

The Blue Ribbon Commission for Ukraine

***The State and the Citizen:
Delivering on Promises***

Kyiv 2006

Table of Contents

EXECUTIVE SUMMARY	2
FOREWORD	7
ABOUT THE BLUE RIBBON COMISSION.....	8
CHAPTER 1. BUILDING A DEMOCRATIC STATE AND SOUND INSTITUTIONS.....	9
1.1. CHALLENGES OF CONSTITUTIONAL REFORM: IMPLICATIONS AT THE NATIONAL LEVEL	10
1.2. CONSTITUTIONAL REFORM: IMPLICATIONS AT THE REGIONAL AND LOCAL LEVEL	11
1.3. ACCOUNTABLE GOVERNANCE	14
1.4. RULE OF LAW: JUDICIAL REFORM.....	17
1.5. HUMAN RIGHTS: TARGETED IMPROVEMENTS	19
CHAPTER 2. ENSURING MACROECONOMIC STABILITY	22
2.1. ENSURING THE SUSTAINABILITY OF PUBLIC FINANCES	22
2.2. REINFORCING A CREDIBLE MONETARY POLICY	27
2.3. EXPANDING FOREIGN TRADE.....	30
2.4. RESPONDING TO HIGHER ENERGY PRICES	34
CHAPTER 3. DEVELOPING A FAVORABLE BUSINESS ENVIRONMENT AND IMPROVING THE INVESTMENT CLIMATE	40
3.1 SECURING PROPERTY RIGHTS	40
3.2 REGULATORY REFORM: LOWERING BARRIERS TO DOING BUSINESS.....	44
3.3 PROMOTING COMPETITION.....	47
3.4 DEVELOPING FINANCIAL MARKETS AND IMPROVING ACCESS TO CAPITAL.....	51
CHAPTER 4. TOWARDS A BETTER SOCIAL POLICY.....	56
4.1. HEALTH CARE REFORM.....	57
4.2. RESTRUCTURING THE EDUCATION SYSTEM	62
4.3. BUILDING A SUSTAINABLE PENSION SYSTEM.....	65
4.4. IMPROVING THE SOCIAL PROTECTION SYSTEM.....	70



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EXECUTIVE SUMMARY

Ukraine has just celebrated its fifteenth anniversary of independence. The intervening years have shown that building a new independent state is not an easy task. Yet, after much struggle and self-reflection, a vitally important power is emerging in a central part of the European continent. Ukraine stands out in its commitment to mainstream European values, pluralism, and democracy, particularly among former Soviet countries. It can also boast more than five years of uninterrupted, and at times very rapid, economic growth.

As these achievements suggest, Ukraine has enormous economic, social, and cultural potential. However, recent experience has also shown that this potential needs careful nurturing and is susceptible to setbacks. This report, the third from the Blue Ribbon Commission of experts, an advisory body established in 2004 to provide advice on economic, social, and political reforms, contains recommendations, backed by supporting analysis, for the President, the new Government, the *Verkhovna Rada*, and civil society, on how best to unleash this potential for the benefit of Ukrainian society as a whole.

Many things have gone well since the Blue Ribbon Commission's first report, published in the wake of the 2004 presidential elections. However, there have also been many disappointments, and precious opportunities have been missed.

The most important success story is that Ukraine is now a functioning democracy, with an empowered civil society and a free press and independent media. It is customary not only within Ukrainian society but also among international organizations to express frustration at the time-consuming wrangling of Ukraine's politicians, at the painfully slow search for compromises, and at delays in implementing important reform measures. Nevertheless, the fact that Ukraine has established a democratic constitutional order that enables its political representatives to govern on the basis of democratic compromises is a real achievement of the 2004 elections and the popular upheaval that followed them.

There are other areas in which solid progress has been made. Ukraine is one of the first countries in the Commonwealth of Independent States (CIS) to have abandoned a "super-presidential" constitutional order to pave the way for one that relies on checks and balances among the different branches – an absolutely key European value. The role of the Parliament has been enhanced and the decentralization of public administration, however incomplete, has started.

The signing of an Action Plan with the European Union (EU) in early 2005 built practical foundations for Ukraine's "European Choice" and provided new impetus for economic reform. Many tax loopholes were eliminated, giving a boost to state revenues and reducing the corruption that plagues collection of taxes and customs duties. The financial sector deepened further, and the range of products and services available to businesses and households increased steadily. Progress was also made towards WTO accession.

However, the last two years have also delivered some notable disappointments. Ukraine enjoyed vast goodwill from many foreign capitals in the wake of the Orange Revolution, and foreign investors expressed fresh interest in the Ukraine market. Yet the debate on re-privatization, accompanied by a virtual halt to the sale of state-owned assets, the imposition of arbitrary price controls on petrol and meat in 2005, and perceived inefficiencies in the Government's daily operations, dashed such early optimism.

Without the highly transparent and successful re-auctioning of Kryvorizhstal, privatization revenues and inflows of foreign direct investment (FDI) would have been meager in 2005. Even the pragmatic Government headed by Yuriy Yekhanurov failed to accelerate privatization. FDI flows thus remain disappointing relative to what the country needs and what

other countries in the region have been able to attract. Yet higher FDI remains essential to help finance corporate restructuring, modernize infrastructure, promote energy savings, and contribute to a badly needed change of corporate culture.

Responsibility for missed opportunities does not lie exclusively with the Government. Quite unbelievably, no action was taken to pass a joint-stock company law, an important legal cornerstone for any market economy, even though a draft has languished in the *Verkhovna Rada* since March 2003. The Parliament also failed to revoke the outmoded Economic (Commercial) Code and amend the Civil Code to ensure it meets the requirements of a modern market economy. It also left in force the moratorium on the sale of agricultural land. And it blocked legislation that could have completed WTO accession. This lack of progress was harmful to Ukraine's vital national interests.

The Government and the Parliament did work together to enact a huge increase in social spending in 2004 and 2005. This increase raised wages for public-sector employees and helped to prolong the reduction in poverty in progress since 2000. However, such sweeping redistribution, including an unprecedented increase in pension spending, presents a number of long-term challenges. First, it is crowding out public investment in a country that badly needs to modernize infrastructure. Second, it has led to a dangerous deterioration in the budget that will require urgent action to correct, as healthy public finances are among the most important public goods a government can deliver to current and future generations. Third, extensive new pension commitments have effectively derailed a promising three-pillar pension reform that was initiated in 2004. Fourth, higher spending on education and health has not been accompanied by structural reforms that are urgently needed to promote quality and efficiency. Fifth, the radical expansion of public expenditure has impeded the completion of tax reforms designed to stimulate growth and help Ukraine begin to catch up with more wealthy nations. High taxes are a powerful incentive to the continuing existence of a large shadow economy, with negative consequences and social risks for those who cannot participate in the formal economy.

The expansion of social funding beyond budgetary means was enacted largely to serve short-term populist political purposes. In the long run, it will have profoundly anti-social consequences. The imbalances created will need to be corrected in the new political cycle, but this will require courageous leadership and a multi-party consensus.

It is not clear whether all of Ukraine's leaders grasp the urgency of this task. Renewed economic growth may lull some into complacency and create a false impression that avoiding policy blunders is enough. Unfortunately, this is not the case. Ukraine's growth prospects depend critically on what the new Government will do in its first few months in office. Moreover, major external challenges lie ahead. Moves by some trading partners to impose world prices, particularly for gas imports, as well as tightening international financial conditions, will put a premium on fiscal and financial prudence.

This report is designed to help Ukraine's leaders respond to current policy challenges and take steps that will unleash robust, stable long-term growth. Building on an analysis of current economic, political, and social trends, the report presents recommendations on policies that will both promote growth and distribute its fruits more equitably.

Ukraine's economy can develop in one of two directions, depending in part on what policies are adopted. Such policy choices are vital, as they will determine the pace of future economic growth and wealth creation. In the last few years the main engines of growth were capital-intensive but technologically outdated industries, with limited potential to add value. Favorable global market conditions with respect to both volumes and price meant that these industries thrived. These sectors will not prosper long in today's globally competitive markets, however, especially without more investment.

An alternative route is therefore for Ukraine to capitalize on its human resources. First and foremost, Ukraine needs to attract top-quality foreign direct investment to a broad range of industries, thus diversifying from a narrow set of industrial branches, such as steel and petrochemicals, to a more diverse, balanced, and service-oriented economy. In this context, the curse of rising energy prices may actually be a blessing, by creating a powerful incentive to push Ukraine towards a more modern industrial structure.

It is therefore crucial for the nation's long-term interests that the new Government resists protectionist pressures from old smokestack industries and instead opens up the economy to international competition and investment. The first step on that road is WTO membership. It is crucial for Ukraine to enter WTO as soon as possible, hopefully before the end of 2006. Membership would help to open up the Ukrainian market for investors and unlock new markets for Ukrainian exporters. Critically, it would also open the door to a free trade agreement with the EU, offering huge new export potential and furthering the aim of European integration. Yet after the 2004 election the previous *Verkhovna Rada* played a very unfortunate delaying game, reflecting the protectionist forces represented there. Now bold leadership is needed, in the spirit of the "Universal of National Unity," to move forward the legislation necessary for swift WTO accession.

At the time the first Blue Ribbon Commission report was written, Ukraine's macroeconomic outlook was highly favorable, with growth strong, inflation low, and fiscal deficits modest. The picture has worsened substantially since then. The report focuses on what needs to be done to maintain growth while restoring macroeconomic stability. In the short term the new Government will have to ensure that the budget deficit does not exceed the 2005 level, so that inflation does not spiral out of control.

To trigger growth over the medium and long term, the Government needs to go further. First, it needs to ensure that macroeconomic policies gradually reduce inflation. Second, in the interest of rebalancing policy from short-term populism towards long-term prosperity, it needs to increase the share of public investment in the budget and improve targeting of social expenditures. Third, it needs to reduce the redistribution of incomes to levels that are sustainable at Ukraine's current stage of economic development and ensure sustained competitive advantages for a country that aspires to close the development gap with highly developed economies in the foreseeable future.

To this end, the Government also needs to move resolutely to improve the business environment, for both domestic and foreign companies, and to encourage fresh investment, whether from east or west. Some of the steps towards this goal are quite simple and were central recommendations of the first Blue Ribbon Commission report submitted to the new President in January 2005. Yet they have yet to be implemented.

Among the most important recommendations on improving business conditions is the need for further deregulation of the economy. Despite progress in recent years, the economy remains badly over-regulated, putting Ukraine at a clear disadvantage in the competition for international capital. This over-regulation also feeds corruption, depresses tax revenues, and promotes the migration of legitimate economic activities from the formal to the informal sector, where they are generally untouched by any regulatory frameworks. Strong executive leadership and effective parliamentary oversight will be needed to support a new concerted drive towards deregulation.

Another key recommendation is to accelerate privatization. In order to restore the security of property rights in Ukraine and ensure stable conditions for existing businesses, an amnesty should be declared covering past privatization abuses. If done correctly, using

transparent procedures and ensuring equal conditions for foreigners, privatization is an obvious way to attract investment from reputable strategic partners.

A further issue needing urgent attention is the moratorium on the sale of agricultural land. This relic of the Soviet past should be lifted quickly. Free turnover of land is important not only for real estate and industrial development, but also for realizing the enormous potential of Ukrainian agriculture. Given its natural endowments, Ukraine is destined to become a major world player of agricultural and food industry export, so long as producers face the right incentives to make dramatic improvements in efficiency. The core of this problem lies in the lack of a properly functioning market for agricultural land.

Finally, the Government needs to rethink fundamentally the way it looks at social policy. The wholesale redistribution undertaken in the past two years has raised household incomes, but at the cost of new jobs and fresh investment that might have provided a more permanent solution to low living standards. Enacting the measures needed to restore macroeconomic stability, reduce taxes, and improve the business environment will have a greater impact on social welfare than maintaining a bloated system of social benefits. And better targeting will ensure that help reaches those families facing true hardship.

Behind all the economic issues lies the fundamental challenge of governance. Ukraine is still struggling with the legacy of the heavily centralized Soviet bureaucracy and the Soviet tradition of treating citizens as subservient to the state. Almost all areas of governance have seen positive changes in the last two years, with the crowning achievement of free and fair elections in March 2006. Unlike in so many CIS countries, civil society is free to develop, and citizens appreciate its diversity and vitality.

In almost all areas of governance, however, reforms remain incomplete. Perhaps the area most urgently needing attention is decentralization. This process needs to be completed in a way that harmonizes administrative authority with financial means, while balancing democratic principles and administrative capabilities. Decentralization is a complex task. It is an expression of fundamental democratic values and human rights; yet it cannot succeed without complex expert work to ensure efficiency. It also requires an ongoing dialogue among all parties and the active involvement of civil society.

A second major reform challenge is corruption, a scourge which threatens to blight the chances for the Ukrainian people to achieve prosperity. The new Government should set itself ambitious anti-corruption targets for the current electoral cycle to achieve measurable improvements. A corrupt state is demoralizing for its citizens and it continuously recreates social inequalities. The report contains detailed recommendations on how to improve the functioning of the state and heighten transparency and accountability. Legislation is urgently needed on access to information, disclosure of media ownership, and conflict of interest. In addition, better and enforced legislation on declaration of assets and interests by parliamentarians and other public officials, to expose and avoid potential conflicts of interest, will be essential to the ongoing drive to eliminate corruption from public life, including at the local level.

Any incoming Government will find it difficult to concentrate on such a wide range of issues at the same time. This Executive Summary highlights the most important areas where well targeted measures enacted by the Government and the Parliament in the next few months can unlock growth potential and social energy. The Blue Ribbon Commission is convinced that a concerted reform effort of this sort can stimulate the dynamic growth that will raise Ukraine's international profile to a level that its human talent undoubtedly deserves. The report aims to support this effort at a more technical level by providing detailed recommendations (at the end of each chapter section).

We trust that this document, which is a product of a joint effort by more than 30 national and international experts, will help the President, the Government, and the *Verkhovna Rada* shape legislative and policy measures in the months and years ahead. This report is also meant to serve civil society as a helpful tool. The political cycle often imposes a shorter time horizon on politicians than is optimal for the nation's vital interests, whereas non-governmental organizations, think-tanks, and universities have the luxury of a more long-term outlook and can hold the Government accountable for pursuing those goals.

Priority measures

1. Cap the budget deficit at the 2005 level and drive inflation under 10 per cent by foregoing any new increase in social spending.
2. Promptly pass the legislation needed to complete WTO accession and refrain from re-opening negotiations.
3. Commit to and undertake large-scale, transparent privatization.
4. Lift the moratorium on the sale of agricultural land.
5. Abolish the Economic (Commercial) Code and pass and implement a joint-stock company law.
6. Pass and begin vigorous enforcement of legislation on access to information and conflict of interest.
7. Complete the establishment of one-stop shops for business registration and reduce to a minimum the paperwork and permits required.
8. Move towards balancing the Pension Fund by freezing minimum pensions, eliminating privileged pensions, and beginning a gradual increase in the retirement age.

FOREWORD

The first report of the Blue Ribbon Commission was issued at a very significant moment in Ukraine's political history – in January 2005. Although the report attracted considerable attention from both the Ukrainian leadership and the public, only modest progress was made towards implementing its twelve key recommendations. Independent Ukraine has undoubtedly moved forward in its institutional evolution in the intervening years, but there is also little doubt that an opportunity for more rapid reform was missed.

This new report, produced under the joint chairmanship of Kalman Mizsei, Regional Director of UNDP for Europe and the CIS, and Oleksandr Paskhaver, Advisor to the President of Ukraine, has been prepared in the wake of free and democratic elections to the Verkhovna Rada in March 2006. The European Parliament deservedly congratulated Ukraine for this achievement. We are pleased to present this new report and hope it will gain the attention of the President and the incoming Government, as well as of the Parliament and the public at large.

This report is intended to draw the Government's attention to the policy measures most urgently needed to secure sustained economic growth and thus close the income gap between Ukraine and its Western neighbors. We have also proposed policies that will work most effectively to secure social justice without hurting economic growth. And we have addressed the challenge posed by energy prices, which is now more pronounced than it was two years ago. We have done all this in the context of the "European Choice," which has been embraced by the overwhelming majority of Ukraine's political elite.

The report treats good governance as the starting point for all reforms. Making the Government more efficient and accountable will improve the chances of gaining broad public support to implement reforms, as argued in Chapter 1. Greater prosperity in Ukraine depends on a return to higher rates of economic growth, such as those attained in the early years of this decade. As Chapter 2 explains, achieving rapid growth has become more difficult because of a tighter budget, higher energy prices, and more challenging trade conditions. Chapter 3 explains the importance of accelerating reforms to improve the business environment to stimulate investment, both domestic and foreign. Stronger growth is also the key to improving social welfare. Although social transfers have helped reduce poverty, the efficiency and targeting of public spending need to be improved, especially in health, education, and social insurance, as argued in Chapter 4.

As with the first Blue Ribbon Commission report, this report is the fruit of strong collaboration between Ukrainian and international specialists. This formula offers one of the best ways of securing the blending of local expertise with accumulated international wisdom to address the different subjects analyzed in the report. The structure of each chapter is similar. Each of the different chapter sections first reviews the challenges as they were seen at the time of the first Blue Ribbon Commission report, assesses the progress achieved since then, and presents recommendations for the future. Many of these recommendations are sufficiently detailed that we expect that they will provide useful inputs into the work of policy makers at a specialist level.

The Executive Summary contains the Blue Ribbon Commission's assessment of the most important challenges facing Ukraine and the solutions that most urgently need to be implemented. We remain optimistic that the young democratic Ukrainian state and society will continue on a path of institutional reform that will help to create prosperous and fulfilling lives for the nation's citizens. We trust that this report will prove to be a useful contribution to the policy debate on the best ways of achieving these goals.

ABOUT THE BLUE RIBBON COMISSION

This report is the third in a series by the Blue Ribbon Commission for Ukraine. This commission was formed in July 2004 with a mission to provide policy advice on economic, social, and political reforms to Ukraine's leaders. The commission's first report, addressed to the new President, was published in January 2005. The second report, assessing progress made in implementing the recommendations of the first report, was published in July 2005. The preparation of the third report, presented here, was prompted by the new political situation created by the elections to the *Verkhovna Rada* in March 2006 and the formation of a new Government in August 2006.

The work of the Blue Ribbon Commission is organized by the United Nations Development Programme (UNDP) under the leadership of Francis M. O'Donnell, United Nations Resident Coordinator and UNDP Resident Representative in Ukraine.

Like their two predecessors, the third report was prepared by a diverse team of Ukrainian and international experts who specialize in a wide range of fields. This team worked under the joint chairmanship of Kalman Mizsei, UNDP Regional Director for Europe and the CIS, and Oleksandr Paskhaver, Advisor to the President of Ukraine.

The main authors were Viktor Shishkin, Viktor Kotygorenko, Vira Naniivska, Dmytro Lutsenko, and Alan Skurbaty (Chapter 1); Inna Golodniuk, Vladislav Komarov, Gerhard Schwodiauer, Valeriy Gladkiy, and Oleksandr Shevtsov (Chapter 2); Oleksandra Kuzhel, Oleksandr Paskhaver, Oleksandr Shevtsov, Dmytro Leonov, and Oleksandr Kilievich (Chapter 3); Volodymyr Rudyi, Olena Osinkina, Irina Akimova, Ella Libanova, and Vitaliy Melnichuk (Chapter 4).

Their work was supplemented by major substantive and editorial contributions from Andrii Palianitsa (Chapters 1 and 3), Kalman Mizsei (Chapter 2), Jerzy Osiatynski (Chapter 3), and Louisa Vinton (Chapter 4). Important inputs were provided by Francis O'Donnell, Daniel Bilak, Irina Akimova, Julian Exeter, Joanna Kazana, Bohdan Senchuk, Valentyn Povroznyuk and Ihor Yakovenko. Helpful advice and comments were also received from Ihor Shumilo, Oksana Ovcharuk, Yevhenia Akhtyrko, Maris Jesse, Vladimir Litvak, Mykola Pugachev, Klavdia Maksimenko, and Ihor Burakovskiy.

Important recommendations provided by missions of the World Health Organization, International Finance Corporation, World Bank, International Monetary Fund, and International Labour Organization are also acknowledged.

Kalman Mizsei, Julian Exeter, and Louisa Vinton edited the English original text. Oleksandr Shevtsov and Tetiana Luzhanska edited the Ukrainian version.

The Blue Ribbon Commission works as an independent, non-partisan body. While UNDP supports its work financially and administratively, the Commission exercises complete editorial independence. The analysis, views, and recommendations in this report are entirely those of the Commission, and not necessarily those of UNDP.

CHAPTER 1. BUILDING A DEMOCRATIC STATE AND SOUND INSTITUTIONS

Fifteen years have passed since Ukraine declared independence. Since then the country has undergone the process of building a new state and attempting to transform the highly centralized, paternalistic system of governance inherited from the Soviet Union into a democracy based on the free market and elected government.

The challenges of this transition were met with mixed results. By the end of 2004 the system of governance remained highly centralized and subject to corruption. Unlike some neighbouring former Soviet countries, however, it was not fully authoritarian or overtly oppressive of the opposition or civil society institutions. This became a key factor during the 2004 presidential elections, when millions of citizens took to the streets to protest fraudulent elections. The citizens won, but, as a trade-off to avoid bloodshed, the Parliament passed a number of constitutional amendments designed to limit the power of the President.

These developments opened a new phase for Ukraine. Lifting explicit and implicit restrictions on freedom of speech, of assembly, and of the media and establishing a truly competitive political environment led to the spectacular publicity of political processes, social pressure for change, and increased accountability of public officials.

Where these “challenges of freedom” are leading is not yet clear, and a number of different outcomes are possible. One is that the results of the 2006 parliamentary elections and the subsequent coalition-building process, combined with public dissatisfaction with recent Ukrainian governments, could lead to the restoration of the system that existed before 2004, perhaps even without its limited freedoms. A more optimistic outcome would be that democracy becomes firmly established, lessons are learned from the mistakes of the past two years, and the Government becomes both more efficient and accountable.

The outcome will depend on whether Ukrainian political elites can contain the centrifugal processes that some observers believe could transform decentralization into disintegration, and strike a workable balance between empowering local governments, on the one hand, and establishing an accountable yet effective national governance system, on the other. It will also depend on success in the fight against corruption, protecting human rights, and establishing an effective and trusted judiciary system.

The constitutional amendments and political events of 2004-2006 represent a departure from established political tradition in Ukraine. For this reason, this chapter presents an overview of the challenges posed by constitutional reform at both the national and local levels, including the most pressing issues related to implementing this reform and related recommendations. This discussion of systemic changes is followed by an analysis of the overall system of governance in Ukraine, with an emphasis on its accountability, transparency, and integrity. A look at the judiciary system and related recommendations follows. Finally, the chapter addresses a number of urgent improvements that are needed in the area of human rights. The analysis and recommendations presented here build on a foundation of Ukraine’s sovereignty as a state, transparent and accountable governance, and protection of freedoms and rights of citizens.

1.1. CHALLENGES OF CONSTITUTIONAL REFORM: IMPLICATIONS AT THE NATIONAL LEVEL

Consistency and Clear Spheres of Responsibility

Important constitutional amendments took effect in Ukraine on 1 January 2006 (Law no. 222). These amendments changed the relationship between the President, the Parliament and the Cabinet of Ministers. The essence of these changes was to shift the subordination of the Cabinet of Ministers from the President to the Parliament. Commentary by analysts and lawyers, as well as the experience of coalition building after the March 2006 elections, illustrated that these amendments failed to delineate clearly the functions and responsibilities of state institutions.

The President no longer wields direct executive power over the operations and decisions of the Cabinet of Ministers. Most importantly, he is no longer involved in the appointment of most individual ministers and their deputies. However, the President retains considerable powers. The Constitution states that the President is the head of state and the guarantor of state sovereignty, the territorial integrity of Ukraine, and the observance of the Constitution, human rights and the freedom of the citizen. He retains primary executive responsibility in the fields of national security, foreign policy, and human rights. The National Security and Defense Council (NSDC), whose existence is anchored in the Constitution, is mandated to support the activities of the Head of State in national security and foreign policy. The President also nominates the Ministers of Defense and Foreign Affairs, as well as the head of Ukraine's Security Service. However, in all cases, final appointments are made by the decision of the Parliament.

