international centre for policy studies

Government policy to support electronics manufacturing in Ukraine

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This document was prepared by analysts from the International Centre for Policy Studies (ICPS) on the basis of discussions with various stakeholders: the Government, Verkhovna Rada, investors and experts. These took place during two roundtables on investment policy: “Government Policy to Support Hi-Tech Investment in Ukraine” and “Prospects for World Leaders in Hi-Tech to Establish Production in Ukraine.”

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Overview

As part of its mandate, the Ukrainian government has committed itself to increasing the level of foreign investment in Ukraine. The new Administration has shown the political will and determination to implement radical policy changes to combat both corruption and poverty in Ukraine.

However, the Government's recent decision to abruptly cancel Special Economic Zones (SEZs) has left investment in Ukraine in the state of uncertainty. On one hand, the suddenness of this decision is justified in terms of the Government's desire to finance a Budget deficit, to combat the widespread corruption associated with earlier investments specifically in these zones, and to establish a level playing field for all investors. On the other, the decision to cancel SEZs without providing for any compensatory mechanisms for those investors who were playing fair has breached commitments made by the state, and this can only weaken trust, confidence and loyalty among current investors. Moreover, some of these are hi-tech companies that have already invested or have plans to invest in Ukraine.

Ukraine should not reject the option of special investment regimes. International experience shows that industrial parks, a widespread form of SEZ, can be very successful in attracting foreign investment to hi-tech, especially in the manufacture of electronics. Successful policy could lead to the creation of hi-tech clusters in Ukraine, an expansion of the country's export potential and an end to its brain-drain.

The new Government should take immediate advantage of the international business community's heightened interest in investing in Ukraine. Any serious delays in defining a new investment policy approach and making the necessary decisions could close the window of opportunity that was opened by the Orange Revolution and once again result in Ukraine's losing key investment to other developing countries.

Part 1: Policy paper

Government policy to support electronics manufacturing in Ukraine

Why should Ukraine support hi-tech investment?

The Government can spur sustainable economic growth by formulating a policy of securing investment in the hi-tech industry. The potential for Ukraine's economy to expand based on remaining soviet industrial capacities will soon be exhausted.

The result of the right investment policy will be modernized "traditional" industry that can ensure the country's competitiveness and the establishment and development of "new economy" sectors that will offer long-term sustainable economic growth.

The high technology industry is defined here as including any company that designs, manufactures, or services advanced technology: companies involved in radio/audio electronics, aerospace, bio- and nanotechnologies, software development, and so on.

One positive result offered by developing hi-tech production would be the transfer of new technological know-how and intellectual capital into other sectors of the economy. Innovative development will foster increased productivity, scientific and technological revolutions, and structural changes to the economy.

Why is investment in electronics manufacturing so important?

Ukraine has historical advantages that match current trends in global market development and favor the attraction of investment to the manufacture of electronics:

- **A high-quality educational system and R&D institutes**. Ukraine has a strong network of schools and universities, which is why it is known for having a generally better-educated population than even some developed countries. Today, some 30% of Ukrainian students major in engineering, mathematics and information science.

- **Good geographic location**. Located close to the huge markets of the EU and Russia, Ukraine is quite attractive for export-oriented full-scale electronics production. Placing part of a company's manufacturing facilities in Ukraine and gaining access to the Pan-European Transport Corridor V that runs Venice–Ljubljana–Budapest–Uzhorod–L'viv–Kyiv, will make it possible for transnational companies that currently maintain manufacture in China to reduce delivery time to European markets by about 20 days.

- **Available natural resources necessary to develop a strong supply network**. Ukraine has all the necessary raw materials and components to start full-scale electronics production: steel (about 500,000 tonnes/year), alloys, chemicals, electricity, water, and so on.

- **Global leaders in electronics manufacturing are interested in Ukraine.** Key electronics manufacturers are keen to develop an alternative to Asia, meaning mainly China, by developing R&D and production capacities in Eastern Europe, especially in Ukraine. Companies like Jabil Circuit and Flextronics have already launched production.

Among the benefits from attracting investment to the electronics industry are:

- **Integration into the global economy.** As top electronics makers begin to invest in Ukraine, suppliers will also come to Ukraine, which will further integrate the country into the global economy.

- **Growth and diversification of exports**. Growing volumes of hi-tech product exports will help diversify Ukrainian exports, which are currently dominated by unfinished goods. Ukraine will develop added value by increasing the processing of domestic raw materials.

- **Development of educational facilities and R&D.** The quality of education will improve as a result of growing demand for highly skilled personnel among hi-tech companies and the appearance of joint scientific, educational and production facilities.

- **Generation of new jobs**. Foreign investors plan to put capital into creating manufacturing infrastructure in electronics, which should generate about 50,000 jobs in the sector.

What's wrong with current investment policies?

Lack of strategy and consistency

Ukraine has no strategy to attract foreign investment in the hi-tech industry:

- the Government has yet to even identify priority sectors and areas with the most growth potential that need some state support;
- previous investment policies are ineffective because of contradictory criteria and objectives and inconsistent implementation.

This ineffective policy is the result of several factors:

- No analysis has been made of the competitive advantages and potential in Ukraine's various sectors and regions. State funding for science is scattered among numerous R&D institutes and across many sectors.
- Certain approaches to protecting domestic producers stifle development by substantially restricting competition.
- There are no effective mechanisms for monitoring the outcomes and impacts of government investment policy.
- Proper infrastructure in transportation, telecommunications, science, and education are lacking in order to attract investment and transfer know-how across the economy.

Indeed, Ukraine has attracted much less foreign investment per capita than other CEE countries (see **Chart 1**).

