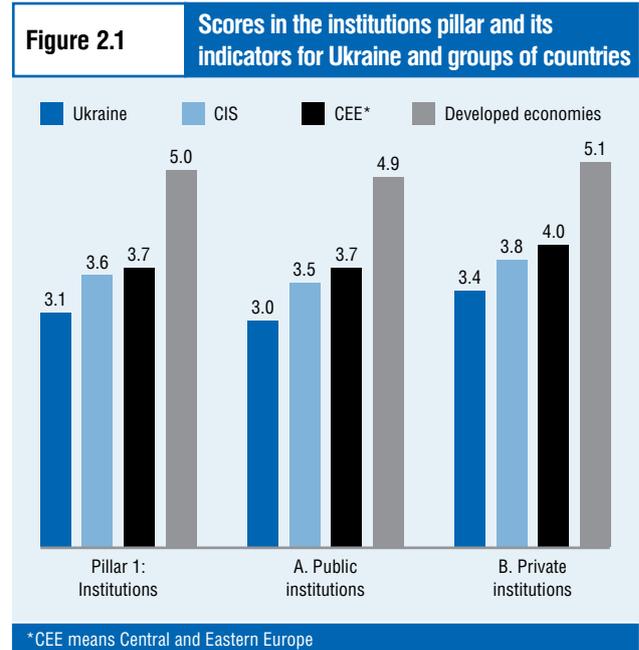


Weak Institutions Restrain the Country's Competitiveness

UKRAINE'S INEFFICIENT INSTITUTIONS ARE AN OUTSTANDING PROBLEM

Institutions remain the weakest point in Ukraine's competitiveness. In the Global Competitiveness Report for 2012 produced by the World Economic Forum (WEF)¹ Ukraine ranks 132nd out of 144 nations in this pillar, one place down from last year. The country is a poor performer not only among EU countries and other developed economies, but also among its neighbors. Ukraine is behind all CIS countries, except Russia and the Kyrgyz Republic, which take 133rd and 137th place respectively (Figure 2.1).



Source: WEF, Global Competitiveness Report 2012.

The impact of institutions on an economy primarily depends on the stage of the country's economic development. WEF assumes that countries move along a development path consisting of three stages: factor-driven, efficiency-driven and innovation-driven development stages. Countries that are between any two stages are transition economies.

The Global Competitiveness Index (GCI) takes the stages of development into account by attributing higher relative weights to those pillars that are more relevant to an economy given its particular stage of development. In other words, the relative importance of each pillar depends on a country's particular stage of development.

At the first stage, economic growth hinges on basic factors represented by four pillars: public and private institutions (pillar 1), infrastructure (pillar 2), macroeconomic environment (pillar 3) and health and primary education (pillar 4).

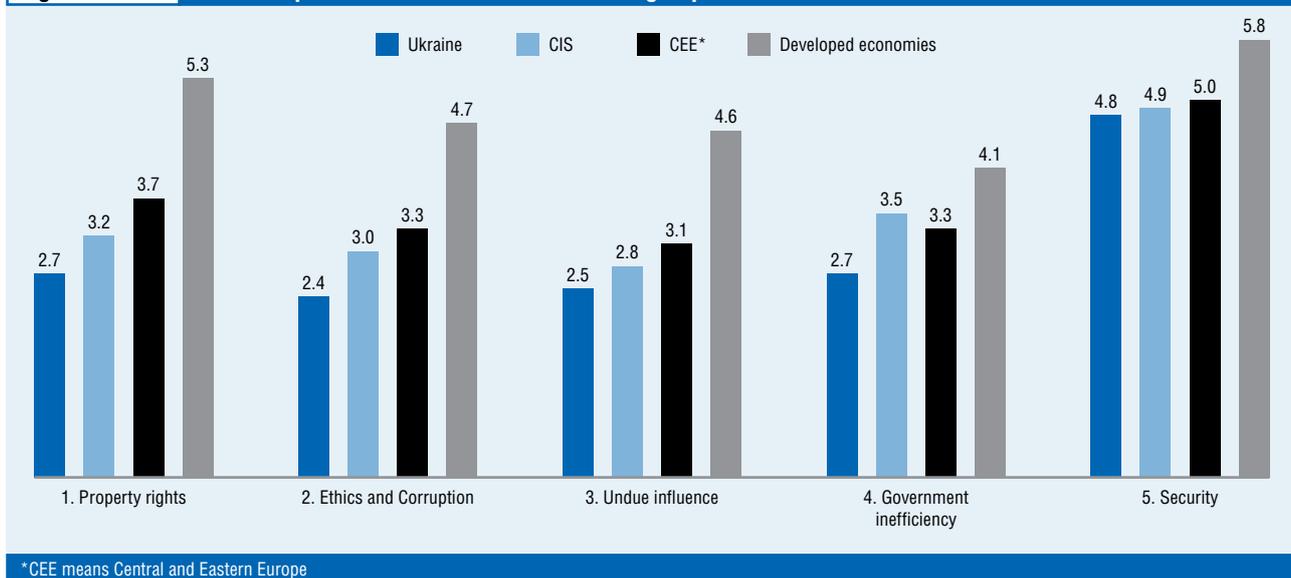
In 2012, Ukraine has cemented its position in the second group of efficiency-driven economies. This means that at this stage the country's growth is mostly fuelled by pillars in the efficiency enhancers subindex (efficient goods market, a well-functioning labor market, developed financial market, strong capacity for technology absorption and the size of domestic and foreign markets).

