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ECONOMIC REGIME AND FOREIGN DIRECT INVESTMENT IN UKRAINE

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Abstract

An economic regime might take the form in which extractive institutions do not allow for the proper development of foreign direct investment. In consequence these countries cannot fully benefit from economic aspects of globalization and increasing standards of living. This is the case of Ukraine, acountry with very good location advantages and awell-educated workforce that attracts only the murky type of FDI. It is acountry that is troubled by corruption and political instability but at the same time acountry that began the path to finding its national identity by fighting against extractive institutions.

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Introduction

To attract FDI, regions need a good institutional environment, a liberal taxation policy, etc. To enhance factors that determine regional attractiveness, they sometimes use special incentives (i.e. special economic zones and CIT reduction). Multinational corporations (perhaps with the exception of natural-resource seekers) are also highly interested in intellectual property (IP) rights crucial for transfer and development of technology and know-how, patents or trademarks and even managerial expertise (Hymer, 1976). FDIs attracted by favorable IP could create various positive spillover effects (Javorcik & Spaterenau, 2005) responsible for certain aspects of globalization. But knowledge-intensive FDI usually settles around locations with well-trained human capital, educated to use complicated machinery. According to the Global Competitiveness Report (2013), Ukraine ranks 63rd among 122 countries in the Human Capital Index with education levels similar to Malaysia (22nd), Jordan (52nd) and Bulgaria (56th). Despite that, in comparison to the above-mentioned countries, the country has little luck attracting FDI.

One of the main factors that influence investment decisions is the risk associated with costs and financing (Wilson, 2000). The other risk factors consistent with popular macroeconomic FDI theories referring to risk-bearing and conditionality is described in the works of Hymer (1976), Dunning (2001), etc. In short, the cost of investment is related to

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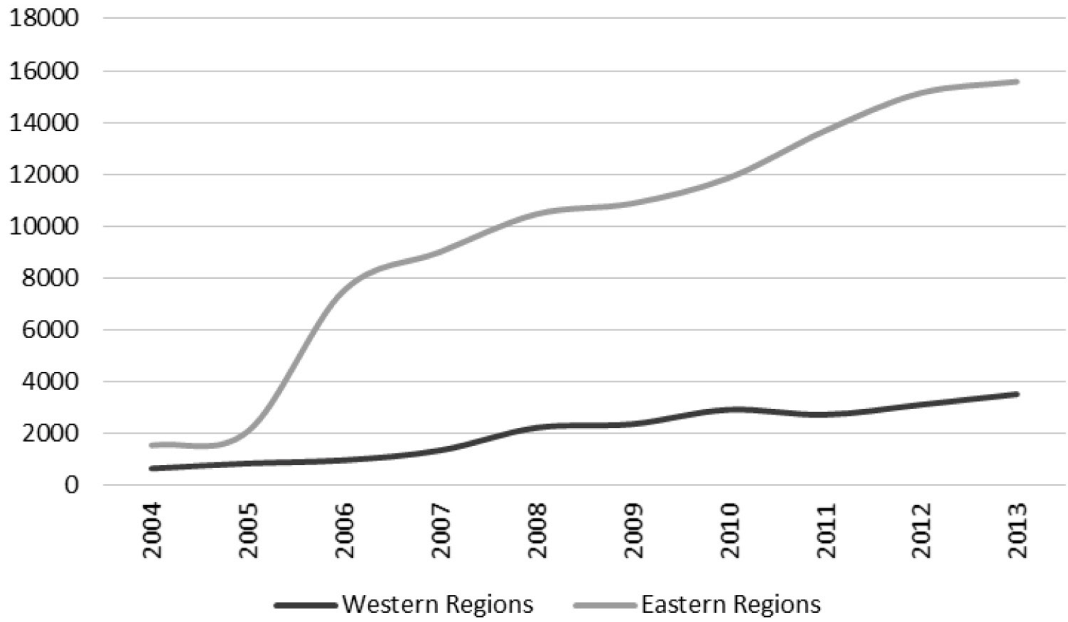
its risk and expected outcomes, opportunity costs and marginal costs associated with the ability to produce a particular good or service at a competitive rate. This is why some regions with better economic regimes display comparative advantages even though they lack natural resources. Ukraine's situation is the opposite, with its excellent localization factors the country should attract a significant amount of FDI, however it does have extractive institutions (Acemoglu & Robinson, 2012) which partially explains some of the recent events and Ukraine's struggle to maintain its integrity after 23 years of independence.

