

UKRAINE

OPPORTUNITIES AND CHALLENGES FOR PRIVATE SECTOR DEVELOPMENT



Ukraine

Opportunities and Challenges for Private Sector Development



THE WORLD BANK



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LIST OF ACRONYMS

EU	– European Union
GDP	– Gross Domestic Product
ECA	– Europe and Central Asia
SME	– Small and Medium Enterprise
OECD	– Organization for Economic Cooperation and Development
NGO	– Nongovernmental Organization
RIA	– Regulatory Impact Assessment
ICT	– Information and Communication Technologies
NPL	– Non Performing Loans
AMC	– Anti-Monopoly Committee
AA	– Association Agreement
DCFTA	– Deep and Comprehensive Free Trade Area
IMF	– International Monetary Fund
TFP	– Total Factor Productivity
SOE	– State Owned Enterprise
DB	– Doing Business
EBA	– European Business Association
CEO	– Chief Executive Officer
CPI	– Corruption Perception Index
WTO	– World Trade Organization
EFI	– Economic Freedom Index
IFC	– International Financial Corporation
SES	– State Sanitary Service
EC	– European Commission
EBRD	– European Bank for Reconstruction and Development
NBU	– National Bank of Ukraine
CEE	– Central and East Europe
M&A	– Mergers and Acquisitions
FX	– Foreign Exchange
IFI	– International Financial Institution
FDI	– Foreign Direct Investment
IPO	– Initial Public Offering
ICN	– International Competition Network
CEM	– Country Economic Memorandum
GCR	– Global Competitiveness Report
US	– United States
CIS	– Commonwealth of Independent States

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EXECUTIVE SUMMARY

1. **Ukraine has untapped growth potential.** Ukraine has fertile agricultural land, an attractive geographical location in Europe, bordering the European Union (the largest market in the world with a GDP of almost \$17 trillion), and a large domestic market of almost 46 million consumers. It also has abundant natural resources, relatively well-developed infrastructure, high quality human capital, and a significant industrial base.

2. **However, Ukraine's potential has yet to be adequately harnessed.** Defying expectations at the time of the collapse of the Soviet Union, when hopes that the newly found independence would spur Ukraine's development loomed large, the country's GDP per capita still lingers below 1989 levels and at a mere 10 percent of the European Union average after twenty years of transition. Incomes have increased much more slowly in Ukraine than in the Europe and Central Asia (ECA) region as a whole. Ukraine has also been under performing relative to regional peers, such as Poland, Romania, Russia and Belarus, especially during the recent global crisis, registering a decline in GDP by 15 percent in 2009. Despite similar starting points at the beginning of transition, Poland's and Ukraine's income levels, for instance, have diverged over the years: income per capita in Poland is now almost four times higher than in Ukraine. Growth projections suggest that the income gap between Ukraine and its peers will not be closed in the short term.

3. **This note argues that the stunted growth of the private sector goes a long way in explaining Ukraine's poor growth performance.** The tepid private sector growth is reflected in (i) the stagnant structure of the country's industry and exports, where old industries such as steel, machine-building and chemicals continue to dominate. They operate at low levels of industrial productivity, which has grown at a much slower pace than in peer countries in the last decade. There is also (ii) the low inflow of high value-added FDI, especially in export-oriented manufacturing and (iii) the relatively limited role of SMEs in developing the economy. All these factors suggest that the market-driven process of entrepreneurship, innovation, and productivity does not seem to work properly, and thus undermines Ukraine's growth prospects.

4. **This note identifies weaknesses in the regulatory environment, limited access to financing, and lack of competition as the main constraints to private sector development, and offers short- and medium-term policy reform options.** The analysis offers evidence based on a stock-taking of existing research produced by the World Bank and external partners – such as the European Commission and the OECD – as well as on discussions with members of the Ukrainian government, business associations, NGOs, and academia. The poor regulatory environment, including tax administration, property rights, permits, certification and inspections, limited access to finance and low levels of overall competition pose obstacles to private sector development, undercutting Ukraine's growth prospects. It finds that there is scope for reforms and provides a list of policy recommendations.

5. **On the regulatory environment, the note argues that despite recent progress, Ukraine continues to suffer from excessive red tape, poor implementation of business regulations, and weak public sector governance.** The note offers recommendations on how to overcome these obstacles, and move ahead with reforming business regulations. The recommended reforms include: (i) full implementation of measures aimed at improving the business climate, proposed in the President's "2013 National Action Plan"; (ii) wholesale reduction of the number of permits and licenses through the introduction of a full regulatory guillotine exercise based on international good practice and building on the previous, partially successful effort in 2005; (iii) fundamental strengthening of the regulatory impact assessment (RIA) of new legislation (that is, some measure of the expected impact on the cost of doing business); (iv) completion of a risk-based system of inspections, (iv) elimination of outdated standards and technical regulations; (v) adoption of EU regulations, especially in areas such as food safety and technical regulations; (vi) effective implementation of the new insolvency law, and (vii) broad introduction of e-government and

ICT solutions to increase transparency and reduce scope for graft. The note also recommends that aside from improving primary and secondary legislation, mostly by harmonizing it with the EU standards, the Government should emphasize the efficient implementation of regulations, as it often lags behind legislation. Consistent, impartial, and efficient implementation of regulations offer substantial “quick wins” for the business environment. Coupled with better governance and committed political leadership, these reforms could play a key role in facilitating a decisive break from the legacy of the Soviet past.

6. **As for access to finance, despite significant outstanding corporate borrowing, access to finance remains limited, especially for SMEs.** This is for a number of reasons. First, prohibitively high interest rates, driven mainly by the central bank’s commitment to maintaining a de facto pegged exchange rate, combined with government’s large borrowing needs that crowd out lending to the private sector, represent a material obstacle to getting credit. Second, lax supervision over related-party lending supports the dominance of the banking sector by a few, locally-controlled business groups, which tend to distribute credit only within their groups rather to the whole economy. Third, access to credit is hindered by the ongoing withdrawal of foreign banks, increased post-crisis risk aversion, and the large number of non-performing loans. Fourth, credit is scarce due to limited access to long-term funding, a weak enforcement environment characterized by inadequate judicial practices, and a fragmented credit information infrastructure that does not support sound credit risk management. Finally, access to finance is undermined by the underdeveloped non-bank and capital markets. Enhancing access to credit, which is critical for financing the private sector, requires a coordinated approach to address inter-related challenges of transitioning to a flexible exchange rate, supporting the growth of long-term deposits, enforcing legislation on the disclosure of the ultimate beneficiaries of banks, identifying and limiting related party lending, removing tax disincentives for NPL transfers and write-offs, and consolidating information on credit histories. The development of the capital markets needs to be supported by enhanced market transparency, higher disclosure requirements, and improved reporting standards and corporate governance.

7. **On competition, this note argues that low levels of competition on Ukraine’s domestic markets are restricting the country’s economic growth and potential.** Many sectors exhibit a high concentration of firms and low rates of firm entry and exit. The effectiveness of competition policy is weak. This is problematic because the degree of competition in an economy has a direct impact on productivity, growth, and consumer welfare. Competition problems in Ukraine are driven by barriers to market entry and exit, created and supported by excessive red tape, weaknesses in the national competition policy framework, and the often ineffective application of competition policies. The Anti-Monopoly Committee (AMC), the competition watchdog, is supported by a relatively strong legal framework—though challenges such as the lack of investigative power remain – but the main challenge is the inefficient application of the law. It is reflected in the fact, for instance, that less than 10 percent of fines imposed by the AMC are actually paid, or that merger and cartel control is often difficult if not impossible without knowledge of the ultimate owners of companies involved. Going forward, enhancing competition to encourage market entry and promote private sector growth would be supported by fully harmonizing Ukrainian legislation with that of the European Union as well as implementing the National Competition Program 2014-2020, thus boosting the AMC’s investigative power, and providing adequate resources to ensure that the AMC can maintain high standards of performance and accomplish its mission. Moreover, enhanced competition would require better-trained judges adjudicating competition cases, truly competitive public procurement and non-distortionary state aid, and stronger awareness and involvement of the civil society. Finally, ensuring the AMC’s independence and clear mandate to go after all transgressors will be decisive.

8. **On a more general level though, private sector will not fulfill its potential without progress in fighting state capture and corruption.** These issues have an across-the-board impact on the business environment, and they represent the main underlying cause for the stunted growth of Ukraine’s private sector, the undiversified structure of the economy and its exports, and the low productivity and uneven

pace of reforms. While Ukraine has made a lot of progress on harmonizing legislation with EU standards, the regulatory framework continues to be patchy, unpredictable and business-unfriendly, reflecting the influence of business lobbies, rent-seeking and an ossified public administration, which benefits from the status quo. The application of policies is, in turn, mired in a culture of legal relativism, where the meaning of the law is subject to an ongoing re-interpretation depending on the play of various interests at the national, regional and even local level. On top of that, corruption is pervasive, and it is perceived as much more than a usual cost of doing business.

9. **There are a number of ways of reducing state capture and corruption.** State capture in Ukraine is reflected in the adverse influence of selected vested interests on public policy at the cost of the society at large. It is rooted in the country's political culture, built upon an old model of fused political and economic power, a non-transparent and non-competitive privatization process (which allowed for the accumulation of large economic assets in the hands of only a few and largely excluded international investors), murky public procurement and state aid. In addition, a partial, dependent and unreliable judiciary impels business elites to resort to wielding direct influence over the legislative process and the state apparatus to secure property rights. Given this background, reducing state capture will require the full transparency of the legislative process for all new regulations, strengthening regulatory impact assessments, and expanding the involvement of the business sector, trade unions, NGOs and society in the legislative process. In addition, state capture and corruption can be mitigated by installing a fully transparent public procurement and state aid system, which would allow for full access to information on every Hryvnia spent from public money, public hearings on the tender criteria in large public contracts, and public monitoring of the bidding process itself. Transparent and competitive appointments of officials in public administration and state-owned enterprises would also be helpful. Opening up to competition, especially from foreign companies, could weaken special interests by forcing them to compete on more equal terms and by lowering rents.

10. **A fundamental reform of the judicial system would also be a critical step towards reducing state capture.** Economies can hardly develop without secure property rights safeguarded by impartial and independent courts. While this topic falls outside the scope of this note, it is clear that an independent, impartial, and professional judicial system would provide the much needed recourse for the private sector to defend itself against inconsistent, unfair, or incorrect application of the law. A reformed judiciary would also strengthen the fundamental system of checks and balances between the courts and public administration, and allow the regulatory framework to learn from its mistakes, based on court rulings, as in other market economies. Today, the perceived lack of recourse to courts leaves enterprises largely at the mercy of the public administration, sustaining state capture and corruption, undermining confidence, and thwarting development. The AA with the EU, which has a special focus on the judicial system, could provide the much-needed trigger for fundamental reform.

11. **Finally, political commitment is also vital.** Economic history shows that the fate of countries ultimately depends on their culture, value system, and quality of leadership. Even the best-designed legislative frameworks crumble in the face of ill-intentioned implementation and "ways of doing things", which tend to be driven by ingrained social and political behaviors. The political leadership in Ukraine thus needs to start by providing the much-needed signal to the whole society and to the public administration in particular that business is no longer as usual, and that poor implementation of the law, administrative neglect and corruption will no longer be tolerated. There is hardly any other way to start improving the business climate in the long-term.

12. **Curbing state capture and corruption requires an across-the-board consensus on reforms.** The strong political momentum stemming from the cross-party consensus on the need to sign the AA with the EU should be sustained to support the adoption of the hundreds of pieces of legislation that would accompany the EU agreements and to spur the overall private sector reform agenda. The consensus could be strengthened by, for instance, establishing a national round table on reforms, which would include all

political parties, business community and civil society. Launching a comprehensive information campaign directed at the public could also be useful to strengthen consensus on reforms.

13. Progress in the reform process can also hardly be envisioned without a much stronger civil society. The current, relatively weak, involvement of civil society – especially NGOs representing small and medium enterprises (SMEs) – in monitoring the business environment and driving the reform process is an important obstacle to private sector development. In contrast to their large counterparts, which often have sufficient resources to deal with the poor business climate, SMEs harbor a long-term interest in improving the regulatory environment and investment climate, as it strongly affects their chances for survival. However, SMEs lack resources that would help them channel their commitment to the reform process and facilitate access to policy-makers. SME business associations are not strong, and they largely focus on advising members on how to cope with the existing regulatory maze rather than on how to improve it. Going forward, the contribution of SMEs to the public debate could be increased by including them in working groups and/or national round tables dealing with the business environment. Similarly, the impact of society at large on the reform process could be elevated by involving it in monitoring progress in implementation of reforms by providing free and user-friendly on line public access to state-generated performance statistics.

14. In sum, Ukraine needs a decisive breakthrough in improving the business climate to fully realize its growth potential. Previous studies of the World Bank (2007, 2010) argue that Ukraine seems to be trapped in a self-perpetuating low equilibrium, characterized by high barriers to market entry, low competition, limited incentives for technology absorption, low export diversification and sophistication, and high vulnerability to commodity prices. This vicious circle, sustained via poor contract enforcement, weak property rights, and weak governance, needs to be broken for the country to achieve its growth potential.

15. The Association Agreement (AA) with the EU could provide an important anchor for the reform process. Implementation of the AA, together with the Deep and Comprehensive Free Trade Area (DCFTA) agreement, could carry substantial benefits for Ukraine. EU accession had such an effect earlier for thenew EU members in Central and East Europe, which took advantage of the intimate engagement with the EU to increase exports, attract FDI, enhance competition, minimize the negative influence of vested interests, and ultimately make a historically unprecedented step towards catching up with the West. The entrance of the EU agreements into full force would create legally binding obligations for the harmonization of Ukraine’s laws with the regulatory architecture of the EU’s single market.

16. Robust implementation of the private sector development agenda will be key to kick-starting the market from its current self-perpetuating low equilibrium. There is often a disconnect between legislation and policy implementation that undermines the impact of the government’s reform efforts. Hence, a radically new approach to the implementation of policy measures will be needed if Ukraine hopes to reap the full benefits of the recent and planned reforms. This would require higher quality of legislation, but also enhanced capacity and efficient monitoring of implementing institutions.

17. If the reforms recommended in the note were effectively implemented, the impact on Ukraine’s GDP would be substantial. A 2006 IMF study (Tiff in 2008) suggests that based on the existing stock of capital and labor, Ukraine’s income levels could nearly double if the country approximated the levels of institutional and market efficiency common in EU10. Given that the institutional gap between Ukraine and EU10 has not diminished much since the analysis was performed, the benefits of further business reforms would still be substantial, helping to offset the time lost since the beginning of transition and boost income convergence.

18. The Ukrainian government is aware of the above-mentioned challenges: the national reform agenda is focused on promoting private sector development. The National Action Plan adopted

in March 2013 by the Ukrainian Cabinet of Ministers aims to spur private sector growth and enhance export competitiveness. The Action Plan offers a list of 44 legal reforms to be enacted in the course of 2013, in areas such as regulatory policy, permits and licensing, investor protection, customs, inspections, competition protection, administrative services, technical regulations, food safety, access to electricity, and tax administration. A summary of the Action Plan is included in Annex 1. The Action Plan sets an explicit objective of improving Ukraine’s Doing Business ranking from 140th place in DB 2013 to the top 100. Thanks to a number of reforms enacted under the Action Plan, Ukraine has already moved to 112th place in DB 2014.

19. **This note aims to inform the World Bank Group’s policy dialogue and technical assistance to the Government in support of its private sector development reform efforts.** Given the Government’s ambitious plans for improving the business climate and competitiveness, the World Bank Group stands ready to continue to support the Government in its reform attempts, building on existing cooperation with the IFC and on-going policy dialogue led by the World Bank Group Doing Business team, in line with the Bank Group’s Country Partnership Strategy.

20. **The note is structured as follows.** The first chapter traces the roots of the tepid private sector growth. The following three chapters focus on the three main constraints to private sector development, reviewing the Ukrainian market’s structural weaknesses in business regulation, access to finance, and competition, and providing recommendations. The last chapter concludes. Table 1 below offers a summary of key policy recommendations made in this note.

Table 1: Key Policy Recommendations: Regulation, Access to Finance and Competition

SUGGESTED REFORMS	SHORT-TERM RECOMMENDATIONS	MEDIUM-TERM RECOMMENDATIONS
Regulatory Framework	<ul style="list-style-type: none"> ◆ Implement a regulatory guillotine in line with international best practice, to allow for a wholesale reduction in permits, licenses and redundant business regulations. ◆ Extend the scope of self-certification to more business activities. ◆ Finalize the inspections reform by introducing a full-scale risk-based system, and adopt appropriate risk criteria and checklists across all inspectorates. ◆ Eliminate mandatory certification for goods and services that do not require it in line with EU and international practice. ◆ Improve the regulatory environment in the agrarian sector by eliminating the compulsory certification of grains and grain storage and enhancing the transparency of policy implementation. ◆ Implement further reforms measured by the Doing Business ranking. ◆ Enforce the law on public access to all documents related to business regulations, including proposed drafts and regulatory impact assessments. 	<ul style="list-style-type: none"> ◆ Implement the 2013 National Action Plan on improving the business climate. ◆ Strengthen the regulatory impact assessment (RIA), in line with international practice, to increase the quality of new legislation. ◆ Harmonize technical and food safety regulations with EU regulations. ◆ Finalize the institutional reform of the technical regulations system. ◆ Ensure the effective implementation of the new insolvency law. ◆ Improve the consultative process for new legislation, including, for example, the public posting of comments and responses. ◆ Develop a comprehensive strategy for SME development in line with good international practice. ◆ Introduce a broad range of e-government and ICT solutions, including the online registration of companies, online applications for permits and licenses, and an Internet based library of all business related requirements.

SUGGESTED REFORMS	SHORT-TERM RECOMMENDATIONS	MEDIUM-TERM RECOMMENDATIONS
Access to Finance	<ul style="list-style-type: none"> ◆ Gradually transition to a flexible exchange rate, and tighten fiscal policy. ◆ Encourage longer-term savings by more strictly distinguishing demand and time deposits and potentially expanding deposit guarantee coverage to include certificates of deposit issued by banks to their clients. ◆ Approve laws removing tax disincentives for NPL transfer and write-offs. ◆ Expedite and reduce costs of access to the State Registry of Encumbrances over Immoveable Assets. ◆ Pass legislation allowing dual listings of Ukrainian companies that are currently listed in foreign jurisdictions. ◆ Remove constraints to Hryvnia-denominated lending by IFIs by reconsidering the interest rate cap imposed by the NBU. 	<ul style="list-style-type: none"> ◆ Review constraints on foreign exchange lending and set appropriate prudential limitations. ◆ Enforce legislation on disclosure of the ultimate beneficiaries of banks, apply consolidated supervision, identify and limit related party lending. ◆ Increase depositor confidence by introducing market conduct regulation, appointing a financial ombudsman, and improving financial consumer protection rules and industry standards. ◆ Approve legislation completing the consolidation of information on credit histories and introduce a minimum unified standard for information on the credit history. ◆ Enact and enforce further legal and regulatory reforms to improve capital market transparency, protect investors' rights, and enhance disclosure requirements. ◆ Enact legislative and regulatory reforms improving reporting standards, and enhancing transparency and corporate governance in Ukrainian firms, including SMEs.

SUGGESTED REFORMS	SHORT-TERM RECOMMENDATIONS	MEDIUM-TERM RECOMMENDATIONS
Competition	<ul style="list-style-type: none"> ◆ Amend the Commercial Code to eliminate conflicts with competition laws. ◆ Enact the Law on State Aid to Business Entities and implement an effective system for controlling anticompetitive state aid, as per the commitments in the EU Association Agreement. ◆ Increase the AMC’s investigative power and capacity to collect evidence of wrong doing. ◆ Modify merger/concentration notification and abuse of dominant position thresholds to focus on transactions likely to raise competitive concerns, including those involving entities concealing ultimate owners. ◆ Improve procedures for imposing and collecting monetary penalties imposed by the AMC. ◆ Amend the leniency program to allow leniency for more than one applicant. ◆ Strengthen competition advocacy activities and outreach to the public. 	<ul style="list-style-type: none"> ◆ Pass legal amendments to harmonize Ukraine’s competition legislation with that of the European Union. ◆ Strengthen the de facto political independence of the AMC. ◆ Improve co-operation with other Ukrainian law enforcement agencies and investigative bodies. ◆ Clarify court jurisdiction for competition cases. ◆ Provide adequate resources to ensure that the AMC can maintain high standards of performance in accomplishing its mission. ◆ Reduce the burden on the AMC in areas that should not belong to its core activities such as natural monopolies, public procurement and trademarks. ◆ Complete the institutional reform of AMC as outlined in the draft Law on “National Competition Program 2014-2024”. ◆ Expand the use of market studies to better monitor levels of competition.

Chapter I: The Private Sector Growth Problem

Summary

21. **This chapter argues that the stunted growth of the private sector goes a long way in explaining Ukraine's poor economic performance.** The stunted growth is reflected in the generally stagnant structure of GDP, domestic production and exports, where old industries such as steel, machine building and chemicals continue to dominate; modest growth and low levels of industrial productivity, which has grown at a slower pace than in peer countries in the past decade; low inflow of high-value added FDI, especially in export-oriented manufacturing; high energy inefficiency; and the relatively limited role of SMEs in the development of the economy. All of these factors suggest that the market-driven process of entrepreneurial self-selection and self-discovery does not seem to work properly, and thus undermines Ukraine's growth prospects.

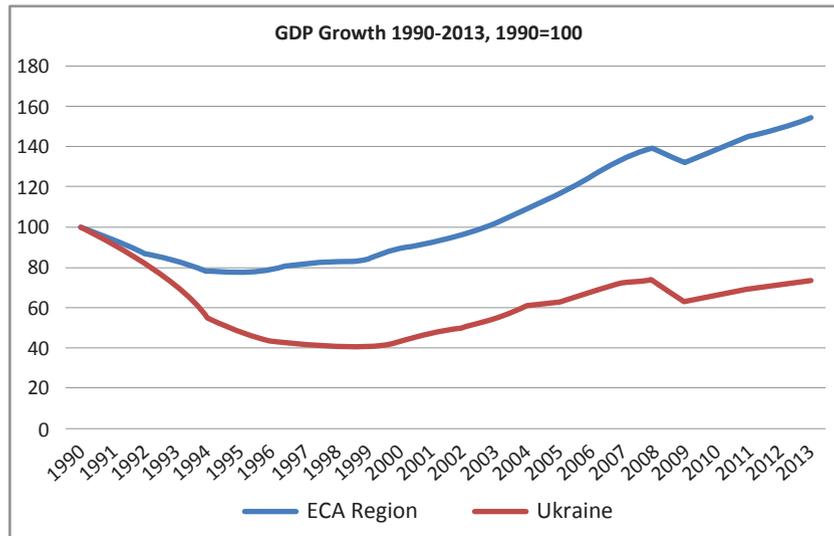
Introduction

22. **At the beginning of transition, Ukraine had a number of strengths, which seemed to predict a successful transition to a market economy and a gradual increase in living standards.** It had fertile agricultural lands, an attractive geographical location in Europe at the crossroads between the West and the East, a large domestic market of almost 49 million consumers, abundant natural resources, relatively well-developed infrastructure, high-quality human capital, and a significant industrial base in the east of the country, featuring global technology leaders such as the Antonov aviation company, which manufactured the largest airplane in the world.

23. **Yet, the economic miracle did not materialize.** Ukraine's GDP per capita lingers below 1989 levels and at a mere 10 percent of the European Union average after twenty years of transition. Incomes have increased much more slowly in Ukraine than in the Europe and Central Asia (ECA) region as a whole (Figure 1). Ukraine has also been under performing relative to regional peers, such as Poland, Romania, Russia and Belarus (Figure 2), including during the ongoing global crisis. Despite similar starting points at the beginning of transition, Poland's and Ukraine's income levels have diverged over the years. Incomes in neighboring Poland, arguably the most successful economy in Europe since 1989 (Piatkowski 2013), are now almost four times higher than in Ukraine. Growth projections suggest that the income gap between Ukraine and these peers will not be closed in the short term.¹

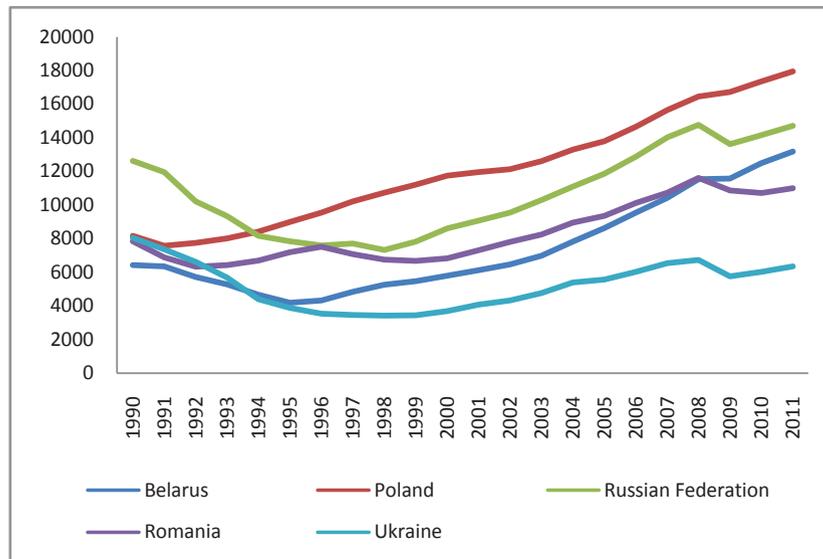
¹ In 2013, GDP growth in Ukraine and Poland, for instance, is projected at around 0 percent and 1.3 percent, respectively.

Figure 1: GDP Growth in Ukraine and ECA, 1990-2013, 1990=100



Source: World Bank, ECA Regional Tables.

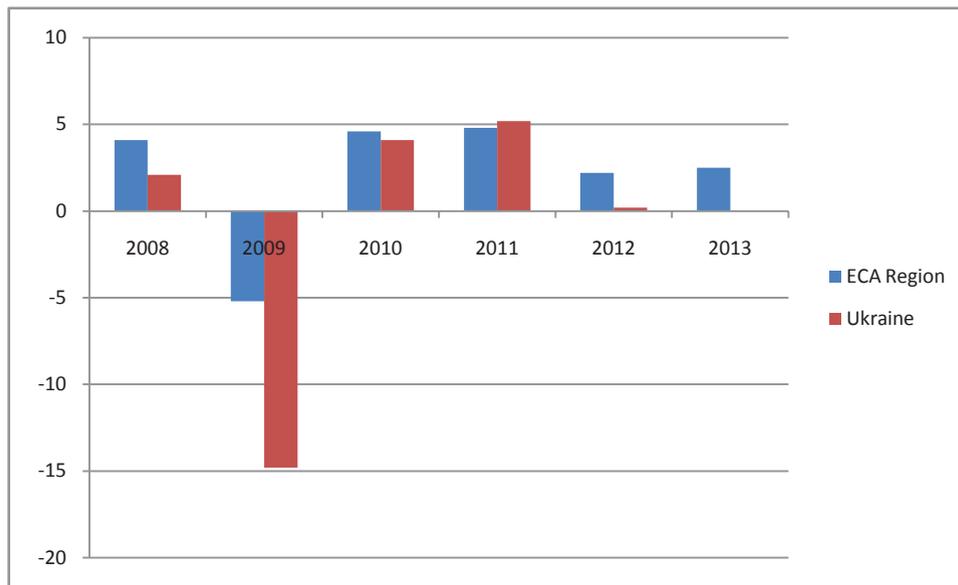
Figure 2: GDP per Capita in PPP, Constant 2005 International \$



Source: World Bank, ECA Regional Tables.

24. **Ukraine was one of the economies most severely hit by the global crisis.** Real GDP declined by 15 percent in 2009, much more than elsewhere in the region. While the economy regained some steam in 2010-2011, the GDP growth rate declined again in 2012, dropping close to zero. It is projected to stagnate around 0 percent in 2013 and slightly pick to 2 percent in 2014, well below Ukraine’s potential.

Figure 3: Real GDP Growth Rate, 2008-2013

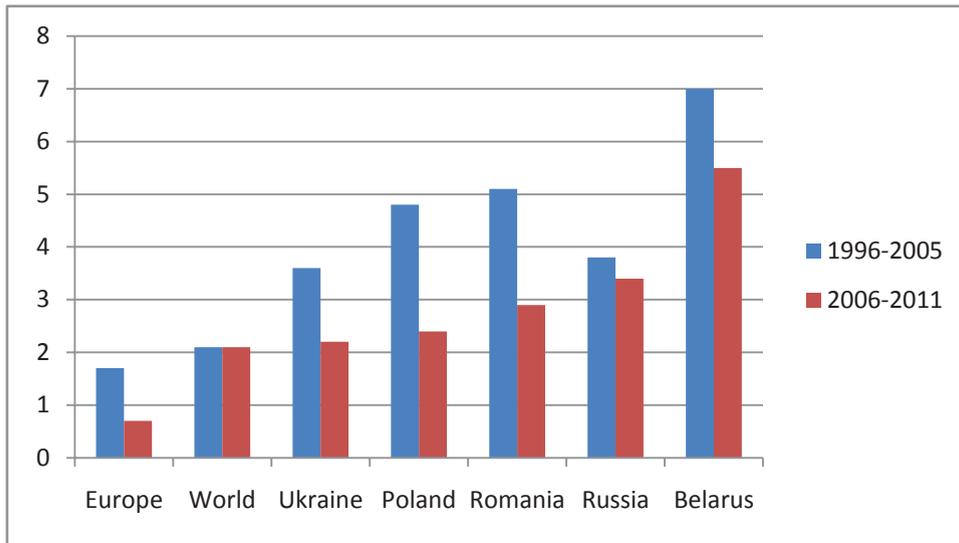


Source: World Bank, ECA Regional Tables, and projections for 2013.

25. **The stunted growth of the private sector is among the key reasons for Ukraine’s poor economic performance.** Evidence of this structural problem is abundant: the stagnant structure of the country’s exports; the low growth rate and overall level of productivity; the low inflows of FDI, particularly in export-oriented manufacturing; high energy intensity; and the relatively small share of SMEs in GDP. Each of these factors is documented in more detail below.

26. **Ukraine’s productivity lags its regional peers.** In 1996-2011, labor productivity growth (GDP per person employed) was lower than in comparator countries (Figure 4). As a result, Ukraine’s level of productivity in 2012 amounted to only 16 percent of the level of productivity in the US (Figure 5). Importantly, Ukraine has done even worse when it comes to Total Factor Productivity (TFP) growth. In 2006-2010, growth rates were actually negative. In the earlier period of 1996-2005, Ukraine’s TFP growth amounted to the rather weak 1.7 percent per year (Figure 6). Such slow growth in TFP suggests that Ukraine’s labor productivity growth was largely based on increases in capital investment, rather than improvements in “pure” productivity driven by higher-quality human capital, enhanced business practices, and faster technology absorption. In other words, Ukraine experienced “extensive” rather than “intensive” growth, unlike most of its peer countries, where TFP growth was the predominant source of development and economic convergence. Inefficient use of the existing, and relatively abundant, capital is also evident in Figure 7, where Ukraine lags regional and global peers.

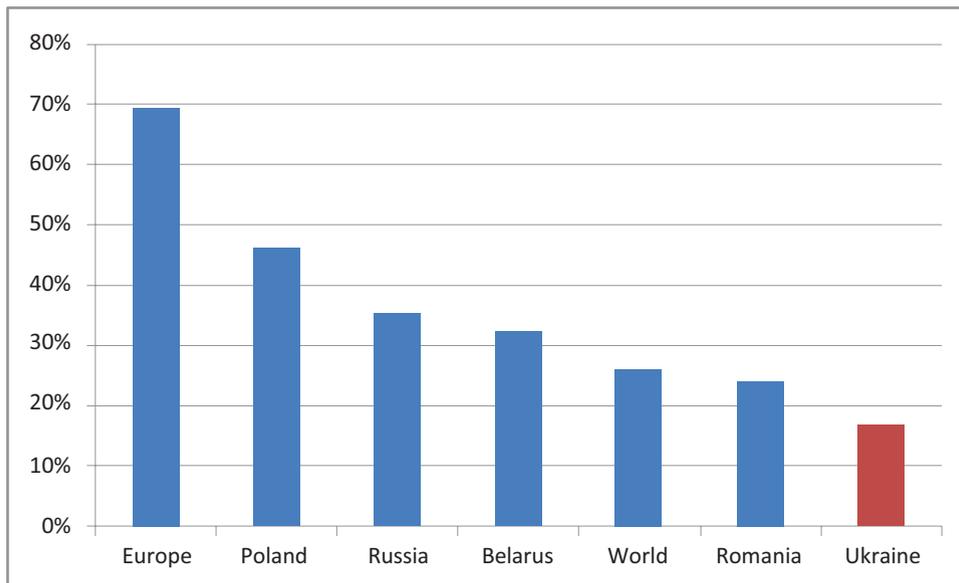
Figure 4: Labor Productivity Growth in Ukraine and Selected Countries, 1996-2011



Note: sorted by 2006-2011

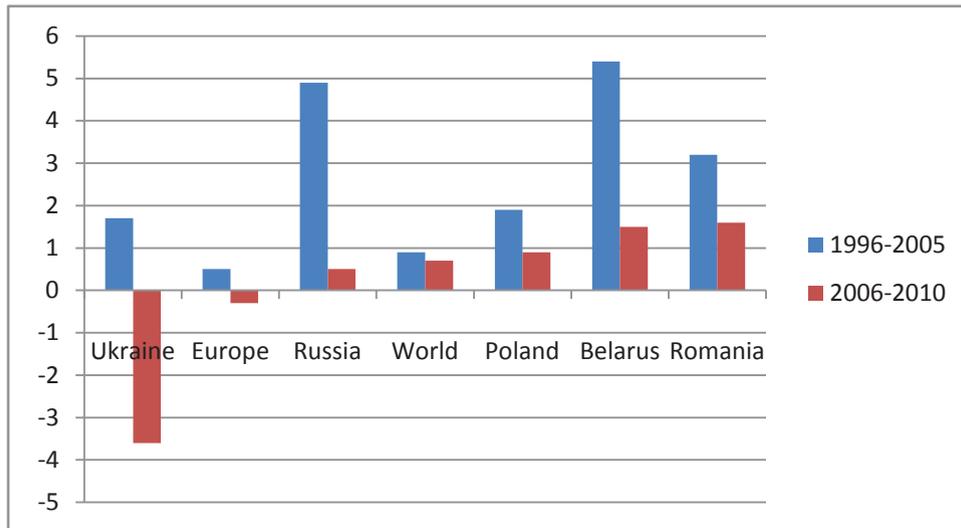
Source: Bank staff calculations based on the Conference Board's Total Economy Database, January 2013.

Figure 5: GDP per Person Employed, US=100, 2012



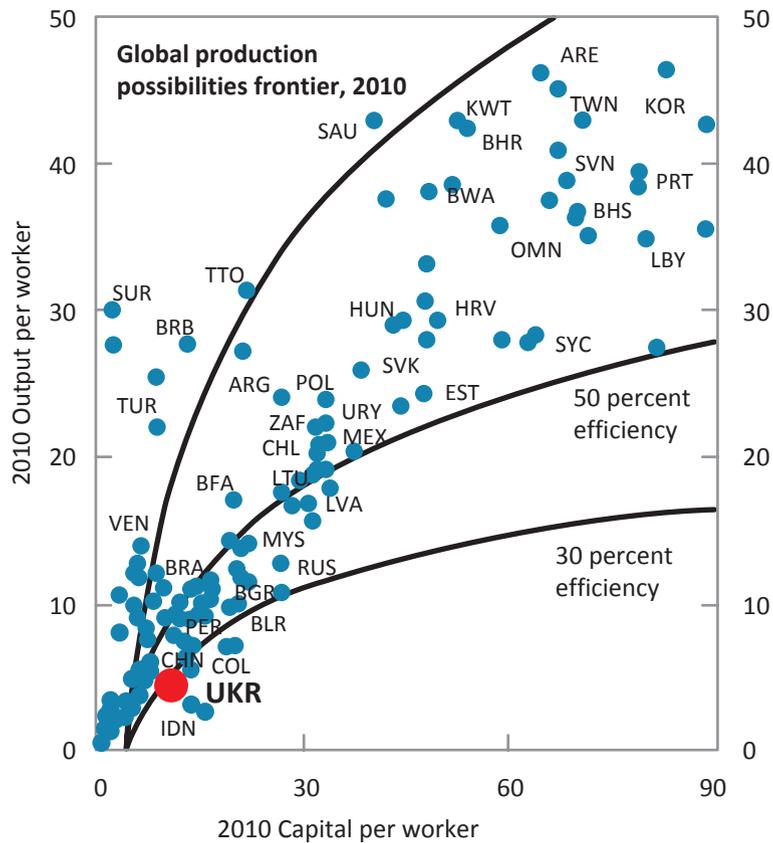
Source: Bank staff calculations based on the Conference Board's Total Economy Database, January 2013.

Figure 6: Total Factor Productivity Growth, 1996-2010



Source: Bank staff calculations based on the Conference Board's Total Economy Database, January 2013.

