Chapter Four
Ukrainian Economy and Economic Reforms

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The first section of this chapter analyzes the state of Ukrainian economic reforms following two decades of transition to a market economy. This analysis is followed by a summary of recent macroeconomic results and an overview of cooperation with IMF in combating the consequences of the global financial crisis. In the next section the business climate in Ukraine is investigated. The following sections analyze corporate legislation and trade in agricultural land, and compliance with WTO obligations as examples of how external actors can influence economic systems in transition economies. The crucial role of the Association Agreement and Deep and Comprehensive Free Trade Agreement between EU and Ukraine is discussed, and the chapter is rounded off with an investigation of the potential role of oligarchs. The chapter concludes with a set of policy recommendations.

Economic Reforms after Two Decades

After two decades of transition Ukraine is still far behind countries that joined the EU, including the three Baltic states, in economic reforms. According to the EBRD transition index Ukraine scores behind Georgia and Armenia in 4-5 dimensions out of nine and behind Mongolia in some of them (such as large scale privatization, and price liberalization).[1] The most advanced areas in Ukraine's transition to a market economy by 2010 were small scale privatization, price liberalization, and trade and the foreign exchange system. The least advanced were governance and enterprise restructuring, competition policy and infrastructure.[2]

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[1] *Transition Report 2010* (London: EBRD, 2010), p. 4.

[2] Ibid.

The slow pace of economic reforms in Ukraine can be explained by the following factors. When the USSR disintegrated, unlike Central Europe, Ukraine faced a triple transition: building sovereign state structures; transforming the economy; and establishing democratic institutions. The Baltic states spent only 45 years under communism, whereas Ukraine was part of the USSR for almost 70 years. Unlike the Baltic states, Ukraine had no recent tradition of statehood and therefore no ability to revive pre-communist institutions.

Ukraine opted for a presidential, rather than parliamentary, system of power in the 1996 constitution, which was in effect until 2005, and to which it returned in 2010. The experience of 20 years of transformation proved that presidential systems in transition countries makes it more difficult to ensure the rule of law, checks and balances, an independent media and judiciary. All countries that have been successful in transformations in Central, Northern and Southern Europe adopted parliamentarian systems. Of course, the presidential system does not preclude the adoption of reforms. There are exceptions, such as President Mikheil Saakashvili, who has undertaken radical reforms in post Rose Revolution Georgia. A series of reforms were implemented by President Leonid Kuchma in the mid 1990s. Following the 2004 Orange Revolution, President Viktor Yushchenko missed the opportunity to introduce reforms in the first years of his presidential term when Ukraine had a presidential constitution. On the other hand, four years of parliamentary rule—2006-2010—were marked by weak majorities and personal conflicts between President Yushchenko and Prime Ministers Yulia Tymoshenko and Viktor Yanukovych.

Ukraine's successful accession to the WTO in May 2008, following 15 years of negotiations, was one of the very few achievements of this period in the area of economic reforms. President Yanukovych, elected in 2010, launched an ambitious plan of reforms in summer 2010, but implementation has been very slow due to a lack of political will, populist concessions ahead of parliamentary elections in 2012, and a deficit in government capacity to draft EU-compatible legislation.

An EU membership perspective was and remains the most powerful external factor contributing to successful transformations in post-communist Europe. In countries offered membership by the EU a great deal of new legislation was adopted and modern institutions were established. Ukraine has been denied a membership perspective by the EU, and among the former Soviet republics only the Baltic states were invited to join the EU. The Orange Revolution was a perfect opportunity for such an offer to be made to Ukraine when it would have led to discipline and provided direction for political leadership, experts and the general public. Denying a membership perspective was a historical mistake by the EU, as Gunter Verheugen observed after he had left the office of Vice President of the European Commission.[3] A Plan of Action between Ukraine and EU was adopted in 2005 and an EU-Ukraine Association Agenda approved in November 2009, but these were poor substitutes for membership, as they lacked sufficient technical support and disciplining measures.

Macroeconomic Balances

Following a 15 percent GDP decline in 2009, the Ukrainian economy grew 4.2 percent in 2010 and is expected to grow by 4.5% in 2011 and 5.0% in 2012. By 2012 Ukraine's GDP will exceed its pre-crisis level. Economic growth is led by consumption that declined by 12.2% in 2009 and is expected to recover by 4-5% per year. Investment in fixed assets were slashed by half in 2009 and are recovering at a similar speed. The CPI is expected to grow by 11.4% in 2011 after it remained down by 9.1% in 2010.

In 2009 exports declined by 22% whereas imports were slashed by almost 40%. Both recovered in 2010 and 2011. Ukraine's current account deficit declined from 7.0% of GDP in 2008 to 1.5% of GDP in 2009. However, the World Bank expects the current account deficit to increase to 4% in 2011 and 5% in 2012 and 2013. FDI declined from $10.9 billion in 2008 to $4.8 billion in 2009 and remained low in 2010 and 2011. Nevertheless a surplus in FDI has compensated for the deficit in Ukraine's current account.

In 2011 proceeds from the privatization of Ukrtelecom and successful Eurobond placement contributed to an increase in the foreign reserves of the National Bank. The external debt is to decline from 91% of GDP in 2009 to 78% in 2011. While the indebtedness of

[3] For example, during the Economic Forum in Kyiv in February 2011.

companies and business persons is declining as a share of public debt while government debt is growing. Ukraine's public debt has been growing rapidly during the crisis from the low level of 12.4% of GDP in 2007. The World Bank predicts that public and guaranteed debt of Ukraine will grow to 40% of GDP in 2011 and will stay at this level for a couple of years requiring fiscal discipline and substantial reforms envisaged in the 2010 Standby Agreement with the IMF.

International reserves declined from $38 billion in August 2008 to $24 billion in April 2009 but have been recovering since then. Devaluation of the *hryvna* from 5 to 8 *hryvna* per U.S. dollar during the last quarter of 2008 had a positive impact on reducing the foreign trade deficit and contributed to the arrest of the depletion of Ukraine's currency reserves.

