

Building favorable investment climate for economic development

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ABSTRACT

The research is devoted to the adaptation of theoretical and applied organizational grounds of favorable investment climate based on the establishment of an efficient mechanism of investment capacity increase in Ukraine. The main aim of the paper is to substantiate the mechanism of forming a favorable investment climate as the basis of investment capacity increase in Ukraine. The paper verifies the authors' hypothesis on the adequacy of the substantiation of the mechanism of favorable investment climate forming as the basis of investment capacity increase leading to the substantial improvement of Ukrainian positions in international rankings. The dependence of Ukraine's investment climate on the formed mechanism of its development is confirmed, and the necessity of its improvement is emphasized. The paper proves that forming of the favorable investment climate as the main precondition of boosted development, reproduction, and efficient use of investment climate at all levels is one of the most important strategic tasks that Ukraine faces. Economic, institutional-legal, and organizational-administrative mechanisms and implementation tools directed at improvement of the investment climate in Ukraine and the creation of conditions for investment capacity growth and its efficient transformation into an investment product are systematized.

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1. Introduction

Forming of the favorable investment climate as the main precondition of boosted development, reproduction, and efficient use of investment climate at all levels is one of the most important strategic tasks that Ukraine faces. An opportunity to come out of recession, structural readjustment, improvement of the national economy's competitiveness, and its further socio-economic dynamics depends on the accomplishment of this task. Forming of favorable investment climate requires the systemization of its major formation factors and analysis of its functioning mechanisms. However, nowadays, there is not any single approach to economic nature and components of investment climate on the level of the national economy.

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2. Literature review

The issues of investment climate improvement in Ukraine are of considerable interest in scientific circles. In particular, most scientists believe investment climate and investment attractiveness are the same. They define the investment climate as a condition of investment environment characterized and evaluated by the gross domestic product (GDP) growth paces, the existing level of taxes and benefits, interest rates, inflation, tariffs and prices, exchange rates, prices for corporate and public securities, and legal framework of investment activity (Maslak & Talover, 2016; Panukhnyk et al., 2019; Shchepina, 2014; Stehnei et al., 2017, 2019; Verbitska, 2018). However, a range of scientists argues that it is not correct to equal investment climate and investment attractiveness, emphasizing that the latter one represents the narrower and more subjective concept. They define the investment climate as a set of influence factors of various types (political, socio-economic, financial, socio-cultural, organizational-legal, and geographical) peculiar to a certain country (region, industry) and determine its attractiveness level for a foreign investor (Mordan & Hushcha, 2017; Kolomiyets & Popadynets, 2016; Melnyk et al., 2018; Vankovich et al., 2018). Meanwhile, the investment climate is considered as “a set of political, economic, legal, geographical, and socio-cultural conditions that together secure and impact the investment activity of domestic and foreign investors on a certain territory. The economic, social, and political situation unfolding in the country impacts the volumes of invested funds” (Slyusarchuk, 2015). Khamutovska (2013) in her research, focuses on the problems related to the attraction of foreign investment to Ukraine and its role and impact on the system of financial maintenance of the Ukrainian economy. She argues that the Ukrainian Government should support investment projects directed at the development of the private sector and organization of various industrial trade exhibitions to attract foreign investment. Vasylytsiv et al. (2017) and M Barna et al. (2017) define the way investment impacts the strategic priorities of public structural import substitution policy in Ukraine. Popov et al. (2019) and Stroyko et al. (2013, 2015), outline the way the favorable investment climate impacts the development of agricultural enterprises in the context of land management, while Yakubiv et al. (2019) and Popadynets and Maksymiv (2016) examine the impact of investment on bioenergy development in Ukraine. Somewhat research of the investment situation in Ukraine is conducted by Shpak (2014). She defines the dynamics of investment attraction to the economy of Ukrainian regions and determines the sources of such investment. She also outlines the regions’ investment activity and evaluates the efficiency of investment in regions. Based on the results of the research, the author suggests recommendations on investment climate and regions’ activity improvement in Ukraine and the model of investment attractiveness evaluation that covers the availability and sufficiency of own financial resources that define the level of a region’s financial health.

