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Ukraine's large market attracts foreign investors, but unstable regulation deters them

Despite its natural comparative advantages, Ukraine has one of the lowest rates of FDI in the CEE/CIS region. A survey of enterprises carried out by the Flemings/SARS Consortium found that Ukraine's underperformance in terms of FDI is to be explained at least partly by its inferior investment climate (legal, economic, and infrastructure aspects), as well as by deficiencies in the country's privatisation approach and effort. Given that market seeking is a dominant drive of foreign investors coming to Ukraine, policy should target lowering entry barriers. The report on survey findings was published in the latest issue of ICPS's Policy Studies journal (June 2000)

Ukraine's cumulative FDI per capita equals US$65 (as of 1999), which exceeds only that of Belarus, Uzbekistan, and Tajikistan.

In order to identify the reasons for FDI underperformance in Ukraine, we performed a mail survey of 65 companies with representation in Ukraine, grouping them into multinational enterprises (MNEs), multilateral financial institutions, private institutional investors, and entrepreneurs. Besides requesting them to identify the major deterrents to investment and to estimate the significance of privatisation for FDI, the survey asked the sampled investors about their motives, risk appetite, and decision-making mechanisms while investing in Ukraine; inquiries were also made about the investors' assessment of priorities for their investment-enhancing policy agenda. The sample included 32 enterprises: 2 multilateral financial institutions, 5 entrepreneurial firms, 3 direct equity funds, and 22 MNEs. The response ratio was 50 percent.

As was to be expected based on the accumulated evidence from other transition economies, Ukraine's underperformance in terms of FDI is to be explained at least partly by its inferior investment climate (legal, economic, and infrastructure aspects), as well as by deficiencies in the country's privatisation approach and effort. Implicit evidence for the inadequacy of Ukraine's privatisation effort may be found in the fact that most of the mail survey respondents (including 60 percent of the MNEs) reported that they had invested in Ukraine through green-field projects or joint ventures with private companies, rather than through privatisation offerings; many of the multinational companies not currently looking at investing in Ukraine also proclaimed their preference for green-field investments.

The survey provides strong evidence that market-seeking activities are the most dominant motives for FDI in Ukraine, well ahead of other possible reasons (including pursuit of cheap and qualified labour). Most investors are attracted to Ukraine's extensive domestic market of 50 million people. The availability of low-cost labour turned out to be insignificant for the majority of companies surveyed except entrepreneurial investors, who tend to be more sensitive to the availability of cheap inputs. Although Ukrainian wages are lower than in other Eastern-European countries, this competitive advantage is diminished by significantly lower labour productivity, the lack of capital, inferior management, and regulatory burdens, making unit costs higher in Ukraine than in neighbouring countries.

The survey ranked the major deterrents to FDI in Ukraine in the following order (descending in significance: 1 = 'major

Motives for companies investing in Ukraine

"major reason"=1; "minor reason"=2; "not a reason"=3

Rank	Why did you choose to invest in Ukraine?	Total
1	Market size and potential for market growth	1.05
2	Access to a new regional (Central/Eastern Europe, CIS) market	1.92
3	Skill set of labour force	2.15
4	Availability of low-cost inputs (e.g., cheap labour; energy; raw materials)	2.27
5	Production capacities	2.32
6	To improve competitiveness in supplying established markets (e.g., Western Europe)	2.53
7	Tax incentives	2.69
8	A chance to access research and technological expertise available in Ukraine	2.71

Source: Flemings/SARS survey

Last Week

ICPS promotes public policymaking in Kazakhstan. Last week, ICPS experts Edward Zakharchenko and Volodymyr Nikitin participated as consultants in a workshop on "Introduction to Public Policy" in Almaty, Kazakhstan. The goal of this seminar was to share basic knowledge on public policy with Kazakhstan's research institutes. The ICPS experts emphasised the necessity of building social dialogue, and introduced the main principles of public participation in policymaking.

The seminar was organized by the Eurasia Foundation and the Soros Foundation in the Republic of Kazakhstan for the activity of the "Public Policy Initiative", within the framework of which 13 institutions received grants for research. Among the seminar participants were directors of the Oriental Institute, the Institute for Forecasting Kazakhstan Development, the Institute for Strategic Studies of Kazakhstan, and representatives of the political opposition, who designed projects focused on building a national forum of political parties and non-governmental organisations.