In addition, the President can appoint and dismiss half of the membership of both the Board of the National Bank of Ukraine (NBU) and the National Television and Radio Council and one-third of the members of Ukraine's Constitutional Court. Very importantly, he still appoints and can dismiss the Prosecutor-General, with the consent of the *Verkhovna Rada*.

The President has the right to suspend acts of the Cabinet of Ministers provided he requests a legal opinion from the Constitutional Court at the same time. The President has veto power with respect to decisions made by heads of local state administrations. More generally, the President can still issue binding decrees and resolutions. This makes the Cabinet of Ministers accountable not only to the Parliament but to the President as well, guided in its activity by both Ukraine's laws and Parliament's resolutions, as well as by the President's decrees.

The constitutional amendments are particularly vague in providing legislative guidelines on the formation of parliamentary coalitions, as became evident in the months following the Rada elections. The amendments do not explicitly require any newly formed coalition to agree on a programmatic agenda. Other than general principles, Article 83 of the Constitution contains no provisions for the formation, organization, or termination of parliamentary coalitions. The constitutional amendments also fail to specify the role of the President in nominating the Prime Minister.

The constitutional amendments on the one hand strengthened the role of the Parliament and the Cabinet of Ministers, while on the other hand allowed the President to retain and in certain cases extend his powers. Most importantly, they did not address such potential problem areas as the issue of the President's discretion in nominating the Prime Minister or provide explicit grounds for dissolving the Parliament or calling new elections.

Moreover, although the Constitution has direct legal force, the fact that it is by necessity a brief document and cannot define implementing mechanisms and procedures make it heavily dependent on specific legislation that has not yet been adopted in Ukraine (e.g., Laws on the Cabinet of Ministers and the President and the internal procedures of the *Verkhovna Rada*).

Such vagueness, contradictions, and lack of implementing legislation have the potential to create conflict between two distinct and legitimate centers of state power: Parliament and the Cabinet of Ministers, on the one hand, and the President and the NSDC, on the other. This potential for conflict is heightened by the lack of a political tradition that would promote the resolution of possible conflicts and the absence of a legislatively defined role for the opposition.

Recommendations

- In order to eliminate contradictions and streamline constitutional provisions, use lessons learned from the coalition building process after the March 2006 elections. A multi-party dialogue on constitutional changes should be undertaken. Such a dialogue must be broad and genuine enough to build a firm base of support for its recommendations among a majority of citizens and political stakeholders. This will help ensure their legitimate enactment. These changes must address, among other things, the necessity and legal status for a coalition program, an explicit time-frame and grounds for dissolution of the Parliament, and an explicit description of the President's discretion in nominating the Prime Minister.
- Passage of Laws on the Cabinet of Ministers, on the President, and on the Reglament (Rules of Procedures) of the Verkhovna Rada would provide the necessary specific mechanisms and implementing regulations for the general provisions of the Constitution to define the roles of all the main players in the political system. Among others, these laws must address such long-standing issues as: the structure and rules of procedures for the Cabinet of Ministers; the political responsibilities of ministers, and grounds for their dismissal; the transparent operations of Cabinet Committees and respective roles of Deputy Prime Ministers; procedures governing the relationship between the Cabinet of Ministers and the President; procedures for impeaching the President; and the binding nature of the Reglament, and sanctions for its violations.
- A functioning democracy requires an opposition that is capable of interacting with the majority in the interests of the people as a whole, while remaining true to its own principles. To fulfill its responsibilities effectively, the opposition should have access to information on the activities of the majority. It should also be able to evaluate these activities and make its own proposals to the public at large regarding its own vision of the future course of policy. The opposition must be able through institutional mechanisms to monitor the activities of the Cabinet of Ministers and the executive branch in general. It is particularly important that, at a minimum, members of the opposition secure leading posts on the Verkhovna Rada committees dealing with budget, regulatory issues, freedom of speech and mass media, and law enforcement. The rights and duties of both the majority and the opposition, as well as the institutional empowerment of the opposition, should be stipulated in a Law on the Parliamentary Majority and the Parliamentary Opposition and further reiterated in the Reglament of the Parliament.

1.2. CONSTITUTIONAL REFORM: IMPLICATIONS AT THE REGIONAL AND LOCAL LEVEL

Decentralization and Regional Development

The main purpose of administrative and territorial reform, as declared numerous times, is to move the services provided, as well as the decision-making processes related to them, closer to the citizen. Such a shift is expected to improve significantly the quality of services provided by increasing the local accountability of elected officials and empowering communities to make

sound decisions and self-govern efficiently. Bringing public-sector decision-making as close to the citizens as possible is a vital precondition for a truly functioning democracy.

On 23 December 2005 the *Verkhovna Rada* preliminarily approved the draft amendments to the Constitution covering the improvement of the system of local self-government (registration no. 3207-1). This draft law still awaits consideration by the Constitutional Court, and this review may result in a thorough overhaul before it is enacted. For now Ukraine remains a highly centralized state in which most regional (*oblast* and *rayon* level) authority rests with local state administrations, the heads of which are appointed by the President. Elected oblast and rayon councils have only nominal functions and no direct power, except the right of approving budgets that are funded from the state budget.

Real local self-government functions at the level of large municipalities (the cities of so-called regional [*oblast*] subordination) that have a direct relationship with the state budget in terms of receiving equalization transfers. Smaller towns and villages have greatly undercut the authority of elected self-government, given that they are largely dependent on district (*rayon*) state administrations that oversee the disbursement of budgetary funds to cover the fulfillment of their competences. Most services, such as education and health care, are thus essentially delivered under the strict supervision and discretion of the rayon authority. The existing system of revenue distribution, in which only a portion of revenues from a single tax, the Personal Income Tax (PIT), are retained at the local level, motivates local authorities to fight for budget transfers at the national level rather than building a sustainable tax base at the local level.

The constitutional amendments that were preliminarily adopted at the end of 2005 attempt to redistribute power from appointed administrations to elected councils at the regional level, and significantly to empower local self-governments not only at the municipal level, but at the level of districts by replacing appointed district administrations with elected self-governments.

These amendments, while attempting to establish a European model for Ukraine, are not comprehensive or internally consistent enough to be implemented smoothly. Their most important shortcomings relate, among others, to the insufficient demarcation lines in the interactions between redesigned local state administrations, other state authorities (such as law enforcement agencies and their departments), and local self-governments, as well as to the transitional provisions according to which these amendments should be implemented. These legislative and institutional shortcomings, as well as the limited availability of local funds, led to calls for a "step by step" implementation of the constitutional amendments.

Furthermore, even if the system of local self-government and local state administrations in Ukraine is eventually streamlined and balanced, significant obstacles for improving services to citizens will remain. These relate to funding. As stated above, localities in Ukraine are able to retain only a part of the revenue from the PIT, and this revenue is retained at the taxpayer's place of employment rather than residence. For this reason, only large municipalities with high population volume and density or a well developed business infrastructure can rely on locally generated revenue to fund most of their services.

In 2005, for instance, only 81 out of 172 cities of *oblast* subordination and only 8 out of 489 districts (*rayons*) did not require equalization transfers from the state budget, whereas the share of transfers from the state budget amounted to 70-90 per cent of the expenditures in local budgets of most rural communities. Furthermore, due to the current equalization system, which works to redistribute revenues from "over-normative" local budgets in the better-off (and therefore more sustainable) communities in favor of the less well-off ones, services remain poorly funded in both economically sustainable and unsustainable cities, towns, and villages.

In most developed countries that provide decentralized services, most revenue comes from land payments and real estate taxes, as well as from grants transferred from central to local governments. In Ukraine there is no real estate tax. As for land tax, first of all, there are numerous exemptions that are largely provided at the national and not at the local level. Secondly, due to the absence of a developed secondary land market, land prices (primarily agricultural) are artificially established and extremely low, and therefore yield very small land tax revenues. At the same time, the share of strictly local taxes and fees is very tiny indeed, rarely exceeding 10 per cent of local budget revenues, and in some localities it is less than 2 or 3 per cent. The large debts of the population for housing and communal services, and the often ineffective management of the communal sector further complicate the situation.

The lowest levels of self-government would not be able to provide some more expensive services, such as health care, even were they to receive larger revenues. Such services must be funded either by district-level self-government or by funds transferred from the budget. For most other services, local self governments must become financially sustainable. Attempts to increase the economic sustainability of self-governing units by merging smaller units into larger ones were at the core of territorial reform initiated in 2005. Within the framework of this reform, draft laws were prepared on the Territorial Structure of Ukraine, Community Self-Government, District Self-Government, and Regional Self-Government, as well as a new revision of the Law on Local State Administrations. After initial public setbacks, however, momentum for this reform was lost in the fall of 2005. Additionally, the draft Law on the Territorial Structure of Ukraine prepared by the Cabinet of Ministers in the framework of territorial reform became inconsistent with the draft constitutional amendments introduced in 2005.

Debate on territorial reform, however, has inspired a number of proposals to address the issue of local government solvency. The *Verkhovna Rada* attempted to determine the current requirements of local budgets with the purpose of bringing the volumes of equalization transfers closer to the real amounts needed to fund general and pre-school education, health care, and culture (Resolution of the *Verkhovna Rada* on Some Issues to Improve the System of State Welfare Community Services at the Local Level, dated 17 November 2005, no. 1317-IV). The proposals of the relevant parliamentary working group, based on information from several local councils, laid the foundation for a recommendation to increase substantially the financial resources of local government budgets at the expense of inter-governmental transfers.¹

These debates also uncovered two key policy problems, namely: (1) the incompatibility of administrative and territorial reform framework and reforms planned or attempted in areas such as health care, general education, and housing and communal services, and (2) the absence of objective criteria to assess the costs of services to citizens based on adopted social standards. The standards to be developed under the Law on State Social Standards and State Social Guarantees should have provided the basis for this cost evaluation. However, in spite of numerous demands from the *Verkhovna Rada* in the six-year period since the law was adopted, progress has been slow. For this reason, the social norms and standards that are used do not cover all state and municipal services and the figures are often outdated.

Finally, even assuming a best case scenario in which all the issues listed above are resolved, not all areas in Ukraine will be able to provide the services that residents need. As in most other countries, Ukraine has its share of depressed territories. The Law on the Promotion of Regional Development, which was adopted on 8 September 2005, merely provides for the coordination of efforts in this direction at the national, regional and local levels and will probably need to be significantly amended after administrative and territorial reforms are implemented.

¹ The revenues of local budgets had been increased in 2005 following the decision of the Cabinet in March 2005 to repeal land tax benefits.

More importantly, this law lacks explicit requirements and guidelines for providing budgetary funding or any fiscal instruments to promote regional development.

Recommendations

- In order to streamline local governance in Ukraine and make it consistent with the European Charter on local government, Ukraine needs to undertake a multi-party dialogue on constitutional changes. This would aim to clarify responsibilities of state administrations and local self-governments, and make territorial divisions consistent with the demands for sustainable self-governing units. In addition, pursuant to the constitutional amendments, Laws on the Territorial Structure of Ukraine, on Community Self-Government, on District Self-Government, on Regional Self-Government and on Local State Administrations must be passed and implemented. The basis for the formation of new administrative and territorial units should be the financial and organizational abilities of territorial communities and local government bodies to perform the responsibilities assigned to them. This reform should be coordinated with reforms in the fields of health care, education, motorways, housing, and communal services. These will provide the framework and procedures for the synergy between the local self-government system and the system of state administration at the local level.
- Steps should also be taken to increase local revenues from taxes. First, land tax should be fully transformed from a national to a local tax. Second, limitations on land transactions should be lifted with the creation of a transparent land market. Taxation should be introduced on real estate; this could become one of the main sources of budget revenues at the local level. Ultimately, the land and real estate taxes could be combined into a single property tax.
- To ensure adequate funding for services, as well as a transparent budgetary process, the objective criteria to assess the costs of services to citizens based on adopted social standards should be developed and adopted. These criteria should become the basis for calculation of most budgetary transfers to localities.
- Communities, rayons, and oblasts should be encouraged, through the adoption of clear legislative provisions and procedures, to pool resources to improve the provision of services that fall within their competence and to develop joint infrastructure projects. To allow this, they should also be given more leeway in deciding on the expedience of retaining certain items of infrastructure (such as schools and clinics), as well as on the disposal of any budgetary funds saved in this way.
- Develop incentives for local self-governments to keep up-to-date cadastres and manage communal property in a transparent and efficient manner.

1.3. ACCOUNTABLE GOVERNANCE

After the 2004 presidential election, the Ukrainian Government faced the challenge of delivering on high expectations for more transparency and integrity in governance and fulfilling promises made in this area during the election campaign and in the mass public protests that followed. This was a fundamental challenge because the entire governance system in Ukraine was established to satisfy the governing elite, limit its accountability, and enforce the status quo. This system was stable, thanks to a combination of low expectations by citizens, high adaptability by businesses, and internal predictability on the government's part. Corruption was pervasive, evident not only in high levels of petty corruption (such as bribery) but also in extremes of grand corruption extending to the highest levels of power, through control of major public and private financial flows and exercise of selective law enforcement.

Since the beginning of 2005, the Ukrainian Government has attempted to address the issue of corruption on numerous occasions. There have been some success stories. First, the empowerment and increased activity of the Internal Security Department within the Ministry of Internal Affairs prepared the ground for the firing and prosecution of thousands of corrupt law enforcement officials. The first stages of the "Stop Smuggling" program addressed endemic corruption in customs and helped generate additional revenues of US\$ 424.5 million in 2005. Increased integrity and enforcement within the tax administration resulted in tax revenue growth of 46.8 per cent in comparison with 2004.

Despite these successes, public perceptions of corruption did not change much. Inadequate prosecutions, lengthy delays in reforms, numerous remaining opportunities for corruption in state agencies, and the absence of a monitoring system underline the depth of the problems related to the integrity of state institutions. At the same time, free media, public awareness, and high expectations of citizens have created political demands for greater accountability of the public sector in Ukraine.

Accountability of governance rests most importantly on the pillars of free and fair elections, freedom of speech and media, a vibrant and independent civil society, and transparency in the machinery of government. Ukraine has made some progress in these areas.

Since the beginning of 2005, one of the most important positive developments in Ukraine was the establishment of a competitive political environment. Elections to *Verkhovna Rada* in March of 2006 were considered by most observers to have been free and fair. This is a stark contrast to all of the elections conducted in Ukraine between 1994 and 2005.

Freedom of speech and the media is widely regarded as another success story. However, changes in this area cannot be considered institutionalized or irreversible. Greater freedom of speech emerged mostly as the result of inaction by the authorities (who ceased conducting proactive media "management" or orchestrating prosecutions for expressing ideas) rather than any targeted reform. This leaves a number of issues still to be addressed. Most important among these are the lack of information on the operations of public-sector media, the still very large share of state- or community-owned media outlets, and the non-transparent structure of privately owned media outlets.

As for a vibrant and independent civil society, Ukraine fares well, both in quantitative terms and in comparison with neighboring former Soviet countries. In this sense Ukraine is probably the most vibrant democracy among the countries of the CIS. There are also built-in mechanisms for public-private dialogue. In comparison with developed countries, however, Ukraine still has a lot of catching-up to do in coming years. Outside assistance to create new organizations, as well as other quick-fix approaches to induce the growth of NGOs in Ukraine, will most probably fail. At the current stage of development, the best motivation for NGOs in Ukraine would be a non-intrusive taxation regime designed to favor non-profit organizations, as well as increased capacity by NGOs to engage in meaningful public-private dialogue.

To be effective, such a dialogue must rely on the following fundamentals: availability of information on government actions, including analyses and alternatives; prescribed procedures for consultation in the decision-making process; and government openness to outside outcome monitoring. The first criterion is not met due to the lack of legislation on access to information. Information currently provided to the media and NGOs depends heavily on the discretion of government officials and tends to be skewed towards more "friendly" organizations.

Attempts have been made to address the consultation issue. Under the Law on the Fundamentals of State Regulatory Policy in the Sphere of Economic Activity (dated 11 September 2003), central, regional, and local bodies of executive power are required to promulgate drafts of normative acts for public comment. This law is inadequately enforced, but

at the national and especially local level, the practice of organizing public hearings is slowly taking hold, especially with respect to general formulations of strategies (e.g., the presidential hearings in November 2005) and budgeting (mostly at the level of local self-governments).

Finally, NGOs are increasingly attempting to monitor the outcomes of government policies. Within an environment of political competition, these attempts can yield important results, but mainly over the long term. Until recently, government institutions did not rely on such monitoring for policy adjustments or personnel decisions. One of the first attempts to do this is evident in the President's new anti-corruption initiatives. On 18 November 2005, the President signed the framework decree 1615/2005 "On Priority Measures on Combating the Shadow Economy and Corruption." This decree, which identifies the main thrust for anti-corruption efforts in Ukraine, includes provisions for a national corruption monitoring system to be executed by non-governmental agencies.

Closely related to the pillars of government accountability addressed above is the issue of the transparency of governance. It is necessary to stress that transparency relates to the decision-making process itself, as well as to underlying possible motivations and data. Ukraine has already had some experience in the introduction of the institutional elements for a transparent decision-making process. From early 2000 to mid-2001, Cabinet Committees conducted open weekly meetings. NGOs enjoyed an opportunity to comment on draft decisions and such comments were reported during Cabinet Committee meetings. Unfortunately, this transparent manner of operations of Cabinet Committees was discontinued; in 2005 regular committee meetings ceased altogether. Public availability of internal documents, an additional method to ensure transparency in decision making, has never been designed, mandated, or implemented in Ukraine.

Regarding possible motivations in the decision-making process, Ukraine still lacks conflict of interest legislation, and despite the availability of provisions for asset declaration by top officials, their monitoring if existent is not public and there is no provision for monitoring of expenses of top officials. On the positive side, the necessity for such legislation is acknowledged by the Ukrainian government and provisions for its development are stipulated in the presidential decree "On Priority Measures on Combating the Shadow Economy and Corruption." Relevant draft laws have not yet been submitted to the Parliament, however.

Legislation on its own and the high capacity of NGOs are not sufficient to move accountability of governance in Ukraine to a qualitatively new level. Synergy between the legislative framework, capacity of government to implement this framework and enforce it, and public participation in outside monitoring through research and investigative journalism will be effective only in an atmosphere of free availability of information, freedom of speech, and political competitiveness. Even in such an environment, systemic changes will not be rapid.

The last variable in the equation is thus the political will of the government to be accountable regardless of the status of possible inefficient or corrupt officials. One of the indicators of such political will is the lifting of immunity from prosecution for the members of *Verkhovna Rada* and establishing clear procedures for independent investigations of the President and Prime Minister. A strong political will to create a transparent and accountable system of governance will provide for short- and medium-term results mostly through the system of motivation for government officials to govern with integrity.

Recommendations

- The Ukrainian Government should develop legislation on access to information and ensure its adoption and full enforcement. This should be followed by the reintroduction of open regular decision-making meetings of Cabinet Committees.

- Central and local authorities should adopt clear procedures for holding consultations, including rules for determining the issues to be discussed (these can, for instance, include distribution of consultative documents, namely “green” and “white” papers, to all interested parties at an early stage in the decision-making process). Responsibilities in this area should be adequately reflected in the administrative duties of the relevant officials and the statutes of the units responsible for organizing and holding consultations. Follow-up monitoring should assess the effectiveness of these procedures. The provisions of the Law on the Fundamentals of State Regulatory Policy in the Sphere of Economic Activity (dated 11 September 2003) should be fully enforced.
- European principles and standards should be followed in developing consultation procedures. Pursuing European norms will also help fulfill Ukraine’s commitments within the framework of the Agreement on Partnership and Cooperation with the EU for the purpose of harmonizing Ukrainian and EU legislation.
- Measures should be taken to limit state-owned media through the creation of public broadcasting, to ensure transparency of operation and editorial independence. In addition, legislation requiring a transparent ownership structure of media outlets should be enacted and enforced.
- In order to create incentives for the development of NGOs, tax legislation should be amended to establish a special regime for non-profit organizations and introduce tax deductions for donations to such organizations.
- Rules of procedure for various state agencies as well as personnel policies of the executive branch of government should include provisions for usage of external monitoring data for consideration in the decision making process.
- The Government should develop conflict of interest legislation and provide mechanisms for its full implementation and enforcement. Additionally, provisions for declaration of assets should be strengthened and mechanisms introduced for monitoring of expenses by top officials.
- Parliament should consider adoption of legislation on the elimination of immunity from prosecution for members of the *Verkhovna Rada* and the creation of special investigation commissions.

1.4. RULE OF LAW: JUDICIAL REFORM

Good governance does not depend exclusively on the design and workings of the country’s legislative and executive machinery of government. The key element for good governance is the ability to govern justly and resolve conflicts in an honest and efficient manner. This element depends on the high integrity and efficiency of the judicial system. Shortcomings in the judicial system have long been recognized in Ukraine, but the piecemeal reform efforts of the 1990s were not sufficient to resolve them. As result, confidence in the judiciary was very low; it lacked resources and professionalism and was plagued by corruption.

In 2005 the President declared fundamental reform of the judiciary as one of his main priorities. A National Commission on Strengthening Democracy and Establishing the Rule of Law was created and focused on developing a comprehensive reform strategy consistent with the commitments that derive from Ukraine’s membership in the Council of Europe. The President approved this strategy as the Concept of Judicial Reform in January 2006.

In addition, a number of important decisions were implemented, including clarifying and making more transparent the system of judges’ compensation and raising salaries, especially for

the lower ranks of judges. These measures were supported by substantial increases in funding for the judicial system in both 2005 and 2006 and ratification of a state program to provide judges with appropriate premises for the period of 2006-2010. New codes of practice, namely the Code of Civil Procedure and the Code of Administrative Procedure, were enacted and the system of administrative courts was created. Moreover, the parliament adopted the Law on Access to the Court Decisions in order to secure civic control over court activity and to ensure a more uniform application of the law by the courts.

Judicial reform, it should be stressed, is a long-term undertaking. To be successful, it requires a number of complex measures that concern not only the court system but also the system of execution of judgment, pre-judicial inquiry, public prosecution, admission to the legal profession, the notary system, and the penitentiary system. Reforms in these areas should be implemented in a simultaneous and coordinated manner. Such an approach to judicial reform would not only bring Ukraine closer to European standards of legal procedures, but would also help such standards to become firmly established in society.

As stated above, Ukraine now has a blueprint for comprehensive judicial reform that provides a framework for drafting legislation in 2006-07. First of all, it is envisioned that this legislation will address the selection of judges. Competitive qualifying examinations will follow compulsory training courses and are planned to be administered at the national level.

Second, actions are planned to prevent corruption of judges during trial proceedings. A random process of assigning cases to judges will be established, and a national database of judicial decisions will be created, as required in the Law on Access to Court Decisions.

Third, compensation packages for judges will be reviewed with the purpose of making them more comprehensive, including schedules for additional payments for service and qualifications, special working conditions (for example, night duty in administrative courts) and for holding executive positions in court.

Finally, in addition to the issues of independence, impartiality, and material security, improvements to disciplinary procedures for judges are planned. A regular Disciplinary Committee of Judges is to be established to supervise the judges of local courts and Courts of Appeal. The institution of "judicial inspector" is to be created to examine allegations of misconduct by judges.

In addition, legislation will also be passed to establish a structure of courts of general jurisdiction that is more streamlined and based on constitutional principles and European standards. This foremost relates to the creation of superior courts as courts of appeal for civil and criminal jurisdiction, district criminal courts (for trying cases which are currently under the jurisdiction of the Court of Appeal in the first instance), and abolition of the Ukrainian Court of Appeal. Legislative preconditions should also be created for the complete abolition of military courts in the Ukrainian judicial system.

Ukraine also needs to establish legislative guarantees of the right to efficient legal procedures, especially concerning reasonable terms of implementation of decisions in line with the European Convention for the Protection of Human Rights. A system of state-funded financial assistance should be established to ensure that disadvantaged members of society have access to high-quality legal redress.