Ukraine's future fiscal balance is heavily dependent upon two reforms: energy tariffs (including gas prices for household consumers) and pension reform. Both are part of the IMF Standby Arrangement with Ukraine. In 2010-2011, Ukraine introduced the first stage of tariff reforms by raising household utility prices by 50% but balked at doing this a second time. Pension reform was adopted by parliament in summer 2011.

Cooperation with the IMF

Ukraine signed a Standby Arrangement (SBA) in an early phase of the global financial crisis in November 2008. However, in the course of the 2010 presidential election campaign Ukraine did not implement reforms aimed at lowering fiscal deficit, in particular reforms in the pension system and household tariffs. In October 2009 a new Social Standards Law was adopted by parliament that resulted in "significant budget pressures due to indexation of wages and pensions to the minimum wage and subsistence levels".[4] In July 2010 a new SBA was approved with the IMF worth $16 billion, available to Ukraine over 2.5 years, conditioned by reforms in its financial sector. The SBA entailed a new approach, the so-called "Exceptional Access Criteria," which allows for increased amounts of the loan for a member country

[4] IMF Country Report No. 10/262 (August 2010).

that is experiencing "exceptional balance of payment pressures" but at the same time having the "political capacity" to deliver sustainable adjustment measures in the medium term. Structural reforms are to bring the budget deficit down to 3.5% of GDP in 2011 and 2.5% of GDP by 2012.

The agreement with the IMF assumes a wide range of reforms aimed at improving the financial sector, in particular through the rehabilitation of the banking sector, improved tax collection, strengthening independence of the National Bank, and an increase in exchange rate flexibility. But reforms to the pension system and energy sector are critically important for restoring Ukraine's financial sustainability.

Pension expenditures increased from 9% of GDP in 2003 to 18% in 2009, one of the highest levels in the world. At the same time, pension fund revenues cover only two-thirds of expenditures, the rest being covered by transfers from the budget. Demographic pressures will increase the burden on the working population even further. The reform of Ukraine's pension system has been long delayed until summer 2011. The new law provides for raising the pension age for women from 55 to 60 years over 10 years by half a year per annum; raising the pension age for male civil servants from 60 to 62 years, increasing the qualification period for pensions from 25 to 30 years for women and from 25 to 35 years for men, lifting the minimum insurance period from 5 to 15 years and capping maximum pension benefits for new pensioners to 10 "living wages" (currently 7,600 *hryvni*, or about $950) The transition from the pay-as-you-go system to a capital accounts system is delayed until the budget of the pension fund and general budget are balanced.

According to the EU/UNDP BRAAC report, only a gradual increase of the retirement age to 65 years for both genders by 2050 would prevent a dangerous increase in demands placed on the pension system.[5] If the pension age remained unchanged, 55 for women and 60 for men, the Ukrainian population of pension age would increase from 11.7 million in 2009 to 14 million in 2050, whereas the working-age population would decrease from 27 to 17 million.

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[5] *Demographic and Financial Preconditions of Pension Reform in Ukraine: Forecast 2050* (Kyiv: EU/UNDP Blue Ribbon Analytical and Advisory Centre, 2010), pp. 8-9.

Ukraine is one of the least energy-efficient countries, consuming 2.6 times more energy per GDP unit than on average in OECD countries. Industrial prices for energy are already at market levels. But prices for gas for households and utilities are heavily subsidized, and owners of large apartments and dachas are the greatest beneficiaries of low domestic prices for gas. With low gas prices there is neither the stimulus nor ability to invest in increasing the domestic extraction of gas. Therefore, Ukraine's domestic extraction of gas is "well below potential."[6] The only beneficiary of the artificially increased demand for gas are foreign suppliers, in particular the Russian state gas company Gazprom. In contrast, the Ukrainian state gas company Naftohas needs budgetary support.

According to the IMF SBA, Naftohaz's deficit is to be eliminated, beginning in 2011. The SBA provides for strengthening the social safety net for the poorest segments of the population as household utility prices are increased, with domestic gas prices being brought into parity with import gas prices. The first increase of household utility prices by 50% was implemented in September 2010. However, the next 50% increase, planned for April 1, 2011, was not introduced, due to the upcoming 2012 parliamentary elections.

Following two tranches (2.250 billion SDR), further installments of the SBA are suspended because prospects for sustainable finances remain uncertain. The third tranche was to be provided following a second review in March 2011. Yet an IMF mission to Kyiv to continue discussions on the second review of the SBA in October 2011 did not produce a breakthrough.

Business Climate[7]

The new Nikolai Azarov government (March 2010-) gave its commitment to deregulation but has prioritized big industrial business. Small and medium businesses feel neglected and are afraid of a further toughening of the administration of taxes.

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[6] Ukraine—Request for Stand-By Arrangement, IMF Country Report No. 10/262 (August 2010) p. 12.

[7] This subchapter draws upon the study by Volodymyr Dubrovskiy prepared for BRAAC in March 2011.

Administrative reform has led to elimination of the SCURPE - an institution playing the role of "Ombudsman" for small businesses. Its functions were transferred to the Ministry of Economic Development and Trade (former the Ministry of Economy), creating an obvious conflict of interests.

Business registration is not a big issue, compared to other barriers.[8] According to the *Doing Business 2012*,[9] Ukraine was ranked 112 among 183 countries in the field of ease of registration procedures, and had overall rating of 152, a decline by 3 positions in comparison to the 2011 Report.[10] These conditions are worse than in OECD countries (especially, in terms of length and number of procedures, as registration in Ukraine takes almost twice as long and requires almost twice as many procedures), and even in comparison to Eastern Europe and Central Asia. The minimal capital requirement for a limited liability company was decreased to one minimal monthly wage (about $100),[11] which has made Ukraine look better in international comparisons.

According to the Law on State Registration, the entire procedure of registration in the State Tax Administration, State Pension Fund and State Statistics Committee should go through the "one-stop shop." But, in reality it works in such a manner only in the city of Vinnitsa and partly in a few other towns. The problem is that the law allows for other opportunities too, and applicants are compelled to use them.

Although registration is definitely not a bottleneck in business development and should not be prioritized at this moment, there is a lot of room for improvement. Closing a business is more cumbersome. In the *Doing Business 2012*, the country's rating on this position is 156.

