

ABSTRACT
of the end-product of the Research

**‘Foreign Investments in Ukraine:
Venture Factors and the Ways of Their Diminution’**

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The end-product of the research on the subject ‘Foreign Investments in Ukraine: Venture Factors and the Ways of Their Diminution’ will be in the form of an academic report adjusted to different categories of users, i.e. representatives of Ukrainian legislative and executive bodies, international financial institutions, domestic and foreign consulting agencies (both governmental and non-governmental) that provide legal and other advice to the Government of Ukraine, foreign investors (both individuals and legal entities active in Ukraine), lawyers, teachers, students, non-governmental organisations, etc.

The end-product will be structured in the same way as the Final Report and will cover the following main aspects:

- outlining major factors that deter foreign companies and individuals from investing into Ukrainian economy (investment risks, or venture factors), their analysis and suggestions as to their mitigation;
- analysis of legal remedies as a main instrument for mitigating investment risks. The end-product will mainly tackle domestic investment laws and bilateral agreements on the promotion and mutual protection of foreign investment between Ukraine and other foreign states as far as these legal systems reflect the specificity of the regulation of investment activities in Ukraine and play a major role in the improvement of the investment climate;
- coverage of the specific aspects of investment activities in Ukraine that present the biggest problem to foreign investors: taxation issues, activity in free economic zones, relations with Ukrainian governmental authorities, etc.

The end-product will be supplemented with visual aids both in English and Ukrainian (e.g. schemes, tables and presentation materials) that would make it possible to use the report during seminars, conferences, and presentations. Such demonstration materials would help people having a very common understanding of the problems touched to fully grasp the ideas and concepts covered by the report.

Initially, the end-product will be prepared in English, but in a few weeks after its delivery to NATO it will be available in Ukrainian.

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FOREWORD

Since Ukraine gained its independence in 1991 it chose and has been constantly following the path of the democratic development and reforms.

Ukraine's openness for fundamental democratic values is firmly stated in its first independent legislative act, the Declaration of the State Sovereignty of Ukraine enacted by Ukraine's Parliament (Verkhovna Rada) on 16th July, 1990, Ukraine then still being a part of the Soviet Union. In particular, the Declaration has on behalf of all Ukrainian people expressed Ukraine's intention to build up a democratic society, to protect in all ways possible human rights and freedoms, to procure political, economic, social and spiritual development of Ukraine's people, and to develop a legal state¹.

The provisions set forth in the Declaration were further enforced by the Act of the Declaration of Ukraine's Independence adopted on 24th August, 1991 that has become a benchmark of Ukraine's independence and a precedent for all other Soviet Republics.

The peaceful way of gaining independence, the deep historical roots of Ukraine's statehood, as well as a lawful and democratic nature of the first legislative acts enacted by the newly created state were, probably, the major factors that led more than a hundred foreign nations to recognise Ukraine's independence shortly after it had been proclaimed.

The world's leading economies welcomed the emergence of a new democracy-oriented European nation with a vast territory, 52-million population, rich natural, manufacturing, and labour resources, and, most important, with untouched, and, thus, so far unlimited, market expansion and investment opportunities.

Though many reservations were made with respect to Ukraine's being for decades a part of the Soviet system, as well as its heavy dependence upon, and close ties with Russia, the optimistic expectations about Ukraine prevailed, especially, when political and economic reforms in new East European democracies brought first positive results.

¹ Prava ludyny. Mizhnarodni dogovory Ukrainy, declaratsii, dokumenty/ Uporyad. Yu.K. Kachurenko. - 2-e vyd. - Kyiv. - Yurinform, 1992.

For Ukraine, it meant at that time significant amounts of technical and financial assistance from Western countries to support Ukraine during a transition period, presence of foreign experts and consultants exploring various aspects of the country's potential, first attempts of investing into Ukraine's economy and occupying numerous free niches at the Ukrainian market. Of course, all this, and the promises of a more close partnership and increased assistance, were made in return to a number of certain commitments from the part of the Ukrainian Government, the commitments to be fulfilled in due time.

Generally, the Western countries required the Ukrainian Government to adapt the country's political and economic system to a new democratic and market-oriented environment for the purpose of Ukraine's gradual integration into a global economic system and international markets. In broad context, it involved:

- carrying out political, economic and social reforms
- building-up the democratic state and the open society
- transition to a market economy
- developing stable laws adapted to a new political and economic environment
- incorporation of progressive international practices in various fields of activities.

From Polish, Czech and Hungarian experience of transition, the Western economic community saw that this process would, as a rule, take a long time, but some steps were to be performed in a quick and expedite manner to enable foreigners to penetrate to the Ukrainian market and start investing into it at the initial stage of the transition. Such steps usually involved legal and other types of guarantees on the part of the Ukrainian Government to protect foreign investments in a volatile and rapidly changing Ukrainian economic environment.

Basically, Ukraine has agreed to provide the global community with the above mentioned guarantees, and started the process of reforms in a number of spheres that strengthened its positions in an international arena and enhanced the trust of the global community towards Ukraine. Many multinationals and private investors associated their plans with Ukraine, and lots of them came here to do business and gain profits from their investment activity.

In almost ten years since gaining its independence, Ukrainian market is still the most attractive investment target in the region, but the investment history and statistics show that the amounts invested so far into Ukrainian economy are not sufficient to cover even the country's minimum demand of capital injections. According to Ukrainian statistics, as at 1st January 1998, the total amount of foreign investment into Ukrainian market through the whole period of Ukraine's independence made USD 2,053 billion, while the country's declared demand in foreign investment makes USD 40 billion for the next ten years². By 1st January 1999, the above figure increased by approximately USD 727 million and made USD 2,78 billion³.

² Window on Ukraine, obzor ekonomicheskoy situatsii. - No. 30 (703), 12th March, 1998.

³ The information provided by the Ministry of Statistics of Ukraine.

In my research, I have made an attempt to investigate the reasons for investors' reluctance to invest into Ukrainian industry, i.e. major venture factors (investment risks) that deter the foreigners from investing into Ukraine, and the problems existing in Ukrainian economic and legal systems that should be tackled in order to improve investment climate in Ukraine. I have also made an analysis of Ukrainian investment and investment-related laws, Ukraine's bilateral investment agreements with other countries, as well as enforcement mechanisms implemented in Ukraine to protect the rights and property of foreign investors.

I GENERAL CHARACTERISTICS OF VENTURE FACTORS (INVESTMENT RISKS) IN UKRAINE

1 Definition of investment risks

The investment risks are usually defined as political, economic and legal factors that could deprive the investors of their benefits, or profits resulting from their activity in the recipient country.

2 Investment risks in Ukraine

In general, Ukraine possesses a strong potential for attracting essential amounts of foreign investments due to its advantageous geographical location, large market with numerous free 'niches', rich natural resources, powerful manufacturing base, cheap and well-educated labour force, and other important factors.

However, the amounts of foreign investment in Ukraine remain at a very low level and are inadequate to facilitate the country's vigorous economic development.

Such a situation has been caused by a number of factors that not only defer the investment processes in Ukraine, but also affect its general economic development. These factors are described below.

2.1 Legislation instability

This risk is considered to exert the most significant influence on the amounts of capital inflow to the country. In the Ukrainian context, it will be analysed more thoroughly in the following sections.

2.2 Political volatility

Though not so unpredictable as in Russia, the volatile political environment deteriorates the investment climate in Ukraine.

As a result of the parliamentary election that took place in March 1998, the largest number of seats in the newly formed Parliament (123 out of 435) were taken by the members of the Communist Party. Taking into account the fact that the Speaker of the Parliament, Alexander Tkachenko, is a member of a left-wing Peasants' Party of Ukraine, and the Socialist Party of Ukraine jointly with the above mentioned Peasants' Party support the policy of the Communist Party of Ukraine, the leftist bloc within the Parliament is the most powerful one that has an impact on the overall state policy. As a result of a strong pro-Communist influence within the Parliament, scarce market-oriented reforms Ukraine managed to achieve during the years of its independence are now under the threat, and the possibility of any radical reforms in the nearest future is quite doubtful because of a strong and large-scale antireformist movement.

The aforementioned tendencies have further enforced pessimist feelings among foreign investors as to the feasibility of Ukraine's transition to a market economy which was aggravated by the consequences of economic crisis in Asia and, later, in Russia.

However, according to the independent foreign experts, disagreements arising in Ukraine around political, or economic issues, or other matters of general concern, are usually settled without resorting to violence. The peaceful nature of all political transformations in Ukraine mitigates the risk of violation of investors' rights guaranteed by Ukrainian laws (in particular, the risk of expropriation of foreign capital) and makes Ukraine by far more attractive for foreign investors than Russia, with its strong dependence on violent methods in solving the country's internal problems.