Finally, Ukraine should capitalize on probably the most important judicial reform measure enacted to date: the creation of a system of administrative courts. This system still needs to be fully established, staffed, and funded. The nature of cases that will go to administrative courts and especially the enforcement of judicial decisions still need to be clearly defined.

Recommendations

- Strengthening the judiciary and bringing legal procedures in line with European standards is one of the key institutional reforms that the new government should implement. Given the many different aspects of the judicial system that overlap with reforms in other areas, and the time it will take to implement reforms, a well-coordinated approach is necessary. This means that in addition to the reform of the court system, for which a blueprint already exists in the form of the Concept of Judicial Reform, comprehensive reforms in the systems of pre-judicial inquiry, public prosecution, execution of judgment, admission to the legal profession, and the public notary must be developed and implemented. In addition, and in order to ensure protection of human rights in Ukraine, the government should enact comprehensive reforms of law enforcement agencies and the penitentiary system.
- The National Commission on Strengthening Democracy and Establishing the Rule of Law proved to be effective in designing the Concept of Judicial Reform. Assuming the passage of legislation developed in the framework of this Concept, attention should be paid to establishing a truly compatible and merit-based system for selecting and appointing judges. Centralization of this process alone will not resolve the problem of corruption. Identification of vacancies, rigorous training, and anonymous test-based examinations and appointments should be transparent and available for administrative and public scrutiny.
- Similarly, instituting a system of random case assignments and making available decisions in a national database will increase the integrity of the courts only if the systems are subjected to rigorous scrutiny by appropriate inspections and analysis by administrative bodies and NGO watchdog groups. Regular surveys will also be critical to assess the general public's perception of corruption and its level of trust in the judicial system. Such surveys will provide the ultimate verdict on the effectiveness of implemented reforms.
- It is critical for Ukraine to develop as rapidly as possible a system of administrative courts. In addition to protecting citizens from government actions as prescribed by the Constitution and European norms, these courts will take over numerous cases from the courts of general jurisdiction and enable the latter to work in a more timely manner. The court system should also introduce guarantees of the right to efficient legal procedures, and ensure assistance to those who might otherwise find the costs of seeking legal redress prohibitively expensive.
- In order to support judicial reform in Ukraine, Parliament should continue work on reviewing legislation in order to eliminate legislative contradictions. One of the most glaring examples is the outmoded Economic (Commercial) Code, which should be abolished and replaced by an updated version of the Civil Code (see Chapter 3). In addition, Parliament should provide adequate financing in the 2007 budget for the judicial system and implementation of reforms. The National Commission on Strengthening Democracy and Establishing the Rule of Law should receive full support and continue developing the reform process to establish the rule of law in Ukraine.

1.5. HUMAN RIGHTS: TARGETED IMPROVEMENTS

Ukraine has ratified most of the major international human rights instruments, both at the global (UN) and regional (European) levels. Notable progress has been made since Ukraine became independent, and especially after the Orange Revolution. Implementation of the systemic governance reforms described above will lead to not only to a more efficient

government and judiciary, but also bring about sustainable human rights improvements. However, some major human rights concerns that are listed repeatedly in recommendations from the UN and European human rights watchdogs, and national and international NGOs need immediate targeted attention from the Ukrainian government. Most important among these are torture and ill treatment experienced by prisoners in police detention stations and prisons.

Despite nation-wide campaigns by the Ombudsperson and a number of NGOs to end this practice, the problem persists. In 2005 alone, more than 1,200 individuals were reported to have been subjected to torture and ill-treatment in the course of interrogation by law enforcement officials. The victims of such treatment often experience permanent physical damage and the most severe cases can result in death. Regrettably, in the vast majority of cases, the perpetrators of torture are not investigated or prosecuted for their crimes. Thus, many ongoing deficiencies in the penal system still exist, including the lack of clarity regarding the time when detained persons may exercise their rights to counsel, medical examination, and contact with a family member, as well as overcrowding in both militia and penitentiary establishments.

The second issue relates to the treatment of asylum seekers and refugees and deportation practices. Ukraine's refugee law breaches international human rights standards by imposing a strict time limit of three to five days after arrival during which asylum-seekers may submit applications. Police and border guards regularly detain undocumented migrants, including asylum-seekers, in unacceptable conditions in border guard and police detention facilities, often for many months. Migrants usually do not have access to interpreters or legal counsel and are unable to challenge their detention. Government officials often refuse to accept applications for asylum, and the migration service is ill-equipped to handle the applications it does receive.

In the first four months of 2005, 1,500 migrants were deported from Ukraine. UNHCR, the UN refugee agency, estimates that, of these, 400 persons (mostly from Afghanistan and Chechnya) should have been granted access to asylum procedures. The most egregious recent case of forced return occurred when ten Uzbek asylum seekers were deported to near-certain torture and abuse in Uzbekistan in February 2006, apparently in response to Uzbek arrest warrants. Many countries and human rights protection organizations asked the Ukrainian government to explain how asylum seekers registered with UNHCR could have been deported.

Finally, Ukraine is a signatory to relevant international conventions prohibiting gender discrimination. In practice, Ukrainian women face obstacles to their full and equal participation in the labor force. Discrimination against women continues to be practiced by public and private sector employers; many women are forced into lower-paying jobs or remain jobless due to discriminatory recruitment practices (well over half of the unemployed in Ukraine are women). As a result, a large number of women opt to seek better economic opportunities abroad, rendering them vulnerable to trafficking. Anti-trafficking legislation, prosecutions of those complicit in trafficking, and implementation of rehabilitation programs for victims remain inadequate.

In June 2002 the United Nations Committee on the Elimination of Discrimination against Women credited Ukraine for adopting a new law on the prevention of domestic violence, but expressed concern about the prevalence of violence against women and the need for improved measures to prosecute offenders and provide victims with assistance.

Recommendations:

- An urgent need exists for more rigorous enforcement of the provision of the criminal procedure code that treats custody pending trial as an exceptional measure and not as a routine practice. Administrative detention should be ruled out when there are no sufficient grounds for holding detainees as criminal suspects.

- Resources should be allocated to address prison overcrowding and insufficient access of prisoners to food and health care, especially those living with tuberculosis and HIV/AIDS.
- The government should take urgent steps to ensure that forced deportations of refugees in violation of international human rights and humanitarian law do not happen again.
- Ukraine's legislative framework on migrants and asylum seekers should be harmonized with relevant European and UN standards.
- The border police and other law enforcement agencies should ensure that migrants and asylum seekers in Ukraine do not face violence, robbery and extortion, and are not denied legal assistance, especially when they face deportation to countries where they might face persecution, torture, or ill-treatment.
- Gender targeting by government-run employment centers should be banned.
- Government should take measures to reduce domestic violence through the imposition of clear guidelines on victim protection for law enforcement agencies, monitoring of the prosecution of perpetrators, and a comprehensive public education campaign.

CHAPTER 2. ENSURING MACROECONOMIC STABILITY

When in the summer of 2004 the Blue Ribbon Commission started its work in Ukraine there was little reason to concentrate on macroeconomic issues, as conditions seemed to be improving. However, after several years of very strong economic growth, accompanied by large current account surpluses, moderate rates of inflation, and low fiscal deficits, the Ukrainian economy slowed markedly in 2005 (and in fact its macroeconomic balances had already begun to deteriorate sharply from the middle of 2004). This was a very important juncture insofar as improving macroeconomic indicators had been one of the main features of the Ukrainian economic landscape since the second half of 1999. The challenge faced now by macroeconomic policy is as formidable as that entailed in improving the business environment or redesigning the rules of social expenditures or decentralizing and cleaning up the state apparatus.

In 2005 GDP grew by just 2.4 per cent, compared with 12.1 per cent a year earlier. The immediate causes of the slowdown were a sharp deterioration in the trade balance and weaker investment. However, the underlying cause of the slowdown was the implementation of costly populist economic policies. This commenced in the lead-up to the 2004 presidential elections but continued into 2005. Rapid fiscal expansion crowded out productive private sector investment while in the business sector a prolonged debate over re-privatization caused uncertainties that made businesses postpone vital investment decisions. Inflation, as measured by the consumer price index, remained in double digits at the end of 2005. Despite a large increase in government spending, the consolidated fiscal deficit was only 1.8 per cent of GDP, partly due to the boost to revenues achieved through the admirable decision to eliminate tax exemptions and loopholes.

Hopes that the economy would rebound quickly were punctured by the sharp rise in gas prices at the beginning of 2006. Nevertheless GDP growth accelerated towards 5 per cent during the first half of the year, the result of stronger domestic demand for consumer and investment goods, improved external conditions as steel prices strengthened and demand for chemicals firmed, as well as more prudent economic management. On the supply side, growth of services accounted for 45 per cent of GDP growth during the first half. The improvement in external conditions for major exporters in the metallurgy and chemical industry enabled them to adjust to the higher energy prices and show some growth in the period.

The fundamental macroeconomic challenge is to return to the favorable trends of the 1999-2004 period. Inflation needs to be reined in by radically reducing the government deficit and the expansion of the government sector needs to be reversed. Ukraine's political leadership also urgently needs to amass the political support needed to take the necessary legislative action to complete negotiations on Ukraine's membership of the WTO so that export expansion to the larger markets will no longer be hindered. WTO membership at this juncture is in Ukraine's vital national interest and political bickering over it in the *Verkhovna Rada* should no longer be tolerated.

2.1. ENSURING THE SUSTAINABILITY OF PUBLIC FINANCES

Fiscal Developments

After several years in which the share of budget revenues and expenditure in Ukraine's GDP remained fairly constant, accompanied by modest fiscal deficits, both government revenues and spending rose sharply in 2004 and 2005.

Tax Changes and Higher Government Revenues. General government revenues² rose from 35.6 per cent to 41.7 of GDP between 2004 and 2005. Tax revenues were buoyant as payments of VAT and Corporate Profit Taxes (CPT) rose strongly. Part of the reason for the strength of tax revenues was the success of government reforms, especially those aimed at eliminating discriminatory tax policies, which have long been regarded as an impediment to the development of a favorable business climate. The amendments to the tax laws introduced in the March 2005 budget eliminated many exemptions relating to VAT and CPT and also abolished privileges for Special Economic Zones (SEZ), including the closure of tax loopholes. In addition, the government's "Stop Smuggling" program had some success in preventing tax evasion in import operations. Partly as a result of these measures, CPT receipts were over-executed by 4 per cent, of VAT by 1 per cent and dividends from state-owned enterprises by 7 per cent.

However, part of the over-execution of tax revenues reflected other factors. During the first half of 2005, the buoyancy of VAT revenues came mainly as a result of an increase in arrears of VAT refunds (which amounted to UAH 3.4 billion by the end of July), and it was only at the end of the year that these arrears were repaid. The strength of CPT also reflected uncertainties regarding tax legislation at the beginning of the year, which led some enterprises to overpay profit tax. The larger than expected payments from dividends on state property were mainly due to retroactive approval of enterprise investment plans.

Several of these tax changes, however, proved to be somewhat overzealous. The abruptness of the change damaged some honest businesses and resulted in a wave of protests against the legislation, including requests for compensation, such as the experience with the implementation of changes in tax policy through the Law on the 2005 State Budget in March last year.³ The amendments that cancelled tax privileges for enterprises in the Special Economic Zones were justified, but the manner in which they were introduced proved to be controversial. Similarly, the government's proposal to radically reduce the list of small and medium-sized enterprises (SMEs) entitled to lump-sum tax was poorly organized and was subsequently withdrawn after a protest and consultations with business representatives. Abrupt changes, especially when followed by a reversal in policy, damage the authorities' credibility and introduce uncertainty into the rules of the game. Making amendments to laws by means of budget legislation is a practice that has been frequently employed in the past in Ukraine. The year 2005 was no exception, with the budget law amended six times during the year.

Expansion in Government Spending. As a result of government decisions to increase spending, general government spending accounted for 44.7 per cent of GDP in 2005 compared with an average of 35.6 per cent in 2000-03. The rise reflected budget revisions in March 2005 that led to a 19.5 per cent increase in expenditures on wages and social transfers as well as decisions taken in both 2004 and 2005 to increase pension payments substantially. Total spending on pensions rose from 9.1 per cent of GDP in 2003 to 11.3 per cent in 2004 to over 15 per cent in 2005. As pension contributions fell far short of outlays, the budget was forced to provide a subsidy that rose from just 0.9 per cent of GDP in 2003 to 5 per cent of GDP in 2005.

The result of these trends was a general government deficit of 3 per cent of GDP in 2005. There are indications that revenues have remained buoyant in the first half of this year with central budget revenues some 2 per cent in excess of target. As a result, the general government deficit was estimated at no more than 0.5 per cent of GDP by end-June, the same level as the consolidated budget deficit.

² General government is defined as the consolidated budget (which comprises the budgets of central and local government) and the Pension Fund. In 2005 the consolidated budget data were as follows (as percentages of GDP): revenues 31.6 per cent, expenditures 33.4 per cent and the deficit 1.8 per cent.

³ Polish and Danish enterprises working in FEZ "Yavoriv" declared their intention to sue the Ukrainian government for breaking investment contracts.

Although the deficits have been readily financed, increases in spending of the order seen in 2005 raise concerns over the medium- and longer-term sustainability of public finances. The main issue of concern is that since 2004 fiscal policy has become a hostage to political populism, with implications for the economy and fiscal stability. Much of the expenditure increase is recurrent and will therefore have to be met in future years, whereas there can be no guarantees that the growth of revenues will remain so buoyant. Higher spending also contributed to the persistence of inflation. Furthermore, the emphasis of the budget on social expenditures led to a reduction in public investment, as capital outlays of the government fell to 4.3 per cent of GDP compared with 6.0 per cent in 2004. When combined with the slowdown in private investment, real fixed capital formation in the economy fell in 2005.

The increased deficit of the Pension Fund also represents a major fiscal risk for the coming years. The fund's deficit in 2005 was financed from the budget,⁴ including some of the proceeds from the privatization of Kryvorizhstal. However, the 2005 privatization receipts were an exception, and although these proceeds can be drawn on to fund deficits for this year, the government cannot count on them to finance the Pension Fund deficit in the future. By 2007 it is probable the government will need to find other means of deficit financing or reduce the deficit.

There are also other factors that could affect fiscal sustainability in the future. The Ministry of Finance has been successful both in reducing the stock of state debt, which fell to 18.7 per cent of GDP by the end of 2005 (from 24.7 per cent in 2004), and in improving the structure of the debt by repaying old expensive debt and issuing cheaper paper. However, municipal debt has been growing quickly recently, especially external debt. In 2005 local budgets borrowed US\$ 250 million on external markets, which represented 16 per cent of total external borrowing during the year. Although these amounts are relatively small, the main concern about the growth of such debt is that it is not always transparent or well managed. In addition, state guarantees on the debt of enterprises carry potential risks, given that the state would have to repay the debt in the event of a default. At the end of 2005, guaranteed state debt was 3.6 per cent of GDP.

Principles of Long Term Fiscal Reform

A relatively poor country like Ukraine with a tradition of weak public administration just cannot afford to tax away more than 40 per cent of GDP. This will not lead to convergence with affluent states. On the contrary, it will lock Ukraine into a low-level equilibrium, characterized by a large shadow economy, weak competitiveness, a sub-optimal trend growth rate and slow wealth creation. The strategic goal of lower budgetary redistribution of the nation's wealth, and thus lower marginal taxes, will require a single-minded effort to balance the budget and to prevent any significant growth in public debt. Ukraine's public debt levels are healthy and need to stay that way, for the benefit of future generations. These principles should guide long-term budgetary policies and translate into annual budget plans. A reversal of the last two years' policies is crucially needed now.

Greater Consultation and Transparency. The government should provide the private sector and the public with complete information on the direction and the timeframe of planned policy changes. Information should be timely and readily accessible. In this context, the practice of holding consultations on major pieces of legislation with interested parties should be developed. The Budget Code needs to be amended where it unrealistically stipulates in Article 27 that laws affecting the budget should be adopted before 15 August of the previous year. Instead, a more realistic deadline of, say, 15 October should be adopted, and at the same time should also be respected by government.

⁴ This amount exceeded the initially planned transfer by almost 3 times, but was made possible by the unprecedented proceeds from privatization of the Kryvorizhstal steel mill.

In addition, the government needs to make available thorough information regarding the general state of public finances. Of special concern here are extra-budgetary funds and government procurement and investment policies. In particular, there are no publicly available statistics on revenues and expenditure of the special fund of the state budget, and there are few details regarding the operations of the Pension Fund.

Improved Efficiency of Government Investments. The government should pay more attention to the investment component of the budget, with an emphasis on increasing the efficiency of such investments. The Accounting Chamber reports on cases where laws and procedures relating to government investment have been violated. However, more information is required to monitor accurately and assess the effectiveness of government investments. Introduction of results-based financial planning will also be vital in this context.

Balancing the Pension Fund. The deficit of the Pension Fund, accompanied by the provision for budgetary financing of the deficit, jeopardizes the stability of public finances. Eliminating the deficit will be a challenge, as nominal reduction of pensions is not politically possible. In the short term, the privileged pensions (for deputies, state sector employees and the military) could be separated from the general budget of the Pension Fund and placed into a special fund. Rapid growth of privileged pensions complicates the task of balancing the Pension Fund while such a separation would allow greater transparency and better management of the pension system.

Realistic Budget Assumptions. Ukrainian public finances are poorly equipped to deal with risk. The budget for 2005 was built upon a forecast of GDP growth of 8.2 per cent, while in reality growth was considerably lower, at just 2.4 per cent. The budget for 2006 is based on a GDP growth rate of 7 per cent, whereas the outturn is likely to be closer to 5 per cent. In general, overoptimistic growth assumptions lead to an overestimation of tax revenues. This clearly did not occur in 2005, partly because of the success of the tax reforms in boosting revenue above target. But this effect is likely to be weaker this year and the projected consolidated budget deficit of 2.5 per cent of GDP in 2006 is high by the standards of the immediate past.

A further issue is the need for realistic projections of energy (especially gas) prices, in view of the implications for government spending. Ahead of the parliamentary elections in March 2006, the government constrained the rise in energy prices for the population. As a result, Naftogas Ukrainy had to subsidize domestic consumers and, consequently, incurred losses. Such a policy was unsustainable and the government subsequently introduced two large increases in gas and power prices for domestic consumers. These are likely to result in higher spending to assist poorer households to meet the cost of higher utility bills.

Priority Areas of Short Term Action and Recommended Policies

- **Limit the growth of budget expenditures and their inflationary effect.** The government should abstain from further major increases in social spending in real terms. The fiscal deficit in 2007 should not grow relative to that of 2006 and the structure of expenditures should shift back gradually towards necessary public investments. In order to limit inflationary pressures, privatization receipts should be spent in a way that promotes investment rather than consumption.
- **The government should not return to the policy of providing huge tax loopholes for the advantage of privileged groups. The achievement in this area of the 2005 policies should not be wasted.** It is of particular concern that the new government has indicated its intention to re-introduce the Special Economic Zones. The indirect subsidization of selected regions or enterprises has already proved to be ineffective and should not be reinstated.
- **Improve the predictability of tax policy.** This could be achieved by:

- Amending the budget law to allow for changes to budget-affecting laws until 15 October of the previous year and strictly enforcing this amended deadline.
- Abstaining from changing tax legislation by means of the Budget Law, and strictly refraining from “forced” tax collection, such as non-payment of VAT refunds, adoption of retroactive tax laws and similar measures. The Ukrainian government needs to adopt a rule-of-law culture if it expects citizens and businesses to adhere to similar behavioral standards.
- **Improve risk management.** To do this the government should:
 - Ensure realistic GDP growth assumptions in the 2007 budget forecast to reduce the risk of non-fulfillment of revenue targets.
 - Compile, in the Ministry of Finance, scenarios of possible developments that would affect budget revenues and expenditures, such as rises in energy prices and the effects of tax reforms. For the downside risks, appropriate provisions should be made in the budget for the financing of such contingencies.
- Increase the transparency of public finances. This could be achieved by:
 - Adopting a law that would establish procedures for citizens’ control over the activities of state and local authorities. This long overdue law should be based on the Draft Law on Public Control (no. 6246, registered on 11 October 2004).
 - Making the practice of stakeholder consultations a norm for proposed changes to government policies, in particular in the area of tax policy.
 - Publishing reports and statistics on budget investment and procurement as well as on the activities of extra-budgetary funds.
- **Pursue tax reform.** The government should proceed with a program of tax reform to be implemented over the next several years, focusing on broadening the tax base and lowering marginal tax rates. In particular, payroll rates should be reduced, through financing some social benefits directly from the budget (from tax revenues) rather than from the Social Fund (from payroll taxation).⁵ Increasing the efficiency of tax collection of both VAT and CPT could compensate for the resulting loss of budget revenues.

The government should also introduce a property tax. Property tax should be seen as a vital accompaniment to decentralization of public administration. There are at least two versions of the Draft Law on Real Estate Tax that could be considered.⁶ It is vital for the development of local democracy that real estate tax be collected and used at the local level. Also, to compensate for the loss of revenue from the payroll tax, the land tax and the tax on the use of natural resources could be increased.

- **Resuscitate pension reform.** The priority for the coming year should be to develop a medium-term program to balance the Pension Fund. It should aim at reducing the

⁵ The Budget Law for 2006 does envisage a reduction in payroll taxes: the pension contribution of the employer is reduced by 0.5 percentage point to 31.8 per cent and the unemployment insurance contribution is reduced by 0.3 percentage point to 1.3 per cent. Yet the magnitude of these reductions is insufficient to lure wages out of the shadow economy, and more ambitious changes are needed.

⁶ The Draft Law on Real Estate Tax no. 3359-1 of 26 September 2005 and another draft proposed by the State Tax Administration.

dependency ratio (the number of pensioners per worker). This could be achieved, for example, by raising the retirement age (particularly for women), reducing early retirement entitlements, eliminating or reducing privileges on contributions for entrepreneurs and agricultural workers. After the Pension Fund is balanced, the government should resume pension reform, with an added emphasis on private-sector involvement in fund management (see Chapter 4).

- **Improve the efficiency of government investments.** The government should report on the plans and actual uses of budget money directed for investment purposes, identifying the names of recipients as well as indicators of the investment projects. Such reports should be published in a timely fashion (at the beginning of 2006, only a report for 2001-03 was available).
- **Implement mid-term budget planning.** This will contribute both to improving the transparency of public finances and increasing the efficiency of public investment, since it will be well targeted and better audited.

2.2. REINFORCING A CREDIBLE MONETARY POLICY

Monetary Policy in 2005: Main Trends

The main monetary aggregates grew rapidly during 2005; the monetary base increased by 53.9 per cent and the money supply by 54.8 per cent. Strong growth in the money supply contributed to an increase in the level of monetization of the national economy (M3/GDP) to 49.8 per cent (compared with 36.5 per cent in 2004). The growth of monetary aggregates was affected by the NBU's increased issue activity on the currency market. Indeed, operations on the currency market accounted for more than 80 per cent of the non-cash issue of hryvnia during the year. In 2005 the balance of NBU currency interventions amounted to US\$ 10.4 billion (compared with US\$ 2.6 billion in 2004). The NBU's gold and foreign currency reserves rose accordingly from US\$ 9.5 billion at the end of 2004 to US\$ 19.4 billion at the end of 2005 (equivalent to 5.8 months of imports). At the same time, the size of banks' refinancing requirements decreased by almost half, linked to the expansion of banking liquidity after its sharp decline at the end of 2004 at the time of the presidential elections.

Stabilization of the banking system and continued growth of household incomes provided the basis for growth of almost 60 per cent in banking deposits in 2005 and for a corresponding expansion of the money supply. The total volume of bank credits rose by nearly 62 per cent. Taking into account the excess liquidity in the banking system, the average weighted interest rate on credits in national currency decreased by more than one percentage point to 16.4 per cent by the end of 2005. Credit expansion was more muted in the first half of 2006, rising by 25.3 per cent, while deposits increased by just 12 per cent. The trend of decreasing lending and deposit rates has continued. There was also a shift of banking flows from the corporate sector to households, as individual bank deposits and loans rose much more rapidly than those of the enterprise sector. This shift reflected a combination of weaker investment activity and rising real incomes supported by the state budget.

