Foreign Direct Investment in Ukraine: Why So Little?

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Abstract

Ukraine has the second largest population of the former Soviet states, with abundant agricultural resources, an excellent educational system, and a well-developed industrial base. Nevertheless, Foreign Direct Investment has been scanty. Compared to the much-researched case of Russia, the difficulties of Ukraine in attracting foreign investment are little known. This paper examines the major deterrents the Ukrainian economy presents to foreign investors, focusing particular attention on what John M. Litwack (1991, JEP) has referred to as the problem of "legality" in Soviet-type economies.

Like many countries, Ukraine has actively sought Foreign Direct Investment (FDI) to develop its economy. The country has many characteristics that should prove attractive to foreign capital, including a well-educated workforce, a diverse industrial structure, rich farmlands, productive mines, and a location on the periphery of Europe, giving ready access to markets in Europe and Central Asia. Nevertheless, since its independence in 1991, it has received very little foreign investment. Foreign investment is deterred by risk, and that risk can stem from political, legal, or macroeconomic instability (Diechmann 2001; Bevan & Estrin 2000).

A number of analyses have blamed political and legal instability as the primary reasons for scarce FDI (IMF 2003; OECD 2003). In the last four years, macroeconomic stability has been achieved, while the country's political stability remains questionable, because of the continuous scandals involving government officials. Legal instability is also a characteristic of the business environment of Ukraine and is the prime deterrent for foreign direct investments. The country's legislation has been reformed to include necessary laws pertaining to privatization, land ownership, regulation of business activities, bankruptcy, intellectual property rights, and direct investment. However, Ukrainian laws remain inconsistent and their enforcement continues to be ineffective. These factors promote government corruption and illegitimate activities of Ukrainian businesses.

Profitability Determinants

According to traditional determinants of foreign direct investment, Ukraine looks like an ideal prospect. Ukraine is the second largest country in Europe. Its location has an immense geopolitical and economical significance. Ukraine borders Russia in the East, Belarus in the North, Poland, Slovakia, Hungary, Moldova and Romania in the West with the Black Sea to the South. This gives Ukraine notable foreign trade possibilities. Ukraine's President, Leonid Kuchma, has recently signed a statement of the creation of a free trade zone called the "Common Economic Space" between Ukraine, Russia, Belarus, and Kazakhstan. This new institution increases the country's export capabilities, making it a platform for international trade with former Soviet states (UNIAN, 2003).

Foreign investors are concerned with the profitability of doing business abroad. By participating in international commerce they seek to maximize their potential earnings. They search for large markets in which the minimization of input and operation costs can occur (Bevan & Estrin 2000). According to State Committee of Statistics, Ukraine's GDP as of November 2003 is 226,338 million gryvna, which demonstrates a sufficiently large host market as well as the purchasing power of the citizens. Ukraine has a population of approximately 49 million people, which include the second largest labor force in Europe. It also has cheap local energy and raw materials resources, which can be attractive to foreign investors.

Not only is the Ukrainian work force inexpensive, but it is very educated as well. As of October 2003 the average monthly nominal wage of persons employed in Ukraine's economy was 498.34 gryvnas. Translated into euro, the Ukrainian average wage is approximately 105 euro, compared to 2,335 euro –the average wage in the European Union (State Committee on Statistics, 2003). The literacy rate in Ukraine is 98%. Furthermore 30% of Ukraine's active population holds higher education degrees. However, despite the higher education, many Ukrainian workers do not possess contemporary technological skills, which may become a problem for highly technological companies. In addition, the mass population in rural areas does not speak English, which also may be a detriment for foreign businesses.

Present FDI

Despite possessing the traditional determinants, Ukraine continues to attract very little Foreign Direct Investments (FDI). From 1992 to 2001, Ukraine received 4.4 billion dollars in investments. That is $88 per capita. The Czech Republic and Poland received over $3000 and $724 per capita respectively. According to the State Committee of Statistics in Ukraine the amount of investment inflow over the last 8 years has been equally low. As of January 2003 Ukraine received $6,212 million in FDI, which is very small compared to the estimated annual need of $2-2.5 billion (State Committee of Statistics).