The future strategy of Ukraine's economic development depends greatly on the results of the forthcoming Presidential election to be held in October 1999. The confrontation between the Parliament and the President has been very tough during the recent years, and a strong figure of the President supported by centrist forces is likely to become a balance against the pressure of the pro-Communist majority in the Parliament and to revive the reforms in the Ukrainian society and economy.

2.3 Tough fiscal policy and unfavorable economic environment

Before Ukraine's investment issues are considered in this context, it should be noted that the risk of the instability of the governmental fiscal policy, and, as a result, the creation of the investment environment that does not attract, but, rather, deters foreign investors from coming to the Ukrainian market is substantially the most complex one and consists of several elements. Simultaneously, these elements form an integrate group, one of them often resulting from the other, and require a comprehensive and balanced approach when examining them.

Inflation. The inflation in Ukraine leads to the instability of Ukraine's national currency - hryvna (UAH). Having introduced hryvna in September 1996, Ukraine's government and the central bank - the National Bank of Ukraine - managed to preserve the UAH:USD exchange rate stability for over two years (the hryvna-dollar exchange rate was approximately 2:1 over the whole period, with little fluctuation). This remarkable achievement of the Ukrainian government was strengthened by a 0% inflation in August 1997 that brought around much optimism about Ukraine among foreign investors.

However, the Asian and Russian financial crisis showed the vulnerability of the Ukrainian economy and led to the hryvna devaluation by more than two times (currently the UAH:USD exchange rate amounts to approximately four hryvna to one U.S. Dollar).

Hindered privatisation. The privatisation process in Ukraine started in 1992, and the state agency responsible for carrying it out - the State Property Fund - was established. In the course of privatisation, over 55.000 state-owned enterprises were privatised through different privatisation forms⁴, including:

- preferential sale of shares to the management and employees of the privatised enterprise;
- sale of shares at public auctions and Ukrainian Stock Exchange for compensation certificates (tradable securities introduced in 1996 as instruments for compensation to the Ukrainian citizens for the losses inflicted to them by the devaluation of their savings with banks resulting from hyperinflation which Ukraine had suffered from for a number of years);
- sale of shares for non-transferable privatisation certificates that have been issued to each Ukrainian citizen and can be either exchanged for shares at a special auction, or directly invested into companies;
- shares sold for cash at commercial tenders where the winner is a bidder who offers the highest price for the shares; and
- shares sold at non-commercial tenders where the selection is in most cases based on the investment commitments provided by the bidders.

The foreign investors can participate in all above mentioned forms of privatisation, except for preferential sale and operations with privatisation certificates due to their specific nature, which means that equal treatment is provided in this respect to both foreigners and nationals. In spite of this, it is worth mentioning that few blocks of shares are sold for cash, with preferential sales prevailing through Ukrainian enterprises.

⁴ The information provided by the Ministry of Statistics of Ukraine as at January 1, 1999.

Foreign investors active in Ukraine have considered the participation in the privatisation of state-owned enterprises in Ukraine as a promising and profit-making business and many of them still do, however, there is a dominant feeling that the privatisation process in Ukraine is impeded in many ways to the extent that an active foreign participation in the acquisition of Ukraine's state property will not be considered until radical changes are made in the current state of affairs.

First of all, foreign investors complain that the Ukrainian Government has exempted a great number of state enterprises which present attractive targets for investment from the privatisation. This includes so-called «enterprises of a strategic importance», mostly, in energy sector, the privatisation of which was banned by the Parliament. Even in case an enterprise that presents any interest in terms of investment is put for sale, it is practically impossible for an investor to purchase a strategic block of shares because in most cases the state-owned stake with the enterprise remains at a rate of 25%+1 share that allows the state to block any decisions adopted by other shareholders. Such a practice is extremely discouraging for potential investors because it deprives them of any managerial or voting powers and provides no efficient mechanisms to protect their vested interests.

The above situation is also aggravated by a number of other factors that make investing into Ukrainian market economically unprofitable: excessively high prices for shares, too large share packages offered for sale, onerous investment commitments, etc.

There is also much lament about insufficiency and poor quality of the information available on the enterprises that are put for sale. This could, however, be explained by the overall deficiency of accounting and reporting system used in Ukraine which has been inherited by the country from the Soviet planning economy and, therefore, is quite archaic and has few things in common with its internationally applied analogues. Ukrainian enterprises have officially transferred to International Accounting Standards starting from 1st January 1999, however, the information that is publicly available on the objects under privatisation is still quite obscure and intransparent.

In this respect, the possibility of involving international advisory services should be considered which would not only make the due diligence at Ukrainian enterprises more speedy and efficient, but would also create additional incentives for foreign investors thinking of investing into Ukrainian market.

Another reason for the investors' reluctance to participate in the privatisation of Ukrainian enterprises in various industries is high extent of corruption and bureaucracy within Ukraine's governmental and

administrative apparatus. It is mainly caused by the reminiscences of the former Soviet practices when the state dominated all spheres of human activities and the governmental officials had almost unlimited powers. Besides, employment with a governmental agency usually infers low salaries and arrears making bribery and other unlawful ways of lobbying one's interests a common phenomenon in the Ukrainian society.

As far as further development of privatisation process in Ukraine is concerned, the Government's privatisation strategy has been outlined in the State Privatisation Program for 1999 adopted by the Decree of the President of Ukraine on 24th February 1999⁵.

Generally, it has much in common with the Privatisation Programs for 1998 and 1997, though some modifications were inserted into it.

The Privatisation program declares the attracting of funds for the development, structural rebuilding of the economy and enhancing the investors' interest with respect to Ukrainian enterprises at international markets among its top priorities.

As distinguished from the privatisation programs for the previous years, the 1999 Privatisation Program envisages the introduction of new privatisation procedures involving exclusively sale for cash. This step reflects the finalization of privatisation through the preferential and certificate sales and creates more equal and fair conditions for the participation of foreign investors in the privatisation of Ukrainian enterprises.

The 1999 Privatisation Program also enforces the right of foreign investors to the information on the privatised enterprises specifying that the information on the terms and conditions of holding open tenders with the participation of foreign investors shall be published in the informational bulletins of the state privatisation agencies, as well as in the central and local press not later than 50 calendar days prior to the date of holding such a tender.

However, the Program contains a material restriction as to the privatisation of land by foreign investors. According to its provisions, foreign legal entities, citizens of foreign states, international organisations and associations with participation of foreign legal entities of individuals, as well as the enterprises fully owned by foreign investors can own the land on the basis of a long-term lease only, while the nationals of Ukraine can privatise the land granted to them for the purpose of construction together with the object being constructed. The ban on privatising the land by foreign

⁵ Dekret Presydynta Ukrainy «Pro Derzhavny programy pryvatyzatsii na 1999 rik» (Decree of the President of Ukraine «On the State Privatization Program for 1999») No. 209/99 dated 24.02.1999.

investors is quite discouraging since it creates a real threat to the owners of property built on the state-owned plot of land in a way that such a property could be easily nationalised by the state through taking away the land.

High taxes and excessive powers granted to tax authorities.
The taxes in Ukraine are high and the taxation system is overloaded with a great number of different taxes, more and more being introduced with astonishing frequency.

The Law of Ukraine «On Foreign Investment Treatment»⁶, a major law regulating foreign investment process in Ukraine, provides national treatment to foreign investors which means that the latter enjoy the same rights and privileges as national investors do, and no additional benefits are granted to them, the same applied to tax holidays. However, such benefits can be granted to a foreign investor in case it is envisaged by the relevant international agreement signed between Ukraine and the investor's country. In some cases, a preferential treatment can be established for particular legal entities if they are carrying out investment projects with attracting foreign investment under the state priority industries development programs.

Before the Law «On Foreign Investment Treatment» had been enacted, the enterprises with foreign investments had a five-year profit tax holiday, depending upon the amount of investment, in accordance with the Decree of the Cabinet of Ministers of Ukraine «On Foreign Investment Treatment»⁷ that was regulating investment activities in Ukraine in 1993-1996.

As will be seen from the above, the status of foreign investors in Ukraine has worsened which couldn't but cause the outflow of investment from the country.

The situation is further aggravated by excessively broad powers granted to the tax authorities in view of the frequent evasion of taxes by Ukrainian enterprises that, paradoxically, results from a heavy tax burden the enterprises are suffering from. Usually, carrying out most activities at the 'black' market and tax avoidance is the only way for the enterprise to survive under the severe pressure of taxation.

A number of regulations have been adopted by the President of Ukraine, the Cabinet of Ministers, the Tax Agency and other executive bodies that not only create an unfavourable environment for business

⁶ Zakon Ukrainy «Pro rezhym inozemnogo investyvannya» (the Law of Ukraine «On Foreign Investment Treatment») No. 93/96 dated 19 March 1996.

⁷ Dekret Kabinety Ministriv Ukrainy «Pro rezhym inozemnogo investyvannya» (the Decree of the Cabinet of Ministers of Ukraine «On Foreign Investment Treatment») No. 55-93 dated 20 May 1993.

development, but also violate fundamental rights and freedoms guaranteed by Ukrainian laws.