Challenges to foreign investors producing hi-tech exports in Ukraine

Investors who are involved in exporting products made in Ukraine point to a number of problems in doing business here:

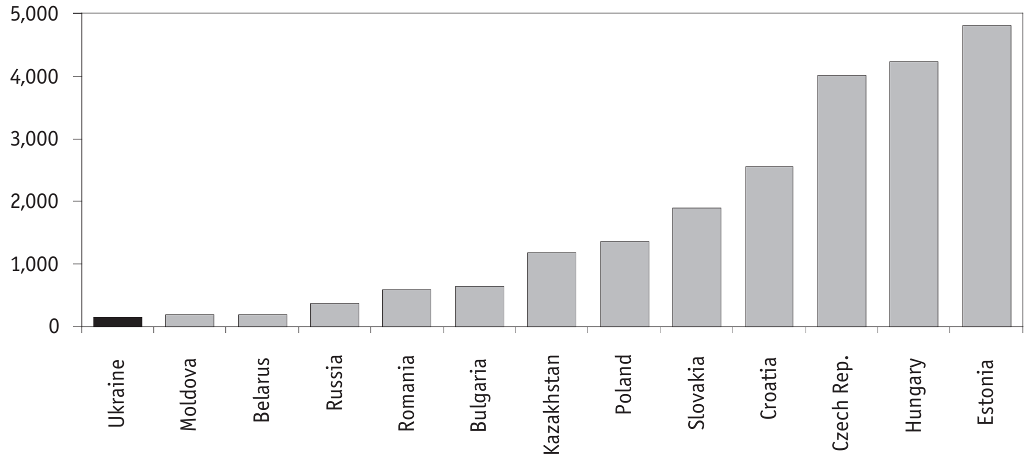
- high import duty;
- complicated customs procedures;
- lack of a supplier base;
- dilatory VAT refunds.

The failure of the SEZ and TPD experiment

The establishment of areas with special investment regimes began in 1996. By early 2005, Ukraine had 11 SEZs and 72 TPDs that covered 10.5% of Ukrainian territory: 0.2% was covered by SEZs and 10.3% by TPDs. The majority SEZs and TPDs were established for a 20–30 year period. Two SEZs were set up for 60 years. Most SEZs and TPDs were designed to improve the difficult socio-economic situation in their respective regions. In addition, several SEZs were set up to take advantage of Ukraine's transit potential.

Meanwhile, the Verkhovna Rada adopted a list of priority areas of activity for each SEZ and TPD: trade and manufacturing, foreign trade, tourism, and recreation. The legisla-

Chart 1. FDI per capita in 2003, USD



Sources: UNCTAD, World Bank; calculations by ICPS

tion focused on manufacturing products involving advanced technologies and attracting investment to R&D.

Investors were exempted from corporate profit taxes, investment taxes, import duty and VAT on goods that were imported as part of an actual investment project. A number of these special areas included a special regime for importing/exporting goods that exempted them from import duty and VAT, and provided for a discounted tax rate on the incomes of non-residents.

Performance evaluation

In early 2005, the Ministry of Economy announced that the results of SEZs and TPDs performance were unsatisfactory. Although investments in these special zones were growing at a relatively high pace, investor commitments were fully implemented in just 2 of 768 projects—less than 0.003%. Since the special investment regime was introduced, 2 of the 11 SEZs and 13 of the 72 TPDs did not even begin to implement any projects. Moreover, the investments that came in amounted to less than 50% of the figures projected when these special zones were set up. Investment inflows were particularly low in economically weak regions.

SEZs failed to become centers where cutting-edge technologies became the focus. Moreover, they mostly attracted domestic rather than foreign capital.

Only three out of six SEZs with a special customs regime were export-oriented. As a result, specific domestic enterprises enjoyed unjustified exemptions, making the regional business environment uncompetitive.

Nor were these projects especially effective from a budget point of view. All the exemptions added up to twice Budget revenues in those regions, and this gap continued to grow. Worse, a large part of the tax breaks and exemptions were applied to imported materials and resources rather than to upgraded equipment, as had been anticipated.

Because of their unsatisfactory performance, the Government shut SEZs and TPDs down as of 31 March 2005.

However, the Government did not prepare either the general public or investors for

SEZs and TPDs: the real picture as of 1 January 2005

- 768 projects were operating, with a total estimated budget of US $6.67bn
- Only US $2.1bn had actually come in, 31.4% of projected budgets
- FDI accounted for 28.5% of overall investments
- Overall sales of companies operating in SEZs and TPDs totaled UAH 45.4bn
- Of this, exports accounted for UAH 15.8bn or 34.8% of total sales

this decision by explaining the real situation and the result was an uproar in the business community.

Why did SEZs and TPDs fail?

The Government's explanation for why SEZs and TPDs did not meet expectations was the inadequate infrastructure in many regions where special investment regimes were introduced. Exemptions and privileges were not enough to make most depressed regions attractive and serious investments channeled to SEZs and TPDs favored relatively developed regions. The lack of appropriate infrastructure also was the main reason why few hi-tech production facilities were established in SEZs and TPDs.

The large volume of tax exemptions was the result of their being untargeted. Moreover, it became widespread practice to take advantage of customs exemptions, not to implement investment projects, but to resell goods on the domestic market

SEZs and TPDs were introduced by Government decision and only those territories designated by the Government were allowed to introduce tax breaks. But these regimes were fixed and local officials could not adjust them. This meant that competition for investment among different regions was not fair, and the established regime for SEZs and TPDs made it impossible to set the best level of holidays for different regions.

Moreover, not enough safety measures were included to eliminate obviously weak projects. Although most zones made the granting of privileges conditional on the size of the investment, some of them had no minimum requirements at all. And despite the fact that implementation plans were supposed to receive official approval, the lack of penalties meant that there was little leverage to guarantee that investors would actually fulfill their promises.