Regional distribution of FDI in Ukraine

Ukraine achieved independence in 1991 coming from the deep communism of the Soviet Union. Since then, the ruling parties have been trying to conduct a series of institutional reforms, but most of them have not reduced investment risks and costs of doing business. In fact when it comes to institutional support for business, reduction of corruption or bureaucracy, Ukraine is known for its negative tendencies in relation to other Commonwealth of Independent States (CIS) countries (Herzfeld & Weiss, 2003). Despite that, in 2012 – according to the National Bank of Ukraine (NBU), the inflow of FDI to Ukraine reached 7.8 bn USD which is 8.7% more than in 2011. When compared, the first half of 2013 and 2012, the value of foreign capital was lower by 63.4%. Also, the cumulative value of foreign investments in Ukraine at the end of 2012 reached 54.5 bn USD and 79% of cumulative FDI inflows to Ukraine came from the EU – and 7.8% from CIS countries.

The average regional dynamics of annual FDI inflows to Ukraine in 1996-2013 varied from 95.5% in the region of Vinnytsia to 13.4% in Ternopil. This indicates that there is a significant regional disproportion of FDI inflows. Also, a descriptive analysis of the available time series indicated that until 2004 the inflows of FDI oscillated around approximately the same level for each of the regions. However, since 2004 some regions managed to attract more FDIs than others. Therefore regional FDI attraction performance has been analyzed according to the average dynamics for two separate time-periods: 1997-2004 and 2004-2013. The median dynamics of annual inflows for all regions after 2004 was 0.19. The results showed that 12 regions have been above the median, these are: Volyn (0.26), Dnipropetrovsk (0.76), Zhytomyr (0.19), Ivano-Frankivsk (0.28), Luhansk (0.41), Lviv (0.21), Poltava (0.21), Rivne (0.25), Kharkiv (0.29), Khmelnytskyi (0.20), Cherkasy (0.38) and Donetsk (0.25). From this it could be concluded that regions with the highest dynamics of FDI inflows are concentrated mainly on the opposite sides of the country. The central regions of the country, with one exception were below the median.

Figure 1: FDI inflows (m USD) – Western vs. Eastern Regions – 1997-2013



Source: State Statistical Office of Ukraine
Western Regions: Volyn, Lviv, Ivano-Frankivsk, Rivne, Zhytomyr, Khmelnytskyi
Eastern Regions: Poltava, Kharkiv, Luhansk, Dnipropetrovsk, Donetsk

FDI inflows concentrated in two opposite sides of the country, and the eastern part attracted more FDI, but their predominance came only from one singular pole of growth located in Dnipropetrovsk – an outlier that only in 2013 managed to attract more FDI than the rest of all the eastern regions together. Actually, in 2013 Dnipropetrovsk attracted more than 32% of all FDI in Ukraine. The power of this singular location is so strong, that if excluded from the analysis, it would change the entire picture of the performance in terms of FDI attraction. It would show that western regions of Ukraine are not worse and perhaps even better than eastern regions and they have a better chance to benefit from spillover effects that are evenly distributed across the western part of the country. A descriptive analysis of the data on total regional FDI inflows shows therefore a Goliath-like Dnipropetrovsk – a strong singular pole of growth surrounded by other relatively attractive regions and the multiple green shoots in western regions of the country.

Dnipropetrovsk's power to attract FDI seemed to outweigh the investment climate of all other regions of Ukraine. In the past Dnipropetrovsk was a key industrial and R&D centre of Ukraine with the focus on advanced aeronautics and nuclear power. In 2009-2013 this region attracted capital from Germany (37.5%), Cyprus (23.5%) and in 2013 also the Virgin Islands (8.6%). In 2013 FDI from Germany amounted for 51.1% of total inflows to this region and from Cyprus 30.0%. In comparison to other eastern regions like Luhansk, in 2013 75.3% of FDI came from Cyprus, 7.8% from Russia and Great Britain 4.0%. In Poltava most of the FDI came from Switzerland, in 2013 it was 55.3%, after that Cyprus (15.2%), Holland (11.5%) and Russia (5.0%). In Kharkiv, most FDI came from France (38.9%) and Cyprus (27.4%). Last but not least Donetsk (in 2013) attracted FDI from Cyprus 53.2%, Holland (19.5%) and the Virgin Islands 5.9% of the total.