Table 1: Foreign Direct Investment in Ukraine (Beginning of the year, million US dollars)

	1995	1996	1997	1998	1999	2000	2001	2002
FDI in Ukraine	483.5	896.9	1438.2	2063.6	2810.7	3281.8	3875.0	4406.2
Ukrainian FDI abroad	20.2	84.1	97.4	127.5	97.5	98.5	170.3	157.5

Source: State Committee of Statistics of Ukraine.

To identify the reasons for scarce investment in Ukraine, we will examine its macroeconomic, political, and legal stability, which were identified as major determinants of FDI (Diechmann, 2001; Bevan & Estrin 2000).

Macroeconomic Stability

Presently, the Ukrainian economy is stable in terms of a growing Gross Domestic Product, increasing international trade participation, stable currency, and low inflation. Development of the economy is also advanced by enlargement of the financial sector of Ukraine.

Ukraine's economy has improved during the last four years. The year of 2003 is the fourth year in a row that Ukraine's GDP has shown growth. According to the State Committee of Statistics, during the first six months of 2003 GDP grew 7.5%. The GDP growth signals an increase in the productive capacity of the country. Participation in international trade is another sign of vibrant economical activity and is positively correlated with FDI (Ferris 1993; Diechmann 2001). For the period of January through September of 2003 exports were $19,412.1 million, which is 24.1% more than in 2002. Imports increased by 30.6% compared to 2002, and were $16,934.5 million

Table 2: Macroeconomic Indicators (1999-2003)

Indicators	1999	2000	2001	2002	November 2003
GDP, million gryvna	130442	170070	204190	220932	226338
Fixed assets, million gryvna	837446	828822	915477	----	N/A
Industrial production, million gryvna	107537	144483	184276	171207	198413
% Enterprises Unprofitable	55.7	37.7	38.2	38.8	N/A
Avg. monthly nominal wage, gryvna	177.52	230.13	311.08	376.38	498.34
Unemployment level, %	4.3	4.22	3.68	3.8	3.4
Export, USD million	16332	19248	21086	23351	N/A
Import, USD million	15237	18116	20473	21494	N/A
External debt service ratio	16.1	14.3	14.5	12.0	N/A

Source: National Bank of Ukraine.

Ukraine's recent economical stabilization is also noticeable in the stability of its currency .

Table 3: Grivna Nominal Exchange Rate (gryvna per 100 units)

Year	USD	EUR
2000	543.45	505.68
2001	529.85	466.96
2002	533.24	553.29
3rd quarter 2003	533.15	608.48

Source: Center of Social and Economical Reform.

Since the inflation-free year of 2002, inflation somewhat increased in 2003 and amounted to 8.2%. Yet, 5.8%-6.3% inflation indicators were predicted for 2004 (The State Committee of Statistics).

Financial Sector

One more important prerequisite to economic growth and also FDI is the development of a sound national financial sector (OECD 2003; IMF 2003). In the recent years, the Ukrainian financial sector and, in particular, the banking sub-segment has grown substantially. According to IMF, in 2002 there were a total of 157 active banks in Ukraine. Loans and deposits in the end of 2002 rose 50%. Assets in active banks included 31% of the country's GDP. However, the banking sector is undercapitalized and is characterized by a big amount of bad debt. This trend is a result of inadequate accounting standards, which lead to difficulties in the assessment of creditworthiness. Consequently, credit risk remains high and the real interest rate on gryvna- denominated loans is still high (IMF, 2003).

Capital markets and the insurance sector are also showing growth. By the end of 2002 the assets of insurance companies included 1.9% of the GDP. The value-added in capital markets accounted for 3% of GDP. Pension funds and credit unions made up 1% of the GDP (IMF, 2003). No matter the growth, these numbers show that the financial sector in general is underdeveloped. One of the obstacles to its more vigorous growth is abusive governance, which is characterized by inconsistent administration that is also not transparent.

Overall, macroeconomic stability has been achieved in Ukraine, which should decrease the perception of high risk associated with Ukraine's business environment among foreign investors.