Nevertheless, the scientific research provides limited information on the impact of investment climate forming mechanism as the basis of investment capacity increase, causing the need for comprehensive research of economic, institutional-legal, and organizational-administrative components and instruments of its implementation.

The paper aims to substantiate the mechanism of favorable investment climate forming as the basis for the investment capacity growth in Ukraine.

3. Materials and Methods

The research is based on the universal methods of formal logic and scientific abstraction, foundations of innovative science, investment science, and institutional economy. Retrospective analysis is used to outline the stages of innovative processes evolution. Systemic, structural-functional, and synergetic approaches are used to classify the models and sub-models of organization and management. Open information sources on the dynamic evaluation of Ukraine’s investment climate position rankings are also examined (The official site of EBA, 2018; American think tank Heritage Foundation, 2018; The official site of The World Bank, 2018).

There are many systems of evaluation of the investment climate’s condition and attractiveness for a certain country on the mega level. As it was already mentioned, the rankings, indices, indicators, and factor parameters are the most common, including the Institutional Investor, Euromoney, Business Environment Risk Index (BERI), Doing Business, The Global Competitiveness Index, Index of Economic Freedom, Global Innovation Index, Investment Attractiveness Index.

Institutional Investor focuses, in the first place, on the countries’ credit solvency, while Euromoney – on the research of three indicator groups: market-, credit- and policy-economy related (Pobochenko, & Smytsnyuk, 2013). Doing Business is the annual ranking of the ease of doing business of the World Bank. The ranking evaluates the conditions of launching, conducting, and closing the business in most countries based on the survey of over 9600 eminent experts from the evaluated countries. The ranking’s index includes 10 sub-indices that express regulatory, fiscal, and market limitations that hamper or facilitate doing business in a country. The sub-indices are divided into two types related to the reliability of legal institutions and the complicacy of regulatory procedures. The first type includes the sub-indices of Protecting Investors, Getting Credit, Enforcing Contracts, and Resolving Insolvency. The second type of sub-indices includes Starting a Business, Registering Property, Getting Electricity, and Trading across Borders (The official site of The World Bank, 2018). The BERI system has a more extended structure of ranking forming.

Among the indices assessing the investment climate of a country, the most common are the following:

- The Global Competitiveness Index of the World Economic Forum. The ranking classifies the economy by the ease of doing business by the 1–190 scale. A high ease of doing business means that the regulatory environment is favorable for the starting and operation of local companies. The ranking is determined by sorting of aggregate scores by 10 topics of equal weight, each including several indicators (The official site of The World Economic Forum, 2018).

- Index of Economic Freedom (American think tank Heritage Foundation, 2018) of the American analytical foundation Heritage Foundation. The Index is created to help interested parties track the progress in economic freedom, prosperity, and opportunities of a certain country. The index includes 12 freedoms – from property rights to financial freedom - in 186 countries.

- Investment Attractiveness Index (The official site of EBA, 2018) is calculated by the European Business Association. The methodology of the Index calculation is based on the survey of the CEOs of the largest international and Ukrainian companies. – the EBA members, who traditionally share their impressions and prognosis of the investment climate development in Ukraine. The European Business Association quarterly asks the CEOs of the companies-members 5 questions: 1) What do we think about the investment climate (IC) in Ukraine? 2) How would we estimate the IC for your company now if compared to the previous 6 months? 3) What are our expectations regarding the IC in the upcoming 6 months? 4) Will it be profitable for new investors to invest in Ukraine within the next 6 months? 5) What are our expectations in terms of the conditions of doing business in our main sector within the upcoming 6 months? This year’s survey included one bonus question – What is our attitude to the introduction of the exit capital tax? The EBA uses the 5-grade Likert scale, where: 1 – very negative, 5 – very positive, 3 – neutral.