Western regions displayed similar characteristics. In Volyn in 2013 31.9% of FDI came from Cyprus, and 17.3% from the Virgin Islands, the third largest group of investments came from Poland 8.5%. In Zhytomyr 51.0% of FDIs came from Cyprus and 10.2% from Holland. Ivano-Frankivsk region attracted investments from Holland 34.5%, Great Britain 2.7%, Poland 5.8% and not surprisingly Cyprus 26.9%. Analogically in Lviv, investments from Cyprus amounted for 29.2% of the total and investments form Poland for 24.3%. There were also investments from Lichtenstein, the Virgin Islands and Switzerland. But in both cases – Lviv and Ivano-Frankivsk, there were also investments from the United States and Germany. Cyprus' investments in Rivne in 2013 amounted to only 12.4%. Most of the investments in this region came from Germany: 30.7% and Great Britain 20.2%. In Khmelnytskyi only 9.9% of the total inflow of FDI in 2013 came from Cyprus, most of FDI to this region came from Holland, 59.9%, and Poland, 7.0%.

FDI in Ukraine in comparison to other destinations

The global downturn of 2008, in terms of FDI inflows, affected more than half of the countries that joined the EU in 2004. The fastest FDI decline in relation to the preceding year accrued in Lithuania (-14.0%) and Cyprus (-8.4%). The other new member states also recorded lower inflows of FDI, but still remained at a slightly higher level in relation to the year before. During a downturn in 2008 a noticeable amount of FDI inflows were noted in Slovenia and Slovakia (in relation to the preceding year). These countries recorded inflows of FDI respectively greater by 8.8% and 5.7% in relation to the year before. However, a year later Slovenia's FDI decreased by 2.9%. FDI inflows to the new members of the EU in 2010-2011 were generally decreasing. In 2010, only Poland and Malta indicated positive FDI inflows – 16.4% in Poland and 83.8% in Malta.

In comparison to neighboring countries and resource-based economies of the region (Russia, Azerbaijan and Turkmenistan) as well as the former centrally planned economies that Ukraine had economic and political relations with in the past (Albania, Macedonia and Serbia) – in 1999-2013 Ukraine was in the upper range in terms of cumulative value of FDI inflows. However the percentage of FDI in relation to GDP shows a significantly different picture. In 2009-2012 Ukraine ranked 6th among neighboring countries and the above-mentioned resource-based economies (10th in 1999-2012). Net inflows of FDI in relation to GDP in Ukraine have been decreasing since 2010 at an average rate of 0.9 pp per year. Ukraine's downward trend was approximately at the same level as in Azerbaijan (which was the highest among the analyzed countries). This suggests that the economic regime in Ukraine might not favor an investment climate suitable for an undisturbed inflow of FDI or considering the previous findings, it favors only a certain type of FDI that happened to flow from Cyprus.

The economic regime indicators for Ukraine might explain some of the determining factors for Ukraine's slow degradation of investment climateQ[1]. Although Ukraine scored above the average in terms of tariff and non-tariff barriers (the score was 85.2, with the average[2] of 81.6), in terms of regulatory quality the country ranked among the lowest (-0.54 with the average 0.13). A lower value of this indicator could be only found in Belarus which also had problems attracting FDI. Ukraine was also among countries with the lowest scores in terms of the rule of law (-0.73 with the average of -0.21). The country was also below average in terms of Internet users per 1000 people (330) and it had also a low rate of produced patents per million people – 0.4 (the average was 0.9) and royalty payments and receipts in USD per population was 16.4 (the average was 37.3). But, in terms of average years of schooling Ukraine was among the best: 11.1 (the average was 10.3) and the best in terms of gross tertiary enrollment rate 81.1 (the average was 54.9).

1 World Bank indicators for Knowledge for Development Project [available online, 09.07.2014 http://web.worldbank.org/WBSITE/EXTERNAL/WBI/WBIPROGRAMS/KFDLP/EXTUNIKAM/0,,menuPK:1414738~pagePK:64168427~piPK:64168435~theSitePK:1414721,00.html].

2 The group of analyzed countries contained data for: Ukraine, Albania, Azerbaijan, Belarus, Hungary, Moldova, Macedonia, Poland, Romania, Russian Federation, Serbia and Slovak Republic.