There was little oversight of the activities of companies in SEZs and TPDs, which made it easy for the majority of investors to ignore their commitments and use their tax holidays for unauthorized purposes. The Government claims that in fact only a handful of the 768 projects have actually fulfilled the commitment made by the investors.

What if there's no new investment policy?

If the Government fails to act to remedy the canceling privileges and exemptions for SEZs, this will have a short- and long-term negative impact on Ukraine:

- Foreign investment will be channeled to other CEE countries;
- Lack of investment in hi-tech industries will push skilled workers to leave Ukraine in greater numbers or result in their skills and qualifications going to waste.

Table 1. Some myths about providing tax breaks to investors

Special investment regimes distort the conditions for doing business	Some economic zones, e.g. duty-free zones or investors with duty-free status where 100% of goods manufactured from imported components are exported do not affect competition among producers or importers of the same goods.
The Budget loses revenues because of excessive tax breaks	International practice has many cases where Budget revenues grew as a result of successful investment projects that were made possible because of preferential treatment. Exemptions and preferential treatment are a way to compensate high short-term economic and political risks that are typical for most developing countries and affect the investment climate negatively.
Companies involved in export-oriented production offer little gross value-added (GVA)	If investment projects are successfully implemented in duty-free areas, the level of localization will increase as the network of local suppliers expands and cooperation with local research and educational facilities develops.
Special investment regimes foster corruption	The real roots of corruption are the lack of effective checks and balances, as well as delays in administrative reform. The cost of administering complicated investment regimes should be balanced by the positive outcome of implementation. Specifically, by requiring minimum investment levels to qualify for entry or approval, only a limited number of companies will be eligible for the special regime, and it will be easier to oversee their activities and the fulfillment of commitments.
Special investment regimes conflict with the requirements of international organizations for Ukraine	Ukraine is likely to accede to the WTO in 2006, so it is important to meet the requirements of this organization. WTO members are not allowed to offer subsidies to encourage exports or to support local manufacturing by setting localization requirements for in-country production. However, special economic zones, especially industrial parks, including those in support of regional development, are allowed. In current agreements between Ukraine and the EU, key EU requirements coincide with WTO requirements. After Ukraine accedes to the EU (no date has been established yet), it will have to limit and alter the form of exemptions and preferences offered in SEZs, as happened in those countries that joined the EU in 2004.

Source: International Centre for Policy Studies

What we recommend

Support investment in electronics

Hi-tech investors manufacturing for export should be granted special status. The main conditions needed to attract hi-tech investment in electronics in Ukraine are:

- **Simplified customs procedures**. A high volume of in-country manufacturing will be possible when the necessary components can quickly be imported from around the world and exported from Ukraine. Manufacturers need a simplified customs process based on EU or other international standards.

- **Change in import and tax procedures**. Goods produced in Ukraine from imported materials and components for export should be exempt from the VAT and import duty. Current tariffs add to 5–10% of the total cost of imported components, making Ukraine uncompetitive for electronics manufacturers, because the components in finished products are around 85–90% of production cost, while labor is only 5%. Having to pay VAT and duty on the import of new production equipment also discourages investors.

- **State guarantees for investors**. Investors need some protection against changes to legislation. By canceling exemptions for SEZs and TPDs, the Government did breach its obligations to investors, which led to some of them initiating legal proceedings. Since companies who used their exemptions and privileges appropriately have a good chance of winning in court, the situation could evolve in two directions. The Government will either renew exemptions and privileges for those investors who played fair or compensate them for losing these breaks. The second option could prove very costly, so the better option will be to renew special regimes for a handful of companies.

Allow special investment regimes

International experience has shown that industrial parks can be an effective means of attracting specific investment to specific sectors and regions, creating new jobs, and boosting the development of better technologies and infrastructure (see "A Success Story: Industrial parks in Hungary", p. 11). Foreign investment could be attracted to the electronics industry in Ukraine by setting up duty-free areas for companies that manufacture in Ukraine and export 100% of their products.

Improve the business environment

Several other problems have a direct negative impact on investment activity across all sectors of the Ukrainian economy:

- **Regulatory and administrative barriers** that complicate access to markets and the development/export of new products;

- **Access to needed resources and infrastructure** to raise productivity and competitiveness;

- **Protection of property rights, including intellectual property**. This will reduce investment risk significantly and spur hi-tech development;

- **Clear and fair rules for doing business**, which should considerably reduce the level of corruption.

In the long term, the Government should continue its strategy of creating political, economic and social stability and predictability. These general factors are often more important to investors than any specific incentives or tax exemptions. Such a strategy should specifically aim at:

- **Combating corruption**. The Government should continue to develop policies and measures that will minimize corruption and protect business.

- **Developing a positive investment image.** Key steps include developing detailed Government Action Plans for promoting the country, providing state support to current investors in resolving problems or disputes, and monitoring the country's standing in the global community. An investment promotion agency, a unified approach to investment, and greater personal commitment among top officials would help develop a positive investment image.

- **Improving infrastructure, education, and the overall business climate.** The Government should ensure that Ukraine has appropriate capital and educational resources to promote an attractive business climate that can draw new foreign investment.

A Success Story: Industrial parks in Hungary

Foreign direct investment is important for integrating current and future electronics manufacturing firms into global production networks. By supporting the establishment of industrial parks, Hungary has positioned itself as a clear leader in attracting foreign investment over the past decade. As a result of its ability to attract FDI, Hungary experienced a high rate of economic growth, outpacing the European Union as a whole. Hungary has also enjoyed success specifically in the electronics industry. While 9% of FDI was directed towards this industry, Hungarian exports represented 50% of total electronics exports from Central and Eastern Europe in 2001.

