects economic growth to strengthen this year", Ukrainian News, 5 January 2001, Kyiv.
3. Often in order for the authorities to issue such permits and licenses special expertise in a particular sector is required. It is difficult to imagine how one agency can issue permits and licenses for law practice, subsoil exploration and production, alcohol production, etc., as well as conduct fire, sanitary or labour inspections in order to grant respective clearances.
4. *Private Sector Development Journal*, Suppl. no. 1, 1998 (OECD).
5. OECD, Paris, 1999.
6. These recommendations include some of the proposals submitted on 5 February 2001 to the Ukrainian Government by the Privatisation Advisory Group in Kiev consisting of the European Commission, the IMF, the World Bank Group, the GTZ and some bilateral OECD donor countries.
7. The OECD's "Policy Guidelines and Recommendations on Entrepreneurship and Enterprise Development in Transition Economies" (Paris, 1999) could provide some guidance.