Table 1: FDI, net inflows (% of GDP) 2008-2012

FDI, net inflows (% of GDP)	2008	2009	2010	2011	2012	Average
Albania	10	11	9	8	7	9
Azerbaijan	8	7	6	7	8	7
Belarus	4	4	3	7	2	4
Hungary	49	-2	-16	8	8	9
Moldova	12	2	3	4	3	5
Macedonia, FYR	6	3	3	5	3	4
Poland	3	3	4	3	1	3
Romania	7	3	2	1	2	3
Russian Federation	5	3	3	3	3	3
Serbia	6	5	4	6	1	4
Slovak Republic	4	2	2	4	2	3
Turkmenistan	7	23	16	12	9	13
Ukraine	6	4	5	4	4	5

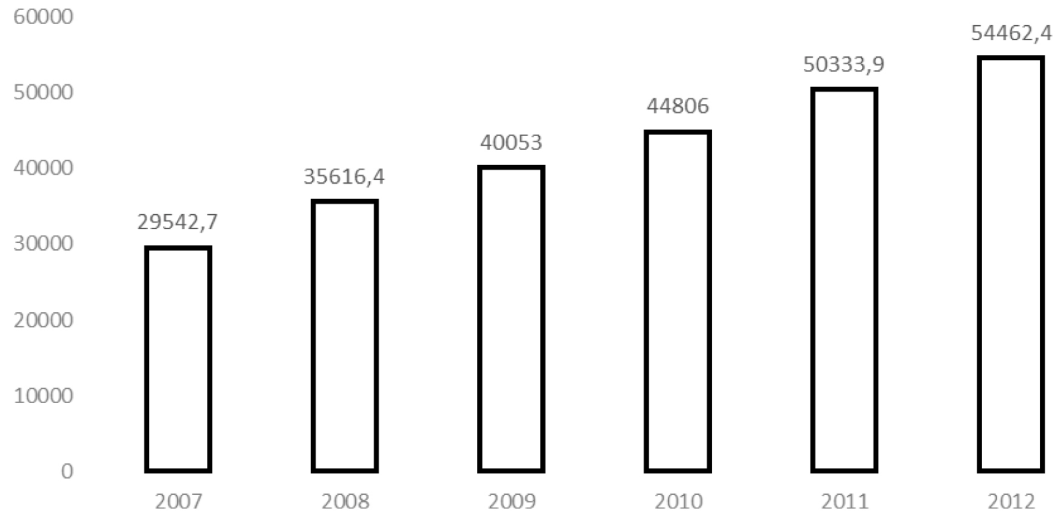
Source: World Bank, 2014

In developed economies good investment climate stimulates competitiveness, innovation and sustainable growth. "Globally, companies that operate in a good investment climate transmit the benefits of low-risk growth on other sectors of the globalizing world' (World Investment Report, 2005). Hence, looking through the prism of sustainable economic growth, a good investment climate makes investment decisions easier to make, because it creates the environment necessary to maintain undisrupted key activities of the company. Therefore economic regime strongly influences the quality of life and the future of people living in the region. Ukraine has good localization advantages and a well-educated work force, but it has also extractive institutions that do not allow for the globalization to take place significantly, decreasing the quality of life for its people.

The sectoral view of FDI in Ukraine

The institutional and legal environment is an essential component of the investment climate. This environment is created by values of law and the effects it has on institutions. It shows how government agencies help to facilitate businesses with foreign capital (Przybylska, 2008). Successful stories of the economies from Eastern Europe that managed to attract FDI include the case of Poland which managed to attract a considerable amount of FDI by adoption since the early 1990s of favorable laws and regulations. To facilitate safe entry and protection of foreign investments, Polish actions to promote FDI led to the creation of the Polish Agency for Information and Foreign Investment (PAIiIZ). Its role was to coordinate promotion and to monitor the investment climate. In a simplified manner accepting that Poland and Ukraine started roughly at the same point, the economic success of Poland in comparison to Ukraine could be explained only by better-working institutions. Poland's success story includes also a recent expansion of FDI to Ukraine, however "the level of Polish investment in Ukraine is very modest (…) Polish FDI flows to Ukraine and stock in Ukraine represent only 1-2% of the value of outward FDI from Poland. At the same time, however, the second largest number of Polish investors have established their affiliates in Ukraine." (Nowak et al, 2014).