Thus, the regulation was introduced allowing the tax agencies to write off in an indisputable extrajudicial manner the funds from the accounts of the enterprises that have failed to pay all the taxes to the state budget in time. Such a practice entrenches the principle of the inviolability of private property considered to be the main element of a market economy and guaranteed by the Constitution of Ukraine. Moreover, the application of this procedure has shown that the results achieved by means of it are opposite to the expected ones: the taxes are still undercollected, the enterprises try not to accumulate funds at their banking accounts and, instead, resort more frequently to barter transactions, and that causes the outflow of capital from the country.

Another regulation adopted by the Chief Tax Administration of Ukraine in August 1998 requires Ukrainian commercial banks to submit to tax authorities upon their request the information on the operations performed at their customers' accounts, thus conflicting with the superior Law of Ukraine «On Banks and Banking Activity» that says: «All bank employees are obliged to keep secrecy with respect to the operations, accounts and deposits of the bank's customers and correspondents» (Article 52)⁸. This requirement undermining the very principle of the presumption of innocence caused a broad negative resonance in business circles since it made legal entities especially vulnerable towards the interference of tax authorities into all spheres of their activities, and forced many of them to switch to operations beyond the banking system, i.e. «shadow economy».

Ukrainian tax authorities are also entitled by the Resolution of the Cabinet of Ministers of Ukraine⁹ to use so-called 'indirect methods' for identifying the amount of operations subject to value-added tax. Such 'indirect methods' mainly involve unlawful and arbitrary mechanisms for revealing presumably undisclosed earnings, for example, defining the amount of the value-added tax by means of comparing the activities of the taxpayer with analogous activities of other taxpayers, or identifying the inconsistency of the standard of life of entrepreneurs, and the members of their families, with the profits declared by them, etc. By legalising 'indirect methods' the Cabinet of Ministers of Ukraine has violated the underlying principles of a legal state, including the presumption of innocence. Besides, 'indirect methods' allow tax authorities to write-off the funds from the accounts of the

⁸ Zakon Ukrainy «Pro banky ta Bankivsky diyalnist» (the Law of Ukraine «On Banks and Banking Activity») enacted by the Resolution of Verkhovna Rada of Ukraine No. 873-12 of 20.03.91.

⁹ The Resolution of the Cabinet of Ministers of Ukraine «On the approval of the Procedure of Application of Indirect Methods for Identifying the Amounts of VAT taxable operations» No. 1997 dated 18.12.98.

enterprises in an extrajudicial manner, without bringing the case to a court of arbitration which is also a gross violation of fundamental legal rules¹⁰.

It is worth saying that all these negative practices and abuses were litigated in the Supreme Court of Arbitration of Ukraine, however, the rulings are pending so far and the outcome of the confrontation between the Ukrainian enterprises and tax agencies is still unpredictable.

In addition to the major investment risks that explain the foreigners' unwillingness to invest into Ukraine, one could also name a number of less important, but still discouraging factors. Among them are:

- the underdeveloped social and transportation network, including low-quality services, poor state of Ukrainian roads, ill-functioning infrastructure;
- lack of good hotels. A satisfying hotel accommodation could be found in Kiev and some other large cities only, though they also need sufficient renovation and improvement of hotel service. There are plenty of old buildings in the centre of Kiev that could be reconstructed to five-star hotels and bring significant income, but reconstruction works have been suspended due to the lack of finance and disagreement between investors and local authorities.
- few people speaking foreign languages which incurs additional expenses for translation services.
- lack of certainty in the irreversibility and success of reforms among foreign investors.

As it could be seen from the given above analysis of investment risks in Ukraine, most deterrent factors for foreign investment could be eliminated by carrying out a complex set of measures in all spheres of investors' activity which would require significant efforts and agreed policy from all legislative, executive and judicial authorities.

3 Relations with international financial institutions

Aside from the influence of investment risks on the amounts of foreign investment coming to Ukraine, such amounts have always been highly dependent upon Ukraine's relations with global financial and lending institutions, such as International Monetary Fund, the European Bank for Reconstruction and Development, and the World Bank.

The International Monetary Fund assists Ukraine by providing lending support under Extended Fund Facility (EFF) subject to Ukraine's commitments to carry out economic reforms, including, *inter alia*, T-bills conversion, speeding-up privatization processes and making them more transparent, market deregulation, etc. As of 3rd May 1999, Ukraine was

¹⁰ By the time of the completion of this Report, the above mentioned Resolution was suspended by the Resolution of the Cabinet of Ministers of Ukraine «On the Suspension of the Effect of the Resolution adopted by the Cabinet of Ministers of Ukraine No. 1997 dated 18.12.98» dated 01.06.99.

granted USD 485 million within EFF framework¹¹, with IMF's commitment to grant an overall amount of USD 2.6 billion within next three years.

So far, the International Monetary Fund has expressed no satisfaction with the reforms carried out by Ukraine which usually add up to promises of reforms from the part of the Ukrainian Government, with no actual achievements that could revive the country's economic development. This means that, in order for Ukraine to get further financial assistance, Ukraine has to persuade IMF and other international financial institutions of the irreversibility and enlargement of reform processes.

The European Bank for Reconstruction and Development and the World Bank cooperate with Ukraine in similar ways by providing finance and lending facilities to Ukrainian enterprises. For example, the EBRD has established an SME credit line facility that enables small and medium enterprises in Ukraine to get loans through Ukrainian commercial banks at quite reasonable interest rates.

The EBRD Annual Meeting held in Kiev in May 1998 has become a prominent event in the course of the development of investment processes in Ukraine. This major international gathering of key banking, financial and business representatives in Ukraine has given an opportunity for them to jointly address the problems existing in the country's economy and to outline the future prospects of Ukraine's development. A general disappointment was expressed with respect to a weak business environment, extremely high interest rates, poor economic indicators, excessive interference of the state authorities into business activity, and imperfect taxation system making foreign investment quite complicated under such conditions. The EBRD officials stated that Ukraine had not used its potential to a full extent and declared their intention to push the Government to hold the reforms in a more prompt manner.

The EBRD has also announced three main trends aimed at facilitation of Ukraine's economic development under which it would be working in the country:

- credit line for small and medium enterprises provided through commercial banks at the amount of USD 120 million;
- large credit and investment facilities, with three target Ukrainian manufacturers being identified - «Ukrrechflot» (river transportation), «Svitoch» (confectionery), and «Obolon» (brewery).
- investment into infrastructure, including energy sector, telecommunications, and municipal projects¹².

According to the EBRD officials, 26 projects were opened for Ukraine by the date of the beginning of the Annual Meeting, including 20 projects for private sector enterprises and 6 projects for public sector, with the amount of finance from the part of the EBRD equalling to USD 600 million and total investment amount of USD 1 billion¹³.

¹¹ 'Business' newspaper. No. 18 (329), 3.05.1999.- page 9

¹² 'Kievskie vedomosti' newspaper. - 11.05.1998

¹³ Ibid.

Within the framework of the EBRD Annual Meeting, over 100 business negotiations were held and an exhibition «Ukraine. A look into XXI century» was organised where 164 investment projects were presented with total investment demand of USD 5 billion¹⁴.

The EBRD Meeting has created the following important consequences for Ukraine's further economic development:

- reassured Ukraine of investors' continuing interest in making capital injections into Ukrainian market;
- pointed out major challenges Ukraine has faced on its way towards quick and efficient economic development;
- provided the Ukrainian Government with a clear and unprejudiced strategy of further economic and political reforms;
- helped Ukrainian businessmen to present their businesses to the representatives of the world's leading financial institutions and multinationals;
- gave a push to a number of large investment projects.

By holding its Annual Meeting in Kiev and dedicating it to Ukraine's specific investment and business issues, the EBRD has recognised Ukraine a part of the global economic system.

Three months later, Ukraine has shown itself a part of this system, with all its negative influences and breakdowns, when Russian-Asian economic crisis affected Ukrainian financial and banking sector.

As it was described above, the crisis caused the depreciation of the national currency by two times and led to the establishing of a new currency band for 1999 (UAH 4-4.6 to 1 US Dollar) instead of former band at a rate of UAH 1.95-2.25 to 1 US Dollar). The hryvna devaluation has seriously hit the banking system in Ukraine and led to the overall downfall of Ukrainian economy, though not so drastic as in Russia.

Less painful consequences Ukraine suffered due to the financial crisis, if compared to Russia, could be explained by the following facts:

- political situation in Ukraine is characterised by a greater stability;
- Ukrainian financial markets, including T-bills and stock markets, are underdeveloped and have few foreign participants, and the withdrawal of funds therefrom has not affected Ukrainian financial sector to such an extent as it did in Russia;
- the crisis in Russia has preceded the one in Ukraine, therefore, Ukraine had some time to assess its threats and undertake measures for the minimisation of its impact.