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[8] The respective question was last asked in a survey in 2004, (http://www.ifc.org/ifcext/uspp.nsf/AttachmentsByTitle/IFC_Ukraine_BE_Survey_2005_Eng/$FILE/IFC_Ukraine_BE_Survey_2005_Eng.pdf). At that time only 44% of respondents considered registration as as a significant impediment to their business compared to 54% a year before, while 66% complained about taxation. Registration does not seem to be a big issue for small and medium enterprises.

[9] *Doing Business 2012* (Washingon DC: World Bank, October 18, 2011).

[10] http://doingbusiness.org/data/exploreeconomies/ukraine#starting-a-business.

[11] Law No. 1759-VI of December 15, 2009 "On the Legal Amendments Concerning Simplification of the Business Conditions in Ukraine."

Licensing[12] *and permits*[13] are much greater issues for SMEs than registration. According to the IFC (2005)[14] they were rated third after taxation and cross-board trading. In this category Ukraine was ranked as 179 in *Doing Business 2011* and 180 in *Doing Business 2012*.[15] The total cost (as a percentage of per capita GDP) for obtaining a typical set of construction permits is almost three times higher than the region's average, and more than ten times higher than in OECD countries. Completion of the process of obtaining these permits requires much more time as well: 374 days compared to 166 on average in the OECD. The situation with construction permits is just an example that reflects the overall problem of registration. In the *Doing Business 2012* rating for Ukraine there is a further decline by three positions to 182.

The "silent is consent" principle was introduced by the Law on Amendments of Some Laws of Ukraine regarding Simplification of Business Conditions in Ukraine (No. 1759-VI of December 15, 2009) but it still does not work because another law stipulates a penalty for undertaking business activity without a permit. This contradiction is expected to be resolved by another bill (No. 6339[16]).

The same law introduced the most substantial improvement in the field of licensing as, unlike before, most licenses are now in perpetuity. By the government's own admission,[17] in 2010 it cancelled licensing of 90.2% (2046 out of 2268) kinds of businesses, and 27% (23 out of 78) kinds of activities. The simplification mainly boils down to aggregation of the licenses; for example, instead of licensing of each particular kind of construction work, like plaster, the entire complex is covered by a single license. This is, of course, a simplification of the paperwork

[12] A license is official permission to perform certain types of economic activity (for instance, sell alcohol).

[13] Permit is a general name for documents certifying that certain conditions are met and therefore a certain type of economic activity can be performed (for instance, a permit is required to start construction or use certain types of machinery).

[14] *Business Environment in Ukraine, 2005*. Ukraine Business Enabling Environment Project's report (Washington DC: The International Finance Corporation (IFC), 2005).

[15] *Doing Business 2012*, op. cit.

[16] http://w1.c1.rada.gov.ua/pls/zweb_n/webproc4_1?id=&pf3511=37592.

[17] http://www.dkrp.gov.ua/control/uk/publish/printable_article?art_id=171378.

but not a genuine deregulation. Also, there are widespread apprehensions that the new Town Planning Code makes developers' life easier at the expense of the interests of local communities, the environment, and architectural issues.

All in all, deregulation was undertaken mostly in respect to licenses[18] and permits that were in relatively short demand. As a result, despite an impressively long list of cancelled licensing procedures,[19] these cover just a few per cent of the total number of licenses that businesses should obtain. The most substantial improvements are in the cancellation of licensing for tourist agencies (but not operators), custom brokers, fitness and health-improvement. Nevertheless, the real situation with permits remains unclear as there is no register of them.

Standardization and certification procedures inherited from the Soviet command economy were burdensome and anti-innovative, imposing precise requirements regarding materials, components, and procedures of production. All industrial sectors had to produce the same few sort of sausages or shoes that were precisely described by the GOST-state agency, which determined standards. The safety of consumers was not specifically described but was assumed to be guaranteed by precisely required components and technologies.

Only in December 2010 did parliament approve two key laws, one on state market surveillance of non-food products and the other on basic safety of non-food products. These provide for the introduction of EU principles and procedures of market surveillance. The main idea of the EU system is to focus on safety features for consumers, regardless of what components and procedures are used in production. Introduction of the EU system requires—as was the case in all former Soviet bloc countries that joined the EU—enormous work in adopting EU safety directives and building new institutions, and in terms of acquiring the human capacity required for market surveillance. There are some laboratories and competent staff in Ukraine that could be employed with the new model, but only after extensive training and following institutional and technical adjustments. Besides, these new

[18]Law No. 2608-VI of October 19, 2010.

[19]For example, http://ukr.lcg.net.ua/licences/cancelled/.

laws do not apply to foodstuffs, which is the main and most problematic type of goods.

Taxation is certainly the main problem in Ukraine's business climate. In the *Doing Business Paying Taxes* 2011 and 2012 rating Ukraine is given the 181th position, the lowest among all country ratings, and the third from the bottom. The December 2010 Tax Code provides for:

- gradual reduction of rates of corporate income tax from 25-16% by 2014;
- reduction in VAT rates from 20-17% by 2014;
- reduction in some fines.

The vast majority of business entities are sole proprietors who normally use the simplified taxation system, which entails fewer costs in accounting and compliance, and attracts fewer inspections.[20] Sole proprietors were allowed to pay a unified lump-sum tax of up to –200 *hryvni* monthly, according to Presidential Decree No. 727/98 of July 3,1998. Revenues were shared between the state (local) budget and the Pension Fund. Businesses using the simplified taxation were exempted from full bookkeeping.

The new Tax Code reforms the simplified taxation in five major ways:

a. major increase in lump sum tax for sole proprietors. The tax was frozen at 200 *hryvni* since its inception in 1998 despite the multiple growth of CPI and salaries. Since the implementation of the unified tax, average salaries have grown more than 20 times and the CPI has increased more than 5 times. Nevertheless, the abrupt increase in lump sum tax has eliminated many small companies.

b. introduction of monthly, instead of quarterly, reporting based on books that in practice eliminated substantial simplifications for sole proprietors.

