

***The New Wave of Reform: on Track to Succeed***

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Analysis of policy developments in January - June 2005  
and further recommendations

**Kyiv  
2005**



UN  
DP

*Ukraine*

The analysis and policy recommendations of this Report do not necessarily reflect the views of the United Nations Development Programme. This Report is the fruit of a collaborative effort by a team of eminent advisors. The United Nations Development Programme accepts no responsibility for any views presented here nor for any error or misrepresentation contained in this report.

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## EXECUTIVE SUMMARY

In November and December 2004, Ukraine experienced its Orange Revolution. This popular upheaval for freedom, democracy, and integration with Europe already stands out as one of the classic liberal revolutions. Marked also by its non-violent nature, it illustrates the growing strength of citizen activism and the imperative of better governance in the 21st century. In many respects it exemplifies the empowering democratic dimensions of the United Nations Millennium Declaration. It has brought an ambitious new administration to power. Early this year the UNDP-sponsored Blue Ribbon Commission presented its report, *Proposals to the President: A New Wave of Reforms*, to the new President and government. The Commission has appreciated the great interest that the new administration has paid to its report, and has been especially pleased to see that many of its ideas have been incorporated into the Government program.

Building on the work of the original Blue Ribbon Commission, UNDP has sponsored a second report, called the Blue Ribbon Commission 2 (BRC2). This report, prepared in April-June 2005, assesses the initial impact of recent developments in economic and social policy in Ukraine, and the extent to which they have followed the recommendations of the initial report, and the stated purposes of the new administration.

The Orange Revolution has naturally left its imprint on the policies of the new Ukrainian government. The revolution was dominated by two groups of demands. The first priority was democracy and the fight against corruption, that is, reform of the state, which formed the key chapter of the Blue Ribbon Commission Report. In this area, much has been done and initiated. An ambitious administrative reform has been launched, and it is vital that it be completed. In particular, the reform of relations between the central state and the regions has been brought to the fore, something that the Commission considered vital. The new Government has also started moving on judicial reform, a long-term but essential undertaking.

The other major demand of the Orange Revolution was that Ukraine strive for European economic and social development standards and a European level of democracy. A considerable amount has been accomplished in this regard. Ukraine has signed an action plan with the European Union (EU). This action plan will help Ukraine undertake necessary reforms, especially adopting market-friendly legislation in various areas and improving the functioning of state agencies. It will also enable Ukraine to participate in various European education and research exchanges. Though only vaguely, it also proposes a future free-trade agreement between the EU and Ukraine as well as an agreement on trade in steel. Ukraine has also moved substantially on accession to the WTO, a goal that seems attainable either at the end of this year or at the beginning of next year, and WTO membership has become the priority it must be. Accession to NATO has become a firmer policy aim, and NATO members have welcomed the new government's ambitions.

During the Orange Revolution, economic demands and even economic discussion were practically absent. The revolution was about freedom and democracy, not about economics. As a result, economic policy was not central to Ukrainian politics during the first quarter of 2005. Moreover, although President Viktor Yushenko has been lawfully elected, and a new government appointed, parliamentary elections will take place only in March 2006. That means that Ukraine has been caught in a pre-election mood, with several repercussions. A particular problem is that the outgoing Government doubled pensions on 1 September 2004; this decision has saddled the new Government with a huge pension bill equal to 16% of GDP (in proportional terms, one of the largest in the world). Election-year politics has three serious consequences for

economic policy in 2005. First, the new Government has been forced to scramble to raise state revenues, making it impossible to start reducing taxes in the short run as the Commission had proposed, and hindering the desired overhaul of the tax system under the current circumstances. Second, it is politically difficult to start complex social reforms in a pre-election year, even if their outcome stands to improve social welfare in the future. The topic is simply too sensitive. The third consequence is that the macroeconomic situation, which looked so good before the election campaign that the Commission chose not to focus on it in its report, has become a concern. The budget deficit will probably be sizeable in 2005, though Ukraine has reserves to manage it for a year. It will be extremely difficult, if not impossible, for the Government to keep the inflation rate in single digits. The scramble for revenues has imposed seemingly excessive restrictions on small entrepreneurs paying lump-sum taxes, yet in the current business environment smaller firms can only thrive legally under very stable and simple tax rules with a minimum of inspection allowed.

These factors complicate the pursuit of reforms this year, but do not make it impossible. Even in social sphere ( where conducting significant reforms till the end of 2005 seems rather unlikely) it is necessary to move forward in creating a strong basis for reforms to be launched in more auspicious environment after parliamentary elections of 2006 are over. There is a pressing need to recognize the risks associated with meeting high pension obligations. Future increase (or indexation) in pensions should depend on a correspondent increase of revenues of the Pension Fund. It is necessary to rank priorities in provision of social assistance and make this process transparent. It seems expedient to organize national debates on the issues of reforms in health protection sector.

Important reforms are possible in a number of areas, but the Government has not yet had paid enough attention to them. Financial legislation is one of these. It is vital that Ukraine adopt modern corporate legislation, notably a law on joint-stock companies. Similarly, the Economic Code should be abolished since it contradicts the Civil Code in many regards, while the Civil Code needs to be further developed. Minority shareholders must be given reasonable legal guarantees. A second promising area is deregulation, where the Government could allow much more freedom. One example is in the area of foreign exchange regulations, which is also important for WTO accession. The Government chose rightly to reduce excessive import tariffs as one of its first measures. At the same time, a major concern remains the large apparatus of inspection agencies, most of which should simply be abolished. Cancellation of unjustified fiscal privileges requires special attention. However, this should be implemented in a coherent and well considered manner, without violations of the Budget Code and without infringement on private property rights. Policy for small and medium business needs a careful consideration.. Small entrepreneurs can only thrive legally under very stable and simple tax rules with a minimum of inspection allowed. Therefore it is necessary to retain system of simplified taxation during short- and mid run and avoid imposing limitations on it as it has happened at the beginning of this year and reverted back at the end of June only.

There are many burning issues in the sphere of competitive policy. It is necessary to develop a comprehensive governmental policy for promotion of competition and strengthening independency of the Antimonopoly Committee. There is also a need to proceed further with the establishment of independent regulatory bodies in transport, housing and dwelling sectors together with stimulation of competition in network industries. This will assist in managing economy using market methods without administrative intervention (including direct price control of the state). Attempts to use non-market mechanisms that were observed during the past months did not bring any changes and resulted in the rise of uncertainty for domestic and foreign investment.

The issue of property rights protection is the area of greatest concern. Any successful reform must be based on a confirmation of property rights, security of titles, their registration, and clear and transparent rules to govern their transfer. Instead, the new Government has declared that it is not intent on facilitating trade in land. A major political topic has become the re-privatization of enterprises already privatized, while plans to privatize other firms have stalled. It had a negative impact on investment activity and contributed to a marked slowdown in production during the first quarter of 2005. The closure of re-privatization related debates and the resumption of privatization that was announced by the President in June 2005 has become the first step in reconsidering of the mistakes of the past. It is important not to loose a vision of the final objective – ensuring property rights – and avoid forcible property redistribution or nationalization. Transparent and efficient continuation of privatization process is a precondition for increasing investment attractiveness of Ukrainian economy. It is important not to lose sight of the final goal: secure property rights. What must be avoided is nationalization or a slowdown in further privatization, because state ownership of enterprises has proven to be too susceptible to endemic corruption, inefficiency, and incompetence. The broad and often contradictory discussion of re-privatization also had a negative impact on investment activity and has added to a marked slowdown in production during the first quarter of 2005.

The Blue Ribbon Commission has proposed in its first report twelve key recommendations with respect to the most essential reforms in Ukraine (See Attachment). The second report clearly shows that all these recommendations remain relevant, and their implementation is necessary to convert the democratic progress of the Orange Revolution into the basis for deep structural reforms. Moreover, our analysis of the policy developments during the last five month provides ground for two additional key recommendations:

1. Preserving fiscal and monetary stabilization is a necessary condition for sustainable economic growth. It is important to strengthen independency of the National Bank that should concentrate its efforts on maintaining price stability. Ukraine needs a new round of substantial fiscal adjustment and well-considered budget correction measures.

2. It is necessary to ensure protection of private property rights and a consistent continuation of privatization process to foster economic reforms. Revision of privatization deals should be guided by court decisions using transparent procedures and proposing, whereas is possible, concluding amicable agreements

After the Orange Revolution, the new Government faced a window of opportunity to implement reforms. The experience of other transition countries shows that such a window of opportunity does not remain open for long. Therefore, it is extremely important for the Government to have a good action plan with a clear set of short- and medium-term priorities and a clear distribution of tasks among the responsible agents that allows it to implement reform goals efficiently over a sufficiently short period of time. Some deviations from the reform path are inevitable. However, they should be accompanied by an extensive use of administrative regulatory measures and violation of private property rights. It is equally important for the Government to monitor the process and make the necessary adjustments and corrections in a timely manner.

The Blue Ribbon Commission is happy to continue to assist the Government in its reform endeavors.

## FOREWORD

The Ukrainian government's bold reform agenda affects the interests of different elites, and diverse political actors, business groups, and the state bureaucracy, as well as communities and social groups across the country. The risks are legion, and the recent abrupt deceleration of economic growth is an early warning of a need for course correction if the overall thrust of reforms is to be sustainable. While it is essential to highlight positive achievements, Ukraine's full range of societal needs can only be met if additional efforts are made. The challenge is now to maintain stability, reach public consensus with respect to the country's development strategy, and reap dividends for the people. The capacity to learn and evolve rapidly through times of systemic change is essential to the successful maturing of democracy.

Whereas the first Blue Ribbon Commission report addressed challenges that were the legacy of an outgoing regime, the second Blue Ribbon Commission report provides a preliminary assessment of the impact of initial reforms launched by the new authorities in February-June 2005. This report is prepared by a mixed Ukrainian-international team assessing the impact of the initial efforts of the new Government in a radically transformed political context, and in an environment of markedly greater regional and global openness and support for Ukraine's place in Europe. It provides impartial and professional analysis and proposes practical solutions to pressing problems. In this context, the Blue Ribbon Commission process represents a further stage in the development of national capacity nurtured by exposure to global best practice.

We remain optimistic about Ukraine's chances to advance successfully towards the highest possible economic and human development standards, which naturally complement Ukraine's European Choice. UNDP Ukraine presents this draft report for the attention of the President, the Prime Minister and the new Government and stands ready to support them in implementing the reforms expected by Ukrainian society.

Francis M. O'Donnell

UN Resident Coordinator and UNDP Resident Representative in Ukraine

## ABOUT THE BLUE RIBBON COMMISSION 2

The Blue Ribbon Commission 2 (BRC2) builds on the activities of the first Blue Ribbon Commission that was formed at the initiative of Kalman Mizsei, Assistant Secretary General of the United Nations and Assistant Administrator of the United Nations Development Program (UNDP), in July 2004. The UNDP office in Ukraine organised the work of the BRC2 under the leadership of Mr. Francis M. O'Donnell, Resident Coordinator of the United Nations and UNDP Resident Representative in Ukraine. The Commission's work has been financed entirely by UNDP.

This report was drafted as a background paper for a Strategic Retreat on Ukraine's Reforms organized by UNDP Ukraine in collaboration with the President and the Government in order to facilitate discussion of economic and social reform in Ukraine.

The structure of this report follows the structure of the first Blue Ribbon Commission report. Its goal is to assess the extent to which recent developments in Ukrainian social and economic policy follow the first report's recommendations. The chapters were written by Oleksandr Paskhaver and Iryna Akimova (Chapter 1), Marek Dabrowski (Chapter 2), Vira Nanivska, Inna Lunina, and Ihor Koliushko<sup>1</sup> (Chapter 3), Oleksandr Rohozynsky (Chapter 4), Sergei Yurgelevich and Dmytro Leonov (Chapter 5), Oleksandr Paskhaver, Oleksandra Kuzhel, Ivan Poltavets, Iryna Akimova, Volodymyr Demyanchuk, and Oleksandr Shevtsov (Chapter 6), and Igor Burakovsky (Chapter 7). Anders Åslund also contributed to the Executive Summary. The shape of the report has changed considerably from the original drafts, which underwent substantial modification during discussions and consultations during and after the Strategic Retreat. The insightful comments of Ben Slay are gratefully acknowledged. Iryna Akimova and Louisa Vinton edited the report. The support of Valeriy Gladkiy, Jeffrey Groton, and Tetyana Luzhanska is acknowledged with gratitude.

This report was written largely during the first five months of the new Ukrainian government's tenure, and was finalized as of June 2005. The Blue Ribbon Commission functions as an independent body. While UNDP supports its work financially and administratively, the Commission exercises complete editorial independence, and the analysis, views and recommendations in this draft report are entirely those of the Commission, and not necessarily those of UNDP.

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<sup>1</sup> We express our gratitude to Mr. Andriy Vyshnevsky for his valuable comments on analysis of the administrative reform and all colleagues who participated in review and discussion of the Report.

# CHAPTER 1. SOCIAL AND ECONOMIC POLICY OF THE NEW GOVERNMENT: PRESENT TENDENCIES

## ***Problematic issues***

After four and a half months of work of the new Government, it is still too early to judge the results. However, the directions, priorities, and style of policy implementation can be seen quite clearly in the government's first social and economic decisions and declarations<sup>2</sup>. Even this short term of activity comprises two periods, which are different from each other from the viewpoint of strategic priorities and implementation tools: a period of political and economic populism (during which populist objectives were pursued through state interference in economy justified by populist slogans) from February until end-May 2005 and a period of return to a liberal approach – from end-May until June 2005.

### **a) Political and economic populism: facts and tendencies**

1. **Social policy in the 2005 state budget.** An unprecedented surge in social expenditures, amounting to a 160% increase on 2004, increased the fiscal burden on economy to 32% of GDP. The share of current transfers in the population's income grew by 5.5 percentage points (to 46.1%) in January-February 2005 compared to correspondent period last year. The ratio of salaries (42.1%) to current transfers (46.1%) fell to 0.93 comparing to 1.5 during the same period of 2004. An active social policy, expressed in an abrupt increase of the state's social obligations, is not supported by the economic growth necessary to fund this increase.

Privileges, preferences and guarantees for selected enterprises, areas and industries (including ship-building, the automotive industry, and the military-industrial complex) have been eliminated. Preferences for small business have been drastically reduced. The abrupt cancellation of privileges and guarantees reflects an attempt to secure revenues for the extraordinary budget rather than a liberal program to create a level playing field and a competitive environment.