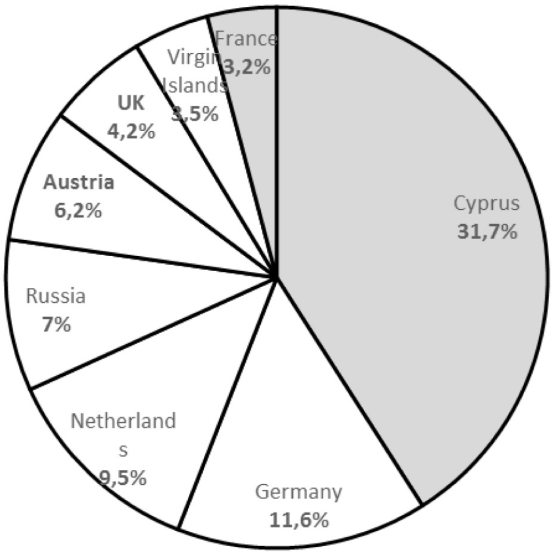
Figure 2: Cumulative value of FDI in Ukraine in 2000-2013 (* in m of USD)



**as of January 1st next year, calculated as the updated value since the start of the investment.*
Source: The State Statistics Committee of Ukraine, 2013

It could be summarized that (according to the data of the State Committee of Statistics in Ukraine) in 2012, most of the investments to Ukraine came from Cyprus (31.7%), followed by Germany (11.6%), Netherlands (9.5%), Russia (7%) and Austria (6.2%).

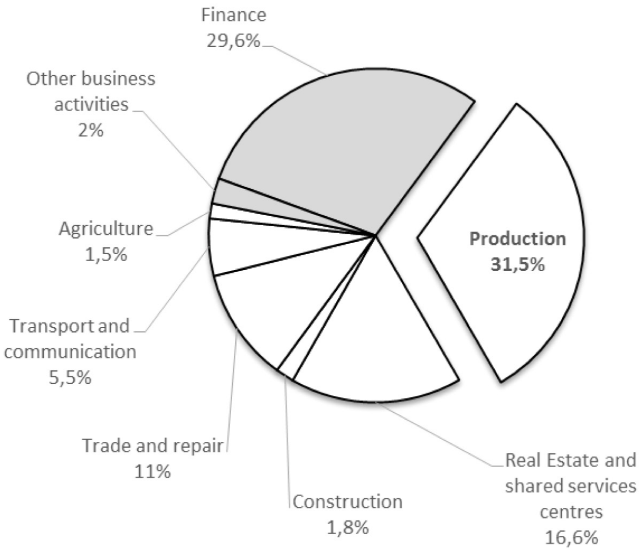
Figure 3: FDI in Ukraine stratification by country's % of total in 2012



Source: The State Statistics Committee of Ukraine, 2012

At the end of 2012 most of the FDIs have been directed towards production of goods (31.5%) – particularly to processing of goods (82% of the total inflow of production). A significant part of the investments have also been located in the service sector, mostly in the financial sector (29.6%), real estate and shared services centres (16.6%) or trade and repair (11.0%). It is worth mentioning that much of the Ukrainian banking sector has been recently acquired by mergers and acquisitions in 2006-2007 mainly by capital from EU countries. These kind of investments have been particularly popular in Dnipropetrovsk and Kharkiv regions as well as in the capital city of Kiev. It might not be a coincidence that FDIs in finance and other business activities (31.6%) are almost the same as the total percentage of investments from Cyprus (31.7%). It is also interesting that 89.64% of the total Ukraine FDI flows to Cyprus. What is more, there is a strong anecdotal evidence that investments from Cyprus carry Russian-Ukrainian M&As popular in Cyprus. The capital from Cyprus might be therefore Ukrainian capital that was moved overseas to avoid taxation and reinvested back in the form of FDI.

Figure 4: FDI inflow to Ukraine by industry in 2012, (% of total)



Source: The State Statistics Committee of Ukraine, 2012

As mentioned above, a substantial amount of Ukraine's FDI flows to tax havens – mainly Cyprus. Ukrainian capital was often reinvested in the form of FDI from Ukrainian-owned Cyprus companies. Therefore in general FDI inflows to Ukraine might be relatively low. What is more is that countries the size of Ukraine are usually able to attract much more FDI (Nowak et al, 2014). Also the preliminary investigation showed that Special Economic Zones and similar institutions have been playing a very marginal role in attracting FDI in Ukraine. The main reason for low effectiveness of SSEs is the very poor quality of regulations. SSEs in Ukraine attracted about 600 million USD which is only 7.2% of the total amount of FDI in Ukraine, but some of them have been withdrawing the capital due to the above-mentioned negative tax policy related to a growing budget deficit.