[20] *Investment Climate in Ukraine as Seen by Private Businesses*. Ukraine Business Enabling Environment Project Report (Washington DC: The International Finance Corporation (IFC), 2009).

c. introduction of "special factual inspection' that, in fact, nullifies restrictions on the number and time length of inspections in some sectors.

d. demanding bookkeeping be based on primary documents.

e. exclusion of payments to sole proprietors using simplified taxation from business costs, making such contracts prohibitively expensive.

VAT refunds remain a major problem, as they are being paid back initially to well-connected firms, with the remainder waiting for refunds for years. The Code stipulates so-called "automatic" VAT reimbursement, although only for firms meeting very strict conditions.

Changes in the rates should be introduced steadily in order to allow businesses to become adjusted to them. They should be also supported by the lowering of non-tax barriers. Hundreds of thousands, if not millions, of people working in businesses because taxes were so low have moved into the shadow economy or become unemployed.

The new Law on a Single Social Contribution (No. 2464-VI of July 8,2010) has merged a number of minor payroll taxes with the main one (contributing towards the Pension Fund) and delegated the administration of this tax to the State Pension Fund. This law simplifies payments and reduces inspections for companies using the basic system of taxation and unified tax payers who have employees (on which they have to pay the payroll tax). In the meantime, it complicates tax compliance and effectively increases the rate more than two times for sole proprietors who are paying a unified tax. In addition to single quarterly payments of the unified tax, they now have to make another one that exceeds by half the upper level of the unified tax rate. Although the 2010 tax code has partly reduced the complexity of paying taxes, the code did not address the main problem of mandatory contributions and payroll tax which remains set at a very high rate. Here reforms would need to be more radical.

The 2010 Tax Code is a controversial document because it introduces some positive amendments, especially for large business and some negative, mainly for small and medium businesses. The Tax Code partly simplifies the structure of tax legislation by converging it into a single law. The Code allows the "administrative" (hence, without a court's sanction) arrest of a taxpayer's property for 72 hours, which in many cases is sufficient for inflicting unacceptable losses to businesses, especially to SMEs that are generally more financially and legally vulnerable than larger companies. Third, it introduces a requirement for monthly reporting on personal income tax. The attempt to drastically increase tax rates of simplified taxation for sole proprietors was reduced by massive protests of entrepreneurs in Fall 2010 (the so-called Tax Maidan).

Improvements in transparency and accountability should be accomplished by the new Law on State Procurement, adopted on January 28, 2011. More competitive procedures should help mid-size companies and, in some cases, larger business entities. However, the law in practice would not allow small- and medium-sized businesses to participate in public procurement.

The burden of regulations related to export (and import) activities is also very high. In addition to VAT reimbursement, the Doing Business rates in "Trading Across the Border" rank Ukraine 139th, which is better than the country's overall rating, but much worse than for OECD countries. This is mainly due to custom clearance times that are estimated at 31 days for exports and 36 days for imports—almost 3 times more than the OECD average. The 2010 Tax Code attempted to forbid any kind of foreign trade activities for sole proprietors using simplified taxation arguing that some of them do not pay VAT on imports and import duties—which are not valid for exporters.

Ukrainian corporate legislation[21] is considerably underdeveloped in comparison not only to EU member states, but even to such countries as the Russian Federation, Kazakhstan or Mongolia.

The Economic Code. The distinctive feature of Ukrainian corporate legislation is preservation of out-dated Soviet-era concepts that leave unclear divisions of property rights and management functions. The Economic Code of Ukraine, the law on enterprises in Ukraine and the law on management of state property objects permit daily administrative interference in management of state enterprises, maintain the primacy of the state over private property, and confuse owners' and man-

[21]This subchapter draws upon the study by Anatoliy Yefymenko prepared for BRAAC in 2009-2011.

agement decisions. Uncertainty over the legal status of property of "economic entities" leads to corruption (especially in state-owned enterprises), avoids responsibility for breach of legal obligations and provokes unfair behaviour by parties, thereby undermining stability of property ownership and hindering of the development of economic growth due to a high risk of non-payment. Until the Economic Code is abolished, progress in the development of corporate legislation and improvement of regulation in other spheres will be difficult to achieve. Therefore, for an "Open Ukraine" to become the future of Ukraine, the Economic Code should be abolished.

The Civil Code of Ukraine (CCU). Provisions in the CCU on regulation of legal entities are mostly consistent with legal approaches common to all European countries. A few provisions contain mistakes that create unjustified risks and undermine efficiency of regulation (e.g. provisions on artificial requirements on maintaining a ratio between net asset value and charter capital for joint-stock and limited liability companies). These should be brought into conformity with the requirements of the Second EU Company Law Directive.

Law of Ukraine on Joint-Stock Companies. In September 2008, Ukraine adopted a law on joint-stock companies which was an important step in moving Ukraine closer to modern corporate law standards. However, the law preserved the out-dated "the winner takes all" principle, according to which the controlling shareholder has the possibility to subdue the joint-stock company's activities to his or her interests. Minority shareholders are regarded as a source of problems, such as difficulties reaching quorum and useless expenses (i.e. burdensome notification requirements). The situation is aggravated by the fact that the capital of most Ukrainian joint-stock companies is excessively concentrated and the minority shareholders' stake does not allow them to influence the company's policy.

However, Ukrainian joint-stock companies will not be able to attract substantial investments without realizing that nobody will invest without guarantees of their participation in profit-sharing and decision-making. Minority shareholders should be provided with powerful enough instruments allowing them to protect their interests in a reliable manner. According to the World Bank *Doing Business 2012*, Ukraine poorly protects investors, not providing even half of the protection level of, say, New Zealand.[22] The corporation's legal model under the Ukrainian law on joint-stock companies vests the controlling shareholder with powers of unrestricted domination in company management and tools to misappropriate all the company's profits, factors that reduce incentives for investors.

Building investors' confidence in Ukrainian joint-stock companies requires revision of legal concepts of the law on joint-stock companies and substantial amendments to the text of law. For Ukrainian joint-stock companies to be able to perform the function of capital accumulation (through raising investments) in an efficient manner, it is necessary to replace the "winner takes it all" with an "investor friendly" model, which would allow minority shareholders to feel secure.