¹⁴ 'Capital' magazine. - July-August 1998

Despite the smoother nature of Ukrainian financial crisis, the foreign investors have been procrastinating with further investments into Ukrainian economy and waiting for better times. The crisis has undoubtedly led to the suspension of most potential investment projects, including those agreed upon during the EBRD Annual Meeting. However, the economic situation during April and May 1999 has proven to be more or less stable which has produced expectations about the revival of investment activity in Ukraine.

4 Successful investment history

Notwithstanding numerous obstacles and deterrent factors the Western businessmen are facing in Ukraine, investing into a number of spheres and specific businesses has proven to be profit-making and mutually beneficial for both foreigners and their Ukrainian counterparts.

Banking sector. The banking system has undergone significant reforms, including transfer to IAS by 1st January 1998, and is now up to international banking standards. Numerous foreign banks have penetrated into Ukrainian financial market and are now operating under the same conditions as domestic banks do. However, a favourable business environment in Ukrainian banking sector was deteriorated by global financial crisis, and there was a precedent of a foreign bank closing its activities in Ukraine in spring 1999. Other banks have adapted their activities to a new situation, and are now operating quite successfully under the modified strategies.

Presently, the banks are mainly involved in lending and trade finance transactions, though incurring high risks, but providing high yields. The loans are mainly granted against a liquid collateral, usually making 125-200% of the total value of the credit facility. Still, the banks often face the problem of identifying the title of the collateral because of numerous complicated and often contradictory procedures for the title establishment.

Starting from March 1999 the State Chattels Pledges Register was introduced in Ukraine which gives the registered creditor a preferential right to the pledged property before the unregistered creditor. Such a centralisation of the information on the pledged assets would make it easier for the creditor to trace the title thereto. The pledge of immovables and transportation vehicles must be notarised, according to the requirements set forth in the Law of Ukraine «On the Pledge»¹⁵.

Debt market. Before the crisis, foreign investors could also get good yields from investing into Ukrainian debt market, with low risks and high profitability both in hryvnas and in US dollars. However, due to the overall economic crisis in the

¹⁵ Zakon Ukrainy «Pro zastavy» (the Law of Ukraine «On the Pledge») enacted by the Resolution of Verkhovna rada of Ukraine No. 2655-12 dated 02.10.1992

country, Ukrainian Government had to announce the exchange of the outstanding treasury bills with more long-term ones. Such debt restructuring has inevitably shattered the investors' trust to the Ukrainian Government and caused the outflow of funds from Ukraine. It is expected, however, that, with the help of IMF's funds, Ukraine would be able to repay its debts to the international borrowers in June this year.

Other sectors. In addition to the above mentioned, active investment processes with high revenues are observed in the sphere of telecommunications, energy production, municipal services, food processing, chemistry, and engineering.

5 Conclusions

The analysis of venture factors (investment risks) in Ukraine made in this section leads to a number of important conclusions:

- Ukraine has been internationally recognised as an independent state with rich resources and high potential;
- Foreign investors have been constantly showing their interest in investing into Ukrainian economy and Ukraine has an experience of receiving investment in almost all sectors;
- In spite of some progress made in transforming the country's economy into a free market one, the Ukrainian legislative and executive bodies are still slow to react to the requirements set forth by the international business community the implementation of which is a prerequisite of extended financial assistance to Ukraine.
- As one of the major priorities, Ukraine has to remove onerous bureaucratic procedures that usually cause a delay in obtaining permits, licences and registrations for an indefinite period of time;
- In the course of privatisation, the authorities should put for sale Ukrainian 'blue-chips', create equal conditions for both domestic and foreign investors, facilitate the availability of sufficient and transparent information on the enterprises to be privatised, replace certificate privatisation with cash privatisation, and simplify privatisation procedures;
- the powers of tax authorities must be restricted to purely lawful, transparent and democratic functions consistent with fundamental rights and freedoms;
- Ukraine's political stability could be further enforced by achieving a consensus between legislative and executive branches of power and their more coherent actions.

II DOMESTIC LEGAL REMEDIES FOR MITIGATING THE INVESTMENT RISKS

1 The role of domestic legislation in mitigating investment risks

The role of legal remedies provided by Ukraine's internal legislation should be analysed in two different contexts:

- the instability of internal investment legislation as a major investment risk; and
- the role of domestic legislation among other ways of legal protection of foreign investments.

1.1 Instability of domestic legislation as a major investment risk

The analysis of investment risks made in the previous section has shown that it is impossible to tackle the problem of investment risks without elaborating and carrying out a complex set of measures in the spheres related to investment activity, nor without an agreed and uniform policy held by all legislative, executive and judicial authorities.

In order to achieve such unified actions under a single strategy throughout the country, a stable and developed legal base must be created with establishing a

clear division of powers among different governmental agencies and specifying the status of foreign investors and foreign investment.

The risks described above give vivid examples of the inefficiency of scattered attempts to reform Ukraine's economy and show how the failure to establish a distinct and unambiguous balance of powers within the state could lead to numerous abuses, excessive interference of governmental authorities into the private sector, and the violation of fundamental rights and freedoms.

Therefore, the instability of the internal legislation is considered to be the major investment risk that casts distrust among foreign investors to the country and creates unfavourable environment for business activity.

The extent to which Ukraine has managed to mitigate this risk will be discussed hereunder.

1.2 Domestic legislation among other legal remedies

The legislative and law enforcement systems existing in each country and internationally usually possess a number of legal remedies to protect foreign investments from the negative influence of venture factors. They include:

- domestic laws and regulations;
- international (multilateral and bilateral) agreements; and
- court judgements.

In the present research, an attempt is made to reveal specific features pertaining to the nature of investment processes in Ukraine, and, therefore, only those legal instruments that could show such specificity are analysed herein.

In this respect, it is worth mentioning that domestic laws and regulations, as well as Ukraine's bilateral agreements on the mutual protection of foreign investments could be referred to such specific instruments, while multipartite agreements and court rulings remain similar to the practices existing in other countries.

Multipartite agreements cover the interests of all the signatories thereto, and, thus, could be concluded upon general issues only. In contrast to the bilateral agreements, they frequently do not reflect the peculiar nature of relations between the parties. Nevertheless, multipartite agreements play a significant role in defining the form and scope of the bilateral agreements related to a specific issue and procure their consistency with international law rules.

Some words should also be said about court proceedings in Ukraine. The Ukrainian judicial system experiences the same problems as the country's whole

administrative apparatus. The low-paid judges are apt to bribery, legal proceedings often take a long time before a decision is made, and the courts lack mechanisms to enforce their decisions.

This, of course, undermines the whole law system of the country, making the existing laws and regulations nominal and deprived of a binding force as far as no legal system could be called stable if it is unable to enforce the rules it establishes.

Deprived of the specific national features and, therefore, not approached in this research, multipartite agreements are nevertheless important for the delineation of the subject matter and context of bilateral investment agreements and, sometimes, domestic laws and regulations, while the court system is designated to facilitate the enforcement and observance of the rules contained therein.

2 Review of domestic investment related legislation

During the years of its independence Ukraine has developed a rather detailed and profound investment and investment-related legislation which is generally consistent with international standards and based on the fundamental democratic rights and freedoms.

Aside from the Constitution of Ukraine and the Civil Code where major principles of civil and public relations are set forth, Ukrainian legislative power has drawn up the laws that stipulate the procedures under which certain kinds of investment and investment-related business activities are carried out in Ukraine, in particular, the Laws of Ukraine «On Foreign Economic Activity», «On the Treatment of Foreign Investment», «On Investment Activities», «On Enterprises in Ukraine», «On Business Activity», «On Privatisation of the Assets of State-Owned Enterprises», «On General Principles of Creation and Functioning of Special (Free) Economic Zones», «On Securities and Stock Exchange», «On Banks and Banking Activity», and a number of other laws and bylaws.

It is worth mentioning that, in line with the general legislation governing various kinds of business activities, Ukraine has developed specific investment laws which marks a progressive step forward as far as many countries have not concentrated the rules on investment in a separate branch of law, but incorporated them into other laws on business activity.

Thus, Ukraine possesses a structured and well-organised legal base for the regulation of investment processes starting from its initial stage (registration) and ending with dispute settlement procedures.

Ukraine has also made another significant achievement in its investment law-making process, namely, it has established a two-level approach towards the regulation of investment relations with participation of foreign investors, and, in particular, towards the protection of foreign investment.

The two-level approach in the sphere of investment processes governing supposes the existence, in addition to domestic rules which form the first level, of the bilateral investment agreements establishment, i.e. the second level of the country's investment legislation.

