# REINVESTMENT ACTIVITY OF INDUSTRIAL ENTERPRISE – STIMULATORS AND MOTIVATORS: CASE OF UKRAINE

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Basic tendencies in investment climate of Ukraine are discovered. The principal sources of investments of industrial enterprises are examined. The process of reinvestment activity of industrial enterprises and its influence on the prospects of economic growth of the country are considered. Basic stimulators and motivators which allow to accelerate the reinvestment activity of the industrial enterprises used in the global economy and recommended by international economic and financial institutions are defined and prospects of its application in Ukraine are considered.

#### INTRODUCTION

Crisis tendencies in global economy which sharply affect on Ukrainian economy accelerated by internal misbalances on the domestic markets, political unstable situation and significant share of hidden economy have sharply cut the possibilities of the industrial enterprises of Ukraine to attract new external especially foreign sources of financing of their activity. Moreover, according to report of World Bank and International Bank of Reconstruction and development [1] value of cross-border mergers and acquisitions in 2009 (1<sup>st</sup> half) fell by 35% and international corporations were oriented on repatriation of profits. This led to decrease in reinvestment and, as a result, to decrease of FDI and divestment. In this situation significant attention should be paid to searching the internal sources of funding.

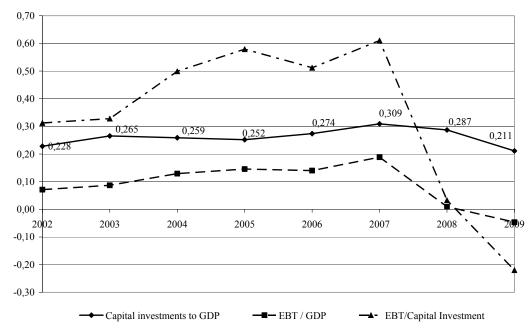
Different approaches to optimization of structure of sources of funding, selection of effective forms and types of financing obligatory consider such principal source as reinvested earnings. Crucial issues in this case are defining the optimal proportion of profit distribution and defining the direction how the distributed profit should be used. But not only this questions should be considered by owners and monitored by the local and state government. Principal question that should be discovered is analysis of motives of each participants of business-process to distribute profit, to pay dividends and to reinvest earnings into enterprise. Moreover reinvested earnings also should be considered as a possibility to improve business-process inside the enterprise or to take part into activity of financial market, activity of other enterprises, etc.

That's why the goal of this article is to consider the basic motives of participants of the market to reinvest profit into extended reproduction, financial operations, etc. and to examine the basic and most effective tools of stimulation of reinvestment process.

## 1. Sources of investments: recent trends and prospects.

As it was mentioned, financial and economic crises sharply affect the investment activity of the enterprises. Especially it concerns to metallurgical and coal-mining industry which are system-basing export branches of Ukrainian economy. Moreover these branches can be characterized as most depressive and depreciated with high level of power-consuming with strongly negative affect on the environment. In this situation one of the most actual problem is finding source of funding which can be directed on the innovations (especially power-saving projects and new technology of production), technical re-equipment and implementation of ecological projects.

As analysis of statistical data testifies, the biggest part of capital investments of industrial enterprises in Ukraine (more than 63% [2]) are financed from the own internal sources such as profit and contribution of capital by owners. But as it shown on the fig. 1 these sources can't satisfy needs of enterprises in capital investments.



Source: Calculated on the basis of data [2]

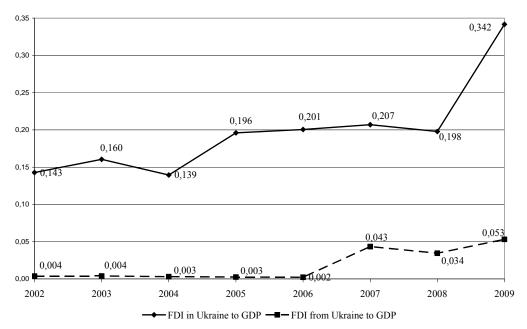
Fig. 1 - Investment activity of enterprises of Ukraine and source of its financing

And what is more in 2008-2009 in conditions of huge losses on domestic and international market these sources were not only practically inaccessible but also requires finding the source of cover of received losses.