The first Hungarian industrial parks were established in 1997 through initiatives of the central government. Primarily located in western Hungary, these parks attracted large international export-oriented firms and were highly efficient, developing rapidly and posting exceptional results. Since 1997, various municipalities have spearheaded industrial park development through regional economic development programs. The second generation of parks was largely dedicated to small- and medium-sized ventures that produced for domestic consumption.

Today, Hungary boasts over 160 different industrial parks that investors can choose from according to their business, professional, or cultural demands. Indeed, both the number and performance of Hungarian industrial parks in terms of revenues and exports more than quintupled their 1997 value, while the number of individuals employed in industrial parks has almost quadrupled. The Hungarian Investment and Trade Development Agency claims that industrial parks in Hungary currently account for 25% of total industrial output and 40% of total industrial exports. At the same time, productivity of industrial parks is more than 70% higher than the national average–and only 15% below average productivity in the EU.

Hungarian industrial parks provide investors with very favorable conditions, including support from municipalities, and various tax benefits. All industrial parks offer a number of key services:

- **Basic infrastructure.** This includes water, sewage, electricity, gas, paved roads, a ground telephone network, and public lighting. More developed parks include supplementary infrastructure such as Internet, Integrated Services Digital Network (ISDN), Asymmetric Digital Subscriber Line (ADSL), fiber optics, and so forth.

- **Support services.** Industrial parks also provide investors with both administrative and innovation services. Administrative services include single-point-of-contact administration, bank branches, management, operation, and legal representation of companies. Additional innovation services range from consulting to tender monitoring.

- **Supplier base.** Industrial parks work to promote the development of a strong supplier base.

- **Professional cooperation.** By linking similar technical operations among corporations, industrial parks can help lower production costs.

In addition to these services, Hungary also has a superb transportation system. Indeed, the majority of industrial parks have highways linked to the European highway network. Even more remote regions are accessible thanks to Hungary's 60 operational airports.

With the help of the government, Hungarian industrial parks have also begun to pay more attention to R&D. Industrial parks now provide a wide range of financial incentives, such as tax allowances and credits, to develop R&D. In addition, Hungary has a number of solid academic institutions that provide organizations with well-educated and skilled individuals.

The Hungarian Government has actively participated in the development of industrial parks, both at the local and national levels. At the local level, regional development programs have helped local governments to initiate industrial park development and encouraged them to actively seek out potential investors. In addition, while previous incentives such as tax privileges or targeted subsidies are no longer allowed since Hungary's accession to the EU, municipalities are allowed to reduce the general industrial tax rate.

At the national level, the Hungarian Government has provided a series of incentives and financial aid packages to help develop industrial parks and attract investors. Once investors have earned the title of "industrial parks," they can apply for various sorts of financial support, ranging from national subsidies to duty-free regimes. The Government has also offered co-financing for various types of investment in industrial parks.

Investors can also receive financial aid by applying for grants from the EU. Such grants focus on job creation, environmental and infrastructure development, agricultural investment, training and retraining workers, and innovative technologies.

Industrial parks were developed in Hungary as a way to further economic development, especially through new jobs, improved technology, and reduced regional disparities. While the overall economy has benefited, the Hungarian Government admits that investments have not been evenly distributed throughout the country, and geographical differences remain. To remedy this situation, the Hungarian Government has pledged to continue support for industrial park development, setting a goal of attracting US $1.5bn to US $2bn per year of investment.

Part 2: Report on the roundtable

Prospects for world leaders in hi-tech to establish production in Ukraine

On 7 July 2005, the Verkhovna Rada Ad Hoc Future Commission, the Ukrainian Union of Industrialists and Entrepreneurs (UUIE), the Institute for Reforms, a non-government policy center, and the International Centre for Policy Studies organized a roundtable called "Prospects for Hi-Tech Leaders to Establish Production in Ukraine." The goal of the roundtable was to organize a meaningful public dialog between the government and Ukrainian and foreign investors on policy options in the high technology sector and solutions to existing problems. During this roundtable, participants also discussed bills and initiatives aimed at mitigating the negative consequences of the sudden cancellation of special investment regimes under Ukraine's SEZs, TPDs and technoparks. This was the second roundtable in a series dedicated to Ukraine's investment policy and it considered five key questions:

1. How important to Ukraine's economic development is the presence of production facilities belonging to top international hi-tech companies likely to be?

2. What obstacles get in the way of such companies establishing facilities in Ukraine?

3. What do investors consider the achievements and drawbacks of Ukraine's new policy to establish such production facilities in Ukraine?

4. To what extent will the proposed regulations tackle the hurdles that prevent developing such facilities in Ukraine?

5. What else needs to be done to encourage the establishment of top hi-tech production facilities in Ukraine?

Participants in the roundtable included:

1. Central executive bodies;

2. Members of the Verkhovna Rada;

3. Independent experts and academics;

4. Business associations, investors.

The roundtable agenda and list of participants are provided in **Appendices 1** and **2**.

The position of the Government

According to First Vice Premier for Industrial Policy Anatoliy Kinakh, 2006 will be the year of investment. Ukraine needs to accelerate the upgrading of fixed assets and change the structure of the economy, which is currently resource-based. Given the country's substantial scientific and technological potential and the high level of education and skills among Ukrainians, it is worth establishing conditions for hi-tech sectors to develop.

"We need to set up a modern legal system that will protect rights of owners and investors, to ensure predictability and a level playing field," said the First Vice Premier. He went on to criticize the unilateral cancellation of special investment regimes in SEZs and technoparks, saying, "This has undermined the confidence of investors in Ukraine." According to Mr. Kinakh, the country needs to take inventory of all investment projects to see where the corruption is and renew special regimes for suitable investors.