Figure 7: Total Factor Productivity Levels Relative to the Global Production Frontier, 2010

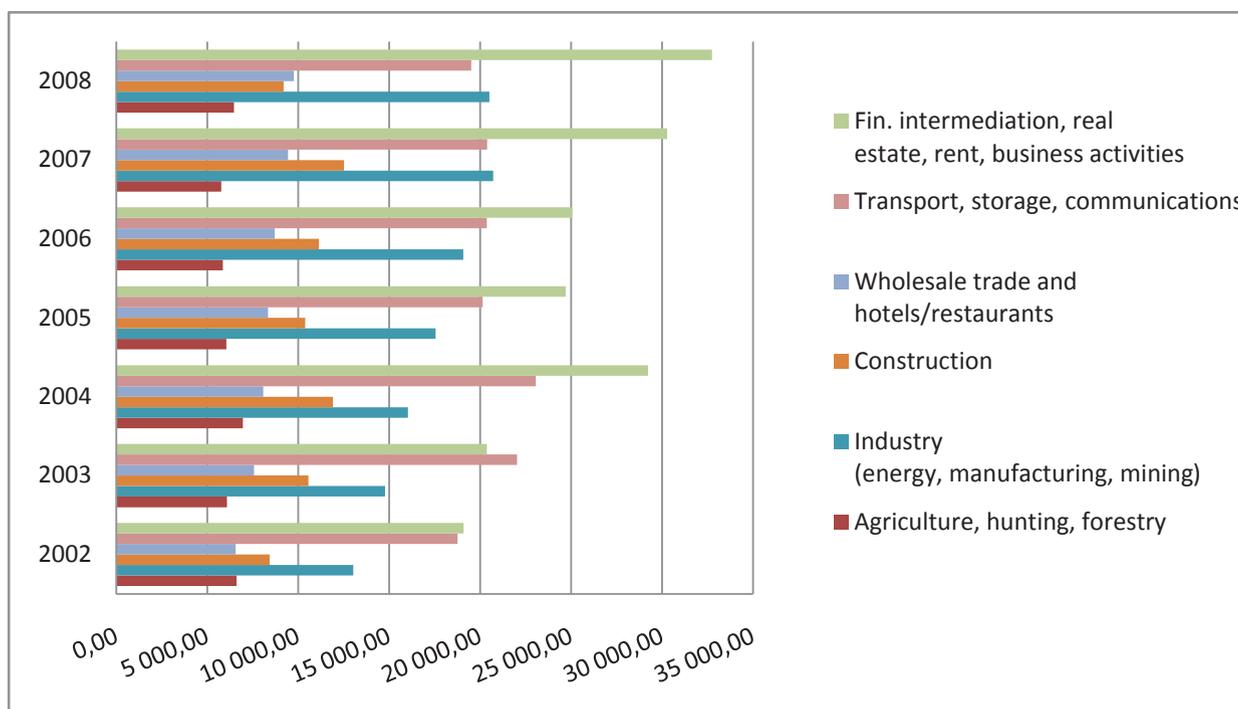


Notes: the frontier represents the implicit output level that could be obtained if a country were to employ all of its resources efficiently (Tiffin 2006).

Source: IMF 2012.

27. **Labor productivity growth on the sectoral level has also been slow.** The productivity of the financial sector and raw materials sector grew between 2002 and 2008 amid a global credit expansion, increased international investment in peripheral markets, and a boom in steel prices. However, these gains did not translate into long-term improvements in product innovation and operating efficiency in the financial sector (as indicated by lower-than-regional peers cost-to-income ratios), nor to energy efficiency or structural improvements in the raw materials sector (as indicated by the high energy intensity of steel production relative to competitor countries).² Productivity in transport, storage and communications, construction, and agriculture barely grew in that period, as shown in Figure 8.

Figure 8: Ukraine's Labor Productivity by Sector, 2002-2008
(In Constant US 2005 PPP International \$, Value Added/Employee)



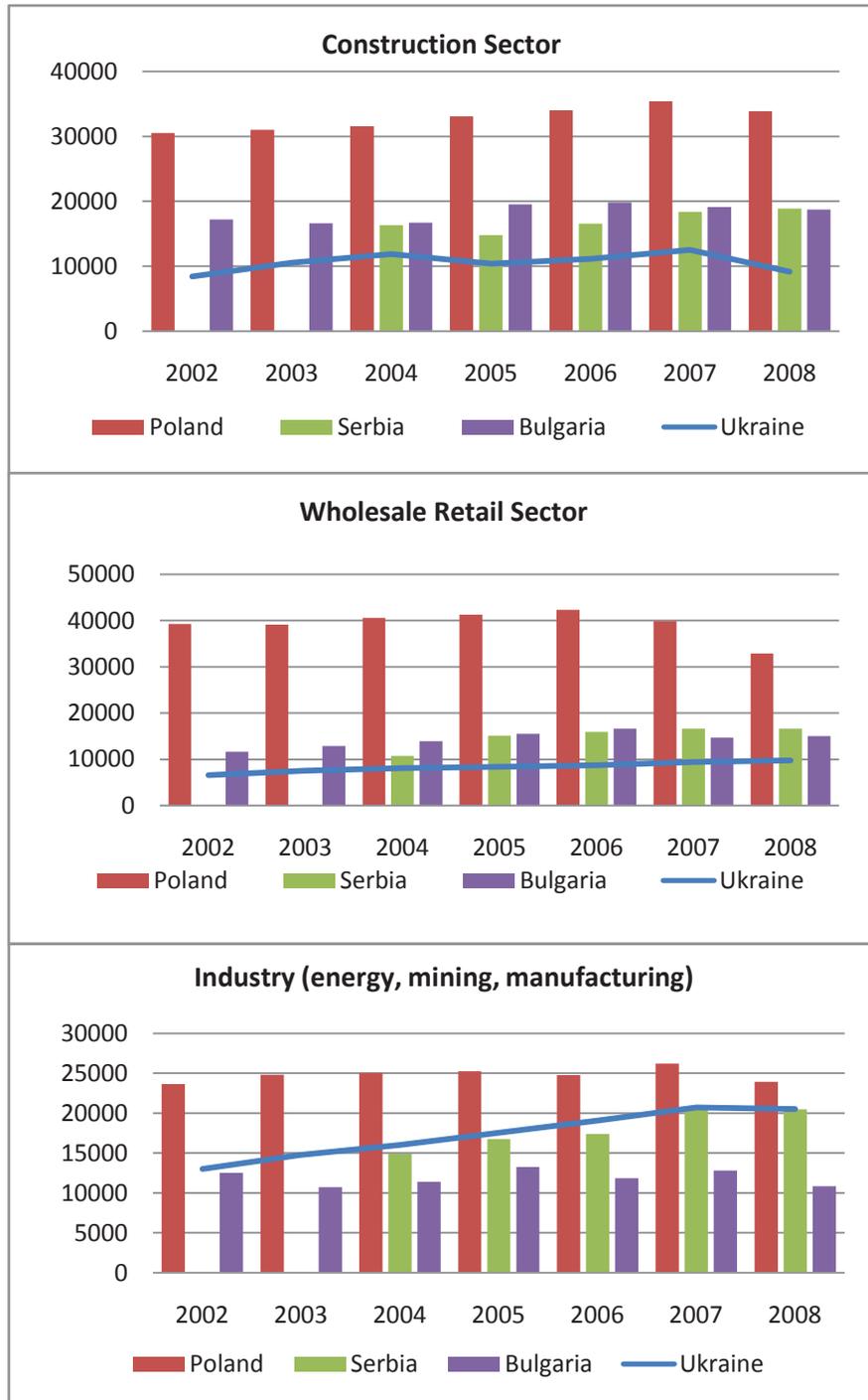
Source: WB staff calculations, based on the ILO and UN dataset.

28. **Overall levels of productivity across sectors have been below those of regional peers.** The gap was most pronounced in construction, and wholesale and retail trade (Figure 9). Productivity levels in energy, mining, and manufacturing were higher, although this likely reflects the positive terms of trade, where prices for steel, Ukraine's major export product, more than doubled in 2008.³

² The data in Figure 7 and 8 have been computed along the categories that are available for Ukraine's data, which combine the value added data for three categories of manufacturing, mining and energy sector, while wholesale also incorporates the hotels and restaurants sector. A similar approach was followed for the comparison countries. Post-2008 data are not yet available.

³ From \$500 per ton in 2007 to \$1100 per ton in 2008, before declining to \$600-700 in 2013. Source: <http://www.wallstreetdaily.com/2012/06/19/how-the-shifting-global-economy-affects-local-economies/>

**Figure 9: Country Comparison of Labor Productivity by Sector
(In Constant US 2005 PPP International \$, Value Added/Employee)**

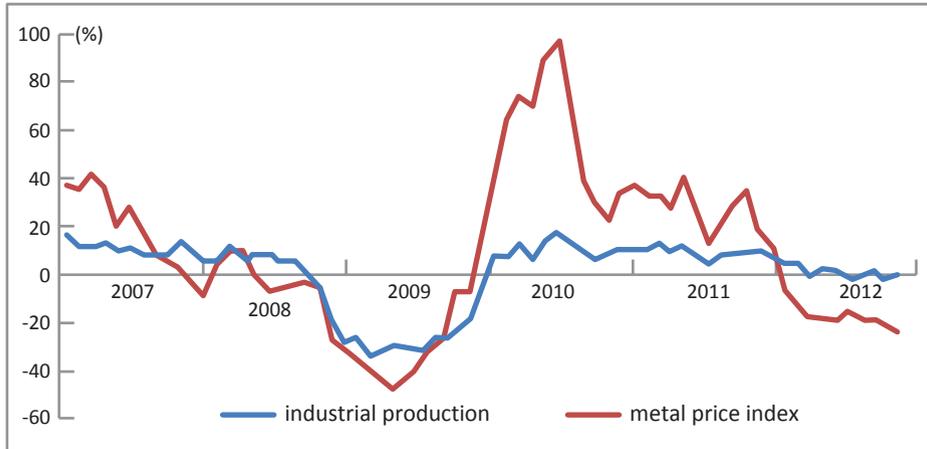


Source: WB staff calculations, based on the ILO and UN dataset

Stagnant Structure of Industrial Production and Exports

29. **Growth in industrial production and exports is largely driven by the sale of natural resources.** Ukraine's fast growth in the run up to the crisis seems to have been sustained by improvements in the trade terms for the country's main exports, steel and iron ore. With 70-80 percent of Ukraine's steel production earmarked for export, and exports accounting for as much as 50 percent of Ukraine's GDP, Ukraine continues to be vulnerable to fluctuations in the global prices of raw materials, especially steel (Figure 10).

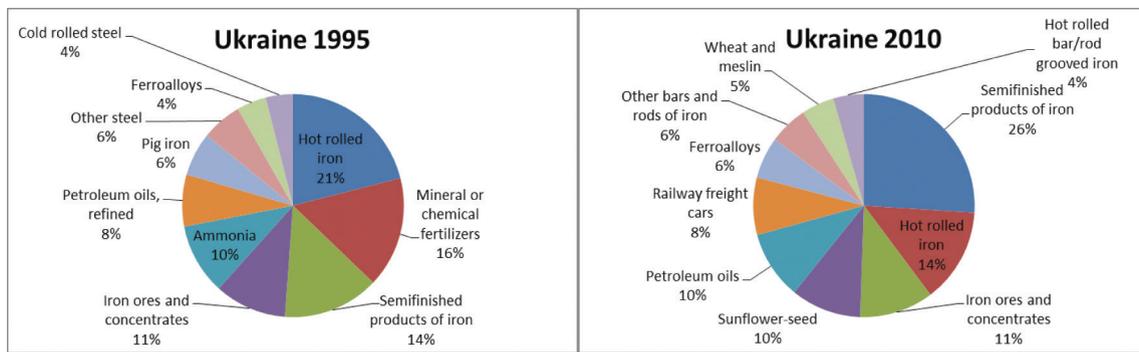
Figure 10: Industrial Production in Ukraine and Global Metal Prices

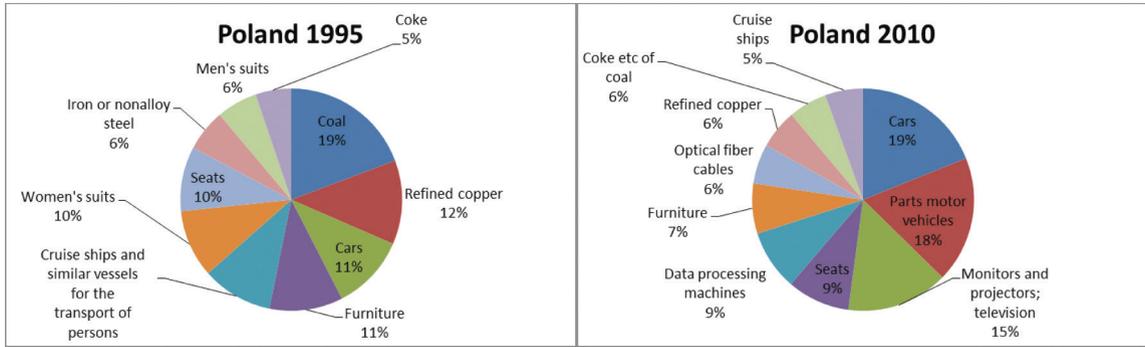


Source: Sarna (2012).

30. **Unlike many regional peers, Ukraine has hardly changed the structure of its exports since the onset of transition.** Exports continue to be dominated by commodities (with steel and steel products accounting for as much as 30 percent total exports in 2010, like in 1995), while the shares of mid-tech and high-tech products remain stagnant (e.g., railway freight cars were the only export item that could be considered higher-value added, with an 8 percent share of exports in 2010). To compare Ukraine's situation to a regional peer, the structure of Poland's exports changed dramatically between 1995 and 2010, owing to large inflows of export-oriented FDI. In 1995, coal, copper, coke, steel, clothing, and ships accounted for the vast majority of Poland's exports, while in 2010, automobiles, car parts, and electronics were the leading export items in the almost \$200 billion exports portfolio (compared to about \$70 billion in Ukraine, Figure 11).

Figure 11: Top 10 Items in Export Baskets in Ukraine and Poland, 1995 and 2010

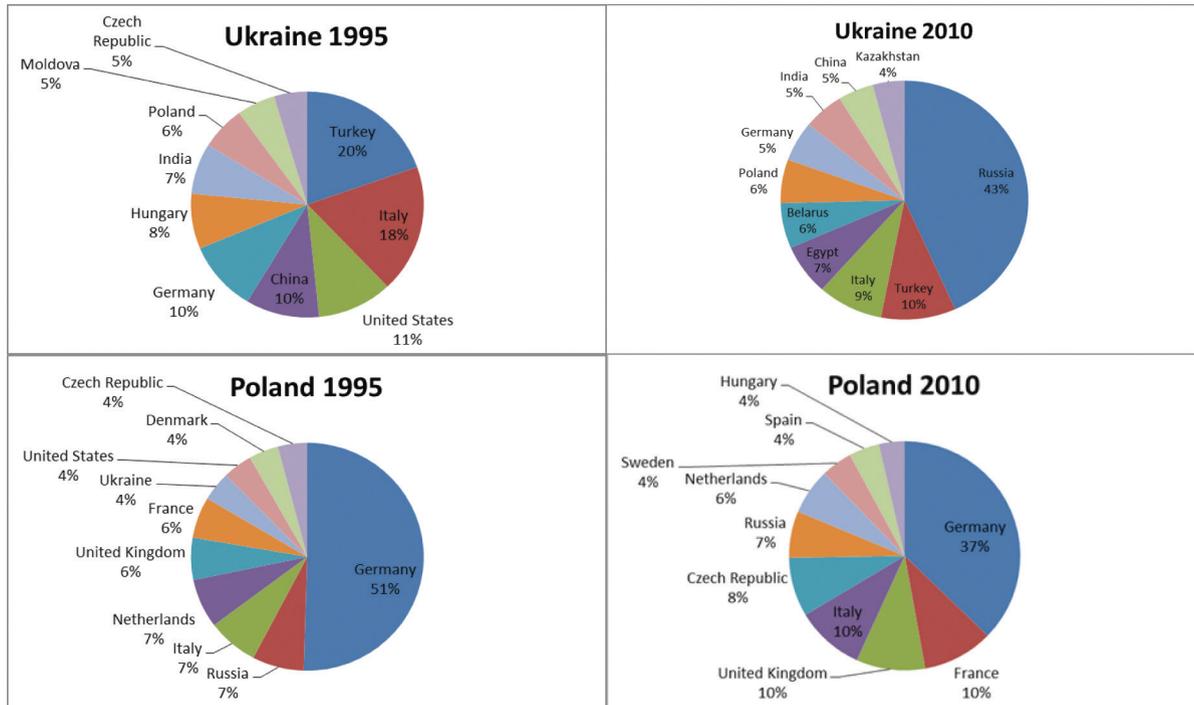




Source: World Bank staff calculations based on Economic Complexity Observatory, MIT Media Lab and the Center for International Development at Harvard University, (TC), <http://atlas.media.mit.edu>

31. **Ukraine's exporters also continue to rely on an old clientele concentrated mostly in post-Soviet countries.** CIS countries consumed 37 percent of Ukraine's exports in 2012, while developed countries in the EU accounted for less than 15 percent of the total.⁴ The top 10 destinations of Poland's exports are very different: almost 80 percent of the country's total exports end up on markets in the EU (Figure 12).

Figure 12: Top 10 Destinations for Ukrainian and Polish Exports, 1995/2002 and 2010

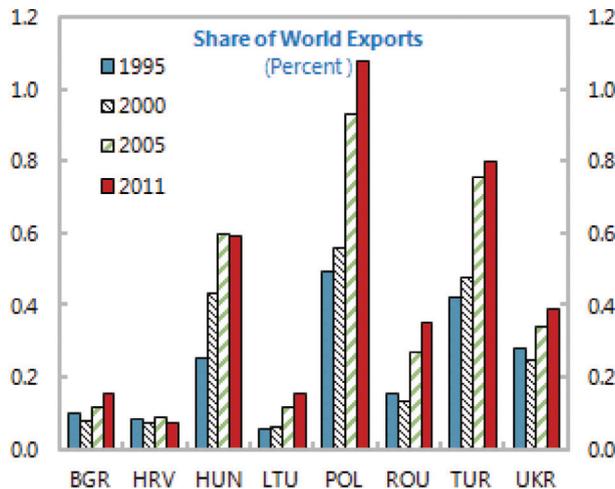


Source: World Bank staff calculations based on the Economic Complexity Observatory, MIT Media Lab and the Center for International Development at Harvard University, (TC), <http://atlas.media.mit.edu> for Poland. Data on Ukraine for 2002 and 2010 from the State Statistics Service for Ukraine.

⁴ Data from the State Statistics Service of Ukraine.

32. **The expansion of Ukraine’s share in the global export markets has been modest.** Despite positive changes in the terms of trade in the 2000s, mainly owing to increased steel prices, Ukraine’s share in global exports increased by only 0.1 percentage points between 1995 and 2011. In contrast, Poland’s share more than doubled, buoyed by inflows of export-oriented FDI.

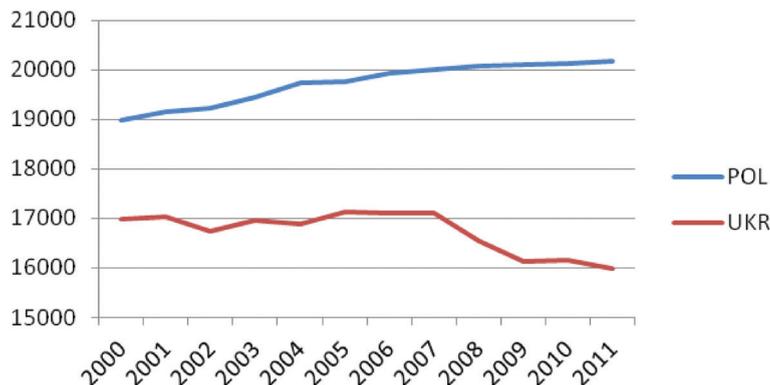
Figure 13: Ukraine’s Share of World Exports Relative to Peers, 1995-2011



Sources: IMF, World Economic Outlook and IMF staff estimates.

33. **Finally, the sophistication of exports has declined and sectors where Ukraine holds a comparative advantage have suffered setbacks.** The declining measure of export sophistication is likely due to the continuing dominance of low-valued added raw materials and food products in total exports. This stands in contrast to the trends in Poland’s exports, where sophistication has continued to increase, largely owing to FDI (Figure 14). Revealed comparative advantage has suffered the most in the chemical industry, animal products, and petroleum (Figure 15).

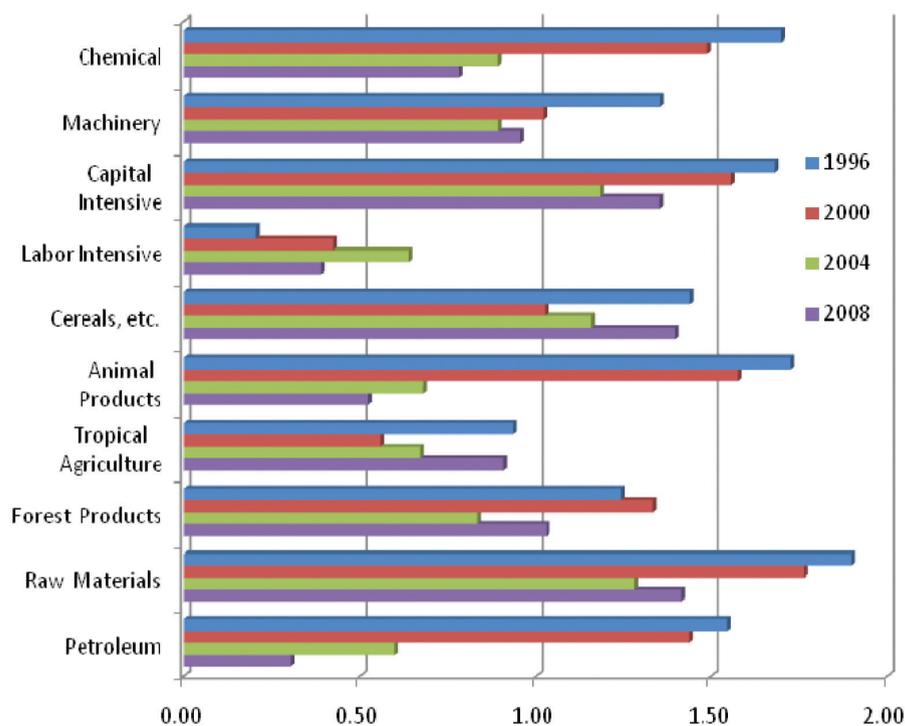
Figure 14: Export Sophistication in Ukraine and Poland (EXPY Index⁵)



Source: WB Staff calculations based on the UN Comtrade data.

⁵ The export sophistication index (EXPY), developed in Hausmann, Hwang and Rodrik (2007), aims to capture the productivity level associated with a country’s export and is a proxy for the set of the 18 most productive products the country can produce at a given time. EXPYs are computed for three categories of exports: goods, manufactured goods, and services. To calculate the EXPYs, each category of goods, manufactured and service exports is ranked according to the income levels of the countries that export it. In other words, the EXPY is higher when a country’s export products are associated with the exports of countries at a higher level of development.

Figure 15: Revealed Comparative Advantages of Ukrainian Exports, by Leamer Category



Note: Calculated using SITC.
Source: World Bank CEM, 2010.

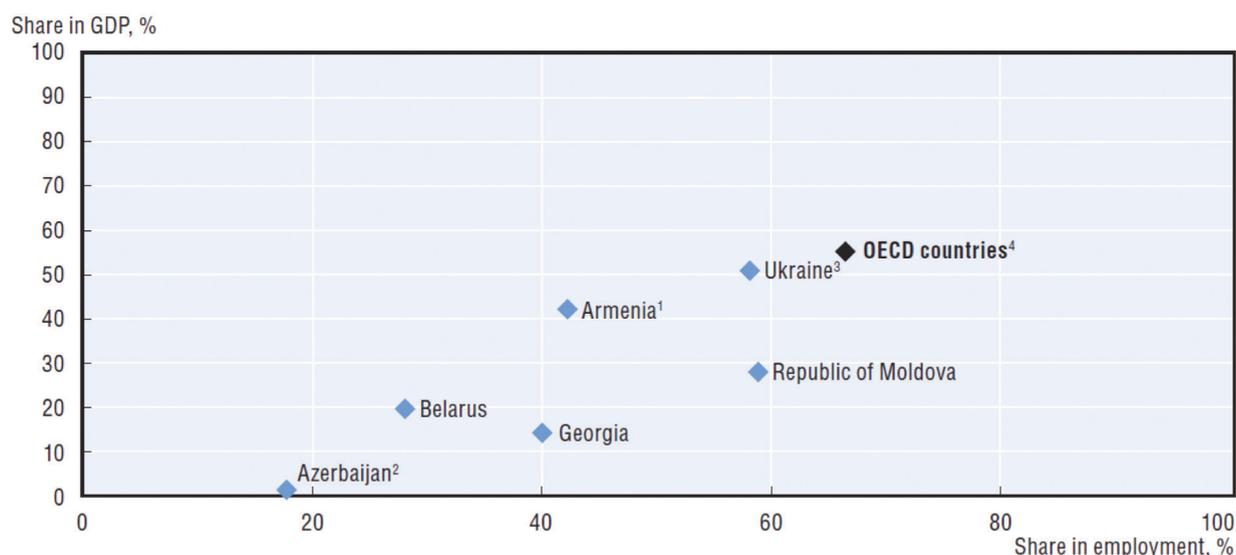
34. **The sub par growth of the private sector is also reflected in the smaller size of the SME sector relative to developed countries.** While considerable evidence has been gathered globally that small and medium enterprises are key to growth and poverty alleviation⁶, in Ukraine financial-industrial groups continue to dominate the economy, relative to the more balanced structure of the private sector among OECD countries, where SMEs play a much more important role (Figure 16). The abundance of larger firms often points to a high regulatory burden, as larger enterprises tend to benefit from economies of scale in dealing with the bureaucratic red tape, while smaller firms opt to escape rent-seeking regulators by operating in the shadow economy. The World Bank’s 2010 Country Economic Memorandum finds that SMEs in Ukraine account for a smaller portion of employment than in other countries in Europe and the region. It also concludes that (i) levels of firm entry and exit are low; (ii) firm entry and exit generate few productivity gains through the improved allocation of resources; and consequently, (iii) levels of allocative efficiency remain low. OECD concurs with the World Bank’s assessment and additionally argues that “the contribution of SMEs to the Ukrainian economy has decreased over the past four years, and employment has decreased particularly in medium-sized enterprises, approximately by 10 percent each year between 2007 and 2010. In terms of turnover, the share of the SME sector has dropped from 60.7 percent in 2007 to 51.2 percent in 2010”.⁷ All these trends signal weak firm dynamics and significant barriers to entry and exit that hamper a healthy churning in the economy, and thereby reduce productivity growth.⁸

⁶ Bartelsman et al. 2010.

⁷ OECD et al. 2012, p. 39.

⁸ CEM 2010, World Bank, p. 42.

Figure 16: SME Sector Contribution to Employment and GDP: Ukraine and Selected Countries



Source: OECD et al (2012) *SME Policy Index*

35. **New firms have largely failed to emerge, but their appearance is a hallmark of well-functioning markets.** The list of Ukraine’s twenty five largest enterprises has not changed much since the early 1990s: state owned enterprises (SOEs) and privatized SOEs continue to dominate the economy. There are only seven new private companies on the list (Table 2). This developmental model differs fundamentally from the one common in the EU10, where there has been much more company turnover owing to fast growth of private companies, and inflow of green-field FDI.

Table 2: Twenty Five Largest Companies in Ukraine, by Revenue, 2012

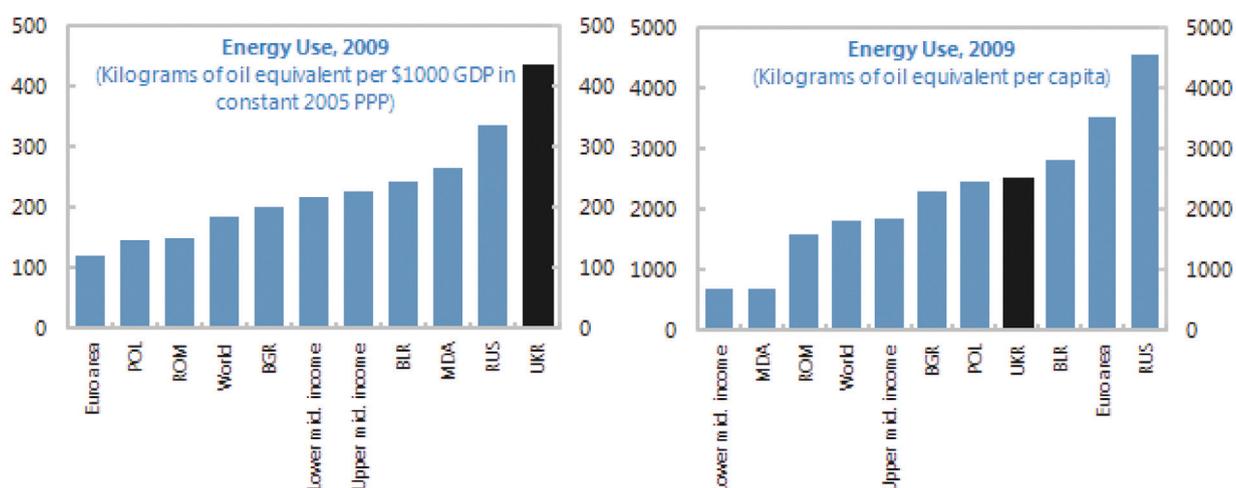
	COMPANY NAME	INDUSTRY	COMMENTS
1	Metinvest	Manufacturing	Holding company comprising privatized SOEs
2	Naftogaz of Ukraine	Energy	SOE
3	Energorynok	Energy	SOE
4	Ukrzaliznytsia	Transportation	SOE
5	DTEK	Energy	Holding company comprising privatized SOEs and newly created private enterprises
6	ISD	Manufacturing	Holding company comprising privatized SOEs
7	Energy Company of Ukraine	Energy	SOE
8	Alcerol Mittal Kryvyj Rih Ukraine	Manufacturing	Foreign owned (privatized SOE)
9	Ukratnafta	Energy	Privatized SOE (oil refinery) and newly created private enterprises (network of gas stations)
10	Donetskstal	Manufacturing	Holding company comprising privatized SOEs
11	Fozzy Group	Consumer (retail)	New private company
12	Ostchem	Manufacturing	Holding company comprising privatized SOEs

	COMPANY NAME	INDUSTRY	COMMENTS
13	TNK-BP Commerce	Energy	Foreign owned (privatized SOE + new private companies)
14	WOG Group	Energy	Holding company: privatized SOEs and new private companies
15	Energoatom	Energy	SOE
16	Kernel	Agriculture and food processing	New private company (but includes former state owned farms)
17	ATB Market	Consumer (retail)	New private company
18	Interpipe	Manufacturing	Holding company comprising privatized SOEs (but also newly built electric steel plant – Dniprosteel)
20	Kyivstar GSM	Telecommunications	Foreign owned (New private company)
21	Philip Morris Ukraine	Consumer	New private company (New private company + privatized SOE)
22	Galnaftogaz	Energy	Holding company comprising privatized SOEs and new private companies
23	Epicentr K	Consumer (DIY)	New private company
24	Nibulon	Food processing	New private companies + privatized SOEs
25	Southern GOK	Energy and Resources	Privatized SOE

Source: based on “Deloitte. Top 500 in Central Europe, 2012”.

36. **The inefficient use of energy also reflects the slow pace of restructuring within the Ukrainian economy.** Energy consumption in Ukraine is almost twice as high as the world average, and nearly four times higher than in Poland (in kilograms of oil equivalent to \$1000 GDP), where the private sector (and households) have undergone a far-reaching transformation and have increased energy efficiency from roughly the same 1989 levels (Figure 17).

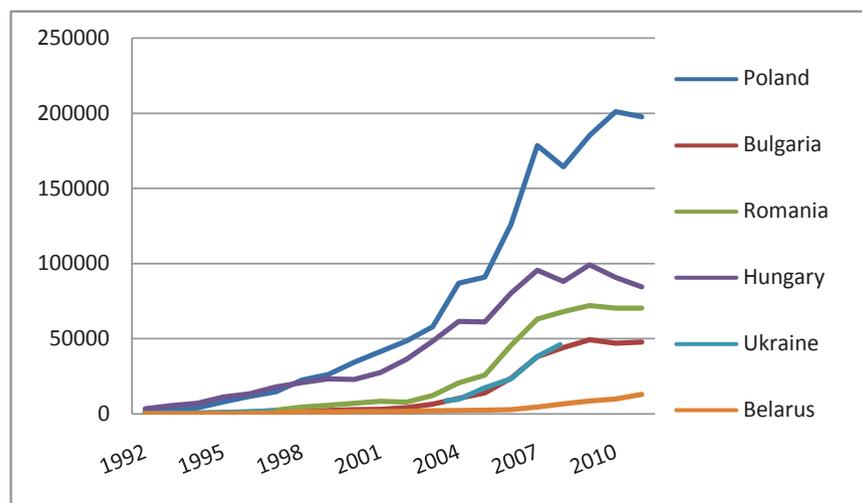
Figure 17: Ukraine’s Energy Efficiency Relative to Peers



Source: World Bank, World Development Indicators.

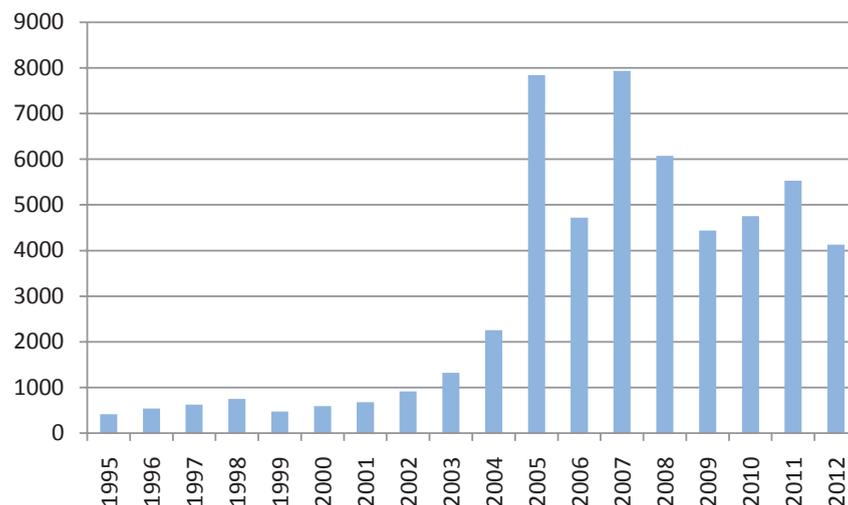
37. **Finally, the stunted growth of the private sector is both driven by and reflected in low FDI.** There is ample international evidence to suggest that FDI flows are more dynamic in economies with strong and transparent institutions, efficient labor productivity, high degrees of export sophistication, free firm entry and exit, and low barriers to doing business. Despite the size of Ukraine’s economy, the country’s FDI flows resemble those of much smaller economies. Ukraine’s peers, such as Poland, Hungary and Romania, have reported much higher FDI inflows (Figure 18). Ukraine’s FDI picked up substantially in the mid-2000s, but the positive trend was largely driven by investment in the financial sector (for more detail, see Chapter III), and the privatization of a large steel and iron ore producer, Kryvorizhstal, by Arcelor Mittal in 2005 (Figure 19). Unlike in the EU10, however, there has been little export-oriented FDI, especially focused on markets in developed countries. Furthermore, IMF estimates that in 2012, one third of the total accumulated stock of FDI came from Cyprus, likely reflecting recycled Ukrainian capital rather than more productive investment by multinational companies.⁹

Figure 18: Cumulative FDI Inflows to Ukraine and Regional Peers, 1992-2011 (In \$ Million)



Source: UNCTAD Stat.

Figure 19: FDI Inflows to Ukraine, 1995-2012, in \$ Million

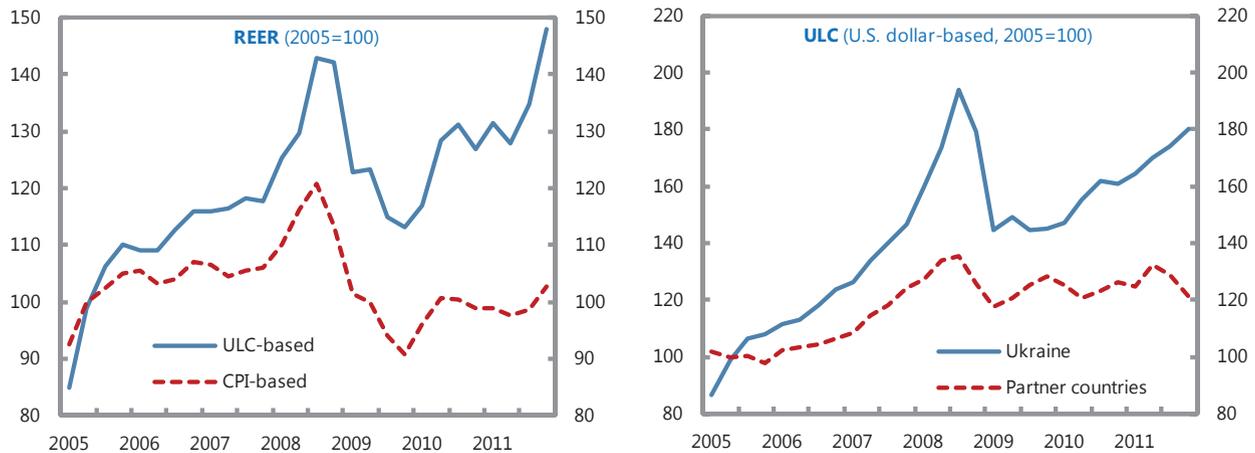


Source: The State Statistics Service of Ukraine.

