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Wirtschaftswissenschaftliche Abteilung

Investment Policies: Removing State Interventionism in Ukraine[1]

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1. Investment, growth, and economic policy

Sustainable growth requires investment, i.e. the accumulation of fixed and human capital. In a market economy, private business accumulates fixed capital to create capacity for future production. Investment in infrastructure, i.e., in transport and network supplies such as energy transmission and distribution, telecommunications, water and sanitation is often made out of public budgets but with the participation of private enterprises. Moreover, long-term growth requires that the technical progress embodied in new capital equipment be supported by appropriate skills in the workforce, i.e. by human capital. These skills, in turn, depend on the education and the health of the workforce. As markets tend to under-invest in human capital, the main way to accumulate it is via public expenditures on health and education. Empirical research suggests significant links between long-term economic growth and an economy's stocks of fixed capital, infrastructure, and human capital.[2]

Growth impulses from investment do not come about automatically but need policy support. Private investment decisions depend on the returns that investors expect and on the uncertainties associated with these returns. Expectations are shaped by the investment climate, which is a general term for the factors that provide incentives or disincentives for private sector investment. These include:

- taxation, policies toward investment financing, and the institutional and regulatory framework. All of this defines a critical role for deliberate public policies towards private investment, over and above macroeconomic, fiscal, monetary, and exchange rate policies and political stability;
- the quality and quantity of the available infrastructure motivates the importance of public and private infrastructure investment for shaping the investment climate.

Policy support, however, should never crowd out private activity. In Ukraine, the prevailing approach towards allocating public funds to support investment is still interventionist. Public investment in Ukraine helps to preserve old structures. It flows into areas with doubtful rationale for long-term state involvement, while budgeting rules lack transparent priorities and rules-based selection criteria. The result is long, primarily political and interest group-driven bargaining processes for public aid. Investment in infrastructure only rarely involves the private sector and investment in human capital does not efficiently exhaust available resources. Public support for private investment follows an approach of selectively targeting industries and/or regions in attempting to pick winners at significant cost to the economy yielding unclear benefits.[3]

[1] First published as Chapter 5 in: Stephan von Cramon-Taubadel et al., Towards Higher Standards of Living. An Economic Agenda for Ukraine. A Program of Work for the new Government of Ukraine, German Advisory Group on Economic Reforms with the Government of Ukraine and Institute for Economic Research and Policy Consulting, Kiev, December 2004.

[2] See Barro R. and X. Sala-i-Martin (2003): Economic Growth, Chapter 12.

[3] For a discussion of regional policy in Ukraine, see Chapter 4.

The solution to these problems is to limit the scope for state interventionism. This chapter outlines ways of achieving this objective with the overall goal of subjecting the allocation of public funds to support investment to transparent and rules-based procedures.

2. Public investment activity

2.1. The impact of public investment

Investment in Ukraine is by now mostly domestic enterprise investment (Table 1). The shrinking economy in the 1990s led to substantial revenue shortfalls for public budgets. The ensuing fiscal austerity had a much more severe impact on public investment than on current expenditures, implying some deterioration of the infrastructure. Following macroeconomic stabilisation, the GDP share of all public investment expenditures, including changes in inventory and capital transfers, has recovered from a low of 1.3% of GDP, according to World Bank data, to 5% in 2003, according to 2003 Budget Act data.