Mr. Kinakh also mentioned that investors face a problem of VAT on investment in the form of fixed assets. He said that a zero VAT rate could be introduced, provided customs authorities carried out stricter oversight of non-resident investors.

According to Mr. Kinakh, the Jackson–Vanik amendment, a relic of the Cold War, needs to be cancelled, as it complicates access to cutting-edge technologies. Once protection for intellectual property rights is instituted in Ukraine, the country will be that much closer to receiving market economy status. The adoption of a number of bills by the Verkhovna Rada needed to accede to the WTO will also foster a more competitive economy.

"The positive expectations of the global business community during the first period of the new government's activities need to turn into actual investment," said First Deputy State Secretary Ivan Vasiunyk. "This could translate into billions of US dollars injected into the hitech industry. This, in turn, will satisfy the high expectations of voters." Mr. Vasiunyk also agreed with business representatives that failure to adopt the right decisions at the right time could frustrate investor expectations.

According to the First Deputy State Secretary, policy related to SEZs was based on a "black and white" approach. "Neglecting the problems that arose with SEZs resulted in widespread abuse and corruption," he added, "which discredited a basically sound concept." Mr. Vasiunyk connected the emotional responses of the new Government to the messy legacy of the previous regime. "But the sooner we let go of the past," he concluded, "the better for Ukrainian society and the new Administration."

"Setting up new economy and knowledge economy companies is a very promising direction for Ukraine to take," said Mr. Vasiunyk. "At the same time, we have to be careful of any attempts made by some government officials to attract investment in a 'hand-managed' mode to the resource sectors and to shift funds from one group of companies to another."

To speed up the emergence of the first success stories, according to Mr. Vasiunyk, investors need to be guided through the maze, but without 'hand managing.' "Investor problems can be resolved through the advisory foreign investment council that will meet this fall for the first time," he pointed out and called on all participants in the investment process to continue the ongoing dialog.

The position of the Verkhovna Rada

Deputy Mykola Onyshchuk called for a liberal approach to the development of Ukraine's economy that would include establishing conditions for investment and avoiding excessive state intervention in economic processes. He presented two legislative initiatives to: (1) make foreign investment in statutory capital VAT-exempt; and (2) extend the investment agreements concluded with business entities under SEZs, TPDs and technoparks for another two years.

According to Mr. Onyshchuk, if the state uses the law to cancel its own contracted commitments, it will have to compensate for all the losses incurred by this unilateral termination. He proposed setting up the institution of 'government investment officer.' "This," he argued, "would make it possible to take investors by the hand and help them deal with the Government and all high-ranking Cabinet officials."

Ihor Yukhnovskiy, Chair of the VR Ad Hoc Future Commission, said the situation was complicated because of efforts to fill up the Budget deficit. Firstly, the previous Government's significant increase in pensions, which the new Government supported, was not covered financially. Secondly, corporate profit tax revenues from steelworks are lower than their VAT refunds because most of the country's steel exports have undergone only low-end processing, where the raw material costs are about 80% of overall production costs. Mr. Yukhnovskiy called canceling all TPDs and exemptions allocated to technoparks for the purpose of covering the Budget deficit "an absurd decision."

The Future Commission chair then presented a bill that renews key privileges for technoparks: exemptions from (1) paying VAT and duty on imported equipment and components; (2) paying profit tax into a special account; and (3) paying VAT for manufactured goods. Mr. Yukhnovskiy explained that the bill does not mention exemptions for land leases because such exemptions are regulated by local governments. In addition, next year, the Budget will include a new item to support innovation at technoparks. He added, "I hope that this bill, which the Economy and Finance Ministries have given preliminary approval, will be adopted by the Rada."

"Ukraine is interested in investments in manufacturing hi-tech products that offer the maximum value-added," said Mr. Yukhnovskiy. "I'm very much against continuing the practice of importing second-hand equipment to upgrade our industries. We need tax exemptions for state-of-the-art equipment."

The position of investors

Nigel Godwin, Intel's EMEA ODM/EMS Programs Manager, presented the wish-list of the East European Working Group (EEWG), which includes top hi-tech electronics companies, in terms of investing in setting up production capacities in Ukraine.

The transfer of some part of production capacities to Ukraine and access to the Pan-European Transport Corridor V that runs Venice–Ljubljana–Budapest–Uzhorod–L'viv–Kyiv will make it possible for international companies that have so far been placing production capacities in Asia to cut delivery times to the European market by 20–25 days and to reduce dependence on China. In addition to a high-quality labor force, Ukraine has all the necessary materials and resources to launch full-scale production: steel (about 500,000 t per year is needed), alloys, chemical substances, electricity, water, and so on. Mr. Godwin said he hoped to meet representatives of the Ukrainian Government or the Ukrainian investment promotion agency to discuss the conditions for Intel to invest in Ukraine.

Jabil Circuit Ukraine General Director Philippe Costemale, whose company is also a member of the EEWG and had previously invested in Ukraine, presented key problems facing further development of the company's production capacities in Ukraine. He emphasized the need to use the positive experience of Central European countries in preparing for EU membership. "All these countries used one and the same mechanism to attract investment," he noted. "They established industrial parks where investors could set up production facilities to manufacture goods for export purposes." Mr. Costemale is convinced that industrial parks, SEZs, scientific parks, and technological free zones are an effective instrument to attract FDI, create new jobs, increase the volume of cross-border commercial activity, transfer technologies, and develop production, raising economic indicators and living standards.

"Jabil Circuit Ukraine stopped investing in Ukraine because of the sudden cancellation of exemptions for the Zakarpattia SEZ," concluded Mr. Costemale. "Jabil is ready to renew its investment, but it needs to know when the Government will resolve the problems facing investors."