⁹ IMF 2012.

38. **The private sector is also adversely affected by the fast increase in unit labor costs and a strong real exchange rate.** In 2005-2012, Ukraine's unit labor costs have increased much faster than in comparator countries, reflecting faster growth in wages than in productivity. This has undermined the price competitiveness of Ukrainian exports, particularly those outside the traditional sectors including steel, machine building and chemicals, and it has made it more difficult for domestic firms to compete with imports (Figure 20).

Figure 20: Price Competitiveness Indicators in Ukraine, 2005-2011



Sources: State Statistics Committee of Ukraine; OECD; Haver; IMF, International Financial Statistics; and IMF staff estimates.

Source: IMF 2012.

39. **An unfriendly business climate seems to pose one of the key obstacles to private sector development.** Ample evidence documented in surveys and international rankings, such as the World Bank's Doing Business Report, and the Global Competitiveness Report, suggests that Ukraine's business climate is much worse than that of its peers. As such, it can largely explain the difference in the economic performance of Ukraine and the EU10 in the last twenty years.¹⁰

40. **Kick-starting private sector growth is critical if Ukraine seeks to resume economic convergence with developed countries.** An IMF study suggests that based on the existing stock of capital and labor, Ukraine's income levels could almost double if the country achieved similar institutional and market efficiency as the EU 10, possibly increasing its long-term growth rate to about 8.5 percent yearly.¹¹ Given that the institutional gap between Ukraine and the EU 10 has not changed much since the IMF analysis was performed, the results are likely to still be largely valid.

41. **This note focuses on the regulatory environment, access to finance and competition as the main constraints to the development of a better business climate in Ukraine.** These three structural obstacles were identified based on: (i) stock-taking of the existing research produced by the World Bank and external partners, including the European Commission and OECD; (ii) evidence from international rankings such as the World Bank's Doing Business ranking, and the World Economic Forum's Global Competitiveness Index; and (iii) discussions with the Government, business associations, NGOs and academia. The following three chapters discuss each of these three constraints in greater detail.

¹⁰ World Bank (2010).

¹¹ Tiffin (2006).

Chapter II: The Regulatory Environment

Summary

42. **Despite notable recent progress in improving business regulation, Ukraine continues to suffer from poor conditions for doing business, characterized by excessive red tape, uneven implementation, and systemic corruption.** This undermines the growth of the private sector and Ukraine's overall economic development. The following chapter offers recommendations on how to overcome these obstacles and decisively move forward with reforming business regulation. The recommendations include: full implementation of measures focused on improving the business climate, as proposed in the "2013 National Action Plan"; wholesale reduction of the number of permits and licenses via the use of a regulatory guillotine; completion of a risk-based system for inspections; adoption of appropriate risk criteria and checklists by all inspectorates; elimination of outdated Soviet-era technical regulations; adoption of EU regulations, especially in areas covered by the DCFTA such as food safety and technical regulations; effective implementation of the new insolvency law, and broad introduction of e-government and ICT solutions increasing transparency and reducing scope for graft. Coupled with stronger governance, reduced state capture, and committed political leadership, these reforms could help Ukraine realize its full growth potential.

Introduction

43. **A friendly business climate is vital for faster economic growth.** There is a substantial body of economic literature that has identified a strong causal link between an auspicious business environment and economic development. Surveys assessing the impact of business regulation on productivity and growth indicate that a friendly business climate promotes economic development by encouraging investment, the entry of new firms onto the market, and entrepreneurial self-selection.¹² There are hardly any examples of countries that have caught up with developed countries while maintaining an unfriendly business climate for private sector growth and entrepreneurship. Unfriendly regulations, excessive red tape, and high costs of market entry and exit undermine the proper operation of the markets, weaken entrepreneurship, and encourage corruption.

44. **Reforms of business regulations are often fiscally friendly.** Improving the business climate by enhancing regulations and strengthening implementation offers an attractive low cost/high return alternative to other pro-growth policies, such as increasing public investment. Many countries therefore prioritize business environment reform. A similar prioritization would also be useful in Ukraine.

Business Environment in Ukraine

45. **Ukraine has made substantial efforts to improve its business regulations.** The country has risen from 140th place in World Bank's Doing Business (DB) 2013 ranking to 112nd place in DB 2014, thanks to across-the-board improvements in most DB areas, including construction permits, property registration and getting credit. In DB 2014, Ukraine was the fastest improving country in the world and ranked in the top five among the economies that have gone the furthest in reducing the distance to the best performers in the world since 2005. Progress has been the greatest in with dealing with construction permits (up by 145 positions), property registration (up by 61 positions), and getting credit (up by 11 positions). Ukraine has been recognized as a top performer in 2012/2013 after implementing reforms in 8 out of 10 areas measured

¹² See Dethier et al (2011) for a useful summary of research. For additional research, please also refer to the World Bank's Doing Business website: <http://doingbusiness.org/research>

by Doing Business and also is ranked fourth among the economies that have gone furthest in reducing the distance to the best performers in the world since 2005.

46. **Registering a business has become much easier.** In 2011, Ukraine ranked only 116th in the world in terms of the ease of starting a business, but improved to 47th place in 2014 by eliminating the requirement to provide minimum capital for company incorporation, notarization of incorporation documents, obtaining approval for a corporate seal, and registering with the statistics authority.

As a result, the number of procedures required to start a business was cut from ten to six, time was reduced from 27 to 21 days, and the cost was slashed to only 1.3 percent of per capita income.¹³

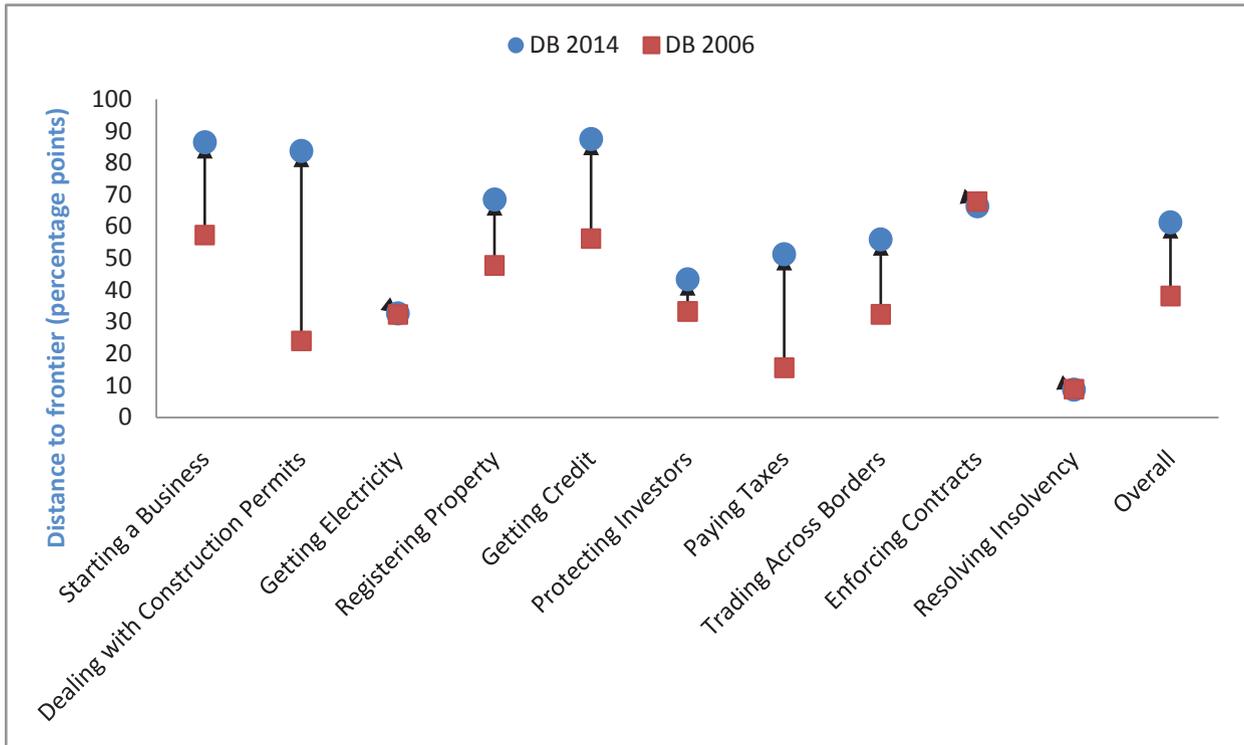
47. **There were also marked improvements in paying taxes, registering property, and getting credit.** In 2010-2013, Ukraine introduced a number of reforms in all of these three areas, supported by the IFC. In taxation, Ukraine made paying taxes easier and less costly for firms by revising and unifying tax legislation, reducing corporate income tax rates (from 21 percent in 2011 to 19 percent in 2013 and planned 16 percent in 2014), unifying social security contributions, simplifying tax returns and introducing online tax payments. In property registration, Ukraine introduced an effective time limit for processing transfer applications at the land cadastre in Kyiv and made transferring property easier by streamlining procedures. Finally, in access to credit, Ukraine extended the coverage of individuals by private credit bureaus and began to collect data on firms from financial institutions, although credit information still remains scarce, as discussed in Chapter III.

48. **The reforms enabled Ukraine to reduce its distance from global best practice in most areas of doing business in 2005-2013, especially in business registration, access to credit, and construction permits.** Many of these reforms were spurred by the quasi-“guillotine” exercise implemented in 2005, which – while far from being in line with the international good practice outlined in Annex 2 –nonetheless helped repeal 4,900 regulations that could no longer be justified, out of about 10,000.¹⁴ However, reform momentum in resolving insolvency, enforcing contracts, and trading across borders has been lagging.

¹³ Detailed information available on the World Bank Doing Business website: www.doingbusiness.org

¹⁴ Jacobs and Astrakhan 2006.

Figure 21: Ukraine’s Performance in the Doing Business Ranking, 2005-2013
(Distance to Frontier In Percentage Points)



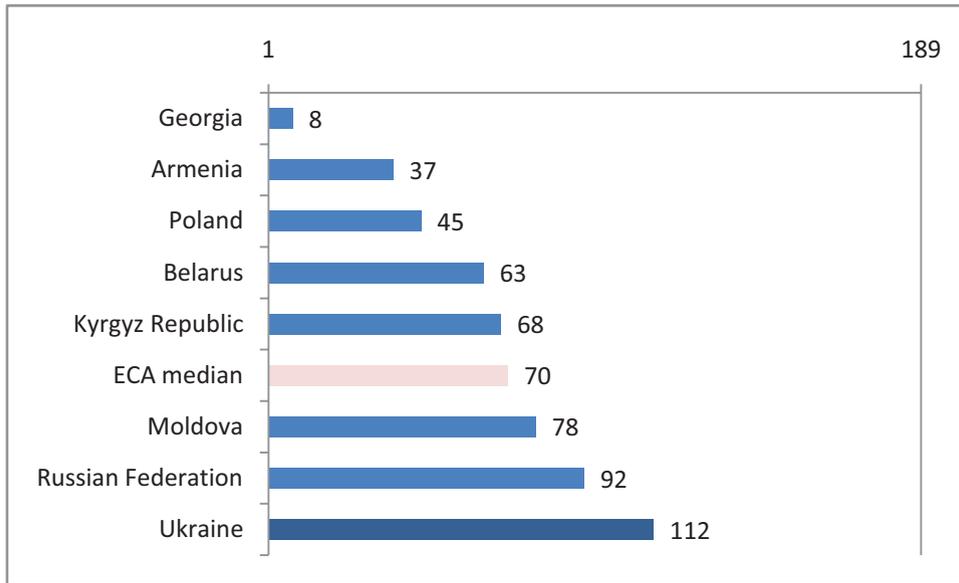
Source: World Bank Doing Business 2006, 2014.

49. **Further reforms aimed at stimulating the development of a friendly business climate are in progress.** In 2012, the Ukrainian president announced that the country would seek to enter the top 100 economies in the Doing Business ranking. The proposed reforms, encapsulated in the “2013 National Action Plan”, were approved by a Presidential Decree in March 2013. The reforms, reflected in Doing Business 2014, included almost all areas covered by the DB ranking, except for protecting investors and enforcing contracts.¹⁵

50. **However, despite the strong reform momentum, the business environment reflected in the World Bank’s 2014 Doing Business ranking is worse than those in peer countries.** The 2014 report places Ukraine in 112th place worldwide, below all regional peers (Figure 22). Ukraine lags in most areas, but especially in getting electricity (172nd), paying taxes (164th) and trading across borders (148th) (Figure 23).

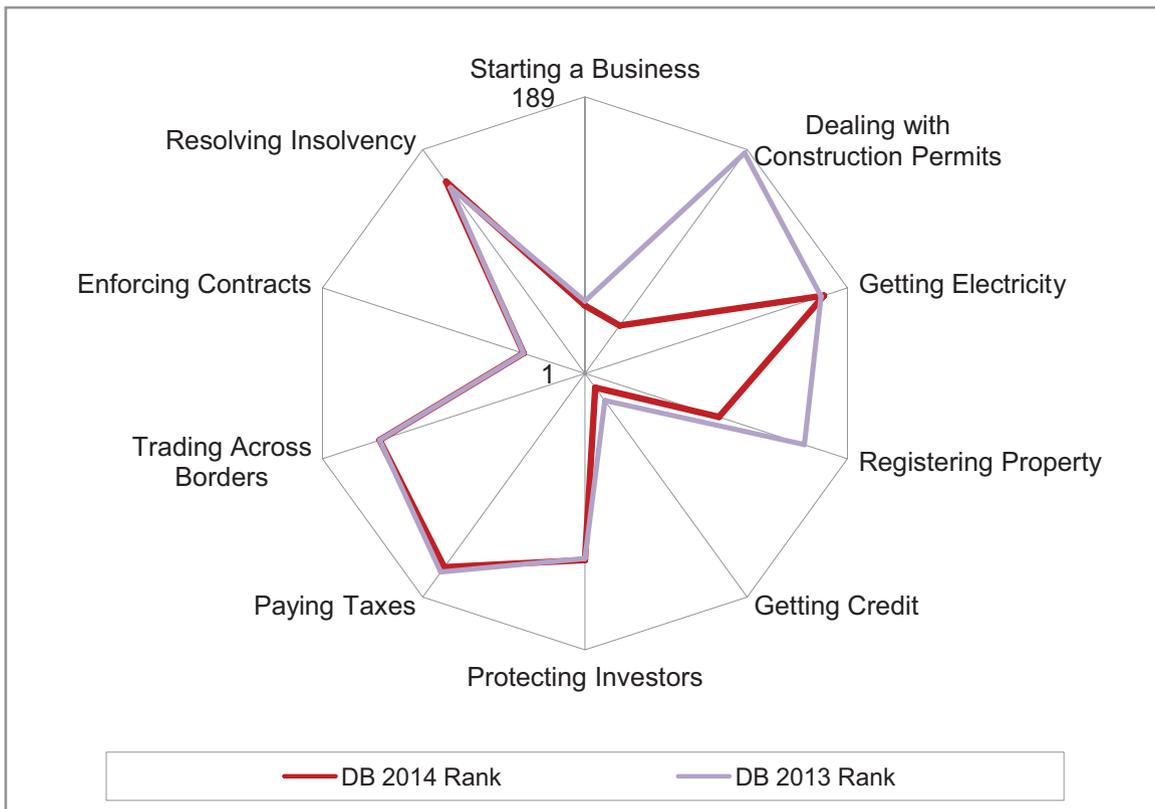
¹⁵ See www.doingbusiness.org for details. Please also see Annex 1 for a summary of the planned reforms under the “2013 National Action Plan”.

Figure 22: Ukraine's Position in the 2014 Doing Business Ranking



Source: World Bank Doing Business 2014.

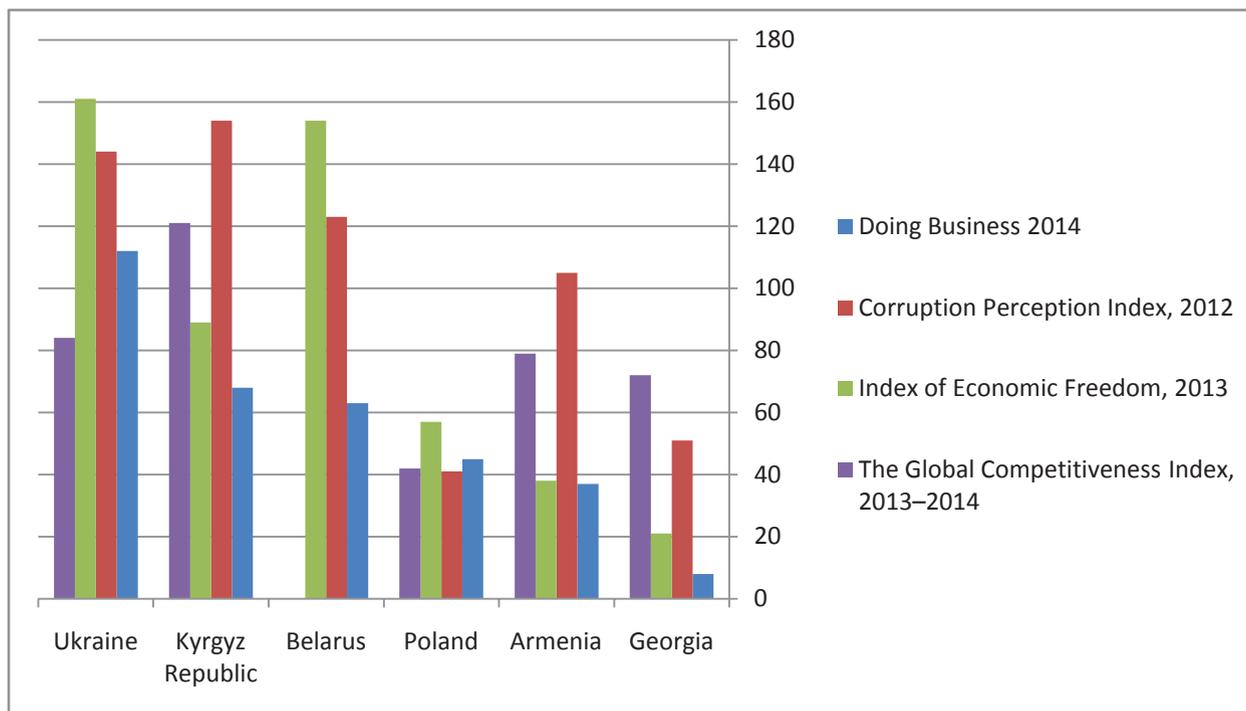
Figure 23: Most Problematic Business Regulations in Ukraine According to the 2014 Doing Business Ranking (189 countries Worldwide)



Source: World Bank Doing Business 2014.

51. **Ukraine also performs poorly in other business environment rankings, some of which even reveal that it is backsliding.** The Global Competitiveness Index 2013-2014 ranks Ukraine as 84th from among 148 countries, down from 73rd place a year earlier. Ukraine scores even worse on the Economic Freedom Index, coming in only 161st from among 177 countries. Ukraine is ranked as 144th in the Corruption Perception Index developed by Transparency International (Figure 24). Domestic business surveys are also downbeat. For instance, the EBA Investment Attractiveness Index, based on a business climate survey of CEOs of foreign companies operating in Ukraine, which is conducted by one of the leading domestic business lobbies, the European Business Association (EBA), shows little improvement in the business environment in 2011-2013, and even suggests a decline relative to 2010.¹⁶

Figure 24: Ukraine and Regional Peers in International Rankings



Note: selected country rankings, on the scale of 1 to 200, where the higher score/rank indicates poorer performance in a specific ranking.

Sources: World Bank Doing Business 2014, Global Competitiveness Report 2013-2014, World Economic Forum, 2013 Freedom of Economy Index, the Heritage Foundation and the Wall Street Journal.

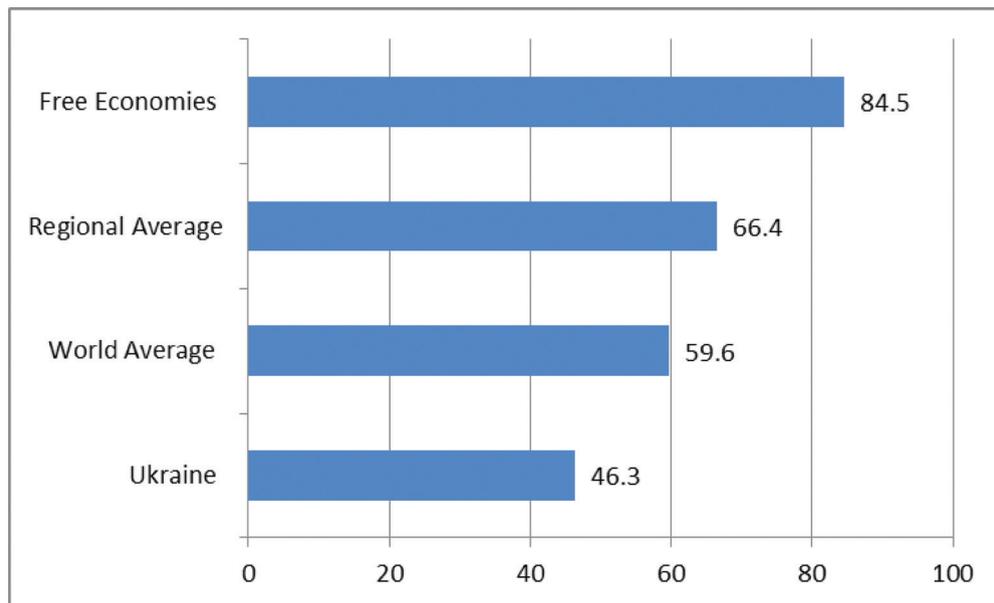
52. **The Global Competitiveness Index (GCI) ranking emphasizes Ukraine’s weak institutional framework.** The GCI consists of many different components, weighed to make up the aggregate, i.e. the overall GCI index. The individual components are divided into twelve pillars. Ukraine dropped from 73rd to 84th place in the 2013-2014 GCI. The country’s most problematic issue area is the poor institutional framework (137th place). A detailed review of the 22 individual components constituting this institutional pillar suggests that Ukraine continues to suffer from excessive red tape, lack of transparency, and favoritism. For instance, in the “efficiency of the legal framework in settling disputes”, Ukraine is 144th, and in “protection of minority shareholders’ interests”, the country is 146th from among 148 countries. On the “burden of government regulation” indicator, its performance earns it 137th place.

¹⁶ European Business Association, “EBA Investment Attractiveness Index. Q2 2013”.

53. **The GCI also highlights the inefficiency of the domestic goods market.** Ukraine occupies 124th place in the group of 148 economies. Customs procedures appear to be especially onerous for the private sector (140th place on the “burden of customs procedures” indicator). Ukraine performs relatively well on the ease of starting a business (74th place on the “number of procedures to start a business”, and 94th place on the “number of days to start a business” indicators), owing to the recent reforms discussed above, and on the trade tariffs indicator (41st place), thanks to its WTO accession.

54. **Economic freedom in Ukraine continues to be labeled as “repressed” by the 2013 Economic Freedom Index (EFI).** Ukraine ranks last out of 43 countries in Europe, and 161st out of the total 177 countries in the ranking. Ukraine’s economic score is 46.3, well below the global and regional averages, i.e. 59.6 and 66.6 respectively (Figure 25).¹⁷ The authors of the ranking argue that, “economic freedom continues to be severely repressed in Ukraine. Previous reforms have failed to spur broad-based economic development or the emergence of a more dynamic private sector. Such reforms are more than offset by poor policies and weak institutional structures throughout the economy. Corruption is pervasive; laws are poorly administered, and contract enforcement and protection of property rights are seriously deficient”.¹⁸

Figure 25: Ukraine, the Most “Repressed Economy” in Europe According to the 2013 Economic Freedom Index (EFI)



Source: based on 2013 Economic Freedom Index.

55. **Regulatory efficiency is particularly weak.** On the “Business Freedom” sub-indicator in the EFI, Ukraine has earned 148th place in a group of 177 countries. Administrative complexity continues to be high, which increases the cost of business transactions. Licensing requirements are time-consuming and costly, at more than ten times Ukraine’s per capita GDP. The country performs even worse on the “Investment Freedom” sub-indicator, ranking 154th in the world, apparently owing to low levels of competition, restrictions on foreign investment in certain sectors, substantial red tape, and corruption.

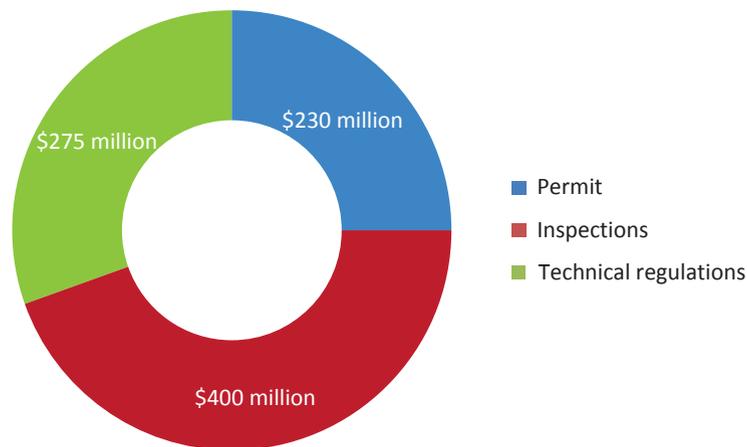
¹⁷ A higher number denotes a better score.

¹⁸ EFI, p. 156.

56. **In addition, the system of permits, inspections and technical regulations reveals several critical weaknesses.** The findings of the IFC enterprise surveys (the last full-scale survey was conducted in 2011, with a small follow-up survey in 2012) consistently show that Ukrainian firms describe the framework of permits, inspections, and technical regulations as burdensome. The percentage of companies inspected every year is higher in Ukraine than in other countries (68 percent in Ukraine in 2011 vs. 31 percent in Georgia in 2005 or 20 percent in Uzbekistan in 2007). The number of permits and licenses remains excessive (29 percent of all enterprises in Ukraine received at least one permit in 2011, vs. 18 percent in Belarus). The process of obtaining permits is long and costly, and technical regulations are not aligned with EU practices.

57. **The direct cost of complying with permits, inspections, and technical regulations for companies in 2010 was about US \$900 million, based on IFC surveys (Figure 26).** This equals to the cost of about 195,000 full-time employees. Although this is a welcome reduction from the US \$1.5 billion reported in 2008, it is still high. The cost reflects the dead weight caused by government regulation and the barriers for businesses wishing to enter new markets.

Figure 26: Direct Cost of Complying with Permits, Inspections, and Technical Regulations



Source: IFC surveys 2008-2010.

58. **The agricultural sector is over regulated, despite some recent reforms.** Given Ukraine's natural endowment, the country's agricultural sector is one of the most attractive sectors for potential investors. However, it is also one of the most regulated, and this undermines its potential. There are many inefficient and non-transparent regulatory procedures that prevent the sector from developing. These include, for instance, food safety standards, which are a key requirement for accessing international markets. In this area, vested interests continue to oppose reforms: the major draft law encompassing amendments to key laws on food safety, and the draft law on canceling 21 permits related to food safety were developed by the Government with the assistance of the IFC and submitted to the previous Parliament, but they were not voted on. Nonetheless, some small-scale reforms in food safety were implemented, including streamlining inspections by the State Sanitary Service (SES), and adopting the HACCP requirements (international food safety management system).

59. **Exiting the market is cumbersome and costly.** Difficulties with closing a business increase the entrepreneurs' perception of the risk involved in market entry, tie up investors' capital in non-productive firms for substantial amounts of time, and therefore may deter businessmen from starting new firms. This keeps economic resources in unproductive activities and hinders the efficient allocation of resources. The new law on insolvency, which came into force in January 2013, marks a welcome improvement. The law

clarifies and reduces time for specific procedures during the bankruptcy process, ensures a better balance between debtors' and creditors' rights, and introduces mechanisms expected to enhance the effectiveness of insolvency officers. However, the challenge will be to implement the law appropriately, especially as tax authorities continue to "view any form of market exit as an attempt to avoid tax liability".¹⁹

60. **Importantly, legislative reform in Ukraine does not always translate into practice, most often due to poor implementation.** A number of business surveys, discussed below, have found that Ukraine's regulatory environment lacks transparency and predictability, and that difficulties or delays in the implementation of legislation remain common. Poor implementation prevents businesses from benefiting fully from the reforms that the Government enacts. For example, despite the adoption of the President's Decree on Optimization of the System of Central Bodies of Executive Power (#370/2011 of 4/4/11), which stipulates the creation of a single Food Safety Agency, the appropriate law has not been finalized by the Government, and it has not yet been approved by the parliament.

61. **Reforms in licensing and permitting were initiated, but they ended up being stalled.** Some progress was made in 2010 and 2012: an exhaustive list of required permits was adopted; the use of self-certification was expanded; the "silence is consent" principle was introduced, and the list of licenses was reduced by almost one third. Yet afterwards, reforms were halted. Drafts of legislation simplifying the system of permits were developed with IFC assistance, but these drafts have not been finalized and adopted. Further reduction of the scope of licensing and permits, along with the simplification of the procedures required to obtain them and continued expansion of the use of self-certification, is needed.

62. **Likewise, although the government has announced reforms of technical regulations, the reforms have not been fully implemented.** The compulsory certification of services and compulsory registration of declarations of conformity were canceled, but many hurdles, such as compulsory standards for local producers, remain in place and should be addressed. The cancellation of the compulsory registration of export contracts was heralded by the Government, but no official resolution has been publicized as of yet.

63. **Despite legislative changes simplifying inspections, poor implementation has not eased the burden for Ukrainian enterprises.** Legislation introducing a risk-based approach and the use of checklists was approved already in 2007, but it has not been fully implemented. Specifically, according to the 2007 Law on Inspections supported by the Order of the President of Ukraine "on measures for accelerating the reform of real economic development in the areas of deregulating business", all inspectorates should have developed, adopted, and applied risk criteria and checklists as of May 3, 2012. However, just 34 out of 65 inspectorates have done so. Similarly, in May 2012, the President of Ukraine issued an order requesting all inspectorates to revise their risk criteria, and develop checklists to make inspections more efficient. Some inspectorates did so with IFC assistance, but there are few visible results. According to a 2010 IFC survey, 74 percent of businesses were inspected in 2010, the same proportion as in 2008. The frequency of inspections was lower, dropping to 4-5 times a year in 2010, from 5-6 times a year in 2008. Sole proprietorships are still inspected more frequently than other enterprises – 6 times a year – although they would seem to pose less risk. This is consistent with the earlier assumption that the government has a more heavy-handed approach to smaller businesses.

64. **Ukraine's regulatory policy is often unpredictable.** For example, the process of grain and grain storage certification was simplified by the Cabinet of Ministers' Resolution of September 19, 2012.²⁰ Certification of grain was canceled for inland shipping, and certification of grain storage became timeless

¹⁹ World Bank 2010.

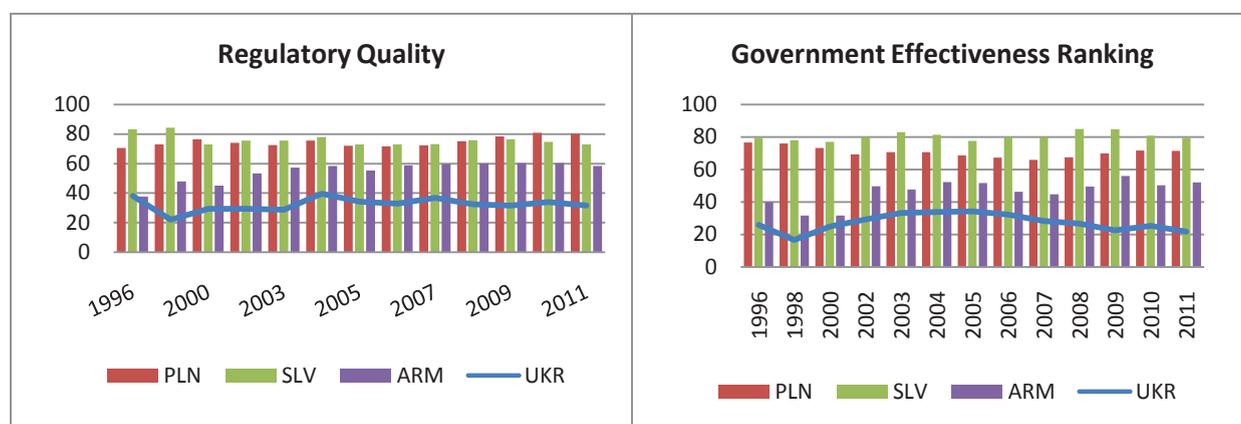
²⁰ Resolution of the Cabinet of Ministers of Ukraine "On amendments to point 1 of the Order of certification of grain and grains products" of September 19, 2012 № 932.

(previously it was compulsory to certify storage annually). Yet later on, the Parliament adopted a law that revoked these improvements.²¹ In the same vein, the Ministry of Agrarian Policy and Food proposed to substitute compulsory registration of all export contracts for agricultural products on the Agrarian Exchange (cancel led in 2012), which cost business USD \$11 million annually, with a similar procedure: the compulsory trading of all export contracts on the Agrarian Exchange. This would incur additional costs on all exporters and, as result, reduce farm gate prices.

65. **Regulatory policy is also plagued by low transparency and weak impact assessment.** Comments and objections originating in the private sector are not always discussed transparently by regulatory bodies and are not always even taken into consideration. In addition, the quality of the regulatory impact assessment (RIA), whose main goal is to assess the economic effects of the proposed legislation and ensure that the benefits of a policy action are likely to be greater than the costs, is generally poor and does not meet international standards (see Annex 3 for more information on the RIA). As a result, many regulatory acts are not business-friendly. The government is also prone to introducing non-transparent regulations with a high potential for corruption, power abuse and constrained competition. Several examples testify to this approach: the cancel led and then renewed Price Regulation Inspection, which codifies an extremely burdensome and obsolete regime of administrative price regulation; the draft law on Internal Trade, advocated by the Government for two years, which stipulates administrative regulation of commercial issues such as the specifics of shops premises or terms of permits; and the recently adopted Laws on Industrial Parks, Priority Investment Projects and One Stop Shops for Investment Projects, which entail non-transparent privileges for certain companies.

66. **Quality of governance remains poor.** The country’s constraints in the regulatory environment are inherently linked to weak governance and negative perceptions of government effectiveness. Despite recent efforts to facilitate improvements, Ukraine continues to suffer from low trust in public institutions, burdensome regulation, and excessive red-tape; weak rule of law; ineffective regimes of property right protection; state capture, and inefficient governance of state owned enterprises (SOEs). Figure 27 depicts Ukraine’s poor performance on the regulatory quality and government effectiveness indicators in the Kaufmann Index, which suggests that Ukraine is under performing relative to its regional peers.

Figure 27: Governance Data for Ukraine and Regional Peers, Based on the Kaufmann Index, 1996-2011²²



Source: Kaufmann Index.

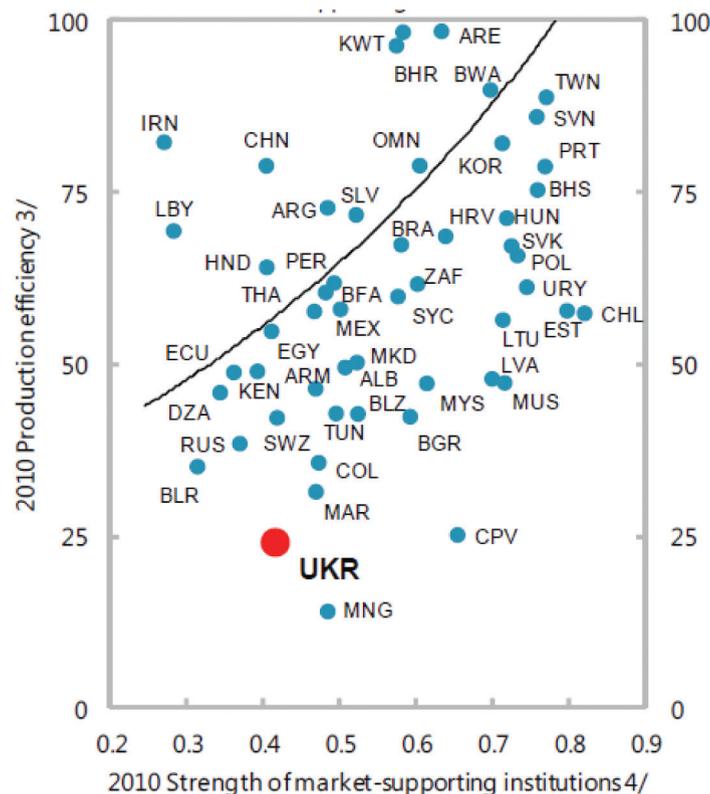
²¹ The Law on Amendments to the certain laws of Ukraine of October 16, 2012 № 5462-VI.