Inflation and Prices

In 2004 the decline in inflation was arrested and annual consumer price increases returned to double-digit levels, primarily as a consequence of expansionist social policies and poorly targeted budgetary expenditures. These trends continued in 2005. Consumer prices rose by 10.3 per cent in December 2005, compared with December of the previous year, a small

reduction from 12.3 per cent at the end of 2004.⁷ The main inflationary stimulus, evident from at least the final quarter of 2004, was strong consumer demand (especially for foodstuffs), reflecting large social payments and rapid wage growth.

Domestic output was not always sufficient to meet this demand, partly owing to a slowdown in investment activity, but also because of protectionist policies in the agriculture sector. Price shocks in the markets for both food and fuels accentuated these trends. In addition, prices for state regulated services increased by an average of 15.8 per cent in 2005, thus accounting for about one-third of the consumer price index (CPI) increase during the year. At the same time, the rise in industrial producer prices slowed during 2005, reflecting a general “cooling” trend in the national economy as well as for some commodities in world markets.⁸ During the first half of 2006 inflation has once more been on a declining trend, although in the year to July the CPI rose to 7.2 per cent following increases to utility and housing tariffs.

Currency and Exchange Rate Policy

In 2005 the real effective exchange rate appreciated by 14.5 per cent, partly reflecting the appreciation of the nominal exchange rate, which was revalued by 5 per cent during the year as a whole. The appreciation of the hryvnia in April 2005 was implemented under verbal pressure from the government, despite concerns from many exporters. The rapid revaluation of the currency provoked short-term instability on the currency markets and contributed to a loss of price competitiveness for exporters and thus to the deterioration in the current account balance. However, a combination of the stronger currency and action by the NBU slowed the inflow of short-term speculative capital⁹ and contributed to a deceleration of inflation, partly offsetting the impact of the expansionary fiscal policy.¹⁰ In the first half of 2006 the real effective exchange rate depreciated slightly, improving the competitiveness of Ukrainian exports.

In 2005 the NBU also introduced a number of progressive measures aimed at the gradual liberalization of the currency and financial markets. These also contributed to a reduction in administrative barriers to doing business and attracting FDI. Among the main measures were: liberalization of some transactions on the inter-bank currency market;¹¹ a simplification of procedures for placing foreign direct investment;¹² revocation of the rules on the obligatory sale of currency by exporters; repeal of the request to show a certificate issued by the State Tax Administration in cases where a bank's client purchases foreign currency; and simplification of the terms of depositing credits issued in foreign currency for residents. The gradual relaxation in the system of currency regulation and control may have been one of the reasons for the greater volatility of the nominal exchange rate. To this extent these measures may also represent one of the first attempts by the NBU to introduce a more flexible currency regime.

⁷ The annual average measure of the consumer price index (CPI) was 13.5 per cent in 2005 compared with 9 per cent in 2004. Given the rise in the average measure during 2005, the decline in inflation on the end-year index suggests that, at that time, inflation was slowing.

⁸ The producer price index (PPI) fell by both average and end-year measures during 2005. In December 2005 the index was 9.6 per cent higher than in December 2004. The corresponding figure in December 2004 was 24.1 per cent.

⁹ The NBU introduced administrative restrictions regarding the access of non-residents to the state securities market and introduced new rules of reservation regarding short-term credits for non-residents.

¹⁰ According to a number of experts, the appreciation of the hryvnia in April 2005 led to a deceleration of inflation of between 2.5-3 per cent.

¹¹ In particular, NBU resolution no. 281 of 10 August 2005 allowed arbitrage and forward transactions on the inter-bank currency market within the limit of the open currency position of commercial banks.

¹² Under NBU resolution no. 280 of 10 August 2005, non-resident investors obtained the possibility to transfer funds directly to their current banking accounts (i.e., without having to open a separate current account in a Ukrainian bank). In addition the obligatory requirement that the investment currency be converted into hryvnia was repealed.

Main Policy Challenges

Reducing the Risk of Higher Inflation. Uncertainties with respect to both the political situation in Ukraine and economic prospects could lead to an increase in inflationary expectations. Although inflation seemed to be on a downward trend by the end of 2005, the sharp increase in gas prices from January 2006 has meant that inflationary pressures are likely to remain strong. The increase in tariffs for energy for households in May and July, as well as housing, have already had a direct impact on the CPI and these rises are likely to feed through to transport prices and the cost of goods more generally. With the high volume of budgetary social expenditures and accelerated growth in the minimum wage, consumer demand will also remain strong, adding to the upward pressures on inflation.

Greater Exchange Rate Flexibility: Inflation Targeting. In the short term the implementation of monetary policy should take into account the possible acceleration of inflation and the risk of a further weakening in economic growth. A gradual but clearly flagged transition from a policy of de-facto pegging of the exchange rate to one of inflation targeting over the course of the next two years – but preferably by next year – now looks inevitable.

Maintaining price stability and preserving the domestic purchasing power of money should be the main objectives of monetary policy. This would provide the broad conditions to achieve sustainable economic growth and higher employment and thus it would also be socially beneficial. At the same time, while the growing openness of the national economy will bring benefits, it also increases vulnerability to external factors. In these circumstances, a more flexible exchange rate policy would accordingly serve as a “built in” stabilizer and help to deal with the impact of any external shocks.

The transition to inflation targeting cannot be wholly successful unless it is accompanied by other measures to tackle some of the structural factors that contribute to inflation. An effective government anti-inflation policy should include recognition of the importance of securing fiscal sustainability (adopting a balanced budget, introducing medium-term budget planning, and increasing the efficiency of public expenditure). In addition, it also depends on a range of structural measures, including implementing effective anti-monopoly legislation to promote competition, reducing the size of the shadow economy, developing the necessary infrastructure for commodity markets, diversifying the sources of energy supplies, and establishing a functioning land market.

Taking into account existing budget constraints, the effectiveness of the disinflation policy will depend on the government’s ability to respond adequately to internal and external price shocks. That will require:

- The use of tariff policy to prevent producers of goods and services in housing and communal services, transport, and construction from taking advantage of monopoly positions;
- A flexible policy towards the import of food products and the formation of commodity reserves to intervene on the domestic market;
- Stimulation of infrastructure development, especially for agriculture products, to reduce both production and marketing costs; and
- Abstaining from further increases in social transfers to the population following legal decisions adopted by the parliament, unless they can readily be funded.

Policy Recommendations

The transition to inflation targeting should be gradual and well prepared, but it should start immediately. This will require the implementation of the following measures over the next several years:

- **Reinforcing the operational independence of NBU.** As international experience unequivocally shows, central bank independence has a strongly positive effect on the rate of inflation. In Ukraine, from time to time politicians attempt to interfere with central bank policy, whether with respect to exchange rate expectations or interest rates or the principles of nominating its officials. This is a risk to macroeconomic stability.
- **Enhancing the transparency of monetary policy.** Greater openness of the NBU towards the general public and financial markets will reduce the uncertainties of monetary policy and, therefore, inflationary expectations. The NBU should publish regular reports on inflation; the meetings of the NBU Board on monetary policy should be held regularly and its decisions communicated with maximum publicity. The Governor and other senior NBU officials should be prepared to explain in public the NBU's policy outlook and the reasons for the latest decisions on interest rates.
- **Gradually widening the currency exchange rate corridor.** A gradual increase in the volatility of the nominal exchange rate will force economic actors to take into account currency risks while carrying out economic activity. The banking system, rather than the NBU, will therefore bear more of the currency risks, which in turn will require the development of hedging instruments and forward markets.
- **Stimulating the development of the state securities market.** The NBU should pressure the government to develop a domestic market in government securities with various maturities to make a genuine policy on open market operations possible. For this to be successful, the government would have to offer positive real interest rates. In addition, the issuance of inflation-indexed government securities would not only contribute to the emergence of a market in hryvnia-denominated bonds, but would also signal the government's commitment to disinflation and thus strengthen the effective independence of the NBU.

2.3. EXPANDING FOREIGN TRADE

Achievements and Trends in 2005

Strong export performance was one of the driving forces behind Ukraine's economic recovery in recent years. However, in 2005 the situation changed dramatically and the contribution of net exports to GDP growth was negative. In real terms, exports fell by 14 per cent while imports fell by just 1 per cent. As a result, the trade balance declined from a surplus of 5.7 per cent of GDP in 2004 to a deficit of 2.2 per cent in 2005.

There were several reasons for the deterioration in the trade balance. In 2000-04, Ukraine benefited from favorable terms of trade: the prices for major exports, especially metals, rose sharply, while the price of imported energy remained fairly stable. During 2005 this situation was reversed. In addition, the appreciation of the hryvnia in real effective terms reduced the cost advantage of Ukraine's traditionally strong exports (metals and chemicals), while demand for these products also weakened in key markets. Meanwhile, access to EU and US markets was limited by quantitative restrictions on imports of Ukrainian steel into the EU and the failure of the US to grant Ukraine preferential treatment under the Generalized System of Preferences, as well as the overall slow pace of negotiations on WTO accession.

These developments showed that GDP growth in Ukraine had become very dependent on demand for a narrow set of exports, including metals, basic chemicals, and services. Furthermore, in 2005 these trends were accompanied by a reduction in the value of exports to both the EU (by 3.3 per cent) and the US (by 29.2 per cent), so that last year they accounted for 27.1 per cent and 2.8 per cent, respectively, of Ukraine's exports. By contrast, exports to the CIS countries rose by 22.7 per cent and accounted for over 33.7 per cent of total exports.

Despite the drastic reduction in the merchandise trade balance, the current account remained in surplus owing to receipts from exports of services (especially gas transit fees) and the continuing inflow of current transfers. For the year as a whole, the current account surplus was 3.1 per cent of GDP (compared with over 10 per cent in 2004). Despite the decline in the current account surplus, the capital account improved markedly owing to substantial inflows of both foreign direct and portfolio investment. In 2005 a record inflow of net FDI was registered, amounting to US\$ 8 billion, mainly the result of the US\$ 4.8 billion paid by Mittal Steel for the Kryvorizhstal steel mill. Moreover, a number of Ukrainian companies were very active in borrowing on the Eurobond market, which boosted the inflow of medium-term capital into Ukraine.

Trade Regime: Achievements and Implications

The efforts of the Ukrainian authorities to improve the trade regime in 2005 had a number of positive outcomes, all of which should help increase trade with western markets:

- Ukraine was granted the status of a fully-fledged market economy by the EU in December 2005 and by the US in February 2006. This status enhances the position of Ukrainian producers in antidumping investigations.
- In March 2006 the US Congress abolished the Jackson-Vanik amendment to the US Trade Act of 1974, as applied to Ukraine. President Bush signed the bill into law later the same month. Although this is unlikely to have a major effect on trade volumes (since Ukraine usually received an annual waiver from the amendment), it should enhance the prospects for Ukraine's accession to the WTO.
- In January 2006 the US Trade Secretary excluded Ukraine from the list of countries it deemed were violating intellectual property rights. The extension of the scope of the Generalized System of Preferences in relation to Ukrainian commodities as a consequence of this decision should result in an increase in exports to the US.

In contrast, Russia has imposed a number of trade barriers on imports from Ukraine since the beginning of 2006. These included antidumping duties of 8.9 - 55.3 per cent on imports of some types of pipes originating in Ukraine. In addition, imports of milk and meat products originating in Ukraine were prohibited in February 2006 on the grounds of problems relating to the sanitary control of food products exported to the Russian market. To date the government of Ukraine has not succeeded in mitigating these trade problems with the Russian authorities.

The government made progress on the unification of custom regulations for imports during 2005. The main measures included improving the customs administration under the program "Stop Smuggling," reducing tariffs on imports of certain consumer goods, and canceling tax privileges that had been granted to businesses in Special Economic Zones, some of which had been used to reduce the cost of imports.

These measures created a more level playing field as regards the regime of import tariffs and also contributed to greater price competition in the market for domestic consumer goods. Imports of consumer goods grew sharply as a result of an increase in household income

generated by strong nominal wage growth (in excess of 30 per cent) and social transfers from the budget.

Unfortunately, Ukraine failed to complete its negotiations on WTO accession by the end of 2005, as the government had originally intended. Nevertheless, considerable progress was made, including the successful conclusion of a further nine bilateral protocols with the WTO working group members. In the early months of this year Ukraine also completed the all-important bilateral negotiations on mutual access to the markets of goods and services with the US, as well as with a number of other countries.

The progress achieved to date makes Ukraine's WTO accession in 2006 a real possibility, provided the government concentrates its efforts on supporting the process politically in Ukraine. Whereas there are undoubtedly sectors that will be challenged by greater competition from imported products, the economy as a whole will benefit greatly from the mutual opening of markets with the outside world. Furthermore, it is in Ukraine's vital political interest that it should not be left behind within the CIS when it comes to WTO accession. During the past year the government did not manage to complete the legislative reforms that are necessary to conclude WTO negotiations, especially those related to state aid and support for agriculture. In addition, it failed both to establish a proposed inter-agency body to coordinate the efforts of the relevant ministries and to prepare a program and schedule relating to WTO accession.

Challenges for the External Sector in 2006

Gas import prices have risen sharply since the beginning of the year, following an agreement between the Ukrainian and Russian governments.¹³ Although this agreement was to cover only the first six months of 2006, it has remained in effect into the start of the second half of the year. Many questions have been raised over the role of the intermediary company, RosUkrEnergo, in this agreement. The increase in energy prices, especially for gas, will create a significant challenge for some sectors, most notably the chemical industry, in the context of weaker demand and lower prices for Ukraine's traditional export items.

Higher energy prices were a factor in the further deterioration of the trade balance in 2006. In January-June exports of goods and services rose by 6 per cent compared with the first half of 2005, while imports grew by 23 per cent over the same period. The deficit on trade in goods was almost US\$3 billion by the end of June. The effect of these trends is that the overall current account is likely to be slightly in deficit in 2006 as the trade balance deteriorates to a deficit of the order of 3 per cent of GDP. The main factors are:

- Higher gas prices will result in a substantial increase in the value of imports. The share of energy products in total imports could rise to some 38 per cent in 2006, compared with 30 per cent in 2005. Furthermore, there is no guarantee that gas prices will remain stable. The higher cost of imported energy will also increase costs for some of the main exporters of metals and chemicals (which tend to be very energy-intensive), reducing their profit margins.
- Relatively high inflation will result in further appreciation of the real exchange rate, with adverse effects for the price competitiveness of Ukraine's exports.
- Continued growth of household incomes in real terms will boost the demand for imports of consumer goods. Further reductions in import tariffs, as trade

¹³ Russia agreed to supply gas to Ukraine at US\$ 95 per thousand cubic meters (tcm), compared with an average import price of some US\$ 50 per tcm in 2005. Part of the increased gas import bill will be offset by higher transit fees (which were raised from US\$ 1.09 per tcm per 100 kilometers last year to US\$ 1.6 per tcm per 100 kilometers in 2006). The implications of the gas price increase for Ukraine are explored in more detail in the following section on Energy.

liberalization proceeds, will also add to these pressures, although the resulting increase in competition on the domestic market should be beneficial for inflation.

The main risks are of possible downward pressure on the nominal exchange rate and ultimately a reduction in the NBU's foreign exchange reserves, unless the NBU resorts to a more flexible exchange rate policy. It could also result in increasingly negative expectations among producers and the population at large about the stability of the currency.

The threat of macroeconomic instability is, however, modest in the short run, as long as the current account deficit is covered by capital inflows. At this stage of Ukraine's transition, it is indeed beneficial to have a modest trade deficit if it mainly reflects imports of capital goods and is financed by FDI flows. As noted above, the substantial capital inflows in 2005 largely reflected two major foreign sales of Ukrainian assets and massive borrowing from abroad by the business sector. There is, however, a need to ensure a more sustained flow of FDI through the adoption of a long-term privatization program and further improvements to the business environment (see Chapter 3). This would also help to slow capital outflows, which, according to data for the first quarter of 2006, increased to some US\$ 3 billion. However, if the economic slowdown was to persist and the incoming government did not correct expansionary fiscal policies, macroeconomic stability could be endangered in the longer term.

The government should resolutely refrain from imposing trade barriers in reaction to the deterioration of the external balances. Although these would have some short-term impact on imports, such barriers would negatively affect economic efficiency. They would also violate Ukraine's commitments under the WTO accession process and under other bilateral trade agreements. The reintroduction of import controls would be tantamount to a major step backwards towards the defunct socialist economic system, with all its rampant inefficiencies. Moreover, it would provide opportunities for further corruption through informal bargains between licensing authorities and the beneficiaries of import licenses. It would also lead to a surge in shadow imports, thus undermining the earlier government's successes in combating smuggling.

Policy Recommendations

A number of policy steps should help to improve the trading environment and contribute to further growth in Ukraine's exports, thus limiting the deterioration in the trade account. In the short term, the government should:

- **Ensure that Ukraine joins the WTO in 2006.** To achieve this aim, the government and the Rada should:
 - Oversee the drafting and timely adoption of legislation necessary to harmonize Ukraine's trade regime with WTO standards, including framework laws on state aid and foreign economic activities as a crucial national strategic priority.
 - Make the WTO accession negotiation process more accessible to the public; disseminate easy-to-understand information on the main terms of Ukraine's WTO accession to all interested parties.
 - Make the Center for the WTO operational, especially so that it can deal with enquiries.¹⁴
- **Accelerate the creation of free trade zones** with the EU and with countries of the CIS following WTO accession to eliminate exceptions from free trade regimes. In

¹⁴ The Center was founded on 31 May 2005 by a Decree of the Cabinet of Ministers.

particular, the government should negotiate a schedule for the elimination of all exceptions from free trade regimes with partner countries.

- Intensify the **harmonization of Ukrainian quality and production standards** with international norms and regulations.
- Ensure that all **agreements on gas imports**, especially the provisions relating to price formation, are **clear and transparent** (see section 2.4). This will reduce the risks of unexpected price increases leading to a sharp deterioration in the trade balance.
- Over the longer term the government should develop policies to **increase trade diversification** through implementing structural reforms. These include:
 - **Refraining from providing subsidies that distort competition.** Tax privileges for producers should be drastically reduced;
 - Ensuring fair competition among domestic and foreign producers by **providing for a “national” regime for imported goods**. Any discrimination against imported goods through differentiated rates of VAT or excise taxes should be explicitly prohibited by law.

2.4. RESPONDING TO HIGHER ENERGY PRICES

Energy sector reforms in Ukraine remain incomplete, and have not advanced much since the end of 2004. The first Blue Ribbon Commission Report suggested that tariffs be increased to cost-recovery levels, payment discipline strengthened, subsidy mechanisms well targeted, privatisation completed, and independent regulators empowered. While there was a general consensus among policy stakeholders over the direction of our recommendations, the implementation of reforms was very modest and largely fragmented. In reality, it was only after the January 2006 Russian gas supply crisis and two-fold gas price increase that the Government committed itself to seriously review energy policies and develop meaningful strategies. Some significant progress has been made in increasing energy tariffs to cost-recovery levels. However, developments on other energy reform issues remain highly inadequate.

Ukraine’s economic growth since 2000 has been supported by low-cost energy inputs through long-term oil and gas supply framework agreements with Russia and Turkmenistan. International oil prices rose during these years. However, the effect of price increases on Ukraine’s growth and external accounts were broadly offset by the increased demand for Ukraine’s main export items from Russia and the energy-exporting economies of Central Asia.

Meanwhile both import and domestic gas prices remained at low levels and these, combined with inadequate energy efficiency policies, meant that Ukraine remained a highly energy-inefficient economy. Indeed, Ukraine’s industrial sector is one of the world’s most inefficient energy economies. In 2003 the energy intensity of the Ukrainian economy (as expressed in Total Primary Energy Supply per GDP) amounted to 0.53 kg of oil equivalent per unit of GDP calculated in 2000 US dollars at purchasing power parity (PPP), while in Poland, Hungary, and the Czech Republic these numbers are 0.22, 0.19, and 0.27 respectively.¹⁵ In France and Germany, countries of comparable size to Ukraine, energy intensity is 0.17 kg oil equivalent. So, Ukraine has huge unutilised reserves in energy efficiency improvements!

Such data should encourage the Ukrainian government not to feel cornered by higher gas prices. The evidence from Central European countries unequivocally indicates that higher energy prices can and should be turned into a pivotal opportunity for Ukraine to undertake further economic restructuring. The experience of Poland, Hungary and the Czech Republic

¹⁵ IEA Key World Energy Statistics 2005

clearly shows that reforms that provide the appropriate market incentives for businesses and households can result in a radical reduction of energy consumption and marked improvements in energy intensity. In Poland, for example, the standard energy input per unit of GDP has been radically reduced since 1993, as the economy left behind its inefficient socialist past. Primary energy use per unit of GDP declined from 0.82 in 1991 to 0.44 in 2004; the comparable figures for energy final use over the same period were 0.50 and 0.28. The rate of decline in energy intensity in Poland was 53 per cent between 1994 and 2004 – the result of intra-industry efficiencies and structural changes in the economy, supported by foreign direct investment.

Clearly, both FDI and the development of small and medium size enterprises played a major part in bringing about those enormous efficiency gains in the Polish economy. All this is of major significance for Ukraine. **Radical reforms that increase market competition are a much more important source of energy security than any effort to achieve special deals from Ukraine's major supplier of energy.** It reinforces the message that Ukraine needs to achieve breakthrough improvements in the climate for foreign direct investments and provide incentives to create and invest in the small and medium size enterprise sector (see Chapter 3).

The rise in gas prices at the beginning of the year was serious, but appears to have been largely absorbed by the economy. There will be a number of immediate economic effects:

- Inflation will increase (see previous section).
- The current account is likely to move into modest deficit this year as the higher cost of gas imports is only partly offset in the current agreement by higher gas transit fees. The main uncertainty is the extent to which gas import volumes fall directly in response to the rise in prices. However, overall weaker net exports will lower GDP growth compared with the initial projections.
- Price competitiveness of major export-oriented industries, especially of chemical products, will be affected as input costs rise. According to estimates of the Union of Industrialists and Entrepreneurs, under present conditions the critical price level of natural gas for the chemical industry is around US\$ 120 per thousand cubic meters (tcm). The corresponding figure for the metallurgical industry is somewhat higher – around US\$ 160 per tcm, partly because the latter can switch to coke supplies.
- Fiscal pressures could emerge given that the budget for 2006 was based on a projection not only of buoyant GDP growth, but also gas prices of US\$ 50 per tcm. As profit margins are squeezed, revenues from corporate income tax could prove lower than planned. Much also depends on the extent of subsidies that the government provides to entities in the energy and industrial sectors to mitigate the impact of higher gas prices.

However, current economic growth, strong FDI inflows, on-going restructuring of industries – all of these factors will allow Ukraine to cushion itself against similar price rises in the future, provided there is strong political commitment to implement market-based policies of energy efficiency. Such policies are one of the most essential prerequisites to shift from recovery to the genuine economic development of Ukraine.

Developing a Modern Energy Strategy

The new National Energy Strategy, presented by the Ministry of Fuel and Energy in 2006, still focuses largely on issues of energy supply and energy balance. It calls for a significant decrease in energy intensity by 2030, with much of this to be achieved by a relative reduction in the share of natural gas in the national energy balance (primarily in power production) as well as

of the share of gas imports in overall gas supplies. The Strategy also calls for the expansion of the use of coal in power generation, the growth of nuclear power, and the development of alternative fuels (such as coalmine and coal bed methane) as well as renewable energy sources.

Although its intention is to improve the efficiency of energy production, conversion, transmission, distribution, and consumption, the Strategy is short on specific plans and measures, particularly on customer-level incentives as well as on ways to increase competition among suppliers. Furthermore, the development of the country's energy policies is still dominated by a rather fragmented set of government agencies responsible for energy supply and production, and there is not enough inter-agency cooperation and coordination in the process.

Mitigating the Impact of Higher Energy Prices. The government has a number of important roles in implementing energy policy. First, it must take the necessary macroeconomic measures to ensure stability when energy prices rise sharply. Second, given that one of the core elements of reform is to increase tariffs as wholesale energy costs rise, household expenditure on energy services will rise. The average Ukrainian household spends an estimated 9 per cent of its net income on energy and housing bills; this year the share could rise to some 12 per cent. Thus the government has to be ready to mitigate financially the adverse impact of the price shock on households where utility and housing costs exceed 15 per cent of income, as provided by the existing programme of support to low-income households (known as subsidies).