The position of experts

Institute for Reforms Director Markian Datsyshyn presented a report on the activities of SEZs and TPDs in Ukraine and a bill "On amending the Law 'On general principles for establishing and running special (free) economic zones.'" This bill envisages: (1) setting up a maximum term of 25 years for SEZs to operate; (2) introducing a fixed list of privileges only: exemptions from direct taxes, such as corporate profit, land use tax and payroll taxes; and (3) limiting exemptions according to the investment involved.

According to ICPS Director Vira Nanivska, the global community that manufactures hitech products has noticed Ukraine. Still, Ukraine has problems: investors cannot enter the market, whereas companies already working here are having a hard time continuing their operations. At first glance, she noted, there is a contradiction: on one hand, it is necessary to develop a consolidated tax regime and a level playing field; on the other, there are real companies who are already operating here and urgent problems that need to be tackled now. "The country's leaders say we first need to set up a system," concluded Ms. Nanivska, "But this cannot exclude the other issues: Ukraine needs to take immediate steps and lay the foundation for its future strategy."

According to Ruben Beliayev, a senior member of the Foreign Commercial Service of the US Embassy, Ukraine now has a unique opportunity. "Perhaps for the first time in the entire history of independent Ukraine, American and global hitech leaders whose budgets are comparable to Ukraine's entire State Budget are showing interest in locating part of their production facilities here," he said. "But they're all facing the same problem: the old system, which was clear and familiar to them, is no longer working, but a newer, better system hasn't been set up in its place yet."

"Foreign companies began to show interest in entering Ukraine's market several months ago," noted Mr. Beliayev, "but this won't last long. The executives of major companies operate according to global concepts and they have to make quick decisions." Meanwhile, local managers in various countries vie with each other to promote projects in their own countries. "If Ukraine does not clear out the uncertainty in its investment policy now," warned Mr. Beliayev, "even the most ideal system for investors will be of no interest to them down the line."

Conclusions and results

The organizers of the roundtable decided to prepare a policy paper reviewing problematic issues and offering various alternatives discussed during the debate and to present it to President Yushchenko.

According to Viktor Ivchenko, adviser to the premier, Ms. Tymoshenko is aware of the situation and is prepared to facilitate investment projects in the hi-tech sector. The president also plans to find systemic solutions to the problems confronting foreign investors, starting with an investment promotion agency.

It became clear that participants have understood the need to tackle the uncertainty in the investment climate and to attract hi-tech companies when, on 13 July 2005: (1) the Government supported the presidential initiative of setting up a State Agency for Investment and Innovation; (2) the president brought up the possibility of restoring investment regimes for SEZs in September 2005, after the activity of each zone is analyzed to determine a compensatory regime; and (3) the premier said that the Government would initiate special tax regime for imports of hi-tech equipment and components.

Appendix 1

Agenda

13:30–14:00	Registration of participants Moderator: Stanislav Dovhiy, Secretary, Verkhovna Rada Ad Hoc Future Commission
14:00–14:15	Opening • Anatoliy Kinakh, First Vice Premier for Industrial Issues • Serhiy Buriak, Chair, Verkhovna Rada Finance and Banking Committee • Vira Nanivska, Director, International Centre for Policy Studies
14:15–14:30	Presentation: "Eastern European Working Group. A look into establishing production in Ukraine" Presenter: Nigel Godwin, Intel EMEA ODM/EMS Programs Manager, United Kingdom
14:30–14:45	Presentation: "Production of electronic components in Ukraine: capacities and requirements" Presenter: Philippe Costemale, General Director, Jabil Circuit Ukraine
14:45–15:00	Presentation: "A Bill amending the 24 March 2005 Law №7248 'On the special investment and innovation regimes of technological parks' with respect to the system of subsidies" Presenter: Ihor Yukhnovskiy, Chair, Verkhovna Rada Ad Hoc Future Commission
15:00–15:15	Presentation: "A Bill amending the 16 May 2005 Law №7486 'On general principles for establishing and running special economic zones'" Presenter: Ivan Vasiunyk, First Deputy State Secretary
15:15–15:30	Presentation: "A Bill on improving the investment climate in Ukraine and state guarantees for investors" Presenter: Mykola Onyshchuk, First Deputy Chair, Verkhovna Rada Legal Policy Committee
15:30–15:45	Coffee break
15:45–16:45	The roundtable considered five key questions: • How important to Ukraine's economic development is the presence of production facilities belonging to top international hi-tech companies likely to be? • What obstacles get in the way of such companies establishing facilities in Ukraine? • What do investors consider the achievements and drawbacks of Ukraine's new policy to establish hi-tech production facilities here? • To what extent will the proposed regulations tackle the problem of developing such facilities in Ukraine? • What else needs to be done to encourage the establishment of top hi-tech production facilities in Ukraine?
16:45–17:00	Wrap-up
17:00	Conclusions and recommendations