Risk factors in Ukraine are critical. The Heritage Foundation in the annual Economic Freedom Index in 2012 positioned Ukraine in 161ste among 183 countries in the survey. In 2013 Ukraine was still in the same place – the lowest score among all countries from the European continent. This puts Ukraine with the group of countries with a repressive attitude towards business. In previous years, the Economic Freedom Index has been fluctuating or improving by 0.1-0.2 points, however the latest changes are negative. This is another reason to believe that Ukraine was suffering from extractive institutions and consequently from a poor economic regime.

Other reports also confirmed the high risk level for business. The Doing Business Index in 2013 positioned Ukraine in 137th place out of 185 countries (World Bank, 2014). Numerous other data and press releases also indicated a bad investment climate. For instance, to start a business in Ukraine, an entrepreneur must overcome approximately 10 complicated procedures, which is almost twice as many as in OECD countries or in the EU. The whole process of setting up a business also takes twice as long as in the above-mentioned group of countries. The situation is similar in the case of construction time or property registration. Notwithstanding the popular FDI in financial services, it is hard to get loans for the initial stage of the project. Many of the difficulties that entrepreneurs have to face come also from the fiscal system. Closing a business in Ukraine is also much more expensive and time-consuming than in other European countries.

Despite the existence of the high level risk associated with doing business, the Ukrainian economy is still a relatively attractive place to invest and the country manages to attract FDI. At the end of 2012 there were more than 130 countries interested in investing in Ukraine, and the value of FDI in Ukraine's economy at the end of 2012 was 54.5 bn USD (Ukrastat, 2013).

Ukraine's outward investments

Only in 2012 most of Ukraine's FDI came from Donetsk: 5.4 bn USD (83.71%), next came Dnipropetrovsk: 191.2 m USD (2.95%), Odessa: 53.9 m USD (0.83%), Zaporojian: 41.6 m USD (0.64%) and Lviv: 27.4 m USD (0.42%). The cumulative value of FDI from Ukraine reached at the end of 2012 was 6.5 bn USD. Most of it, (93% of the total), was invested in the EU. In the 1990s, firms from Ukraine invested mainly in Russia. After 2006, however, they changed their destination almost entirely towards Cyprus. Most of Ukraine's FDIs are allocated in sectors like real estate, business supporting services and financial activities (6.83%). In 2012 investments in Russia did not exceed 4.5% of total investments from Ukraine (292.5 m USD). Six years earlier Russia attracted 42.8% of the capital from Ukraine. In the past the most popular destination of Ukraine's investments was trade and repair services (80.44%).

Latvia and Poland are among the second most popular destinations of Ukraine's FDI. At the end of 2012, the cumulative value of investments from Ukraine to Latvia added up to 95.5 m USD (1.5% of the total). As in the case of Cyprus, these are financial sector investments. The total value of the capital invested in Poland summed up to 54.2 m USD. According to the State Statistics Committee of Ukraine, the cumulative value of Ukrainian investments in Poland at the end of 2012 reached 54.2 m (0.8% of total direct investment abroad from Ukraine). This value differs from the estimates of the National Bank of Poland (NBP). According to the NBP at the end of 2012, Poland attracted 237.3 m USD of investments from Ukraine.

Since 2005, Poland and Ukraine have shared a number of joint financial and industrial projects. The process has been stimulated by the accelerated privatization in Poland. The examples of cooperation include companies like: the Car Factory in Warsaw (the investor - Авто-ЗАЗ), the Metallurgical Plant Huta Częstochowa (the investor-ІндустріальнийсоюзДонбасу), Gdańsk Shipyard (the investor- ІндустріальнийсоюзДонбасу), the metallurgical industry Centrostal Bydgoszcz (the investor- УкраїнськаГірничо-металургійнаКомпанія). Development of financial projects fast-tracked a little later and in 2008 companies from Ukraine were first listed on the Warsaw Stock Exchange (WIG). In 2012 Ukraine listed on the WIG: Astarta, Kernel, Agroton, KSG Agro and Milkiland, Industrial Milk Company, Ovostar Union, SadovayaGroup, CoalEnergy, Westa ISIC KMD Shipping, and last but not least Agroliga listed also in New Connect. The joint projects between Poland and Ukraine might be considered a good sign as Poland is among Eastern Europe's leaders in creating a favorable climate for foreign direct investment, especially when taking into consideration the close cultural proximity of both countries.