This existing subsidy program for low-income households should be better targeted, to provide benefits on an equitable basis to low-income households while providing incentives to consumers to minimize household energy consumption (see Chapter 4). Sound eligibility criteria are very important. The program should focus on those households most in need and include a requirement for them to have paid rent, property taxes, and utility bills in full during the preceding period. In this manner, the government will provide strong incentives for households to strengthen payment discipline.

Enhancing Energy Efficiency. An accelerated and steady decrease in the energy intensity of the economy is the key to Ukraine's continued economic growth and competitiveness. It is also critical for the country's energy security in view of its dependence on imported energy. To achieve this goal, dramatic improvements in the efficiency of energy supply, production, conversion, transmission, distribution, and, in particular, consumption, are urgently needed. While price and tariff increases to reflect costs, accompanied by regulatory improvements, are essential drivers in this process, they also need to be accompanied by a range of governmental stimuli and other measures to improve energy efficiency and increase domestic supplies of energy.

The experience of Central European countries shows that co-generation has huge potential for increasing energy efficiency. Developed countries also promote co-generation as a powerful tool to increase the effective utilization of energy. Further development in this direction depends on the liberalization of energy markets in Ukraine. The government could, for instance, give additional rights to producers of electric power that apply innovative energy efficiency technologies. Those producers could then be entitled to sell their electricity directly to consumers, rather than mainly through the regional monopolies (Oblenergos), as at present.

While Ukraine started to develop some timid energy conservation programs in the late 1990s, they often lacked specificity, financial underpinning, and implementation mechanisms. In addition they tended to concentrate on reducing energy consumption and increasing domestic energy supplies, rather than improving the utilisation of existing resources. The recent establishment of the National Energy Efficiency Agency is encouraging, but it needs institutional strengthening to jump-start its activities.

Ensuring Energy Supplies

The composition of total primary energy supply in Ukraine has changed little over the last eight years. The share of gas is around 44 per cent; coal, 27 per cent, nuclear energy, 16 per cent, and oil, 12.5 per cent. The balance of some 1 per cent comprises hydropower, renewable energy, waste energy and other sources. Not surprisingly, the relative stability of gas prices in recent years has resulted in a high degree of dependence on gas; in the industrial sector it accounts for 36 per cent, in the residential sector for 41 per cent, and in commercial and public services for 22 per cent of total consumption.¹⁶ 22 per cent of demand for natural gas in Ukraine is covered by domestic production, 15 per cent by payment in kind for the transit of Russian and Turkmen gas to Europe, and the balance of 60 per cent from Russian and Turkmen imports. The share of gas imports from Turkmenistan has steadily increased in recent years from 22 per cent in 2002 to a planned 40 per cent this year.

Increasing Domestic Sources of Energy. Traditionally, coal represented a significant share of Ukraine's energy balance. During the last 10-15 years it has been steadily replaced by supplies of cheaper natural gas. Now, however, the situation is changing and coal is becoming an increasingly competitive domestic energy source. For this reason, the government should tighten pollution control (especially on carbon emissions) in case a reorientation from gas to coal as a main energy resource takes place. At first glance, revival of the coal industry might seem to require substantial financing from the budget, since coalmines need well-developed infrastructure and adequate social provision. In reality, it might be not so expensive for the state to rehabilitate the coal-mining sector and increase its output, since the owners of chemical and metallurgical plants, which account for the bulk of domestic gas consumption, often also own (directly or indirectly) coal mines.

Ukraine's existing gas resources have been used intensively, but the country's gas potential remains underdeveloped. The government should intensify its efforts to locate additional gas reserves and prepare a long-term plan for the exploitation of gas fields to develop domestic gas production. Financing should not be a problem, as the authorities should not hesitate to attract private investors to develop gas fields on lease or concession conditions, or even through access to direct ownership of gas fields.

The robust development of alternative and renewable energy sources can further enhance energy security while reducing the negative environmental impact of conventional energy. Ukraine has a significant potential to develop wind power, biomass, bio-fuel, and coal methane. As in the case of energy efficiency, a comprehensive set of laws, regulations, and fiscal measures and their enforcement is needed to utilize the potential and reduce the country's dependence on imported primary energy sources.

Ensuring the Stability of Imported Supplies of Energy. Ukraine will remain dependent on imports of oil and gas for many years to come. In the immediate future Ukraine is likely to have to adjust to higher international prices for gas imports, as suppliers increase their prices. This emphasizes the importance of sound management of imported energy resources to soften the impact of price volatility and supply shocks. The current supply agreements, particularly for natural gas, are not sufficiently transparent, are short-term, and lack appropriate flexibility. Furthermore, they do not allow competition of suppliers on the Ukrainian domestic gas market.

The government needs to take steps to shift to long-term supply agreements with provisions for price adjustments to account for changes in international prices and to improve the capacity of the state institutions to negotiate and manage such agreements. While such agreements are bilateral and information disclosure is often limited by commercial considerations, existing international platforms, such as the UN Economic Commission for

¹⁶ IEA Statistics 2003

Europe (UNECE) Gas Centre and the Working Party on Gas, could be used to minimize barriers to cross-border trade and reach trade agreements.

In this context, the tripartite scheme currently in force still raises more questions than answers. The commitment to sell gas to Ukraine at US\$ 95 per tcm is not Russia's sovereign obligation, but rather a third-party deal. It makes Ukraine vulnerable to a private company whose role is obscure and which can hardly be held accountable for any irregularities of gas supplies. With Gazprom improving its corporate transparency and prudence, it is natural that current complex and opaque, highly discredited arrangements should be replaced by direct, predictable, and transparent mechanisms in the shortest possible time frame.

Ukraine has not fully exploited the opportunity to analyse the real value of its gas transit tariff. Until recently, Ukraine was extensively bartering its gas transit services, receiving gas from Russia as payment for transit. In other Central European countries (Poland and Hungary, for instance), transit tariffs for Gazprom exceed US\$ 2.4 per tcm per 100 km. At the same time, the new gas agreement between Russia and Ukraine increased the transit tariff from just US\$ 1.09 to US\$ 1.6 per tcm per 100 km. Moreover, until 2009 this increase will be counted as compensation for Ukraine's debt of US\$1.2 billion to Russia for the supplied gas. The Government of Ukraine should initiate in-depth research on this issue.

Financing Energy Sector Transformation: Use of New Economic Instruments.

Domestic and international private sector and financial institutions, as well as energy consumers, provided with the appropriate business environment and incentive framework, can contribute to the financing of the transformation of Ukraine's energy sector. International financial mechanisms are also available to supplement the financing and expertise available from more conventional sources. The Global Environmental Facility (GEF) is designed to promote the reform of energy markets. GEF-supported activities can include the development of policies, laws, and regulations to stimulate energy efficiency and supplies of renewable energy. For example, a project is currently being developed with the support of UNDP that would assist the Government in developing policies and mechanisms to promote private investment in wind power. Development of energy standards and labels for appliances and buildings could also be supported.

The Kyoto Protocol mechanisms, such as Joint Implementation (JI) and Emissions Trading (ET), could become very significant sources of finance for promoting energy efficiency and renewable energy in Ukraine. The prompt completion of the necessary legal, regulatory, and institutional framework to allow the country to begin participating in these mechanisms is crucial to mobilize potential financial resources.

Policy Recommendations

- Revise and improve the National Energy Strategy to include more specific plans and measures, particularly on customer-level incentives and increased competition among suppliers. The strategy should also provide for better policy formulation framework.
- Replace the existing fragmented institutional framework for energy policy with a permanent inter-agency arrangement involving key stakeholders.
- Continue the adjustment of domestic tariffs towards cost-recovery levels and strengthen payment discipline.
- Develop comprehensive measures to mitigate the impact of higher energy prices. This will help to ensure macroeconomic stability when energy prices rise sharply and also soften the impact on households in which utility and housing costs exceed 15 per cent of income. The existing programme that provides utility subsidies to low-income

households should be improved to provide better targeted support and stimulate energy savings.

- Explore the possibility of reviving parts of the coal-mining sector and of increasing domestic gas extraction to make Ukraine less dependent on imported gas, and adopt long-term plans on exploitation of these energy sources.
- Make existing alternative and renewable energy programmes fully operational.
- Establish the transparency of gas import agreements; switch to open bilateral arrangements without unnecessary intermediaries. Make steps to move to long-term supply agreements with provisions for price adjustments to account for changes in international prices. Use existing international platforms, such as the UNECE Gas Centre and the Working Party on Gas, to minimize barriers to cross-border trade and reach trade agreements.
- Introduce incentives, including those of a fiscal nature, for energy-efficiency investments, particularly by enforcing energy efficiency standards and labels for energy conversion, industrial equipment, systems and processes, household appliances, and buildings.
- Provide capacity building for industries, service providers, and financial institutions to prepare, appraise, and implement energy efficiency measures. Explore new economic instruments, including the GEF and Kyoto Protocol mechanisms.

CHAPTER 3. DEVELOPING A FAVORABLE BUSINESS ENVIRONMENT AND IMPROVING THE INVESTMENT CLIMATE

To meet its aspirations to build a powerful economy and a prosperous European state, Ukraine needs to achieve trend economic growth rates above the world average and significantly higher than the average of the European Union (EU). However, Ukraine now faces a new challenge as the easy sources of growth – the rebound from the post-Soviet transitional recession and temporarily favorable terms of trade for smokestack industries such as steel – are exhausted (see Chapter 2). As these impulses fade, the importance of creating a favorable business and investment environment grows.

To ensure a steady and sustainable rise in prosperity, it is vital that Ukraine create an exemplary regulatory environment designed to promote business activity that creates jobs, spurs investment, fuels trade, and drives innovation. Despite considerable improvement in the country's regulatory regime in recent years, Ukraine ranks just 128th of 175 countries in the World Bank's *Doing Business 2007* report. What is required now is a **radical overhaul of the regulatory environment**, along with marked improvement in the efficiency and ethics of the civil service (see Chapter 1).

This chapter addresses a number of key areas of reform that together can generate the improvements that are needed to achieve sustained economic growth and wealth creation. The first section deals with the issue of securing property rights, as the political debates of the past year have unwittingly called into question ownership rights across the economy and contributed to the marked slowdown in growth that was witnessed in 2005. Secure property rights are also vital for agricultural land, in order to unleash Ukraine's immense agricultural potential. The chapter also emphasizes the need to reduce the large number of regulations, one of the main obstacles to doing business in Ukraine.

Notable successes have been achieved in creating a competitive market economy and establishing an anti-monopoly watchdog. Based on these achievements, the chapter outlines further policy steps that can promote competition in Ukraine's still monopolized economy. Without progress here, Ukraine runs the risk of forgoing the invaluable market pressures that can drive efficiency gains in the economy. Finally, the chapter suggests ways in which Ukraine can develop its financial sector to fund economic expansion by delivering a full range of financial services with a minimum of risk.

If the bulk of the measures proposed here and in the previous chapter are implemented, Ukraine has a strong chance of moving up the ladder of international comparisons. Indeed, the Government should treat this as one of the benchmarks of success. This achievement is by no means unprecedented in this region: Georgia is this year ranked by the World Bank as the world's top business reformer, having jumped in a single year from 112th in the world to 37th on the strength of reforms to the business environment very similar to those proposed in this report. No doubt such improvements in Ukraine would have a very favorable impact on economic growth in the years to come.

3.1 SECURING PROPERTY RIGHTS

Sanctity of Private Property

Re-privatization initiatives announced by the authorities at the beginning of 2005 aggravated the problem of property rights guarantees for entrepreneurs and caused uncertainty among foreign investors as to the Government's intentions. Calls for re-privatization of as many as 3,000 enterprises resounded with a public that had been outraged at past violations of the

law and injustices in the sale of state assets. However, the re-privatization campaign faced strong criticism from those in the business community and the political sphere who worried that it would unduly compromise property rights. Questioning privatizations enacted legally, even if unjustly or unfairly, threatened to undermine economic stability and spread uncertainty among investors.

President Yushchenko attempted to scale back the re-privatization campaign, beginning with a statement in late April 2005, when he first called for moderation. In July 2005 the President, the Prime Minister, and the Speaker of the *Verkhovna Rada* adopted a Memorandum on Guarantees of Property Rights and Securing Their Lawful Exercising, which was followed by a Presidential Decree on Measures to Establish Guarantees and Increase Effectiveness of Protection of Property Rights in Ukraine (of 24 November 2005). These proclamations aimed to reassure property owners and investors.

Other initiatives to resolve the situation included attempts to limit re-privatization administratively by compiling a list of 25-40 objects that could be re-privatized. This stimulated discussion in the media as to the possible candidates and made the atmosphere surrounding re-privatization even more strained. Attempts to draw up such a list were eventually abandoned, but the re-privatization issue was never explicitly or conclusively resolved, encouraging a damaging perception that the sanctity of property rights in Ukraine was not fully respected.

Continuing Privatization

The focus on re-privatization in 2005 also adversely affected the program of large-scale privatization as a whole. By the end of June 2005 privatization revenues were less than UAH 700 million, just 10 per cent of the government's original target for revenues for the year. The government did approve accelerated privatization plans to sell 284 entities during the year. However, due to apparent court prohibitions to sell assets of some firms, judicial inquiries, and assets handed to statutory funds of joint ventures in other companies, this plan proved to be unrealistic. A review of the privatization list by the new Government headed by Yuriy Yekhanurov contributed to a further delay in developing plans to prepare firms for privatization.

With the important exception of the re-sale of Kryvorizhstal in October that year, no other important enterprise was sold in 2005. Excluding the receipts from Kryvorizhstal, the state budget earned less than UAH 1 billion from privatization, compared with more than UAH 2 billion in 2003 and UAH 9.2 billion in 2004 (including UAH 4.2 billion from the proceeds of the initial sale of Kryvorizhstal).

In 2006 the government again decided to revive the privatization of major assets. In December 2005 the cabinet approved a resolution that listed a number of firms to be prepared for privatization and sale in 2006. The list now includes 36 strategic companies, but none of the most lucrative ones (such as Ukrtelecom, Turboatom and the Odessa port-side plant). Revenues for the entire year are planned at UAH 2.1 billion - the same volume as privatization earnings in 2003.¹⁷ However, by the end of June 2006, privatization had yielded a mere UAH 160 million, 7.6 per cent of the target. The privatization target in 2006 looks likely to be missed by a wide margin.

There was, however, one exemplary and very successful privatization completed in Ukraine in 2005. The sale of Kryvorizhstal in October was unprecedented in that it was well prepared and transparent. The world's largest steel producer, Mittal Steel, won a televised auction with an offer of US\$ 4.8 billion (UAH 24 billion). The purchase price almost doubled the market price of Kryvorizhstal shares traded on the domestic stock exchange. The proceeds from this deal exceeded the total sum of revenues from all previous privatizations in Ukraine. The sale

¹⁷ Law of Ukraine on the State Budget of Ukraine in 2006, no. 3235-IV of 20 December 2005.

also served as a clear illustration to the public of how transparent and honest privatization procedures can provide a fair and realistic assessment of asset values. It should serve as a model for future privatizations.

The new Government will face many challenges in continuing privatization in Ukraine. The state still owns significant stakes in many large industrial complexes, along with the related infrastructure. Any future approach to privatization will need to take account of many previous mistakes.

- For sectors in which enterprises enjoy a legally defined monopoly position, regulatory frameworks and reliable and efficient regulatory institutions need to be fully developed prior to the privatization of these enterprises.
- Companies that operate in all other sectors, with the possible exception of strategic *"kazenni"* enterprises, must be transparently privatized. In addition to raising significant revenues, this approach will address the issue of corporate governance of the state share in these companies. State shareholding generates frequent allegations of corruption in current conditions and also leads to unequal competitive conditions for companies that operate in Ukraine. If privatization is carried out in a proper, transparent way, it will not only generate revenues, but will also contribute to making Ukrainian assets more attractive to international investors. Judging from international experience and particularly that of Ukraine's Central European neighbors such as Poland and Hungary, this will generate significant improvements in corporate governance, lower levels of corruption, and very large improvements in energy consumption, thus decreasing the very heavy dependence of the Ukrainian economy on energy (see Chapter 2).
- Excessively short terms for tenders (compared to those legally required) and violations of both tender transparency and transparency of pre-privatization preparation strategies must be discontinued.

Creating a Market in Agricultural Land

Full and well guaranteed property rights provide owners with the right to make transactions with their property (mortgaging, selling, etc.). International experience suggests that economic growth and poverty reduction are best served when efficient producers and investors have free access to productive assets. The issue of agricultural land as property in Ukraine, therefore, must be fully addressed.

An estimated 5.9 million of the 6.8 million Ukrainian farmers entitled to participate in the privatization of agricultural land have so far received their land titles. Yet a moratorium on land sales remains in force, and is set to be extended until 1 January 2008, in line with the recent Anti-Crisis Coalition Agreement and the Universal of National Unity. The original deadline was set for end-2004 and has already been extended once.

The delay in permitting the free sale of land has a range of negative consequences. The redistribution of land assets in favor of more efficient forms of farming remains restricted; the introduction of mortgages, which could become a source to attract long-term funds to finance new technologies and innovations, is prevented; and land owners are limited in exercising their lawful right to dispose freely of their property.

The Ukrainian Institute of Agrarian Economics estimates the total value of Ukraine's agricultural land at US\$ 50 billion. The lack of an agricultural land market makes it impossible to verify this tally, but it is telling that this figure is nearly 17 times the \$3 billion estimated to have been invested into primary farming in Ukraine in 2001-06.

Those in favor of the moratorium argue that farmers are not yet ready to dispose of their land plots, do not know their value and thus will sell them well below their market value, and that the legal framework that could prevent such distortions is still missing. Although much of this is true, some essential draft laws, such as on the Land Market, have been pending in the Parliament for a number of years.

More importantly, the moratorium is not fully observed, leading to the very abuses it was designed to prevent. According to the State Land Committee, by 2006 some 95,000 agreements on land gifts had been concluded and notarized, 2,500 individuals had exchanged their land shares for other assets, and over 13,000 individuals had sold their land. Many cases of entering into unreasonably long land lease agreements had also been observed. Such open defiance of the moratorium illustrates the impracticality of restraining the development of market-based land relations. Further delays in lifting the moratorium will merely result in the growth of a huge shadow land market that will not be beneficial to original landowners - the farmers who work on these plots.

Early termination of the moratorium, together with the adoption of appropriate and long-awaited laws on the Ukrainian land market, will produce many positive results. First, more efficient owners will rely less on the national budget for subsidies. Second, the introduction of agricultural land mortgages will work to reduce interest rates and make lending more accessible for small and medium-sized farms. Third, villagers who prefer to undertake non-agricultural business in rural areas will be able to sell or collateralize their land, thereby obtaining start-up capital for other ventures.

Securing Property Rights for Shareholders

In the years since independence Ukraine, like most other former Soviet countries, has witnessed its share of fraud and extortion of private assets by unscrupulous private entities or individuals. This relates to both real estate property and shares in companies. Such "transactions" flourished owing to unreliable property registry systems, poor corporate governance regulations, and weak bankruptcy legislation, all of which corrupt state officials and judges could exploit. The lack of reliable property protection mechanisms continues to discourage both domestic and foreign investment, and greatly limits the benefits that the stock market could provide to the productive sector.

Recommendations

- The Ukrainian state must guarantee the sanctity of private property. The authorities should bring re-privatization to a legal close. An amnesty should apply to potential violations of privatization legislation under agreements concluded before an agreed cut-off point. This amnesty should not apply to criminal offenses or to failures to observe the terms of privatization agreements, in particular those relating to investment commitments.
- The Government should take a political decision to privatize most companies that operate in the sectors legally defined as natural monopolies. The privatization process should take account of the maturity of governmental regulatory systems in these sectors.
- In all other enterprises where the state retains an interest, aside from natural monopolies and strategic "*kazenni*" enterprises, it is important that the Government take a political decision fully to privatize state assets. Proceeds from such privatizations should be used by the state budget to finance investments.
- The Government should take necessary actions to ensure that privatization of both state and municipally owned enterprises always include the sale of the land parcels they occupy.

- All privatization transactions must be conducted transparently and be subject to both state and public oversight. All allegations of abuses must be fully and transparently investigated. If violations are found, the perpetrators must be prosecuted.
- The Government and the Parliament should urgently review drafts of the enabling laws for land sales (some of which have already passed a first reading in the Parliament), approve this legislation, and lift the moratorium for agricultural land sales as soon as possible.
- The draft law on joint-stock companies, which has been registered in the *Verkhovna Rada* since March 2003, must be adopted. Adopting this law is crucial to ensure that the rights of owners, especially minority shareholders, are protected and regulated.
- The Economic Code must be annulled, as recommended in the two earlier the Blue Ribbon Commission reports. This Code conflicts with the Civil Code, thus providing considerable scope for conflicting interpretations and excessive discretion by both regulatory agencies and the judiciary. The Civil Code, with some necessary amendments, should replace the Economic Code.

3.2 REGULATORY REFORM: LOWERING BARRIERS TO DOING BUSINESS

Regulatory Reform in 1998-2004: Lessons Learned

Significant attempts to reduce administrative barriers for businesses operating in Ukraine started in 1998. Among the initiatives developed and implemented by 2004 were: the reform of the licensing system; implementation of a simplified taxation system for small companies and sole proprietors; and initial reform efforts to simplify the system of registration of businesses, inspections and reform of technical regulations. In addition to these targeted reforms, in 2000 and 2001 the Cabinet of Ministers undertook significant efforts to streamline its decision-making process, to make it more transparent and predictable. Some new mechanisms proposed during this time, and later codified in the Law on the Principles of Regulatory Policy, were innovative not only for Ukraine, but for the broader international community. Among such initiatives were the introduction of an obligatory regulatory impact analysis (RIA) for new regulations, with specific cost-benefit based methodologies and the usage of measurable regulatory indicators with a system of obligatory benchmarking and monitoring.

These efforts contributed to significant expansion in small and medium-sized enterprises (SMEs) between 1999 and 2004, which in turn boosted the growth of the Ukrainian economy. However, most of these efforts were not institutionally sustainable, particularly because implementation and enforcement was far from uniform. This has been apparent in the continuing practice of selective enforcement and in the significant shifts in policy effectiveness depending on the specific individuals in charge.

Selective enforcement of regulatory regimes has long been a factor in Ukraine and became even more haphazard in the run-up to the 2004 presidential elections. The forces supporting regulatory reform have long underestimated the degree to which state officials can preserve their control over economic processes. Such hands-on management has effectively short-circuited policy proposals and reform initiatives from the private sector, think-tanks, NGOs, and foreign experts, as well as from some mid-level public servants and local self-governments. This disconnect explains how Ukraine's relatively progressive regulatory regime could so easily fall victim to such debilitating backsliding.

Analysis of Initiatives Implemented in 2005-06

From 2005 to date, progress in creating a favorable business environment has been mixed. On the positive side, the executive branch of government has withdrawn considerably from the real sector, enabling businesses to develop and grow. Businesses have become much less dependent on the political situation and on the specific individuals in charge of various state agencies.

However, the Government failed to capitalize on the opportunities that emerged at the beginning of 2005. These failures included clear missteps, as in the attempt to liquidate the simplified taxation system for SMEs at the beginning of 2005, and excessive reliance on ineffective yet highly publicized policies such as “guillotine” deregulation that were enacted mostly for show. The Government also failed to capitalize on the lessons learned in 2001-02 on the institutionalization of regulatory reform in Ukraine.

In June 2006, the President, a strong advocate of economic liberalization, issued Decree no. 901 “On Some Measures on Implementation of State Regulatory Policy.” This decree established a regulatory “guillotine” with provisions to review secondary legislation at all levels of government to assess which regulations should be cancelled or amended. By the end of 2005 a total of 9,340 regulatory acts had been reviewed; of these, 4,940 acts affecting economic activity had been cancelled. As in the case of a similar deregulatory exercise undertaken in 1998-2000, success was measured by the number of regulations cancelled, rather than by the potential for improvement in the business environment. In addition, the latest review only applied to bylaws, whereas previous experience had shown that if laws specified regulation, new bylaws would instantly replace those that had been the subject of deregulation.