- Global Innovation Index (The official site of World Intellectual Property Organization, 2018) annually issued by the World Intellectual Property Organization. The Index covers detailed data on innovative activity for 126 countries and territories in the world. It is calculated by 80 indicators for the evaluation of investment development, including the political situation review, education domain perspectives, and level of infrastructure and business.

The scientific paper of Luchko (2002) specifies that to evaluate the investment capacity on the mega level, UNCTAD (body dealing with foreign investment) suggests using two indicators that characterize the positions of various countries on the global investment market. The first indicator is The foreign direct investment (FDI) Attraction Index, calculated as the ratio of a recipient country’s share in global investment volumes to the share in global GDP. The second indicator is The FDI Potential Index, calculated as an average of eight parameters for a country: 1) rate of GDP growth; 2) per capita GDP; 3) share of exports in GDP; 4) telephone lines per 1,000 inhabitants; 5) commercial energy use per capita; 6) share of R&D expenditures in gross national income; 7) share of tertiary students in the total number of higher educational establishments; 8) political and commercial country risk (Luchko, 2002). Heritage Foundation/Wall Street Journal suggests assessing the country’s investment attractiveness based on global indices of economic freedom in the process of production, distribution, and consumption of goods and services based on 50 indicators (Johnson, 1999). Economic Intelligence Unit evaluates the country’s investment attractiveness based on 10 groups of parameters: political environment, macroeconomic environment, market opportunities, policy towards free enterprise and competition, policy towards foreign investment, foreign trade and exchange controls, taxes, financing, labour market, and infrastructure (Nefiodova, 2014).

To build a favorable investment climate to boost a country’s economic growth, it is necessary to:

1) calculate the indicator of investment climate assessment by the results of international rankings by the formula:

$$IC = \sum R_i p_i \quad (1)$$

where R_i – dynamics of a ranking’s value compared to the previous year (“1” – growth, “0” – decline or no change), p_i – the weight of the rankings.

2) build the economically-mathematical model of investment climate’s impact on the economic development by the formula:

$$GDP = a_0 FDI + a_1 CI \quad (2)$$

where GDP – Gross Domestic Product, economic growth indicator;

a_0 and a_1 – linear regression coefficients;

FDI – foreign direct investment;

CI – capital investment.

4. Results and discussion

Regulative and institutional grounds of investment climate are the important factors of its forming. The following are the most significant elements of the institutional-legal environment that have a decisive impact on the creation of the investment climate:

- availability (or lack thereof) of specific authority in the country responsible for public investment policy at all levels that promotes the implementation of investment projects important for the economy. There isn't such a single public authority in Ukraine thus far. The functions on the promotion of investment projects' and programs' implementation are distributed between the Investment Attraction Department and other subdivisions of the Ministry of Economy and Trade of Ukraine, and Foreign Economic Relations and Economy Development departments at the level of Oblast State Administrations and municipalities. Nevertheless, to boost the attraction of foreign investment, a range of public authorities has been established during 2014-2017 to perform advisory and representative functions. In particular, in 2014, the President founded the National Investment Council as the advisory authority under the President, and, in 2016, the Ukrainian Government created the Ukrainian Bureau on Investment Encouragement (Ukraine Invest) as an independent advisory authority empowered to attract and support foreign direct investors. In 2015, the position of business ombudsman was established to represent the interests of domestic and foreign companies in case their rights are violated, or they face unfair treatment by public or municipal authorities, public or controlled companies, or their officials.

- availability (or lack thereof) of documented strategic policy papers regarding the investment activity, namely: investment strategy, policy, and plans of the national economy's investment framework. Unfortunately, Ukraine nowadays lacks a single complex of strategic documents in the investment activity domain. Certain strategic objectives and priority directions are provided by the 2020 State Strategy, Sustainable Development Goals, and in the form of certain provisions in regional strategies. Despite the declarations of Ukraine's transition to the sustainable development model, currently, there isn't a single complex organizational-legal mechanism of investment activity regulation. This affects the investment climate condition and aggravates the uncertainty in the investment environment.