Two levels of investment processes regulation differ in a number of ways, namely:

- *the structure and form of the instruments that are the elements of two levels.* Domestic rules are mainly issued by the country's legislative body in the form of a law, regulation, decree, order, etc., while bilateral agreements are at first signed by two signatory states, and only after that incorporated into domestic legislation;
- *the number of subjects of regulation.* On the first level, the force of an instrument extends to the subjects of investment activity of one country, while on the second level it covers two signatory countries themselves, or the nationals of the two countries;
- *the nature of guarantees and commitments provided.* In case of domestic legislation, the state provides the guarantees on the protection of foreign investment in a unilateral way, and in case of bilateral investment agreements, the parties agree upon mutual legal protection and facilitation of foreign investment and, thus, have equal commitments in the sphere of investment.
- *enforceability.* The disputes arising out of the implementation of domestic investment laws are, in case the state is a party to a dispute, subject to consideration in Ukrainian courts, and bilateral agreements stipulate the possibility of dispute settlement in international arbitration, or the International Centre of Investment Disputes, as the case may be.

The peculiarities of Ukraine's bilateral investment agreements with other countries are described in the next section hereunder, and this section proceeds with certain issues of investment activity covered by Ukraine's investment and investment-related legislation.

2.1 The main issues of investment activity in Ukrainian domestic laws

Ukraine's internal legislation provides a broad and detailed regulation of main issues pertaining to the investment activities in Ukraine, covering the following aspects:

General principles. The Constitution of Ukraine adopted on 28 June 1996 provides major constitutional rights and freedoms, and, among others, guarantees the right to ownership and inviolability of private property (Article 44)¹⁶ that are considered to be essential prerequisites for the development of a free market economy in Ukraine.

¹⁶ Konstytutsia Ukrainy (the Constitution of Ukraine) dated 28.06.1996

Status of foreigners and property owned by foreigners in Ukraine. The status of foreigners and foreign property in Ukraine is established by the Constitution of Ukraine, the Law of Ukraine «On Property», and the Law of Ukraine «On the Legal Status of Foreigners» declaring the equality in rights and obligations between Ukrainian and foreign citizens. The Law «On Property» specifically states the equality of rights and freedoms with respect to the property belonging to foreigners in the territory of Ukraine (part 2, Article 11)¹⁷.

Guarantees of the governmental protection of foreign investment. In the Law «On the Treatment of Foreign Investment», the Ukrainian state provides the following guarantees as to the protection of foreign investment in Ukraine:

- (1) Guarantees in case of change of legislation. The state provides a 10-year delay for the entry into force of any alterations made to the guarantees provided by Ukrainian investment laws in force;
- (2) Guarantees against forcible seizure and illegal actions of governmental bodies and their officials. The law protects foreign investments from the nationalisation and bans governmental bodies to seize them, except for performing salvage measures in cases of natural calamities, accidents, epidemics and epizootics. To carry out such a seizure, the corresponding governmental body must obtain an authorisation of the Cabinet of Ministers of Ukraine.

The law also stipulates the right of investor to appeal the decision on the nationalisation of its investment in court, but as far as the state's interests are concerned the court rulings will hardly be in favour of foreign investors, and, therefore, it is not worth relying upon an unprejudiced ruling delivery in this case.

- (3) Compensation and indemnification for the damage incurred by foreign investors. Foreign investors are guaranteed, on the following quite fair conditions, the compensation for the losses, including moral damage and lost profit, caused by the fault or omission of the governmental bodies:
 - such losses must be compensated on the basis of market prices prevailing at that time and/or the losses assessment confirmed by an auditors' firm.
 - the compensation must be prompt, adequate and effective.
 - the amount of compensation for the nationalisation of the investor's property is defined as at the moment of the termination of ownership title;

¹⁷ Zakon Ukrainy «Pro vlasnist» (the law of Ukraine «On Property») enacted by Resolution of Verkhovna Rada of Ukraine No.885-12 dated 26.03.1991

- the amount of the compensation for the damage incurred by the foreign investor as a result of illegal actions committed by the governmental bodies is defined as at the moment of the actual enforcement of such illegal decision
- the compensation must be made in the currency in which the investment was made, or another currency acceptable for the foreign investor and consistent with Ukrainian laws then in force.
- For the period when the right for compensation commences and until it is actually paid out the interest will accrue on the sum of the compensation at a LIBOR rate.

(1) Guarantees in case of the termination of investment activity. If a foreign investor would be wishing to terminate his investment activity in Ukraine, the state ensures the investor's right to return his investment within six months in full amount, and all proceeds from such an investment. However, different rules may be established for the termination of investment activities by other laws of Ukraine and international agreements which Ukraine is a party to.

(2) Guarantees of transfer of profit, revenues and other proceeds from foreign investment. Foreign investors are guaranteed unhindered and immediate transfer abroad of all their profit, revenues and other proceeds from foreign investment.

Treatment of foreign investment in Ukraine. The Law of Ukraine «On the Treatment of Foreign Investment» establishes the national treatment for the foreigners' investment activities in Ukraine and thereby grants equal rights to foreign and domestic investors. Exceptions to this provision could be specified in other laws and international agreements of Ukraine.

The foreign investment can be subject to any guarantees and preferences set out by Ukrainian laws and regulations only in case it is registered in the established order with appropriate governmental bodies (state administrations).

In terms of preferences and taxation, the Law provides less favourable conditions for foreign investors than previous investment legislation. According to the Decree of the Cabinet of Ministers of Ukraine «On the Treatment of Foreign Investment»¹⁸ that was adopted in 1993 and governed foreigners' investment activities in Ukraine until cancelled by the above mentioned Law «On the Treatment of Foreign Investment», the enterprises with so-called «qualifying» foreign investment were exempted

¹⁸ Dekret Kabinety Ministriv Ukrainy «Pro rezhym inozemnogo investuvannya» (the Decree of the Cabinet of Ministers of Ukraine «On the Treatment of foreign Investment») No. 55-93 dated 20.05.1993.

from profit tax for the period of five years. For the purposes of the aforementioned Decree, the «qualifying» foreign investment meant a foreign investment in the amount of not less than twenty per cent of the enterprise's charter capital and, simultaneously, not less than:

- USD 1Mio for the banks in case of cash investment;
- USD 500 000 for other enterprises and organisations in case of cash investment;
- USD 100 000 for the banks in case of in-kind investment;
- USD 50 000 for the enterprises and organisations in case of in-kind investment.

The newly adopted Law has cancelled this tax holiday and eliminated qualifying investments by establishing a general 10% ceiling of foreign investment in the charter fund of an enterprise to be qualified as an enterprise with foreign investment.

Such a deterioration of investment environment has led to lodging a number of lawsuits with Ukrainian courts of arbitration by the enterprises that enjoyed tax holidays in accordance with the Cabinet of Ministers Decree. In the majority of cases the courts of arbitration delivered decisions in favour of such enterprises and awarded the return of tax holidays to the enterprises entitled to them under the Decree which caused a new wind of confrontation between different branches of power.

The conflict around tax preferences for the enterprises with foreign investment reached its culmination point upon the issuance by the President of Ukraine of the order requiring to suspend foreign economic activities of 37 foreign investment enterprises with tax holidays, as well as the operations on their LORO accounts related to the settlements under foreign economic contracts, until the consideration by the Constitutional Court of Ukraine of the suits on the official interpretation of the laws on foreign investment¹⁹.

«The 37s' case», as it was called, reflects the instability of Ukrainian investment legislation and the lack of efficient enforcement mechanisms allowing foreign investors to protect their rights.

The exemption from import duties of property imported into Ukraine as an investment into the charter fund of an enterprise seems to be the only obvious preference established for foreign investors by the Law «On the Treatment of Foreign Investment».

¹⁹ Rasporyazheniye Prezidenta Ukrainy «O nekotorykh voprosakh vneshneekonomicheskoy deyatel'nosti. (the Order of the President of Ukraine «On Some Issues of Foreign Economic Activities») No. 42/99 dated 26.02.1999

However, it has also been restricted in comparison with the cancelled Decree of the Cabinet of Ministers. The Law sets out a three-year ban for the alienation of the property imported into Ukraine as an investment into the enterprise's charter fund and exempted from import duties, while no time restrictions for the alienation of such property were stipulated in the cancelled Decree.

Settlement of disputes with participation of foreign investors. The main principles of the consideration of disputes with participation of foreign individuals and legal entities are established by the Civil Procedural Code of Ukraine²⁰.

In particular, it establishes the equality of domestic and foreign individuals in procedural rights, without providing such an equality to foreign enterprises and organisations. The Code also admits the possibility of the restriction of procedural rights enjoyed by individuals and legal entities of those countries that apply special restrictions to the Ukrainian individuals and legal entities.

A specific procedure for the settlement of investment disputes is envisaged in the Law of Ukraine «On the Treatment of Foreign Investment». According to it, the disputes between foreign investors and the state arising out of the state regulation of foreign investment and activities of the enterprises with foreign investment are subject to consideration in Ukrainian courts, unless otherwise provided in Ukraine's international agreements. All other disputes may be considered in courts and courts of arbitration both in Ukraine and abroad.