Limited Liability Companies. Limited liability companies are the most common organizational and legal form for small and medium-sized business. More than 400,000 limited liability companies are registered in Ukraine, and their share in GDP output shows a steady growing trend. However, the quality of legal regulation of limited liability companies remains unsatisfactory thereby reducing the capacity of these organizations.

Legislation on limited liability companies suffers from numerous deficiencies that unnecessarily restrict the flexibility of this form of corporation,[23] and fails to secure effective protection of minority shareholders' rights. Limited liability companies regulating legislation also reproduces the "winner takes it all" model that does not allow Ukrainian limited liability companies to efficiently perform the function of the pooling of capital and turning relations among company members into a bitter struggle for control over the company's executive body and its cash flows. Moreover, legal tools to control managers remain too weak leading to unnecessary and often inefficient concentration of ownership, thereby complicating the separation of management from ownership. This makes the attraction of additional investors risky and unattractive and brings a number of other adverse consequences. Therefore, there is a need for a new law that would

[22] *Doing Business 2012*, op cit., p. 12.

[23] http://brc.undp.org.ua/img/publications/TOB%20-LLC%20law%20ENG(23)%20(1).ppt.

resolve these and other problems that are hampering the development of limited liability companies.

The lack of proper regulation of limited liability companies hinders direct foreign investment in Ukraine. Foreign investors do not wish to engage Ukrainian partners or managers due to high risks of corporate raiding or loss of investment arising from conflict between company members. The draft Law on limited liability companies is an interpretation of the Russian law and continues to include the shortcomings found in the law of Ukraine on business associations.

*Regulation of Insolvency and Bankruptcy***.** Ukraine ranks 156th among 183 countries in the world in the "closing business" indicator. The average duration of bankruptcy procedures in Ukraine is 2.9 years, the costs of bankruptcy proceedings reach as high as 42% of the debtor's property value on average, whereas the collection rate is at most 7.9% of the value of creditors' claims.

Under these current conditions, the law of Ukraine on re-establishing solvency of a debtor or declaring a debtor bankrupt encourages unscrupulous conduct and provides grounds for illegal enrichment. This is undertaken through companies escaping compliance with commitments or through seizure of somebody else's assets, two factors that adversely affects the macroeconomic situation in Ukraine and results in degradation of its industrial base and human capital. Legal concepts dealing with regulation of insolvency and bankruptcy towards identification and respect of personal interests of all parties involved should be revised. There needs to be introduced sound motivation of a bankruptcy commissioner through a combination of legal tools for control over his decisions, fair compensation for performance and liability for losses.

Establishment of an Agricultural Land Market. Land reform, which has been implemented in Ukraine since 1991, has not created a fully-fledged market for agricultural land. Most of Ukraine's agricultural land is parcelled into 6.7 million plots of only 1.5 to 15 hectares The average size of land holdings is approximately 4 hectares. Trade in farmer's land certificates began in Ukraine in 1994, but without the adoption of proper legislation that would have resolved the transfer of land certificates.

A temporary moratorium on the sale of agricultural land was introduced on January 1, 2002. This moratorium has been extended several times since then and is still in effect today. The moratorium does not restrict the exchange of land holdings through family succession, as a gift or in the form of an exchange.

The leasing of land is the main way of transferring land due to the effective moratorium on sale of agricultural land. Lease agreements are typically being concluded for a term of 4 to 5 years (accounting for almost 50% of all lease agreements). The moratorium on trade in agricultural land is to be lifted provided legislation is adopted that would regulate the land market and cadastral system. The law of Ukraine on the land market (developed by the State Agency for Land Resource of Ukraine) was adopted in summer 2011 and proposed to establish a special state institution for managing state owned lands that are cultivated for agricultural purposes.

This specialized institution is responsible for:

- ensuring implementation of state policy on regulation of the cultivated land market and for state policy of preserving and enhancing the state fund of agricultural lands;
- consolidating agricultural land;
- resolving problems associated with ownership rights of deceased private land holders;
- realizing the right to the primary acquisition of agricultural land shareholdings on behalf of the state in the event of their sale;
- issuing mortgage securities;
- carrying out activities related to the planning of land use and control over and protecting agricultural lands.

The law on the land market does not permit foreign individuals or companies to own agricultural land. The adoption of the further legislation is envisaged to open up trade in agricultural land on the State Land Cadastre, on Consolidation of Lands, and on a Land Inventory.

Compliance with WTO commitments.[24] Ukraine became the 152th WTO member in May 2008, following 15 years of negotiations. In the years preceding WTO accession Ukraine adopted or revised 55 laws to comply with WTO rules within the 5 year transition period granted to Ukraine to fully comply with its commitments.

Ukraine undertook steps in order to adjust its system of foreign trade to meet WTO commitments. External tariffs were transformed into ad valorem and rates are to be set in accordance with Ukrainian commitments. Quantitative restrictions are to be abandoned. Ukraine is committed to decrease export duties and refrain from applying any obligatory minimum export prices. Sanitary measures are to be applied according to WTO requirements.

Subsidies, in particular in the agricultural sector, are to be gradually reformed in order to reduce measures falling into the "amber box" and develop the "green box" of instruments. Domestic support for agriculture under the "amber box" in 2009 did not exceed the Aggregate Measure Support permitted by the WTO.

Development and implementation of new "green box" programs should become a fundamental direction of state policy on agricultural support following Ukraine's accession to the WTO. The WTO does not impose any restrictions on the amount of state financing for "green box" measures. Around 95% of the budget funds under Ukraine's "green box" programs are aimed at the financing of so-called "general services," which cover scientific research, pest and disease control, training and re-training services, obtaining professional higher and technical education and general inspection services (including inspecting agricultural raw materials and foodstuffs). Direct payments to farmers based on acreage are also counted as "green box measures" although their usefulness is questioned support for the largest and usually wealthiest farms are very costly. Since 2009, Ukraine has adhered to its commitments on the gradual decrease of export duties for sunflower seeds, live cattle, animal hide and nonferrous metal scrap.

[24]This section draws upon the study by Iryna Kobouta, prepared for BRAAC in 2009-2011.