Political Stability

Since its independence in 1991, Ukraine has come a long way in its development of a free democratic state. Political stability and a real functioning democratic system are key components of the social and economic development of a country (Mau & Yanovskiy 2002). These two important factors have also been identified as prerequisites for FDI. Stability of regime leaders, independent mass media, organizations for the defense of human rights, and federal guaranties of personal security are all requirements for FDI that have been satisfied by Ukraine's reforms. However, true political stability in Ukraine remains questionable. Frequent conflicts between the Ukrainian President, Parliament, and Prime Minister over the direction of economic reforms undermine policymaking and make the Ukrainian business environment unpredictable (Ishaq 1997).

Recently, The Ukrainian government has been the focus of several scandals. In 1999 the Central Bank of Ukraine has been accused of falsification of foreign exchange reserves and of misuse of IMF funds. In 2000, the President of Ukraine, Leonid Kuchma, was accused of involvement in a murder of an independent journalist Georgy Gongadze. If fact, Ukrainian authorities have been accused of intimidating the Ukrainian press. These scandals raised questions about the freedom of the press and the democracy in Ukraine.

In 2002, President Kuchma was also accused by the United States of selling a military air defense system to Iraq. If true, these allegations will mean that Kuchma has violated the United Nations embargo sanctions against Iraq as well as aided world terrorism. These accusations have been damaging for the Ukrainian president as well as the country of Ukraine itself.

Overall, the scandals involving Ukraine in recent years have been numerous. They decrease Ukraine's attractiveness for FDI as investors perceive the political situation in the country as unstable and risky.

Legal Base of Ukraine

A principal step toward the legal stability of a country is the development of an adequate legal base (Litwack, 1991). Ukrainian laws are the warrantees of personal and business security for foreign investors. Therefore, to attract FDI, they should comply with the standards of developed countries.

In the past several years, the Ukrainian government has implemented many reforms and improved its legal system substantially. Ukraine's legislation is approaching the standards of the World Trade Organization as well as those of the European Union (EU). It has been identified that EU membership can be beneficial to Ukraine (Dimitrov 2000; Bevan & Estrin 2000). Membership in the EU would indicate that the Ukrainian legal system is compliant with the norms of developed, free-market countries. Bevan and Estrin claim that even a prospective accession of the country in the EU will improve its investment rating and will cause an increase in FDI. The Ukrainian government has made EU membership its main goal and set specific timetables for the accession. World Trade Organization membership has been planned for 2004 (Mission of Ukraine to European Communities).

Privatization

One of the most important processes in the transition of Soviet type economies to a free market is the privatization of state owned enterprises (Bevan & Estrin 2000). In Ukraine, this process has been slow and fractional, which has made foreign investors doubt the attractiveness of the Ukrainian market. By law, foreign investors have the same rights to privatization as citizens of the country. In reality there are limitations to the foreign participation in acquisition of state owned ventures. Foreign investors are excluded from involvement in the privatization of "strategically important" industries. Those identified as of "strategic importance" are areas concerning energy, the military sector, the aerospace industry and some others. There are also restrictions on the degree of participation allowed in telecommunication and banking industries. Even in sectors where full participation of foreign investors is allowed, the investors are blocked from acquiring strategic blocks of shares, which is necessary to participate in the management process. In many industries, the state-owned share remains at over 50%, so that the state holds a majority and is able to block conflicting decisions (OECD 2001).

Excluding government restrictions on participation, foreign investors face other difficulties with the process of privatization in Ukraine. The share prices of enterprises for sale remain very high and the share packages sold continue to be very large. Lack of information and government transparency is a persistent problem in Ukraine. There is little information available about the procedures of privatization or about the objects of privatization. Different accounting and executive measures make it difficult to examine the financial soundness of the enterprises and their cost effectiveness. Because of these problems with the current process, many foreign investors in Ukraine choose not to participate in privatization, and instead create foreign and joint ventures. As of 2002 only 63,500 state-owned enterprises were privatized. However, 60 percent to 70 percent of total revenues from privatization in the state budget are in fact from FDI. Because the importance of FDI resources to Ukraine's financial state is obvious, the government has recently readdressed the problems of privatization. The State Program of Privatization for 2003-2008 has been designed to speed up the process and make it more transparent and democratic (Pionkovsky 2003). This program, however, will not eliminate many of the foreign ownership restrictions.