The Government also faced setbacks in its efforts to create one-stop-shops for business registration, customs clearance, and permits. In initiating this extremely progressive idea, it failed to envisage the complexity of the required regulatory and legislative changes, ranging from full-fledged laws down to the level of rules of procedures and standards. It also failed to address the issue of the complex relations between different government agencies, resulting mostly from administrative rent seeking. Results were therefore mixed. True one-stop-shops were not created, although some procedures were simplified.

The Government also undertook to address the problem of business permits through the adoption of the Law on the Business Permit System (no. 2806-IV of 6 September 2005), which took effect in January 2006. Complicated and inefficient procedures for granting permits for starting and operating a business have always been a major impediment to private sector development in Ukraine. They were also the prime reason that the World Bank’s *Doing Business in 2006* report ranked Ukraine only 124th among 155 countries. In addition to their regulatory function, permits at the local level are frequently used as fiscal instruments and parts of the levy collection system.

The Law on the Business Permit System, however, is framework legislation that requires a number of steps to be completed for overall implementation. These include amendments to other laws, the adoption and enforcement of adequate secondary legislation to cancel permits that are no longer legal, development of new procedures for issuing permissions, and new tariff rates for the provision of state expertise. To date, these steps have not been taken. The permit law also creates requirements that are unnecessary and overlap with requirements of the Law on Licenses. This mainly relates to the introduction of a list of activities that must be reported to government agencies if businesses engage in them. This second tier of so-called declaratory types of activities to be regulated by law is unnecessary. This tier serves no other purpose than to meet the information-collecting function of government.

On the positive side (and unrelated to the Law on the Business Permit System), at the beginning of 2006, the Ministry of Construction and Communal Services started work to streamline completely the construction, land use, and occupancy permit system. This initiative has not yet resulted in draft legislation, but has enormous potential to resolve one of the most complex and difficult issues for business regulatory regimes. It can also serve as example to the new Government of a thorough and transparent reform measure.

Enforcement of the Law on the Principles of Regulatory Policy

The implementation of state regulatory policy, as envisaged by the Law on the Principles of Regulatory Policy, has been hindered by the weak institutional capacity of the state administration and the outright unwillingness of officials to implement this law. As a result, the impact analysis of regulatory measures has turned into a bureaucratic exercise. Similarly, the procedural requirement that a draft of every regulatory act must be submitted to the State Committee on Regulatory Policy and Entrepreneurship (the agency currently designated to enforce regulatory policy) for its approval has also become a mere bureaucratic formality. This situation is further aggravated by confusion over the functions and future of the Cabinet Committees.

Most observers agree that Ukraine has high-quality technical expertise to draw on in reforming the business environment. This expertise, moreover, is present at the national as well as at the local level and especially in the State Committee on Regulatory Policy and Entrepreneurship. The State Committee is subordinated to the Government and enjoys the same status as other government structures, rather than that of an independent regulatory institution, leading some observers to focus on what they see as the State Committee's weakness as a cause of uneven progress in regulatory reform.

However, the status of the State Committee is not the real problem. In most countries, such institutions have the power only to issue recommendations, and it is the Government's responsibility, and eventually a matter of its accountability before the public, as to how these recommendations are treated. What has been lacking in Ukraine is strong political will to pursue de-regulation. Only such political will and leadership can ensure that legislative measures are fully implemented and provide sufficient motivation for public servants to undertake new measures to improve the business environment.

Recommendations

- Administrative procedures for the regulatory process stipulated in the Law on the Principles of Regulatory Policy must be fully implemented. The Government should amend the rules of procedure for the Cabinet of Ministers and all government agencies to enable full implementation and enforcement of this law.
- The Law on Business Registration must be reviewed for the purpose of establishing registration by declaration and replacement of numerous national databases with just one. This review must follow annulment of the Economic Code and consolidation of all social protection funds into one. These measures should be followed by reform of reporting requirements for businesses aimed at their simplification. This reform can save significant public resources in administering various social protection funds, and will also simplify registration procedures and reporting.
- A Tax Code should be adopted. It should codify a simplified taxation system for SMEs; eliminate the practice by the State Tax Administration of sending explanatory letters that reinterpret laws; consolidate the process of making tax payments and reporting and ensure that the frequency of the process is considerably reduced; ensure that tax penalties correspond to the severity of the violation, and completely eliminate

penalties for unintentional mistakes. It is critical that the Parliament does not change the tax regime through the annual budgetary process.

- The Parliament should assume the function of parliamentary oversight over enforcement of regulatory policy.
- The Government should continue far-reaching reforms in the area of permits for construction and occupancy that have been initiated by the Ministry of Construction and Communal Services.
- The Government should undertake monitoring of the impact of the Law on the Business Permit System. This should be used to help establish an effective enforcement system, and identify agencies that fail to bring their regulations into conformity with the law.
- It is critical to continue impartial monitoring of the business environment through assessing measurable, survey-based indicators, as was done in the World Bank's *Cost of Doing Business* surveys in 2002 and 2004.

3.3 PROMOTING COMPETITION

Institutional Background

Local markets in Ukraine remain highly monopolized. In December 2004 it was estimated that there were 548 national commodity markets where business consortia held a monopoly (dominant) position, with 368 monopoly structures acting in them. The corresponding figures for regional commodity markets were 6,400 and 4,358, respectively. In 2005 the instances of companies being found to have abused their monopoly position increased by 10 per cent compared with the previous year. However, market concentration is on the decline in most markets. In industries judged to enjoy full-fledged competition, such as food processing, woodworking, and light industry, recent growth rates have been 1.2-2 times the average for industry as a whole. Such competitive trends are likely to embrace many other goods and services, especially after Ukraine joins the WTO.

There are number of important exceptions from truly competitive practices in Ukraine. These relate to companies that operate in the sectors that are legally defined as natural monopolies; state or communally owned companies that enjoy favoritism by the authorities; large companies whose economic viability is in question, but are supported by the state to avoid high rates of local unemployment; and other cases where, either because of the ownership structure or price fixing, competition is not evident.

The Government continues to engage in the practice of supporting large failing companies on the grounds that either domestic manufacturers or employees need protection. Plans to make bankruptcy procedures more effective have not been implemented, as much of the needed legislation was not prepared and one of the relevant laws was voted down during hearings on privatization in the *Verkhovna Rada* in December 2005.

The first Blue Ribbon Commission report recommended extending the sphere of responsibility of the Anti-Monopoly Committee (AMC). This recommendation has been partially implemented. The AMC obtained new powers over state procurement, following amendments to the Law on the Purchase of Goods, Works, and Services with State Funds (Law no. 3205, of 15 December 2005). The AMC also received the powers of a specially authorized central agency of executive power to promote economic competition. This created some ambiguity in the status of the AMC. Designating the AMC as a central agency of executive power could be interpreted as an attempt to reduce the AMC's independence and increase its accountability to the executive branch of government.

Limiting Uncompetitive Practices

The AMC implemented the recommendations of the first Blue Ribbon Commission report regarding monitoring the activity of government agencies and local self-government bodies. The AMC issued numerous binding recommendations for state and local government bodies to follow and these received widespread publicity. The success of this approach was reflected in a record number of requests on competition policy to the AMC – nearly 6,000 such requests were made in 2005 – although this upsurge probably also reflects the population's greater willingness to make demands on the authorities in the wake of the Orange Revolution.

There were, however, no changes regarding the powers of the AMC to apply sanctions against government institutions that ignored its binding recommendations (as recommended in the first Blue Ribbon Commission Report). There was also no change in the AMC's monitoring of state aid, owing to the absence of the necessary legislation (the draft law has not yet been approved by the *Verkhovna Rada*).

The AMC, unfortunately, was not fully successful in restraining the anti-competitive practices of large or politically influential enterprises. The AMC's decision in February 2006 to impose heavy fines on some sugar trading companies (following a sugar market price conspiracy in the summer of 2005) was unconvincing owing to the length of time between the violation and the punishment and because the seven companies that were fined had less than a 30 per cent share of the domestic market. This case illustrates the need for the AMC to become truly politically impartial and strengthen its capacity to undertake economic analysis.

Regulating Monopolies

The Government's largest failure in safeguarding competition was in the area of communal (municipal) services. These services are regulated through tariffs, but tariff-setting policies continue to be mainly politically driven and do not reflect the real costs of providing services. Low tariffs undercut the opportunities for private unsubsidized operators to provide services. In addition, local self-government bodies often discriminate against private enterprises to the benefit of communally owned companies, with the aim of pushing private firms out of the market. Communally owned companies frequently operate in a non-transparent manner and are usually unprofitable and inefficient.

In 2006, however, the government plans to establish a legislative base for streamlining regulations in the field of communal services and utilities and to implement pilot projects in four regions, as well as in the city of Kyiv. These pilot projects will involve the provision of communal services on the basis of concessions granted to enterprises.

In the case of bankruptcy procedures for natural monopolies, where it is impossible to stop providing services due to the absence of alternative suppliers, appropriate improvements must be made to strengthen management and restructure enterprises (if necessary) as well as to implement measures to reduce payment arrears to providers of these services.

Some positive developments took place in the area of transportation. Firstly, the Ministry of Transportations and Telecommunications disengaged from administrative functions in *Ukrzaliznytsya* (Ukrainian Railways). Secondly, the Ministry declared its intention to eliminate the non-transparent ways in which railway tariffs were formed. This could include legal amendments to create an independent regulator. Finally, the AMC identified and halted some abuses by *Ukrzaliznytsya* of its monopoly position.

The adoption of the Law on Motorways (no.2862-IV, of 8 September 2005) established conditions that are expected to attract additional investment as well as promote greater competition between state, public, and private enterprises in the development and operation of the road transport network.

In telecommunications, the National Committee on the Regulation of Communications (NKRZ), which was formed in 2004, began active operations. Membership of this committee was brought into conformity with the Law on Telecommunications in early 2005 by ensuring that Committee members did not have commercial interests in this field.

An agency to carry out state inspection of the telecommunications market, the usage of radio frequencies, and the postal service, was created within the NKRZ.¹⁸ There was progress in tariff policy: tariffs for postal services were reformed and extended opportunities for civil use of the radio frequency spectrum were provided, which will have a positive effect on competition in the industry. In reaction to recommendations from the AMC, the committee also undertook to develop methods of tariff formation for universal telecommunications and for postal services, based on transparent mechanisms of price formation. However, it is important to stress that the NKRZ is not yet sufficiently independent from the government, a shortcoming that undermines the chances of achieving regulatory objectives in the telecommunications market.

Limiting Price Controls in Competitive Markets

Unfortunately, in addition to the existence of monopoly markets, the Ukrainian government and some local self-government bodies continue to engage in price regulation. The highest-profile case was the Government's aggressive interference in the markets for oil and sugar in the spring of 2005.

Since then there have been a number of improvements in price formation and in the monitoring of markets. During 2005-06, the AMC continuously monitored eight commodity markets (bread and bakery, flour and sugar, the retail and wholesale markets for oil, cable television services, freight transport, and some fertilizers). Some of these markets were chosen because of their social importance, but other cases stemmed from ongoing AMC anti-monopoly proceedings dating from previous years. To forestall future price crises, the Government took a decision to create information and analytical systems to monitor national and regional oil markets, but the system has yet to be implemented.

Price formation policy had a marked impact in 2005 on the agricultural sector, where certain prices rose sharply, mainly because of adverse weather. However, the situation was aggravated by the Government's inconsistent price policies, the impact of governmental restrictions, and the anti-competitive behavior of some market intermediaries. The last factor can be dealt with by developing a system of commodity exchanges. One step in this direction are the decrees of the Cabinet of Ministers on the establishment of the Agricultural Fund, a specialized budget institution that is under the administration of the Ministry of Agricultural Policy, and is authorized to implement price policy for agro-industries. A decree on the Agricultural Exchange (no. 1285 of 26 December 2005) is intended to facilitate price formation in agricultural markets.

The capacity adequately to monitor market trends is still lacking, as current legislation does not provide for this. The identification of price collusion by suppliers of goods and services will require substantial additional resources (especially for the analysis of regional markets). The Law on Prices and Price Formation needs to be amended and supplemented to conform with the principles of economic liberalism. However, some drafts (for example that of the Ministry of Economy of October 2005) are accompanied by too shallow an analysis of the expected regulatory impact of the measures proposed. These steps should be accompanied by the abolition of the Economic Code with its definition of prices (especially in Article 189) and replacing it with a substantially revised Civil Code that would more accurately define the role of prices in a market economy.

¹⁸ Decision of the Council of Ministers, no. 844 of 31 August 2005.

Subsidies and Aid

In addition to price regulation, the Government provides aid and subsidies to some companies. This is especially pronounced in the agricultural sector. The issue of agricultural subsidies has already been the subject of tense negotiations on Ukraine's entry into the WTO. The volume of such aid in Ukraine is significant (about US\$ 1.1 billion in cash and US\$ 0.65 billion in terms of tax exemptions). This aid is not always channeled to promote efficiency and innovations in the farming sector. The aid is fragmented among too many programs and too widely dispersed, and therefore difficult to administer. Moreover, tax exemptions are often absorbed by agricultural intermediaries rather than by agricultural producers (especially in the milk and dairy product markets).

Further development of agricultural production depends on increasing agricultural exports and therefore on greater international trade integration. Ukraine thus needs to take into account long-run trends in state support for agriculture in the world's leading economies, where a substantial reduction in subsidies is expected. Considering that most of Ukrainian agriculture is competitive on world markets, a shift from "amber box" subsidies (the volume of which is limited by WTO rules) to "green box" support (subsidizing agricultural innovations, land conservation, etc.) will be to Ukraine's advantage.

The first Blue Ribbon Commission Report recommended the creation of an appropriate regulatory base for providing state aid by improving and adopting a Law on State Aid. This recommendation was not implemented, however, as the law received little support in the *Verkhovna Rada*. The one positive aspect was that the concept of counter-competitive state aid was incorporated into the draft. Further discussions on the draft law will need to take account of the WTO treaties on government subsidies as well as EU legislation on government support to the enterprise sector.

State Procurement

In December 2005 the *Verkhovna Rada* approved amendments to the Law on the Procurement of Goods, Works, and Services for Public Funds, and on 21 February 2006 it overrode the President's veto of this law. In March the President signed the version of the law approved by the *Verkhovna Rada*. At first glance, the signed version of the law offers better conditions for ensuring protection of economic competition as it gives large powers in this area to the AMC. However, the law entrusts the AMC with the function of coordinating public procurement. This delegation is unwise, given that the AMC, as a non-government body, may oversee the observance of competition rules by government agencies in procurement coordination, but should not be involved directly in any such coordination. Such delegation of powers is inconsistent with international practice.

Although progress in many areas of competition policy has been only modest, policy is moving in the right direction. First, awareness of the importance of promoting competition in the economy has grown as a result of a stronger civil society and greater media exposure of the AMC's actions. Second, the AMC has also developed and expanded its powers, especially in promoting competition. Finally, decisions by both the EU and the US to recognize Ukraine as a market economy are important steps in fostering competitive behavior since they set certain standards for the conduct of economic operations that should be maintained.

Recommendations

- Preparation and approval of a law to provide a suitable regulatory foundation for state aid is necessary (as recommended by the first Blue Ribbon Commission Report). This will almost certainly be a precondition for Ukraine to complete WTO accession, but will also become inevitable over time, as the economy faces growing competitive

pressures through expanded external trade in goods and services, especially with the EU countries.

- Progress is needed in resolving the problem of cross-subsidization of utility tariffs. Cross-subsidization among most utility services remains extensive, adding to cost pressures on industry while ensuring that most residential consumers do not pay the full costs of the services they receive. Further progress in establishing the independence of regulatory bodies in many of these sectors in order to ensure regular and transparent tariff-setting remains an important goal for public policy.
- Although the AMC may have become more independent from the executive branch of government, the recent granting of executive powers of coordination of public procurement to the AMC should be revised.
- Action to strengthen the effectiveness of bankruptcy procedures would assist the AMC in tackling cases of anti-competitive behavior by large enterprises. To achieve this, as noted already in the first report of the Blue Ribbon Commission, the Moratorium on the Compulsory Sale of Assets (of 19 November 2001), which prohibits the recovery of debts through bankruptcy of enterprises in which the state owns at least 25 per cent, must be terminated.
- The Government should halt the practice of price regulation in competitive markets. Specific penalties should be imposed for violations by regional administrations and local self-governments. Penalties should also apply to regional limitations placed on the free movement of goods and services.

3.4 DEVELOPING FINANCIAL MARKETS AND IMPROVING ACCESS TO CAPITAL

Ukraine's financial sector has experienced profound and fundamentally positive change over the last few years. After several years of strong credit growth and growing participation by foreign banks, it is now well positioned to serve the needs of the economy and the population with a wider range of products and services, as well as to take on a more significant international role, especially within the CIS region.

However, in order to realize this potential, there is a strong need to further strengthen prudential oversight by the main financial regulators. If the development of the regulatory framework fails to keep pace with the growth of the sector itself, risks can accumulate over time. As international experience shows, problems in the financial sector can cause considerable dislocation and even economic contraction. Therefore, in view of the opportunities for further development of the financial sector but also the risks, we urge the government to strengthen the sector's regulatory standards.

In 2005 the government incorporated into its program many of the Blue Ribbon Commission's recommendations for financial sector development. However, legislative changes have not been introduced systematically, so parts of the regulatory framework remain vulnerable. Furthermore, the lack of progress more generally in adopting legislation to guide and improve corporate governance in the corporate sector (see also Chapter 3.1) has presented problems for the financial sector as well. Moreover, a more systemic approach to the risks involved in the financial sector dictates the need for much more transparent ownership structures of financial institutions. It also requires strict regulation and oversight of connected lending – loans to clients that are linked to the lender by ownership – and cross ownership between banks and other financial institutions, particularly insurance companies.

The new Government has the opportunity now to address swiftly these regulatory shortcomings and create a sound regulatory structure that would promote the further development of the financial sector while minimizing risks. If it does that, a much safer and productive financial sector will emerge during the current electoral cycle. The sector would also be in a position to participate confidently on the international capital markets and penetrate many CIS countries' markets, in much the same way that Kazakhstan's banks have already done. Ukraine's size makes this development all the more exciting.

Development of the Banking Sector

Sound regulation of the banking sector in Ukraine, supported by recognized standards of corporate governance, is a critically important determinant of financial stability. Strong management and respect for stakeholders' rights will engender the trust of depositors and strengthen the financial sector. Implementation of best practice standards depends directly on the attitudes and intentions of bankers and regulators. Ukrainian legislation and regulatory requirements should clarify the rules for all market players. In particular, in the light of the new Basel II Accord and new capital adequacy requirements, revisions to the Law on Banks and Banking Activities are urgently needed. The new Basel II Accord encourages good corporate governance in banks and puts greater emphasis on market discipline. The market discipline mechanism in Ukraine is not as effective as in more advanced economies, mainly because bank shares are rarely publicly traded. Legislation must compensate for this situation. The opportunity should also be taken to align the banking law more closely with the respective directives of the European Union, which would make Ukraine's "European Choice" more credible.

The domestic market for traditional bank deposit and credit services is competitive and generally efficient. Regulatory policy in banking aims mainly to foster bank concentration by applying higher capital requirements and to promote the expansion of banking operations through the unification of liquidity requirements and reduction of required reserves. This approach aims to increase lending while maintaining acceptable levels of risk.

The market for specialized banking services has grown, especially for mortgage loans, factoring, leasing, and investment operations. The Laws on Mortgage Securities and on Credit History Formation and Circulation that were adopted in 2005, as well as accession to UNIDROIT¹⁹ conventions on international factoring and international financial leasing, have the potential to increase considerably the contribution that banking can make to Ukraine's development, as well as to diversify bank assets.

However, this progress has not been matched by adequate regulatory changes. Most importantly, bank ownership is still not transparent, and connected lending and "pocket banks" remain widespread and pose serious risk to the banking sector and thus to the whole economy. Moreover, legislation on the establishment of specialized banks, such as investment and mortgage banks, and on their reporting requirements is insufficient and poorly elaborated in the regulatory acts of the National Bank of Ukraine (NBU). This in turn constrains the development of specialized banking services because the lack of some basic normative regulations for many specialized services complicates the adequate assessment of the risks involved in dealing with specialized banks.

Unified banking services will increasingly become integral parts of the financial mechanism for implementing nationwide programs such as residential housing construction and the financing of higher education, thereby contributing to the social and economic development of Ukraine. However, at the moment the banking services in many specific fields, such as mortgage or education loans, are mainly provided by banking institutions on the basis of

¹⁹ I.e., the [International Institute for the Unification of Private Law](#).

their own schemes. This makes it difficult for the government to provide efficient support to consumers of these services.

Development of the Non-Bank Financial Sector

In 2005 new legislation on the non-bank financial sector included the adoption by the *Verkhovna Rada* of the Laws on Mortgage Securities and on Credit History Formation and Circulation, and related legislation on the activities of financial institutions in the securities market. This legislation laid the legal foundations for modern mortgage lending in Ukraine.

At the same time, certain improvements were introduced into the mechanisms stipulated by the Laws on Mortgages; on Mortgage Loans, Transactions in Consolidated Mortgage Debt, and Mortgage Certificates; and on Financial and Credit Mechanisms and Property Management during House Building and Real Estate Operations. However, property asset management as a professional activity in the financial services market is still unregulated, and the law on the management of certain types of assets has not yet been adopted.

Legislative restrictions on the financing of residential construction with the use of physical persons' funds, introduced at the end of 2005, were a positive factor. However, the law did not provide for a transition to new financing mechanisms, and thus the growth of stable sources of financing for residential construction may remain underdeveloped.

The Law on Securities and the Stock Exchange adopted in February 2006 holds the promise of marked improvement in the development of the securities market. The law is intended to help to modernize the foundations for the operations and institutional infrastructure of the securities market. In particular it aims to:

- Improve the range of financial services through the regulation of securities management as a new type of professional activity;
- Enhance the reliability of non-bank financial institutions that provide services in the securities market through much stricter requirements on their statutory capital assets;
- Systematize requirements for the regulation of the securities exchange market and stock exchanges; and
- Regulate the system for the public disclosure of information.

The State Stock Market and Securities Commission (SCSSM) is also developing regulatory documents that will set more rigid requirements for the securities exchange market and strengthen disclosure, as well as promote the unification of technical requirements applied to stock exchanges. These new rules will increase the liquidity and enhance the transparency of the stock market. They should also create the technical preconditions for the consolidation of stock exchanges into a single exchange system.

These positive trends, however, could be adversely affected by inadequate basic legislation on corporate governance. The absence of a law on joint-stock companies, which leaves minority shareholders unprotected, is especially important. In addition, the current national depository system provides no reliable guarantee of the right of securities ownership. The underdeveloped state of legislation on these issues greatly increases the risks for investors and thus interferes with issuers' attempts to attract capital from the real and financial sectors to the securities market.

There is no special legislation to regulate the issuance of and trading in derivative securities. These are now based on provisions of secondary legislation (especially tax laws), or on

regulatory acts of the Government and the SCSSM. The absence of a primary special law in this field seriously hinders the orderly development of futures markets in the commodity, currency, and stock exchanges. In addition, there has been no action to enact the laws on property asset management, pawn-broking, and factoring.

The complicated system of currency regulations related to investment activities by foreign investors, and capital exports by domestic investors, inhibits capital flows in the economy. Procedures for obtaining unlimited currency licenses for non-bank financial institutions need to be simplified. Current procedures tend to limit investing in pension funds, because funds face legal restrictions on their rights to invest in foreign assets.

With respect to the insurance sector, the State Committee for Financial Services (SCFS) needs to strengthen its supervisory operations by introducing requirements for diversification of the reserve placement of life insurance companies, given that the existing structure of these reserves reveals a high level of risk for most assets. Strengthening the supervisory framework requires new legislation.

In the field of general insurance, the level of payments to meet claims tends to be low compared with the insurance contributions received. Of particular concern is the divergence between insurance tariff rates and actual payouts for vehicle owners' obligatory civil liability insurance.