Previous attempts to improve investment climate in Ukraine

Investment climate in Ukraine is subjected to significant inequalities regarding distribution of foreign capital in regional perspective and a low efficiency of inward investment. This could also affect the spillover effects of FDI. At present this has been reflected by 'a lack of economic and social effects of foreign capital in the economy'. Ukraine suffers from an insufficient amount of credit institutions – also its markets are not transparent and extremely risky.

To stimulate investment the Ukrainian government issued a package of structural reforms separated into 5 main blocks (State Agency for Investment and National Project of Ukraine, 2014):

1) InvestPROPOSAL – aimed to create mechanisms that would produce the opportunity to participate in international investment market projects.
2) InvestINFRASTUCTURE – aimed to create a system of institutions that facilitate the work of foreign investors in Ukraine (inter alia: Ukrainian Development Bank, Regional Development Fund, the Documentation Project Financing Fund and State guarantees).
3) InvestPARTNERSHIP – joint international investment projects.
4) InvestMARKETIN –information and marketing campaign, with a positive impact on the investment attractiveness of Ukraine throughout the world.
5) InvestCLIMATE – a program to develop a sustainable legislative framework. The majority of bills have been issued by the President of Ukraine; this included: Law of Ukraine „On Industrial Parks," Law of Ukraine „On National Projects", Law of Ukraine „On investment activity" (change), Law of Ukraine „On State Guarantees Administration", Law of Ukraine „On Application of Accounting Statements International Standards".

The Act from January 1st, 2013 – „on stimulation of investment activity in sectors of priority in order to create jobs," proposed to use tax incentives for importers. Eligible investments could expect a release from the payment of income tax until 2017 or a release from payment of import duty[§].

Despite the existence of institutions designed to improve the climate of investment and despite initiated reforms, it is still hard for Ukraine to attract FDI and to benefit from spillover effects. The main list of causes for that fact could be formulated as follows:[**] High level of corruption and bureaucracy at various levels of government. There is no transparency in the initial investment process. Significant tax burden. There is a large number of taxes and they sum up to a heavy burden. Yet, previous investigations encountered problems with meeting deadlines for VAT refunds. Difficult and time-consuming registration, licensing and customs procedures; weak protection of property rights, ownership of land, difficult requirements for starting and running a business. No state protection or guarantee of help for investments. Political instability, no reliable protection against changes in the Ukrainian legislation on foreign investment. Low level of development of market infrastructure and secure cooperation between Ukraine and foreign capital markets.

Conclusions

At first glance, Ukraine seems to have a comparative advantage in attracting FDI from the financial sector, this is, however, just an illusory effect because in fact the country lacks good financial institutions and suffers from insufficient credit institutions dedicated to business. Moreover, approximately one-third of the investments to Ukraine come from Cyprus, and there is strong anecdotal evidence that those investments are murky in nature as they might be related to reallocation of Ukraine's own capital to avoid taxes. This fact alone says much about the economic regime of the country where the economic system encourages flight of capital. Moreover, the scale of the murky investments and economic regime in Ukraine creates a distorted picture of FDI in the country, they are neither north-south nor south-south in nature.

Despite Ukraine's localization advantages and well-educated work force, the country attracts relatively little FDI. FDIs in Ukraine are concentrated in opposite sides of the country – evenly distributed in the west and centralized in the singular strong pole of growth in the east. Also, despite government effort to create friendly regulations, even Special Economic Zones in Ukraine do not give a sufficient incentive for investment. The reason might be an extremely high level of corruption and unsound tax regulations. In other words Ukraine suffers also from sham reforms, which suggests an economic regime typical of extractive institutions.

It is therefore not surprising that Ukraine's people decided to take action against the extractive government during recent events building its new national identity after 23 years of sovereignty. Ukraine has all that it takes to create a strong economy and become one of the major players in the region, the only thing it lacks are good inclusive institutions.

§ Закон України «Про стимулювання інвестиційної діяльності у пріоритетних галузях економіки з метою створення нових робочих місць» від 06.09.2012 р. № 5205 [Електронний ресурс]. – Режим доступу: http://zakon4.rada.gov.ua/.

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