2. **Import tariffs have been reduced** (for products of the machine-building and light industries and home appliances) in an attempt to combat smuggling and evasion of customs payments. The industries covered by the tariff reduction had been destroyed by the financial crisis of 1998-1999, and their recovery had only taken root within the last two to three years.

The Government has submitted to the Parliament a draft law proposing the reduction of custom tariffs for a much broader range of products. For the sake of fairness, it should be noted that the currently formulated tariff is the average value of the illegitimate import tariffs (at a zero rate), import through free economic zones at reduced rates, and legitimate import rates. Producers' representatives assert that a one-off, wide scale reduction of import tariffs may have detrimental consequences. The Government expects that a drastic reduction in smuggling and the elimination of privileged reduced rates in combination with their overall reduction, will justify the actually existing level of import tariffs. The Government appears to be counting on the effectiveness of a policy of persecuting businesses that operate in the shadow economy and, as the result, sees the legalization of the economy as a determinant factor for increasing budget revenues without regard for the pace of economic growth pace.

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<sup>2</sup> *Decisions and declarations made by the Government in the monetary, credit and banking, and foreign economic spheres are not considered here.*

**3. Government policy documents envisage a drastic change of policy priorities in favor of the state-run industrial sector of Ukraine.** These policies are based on preserving and strengthening the public sector and improving its manageability. A regulation has been introduced making 50% of net income of state-owned enterprises subject to mandatory deduction to the budget as dividends.

Privatization is viewed by the Government only as a means to dispose of inefficient enterprises. The privatization of infrastructure complexes has been rejected. Governmental officials have made numerous declarations concerning de- and re-privatization. The scope of re-privatization in official accounts has ranged from dozens to as many as 3,000 entities. That process is acquiring a spontaneous nature. The Government has not specified criteria for re-privatization.

4. State interference in the economy has expanded significantly, and “manual control” methods, primarily in pricing, are widely applied:

a) **The Government fights against price increases on petrochemical products and reduced price for agriculture.** Instead market interventions, the Government applies mainly administrative pressure: the centralized introduction of wholesale and retail price caps and profit caps, the imposition of temporary export bans on diesel fuel, the dispatch of special governmental supervisors to oil refineries, making declarations about total control over prices at filling stations accompanied by accusations of monopolistic collusion by private oil producers and traders without proper investigations.

b) **The Government attempts to limit price increases on meat and meat products.** Administrative pressure is combined with economic levers in this sector. A gradual reduction in import duties is planned due to pressure from the agrarian lobby. Budget funds are allocated for state purchases of meat products with consequent intervention on the domestic market.

On top of that, officials make clearly unrealistic declarations about monopolistic conspiracies in the meat retail trade (which involves hundreds of thousands of traders), about exerting total state control over the meat and dairy retail markets, and about demands of the local authorities to organize direct trade on the farmers' markets by eliminating intermediaries.

c) **Plans to increase railway transportation tariffs by up to 50% have been announced.** It is necessary to take into account that Ukrzaliznytsya (Ukrainian Railways) incorporates hundreds of enterprises that are not directly related to the technical support of transportation. Government willingness to raise prices in a state-owned monopolistic sector is particularly unfortunate in light of its willingness to introduce price controls in more competitive sectors. These intentions could also have a significant impact on producers' prices at a time when inflation may be spinning out of control.

5. In general, the governmental choice of instruments, style of decision-making, and implementation mechanisms is of a radical anti-crisis nature. This style has certain typical features. It starts with an active public reaction to the problem selected for resolution, then moves to alarm signals and then on to the methods chosen for their resolution. This is followed by swift decisions that come as a shock to interested parties but are more moderate than were the initial signals. The solution itself, as a rule, combines both market and strict administrative methods. Even when administrative measures cannot be implemented, discussion of them nevertheless signals the government's resolve.

In the course of an active propaganda campaign, the opponents (entrepreneurs, as a rule) are accused of creating illegal opposition. There are even some accusations of sabotage (for example, against the owners of the Zaporizhya Automobile Plant, and owners of metallurgy plants). However, after the decisions have been taken, negotiations with the interested parties are conducted to mitigate the negative consequences of the Government's decisions.

**Table 1: Comparative statistics of economic development in Ukraine during Q1-2004 and Q1-2005**

	(the same period of the previous year = 100)	
	Q1-2004	Q1-2005
Nominal incomes of population (January–February)	130.8	143.6
GDP in comparable prices	112.3	105.4
Deflator index	110.7	116.3
Consumer price index (March through December in previous year)	102.2	104.4
Industrial output index	119.5	107.0
including:		
light industry	118.3	103.3
metallurgy and metal processing	119.6	101.6
petroleum derivative products	117.5	97.1
Freight turnover	113.9	102.4

During this period, the priorities selected and the style in which they are implemented are in line with the socialist expectations and anti-bourgeois sentiments (especially as regards representatives of large capital) of most of the population. The popularity rating of the Government is extremely high (over 50%) and is not falling. At the same time, the trends described above carry a high risk of destabilizing the economy and decelerating economic growth, as it clear from economic statistics for the first quarter of 2005 (see Table 1).

### **Return to a liberal approach**

President Victor Yushenko criticized some aspects of the Government's activities and initiated a return to a liberal approach through decrees issued at the end of May 2005. This change in priorities in economic policy has taken place under the slogan of radical improvement in the investment climate and the foreign investment regime:

1. **Suspension of direct state intervention in price formation mechanisms.** The President criticized direct state intervention in price formation mechanisms and prohibited direct regulation of prices for fuel through his decree at the end of May 2005 (Unfortunately, this measure was ignored by the international community and the Government's previous practices negatively influenced the decision on granting Ukraine the status of a market economy).

2. **Change priorities in privatization policy.** On the eve of the World Economic Forum's international conference ("mini-Davos") in Kyiv, the President criticized the official course on re-privatization and signed, together with the Prime Minister and the Speaker of the Parliament, a Memorandum on guarantees of private property rights and securing the rule of law in implementing re-privatization. The Memorandum declares the intention of all institutions of state power in Ukraine to guarantee owners' rights and the stability of property conditions. The President in his message to the conference stressed that lists of enterprises for re-privatization

do not exist; promised to create conditions for the restoration of property rights solely within the legal framework and guided by court decisions in case an infraction of the law in the process of privatization has been discovered; and pledged to contribute to the resolution of ownership disputes, including by concluding amicable agreements. The President underlined the necessity of continuing privatization, including through the sale of strategically important enterprises, and named several objects to be privatized in 2005.

### **3. Steps toward deregulation and stimulation of the development of small and medium-sized enterprises:**

a) In May and early June the President issued two decrees on the liberalization of entrepreneurial activities and the implementation of state regulatory policy<sup>3</sup>. These decrees required the authorities to intensify activities aimed at simplifying of the business regulatory framework and implementing in practice the principles of regulatory policy. It is expected that accelerated revision of adopted regulatory acts of central and local authorities from the viewpoint of their compliance with the principles of state regulatory policy will take place during July-August 2005. It is anticipated that outdated governing acts will be cancelled, and the regulatory environment simplified.

The President has also activated legal initiatives of the Government and demanded that it prepare and submit to the Parliament by 1 October a set of draft laws aimed at improving the framework for starting a business (on the system of permits and licenses in the sphere of economic operations; and on changes to the Law "On licensing of some types of business activities" that would reduce the list of business operations that require licensing), improvement of tax administration (on changes to the Law "On value added tax" to improve tax administration, including VAT refund mechanisms, introduction of the cash tax accounting method for business entities whose volume of taxable operations do not exceed certain ceiling defined by law; on changes to the law on corporate income tax in order to simplify administration) and on single social tax that would envisage consolidation of social insurance contributions and unification of their procedures. Preparation of these draft laws could be an important step in establishing the preconditions for structural reforms and increasing transparency.

b) In June 2005, after numerous public and expert discussions, the Parliament adopted and the President signed into law legislation that restores that principles of simplified taxation that were effective until January 2005.

**4. Revision of the principles governing support to investment projects in special economic zones is possible.** Discussion is ongoing on the violation of investors' rights caused by the single-stage cancellation of all preferences in special economic zones and territories of prioritized development. Two draft laws the would restore preferences to active investment projects for the period of their implementation are registered in the Parliament. It is important that the Government insists on the direct subsidizing of separate investment projects (if necessary) instead of granting fiscal privileges as was earlier the case. Such a change in the instruments supporting investment projects would contribute to greater fiscal transparency.

## **Conclusions**

The Government from the beginning of its activity has set correct priorities: to reduce corruption and smuggling, ensure a level playing field, de-monopolize the economy, and create

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<sup>3</sup> Decree "On liberalization of entrepreneurial activities and state support of entrepreneurship" of 12 May 2005 and "On some measures to secure implementation of state regulatory policy" of 1 June 2005.

a competitive environment. However, these tasks have often been addressed using non-market measures and administrative interventions, and without a permanent dialogue with business representatives and civil society. The result has been shocks to the economy and an increasing risk of economic turmoil.

It is clear that the Government has inherited deeply corrupt and sometimes criminal relations within the state and the economy together with a state apparatus adapted to those relations. However, even the most resolute struggle against constantly arising problems cannot change the state apparatus and the institutional system. There is a need for consistent implementation of structural reforms. What matters is not their swiftness but timeliness, consistency, and systemic nature. It is hard to expect any noticeable structural changes within the first months of the Government's activity. However, it is significant that implementation of structural reforms was not a priority issue among the numerous signals that the Government has been delivering to society. Activities of the Government during its first months in power were an active reaction to unavoidable post-revolutionary problems. This reaction was based on political tactics rather than economic strategy.

Starting from May 2005, thanks to the President's initiatives, signs have appeared suggesting that an analysis and correction of mistakes and the launching serious reform work will gradually replace the early post-revolutionary syndrome. It is crucial that this reformatory work is systemic, consistent and based on the ideas of liberal, evolutionary economic development, a decrease of state interference in the economy, the compatibility of economic development and social transfers, and a systematic reform of the state and its economic and social institutions.

## CHAPTER 2. MACROECONOMIC RISKS AFTER THE ORANGE REVOLUTION

### *Problematic issues*

The macroeconomic situation in Ukraine in 2004 was in many ways exceptional compared to preceding years. GDP growth reached its highest level (12.1%) in the history of independent Ukraine (see Table 1). However, one must remember that such growth occurred thanks to exceptionally favorable external factors and domestic policies that promoted noticeable inflation. The negative effects of the second factor were already evident in the last quarter of 2004 and even more dramatically in the first months of 2005.

**Table 1: Ukraine: Basic macroeconomic indicators**

Indicator	1999	2000	2001	2002	2003	2004
GDP growth, annual % change	-0.2	5.9	9.2	5.2	9.4	12.1
Annual inflation, annual % change	19.2	25.8	6.1	-0.6	8.2	12.3
UAH/US\$ official exchange rate, e.o.p.	5.22	5.4	5.3	5.33	5.33	5.31
Current account balance, US\$ billion	1.7	1.5	1.4	3.2	2.9	7.2
Fiscal balance, % of GDP	-1.5	-0.4	-1.6	+0.8	-0.2	-3.1

Source: Ukrainian Economic Outlook (UEO), <http://www.case-ukraine.kiev.ua/main.php?action=prj-full-desc&type=current&id=9&lang=en>

**Figure 1. Composite metal price index, 1998–2004**



Source: IMF Research Department (Commodity Metals Price Index, 1995 = 100, includes Copper, Aluminum, Iron Ore, Tin, Nickel, Zinc, Lead, and Uranium Price Indices); UEO, 2005 Q1, Figure 7.1

Strong external demand and high prices for metal products (see Figure 1) helped to prolong favorable conditions for this traditional sector of Ukraine's industry and export. Additional support for exporters came from an exchange rate policy conducted by the National

Bank of Ukraine (NBU): pegging the hryvna to the US dollar meant its nominal depreciation against other major currencies such as the Euro, the British pound or even the Russian ruble.

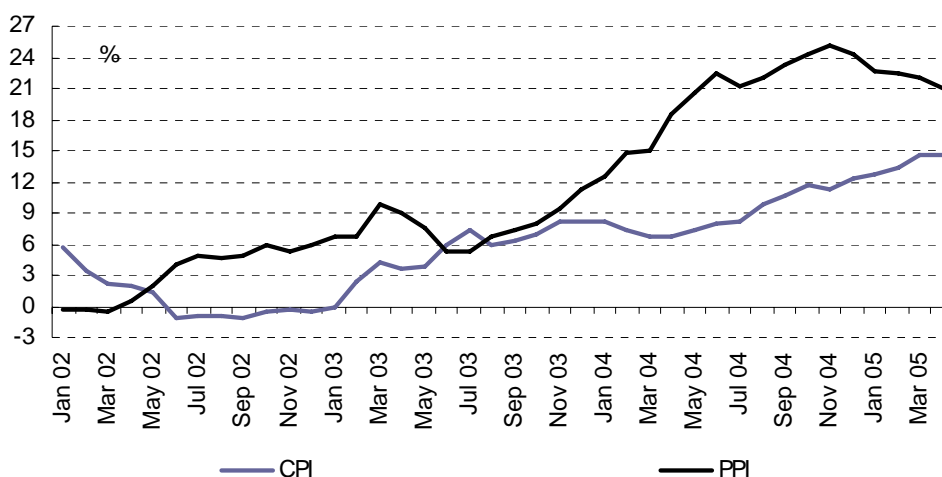
On the domestic front, loose fiscal policy (the effects of which were somewhat softened by restrictive monetary policy implemented during the second half of 2004) promoted private consumption and the latter became the main driving force for economic growth in 2004 and the first quarter of 2005. Most of rapidly rising budget spending was channeled to finance higher wages and salaries in the public sector and social transfers — a shift with unavoidable inflationary consequences. Moreover, such a high growth rate is hardly sustainable even over the short term, particularly given the specific factors driving it. The developments of the first quarter of this year fully confirm this concern.

Looking quarter by quarter, GDP growth reached its highest point in the third quarter of 2004 (14.2%) and then rapidly decelerated to 9.1% in the fourth quarter of 2004 and 5.4% in the first quarter of 2005. While the fourth quarter of 2004 was marked by exceptional political circumstances (three rounds of presidential elections and the Orange Revolution) that might negatively affect economic activity, preliminary data for the first quarter of 2005 definitely testify to a change in the growth trend.

In the light of earlier arguments, the slowdown in growth should not come as a surprise. However, any continuation of inappropriate macroeconomic policies (particularly - fiscal expansion) and inconsistent steps in the sphere of the business and investment climate (see Chapter 6) could further undermine growth in the near future.

The increasing domestic disequilibrium could have an effect on a number of macroeconomic indicators, including inflation, money supply and the fiscal deficit.