- legal documentation (or lack thereof) of investment activity parameters and investment objects that regulates the regimes applied to them in terms of taxation, benefits, restrictions, etc.;

- development (or lack thereof) of incentives and rewards in the investment domain to be used for targeting investment flows into the priority industries and economic sectors. Currently, the Tax Code of Ukraine establishes a range of benefits for investors, including foreign ones. They include the benefits for infrastructural projects implemented in the framework of intergovernmental agreements that stipulate the complete exemption from taxes and VAT; reduced tax rates for withdrawn capital and interest accrued on funding by foreign creditors attracted at international stock markets; reduced VAT rate (7%) for import and sale of medical products and pharmaceuticals; VAT exemption for software providers up until 2023; excise exemption for energy supply produced from renewable sources; exemption from import duty for equipment produced beyond the territory of Ukraine; application of the accelerated method of investment capital depreciation, etc.

Therefore, taking into account the abovementioned criteria, one can conclude that, currently, Ukraine has a certain institutional-legal environment that promotes boosting of investment activity, including on part of foreign investors. However, a substantial share of tasks requires further elaboration and improvement in terms of systematization of regulative levers, their consistency with budgetary, fiscal, and monetary policy, and development of a balanced investment policy.

Despite some positive changes, the investment climate in Ukraine remains to be disadvantageous. Declining foreign direct investment volumes and significant outflow of investment capital from Ukraine are the evidence to it. According to the Government's estimations, the structural transformation of the economy requires total investment in the amount from \$140 to \$200 billion, while the annual need for investment amounts on average to \$ 20 billion.

Russian Federation's aggression in the East of Ukraine and the occupation of some parts of the territory have inflicted a crushing blow to the investment climate in the country. It caused the loss of almost 20% of economic capacity, human, material and energy resources, destruction of logistics flows, and loss of some part of sales markets. Military aggression and the uncertain status of some territories are still one of the most urgent problems related to the forming of investment climate due to considerably increased investment risk level, especially the long-term one. Moreover, the investment climate in Ukraine is rather specific. It lacks the systemic nature and consistency in decision-making at various governance levels and is characterized by very dynamic changes in legislation and economic policy, a substantial level of bureaucratization in economic activity, and prevailing subjective factors in the public administration processes. The results of the research show that Ukraine is improving its positions in the abovementioned international rankings. The dynamics of Ukraine's positioning by the most famous investment climate rankings are in Table 1. According to Doing Business, in 2018 (by the 2017 results), Ukraine ranked 76 among 190 countries in the world, having improved its positions by 4 points compared to the previous period. According to World Bank experts' calculations, each additional point in Doing Business boosts the additional investment flow in the economy in the amount of about \$ 500 million. Despite the positive trend of the outcome indicator, several Index criteria have deteriorated compared to the previous year, including the following:

- trading across borders (-5 points) from 109th to 115th position;
- registering property (-2 points) from 61st to 63rd position;

- getting credit (-1) from 19th to 20th;
- paying taxes – from 83rd to 84th (-1 position);
- enforcing contracts – from 40th to 81st position (-40 positions).

Despite the loss of some positions, the progress in the creation of conditions for business environment development in Ukraine is obvious. Such changes are positioned by the authorities as an indicator of successful ongoing reforms. However, the following issues remain to be most urgent both for foreign and domestic investors in Ukraine: corruption, protection of property rights, high lending rates, conducting of international trade, and administrative barriers in launching and closing a business. In general, the integral value of investment climate international rankings for Ukraine changed essentially in the periods the military conflict and political instability began. According to research published in The Global Competitiveness Index 2018 rankings of World Economic Forum, the country was ranked 83rd, having risen 6 spots compared to the 2017 position. The following are the relative advantages of Ukraine that still secure its decent position among other countries:

- infrastructure – 57th place due to high level of electrification and branched transport system;
- labor market efficiency – 66th place due to accessible and qualified workforce;
- innovation – 58th place, while technological readiness – 7th place;
- market size – 47th place.