It should be mentioned that during 2002-2009 years level of investments that can be measured by index of capital investments to GDP has been fluctuated within the limits of 21-29% of GDP. Only in 2007 this level has increased up to 30.9%. It should be underlined that during the period 2003-2007 share capital investments that was financed by earning before taxes has been practically permanently increasing from 31.2% in 2003 up to 61.0% in 2007. But collapse of the economy and financial system in 2008 has led to decrease of this level to 3.3% in 2008. So, enterprises have faced with problem of searching for new sources of funding and covering of their losses.

Similar situation was in FDI, which comprises equity investment, reinvested earnings and intra-company loans. Accelerated by unstable political situation, global tendencies of divestments conducted by MNC, fluctuation of foreign exchange rate of Ukrainian national currency, permanently increased external state debt (including credits of IMF and World Bank) the flight of capital from Ukraine was announced as one of the critical threats of future development of the country [3, 4]. Strong motives of business owners to divestments and flight of capital reflect the general situation on Ukrainian economy which is in need of principal structural reforms that should be implemented in order to turn the orients of participants of domestic markets in direction of financing the national economy instead of buying the luxury goods, expensive real estate and financing the investment project abroad.

Despite of official statistics (fig. 2) that testifies the increase in level of FDI to GDP from 19.8% in 2008 up to 34.2% in 2009, factor analysis shows that this increasing is illusive because of increase in foreign exchange rate from 5.2672 UAH/USD up to 7.7912 UAH/USD and as a result fall of GDP in UAH only on 3.8% but in USD – on 53.5%. Another accent should be made on stable tendency of divestment of 4.3-5.3% of GDP in form of FDI from Ukraine, 92.5 % of which has been directed in Cyprus and other off-shore zones. In conditions of lack of financial resources such tendencies are very harmful and threatening.



Source: Calculated on the basis of data [2]

Fig. 2 – Dynamics of FDI to GDP in Ukraine

Development of financial market in Ukraine in 2008-2009 also didn't provide the sufficient and effective access of industrial enterprise to financial resources. This was caused by the following factors:

- significant losses of the financial institutions caused by fall of foreign exchange rate of the national currency and increase in bad debt (up to 45-78% of credit portfolio especially mortgage);
- mass cash withdrawals from deposits and cutting in terms of deposit portfolio to 1-3 months:
- political aspects of governing the National Bank of Ukraine that has led to increase of uncertainty of financial institutions and investors to the financial market rules and regulations;
- significant declining in financial flows of industrial enterprises, passing through the banking system and as a result decrease in current accounts of the clients.

In this situation banks have direct their forces not on crediting the national economy but on providing the own liquidity and creditability by conducting the short-term speculative operations on money-market, crediting the insiders operations and increasing the tariffs on clearing operations.

Thus, in 2008-2009 Ukrainian industrial enterprises have faced with critical lack of long-term financial resources, disability and lack of motivation to finance investment projects directed on the extended reproduction, modernization of production and implementation of power-saving and ecological projects. Crucial issue in this situation is exactly lack of motivation and absence of proper stimulators for investment activity and reinvesting the profit.

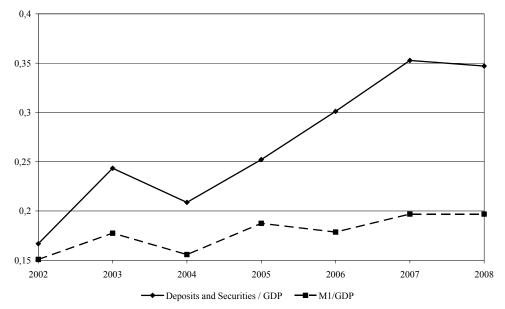
## 2. REINVESTMENTS AS A KEY FACTOR OF INTENSIFICATION OF ECONOMIC GROWTH

From the one hand [5] the positive side of limited bank finance is stimulation of reinvesting the profits. From the other hand [6] exactly development of financial system is the basic condition for intensification of economic growth and structural improvement of the economy.