¹ Text from WEF's Report 2012

Table 2.1 Ukraine's results in institutions

	2012		2011		Change		Weight
	Rank	Score	Rank	Score	Rank	Score	%
Pillar 1: Institutions	132	3.13	131	2.98	-1	0.15	25%
A. Public institutions	129	3.03	131	2.86	2	0.17	75%
1. Property rights	136	2.72	134	2.65	-2	0.07	20%
2. Ethics and corruption	130	2.42	131	2.32	1	0.11	20%
3. Undue influence	125	2.50	129	2.36	4	0.14	20%
4. Government inefficiency	136	2.68	136	2.63	0	0.06	20%
5. Security	75	4.84	101	4.37	26	0.47	20%
B. Private institutions	131	3.43	134	3.34	3	0.09	25%
1. Corporate ethics	124	3.22	126	3.10	2	0.12	50%
2. Accountability	128	3.65	132	3.59	4	0.06	50%

Source: WEF, Global Competitiveness Reports 2011 and 2012.

Figure 2.2 Scores in public institutions for Ukraine and groups of countries

*CEE means Central and Eastern Europe

Source: WEF, Global Competitiveness Report 2012.

Yet despite its rise to a higher level, Ukraine continues to face many challenges in the basic pillars (including institutions). This means that Ukraine cannot fully employ the advantages of countries at the factor-driven stage to boost competitiveness, because the problems remaining at the previous level are distracting resources and time.

WEF methodology establishes that institutions are an integrated pillar consisting of two components with different weight: public institutions (0.75%) and private institutions (0.25%). The first component has higher weight, as it includes five integrated indicators that describe quality of cooperation between government and other market players (property rights, ethics and corruption, undue influence, government inefficiency and security). The second component, private institutions, covers two integrated indicators: corporate ethics and accountability. Ukraine's results in each indicator and component of the institutions pillar are given in Table 2.1.

PUBLIC INSTITUTIONS

In the public institutions component, Ukraine has climbed up two positions year on year to reach 129th place (see Table 2.1). The component consists of five indicators,

which describe how government and other market players interact to generate wealth. Ukraine's better performance for this component was driven by security scores, which are twofold higher on average than the scores for the other four indicators (Figure 2.2).

The security indicators account for Ukraine's greatest progress in the institutions pillar in GCI 2012. In business costs of crime and violence the country has soared 35 positions to 42nd place. It has also improved its position in business costs of terrorism (36th) and organized crime (94th), moving up 22 and 24 spots respectively since last year.

This improvement in security indicators is likely to be a result of preparations for the 2012 UEFA European Football Championship. The Executive Opinion Survey used to calculate the Global Competitiveness Index 2012 was being conducted during the final stage of preparations for the championship, when security measures in Ukraine were enhanced. Thus, respondents might have had the impression of a higher security level, which in turn resulted in better scores for business costs of crime, terrorism and violence.

The fight against corruption also shows a positive trend. Since last year, the assessment of diversion of public

funds has moved up nine positions in the ranking to 117th place. Judicial independence is evaluated higher as well, rising 10 spots to 124th position. The biggest problem lies in property rights protection (136th): Ukraine has fallen another two spots in this indicator. Such deterioration can be attributed to factors that have changed little in Ukraine: a dependant judicial system, corruption, favoritism in decisions of public officials, flawed laws and insufficiently reliable police services.

Favoritism in the decisions of public officials (119th) has seen the biggest drop year on year – down 24 positions. This demonstrates that a long delay in systemwide administrative reforms has allowed Ukrainian officials to manipulate the system for private interests, at the expense of public interests.