Appendix 2

List of participants

№	Name	Organization
1.	Ruben Beliayev	Foreign Commercial Service, US Embassy
2.	Viktor Bondar	First Deputy Minister of Transport and Communications
3.	Philippe Costemale	General Director, Jabil Circuit Ukraine
4.	Hryhoriy Danyleiko	Director, Slavutych SEZ
5.	Markian Datsyshyn	Director, Institute for Reforms, a national policy center
6.	Lesia Dovhaniuk	Manager, Department of Finance and Investment, Ministry of Economy
7.	Stanislav Dovhiy	Secretary, Verkhovna Rada Ad Hoc Future Commission
8.	Taras Dovhiy	Chair, Tax Policy Sub-Committee, VR Finance and Banking Committee
9.	Serhiy Dzhyhalov	Manager, Department of Customs Settlements, State Customs Service
10.	Yevhen Fedotov	Expert, SigmaBleyzer
11.	Ildar Gazizullin	Economist, International Centre for Policy Studies
12.	Nigel Godwin	EMEA ODM/EMS Programs Manager, Intel
13.	Andriy Hurzhiy	Cabinet of Ministers
14.	Viktor Ivchenko	Adviser to the premier
15.	Anatoliy Kinakh	First Vice Premier for Industrial Policy
16.	Pavlo Kruhliakovskiy	Martin Group
17.	Bohdan Kupych	General Director, Kvazar-Micro
18.	Valentyna Lashkevych	Chair of the advisory board, ZAT TAS-Investbank
19.	Yuriy Liashenko	General Director, TOV Softline International
20.	Vira Nanivska	Director, International Centre for Policy Studies
21.	Oleksiy Nohovitsyn	Director, Scientific, Technological and Innovative Industrial Policy Department, Ministry of Industrial Policy
22.	Oleksandr Oliynyk	Expert, Institute for Reforms, a national policy center
23.	Mykola Onyshchuk	First Deputy Chair, Verkhovna Rada Legal Policy Committee
24.	Vsevolod Popovych	Deputy General Director for General Administration, TOV Softline International
25.	Oleksiy Savchenko	Academic Secretary, Math Department, National Academy of Sciences
26.	Volodymyr Sharov	Director, Intel representative office to Ukraine
27.	Viktor Shovkaliuk	Deputy Director, Financial and Investment Policy Department, Ministry of Economy
28.	Brian Smith	Foreign Commercial Service, US Embassy
29.	Oksana Sukhina	Economic assistant, US Embassy
30.	Oleh Syniutka	Ivano-Frankivsk Deputy City Mayor

№	Name	Organization
31.	William Varettoni	US Embassy
32.	Ivan Vasiunyk	First Deputy State Secretary
33.	Andriy Voznenko	Manager, Industrial Finance Department, Finance, Industry and Construction Administration, Budget Policy Division, Ministry of Finance
34.	Volodymyr Yaremiy	Executive Director, Ukrainian Association of Business Incubators and Innovation Centers
35.	Ihor Yukhnovskiy	Chair, Verkhovna Rada Ad Hoc Future Commission
36.	Anton Zatsepin	Cabinet of Ministers

Appendix 3

About the roundtable on "Government policy to support hi-tech investment in Ukraine"

A shift in hi-tech policy could made Ukraine one of the world leaders, agreed participants in a roundtable called "Government Policy to Support Hi-Tech Investment in Ukraine" that was organized by the Verkhovna Rada Ad Hoc Future Commission and the International Centre for Policy Studies on 14 June 2005.[1]

That part of Ukraine's economic potential based on old soviet production capacities will soon be exhausted. Yet the development of future technologies is in a state of confusion: the existing scientific base and qualified specialists face administrative barriers and the lack of state support for hi-tech investment. Better policy could bring hi-tech development to Ukraine, increase export potential and stop the country's brain-drain.

Participants in the roundtable included lawmakers and representatives of the Government, foreign and domestic companies, independent experts, and academics. Key presentations were delivered by top mangers of hi-tech companies: Serhiy Loboiko, president of TECHINVEST, a venture capital firm, and Philippe Costemale, General Director of Jabil Circuit Ukraine.

In his introduction, ICPS economist Ildar Gazizullin said that sustainable economic growth might be secured by attracting investment and transferring high technologies, as the potential for the Ukrainian economy to expand its remaining soviet industrial capacities is rapidly shrinking. However, he noted, Ukraine has no strategy to support hi-tech development, having not identified priority areas with the greatest potential. As a result, the policy of encouraging investment is not effective because of contradictory criteria and goals, and inconsistent implementation. Policy instruments for attracting investment have failed because: (1) there was no analysis of the country's competitive advantages and potential, while state funding for science was scattered among numberless R&D institutes and across many sectors; (2) infrastructure was lacking to attract investment and transfer new know-how into the economy; and (3) there were no effective mechanisms for monitoring the outcomes and impacts of policies intended to stimulate investment.

According to Mr. Loboiko, Ukraine has enormous potential for developing its IT sector. Computer technology has been developing in Ukraine for 50 years, and 30% of all R&D in the FSU took place in Ukraine. Although Ukrainians are among the best IT specialists in the world—fourth place in the 2002 BrainBench rating for the number of certified programmers and third place in the 2003 ACM programming competition—, the IT sector has little presence in the global IT market. In 2004, Ukraine's IT exports stood at a little over US $110mn. Mr. Loboiko says the policy of promoting IT exports should include: (1) promoting the history of IT in Ukraine and its technological and innovative potential; and (2) incentives for private investment into technological venture funds, R&D and design, business incubators, technological parks, including state co-investment, and transfer of suitable state-owned assets into private management. Meanwhile, HR and scientific potential can be development through (1) joint scientific, educational and production facilities organized between educational institutions and major IT companies; and (2) transferring rel-

[1] Materials from this roundtable can be found online at: *http://www.icps.kiev.ua/project.html?pid=79*.

evant state educational facilities and institutes into private management.

Mr. Costemale says Ukraine could become a key regional leader in attracting hi-tech investment during the next decade. Major companies whose combined global revenues in 2004 stood at US $200bn are looking for an alternative to Asia by developing R&D institutions and production facilities in Eastern Europe. With its highly qualified and competitive workforce and borders with the EU, Ukraine has every chance to be considered. But those investors exporting products made in Ukraine note four obstacles to doing business in Ukraine: (1) high import duty; (2) complicated customs procedures; (3) lack of a supplier base; and (4) VAT refund arrears. According to Mr. Costemale, establishing industrial parks and granting investors who manufacture in Ukraine and export 100% of their products free customs status could compensate for the cancellation of various exemptions connected to SEZs.