Table 1

Assessment of the integral value of investment climate international rankings for Ukraine

Rankings	2011	2012	2013	2014	2015	2016	2017	2018	Change of positions	
									2018/ 2011	2018/ 2017
Investment environment (70%-0.70)										
Doing Business (30%-0.3)	147	149	152	137	112	96	83	76	71	13
Global Competitiveness Index (20%-0.2)	89	82	73	84	76	79	89	83	6	6
Index of Economic Freedom (20%-0.2)	162	164	163	161	155	162	166	150	12	16
Investment attractiveness (15%-0.15)										
Investment attractiveness	2.58	3.28	2.18	2.12	1.87	2.57	2.88	3.15	0.57	0.27
Investment activity (15%-0.15)										
Global Innovation Index	58	62	66	63	58	56	50	43	15	7
Integral value of an indicator	X	0.8	0.45	0.2	0.0	0.55	0.55	0.15	X	X

Source: calculated by authors based on the data (The official site of EBA, 2018)

The data of the conducted survey shows that, in 2018, the Investment Attractiveness Index of Ukraine got out of the negative plane and transferred to the neutral one. Among the changes positively influencing the condition of investment climate, the respondents mentioned the open public data, gradual deregulation of the business environment, development of electronic services and economy digitalization, simplification of authorization procedures, imposing of revisions moratorium, automatic VAT refund, and seal abolition. Moreover, 30.5% of surveyed companies' managers positively evaluate the adoption of Laws "On Limited Liability Companies", "On Currency", and "On Anti-Corruption Court". Nevertheless, the results of the research show that despite some remission, the negative business sentiments are still present. They are aggravated, in the first place, by the ongoing military conflict, unstable macroeconomic situation, smuggling, and hostile business takeovers, as well as growing tax pressure and prices for energy products. The substantial corruption level that is yet to be overcome despite numerous legal, administrative, and organizational innovations is the key problem significantly affecting the investment climate in the regions of the country. In particular, "according to the research of the global anti-corruption organization Transparency International, Ukraine gained 30 points out of 100 possible by The 2017 Corruption Perceptions Index (CPI) and was ranked 130th (out of 180 countries). This was 1 point more and 1 position higher than the previous year (29 points, 131st place out of 176 countries). However, in dynamics, the 2017 results were lower (1 point against 2), than in 2016" (The official site of EBA, 2018). Moving up the corruption control rankings became possible due to the introduced system of anti-corruption measures, including:

- stimulation of anti-corruption authorities' activity (Specialized Anti-Corruption Prosecution (SAP), National Anti-Corruption Bureau of Ukraine (NABU)) and adoption of the Law on the establishment of the anti-corruption court;
- proceeding with the reform of the public procurement domain with mandatory use of ProZorro system;
- the gradual elimination of flaws in the functioning of the register of officials' e-declarations;
- proceeding with the reform of the gas market;
- carrying out activities on business deregulation and simplification of its administering.

Nevertheless, the efficient reforms implementation and proceeding with the structural economy reconstruction that are bound to positively impact the forming of the investment climate are only at their initial stages and have not produced substantial positive results. The lack of clear strategic vector and targeted certainty regarding the further national economy's development, lack of political consent regarding the methods to solve the long list of accumulated problems, and pressure of foreign creditors and important global actors slow down the abovementioned processes. Based on the conducted research, the factors that substantially impact the investment climate condition in Ukraine by forming the opportunities and barriers to efficient investment activity are systematized. The conducted research shows that despite the improved condition of the investment climate in the last 2 years across the defined range of positions, existing barriers, first of all, of economic, political, and security nature substantially suppress the development of investment activity in Ukraine. Existing opportunities are outweighed by current risks of financial, political, ecological, and technological nature, while the unstable legal framework and unpredictable macroeconomic condition restrain the launching of the large-scale long-term investment projects. Ukraine possesses substantial resources capacity and branchy infrastructural network that remain to be important factors of investment attractiveness from the viewpoint of foreign investors. However, the existing trends characterized by inefficient and irresponsible use of natural resources cause their gradual reduction and environmental pollution, while the current short-term investment policy does not contribute to the efficient reproduction of basic means of production and infrastructure. Based on the statistical data of GDP, capital, and foreign investment growth in 2010-2017, the linear regression equation showing the dependence of Ukrainian GDP on investment in the national economy is built:

$$GDP = 36.8FDI + 5.25CI. \quad (3)$$

The model is characterized by the quite high significance of parameters, which is confirmed by the obtained multiple correlation coefficient $R = 0.98$ and the coefficient of determination $R^2 = 0.97$. Correlation significance is also verified by the F-criterion amounting to 209.1 (with critical value – 104.6). Therefore, based on the obtained information, the investment is confirmed to have the key importance in the process of GDP forming, namely the increased foreign direct investment by \$ 36.8 million and increased capital investment by UAH 5.29 million lead to the GDP growth in Ukraine by UAH 1 million. Using the model, the dependence of GDP elasticity on investment growth which is the precondition for determining the volumes of investment resources necessary for the economic growth is calculated by the formula:

$$E_{GDP}(FDI) = 36.8 \times \frac{4391}{1706952} = 0.09 \quad (4)$$

$$E_{GDP}(CI) = 5.25 \times \frac{28065.6}{1706952} = 0.86 \quad (5)$$

According to these calculations, GDP growth by 1% needs foreign direct investment growth by 0.09% and capital investment growth by 0.86%. The research proves that improvement of the investment climate in Ukraine requires the complex, coherent at all levels, and balanced strategic approach. Its implementation is subject to a single strategic objective, namely the transition of the national economy to the innovative model of sustainable development. Achievement of the objective requires the development of a complex of economic, institutional-legal, and organizational-administrative mechanisms of public governance and instruments to realize them in the framework of the developed investment policy. According to scientists Romanova and Herasymchuk (2017), the mechanism of investment activity regulation should be considered as a set of measures and instruments directed not only at the stimulation of investment inflow in the country, but also at the optimization of the process – adjustment of their structure and forms, and orientation at the needs and strategic interests of our country. Economic mechanisms that define the investment climate condition include the system of fiscal, monetary, customs, and budgetary instruments directed at adequate regulation of investment process in correspondence with the current and strategic goals of national economy development by stimulation, restriction, or targeting of respective domestic and foreign investment flows. Institutional-legal mechanisms are directed at the establishment of the legal environment necessary to activate the investment activity and attract foreign investment based on the current economy's condition, economic security requirements, best global practices in the domain, and the country's international commitments. Organizational-administrative mechanisms are bound to stimulate and coordinate investment flows between sectors, regions, and types of economic activity in order to use available capacity the most efficiently according to the needs of economic growth and maintenance of the national economy's balanced development. The methods of planning, regulative-methodological, authorizing and informational nature are the major instruments of implementation of organizational-administrative mechanisms. The Fig. 1 systematizes the top-priority measures of improvement of investment processes regulation mechanisms, which, according to the authors, will contribute to the improvement of the investment climate in Ukrainian regions in the short-term perspective. The favorable investment climate should be the main basis for the domestic economy to come out of the zone of permanent "instability" and "poverty" and to gradually come closer to economically developed countries.