The nation's performance in the government efficiency indicators has also gotten worse. Whereas institutions are a weak spot in Ukraine's competitiveness, government efficiency is a weak point in the pillar. For example, transparency of government policymaking has seen deterioration, making Ukraine fall seven places to position 123rd. The country is among the worst performers on the efficiency of legal framework in settling disputes, down five spots to 141st.

The following are reasons for such a poor performance in government efficiency:

- **Burdensome regulatory framework.** Formalism, complicated bureaucratic procedures and overregulation create heavy obstacles for business. The Executive Opinion Survey held by the Foundation for Effective Governance in 2012² revealed that 61.1% of business executives perceived business regulation (obtaining permits, filing reports) as extremely burdensome. On the one hand, intricate regulatory procedures and frequent changes in the application of rules create a complicated environment for doing business. On the other hand, the excessive concentration of power in the hands of public officials facilitates corruption.
- **Inflated and inefficient government machine.** The present-day administrative system does not differ much from the one that existed during the Soviet era. Professionalism in government service is limited. By and large, hiring practices, remuneration, non-transparent promotions and the lack of a proper system to evaluate government efficiency and effectiveness lead to arbitrary actions by civil servants and enhance the role of political and personal ties.
- **Non-transparency and low accountability.** Central and local governments are not accountable to the public or the business community, with feedback mechanisms operating very badly. The public has no effective leverage on the government, which is necessary for an efficient system of checks and balances.

The Survey annually conducted by the Foundation for Effective Governance also shows that Ukrainian government is hampered by inefficiency and corruption. In the latest Survey, 12.2% of business executives cited corruption among the top three most problematic factors in Ukraine. An analysis of past annual surveys shows that

the top five problems have been dominated by institutions-related factors: inefficient government bureaucracy, policy instability, tax regulations and local and national government instability.

PRIVATE INSTITUTIONS

Compared to 2011, private institutions have witnessed a heavy deterioration in the efficacy of corporate boards, bringing Ukraine seven spots down to 113th place out of 144 economies in this indicator. Also, Ukraine has performed badly on protection of minority shareholders' interests, down to a very low 141st position. The degradation is in part due to slow legislative reform in the area. For example, the Law On Joint Stock Companies adopted in 2008 became fully effective only in April 2011. Therefore, businesses have not yet fully perceived how the law influences protection of shareholders' rights.

PROFILE OF UKRAINE'S INSTITUTIONAL FRAMEWORK BY REGION

The Survey, carried out in 27 Ukrainian regions (2 100 respondents), indicates that Ukrainian regions demonstrate a wide range of scores in the institutions pillar. The gap between the best performer (Volyn, 4.04 points) and the worst performer (Kyiv, 3.32 points) is 0.72 points. Globally, Volyn's performance in 2012 corresponds to that of Slovenia (4.05 points, 58th) and Poland (4.11 points, 55th), while Kyiv's result in the institutions pillar is in line with those of less developed countries such as Pakistan (3.34 points, 115th) and Nigeria (3.33 points, 117th)

The regions' uneven performance in institutions comes primarily from the state of their public institutions, which show the lowest scores for property rights and undue influence. However, the oblasts show better results and less dispersion in security indicators.

The gap between the top-ranked and bottom-ranked regions is 0.91 points in the public institutions component, with Chernivtsi earning 4.09, and Kyiv scoring 3.18. Globally, top performing Chernivtsi Oblast's result for public institutions matches that of Poland (4.04 points, 56th), whereas Kyiv performs in line with Nicaragua (3.20 points, 117th), Nepal (3.16 points, 119th) and Columbia (3.14 points, 122nd).

The low assessment of public institutions by business executives is due in part to complicated relationships between business and government in Ukraine. The Survey revealed that 34.6% of respondents mentioned conflict-ridden relations between business and government in their regions. Larger cities had even a greater share of corporate executives who were of this opinion: Kyiv with 52%, Lviv – 50.5%, and Odesa – 46.5%.

Property rights are still an issue in Ukraine and are particularly critical in some regions. The worst situation is in Kyiv (3.48 points), which holds the very last place in the national ranking; while the best result is shown by Zakarpattia (4.33 points). In 2012, the gap in the indicator between the best and worst regions is relatively small – 0.85 points. In the global report, Zakarpattia's score corresponds

² Executive Opinion Survey 2012 (the Survey) with a breakdown by region is conducted annually by the Foundation for Effective Governance following the methodology of the World Economic Forum. Business executives are suggested to evaluate business environment in the region where they live and do business. Using the data of the Survey, Foundation for Effective Governance calculates annual competitiveness index of Ukrainian regions.