²² Note: the values presented in these tables correspond to percentile rank among all countries (ranges from 0 (lowest) to 100 (highest rank)).

67. **Policies supporting SMEs are inadequately developed, and poorly implemented.** The 2012 OECD report argues that Ukraine lacks a clear and efficient strategy for fostering SME development. It also lacks an institution directly responsible for SME policy and its implementation. On implementation, the report notes that “the government has made a number of commitments to support SME development; however, there is little follow through to effective implementation of reform”.²³ In addition, the report points out that “important initiatives in the areas of innovation policy, access to finance and SME support tools have been set, but most have not been enforced due to a lack of political will and/or insufficient funding”.²⁴ The report recommends developing a robust SME strategy, and improving implementation.

68. **Ukraine also suffers from insufficient overall strength of market-supporting institutions.** An IMF index based on a normalized average of five in dices from the World Bank Governance database (rule of law, political stability and absence of violence, control of corruption, government effectiveness, regulatory quality, and voice and accountability) indicates that Ukraine’s market-supporting institutional framework is weaker than those of most peers (Figure 28). Furthermore, it shows that even among countries with similar institutions, Ukraine’s production efficiency is ranked low, suggesting that additional, unidentified factors (probably corruption and governance issues) may constrain the country’s ability to increase its economic efficiency and develop.

Figure 28: Strength of Market Institutions and Production Efficiency



Notes: 3/ measures how closely (in percent) a country operates to the global production possibilities frontier.
 4/ calculated as the normalized average of five in dices from the World Bank Governance database:
 rule of law, political stability and absence of violence, control of corruption,
 government effectiveness, regulatory quality and voice and accountability.

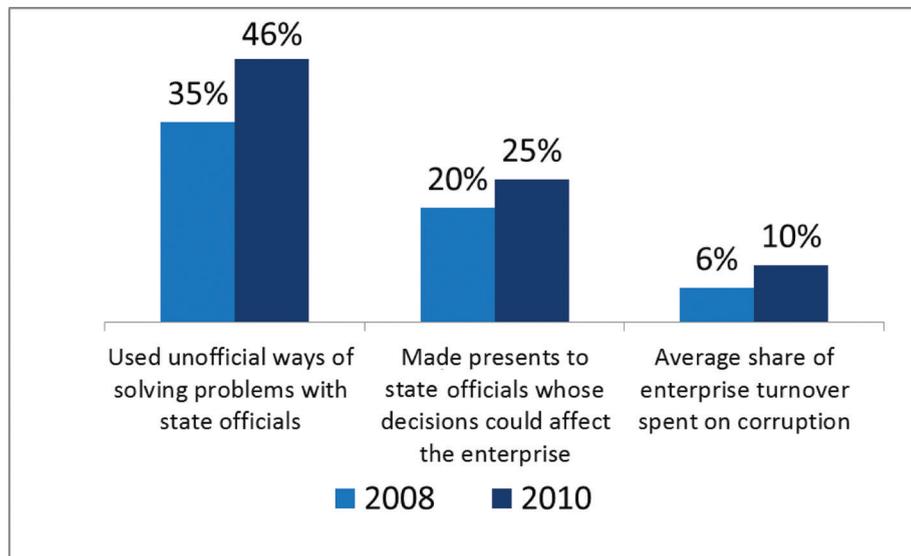
Source: IMF (2012).

²³ OECD et al. 2012, p. 39.

²⁴ Ibid.

69. **Finally, the business environment is undermined by corruption.** Corruption is often cited as an ingrained feature of the Ukrainian business environment, and a primary hurdle to the country’s success on international markets. According to Transparency International’s 2012 Corruption Perception Index (CPI), Ukraine dropped ten rungs on the ladder, from 134th place in 2011 to 144th place out of 176 countries worldwide, and from 14th place in 2011 to 16th place out of 20 countries in the region. Only Tajikistan, Kyrgyzstan, Turkmenistan, and Uzbekistan perform worse in the ranking.²⁵ This under achievement correlates with Ukraine’s low ranking on the “Freedom from Corruption” sub-indicator of the EFI, considered above. Corruption is often encountered by businesses in their dealings with regulatory procedures, such as permits, inspections, and technical regulations. According to the 2010 IFC survey, almost half of Ukrainian firms resorted to unofficial means of solving various issues with state officials, an increase of 11 percentage points in comparison to 2008 (Figure 29). Companies’ spending on corruption has also increased, to 10 percent of total turnover in the same period. There has been no IFC survey since 2010, but the negative trend highlighted by the Transparency International index suggests that corruption has not diminished since then.

Figure 29: Percentage of Enterprises Resorting to Unofficial Ways of Solving Problems with State Authorities, 2008 and 2010



Source: IFC Survey 2011.

Causes of Poor Legislation and Policy Implementation

70. **The poor business and regulatory climate in Ukraine is driven by a number of factors.** The proximate causes include: (i) low quality and clarity of business regulations, (ii) poor and inconsistent implementation of regulations, (iii) low capacity and transparency of public administration, and (iv) arbitrary and unpredictable justice system and weak property rights. The ultimate causes, which ensure that the system largely maintains the status quo likely include: (i) state capture, i.e. harmful influence of special interest groups or individuals on public policies at the expense of society at large;²⁶ (ii) corruption; (iii) low public awareness; and (iv) political, administrative, and business culture.

²⁵ <http://cpi.transparency.org/cpi2012/results/>

²⁶ World Bank (2000, p. 15) defines state capture as “the actions of individuals, groups, or firms both in the public and private sectors to influence the formation of laws, regulations, decrees, and other government policies to their own advantage as a result of the illicit and non-transparent provision of private benefits to public officials. See also Hellman, Jones and Kaufmann (2000).

71. **This is in line with the public interest theory on regulatory capture and rent-seeking.** The theory posits that business regulations are introduced on behalf of the regulated sectors of the economy to benefit the sector at the expense of the public at large. The regulated sectors are able to capture the state regulatory policies, and benefit from monopoly rents because they are much better organized and financed than the consumers, and because the benefits for the regulated sectors are much more important than small costs for individual consumers.²⁷ Additional reasons for bad regulations include lack of accounting for costs of regulations, lack of public sector coordination, and often little political gains in fighting the vested interests (Box 1).

Box 1: Why are bad regulations so common?

Why are poor regulations so universal? It seems odd that governments claim to want business growth and private sector development but actually hinder the private sector through costly rules and administrative barriers. The reason for the paradox is partly that governments try to achieve many objectives at the same time, and partly that developing countries in transition from planned economies suffer from the legacies of over-control, due to earlier state-led development strategies. But the more enduring reason is that regulations fall into that class of fragmented, institutional, and crosscutting issues that governments are the least capable of tackling. Unlike spending through fiscal budgets, there is no accounting system for the hidden costs of regulation. Therefore, governments tend to treat the business costs of responding to government demands and of waiting for decisions as a free good, with zero opportunity cost. Another cause is structural: the most common cause of governance failure is lack of coordination across multiple legal and bureaucratic jurisdictions, which lead to excessive and overlapping demands on businesses. The political economy of policies where benefits are concentrated, but costs are widely dispersed, is difficult to reverse. Administrative formalities generate rents for many interests, such as lawyers who sell services to help businesses, civil servants who sell favors such as faster processing, and incumbent producers who want to reduce entry. Every administrative barrier is fiercely guarded by stakeholders, and in fighting them, politicians can expend vast political resources with little political gain. These problems of incentives, information, and structure are exceedingly difficult to address in a sustainable way. They require much more than marginal changes to a few procedures. Developing countries face a triple legacy of 1) numerous interventions into business decisions from previous state-led economic models, 2) poor institutional capacities to implement them, and 3) weak reform and corrective mechanisms to remedy problems. The resulting overly complex, multi-layered, arbitrary, and interventionist administrative and regulatory environments make it difficult to create a transparent and predictable business environment. Sustainable changes require institutional reforms to the state.

Source: Jacobs and Astrakhan (2006. p. 9).

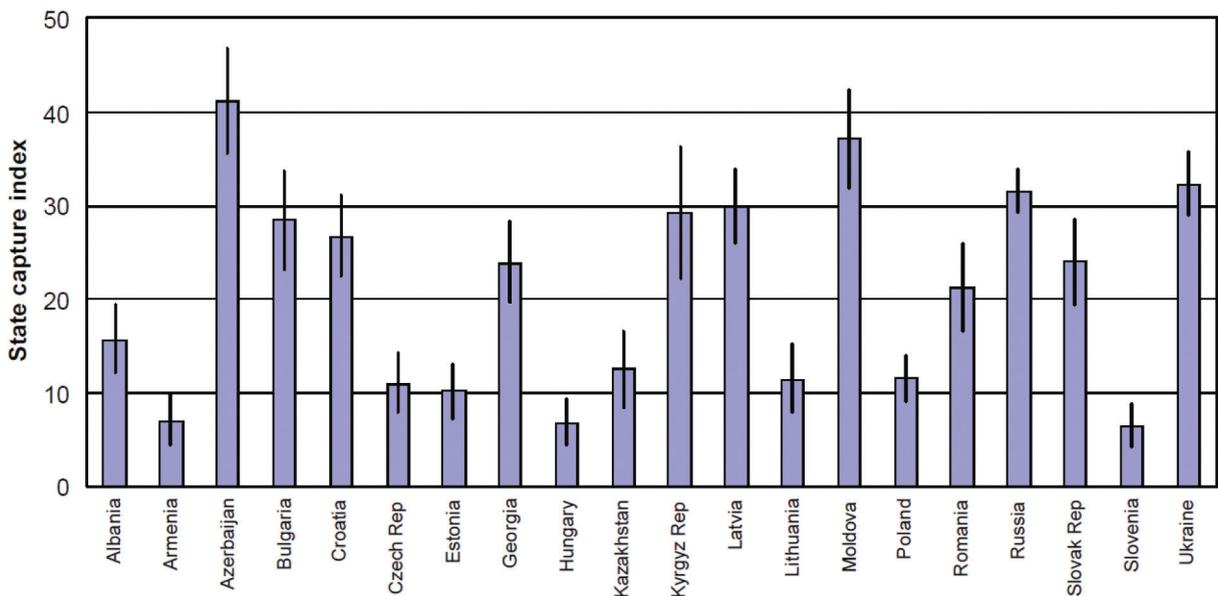
72. **State capture and corruption have a particularly negative impact on the business environment and investment climate.** These issues have an across-the-board influence, and represent the main rationale for the stunted growth of Ukraine's private sector, undiversified structure of the economy and its exports, low productivity, and uneven pace of reforms. Ukraine has made a lot of progress in harmonizing legislation with EU standards, and the possible signing of the AA and the DCFTA with the EU would likely to accelerate this process. However, the regulatory framework continues to be patchy, unpredictable, and often business-unfriendly. This reflects the influence of business lobbies, political rent-seeking, and an ossified public administration, which all benefit from the status quo. The application of policies is, in turn, mired in a culture of legal relativism, where the meaning of the law is subject to an ongoing re-interpretation depending on the play of various interests, at the national, regional and local level.

²⁷ Balcerowicz and Ustenko 2006.

73. **There is ample evidence for pervasive corruption.** The previous section documented various sources of evidence suggesting that corruption in Ukraine is running rampant, as reflected in recent international rankings. Domestic surveys suggest that corruption is perceived as the worst problem faced by Ukraine. According to the Global Corruption Barometer,²⁸ 74 percent of Ukrainians believe that the public sector is corrupt; 43 percent believe that corruption has become worse within the past two years; 80 percent describe the Government’s anticorruption efforts as ineffective, while only 4 percent believe they produce at least some results. 83 percent of respondents believe that personal contacts are key to “settling issues” in the public sector, and 84 percent believe the country to be run by vested interest groups. 66 percent perceive the judiciary as the most corrupt institution, followed by law enforcement bodies (64 percent), and the civil service (56 percent). About 36 percent see the business sector as corrupt. 74 percent of the respondents have never reported corruption cases, as they fear the consequences (24 percent), or think that reporting them would change nothing (63 percent).

74. **There is, however, much less explicit evidence of state capture.** This is largely due to its own, non-transparent and politically sensitive nature, which is by definition hard to measure. Nonetheless, in one of the few, if outdated, comprehensive attempts to measure it, Hellman, Jones and Kaufmann (2000) investigated the extent of state capture in transition economies, including Ukraine, based on firm level data from the 1999 Business Environment and Enterprise Performance Survey (BEEPS). They found that the extent of state capture in Ukraine was larger than that of its regional peers (Figure 30). While there are no more up-to-date assessments of the size of state capture, anecdotal evidence suggests that it is not likely to have diminished much.

Figure 30: Index of the Share of Firms Affected by State Capture, 2000



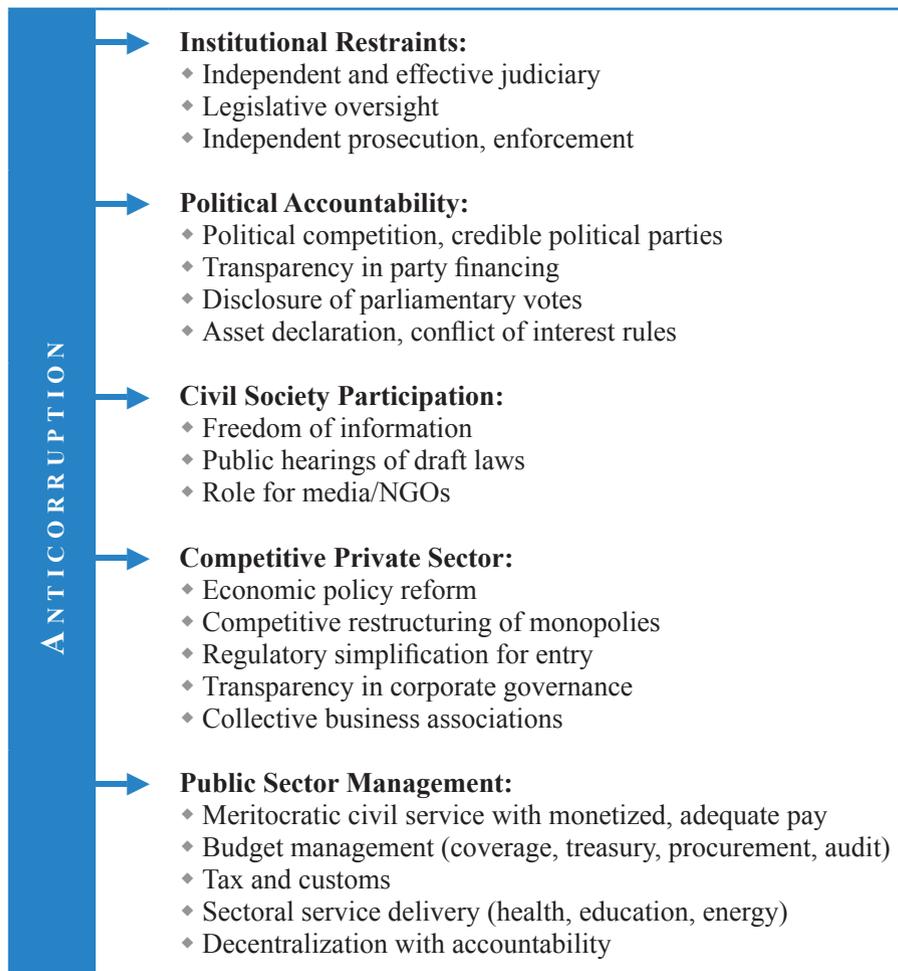
Source: World Bank (2000) based on Hellman, Jones and Kaufmann (2000).

75. **Corruption and state capture in Ukraine has its roots in the political and business culture,** arguably built upon an old model of a fused political and economic power, but also in a non-transparent privatization process, which enabled the accumulation of large economic assets in the hands of only a few and largely excluded international investors, often murky public procurement and state aid, and a partial, dependent and unreliable judiciary system, which forces business elites to resort to wielding direct influence over the political and legislative process and the state apparatus to secure their property rights.

28 <http://ti-ukraine.org/news/2815.html>

76. **There are a number of strategies to fight state capture and corruption.** As reflected in Figure 31, these include: imposing institutional restraints, strengthening political accountability mechanisms, establishing a competitive private sector, re-energizing civil society, and improving public sector management.

Figure 31: Strategies Addressing State Capture and Corruption



Source: World Bank (2000, p. 22).

77. **All these recommendations apply to Ukraine, with some modifications.** Given Ukraine's lively democratic debate, it would be important to rely on the growing strength of civil society to monitor the quality of regulations and ensure proper checks and balances. This would require the full transparency of the legislative process, freedom of information, and incentives for the involvement of the business sector, trade unions, NGOs, and society at large in the legislation process. In addition, the poor quality of regulations driven by state capture and corruption could be mitigated by a fully transparent public procurement and state aid system, allowing taxpayers to have full access to information on every Hryvnia spent from public money. The system could also include public hearings on tender criteria in large public contracts, and public monitoring of the bidding process itself. Transparent appointments of officials in public administration and SOEs would also be helpful. Opening up to more competition, supported by the adoption of the AA and DCFTA with the EU, could also weaken special interests by forcing them to compete on more equal terms and by lowering rents. Finally, the privatization of the remaining state assets should follow international standards.

78. **Fundamental reform of the judicial system is also crucial.** Economies cannot develop without secure property rights safeguarded by impartial and independent courts. While this topic falls outside the scope of this note, an independent, impartial, and professional judiciary is greatly needed to provide recourse for the private sector to defend itself against inconsistent, unfair, or incorrect applications of the law. A reformed judiciary would also strengthen the fundamental system of checks and balances between the courts and public administration, and allow the regulatory system to learn from its mistakes, based on court rulings, as in other market economies. Today, the perceived lack of recourse to courts leaves enterprises largely at the mercy of public administration, thus supporting state capture and corruption, undermining confidence, and thwarting development. The AA agreement with the EU, which has a special focus on the judicial system, could provide the trigger for fundamental reform.

79. **Ultimately though, political commitment, leading by example, and a fundamental change in culture will be needed to break the deadlock.** Economic history shows that the fate of countries ultimately depends on their political culture, value system, and quality of leadership. Even the best designed legislative frameworks crumble in the face of ill-intentioned implementation, old “ways of doing things”, and ill-set incentives, driven by ingrained social and political behaviors. Without transformation in political culture, regulatory bodies in Ukraine can find a way to re-regulate the economy, and expand their powers again. The leadership in Kyiv thus needs to start the process by sending a signal to the public administration and the whole of society that “business is no longer as usual”, and that poor implementation of the law, administrative neglect, and corruption will no longer be tolerated. There is no other way to break out of the current vicious circle and improve the business environment in the longterm.

80. **A consensus on reforms would be vital.** The strong momentum stemming from the cross-party consensus on the need to sign the AA with the EU should be sustained to support the adoption of the hundreds of pieces of legislation that would accompany the AA. This could be achieved by putting the reform agenda above political competition, the way it has been done before in the new EU member states in the run up to EU accession. The consensus could be strengthened by, for instance, establishing a national roundtable on reforms, which would all political parties, business community and civil society. Launching an information campaign directed at the society at large on the benefits of reforms could also be useful.

81. **A much stronger civil society is also called for.** The current, relatively weak, involvement of civil society – especially NGOs representing small and medium enterprises (SMEs) – in monitoring the business environment and driving the reform process is one of the most important obstacles to private sector development. In contrast to their large counterparts, which often have sufficient resources to deal with the poor business climate, SMEs harbor a long-term interest in improving the regulatory environment and investment climate, as it strongly affects their chances for survival. However, SMEs currently seem to lack the political resources that would help them channel their commitment to the reform process and/or facilitate access to policy-makers. SMEs business associations largely focus on advising members on how to cope with the existing regulatory maze rather than on how to improve it. Going forward, the contribution of SMEs to the public debate could be increased by including them in working groups and/or national roundtables dealing private sector reform agenda. Similarly, the impact of society on the reform process could be elevated by involving it in the monitoring of the progress in the implementation of the two new agreements, as well as by providing free and user-friendly online public access to state-generated performance statistics.

82. **Recommendations to improve the regulatory framework and to help reduce state capture and corruption are listed below.** The recommendations are aimed at mitigating and/or eliminating the many interrelated challenges identified in the chapter, and are based on international good practice.

Policy Recommendations

SUGGESTED REFORMS	SHORT-TERM RECOMMENDATIONS	MEDIUM-TERM RECOMMENDATIONS
Regulatory Framework	<ul style="list-style-type: none"> ◆ Implement a regulatory guillotine, in line with international best practice, to allow for a wholesale reduction in permits, licenses and business regulations. ◆ Extend the scope of self-certification to more business activities. ◆ Finalize the inspections reform by introducing a full-scale risk-based system, and adopt appropriate risk criteria and checklists across all inspectorates. ◆ Further simplify procedures of starting a business by canceling the compulsory status of a corporate seal, and introducing electronic registration. ◆ Eliminate mandatory certification for goods and services that do not require it in line with EU practice. ◆ Improve the regulatory environment in the agrarian sector by eliminating compulsory certification for grains and grain storages and enhancing transparency of policy implementation. ◆ Implement further reforms measured by the Doing Business ranking. ◆ Consider a new rule for changes in business regulations to happen only twice per year and ensure sufficient vacatio legis. ◆ Enforce the law on public access to all documents related to business regulations, including proposed drafts and regulatory impact assessments. 	<ul style="list-style-type: none"> ◆ Fully implement the 2013 National Action Plan on improving the business climate. ◆ Strengthen the regulatory impact assessment (RIA) in line with international practice, to increase the quality of new legislation. ◆ Finalize institutional reform of the technical regulations system. ◆ Finalize the reform of food safety regulations in line with EU legislation. ◆ Ensure effective implementation of the new insolvency law. ◆ Improve the consultative process on new legislation, including for example public posting of comments and responses. ◆ Develop a comprehensive Government strategy for SME development in line with international good practice. ◆ Introduce a broad range of e-government and ICT solutions, including on-line registration of companies, online applications for permits and licenses, and an internet based library of all business related requirements. ◆ Introduce and then enforce liability for violations of the law on regulatory policy by public officials.

Chapter III: Access to Finance

Summary

83. **Although Ukraine's banking system is relatively well developed, access to finance remains limited, especially for SMEs.** This is because of a number of reasons. First, prohibitively high interest rates, driven mainly by the central bank's commitment to maintaining a de facto pegged exchange rate, combined with the government's large borrowing needs that crowd out lending to the private sector, represent a material obstacle to getting credit. Second, lax supervision over related-party lending supports the domination of the banking sector by a few local business groups, which tend to distribute credit only within their groups rather than to the whole economy. Third, access to credit is hindered by an on going withdrawal of foreign banks from the Ukrainian market, increased post-crisis risk aversion, and a large number of non-performing loans. Fourth, credit is scarce due to limited access to long-term funding, a weak enforcement environment characterized by inadequate judicial practices, and a fragmented credit information infrastructure which does not support sound credit risk management. Finally, access to finance is undermined by the underdeveloped non-bank and capital markets. Enhancing access to credit, which is critical to finance the revival and expansion of the private sector, requires a coordinated approach to addressing the inter-related challenges of transitioning to a flexible exchange rate, supporting the growth of long-term deposits, enforcing legislation on disclosure of the ultimate beneficiaries of banks, identifying and limiting related party lending, removing tax disincentives for NPL transfer and write-offs, and consolidating information on credit histories. The development of capital markets needs to be supported by enhanced market transparency, higher disclosure requirements, and improved reporting standards and corporate governance. The anticipated signing of an AA with the EU could provide a strong catalyst for all these reforms by harmonizing financial sector legislation with that of the EU.

Introduction

84. **Access to finance is a major driver of economic growth and competitiveness.** Access to finance at a reasonable cost to finance working capital and investment of enterprises is a sine qua non condition for economic development, as demonstrated by extensive literature.²⁹ Financial access increases entrepreneurship, innovation, and productivity by allowing firms to benefit from existing growth opportunities. It also promotes competition by lowering barriers to entry for new firms, creates jobs, and reduces income inequality.

85. **Efficient intermediation and access to affordable finance is especially critical to Ukraine as a low-middle income country that needs substantial private investment to boost productivity, and accelerate economic growth.** Ukraine also needs improved access to finance, especially for SMEs, to increase competition in the economy (as discussed in Chapter IV), and promote new, innovative companies, which now struggle to finance their development.

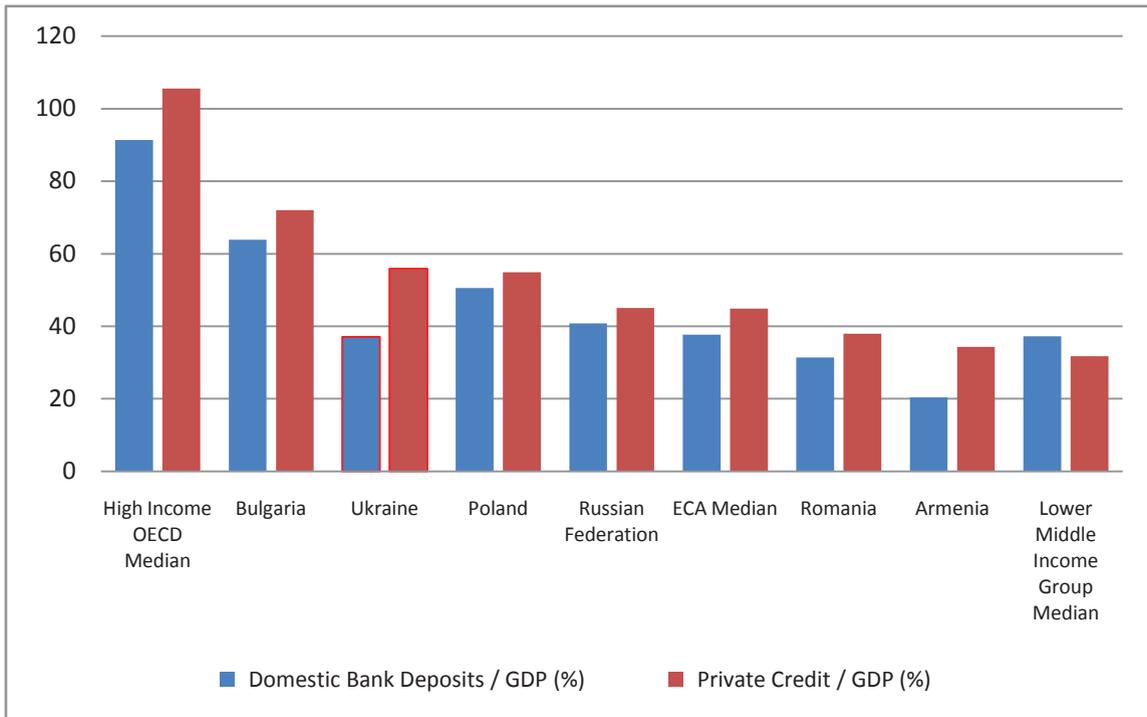
Evidence of Problems

86. **Access to finance, while much improved over the years, remains difficult, particularly for SMEs.** While financial depth in Ukraine is higher than among its regional peers (Figure 32), there is evidence that SMEs have limited access to finance, and thus find it difficult to grow. This is because the high ratio of credit to the private sector is largely driven by loans to a few large, capital-intensive business groups, making access to finance difficult for SMEs, as reflected in the EC/OECD/EBRD/ETF access to finance index, and the resulting relatively low credit exposure to the SME sector (Figure 33).³⁰

²⁹ See, for instance, Claessens 2005, for a useful summary.

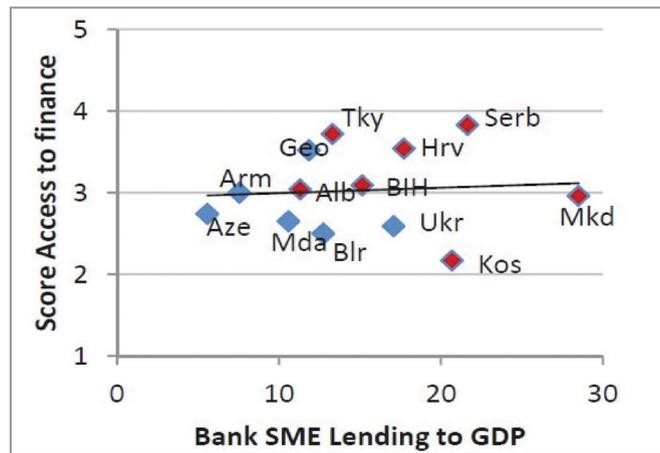
³⁰ The access to finance index covers government policy to i) increase sources of finance; ii) enhance the legal and regulatory framework that supports bank lending; and iii) improve SME financial literacy (OECD et al. 2012).

Figure 32: Financial Sector Depth in Ukraine Relative to Peers, 2011



Source: World Bank, Fin Stats (2011).

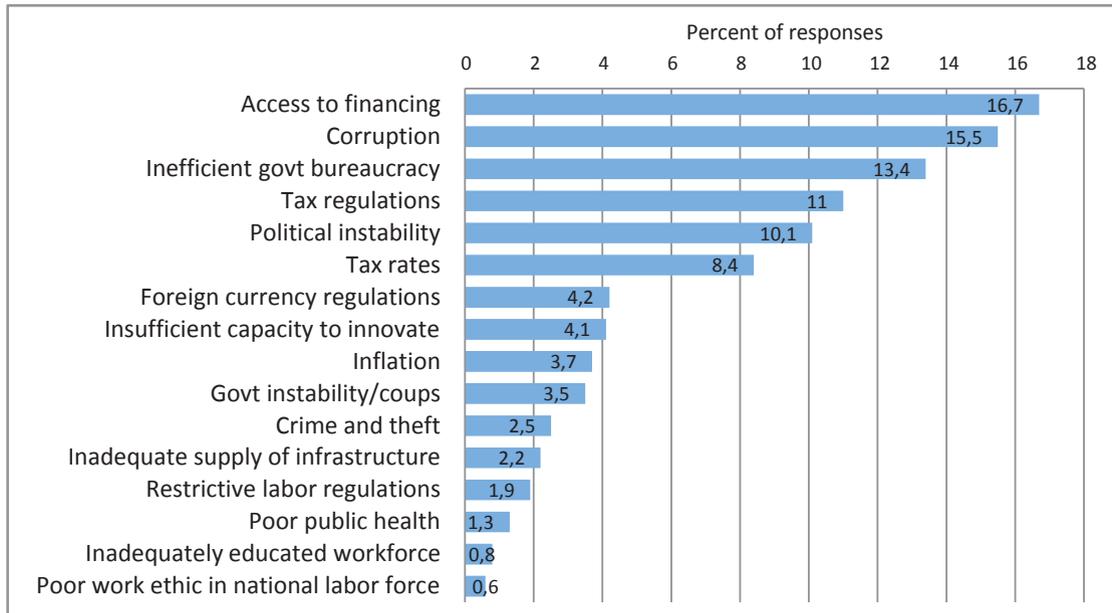
Figure 33: SME Lending in Ukraine Relative to Selected Peers, 2011



Source: OECD et al (2012) *SME Policy Index*.

87. The 2013-2014 Global Competitiveness Report highlights access to finance as the number one obstacle to doing business in Ukraine, with 16.7 percent of respondents identifying it as such (in a single choice survey), up from 15.3 percent in the 2012-2013 survey, and ahead of corruption and inefficient public administration (Figure 34).

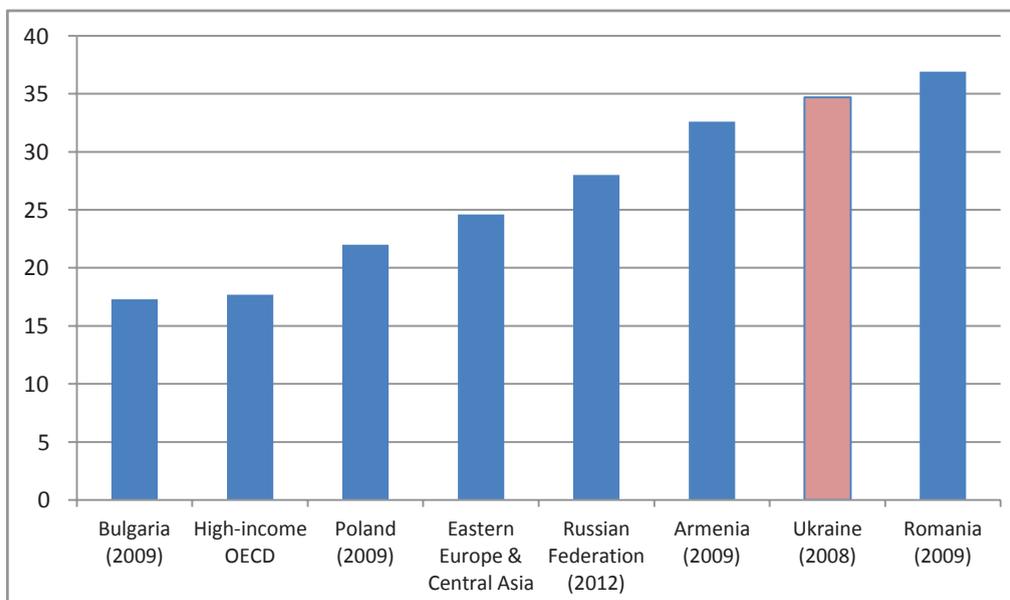
Figure 34: Main Challenges to Doing Business in Ukraine, GCR 2013-2014



Source: World Economic Forum, the 2013-2014 Global Competitiveness Report.

88. **The World Bank’s research offers similar evidence.** The World Bank Enterprise Surveys reveal that access to finance remains a challenge in Ukraine: 34.7 percent of the surveyed enterprises perceive access to finance as problematic. This is a significantly larger proportion than in Poland (22 percent), Russia (28 percent), and developed economies (17.7 percent on average), as Figure 35 shows. In Ukraine’s over banked system, limited access to financial services might either reflect voluntary exclusion of individuals and businesses, or low affordability of credit. Local business surveys conducted by the National Bank of Ukraine (NBU) suggest that companies need credit, and are willing to take it, but remain challenged by the high prices, the limited selection of products, the difficult access to long-term loans, and – in the case of SMEs – banks’ risk filters.

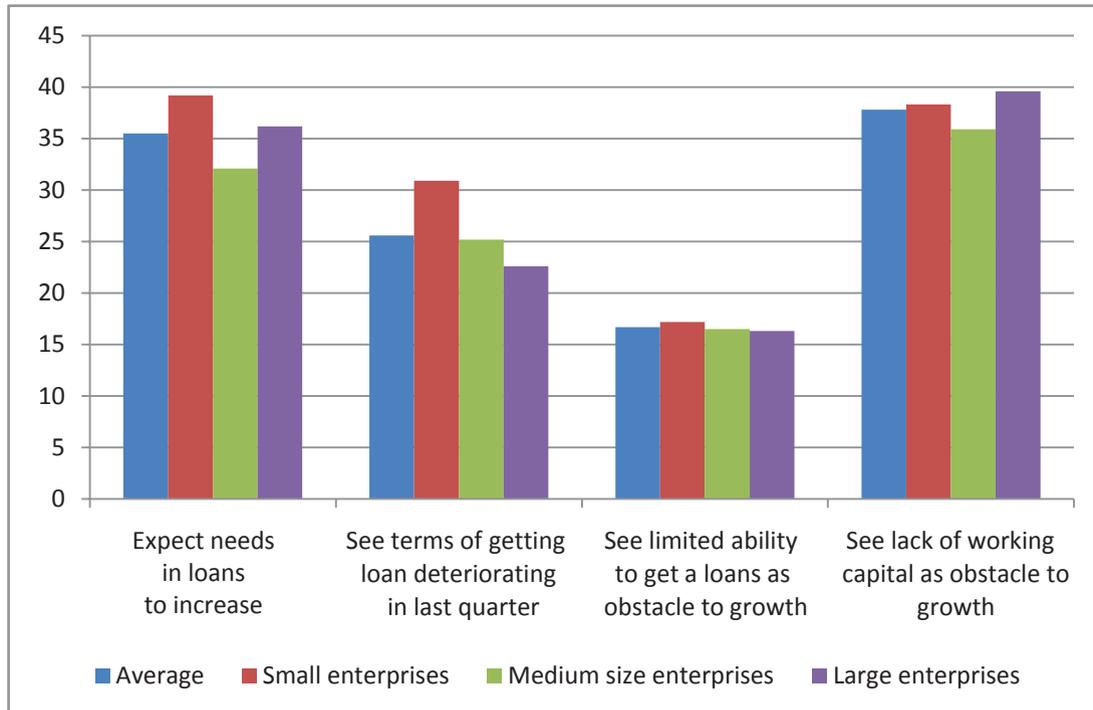
Figure 35: Percentage of Firms Identifying Access to Finance as a Major Constraint



Source: World Bank, Enterprise Surveys, www.enterprisesurveys.org

89. **Other domestic surveys paint a somewhat brighter picture, but nonetheless suggest that SMEs have more difficult access to finance than larger firms.** The 1Q2013 NBU survey of business expectations finds that energy prices, high raw material prices, strong competition, and heavy tax pressure are the top four hurdles in doing business. Access to finance ranks 10th on the list, following corruption. However, the survey results highlight the more difficult position of SMEs relative to larger firms in getting financing: securing a loan is more of a challenge for small enterprises (31 percent saw conditions deteriorate), than for large enterprises (22.6 percent saw conditions deteriorate). Almost 95 percent of respondents reported having no problems with processing bank transactions. However, 40.3 percent worried about the lack of working capital, likely stemming from the high cost of credit rather than low accessibility (see Figure 36).