Land Ownership

Privatization is tightly connected to the issue of land ownership. Many investors believe that rights to land are an essential part of a real estate purchase or construction. Without these rights, there is a risk of the nationalization of an investor's property through government reclamation of the land. This risk does still exist in Ukraine. According to the Land Code of 1992, foreigners were not permitted to own land. Therefore, most of them operated in terms of long-term leases. However, on January 1st of 2002, a new Land Code of Ukraine became effective. In accordance with the new law, any legal entity or individual can own non-agricultural land. Consequently, foreign citizens are allowed to own non-agricultural land There are also no limitations on a foreign investor's right to participate in the privatization of land. Yet the equality between foreigners and the citizens of Ukraine in this issue is only theoretical. The Cabinet of Ministers of Ukraine, by means of an agreement with Parliament, executes the sale of state-owned land to foreign citizens. Therefore, foreign investors are required by law to go through an enormous bureaucratized process to take part in land privatization, which of course discourages many of them from participation. The new Land Code still does not allow foreigners to own agricultural land. There are also other temporary administrative restrictions on land ownership, which show the government's overall reluctance of turning land into private property. For example, the sale and purchase of land is not allowed until January 1st of 2005. Until the same date, corporations may not own land. Until January 1st of 2010, a single private owner cannot posses more than 100 hectares of land. The establishment of a single Land Code has been a positive event in Ukraine's effort for legal and economic stability, but many more supplementary legal acts will be required to govern the private ownership of land (Lymar and Onishchenko 2002).

Civil and Business Codes

Effective January 1st of 2004, New Civil and Business Codes control the incorporation, management, operation, and termination of companies in Ukraine. Regrettably, the law does not provide for a clear division of the scope of control for each of the Codes (Konnov & Sozanovsky 2003). The absence of precision in the word of law most probably will bring about different interpretations of regulations. Consequently, the regulation of commercial issues will likely remain ineffective.

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Special Economic Zones & Priority Sectors

In order to attract FDI, the Ukrainian government has formed a number of Special Economic Zones (SEZ) as well as “priority sectors” in its industries. SEZs and “priority sectors” are preference regions and industries for FDI, which receive fiscal benefits from the government in form of the case-to-case tax concessions. The number of these formations has been reduced in recent years, as they are criticized for impairing the country’s economical growth by eliminating the fair grounds for competition and establishing conditions for the escalation of corruption among administrative officials (IMF 2003, OECD 2001).

Intellectual Property Rights

Intellectual Property Rights (IPR) is one of the most detrimental issues in the Ukrainian business environment. Ukraine is a member of World Intellectual Property Organization. Its legislation has been reformed to meet the IPR standards of the world. Ukrainian IPR protection laws cover patents, trademarks, copyrights and industrial designs. However, these laws are not effectively enforced. Ukraine remains one of the biggest piracy hubs in the world. US videocassettes, films, music, recording, books, and computer software are all illegally copied and mass-produced. Optical media piracy has achieved the largest scale. The United States’ Trade Representative Office has listed Ukraine as a “Priority Foreign Country” for the last few years. As a result it has been suffering US trade sanctions in the form of 100% punitive duty on certain exported goods to the US for the sum of 75 million dollars. In 2000 a “Joint Action Plan to Combat Optical Media Piracy” between the United States of America and Ukraine was implemented. The undertaking of the plan was the development and enforcement of IPR protection. Since 2000, Ukraine has fulfilled most of its obligations of the joint plan. Ukrainian officials closed all but one pirate CD plant down. And the CD licensing laws have been amended. However, a loophole in new Ukrainian legislation was found: IPR protection does not extend to commodities in transit. Ukraine has become a transfer point for Russian pirated software between Europe and the Middle East (USTR 2003).