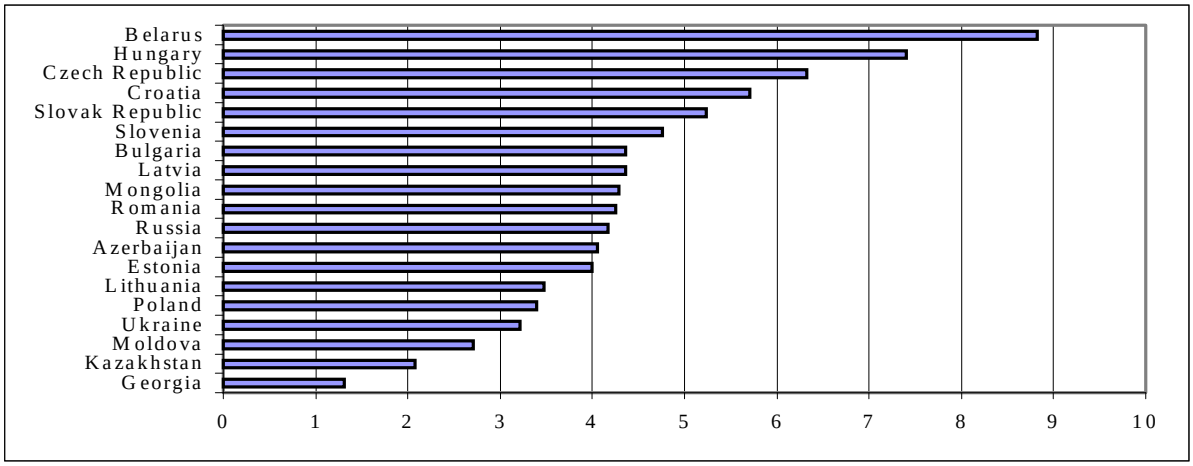
Table 1 **Gross fixed capital formation in Ukraine, % of GDP**

	1999	2000	2001	2002	2003 (est.)	2004 (proj.)
Total fixed capital investment	13.5	13.9	16.0	16.8	19.3	17.2
Out of public budgets	1.6	1.3	1.5	1.5	2.1	1.8
By enterprises	11.9	12.6	14.5	15.3	17.2	15.4
Net FDI inflows	1.6	1.9	2.1	1.7	2.8	2.3

Note: At 19.3%, Ukraine's share of total fixed investment in GDP was within reasonable limits for a transition economy in 2003: the UN Economic Commission for Europe's Common Database reveals a median of 21.1% for a sample of 25 transition economies in 2002. Public fixed capital investment is fixed capital investment directly financed out of state and local budgets. Public capital transfers to enterprises are part of enterprise investment, independent of the nature of the enterprise
Source: State Statistics Committee of Ukraine, World Bank, World Development Indicators 2004, and IER calculations

Although there are significant links between long-term economic growth and an economy's stocks of fixed capital stock, infrastructure and human capital, there is no statistically significant cross-country relationship between public investment and per capita GDP levels or growth. Public investment often involves large projects creating vested interests with inefficient outcomes, so the quality of investment and the efficiency of investment budgeting rules matter a lot in this relationship, as does private versus public ownership in infrastructure. Accordingly, shares of public investment in GDP sufficient to support sustainable growth are certainly much smaller than the highest levels indicated in Graph 1.

Graph 1 **Public investment as a share of GDP: Selected transition economies, 1999–2001 averages, in %**



Note: Public investment is all consolidated capital expenditure financed out of the central or local budgets. In addition to purchases of fixed assets, this especially includes capital transfers to enterprises, to the population, or abroad. Most OECD countries' public investment to GDP ratios are between 3 and 5 per cent
Sources: IMF, Government Finance Statistics and International Financial Statistics, World Bank, World Development Indicators, and IER calculations

After recent increases, current public investment levels in Ukraine are comparable to OECD levels and do not appear to be insufficiently low (Graph 1). The impact of public investment on the Ukrainian economy is thus less a problem of the amount than of the efficiency of investment expenditures.

Above all, efficiency requires good public investment budgeting rules. The relevant Ukrainian rules and regulations lack transparent priorities and rules-based selection criteria for selecting between competing projects. For example, as a rule cost-benefit analysis is not applied. Decisions on capital expenditures are not fully integrated with respect to the decision making bodies, the different components of capital expenditures, capital versus current expenditures, and planning horizons. As resource ceilings are set only in the final stages of the project selection process, capital transfer decisions are prone to drawn-out bargaining. The process is thus biased towards creating excess demand for public funds, and results in too much state aid to loss-making public enterprises.