Development of financial sector provides the increase in investments, attraction of savings and an efficient distribution of resources on the background of intensification of production and increase in productivity [6]. Intensive development of financial sector, from the one hand, slackens the influence of external shocks on the national economy [6]. From the other hand, intensive

development of the financial market especially in developing countries is impossible without participation of the international and foreign financial institutions, which can provide enterprises with cheaper and more durable financial resources. These institutions are more reliable and acts under international business rules and traditions. In such countries as Czech Republic, Poland, Croatia etc. the presence of international and foreign banks is over 80%.

Analysis of statistical data shows that in Ukraine the levels of monetization and securitization of the economy are significantly lower than in developed countries (fig. 3).



Source: Calculated on the basis of data [2, 7]

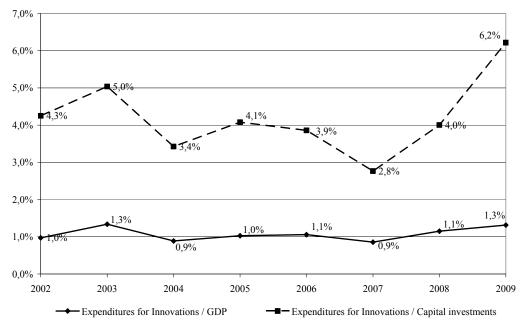
Fig. 3 - Dynamics of level of monetization and securitization of the Ukrainian economy

Only in 2007-2008 level of securitization of the economy achieves 35%. For example in EU countries the average level of securitization of the economy is 67-83%. Moreover deposits and securities to GDP are only by 15% higher then M1 to GDP. This testifies that undeveloped stock market and financial infrastructure don't allow enterprises to use direct financial instruments and derivatives to attract financial resources.

Crisis tendencies in financial sector restrain wishes and abilities of the financial institutions to finance the long-term investment projects especially it concerns innovative projects which can be characterized as high risky ones. That's why reinvestments and capital contributions of the owners are sometimes the only one source of financing of such types of project. Taking into account that fact that innovations are key factor of intensification of economic development and growth problem of intensification of reinvestment process is the crucial issue for developing countries. In this case named problem should be under rapt attention of the government both state and local.

As the statistical data testifies (fig. 4) in Ukraine level of innovation activity not only insufficient but also out of some kind of dynamics. Expenditures of enterprises to innovation during 2002-2009 were not more than 1.3% of GDP. Only 4.2% of capital investments in average were directed on innovations. Other 95.8% of capital investments were directed on providing the traditional production process, renewal and current repairing which didn't provide the transition to new technologies and types and production.

Lack of motivation for intensification of the innovative activity of industrial enterprises leads to stagnant process not only in particular industry but in all economy causing the structural misbalances and contortion.



Source: Calculated on the basis of data [2]

Fig. 4 - Innovation activity of enterprises of Ukraine

The principal questions that should be considered by state and local government are investigating the motives of foreign and domestic investors for reinvestments and finding out the most effective stimulators for reinvestments in domestic enterprises, regions and state (including the prevention the flight of capital).

Thus, innovation activity can't be effectively conducted without proper support of financial sector. In this case the most crucial issue is to provide stability and efficiency of financial system [6] the basic factors of which are macroeconomic stability, legislative-contractual and information system. Basing on the institutional approach to analysis of economic events and managing the financial flows [8, 9] it is necessary to analyze the basic motives of foreign and domestic investors for reinvestments which are formed under influence of informational skewness, official and hidden operating rules and complex of interests of participants of reinvestment process.

### 3. Reinvestment activity: Stimulators vs. motivators

In order to define the basic motives of foreign and domestic investors for reinvestments it is necessary to understand the specific of the environment in which they operate. This environment is formed under conditions of globalization and internationalization of economic and social relations, unification of operating rules and official and hidden contracts. The basic sectors which define the peculiarities of motivation for reinvestments are:

- 1. <u>Economic environment</u>, which define the basic parameters of economic activity of the enterprise: types and forms of activity, volume and directions of financial flows and flows of goods and services, peculiarities of taxation, abilities for participation in international capital markets, financial markets, variety of financial and credit instruments, clearing forms, currency portfolio, level of currency risk and hedging, international credits and loans, access to resources in other countries, etc.
- 2. <u>Political environment</u> which has an influence on the abilities for establishing the international cooperation (embargo regime, economic blockade, restriction of financial flows, etc.), involving the international financial institutions in cooperation (IMF, IBRD, EU institutions, etc.) and indirectly has an influence on the economic positions of the national enterprises on the domestic and international markets by providing the monetary, fiscal and other policy by different countries.