**Figure 2: CPI and PPI dynamics, % change, y-o-y, 2002-2004**

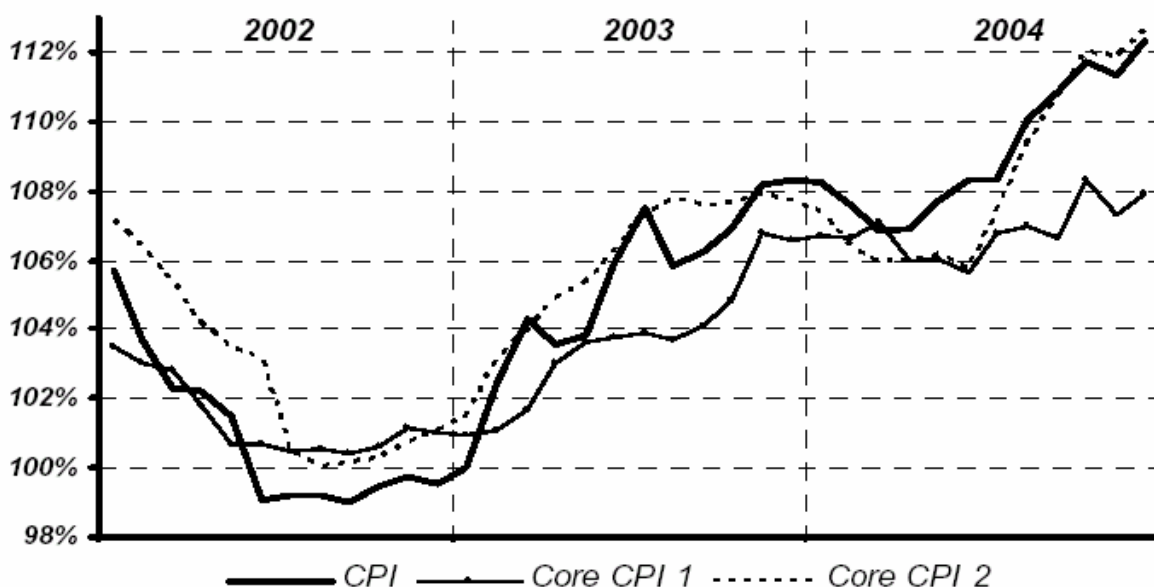


Source: State Statistics Committee of Ukraine; UEO database

After reaching its lowest (i.e., negative) level in the summer of 2002, annual consumer price inflation (CPI) has steadily increased, reaching double digits already in the third quarter of 2004 (see Figure 2). There were supply-side factors that contributed to this trend over the last two years, including poor harvests in 2003 (although this effect was reversed by relatively good harvests in 2004) and high oil and energy prices. Nevertheless, these trends (see also the producer price inflation/PPI trend in Figure 2 and core inflation trend in Figure 3) are insufficient

to explain the reversal of the deflation of 2002 and the onset of the inflationary trend observed in 2003-2005.

**Figure 3. CPI and core inflation in 2002 – 2004 (monthly data, y-o-y % changes)**



Source: State Statistics Committee of Ukraine, CASE Ukraine estimates; UEO, 2005 Q1, Figure 5.1

Money supply statistics show high growth in monetary aggregates through the entire period following the 1998-1999 crisis. The broad M3 money aggregate increased by 40.5% in 1999, 46.1% in 2000, 41.4% in 2001, 41.7% in 2003, 46.5% in 2002, and 32.4% in 2004. The monetary base grew by 41.4% in 1999, 39.9% in 2000, 37.4% in 2001, 33.6% in 2002, 30.2% in 2003, and 34.1% in 2004 (faster growth in M3 than in the monetary base reflected increasing financial intermediation and, therefore, in the money multiplier). Rapidly growing international reserves of the NBU (which rose to US\$ 13,117.92 million at the end of April 2005) were the main factor contributing to this extraordinary pace of monetary expansion. This brings us again to exchange rate policy, which focused on defending the hryvna against nominal appreciation through the entire post-crisis period. On the other hand, a stable UAH:US\$ exchange rate promoted rapid demonetization (M3/GDP more than doubled – from 16.9% in 1999 to 36.3% in 2004), which absorbed most of the money supply increase. However, demonetization at such a high pace could not continue indefinitely, and from 2003 it became clear that inflationary pressure was increasing rapidly. In addition, the UAH peg to the weakening US dollar meant importing inflation through an import pricing channel.

Fiscal expansion constituted another important source of inflationary pressure. Until 2003 the Ukrainian budget was relatively balanced, with the deficit not exceeding 1.5% of GDP (see Table 1), although such a high rate of economic growth dictates a substantial surplus rather than a deficit. The fiscal situation deteriorated dramatically in the second half of 2004, during the election campaign and the Orange Revolution. In the fourth quarter of 2004 the fiscal deficit already amounted to 9.7% of GDP and over the whole of 2004 it amounted to 3.1% of GDP. The available fiscal statistics show that rapidly growing expenditures (mostly for wages and salaries in the public sector and social transfers) caused this deterioration.

Generally, the first months of 2005 did not improve the gloomy macroeconomic picture because the macroeconomic policy of the new Government contained contradictory measures. Representatives of the IMF Mission to Ukraine in their statement of 8 June 2005 expressed deep concern about growing inflationary pressure, fiscal imbalance, and a lack of consistency in macroeconomic policy.

In monetary and exchange rate policy, the NBU initiated a modest revaluation of the hryvna in March and April 2005 (from UAH 5.30 to 5.05 per US dollar). This, together with some dollar strengthening vis-à-vis other currencies, helped to mitigate inflationary pressure conveyed through the trade and price channel. This step should also slow the rapid pace of growth in NBU international reserves and, consequently, in the money supply (although over the short term it may boost the inflow of speculative capital). However, this policy can bring the expected benefits only if fiscal policy works in the same direction; otherwise, it will lead to deterioration in the balance of payments without affecting the inflation rate.

In the fiscal policy sphere, the Government undertook several measures aimed at disciplining the revenue side. It eliminated numerous tax loopholes (such as free economic zones), tax exemptions, and special tax regimes; increased discipline and started to fight corruption in the tax and custom administrations; decreased the number of tariffs and simplified the tariff system. The Ministry of Finance reported a 68% nominal increase in budget revenues in the first four months of 2005, compared to the same period of 2004<sup>4</sup>. This tendency continued in May as well. However, such a favorable short-term outcome is likely to have been influenced by one-off factors, such as personnel changes in the tax and customs administration or the settlement of delayed transactions from the fourth quarter of 2004. It does not necessarily give grounds to expect a similar pace of improvement in the longer run.

At the same time, budget expenditures continued to expand as result of both the electoral populism of Victor Yanukovich's government and additional wage and social obligations accepted by the new Government already after the Orange Revolution (see Chapter 4). The revised budget for 2005 approved by the Parliament in March 2005 has increased both revenues and expenditures by some UAH 20 billion compared to the previous version. The new revenue projection is built on very optimistic growth and revenue collection assumptions, which may result in a revenue shortfall and spending cuts (as happened several times in 1995-1998). The practice of budget execution for the first four months of 2005 demonstrates that increased wage and social spending crowds out other expenditure items.

The budget deficit is projected to amount UAH 7 billion. It is to be financed almost totally by proceeds from privatization, as was the case in 2004. However, privatization has been stopped for political reasons during the first half of this year (see Chapter 6) and although the President has demanded that it begin again, it is very unlikely that the expected amount of revenues will be collected. The resulting shortfall will prompt a much larger recourse to public sector borrowing and increasing interest payments in coming fiscal years. The actual fiscal deficit might amount to over 4% of GDP depending on nominal GDP and the effectiveness of revenue collection in 2005.

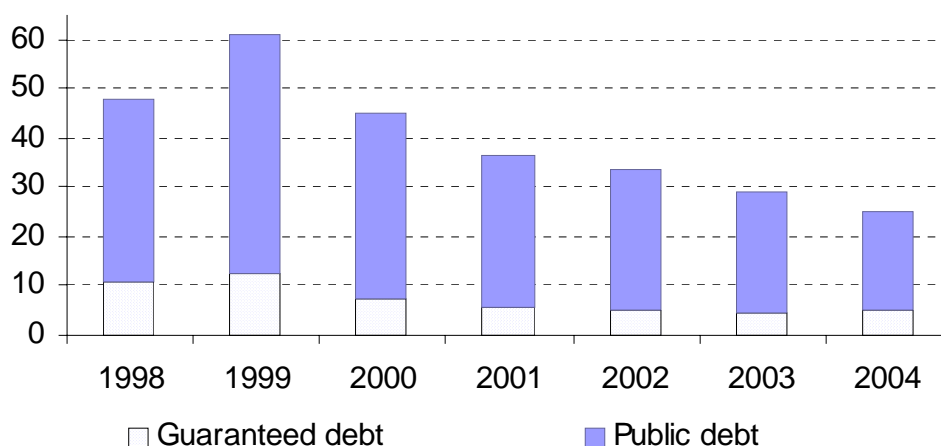
The level of public debt is now not very high (see Figure 5) and the Government can borrow relatively cheaply on both domestic and international financial markets. However, borrowing conditions may become less favorable and Ukraine could face a dramatic situation similar to the near-default of 1998-1999 if the fiscal situation continues to deteriorate. Moreover, rising wage bills and social transfers have long-term consequences for coming budgetary

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<sup>4</sup> [http://www.minfin.gov.ua/control/en/publish/article?art\\_id=54475&cat\\_id=34244](http://www.minfin.gov.ua/control/en/publish/article?art_id=54475&cat_id=34244)

periods. Once granted, social entitlements cannot easily be withdrawn in bad fiscal times. Ukraine already has one of the highest levels of social spending (in relation to GDP) in the world and its very unfavorable demographic structure will further worsen this ratio.

**Figure 4. Public debt (including guaranteed debt), % of GDP, 1998-2004**



Source: Ministry of Finance of Ukraine

## Conclusions

1. Ukraine urgently needs a new round of substantial fiscal adjustment measures. They should include, among other things, a complex social reform aimed at eliminating of various pension and social privileges and better targeting of social transfers to the most vulnerable groups of the population, and in the mid term – optimization of pension expenditures by means of an increase in the effective retirement age. A failure to enact such reforms will threaten a further deepening of the fiscal crisis and rising inflation (which reached a year-on-year level of 14.6% in May) just before the March 2006 parliamentary elections. This would be the least desired social and political scenario.

2. The recent exchange rate policy geared to hryvna appreciation to reduce inflationary pressure could be an effective measure provided it is supported by a sound fiscal adjustment policy. In the medium term, the NBU must abolish attempts to use a hybrid policy of simultaneous control of both the exchange rate and the money supply (or interest rates). International experience shows that a hybrid monetary policy does not guarantee effectiveness in fighting inflation and contains risks of serious macroeconomic destabilization in the case of adverse shocks. The NBU with the support of the IMF has declared its intention to switch to a direct inflation targeting policy. It is necessary to take into account that this strategic choice, though appropriate on the whole, is difficult to implement from the viewpoint of both economic and technical considerations. It will require substantial modernization of the NBU's legal foundations, above all increasing its political independence from the legislative and executive branches, improvement of money and inflation statistics, strengthening capacity for analysis and forecasting, and improvement of operational procedures of the NBU and its communication with financial markets. But the biggest changes are needed for exchange rate policy, since effective inflation targeting requires a floating exchange rate policy.

## CHAPTER 3. STATE AND CITIZEN: IMPROVING THE STATE

### 3.1. ADMINISTRATIVE REFORM

#### *Positive developments*

Issues of administrative reform have become an integral part of the "Toward the People" program of the Cabinet of Ministers of Ukraine (incorporating most of the recommendations proposed by the Blue Ribbon Commission), approved by Cabinet Resolution #115 dated 4 February 2005, and the Ukraine-EU Action Plan that determines the strategy of relations with the EU for the next three years. Actually, the Ukraine-EU Action Plan signed in Brussels on 24 February 2005 and Measures to Implement Ukraine-EU Action Plan for 2005, which was approved on 22 April 2005, will become the basis for the government's activities in directions defined by Ukraine and the EU jointly.

**1. The current Government has shown its readiness to undertake radical steps in the public administration sector through the appointment of a Deputy Prime Minister in charge of administrative-territorial reform.** Actually, after the appointment of Roman Bezsmertny to this post on 4 February 2005, one can speak about the beginning of a new period in the implementation of administrative reform. His operations are to be supported by analytical, organizational, and technical services to be provided by the Division of Administrative Reform as a correspondent structural unit of the Secretariat of the Cabinet of Ministers of Ukraine, together with the Office of the Deputy Prime Minister.

The division of responsibilities between the First Deputy Prime Minister and other deputy prime ministers specified by the Resolution of the Cabinet of Ministers #175 "On functional authorities of the First Deputy Prime Minister and deputy prime ministers" of 3 March 2005 gives the Deputy Prime Minister the following areas of responsibilities:

- Formation and realization of state policy concerning implementation of administrative and administrative-territorial reforms in Ukraine;
- Coordination of the activities of the state bodies in these spheres;
- Preparation of draft laws and corresponding normative and legal acts to fulfill the duties and organization of activities of executive and local self-governance bodies; on operations of civil service and local self-governance; and
- Securing openness in administrative and administrative-territorial reform, in particular by informing the public about the main priorities, progress, and results achieved in the course of their implementation.

The new Government has also introduced the post of Deputy Prime Minister responsible for European integration policy. Insofar as questions of Ukraine's European integration touch upon and imply changes to all spheres of the country's public and social life, the resolution of issues surrounding the introduction of European standards of public administration is a prerequisite for meeting the political Copenhagen criteria of accession to the European Union. That is why the issue of "coordination of Euro-integration policy measures and results of the executive authorities' activities to create preconditions to obtain the EU membership" has been included in the competence of the Deputy Prime Minister for Issues of European integration. Such preconditions include the creation of appropriate institutions, formulation of procedures and performance standards for ministries and agencies, and training civil servants in appropriate skills.

Two authorities — the Deputy Prime Minister for Administrative-Territorial Reform and the Deputy Prime Minister for European Integration—will be responsible for the reform of the public administration system. The consistency of the Government's measures undertaken in this direction will depend upon the coordination of their actions.

By directive of Deputy Prime Minister Bezsmertny, three working groups were created to prepare draft legislation "On the President", "On the Cabinet of Ministers", and on civil service and administrative-territorial divisions.