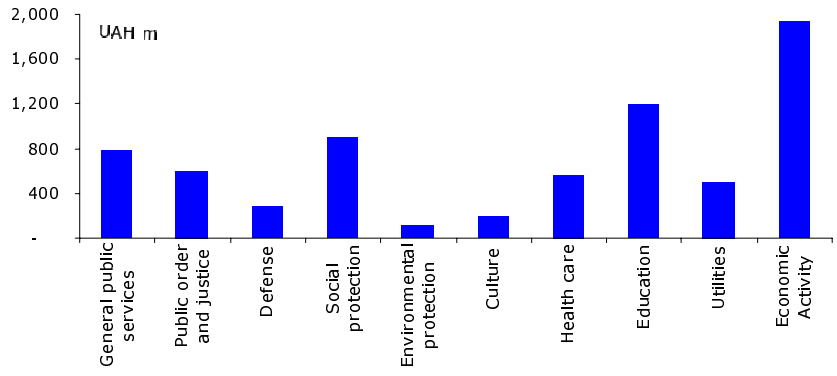
2.2 The scope for public investment in Ukraine

Public investment should be motivated by market failure arguments and by distributional objectives. Hence, the strongest grounds for public investment include the provision of core public goods and services (i.e., defence, public order and justice, general public services, and social protection) and equity considerations. Market outcomes may be socially unacceptable and provide ground for public investment to ensure equal access to a socially agreed upon catalogue of goods and services.[4] Examples include health care and education, which also exhibit spill-over effects, as individuals often ignore the social return of human capital investment.

The prevailing government investment priorities in Ukraine[5] appear dominated by intervention on private markets motivated by only temporarily valid transition-specific concerns over the fuel and energy complex and the implementation of energy and resources saving technologies, agriculture, and the medical and microbiological complex. In fact, core public activities receive only roughly one third (36.3%) of all public capital expenditures in Ukraine in 2002 (Graph 2). Another third is composed of investment in environment, health, education and culture, much of which rightly responds to equity considerations and spill-over effects of these goods to society as a whole. Capital expenditures on functions with only some or even doubtful rationale for long-term state intervention, especially the broad sector of all "economic activities" and utilities, attract public investment in the same order of magnitude (34.5%). More than half of this is state aid in the form of capital transfers to publicly owned enterprises.

The share of all capital transfers to enterprises in consolidated public investment was 24% in 2002 and has since even risen sharply to 52% in the budget for 2004. Most central government capital transfers go to coal mining, while capital transfers to utilities are financed out of local budgets. Public investment expenditures on economic activities and utilities appear excessively high and can be re-allocated over the medium term.

Graph 2 **Consolidated budget capital expenditures in Ukraine (2002, in million UAH)**



Note: Public investment is defined as in the note to Graph 1. Utilities include other (minor) housing and communal services capital expenditures. Public investment in utilities is financed out of local budgets. While most economic activity expenditures are financed out of the central budget, road financing is split between central and local budgets
Source: Statistical Bulletin, Capital Investments in Ukraine for the Year 2002

[4] This point is also made in the introduction to Chapter 3 on the social security system in Ukraine.

[5] As defined in the 'Concept of Regulating Investment Activity under the Conditions of Market Transformation of the Economy' of January 1, 1995, No. 384, with amendments of February 15, 2002, and the MoE 'Order On Approving the Decree on Assessment and Selection of Investment Projects'.

2.3 Public infrastructure investment and the scope for private involvement

Transport and network supplies, such as energy transmission and distribution, telecommunications and water and sanitation are the backbone of a country's infrastructure. An adequate infrastructure is growth enhancing since it improves productivity and competitiveness, reduces poverty, contributes to environmental stability, links people, and is also a major decision criterion for private investment decisions. Given the poor state of infrastructure in Ukraine and limited budget resources, investment in new infrastructure and maintenance of the existing stock represents a serious challenge.

Involving the private sector in public infrastructure investment in the form of public-private-partnerships (PPPs) can reduce the burden on the public budget, especially when there is a potential for revenue generation. The financing of road construction provides a classic opportunity, usually involving concession schemes through which private firms finance and build the project and then operate it for a pre-defined period of time, recovering the investment by collecting user tolls.

Although the legal basis for such concessions exists in Ukraine, World Bank data indicate that between 1997 and 2002 the sum of private and public investments in completed infrastructure projects with private participation were limited to USD 338.5 m. Most of this is in natural gas and electricity transmission, none in road construction. Attempts at making use of road concession schemes have only started in 2002 when concession agreements were reached concerning construction and use of roads between Lviv and Brody and Krakivets and Lviv.