Box 1: Weak institutions pose a serious hindrance to a competitive economy

In recent decades, researchers have made much progress in learning about institutions, including how internal mechanisms and factors facilitate or hinder development of institutions in different countries. A continuing interest in the study of this issue has provided insight from different perspectives, allowing for a comparison of the impact institutions have over time, broken down by country. Despite the abundance of theoretical studies, the subject of institutions remains, in practice, one of the most challenging issues.

WHAT DOES "INSTITUTIONS" MEAN?

Douglass C. North, a classicist of institutional economics, defined institutions as rules, enforcement mechanisms and norms of behavior that structure human interaction [1]. Institutions can be public or private. Working together, public and private institutions underlie the institutional framework where government, businesses and individuals interact. The quality of the institutional framework has a material impact on each group of players, influencing their investment decisions and process management.

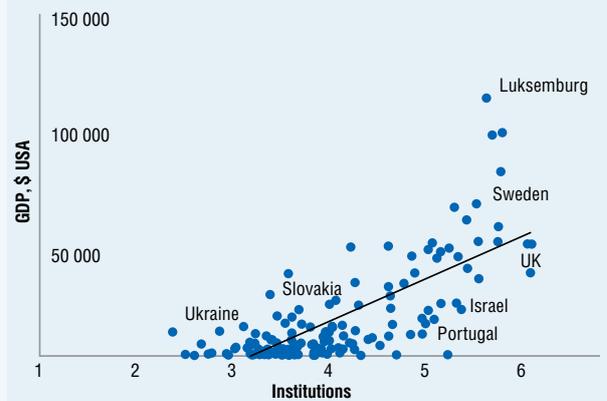
Without the protection of property rights, business would not invest in the upgrade of assets, but rather continue to divest its capital. Overregulation, corruption, bureaucracy, kickbacks and a lack of integrity in public contracts both weaken the efficiency of public officials and cause material business costs. In a weak institutional framework, the government channels public resources into inflated, overstated and useless projects instead of initiatives in such strategic sectors as infrastructure, health, education or high return projects. Priorities are guided by private, not public interests.

A politically dependent judicial branch and the absence of a level playing field undermine the government's efficiency, adversely affecting overall macroeconomic efficiency and public welfare.

There are many other examples of the negative impact of institutions. Yet statistical figures will give a better understanding. The World Bank estimates that countries spend about USD 1tn on bribes annually, a figure that corresponds to 3% of global GDP [2]. If we try to evaluate all economic loss from inefficient institutions (lost investment projects, lack of integrity in public contracts, inefficient government spending, etc), we get a value notably exceeding the World Bank's estimate.

Figure 2.3

Quality of institutions and GDP per capita, 2011



Source: WEF, World Development Indicators, calculations by Foundation for Effective Governance

Institutions lie at the core of the market economy. Economic development of other countries demonstrates that efficient and well-functioning institutions correlate with economic growth (see Figure 2.3).

The correlation between the institutions pillar in the GCI and GDP per capita is 0.74. A simple regression analysis shows that if institutions improve by one point, GDP grows 1.21 percentage points on average. As institutions are a driving force of economic growth, institutional reforms can be a key factor that would spur Ukraine's economic development.

CEE nations with high GDP per capita (Slovenia with USD 24 500, Estonia with USD 16 600 and Poland with USD 13 500) are among the better performers in institutions (Estonia ranks 30th; Poland, 55th; Slovenia, 58th).

In addition to its direct economic influence, the quality of public and private institutions shapes the government's ability to influence processes domestically and implement reforms needed to boost other aspects of national competitiveness. Because Ukraine chose the path of transformation in 2010, its declared commitments to improving the quality of public institutions should maintain a priority, particularly commitments to enhancing the protection of property rights, fighting corruption and ensuring independent and fair judicial proceedings.

