Free economic zones in Ukraine: genesis, trends and prospects

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The Context
Last week, leader of the IMF mission to Kyiv was quoted in the Ukrainian media as saying that the IMF was positive about the economic progress made by Ukraine, and satisfied with the course of negotiations with the Ukrainian government about possible resumption of the IMF's loan-making facility for Ukraine (Ukraina Moloda, September 19, 2000). The positive comments were amplified and emphasized by Prime Minister of Ukraine Victor Yushchenko.

Yet, notwithstanding the friendly statements, the IMF mission offered no clear answer as to when the EFF for Ukraine might be resumed and what amount of loans Ukraine could expect. On September 10, 2000, Ukraine's economy could mark a special anniversary, its first year without foreign loans. And, as the recent developments suggest, chances for getting them in the near future look murky. IMF representatives provided the Ukrainian government with a draft of the IMF's final statement, expected to serve as the basis for formulation of the conclusive assessment of the economic situation in Ukraine to be reviewed at the session of the IMF Board of Directors in November (ITAR-TARS, September 22, 2000). According to the IMF mission leadership, it is still too early to speculate about the amounts Ukraine may expect to receive. The decision to de-freeze the loan is made conditional on effective preparation and adoption of the 2001 state budget and, as the IMF authorities emphasize, on the implementation of Ukraine's privatization program and soundness of its banking system.
Like similar documents before, the draft 2001 State Budget of Ukraine, submitted to the parliament by the government on September 15, is enthusiastically criticized by members of the parliament and independent experts as unrealistic. One of the most serious criticisms, related to the outdated taxation framework used as the basis for calculating the budget, may be enough to severely influence, if not ruin, the government's plans expressed through its version of the country's main financial document. According to Minister of Finance Ihor Mitiukov, the government's draft of the 2001 consolidated budget envisages equal revenues and expenditures in the amount of UAH 52.3 billion. The draft is based on the expectation that the GDP will grow by 4 percent in 2001, the Ukrainian hryvnya to US dollar exchange rate will not exceed 6.3UAH/1$ (currently it is 5.62UAH/1$) and that the annual inflation rate will be 19 percent or less. Previously the Ministry of Finance proposed to set the estimated budget revenue at UAH 47 billion and calculate the budget at 6.7UAH/1$ exchange rate (Den, September 20, 2000).
The Issue
There is one point directly linked to prospects for the resumption of the IMF loans but normally neglected in the loan-seeking marathon more than other economic factors. The issue of liquidation of various kinds of special economic zones (known by their abbreviations SEZ (for "special economic zones", FEZ for "free economic zones", or PDT for "priority development territories") on the Ukrainian territory occupies a key place in a long list of economic prerequisites for continuing the funding facility.
The history of SEZ/FEZ in the Ukrainian legislation is almost a decade long. The "green light" flashed for SEZ for the first time in Article 24 of the law "On Foreign Economic Activity" No. 960-XII of April 16, 1991. The law stipulated that "special economic zones of various types can be established on the territory of Ukraine. The status and territory of such zones shall be established by the Verkhovna Rada [i.e., the parliament] of Ukraine in accordance with the Ukrainian legislation on special economic zones by means of adoption of a special law of Ukraine for each of such zones."
The next step of law making on the SEZ/FEZ issue was the Law of Ukraine "On General Foundations of Establishment and Operation of Special (Free) Economic Zones" No. 2674-XII of October 13, 1992. By the way, it is worth noting that notwithstanding repeated expert comments in favor of serious updating of the bill, it has never been amended since 1992.
According to the law, SEZ/FEZ can be established by the parliament of Ukraine following the initiative of the Cabinet of Ministers, the President of Ukraine, local councils of people's deputies or local state administrations. The law specified provisions for establishment and liquidation of the SEZ/FEZ, mechanisms of their operation in Ukraine, general legal and economic frameworks for their status, as well as general rules regulating relations between economic actors of such zones with local authorities and state executive agencies. The law specified the purpose of establishment of SEZ/FEZ as "attraction and promotion of foreign investment, activation, jointly with foreign investors, of enterprise development for the sake of increasing the exports of goods and services; for the supply of high-quality

goods and services to the domestic market; for attracting and introducing new technologies, market methods of economic activity, market infrastructure development, improving the use of natural and labor resources, acceleration of social-economic development of Ukraine." Given the declared goal, advocates of the special economic zones have to admit that so far SEZ/FEZ have failed to meet the expectations in full. According to the data provided by the Cabinet of Ministers of Ukraine on September 12, 2000 at the recent "day of the government" in the parliament, the amount of investment attracted by SEZ/FEZ has totaled US$ 305 million, or 23 percent of the amount supposed to be invested under approved projects. The investments were expected to create over 25 thousand of new jobs and save 37 thousand of existing jobs in the areas, but the real result was only 30 thousand of new and saved jobs, that is, less than half of what was initially planned.