In general, the private sector has so far been reluctant to be involved in PPPs. As the list of potential objects that could be financed via PPPs is extensive, this is likely to be connected to poor policies and inadequate regulations that increase the risk for private investors. High contracting and bidding costs might be due to non-transparent tender conditions. Underdeveloped domestic capital markets contribute to expensive financing terms. To complicate matters, few sub-sovereign governments are creditworthy, and an unbalanced approach towards decentralisation has increased the share of infrastructure that falls under the jurisdiction of provinces and municipalities that do not have adequate sources of finance.[6]

2.4 Human capital accumulation via public expenditures on education and health

The human capital of an economy lies in the skills of its workforce. As both current and capital expenditures on health care and education generate a future stream of benefits in the form of improved skills in the workforce, both expenditure types meet the economic definition of investment. However, individuals often ignore the social returns of human capital investment, which is to say that they ignore the effect that their health and education has on the productivity of society as a whole. Therefore, private markets tend to underinvest in skills, and human capital accumulation largely depends on public health and education expenditures.

World Bank data indicate a positive link between the GDP share of public expenditures on health care and education and the level of economic development. Specifically, in 2001 high-income countries spent on average 11.5% of GDP on public expenditures on health and education, while middle-income countries spent 7.6% and low-income countries 4.2%. Ukraine's 7.1%, of which 2.9% are on health care and 4.2% go to education, represent the highest figure of all CIS countries represented in Graph 1.

However, GDP share data do not reveal information on how much public expenditure reaches individuals. In Ukraine, the government has committed itself to provide equal and free access to health care services. Still, per capita expenditure on health care is one of the lowest in the sample of countries in Graph 1. As research indicates that the dominant direction of causality is from human capital to growth, and taking into account the pressure of an ageing population there is a clear-cut need for reform. There is also an evidence of insufficient provision of fixed assets investment in this sphere.[7] In particular, the accumulated depreciation of fixed assets in health care and education (39% and 42%, respectively) are among the highest in the economy. In addition, evidence of large shadow payments to doctors and teachers in Ukraine suggests that funding is insufficient even for the current level of economic development. Also, low quality services in rural areas can be connected to insufficient funding of local budgets.

Even more importantly, as already demonstrated for public investment expenditures on fixed capital, spending levels are less relevant for the impact of public human capital investment on the economy than spending efficiency. The criticism of budgeting rules in the area of fixed capital

[6] See Chapter 4 on regional development in Ukraine for proposals on how to improve this situation.

[7] See the discussion of health care reform in Chapter 3.

spending also applies to investments in human capital. In summary, due to inadequacy of funding and inefficiency of spending, only part of the public expenditures on health care and education in Ukraine represents effective investment in human capital formation.

3. Public support for private investment

Private investment in physical business equipment provides the main thrust of capital formation. In an open market economy, both private domestic investment and foreign direct investment (FDI) contribute to growth impulses.

Public policy to further private investment may in principle follow two different patterns; a selective targeting or an institutional framework approach.[8]

- Public policy towards private domestic investment and FDI may be based on specific support for pre-defined priority sectors, regions, and/or types of investment.
- Public policy towards private investment may concentrate on providing a good business environment and institutional framework for investment.

While the institutional framework approach is advocated by international organisations as well as by us, Ukraine has so far leaned towards a selective targeting approach in providing public support to private investment (Box 1). Specifically, as direct transfers out of the budget are mainly reserved for supporting public rather than private enterprises, public support for private investment in Ukraine comes mainly in form of credits out of the budget and, most importantly, via the provision of different forms of tax preferences.

However, selective targeting represents a risky strategy. Deciding which investment projects to subsidise, how much to subsidise them and by means of which instruments involves difficult political and economic choices. Authorities risk finding themselves over-subsidising projects or creating unintended economic disturbances if they do not succeed in 'picking the winners'. At the more practical level, incentive programs are often administratively burdensome.