A similar situation holds sway with regard to patent protection. US pharmaceutical companies claim that Ukraine produces generic copies of American medications with valid US patents. These medications are freely sold in the domestic market as well as exported into neighboring countries. The US Trade Representative maintains that the difficulty of enforcing IPR laws in Ukraine is a product of the incompleteness of legal reforms and the incompetence of the judicial branch in questions of intellectual property. In fact, only few Ukrainian judges are trained in IPR laws (USTR 2003).

Foreign Investment Legislation

Ukraine’s government has made many reforms, with the attraction of FDI into Ukraine’s economy being its main goal. Programs of “Investment image of Ukraine” and of “Development of Investment Activity in 2002-2010” have been passed by Cabinet of Ministers of Ukraine as well as a decree “Of the President of Ukraine on Additional measures to Increase Investment into Ukrainian Economy.”

Foreign investment in Ukraine is governed by Bilateral Investment Treaties with 15 counties, eight of which are OECD members, and the following domestic investment legislation: Law of Ukraine “On the Regime of Foreign Investments,” Law of Ukraine “On Investment Activity,” and Law of Ukraine “On Ownership.” This legislation not only provides all the standard rights and warrantees to foreign investors, but it also offers a number of federal guarantees, which can seem attractive to the investors. Some of these guarantees are:

- If the future special legislation of Ukraine on foreign investments change, guarantees of protection of foreign investments are applied during the ten year period after the legislation takes effect (RFI, A8)

- Foreign investors are guaranteed the right to free and prompt remittance abroad of profits, revenues and other assets (RFI, A12).
- Property imported by foreign investor as a contribution to an enterprise is exempted from duties (RFI, A18).

Legal Stability

Although, Ukraine has an adequate legal base, the stability of the legislation is doubtful. The so-called “legality” is absent not only from Ukrainian business environment, but also from administrative and societal sectors (Litwack, 1991). In Ukraine the judicial reform in Ukraine has been partial. The laws are not clear and rigid, and therefore continue to change and bring about different explanations of legal and normative acts. These occurrences undermine the investment image of Ukraine. The law “On the regime of Foreign Activity” has been modified 3 times in the last 4 years. Tax laws also change very frequently. In December 2001 the Ukrainian Parliament instituted equal treatment for foreign and domestic taxpayers. The new tax law abolished tax holidays given to foreign investors by the tax law of 1993 and disallowed the use of rights even to those privileges that were granted before 2001. Although the change had the motivation to discontinue unfair competition, it caused foreign investors to loose their trust in Ukrainian law enforcement (German Advisory Group on Economic Reform, 2003).

Transparency

As administrative reform remains incomplete, the decision-making processes of government bodies in Ukraine continue to lack transparency (OECD, 2001). Transparency International’s annual index of Corruption Perceptions ranks Ukraine as the 106th country out of 133. An overall lack of information concerning government regulations is a prominent problem for Ukrainian businesses. As there are no standards stated by law, both federal and local bureaus have power over the same subjects, but have different requirements and procedures. Not only is it difficult to find information about what government regulations are, but it is even harder to find how decisions are made within the regulatory organizations. Many of the denials received by companies pertaining to their requests to government agencies do not include any explanations for the denial. Therefore, required activities like licensing of businesses and procuring permissions can become an unpleasant ordeal for companies (International Finance Corporation 2003).

Table 4: Percentage of companies that identified regulation as impediment.

Factors	2002	2001	2000
Audits	48	46	42
Obtaining permissions	35	41	44
Licensing	32	35	42
Process of certification	30	40	42
Process of registration	19	21	22

Source: International Finance Corporation, p8

Excessive Regulation

A consequence of the transparency deficiency and the incompleteness of Ukrainian reform is the excessive government regulations, which are also a detriment for FDI (OECD, 2001).

Table 5: Percentage of Management Time Spent on Regulatory Issues.

Country	% of Time
Czech Republic	5
Hungary	7
Poland	9
Belarus	11
Russia	12
Ukraine	17

Source: Sigma Bleyzer.