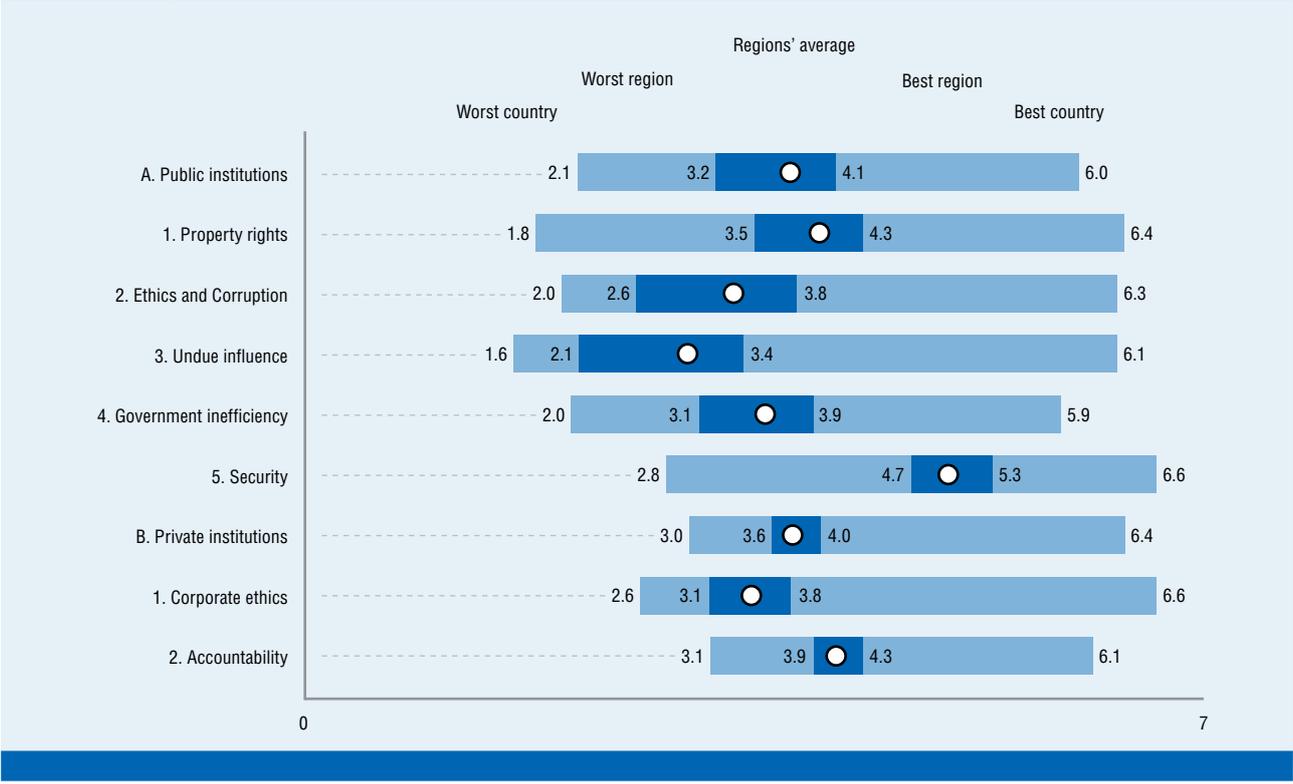
to that of Slovenia (4.38 points, 52nd), while Kyiv's performance matches that of Thailand and Cameroon (3.50 and 3.56 points, 100th and 96th respectively in GCI 2012).

In Ukraine, the overall score for property rights is higher than the one for intellectual property protection, yet the gap between the best and worst performing regions is bigger in the latter indicator – 0.99 points. Volyn leads in intellectual property protection, with 3.51 points, a

result that corresponds to Macedonia's 73rd place in the global ranking (3.51 points). Odessa Oblast is the worst performer in this indicator, getting only 2.72 points, which is in line with the position of Dominican Republic (2.74 points, 119th).

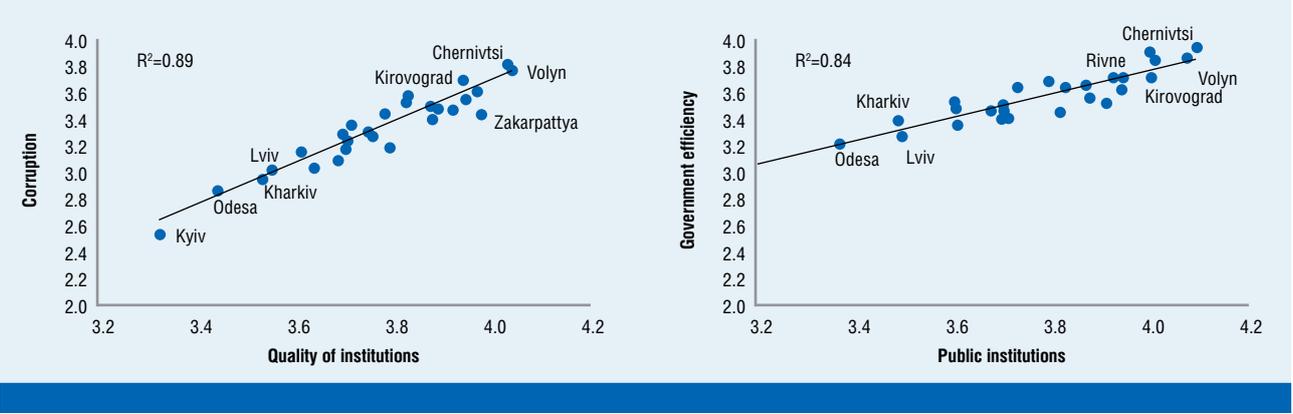
The breakdown by region shows the biggest point spread in corruption and undue influence. The difference between assessments of corruption in the best and worst