The settlement of disputes between the enterprises with foreign investment can be performed in the international commercial arbitration, according to the Law of Ukraine on International Commercial Arbitration²¹. The Law is strongly based on the provisions of a standard law adopted by the United Nations Commission on International Trade Law in 1985 which makes it consistent with principal international standards existing in this sphere.

The Law on International Commercial Arbitration ensures the principle of equal treatment of both parties to a dispute and provides much freedom to the parties in defining the conditions and procedure of the dispute settlement.

²⁰ Tsyvilny Protsesualny Kodeks Ukrainy (the Civil Procedural Code of Ukraine) enacted by the Law of Ukrainian Soviet Socialist Republic «On the Approval of Civil Procedural Code of Ukrainian Soviet Socialist Republic» dated 18 July 1963, with alterations and supplements.

²¹ Zakon Ukrainy «Pro mizhnarodny komertsyyny arbitrazh» (the Law of Ukraine «On International Commercial Arbitration») enacted by the resolution of Verkhovna Rada of Ukraine No. 4003-12 dated 24.02.1994.

In Ukraine, the international commercial arbitration proceedings are carried out by the International Commercial Court of Arbitration at the Chamber of Trade and Commerce of Ukraine.

3 Special (free) economic zones in Ukraine

Ukraine has developed a number of special laws for the regulation of activities in free economic zones created in Ukraine.

The Law of Ukraine «On the Treatment of Foreign Investment» stipulates that the principles of regulation of foreign investment in free economic zones shall be established by special laws on free economic zones, but such principles cannot create worse investment conditions than those set out in the Law itself.

Special laws and regulations on free economic zones in Ukraine include the Law of Ukraine «On General Principles of Creation and Functioning of Special (Free) Economic Zones», laws and regulations on each free economic zone created in Ukraine, the Resolution of the Cabinet of Ministers of Ukraine «On the Concept of Creation of Free Economic Zones in Ukraine», etc.

Ukraine's legislation on free economic zones has established a quite complicated procedure of such zones creation. According to the Law of Ukraine «On General Principles of Creation and Functioning of Special (Free) Economic Zones»²², each free economic zone is created through the adoption of a particular law by Verkhovna Rada of Ukraine which usually takes a rather long time.

In order to simplify this procedure, a draft law has been drawn up stipulating the creation of each free economic zone in Ukraine on the basis of a decision of the Cabinet of Ministers of Ukraine and, in case it is adopted, the process of establishing free economic zones in Ukraine will go in a more easy and expedient manner.

The Law «On General Principles of Creation and Functioning of Special (Free) Economic Zones» confirms the all guarantees provided by the Law «On the Treatment of Foreign Investment» in free economic zones created in Ukraine, and further specifies the following guarantees:

- unhindered export of the capital invested in a free economic zone and proceeds thereof from both such a zone and Ukraine;

²² Zakon Ukrainy «Pro zagalni zasady stvorenniya i funktsionuvannya spetsialnykh (vilnykh) ekonomichnykh zon» (the Law of Ukraine «On General Principles of Creation and Functioning of Special (Free) Economic Zones») enacted by the Resolution of Verkhovna Rada of Ukraine No. 2674-12 dated 13.10.1992.

- freedom of economic activities in a free economic zone, including the freedom of choice of the types, forms and ways of carrying out activities in a free economic zone, provided they are consistent with Ukrainian laws in force;
- free transfer of income of foreign employees working in a free economic zone abroad, including their savings in the banks located in such a zone;
- protection of interests of participants of a free economic zone in case of its liquidation.

The recommendations as to the developing of the mechanisms of creation of free economic zones in Ukraine and delineating the principles of their functioning are incorporated into the Concept of the Creation of Special (Free) Economic Zones in Ukraine approved by the Resolution of the Cabinet of Ministers of Ukraine²³.

The Concept based on the Law «On General Principles of Creation and Functioning of Special (Free) Economic Zones» gives explanations as to the objectives and priorities of the creation of free economic zones in Ukraine, outlines the measures needed to be undertaken for the developing of favourable investment climate in Ukraine; introduces the principle of the conceptual integrity of approaches which should be observed in order to form effective and flexible administrative mechanisms in a free economic zone, elaborates on the types of free economic zones that can be created in Ukraine, and declares among the top priorities the consistency of the strategic development of free economic zones with the overall strategy of Ukraine's economic development.

In accordance with the Law «On General Principles of Creation and Functioning of Special (Free) Economic Zones», favourable tax and customs conditions are established in such zones, including preferential taxation treatment, special governmental investment system, and financial and banking conditions, etc.

However, specific benefits for each free economic zone are set out in a law adopted by the Ukrainian Parliament to govern its activities. By now, the laws have been adopted on the functioning of the following free economic zones in Ukraine: «Sivash» (Northern Crimea), «Yavoriv» (Western Ukraine, near Lviv), Slavutich (Chernobyl region), «Donetsk», «Azov» (Southern Ukraine, near Mariupol), Truskavets (recreation zone in the Carpathian Mountains, Western Ukraine). Additionally, a special (preferential) treatment of investment activities was established by the Decrees of the President of Ukraine for the Trans-Carpathian region (Western Ukraine) and for the priority development territories in Lugansk region (Eastern Ukraine).

Thus, the Law of Ukraine «On Some Issues of Currency Regulation and Taxation of the Subjects of «Sivash» Experimental Economic Zone»²⁴ establishes the following benefits for the participants of the experimental economic zone:

²³ Postanova Kabinetu Ministriv Ukrainy «Pro Kontseptsiyu stvorennya spetsialnykh (vilnykh) ekonomichnykh zon v Ukraini» (the Resolution of the Cabinet of Ministers of Ukraine «On the Concept of the Creation of Special (Free) Economic Zones in Ukraine») No. 167 dated 14.03.1994.

²⁴ Zakon Ukrainy «Pro deyaki pytannya valyutnogo regulyuvannya ta opodatkovannya sub'ektiv eksperymentalnoi ekonomichnoi zony «Sivash» (the Law of Ukraine «On Some Issues of Currency Regulation and Taxation of the Subjects of «Sivash» Experimental Economic Zone») enacted by the Resolution of Verkhovna Rada of Ukraine No. 66/96-BP dated 23.02.1996

- profit tax reduction up to 50% in case of the re-investment of profits;
- exemption from value-added tax and duties on materials and equipment imported for the company's own production;
- no obligatory sale of currency at the interbank currency exchange in case of re-investment.

Additional benefits established for «Sivash» experimental economic zone by other laws include the exemption from VAT and duties on exports of the companies working in the zone, and lifting licensing and quoting export restrictions.

In spite of the established benefits, in case of the Sivash zone, the foreign investors have faced the problems that are common for Ukraine. The complicated mechanisms of the creation and registration of free economic zones, long-lasting procedures of business plans consideration and approval (18 investment projects out of 27 submitted were selected), procrastination and unwillingness to co-operate from the part of central and local authorities have cast disappointment and pessimism with foreign investors as to the success of the zone development which has led to a significant shortfall of capital inflow into the region.

Besides, after the introduction of the above mentioned benefits Verkhovna Rada of Ukraine made several attempts to cancel the benefits it granted to the Sivash zone. Due to the strong resistance to such unpopular measures, the benefits were restored, but such a practice makes it doubtful that similar attempts will not be repeated in the future.

The disturbance and volatile legal environment in the Sivash zone resulted in a reduced number of investment projects from 60 having declared their intention to work in the zone to 4 that are really working there²⁵.

Notwithstanding all the difficulties the participants of the Sivash zone have faced in the course of their activities, the progress achieved over the period the zone's functioning since its registration in September 1996, with the complete collapse of the national economy in the background, looks quite impressive:

- the amount of sales reached the level of USD 40 million;
- USD 2.5 million transferred to the state budget;
- benefits granted for the amount of USD 1 million;
- reinvestment of profits equalling to USD 650 000;
- USD 700 000 of foreign investment attracted;
- 120 working places created and 4 000 saved;
- the balance sheet profit made USD 2 000 million²⁶.

The working projects show good results and a number of new ones are being prepared, in particular, the power plant construction project in the Crimea jointly with a German investor (Siemens).

²⁵ 'Capital' magazine.- July-August 1998.

²⁶ Ibid. For the purposes of convenience, the statistics in gryvnas was rounded and converted into U.S. Dollars at an approximate rate of 2 gryvnas per 1 U.S. Dollar existing at that period of time.

The types of benefits granted to other free economic zones in Ukraine are quite similar to those existing in «Sivash» experimental economic zone, differing mainly in the rates and periods of time for which such benefits are provided. The common scheme involves complete or partial exemption from the profit tax for the first two or three years and further gradual increase of the tax rates over the following years. The special treatment of some zones requires a qualified investment for being granted tax benefits, though the amount of such a qualified investment varies from zone to zone.