**2. Steps aimed at making the Government "political" have been taken.** The Government has been staffed by representatives of the three main political forces that supported Viktor Yushchenko during the presidential campaign: the "Our Ukraine" Coalition, and the "Fatherland" and Socialist parties. In particular, the "Fatherland" Party is represented in the Government by the Prime Minister, Yuliya Tymoshenko, herself and by the Head of the Security Service of Ukraine Oleksandr Turchynov, while the Socialist Party is represented by the Head of the State Property Fund Valentyna Semenyuk, the Internal Affairs Minister Yuriy Lutsenko, and the Agrarian Policy Minister Olexandr Baranivsky.

**3. Structuring the Cabinet.** While forming the current Government, there was an attempt to depart from the branch principle in favor of the functional principle. This is clear in the appointment of deputy prime ministers who have been assigned execution of clearly defined functions: administrative and administrative-territorial reform and European integration. Unfortunately, as regards all other positions, the new Government has been formed based on the same old principle of branch government.

One of the top-priority tasks of the Government is the preparation of a draft Law "On the Cabinet of Ministers of Ukraine" that would define clearly the functions and powers of ministers and the principles of their interaction with state authorities. In March, an interdepartmental working group for elaboration of this draft law commenced its work. The plan of measures to fulfill the Ukraine-EU action plan proposes to pass this law and a number of other regulatory and legal acts (namely the laws "On Ministries and Other Central Executive Authorities," "On the Civil Service," and "On the Administrative-Territorial System"), and to amend the laws "On Local Self-Governance," "On Local State Administrations," and other regulations that will form the basis for reforming the public administration system. The appropriate laws are to come into force in 2005.

**4. Concentrating on strategy and policy.** The Cabinet of Ministers approved a plan to address the most important issues concerning the formation and realization of state policy by issuing Order #63-r on 12 March 2005. In taking this step, the Cabinet declared its priorities for the first half of the current year. To process those priorities in a comprehensive way, the Secretariat of the Cabinet of Ministers, in addition to the Provisional Order on the Cabinet (in the section titled "The Order of Developing Conceptual Basics for State Policy Implementation"), proposed the principles of preparation of a position paper for the Cabinet of Ministers. The principles describe the preparation procedure of appropriate documents, including standard forms, which will allow standardization of documents submitted for the Cabinet's consideration.

Unfortunately, this document is extremely complicated to use. It does not clearly separate methodological approaches from purely technical points, and its text does not contain any instructions on filling out the proposed forms. The results of the semi-annual performance plan will help determine the efficiency of this step.

The first protocol instructions of the newly formed Cabinet of Ministers proposing that ministries and other central executive bodies define priorities for 2005 seem to be a positive

practice. These priorities served to define an action plan for the fulfillment of the Government's "Toward the People" program. This employed a sound approach for policy planning and coordination based on a general policy framework defined by the program of the Government from the "top" and content defined as priorities of ministries from the "bottom."

A serious obstacle to implementing this generally positive approach is the lack of skills of public servants to define priorities within the limits of available resources to attain formulated political objectives. As a result, most central executive bodies failed to accomplish this strategic task. The Cabinet of Ministers had to demand that ministries define their priorities for three consecutive sessions.

**5. Delineating functions of political officials and civil servants.** The presidential Decree "On Changing the Number of Chief Administrators in the System of Central Executive Bodies" limited the number of deputy ministers. Specifically, the positions of first deputy minister – chief of ministry apparatus and first deputy minister responsible for relations with the Parliament have been abolished. In addition, a minister may have no more than four deputies, including one first deputy minister, in the chief administration of the particular ministry. In case of necessity, this number may be increased by presidential decision. Legislative regulation of political and administrative functions has yet to be implemented. The issue of introducing the post of state secretary in the ministries remains on the Government's agenda.

### ***Problematic issues***

**1. Administrative reform has started without any governmental plan or implementation strategy** that would clearly define the main directions, the sequence of their achievement, and the financial and human resources needed for their realization. There is no confidence that the Government will pay proper attention to the issues of administrative reform. Cabinet of Ministers Order #63-p of 12 March 2005 elaborates the most important issues of state policy to be considered in meetings of the Government during the first half of 2005. Only paragraph #26, "On the Introduction of Public Monitoring of Efficiency of Operations of Executive Bodies," alone of 40 positions, is seen as derived directly from the Government's program on administrative reform.

**2. The practice of non-constitutional relations between the Secretariat of the President and the Cabinet of Ministers** and commissioning directives to central executive bodies continues. The Secretariat of the President was created by re-organizing the previous Administration of the President by Presidential Decree #108/2005 "On the Secretariat of the President" of 24 January 2005. A certain abstract confusion was added by the introduction of the post of the Head of the Presidential Apparatus (patronage service) in the form of the State Secretary of Ukraine.

Presidential Decree #208/2005 "On Issues of Organization of the National Security and Defense Council" of 8 February 2005 commits numerous violations of constitutional norms by extending the council's authority, defined and regulated by a special law, and assigning illegal powers to the Head of the Council.

Presidential Decree #593/2005 "On Improvement of the Structure of Local State Administrations" of 3 April 2005 recommends a certain unification of the structures of local executive bodies with the Cabinet of Ministers, and is more consistent with constitutional regulations with respect to presidential authority in terms of content and format.

**3. Structuring the Cabinet of Ministers.** The Government's program stipulates:

*“...transforming Governmental Committees into the real operational structure of the Cabinet of Ministers and instruments that would coordinate and secure interaction and coordination between different central executive bodies (administrative reform)”*

However, these governmental committees have not yet been formed. This violates a temporary order of the Cabinet of Ministers established by the Decree of the Cabinet of Ministers #915 of 5 June 2000.

**4. Optimization of structure of executive bodies precedes improvement of functions of the Government.** The system of central executive bodies is irrational at present. Its current shortcomings are continued growth in the number of central executive bodies; direct subordination of many of them to the President instead of the Government; the lack of a clear difference between the status of ministries and that of other central executive bodies; poor horizontal interagency coordination; excessive concentration of executive power (the tendency for bodies to build their own administrative structures). The internal structure of ministries is likewise not effective. It is characterized by an incomplete separation of political and administrative management; ministers are overloaded with administrative tasks; governmental bodies are not independent in terms of organization (their formation “within” ministries limits their autonomy and optimization of management); the internal structure of the ministerial apparatus is unsystematic.

Therefore, Government plans to re-organize the system of central executive bodies and their apparatus are important and timely. It was proposed to build the system according to the sector principle in February 2005. This approach implies the formation of integral sectors that will be administered by ministers and will allow the ministers to represent all issues related to the executive branch of power. The proposed classification envisages the ministries (as the governmental organizations responsible for formulating and implementing state policy) and other central bodies, which carry out the functions related to public services. At the same time, it dismisses the bodies with a special status (as of early February 2005 the number of such bodies was 23 of 62 executive authorities existing at the central level), and cuts the number of state committees. In particular, it was planned to disband the State Committee on Elimination of Chernobyl Accident Consequences, the State Committee on Energy Conservation, the State Aviation Service, the State Committee on Natural Resources, the State Committee on Export Control, the State Committee on Construction and Architecture, the State Department of Incarceration, the State Committee on Religions, the State Committee on Tourism, the State Committee on Sports, the State Committee on Veterans’ Issues, the State Committee on Technical Regulation and Consumer Policy, and others.

In March 2005, the Government approved changes to the structure of the central executive authorities’ apparatus, their territorial units, and local state administrations.<sup>5</sup> It is expected that the internal structure of the ministerial apparatus should be defined based on key functions (main directions of its work) while attendant units should be created according to a structure that is typical for all ministries. At the same time, solving problems of organizational structure is purely a technical issue and should be done only after a thorough functional analysis, since executive bodies should be formed to fulfill concrete functions and not vice versa. In the past, formation of a set of functions in the Regulation on executive bodies was done spontaneously and institutions sought to capture as many functions as possible to expand their spheres of influence. These functions have been accumulated over a long period of time, some

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<sup>5</sup> See Resolution of the Cabinet of Ministers #179 “On changes to the structure of the central executive authorities’ apparatus, their territorial units, and local state administrations” of 12 March 2005, “Uryadovy Currier 6 April 2005 p.6.

of them are not executed, and others do not reflect a real distribution of responsibilities and powers. It is necessary to avoid these mistakes. Therefore, a functional review of ministries and other central executive bodies according to a sector distribution of state policy should facilitate optimization of organizational structures. Decentralization and de-concentration of administrative functions and authorities, ordering of public administration bodies and their territorial divisions, and internal organizational structures are possible based on the results of a functional review.

**5. The problem of transparency of the government's operations raises major concerns.** Although, according to the Deputy Prime Minister for Administrative Reform, "power should become qualitatively different: maximally exposed to the public while having minimal control functions," some activities of the Government contradict this declaration. For example, amendments to the state budget for 2005 were approved without public dialogue; even the members of the Parliament voting for amendments did not have a chance to familiarize themselves with the content of the relevant document. Another example is a large number of presidential legal acts with restricted dissemination, i.e. "not for publication" (39 over the past two months).

The Decree of the Cabinet of Ministers #263 of 6 April 2005 envisages monitoring of the activities of the Government and regional executive bodies with respect to social and economic development in Ukraine. The goal of the monitoring is *"to analyze whether social and economic development of the country corresponds to the priorities stated in the government's program"* and *"to evaluate the performance of central and local executive bodies across different sectors of the national economy."* It is important to support this statement through relevant implementation efforts.

**6. Civil service reform should become an alternative to a personnel revolution and a purely quantitative approach.** The reform must be based on the Concept of Development of Legislation on Civil Service, approved by a presidential decree of 5 January 2005. The Government is considering a new draft of this Concept, which provides a political framework for the new Law "On Civil Service". Currently, the Central Directorate for Civil Service together with the relevant interdepartmental working group of the Government lead by Deputy Prime Minister Bezsmertny are working on this document. The Government expects to submit the new draft law to the Parliament by 1 September 2005.

Important innovations stipulated by the new draft law include provisions that will enable Ukraine to bring its civil service into line with EU standards:

- Regulation of civil service based on public law;
- Separation of political and administrative positions and creating the post of state secretary;
- Introduction of an open contest for all positions in civil service;
- Improvement of the civil service managerial framework; and
- Modernization of the staff remuneration system and pension provision for civil servants.

According to official information, some 18,000 public servants were dismissed at a managerial level in public institutions in Ukraine in the last few months. This approach creates

serious risks for the new administration since neither the bureaucracy nor the Government is changing its methods. There are no clear qualification requirements for positions, transparent selection procedures are lacking, or, most importantly, the procedures of governmental bodies are not changing. Newly appointed public servants without civil service experience are not receiving the management training they need. The civil service personnel management system remains institutionally weak. Appointment and dismissal of public servants still lie with the political leadership. At the same time, the main principles of a professional civil service – political neutrality and loyalty to legitimate government – are being violated.

It is important to understand the inefficiency of a purely quantitative approach to administrative reform, i.e., a mere reduction in number of civil servants. Ukraine already witnessed such measures in 1999: not only dozens of state committees and services but also even several ministries were liquidated, resulting in a decrease in central executive authorities to 47. However, these reductions did not bring any qualitative change in the structure of the state power and its administration. Consequently, over the next five years the number of central executive authorities again climbed to 60. The problem is not the quantity of civil servants as such, but the efficiency of governmental mechanisms and quality of service provision. Besides, the number of civil servants in Ukraine is not high: as of early 2004, total employment in the civil service system in Ukraine was about 250,000, or 0.5% of the total population, whereas in Poland this indicator is 0.6%, in Russia, 0.8%, and in Hungary and Sweden 0.9%.

**7. The government's relative inactivity as a source of legislative initiative is surprising.** During its first months in office, the new Government as a source of legislative drafts submitted to the Parliament only 17 draft laws (including two draft resolutions, on the program of the Cabinet of Ministers and on changes to the law on the 2005 state budget). During a similar period (1 February 2000 to 8 April 2000), the Cabinet of Ministers under then Prime Minister Viktor Yuschenko submitted 60 legal initiatives to the Parliament.

## **Conclusions**

Although the Government devotes considerable attention to administrative reform, its steps are sometimes inconsistent and not transparent. One reason for such inconsistency is the lack of a clear plan for reform that specifies concrete measures, dates, and required financial and human resources. It is necessary to:

1. Adopt quickly a set of legislative initiatives designed by working groups under the Cabinet of Ministers, including, in particular, the law "On the President of Ukraine," the draft Law "On the Cabinet of Ministers," the law "On Ministries and Other Central Executive Bodies," and the Law "On Civil Service";

2. Clearly define the powers of different executive authorities that are responsible for administrative reform. In particular, it is important to clarify the place of the National Security and Defense Council (NSDC) and the Secretariat of the President in this process, since after the sessions of NSDC some government decisions related to administrative reform were suspended (e.g., defining the structure of ministries and the mechanisms of subordinating certain central executive bodies to ministers). In addition, the selection, assignment, and career promotion of 1<sup>st</sup> and 2<sup>nd</sup> rank civil servants are taking place without transparency and in fact under control of the Secretariat of the President;

3. Undertake a functional review (and use results of functional examinations) to determine the functions of the Government in each sector of public administration, and improve the structure and optimize the size of executive bodies at all levels of public administration.

Carry out decentralization of functions using the results of a functional review and transfer some functions from executive to local self-governance bodies (primarily rendering services) and other functions, from ministries and other central executive bodies to governmental public administration bodies (primarily asset management, supervision and control, and provision of administrative services).

Secure accountability of all central executive bodies to the Cabinet of Ministers, streamlining and coordination of central executive bodies headed by civil servants to corresponding members of the Government and provide for more autonomy for governmental bodies;

4. Conduct intensive short-term training on state policy analysis, strategic planning and managing organizational change for civil servants – managers of top and middle-level public administration, first of all – at the central level of the Government;

5. Submit all draft documents on issues of state policy and important legal initiatives in the sphere of public administration to expert and public discussion that will enable the Government to explain unpopular decisions and reach a public consensus for their effective implementation.