Figure 2.4 Spread of values: the best and the worst results in the institutions pillar, 2012



Source: Foundation for Effective Governance, Executive Opinion Survey 2012; WEF, Global Competitiveness Report 2012; calculations by Foundation for Effective Governance.

Figures 2.5-6 Corruption, quality of institutions and government efficiency in Ukrainian regions



Source: Calculations by Foundation for Effective Governance.

regions is 1.27 points. The Survey revealed that the Kyiv has the worst situation with corruption (27th among Ukrainian regions with 2.55 points), performing in line with such developing economies as Zimbabwe (2.85 points) and Uganda (2.51 points). Chernivtsi Oblast, however, fights corruption more efficiently (1st among 27 regions with 3.82 points). This result corresponds to that of Spain (3.72), Turkey (3.74) and Poland (3.78).

The breakdown by industry shows that executives from investment companies (20.7%), banks (16.5%) and the mining sector (15.2) regard corruption as the most problematic factor for doing business.

Figure 4 below shows that Ukraine's lowest score for undue influence is 2.1 points. This component includes two indicators, judicial independence and favoritism in decisions of government officials, which are the most pressing issues both for particular regions and for Ukraine as a whole. Chernivtsi, Volyn and Rivne oblasts can boast Ukraine's best judicial system and lowest favoritism among government officials,

comprising the top three regions in the national ranking 2012, with 3.41, 3.39 and 3.28 points respectively. Notably, oblasts with Ukraine's biggest cities – Kyiv, Kharkiv and Odesa – rank at the very bottom of the Ukraine Competitiveness Report. In 2012, Kyiv's position in undue influence corresponds to one of the lowest places in the global ranking – 140th taken by Argentina with 2.07 points.

The low score in these indicators is a signal to businesses that judicial reform is crucial and that recently adopted amendments to the Law On Judiciary and the Status of Judges have still not produced their intended effect.

Western oblasts lead Ukraine in terms of government efficiency, with Chernivtsi ranking 1st (3.94 points), Rivne 2nd (3.89 points) and Volyn 3rd (3.86 points). Kyiv (27th, 3.05 points), Odesa (26th, 3.22 points) and Lviv (25th, 3.27 points) are at the bottom of the list. Such low assessments of government efficiency in Kyiv, Odesa and Lviv are in part due to the fact that businessmen in these regions have an opportunity to compare the current local situation with

Box 2: Institutional reform in Turkey

The combination of official recognition as an EU member candidate in 1999 and growing domestic demand resulted in a significant drive in Turkey for institutional reform to meet the requirements outlined in the Copenhagen criteria. Between 2003 and 2007, Turkey's world ranking in 'Quality of Public Institutions' improved from 63rd to 55th. As illustrated below in Figure 2.7, significant improvements were made in key institutional indicators up until 2007, following a series of legal and constitutional reforms in the early 2000s. By 2007, the accession fuelled reforms had slowed following a freezing of negotiations with the EU due to political disagreement over Cyprus, and rising domestic tensions. Kemalist segments of Turkish society and the military became suspicious that the ruling AKP party's hidden agenda was to exploit the EU membership process to diminish the military's political role, and eventually the Kemalist legacy, to advance an Islamist agenda. This culminated in the military threatening a coup to which the AKP party responded by calling early elections and winning a landslide victory in 2007. This domestic political turmoil further undermined focus on the impending reform process.

JUDICIAL INDEPENDENCE AND EFFICIENCY

The independence of the judicial system is protected by the constitution so that in theory there is no organization, person or institution that can interfere in the operation of Ukraine's courts. Reforms in 2001 improved this in practice, resulting in a rise in global rankings from 57th in 2003 to 50th in 2007. The judicial system was strengthened with the establishment of a new system of family courts, and the ability of military courts to try civilians was abolished. There was a decline in assessments after 2007, however, (to a rank of 88th in 2011) reflecting governance problems within the Judiciary. The Supreme Board of Judges and Prosecutors, consisting of five elected Supreme Court members

and two from the Justice Ministry, is responsible for appointments and postings of judges and prosecutors on an annual basis. Its chairing by the Minister of Justice means the recruitment, promotion and training of the Judiciary is concentrated with the ministry and there have been increasingly frequent clashes between the judiciary and government due to this involvement. Thus despite the successful reduction of military authority over the judiciary, independence is now threatened by civic tutelage.