All in all, Ukrainian authorities have adopted about 100 of laws, presidential decrees and governmental resolutions on the issues of SEZ/FEZ. Those included the bills "On Making Changes to the Legislation On Taxation (Concerning Special Economic Zones)"; "On Some Issues of Operation of Special Economic Zones and Territories of Special Investment Status (concerning the Truskavets Resortpolis and the Zhytomyr region); "On Making Amendments to Some Laws of Ukraine on Issues of Taxation (concerning levying taxes for the period of introduction of special provisions for investment and innovation activities of technoparks)", and "On Stimulating Economic Development of Production and Territories".

Nowadays, eleven special economic zones operate in nine regions that offer special investment opportunities. These include seven districts in the Crimea, 22 cities and towns, and five districts in the Donetsk region, three cities and nine districts in the Volyn region, the Transcarpathia, six cities and three districts in the Luhansk region, seven districts of the Chernihiv region, the town Shostka and Kharkiv. The most prominent of the special economic zones are "Donetsk" in the Donetsk region, "Slavutych" in the Kyiv region, "Resortpolis Truskavets", "Yavoriv" in the Lviv region, "Mykolayiv" in the Mykolayiv region, and the southern Crimean experimental economic zone "Sivash". Some special economic zones focus on export-import operations. Those include "Azov", "Zakarpattya", "Interport Kovel", "Reni", "Porto Franco" of the Odessa Sea port, and "Port Krym". According to Ukraine's Minister of Economy Vasyl Rohovyi, of 260 investment projects that have been improved to date, 166 belong to the priority development territories, and 94 to special economic zones (Uriadovyi Kurrier, September 15, 2000).

Although statistically activities of SEZ/FEZ may look impressive, the issue to be addresses is their economic efficacy and feasibility. So far the Ukrainian SEZ/FEZ have failed to serve as an illustration to a Hegelian classical dialectics law of transformation of quantitative changes into new qualities. Nevertheless, the issue of special economic zones has been a matter of heated debate in Ukrainian analytical and political environments. The fact that SEZ/FEZ have their devoted advocates and similarly determined critics has more to do with real interests of local and regional political and business elite that with theoretical debates about trends and prospects of free economic zones in general.

The debate has been on in Ukraine for about eight years. On the one hand, there is international positive experience suggesting that in transitional economies special economic zones contribute to fast and unrestrained development of market mechanisms and, as an advocate of SEZ/FEZ Valery Konovaliuk, MP, put it, act as "a model for the whole country" (Holos Ukrainy, September 19, 2000). The proportion of products created in free economic zones worldwide exceeds 5 percent of the global trade. However, critics of free economic zones argue that in Ukraine's case the "model" malfunctions badly, particularly at the macroeconomic level. The criticism relates, primarily, to the efficacy of SEZ/FEZ. Their ability to attract foreign direct investment, and the problems of creating conditions for the development of national economy sectors within free economic zones, combined with special taxation provisions applicable to those formations. Commenting on the challenges, Victor Pynzenyk, MP, argued: "we have created in many corners of Ukraine certain "islands" with special taxation arrangements, and, by having done so, discriminated against producers in other zones. The state cannot have several different taxation modes..." (from the transcript of the session of the parliament, February 16, 2000). The major challenge, as seen by opponents of SEZ/FEZ, is that the creation of favorable, "positive discrimination" conditions for some enterprises and branches in fact results in higher taxation pressure for others, which results in inequality in taxation conditions and creates additional disincentives for "non-zone" enterprises.

There are also a number of other counter-arguments offered by critics of SEZ/FEZ in the context of Ukraine's economic development strategy and the reform course. One of the strongest challenges to the SEZ/FEZ idea is the broadly advocated need for the government to create favorable investment climate for domestic as well as foreign investors throughout Ukraine, not just on selected economic "islands". According to Victor Pynzenyk, "the whole Ukraine should be a free economic zone" (Ukraina Moloda, June 7, 2000). This definition has much in common with the IMF's attitude to Ukraine's free economic zones. Commenting on the view, chairman of the parliament's Special Control Commission for Privatization Oleksandr Ryabchenko, MP, argued that "from the international experts' point of view, Ukrainian FEZ are unnatural and should be closed down. The West wants the whole Ukraine to work in a mode that would be similar to that of a free economic zone. Hence, the point is [to achieve] investment motivation of the entire economic policy of Ukraine" (Den, September 28, 2000). However, the task seems to be rather hard to complete given the contemporary economic reality of Ukraine. BY January 2000 the per capita foreign direct investment in Ukraine reached only US$ 66.