The 2008-2009 global financial crisis came only a few months after Ukraine's WTO accession, and therefore became a serious test for Ukraine's ability to uphold its commitments. Parliament rejected the draft law on customs tariffs, which aimed to reduce import duties for 3,000 items. However, the Custom Service continued to apply tariffs established by the Protocol on the Accession of Ukraine to the WTO that was ratified earlier by parliament. In February 2009 parliament approved a law introducing a 13% surcharge to applied rates of import duties for several goods. The WTO agreement contains no provision that allows a country to implement such duties by blaming the global financial crisis and in June 2009 the WTO Committee on Balance of Payment Restrictions declared them as infringing WTO rules. Ukraine did not renew the surcharges and they expired on September 7, 2009. Nevertheless, in 2010 parliament again attempted to circumvent WTO rules and introduce protective duties for producers of automobiles, refrigerators and some foodstuff products aimed at the protection of the interests of a narrow groups of producers but to the detriment of Ukrainian consumers.

After joining the WTO the Tymoshenko government lifted export quotas for grain, wheat (mixture of wheat and rye), barley, corn, and rye. The restrictions on the export of grain and oil-yielding crops were introduced in 2006-2008 under the pretext of protecting foodstuff prices on the domestic market but damaged the interests of exporters and producers. Tons of grain prepared for export were ruined in ports and warehouses.

The following are the negative consequences resulting from export quotas:

- Decrease in foreign currency inflows to the Ukrainian economy;
- Increase in devaluation pressure on the *hryvnia* that led to increases in costs of imported goods;
- Loss of attractiveness for domestic and foreign investors;
- Long-term decrease in the production of goods subject to quotas.

The image of Ukrainian exporters as reliable suppliers of foodstuffs was ruined. Ukrainian producers were pushed out of profitable markets because they are considered unreliable.

The WTO permits export restrictions in cases of "critical deficiency of foods" (paragraph 2 (a) of Article XI of GATT 1994) which would be rather difficult to prove in the case of grain and sunflower products in Ukraine. Certainly, the export of food products that would benefit from world prices may push domestic prices up. The recipe to deal with this is to keep the indexation of income for poor families to compensate for price increases, and food stamps or other similar measures targeted on poor. The state reserves accumulated in good harvest years can be utilized in poor years to moderate possible price hikes on critical food products.

Unfortunately, the Azarov government resorted to old practices again in 2010 and 2011, when restrictions were introduced through the imposition of extremely bureaucratic measures to control the quality of exported grain. Finally, in October 2010 the government issued a decree introducing an export quota of 2.7 million tons of grain from the beginning of 2011. The export quota for wheat is 0.5 million tons, for barley 0.2 million tons, for corn 2 million tons and quotas for exports of rye and buckwheat of 1,000 tons each.

The other impediment to export activities is the long-standing problem of VAT refunds to exporters. Despite a serious effort to reduce VAT refund arrears through the issuing of VAT bonds and transition to on-time refunds, the problem remains in place.

A Cabinet of Ministers decree from December 13, 2010 establishes a mandatory registration of export contracts for some agricultural goods at the Agrarian Exchange or at exchanges provided with the right to register foreign economic contracts. This Decree distorts market competition and imposes technical barriers to the efficient operation of the agricultural market.

Economic and Trade Impact of the Deep and Comprehensive Free Trade Agreement (DCFTA)

In view of the absence of an EU membership perspective, the DCFTA may become a milestone vehicle for modernization of the Ukrainian economy, if it is signed, ratified and implemented. The DCFTA between Ukraine and EU is not a standard free trade agreement, and from the very beginning it was conceived as a new generation agreement. Besides liberalization of trade, the DCFTA is aimed at deep and comprehensive harmonization of economic legislation. Chief EU negotiator Philippe Cuisson compared the legal status of relations with Ukraine after implementation of the DCFTA with that of Norway or Switzerland. The DCFTA will provide access for Ukrainian companies to EU markets and public procurement meaning that Ukrainian companies can compete on an equal footing in construction work, transportation services, and supply of goods and services for central and local governments throughout the European Union.

In the sphere of trade at least 95% is to be fully liberalized with the elimination of quotas and tariffs. The EU is the largest single market in the world, about 130 times larger than the Ukrainian domestic market and 15-20 times larger than the Russian, Belarus and Kazakhstan markets combined. Free trade between Ukraine and the EU will open up opportunities for deep integration, including in highly specialized intra-industrial integration. Evidence from Central-Eastern European countries proves that open access to the EU market gave enormous stimuli to small enterprises as well as to big business. In 1995-2003, that is after Poland signed the Association Treaty but still before becoming an EU member, exports from Poland to the EU increased 2.6 times.

Ukraine will also become more attractive for foreign investors. Of course, the DCFTA will be an insufficient factor attracting foreign investors to Ukraine. There is also a need for reliable protection of property rights, independent judiciary, and other reforms.

The DCFTA will, however, impose costs on Ukrainian businesses. The most costly rules are to be implemented gradually over a period of time, at least over 10 years, and for some areas even longer. Ukrainian companies will also secure measures protecting them against unfair competition. It is worth pointing out that the Ukrainian market is already relatively open for competition.

When Ukraine changes its legislation and administrative procedures and restructures some of its institutions in order for them to mirror the rules and regulations of the 27 EU member states, the EU will treat Ukrainian institutions as their own and will accept their authority and judgement. It means that products approved in Ukraine will be accepted without any further checks in the EU.[25]

Ukraine can maintain its Free Trade Agreement (FTA) agreements with other countries, including with Russia, Belarus and Kazakhstan. The rules of origin protect unlawful flow of EU goods into other markets through Ukraine, as in all other free trade agreements across the world. However, joining the CIS Custom Union with the Russian Federation, Belarus and Kazakhstan would make the DCFTA with the EU technically impossible. Ukraine cannot be a member of two customs unions. Joining the CIS Custom Union with countries that are not members of the WTO (Russia, Belarus, Kazakhstan) would require a renegotiation of Ukraine's accession agreement with the WTO. FTAs and custom unions with countries that are not members of the WTO, deprived such countries of WTO arbitration in the event of trade disputes. Joining an FTA with any country or group of countries, even those not belonging to the WTO, is compatible with the EU's DCFTA, but membership of the CIS Custom Union is not.