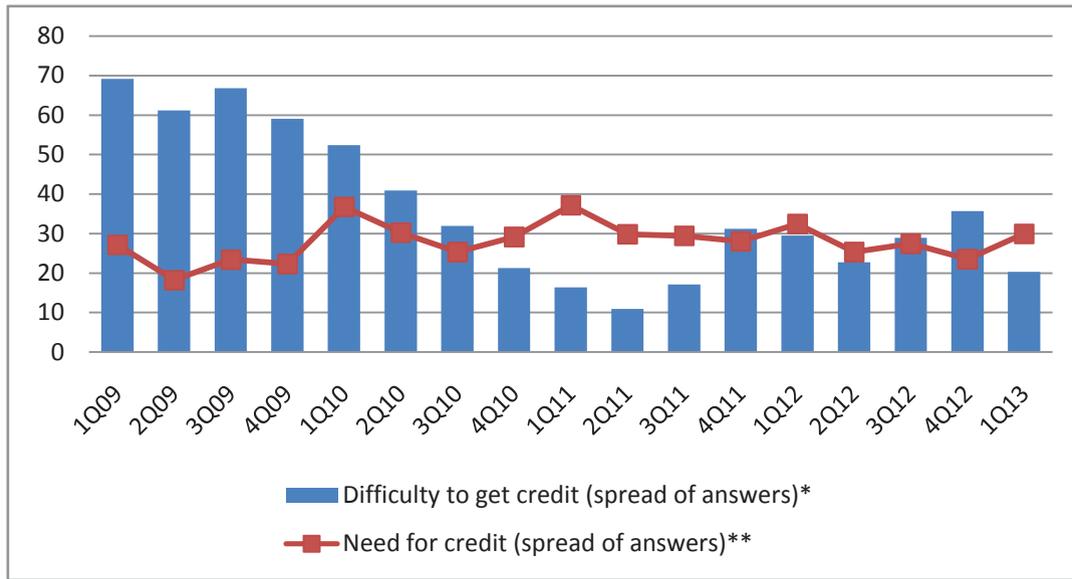
Figure 36: National Bank of Ukraine 1Q 2013 Enterprise Survey Results: Access to Finance



Source: NBU (2013).

90. **Even if the overall conditions for getting credit seem to have improved, significant obstacles remain, especially for SMEs.** According to the NBU survey, access to credit for companies has become much easier since the 2008-09 crisis. The NBU uses the spread between the negative and positive answers (the higher the spread, the harder to get a loan) as an indicator of difficulty in accessing credit. In 1Q 2013, the spread of opinions stood at 20.3 pp, down from 69.2 pp in 1Q 2009, but up from the bottom level of 10.9 pp in 2Q 2011. The majority of businesses, however, while maintaining the same appetite for credit, saw the conditions for getting a loan deteriorate in 1Q 2013: only 5.4 percent of the respondent companies (3 pp up q/q) believed that the conditions improved over the past quarter, while 25.6 percent held the opposite view (see Figure 37).

Figure 37: NBU Enterprise Survey Results, 1Q 2009-1Q 2013



* Percentage point difference between the share of those that believe it became harder to get a loan in past quarter and those that believe it became easier. The lower the better.

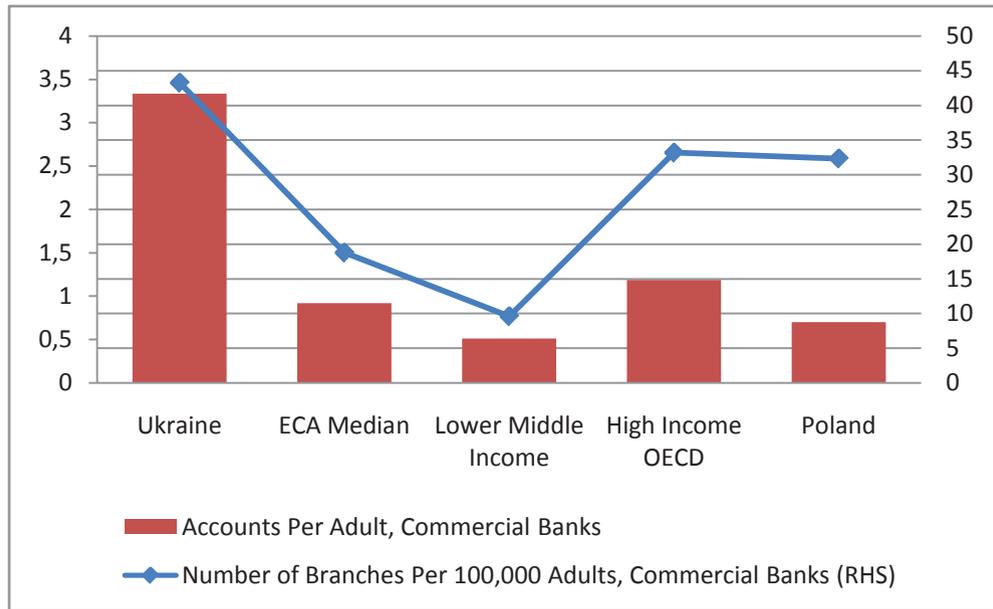
** Percentage point difference between the share of those that believe they will need more credit in next quarter and those that believe they will need less.

Source: National Bank of Ukraine.

91. **Banking sector asset growth has been nearly flat in the past few years.** The banking sector represents 95 percent of the total assets of the financial sector. The compounded annual growth rate (CAGR) of the banking sector gross loan portfolio was only four percent in 2010-2012, and in 2012 alone the banks' gross loan portfolio expanded by only 2 percent, driven mainly by loans to the corporate sector. Lending slightly picked up in 2013, rising by 4.5 percent from January to August, but this is happening against the backdrop of negative GDP growth, which suggests that the growth may be driven by a few large state related projects.

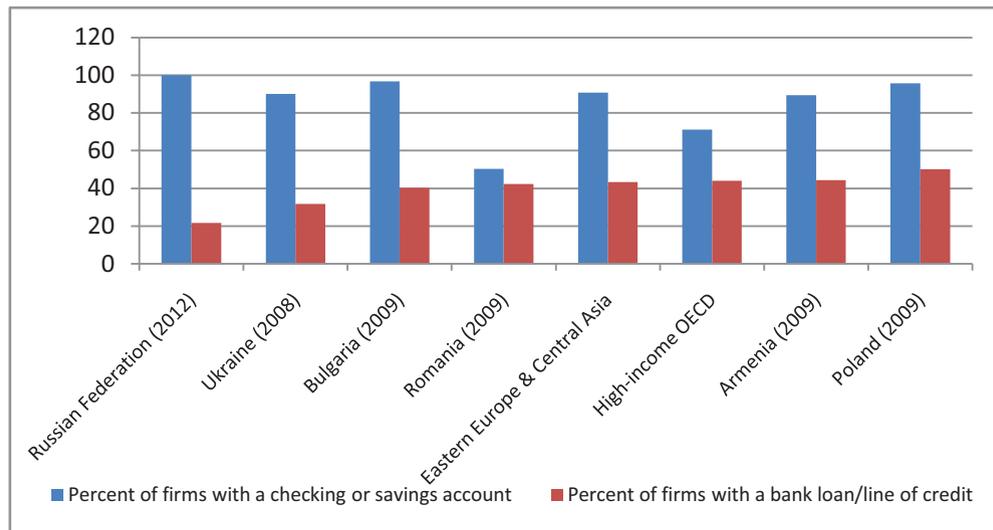
92. **In addition, the banking sector seems to be over saturated.** Ukraine has 176 active banks running a network of nearly 20,000 outlets, 1.5 payment cards per person (and 0.7 active cards per person), and a ratio of banking assets to GDP of 81 percent (see Figures 38-39). In terms of the number of accounts, and banking branches per adult person (see Figure 38), Ukraine is ahead of its peers, and could even be considered a regional leader.

Figure 38: Banking Sector Coverage



Source: World Bank: Fin Stats (2011), National Bank of Ukraine (2013), www.prnews.pl

Figure 39: Use of Banking Services by Companies

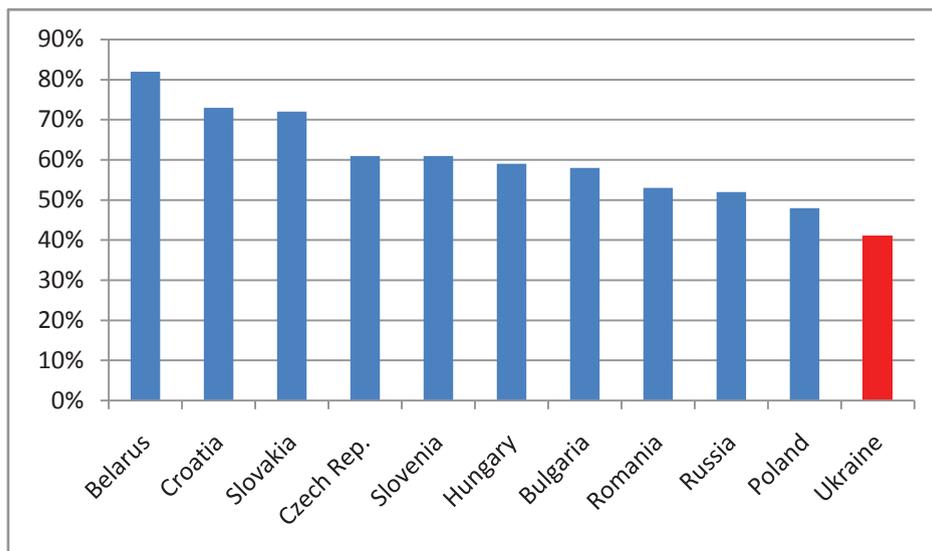


Source: World Bank, Fin Stats (2011).

93. **The banking system has an inefficient structure.** The sector is dominated by small, captive banks closely related to domestic business groups, which tend to direct most of their lending internally. The banking system remains highly fragmented, with the share of the top five banks in total assets amounting to only 40 percent in 2010, less than in peer countries (Figure 40). The very low 2012 YE Herfindahl – Hirschman

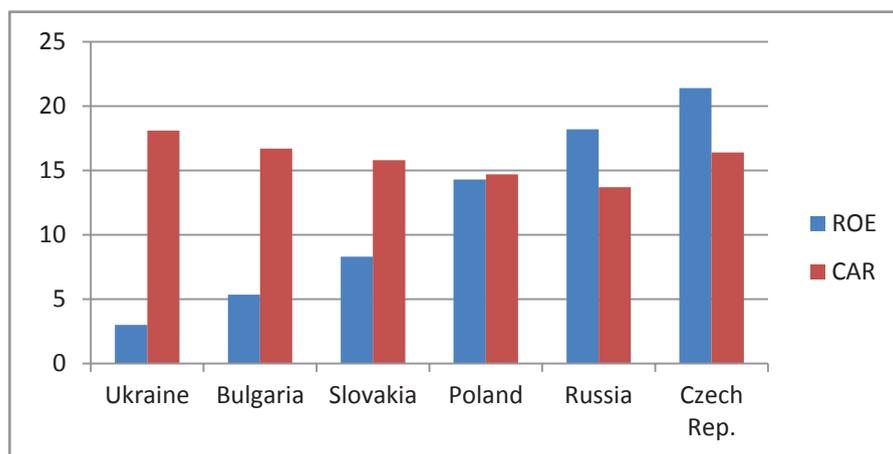
index for assets of 470 also indicates that only a few large banks have achieved economies of scale.³¹ The majority of small banks operate inefficiently, and do not sufficiently utilize capital (see Figure 41). These banks drag down the profitability of the system, which reports a high average cost to income ratio of 66 percent. This has resulted in low returns on equity, which have not significantly exceeded 10 percent, even in good years. This is less than in peer countries. For example, according to a special Central and East European (CEE) banking study done by Raiffeisen International, the Polish banking sector posted an ROE of 14.3 percent in 2012 and 23.6 percent prior to the crisis in 2008. The incentives for domestic business groups to retain stakes in seemingly under performing banks may appear puzzling, but this may reflect the investors' preference to mask profits in their captive banks, ensure the access to business networks and related-party lending that such captive banks provide, enhance security by in-house processing onshore financial transactions, and retain free financial resources within the same group.

Figure 40: Banking Market Concentration in Selected Countries, 2010 (in Percent)



Source: Based on "Ukraine Banking Sector Report", Raiffeisen Research, 12 February 2013.

Figure 41: Peer Countries' Banking Sector ROE and CAR, 2012 (in Percent)



Source: Raiffeisen Research CEE Banking Sector Report (2013).

³¹ World Bank 2010.

94. **The banking sector is only slowly consolidating.** Until 2012, fewer than ten mergers took and those happened only within business groups. This reflected complex rules that make mergers burdensome for parties as well as a lack of transparency and trust that would allow for credible valuations and competitive tenders. M&A activity picked up in 2012-2013, as foreign investors exited the Ukrainian market, but it has not materially changed the fragmented structure of the market.

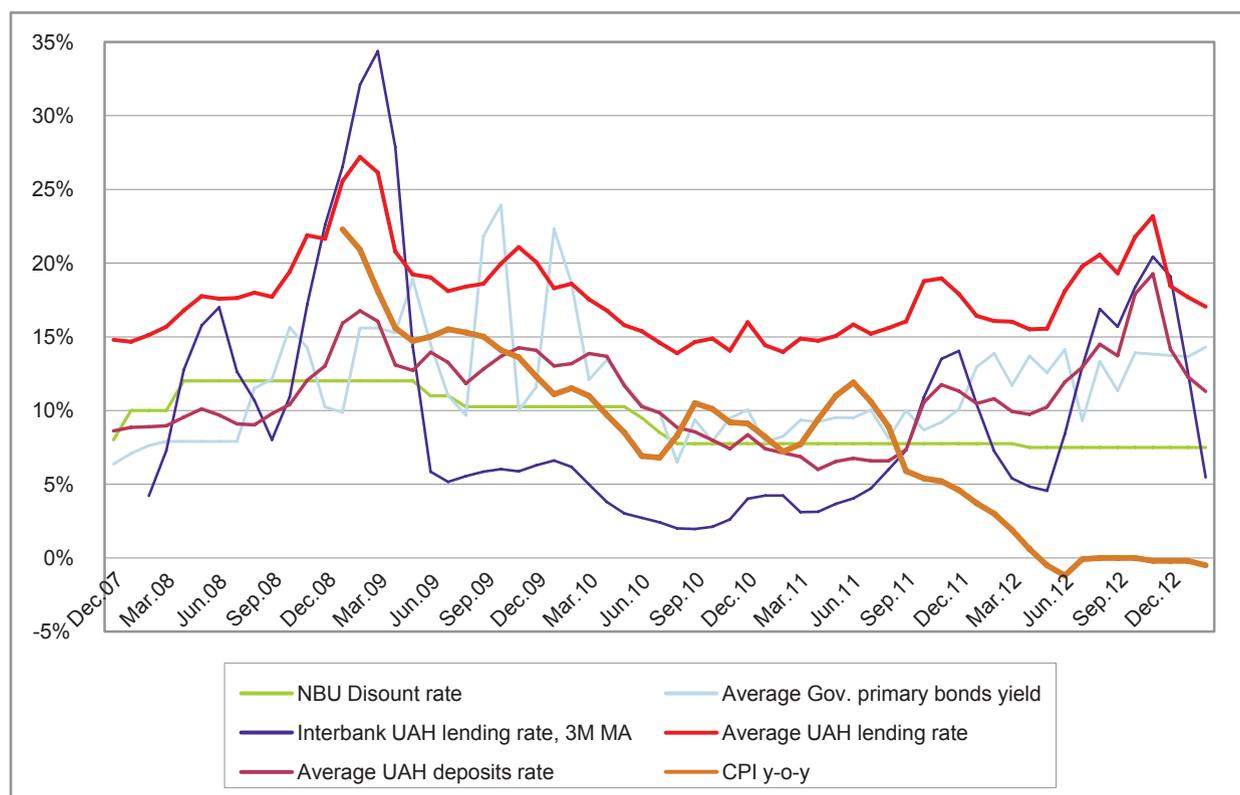
Underlying Causes of Weak Access to Finance

Macro- and Micro-Level Constraints on Finance

95. **There are several key reasons for the relatively difficult access to finance in Ukraine.** First and foremost, access to finance is thwarted by the high prices of credit instruments caused by macro-level policies, and increasing domination of banks controlled by business groups. On the macro level, maintenance of a *de facto* fixed exchange rate in an environment of expansive fiscal policy results in tight liquidity, and high interest rates in the banking sector. Since 2009, increasing market control by business groups has led to an expansion of internally-focused lending to the detriment of outside businesses. Furthermore, following the 2008-2009 financial crisis, universal banks with Western capital, which have served as the primary source of financing for SMEs and households, have adopted much stricter risk criteria. Many foreign banks have sold their Ukrainian subsidiaries, or are shrinking their balance sheets, as discussed below. The remaining banks face further constraints: the overhanging burden of bad assets, legal and tax obstacles to effective non-performing loan (NPL) workout, limited access to long-term funding (available mainly to large businesses on foreign markets), a weak enforcement environment caused and sustained by inadequate judicial practices, and finally, a fragmented and inadequate credit information infrastructure upon which a sound credit risk management must be built.

96. **A de facto foreign exchange (FX) peg has been the key driver of high and volatile interest rates.** While the NBU officially states that it does not maintain a currency peg, interventions in the foreign exchange market in 2012-2013, non-market-based public debt issuance, limited and nontransparent refinancing facility, and tightened export foreign exchange surrender requirements suggest that the stability of the exchange rate is the NBU's priority. The de facto currency peg leads to chronically high interest rates for Hryvnia resources, as the NBU supports the exchange rate by limiting Hryvnia liquidity on the interbank market. This also leads to extreme volatility in overnight rates, thus driving up bank interest rates. This pattern was repeated in October-November 2008, 2011, and 2012. In all three cases, the NBU sterilized Hryvnia liquidity on the interbank market, making overnight rates skyrocket to levels above 30 percent on some days. As a result, nominal and real interest rates (given zero inflation) amount to almost 20 percent per year, undermining lending (see Figure 42).

Figure 42: Interest Rates and Inflation, 2007-2012



Source: National Bank of Ukraine.

97. **The FX peg has also created a number of structural problems.** The fixed exchange rate undermines the development of the domestic hedging market for foreign exchange and other derivatives. In addition, it encourages international transfer pricing, whereby large exporters keep foreign currency revenues in offshore centers to avoid returning them to Ukraine and exchanging for Hryvnia, which is expected to depreciate. Finally, it increases macroeconomic risks and thus lowers the banks' risk appetite.

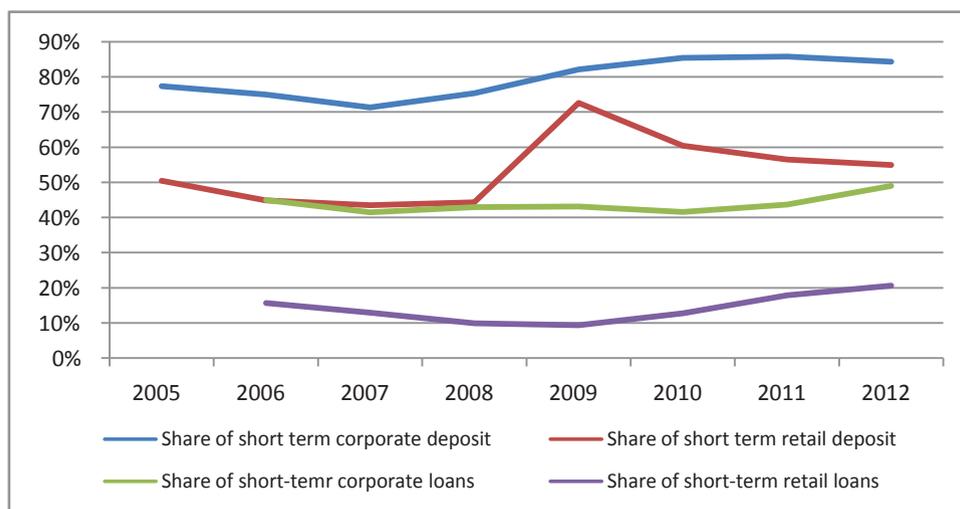
98. **Limitations on foreign exchange lending have made it more difficult to access credit.** Whereas the brisk credit expansion before the crisis was primarily driven by expansion of foreign currency loans, such credit is now limited. The NBU has completely banned FX retail lending, and limited FX corporate lending only to exporting enterprises. Although such limitations reflect a justifiable caution of the regulator, they have nonetheless contributed to reducing imports of foreign savings, and have made it more difficult to benefit from domestic foreign exchange savings, which represent around 40 percent of the banking sector's deposits, as well as from cash accumulated outside the system.³²

99. **Moreover, access to long-term corporate funding has diminished, as the foreign-owned banks, preoccupied with NPL workout and deleveraging, have adopted much more risk-averse policies than before the crisis.** Foreign banks are not willing to accept currency risk by providing loans to Ukrainian clients in Hryvnia, while taking EUR/USD parent funding. At the same time, little has been done to create long-term local currency funding for financial institutions, notwithstanding the enactment in July 2013 of

³² The authorities admit (as stated in an April 2013 interview of the former NBU Governor and First Vice-Premier Serhiy Arbuzov) that up to USD 100 billion of cash, equivalent to some 70 percent of banking sector assets, circulates outside the banking system in Ukraine.

the law enabling IFIs to issue local currency-denominated bonds. Despite the fact that shares of short-term deposits in the system have been gradually declining since 2009, banks have generally failed to transform them into longer-term credit. The share of short-term loans in total corporate credit increased to almost 50 percent by 2012 (Figure 43).

Figure 43: Shares of Short-term Loans and Deposits in Total Loans and Deposits



Source: NBU.

100. **Ukrainian banks lack local currency funding from which to extend long-term credit, and finance investment projects.** The majority of retail deposits, 55 percent, are demand deposits or short-term deposits are under one year in maturity, and only 3 percent of retail deposits are two or more years in maturity.³³ Private pension funds are virtually non-existent. Heavy government borrowing on the bond markets at high yields has also crowded out borrowing by banks and then lending to the private sector.

101. **As a result, domestic project financing is practically absent in Ukraine.** As such, banks lend primarily to fund only short-term capital needs. According to NBU data, half of the corporate loans in the banking system are short-term, under one year in maturity, and only about twelve percent of corporate loans have maturity of five years or more. Although group-related lending is under-reported, it is likely that these longer-term credits are issued by captive banks to related enterprises within the same business groups.

102. **International financial institutions could help expand long-term project finance.** IFIs such as the European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC) have comparative advantages in long-term project finance, because they can spread the risk among foreign and local sponsors, and therefore offer longer-term loans at a lower cost than domestic financial institutions. However, it was only in July of 2013 that the parliament adopted a law enabling IFIs to place Hryvnia-denominated local bonds to raise additional capital for project finance. It remains to be seen how this mechanism will work in reality and what will be the volume of IFI placements.

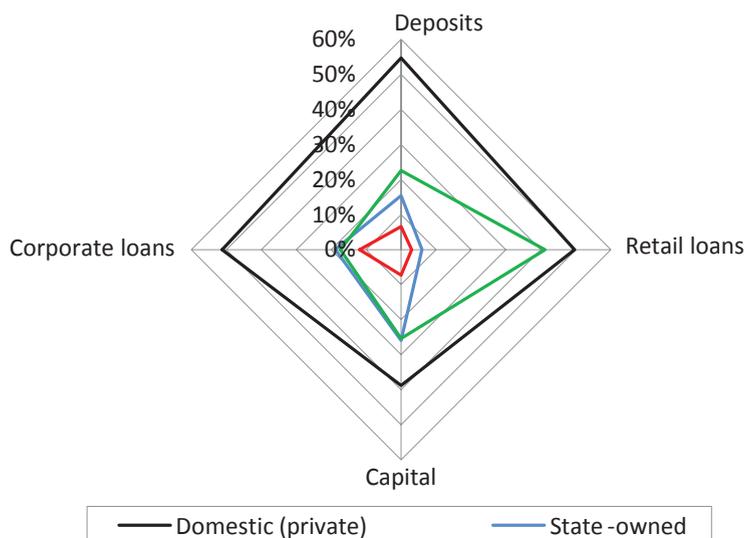
³³ Moreover, the term-deposits held by banks are all de facto demand deposits, since the Civil Code allows all deposit types to be withdrawn on demand with forgone interest as the only penalty. Certificates of deposits have defined maturity and could become funding vehicles for more stable and long-term retail financing for banks. However, CDs are not covered in the deposit insurance scheme, reducing their appeal.

Market Structure and Competition

103. **Western banks significantly enhanced access to finance in the pre-crisis period.** The *en masse* expansion of Western banks to Ukraine commenced in 2005 following the Orange Revolution and subsequent lifting of foreign exchange limits on lending for foreign banks. The inflow of foreign capital started with the acquisition of Aval Bank by Raiffeisen. Subsequently, the number of banks with foreign capital more than doubled, from 23 in late 2005 to 53 in late 2008. At the peak of foreign investment in the banking sector in 2008, Ukrainian banks were acquired at price-to-book-value multiples above four.³⁴

104. **Foreign-owned banks have introduced higher service standards and more diversified products.** They have been promoting healthy financial intermediation, as they use about the same proportion of parent capital and deposits to extend retail loans, whereas state-owned banks have continued relying mainly on state capital for corporate credit, and local banks have disproportionately depended on the deposit base as opposed to equity capital (see Figure 44). Foreign-owned banks have also introduced new, European standards of service and new products, such as cash management and settlement services. As a result, foreign-owned banks started to crowd out and marginalize the captive banks of Ukrainian business groups.

Figure 44: Portfolio Composition by Bank Ownership, 2012 YE

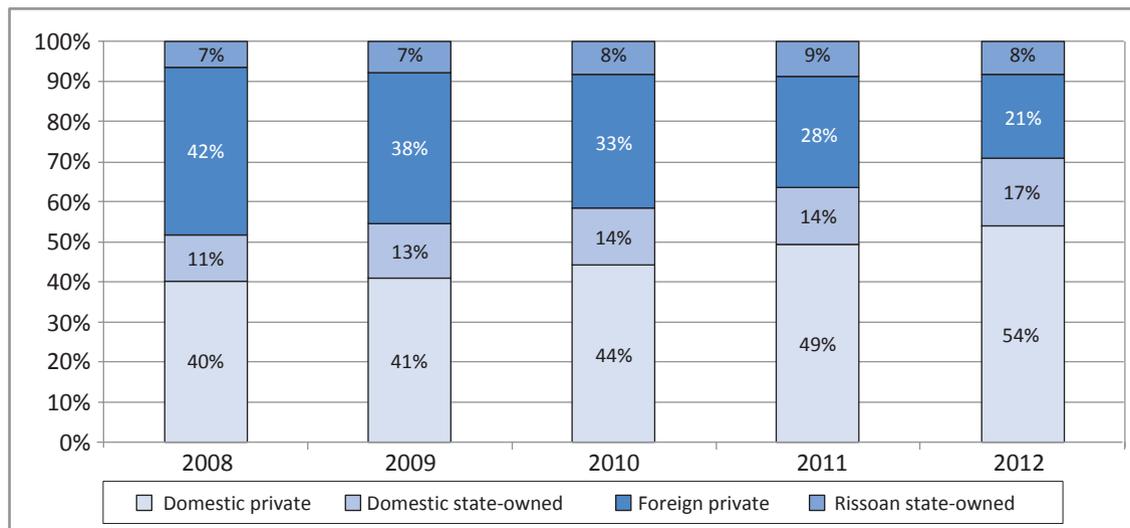


Source: National Bank of Ukraine and World Bank estimates.

105. **Unfortunately, the post-crisis environment saw the reversal of this trend, as foreign banks started exiting the market.** Their exit, driven both by the pressure of home-country regulators to deleverage and exit risky frontier markets like Ukraine, and by the unrealized growth prospects of the Ukrainian market, has reduced access to higher-quality financial services and led to the revival and expansion of captive banks. In 2012-2013, Commerzbank, Swedbank, SEB and Erste have all left Ukraine by selling their subsidiaries to Ukrainian investors. Platinum Bank was sold to Delta Bank, and Unicredit Bank and Ukrsofsbank have merged, consolidating the position of the Italian parent. Other groups, like BNP Paribas and Raiffeisen have stayed but remain in a risk-averse mode, and have been shrinking assets. Some remaining foreign-owned banks allegedly are considering market exits, too. Overall, the share of foreign non-state-owned banks in total banking assets halved from 40 percent in late 2008 to 20 percent of the market in 2012 (see Figure 45).

³⁴ The last large pre-crisis deal was closed in February 2008: Intesa Sanpaolo acquired Pravex Bank at price-to-book value ratio of nearly 4.8.

Figure 45: Ownership Structure of the Banking Sector, 2003-2012, in Percent of Total Assets



Source: National Bank of Ukraine, World Bank estimates.

106. **The banking system is increasingly dominated by large domestic banks organized around holding company structures and industry groups.** These so-called captive banks work as in-house treasuries of business groups, taking deposits and lending to related companies and individuals within the holding company structure. Growth in bank lending has been facilitated by the aggressive lending activity of a few banks, and there has been little additional intermediation to enterprises outside the group structures, including especially start-up firms. In the context of non-transparent ownership structures and weak enforcement of regulation on the disclosure of ultimate ownership by the central bank, this pattern of lending may lead toward excessive concentration of risk in industry segments and related parties as well as an inadequate measure of risk by banks and the regulator. Such banks also put household deposits at risk, offering high interest rates and then lending out to related companies. Without adequate disclosure of related-party lending, the scale of this problem is hard to estimate.

Legislative, Regulatory, and Infrastructure Hurdles to Credit Supply

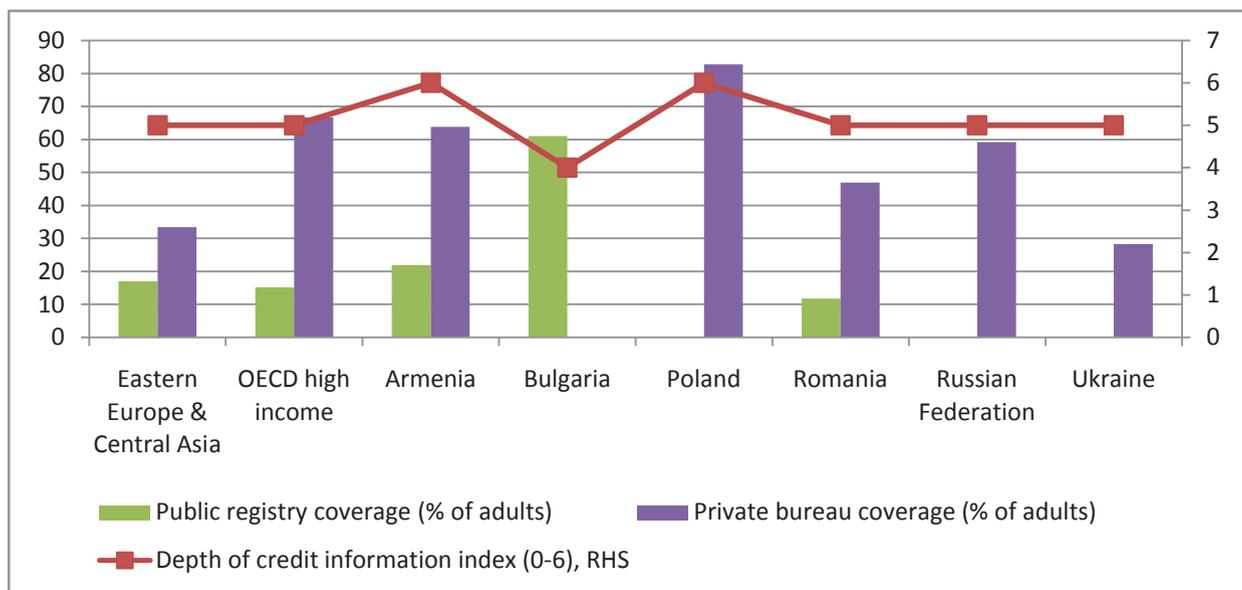
107. **Ukrainian banks lend in a risky environment.** The environment is characterized by group business affiliations; uncertain, absent or inaccessible information about borrowers' creditworthiness; limited creditor rights; and costly, prolonged and unpredictable judicial proceedings for contract enforcement. This type of lending environment inhibits the development of bank risk management and lending to underserved segments or new firms, and it is inclined to develop conservative and expensive credit allocation patterns. In this context, Ukraine's financial sector needs to upgrade its information infrastructure – collateral registries and credit history bureaus – and its legal and enforcement frameworks for protecting creditor and debtor rights.

108. **Knowledge of borrowers' creditworthiness is a critical factor in bank lending decisions.** In an uncertain enforcement environment, especially, creditors place strong emphasis on such information. Asymmetric information is a root cause of credit rationing in Ukraine: when banks lack prior lending experience with firms, they are limited in their capacity to distinguish among borrowers, and identify and score risks accordingly. For this reason, many banks serve small groups of repeat borrowers, and some banks display poor credit risk management. The lack of adequate, accessible, and timely credit history information is cited by many banks as an obstacle to the growth of their portfolios. SMEs, entrepreneurs,

and start-up businesses that could be potential customers within a well-constructed risk management model are often rejected by banks. Many conservative banks do not trust their credit worthiness: the companies' (especially SMEs') financial reporting is often unreliable, as they hide their activities for tax reasons and in fearful attempts to preserve their business when it becomes successful.

109. **But Ukraine's credit information system is fragmented, unreliable, and incomplete.** It consists of seven licensed credit history bureaus, of which three are active, that gather various, non-standardized data based on contributions by selected banks. There is no public credit registry, no information aggregator, and no mechanism for quality assurance or format standardization among the private bureaus. As a result, credit information is less available than among peers (Figure 46). Banks tend to purchase the services of one or a few bureaus (one bank owns a proprietary bureau) and then lend to those customers whose data can be found in the bureau(s) to which they have access. Bankruptcies are registered with the State Bankruptcy Authority, and can be accessed through publicly available information channels. The State Tax Authority can verify basic information for banks – borrowers' identity and any unpaid tax issues – only upon a specific written request. To obtain an information packet consisting of a new borrower's identity, tax, bankruptcy and credit history, a bank needs to submit several written requests to several government authorities (even though some of this information is publicly available, it is not easily accessible, or consolidated in a one-stop shop), and search up to five credit bureaus, none of which might end up having the necessary data. The delays, costs and risks inherent in this process are passed along to borrowers in the form of higher interest rates, less favorable terms, and rejections.

Figure 46: Credit Information: Ukraine and Regional Peers, 2013



Source: World Bank, Doing Business, 2014, www.doingbusiness.org

110. **Establishing a National Credit Histories Registry would help improve the credit information system.** Some of the private bureaus have spearheaded an initiative called “One-Point-of-Access” that seeks to put together a voluntary consortium of credit bureaus for the purpose of information-sharing, so that banks subscribed to any one bureau can access information from all of them. The draft law on establishing a National Credit History Registry would offer a single credit information locator, which would point to the location of credit history subjects in existing private bureaus. The law proposes an arrangement similar to the Central Catalogue of Credit Histories maintained by the Central Bank of Russia. Banks and credit bureaus have formed a working group, and are discussing various policy options for improving the credit information system. However, this approach falls short of what is needed; data reporting is still voluntary;

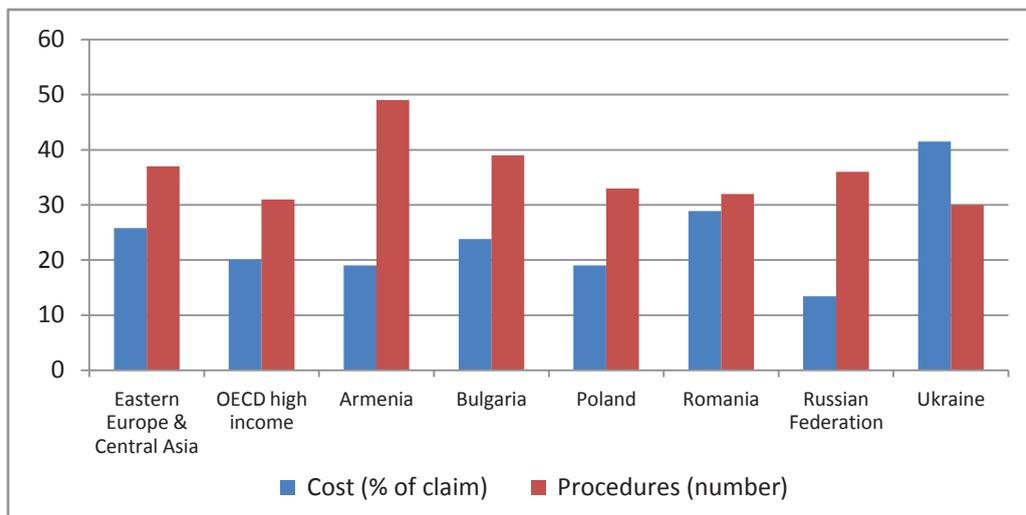
credit bureaus have partial coverage; banks get only a rudimentary picture by subscribing to an individual bureau, and data are not standardized or aggregated by a supervisor. In this regard, further consideration should be given by the authorities to approaches that would require the sharing of an information minimum across bureaus, standardization of the information required, and appropriate supervision of credit bureaus. It is imperative that any proposed legislation takes account of governance and accountability, quality assurance, timeliness and reliability of data, and accessibility by banks and credit history subjects.