4 Institutional infrastructure for facilitating foreign investment in Ukraine

In Ukraine, an institutional system of special organisations, governmental bodies and other structures was formed to protect the rights and property of foreign investors. It includes the following main elements:

The Foreign Investment Advisory Council at the President of Ukraine's Office. The Advisory Council was founded in 1997 for the purpose of drawing up recommendations as to the improvement of investment climate in Ukraine and providing them to the top officials of the country, first of all, to the President of Ukraine. The members to the Council are top Ukrainian governmental officials specialising in the sphere of investment and economy, as well as key executives of major foreign companies active in Ukraine.

The Council's definite advantage lies in providing the possibility for foreign investors to address to the Government the problems they are facing in the course of carrying out investment activities in Ukraine, and to build up a constructive and open dialogue with the governmental bodies that are regulating such investment activities.

For the Ukrainian Government, the Council plays an important role in defining main deterrent factors that discourage foreign investment into Ukraine, and providing an unprejudiced evaluation of the economic developments in Ukraine based on international experience and standards. The Government would benefit greatly from allowing foreign investors to participate as advisors in the law-making process in the spheres of investment and other kinds of economic activity in the country.

The recommendations discussed at the Council's meetings, further elaborated in expert groups and finally provided to the Ukrainian Government have practical effect as far as their are the basis for drawing up draft laws and regulations aimed at mitigation of investment risks in the country.

The Chamber of Independent Experts at the President of Ukraine's Office for the Investment Affairs. Like the Advisory Council, the Chamber presents an advisory body composed of the leading foreign and domestic experts in the fields of law and economy, and performs the functions of a non-binding arbitration in the

settlement of disputes between foreign investors and state authorities. The Chamber has already managed to enforce the rights of foreign investors in a number of disputes.

The National Agency of Ukraine for Reconstruction and Development. According to the Provision «On the National Agency of Ukraine for Reconstruction and Development»²⁷, The Agency is a central executive body subordinate to the Cabinet of Ministers of Ukraine.

The Agency plays a co-ordination function in the state's relations with international financial organisations and institutions for the purpose of attracting loans, grants, foreign investments, and international technical and humanitarian aid, participates in the preparation of proposals as to the improvement of the legislation in the above mentioned spheres, enforces existing laws and regulations, organises and takes part in the state investment projects and programs.

Ukrainian State Credit and Investment Company. The company is a state enterprise founded by the Cabinet of Ministers of Ukraine in 1995.

The Company exercises operational and controlling functions, including the attraction of credits and investments into the priority sectors of Ukraine's economy, evaluation, selection, financing and support of investment projects, servicing of foreign loans, etc.

The creation of a network of governmental bodies and organisations the activities of which are aimed at the promotion of co-operation between foreign investors and Ukraine's state authorities shows the readiness of the latter to seek for constructive approaches to the improvement of investment climate in Ukraine and the development of its economy. An active participation of foreign advisors and experts could speed up this process to a great extent and an openness of the Ukrainian Government towards the recommendations and proposals made by them would facilitate the creation of Ukraine's positive image at an international arena and among global financial institutions.

However, as it could be seen from the description of such organisations and governmental bodies, the scope of their responsibilities is often limited to purely advisory, or supportive and co-ordination functions depriving them of real powers, or a decisive vote in determining the investment strategy of the country. By vesting a part of administrative and regulatory functions to the institutional infrastructure designated to support foreign investment, the Government would benefit from a more uniform and agreed investment policy developed with due regard to the interests of all the parties concerned. Moreover, if permitted to participate in governmental or near-governmental bodies and organisations for the investment issues, foreign investors would bring to Ukraine the experience of successful regulation of investment processes at a state level.

²⁷ Polozhennya «Pro Natsionalne agentstvo Ukrainy z rekonstruktsii ta rozvytku» (the Provision «On the National Agency of Ukraine for Reconstruction and Development») approved by the Decree of the President of Ukraine No. 771/96 dated 30.08.1996.

5 Conclusions

- Instability of the country's domestic legislation presents major investment risk for foreign investors and makes any other positive transformations aimed at attractive foreign investment into the country impossible;
- Ukraine has a rather developed legislation in the sphere of business activity. Special laws for the regulation of investment processes in Ukraine have been adopted, thus, forming a separate field of law - investment law. This marks a significant progress made in the law-making process in Ukraine, if compared to a number of other post-Communist and former Soviet Union countries that have developed only general legislation for the regulation of all kinds of business activity;
- The two-level approach towards the regulation of investment processes has been formed in Ukraine with domestic laws and regulations providing unilateral guarantees from the part of the state at the first level, and a system of bilateral agreements on the mutual protection of foreign investments concluded between Ukraine and a number of other countries at the second level;
- Ukrainian investment and investment related laws are generally consistent with international standards and provide foreign investors, at least nominally, with major guarantees as to the protection of their rights and property in the course of carrying out investment activity;
- Though possessing a strong legislative basis for the attraction of extensive finance from abroad, the international opinion is that Ukraine is lacking enforcement mechanisms to make its laws work more effectively and procure concrete protection to foreign investors. This is mainly caused by the insufficient progress made in reforming administrative and judicial systems, lack of harmonised strategy in legal, fiscal and taxation fields, discontent between the legislative and executive branches of power, bribery and corruption among governmental officials;
- Ukraine has established a so-called 'national' treatment towards foreign investors which actually means the deprivation of privileges and tax holidays granted to them by previously acting laws. The tougher fiscal and taxation policy naturally led to the withdrawal of large amounts of foreign capital from the Ukrainian market. In order to restore the trust of foreign investors in the irreversibility of reforms in Ukraine, the state should renew all benefits cancelled by it and create more favourable environment for investors.
- The only examples of granting benefits to foreign investors in Ukraine are investments into free economic zones. The Government promises attractive and profitable conditions for those willing to invest into free economic zones, however, the problems investors face in such zones are quite similar to those existing in the rest of the Ukrainian territory: burdensome selection and registration procedures for investment projects, abuses from the part of local authorities, as well as attempts of the reversal of the tax holidays and other exemptions guaranteed to foreign investors by the state.

- The institutional infrastructure for the support of foreign investment in the country has limited access to real decision making mechanisms and is seen only as advisory, or auxiliary system. The aforementioned network of organisations could serve as a two-way channel for communication between governmental officials and the representatives of foreign companies active in Ukraine. Moreover, this can be a good opportunity for the foreigners to take part in the country's decision-making processes. Such participation would in this case be fully controlled by the state and, thus, would present no threat to the national interests and security of Ukraine.

III UKRAINE'S BILATERAL INVESTMENT AGREEMENTS AS AN EFFECTIVE INSTRUMENT FOR FOREIGN INVESTMENT PROTECTION

1 Correlation of bilateral investment agreements with domestic laws and multilateral agreements

Bilateral agreements on the promotion and mutual protection of foreign investments create an efficient legal mechanism for the protection of the investor's rights as far as they represent the state's commitment to exercise such protection before another state, in return to the equal commitments of the latter.

The system of bilateral investment agreements facilitates further progressive development of domestic investment laws and creates additional enforcement possibilities for foreign investors because a bilateral investment agreement is binding for both signatories and is not changed so easily as internal laws and regulations. If incorporated into the national legislation and duly harmonised with it, the bilateral investment agreements system presents a reliable and attractive stimulus for foreign investors to place their capital with an economy of a country that is a party to such an agreement. In this case, the two systems, national and international, reinforce each other perfectly.

As far as the interaction of bilateral and multilateral investment and investment related agreements is concerned, the following distinctive features could be pointed out:

- in contrast to multilateral agreements, bilateral agreements involve only two parties that allow to take into account all specific issues of their relations in the investment sphere;
- bilateral investment agreements cover a more narrow scope of issues, with paying more attention to the details of legal and investment relationship between the two signatory states. Simultaneously, multilateral agreements usually outline the form of particular bilateral investment agreements and the typical provisions that should be covered by them, and ensure their consistency with the international legal standards.

2 Treatment of bilateral investment agreements in Ukraine

As discussed in the previous section, Ukraine has developed a rather positive two-level approach towards the regulation of relations arising out of investment activities in its territory, including both special domestic investment laws and bilateral investment agreements system.

However, it is necessary to define the role of bilateral investment agreements in the system of domestic investment laws, and to analyse the question of supremacy between these two levels of the national investment legislation.

According to the Constitution of Ukraine, all duly ratified international agreements concluded by Ukraine with other states, or international organisations, are a part of Ukraine's domestic legislation, however, such agreements cannot conflict with the Constitution. The ratification is carried out through the adoption by Verkhovna Rada of a separate ratification law for each agreement, as stated in the Law «On the International Agreements of Ukraine»²⁸.