## **3.2. REFORMS OF RELATIONS BETWEEN CENTRAL AND LOCAL AUTHORITIES**

### ***Positive developments***

Several important steps have been undertaken with an eye to reforming the relations between central and local governments in the course of recent months:

1. The Government's measures to implement its program "Toward the People" for 2005 contribute to a clear delineation of the functions and powers of central bodies and local governments, since they envisage:

- The development of a draft law on basic principles of subventions from the state budget to finance investment projects that will allow the formulation of common methodological principles for granting investment subsidies to local budgets;
- The approval of the Cabinet of Ministers resolution on the establishment of tariffs for housing and communal services (amending the resolutions "On Amending the Annex to the Cabinet of Ministers Resolution #1548 of 25 December 1996" and "On Amending the Cabinet of Ministers Resolution #1168 of 28 December 1997") and a draft law on the powers of local governments to determine tariffs for housing and communal services. If passed, this law will eliminate incongruities between local governments and local executive authorities concerning tariff-setting powers;
- Cataloguing lands in state and municipal ownership;
- Amendments to the law "On motor transport", to define unambiguously the responsibilities of the local executive authorities of certain regions to provide feasible passenger transport. This will define the powers of state authorities and local governments concerning passenger transportation, highlight their obligation to resolve issues related to the social and economic development of regions, and create conditions for a transparent mechanism of control, including public control, over these public services;

- Approval of draft regulations on the procedure of entering information about financial institutions that are subjects of civil law into the State Register of Financial Institutions, particularly those created by local governments. This will promote the introduction of uniform and transparent requirements for financial institutions, and will improve the quality of financial services rendered by local governments.

2. **The revised draft law “On Amending the Constitution of Ukraine” has been passed in the first reading.** This bill includes amendments to Article 140 of the Constitution of Ukraine regarding the legislative delineation of powers between the state and local self-governance bodies, and procedures for the mutual delegation of powers. It also eliminates duplication of powers that may have been granted to both state authorities and local governments.

3. **Amendments to the Budget Code of Ukraine have been made that reduce the budgetary burden on villages, settlements, district-level cities, and their associations.** Budget expenditures on primary medical, outpatient and inpatient care (district hospitals, outpatient medical facilities, obstetric stations, and first aid stations), and village, settlement and city cultural centers, clubs, and libraries will be financed from the budgets of rayons and cities. The changes, which take force as of 1 January 2006, are a step in the right direction, since they will help to bring budget spending into line with realistic opportunities for income accumulation, and they will improve the efficiency of expenditures from local budgets on local health care and culture. These changes will also make it possible to increase the financing of other expenditures from the budgets of villages and settlements.

4. **Expansion of territorial communities is envisaged within the framework of administrative and territorial reform.** The draft law “On the Territorial System of Ukraine” proposes a systematic approach for implementation of the reform. The first stage (two to four years in length) would create expanded self-sufficient communities and four or five centers at the rayon level to provide administrative and social services to the inhabitants of the surrounding settlements. The second stage of reform would introduce changes at the rayon level, and the third, at the oblast level. The draft law proposes the following territorial system: community – at least 5,000 inhabitants; rayon – at least 70,000 inhabitants; rayon centre – no less than 70,000 inhabitants, regional centre – no less than 750,000 inhabitants. Special working groups were established in four oblasts (Vinnystya, Odessa, Ivano-Frankivsk, and Luhansk) to test provisions of the draft law. An alternative model of territorial system proposes shifting the basic level of self-governance from the community to the rayon. Issues of implementation of local self-governance reform have been discussed at the all-Ukrainian meeting on local self-governance on 23 April 2005.

### ***Problematic issues***

1. **The criteria to be used for the expansion of communities are still undefined.** The authors of the draft Law “On the Territorial System of Ukraine” propose the following criteria:

- Accessibility to public pedestrian or transport services.<sup>6</sup> Utilizing standards adopted by city planning specialists and others for the time allocated to reach public transport and wait for the transport to arrive, and additionally considering the speed of public transport between settlements, the draft’s authors believe that the largest possible distance from villages to a population centre where services are provided must not be greater than 10-12 kilometers.

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<sup>6</sup> *Uryadovy Kurier*, # 65, 8 April 2005, p. 6.

- Population size.

The main problem today is not to ensure that the state-guaranteed package of social and administrative services is provided at the lowest community level *per se*, but rather to ensure that such services are provided in the most efficient way. The authority to make decisions regarding the provision of social and other public services (that is, allocations of these services) should be distributed among various levels of executive power and local self-governance in such a way that the optimal distribution of national resources is achieved. Budgetary allocations for public services depend on the size of the population that uses them. The optimal administrative-territorial size, which would both take into consideration the preferences of the local populace and provide services at the lowest possible cost, varies depending on the services in question (for example, an administrative-territorial size for schools differs from a similar indicator for sports facilities or universities).

The administrative-territorial division system should create conditions for the most comprehensive consideration of people's needs in relation to public goods and services. For example, the needs of rural residents differ from those of city dwellers. Therefore, proposals that include urban and rural settlements in one community, with the simultaneous guarantee of rural inhabitants' right to have larger household plots or pay for electricity at lower rates than urban residents, appear rather disputable. An important factor when forming communities is the uniformity of needs of the people living within their territories.

The physical accessibility of services should conform as much as possibility to the residence of those who finance them (the territorial conformity principle), so that there is no incentive to shift financing of services onto third parties. Failure to take territorial conformity into account results in economic inefficiency (for example, in the form of tax evasion).

**2. It is rather problematic to increase the share of local budgets in consolidated budget expenditures** as the Government's program proposes to do. Changing the share of local budgets cannot be an independent, separate task. It is not by accident, then, that the draft plan of measures offers no mechanism for its implementation.

The share of each budget in state expenditure financing should correlate with the distribution of functional powers between public authorities and local governments. Meanwhile, only some steps have been made toward solving this task. The Budget Code only mandates separating expenditures into those that are considered when determining the amount of inter-budgetary transfers and those that are not. Currently in Ukraine, expenditure liabilities of local governments are actually based not on their functions, but on the number of facilities in municipal ownership (that is, not a functional but an objective approach is used). Identical expenditure items are financed from both state and local budgets.

## **Conclusions**

While designing the territorial-administrative reform, two important things should be taken into account:

1. Economic criteria (the type of consumer of public services, interregional external effects of public services, average change in cost in the provision of public goods and services) should be the basis for making decisions on the allocation of responsibilities concerning the provision of public services on the local level. The principle of territorial conformity should be observed.

2. Changing the share of local budgets in consolidated budget expenditures should be preceded by completion of a clear delineation of functional powers between public authorities and local governments that would prevent duplication of functions. The next step should consist of the distribution of expenditure liabilities between various levels of budgets, which must correspond to the distribution of functional powers as much as possible; that is, both expenditures and relevant decision-making authority should belong to the same authority level. This would permit the introduction of distinct responsibilities among authorities for budget allocations and for the effectiveness of budget allocations, as well as exercising proper control over the work of the administrations involved.

### **3.3. JUDICIAL REFORM**

#### ***Positive developments***

Most of recommendations of the Blue Ribbon Commission with respect to judicial reform have been reflected in the Government's "Towards the People" program. The Government's action plan also includes a special chapter devoted to the development of the judicial system. The extent of incorporation of Blue Ribbon Commission recommendations into the Government's program varies from the general to statements that are more detailed. For instance, the necessity to implement constitutional foundations for the court system is only highlighted without identifying particular measures. At the same time, the need to adopt codes for implementation of a new codification of procedural law is supported by the description of some quality requirements.

The major part of the judicial reform could be implemented through legislative changes. At the same time, the new Government has not yet submitted to the Parliament legal initiatives aimed at implementation of judicial reform. The Ministry of Justice does certain work to prepare necessary legal initiatives. The Government's inaction is counterbalanced by legal initiatives from people's deputies. For instance, people's deputies proposed that the Parliament consider a draft Law "On legal assistance", which aims to provide free of charge legal assistance to low-income households.

The only practical step taken towards reforming the judicial system concerns an increase in financing: amendments to the 2005 state budget envisage slightly higher expenditures on financing the judicial system than in the past. Though the general increase of expenditures on the judicial system is not large, the financing of the local general court system has been increased by one-third. However, even this increase in financing is not sufficient to finance the actual needs of judges in full.

#### ***Problematic issues***

1. The Blue Ribbon Commission emphasized the need to adopt a **concept of judicial system development** covering the 2005-2015 period. The Government's program acknowledges the slow pace and inconsistency in implementation of judicial reform due to the absence of an overarching concept and implementation mechanisms. The parliamentary hearings on judicial reform that took place on 16 March 2005 have also highlighted a necessity to develop and adopt a concept. However, so far no practical steps have been undertaken in this direction.

2. The creation of **administrative courts**, initiated by a decree of former President Leonid Kuchma issued on 16 November 2004, is moving slowly. The new Government should undertake active measures to create an administrative courts system, and, in particular, to provide the courts with facilities. The Parliament adopted a code of administrative legal procedure that is an

important step toward modernization of procedural legislation. Unfortunately, the President has vetoed the code and appealed to the Parliament to give second consideration to his proposals. However, the President's proposals violate the norms of the Constitution of Ukraine and conventions on protection of human rights and freedoms. For instance, the President proposed to prevent individuals and legal entities from appealing against illicit normative and legal acts of the President, the Government and the Parliament of Ukraine and the Parliament of the Autonomous Republic of Crimea. Vetoing the code of administrative legal procedure impedes the coming into force of the new civil procedural code.

3. The Government's program has declared a necessity to initiate **public consultations on the rationale for the military courts system**. These public consultations are already under way in the mass media. Though the previous Government has already submitted to the Parliament a draft law on the abolition of the military courts system, the new Government has recalled it. It would be expedient to resubmit this draft law for consideration by the Parliament.

4. No attention has been paid to the necessity to **adjust the responsibilities of the President with respect to judicial system (in particular with respect to the appointment of heads of courts) to the norms of the Constitution of Ukraine**. There are certain alarming signs that the President sometimes exceeds his authority. For instance, the Presidential Decree "On Some Issues of Organization and Operations of the National Security and Defense Council" of 8 February 2005 gives the Secretary of the Council the right to propose to the President candidates for judges. This contradicts the appointment procedures for judges stipulated by the existing law.

5. Other Blue Ribbon Commission **proposals have so far been ignored** by the Government. This concerns recommendations on:

- Setting a fee for going to court, a procedure for payment of this fee, and the procedure for spending the revenues generated from such fees;
- Preparing amendments to the Constitution regarding the composition of the Supreme Council of Justice (to ensure that judges, including retired judges, would constitute not less than a half of the members);
- Making the powers of the prosecutor's office consistent with the Constitution (in particular by relieving the prosecutor's office of general pre-trial oversight and investigation and assigning pre-trial investigation functions to a special body created within the system of executive bodies).

The President has created a commission to work out proposals on creating a National Bureau for Investigation. The National Bureau for Investigation could undertake the function of pre-trial investigation.

Similarly, on 26 May 2005 the President created a commission on reforming the judicial system, but surprisingly assigning this task to the Secretary of the National Security and Defense Council. The commission was ordered to formulate proposals with respect to reforming the judicial system by the end of 2005. Unfortunately, outstanding figures – the Head of the Supreme Court, the Head of the Higher Administrative Court, the Head of the Higher Economic Court, the head of the State Court Administration – do not form a part of the commission. Representatives of public organizations that work actively in this field are excluded from the commission as well.

6. The government's program has highlighted the **necessity to restrict the administrative authority of court presidents and separate the provision of justice from the provision of support to judicial proceedings**. However, no steps have been undertaken in this direction. Moreover, according to the statement of the Secretary of the NSDC, a decision has been taken to liquidate the State Court Administration or subordinate it to the Supreme Court. Implementation of this decision (which ignores both provisions of the government's program and Blue Ribbon Commission recommendations) would further intertwine the administration of justice and the provision of support to judicial proceedings.

## **Conclusions**

Although many Blue Ribbon Commission recommendations concerning reform of the judicial system are reflected in the Government's program, practical implementation has not yet started. This should speed up. The most urgent reform measures that can and should be implemented in the short term include:

- Drafting and adopting a concept of development of the judiciary system;
- Accelerating the establishment of an administrative courts system, setting in practice the code of administrative legal procedure and the new civil procedural code;
- Bringing the authority of the President with regard to the judicial branch into conformity with the Constitution of Ukraine;
- Re-submitting the draft law on the liquidation of military courts to the Parliament;
- Restricting the administrative authority of court presidents, and separating the provision of justice from the provision of support to judicial proceedings.

## CHAPTER 4. A MORE EFFECTIVE AND HUMANE SOCIAL POLICY

Social reforms are unpopular, because they can have a negative short-term impact on the incomes of a large share of the population. At the same time, these reforms can have a significant positive impact on economic stability and the well-being of the population in the medium and long term. Unfortunately, recent developments suggest that the Government is not using its existing window of opportunity to implement long-needed reforms in the social sector. So far, the major changes in the social sector have been mainly of a populist nature, and have led to an increase in budget expenditures. This is a dangerous strategy that could result in the destabilization of the social sector in the long run.

In the next four sections, we provide a brief assessment of what has been done in health care, education, social support, and the pension system, and suggest some steps that can be implemented before the window of opportunity closes.

### 4.1. HEALTH CARE REFORM

#### *Positive developments*

The Program of the Cabinet of Ministers directly addresses most of the Blue Ribbon Commission's recommendations. Specifically, various parts of the program articulate the following intentions of the Government:

- To provide every citizen with a certain level of free medical services;
- To implement a unified system of quality indicators in medical institutions;
- To shift medical funding to the benefit of primary health care;
- To introduce mandatory medical insurance and encourage additional voluntary medical insurance;
- To promote the establishment of the institution of family physicians;
- To design and implement a viable mechanism to monitor the production, import, and sale of pharmaceutical products; and
- To treat the prevention of socially dangerous diseases as a state priority.

The government's program plans to increase the effectiveness of public funding by providing greater transparency in public expenditures, building a competitive procurement system, and exercising greater control over the direct use of funds. This is important for improving the state-supported health care sector.

#### *Problematic issues*

1. The main goal of the Blue Ribbon Commission's recommendations for health care reform was to increase the efficiency and effectiveness of use of public funds, in order to provide better-quality health care at reasonable public expense. **So far, the attention of the Government has been concentrated exclusively on the state-supported sector of the health care system.** The Government has attempted to resolve a number of problems in the health care system simply by increasing budget spending. In other words, it has tried to cure the symptoms of the disease instead of dealing with the root causes. This is not the optimal approach. It is necessary to develop private and public insurance funds and organize the

distribution of funds among health care providers on a pay-for-service basis, so that the public and/or private health care insurance system pays care providers for services actually delivered, instead of financing theoretically available beds or doctor visits.

Unfortunately, there is no sign that discussion of such a system might start soon.

2. **Words are not followed by deeds.** Although the government's program declares an intention to create health care insurance, guarantee only a limited set of free medical services, focus on providing primary health care, and establish effective control over the production and distribution of medicine, it does not say how to implement this. Instead, the Government has chosen the old way, trying to solve the immediate problems of the health care system by increasing budget spending (primarily on wages). Such fresh funding may temporarily resolve the problem of retaining qualified medical personal in public hospitals. However, it increases the overall burden of the health care system on the state budget, raising the risk of fiscal instability, and it also does not contribute to the reform of health care system.