- 3.<u>Legislative environment</u> (including the official and hidden operating rules) which has an influence on activity of the enterprise and its departments and branches (especially it concerns to MNC), basic parameters of financial flows one of which is reinvested earnings both on international and domestic level, stipulates for rules of legal procedures (international court and legislation, internal peculiarities of legislative and court system, etc.).
- 4. <u>Social environment</u> which stipulates for perception of enterprise activity in the particular region, its influence on the social processes (employment, average wage, social guarantees and provision of pensions, perception of individual development, etc.) and motives of such stakeholders as staff, community etc. to take an active part in activity of enterprise, including the reinvesting earnings in the image and social projects.
- 5. <u>Ecological environment</u>, maintaining of which requires the strong government control and monitoring of international ecological organization and also requires huge volume of investments especially in developing countries. Ecological projects are one of those for financing of which it is very hard to attract financial resources on the financial market and which requires the existence of permanent program of reinvestments.

According to conditions of functioning of enterprises in each environment the complex of factors that caused motives of an enterprise to reinvest profit in different projects appears (tab. 1).

Table 1 Interests of key groups and their influence on goal setting in reinvestment process

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Group	Interests	Influence on the enterprises goals
Participants of market of goods and services		
Suppliers	Timely execution of financial liabilities, stable and durable financial relations, proper level of prices	Stable financial outflows that provides slackening of influence of changing in business-environment and most effective allocation of the reinvested profit.
Consumers	Most complete satisfaction of needs in conditions of appropriate level of quality and price of goods and services	Stable financial inflows that provide the ability of enterprise to create profit for distribution and to form an effective proportion between dividends and reinvested profit.
Competitors	Observance of rules and traditions of conscientious competition, possibility to create the strategic alliances.	Possibilities of optimization of financial flows including the allocation of reinvested profit due to strategic alliances, opportunistic behavior of competitors and clients.
Participants of market of resources		
Staff (managers and workers)	Receiving the stable and equitable compensation for the given labor resources, intellectual potential, possibilities of career growth and realization of they potential	Possibility to apply the motivation and stimulation methods in order to accumulate financial inflow and to increase profit to be reinvested.
Investors and owners	Stable increase of they prosperity in the form of increase in dividends, market value of enterprise, increase in social and business status.	Willingness of investors and owners to refuse from dividends in favour of reinvestments. Possible conflict of goals between managers, owners, state, international organizations.
Participants of financial market		
Financial-credit institutions, institutions of market	Timely execution of financial liabilities, stable and durable financial relations, increases in financial flows directed through the particular	Possibilities for optimization of financial flows with use of particular financial tools. Increase in efficiency of allocation of reinvested profit.

infrastructure	financial-credit institute.	Providing the stable creation, distribution and use of financial flows.	
State and social sector of economy			
Local and state budget	of state and local budgets, declining the subsidies and subventions of budgets, directed to enterprise. Maintenance of ecological norms and providing the social development of	Usage of stimulus and motives provided by state and international legislation for reinvestments.	
State institutions and organizations	the region and state.  Observance of requirements of domestic legislation and requirements of international organizations including FATF	Optimization of financial flows (including reinvested earnings) in conditions of domestic legislation and requirements of international organizations.	
Local community	Effective and intensive development of regional (local) infrastructure, improvement of ecological and social conditions in the region	Necessity of taking into account requirements of local communities for improvement of ecological and social conditions in the region in the process of profit distribution.	

Considering the presented motives of different stakeholders the following directions of stimulators application can be defined:

- fiscal stimulators of reinvestment activity;
- financial-credit stimulators;
- protective measures;
- infrastructural motivators and stimulators;
- stimulators and motivators for implementation of particular investment projects.

