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# Encouraging Trade and Foreign Direct Investment in Ukraine

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Prepared for the  
Institute of European and International Studies in Kyiv



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The research described in this report was sponsored by the Institute of European and International Studies in Kyiv. It was conducted in the International Security and Defense Policy Center of the RAND National Security Research Division (NSRD). NSRD conducts research and analysis for the Office of the Secretary of Defense, the Joint Staff, the Unified Combatant Commands, the defense agencies, the Department of the Navy, the Marine Corps, the U.S. Coast Guard, the U.S. Intelligence Community, allied foreign governments, and U.S. and foreign foundations.

**Library of Congress Cataloging-in-Publication Data** is available for this publication.

ISBN 978-0-8330-4216-3

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Published 2007 by the RAND Corporation

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## Summary

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Ukrainian governments have found it singularly difficult to liberalize trade and improve the climate for foreign direct investment (FDI), ostensibly two of Ukraine's economic policy priorities. Trade and FDI have greatly contributed to economic growth and increases in standards of living throughout the world, especially in Central Europe. However, in contrast to Central Europe, Ukraine has been slow to open its borders to trade and has had difficulty attracting sizable inflows of FDI. As a result, Ukraine has suffered economically: Its standards of living are currently far below those in Central Europe, Russia, and Kazakhstan.

### **Barriers to Trade and Foreign Direct Investment in Ukraine**

#### **Corruption**

*Corruption, petty and grand, constitutes the single greatest barrier to expanding trade and investment in Ukraine.* Grand corruption involves high-level officials with discretionary authority over government policy, the sale of government assets, or large government contracts. Petty corruption involves lower-level officials who make decisions about enforcing (or not enforcing) regulations.

*Foreign businesses complain most vociferously about Ukrainian regulatory and legal hurdles designed to elicit bribes.* As in most countries afflicted by corruption, Ukrainian government employees, in hopes of eliciting bribes, deliberately design licensing and registration procedures to be so complex that they may credibly threaten to halt or slow

trade or a foreign investment. As a consequence, the time and expense of obtaining the requisite permits and licenses to trade or to set up and open a business add substantially to costs, reducing both trade and investment. Rigged privatizations also impede foreign investment. Ukraine's contradictory laws and corrupt judges make it difficult for businesses to enforce contracts, which also discourages investment.

### **Barriers to Trade**

*The most immediate problem facing Ukraine is that it is not yet a member of the World Trade Organization (WTO) despite support for this step from all major political parties.* Because Ukraine is not a member of the WTO, Ukrainian firms face discriminatory treatment in most of their export markets. Exporters and importers in Ukraine confront arbitrary changes in domestic policies because the Ukrainian government is unconstrained by treaty obligations.

*The most severe impediment to exports in Ukraine is the corruption embedded in the system for providing rebates to exporters for value-added tax (VAT).* Government employees encourage companies seeking VAT refunds to hire local law or consulting firms that charge a “fee” of 25 to 30 percent of the refund to expedite reimbursements. Companies that hire these firms have their VAT reimbursed promptly; companies that do not, wait three to 18 months for reimbursement. Smaller companies sometimes receive no refunds at all.

*The greatest barrier for importers is Ukraine's complex, corrupt system of certifying imports.* The accepted international practice is for importing countries to recognize products certified by accredited bodies in partner states with internationally recognized accreditation procedures as acceptable. In Ukraine, all products subject to mandatory certification—which constitute a very long list—have to be recertified, substantially increasing importers' costs.

*Nothing has undermined Ukraine's reputation as a responsible trading partner more than the embargoes imposed on grain exports in 2006 and 2007.* These embargoes were instigated by Ukrainian commercial interests tied to the government that hoped to obtain export quotas and resell them to legitimate grain exporters, pocketing substantial sums in the process. This policy caused legitimate grain exporters to lose

upwards of \$200 million. Additionally, it will have a lasting, depressing effect on the incomes of Ukrainian farmers given that international grain trading companies now shun the Ukrainian market because of the risks of export embargoes and quotas.

### **Barriers to Foreign Direct Investment**

*Potential investors have great difficulty obtaining satisfactory sites in Ukraine.* Potential investors cannot obtain the land they need to build distribution centers and factories. Retailers and restaurateurs complain that municipal governments sell or lease all the best commercial sites to favored individuals. Problems in obtaining titles, construction permits, and operating permits add to costs and complexity.

*A number of provisions in the 2004 Commercial (or Economic) Code contradict existing provisions in the more market-oriented, Civil Code.* Businesses find that activities mandated by one of these codes sometimes violate provisions of the other. Some Ukrainian businesses exploit these legal discrepancies by selecting the laws they find preferable for their current operations. If disputes arise, they choose courts that favor their choice of applicable laws or judges who are willing to be bribed to do so.

*Because of deficiencies in the laws pertaining to joint stock companies, shareholders lack key rights of ownership.* Majority shareholders can use the legal system and a friendly court to issue new shares and steal assets. Minority shareholders (“raiders”) have used current laws to deprive majority shareholders of their rights and, in a few instances, control of their company.