## **Conclusions**

The main Blue Ribbon Commission recommendations should be adopted for implementation. This includes first of all the following:

1. **Shift to a pay-for-result system of financing health care institutions.** Both public and private service providers should receive payments only for results of their work, in other words for healed patients. Changing the financing mechanism will initiate a fundamental change in the structure of medical services, ensure the proper allocation of resources, and support further development of the medical insurance system. These are fundamental changes for the health care system in Ukraine.

2. It is important to take a **first step** in the right direction: to launch a national debate on the health care system, and analyze the costs and benefits of the proposed reform. This can be done within the government's present window of opportunity. Even unpopular reforms may receive sound public support if during public debates their long-term benefits are clearly shown. This will also contribute to the credibility of the Government by showing its focus on achieving long-term benefits for the people, instead of gaining short-term popularity.

## **4.2. EDUCATION REFORM**

### ***Positive developments***

The program of the Cabinet of Ministers directly addresses most of the Blue Ribbon Commission recommendations concerning the system of education, including the following:

- Ensuring access to quality secondary and higher education, promoting the comprehensive development of science, culture, and spirituality;
- Implementing efficient mechanisms for expanding the access of youth to quality education and the labor market;
- Introducing a state support system for acquiring higher and secondary special education;
- Promoting the principles of autonomy and self-governance for both public and private institutions of higher education;

- Developing and promoting a new generation of nationwide manuals, handbooks and materials and equipment for instruction, including state-of-the-art technology, and establishing Internet access in schools;
- Implementing a unified system of testing for enrolment in institutions of higher education.

The Government plans to take or already has already undertaken some steps to reform the education system. These include on-going preparations for implementation of a single testing system, changes to the Law "On Higher Education" that promote self governance among education institutions, development of a system of state credits for obtaining higher education, reform of the wage-setting mechanisms for instructors, and preparation of revised curricula. Some of these changes are already supported by revisions to the 2005 budget and changes in the Budget Code.

### ***Problematic issues***

1. While seemingly accepting most of the Blue Ribbon Commission recommendations, the Government has decided to take **a very gradual approach to their implementation**. This approach is reflected in the declaration by the Minister of Education that the education system will undergo changes rather than reform. So far, the Government has concentrated on increasing teachers' wages (through changes to the 2005 budget), eliminating part-time teaching positions, and increasing the role of the Ministry of Education in managing some institutions of higher education. The last measure seems to contradict the government's declared intention to increase university autonomy.

2. As in the case of the health care system, the Government has attempted to deal with problems in the education system simply by increasing budget financing for education. However, while promising higher salaries to teachers and setting better education standards, the **Government has not introduced proper mechanisms to ensure the financial sustainability of the education system**.

Introduction of a pay-per-pupil principle of financing, in primary and secondary schools as well as in higher education, is a matter of principle. However, the Government has not yet managed even to undertake discussion of this proposal. The education system has remained more or less unchanged since the time of Soviet Union. The further Ukraine moves towards a market economy, the more evident and dangerous the gap it faces between the economy as whole and the education system with respect to the basic principles of their functioning. With time, this mismatch will result in a heavy fiscal burden and increasing transaction costs of reforms to the education system.

3. The decision to halve the share of students attending state higher education institutions on a contractual basis is worrisome. This measure will contribute to a decrease in financing of state higher education institutions from private sources and contradicts the idea of increasing their autonomy. In addition, an increase in the share of students being trained by state order is no solution to the inconsistency between the educational system and the needs of labor market.

### ***Conclusions***

Two recommendations of the Blue Ribbon Commission of utmost importance have not yet been recognized by the Government:

1. Budget financing must be redirected towards primary and secondary education, so that the state guarantee of free education for all children is ensured. The education system should become more market-driven to promote efficient use of capacities and better quality services. Specifically, a clear pay-per-pupil system of financing should replace the current system based on "school needs."

2. Universities should be made autonomous and have independent boards that exercise full control over finances and curricula. The decision to halve the share of students attending on a contractual basis needs revision. The system of state order in higher education should rely on long-term forecasts of demand for qualified labor defined for professions and specialties.

As a first step, the Government should initiate a wide public discussion on reforms in the education system. Analysis of international experience should help to choose the optimal implementation mechanisms and garner public support.

3. The following considerations should be taken into account in the process of reforming education in the future:

a) **Creation of a system to monitor education quality.** It is necessary to develop functional standards for the system of education according to best world practices and effective mechanisms to give society a way to monitor their fulfillment by the state. Of strategic importance is Ukraine's participation in international comparative studies (PISA, TIMSS etc.), carrying out forecasting with respect to development of education and labor market demand. Without this system, existing initiatives to establish independent testing centers and other reforms will remain isolated actions that do not complement a general course on modernization of education.

b) **Establishing mechanisms for public control over expenditures assigned to finance educational institutions at the level of local budgets.** This approach will secure transparency of procedures of financing, improve technical and material equipment, and increase efficiency in servicing schools and other education institutions. Creation of modern financial, market mechanisms of financing with a possibility to obtain resources from different sources is important as well<sup>7</sup>.

c) **Creation of mechanisms to match the education system with the current needs of the labor market.** This requires filling the gap between demand for professions and chances to get correspondent educations; bringing the content of educational programs into conformity with the needs of the labor market and society; establishing market mechanisms for the design and selection of textbooks; and introduction of an effective life-long professional training system.

d) **Creation of a transparent and effective motivation system for pedagogical personnel** by means of encouraging raising the level of personnel's skills. Substantial increases in teachers' wages to reflect qualifications and revision of mechanisms of supplying educational specialists with necessary guidance materials and organization of workplaces are necessary as well.

### 4.3. BETTER TARGETING OF SOCIAL BENEFITS

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<sup>7</sup> Millennium Development Goals. Ukraine. - Ministry of Economy and European Integration. 2003. - p. 14-15

## ***Positive developments***

The new Government has acknowledged that poverty is an important problem and has declared overcoming poverty to be one of its main goals. It has already begun work on the implementation of a "Strategy for Overcoming Poverty in 2006". The Government has accepted the need to reform social programs in order to provide better-targeted social assistance and protection. A first step in this direction is an improved methodology to measure poverty, expected to be ready by November 2005. It is also important to realize the importance of the interconnection between improvements in social assistance and changes in the framework for employee compensation.

The 2005 budget is the main governmental tool for fighting poverty. The Government increased lump-sum payments to parents upon the birth of a child to about US\$1,500 at current prices (that is equal to almost 12 average wages). In order better to protect children from poverty, the Government has also increased support to families with children, and increased budget spending on programs for children without parents. The widening of other types of social assistance has contributed to the overall increase in budget spending on social programs. For example, the introduction of higher minimum standards of living has automatically increased the level of budget expenditures on all types of social assistance.

One of the main Blue Ribbon Commission recommendations was to use public funds for social insurance more efficiently by raising the level of transparency in the system and through the careful selection of target groups. One effective step in this direction was the continuation of Government cooperation with the World Bank and local administrations in implementing a system of personal accounts for social benefits and a single-window application for social assistance. In our view, successful implementation of this program will have more impact on the accountability of budget spending than any other supplementary measures so far implemented by the government.

## ***Problematic issues***

The new Government's main problem is that **a significant increase in social spending is not supported by reliable sources of additional budget revenues.** The "cavalry" attack on tax privileges and the attempt to revise the simplified system of taxation of small entrepreneurs (see Chapter 5) raise doubts about the chances of reaping new budget revenues from a wider tax base. This stands in direct conflict with the ideas expressed in the Blue Ribbon Commission report, and fails to solve any long-run social protection problems. Moreover, increased social spending has already begun to cause economic problems in the country. The signs of increasing inflationary pressure have become more obvious. The fiscal risks are rising. This is a direct result of a populist approach, when an increase in public spending on social programs is not supported by a respective increase in budget revenues.

The Government has not yet used its window of opportunity (or window of trust) to enact important reforms to the system of social assistance. This would involve eliminating a broad range of privileges, monetizing the remaining privileges, and optimization of number of beneficiaries eligible for receiving social assistance.

Increased social spending is generally used by governments to gain popularity and trust before launching economic and social reforms. However, if not supported by a sound increase in budget revenues, such efforts produce the opposite effect: people lose their trust in a Government that "buys their favor" with social assistance. This in turn limits the window of opportunity for economic and social reform.

The methodology for calculating the minimum subsistence level remains imperfect. It is based on average prices for consumer goods and thus yields too high a figure.. A system of indicators is needed for regional subsistence levels, as this would help ensure common standards of consumption across Ukraine.

## **Conclusions**

Given that the fiscal risks associated with the government's current social policy are already high, we suggest that the following steps be taken more or less immediately:

1. **Change the rhetoric around the issues of social assistance.** The Government should carry on a dialogue with society and explain that any further increase in social assistance could have a dramatic impact on the country's macroeconomic and fiscal stability. Promises to increase social protection should be replaced by a discussion about how to modernize and prioritize.

2. **Make transparent changes in priorities as well as the implementation of social obligations.** Set and make public a new (more realistic) set of priorities with respect to social protection. Make clear that the priorities of a lower level are fulfilled only after all priorities of a higher level are met, and inform the public on the fulfilling of social assistance obligations on a monthly basis.

3. **It is necessary to improve a methodology of calculation of minimal subsistence level** based on minimal prices and develop corresponding regional indicators, which would assure common standards of consumption across Ukraine.

For the medium and long term, it is expedient to follow the Blue Ribbon Commission recommendations on decreasing the number of privileges and beneficiaries of the social assistance system by tightening eligibility criteria, and setting up transparent and straightforward mechanisms of providing social protection.

## **4.4. PENSION REFORM**

Reforms of the pension system in Ukraine have gone much further. The Blue Ribbon Commission report suggested continuing the development of the institutional and regulatory framework of the stock market that is necessary for the second and third tier of the pension system. At the same time, the Blue Ribbon Commission cautioned the Government that Ukraine has an aging problem similar to Europe that requires a reduction in the costs of the solidarity pension system.<sup>8</sup> Problematic issues

Contrary to the Blue Ribbon Commission's recommendation, the Ukrainian Government has chosen a path which has led to a **significant increase in costs of the solidarity pension system**: a rise in the level of pensions drove an increase in the share of the pension fund in GDP from 9% (in 2004) to about 14-16% in 2005. The expected deficit of the Pension Fund is supposed to be covered by transfers from the state budget<sup>9</sup> and by increased contributions, including those from private entrepreneurs. A ceiling for pension payments (i.e., the highest monthly wage from which the pension contributions are paid by employees) has increased from UAH 2,650 to UAH 4,100.

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<sup>8</sup> One of the ways to decrease future costs of the solidarity system is to start gradually increasing the pension age. This is the approach introduced by most of the Eastern European countries at the moment.

<sup>9</sup> The resources for these transfers are expected to come from cutting some capital expenditures and increasing tax revenues through a cut in tax exemptions for enterprises.

The increased amount of pension expenditures under present conditions seems to be unsustainable and unrealistic for financing even in the short-run. Increased pension obligations may create the accumulation of pension arrears and result in higher inflation. Attempts to finance the pension system by collecting extra contributions from private entrepreneurs will provide incentives to return to the shadow economy. In addition, the existing system provides no incentive to pay pension contributions from relatively low wages; it is more advantageous to pay a minimal deduction and retain seniority.

The expected populist effect of increased pensions may also be overestimated. Current expectations of the population of a higher inflationary pressure in the near future are based on similar experiences with past pension increases. Should these expectations be fulfilled, trust in the Government will immediately fall.

## **Conclusions**

In the short term, we recommend the following politically feasible steps:

1. Stop promising more generous pensions and acknowledge the risks associated with meeting high pension obligations.
2. Make any future increase in or indexation of pensions conditional on the increase of revenues of the Pension Fund.

This will make the current Government pension policy trustworthy and help to gain public support.

In the medium and long term, the Government should follow these Blue Ribbon Commission recommendations:

**1. The first and second pillars of the pension systems must be fully funded.** Consider the total costs and make necessary cuts if needed. The decrease in total costs may be achieved extensively (if the pensions are not indexed to inflation for some time) and by normalization of the principles of early retirement.

The retirement age must be raised. To ensure that these changes are gradual, they should start right now.

**2. There is a need to design a strategy for the development of an accumulation system** since existing legislation does not provide a clear answer on how this should be done. The design of a strategy to foster hired employment requires a special attention in the context of pension reform since it creates a base for increased contributions to the Pension Fund.

**3. Establish a strong regulatory authority that is independent of political pressure.** Strengthening the regulatory authorities that supervise financial markets in general should be a high priority objective for the new administration. In terms of pensions, the independence and authority of the executive directorate of the accumulation fund must be strengthened. Its fourteen members should be remunerated at professional rates. During their terms, they should be (short of criminal conviction) immune to removal.

**4. Competing private pension fund managers should be used in the second-pillar of the pension system in Ukraine.** While the Accumulation Fund hires private asset managers to maximize value, it may also direct investments into projects and sectors that are "in the national interest." Utilize international experience (e.g., Hungarian or Polish) in creating an independent

regulatory agency for licensing private domestic and international financial companies that will compete for the right to manage pension savings.

# CHAPTER 5. TAX AND FINANCIAL REFORMS

## 5.1. TAX REFORM

### *Positive developments*

The Cabinet of Ministers' program "Towards the People" has incorporated a number of recommendations concerning taxation from Chapter 4.1 on the "Necessity of further tax reform" from the Blue Ribbon Commission report. In particular, the guiding rule of the Government in the fiscal policy domain — taxes should be reasonable, stable and low, but everybody should pay them — coincides with the general approach of the Blue Ribbon Commission.

The list of measures that are intended for implementation by the Government is also very close to Blue Ribbon Commission proposals. It includes the following:

- a) Reducing the tax rate while simultaneously expanding the tax base defined as the first item in action plan of the government;
- b) Abolishing tax exemptions for selected groups of taxpayers and territories;
- c) Codifying tax laws and simplifying their wording, bringing together tax and business accounting principles;
- e) Canceling fiscal payments that require high administrative costs;
- e) Initiating a broad public discussion on the introduction of a real estate tax; and
- f) Reforming the fiscal authorities to eliminate competition among them, remove opportunities for abuse and corruption amongst their officers, and reduce administrative costs to taxpayers.

Finally, the Government intends to create an integrated social tax that will include contributions to three social funds (temporary disability, unemployment and on-the-job injury) to make additional incentives to employers. The President in his address to the US Chamber of Commerce announced plans to consolidate all social taxes into one 20% tax, to be made in a single payment. This corresponds to the Blue Ribbon Commission recommendation to consolidate four social payroll taxes into a single social tax.