Paradoxically, this circumstance adds strength to the arguments of SEZ advocates. Logically, they claim, SEZ are indispensable until the investment climate in Ukraine is improved. They emphasize microeconomic dimension of the issue, arguing that locally and regionally special economic zones are seen (or at least are presented) as a direct way of solving the problems of unemployment, improving the socio-economic situation in individual economically depressive areas. For instance, analysis of economic processes in the "Yavoriv" special economic zone (established in early 1999) shows that before the zone was established the local sulphur combine had practically halted its operation, for the face value of its products had been US$ 100-120 per ton, as compared to US$ 58-60 at the world market. However, implementation of several investment projects allowed to reduce the face value of sulphur to US$ 38 per ton and cut down unemployment by 10 percent (Holos Ukrainy, March 7, 2000).

Meanwhile, notwithstanding some achievements, it should be noted that results of activities of special (free) economic zones differ dramatically from case to case and from region to region. One of key factors to test the efficiency of a specific zone is the volume of investment it has managed to attract. For instance, the Donetsk region received US$ 237.7 million of investment, or 78 percent of the total received by all Ukrainian special economic and priority development areas. Simultaneously, the Luhansk region has not been successful. Notwithstanding the special investment incentives offered by the priority development territories since December 18, 1998, only US$ 3.8 million (1.2 percent of the whole) of foreign direct investment in Ukraine and only 8.7 percent of the total cost of projects approved in that area have actually arrived. Other statistics for the Luhansk region also fail to make any positive impression and appears to be typical of the "economically depressive" area. Instead of creating 1,453 new jobs, the region's priority development territories provided only 64 jobs (or 4.4 percent of the number of jobs originally expected). Meanwhile, supporters of the idea of SEZ/FEZ argue that without the establishment of the zone the economically depressed region would have performed much worse.

There is yet another aspect of activity of the special economic zone in the Luhansk region. According to Yuri Kononov, head of the regional committee for facilitating the establishment of the priority development territory and investment, the previous government led by Valery Pustovoitenko adopted a resolution that allowed the Luhansk special economic zone to have 128 development priorities. The current Cabinet of Ministers reduced the list of such allowed priorities to 28, but finally slashed the number down to three (Ukraina Moloda, June 7, 2000).

In the neighboring Donetsk region the special economic zones were critical for creating the largest number of new jobs: 3,643 in Donetsk and 6,844 in the Donetsk region, i.e., 23 percent of all jobs, created or saved by all special economic zones and priority development territories of Ukraine.

The above figures may serve as an illustration to specific features and different levels of effectiveness of SEZ/FEZ in this country and suggest that the special economic formations require "personalized" case-by-case economic analysis of their roles in improving the general economic condition and investment climate in Ukraine and their respective regions. Otherwise they have the risk of becoming merely the "black-holes" of the state budget. According to the State Taxation Administration, there has been no reduction in general revenue from taxes and dues from the special investment mode territories. Since the establishment of special economic arrangements, budgets of all levels received UAH 2,970.7 million. However, within the same period of time subjects of economic activity received benefits and incentives worth the total of over UAH 266 million (Uriadovyi Kurrier, September 15, 2000). This is yet another argument in favor of the need to analyze the performance of each of the zones and territories. Without such analysis it would be problematic to judge about the role of each of them in particular based only on the generalized statistics data. In this context Oleksandr Ryabchenko, MP, commenting on potential abilities of individual special economic zones at the microeconomic level, argued that "local authorities urge for "freedom" that may become a way towards realization of the region's potential. On the one hand, this is correct, for the regions' general resources are currently being used too ineffectively. However, there are certain problems as well, when special economic conditions are created on a territory that is not suitable at all" (Den, September 28, 2000).

Therefore, given the IMF's conditions concerning the liquidation of SEZ/FEZ, it is worth "not to splash the baby out with the used water", as Stanislav Hurenko, MP argues (Holos Ukrainy, March 7, 2000).

There is a negative aspect that will follow the liquidation of the SEZ/FEZ that Ukraine should not allow under the current investment reality: further dissatisfaction of investors with the changing environment. Some of the special economic zones were originally planned to last for 30 years.

Conclusion

Hence, the history of development of special (free) economic zones offers few convincing positive examples; the SEZ development trends remain uncertain, and prospects unclear. It should be noted that the government has introduced temporary moratorium on submitting proposals for creation of new SEZ and priority development territories. The decision was announced at the "day of the government" session in the Rada on September 12, which almost symbolically coincided with the beginning of the IMF mission's negotiations in Kyiv. The government also announced plans for complex monthly monitoring of the zone's effectiveness. Yet another step to be taken by the government involves the liquidation of ineffective special economic zones and special investment provision territories. However, it is unclear what criteria will be used to determine effectiveness of the zones and territories, and whether (and if yes, how) unbiased judgement on individual issues will be ensured.

The decision indicates that the government is seeking a compromise between advocates of the SEZ/FEZ - primarily local leaders and representatives of interested political and business elites - and the IMF's requirements for closing down the free economic zones in Ukraine. The "to be or not to be" issue of the free economic zone policies has moved up the government's agenda recently, but it is unclear if (and whether at all) the solution will help to resume the IMF loan-making activity in Ukraine.