Investment in Ukraine

Barbara Peitsch

Since Ukraine gained its independence in 1991, there has been a substantial improvement in its framework for foreign direct investment.¹

L
ike most of the other former Soviet republics, Ukraine is on the path from being a centrally planned economy to one based on market principles. It has recently made sweeping changes to its legislation in order to promote reform. With a new law on foreign direct investment (FDI), adopted in 1996, the implementation of an ambitious privatisation programme, and several new commercial laws regulating foreign trade, taxation and banking, the legal and regulatory framework for investment, and for commercial activity in general, is now much more transparent than it used to be and should facilitate FDI.

Between 1991 and 1995 hyperinflation, political instability (there were two presidents and seven cabinets in those four years) and volatile regulations were strong disincentives to investment in Ukraine. Up to the beginning of 1995 Ukraine had attracted only $150 million. The stock of FDI in Ukraine nonetheless doubled by the end of 1995, to over $300 million, thanks largely to improved economic performance and a more reform-oriented government. As of the beginning of September 1996, the cumulative stock of FDI is estimated to have reached $900 million. Although this increase is an indication that the climate for investment is improving, FDI in Ukraine remains low, particularly when measured on a per capita basis (Table).

By country of origin, companies based in the United States account for 22.8% of the total amount invested, followed by those based in Germany (17.3%), the Russian Federation (7.0%), the United Kingdom (6.2%), Cyprus (5.1%) and Switzerland (4.7%). Most FDI was channelled into commerce (26.4%), agricultural processing (14.5%), machine building (12.8%), transportation and communications (4.1%) and the chemical sector (3.7%). Geographically, the cities of Kiev, Lvov, Odessa, Dnipropetrovsk, Donetsk and Zakarpattya have attracted more than 70% of total investment to date.

The Legal Framework

The legal framework for FDI in Ukraine has improved over time. A first ‘Law on Foreign Investment’, passed in 1992, provided extensive tax ‘holidays’ (up to ten years for some sectors and investments of a given size) but did not stimulate substantial inflows of FDI.² In 1993, the initial law was superseded by a decree from the Cabinet of Ministers, which introduced the notion of ‘qualified foreign investment’. This decree was also based on tax-incentives but set conditions which had to be met before the investor would qualify for any of them. In 1995, the Ukrainian Parliament passed a new law on the taxation of profit, which applies equally to all enterprises, both domestic and those with foreign participation. The new foreign-investment law followed shortly thereafter and eliminated all automatic tax incentives previously granted.


Barbara Peitsch works in the Capital Movements, International Investment and Services Division of the OECD Directorate for Financial, Fiscal and Enterprise Affairs.

E-mail: daf.contact@oecd.org

Energy is a priority sector for the Ukrainian government, although export restraints and other factors limit its attractiveness to foreign investors.
to foreign investors, since it had been found that incentives alone were not effective in attracting FDI.

In 1996, Ukraine revised its legislation on FDI for the third time in four years. Unlike the previous legislation, which was focused on incentives for enterprises with FDI, the new legislative approach is to strengthen the national-treatment regime - that is, to set up non-discriminatory legal conditions for both foreign and domestic investors.

The attraction of additional FDI is a top policy priority for the Ukrainian government and the reason for the establishment, in 1996, of the National Agency for Reconstruction and Development (NARD). The NARD has the status of a ministry and is responsible for promoting investment and improving the legal framework by streamlining existing rules and regulations. The Ukrainian State Credit and Investment Company was set up in 1995 to finance investment projects and to oversee implementation of the government’s investment programme. Although it tends to focus more on domestic investment, to the extent that foreign investment is required to support particular projects, it co-ordinates closely with the NARD and relevant ministries. In addition, there are departments within a number of governmental bodies (for example, the Cabinet of Ministers, the Ministry of Finance, the Ministry of Economy, and the Ministry of Foreign Economic Relations) that deal with issues related to FDI.

To enjoy the guarantees and benefits provided by the foreign investment law, an investment must be registered with the appropriate authorities (usually the regional or city administration) within three days after it has been made. The investor will be notified that registration has occurred within three working days from receipt of all required documentation. The registration office also requires that it be notified if and when an investment is terminated (it is no longer necessary to register commitments to invest). All companies, including those with foreign participation, must also register with the local tax-authorities, the local social-security office and with the national pension fund within ten days from the date of their state registration.

There are still some sectors in Ukraine - including banking, insurance, and heavy industry where damage to the environment could result - in which neither foreign nor domestic investors can invest without special permission, which has to be granted by the Cabinet of Ministers of Ukraine or its authorised body. As in most of the other former Soviet republics, the production of drugs, weapons and ammunition, and explosives is restricted to state-owned enterprises only and is therefore closed to foreign investment. Restrictions also affect other activities, but the lists change often and do not always promote liberalisation.

Those exceptions apart, national treatment for foreign investors is provided by the current legislation, which states that foreign investors are to be treated no less favourably than Ukrainian nationals.