111. **The secured transaction framework, particularly in the registration of moveable and immovable collateral, has recently improved.** A new Law on the Single State Register of Immovable Property came into effect on January 1, 2012, providing banks with a reference to borrowers’ property rights and encumbrances. Furthermore, a State Registry of Encumbrances Over Movable Property, administered by the State Enterprise Information Center, has also been created. These registries provide information to banks, and they have contributed to Ukraine’s progress in the Doing Business ranking on the “Enforcing Contracts” indicator in 2012. This should help improve access to finance, as a recent World Bank/IFC study demonstrates that borrowers across European and Central Asian financial markets that secure financing with collateral usually obtain better terms than borrowers without collateral.³⁵

112. **However, the timeliness and accessibility of information on secured collateral remain problematic.** Since January 2013, according to the Ministry of Justice Order 17-32/1661 of December 29, 2012, banks seeking information from the State Register of Encumbrances Over Movable Property are required to submit written requests for data, pay ex-ante fees, and wait several days for the information that they need. Previously, the system allowed for electronic submission of requests, invoiced monthly fee payment by banks, and provided the necessary information within an hour.

113. **In addition, secured lending relies on the creditors’ confidence that they will be able to execute collateral efficiently in the event of a default.** In this respect, Ukraine can make further progress in improving the efficiency, cost, and simplicity of court proceedings, and should introduce out-of-court arbitration and resolution options. While the 2013 Doing Business survey reflected improvement in the efficiency of contract enforcement in Ukraine, DB 2014 survey showed increasing costs of contract enforcement. As a result, Ukrainian firms face the highest costs of enforcing contracts among regional peers (Figure 47).

Figure 47: Enforcing Contracts in Ukraine and Peer Countries, 2013



Source: World Bank, Doing Business, 2014.

³⁵ Shahidsaless 2012.

114. Banks' associations have lobbied for the simplification of judicial proceedings in which banks are claimants as creditors or pledges, but with few results as of yet. Banks have also petitioned to improve out-of-court tools for pledged assets forfeiture, but such mechanisms do not yet work in Ukraine. Though the fast track procedure for repossessing collateral under retail loans has been provided for in the legislation, it is rarely used by banks, only in cases when there is goodwill on the part of the borrower and no legal complications, since any such out-of-court fast-track repositioning of collateral can be easily challenged and blocked at a court.

115. Notable legislative progress has been made in streamlining bankruptcy and insolvency proceedings. The Law on Restoring the Debtor's Solvency or Declaring it Bankrupt #4212 of December 22, 2011 and accompanying regulations on Training and Licensing Insolvency Practitioners, as well as the Law on Amendments to Certain Legal Acts on Improvement of Bankruptcy Proceedings #7329 of December 23, 2012, are welcome improvements to creditor rights in Ukraine. The former law establishes professional quality standards for insolvency practitioners; introduces procedures for out-of-court restructuring and cross-border bankruptcy; provides transparent and competitive procedures for selling debtors' assets; establishes the priority of sale as an ongoing concern; reduces the time at each stage of the insolvency proceedings, and lifts a moratorium on the bankruptcy of insolvent state-owned enterprises. The latter law requires the announcement of bankruptcy filings on the website of the State Bankruptcy Authority; clarifies the rules of appealing that does not allow appeals to halt proceedings; sets a 12-month limit on the duration of property management processes; limits rehabilitation actions to cases in which a rehabilitation plan is approved by court; and sets a duration limit for such actions at 18 months. The new law is expected to reduce or remove attempts of borrowers to use managed insolvency procedures to void or delay repayments of the bank laws, a practice widely utilized under the old legal framework. The impact of the new law, however, will largely depend on its application in practice, which so far has largely lagged behind progress in legislation.

Mechanisms for Disposing of Non-Performing Loans

116. New bank lending is constrained by the burden of impaired assets on bank balance sheets, in a market that fails to provide mechanisms and incentives to unload non-performing loans. While officially reported non-performing loans according to the narrow definition set by the NBU are at 10 percent, the IMF estimates NPLs at 35-40 percent of the banks' aggregate portfolio. Econometric analysis in the 2011 IMF Europe Regional Economic Outlook indicates that banks with higher NPL ratios systematically demonstrate lower loan growth.

117. Tax incentives for NPLs write-off remain limited. The banking community has lobbied for improvements in the tax treatment of write-offs and transfers of non-performing loans to boost incentives to unload bad assets from the banks' balance sheets, but to no avail. Moreover, the market for purchasing distressed assets has shown little activity, mainly due to non-uniform and complicated treatment of such transactions by tax authorities, and the unclear definition of such transactions and buyers (e.g. licensed factoring companies or non-financial companies) by the legal framework. Different agencies and regulators within the country treat NPL transfers differently, creating additional hurdles. This has opened a door to various interpretations of the law, and increased the risk that banks engaging in sales of distressed assets may face fines, additional tax liabilities, penalties, or later nullification of such sales.

Demand-Side Trends

118. **There seems to be unmet demand for credit.** As shown in a recent NBU survey of business expectations, Ukrainian enterprises would generally prefer to use credit to support their growth, but barriers such as the cost of credit limit their appetite substantially. 43.4 percent of respondent enterprises plan to take a loan within the next quarter. This ratio, fairly stable at 40-45 percent over the past several years, implies voluntary exclusion from credit among the remaining 55-60 percent of enterprises. The respondents planning to take a loan are predominantly large enterprises from processing industries, agriculture, and construction. Among the companies that plan to take a loan abroad, large mining companies are the leaders. More than 35 percent of respondent enterprises expect to increase their need for borrowed funds. The vast majority of respondents, 83.3 percent, also seek to borrow in Hryvnia.

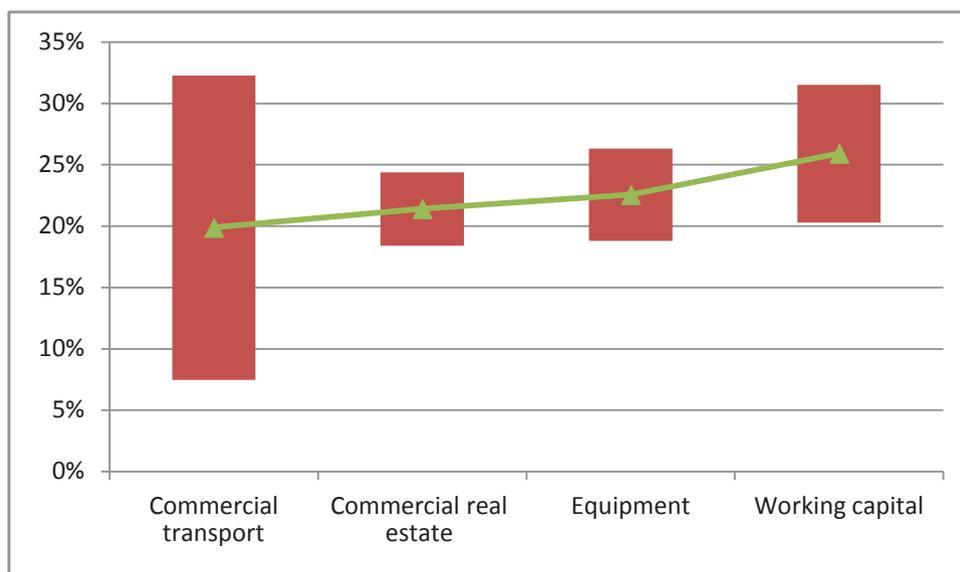
119. **Large Ukrainian business groups (mainly in steel and energy sectors) as well as large public agriculture holdings are “too big to lend to” for local banks, given the banks’ lending limits relative to equity capital.** Hence, the business groups access foreign debt and equity markets instead. Such conglomerates are usually not interested in loans from Ukrainian banks, mainly due to high local interest rates. Secondly, Ukrainian banks must comply with the regulatory single exposure limit of 25 percent of capital, which makes it difficult for large business groups to deal with local banks. Syndicated lending among local banks is not a widespread practice, due to weak contract enforcement and legal practices.

120. **Large business group also utilize intra-group offshore financing.** They retain revenues abroad via international transfer pricing and then re-invest them into Ukrainian enterprises as foreign direct investment (FDI). Cyprus is reportedly the number one source of FDI inflows into Ukraine, accounting for 32 percent of the total in 2011.

121. **The recent NBU survey of business expectations suggests that SMEs are generally more inclined to seek loans than large enterprises, implying that they have a greater need for external financing.** 39 percent of smaller-sized companies expect their need for credit to increase in the next quarter, compared to 32 percent of medium-sized enterprises and 36 percent of large enterprises. However, getting a loan is generally more complicated for SMEs, as 31 percent of smaller companies – compared to 22 percent of larger companies – believe that conditions for getting a loan have deteriorated. The majority of small companies, 88 percent, plan to borrow in Hryvnia, whereas 24 percent of large companies plan to borrow in foreign currency.

122. **However, Ukrainian group-owned banks and the growing number of Russian-owned banks have not shown much interest in lending to SMEs.** Although official statistics for SME-lending are not provided by the NBU, bankers report that the SME segment has had a larger portion of problematic loans than the large enterprise segment during the 2008-2009 financial crisis, as SMEs were borrowing in foreign currency, disregarding the devaluation risk. In addition, there is a relative lack of credit worthy SMEs, as many of them suffer from inadequate management capacity, poor accounting and reporting standards, and low transparency. Moreover, the level of financial education among the key managers is often low. Finally, the quality of the available collateral is often far from adequate. Therefore, most banks are now employing stricter risk metrics in this sector, which results in prohibitively high interest rates on SME loans (see Figure 48), while FX loans for non-exporting SMEs are legally prohibited.

Figure 48: Effective Interest Rates for SME Loans, Range and Average (August 2013)



Source: based on www.prostobankir.com.ua, 2013.

123. **SMEs thus partly rely on lending support from programs financed by the IFIs and Western banks.** The most active providers of refinancing for SME lending are the EBRD and KfW. Since the SME segment is one of the key drivers of banking business in Western Europe, European banks have been very active in implementing special programs focused on SME lending in Ukraine. However, with the exit of Western banks from Ukraine, discussed above, access to credit for SMEs is declining.

124. **State support for SME lending may become an important driver of improvement in SMEs' access to finance.** In the current inopportune economic conditions it will be hard to re-launch SME lending on a mass scale without additional support from the IFIs or the government. Ukraine may consider launching a state supported program for SME lending based on experience in EU countries. For instance, in 2013, BGK, Poland's state development bank, introduced a new *de minimis* portfolio guarantee facility to support access to finance for SMEs by reducing lending risks for commercial banks participating in the program. Within less than a year, the new program helped finance almost 15,000 SMEs for a total amount of more than US \$1.5 billion.³⁶

Access to Finance Outside the Banking Sector

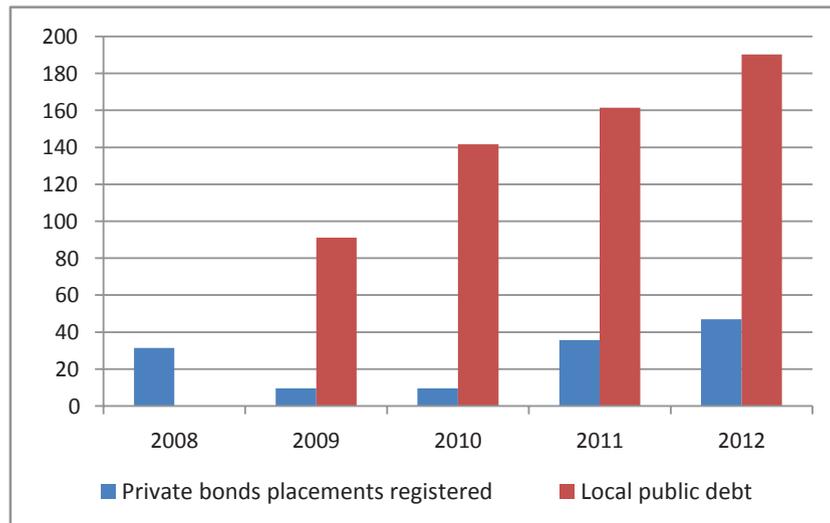
125. **Non-bank financial institutions comprise only about 5 percent of Ukraine's financial sector assets, and of these 4.5 percent are insurance companies.** Other non-bank companies, such as factoring, leasing, and credit unions, hold negligible shares of assets, compared to banks. The largest factoring and leasing companies are subsidiaries of or related to large banks; they function as supplements for the parent banks' core lending activities or special-purpose vehicles for NPL-workout.

126. **The key reason for the weak development of NBFIs is the poor institutional and regulatory framework.** NBFIs rely on healthy judicial systems and efficient and transparent enforcement of contracts, which are areas often described by market participants as problematic in Ukraine. Also, the National Regulatory Commission for Financial Markets, which regulates NBFIs, lacks capacity, compared to the NBU, to enact and enforce sound rules for market participants.

³⁶ Based on information from www.bgk.com.pl and <http://www.deminimis.gov.pl/>

127. **Ukraine’s capital markets have been in a standstill in recent years.** Despite the fact that local stock exchanges are technologically advanced, they are in a stagnant state. Likewise, private bond issuance has been flat since 2008, crowded out by heavy government borrowing. Although the volume of bond issuances on domestic capital markets has increased markedly since the 2008 financial crisis, the overwhelming majority of issuances have been government bonds financing the state budget deficit (Figure 49).

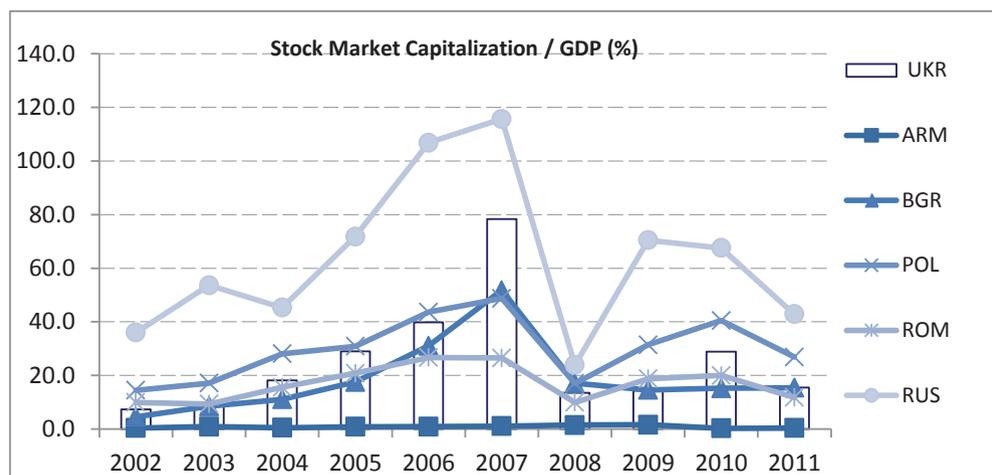
Figure 49: Local Hryvnia Debt of Private vs. Public Sector



Source: Ministry of Finance, National Regulatory Commission for Securities and Stock Market.

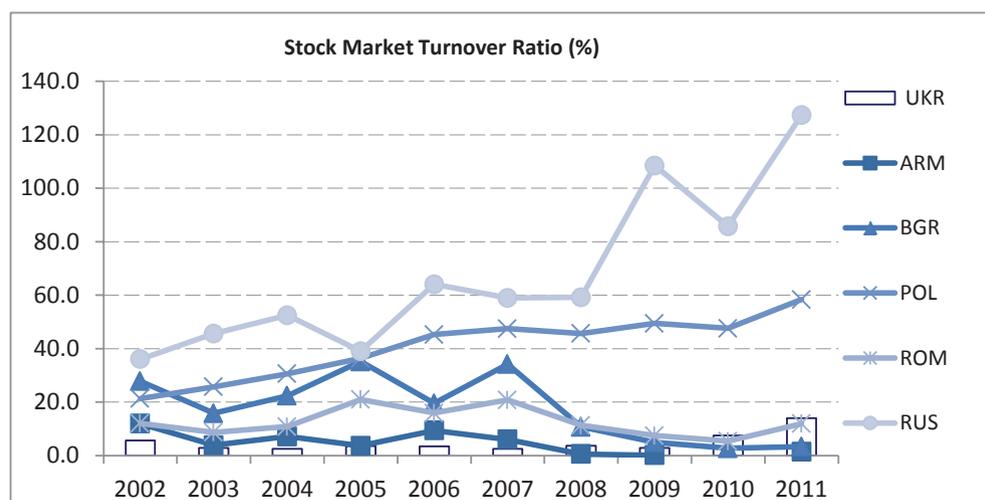
128. **Equity markets have failed to mobilize capital for banks and private firms.** Issuance, market capitalization, and turnover are very low (Figures 50 and 51). This is attributed to a number of factors, including the underdeveloped local investor base, the concentration of shareholdings of listed companies, poor information disclosure, and weak rights of minority shareholders, which suffer because the free-float in most locally listed stocks is under 5 percent. On top of this, incomplete corporate disclosures create an information asymmetry that undermines investor confidence and raises transaction costs, while majority shareholders continue to benefit from large transaction gains.

Figure 50: Stock Market Capitalization, Ukraine and Peer Countries, 2002-2011



Source: World Bank, Fin Stats, 2011.

Figure 51: Stock Market Turnover, Ukraine and Peer Countries, 2002-2011



Source: World Bank, Fin Stats, 2011.

129. **Recent tax changes have further complicated the situation on the equity markets.** Earlier this year, the government enacted new legislation aimed at reducing the turnover of junk bonds and stocks used for tax evasion purposes, converging the tax and financial accounting of securities operations, and introducing an excise tax for securities transactions (higher rate for over-the-counter deals and lower rate for in-market deals). Although these measures sought to prevent the use of capital markets for tax evasion, they have inadvertently reduced the volume of healthy capital market activity.

130. **Nontransparent privatization and weak protection of minority shareholders undermine the potential for equity market development.** The post-Soviet privatization of state enterprises rarely involved transparent, equitable tenders and open access for foreign investors. As a result of questionable practices of acquiring property, new owners lacked the incentive to conduct initial public offerings (IPOs), make their businesses transparent, and comply with high standards of disclosure and corporate governance, which are essential to the operation of a healthy stock market. Thus, privatization has not created a critical mass of properly governed companies to enter the stock market. Paradoxically, only few of the companies listed on local exchanges have been listed with the consent of their owners or management; most of the shares were brought to the stock exchanges after the voucher privatization in the 1990s. In addition, the insufficient protection of minority shareholder rights reduced retail investors' confidence in the market.

131. **Low liquidity makes Ukrainian exchanges uncompetitive relative to neighboring countries.** Among Ukraine's neighbors, Poland and Russia have very strong capital markets. The growth of Poland's equity market has been strongly supported by a large number of transparent IPOs of state-owned enterprises, strong governance standards, and high transparency. Russia's market in turn has been supported by strong oil- and gas-driven cash inflows. Ukraine has neither the former nor the latter, and thus most of its healthy local companies seek capital on foreign exchanges. In 2005-2011, Ukrainian companies conducted over 50 IPOs and sizable private placements, of which only one was a dual placement on the local market and abroad (through depositary receipts traded in Frankfurt). The remaining placements were on Western stock exchanges in London, Frankfurt and Warsaw.³⁷

³⁷ During 2005-2011, 13 placements were done in London raising about \$1.9 billion and 13 in Warsaw, raising nearly \$1 billion.

132. **To revitalize Ukraine’s enterprise sector, financial services for SMEs, which represent the critical growth engine, need to be expanded.** Although Ukraine’s bank branch penetration, deposit account penetration, and large corporate borrowing suggest adequate access to finance, the story is quite different for SMEs. Due to a combination of misaligned macro-level policies, limited long-term funding, group ownership structures in banking, weak infrastructure, under-developed legal environment for lending, and stagnant capital markets, small and start-up enterprises have limited prospects for accessing credit.

133. **Unlocking access to finance for enterprises requires a coordinated approach to addressing the inter-related challenges cited above.** Recommendations for policy reforms are provided for each area.

Policy Recommendations

SUGGESTED REFORMS	SHORT-TERM RECOMMENDATIONS	MEDIUM-TERM RECOMMENDATIONS
Access to Finance	<ul style="list-style-type: none"> ◆ Gradually transition to a flexible exchange rate, and tighten fiscal policy, while maintaining macroeconomic and banking system stability. ◆ Encourage longer-term savings by more strictly distinguishing demand and time deposits and potentially expanding deposit guarantee coverage to include certificates of deposit issued by banks to its clients. ◆ Approve laws removing tax disincentives for NPL transfer and write-offs. ◆ Expedite and reduce costs of access to the State Registry of Encumbrances over Immoveable Assets. ◆ Pass legislation allowing dual listings of Ukrainian companies that are currently listed in foreign jurisdictions. ◆ Remove constraints on Hryvnia-denominated lending by IFIs by reconsidering interest rate cap imposed by NBU. 	<ul style="list-style-type: none"> ◆ Review constraints on foreign exchange lending and set appropriate prudential limits. ◆ Enforce legislation on disclosure of the ultimate beneficiaries of banks, apply consolidated supervision, identify and limit related party lending. ◆ Increase depositor confidence by introducing market conduct regulation, appointing a financial ombudsman, and improving financial consumer protection rules and industry standards. ◆ Approve legislation completing the consolidation of information on credit histories and introduce a minimum unified standard for information on the credit history. ◆ Improve the capacity of commercial courts, train bailiffs and judges, and expedite collateral enforcement by reducing loopholes and possibilities for delay tactics. ◆ Enact and enforce further legal and regulatory reforms to improve capital market transparency, protect the investors’ rights, and enhance disclosure requirements. ◆ Enact legislative and regulatory reforms improving reporting standards, and enhancing transparency and corporate governance in Ukrainian firms, including SMEs. ◆ Enact legislation aimed at strengthening supervision in non-banking segment of the financial market (mainly new laws on insurance and credit unions).

Chapter IV: Competition

Summary

134. **The low level of competition on Ukraine’s domestic markets is limiting the country’s economic growth and potential.** Many sectors have a high concentration of firms; the rates of firm entry are low, and the effectiveness of competition policy is weak. This is a problem because the degree of competition in an economy has a direct impact on productivity, growth, and consumer welfare. Competition problems in Ukraine are driven by barriers to market entry, which are created by oligopolistic market structures, vertically and horizontally integrated business group structures, the exit of many foreign investors, non-market input prices (especially of natural gas) and weaknesses in the design and implementation of the economy-wide competition policy framework. To address these issues, barriers to market entry must be lifted, through reforms of licensing, permits, technical regulations, and inspections; price controls must be removed, and future rounds of privatization must be carried out in a way that enhances competition. The framework for competition must also be upgraded, via legislative improvements harmonizing it with EU legislation, enactment and robust implementation of the Law on State Aid, and reform of the Anti-Monopoly Committee’s (AMC) operations, investigations, and enforcement. Above all, however, competition policies need to be enforced more effectively. This will require enhancing AMC’s capacity, ensuring its political independence and impartiality, and strengthening competition outreach and advocacy to the public at large.

Introduction

135. **Competition policy is defined as the set of policies and laws which ensures that competition in the marketplace is not restricted in a way that reduces economic welfare.** In practical terms, competition policy usually involves the enforcement of antitrust legislation (typically rules against anticompetitive business conduct and mergers), and the promotion of measures enabling firm entry and rivalry, through the elimination of restrictive product market regulation and the opening of markets to competition, typically referred to as competition advocacy.³⁸

136. **Competition on domestic markets is critical to ensure increased productivity, innovation, and economic growth, and ultimately international competitiveness.** Firms facing more intense competitive pressures are more likely to introduce new products and upgrade existing product lines. Firms usually acquire many of their inputs (such as transportation, energy, construction, and professional services) on local markets. If these upstream markets lack sufficient competition, the goods and services necessary for production will not be provided at competitive prices. As a result, firms may be less competitive than their foreign rivals, and less likely to compete globally.

137. **Empirical evidence indicates that increased competition has a traceable impact on productivity, growth, and consumer welfare.**³⁹ A recent study of 22 industries across twelve OECD countries has shown that a 20-percent improvement on a competition policy index – roughly equivalent to moving from the level of enforcement in the Czech Republic to that in the United Kingdom – increases total factor productivity growth by one percent. In Australia, competition policy reforms during the 1990s increased GDP by 2.5 percent, or US \$20 billion. In 24 transition economies, firms facing between one and three competitors saw real sales grow by almost 11 percent over three years, while monopolists saw real

³⁸ Motta (2004). For more details, see International Competition Network’s (ICN) Report on Assessment of the ICN Members’ Requirements and Recommendations on Further ICN Work on Competition Advocacy, 2009.

³⁹ This paragraph summarizes findings from a literature review conducted by the World Bank Group’s Competition Policy Team and published in: “Competition Policy: Encouraging Thriving Markets for Development”, View Point Note 331, September 2012.

sales decline by one percent in the same period. A study of 40 international cartels in the 1990s concluded that prices had reduced by 20-40 percent since the cartels dissolved. A study of 20 OECD countries showed that reforms reducing state controls that affect competition increased long-term employment rates by 2.5-5.0 percentage points. Research on state aid suggests that sectors in which subsidies and state aid are concentrated in a few firms exhibit lower productivity growth, and that the effect is especially strong in developing countries.

138. A healthy level of competition on domestic markets helps firms prepare for possible future external and competitive shocks, such as the one that hit Ukraine in 2009. Conversely, the existence of distorted and uncompetitive markets reduces investment opportunities, increases business risks, raises the costs of inputs, and reduces the private sector's contribution to economic development and poverty reduction.

139. Some progress in liberalizing Ukraine's services sectors has demonstrated the potential benefits of enhancing competition. According to a study done by the Kyiv School of Economics, the liberalization of the services sector in 2001-2007 was accompanied by a 68 percent increase in the productivity of service providers. Total factor productivity (TFP) levels in manufacturing firms indicate that exports also grew in this period, and that TFP growth is associated with more intensive use of liberalized services inputs.⁴⁰ This shows that increased competition can have significant effects, not only in liberalized sectors, but across the economy.

Evidence of Problems

140. Insufficient competition adversely affects the performance of Ukrainian enterprises and the whole economy. Sector- and micro- analyses undertaken as part of the World Bank's 2010 Ukraine Country Economic Memorandum (CEM) show that Ukraine seems to be trapped in a self-perpetuating low equilibrium of high barriers to market entry, low competition, limited incentives for technology adoption, low export diversification and sophistication, and high vulnerability to commodity prices. The CEM also finds that this "vicious circle hampers the structural transformation of the country's economy while key comparator countries move ahead, and cripples the aspiration of achieving higher per capita income levels and living standards for Ukraine's citizens".⁴¹ Businesses complain not only about shortcomings in competition policy and enforcement, but also about weak rule of law, excessive and unjustified hassles from regulatory and inspection authorities, and about an overall lack of a level playing field, sustained via feeble governance in most institutions.⁴²

141. Available evidence points to a low level of competition on domestic markets, a high concentration of firms, and low rates of firm entry. While concentration is not a problem in itself, it creates possibilities for abuses of dominant positions, and for collusions or anticompetitive cooperation by a small number of firms in ways that limit the entry of new firms onto the market. These problematic issues are further explored below.

142. Indicators reflecting on concentration levels and competitive pressures show that the economy suffers from insufficient competition. There are signs of weak firm dynamics and significant barriers to entry and exit, which hamper healthy churn in the economy and thus reduce productivity growth. While much of the market-specific data are quite old, Ukraine's scores on the Global Competitiveness Report's

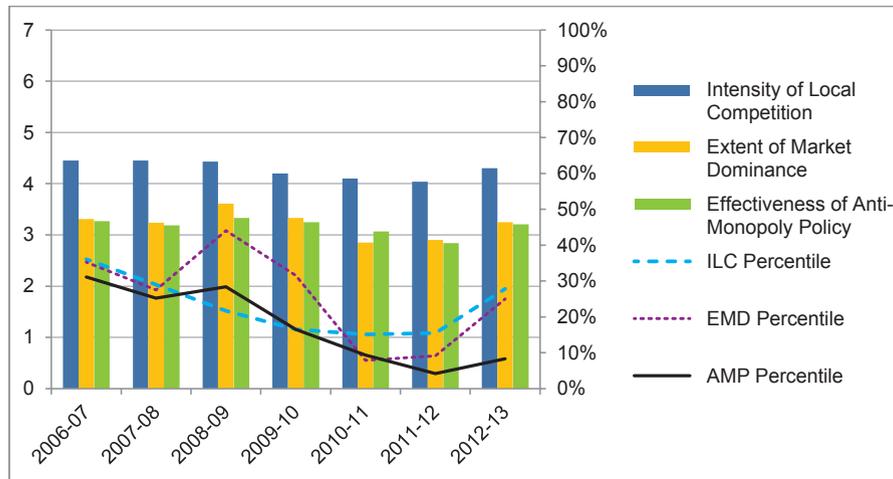
⁴⁰ Shepotylo and Vakhitovy 2010.

⁴¹ World Bank 2012.

⁴² From World Bank Group enterprise surveys conducted in Ukraine over several years. For more information, see www.enterprisesurveys.org

(GCR) measures of the intensity of competition have not improved, suggesting that similar problems still persist. In the 2006-07 GCR, Ukraine earned 4.45 (out of 7) on the intensity of local competition indicator. In the 2013-14 GCR, the score has hardly changed (4.5), ranking Ukraine only 106th worldwide. Likewise, in 2006-07, Ukraine was awarded 3.31 on the extent of market dominance indicator, and received a lower score of 3.0 in 2013-14 (ranking Ukraine 132nd out of 144 economies, down from 108th a year earlier). The country also ranks low on the effectiveness of anti-monopoly policy indicator, which will be discussed in the next section.

Figure 52: Ukraine's Performance on Competition Elements of the GCR, 2006-2013

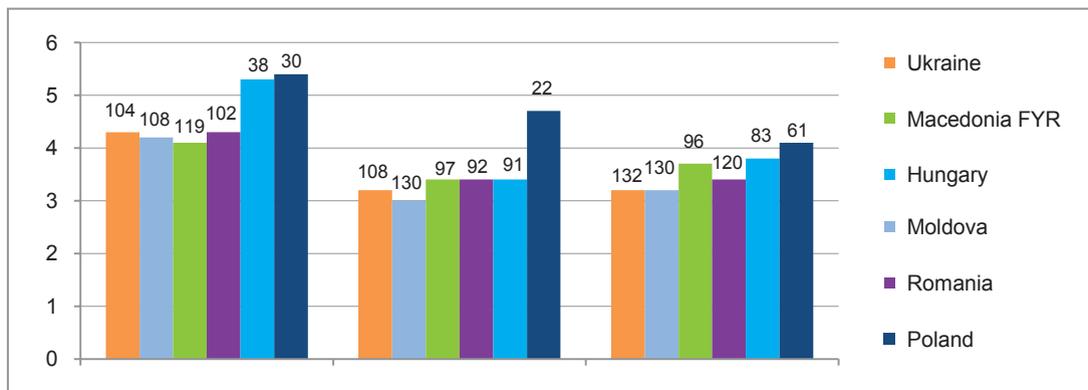


Source: Global Competitiveness Reports for the years indicated.

Note: score scale is 1-7, with 1 being worst. Percentile is calculated using Ukraine's rank out of the total number of economies included in the ranking for that year to make it comparable across time periods.

143. **Market competition and competition policy in Ukraine is weaker than in peer countries.** The figure below outlines how Ukraine performs on these measures compared to other countries in the region. The largest difference is among Ukraine and Poland, a neighboring EU member state with the strongest levels of competition, and a potential benchmark for Ukraine.

Figure 53: Indicators of Market Competition and Competition Policy

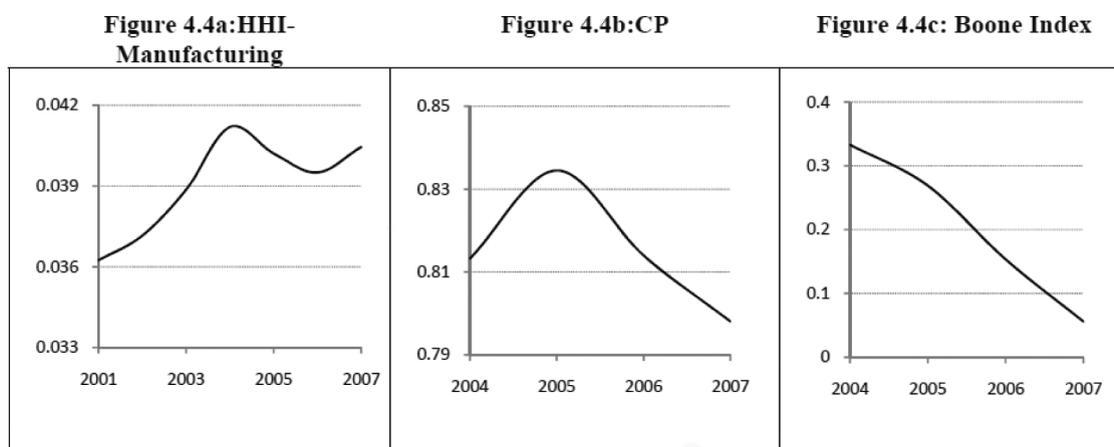


Note: Height of bar corresponds to score, which for Ukraine is the same as the bars in the figure above. Number shown corresponds to rank out of 144 economies, which for Ukraine is the same rank used to calculate the percentiles in the figure above.

Source: Global Competitiveness Report 2013.

144. **Measures of firm concentration and productivity also point to low levels of competition.** The HHI and Boone indices calculated by the World Bank show that concentration in manufacturing increased in the 2001-2007 period, and that competition decreased in the 2004-2007 period, respectively (Figure 54). Within manufacturing, the pulp and paper industry exhibits relatively higher levels of competition, but the metal and machinery sectors show very low levels of competition. In the services sector, high mark-ups, high entry barriers, and higher productivity of new entrants rather than incumbents, also indicate that competition is insufficient. These factors are pronounced especially in wholesale and large retail trade, and in the transportation industry. This is not surprising, as there are only five to seven large market players in the grocery and large consumer products retail segments, and given that the transport sector has large state monopolies.

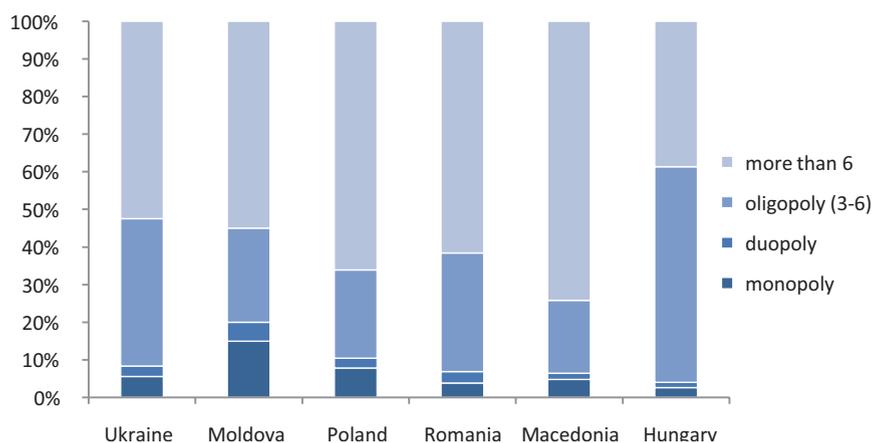
Figure 54: Measures of Firm Concentration in Ukrainian Manufacturing Sectors



Source: World Bank, 2010.