By 2002 the judicial system was faced with a large backlog, excessively long average duration of judicial proceedings and intolerably high workload of judges and public prosecutors reflecting their insufficient and decreasing number. The Ministry of Justice initially implemented some reforms to ease pressures. First courts with low workloads were closed and staff transferred to those with heavy workloads. Staff numbers were still lacking however and reversing this progressed slowly such that by 2010 there was a total of 11 394 judges and prosecutors compared with the 9 162 in 2003, a number still dwarfed by the approx. 70 000 employed in comparably sized Germany. Furthermore a system of Alternative Dispute Resolution in criminal and civil cases was introduced to reduce the inefficient backlogs of minor disputes in courts. Another significant improvement was the modernisation of the judiciary through the improvement of information and communication technology which started in late 2001 thus reducing mistakes and ensuring some degree of transparency. This program was successfully implemented and yielded positive results.

FAVORITISM IN THE DECISIONS OF PUBLIC OFFICIALS

Favoritism is in part a reflection of the public procurement system, which prior to 2000 left too much discretion to public official and thus created a

that in other countries. Therefore, they set higher standards for their local authorities than their peers in other regions. Also, the performance of even the most efficient regional governments in Ukraine is not that high if compared with other countries. The spread between Ukraine's best result in government efficiency and that of Singapore (5.9 points), which topped the Global Competitiveness Report 2012, is two points, or 79 positions in the global ranking.

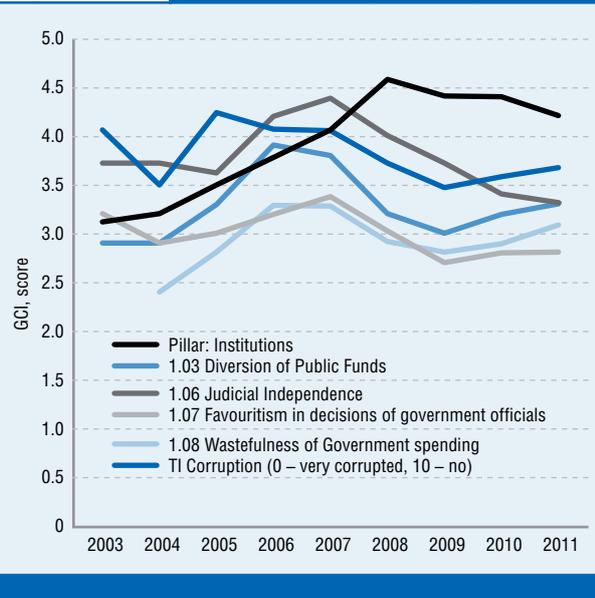
All Ukrainian regions score low in all indicators describing the quality of private institutions. The difference in the results of the top and bottom-ranked regions is only 0.4 points. Private institutions are most developed in Dnipropetrovsk (3.99 points) and show the worst performance in Ivano-Frankivsk (3.61 points). In this indicator, Ukraine lags significantly behind global leaders. The spread between Ukraine's best result and that of the top performing country, New Zealand with 6.4 points, is 2.4 points, corresponding to 75 places in the global report.

The private institutions component consists of corporate ethics and accountability indicators. The weakest point of the Ukrainian corporate sector is accountability, particularly protection of minority shareholders' interests.

International practice suggests that poor quality of institutions is a complex but surmountable challenge. The efforts taken by Turkey (Box 2) and former socialist countries Slovenia and Poland can be regarded as excellent examples of how to overcome this challenge. A strong political will and a society's commitment are the key to the success of institutional reforms.

Figures 2.5 and 2.6 show a correlation between corruption and the quality of institutions, and between public institutions and government efficiency. In both cases, the coefficient of determination is above 0.8, which means that a strong linear relationship exists between the indicators.