Targeted policies often lack transparency. This relates both to approval procedures, which typically result in rent-seeking activities, and to the assessment of costs and benefits of investment projects. As the instruments applied are not explicitly targeted to measurable objectives, it is difficult to evaluate the alternatives and the efficiency of the often costly measures (Table 3). In

Box 1 Selective targeting to support private investment in Ukraine

Sector-specific incentives allow targeting investment to specific sectors while special economic zones aim at furthering investment in particular regions. Examples of sector-specific supporting programs in Ukraine include: *Stimulating the production of cars in Ukraine*, *State support of plane construction in Ukraine*, *Stimulating the development of agricultural sector*, and *Bronetechnika of Ukraine*. State support to facilitate investment in these sectors covers granting privileges on major taxes such as VAT on output, EPT, import duties, VAT on imported inputs and the land tax.

Ukraine has also established 11 *special economic zones* and 72 *special regimes of investment activity* that were created mainly for the purpose of attracting foreign investors to foster regional development and stimulate investment and innovative activity. Special economic zones usually involve the exemption from VAT and import duties on imported inputs, as well as exemption from EPT and the land tax.

Table 3 Costs of tax preferences in Ukraine, % of GDP

	2001 est.	2002 est.	2003 est.	2004 proj.
EPT	1.3	0.8	0.4	0.3
VAT	2.1	2.5	1.9	1.6
Import duties	0.2	0.3	0.2	0.3
Land tax	0.5	0.6	0.4	0.4
Excises	0.0	0.0	0.1	0.1
Total revenues foregone	4.3	4.5	3.2	2.7

Note: Table 3 contains estimates on all tax preferences, including those explicitly aimed at providing investment incentives. However, in as much as all tax preferences tend to have intended and unintended investment implications, Table 3 figures effectively represent upper-bound estimates for private investment-related costs of tax preferences in Ukraine
Sources: Ministry of Finance and State Tax Administration of Ukraine, IMF, and IER estimates

[8] There are obvious parallels between this distinction and the distinction between vertical and horizontal approaches to regional policy made in Chapter 4.

fact, many incentives are of little relevance to the investors being targeted, despite high costs to the authority. For example, investment in research and development requires a functioning patent system to secure long-term benefits. In the absence of effective patent protection, any subsidisation is a very costly and ineffective substitute.

For these reasons targeted tax incentives are usually not consistent with international best practice in the area of investment support. We recommend that improving all aspects of the institutional framework for private investment in Ukraine be given priority over selective targeted policies. Especially, we argue against discrimination by type of investment under any circumstances and cannot recommend the use of incentives targeted at specific sectors or regions without prior substantial institutional framework reforms.

4 Policy recommendations

The ultimate objective of our recommendations is to limit the scope for public interventionism and thus to increase the impact of investment in fixed capital, infrastructure and human capital on the long-term growth prospects of the Ukrainian economy. This can and must be achieved at current levels of public spending relative to GDP, in order to safeguard the sustainability of public finances.[9] The key is to increase the efficiency of both public investment and public support of private investment.

4.1 Proposals to increase the efficiency of public investment activity

The impact of current levels of public investment relative to GDP can be increased by a number of short- and medium-run measures.

a) Public investment budgeting rules and regulations can be improved immediately. This requires:

- transparent priorities and the application of standardised rules-based selection criteria, such as cost-benefit analysis, in order to eliminate at least the poorest investment projects from the selection process;
- smoother integration of capital expenditures in the budgeting process. Multi-year development programs should be regularly updated against actual budgets. A medium-term planning procedure has to be implemented requiring medium-term budget estimates for spending units. Combined with efficient project selection, this helps policymakers to see the long-term consequences of their decisions. Initially, capital and maintenance decisions should be harmonised by introducing multi-year controls where all project proposals must include a task description, a statement of the financial resources required over the life of the project, and a cost-benefit analysis. This requires the establishment of a database to monitor spending and the progress of multi-year public projects; and
- resource ceilings in project selection should be set early, to minimize the demand for public funds and to avoid long bargaining processes for public aid.

b) In the near future, socially useful infrastructure investment can be stepped up by **increasing the involvement of the private sector**, especially in revenue generating projects.