Again, as laws continue to be partial and vague in their definitions, on both federal and local levels, the Ukrainian government has no constraints. Companies in Ukraine are audited periodically as are businesses in any country. The difference in Ukraine, however, is that in the absence of a specific law about auditing, there are no precise limitations of an auditing agency's power. There are no clearly identified reasons needed by the agency to investigate a company. The goals and types of audits are also absent from legal definitions as well as is the number of times an agency can audit a business. The average number of times a company was audited in 2002 was 14 times per year. Small businesses were audited 12 times per year and larger ones went through the auditing process 23 times per year (International Finance Corporation 2003). As there is no specified time limit governing audits, the average length of one in 2002 was seventeen days. The International Finance Corporation did a study of 2,014 businesses in the Ukraine during April 2003 and found that 48% of those surveyed believed that the length and frequency of government audits impaired their business practices. In general, government administration in Ukraine is characterized by unpredictability. Thirty-two laws, 30 presidential decrees, and over 80 resolutions regulate business activities. Over 32 ministries have a right to license business activity. Recently, licensing requirements have been lowered from 112 to 62 business activities, but this number is still considered high (International Finance Corporation 2003).

Taxation

One of the harshest regulatory activities of the Ukrainian government is taxation. Foreign investors view an excessive tax load as one of the principal problems with Ukraine's investment climate. The International Finance Corporation found that 70% of Ukrainian companies acknowledged the large amount of taxes and their high costs as being an impairment to their businesses. In 2002 businesses paid an average of eight taxes. The average tax collection was 28% of a company's profits. The Ukrainian tax system continues to operate in absence of a Tax Code, which has been awaiting approval from Parliament for the last few years. Without a single normative act to govern taxation, tax laws continue to change numerous times a year. For example, the income tax law changed six times in 2002 and five times during the first six months of 2003. The law that pertains to the taxation system itself changed three times in 2002 and 3 times in the first six months of 2003 (International Finance Corporation 2003). The approval of the country's Tax Code could solve many problems by setting up a stable and standard tax system (OECD 2001). Together with volatility, other deficiencies of the tax mechanism should be eliminated. Too few expenditures and amortization write-offs are allowed by contemporary rules as vehicles for the balancing of taxable income. Only a scarce amount of tax breaks are given to not-for-profit, educational, and research organizations (International Finance Corporation 2003).

As of 2004, a Tax Code is still pending endorsement, but new and more favorable tax laws have become effective since January 1st. These laws have decreased to some extent the tax loads of Ukrainian tax payers, as well as implemented new procedures and rules of tax collection (State Tax Administration of Ukraine 2004). Yet, the new system provides for an amplification of tax collection agencies authority. Tax collectors are now permitted to withdraw obligatory debt amounts from taxpayer's bank accounts. They are also allowed to "collect debt directly from taxpayer's debtors" (Timofeeva, 2003).

Corruption

As one can see the legal system of the country has been reformed, but the reforms left big gaps in the legal sector. We can conclude that "legality" in a sense that Litwack uses it, does not exist in Ukraine. The laws remain inconsistent and are not rigid. As a result the second requirement of Litwack's "legality" is also not satisfied. Not only the people of Ukraine but also government officials themselves do not believe in the stability and enforcement of the laws. Bribery has become the only way of doing business in Ukraine(Foglesong & Solomon 2001). During a survey conducted by the International Financial Corporation (2003), it was found that "unofficial" payments were demanded from many of the businesses during all of their dealings with government agencies.

"Unofficial Payments" were demanded by government agencies during audits from 41% of the surveyed businesses. During the export/import process one quarter of all the business involved in international trade were asked to pay "unofficially." During certifications and licensing, demands were given to 46% and 24% of business respectively (International Finance Corporation 2003).

Table 6: Percentage of Companies that Claim Procedures Require Bribes.

Procedures	Small Businesses	Medium-sized Businesses	Large Businesses	Average
Obtaining Permission	42	38	33	40
Registration	28	26	18	26
Licensing	27	26	23	26
Certification	24	23	23	24

Source: International Finance Corporation, p10.