Regions with higher quality institutions (Figure 2.5) enjoy a better situation in terms of corruption; while

Figure 2.7 Institutional Quality in Turkey

wide scope for favoritism and corruption. In 2000, the Public Procurement Law (PPL) and Public Procurement Contracts Law (PPCL) were introduced, extending the principles of transparency, competition and equal treatment to all areas in which public money is spent, helping to improve global rankings in this indicator from 61st in 2003 to 49th in 2007. The law standardized the procurement process, making it obligatory to assign a tender commission and to advertise (no less than 40 days in advance) all projects above a threshold value on the Public Procurement Bulletin. The contract was then to be awarded to the most economically attractive bidder. The PPL established the Public Procurement Authority to ensure accurate implementation of the principles specified in the law by evaluating complaints, providing training, keeping records and publishing related statistics, regulating tender notices and publishing the bulletin in printed and electronic media. An electronic public procurement platform was also introduced in 2002. Although this contributed to some improvement in indicators in the beginning of the 2000s, improper

influence by the government in the form of one-time exceptions to the regulatory framework, continually extended corruption within procurement, culminating in a ranking of 95th in 2009. The state procurement law still gives precedence to domestic bidders, and SOEs allegedly enjoy preference. Some progress was made towards mitigating these problems in 2010, when a strategy for enhancing transparency and strengthening the fight against corruption in public procurement was adopted. The Public Procurement Authority launched a call centre to provide advisory services to procuring entities and comprehensive guides to tenders were published.

WASTEFULNESS OF GOVERNMENT SPENDING

Prior to 2003, public spending was not managed according to clear policy objectives, and there was no comprehensive public accounting framework. The Public Financial Management and Control Law of 2003 addressed this to secure financial control in line with the policies and objectives covered in development plans. Public authorities were to prepare strategic plans covering a five-year period outlining corresponding methods to achieve these objectives and allocate resources. Annual activity reports were to be publicly announced. Further administrative reforms were undertaken to improve the efficiency of the Turkish public sector through privatization and the outsourcing of functions such as waste collection, security and IT services. Although rankings initially improved slightly, the implementation and enforcement of these reforms remains a critical issue, as they are built on a managerial approach, which is incompatible with the traditional administrative structure. The mechanisms and structures established to see through the reforms do not have sufficient authority, autonomy or resources to undertake their functions. Since 2009, rankings improved from 101st to 72nd in 2011, as budget spending units started to submit their action plans to the central harmonization unit for financial management in line with a revised guide published in 2009.

government efficiency is stronger in oblasts with a higher quality of public institutions (Figure 2.6).

We can therefore conclude that in a linear relationship an improvement in the quality of institutions would improve the situation with corruption and government efficiency. This is another argument for much-needed institutional reforms.

If the role of institutions is so vital, why haven't institutional reforms been implemented? An interesting answer can be found in the measures taken by Turkey, which managed to implement an unpopular institutional reform despite tenacious opposition and rejection. Turkish practices show that it is not only about institutions, but also about the readiness of society and business to adopt new, effective and mutually beneficial rules (Box 2). However paradoxical this may appear, both business and society may show little interest in institutional reforms, especially at their initial stage.

CONCLUSIONS: STRONG INSTITUTIONS ARE NECESSARY, BUT INSUFFICIENT FOR UKRAINE'S ECONOMIC BREAKTHROUGH

Institutions determine how effectively and efficiently the government implements reforms. Bad institutions are a problem that requires immediate measures. With solving this problem, Ukraine will unlikely continue climbing up the competitiveness ladder. International practices show that addressing weak institutions is a complex yet realistic task that can be successfully overcome if potential hardships are foreseen, and priorities are set properly.

A strong political will lies at the core of any improvements in institutions. Political will, however, is vulnerable and changeable amid frequent elections. Therefore, institutional reforms are possible only if all parties involved – the government, civil society and the

media – show strong commitment and interact with each other.

Major efforts should be on enforcing rather than on making proper draft laws. In Ukraine, many good laws remain a formality. Reforms are not accomplished and institutions, being weak, fail to perform their functions.

Institutions are diverse and affected by problems requiring different time inputs to address. Some issues can be addressed with the stroke of a pen and implemented within several months, while others involving long-standing traditions and rules may need a generation to change. Putting reform into action, the government should work out a mechanism to make this transformation sustainable.

There are no universal or turnkey solutions to institutional weakness, because countries are subject to national diversity and historical peculiarities. Addressing the issue, they should remember that the ultimate goal is not improved institutions, but positive economic phenomena brought about by strong and transparent institutions (stronger investor trust, a better investment climate, greater competitiveness and higher GDP).

It is therefore not only about improving institutions, which is an important yet insufficient measure. Moving towards stronger competitiveness, Ukraine should keep an eye on other pillars, which will work together to drive the country's competitiveness in the near future.

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