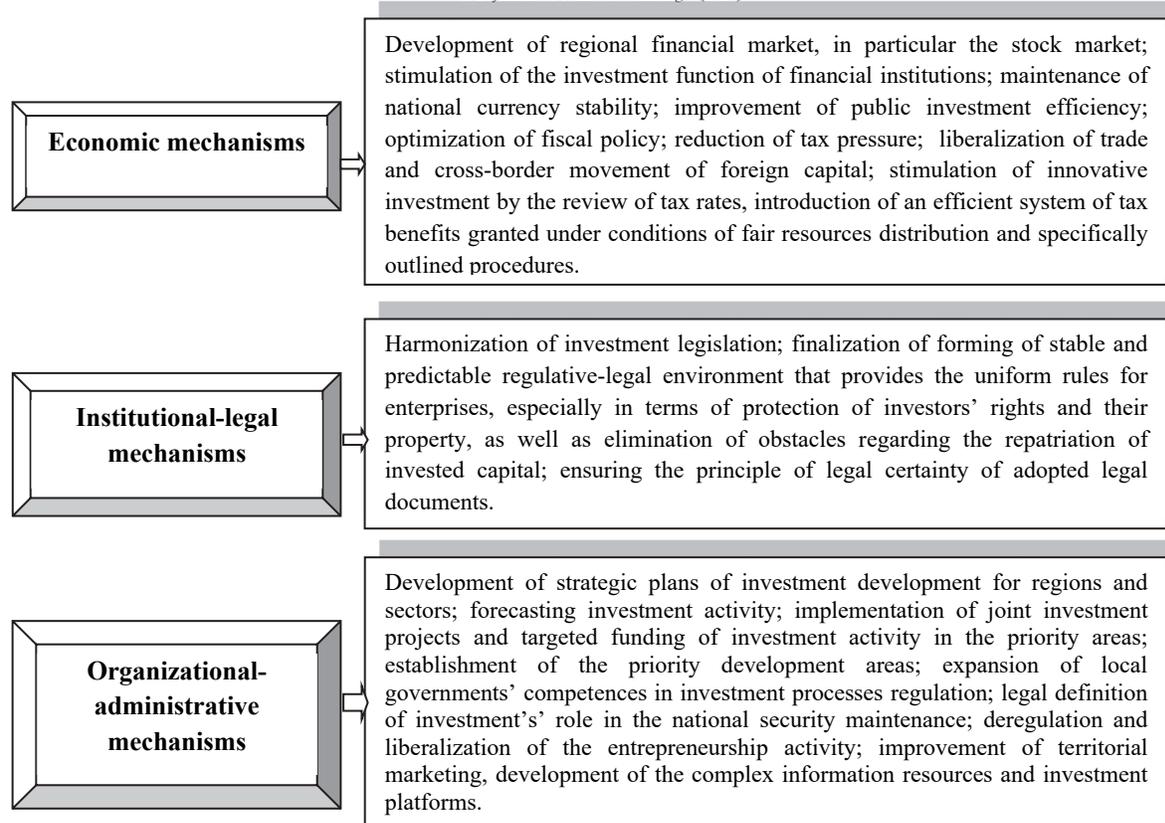


Fig. 1. Mechanisms of the investment climate improvement in Ukrainian regions at the stage of economy destabilization

Source: calculated by authors

Summarizing the discussion, the research shows that the favorable investment climate boosts the country's economic growth, therefore the need to create an efficient mechanism of its implementation has become relevant. The mechanism of investment climate improvement substantiated by the authors will secure the increased competitiveness of the country and its advancement in international rankings.

5. Conclusion

The investment climate in Ukraine has been analyzed from the viewpoint of domestic investors and international rating organizations, contributing to the systematization of available and prospective opportunities and barriers that form its current condition. It should be emphasized that despite the improved condition of the investment climate in the last 2 years across the defined range of positions, existing barriers, first of all, of economic, political, and security nature substantially suppress the development of investment activity. Existing opportunities are outweighed by current risks of financial, political, ecological, and technological nature, while the unstable legal framework and unpredictable macroeconomic condition restrain the launching of the large-scale long-term investment projects. Ukraine possesses substantial resources capacity and branchy infrastructural network that remain to be important factors of investment attractiveness from the viewpoint of foreign investors. However, the existing trends characterized by inefficient and irresponsible use of natural resources cause their gradual reduction and environmental pollution, while the current short-term investment policy does not contribute to the efficient reproduction of basic means of production and infrastructure. Economic, institutional-legal, and organizational-administrative mechanisms and implementation tools directed at improvement of the investment climate in Ukraine and the creation of conditions for investment capacity growth and its efficient transformation into an investment product are systematized.

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