No progress has been made towards creating a legislative foundation for the introduction of a health insurance system. This in turn impedes the creation of a single financial mechanism for reform of the health sector (see Section 4.1).

Issues related to pension reform are dealt with in Section 4.3. Here we would only underline the point that private pension insurance has beneficial effects not only on citizens' sense of responsibility and independence, but also on the deepening of the capital markets, as pension funds need to invest in longer dated bonds and publicly traded equities. Ukraine would benefit considerably from faster growth of private pension funds, both mandatory and voluntary.

Strengthening Financial Market Regulatory Agencies

Two different models of financial regulatory agencies currently co-exist in Ukraine. The model typical for banking supervision is based on framework (generic) legislation, which gives considerable regulatory and supervisory powers to the regulator itself. For specialized regulators (the SCFS and the SCSSM), a different model is used, under which the competence of the regulatory agency is clearly specified in the provisions of the specialized legislation.

The development of financial market regulatory agencies has been mixed. Changes made in 2005 to the Law on State Regulation of the Securities Market and the adoption of the Law on Securities and the Stock Exchange helped to reinforce the independence and efficiency of the SCSSM. At the same time, however, the absence of a law on joint-stock companies and the failure to revise the law on the national depository system have made it very difficult for the SCSSM to work effectively in the sphere of pre-trial settlement of corporate conflicts. The SCSSM has also been affected by the lack of special legislation enabling it adequately to regulate professional activities related to the provision of certain financial services and stipulate specific regulatory measures for particular types of financial institutions (for example asset management).

Recommendations

- The newly constituted *Verkhovna Rada* should enact necessary changes to the Law on Banks and Banking Activities, which has languished in the Committee on Finance and Banking Activities for about two years. This remains important given that current

banking legislation does not sufficiently comply with the core principles of corporate governance.

- More specifically, the amendments to the present Law on Banks and Banking Activities should include strict and sound regulation of the disclosure of bank ownership and related-party lending to investors and the public at large; these regulations are presently missing.
- In conjunction with the need to approve a suitable law on joint-stock companies, because it is indispensable for reinforcing the institutional capabilities of all the main regulatory bodies, the *Verkhovna Rada* should approve amendments to the law on the national depository system.
- The NBU should strengthen the regulatory norms for banking operations in mortgage crediting, factoring and leasing as well as develop the regulatory base for more specialized banking institutions. This needs to be supported by the adoption of special laws on factoring; expanding the Civil Code norms to ensure they are in compliance with the UNIDROIT conventions; making amendments to the law on financial leasing; and adopting a law to permit the regulation of certain types of financial services, such as property asset management.
- The Cabinet of Ministers should decide on a system for the formation of registries containing information on credit case histories and the state agencies that would administer these. This should include consideration of mechanisms to encourage the Bureau of Credit Histories to collect and process data from these registries.
- Following the adoption of the Law on Securities and the Stock Exchange, and other related laws, the SCSSM should review some of its regulations, for example on mortgage securities, on protection of interest of investors, on listing procedures, and on the disclosure of insiders' information, to ensure that they are all in compliance with the stricter requirements of the more recently enacted laws.

CHAPTER 4. TOWARDS A BETTER SOCIAL POLICY

Progress in improving social welfare in Ukraine has been mixed in recent years. On the one hand, sustained growth since 2000, along with sweeping redistribution policies effected through the pension and social benefits system, have helped to reduce poverty. According to a new absolute poverty line defined by the World Bank and Ukrainian experts in 2005, the share of the population living in poverty fell from over 30 per cent in 2000 to under 19 per cent in 2003. Extreme deprivation – the share living below the minimum daily calorie threshold – dropped to just 4.8 per cent in the same period. The boom in 2004 and growth thereafter are certain to have contributed to further reductions in poverty. Other absolute measures of poverty reflect the same downward trend.

On the other hand, this period of sustained growth has not been used to reform the sectors key to the development of Ukraine's human potential: health and education. Despite many government declarations of reformist intent, little action has been taken to restructure notoriously inefficient Soviet models of social service provision. Nor have the social assistance or social insurance systems been made more efficient or equitable. Even the pension system, the one area in which Ukraine had registered significant reform progress, suffered from the massive benefit hikes of 2004-05; these have thwarted the promise of 2003 legislation designed to create a more secure three-pillar system.

Per capita spending on social services in Ukraine is small by comparison with wealthier economies, but, as argued in earlier Blue Ribbon Commission reports, the root problem with Ukrainian social policy is inefficient use of what resources are available. First, the system legally guarantees (often at the level of the Constitution) broad services, such as universal free health care, that are simply beyond the country's means. Second, because budget resources are insufficient to fund such far-reaching guarantees, available services go to those with the money to pay for them, thereby hindering access to vital social services for the poor. Third, such private payments are often made "informally," under the table, so that standards in education and health care, in particular, are eaten through by corruption. Fourth, targeting is inadequate, so that wealthier parts of the population secure a disproportionate share of the benefits, even those meant to combat poverty. Fifth, outmoded and over-centralized financing mechanisms discourage both efficient use of resources and civic oversight of spending.

Finding remedies for these long-standing problems is no easy matter. Reform of social services is politically difficult everywhere, not just in Ukraine. Any attempt to rationalize benefits is bound to provoke popular protest, even when the benefits in question have been unavailable (except in theory) for many years. By the same token, promising to expand benefits is an almost irresistible temptation for populist politicians, especially at election time, as was abundantly the case for pensions in Ukraine in 2004 and 2005.

These difficulties underscore the importance of political leadership in effecting change. Leaders need to present a persuasive vision that can mobilize a popular constituency for reform by explaining the long-term benefits, and then show the courage to defend reform from any popular backlash or retreat based on short-term political calculations.

So far, this leadership has been sadly absent in Ukraine. The enormous credibility enjoyed by the new leadership following the 2004 presidential elections could have been used to carry out the sort of far-reaching reforms that the social sector so urgently needs. This opportunity was not seized, however. Although improving social welfare was deemed a priority, the new authorities opted to prolong the spending spree started in 2004, without overhauling social sector financing, structure, or delivery. Not only has this approach further delayed (and probably increased the cost of) urgently needed structural reforms; it has undermined fiscal stability,

particularly with respect to pension commitments; hindered job creation by keeping payroll taxes prohibitively high; and diverted funds initially intended for capital investment (see Chapter 2).

The challenge now faced by Ukraine's new authorities is to build a political consensus behind needed reforms. The lack of national elections in the near term should prove an asset. This broad consensus should rest on a number of clear principles:

- The social obligations of the state must not exceed budget resources.
- Improved services must come through greater efficiency, not greater spending.
- Social assistance must be strictly limited to helping those in need.
- Social sector reform cannot be viewed in isolation, and depends on reform progress in other areas, including macroeconomic stability and growth, business development and job creation, decentralization, and civil society development.
- Better delivery of social services depends, crucially, on true decentralization, the strengthening of local governments, and greater citizen involvement.
- The private sector has a key role to play in social service provision, particularly in promoting competition on quality and price with state-owned entities.

Ukraine is a relative latecomer to social sector reforms. This delay has costs, particularly in the form of the vested interests that have come to thrive on the Soviet-legacy status quo. However, starting late also means that Ukraine stands to benefit from the experience of other countries in the region that grasped the reform challenge earlier, particularly those that combined these reforms with adaptation to EU standards and norms. Such borrowed experience has already proved helpful in the design of Ukraine's 2003 pension reform; similar expertise is at hand for many other areas.

4.1. HEALTH CARE REFORM

Discussions on the far-reaching inadequacies of Ukrainian health care typically lament the low levels of funding available. At roughly US\$ 148 per head per year (at purchasing power parity in 2002), health care spending in Ukraine is indeed miniscule compared to the US\$ 2,128 spent on average in the EU, or even to the sums spent by new EU member states (US\$ 645 for Poland, US \$491 for Lithuania). Measured as a share of GDP, health care spending in Ukraine, at 3.7 per cent, is also lower than in many other countries (the EU average is over 8 per cent of GDP), although out-of-pocket payments add a sizeable amount to this figure. However, as the first and second Blue Ribbon Commission reports argued, a more pressing problem is the glaring inefficiency with which public funds are spent. Without far-reaching reform, funding increases are likely to go to waste rather than improve health care provision.

Unfortunately, little has been accomplished in the way of structural reforms in the past two years. The government has increased health care funding substantially, to UAH 12.4 billion in 2005 and UAH 16.9 billion in 2006. But most of the increase went towards wages, and the Soviet-legacy health care system remained virtually untouched.

On the plus side, health care reform was designated a top priority, and the President and the Government embraced many of the goals identified in the Blue Ribbon Commission reports. A presidential decree on "Urgent Measures Regarding the Reform of the Public Health System" issued on 6 December 2005 required the Cabinet of Ministers to draft an action plan on health care reform, setting a number of lofty aims, including improving quality, expanding access, and rationalizing use of resources. The President has also supported efforts to stimulate debate and raise public awareness of the choices involved in health care reform. On the minus side,

however, the government action plan has yet to take shape, and other official declarations remain unfulfilled.

Key Challenges

Resolute action is needed to plan and enact a complete overhaul of health care in Ukraine, with a focus on more efficient financing, as the problems are mounting:

Health indicators are alarming. Ukraine faces a debilitating combination of health and demographic issues. The population is ageing. The birth rate fell from 12.7 per 1,000 to just 8.5 per 1,000 in 2003, though with a slight increase in subsequent years. The death rate is double that for the EU. The rate of natural population decline (-7.59 per 1,000) exceeds that even for Russia (-6.54), and the downturn since 1990 (when growth was +0.6 per 1,000) has been unprecedented in peacetime. Mortality rates of the working-age population are disastrously high, including severe “excess mortality” for men, much of it attributable to alcohol abuse and much of it, thus, preventable. Average life expectancy fell to 67.6 years in 2003, more than ten years shorter than for EU countries. The gender gap is large: life expectancy is 62 years for men and over 73 years for women. Prevalence of HIV is three times higher than in the EU and affects nearly 1.5 per cent of the adult population. Tuberculosis trends are worrisome; in the last 12 years the incidence of TB doubled from 40 cases to 100,000 to 80 cases today. Disease strikes low-income groups more frequently than it does the well-to-do; the poor are three times more likely than the wealthy to succumb to some diseases. These factors, together with outward migration in search of better economic prospects, have led to a drop of more than five million in the Ukrainian population in the past 15 years.

“Free” guarantees are excessive. The unlimited scope of state guarantees of free medical care is incompatible with the finite resources the state has available to meet these obligations. Even the richest socially-oriented states do not assume obligations of this scope. Such guarantees are not easily revised to suit Ukraine’s economic possibilities. Article 49 of the Constitution enshrines the guarantee of free universal health care and prohibits any reduction in the existing network of health care institutions. Constitutional Court rulings based on this provision have hindered the introduction both of fee-based health services and mandatory health insurance.

Private fees compromise equity. At the same time, “free” health care is a myth. Since 1996 the share of private payments made officially by the population has risen from 18.8 to 38.5 per cent of total spending on health. This share rises to 52 per cent if informal payments are included -- meaning that Ukrainians are in fact paying more than half of their health care costs out of pocket. The lion’s share of this money goes for drugs and medicines. The prevalence of private payments makes health care less accessible to the poor, thereby violating the principles of equity and solidarity. Such out-of-pocket costs lead the poor to delay visiting a doctor, with the result that many seek treatment only on an emergency basis, once an otherwise treatable condition worsens to the acute stage.

Informal payments encourage corruption. The informal payments routinely made by patients for health care services are viewed by much of the health care profession as justified compensation for low salaries. The volume of these payments is large: unofficial estimates put the total “shadow” turnover of funds in the health care system in 2001 at UAH 3 billion, or more than half of that year’s health care budget. Although such payments may well keep health care workers on the job, they are demoralizing, because they favor the rich and undermine transparency

Urban-rural disparities are growing. The average city dweller makes 14-15 visits to an outpatient facility per year, whereas the typical village dweller makes just 7-8. Moreover, owing

to the shortage of skilled personnel willing to live in rural areas, villagers are more likely to be seen by a nurse or assistant than by a physician.

Financing mechanisms discourage efficiency. Public funds are allocated, in essence, to support the costs of existing health care facilities, and not to achieve health care results. Hospitals face little incentive to reduce the number of admissions, as financing is still based on bed capacity. This creates perverse incentives, resulting in a rise in unsubstantiated hospitalizations. Hospital stays in Ukraine are among the longest in Europe, at an average of 14.4 days. State and communal health care institutions continue to have the status of spending units with very limited rights and incentives to make management and financial decisions that would allow for more efficient use of resources. Allocation of budgetary funds is based on a list of permitted line items, with norms set by the Ministry of Health. Although financing is decentralized, with 80 per cent of total funding allocated at the regional and local levels, health care administrators have little authority to deviate from rigid line-item budgets. Budgets are strictly itemized, and the volume of resources set aside for each budgetary item is strictly regulated. Similarly, health care professionals receive fixed salaries set in accordance with a national pay scale, so remuneration bears little relation to quality of work or number of patients seen. Staffing levels are determined in accordance with norms set by the Ministry of Health, most often based on a set standard of hospital beds per 10,000 people.

Primary care is neglected. Too much funding goes to expensive inpatient care, while less costly primary care is neglected. Ukraine has 5.94 hospitals per 100,000 people, higher than the EU average of 3.2. Maintaining such a large number of inpatient facilities restricts funding for other purposes. The volume of specialized care exceeds that of primary care, turning the typical "health care pyramid" upside down. Primary doctors constitute just 26 per cent of all doctors, whereas in some European countries the share is as high as 50 per cent. Ukraine has only 3,354 of the 33,000 general and family physicians it needs, so hospitals and ambulance services are used to provide routine medical assistance. By one estimate, nearly one-third of hospital patients would qualify for outpatient care. A legislative framework was created in 2000 to put family-based primary care at the heart of the health system, but this has failed to turn the pyramid right side up.

Specialists are overused. Patients are not required to seek a referral before consulting a specialist. As a result, patients tend to follow a chaotic and uncoordinated "medical route," and care is often provided at a higher level than that justified by the patient's condition. Experience elsewhere in the world suggests that giving patients direct access to specialists increases health care costs while actually undermining the quality of the care they receive, yet in Ukraine direct access to specialists is prized as a privilege. The health care workforce is overspecialized, with training provided for as many as 123 specialties, whereas the standard for Europe is 16-28.

Quality control is deficient. Quality control concentrates on the actions of personnel, not on the results of medical care. Unlike private entities, State and municipal health care institutions are not subject to licensing, perhaps because they are not viewed as "business entities." Certification of medical personnel is not controlled by self-governing professional bodies of the medical profession.

Legislation is contradictory. As is the case with other areas of Ukrainian life, health care legislation is contradictory and ambiguous. Numerous laws designed to enact change remain ineffective, in part because of a government failure to issue proper executive instructions or procedures. Such dormant measures include not only the 2000 initiative to focus on primary care mentioned above, but also legislation to allow use of state funds to make "contractual" purchases of health care services from private as well as state entities, and to grant health care institutions greater autonomy by transforming them from budget entities into state enterprises.

As is clear in the effort to define a minimum package of free medical services, ongoing since 1992, the coexistence of contradictory regulations increases the potential for reform setbacks.

Decentralization is incomplete. As so far enacted in Ukraine, decentralization does not give local or regional authorities discretion over health care spending (see Chapter 1). Although 80 per cent of health care funds are disbursed at the local and regional level, allocations are determined centrally (and quite rigidly). There is thus no incentive for smaller communities to pool their resources or to seek efficiency through the closure or consolidation of institutions too small to serve the public effectively; on the contrary, there is every incentive to fight to keep existing facilities operating. New regulations enacted at the end of 2005 (amendments to the budget code) have tried to remedy the excessive dispersion of resources at the town and village level by consolidating health care financing for primary and secondary medical aid at the level of the rayon or oblast-level city. However, their implementation in 2006 was suspended by this year's state budget law.

Recommendations

The main objective of health care reform in Ukraine should be to achieve the best health outcomes possible given the resources available. Aspirations need to be grounded in the hard realities of funding. Equity and solidarity need to be restored. And for reforms to succeed, many fundamental changes need to be enacted as a package:

- **Revisit legal guarantees.** The government should define a basic package of medical services that are to be provided to the population free of charge at public expense, and define what sort of fees can and should be required for everything else. This cannot take place until Ukraine comes to terms with the illusory nature of the guarantees provided in Article 49 of the Constitution, as otherwise reform efforts run the constant risk of being overturned by Constitutional Court rulings. A legal framework also needs to be created to govern the form and scope of public participation in expenditures to cover the cost of medical care.
- **Admit that nothing is really free.** Accurate information and public debate is important here. The Ukrainian public needs to understand that "free" services are in fact funded through taxes, that high taxes in Ukraine are a serious impediment to job creation and investment, and that taxpayers have every right to demand responsible and efficient use of their money. Publicizing the extent to which the public already pays directly for health care services through out-of-pocket expenses will also be helpful. Bringing this out into the open should help build momentum for reform.
- **Give priority to primary care.** Revive and intensify efforts to reorganize primary health care to focus on general-practice and family medicine. Encourage quality by giving patients the right to choose a primary care doctor. Create a "gatekeeper" function for primary doctors, so that they control the "medical route" of their patients. Require referrals for specialized care. Streamline inpatient care by adopting a regional principle for hospital organization (including the integration of privileged departmental hospitals, such as those run for railway workers, into the mainstream, reducing the number of specialized hospitals, and transforming some hospitals into nursing homes, hospices, and other much-needed "hospital-substituting institutions" that are currently delivered at excessive cost in hospitals.
- **Encouraging preventive medicine and promoting healthy lifestyles,** particularly with an eye to reducing alcohol-related deaths among working age adults. This effort should help Ukrainians to understand the impact of personal behavior on health. The imposition of a dedicated health tax on tobacco and alcohol should be considered.

- **Shift to a contract management model.** Moving to a contract public procurement model promises clear efficiency gains and should have top priority in health care reform. To achieve this, a distinction needs to be established between the purchasers and providers of health care services. Local authorities should function as the purchasers of medical services on behalf of the population. Existing public procurement legislation already provides a legal basis for the use of state funds to purchase health care services from a variety of providers, including private ones. Competition should be encouraged between state and private providers. For the contract model to function properly, all forms of health care funding should be concentrated at the regional level, and a “single payer” approach adopted. Contracts should also be the basis on which health care institutions hire medical personnel, to apply performance standards and provide incentives for quality and efficiency.
- **Give health care providers more autonomy.** Existing legislation also provides a basis to give state medical institutions managerial and financial autonomy by transforming them from budget-funded organizations to non-profit enterprises. This shift will allow health care providers to allocate public funding in accordance with patients’ needs. Line-item funding should be replaced with payment for services, so that finances reflect the scope and structure of the medical services rendered.
- **Develop more sustainable financing.** These two measures – introduction of a contract model and the transformation of state health-care providers into non-profit state-owned enterprises – are both preconditions for a shift to sounder financial foundations for health care provision. Ukraine has two long-term financing options: modifying the existing budget system, which is funded from general taxes, or introducing mandatory health insurance.

The first Blue Ribbon Commission report recommended adopting a mandatory health insurance model, in part because the targeted nature of premiums would help to protect health care funding from the vagaries of politics; improved financing would promote both solidarity (providing generally accessible services) and equity (redistributing resources from the rich to the poor); and reorganization into a territorial system would help eliminate the overlap of current “branch” systems. However, the *Verkhovna Rada* has already rejected health insurance legislation once, in 2004, after three year’s preparatory work.

Returning to the issue now would be extremely difficult, owing to the already heavy burden of payroll taxes that has become nearly unsustainable after the pension increases of the past two years. Moreover, as the state-funded health care system has deteriorated, numerous small-scale alternatives have emerged to fill the gap, including voluntary insurance schemes and occupational or local sick funds. These currently cover only a tiny slice of the Ukrainian population, but legislation needs to be developed to ensure that they can operate freely and productively, as they may hold the promise to evolve into larger-scale initiatives, even if Ukraine decides ultimately to opt for the model of mandatory health insurance.

Other measures that would improve the prospects for Ukrainian health care include:

- **Promoting the development of medical self-government bodies.** In developed economies, such professional associations perform a range of regulatory functions currently exercised by the state. Ultimately, such professional associations could be authorized to monitor professional credentials, for instance, or take part in approving standards for accreditation of health care providers.
- **Prioritizing training of health care administrators** and other specialists (economists, insurance analysts) needed to create and manage a reformed system.

- **Improving quality standards** by requiring licensing for health care institutions of all ownership types, public as well as private; assessing physicians by results and not by years of service; developing the statistical methods and profiles necessary to compare the performance both of individual doctors and entire health care institutions; and shifting to evidence-based standards of diagnosis and treatment.

4.2. RESTRUCTURING THE EDUCATION SYSTEM

The problems facing Ukraine's education system are similar to those encountered in health care. Statistics suggest the country has attained high educational standards. Students on average spend almost as much time in formal education as do their counterparts in developed economies. Literacy rates are high, at 99.4 per cent of the adult population and 99.8 per cent of young adults. The proportion of students aged 15-18 in full-time education is one of the highest in the world.

Yet while the quantitative results are impressive, quality is increasingly a problem. Funding is used inefficiently, giving higher priority to the maintenance of schools and other facilities than to educational results. Management is overly centralized. Educational opportunities are unequal, leaving rural areas and the poor disadvantaged. Low salaries encourage corruption, undermining educational standards. Professional training does not match the needs of an emerging market economy.

This is a major shortcoming, given that education is increasingly key to economic opportunity. In Ukraine, the lower the education level, the higher the risk of joblessness. Between 1999 and 2003 poverty fell far more significantly for better educated households than for others; the poverty rate for households headed by those with an elementary education or less remained almost unchanged at around 30 per cent.

Whereas the authorities have embraced many of the priorities outlined in the first and second Blue Ribbon Commission reports – and a March decree by the Cabinet of Ministers even defined 2006 as a year of systematic structural reforms in the field of education – as in the case of the health care system, practical action has yet to attain the sweep of rhetorical aspirations. And, as with health care, the government has attempted to deal with problems in the education system largely by increasing budget financing, mainly by raising salaries for teachers, rather than through structural reforms.

Key Challenges

Inefficient spending. The problems with Ukraine's education system are commonly attributed to scarce funding. However, the country allocates 5.7 per cent of GDP to education, a proportion that is above the average for OECD countries.

The problem is that what funds are available are often spent wastefully. The main flaw is that spending is planned and allocated on a "per need" approach, which favors existing facilities and staff, rather than on a "per student" basis. Like health care institutions, schools have no authority to reallocate funds assigned for one purpose to another. This leads to money being spent on improvements to school buildings and equipment that do not reflect the specific needs of educational institutions. Education funding has also been lost through numerous abuses and misconduct.

Such misdirection is undermining the quality of educational services. Access to equipment and technical support is poor, particularly in vocational schools, where 80 per cent of equipment is reckoned to be out-of-date. Graduating students lack experience of working with modern technology, narrowing their employment prospects. Teachers have limited opportunities to attend conferences, participate in exchange programs, and access up-to-date

printed materials and the Internet. These problems are most acute in rural areas and depressed regions where skilled teachers are scarce and resources are dispersed among many small country schools.

Incomplete decentralization. The benefits of decentralization are inadequately harnessed to give local communities a stake in educational quality and efficient use of funds (see Chapter 1). As is the case with state-funded health care, expenditure is decentralized, but decision-making is not. Moreover, funding allocations give local communities little incentive to pool resources or rationalize existing school facilities, even as demographic trends reduce the numbers of children attending.

Low salaries. Boosting standards in education depends in part on raising salaries. The average monthly salary in education was UAH 672 in January 2006, 22 per cent lower than the UAH 864 national average. The government reports that in the course of the last year, salaries in health care, social services, and culture rose considerably faster than those in education. Relatively low salaries and a widening gap with other professions undermine staff morale and undercuts quality. Low compensation also encourages the informal payments and outright bribes that undermine education standards and make diplomas an unreliable indicator of student achievement.

At the same time, student-teacher ratios are very low (12 students to 1 teacher in secondary schools in 2003), suggesting that staffing levels could be trimmed by raising professional standards and adopting more systematic performance monitoring.