To date, the most important legal act that has actually been developed by the new government, and that has a significant impact on the national taxation system, is the Law "On Amending the Law of Ukraine on the State Budget of Ukraine for 2005 and Other Legal Acts" (# 2505-IV of 25 March 2005). This Law stipulates equal fiscal conditions. Every entity should pay value added tax and enterprise income tax at effective rates. The law abolishes exemptions from VAT, excise tax and land tax for free economic zones and priority development territories are abolished (Article 39, cc.6-17 of the Interim Provisions) as sector fiscal privileges (for shipbuilding, automobile and military production, etc., Article 12[d]). The law limits the unsystematic granting of fiscal exemptions. A moratorium on granting new exemptions or expanding existing exemptions is introduced for five years from the date when the law is enacted (Article 2, c.15). These important provisions reflect the Blue Ribbon Commission's recommendation on the gradual abolition of almost all fiscal exemptions (including those for special economic zones and industry-specific and individual exemptions), in order to expand the tax base and make the tax burden more even.

This law allows the use of higher depreciation rates than those that were suspended before. Applying these depreciation rates in 2005 will have a positive impact on the renovation of enterprise fixed assets. This is in line with the Blue Ribbon Commission recommendation on simplifying and liberalizing the requirements for depreciation of enterprise assets in order to promote investment.

### ***Problematic issues***

The Government program did not take into account important recommendations in favor of a simplified system of taxation for agriculture and small business, as well as a whole range of issues on improving tax discipline and relations between taxpayers and tax authorities, like VAT refund to exporters, decriminalization of most tax infringements, prohibition of tax on-site inspection without a well-founded suspicion and a court decision, liquidation of the tax police, reduction in the number of tax inspectors and an increase of their salaries, and a study of opportunities to decrease a level of fiscal sanctions. The Law "On Amending the Law of Ukraine on the State Budget of Ukraine for 2005 and Other Legal Acts" #2505-IV of 25 March 2005 has also some amendments, **which took into account incompletely or contradict Commission recommendations.**

#### **1. introducing taxation changes through the Law on the state budget**

According to the law "On the tax system" of 18 February 1997, amendments to tax legislation made in the current year should take effect only in the following year. Moreover, all amendments to tax legislation should be adopted no later than six months prior to the beginning to the next fiscal year. However, the Law "On Amending the Law of Ukraine on the State Budget of Ukraine for 2005 and Other Legal Acts" took effect with the date of its publication, i.e., on 31 March 2005. This law changes some rules for, among others, VAT, enterprise income tax, individual income tax, excise duty, land payment.

This shows that the tradition of making annual adjustments to taxation legislation is, unfortunately, perpetuated. The introduction of tax changes through the state budget law violates legislation that provides for amending tax laws exclusively through the introduction of changes to these very laws. This practice creates legal problems and heightens the instability and uncertainty of the investment climate. This has a negative impact on business activity and hampers economy growth.

#### **2. Changes in the simplified system of taxation and entrepreneurship**

The attack on the simplified system of taxation was most worrying. Some regulations of the Law "On Amendments to the State Budget for 2005 and Some Other Laws of Ukraine" have had a negative effect on entrepreneurs who use the simplified tax regime:

- Reduced the ceiling for annual turnover that gives the right to pay presumptive tax (without paying VAT) from UAH 1 million for legal entities and UAH 500,000 for individuals to unified level of UAH 300,000 and hence hit systems of simplified taxation and business accounting of small enterprises.
- Equated self-employed individuals who pay the presumptive tax and delivers services to another entity based on a contract that is longer than one month within the same tax year to hired employees with correspondent taxation of gained incomes taxed with regular personal income tax.

This discriminates against individual entrepreneurs and against legal entities that are allowed to provide services to another a legal entity on an unlimited time basis. In addition, the income of an entrepreneur and the salary of an employee are not the same things and cannot be taxed in the same way. In contrast to the employee, the entrepreneur bears all the risks related to the provision of goods or services himself.

- Removed several types of entrepreneurial activities (including gambling and foreign exchange activities; manufacture of goods subject to excise duty; operations with real estate; and operations with precious metals and gems ; and individual entrepreneurs engaged in activities in the financial sector, slot-machine gambling, trading pharmaceuticals and medical articles, providing services in architecture and construction, advertising, information science, law, audit, and accounting, as well as management consulting and activities related to body care) from the list of activities eligible for the simplified taxation system.

Unclear and blurred terminology meant that virtually any entrepreneur could be portrayed as belonging to prohibited categories and thus encouraged them to retreat into the shadow economy.

Numerous public and expert discussions which begun immediately after these changes came into force resulted in the Law "On Changes to Some Laws of Ukraine" that was prepared at the initiative of the President and adopted by the Parliament on 3 June 2005. The Law re-introduced a VAT administering framework that had been cancelled earlier for economic entities subject to the simplified tax regime. Separate norms excluded individual entrepreneurs engaged in trading pharmaceuticals and medical articles, providing services in architecture and construction, law, audit, and real estate operations from the list of activities that are not subject to simplified taxation.

Despite the reintroduction of simplified taxation, the attack on it had an impact, in that many entrepreneurs suspended their operations over the last few months. It is important to undertake a critical review of this "experiment" and take it into account in the process of future drafting of tax legislation that relates to simplified taxation.

### **3. Increase in Tax Burden**

Amendments to the 2005 state budget stipulated a significant increase in excise tax rates for spirits, alcohol and tobacco articles, transportation means and fuel. The cost of licensing for spirit and tobacco manufacturing has significantly increased, the cost of an annual license for the import of tobacco articles has doubled, and the cost of a license for wholesale operations with spirits and tobacco articles has increased five times. This is in contrast to intentions of a significant reduction in the tax burden.

## **Conclusions**

1. The practice of introducing changes in the taxation system through the Law on the State Budget should be halted. This law needs to be respected both by citizens and by governmental authorities. Overuse of the tax system to perform fiscal functions is a dangerous path that can hamper economic growth.
2. Decisions concerning the simplified system of taxation need careful treatment. The success of the low and fixed presumptive tax should be safeguarded until the small and medium enterprise sector has reached at least a 40% share of GDP.

3. The Government should pay serious attention to putting the relationship between tax authorities and taxpayers onto a normal voluntary service basis. In particular, this applies to decriminalization of most tax violations; prohibition of conducting tax inspections on-site without due suspicion and a court ruling; abolishing the tax police; and considering a reduction in tax penalties.

## **5.2. DEVELOPMENT OF FINANCIAL MARKETS**

### ***Positive developments***

The Government has incorporated more than half of the Blue Ribbon Commission recommendations for financial sector development into its program documents as specifically planned activities.

Primarily, this concerns the government's intentions to:

- Adopt within one year laws "On state registration of real estate property rights and their restrictions", "On derivatives", "On organization and formation of credit history circulation", and "On trust property management".
- Draft and adopt new Laws on financial leasing, on insurance, on financial services and state regulation of the financial services market, on the national depository system and electronic circulation of securities in Ukraine, and on securities and the stock exchange (October 2005).
- Eliminate most discrepancies between taxation laws and the laws on specialized financial services, in order to create favorable conditions for the development of leasing, factoring and reinsurance by non-resident companies.
- Facilitate the advent of a land market by issuing state land ownership certificates and establishing a uniform system of land-rights registration;
- Encourage the creation of non-governmental information and rating agencies;
- Ratify relevant international agreements to facilitate international financial integration (including UNIDROIT conventions on international factoring, international financial leasing, the Convention on international guarantees of rights for moveable property, the Istanbul Convention on temporary export and the Kyoto Convention on simplifying and harmonizing customs procedures), as was included in the government's action plan for the first six months of 2005, and according to which the corresponding draft documents are prepared; and
- Create conditions to facilitate the development of both voluntary and mandatory private pension funds.

All these measures were included into the Government program and action plan for 2005, and their consistent implementation will be very important.

A number of steps have been taken to create incentives for facilitating capital inflow into Ukraine's financial sector:

1. The National Bank of Ukraine has declared its intention to liberalize regulations on foreign investments in banks and insurance companies (although it did not set a time span to fulfill these intentions);

2. The National Bank of Ukraine has developed and submitted to the Parliament for consideration a corresponding draft law on amendments to the law on banks and banking activities, which will enable the creation of foreign bank subsidiaries in the Ukrainian financial market. Opening the banking sector to foreign bank subsidiaries will stimulate competition, increase efficiency, boost the volume of capital imports and direct foreign investment, and positively affect trade and negotiations concerning Ukraine's admission to the WTO. Adoption of the draft law will also improve the diversification of domestic banks, as a result of granting Ukrainian banks of the right to open subsidiaries in the countries of origin of the foreign banks that operate subsidiaries in Ukraine.

### ***Problematic Issues***

At the same time, a number of the Blue Ribbon Commission's recommendations **were not** reflected in the government's plans and activities.

**First**, this concerns the adoption of an up-to-date Law "On Joint-Stock Companies" and laws on other legal and organizational forms of enterprises; this is only planned for completion in December 2005. The long delay is groundless (taking into consideration the availability of a ready text). The cause lies in efforts to resolve problems connected with the redistribution of corporate property that the Government may have claims to regarding privatization, and also in the existence of a "directors' lobby" in Government that is not interested in strengthening the position of investors in their relations with management in joint-stock partnerships.

**Second**, there is no sign of an attempt to resolve the contradictions between the Economic Code and the Civil Code (the Blue Ribbon Commission consistently recommended cancellation of the former and improvement of the latter). One of the reasons for this aversion to canceling the Economic Code is that it contains provisions supported by the "directors' lobby" that preserve obsolete legislative norms for closed joint-stock companies, impeding realization of shareholders' property rights.

Further procrastination in adopting a law on joint-stock partnerships and resolving the conflict between the two codes increases the risk of discouraging investment, as well as preserving the speculative nature of the stock market.

There is also no evidence of activities designed to improve the protection of property rights:

1. The creation of special economic courts charged with resolving corporate and property disputes concerning securities is not under consideration. Such courts would be especially important for resolving conflicts between stockholders, as well as among stockholders and joint-stock companies;
2. There is also no plan to forbid the Ministry of the Interior from interfering in financial sector affairs without a well-founded suspicion of criminal activity;
3. The issues of canceling the moratorium on bankruptcy of companies with state-owned property, and of improving debt collection, are being resolved in a very inconsistent manner. On the one hand, proposals to amend legislation on bankruptcy are contained in several sections of the government's action plan. On the other hand, the issue of bankruptcy of companies with state-owned property is only mentioned in connection with measures designed by the authorities to prevent fraudulent bankruptcy, although without action to develop civilized procedures for the bankruptcy of such companies. This

aggravates the risk of freezing the problematic debts of enterprises with state-owned property, and of further violating the rights of those enterprises' creditors;

4. There is no plan to reduce the need for notarizing documents or to fix payments for those notary services at a low level. This does not improve the business environment, especially in the small and medium sectors of the economy;
5. No attention is being paid to the elimination of the state monopoly on the leasing market, and to guaranteeing equal opportunities for state-owned and private companies. Any further delays with reforms in this sphere will choke the development of the leasing services market, and create anti-competitive environments and inefficient services;
6. The creation of a regulatory and legislative basis for the development of specialized banks has been delayed, inhibiting the development of banking services, especially in investment and mortgage banking;
7. There are no plans to improve information services for financial banks through the collection and publication of necessary and permitted financial information through a universal and publicly accessible state information system. This limits access by the public and investors to information they may need, and promotes duplication of information to be provided to various state authorities.
8. There are contradictions in the process of establishing a single repository with standard rules for document circulation and interaction among subjects of the National Depository System.

Although the draft amendments to the Ukrainian law on the National Depository System and electronic circulation of securities in Ukraine are included in the Government action plan for 2005, expenditures for the National Depository in the 2005 budget were cut to less than a third of the cost estimate of the State Program for National Depository System Development. The economic justification for that measure raises doubts. It may inhibit the creation of a uniform and reliable system to account for ownership rights to securities.

Actions taken **against** the recommendations of the Blue Ribbon Commission are a source of special concern. The Blue Ribbon Commission recommended that amendments should be made to the Law "On Mortgage Lending and Operations with Consolidated Mortgage Debt and Mortgage Certificates" (#979-IV) enacted on 19 July 2003 and the Law on Special Mechanisms for Financing of Housing Construction of 19 June 2003, in order to bring them into consistency with Ukrainian law on real estate mortgages and to incorporate best international practices. Consideration of the draft Law "On Mortgage Securities" was to be expedited.

Unfortunately, only the current work on the draft Law "On Mortgage Securities", with an unjustifiably late completion time (December 2005), can be assessed as positive, to a certain extent. In practice, other legislative acts are being brought into consistency with laws that have been proposed for cancellation. Partially this can be explained by the presence in Government of people who had lobbied for those laws while in the Parliament.

Progress in creating powerful and competent state regulatory bodies for all financial markets has been rather controversial. Amendments to the Law "On State Regulation of the Securities Market in Ukraine", passed to improve the level of independence and effectiveness of the State Commission on Securities and the stock market, were prepared by this commission. The Government refused to accept the amendments, however. At the same time, certain ministries tried to reduce the independence of the State Commission on Securities and Stock Market and the State Committee for Financial Services, and to make those independent bodies subordinate to the ministries. Lobbying for expansion of the powers of the non-sector ministries

and elimination of independent state regulators will trigger deterioration in the regulatory conditions of state financial markets.

## **Conclusions**

More than half of the Commission's specific recommendations for the development of the financial sector of the economy have been incorporated into Government programmatic documents as planned activities. It is difficult to assess the degree of compliance of legislative acts planned for adoption with these recommendations, because most are to be considered only in the second half of 2005.

At the same time, there are signs that important problems connected with financial market development are not being resolved or even that the situation is deteriorating. We believe that to ensure successful reforms carried out by the Government in the financial market sphere the following issues are important:

**1. To resolve the conflict between the Economic Code and the Civil Code.** Development and approval of all planned legislative acts on local issues will depend on the degree to which they are in compliance with those key laws.

**2. To include preparation of legislative acts concerning the regulation of free-market circulation of agricultural lands into current Government plans.** Postponement of this problem for an indefinite period will inhibit reforms in the agrarian sector.