However there were only 654 officials convicted of bribery in 2002 (MBD 2003). It is evident that most bribery incidents go unidentified and those who commit the crime are usually not charged with breaking the law. This fact enforces existing assumptions that law enforcement agencies in Ukraine are also corrupt, and that they facilitate the existence of fraudulent activities (Kalman). The Ukrainian population, in general, does not believe in the willingness of the government to eliminate corruption. According to the argument of Calbelkova (2001), perception of corrupt administration among the people can facilitate the true corruption in government. At the same time, the perception of illegitimacy is endorsed by people's readiness to give bribes. At the core of it all lays the pervasive "Everything can be bought and sold" mentality in Ukrainian society (Kalman). Instability and the lack of transparency of present legislation promote the increase of corrupt conduct among government bodies (Kalman, Pidluska). Inconsistencies and ineffective enforcement of Ukrainian laws make it easy to find excuses for bribery and other dishonest behavior.

Shadow Economy

As law enforcement remains ineffective and the example of those in power continues to discourage legality, many businesses in Ukraine operate illegitimately. Many believe that "credibility of corrupt transactions is higher than government policy" (Pidluska). The illegitimate business practices of the so-called "shadow economy" are most often attributed to excessive state regulations (Foglesong & Solomon 2001). As it was pointed out earlier, the unrestrained power of audit institutions can shut down a business if demands of unofficial payments are not satisfied. Excessive obligatory payments required by the government along with taxes can often become difficult to pay. Therefore, many businesses resort to concealing part of their profits from taxation and find other ways of defrauding the tax collections. On average, companies admitted to concealing 21% of their profits (International Finance Corporation 2003). As few businesses are willing to openly admit to deceiving the government, it is reasonable to state that in reality this number is much higher. In 1996, it was estimated that 60% of Ukraine's GDP came from a "shadow" sector (Foglesong & Solomon 2001). According to some analysts, it was this unreported income and resources that kept the country's economy and society "intact" during the deep depression of the nineties (Dimitrov 2000). However, in this contemporary situation where the country's economy is becoming more stable and industrial growth continues, the "shadow economy" cannot be overlooked as something insignificant. Not only does it deprive legitimate companies of a chance of survival by creating unfair competition, but it also impairs the country's social stability through enhancement of the criminal sector (Kalman).

Conclusion

As legality continues to be an imperative base for the efficient development of a free-market society, a country's political and economical stability, growth, and consequently FDI are reliant on the formation of effective legislation (Litwack 1991). In the case of Ukraine, however, the reform of the legal system on its own will not be sufficient enough to bring about positive changes. As we have shown earlier, the government has already instituted an adequate set of laws. The issues of government transparency, excessive tax loads, and the "shadow economy" have also been addressed by Ukrainian officials. These issues, along with a speedy acceleration of privatization and enhancement of the country's financial sector are identified as strategic directions for reform in the resolution of government programs. However, even if the best laws in the world will be established in Ukraine, legality still will not exist without the effective enforcement of these laws (Litwack 1991). Until the general population perceives the law as a principal code of behavior and the breach of this code is viewed as consequential, illegitimacy will continue to prevail among Ukrainian society. While government bodies pronounce the elimination of the "shadow economy" and bureaucratic corruption as their main goals, one cannot help but doubt the success of their ambitions. There is no obvious vehicle for eliminating illegitimate practices in Ukrainian business without the eradication of the corrupt government (Kalman). However, corruption is so deeply rooted in the administrative sector that even those on the very top with the most authority are guilty of a Soviet-type corrupt way of thinking. Some will argue that those at the top are the most corrupt (Kalman). The Ukrainian press claims that the country's top officials have close connections with the criminal sector and some of them are even part of criminal families, a claim given some credibility by the unsolved murders of Ukrainian journalists critical of the government. Kalman even defines the Ukrainian mafia as "corrupt representatives of various branches of power." Because Ukraine's independence was achieved without an overthrow of the ruling elite, Soviet-era political and economic officials retain power only under a new label (Foglesong & Solomon 2001). None of them will be willing to give up their long-run lucrative personal ties (Litwack 1991) and suffer the consequences for the institution of legitimacy. Therefore, as long as those at the top remain in power, true legality in Ukraine will not exist. The desired political and economic stability will remain problematic and will continue to be a detriment for foreign direct investment.

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