Poor fit with economic needs. The professional development and training system that once generated cadres for the centralized Soviet economy has collapsed, but has yet to be replaced with a system that meets the requirements of a market economy. A lack of co-operation between education authorities, employers, and educational institutions means that the training provided by higher and vocational schools is often irrelevant to employers' needs. According to the State Demographic Institute, upwards of 70 per cent of college and university graduates in the fields of physics, mathematics and engineering work outside their subject areas; the corresponding figure biology, agronomy and medicine is 46 per cent. Unemployment rates among graduates of higher education and vocational schools are on the rise.

A law passed in 2004 was designed to address this challenge by creating first jobs for graduates of higher education institutions or vocational schools through subsidies granted to employers. But the government never developed provisions to implement the law, and it has been assigned suspended status until 2007.

Experts project that by 2015 only 40 per cent of the demand for qualified industry professionals will be met in most regions of the country. Acceptance and graduation rates at vocational schools are falling. Vocational schools traditionally attract secondary school students who demonstrated poor results at school and did not wish to continue their studies in the tenth grade. Vocational schools are also often viewed as the proper place for young people representing socially vulnerable groups (such as orphans).

Inadequate quality standards and monitoring. Standards for secondary education were developed in 2004, but these do not comply with international norms. No standards have yet been developed for vocational training and higher education. There are no agreed indicators to assess the efficiency of the education system, a lack that prohibits any ranking of schools or teachers, and thus inhibits the diversification of school financing and teacher remuneration based on performance and qualification.

Although the government is committed to implementing a unified system of testing for enrolment in higher education, in part as a measure to reduce corruption and help restore more

equitable access for poorer students, the national school testing mechanism does not yet provide an objective or transparent assessment of performance. Most existing indicators are intended for secondary school graduates, and are based mainly on non-standardized criteria such as academic advancement and participation in various academic competitions. In vocational schools, the independent evaluation of qualified teachers has yet to be introduced.

Within higher education, quality control is partially exercised by indirect methods, through an accreditation system. The problem is that institutions are usually assessed for accreditation by government officials who have no affiliation with the university system. In addition, there is no practice of external evaluation with the involvement of international experts. Introducing such practices would help to improve the quality of higher education and create a more positive image of universities.

At present, however, higher education standards do not always match international standards. Ukrainian academic degrees are sometimes rejected in other countries, while at the same time Ukraine does not recognize doctoral degrees earned abroad (with the exception of those from Russia), even from renowned universities. These tendencies not only hinder the development of Ukrainian education, but also encourage corruption and the practice of "selling" academic degrees.

Finally, the design and selection of educational programs, textbooks, and teaching materials is still not subject to the beneficial impact of market rules, owing to the Ministry of Education's influence on the Independent Selection Commission.

Recommendations

Although there is widespread agreement on the general principles that should govern reform of education in Ukraine, in practical terms the system remains very much in the grip of the past. Many quite basic steps still need to be taken to provide a sound foundation for future reforms. Among the most important, the government should:

- Revamp education funding to ensure that any future spending increases work to improve efficiency while raising performance standards. Mostly importantly, introduce a pay-per-pupil principle of financing, to replace the legacy command-economy system that works essentially to maintain existing facilities regardless of enrollment levels. Budget funding should give priority to primary and secondary education, allowing the state to fulfill the constitutional guarantee of free education for all children.
- Grant schools autonomy in using budgetary funds, within a framework of proper oversight and quality-control mechanisms. As part of a broader deepening of decentralization in Ukraine, ensure the participation of local communities in setting education goals for primary and secondary education, and make local authorities accountable. Promote the involvement of parents in school oversight.
- Encourage private initiative in education, subject to appropriate accreditation and monitoring. Private options will help make the education system more flexible and responsive.
- Rationalize teacher employment levels and encourage professionalism. Salary increases should depend on teachers' experience and skills. For secondary education, the Ministry of Education should establish more stringent requirements with respect to qualification categories and raise base salaries accordingly.
- Address growing disparities between urban and rural education quality by consolidating village schools into bigger entities and transporting children to them by bus.

- Bring national standards for secondary, vocational and higher education into line with the best European and international examples. The process of adopting and developing such standards should be transparent and include all stakeholders.
- Develop a system of education quality monitoring. Draw on international standards to develop indicators of education quality and mechanisms for data collection and processing, and for use of data in management of education quality. Make data publicly accessible to ensure accountability of educational institutions. Ukraine should take part in international comparative research on education quality (including such prestigious studies as the Programme for International Student Assessment/PISA of the OECD and the Trends in International Mathematics and Science Study/TIMSS).
- Liberalize the selection of textbooks and educational materials by educational institutions as well as the purchase of educational programs that comply with standards to allow market mechanisms to promote quality and price competition.
- Develop objective indicators to monitor the efficiency of the education system. Forecast-oriented analysis to assist in aligning education development with labor market requirements should be commissioned in partnership with the think tanks. The Ministry of Education should apply such longer-term forecasts to ensure that adequate training facilities are available to support the demand for personnel in professional areas.
- Make the education system more responsive to the demands of the labor market. Employers, including those from private-sector businesses, should participate in the development of educational programs at all levels. Employers' representatives should also sit on the supervisory councils of educational institutions.
- Modernize the vocational training system in Ukraine to meet the demands of a modern market economy. The very concept of vocational training should change. Based on existing vocational schools, training and service centers should be established, especially in rural areas. In co-operation with the employment service, vocational schools should provide retraining for those without jobs.
- Grant autonomy to higher education institutions that meet licensing and accreditation criteria developed in line with accepted international standards, and allow independent boards to exercise full control over finances and curricula.

4.3. BUILDING A SUSTAINABLE PENSION SYSTEM

The first Blue Ribbon Commission report saluted Ukraine's progress in pension reform, which was embodied in the adoption of major legislation that took effect at the beginning of 2004. Since then, however, the situation has deteriorated dramatically.

Populist pledges made during the 2004 presidential election campaign yielded massive increases in pension benefits. Within just 12 months, the minimum pension was raised by 155 per cent. At UAH 65.7 billion in 2005, total pension spending was 75 per cent higher than in 2004, and the share of GDP devoted to pensions rose from 11.3 per cent of GDP to more than 15 per cent in a single year. This unprecedented increase made Ukrainian pensions among the world's most generous, at least as a share of GDP.

Along with a more than 50 per cent hike in nominal public sector wages in 2005, this spending provided a big boost to household incomes and played a significant role in reducing the share living in poverty. But this largesse came at the cost of higher inflation, a sharp hike in

corporate taxes, and a huge deficit in the Pension Fund (equal to 5 per cent of GDP) that had to be filled by a budget subsidy that diverted spending from other priority areas.

The pension increases reflected a government decision to bring the value of the minimum pension into line with the "subsistence minimum," and to establish an automatic linkage between the two values. The subsistence minimum is an administratively defined poverty threshold that is based on a consumption basket reflecting desirable (rather than actual) levels of consumption. Steady rises in the subsistence minimum over the past two years have thus spurred a chain of increases in the minimum monthly pension, which ballooned from UAH 130 in September 2004 to UAH 332 at the end of 2005 – and is planned to rise to UAH 366 in October 2006.

Key Challenges

The negative impact of these measures on both the fiscal accounts as well as the prospects for pension reform is hard to overstate. Granted, the increases raised the share of pensioners receiving a pension at or above the minimum subsistence level from just 10 per cent in April 2004 to 80 percent a year later. Since half the population lives in households with pension beneficiaries, income gains were widespread. However, the increases have created a range of potent challenges:

Pension reform off course. The pension hikes are a major setback for Ukrainian pension reform and threaten to nullify many years of preparatory work.

The reforms that took effect at the start of 2004 had ambitious goals: 1) to increase substantially the income level of pensioners; 2) to ensure the maximum dependence of pension payments upon individual insurance contributions; 3) to enhance work incentives and legalize wages; 4) to encourage the insured to save for old age; 5) to diversify the sources of pension payments through use of mandatory state pension insurance contributions and voluntary savings; and 6) to create powerful domestic investors in the form of the second-pillar Accumulation Fund and non-state funds.

The three-pillar system adopted by Ukraine follows the model of successful pension reforms pursued elsewhere in Central Europe and the CIS. The first pillar is a rationalized version of the existing pay-as-you-go (PAYG) pension system, and is meant to provide two types of benefits: uniform minimum pensions at close to the subsistence level and additional payments that reflect an individual's lifetime contributions. The second pillar, still to be created, is to be a system of mandatory accumulation, in which younger workers contribute to an Accumulation Fund whose assets are invested to generate an annuity-like stream of retirement income at the end of their active life. The third pillar, introduced in 2004, provides a vehicle for additional retirement savings through voluntary investment in private pension funds.

The 2004 pension reform law stipulates that the second pillar cannot be introduced until a number of preconditions are met, including two consecutive years of at least 2 per cent real GDP growth; functioning supervisory systems; an increase of the actual minimum pension to the subsistence level; and a balanced Pension Fund budget according to international accounting standards.

Although the second pillar was originally scheduled for launch in 2007, the Pension Fund deficit has invalidated this timetable. The deficit is likely to fall from UAH 16 billion to UAH 11 billion in 2006 owing to a combination of continued wage growth (and thus higher pension contributions) and the legalization of some previously informal-sector wages. However, a large deficit is set to persist. This will make it exceedingly difficult to lower contribution rates for the PAYG system in order, as was originally planned, to channel one per cent of the wage fund (rising by one percentage point a year to a ceiling of seven per cent) into the second pillar.

This delay is unfortunate, given the promise that the three-pillar pension reform held to address adverse demographic trends, promote financial market development, and encourage individual responsibility by providing incentives to save for old age.

Social transfers at the expense of growth. The massive redistribution underlying the pension increases suggests an attempted shortcut to improved social welfare, rather than promoting the growth and job creation that are better long-term solutions. Although the budget was able to fund the deficit resulting from the gap between Pension Fund contributions and higher pension payments in both 2004 and 2005, the higher fiscal burden has serious consequences. Insurance payments to the Pension Fund amount to 32 per cent of payroll and are supplemented by a number of additional “fees,” including a tax on commercial banks’ foreign currency transactions. Yet according to IMF calculations, contributions would have to increase by 15 percentage points, to over 47 per cent, to cover the Pension Fund deficit. Such an increase is politically impossible, so budgetary subsidies equal to around 4 per cent of GDP per year will remain a necessity over the medium term. This will hinder the payroll tax reductions that are needed to stimulate job growth and will provide a new incentive for shadow employment in the informal sector. It will also crowd out investment in other important areas, such as infrastructure, health, and education.

“Social mandate overhang”. The pension increases were rationalized by the government as simply fulfilling a constitutional obligation: Article 46 of the 1996 Constitution states that no pension should be below the minimum subsistence level. However, before 2004, this provision had never been met. The Constitution and other laws enshrine many additional social mandates that are either only partially or intermittently funded, or simply ignored. These obligations represent what the IMF calls a “social mandates overhang,” posing a constant risk of fiscal folly should politicians opt to seek electoral capital by fulfilling unmet social guarantees.

Confusion of social insurance and social protection. The Government’s resolve to bolster minimum pensions has severed the link between individual contributions and individual benefits that the 2003 reform of the pay-as-you-go system was meant to reinforce. Benefits have become compressed, and most pensioners receive similar pensions irrespective of their contribution history. Moreover, while pension increases have helped reduce poverty, they have done this in an extremely inefficient way. In 2003, for instance, the poorest 20 per cent of the population received only 12 per cent of pension benefits, while the richest 20 per cent secured 27 per cent. Ukraine thus needs to separate the pension system from the system of social protection, and reinforce the insurance principles of social insurance. The poor and vulnerable should be protected through targeted social assistance programs that are financed through the budget, not through the pension system.

Problems with poverty definition. The subsistence minimum, as currently defined, tends to overstate deprivation. The basket used to set the minimum is a normative one, and does not reflect actual Ukrainian consumption patterns (for example, it includes about 7 kg of meat per month, when the average consumption actually observed in household surveys ranges from 3 to 4 kg. It also uses average prices, rather than the lower prices that the poor actually pay. In practice, the subsistence minimum is also a highly politicized notion, as it is determined annually by the parliament, often without any clear calculation of the economic impact of changes (in 2005 it was raised once; three increases are scheduled for 2006).

Controversy over private pension provision. Growth in the private pension funds that make up the third pillar remains promising, even if generally only wealthier Ukrainians can benefit. In the past two years the number of institutions administering non-state pension funds and their membership have both grown rapidly. In 2005 the assets of non-state pension funds increased from UAH 3 million to UAH 46 million. However, this is still a marginal sum, and only 0.3 per cent of the work force is involved. More robust growth should be encouraged.

A serious argument erupted in 2005 about access to the private pension fund market, and this threatened to discredit private pensions among the public. The insurance lobby sought access to the non-state pension fund market, and life insurers proposed amending existing legislation on non-state pension funds to allow them to offer all types of pension products and perform asset management. Existing pension fund providers responded by trying to block the insurers from the market, suggesting that their involvement would undermine regulatory safeguards.

The dispute is fuelled by a contrast between the weaknesses of the Law on Insurance and the rigor of the Law on Non-State Pension Funds. The former fails to define clearly the role of life insurance companies in the pension market or to establish proper regulations for life insurance, inhibiting the development of life insurance products. The latter, by contrast, has detailed provisions and sets clear and rigorous rules for the operation of private pension funds. This dissonance needs to be eliminated in order to build public trust in the third pillar.

Recommendations

- **Restore financial balance in the Pension Fund.**²⁰ This goal should have top priority, given that the future of pension reform depends on eliminating the Pension Fund deficit. There are basically only two remedies available: to increase revenues or reduce expenditures. Both options are highly politically sensitive. Given that each contributor is already supporting essentially one pensioner (the ratio is now 1 to 0.93), and high payroll taxes are already a major obstacle to legal job creation, an increase in contributions is not feasible.

Among the specific remedies to be considered:

- Fix the minimum pension in nominal terms until it falls to a more reasonable level in real terms, and avoid further linkage with rises in the subsistence minimum.
- Increase statutory retirement ages, particularly for women, and bring the retirement age for women into line with that for men. At 55 years for women and 60 years for men, Ukraine's retirement ages are extremely low by international standards. Most countries in the region that have tackled pension reform have already raised retirement ages, for example to 57 years for women and 62 years for men, with further increases are planned. Some caution is needed in Ukraine, however, given the precipitous decline in male life expectancy, which now averages just 62 years. Gradual increases in retirement age would bring considerable savings over the medium term, but offer little relief in the short term.
- Lengthen the contribution period for eligibility for a full pension. This currently stands at 20 years for women and 25 years for men. Extending this period would both reduce expenditures and increase contributions.
- Reduce early retirement and privileged pensions. Early retirees currently amount to more than 16 per cent of total pensioners. Reducing this share might be achieved through a screening of occupations currently entitled to early retirement to assess whether health risks or hazardous conditions actually justify the privilege.
- Revise the contribution system for the self-employed and agricultural workers. Currently these groups fall under a simplified tax regime that allows them to pay a

²⁰ This section draws heavily on "Rebalancing Ukraine's Public Pension Finances," in *Ukraine: Selected Issues*, IMF Country Report No. 05/416, pages 101-114.

fixed amount of tax, a portion of which is remitted to the Pension Fund. The resulting tendency is to underreport tax liabilities. Making a clear link between these groups' pension contributions and eventual benefits would help to address this deficiency.

- Encourage the growth of the legal labor force. Broaden the base for insurance contributions through the legalization of wages, the formalization of labor relations, and reducing both underemployment and unemployment.
- Index pensions to inflation only. Current legislation enables pensions to rise to reflect 20 per cent of wage growth, as well as inflation. This provision is not applied elsewhere in Europe, and under current conditions is too generous for Ukraine.
- Restore the link between benefits and contributions.
- Redefine the subsistence minimum. Given that this measure has provided the reference point for successive pension increases, the calculation method ought to be revised to reflect international standards. Objective standards, not politics or parliamentary improvisation, should govern the amount.
- Introduce a unified social contribution. Currently employers have to pay separately into four different social insurance funds (for pensions, temporary disability, work accidents, and unemployment). Each contribution is calculated on a different basis and paid through a separate payment order. Introducing a streamlined system would reduce administrative costs and encourage compliance.
- **Revive the prospects for pension reform.** The chances of launching the planned mandatory Accumulation Fund that would embody the second pillar of a reformed pension system now look bleak. Even if the design of the system can be salvaged, the timetable may have to be set back. The potential benefits of a reformed system, however, provide an imperative for Ukraine to reassess the prospects for pension reform and draft a new roadmap, indicating how necessary transitional funding will be secured for the new system. Sustaining growth will help ease the deficit by bolstering contributions, and earmarking a share of privatization receipts to fund pension reform would be well worth considering.

In addition to restoring balance to the pension fund, the government will need to prepare and the Rada to approve a law on *Assignment to the Accumulation Fund of a Portion of General Mandatory Pension Insurance Contributions*. Once enacted, this law will provide for a gradual increase in contributions to be set aside for long-term investment on behalf of individual employees, starting with one per cent of the wage fund for eligible workers and then rising by one percentage point per year until the level of seven per cent is reached.

Delays in implementation make it all the more important to improve the structure of the second pillar in line with recommendations made by the first and second Blue Ribbon Commission reports. Competition from private pension fund managers needs to be introduced as soon as the Accumulation Fund is established, rather than only after 11 years, as is currently envisaged. Financial regulation should also be strengthened. The independence and authority of the fund's steering body should be ensured.

- **Promote non-state pension plans.** The weakness of the current PAYG system means that the Government will need to encourage investment in private pension funds by all those who can afford to do so. A publicity campaign should be conducted to explain the benefits, while regulations are tightened to reduce risk. To promote competition and provide a level playing field for pension fund managers, the Government should work jointly with the different financial services sectors to adopt legislation that would enable insurers to participate in non-state pension provision while adhering to the same rigorous requirements applied to other pension fund providers. In the process, the Law on Insurance should be amended.
- **Pass the joint-stock company law.** This will promote financial market development and build an environment conducive to the expansion of private pension funds (see Chapter 3).

4.4. IMPROVING THE SOCIAL PROTECTION SYSTEM

Buoyant economic growth and massive social transfers have significantly reduced poverty in Ukraine, from over 30 per cent in 1999 to under 19 per cent in 2003. However, improvement is not uniform. Urban-rural disparities are growing, and poverty reduction has been slower in villages. By 2003 the poverty rate in rural areas was more than twice that in big cities, and average consumption of people living in towns was 18 per cent higher than that of those living in villages (up from ten per cent higher in 1999). Differences between regions are also growing, with eastern regions generally better off, reflecting an economic recovery that depends heavily on industry and trade. Strong economic growth, moreover, has not been matched by a similar rise in employment.

These trends underscore the need for an efficient social safety net in Ukraine. The government has responded to lingering poverty with a massive increase in social transfers, which together amount to some 20 per cent of GDP. As described above, this increase took place mainly through the pension system, and pensions now account for more than one-fourth of average household incomes. But other benefits were affected as well. The most spectacular of these was the twelve-fold increase in the lump-sum grant awarded to parents upon the birth of a child, to a full year's average wage. Three-quarters of Ukrainians live in households that receive at least one social transfer.

Ukraine's social assistance system suffers from a number of shortcomings that undermine efficiency, strain the budget, and thwart equity. First, the authorities strive to grant too many categories of aid and benefits to too wide a range of citizens, so that the total financial obligations exceed the country's means. Historically, benefits were extended for a host of reasons (often political) unrelated to poverty reduction. Yet the Constitution stipulates that social benefits once extended cannot be rescinded, a provision that (though often disregarded in practice) hampers reform.

These distortions mean that the many of the poor are deprived of badly needed government aid while those who are better off enjoy more than their fair share. Those in rural areas are the worst affected since often they simply do not have access to the services (such as free public transportation) to which they are entitled. The result is that in practice the current system is not financially sound, transparent, or socially just.

Key Challenges

The main issues which the new authorities should address include:

Excessive spending. Improving social welfare has been a government priority since before the 2004 elections. Most types of benefits have been increased repeatedly. Such a rise in

the fiscal burden limits the potential for spending on investment and other growth-stimulating priorities and keeps a stranglehold on taxpayers.

Poor targeting. The current social security system is to a great extent based on universal rather than individual principles, in that aid is provided without any regard to an individual's financial circumstances. For example, all pensioners, including those receiving a pension of over UAH 1,000 per month, enjoy the right to free urban transportation. Social transfers are poorly targeted, with high leakage to the wealthy. Subsidies for housing and utility expenditures, for instance, are provided on a large scale, but the poorest 20 per cent of the population receives less than 8 per cent of total benefits while the richest 40 per cent captures more than 61 per cent. More targeted benefits that are actually consumed by the poor suffer from very narrow reach.

Recordkeeping is haphazard, so members of the same family can simultaneously enjoy different types of benefits related to the same event (for example, illness or poverty). A lack of knowledge of their entitlements means that many poor people fail to exercise their right to social assistance. Whereas 94 per cent of those entitled are able to secure utility benefits, less than five per cent exercise their right to benefits for sanatorium-resort therapy, acquisition of medicines, housing, and motor transport.

Misuse of insurance funds for social assistance purposes. A considerable part of social insurance funds are spent on transfers that are not insurance in nature. This primarily concerns compensation for funeral costs (equivalent to two monthly pensions of the deceased), which currently comes from the Pension Fund, and the financing of maternity grants to women who were previously employed, which currently comes from the temporary disability fund. In both cases, the benefits awarded bear no relation to insurance payments (which would be paid out, for instance, in the event of an insured accident), but are social assistance that should be financed from the budget.

Economic distortions. Providers of in-kind benefits such as housing, utilities, and free transportation are not always fully compensated by the state budget. This puts an unfair burden on the enterprises providing the services, reducing their profitability and often resulting in cross-subsidization of households by corporations. Such subsidies also encourage excessive consumption of resources, particularly water.

Recommendations

The enormous social transfers that helped make such a significant reduction in poverty possible are not sustainable. More limited, targeted aid is needed. A transformation to a more efficient system should include the following measures:

- **Tailor social commitments to available resources.** Any increase in social transfers that cannot be financed should be immediately forbidden. Creation of new benefit categories, particularly those awarded for "services to society," should be eschewed, as should replenishing the ranks of benefit holders that are being depleted by age (for example, Chernobyl sufferers). Benefits that are designed as compensation for damages suffered should relate directly to the nature of the injury and its causes.
- **Focus on poverty reduction.** The social protection system must be designed to alleviate poverty. Persons living above the poverty line have no place in the system.
- **Improve benefit targeting.** This is needed to ensure that social protection funds actually get to the poor, and are not instead consumed by the already well-to-do. Better methods of measuring poverty will help, along with the use of poverty mapping.

- **Reduce the number of benefits and monetize them.** Converting in-kind benefits into cash payments will increase transparency and accountability. In the long term, social protection should be based on two key pillars: welfare payments for low-income families and child support assistance. (These would be supplemented by unemployment and pension insurance, while the medical and education systems should ensure access to proper health care and education for low-income families.)
- **Means test beneficiaries.** Since better targeting of social benefits requires the indirect estimation of incomes, better methodologies are needed. Better targeting will require the retraining of existing social inspectors and changes in legislation.
- **Delineate clearly between social protection and social insurance.** Under insurance programs, a clear link must be established between the amount of premiums paid and the level of compensation received by beneficiaries. This will help restore the financial viability of insurance funds and end the need for budget subsidies. It will also encourage legal employment, as compensation will be linked to the time and total of premiums paid. All insured persons must make contributions to all compulsory state insurance; any exceptions must be covered by the state budget, not the insurance fund. Only those who have paid premiums should receive compensation after an industrial accident. Similarly, insurance funds should stop funding unrelated benefits.
- **Focus on growth, investment, and job creation.** Ultimately, the key to poverty reduction is sustained economic growth and job creation rather than relying primarily on social transfers. Enacting necessary measures to sustain macroeconomic stability (outlined in Chapter 2) and improve the business environment (Chapter 3) would arguably have greater impact on social welfare than trying to maintain a bloated system of anachronistic social benefits.