*In contrast to the governments of Central Europe, Ukrainian governments have not extensively used privatization to attract foreign capital and business expertise.* With the exception of a very few transparent sales of major assets, privatization has resulted in formerly state-owned enterprises being acquired by Ukrainian businessmen or foreign companies controlled by Ukrainians. In most instances, Ukrainian businessmen have effectively excluded foreign investors by usurping the privatization process.

*Current laws and policies, ostensibly designed to make it possible for foreigners to invest in Ukraine’s energy sector, effectively discourage most*

*potential investors.* Those companies that have invested in Ukraine's energy sector have experienced difficulties with Ukrainian regulators. Some decisions have been in violation of the law or based on extraordinarily narrow interpretations of regulations.

## **Recommendations for Improving the Climate for Trade and Foreign Direct Investment in Ukraine**

*The Ukrainian government should adopt a two-pronged strategy to remove the worst of these impediments to trade and investment.* First, the government should focus on making a few highly visible policy changes that promise results within 100 days. Second, the government should set in motion changes in Ukraine's institutions that will, with time, reduce corruption and other impediments to trade and investment. Several recommendations whose adoption would reduce the most egregious barriers to trade and FDI are provided below. We have classified them according to whether they are expected to bring results within 100 days or over a longer period.

### **Corruption**

Within the next 100 days, the Ukrainian government should do the following to reduce opportunities for government employees to manipulate the regulatory system in order to solicit bribes:

- Set up a network of regional boards to which businesses and citizens can appeal administrative decisions. The boards should be composed of civil servants, businessmen, and citizens, and should have the authority to stay decisions taken by lower-level civil servants until they can be reviewed by higher-level administrators or administrative courts. All board meetings should be open to the public.
- Give Inspector Generals the authority to immediately put government employees facing credible accusations of soliciting bribes on administrative leave and to then quickly bring cases to court for resolution.

- Hold supervisors responsible for the behavior of their employees, and reprimand or dismiss supervisors whose employees have been convicted of corruption.

### **Fostering Trade**

*Joining the WTO is the most important near-term step that the Ukrainian government can take to spur trade.* If bilateral negotiations fail to resolve issues with current WTO members that threaten to block Ukraine's entry, the Ukrainian government should turn to the secretariat of the WTO, the U.S. government, or the European Commission for assistance in resolving these issues.

The Ukrainian government will need to maintain an inter-ministerial working group with the clout to prevent laws or regulations being made that violate Ukraine's agreements with the WTO. *The Ukrainian government should give the Department on Cooperation with the WTO full authority to ensure that Ukrainian legislation and regulations remain in compliance with the WTO.*

*The Ukrainian government should promptly reimburse exporters for VAT payments.* Regulations should be issued stipulating that VAT reimbursement requests be processed in accordance with the law (that is, within 60 days). Supervisors should be penalized if the regulations are not followed.

*Ukraine should immediately accept all products that conform to European Union (EU) standards.* Once a product is certified by the EU, no further certification should be necessary in Ukraine.

*The Ukrainian government should immediately eliminate all remaining embargoes on grains.* It should pass legislation conforming to WTO practices that strictly defines when export quotas on agricultural products may be imposed and how they will be allocated.

### **Attracting Foreign Direct Investment**

*The Ukrainian government should set legal limits on the ability of government employees to impede the establishment of businesses in Ukraine.* The government should

- Set fixed deadlines for action on permits.

- Set a yearly limit on the number of inspections to which a business will be subject.
- Ensure that initiatives for one-stop registrations and permits are operating by January 1, 2008.

*The Ukrainian government should ensure that its decision to repeal the ban on agricultural land sales goes into effect on January 1, 2008.*

*The Ukrainian government should immediately abolish the Commercial Code and appoint a task force to revise the Civil Code.* The task force should be composed of representatives from the judiciary, government agencies, the legal profession, businesses, and consumer groups. It should provide draft legislation or regulations to fix laws affecting Ukrainian businesses that are contradictory, poorly written, or lacking. It should also appoint a small team of senior government officials to spearhead efforts to make the necessary legislative changes.

*The Ukrainian government should replace its current privatization strategy with a new one that is geared toward rapid, transparent privatization of almost all the commercial assets it still owns.* The government should create a revised list of companies to be privatized and an accelerated time schedule for privatization. It should also establish clear procedures for issuing tenders for trade sales, permit all interested parties to bid, and publish the terms of all bids and the winning bid. The highest bid should win.

*To ensure adequate, competitive supplies of energy, the Ukrainian government should actively seek FDI in the energy sector.* To encourage foreign investment in domestic production of oil and gas, the government should lengthen the current five-year production-sharing agreements to ten to 20 years, periods customary elsewhere in the world. In addition, the government should increase the wholesale prices of Ukrainian natural gas to those of imported gas. It should also encourage foreign investors to participate in the construction and ownership of new gas and oil transit pipelines.