145. **Ukraine has a greater share of monopolistic and oligopolistic markets than other economies in the region.** This is evidenced in data from the World Bank’s 2009 Enterprise Survey, which suggests that almost half of the manufacturing sub-sectors covered in the survey exhibit an oligopolistic or monopolistic market structure. This is higher than in the other comparator countries depicted in the graph below, with the exception of Hungary. However, Ukraine’s share of monopolies in manufacturing is double Hungary’s share (6 percent vs. 3 percent).⁴³

Figure 55: Market Structure in Manufacturing Sectors, 2009

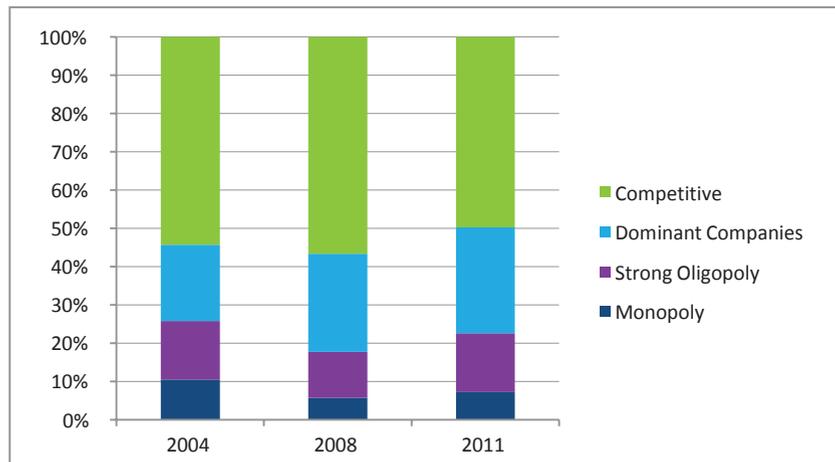


Source: World Bank Group Enterprise Surveys, 2009.

⁴³ Results from a new, 2013 BEEPS study should be available in early 2014.

146. **Market concentration has recently deepened further.** In 2011, the AMC calculated that 7.2 percent of the markets in Ukraine were controlled by monopolies; 15.4 percent of local markets were in the hands of strong oligopolies, and 27.6 percent of Ukrainian markets showed signs of the presence of dominant companies. All three categories of market dominance widened in 2008- 2011, as the Figure 56, below, suggests.

Figure 56: Market Structure as Calculated by AMC, 2004-2011



Source: Maria Zaslavska “Tycoon Heaven: Ukraine Offers the Perfect Environment for Monopolies to Grow and Thrive”. The Ukrainian Week, September 17, 2012.

147. **Output and employment also tend to be concentrated in larger enterprises.** Though they represent a mere 0.1 percent of firms in the Ukrainian economy, large enterprises account for almost half of the sales, with 49 percent in 2011, and 46 percent in 2010. They also employ nearly 40 percent of salaried workers, with 39 percent in 2011, and 37 percent in 2010.⁴⁴ The World Bank CEM has found that average firm size in Ukraine tends to be larger than in other transition and industrial economies, and that the share of small firms in total employment has been decreasing (see also Chapter I for more details). A 2013 United Nations Conference on Trade and Development (UNCTAD) peer assessment of Ukraine’s competition policy confirms that “Ukraine’s economy still features exceptionally high levels of concentration unrelated to superior economic performance”, driven by distortive state aid, barriers to entry of new firms, and weak governance of natural monopolies.⁴⁵

148. **Market dominance in Ukraine can be explained via a four-category classification.**⁴⁶ First, there are natural monopolies, in which the underlying economics of the sector – for instance, high barriers to entry, high sunk costs, and economies of scale – imply that a monopolist will have the lowest long-run average cost, and thus monopoly is the most efficient organization of production. In these cases, prices are regulated by economic regulators to simulate the price pressures of a competitive market, and the capacity and strength of the regulator is thus very important. Examples of natural monopolies include railways, water utilities, and electricity transmission and distribution utilities. The second category of market dominance includes regional players that have distinct advantages in certain geographic areas. Ukraine’s National Committee for State Regulation of Communication and Computerization has found that over 400 Ukrainian operators enjoy such market privileges. The AMC has uncovered the existence of these types of companies on regional markets with funeral services, bus stations, parking, paid health

⁴⁴ World Bank 2010.

⁴⁵ Page 2 of UNCTAD’s “Voluntary Peer Review of Competition Law and Policy: Ukraine. Overview”.

⁴⁶ As argued by Zaslavska 2012.

care, etc. The third category of market dominance consists of national Ukrainian companies operating on competitive markets where they have large market shares. This includes two mobile phone operators that cover 45.8 percent and 35.5 percent of the market, respectively. Finally, the fourth category of market dominance includes companies that are part of large financial and industrial groups. Because of economies of scale in administration, and potentially also because these enterprises are controlled by and have access to powerful individuals, they can assert market power on multiple markets.

149. **Firm entry and exit rates also indicate insufficient competition.** The World Bank CEM has found that the entry rate of new firms onto the Ukrainian market has been low compared to other countries – including transition economies – and is a sign of lingering regulatory obstacles to entry. Exit rates of firms have also been persistently low.⁴⁷ Inefficient large firms, often SOEs, are able to continue operating in numerous sectors; data on the services sector indicate that firms that exit the market do so with a level of productivity that is extremely low compared to the average incumbent. This suggests that the firm was able to survive on the market even with extremely low levels of productivity. Having scarce factors of production bound up in these firms and thus unavailable to more efficient smaller producers is a drag on economic efficiency and growth.

150. **Ukrainian authorities acknowledge problems with competition.** The draft 2013 Law on the “National Competition Program for 2014-2020” agrees that, “the level of competition in products markets remains low”, both on the national and regional level, which undermines the efficiency of product markets.⁴⁸ The low level of competition is inter alia reflected in high prices that are not always justified by fundamentals, high degree of monopolization of commodity markets and utilities, including fuel and energy, transport and postal services, and housing, and low level of enterprise productivity and innovation. According to AMC’s research, only 25-49 percent of business managers consider competition to have a big impact on their activity.

Drivers of Competition Problems

151. **Competition problems generally occur due to the following factors:**⁴⁹

- *Absence of pro-competition sector policies.* Competition in key economic sectors is hampered by regulations that limit entry, or affect firms’ capacity to compete. For example, in the transport sector, restrictive road transport regulations (backhaul and cabotage regulations) hinder the operation of foreign companies, encourage unregulated vertical relations in complementary markets (such as warehouses and ground handling services), and distort competition dynamics, resulting in higher transportation costs.
- *Ineffective competition policy frameworks and implementation.* Weaknesses include: (i) unjustified and discretionary exemptions (for example, utilities managed by the state, key sectors); (ii) lack of sufficient investigative powers, including for instance “dawn raids”, and tools to deter anticompetitive behavior (leniency for a number of whistleblowers, effective fines); (iii) a broad range of reasons and discretion to exempt cartels; (iv) no effective provisions for distortive state aid; (v) lack of clarity in the division of competence between the competition watchdog and various ministries and other public agencies; (vi) insufficient financial and human resources of the competition watchdog; (vii) an ineffective judiciary and lack of clear division in handling

⁴⁷ World Bank 2010.

⁴⁸ “National Competition Program for 2014-2020”, II General Part, p. 2. From:

⁴⁹ Competition Policy Approach, 2012 (Competition Policy Practice, Investment Climate, World Bank Group) and UNCTAD’s “Voluntary Peer Review of Competition Law and Policy: Ukraine. Overview”.

competition cases between various courts; and (viii) significant government intervention in markets (such as price controls in potentially competitive markets), controlling essential products, margins, and geographic areas.

- *Discriminatory treatment and distortive state aid for incumbents.* Discriminatory policies favoring incumbent firms and excessive government intervention still dominate many markets in developing economies. In some economies, more than 50 percent of anticompetitive actions are carried out by public and local authorities.
- *Lack of competitive access to essential business services.* These services facilitate the entry and expansion of young firms (essential local business services such as banking and related financial services, communications, transport and required energy services, gateways to export markets, open real estate markets, and profession and administrative support services).
- *Poor market practices and regulations that hinder competition.* These include firm collusion, market foreclosure, and discrimination against new entrants: all practices that also limit firms' competitiveness, and affordability of key consumer goods. Self-regulation imposed by business associations, particularly in the services sectors, decreases competition by either restricting entry or aiding members in coordinating prices. Lack of transparency on the companies' ultimate owners, especially for business registered offshore.
- *Lack of independence.* Competition watchdogs, while often de jure independent, are de facto often subject to substantial pressures from the political establishment and businesses' vested interests, which undermines their impartiality and effectiveness.

Barriers to the Development of Competitive Markets: Market Entry and Expansion

152. **The ease with which companies can enter and exit markets affects the competitive dynamics even in the absence of deliberately anticompetitive behavior.** This area includes not only starting and closing a business, but also policies and regulations that govern market access, restrict the number and type of firms, and control prices. Markets will have freer competition when company owners can enter them relatively easily, operate in a fairly stable and predictable regulatory environment, and exit the business if the investors identify a market where their capital can be employed more productively.

153. **Registering a business has recently been made easier.** In 2014, after a number of reforms, Ukraine improved to 47th place in the “starting a business” category in the Doing Business survey.⁵⁰ In addition to reforms reflected in DB 2013 such as the elimination of the minimum capital requirement for company incorporation, the requirement to have incorporation documents notarized, and the requirement to obtain approval for a corporate seal, in 2013 eliminated the requirement for registration with the statistics authority and eliminated the cost for value added tax registration (for more detail, see Chapter III on the regulatory environment).

154. **However, the permit and license environment continues to block market entry.** Companies still have to comply with a long list of permits, go through a protracted process of licensing, and often meet unnecessary mandatory standards and certifications. The World Bank's 2010 report found that entry and operation costs are particularly burdensome for promising growth sectors that have export potential and have been more resilient to the crisis, such as food processing and new light manufacturing. In addition, it concluded that Ukraine's institutional and regulatory framework, “imposes high entry barriers, high operational costs, high exit barriers, and consequently limits competition, new products in the market and

⁵⁰ World Bank Doing Business data, available at: www.doingbusiness.org

export potential” in all sectors, with some exception for banking.⁵¹ In addition, the processes of setting up a business are prone to rent-seeking activities of regulatory agencies and local governments. Prior to the crisis, and in the context of high profits and low competition, these issues were considered by many enterprises as an unavoidable extra tax on their business; however, in the post-crisis environment, they hinder growth and employment recovery by keeping the number of new businesses and FDI inflows low (while sustaining high rents for incumbents).

155. Exiting the market is also long, cumbersome and costly. This keeps economic resources tied up in unproductive activities and hampers the efficient allocation of factors of production. Companies also face difficulties when dealing with the tax authorities during the process of closing a business. Difficulties with closing a business increase entrepreneurs’ perception of risk of market entry, tie up investors’ capital in non-productive firms for a substantial amount of time, and therefore often deter entry. The new law on insolvency, which entered into force in January 2013, promises welcome improvements as it clarifies and cuts time lines of specific procedures during the bankruptcy process; ensures a better balance between debtors’ and creditors’ rights; and introduces mechanisms expected to enhance the effectiveness of insolvency officers. However, as is common in Ukraine, the challenge will be to ensure that the new law is implemented well.

156. Ukraine’s economy maintains substantial barriers to FDI in some sectors. Among the 20 countries covered by the World Bank Group’s Investing Across Sectors indicators in Eastern Europe and Central Asia, the restrictions on foreign equity ownership imposed by Ukraine are more severe than in most other countries. For instance, foreign capital participation in the domestic and international air transportation sectors is restricted to 49 percent. In addition to legal barriers, foreign investors are also deterred from entering Ukrainian markets in practice, by the non-transparent and unpredictable regulatory environment. The overall low FDI inflows as well as high levels of net inflows from Cyprus and other tax havens, which largely represent recycled investment from Ukraine, support this statement.

Discriminatory Treatment of Market Players

157. The state involvement in the economy often results in the discriminatory treatment of some market players. Examples of this include the establishment of the State Food and Grain Corporation in 2010, state control over domestic food prices and grain export quotas, and government price controls and subsidies in gas, heating, and electricity supply. There are ongoing attempts to further increase state control. For instance, in 2010-2011, the government imposed ad-hoc export restrictions on grains, blocking access to export markets and paralyzing FDI in these sectors. Other government policies that interfere with market entry include favoritism toward domestically-produced equipment, which deters competition from foreign suppliers (as well as foreign investment), the moratorium on agricultural land sales that has been in effect since 2001, and the need to register exports exclusively at the State Agrarian Commodity Exchange.

158. Competition in the agriculture and food-processing sector is stymied by the overabundance of regulations. As argued by the World Bank, government policy in the sector is “outdated, fragmented, complex, burdensome, and plagued by governance shortcomings”.⁵² Over time, the government has developed different regulations for different subsectors, including specific regulations for sugar, bakery, oilseeds, alcoholic beverages, dairy products, and baby food, among others. Factories that produce various types of products face complex and overlapping requirements. Even existing firms wishing to expand their product variety face lengthy and costly permit and licencing procedures: for instance, a fruit juice company that sought to add a line of pear juice to an existing line of apple juice had to go through the full process of licensing and permitting, as if it were a new business.

⁵¹ World Bank 2010, p. 41.

⁵² World Bank 2010, p. 33.

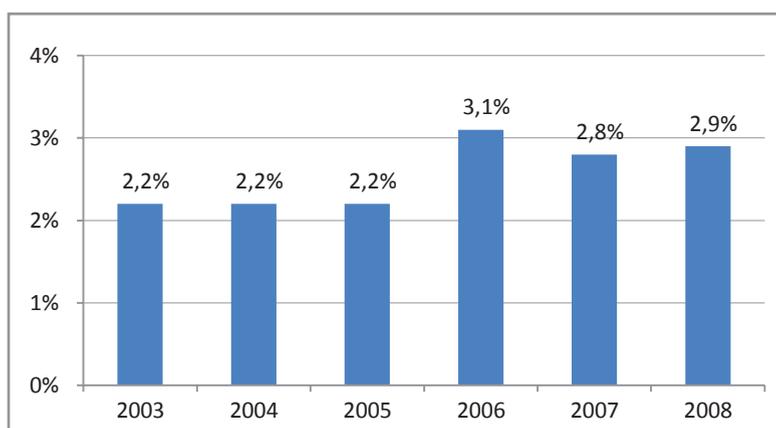
159. **Competition is strong in some segments of the telecommunications sector, mostly mobile services, but weak in Internet and landlines.** A double licensing system is in place, out of line with the common practice in the European Union. Internet providers must obtain three licenses from the regulators to start operations, and the landline market is dominated by Ukrtelecom, the old incumbent operator. According to the company website, the company has a 71 percent market share on the local telephone market and 83 percent share on the long-distance and international telephone market.⁵³

160. **A level playing field needs to be guaranteed for all market players.** The principle of competitive neutrality stipulates that no entity operating on an economic market is subjected to undue competitive advantages or disadvantages. The rationale for pursuing competitive neutrality is both political and economic. The main economic rationale is that it enhances the efficiency of allocation across the economy, where economic agents – whether state-owned or private – are put at an undue disadvantage, so that goods and services are no longer produced by those who can do it most efficiently. The political rationale is linked to the government’s role as universal regulator in ensuring that economic actors are “playing fair” – where state-owned corporate assets are concerned and vis-à-vis other market participants – while also guaranteeing that public service obligations are being met.⁵⁴

Government Interventions through State Aid

161. **The government is an active market participant through its control of state-owned enterprises (SOEs) and allocation of state aid.** SOEs continue to represent a substantial portion of GDP – approximately 20 percent – and have a strong presence in several sub-sectors, including energy, transport, and machine-building. The government itself spends roughly 47 percent of GDP. The government provides product-specific subsidies in agriculture, including area payments for horticulture, viticulture and hops; and it reserves substantial support for poultry and sugar production. Meanwhile, government policies implicitly tax cereals exports, a sector in which Ukraine is more competitive. Budgetary subsidies and current transfers to enterprises represented 2.9 percent of GDP in 2008, down from 3.1 percent in 2006, but still a greater amount than any other in 2003-2005 (Figure 57).⁵⁵

Figure 57: Budgetary Subsidies and Current Transfers to Enterprises (in Percent of GDP)



Source: EBRD 2009.

⁵³ From: <http://en.ukrtelecom.ua/about/today>. There is also a lack of clarity about the ultimate ownership of the company: it was privatized in 2011 and sold to a small, previously unknown Austrian investment company EPIC.

⁵⁴ OECD 2012 “Competitive Neutrality. Maintaining a Level Playing Field Between Public and Private Business”.

⁵⁵ EBRD 2009.

Controls on Prices Increase Business Risk and Reduce the Ability of Firms to Compete

162. **Prices of socially sensitive products are often subjected to de facto price controls, thus undermining competition.** The Holzler 2013 report notes that, “currently, the AMC invests substantial time in price control – the majority of the AMC assignments is initiated by the central executive government, and the AMC is expected to immediately react to price fluctuations on so-called ‘socially sensitive’ markets”.⁵⁶ The report also states that, “the AMC is a governmental instrument for controlling sensitive markets, and price movements in particular”. The UNCTAD peer review report presents the same view. The AMC staff understands its own role as that of a kind of a price controller, moving prices up in parallel, so that there is no obvious increase in costs for such a price movement. Automatically, such price movements are seen as cartels.⁵⁷ Such de facto price controls may be effective in stabilizing prices in the short term, but are likely to decrease consumer welfare in the long run as such controls encourage the formation of cartels, facilitate market control by favored individuals, reduce market entry, and raise governance issues related to corruption and arbitrariness of price levels.

Competition/Antitrust Framework

163. **The legal framework and its implementation remain deficient.** In the 2013-14 GCR, Ukraine ranks 137th out of 148 economies on the effectiveness of anti-monopoly policy. Likewise, the EBRD index of competition policy has rated Ukraine as a 2.3 in 1997-2012, just above category number two, i.e. “competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant firms,” but still well below category number three, i.e. “some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions”.⁵⁸

164. **The Competition Law is broadly aligned with international practices.** The 2001 Law on the Protection of Economic Competition (or more simply, the Competition Law) is the principal law on competition. It addresses five main categories of uncompetitive activities: 1) concerted actions, 2) abuse of dominance, 3) concentrations, 4) certain “restricting and discriminating” activities of business entities and associations, and 5) anticompetitive actions of government bodies. The 1996 Law on Protection against Unfair Competition deals with conduct by a single company intending to reduce the competitive ability of a competing enterprise. It prohibits activities such as exploiting another firm’s reputation, gaining an unfair competitive advantage by disseminating false information, inducing third parties to boycott another company, bribing another company’s employee, and illicit acquisition or unauthorized disclosure of commercial secrets.

165. **But some regulatory weaknesses still linger.** The 2008 OECD peer review report on Ukraine’s competition law and policy and the 2013 UNCTAD report conclude that overall the country has developed a rather comprehensive and well-designed legal framework for competition. However, some notable structural weaknesses have remained in place. They are identified in the OECD and UNCTAD analyses and other reports⁵⁹, and they include the following:

⁵⁶ Completion report of the project “Harmonization of Competition and Public Procurement Systems in Ukraine with EU Standards”, (Holzler 2013, p. 9).

⁵⁷ Holzler 2013, p. 38.

⁵⁸ EBRD 2012.

⁵⁹ OECD 2008b, Svehkar 2010, Haid 2010, Holzler 2012, Denisenko and Nizhnik 2013. See also the upcoming UNCTAD peer assessment.

- A number of provisions of the Competition Law are in conflict with Ukraine’s Commercial Code.
- The Competition Law’s merger notification requirements clash with accepted international standards, although a recent draft amendment to the law provides for a significant increase in thresholds, which – if adopted – would enhance the merger control regimen and help the AMC focus on the most important cases.⁶⁰
- Concentrations exceeding specified thresholds must be reported to the AMC, and may not be prosecuted until a waiting period has elapsed. The notification thresholds have been criticized for disallowing the AMC to effectively focus on transactions likely to spark competitive concerns. Furthermore, the AMC has not issued merger guidelines to explain the methodology that it uses to permit or ban concentrations.
- The Competition Law states that Ukraine’s Council of Ministers may grant permission on public interest grounds to allow certain conduct or a merger that the AMC has previously rejected.
- The limits on concerted actions are similar to those common in the EU, but Ukraine’s block exemptions are generally less detailed, and local procedures still call for companies to apply to the AMC for approval of concerted agreements.
- The legislation does not distinguish between very serious cartel behavior (price fixing, market sharing, bid rigging or production/sales quotas), and other types of cartel behavior.
- There is no criminal regime for cartel offenses.⁶¹
- The AMC’s investigative power is weak, including a lack of authority to conduct “dawn raids” (firms accused of cartel behavior are supposed to deliver evidence of wrong doing voluntarily), and the agency has a poor cooperative relationship with the police, prosecutors, and other law enforcement agencies.⁶²
- The leniency program applies only to the first applicant, reducing incentives for other whistleblowers.
- The choice of jurisdiction between administrative and commercial courts is not always clear.
- Merger control is weakened by a lack of information on the ultimate business owners, especially for offshore companies.

166. **The AMC seems overextended.** Unlike most other competition watchdogs, it also deals with procurement. It audits government agency compliance with procurement laws, examines alleged tender violations by procuring agencies, and authorizes the use of restricted tendering and single-source procurement procedures. These additional duties have put a strain on the AMC’s capacity and resources. In addition, AMC handles some cases that could be left to the courts if they dealt more effectively with disputes between companies over claims of unfair competition and trademark infringement. If privatizations were carried out with a greater emphasis on creating multiple competing entities (on markets where competition is possible), then the AMC would be faced with fewer cases of abuse of dominance, which would also reduce its workload. There are also some weaknesses in the economic regulation of natural monopolies by regulatory bodies, which increases the burden on the AMC’s enforcement resources. According to the OECD, “all of these diverse demands on the AMC’s attention and resources challenge the agency in its efforts to maintain high standards of performance in accomplishing its mission”.⁶³

167. **The AMC’s overextension has contributed to the poor execution of its duties.** Legal practitioners reason that the AMC is not able to complete the reviews of concentration applications within the allotted

⁶⁰ OECD 2008a and UNCTAD 2013.

⁶¹ Denisenko and Nizhnik 2013.

⁶² OECD 2008b.

⁶³ OECD 2008b, p. 77.

time frames, and that the AMC sometimes takes a superficial approach to cases, avoiding examination of the underlying competitive dynamics. The AMC is aware of these perceptions, and has stated that additional resources are necessary for it to maintain high standards of performance. The OECD made general recommendations on budget allocations for the AMC as well.

168. Some of the procedures prescribed in the law, regulations, and/or procedures are burdensome for the AMC. For instance, the AMC’s concentration notification requirements call for the parties to provide extensive documentation, even from affiliated entities that may not be active on the markets relevant to the transaction. Additionally, a great number of global transactions with no impact on competition on Ukrainian markets still triggers local merger control thresholds. The AMC has expressed its interest in simplifying merger control clearance procedures. In other areas, the AMC has the power to adopt regulations and guidelines that can help reduce inefficiencies and improve its operations, but it has not fully taken advantage of this possibility.⁶⁴ Finally, the AMC could also facilitate understanding of and compliance with competition frameworks across the private sector, by articulating its decisions and policies more clearly to the public. Doing so could also improve the efficiency of its work.

169. There are claims that the AMC is not effectively combating the abuse of dominant positions by monopolists. Annual reports by the AMC have stated that, “Ukraine has not yet established a system to counteract and prevent monopolies, adjusted its antimonopoly legislation to EU competitive policy standards, systemized and monitored violations on the commodities markets by branches, analyzed the competitive status of commercial entities, or examined monopoly (dominating) entities”.⁶⁵ In the energy sector, the Audit Chamber’s report on sector regulation in 2008-2011 has noted that the sector regulator’s “existing system to control monopoly companies on Ukraine’s energy market is inefficient, therefore their violations of the legislation have become systemic.”⁶⁶ The Antimonopoly Committee has often failed to apply any relevant measures against violators”.⁶⁷

170. Cartel behavior and the systematic application of fines is also an area that needs attention. About half of the AMC’s caseload involves abuses of dominance, while only 4 percent of it focuses on concerted actions, and less than 3 percent deals with horizontal concerted actions.⁶⁸ Horizontal concerted actions are, “widely considered to be the most pernicious form of anticompetitive behavior by business entities, and should therefore be a prime focus of enforcement efforts”⁶⁹, but Ukraine’s efforts to uproot these practices have been feeble. The most effective way of deterring cartels is through the imposition of heavy sanctions and the consistent, effective and efficient investigation of cartel behavior. An analysis published in the 2010 Schoenherr Roadmap⁷⁰ has found that Ukraine’s AMC has deficiencies in these areas, compared to other competition authorities in CEE.

171. The AMC does not make use of maximum fines for breaches of competition laws. It is entitled to apply fines of up to three times the unlawfully-earned profit in some instances, and even if the undertaking did not produce any turnover or information, the AMC can still impose a fine of up to UAH 340,000 (approximately €32,000). Thresholds for these amounts are determined and applied in other cases. However, many experts argue that the AMC rarely resorts to imposing maximum fines and as a

⁶⁴ Svehkar 2010.

⁶⁵ As reported by Kramar 2012, p. 14.

⁶⁶ The sector regulator is the Committee for the Regulation of the Energy Sector.

⁶⁷ Kramar 2012.

⁶⁸ OECD 2008.

⁶⁹ OECD 2008b, p. 92.

⁷⁰ An annual publication by a leading Central European law firm.

result, the sanctions often do not have the desired deterrent effect.⁷¹ In addition, only a small portion of the fines that the AMC does impose are paid. The 2008 OECD report notes that only 10 percent of the fines imposed in 2004-2007 were actually paid (Table 3). If penalties are not paid, the AMC must go to court for a judicial order. If, after this order, the fine is still not paid, the court order must be referred to Ukraine’s State Executive Service for Collection. According to UNCTAD’s 2013 report, the amount of paid penalties declined to only 5 percent in 2012, largely because many liable entities avoid payments by being liquidated, and then re-registered as new legal entities. Thus, even if the AMC applies large penalties, they do not serve as effective deterrents.

Table 3: Penalties Imposed and Collected Under the Competition Law and Unfair Competition Law

YEAR	PENALTIES IMPOSED		PENALTIES COLLECTED	
	UAH (MILLION)	EUR (MILLION)	UAH (MILLION)	EUR (MILLION)
2012	814.7	74.0	40.6	3.7
2011	43.5	4.4		
2010	27.1	2.7		
2007	11.6	1.7	5.9	0.9
2006	23.5	3.7	3.5	0.6
2005	4.0	0.6	2.3	0.4
2004	2.9	0.5	1.7	0.3
2003	102.8	17.1	1.9	0.3
Total	144.8	23.6	15.3	2.5

Source: OECD 2008, Kramar 2012 for 2010 and 2011 and UNCTAD for 2012.

172. Inadequate training among judges and prosecutors undermines the implementation of competition policy frameworks. Public prosecutors are commonly unfamiliar with the complexities of investigating anticompetitive conduct. Judges’ education is also not conducive to thorough analyses of the economic dynamics at play in the various cases, as it is based on a civil law tradition. As argued by UNCTAD, judges must be sufficiently specialized to “understand the wider implications of competition with respect to issues beyond pure law enforcement”.⁷²

173. The delay in enacting legislation on state aid is also a constraint to market competition. The EU-Ukraine Association Agreement requires Ukraine to apply EU-compatible rules on state aid.⁷³ The logic of the EU legislation on state aid is to ensure that government interventions do not distort competition and trade on the common market. State aid is generally considered to be incompatible with the common market. However, it is compatible in some cases of regional development, horizontal objectives (related to SMEs, employment, environment, research and development, and others), and sectoral aid. The EU frameworks provide guidelines on the types of aid that are acceptable, and the ways in which they should be applied. The process of granting incentives to firms needs to be clear, transparent, and competitive. EU authorities must be notified of some types of state aid schemes.

⁷¹ Haid 2010. See also the European Antitrust Review 2013 Ukraine: Merger Control and Kramar (2012).

⁷² UNCTAD 2013, p. 15.

⁷³ The AA states that: “Any aid granted by Ukraine or the Member States of the European Union through state resources which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods is incompatible with the proper functioning of this Agreement insofar as it may affect trade between the Parties” (Article 262).

174. **A new law on State aid is expected to be approved later this year.** Even as early as 2005, the draft law on state aid was supposed to pass “soon”. The draft Law on State Aid to Business Entities was drafted by the AMC with support of the EU-funded project described below in paragraph number 169⁷⁴, approved by the Cabinet of Ministers, and submitted to the Parliament in August 2012. But voting on the Law has not taken place yet. Many agencies within the Ukrainian government are administering state aid programs, and the AMC needs to be given the authority to assess and interdict aid on the basis of its prospective anticompetitive effect. The EU-funded project produced an introductory handbook on state aid, and prepared draft guidelines, templates and instructions for the state aid inventory that will be required by law. The project also provided some relevant training and staged public awareness activities.

175. **Finally, the AMC is in need of capacity-building and improved human resource management policies to address weaknesses identified in the completion report of the EU-funded project.** The Holzler report states that the AMC suffers from a large staff turnover, there is not much learning effect from the AMC’s participation in OECD, UNCTAD, ICN and other international conferences, and the fact that “AMC decisions are not published as to their legal deliberations for decision-making, the learning effect among the AMC employees is also limited, although the number of decisions made is high (more than 2000 decisions per year)”.⁷⁵

176. **The AMC has recently formulated new policy and enforcement priorities.** The draft Law on the “National Competition Program 2014-2020” has a number of important priorities, including harmonization with EU regulations, improvement in the implementation of state aid, improvement in the institutional framework for monopolized commodity markets, strengthened investigative powers, reduction of barriers to firm entry, and enhanced engagement of the civil society.

177. **The AMC has also engaged in preparatory and capacity-building activities, especially through the EU-supported project on “Harmonization of Competition and Public Procurement Systems in Ukraine with EU Standards”.**⁷⁶ The project helped the authorities develop the concept and draft action plan for the “National Program for Competition in Ukraine in 2014-2024”; it made recommendations on amendments to the competition law in some specific, technical areas; and it deepened the AMC’s understanding of EU guidance and practices in areas such as fines and transparency of decisions made by competition authorities. It also assisted the AMC with institutional development, training, and attendance of international conferences; and it helped draft amendments to public procurement laws. There are also additional initiatives in the area of competition law and policy undertaken by the Ukrainian authorities themselves, as well as Ukraine’s commitments under its draft AA and its Partnership and Cooperation Agreement with the European Union.⁷⁷

178. **However, enhancing competition will require more fundamental reforms.** The completion report of the EU-funded project on competition, state aid, and public procurement notes that the, “willingness to change the Ukrainian system in accordance with [developments in the EU and US] is limited,” attributing this limited political will to concerns related to political economy and rule of law.⁷⁸ Additional concerns include, for instance, that certain individuals or groups will not be able to influence state agencies to make favorable decisions that would protect their economic interests. Overcoming this will require deep institutional reforms in the longterm, including (i) the reform of the judiciary and the

⁷⁴ “Harmonization of Competition and Public Procurement Systems in Ukraine with EU Standards”.

⁷⁵ Holzler 2013, p. 38.

⁷⁶ Project carried out under the “Technical Assistance to the Commonwealth of Independent States” (TACIS) program of the EU, which aims to promote the transition to a market economy and reinforce democracy and the rule of law in partner states in Eastern Europe and Central Asia. See the completion report from this project (Holzler 2013).

⁷⁷ See Holzler 2013 for details.

⁷⁸ Holzler 2013, p. 38.

entire legal system, (ii) public administration reform, (iii) the reform of oversight bodies, and (iv) enhanced institutional transparency and accountability. These reforms are complex and politically difficult. They will require leadership and quick “early wins” to be sustained.

179. **The potential benefits of enhanced competition are large.** Signs of improved governance would give more confidence to domestic and foreign investors. This would increase economic activity, creating more jobs, spurring enterprise growth, and facilitating the transition to a more dynamic economy. It would also nudge Ukraine forward on its path to European integration.

180. **Specific recommendations to improve competition law and policy are listed below.** The recommendations are largely in line with the draft Law on the “National Competition Program 2014-2020”, the UNCTAD’s 2013 peer review report as well as the 2008 OECD peer review and Holzler’s 2012 and 2013 reports.

Policy Recommendations

SUGGESTED REFORMS	SHORT-TERM RECOMMENDATIONS	MEDIUM-TERM RECOMMENDATIONS
Competition	<ul style="list-style-type: none"> ◆ Amend the Commercial Code to eliminate conflicts with the competition laws. ◆ Enact the Law on State Aid to Business Entities and implement an effective system for controlling anticompetitive state aid, as per the commitments in the EU Association Agreement. ◆ Increase the AMC’s investigative power and capacity to collect evidence of wrongdoing. ◆ Adjust enforcement priorities to focus more on substantial violations of the competition laws. ◆ Modify merger/concentration notification and abuse of dominant position thresholds to focus on transactions likely to raise competitive concerns, including those involving entities concealing ultimate owners. ◆ Make more use of block exemptions for horizontal and vertical restrictions of competition. ◆ Issue and publish relevant guidelines, including those on mergers and abuse of dominance. ◆ Improve procedures for imposing and collecting monetary penalties imposed by the AMC, including by prosecuting willful wrongdoing. ◆ Amend the leniency program to allow leniency for more than one applicant. ◆ Increase transparency of decisions by publishing their full text on the AMC website. ◆ Expand international cooperation, including by creating effective twinning arrangements with counterparts in the European Union. ◆ Strengthen competition advocacy activities and outreach to the public. 	<ul style="list-style-type: none"> ◆ Pass legal amendments to harmonize Ukraine’s competition legislation with that of the European Union. ◆ Strengthen the <i>de facto</i> political independence of the AMC. ◆ Improve co-operation with other Ukrainian law enforcement agencies and investigative bodies. ◆ Clarify court jurisdiction for competition cases. ◆ Establish effective penalties for hard violations of the competition law. ◆ Provide adequate resources to ensure that the AMC can maintain high standards of performance in accomplishing its mission. ◆ Upgrade the investigative and analytical skills of the AMC staff, including in regional offices. ◆ Reduce the burden on the AMC in areas that should not belong to its core activities such as natural monopolies, public procurement and trademarks. ◆ Complete the institutional reform of AMC as outlined in the draft Law on “National Competition Program 2014-2024”. ◆ Work to create a “culture of competition” within the business community. ◆ Expand the use of market studies to better monitor levels of competition.

Concluding Remarks

181. **Ukraine seems to have many strengths that could help it to become Eastern Europe's future economic powerhouse.** It benefits from an attractive location with direct access to markets in the EU and the CIS, relatively high-quality human capital and abundant natural resources. It also has fertile agricultural lands, relatively well-developed infrastructure, and a large industrial base in the east of the country. Finally, it has notable space to boost productivity by simply absorbing technologies and ideas from abroad. These strengths, if managed properly, should allow Ukraine to start catching up with developed countries at a fast pace.

182. **However, Ukraine continues to struggle to turn its viable comparative advantages into competitive advantages and accelerated growth rates.** It remains among Europe's economic laggards, with current income levels below those from the beginning of the transition to a market economy and only at a fraction of those registered in neighboring countries, which started the transition at the same income level. Short-term growth projections suggest that the income gap between Ukraine and the neighboring countries will not diminish in the short term.

183. **The private sector has not been given a full chance to grow.** This note provides evidence that the private sector has been relatively stagnant since 1991. The structure of the country's exports has hardly changed in the past twenty years, and the sophistication of value-added products and services has not progressed. Levels and growth rates of productivity have remained below that of Ukraine's peers. There is hardly any export-oriented FDI, the proven engine of industrial restructuring, technology transfer and know-how in the neighboring new EU member states. The role of SMEs in the development of the formal economy is limited. In short, the market-driven process of entrepreneurial self-selection and self-discovery does not seem to work properly, thus undermining the country's growth prospects.

184. **The missed growth opportunities can largely be explained by a poor business environment.** Ukraine scores below peers in most international ranking on doing business, competitiveness, economic freedom, governance, and corruption. It also scores low in domestic opinion surveys among private sector entities operating in Ukraine. The low quality of the general business environment undermines entry of new firms, pushes firms into informality, weakens incentives to grow, and thwarts the will to compete with incumbents.

185. **To move ahead, Ukraine should emulate the more successful economies of the new EU member states in their decisive efforts to leave the past behind, and wholeheartedly embrace the principles of a properly functioning market economy.** It needs to break the vicious circle of weak governance, weak property rights, and poor business environment, driven by state capture, corruption, and political culture. Otherwise, the growth of the private sector will remain stunted, and continue to undermine Ukraine's economic development.

186. **This note provides recommendations on how to spur the growth of the private sector by improving the regulatory environment, enhancing access to finance, and increasing competition.** Based on the existing research as well as discussions with the Government, the private sector, the academia and NGOs, it diagnoses the situation in each of the three challenged issue areas. It focuses on specific obstacles to private sector development such as permits, licenses, certification and inspections; high cost of financing; inadequate credit information, and poor implementation of pro-competition policies. It provides short- and medium-term policy recommendations, including "quick-win" reforms that can be implemented quickly at a low cost, but with a large impact.