According to analytical paper of National Institute of Strategic Researches [3] under conditions of risks of fiscal policy one of the methods of overcoming these risks is implementation of fiscal stimulus for reinvestment the capital in Ukrainian economy and introducing "soft" restrictions for its outflow from Ukraine. These incentives should be reflected in tax legislation in the form of decreased level of taxes, reduction of tax burden on the investment-innovative activity of the enterprise. In accordance with new Tax-Code [10] accepted at the end of 2010 in Ukraine profit reinvested into modernization of production and power-saving technologies is tax-free. But the process of providing this tax-concession is not clear and transparent. That's why it can't be effectively use by industrial enterprises.

Mechanism of usage of financial-credit stimulators (for example, zero interest loans, privilege credits, special investment guarantees) is not accessible too because of influence of financial and economic crises and peculiarities of Ukrainian legislation and low level of trust to government guarantees on such projects.

According to report of World Bank and its assessment of investment climate in different countries [11] most significant influence on the willingness and motives of investors to invest financial resources and to reinvest earnings is infrastructural conditions and its development. Analysis of infrastructural changes conducted in countries of Eastern Europe (Albania, Belarus, Bosnia and Herzegovina, Croatia, Kosovo, Macedonia, Poland, Russian Federation and Serbia) shows that the crucial issues for improving the investment climate are:

1) <u>Improving the regulatory system</u>: implementation of an e-registry of administrative procedures, which gives the opportunity to start and conduct business easily; implementation of a Regulatory Impact Analysis, which allows to monitor economic, social and environmental impact on investment climate and to inform investors about recent

changes in the climate; improvement or creation of consultation mechanisms in the regulatory process; increasing labor market flexibility; increasing the transparency of related party transactions in company periodic fillings; defining in much greater detail the type of information that needs to be published in the annual report, including issues such as the nature and extent of the conflict of interest, etc.

- 2) <u>Reducing regulatory costs</u>: rationalization in the number of regulations related to business operations (licenses, construction permits, inspections, etc); reduction in time taken to process payment applications; reduction in the number of days to register property, to comply with construction permitting, etc.
- 3) <u>Improved efficiency in business registration and closing the business</u>: reduction in the number of costs, days and procedures to comply with business regulation related to business entry; creation or improvement of institutions dealing with business entry (reducing the minimum capital requirement amount, simplified the registration process by consolidating the application system to different agencies, etc.).
- 4) <u>Improving tax, legal and regulatory framework</u>: rationalization in the number of distinct taxes; implementation of electronic systems for taxpayers to comply with tax obligations; reduction in the number of days to file taxes, etc.
- 5) <u>Improved investment policy, regulations and institutions</u>: creation or improvement of institutions dealing with investment promotion (investment and promotion agency performance of which directed on targeted investor outreach and PR campaigns, developing the software system for tracking investments, involving the international experts); increase in the number of leads from strategic sectors; improvement positions in the Global Investment Promotion Benchmarking (GIPB).

All named directions are very actual for Ukraine. In these conditions the government and large business (owners of the biggest part of industrial enterprises) should define the instruments and tools of stimulation of reinvestments and capital mobility inside the country.

# **CONCLUSIONS**

In order to accelerate the process of reinvestment it is necessary to introduce the target long-term program of improvement of investment climate of the country and each particular region, which will contain the following directions:

- improvement of legislation in the field of investment and innovative activity of the enterprises, that will stimulates the process of reinvestment on the state (system of taxation) and regional (preferences in solving the strategic problems of an enterprise) level;
- directing the reinvestment activity of the enterprises (especially owned by non-residents) on the improvement of ecological and social situation in the regions where the particular enterprises are located;
- creation of the system of legal escort and defense of interests of investors (including the non-residents), the activity of which is directed on implementation of innovations, ecological and social projects especially at the expense of reinvestments;
- elaboration of target regional programs of development of cooperation between domestic and foreign enterprises with accentuation on the social and ecological projects, innovative projects of development of local, regional and municipal infrastructure.

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