The most disputable part of the DCFTA consists in restrictions to trade in some agricultural products. The EU—as in the case of other FTAs—wants to protect its domestic market for a few agricultural products, but the problem is that some of these are very important for Ukraine. Ukraine was the granary of Europe, as 70% of European black soil is to be found in Ukraine. Ukraine has a large underutilized labor force and excellent climate. According to FAO estimates Ukraine could more than double its agricultural production. The consequences of restrictions in agricultural trade between the EU and Ukraine will be the following:

- EU consumers will be deprived of food supplies that are more diversified in price, assortment, and quality;
- Ukraine will not receive a stimulus to develop its agricultural sector to its fullest potential;
- the best European soils will remain underutilized;

[25]Mark Hellyer, *The Ukraine-EU FTA: What's it All About*?, (Kyiv: British Embassy, Kyiv, September 2009), p. 8.

- the worst European soils will be still cultivated because they are subsidized by taxpayers;
- migratory pressure from Ukraine to EU will continue.

The DCFTA is to be reviewed after 5 years. Restrictions in agricultural trade should be lifted at that stage to benefit both sides of the agreement. The vested interests of small groups of the EU farmers that are not competitive, despite the provision of heavy subsidies, should not be permitted to prevail over the interests of European consumers, taxpayers, and the EU's strategic interest in integrating Ukraine into the European economy and structures.

The EU's Association Agreement with Ukraine, including the DCFTA, could be the first of its kind under the European Neighborhood Policy and Eastern Partnership. On October 20, 2011 Deputy Prime Minister Andrey Klyuyev and EU Trade Commissioner Karel De Gucht reached an agreement on all elements of a free trade deal. But—as De Gucht said—"we still have to fine tune some technical details. It is now up to the Ukrainian leadership to create the political conditions wherein this deal can materialize. This should allow us to technically conclude the Association Agreement including the deep and comprehensive free trade area by the end of the year; of course provided that the political conditions are created so that this deal can happen in practice."[26] The EU and U.S. had condemned the sentencing of Tymoshenko to seven years imprisonment on October 11, 2011 and Yanukovych's visit to Brussels planned for nine days later was cancelled by the EU.

Oligarchs and Reforms

Privatizing on advantageous terms, obtaining preferences in lucrative tenders, and limiting internal and external competition are the most widespread arenas within which rent-seeking oligarchs operate in Ukraine. Unlike the Russian oligarchs, who are subordinated to political rulers since Vladimir Putin first came to power in 2000, Ukrainian oligarchs are active in politics and have influence on politicians from various groups. Their political preferences are diverse,

[26]http://ec.europa.eu/commission_2010-2014/degucht/.

although they tend to seek to be on good terms with the winning camp. Despite their widespread influence, oligarchs did not prevent an increase in gas prices for the industrial sector or the opening of Ukraine to external competition after the country joined the WTO. Legislation introducing additional tariffs to protect a few inefficient producers in breach of WTO commitments were introduced but after a dispute with the WTO were cancelled. Oligarchs have accumulated enormous assets due to non-transparent privatizations, unclear rules, private connections, and high-level corruption in the government and courts. "The systematic plunder of economic resources, perpetrated under the oligarchic system, has imposed great costs upon Ukrainian societyn" observed Rosaria Puglisi.[27]

Can Ukrainian oligarchs become more interested in the protection of property rights, good legislation, and an independent judiciary? They are certainly afraid of the introduction of the Russian model of relations between political leaders and the business community. Some of them, such as two leading oligarchs Rinat Akhmetov and Viktor Pinchuk, promote European values and rapprochement with the EU through the financing of seminars, events, scholarships, including with reformers in the presidential team. Oligarchs are also becoming aware that developing ties with the EU, and eventually joining the EU, will open new business opportunities and, even more important, will make their assets more valuable. They are also interested in social and political stability, as seen in their facilitation of compromise in the spring 2007 political crisis, when President Yushchenko disbanded parliament, leading to early elections in September of that year. Some Ukrainian oligarchs have recently started to improve their reputation and public relations.

Nevertheless, it would be naive to assume that one day oligarchs will stop abusing opportunities for corrupt rents. Established tycoons might contribute to reforms, but their approach to reforms will remain multifaceted. As Slawomir Matuszak from Poland's Center of Eastern Studies states, "A Majority of the oligarchs treats the association agreement with the EU above all as a way of blocking Russian integration projects and consolidating their political position with

[27]Rosaria Puglisi, "The Rise of the Ukrainian Oligarchs," *Demokratization*, Vol. 10, No.3 (Autumn 2003), p. 99.

regard to Russia.(..) The reluctance to sign the agreement is caused by the fear that it will lead to a fierce conflict with Russia.(...) The signing of the DCFTA may be even of advantage to Firtash's interests if it boosted exports of chemical goods to Western countries. The conclusion of the DCFTA will hurt smaller oligarchs, e.g. the owner of the AvtoZAZ car company."[28]

Freedom of media, a parliamentarian system of government and independent NGOs combating corruption could contribute to disciplining oligarchs. It would be also advisable to work with them, including them in meetings with delegations of foreign leaders visiting Ukraine, inviting some to prestigious gatherings, and encouraging them to fund philanthropic educational activities. They need to be convinced of the advantages of an alternative way of doing business than the one to which they have become accustomed.

Conclusions and Recommendations

There have been a number of programs of reforms consisting of lists of recommendations during the two decades of Ukrainian independence.[29] However, the implementation of reforms is very slow. The Tymoshenko cabinet lacked a parliamentary majority, was in conflict with President Yushchenko, and was preoccupied with the upcoming 2010 presidential elections, neglecting difficult reforms. However, the Tymoshenko government solicited a reform program from a group of international experts that would be ready following the presidential elections. These proposals were not used, however, as Tymoshenko lost the 2010 election to Yanukovych.

The Azarov government elaborated a "Presidential" program of reforms entitled "Affluent Society, Competitive Economy, Efficient

[28]Slawomir Matuszak, "How Ukrainian Oligarchs View Economic Integration with the EU and Russia," *EASWEEK*, September 14, 2011.