The preliminary assessments of the research projects showed a poor understanding of public policy principles. In the seminar sessions, the ICPS experts analysed the projects and concluded that the major deficiencies included a lack of balanced objectives and tasks, an absence of organic dialogue between NGOs and the government, and the conviction of Kazakh scholars that foreign experience is not applicable to Kazakhstan. Messrs Zakharchenko and Nikitin also assisted in finalising several projects and adjusting their objectives and tasks.

Sponsors and participants of the seminar concluded that an independent think tank should be established in Kazakhstan. Also it was agreed that Kazakh scholars would study and apply Ukraine's experience in educational reform.

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problem'; 2 = 'minor problem'; 3 = 'not a problem'):

- instability and exorbitance of regulations (1.03);
- ambiguity of the legal system (1.21);
- uncertainty of the economic environment (1.27);
- corruption (1.34);
- high tax burden (1.46);
- problems establishing clear ownership conditions (1.56);
- depressed disposable income levels (1.69);
- difficulty negotiating with government and privatisation authorities (1.79);
- volatility of the political environment (1.82);
- lack of physical infrastructure (2.09);
- problems in accessing domestic and export markets (2.16).

It is noteworthy that all these impediments were recognised as causing problems. Though on the lower end of the ranking, clarity of ownership rights and ease of negotiating with government/privatisation authorities were still ranked between 'major problem' and 'minor problem', i.e., they were perceived as significant FDI deterrents.

Respondents provided their views on what should be done by the Ukrainian government to improve Ukraine's attractiveness for FDI (from "1—a top priority" to "3—not a priority"):

- liberalise capital, foreign exchange and profit repatriation controls (1.12);
- lift restrictions on foreign ownership and control (1.16);
- minimise red tape (1.17);
- reduce tax rates and the number of taxes (1.32);
- lift restrictions on accessing domestic and export markets (1.78);
- enhance the contract enforcement system (1.81).

On the other hand, improvements in physical infrastructure and increasing import barriers were rated to be of low priority. In brief, the suggested policy agenda may be summarised as follows: investors want to deal with fewer government officials, and less frequently. Many of them believe that a comprehensive and rigorous privatisation approach would lead to this end.

As anticipated, the status of privatisation in Ukraine was significant for the majority of survey respondents. Only 5 percent of respondents (deep-pocketed MNEs) found privatisation status to be unimportant in their activity. For the rest of the investors (95 percent), privatisation policy appears to be a very significant factor, which affects their investment decisions. It is expected that privatisation will not only create new acquisition opportunities, but also enhance the overall business climate, through productivity growth and reduction of unproductive government interference. While the importance of privatisation in creating acquisition opportunities was recognised by most institutional (private and multilateral) and entrepreneurial investors, it was surprising to note that the sampled MNEs do not significantly rely on privatisation while structuring their strategy in Ukraine.

The survey resulted in a number of policy recommendations for Ukraine's FDI policy in general, and its privatisation policy in particular. In a nutshell, Ukraine's privatisation policy has to be tailored more towards the preferences of MNEs, who have so far failed to participate in Ukraine's privatisation process in any significant way. ■

The study was performed by the Flemings/SARS Consortium, led by Robert Fleming & Co. Limited, as part of the project "Strengthening the State Property Fund: Individual Privatisation of Enterprises" within the technical assistance component of the Enterprise Development Adjustment Loan from the World Bank.

This issue of ICPS's Policy Studies journal also contains the report from a survey titled "Enterprise Land Privatisation: Appraising Its Impact on Foreign Direct Investment in Ukraine", to be presented in upcoming issues of the ICPS newsletter.

If you wish to receive ICPS publications, please send your information to the e-mail address: marketing@icps.kiev.ua or contact Oleksii Blinov, ICPS marketing office, tel.: (380-44) 463-6337.

ICPS disseminates seminar reports

The International Centre for Policy Studies has completed its series of public discussions of the Cabinet of Ministers Action Plan as part of the Project "Ukraine's Future: Public Feedback on the Reform Policy".

We are very grateful to all seminar participants and would like to announce that reports on the seminars will be prepared by the end of June, 2000. All the reports are being posted in both English and Ukrainian on the ICPS web-site http://www.icps.kiev.ua

If you would like to have a free electronic or hard copy of the document package delivered, please contact Andrew Bega, e-mail: abega@icps.kiev.ua, tel.: (380-44) 463-5967.