At the central government level, this concerns concession schemes for road financing. On local level, this could involve utilities and local transport. Advances in regulatory practices and in the transparency of public tender conditions are clear pre-requisites for progress in this area, to overcome the reluctance of the private sector to be involved in PPPs. In the end, private involvement in public infrastructure projects can be an efficient instrument for increasing investment in infrastructure and simultaneously concentrating limited budget resources on investment in core public activities and in human capital formation via increasing public expenditures on education and health. The latter, however, has to be coupled to reforms in these two sectors.

c) In the medium term, this reallocation of public investment can be further strengthened by **phasing out state aid in form of capital transfers to public enterprises**, especially to coal mining and utilities.

Related social policy objectives can be more efficiently dealt with by temporary social assistance to households rather than sustained capital transfers to enterprises. This would again allow for increases in public investment in core public activities and in human capital formation.

4.2 Proposals to increase the effectiveness of public support for private investment

In line with private investor preferences and international experience, we recommend replacing prevailing selective targeting practices by a consistent set of non-discriminatory policies, based

[9] See Chapter 1. Maintaining Ukraine's hard-won macroeconomic stability is an absolute priority.

on the OECD *Guiding Principles for Policies toward Attracting FDI* (Box 2), bearing in mind that a non-discriminatory policy approach dictates that these principles are applicable to domestic private investment as well. These policies should be drafted and published in a document outlining *Ukraine's Guidelines for Public Support of Private Investment*.

Box 2 OECD Guiding Principles for Policies toward Attracting FDI

1. Safeguard public sector transparency, including an impartial system of courts and law enforcement
2. Ensure that rules and their implementation rest on the principle of non-discrimination between foreign and domestic enterprises and are in accordance with international law
3. Provide the right for free transfers related to and protecting against arbitrary expropriation
4. Put in place adequate frameworks for a healthy competitive environment in the domestic business sector
5. Remove obstacles to international trade
6. Redress those aspects of the tax system that constitute barriers to FDI
7. Ensure that public spending is adequate and relevant

Source: OECD, Checklist for Foreign Direct Investment Incentive Policies, Paris, 2003

Translated into the Ukrainian context, these principles imply that:

- All instruments of public support for private investment that constitute outright state aid (including state credits or state guarantees for bank credits) should be cancelled. Aid is suitable to correct imperfections in the domestic environment that cannot otherwise be addressed.
- Such imperfections exist in Ukrainian agriculture, at least as long as land cannot be used as collateral to secure investment loans. In the meantime, a second-best instrument to alleviate credit constraints is interest rate subsidisation rather than direct budget aid or quasi-fiscal aid via the banking system. To ensure efficient allocation of subsidised credits, the recommendations made above for public investment budgeting rules and regulations should be applied to such support for agriculture as well.
- A similar imperfection may temporarily exist in the limited access of small and medium enterprises (SMEs) to the capital market, costly access to information, and relatively high administrative costs. However, interest rate subsidisation is no permanent substitute for steps to ease the entry and exit of enterprises, to increase access to information and streamline tax administration.
- Tax investment incentives targeted at specific regional and/or sectoral development are inferior to consistent non-discriminatory policies and institutional improvements: tax legislation needs to be simplified, discriminatory provisions should be eliminated. Depreciation policies need to be aligned with best practice accounting rules in order to avoid distorting firms' production decisions. To encourage foreign investors, the government should follow the provisions of bilateral agreements that ensure the avoidance of double-taxation.
- Sustainable FDI promotion presupposes stable conditions for investors. This limits the government's scope for reforming existing inefficient and distorting schemes of tax investment incentives that have been misguidedly established to promote FDI. This might imply that a number of existing special economic zones and special regimes of investment activity must be maintained. However, the proliferation of such schemes should stop.
- FDI promotion must be non-discriminatory and must ensure that the private sector benefits from foreign participation through spill-over benefits. In special economic zones, incentives should apply to foreign and domestic investors alike and focus on activities with the strongest potential for spill-over effects, including linkages between foreign and domestic firms, education, training, and research and development. Concerning other investors' rights, these should first be addressed by provisions favouring non-discrimination of foreign investors in land ownership.