[29]Affluent Society, Competitive Economy, Efficient State. Program of Economic Reforms for 2010-2014, Committee for Economic Reforms under the President of Ukraine, June 2010; Policy Recommendations on Economic and Institutional Reforms 2009 (Kyiv:EU/UNDP Blue Ribbon Analytical and Advisory Centre, April 2009). Anders Aslund and Oleksandr Paskhaver, *Proposals for Ukraine: 2010—Time for Ukraine*, International team of experts, Kyiv 2010.

State" that was adopted in June 2010. But the program was merely a list of tasks and government capacity in developing modern legislation remains low. Highly qualified lawyers work for private companies, banks and Western foundations—not for the government.

Coordination of foreign assistance is poor. EU donor countries base their plans on directives from their national capitals and perceive the EU-Ukraine Association Agenda as a guide, ignoring the presidential program of reforms. Coordination of foreign assistance was not transferred from the remote Division of Foreign Cooperation at the Ministry of Economy to the Presidential Administration's Committee on Reform that became a hub for generating reform ideas. The Committee on Reform lacks staff to develop draft legislation and government employees are not qualified enough to develop modern economic legislation. Under these circumstances, some external support that would enable the hiring of lawyers and experts from the private sector has been provided by Akhmetov's Foundation for Effective Governance.

Successful adoption of WTO-related regulations or first steps in implementation of the IMF's SBA are important examples of how international organizations can play an important role in reforms. Therefore, it is justified to consider implementation of the DCFTA as a potentially very powerful vehicle for modernization of Ukraine and implementation of reforms. However, the organization of technical assistance will be crucial in making the DCFTA an effective tool for the modernization of Ukrainian legislation and economic institutions.

Cooperation with the IMF as a source of affordable support for the balance of payments, as a generator of confidence for investors in Ukraine, and as a sound and professional point of reference for reforms should be continued. Foreign investors trust in the IMF and appreciate a country's cooperation with this institution. Two politically difficult reforms that Ukraine agreed to undertake with the IMF are pension reform, especially raising the retirement age, and bringing household utility tariffs in line with market prices. Any energy tariff reform should be accompanied with compensatory measures for low income households. Developing energy savings projects with the World Bank and EBRD based on returns from energy savings will bring enormous savings in energy consumption. If added to this there is the elimination of obstacles such as price controls and restrictive licensing for extraction of domestic gas and oil there will be a dramatic increase of Ukraine's energy independence.

Simplified taxation should be introduced for small and medium businesses, to include simplified accounting of revenues with no requirement for primary documents or cash registers. The schedule for an incremental increase in unified tax rates and ceiling in order to adjust them to changes in social welfare and inflation should be based on an indexation linked to the CPI or subsistence level. The one-shot increase in the rates should not exceed 25% each quarter. Previously introduced principles of the "one-stop shop" for registering and licensing businesses, "silent is contest," self-certification and the declaratory principle should be made operational. All types of permits other than those directly stipulated by the law should be abolished. Business associations could play an important role here. The reduced number of permits and activities subject to mandatory licensing should be compiled into a single piece of legislation.

Despite a new law on joint stock companies the corporate legislation that Ukraine still uses is in dire need of reform. The Economic Code of Ukraine, which combines element of the Soviet command administrative economy and market institutions, should be abandoned. The norms of the Civil Code of Ukraine dealing with legal entities should be in compliance with requirements in EU Directives on company law.[30] The law of Ukraine on joint-stock companies should be amended in order to comply with requirements of EU Directives on company law, and internationally accepted principles of corporate law and corporate governance best practices. The main change that is required is to transform the legal model of a joint–stock company from one of "profit-extracting" to "investor protection."[31] There needs to be a separate law on limited liability companies, with an efficient system of governance, control bodies and reliable protection of minority participants in order to provide modern legal structures for the most advanced small and medium enterprises, domestic

[30]The text of the draft law could be found at http://brc.undp.org.ua/img/publications/ProposalsCivCode%20.doc.

[31]The text of the draft law developed by BRAAC can be found at http://brc.undp.org.ua/img/publications/JSCAmd2010%20.doc.

and foreign investors.[32] An amendment to the law on re-establishing solvency of a debtor or declaring a debtor bankrupt is also necessary, with provisions that prevent abuses by related-party (conflict of interest) transactions, and that enhance the personal responsibility (liability) of company officers and bankruptcy commissioner in order to prevent abuse of power, while permitting quick sale of businesses.

Ending the moratorium on trading agricultural land and ensuring free access of citizens and agricultural producers to land resources are long overdue actions. Prices for agricultural land should be liberalized and work on establishing a land cadastre should be continued. Allowing access of foreigners and foreign-owned companies to ownership of some agricultural land deposits (e.g. up to 10% of land in each oblast) should be discussed. Such reforms would attract more capital, help to import and disseminate modern agricultural technologies, and facilitate greater access to international channels of distribution of agricultural products.

Administrative restrictions on exports should be abandoned. Targeted income support measures for poor families, as an instrument for compensating the rise in foodstuff prices, should be implemented. The Agricultural Fund and State Reserves can be drawn upon to moderate the domestic impact of price fluctuations on the internal market.

It is in the interest of Ukraine to liberalize global trade in foodstuffs. Ukraine might contribute to enhancing this step through lobbying in the Doha round of multilateral trade negotiations. It would be also useful to establish an information service for agricultural markets that would monitor and forecast the situation on the global food markets and collect information on standards in other countries. Speeding up the harmonization of Ukraine's certification and standardization system with international and European systems, to bring sanitary and safety standards up to the levels of the European Union, are important reforms. Establishing free trade area agreements based on WTO rules with other non-EU trade partners is also in Ukrainian interests. The scandalous problem of delays in VAT refunds for exporters should be urgently fixed.

[32]BRAAC has prepared the text of the draft law which is available at http://brc.undp.org.ua/img/publications/Draft_LLC.doc.

The strengthening of programs of social support and re-training programs for redundant leased agricultural workers is also important. Transforming the law of Ukraine on state support of agriculture into a single piece of legislation would simplify and rationalize the question of state support to this important sector of Ukraine's economy.