Appendix 4

Declaration from the roundtable on "Government policy to support hi-tech investment in Ukraine"

This is a historical moment for Ukraine to attract major industrial players from the hi-tech industry.

The Eastern European Working Group, which encompasses major electronics manufacturing companies worth US $100bn in revenue last year, is in Kyiv this week[2] to explain to the Ukrainian Government its intention to develop an alternative to Asia by expanding R&D and manufacturing capacities in Eastern Europe, especially in Ukraine.

Thanks to the improving political situation in Ukraine, which is located in Eastern Europe, this country could become a key regional leader for attracting hi-tech investment over the next decade.

At the moment, despite the current education system, a base for hi-tech production, and proximity to the EU, all electronics manufacturers, such as Jabil Circuit, Flextronics and other global players, have stopped their investment projects because of deteriorating investment conditions.

We greatly appreciate the intent of the new Ukrainian Government to set attractive and fair business conditions for all investors and to introduce the reforms necessary to reduce corruption and red tape.

But we urge the new Government to implement additional conditions that might unblock investment in the hi-tech industry.

Foreign direct investments were the main driver that revived all Central European economies during the last 10 years and made it possible for them to join the EU in 2004.

We encourage the Ukrainian Government to follow the same path to EU integration by applying the economic tools developed successfully in the Czech Republic, Hungary, Poland, Slovakia and other EU countries.

[2] This declaration is dated 14 July 2005.

Appendix 5

Proposal from Jabil Circuit Ukraine Limited: "Conditions for major investors to operate in hi-tech industries in Ukraine"

Commercial operations

1. **The import of raw materials or components with further export of ready products manufactured from these:**

- a simple (unsecured) promissory note, maturing in 180 calendar days, should be registered for the amount of VAT and import duty for such components and materials calculated in the cargo customs declaration;
- such a promissory note should be withdrawn on condition that ready products manufactured from these components and materials are exported. Otherwise, if some part of these components and materials is not exported outside Ukrainian customs territory within 180 days, that part of VAT and import duty that represents these should be paid in full.

2. **The purchase of components and materials** on Ukrainian customs territory: VAT should be calculated at a rate determined in the Law "On the Value-Added Tax" and refunded according to the procedure specified by Art. 7 of this Law.

3. **The import of services provided by nonresidents on Ukrainian territory:** VAT should be calculated at a rate determined in the Law "On the Value-Added Tax" and refunded according to the procedure specified by Art. 7 of this Law.

4. **The provision of services by Ukrainian residents on Ukrainian territory:** VAT should be calculated at a rate determined in the Law "On the Value-Added Tax" and refunded according to the procedure specified by Art. 7 of this Law.

5. **The import of equipment (investment) onto Ukrainian customs territory:** this type of investment should be exempted from import duty and VAT, provided it is eligible to be classified as fixed assets under Ukrainian law. For greater assurance, the investor can be required to sign an additional investment agreement with a body appointed by the Government of Ukraine to be responsible for relations with foreign investors. At the option of the investor, an investment can be the founder's contribution to the statutory fund or the investor's purchase with their own capital. The investor can also be required to make a written commitment not to alienate such equipment on Ukrainian territory. Otherwise, they should be liable for VAT and import duty both.

6. **The import of equipment under a leasing agreement:** this should be done on condition that the investor registers a simple (unsecured) promissory note for the amount of VAT and import duty, maturing at the time when the leasing agreement expires.

7. **The purchase (or lease) of equipment on Ukrainian customs territory:** VAT should be calculated at a rate determined in the Law "On the Value-Added Tax" and refunded according to the procedure specified by Art. 7 of this Law.

8. **Re-imports:** the re-import of equipment that was temporarily exported outside of Ukrainian customs territory for repair pur-

poses should be exempted from VAT and import duty. The re-import of finished goods manufactured by the investor and returned with a claim for repairs should be exempted from VAT and import duty.

9. **The disposal of defective goods:** defective goods (seconds) should be destroyed in the presence of authorized representatives of customs and tax bodies. A protocol signed by these representatives and a representative of the investor should be sufficient grounds for withdrawing that part of the promissory note that covers such defective goods.

10. **VAT refunds:** The Government of Ukraine should guarantee direct VAT refunds to investors. Investors should have first claim to VAT refunds without additional document checks.

Customs procedures

Given that components and materials will be directly delivered from the border to the plant and finished goods will be exported, Jabil Circuit Ukraine Limited (hereinafter referred to as Jabil) proposes to simplify the customs procedures so as to remove requirements that are not present in European Union legislation.

Jabil proposes changing requirements to the customs procedures for cargos as follows:

1. All customs procedures and inspections (sanitary, epidemiological, ecological and phyto-quarantine inspections) should be carried out on the territory of the Jabil plant.

2. Cargo crossing of Ukraine's customs border should not require the registration of preliminary declaration and preliminary notification, but use data under the state registration numbers of the transport vehicles and the relevant cargo (commercial invoices or pro forma invoices for cargo in English) submitted by the investor via telecommunication channels.

3. Customs procedures should not require the registration of a separate customs value declaration. Standard commercial invoices or pro forma invoices submitted in English should suffice.

4. The registration of packing lists should be cancelled. The company commits itself to recycle commercial waste independently or through a network of companies engaged in recycling secondary raw materials.

5. Jabil should be exempt from import duty.

6. Imported equipment and raw materials should be exempted from mandatory certification procedures. Such equipment will be used solely for the company's own production purposes and will not be sold on Ukrainian customs territory.

7. When crossing the international border, the investor's cargo should be eligible to use the "green corridor" regime.

The transitional period

Jabil hereby addresses the Government of Ukraine with a request to provide an opportunity to register imports of resources for further processing on a tolling basis with a simple (unsecured) promissory note for the transitional period, that is, during the implementation of the pilot project.