The aforementioned law also stipulates that in case international agreements establish the provisions other than those established by domestic laws, the provisions set forth in the

²⁸ Zakon Ukrainy «Pro mizhnarodni dogovory Ukrainy» (the Law of Ukraine «On the International Agreements of Ukraine») enacted by the resolution of Verkhovna Rada of Ukraine No. 3768-12 dated 22.12.93.

international agreements are applied. Thus, in addition to the equal legal effect of domestic laws and international agreements provided by the Constitution of Ukraine, the supremacy of the latter is established in Ukraine's national legal system.

Special investment laws, for example, the Law «On the Treatment of Foreign Investment», further enforce the international law supremacy rule by applying it to a specific sphere of investment relations. Therefore, bilateral investment agreements concluded between Ukraine and other states can establish a more preferential treatment for the foreign investors from these states in Ukraine than the national legislation does.

3 Specific features of bilateral investment agreements concluded between Ukraine and other states

By now, Ukraine has entered into, and ratified, bilateral agreements on the promotion and mutual protection of foreign investment with the following countries: Argentina (year of execution - 1995), Armenia (1994), Austria (1996), Azerbaidzhan (1997), Belarus (1995), Bulgaria (1994), Canada (1994), Chile (1995), China (1992), Croatia (1997), Cuba (1995), the Czech Republic (1994), Denmark (1992), Egypt (1992), Estonia (1995), France (1994), Georgia (1995), Germany (1993), Greece (1994), Hungary (1994), Indonesia (1996), Israel (1994), Iran (1996), Italy (1995), Kazakhstan (1994), Korea (1996), Kyrgyzstan (1993), Latvia (1997), Lithuania (1994), Macedonia (1998), Moldova (1995), Mongolia (1992), the Netherlands (1994), Poland (1993), Slovakia (1994), Spain (1998), Sweden (1995), Switzerland (1995), Turkey (1996), the United States of America (1994), Uzbekistan (1993), and Vietnam (1994).

A number of other Ukraine's bilateral investment agreements are not ratified by the other contracting party.

The term of most bilateral investment agreements concluded by Ukraine is ten years, normally, with the possibility of their further prolongation by the tacit consent of the parties.

It is worth mentioning that almost all bilateral investment agreements concluded by Ukraine are: (a) similar in structure, and (b) characterised by the uniformity of legal mechanisms for the protection of foreign investment.

3.1 Structural similarity

The structure of bilateral investment agreements between Ukraine and other states is usually as follows:

- preamble where mutual assurances are given as to the willingness to enlarge and promote the economic co-operation between the two contracting parties;

- definition of terms, such as ‘investment’, ‘investor’, ‘income’, ‘intellectual property rights’, ‘citizens’, ‘companies’, ‘financial institutions’, ‘territory’, etc. Though the list of terms is basically the same in all agreements, it may differ in details, and some agreements may include the terms which are not contained in the others;
- the provisions as to the treatment of foreign investment in the territories of the contracting parties. Normally, the most favoured nation treatment is established, though some agreements have separate articles that additionally provide for the national treatment in certain cases, for example, the Agreement Between the Government of Ukraine and the Government of Canada on Investment Promotion and Protection²⁹;
- guarantees of the compensation in cases of foreign investment expropriation, and free transfer of investments, and/or proceeds therefrom;
- subrogation clauses, in case of agreements with a number of countries, e.g. Poland, Germany, Hungary, Canada, etc.;
- the procedure of the settlement of disputes arising out of investment relations between the parties.
- final provisions setting out the term of the agreement and the procedure of its coming into force.

The majority of bilateral investment agreements which Ukraine is a party to are structured in a way described above, with slight differences resulting from specific relations between Ukraine and another contracting party.

3.2 Uniformity of foreign investment protection mechanisms

Most bilateral investment agreements concluded by Ukraine incorporate the following provisions and guarantees for the promotion and protection of foreign investment:

- establishing a non-discrimination treatment for the investors, and investment, of the other contracting party that envisages a just and equal attitude towards them as well as procuring a full protection and security thereto;
- establishing the most favoured nation treatment as to the investments belonging to the nationals of the contracting parties.
- establishing of a national treatment as to the individuals and legal entities of the contracting parties. As mentioned above, some agreements specify other cases when the national treatment is applied. Thus, in case of the bilateral investment agreement with Canada, a separate article has been included therein that provides for establishing a national treatment with

²⁹ Agreement between the Government of Ukraine and the Government of Canada on Investment Promotion and Protection; signed on 24.10.94, ratified on 02.06.95 by the Law of Ukraine No.203/95-BP

respect to the enlargement, management, alienation, sale, or placement of investments³⁰.

- establishing of a national treatment in case of indemnifying the investors of the contracting parties for the damages caused by wars, armed conflicts, natural calamities, state of emergency, revolutions, disturbances, etc.;
- the expropriation of foreign investment may only take place for public purposes on a non-discriminatory basis, subject to a just, adequate and prompt compensation. Interest must be paid for the period from the date of actual expropriation till the full repayment of compensation;
- ensuring a free and immediate transfer of investments, proceeds therefrom, and of compensation is guaranteed to the investors of the contracting party (however the kinds of funds subject to a free transfer vary slightly from one agreement to another);
- granting the right of a contracting state to subrogation (transfer of investor's rights and claims to the contracting state in case it makes guarantee, or insurance, payments under the agreements concluded with such investor);
- setting out the principle of the settlement of all disputes arising out of investment agreements in an amicable way, by means of negotiations;
- in case the parties fail to settle the dispute in an amicable way, the procedure of the dispute settlement in the courts of arbitration is applied;
- in the course of arbitration proceedings, each party nominates an arbitrator, and such arbitrators are responsible for nominating a third arbitrator who, in the most cases, would be the Head of the Court of Arbitration. The court delivers a decision by a majority of votes. Such decisions are final and binding for both parties participating in the dispute;
- the parties may usually choose between the courts of the recipient country, the International Centre for the Settlement of Investment Disputes (ICSID) founded in accordance with the Convention on the Settlement of Investment Disputes Between the States and Nationals of Other States (1965 Washington Convention), provided one of the contracting parties is a member to such a Convention, or to an international or *ad hoc* court of arbitration established in accordance with the UNCITRAL (United National Commission of International Trade Law) Arbitration Rules.

4 Conclusions

- Bilateral investment agreements concluded between Ukraine and other states and duly ratified by Verkhovna Rada are a part of the Ukrainian domestic investment legislation and have equal legal force and effect with such domestic investment laws;

³⁰ Ibid.

- In Ukraine, the supremacy of the international agreements is established which allows to create more favourable conditions for foreign investors than those provided by the national legislation;
- Ukraine has bilateral agreements with a large number of countries that reveals the interest of the international community towards investing into Ukrainian market;
- The provisions of Ukraine's agreements on the protection of foreign investments with other states basically overlap the principles of investment activities set forth in the domestic legislation, and this gives an additional evidence of the consistency of Ukrainian internal investment laws with international standards.

AFTERWORD

The analysis of venture factors (investment risks) existing in Ukraine undertaken in this research and the attempt to outline the most effective ways of their mitigation leave good grounds for optimism.

Ukraine's outstanding potential and its positive political image in the world make it one of the most attractive targets in the region, and many potential foreign investors express their readiness to start co-operation with Ukrainian partners as soon as favourable conditions are created for this. As could be seen from the conclusions made in the previous sections, such conditions mainly allow for carrying out structural economic reforms in the country.

Ukraine has demonstrated rather a progressive pace ahead in the course of holding such reforms by developing a strong legal base consistent with the international standards, including the bilateral investment law system, that provides protection to foreign investors' rights and property, and guarantees as to treating them in a equitable and lawful manner.

As a country in transition, Ukraine is still in the process of creating a working enforcement system to support the investment legislation, and, in the course of carrying out this objective, faces a number of difficulties that are mainly inherited from the time when Ukraine was a part of the Soviet Union (such as unclear division of powers between legislative, executive and judicial branches, overcentralized economy, bureaucracy, abuse of power by the governmental authorities, fear of foreign penetration into the country, etc.).

All these, and other problems that slow down economic transformations in the country and deter foreign individuals and companies from investing into Ukraine show all the controversies the country experiences when switching to another economic system. On the example of Ukraine, it could be perfectly seen how ambiguous and unaccorded actions of different branches of power could completely block positive initiatives, if not reverse them.

Currently, the top priority of Ukraine's policy is to integrate all its forces and to elaborate a single strategy of reforms implementation on all levels and in all spheres of the country's life. Without a uniform approach towards the improvement of current economic, social and political situation, it would be impossible for Ukraine to meet the challenges existing in the global environment, and to integrate into the international economic community.

Ukraine should become more open to an international business, since the penetration of foreign capital and intellectual property would not only revive the paralysed industrial sector of the country and, thus, decrease the level of unemployment, but would rather help to create new resource saving industries based on the latest technological developments which would facilitate Ukraine's new birth as a technologically advanced state.

Foreign investors are awaiting for the possibility to start exploring Ukraine's rich resources, and creating a favourable climate for that would give a rise to Ukraine's future prosperity.