### Investment Protection

The law adopted in 1996 protects FDI in several ways. It allows for the full repatriation of profit, invested capital and wages of expatriate employees in hard currency - once all taxes and outstanding debts have been paid. In the event of nationalisation or expropriation, the 1996 law guarantees prompt compensation in hard currency equal to the present value of the amount initially invested. In addition, it provides a ten-

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>..</td>
<td>38,524</td>
<td>56</td>
<td>171</td>
<td>196</td>
<td>150</td>
<td>17</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>..</td>
<td>612</td>
<td>1,123</td>
<td>586</td>
<td>860</td>
<td>2,500</td>
<td>242</td>
</tr>
<tr>
<td>Hungary</td>
<td>..</td>
<td>1,459</td>
<td>1,471</td>
<td>2,339</td>
<td>1,147</td>
<td>4,400</td>
<td>426</td>
</tr>
<tr>
<td>Poland</td>
<td>..</td>
<td>117</td>
<td>284</td>
<td>580</td>
<td>542</td>
<td>2,500</td>
<td>64</td>
</tr>
<tr>
<td>Romania</td>
<td>..</td>
<td>42</td>
<td>80</td>
<td>94</td>
<td>342</td>
<td>400</td>
<td>17</td>
</tr>
<tr>
<td>Russia</td>
<td>..</td>
<td>..</td>
<td>500</td>
<td>1,000</td>
<td>1,100</td>
<td>2,000</td>
<td>13</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>..</td>
<td>..</td>
<td>234</td>
<td>350</td>
<td>516</td>
<td>200</td>
<td>36</td>
</tr>
<tr>
<td>Slovenia</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>150</td>
<td>..</td>
<td>73</td>
</tr>
<tr>
<td>Ukraine</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>150</td>
<td>300</td>
<td>6</td>
</tr>
</tbody>
</table>

.. not available.

year guarantee against changes in legislation that would adversely affect a foreign investor.

Ukraine has signed bilateral investment treaties with 15 countries, eight of which are members of the OECD – Canada, the Czech Republic, Denmark, Finland, France, Germany, Poland and the United States. Such treaties enhance the guarantees provided in the 1996 law, provide for national treatment and/or most-favoured-nation status for FDI. Investment from those countries which have a treaty may thus be able to import machinery and other equipment duty free, or at concessional rates, with possible exemptions for investment in selected sectors of the economy, such as banking, insurance and heavy industry, and procedures for international arbitration in the settlement of disputes that arise between foreign investors and the state.

**Some Incentives Remain**

Although in general tax incentives to attract FDI have been abolished, Article 7 of the 1996 law does allow for their provision on a case-by-case basis if the investment has been made in a priority region or sector. Priority sectors include energy (especially energy conservation), food-processing, shipbuilding, aviation, chemicals, electronics and light industry while the regions targeted for development through FDI include Odessa and the eastern industrial regions. But it is still not clear which government agency will authorise the incentive(s), and under what circumstances.

FDI in the form of an ‘in-kind contribution’ is exempt from customs duties and VAT. A new mechanism for the customs clearance of non-cash investment was introduced in 1996. Such investment will be cleared by the customs against a promissory note issued by the investor. The investment will be exempt from customs duties if the promissory note is settled within 30 days; with possible exemptions for investment in machinery and other equipment for assembly.

Products manufactured by an enterprise with foreign participation are exempt from export duties. Where goods are imported to Ukraine for assembly, foreign investors are not required to remit the foreign investor’s own production in Ukraine in lieu of taxes, while allowing the government to maintain ownership and control of the resource. Ukraine participates, moreover, in the Network of Co-operation between Investment Promotion Agencies established by the OECD Istanbul Centre in 1996, which allows Ukrainian officials to regularly consult their peers on policy, promotional techniques and other matters. This network is especially important for a country like Ukraine, which to date has relatively limited experience in investment promotion.

### FOCUS: Ukraine and the OECD

The OECD has been working with Ukrainian authorities in revising the country’s FDI and related legislation. If adequate funding is available, a group of experts, under the auspices of the Committee for Investment and Multilateral Enterprises (CIME), will meet later this year to assist in the drafting of legislation on production sharing and concession agreements. Legislation on the sharing of production would improve conditions for investment in energy by allowing all investors, both domestic and foreign, to provide the government with an agreed amount of product in lieu of taxes, while allowing the government to maintain ownership and control of the resource. Ukraine participates, moreover, in the Network of Co-operation between Investment Promotion Agencies established by the OECD Istanbul Centre in 1996, which allows Ukrainian officials to regularly consult their peers on policy, promotional techniques and other matters. This network is especially important for a country like Ukraine, which to date has relatively limited experience in investment promotion.

Foreign investors are also exempt from the 50% mandatory sale of hard-currency export revenue, which applies to local companies, who must exchange half of all hard-currency revenue from exports for local currency with the National Bank upon receipt, at the official rate set on that day. But this exemption is authorised only if the hard currency was obtained through the sale of the foreign investor’s own production in Ukraine (goods or services). Foreign investors are not exempt from the mandatory sale if they re-export goods manufactured elsewhere and imported to Ukraine for assembly.

In October 1992, preferential conditions for economic activity undertaken by both foreign and domestic investors were established in ‘free economic zones’. At present, only two such zones exist, one in Odessa and one in Uzhgorod. Although both have been established from a legal point of view, no investment has entered since their creation. Other free economic zones are in the process of being created. Since each zone has the right to set its own conditions, some are likely to be more concessional than others.

Ukraine has made considerable progress over the past 18 months in stabilising its economy. The political leadership is clearly committed to reform. The legal framework is now more liberal and transparent, but more work is required, particularly in legislation outside of the FDI law that applies to both foreign and domestic investors, such as taxation, property rights and exchange controls. In addition, existing legislation must be more effectively implemented. Tax evasion remains a problem among entrepreneurs and small and medium-sized businesses, which has led the Finance Ministry to tax trade and investment excessively, since the revenue is easier to collect. Legislation that would stimulate investment in energy and natural resources, on production sharing and concession agreements, is still missing. The recent increase in FDI has made Ukrainian officials realise that the benefits of FDI – not least the creation of jobs, the transfer of technology and access to new management techniques and expertise – far outweigh the costs of foreign ownership and control of assets.

---

**OECD Bibliography**

- *Foreign Investment in Russia*, The OECD Observer, No. 193, April/May 1995