187. **However, this note also posits that more fundamental reforms will be needed for Ukraine to become an economic powerhouse.** The challenges include greater macroeconomic stability, enhanced public sector governance, improved financial sector stability, more robust technology absorption and

innovation, stronger property rights, and a more independent judiciary. Above all, however, Ukraine needs to crack down on state capture and corruption, the ultimate causes of its poor economic performance, and sustain strong political commitment and leadership. While calling for more research on the underlying causes of the poor business climate, this note recommends fighting state capture and corruption by fully opening the legislative process to public review, strengthening regulatory impact assessment (RIA) of new laws, ensuring full transparency and civil society involvement in public procurement and monitoring of state aid, and enhancing policy coordination among the private sector associations, especially those representing SMEs.

188. The adoption of AA and the DCFTA with the EU provides a historical opportunity to address many of the causes of Ukraine’s economic underperformance. Both agreements, especially if implemented efficiently, could provide the much-needed incentives for pro-reform political and social forces to *inter alia* improve public governance, ensure full independence of the judiciary, and enhance the level of competition in product and service markets.

189. Ukraine has a rendezvous with history. It can continue to muddle through, or it can reinvent itself as a success story. Committed, unwavering, and persistent leadership, as well as substantial changes in business culture, will be needed to achieve this goal.

2013 NATIONAL ACTION PLAN
of the Implementation of the Economic Reform Program for Years 2010 to 2014
“Prosperous Society, Competitive Economy, Efficient State”
World Bank Summary⁷⁹

**VI. DEREGULATION, ENTREPRENEURSHIP DEVELOPMENT AND REFORM
OF THE PROVISION OF ADMINISTRATIVE SERVICES**

Entering and Withdrawing from a Business

- 63 Simplification of the procedure for starting a business**
- 63.1.** Submission of a draft Law of Ukraine on incorporating amendments to some Laws of Ukraine concerning the simplification of the procedure for starting a business for consideration in the Verkhovna Rada of Ukraine, such draft Law providing, in particular, for:
- ◆ furnishing the state registrar in the course of state registration of a legal entity or a sole proprietor with information required by the state tax service authorities to register such legal entity or sole proprietor as payer of value added tax, single tax or other taxes and levies (provided that registration of such legal entity or sole proprietor as payer of a respective tax is envisaged by applicable law or under a decision of such legal entity or a sole proprietor);
 - ◆ abolishing the requirement to pay a registration fee for state registration of a legal entity or a sole proprietor;
 - ◆ state registration of a legal entity or a sole proprietor against electronic documents without mandatory affixation of a digital signature (using other means of identification);
 - ◆ principle of carrying out a business without a seal by entities governed by private law
-
- 63.2.** Submission of a draft Law of Ukraine on incorporating amendments to the Tax Code of Ukraine for consideration in the Verkhovna Rada of Ukraine, such draft Law providing, in particular, for:
- ◆ abolishing the requirement for a business entity to apply to state tax service authorities for registration as payer of value added tax, single tax or other taxes and levies if the respective information has been furnished to the state registrar in the course of state registration of the legal entity or sole proprietor;
 - ◆ shortening the time frame for notification of state tax service authorities by banks and other financial institutions of an account opening by tax payers and the time frame for notification of banks and other financial institutions by the state tax service authorities that the said accounts have or have not been taken record of

⁷⁹ Selected highlights of the 2013 National Action Plan. Unofficial translation.

**VI. DEREGULATION, ENTREPRENEURSHIP DEVELOPMENT AND REFORM
OF THE PROVISION OF ADMINISTRATIVE SERVICES**

Simplification of the Permit and Licensing System

66	Improvement of permit procedures	<p>66.1. Submission of a draft Law of Ukraine on incorporating amendments to the Law of Ukraine "On the Permitting System in the Field of Business" for consideration in the Verkhovna Rada of Ukraine, such amendments providing, in particular, for:</p> <ul style="list-style-type: none">◆ issue (re-issue, duplicate issue, cancellation) of permitting documents, executed by central executive agencies, to business entities by the state administrator at administrative service provision centres;◆ assigning it to the exclusive competence of the court to make decisions to cancel a permit subject to a request from a permitting agency if it has been ascertained that a business entity has furnished unreliable information or violated the law in the course of business covered by the permit <hr/> <p>66.2. Submission for consideration in the Verkhovna Rada of Ukraine of a draft Law on incorporating amendments to some Laws of Ukraine that govern relations associated with the obtaining of permitting documents by bringing them into conformity with the provisions of the Law of Ukraine "On Administrative Services" and of the Law of Ukraine "On the Permitting System in the Field of Business"</p> <hr/> <p>66.3. Submission for consideration in the Verkhovna Rada of Ukraine of a draft Law on incorporating amendments to the Law of Ukraine "On Radio frequency Resource of Ukraine" and other legal acts of Ukraine in respect of withdrawing government functions from the Ukrainian State Radio frequencies Centre State-owned Enterprise, including, in particular, provision of administrative services and involvement in state surveillance (control) measures</p> <hr/> <p>66.4. Adoption of regulations by the Cabinet of Ministers of Ukraine to approve procedures for the issue of permitting documents that must be obtained in accordance with the Law of Ukraine "On the List of Permitting Documents in the Field of Business"</p> <hr/> <p>66.5. Issue of an act by the Cabinet of Ministers of Ukraine to amend Resolution of the Cabinet of Ministers of Ukraine No. 725 of 25 August 2010 "On approval of the list of certain actions as to carrying out an economic activity or types of economic activity, which cannot be carried out based on a declaration of compliance of a business entity's material and technical facilities with the requirements of the law", by deleting the permitting documents, the obtainment of which is not mandatory under the Law of Ukraine "On the List of Permitting Documents in the Field of Business", from this list</p>
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**VI. DEREGULATION, ENTREPRENEURSHIP DEVELOPMENT AND REFORM
OF THE PROVISION OF ADMINISTRATIVE SERVICES**

68	Improvement of the mechanism for state regulation of the issue of permitting documents in the field of environmental protection	<p>68.1. Submission for consideration in the Verkhovna Rada of Ukraine of a draft Law of Ukraine on incorporating amendments to some legal acts of Ukraine, providing, in particular, for:</p> <ul style="list-style-type: none"> ◆ assigning decision-making functions in respect to the issue of permitting documents for the performance of operations in the field of hazardous waste management to the scope of powers of local executive agencies; ◆ mandatory annual notification of the Ministry of Ecology and Natural Resources of Ukraine by local executive agencies of the indicators of total waste generation in the regions; ◆ setting at least a three year validity period for permitting documents in the field of waste management; ◆ cancellation of the requirement to obtain waste generation limits; ◆ cancellation of the licensing of the business of collecting and procuring some types of waste as secondary raw materials (according to lists to be specified by the Cabinet of Ministers of Ukraine); ◆ shortening of the list of documents to be submitted by business entities to obtain permitting documents in the field of waste management, and the prohibition of additional expert appraisals of such documents on a paid basis; ◆ exemption of business entities generating waste, which are not subject to the entry into the Waste Generation, Processing and Disposal Facilities Register in terms of the total waste generation volume, from obtaining permitting documents for the performance of operations in the field of waste management; ◆ introduction of the submission of annual waste declarations by such entities via permitting centres and administrative service provision centres, and registration of such declarations; ◆ the reversal of provisions requiring the endorsement of the issue of permitting documents by central executive agencies in charge of implementing the state policy of state supervision (control) in the field of protection and sustainable use of water and water resource restoration, in the field of management and control of protection and use of water and water resource restoration <hr/> <p>68.2. Issue of an act by the Cabinet of Ministers of Ukraine to specify the procedure for the issue of permits to carry out operations in the field of waste management</p>
69	Simplification of the urban development permitting system	<p>69.1. Submission of a draft Law of Ukraine on incorporating amendments to the Law of Ukraine "On Regulation of Urban Development Activities" for consideration in the Verkhovna Rada of Ukraine, such draft Law providing, in particular, for:</p> <ul style="list-style-type: none"> ◆ approval by the Cabinet of Ministers of Ukraine of the procedure for categorizing a construction project under complexity categories I to V and the procedure for connecting a completed construction project to utility networks (other than electricity and gas networks); ◆ the right of the project principal to apply autonomous utility systems regardless of the availability of the required utility networks within the relevant area;

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**69 Simplification
of the urban
development
permitting
system**

- ◆ cancellation of the procedure for registration by the state architectural and construction control agency of declarations of the commencement of preparatory and construction works;
- ◆ the right of a project principal to dispute at court decisions to deny:
- ◆ registration of an object operation readiness declaration;
- ◆ issue of a certificate confirming the commissioning of completed construction projects of complexity categories IV and V;
- ◆ placement of the information about received notices of commencement of construction work, filed declarations of the commencement of preparatory and construction works, issued construction work execution permits on official web sites of the relevant state architectural and construction control inspectorates in order to secure free and at will access to the said information

69.2. Submission for consideration in the Verkhovna Rada of Ukraine of a draft Law of Ukraine providing for bringing the laws of Ukraine that govern the issues of connection to utility networks into conformity with the provisions of the Law of Ukraine "On Regulation of Urban Development Activities"

69.3. Submission for consideration in the Verkhovna Rada of Ukraine of a draft Law of Ukraine on incorporating amendments to some Laws of Ukraine, such amendments providing, in particular, for:

- ◆ cancellation of the requirement to obtain a permit for reequipping or rearranging a dwelling house or residential premises not interfering with load-bearing elements;
- ◆ specification of conditions for reconstruction and major repair of a dwelling house or residential premises (apartment);
- ◆ introduction of liability for the performance of construction works related to reconstruction or major repair of an apartment in a multi-dwelling building without obtainment of a document (declaration, permit) granting the right to perform such works, for the provision of inaccurate data in such a document, and for the operation of reconstructed apartments or apartments subjected to major repairs that have not been taken over for operation

69.4. Approval of the composition, contents and procedures of the issue of technical specifications for installing utilities at the construction project and procedures for determining the cost of services associated therewith

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69 Simplification of the urban development permitting system

69.5. Bringing the Procedure for the Issue of Construction Certificate for the Development of a Land Plot approved by Order of the Ministry for Regional Development, Building and Housing of Ukraine No. 103 of 5 July 2011, into conformity with the requirements of the Law of Ukraine "On Regulation of Urban Development Activities" by making, in particular, provisions for the following:

- ◆ issue of a construction certificate within ten business days of receipt of the respective application and appropriate document package;
- ◆ cancellation of the requirement for mandatory inclusion of technical specifications for utilities into the construction certificate;
- ◆ cancellation of the provision requiring a specifically authorized urban development and architecture agency to prepare the requirements for the development of a land plot as a separate document

69.6. Preparation and issuance of clarifications on the procedures for obtaining permitting documents in the field of construction for private developers and legal entities (depending on the construction project complexity), placement of printed copies of clarifications in permitting centres, administrative service provision centres, on the premises of authorized urban development and architecture agencies and state architectural and construction control agencies, in which developers are received, with the simultaneous placement of the electronic version of clarifications on official web sites of the said agencies

69.7. Bringing regulations of local executive agencies into conformity with the provisions of the Law of Ukraine "On Regulation of Urban Development Activities"

70 Further reduction in the types of economic activity, which are subject to licensing

70.1. Submission for the introduction by the President of Ukraine of a draft Law of Ukraine on incorporating amendments to the Law of Ukraine "On Licensing of Certain Types of Economic Activity" and other legal acts of Ukraine concerning a more than 50-percent reduction in the number of types of economic activity, which are subject to licensing

Strengthening Protection of Investors' Rights

71 Enhancing protection of investors' rights

71.1. Submission for consideration in the Verkhovna Rada of Ukraine of a draft Law of Ukraine on incorporating amendments to some legislative acts of Ukraine concerning the protection of investors' rights providing, in particular, for the right of shareholders to file actions with a court in the company's interests (derivative actions) to the extent permitted by applicable law (concerning, in particular, declaring revenue intensive transactions and related party transactions null and void)

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Reform of Customs Procedures

75	Reduction in the number of documents submitted for customs clearance	75.1. Introduction of electronic waybills (SMGS, CIM/SMGS, CIM) for non-excisable goods to replace customs declarations
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State Supervision (Control)

76	Streamlining and refining the procedure of state supervision (control) in the field of business; reducing the number of state supervision (control) measures, in particular by eliminating duplication of functions of the supervision (control) agencies	76.1. Submission for consideration in the Verkhovna Rada of Ukraine of a draft Law of Ukraine on incorporating amendments to the Law of Ukraine “On Fundamental Principles of the State Supervision (Control) in the Field of Business”, providing, in particular, for the following: <ul style="list-style-type: none">◆ shortening of the list of relations associated with the exercise of state supervision (control) in the field of business, which are not subject to operation of the Law;◆ mandatory publication of regulations, with which the compliance is checked in the course of state supervision (control) measures, on official web sites of state supervision agencies, and prohibition from checking compliance with the requirements that are not freely and accessible at will by business entities;◆ performance of a comprehensive scheduled inspection of a business entity during a calendar year together with state supervision (control) agencies permitted by law to carry out the relevant measures;◆ approval of the procedure for the development and implementation of comprehensive state supervision (control) measures by the Cabinet of Ministers of Ukraine;◆ publication of plans of comprehensive state supervision (control) measures on the official web site of a government authority in charge of implementing the policy of state supervision (control) in the field of business and on official web sites of state supervision (control) agencies by 20 December of the year preceding the year under planning;◆ removal of requests of legal entities and requests of individuals from the list of grounds for off-schedule state supervision (control) measures, unless the request is substantiated by pecuniary damage caused to the author (authors) of the request as a result of a violation of the requirements of the applicable law by a business entity or unless the entitlement to proper, safe and healthy lab our conditions, to the environment safe for life and health, safety of products, work and services guaranteed by the Constitution of Ukraine has been violated;◆ establishment of an integrated automated system of state supervision (control), which must contain information about business entities, automatic assignment of business entities to risk groups depending on the degree of risk associated with the exercise of business and frequency of performance of scheduled measures by each of the state supervision (control) authorities eligible to carry out such measures by law, as well as information about all of the performed (scheduled and off-schedule) inspections of the business entity with indication, in particular, of the inspection date, officers of the state supervision (control) agency who participated in the inspection, grounds for the off-schedule inspection, information provided in the certificate of inspection, and decisions of state supervision (control) agencies made as a result of the performed inspection;
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**VI. DEREGULATION, ENTREPRENEURSHIP DEVELOPMENT AND REFORM
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76 Streamlining and refining the procedure of state supervision (control) in the field of business; reducing the number of state supervision (control) measures, in particular by eliminating duplication of functions of the supervision (control) agencies

- ◆ placement of the generalized information about results of the performed state supervision (control) measures on official web sites of state supervision (control) agencies, detected typical violations and explanations of the contents of the relevant regulatory requirements;
- ◆ specification of the procedure for business entities to dispute actions of state supervision (control) agencies, their officers, and decisions of state supervision (control) agencies;
- ◆ introduction of administrative liability of officers of state supervision (control) agencies for violation of the procedure for performance of scheduled and off-schedule state supervision (control) measures

76.2. Submission for consideration in the Verkhovna Rada of Ukraine of a draft Law of Ukraine on incorporating amendments to legislative acts of Ukraine on state supervision (control) in the field of business, providing, in particular, for:

- ◆ specification of the list of state supervision (control) agencies, scopes of their supervision (control) and the subject matters of their supervision and control powers;
- ◆ bringing the legislative acts of Ukraine used as guidance by central executive agencies during performance of the state supervision (control) measures into conformity with the Law of Ukraine "On Fundamental Principles of the State Supervision (Control) in the Field of Business"

76.3. Development of a draft Law of Ukraine on incorporating amendments to some legal acts of Ukraine concerning response measures to be taken towards business entities and introduction thereof to the President of Ukraine for submission for consideration in the Verkhovna Rada of Ukraine, such draft Law providing, in particular, for:

- ◆ application of response measures to business entities (suspension of manufacture (production) or sale of goods and works, provision of services, etc.) solely under the administrative court decision in all areas of state supervision (control);
- ◆ definition of situations, in which the application of response measures to business entities (suspension of the manufacture (production) or sale of goods and works, provision of services, etc.) are to be carried out by state supervision (control) agencies subject to mandatory confirmation of reasonability of response measures in the field of state supervision (control);
- ◆ definition of specific features of proceedings under cases related to the confirmation of the reasonability of response measures taken by state supervision (control) agencies

76.4. Approval of the procedure for the development and implementation of comprehensive state supervision (control) measures by the Cabinet of Ministers of Ukraine

76.5. Approval of the Integrated Automated State Supervision (Control) System Development Program by the Cabinet of Ministers of Ukraine

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76 Streamlining and refining the procedure of state supervision (control) in the field of business; reducing the number of state supervision (control) measures, in particular by eliminating duplication of functions of the supervision (control) agencies	<p>76.6. Development of a pilot version of the Integrated Automated State Supervision (Control) System on the basis of the Uniform State Register of Legal Entities and Sole Proprietors, thus making it possible to automatically group business entities depending on the level of risk associated with the exercise of business, and the frequency of performance of scheduled measures by each of the state supervision (control) agencies</p> <hr/> <p>76.7. Adoption of the acts by the Cabinet of Ministers of Ukraine concerning the review of the criteria for the assessment of the degree of risk associated with the exercise of business in order to:</p> <ul style="list-style-type: none"> ◆ reduce the number and frequency of inspections; review the criteria for assigning business entities to high and medium risk groups for the purpose of narrowing the range of such business entities <hr/> <p>76.8. Approval of a common form for reports that are drawn up following the results of scheduled state supervision (control) measures, having provided, in particular, for:</p> <ul style="list-style-type: none"> ◆ their compliance with the recommended practices for developing checklists to carry out scheduled measures of state supervision (control) with due account for the degrees of risk associated with the exercise of business activities, as well as standard forms of reports drawn up following the results of scheduled measures of state supervision (control); ◆ setting up an exhaustive state supervision (control) checklist; ◆ preclusion (prohibition) of the measures of state supervision (control) on the issues that have not been included in the report's form <hr/> <p>76.9. Securing free and at-will access of business entities to the regulations, the compliance with which is checked in the course of scheduled and off-schedule measures of state supervision (control), by having such regulations placed on official websites of regulatory authorities</p> <hr/> <p>76.10. Adoption of regulations for the establishment of an efficient mechanism to coordinate the efforts of the state supervision (control) authorities, securing a consistent methodological approach to the development of draft regulations in the area of state supervision (control) concerning, in particular, the assignment of business entities to respective risk categories, preparation of common forms of reports drawn up following the results of state supervision (control) measures and the involvement of business associations and non-governmental organizations in these activities</p>
77 Optimization of activities of the state supervision (control) agencies, elimination of duplication of their functions	<p>77.1. Submission for consideration in the Verkhovna Rada of Ukraine of the draft Law of Ukraine on incorporating amendments to some Laws Ukraine concerning the elimination of the duplication of functions of the central executive agency in charge of implementing state policy in the field of supervision (control) over the agriculture industry (the State Agricultural Inspectorate of Ukraine) by making provisions for the transfer of powers of the State Agricultural Inspectorate of Ukraine to other central executive agencies as follows:</p>

VI. DEREGULATION, ENTREPRENEURSHIP DEVELOPMENT AND REFORM OF THE PROVISION OF ADMINISTRATIVE SERVICES

- 77 **Optimization of activities of the state supervision (control) agencies, elimination of duplication of their functions**
- ◆ control over compliance with occupational safety legislation — to a central executive agency in charge of implementation of the state industrial safety and occupational safety policy (the State Service of Mining Supervision and Industrial Safety of Ukraine);
 - ◆ control over the quality and safety of agricultural products, supervision and co-ordination of implementation of targeted programs and measures aimed at producing radiologically safe agricultural products and control over the content of radionuclides in agricultural products — to a central executive agency in charge of implementing state policy in the field of veterinary medicine, food safety, plant quarantine and protection, protection of the right to plant varieties and the state supervision (control) over pedigree management in animal husbandry (the State Veterinary and Phytosanitary Service of Ukraine);
 - ◆ control over fire safety at agro-industrial enterprises, institutions and organisations of all forms of ownership — to a central executive agency in charge of implementing the state policy in the fields of fire and technogenic safety (the State Emergency Service of Ukraine);
 - ◆ control over compliance with the consumer protection legislation — to a central executive agency in charge of implementation of the state policy in the field of the state control over compliance with the consumer protection legislation (the State Inspection of Ukraine for Protection of Consumers' Rights);
 - ◆ control over road traffic safety — to a central executive agency in charge of development and implementation of the state road traffic safety policy (the Ministry of Internal Affairs of Ukraine);
 - ◆ control over inspection of establishments for training, re-training and advanced professional training of tractor drivers/machine operators — to a central executive agency in charge of developing and implement the state policy in the fields of education and science (the Ministry of Education and Science of Ukraine);
 - ◆ control over laboratory analysis of land contamination (including radioactive contamination) in the zones of direct impact of contaminant discharges and emissions by enterprises and control in the event of accidents and emergency situations — to a central executive agency in charge of implementation of the state policy of state supervision (control) in the field of environmental protection (the State Environmental Inspectorate of Ukraine) and a central executive agency in charge of implementation of the state policy in the field of sanitary and epidemic well-being of the population (the State Sanitary and Epidemiological Service of Ukraine);
 - ◆ metrological supervision and control over compliance with the requirements of standards and regulations, metrological support to radiation and dose metering control in the course of producing and processing of agricultural products in the prescribed control zones — to a central executive agency which isa specially authorized body in the field of metrology (the Ministry of Economic Development and Trade of Ukraine)

Annex 2

Overview of the Regulatory Guillotine

The regulatory guillotine is a process of evaluating the entire stock of regulations that leads to an automatic repeal by a set deadline of all regulations, which do not continue to provide social value.

The guillotine is designed to be quick and efficient and implemented according to clear and understandable rules. This increases the likelihood of successful reform and prevents the blocking of reforms by vested interests. Filters and criteria used during the guillotine process can be used for the further evaluation of new regulations.

The objectives of the regulatory guillotine include:

1. Reducing administrative costs of doing business by cancelling a large number of unnecessary rules.
2. Changing the motivation of regulatory bodies, ensuring an attitudinal change and transfer from passive resistance to support of reforms.
3. Setting up of an active consultation process with business and other stakeholders.
4. Introducing a solid procedure for the future control of safety and quality assurance of regulations, primarily through reviewing the stock of regulations, establishing a regulatory registry and the subsequent analysis of all new regulations.
5. Creating an institutional infrastructure for sustained and effective implementation of the reform in general, including mechanisms of interaction between regulatory bodies and building capacities for performing regulatory analysis.

The essential principles of the guillotine are that:

- *There is no selection bias* in that all regulations in the scope of the guillotine are reviewed. That is, the scope is determined top-down and comprehensive in the field of regulations included in the guillotine;
- *The burden of proof is reversed in favor of reform.* In the listing approach, reformers must make the case for why reform is needed. This is reversed in the guillotine. The presumption is that all regulations in the scope of the guillotine will be eliminated UNLESS they are shown to meet basic standards of need, legality, and market friendliness within the time frame of the reform. In other words, those who want to keep the regulations must defend them. This threat provides the key incentive for cooperation in the reform.
- *The review is fast and the final decision is taken collectively by the Council of Ministers or the Parliament without the need for an individual decision on each affected regulation.* This avoids reform fatigue and reduces the capacity of insider interests to block change.
- *The filters and criteria used for the guillotine review process can be used on an ongoing basis* to review new regulations within the scope of the guillotine, that is, the guillotine is the first step of the larger regulatory strategy. This ongoing regulatory quality management is strengthened by the establishment of an electronic registry of regulations with positive security that is self-enforcing.

This guillotine process can be broken down into the following steps:

1. The government establishes the scope of the guillotine, that is, defines precisely the kinds of regulatory instruments to be included.
2. The government adopts a legal instrument that sets out the guillotine process, schedule, and institutions.
3. The legal instrument contains a set of explicit and simple criteria that define which regulations pass and which regulations fail. Three common criteria are: (i) Is the regulation legal (has it been published and is it authorized by parliamentary law)?, (ii) is the regulation necessary for the future policy priorities of the country?, and (iii) is the regulation business friendly?
4. The regulations are passed through three filters or review processes. In each filter, unnecessary, outdated, and illegal rules are identified, and excluded from the list. In the first review, all government agencies establish lists of their regulations within the scope of the guillotine by a certain date, and justify those regulations that they want to keep; in the second review, the lists are reviewed by a central review unit which carries out the same review of regulations that passed the first review; in the third review, the lists are reviewed by stakeholders and recommendations are given to the central review unit.
5. Once the final review is completed, a centralized list is created by adding all the ministries' lists together. When the deadline is reached, any regulation not on the list is automatically cancelled without further legal action or further legal action is scheduled to eliminate any rules not on the list (the guillotine drops).
6. The list defines the contents of a comprehensive electronic registry of all regulations in force, and is recognized in law as the legal database of regulations for purposes of compliance.
7. In future, all new regulations and changes are entered in the registry within one day of adoption and/or publication. The registry should have legal security – no regulation not in the registry can be enforced against a business.
8. This process is explicitly a top-down and rather brutal approach to reform. It is designed to break through the paralysis and interest group capture that so often slow and blocked reforms. Its implementation requires the careful design of three strategies: an administrative strategy to enable a highly structured “top-down” review process with clear filters and incentives for reform; a legal strategy for an over-arching legal process within the legal system of the country; a political strategy to support the brave ministers who champion this reform, and to gain and sustain support for a radical reform affecting many stakeholders.

Source: Based on Jacobs and Astrakhan (2006).

Annex 3

Overview of the Regulatory Impact Assessment (RIA)

Objective

The objective of RIA is to improve the quality of regulation. Regulation only maximizes community welfare when it is effective, efficient and transparent. However, the impacts of regulation, both positive and negative, are not always apparent. For example, the behavior of firms and individuals will often change in response to regulation, but these changes are often subtle and difficult to predict or measure. The problem of understanding regulatory impacts is especially acute when the longer-term is considered, because the impacts of regulation can often change substantially as the economic and social environment in which it operates changes. Indeed, decisions about regulation are often based on limited information and in some cases ‘guesses’ regarding who is affected and how. Therefore, a systematic approach is needed to identifying and weighing regulatory effects. Only in this way can policymakers be confident that the benefits of a policy action are likely to be greater than the costs. Only if total benefits exceed costs will society as a whole be better off as a result of regulation.

While there is no one single definition of RIA, RIA systems have several common elements and features which are evident in all countries with functioning RIA systems. A common feature of RIA is that each country with RIA has used this process to strengthen existing decision making processes, not replace them. Furthermore, existing RIA process include (i) a *process* of systematically identifying policy options and assessing the expected effects of regulatory proposals, using a consistent analytical method; and (ii) a *document* presented to policy makers summarizing potential alternatives, their impacts and implementation aspects of proposed measures.

Who does it?

RIA is prepared by regulatory departments, agencies or ministries — sometimes called regulators — which sponsor new or amended regulation. The regulators responsible for areas of regulation are generally best placed to understand and regulatory problems, issues and possible solutions in their area of responsibility. Regulators also typically have links with affected stakeholders, have a relatively good understanding of the impact of regulation on them and are well placed to lead consultation processes on regulatory issues. That said, such regulatory agencies also can have an entrenched culture which is risk averse or conservative and, therefore, is not open to new ideas or approaches to regulation. Regulators can be ‘captured’ by the businesses they regulate and seek to benefit these businesses, even if this is at the expense of consumers and broader society. Indeed, regulators may also benefit from particular regulatory outcomes, for example, because their budgets or staff can gain from particular regulatory solutions or approaches. For these reasons, the RIA process is usually supervised by an independent unit or group based in a central agency. This unit is not involved in regulating business and does not have vested interest in particular regulatory outcomes. Therefore, it can provide regulators and ultimately decision-makers with high quality, trusted and impartial advice about regulatory issues and the quality of analysis contained in RIA.

The potential benefits of RIA

The main focus of RIA is to improve the quality of regulation. A common feature of poor quality regulation is that the underlying problem and objective of an existing (or proposed) regulation are not clearly identified. The RIA process favors the identification of the underlying policy problem and then an objective which is focused specifically on addressing the problem. Clearly identifying the policy problem and then objective is necessary in high-quality regulatory policy analysis and development. There are usually several different policy actions that could potentially be taken to achieve a particular objective. However, only if the policy problem and objective are properly identified can a ‘menu’ of possible and feasible solutions be identified. The RIA process is also inherently an evidence based approach to scrutinizing and comparing several policy options. It involves not only comparing the impacts, positives and negatives (e.g. benefits and costs) likely to be associated with a particular policy action. RIA also compares these expected outcomes with those that would result from the other possible policy actions that could also be taken in pursuit of the same objective. RIA helps identify information gaps, highlighting where information collection programs should be focused. For example, RIA encourages the use of consultation with stakeholders in considering how identified problems might be fixed. Consultation can also be a useful way of collecting information about possible solutions and the likely impacts.

Only if governments choose a policy response — or mix of responses — that is based on high quality and reliable information can governments be confident that they are making the right choices. Indeed, if government decisions are based on poor quality information then such decisions are essentially based on guesses and, therefore, are likely to result in ‘regulatory failure.’ In addition to limited information, governments also have limited capacities to make, administer and enforce regulation. This, in itself, means that governments must take care before committing to new regulatory requirements. Indeed, there are limits to the amount of regulation that any government can impose. Some critics of the use of RIA have questioned whether it is appropriate to all legal and constitutional contexts or whether its development largely reflects the specific circumstances of the common-law countries in which it has historically been largely developed. In assessing this view, it is important to bear in mind that the expected result of applying the RIA model is the provision of better information to political decision-makers. These outcomes are clearly desirable in all political, legal and institutional contexts. The key premise underlying RIA is that decision-makers will make better decisions — and the quality of regulation will be better — if decision makers are presented with better quality information, prior to making decisions. In these ways, RIA can contribute to the improvement of all the different aspects of regulatory quality. Better quality regulation is less restrictive of business, effectively protects consumers, better protects citizens’ rights, especially those of vulnerable groups, and reduces opportunities for corruption.

Further benefits of RIA are that it (i) does *not* necessarily involve making significant institutional and processes changes, (ii) does not require significant additional resources or fiscal outlays and (iii) results not only in more and better information being made available, but also that this information is presented in a systematic, logical manner.

Source: Based on World Bank. 2010. “Making It Work: “RIA Light” for Transition and Developing Countries”. Investment Climate Advisory Services. The World Bank Group.

Annex 4

Actions Under the Proposed EU-Ukraine Association Agreement: the Financial Sector (Appendix XVII-2 of the Proposed AA)

Banking sector

- Directive 2006/48/EC of the European Parliament (EP) and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (here in after referred to as “Directive 2006/48/EC”). Within four years:
 - principles of prudential supervision;
 - large exposures provisions;
 - definition of own funds;
 - requirements for access to the taking up and pursuit of the business of credit institutions;
 - relations with third countries;
 - Basel I (capital requirements for credit risk, position risk, settlement and counter party risk, FX and commodity risk);
 - Within 6 years: Basel II, Title V Chapter 4 on supervision
- Commission Directive 2007/18/EC of 27 March 2007 ... as regards the exclusion or inclusion of certain institutions from its scope of application and the treatment of exposures to multilateral development banks (4 years)
- Directive 2007/44/EC of the EP and of the Council of 5 September 2007 ... as regards procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of holdings in the financial sector (6 years)
- Directive 2006/49/EC of the EP and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (4-6 years)
- Directive 2002/87/EC of the EP and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (4 years)
- Directive 2009/110/EC of the EP and of the Council of 16 September 2009 on the taking up, pursuit of and prudential supervision of the business of electronic money institutions (4 years)
- Directive 94/19/EC of the EP and of the Council of 30 May 1994 on deposit-guarantee schemes (4 years)
- Council Directive 86/635/EEC of 8 December 1986 (and Directive 2003/51/EC of the EP and of the Council of 18 June 2003 and Directive 2006/46/EC of the EP and of the Council of 14 June 2006) on the annual accounts and consolidated accounts of banks and other financial institutions as well as Directive 2001/65/EC of 27 September 2001 as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions (4 years)
- Council Directive 89/117/EEC of 13 February 1989 on the obligations of branches established in a Member State of credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents (4 years)
- Directive 2001/24/EC of the EP and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions (4 years)

Insurance sector

- Directive 2009/138/EC of the EP and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (4-8 years)
- Directive 2009/103/EC of the EP and the Council of 16 September 2009 relating to insurance against civil liability in respect of the use of motor vehicles, and the enforcement of the obligation to insure against such liability (codified version) (2-8 years)
- Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings (4 years)
- 92/48/EEC: Commission Recommendation of 18 December 1991 on insurance intermediaries (no need of legislative changes)
- Directive 2002/92/EC of the EP and of the Council of 9 December 2002 on insurance mediation (2 years)
- Directive 2003/41/EC of the EP and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision (2 years)

Securities

- Directive 2004/39/EC of the EP and of the Council of 21 April 2004 on markets in financial instruments (4 years)
- Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the EP and of the Council as regards organizational requirements and operating conditions for investment firms (4 years)
- Directive 2004/39/EC of the EP and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading (4 years)
- Directive 2003/71/EC of the EP and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and other directive regarding prospectus and disclosure (4 years)
- Directive 2004/109/EC of the EP and of the Council of 15 December 2004 (and Commission Directive 2007/14/EC of 8 March 2007) on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading (4 years)
- Directive 97/9/EC of the EP and of the Council of 3 March 1997 on investor-compensation schemes (4 years)
- Directive 2003/6/EC of the EP and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) (4 years)
- Commission Directive 2004/72/EC of 29 April 2004 implementing Directive 2003/6/EC of the EP and of the Council as regards accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspicious transactions (4 years)
- Commission Directive 2003/125/EC of 22 December 2003 implementing Directive
- 2003/6/EC of the EP and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest (4 years)

- Commission Regulation (EC) No 2273/2003 of 22 December 2003 implementing Directive 2003/6/EC of the EP and of the Council as regards exemptions for buy-back programs and stabilization of financial instruments (4 years)
- Regulation (EC) No 1060/2009 of the EP and of the Council of 16 September [2009] on Credit Rating Agencies (4 years)
- 10 more Directives related to information disclosures, prevention of abuse and conflict of interests on securities markets

Collective Investment in Transferable Securities (UCITS)

- Directive 2009/65/EC of the EP and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (4 years)
- Commission Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the EP and of the Council as regards organizational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depository and a management company (4 years)
- Directive 2009/65/EC of the EP and of the Council as regards certain provisions concerning fund mergers, master-feeder structures and notification procedures (4 years)
- Three more directives related to activities of UCITS

Market infrastructure

- Directive 2002/47/EC of the EP and of the Council of 6 June 2002 on financial collateral arrangements (6 years)
- Directive 2009/44/EC (and Directive 98/26/EC) of the EP and of the Council of 6 May 2009 amending Directive 98/26/EC on settlement finality in payment and securities settlement systems and Directive 2002/47/EC on financial collateral arrangements as regards linked systems and credit claims (6 years)

Other issues related to financial services markets:

- Directive 2007/64/EC of the EP and of the Council of 13 November 2007 on payment services in the internal market (5 years)
- Directive 2005/60/EC of the EP and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (2 years)
- Directive 2005/60/EC of the EP and of the Council as regards the definition of 'politically exposed person' and the technical criteria for simplified customer due diligence procedures and for exemption on grounds of a financial activity conducted on an occasional or very limited basis (2 years)
- Regulation (EC) No 1781/2006 of the EP and of the Council of 15
- November 2006 on information on the payer accompanying transfers of funds (2 years)
- Articles of TFEU related to free movement of capital and payments (time table to be decided separately)

Financial Consumer Protection / ADR (ANNEX XXXVIII)

Among numerous consumer protection measures, AA provides for concrete steps in the financial sector. Within 3 years Ukraine undertakes to implement:

- Directive 2002/65/EC of the EP and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC
- Directive 2008/48/EC of the EP and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC

Ukraine will also take into account (without making legislative changes):

- Recommendation on principles applicable to out-of-court settlement (98/257/EC) Commission Recommendation of 30 March 1998 on the principles applicable to the bodies responsible for outof-court settlement of consumer disputes
- Recommendation on consensual resolution out-of-court (2001/310/EC) Commission

Recommendation of 4 April 2001 on the principles for out-of-court bodies involved in the consensual resolution of consumer disputes

Furthermore Ukraine undertakes to implement Rules of Procedure for Dispute Settlement and Code of Conduct for Members of Arbitration Panels and Mediators

Corporate Governance, Accounting and Auditing (ANNEX XXXIV)

Within two-four years Ukraine undertakes to implement a number of measures to improve corporate governance and other measure aimed at strengthening capital markets:

- Commission Directive 2007/14/EC of 8 March 2007 laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (4 years)
- Directive 2004/109/EC of the EP and of the Council of 15 December 2004 on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC (4 years)
- Directive 2007/36/EC of the EP and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies(4 years)
- Fourth Council Directive of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies (78/660/EEC) (3 years)
- Seventh Council Directive of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts (83/349/EEC) (3 years)
- Regulation (EC) No 1606/2002 of the EP and of the Council of 19 July 2002 on the application of international accounting standards (2 years)
- Directive 2004/25/EC of the EP and of the Council of 21 April 2004 on takeover bids (4 years)
- Additionally Ukraine undertakes to observe OECD Principles on Corporate Governance

Source: based on the proposed text of the Association Agreement between Ukraine and the European Union.

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