**3. To accelerate consideration of key legislative acts** that have been prepared (in part, with the assistance of leading experts in international organizations) but not promoted by the previous government. Primarily, this concerns the following:

- Consideration of the draft Law "On Joint-Stock Companies" by the Government in May and June 2005, and submission of the draft law to the Parliament before its current session ends;
- Passage of the draft Law "On Amendments to the Law on Banks and Banking Activities";
- Consideration by the Government and submission to the Parliament of prepared draft laws on derivative securities, the organization and form of credit history circulation, fiduciary management of property, the national depository system and electronic securities circulation in Ukraine, and on securities and the stock market, all by the end of June 2005; elaboration of draft laws currently in preparation, and their consideration by the Government and submission to the Parliament by September 2005;
- Acceleration of work on amendments to taxation laws and expansion of the list of financial services that those amendments concern.

This will allow a breakthrough in the financial sector (especially in the corporate securities market) that will stimulate investment activities and attract considerable investment resources to the real economy in 2005.

**4. To continue liberalization of regulations on currency operations for all financial institutions,** and to complete the transition to issuing indefinite currency licenses without time limitations;

5. To take into account the Blue Ribbon Commission recommendations concerning the introduction of special jurisdictions within the judiciary (in order to consider specific-nature cases in the sphere of corporate management and financial markets), as well as the limitation of the law-enforcement ministries' right to interfere in the financial sector beyond the scope of their direct competences, in order to improve private sector entities' qualified protection of their rights;

6. To promote the **establishment of a public system for dissemination of report information on enterprises and financial institutions**. The information is to be collected by the state authorities and provided for public use in making well-balanced investment decisions. It is necessary to put order into the state system of public notification on progress in pension reform and engage in this work the representatives of the respective state bodies that are responsible for every pillar of pension reform;

7. To abstain from reorganization of state financial regulators in the sphere of financial markets for the next four years;

8. To add to the Government action plan for 2005 the preparation of amendments on bankruptcy involving enterprises with state-owned property.

# CHAPTER 6. PRIVATIZATION AND REGULATORY REFORM

## 6.1. PRIVATIZATION POLICY<sup>10</sup>

### **Facts**

1. Both before and during the election campaign, the forces in opposition to President Leonid Kuchma described privatization, in program documents and publicly, as a process of social fraud and robbery, putting a special emphasis on the privatization of large enterprises over the past few years.

2. In the wake of the elections, in late January 2005, the Government headed by Acting Prime Minister Mykola Azarov imposed a moratorium on privatization in accordance with a resolution of the Parliament.

3. One month was enough for the new Government to realize that a strict moratorium suspending privatization was an impediment to the Government's everyday activities. In Ukraine's contemporary history, similar instances took place two times, both with the same result: prompt cancellation of the ban.

4. In 2005 the Government plans to gain UAH 7 billion of revenues for the state budget from the privatization of state assets. A sum this large cannot be acquired through the routine privatization of small or even medium-size enterprises. Yet the State Property Fund does not have large entities readily available for privatization. The preparation and sale of a large enterprise realistically takes at least five to six months. It is possible to assume the Government is counting on other sources of revenues, including sales of re-privatized objects or the collection of supplemental payments for property privatized earlier. However, litigation with large owners will not take place quickly; moreover, sales of adjudicated large entities may require several months. One possible source of budget revenues is supplemental payment for property privatized earlier. That requires agreements between the Government and the owners. More revolutionary methods of revenue generation, e.g., confiscation of property without a court decision, are unlikely in Ukraine.

5. The Government is developing two program documents that define its policies in the sphere of privatization: the "People's Ownership" program, and the next privatization program.

These documents reflect a radical shift in priorities in the Ukrainian state industrial sector. These policies are based on the preservation and strengthening of the state sector, and improvement of its manageability. The state sector is regarded both as decisive to the country's security and as a bulwark against the purportedly monopolistic aspirations of private capital.

That said, the Government is still expecting an increase in budget revenues from the state sector. This is to be achieved by encouraging top management to improve profitability and thereby tax revenue. The new regulation on the mandatory deduction of 50% of net income of state-owned enterprises subject to mandatory deduction to the budget as dividends has the same goal. The size and uniformity of that regulation for all economic entities, regardless of their

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<sup>10</sup> The materials presented below analyse the government's actions and messages to society in the sphere of enterprise privatisation. Privatisation policies concerning non-agricultural lands and social infrastructure objects are not considered. Government decisions with respect to the privatisation of land are far less controversial than privatisation decisions involving enterprises. The goal of this analysis is to identify the basic trends of the new policies. For that reason, inconsistencies in approaches to privatisation and re-privatisation by individual representatives of the new Government are not analysed. It is believed that the Government expresses the new trends in a most vivid and open manner.

investment needs, clearly point to the primacy of fiscal policies over those of state sector development.

In the Government's draft documents, privatization is regarded only as a means to dispose of enterprises that are inefficient, constitute a burden on the budget, or lack any strategic importance for the state. The privatization of basic infrastructure industrial complexes (e.g., transport, power engineering, telecommunications, the defense industry, public amenities) is not discussed. The concept of privatization as a crucial vehicle of social transformation, as a means to create a class of owners, and as a factor for the integration of Ukraine's economy into the international economic system, is no longer on the political agenda. The appointment of a Socialist Party member and staunch and steadfast opponent of privatization to head the privatization agency is indicative of this policy shift.

6. Government members have made numerous declarations about plans for re-privatization. The scope of re-privatization mentioned in these declarations varies, from a single integrated iron-and-steel works to dozens, hundreds and, finally, as many as 3,000 entities. Obviously, what is meant here are plans to file suit to cancel past privatization agreements.

Statements by officials also vary on the period to be covered (from the beginning of the privatization process in 1991 to the year 2004 only). As a rule, the biggest privatization deals are mentioned, but medium-sized enterprises may also be included.

The customized nature of privatization agreements—the intentional limitation of the number of bidders and underestimated prices—has been quoted as the main reason for these initiatives. Other important reasons include inefficient management of privatized enterprises, failure to fulfill investment obligations, malevolent misappropriation and/or poor management.

The Government has not yet identified specific criteria for re-privatization.

7. A number of draft laws on re-privatization and nationalization have been registered in the Parliament. The draft bill presented by the current head of the State Property Fund of Ukraine is of special significance; it envisages re-privatization mechanisms suitable for a wide-ranging and open-ended process.

8. The first vivid signs of a spontaneous expansion of the re-privatization process outside governmental control have appeared. The most typical examples include declarations about re-privatization made by representatives of local authorities and lawsuits by entrepreneurs and ordinary citizens petitioning to nullify privatization agreements on the grounds that their privatization rights have been violated.

9. Ordinary citizens have responded with approval to harsh criticism of privatization, curtailment of its scope, and plans for re-privatization. Seventy-one percent of Ukraine's citizens are in favor of re-privatization, with only 4.5% opposed (Razumkov Centre findings, February 2005). Fifty-six percent of citizens are opposed to the privatization of large enterprises; only 17.5% support it (data from the Institute of Sociology of the Ukrainian Academy of Sciences *et al.*, February 2004). At the same time, foreign investors express growing concerns on re-privatization and the low level of property rights protection in Ukraine.

### ***Correcting the course of privatization***

Positive signs of a radical correction of the governmental course with respect to privatization begun to appear in June 2005.

10. Responding to investors' concerns and on the eve of an international conference organized by the World Economic Forum ("mini-Davos") in Kyiv, President Yuschenko criticized the Government's course on re-privatization and signed together with the Prime Minister and the Speaker of the Parliament a memorandum on guarantees of private property and securing the rule of law in their implementation. The memorandum declares the intention of all institutions of state power in Ukraine to guarantee owners' rights and the stability of property conditions. The President in his speech at mini-Davos highlighted that there are no lists of enterprises earmarked for re-privatization; promised to set up conditions for restoration of property rights within the legal framework only and guided by court decisions in case legal infractions in the process of privatization have been discovered; and contribute to resolution of disputes on ownership, including concluding amicable agreements. The President underlined the need to continue privatization, including through the sale of strategically important enterprises. He named several objects to be privatized in 2005.

11. On 1 July 2005, the Government approved the list of enterprises for privatization in 2005. This list contains important strategic firms (for instance, the Nikopol south-pipe plant) and emphasized the need to adopt a law on privatization of enterprises together with their land plots.

12. Prime Minister Yulia Tymoshenko criticized heavily the position of the Head of the State Property Fund Valentyna Semenyuk on retaining strategically important enterprises (Including Kryvorizhstal) in state ownership and underlined the ineffectiveness of the state as an enterprise owner.

### ***Problematic issues***

The developments of June 2005 marked the intention of the Government and the President to stop dangerous discussions on re-privatization and continue privatization. Although this is indisputably positive step, practical implementation of these intentions is a matter for the future while the risks of a return to the re-privatization path have not yet been eliminated completely. It is necessary to size up the economic risks connected with the termination of privatization and encouragement of de-privatization and re-privatization in order not to repeat past mistakes. They include:

#### **Related to the termination of legitimate privatization:**

- Encouragement of non-privatization methods for transferring property out of state ownership, expansion of illegitimate private control over material and financial flows at state-owned enterprises;
- Degradation of the state sector, which suffers from an acute need for a competitive environment, effective management and investment;
- Extension of the property re-distribution period as a transitory, non-transparent, extraordinary economic condition.

#### **Related to re-privatization:**

- Legitimizing of positive opinions about property re-distribution and disregard for ownership rights;
- Expansion of corruption;
- Spontaneous and open-ended expansion of the re-privatization process;

- Decreased trust of investors in the country;
- Further postponement of crucial reforms in the social security system, growing determination by the Government to use the revenues from re-privatization to cover social obligations in the future.

The idea of mass re-privatization is harmful to the further reform process and difficult to implement without risking a loss of political support for the Government from domestic private owners. The reasons are the following:

- Violations of some sort can be found in the privatization of almost any entity (not just the larger ones). The past legal framework was very vague; it included multiple laws for the privatization of many individual entities, instead of providing a unified and clear framework for the privatization process as a whole. However, the revision of all privatization results is technically impossible. Some selection criteria are needed to narrow down the group of enterprises to be subject to re-privatization procedures;
- The only plausible selection criteria are those already specified in current legislation (e.g., the neglect of investment obligations). Choosing other criteria would reflect political preferences rather than economic ones; consequently, they would not reduce future re-privatization risks even for those private owners whose property rights are not now subject to revision;
- The courts are weak and lack the technical capacity to deal with multiple re-privatization cases. In addition, the courts are not completely independent, and their decision-making is often susceptible to political pressure. Drawn-out court cases will have an immediate negative impact on the investment decisions of current owners, and this will hamper economic growth.

## **Conclusions**

The rethinking of privatization priorities in June 2004 has shown that the Government realizes risks of re-privatization and their consequences for country's economy. Now is the time to shift from a short-term post-revolutionary syndrome of radicalism associated with aspirations of a new elite to redistribute ownership and reduce the influence of defeated opponents to building a consistent privatization strategy, even if its implementation in most cases might be expected only next year.

It is very important for Ukraine that a definitive halt is called to discussions on re-privatization and that the Government concentrates on the protection of property rights. Intentions promulgated in the 16 June memorandum should be implemented in practice. Revision of privatization deals can be undertaken only through a court decision, using transparent procedures and proposing wherever possible an amicable agreement to the current owners.

It is important to avoid past errors, for instance excessively short terms (compared to legal requirements) for tenders or violation of transparency in the course of their implementation. Pre-privatization preparation as well as procedures of privatization should adhere to law and maximal transparency.

The Blue Ribbon Commission recommendations that were not implemented in the course of last five months are of great importance now. This concerns to the following recommendations:

- On mechanisms for completion of mass privatization, primarily, the accelerated sale of small state-owned packages of stock;
- On a strategy of privatization in infrastructure sectors;
- On the inadmissibility of selling separate large enterprises outside plans for market adaptation of their respective industrial complexes, including systems of state regulation;
- On technologies to ensure openness of privatization processes.

Adoption of a law on privatization of enterprises together with their land plots will be an important incentive to interest strategic investors in Ukrainian privatization objects.

## **6.2. REGULATORY POLICY AND ENTREPRENEURSHIP**

### ***Positive developments***

At the level of general intentions and planned tasks, the Government has adopted most of the Blue Ribbon Commission's recommendations on "Regulatory policy and entrepreneurship." In particular, the governmental program declares an intent to implement the following tasks:

a) To pursue additional measures for the implementation of state regulatory policy to provide favorable conditions for the development of entrepreneurship;

b) To make Government officials more accountable for illegal intervention in economic activities and for committing unlawful acts;

c) To regulate the system of granting permits, and providing expert conclusions concerning starting up and doing business; to improve the system of licensing and the system of state control (supervision) over the activities of economic entities;

d) To promote further improvement in the simplified system of taxation, accounting, and reporting for small business entities;

e) To bring the law governing the registration of business entities into conformity with the basics of state regulatory policy.

In May 2005 and after few months of "silence," the authorities have started to rethink the role and potential of state regulatory policy and to search for implementation mechanisms.

1. The process has been intensified especially in May-June, when the President issued two decrees "On liberalization of entrepreneurial activities and state support of entrepreneurship" and "On some measures to secure implementation of state regulatory policy".

The decree "On liberalization of entrepreneurial activities and state support of entrepreneurship" touches upon important principles of state policy in the sphere of entrepreneurship – a necessity to eliminate regulatory and administrative barriers, improve of resource support, dispute resolution and other problematic issues; and proposes strategic directions for development of legal foundations in 2005.

The decree "On some measures to secure implementation of state regulatory policy" envisages top priority issues for improvement of the regulatory environment; creation of specialized public-civil workgroups on an equal footing for the purpose of revision of regulatory

acts and organizing their work, their classification and systematization in a way that reflects the international experience of liberalization and normalization of the regulatory environment.

In particular, these decrees require the introduction of the "single window" principle by 1 July 2005 and the revision of outdated regulatory acts together with proposals for public-civil workgroups to select regulations for abolition in July 2005. It is expected that 1,300 outdated regulatory norms will soon be abolished.

The presidential decrees contribute to building transparent mechanisms of normalization of the regulatory environment, implementation of methods of control over regulatory efforts, transparent procedures for the revision of regulatory acts, and encouragement of the participation of civil society and civic control. The decrees set a brisk implementation schedule (during July-August 2005). It is important that the presidential decrees not to become one more example of unfulfilled good intentions.

The status of the implementation of the presidential decree "On some measures to secure implementation of state regulatory policy" by regulatory bodies could serve as an indicator of bureaucratic resistance to real liberalization of the regulatory environment and formation of state regulatory system in Ukraine.

2. Two public hearings ("State power and business are partners" and "Regulatory policy as a basis for transparency of the state power") and a hotline created by the Cabinet of Ministers for communication with entrepreneurs and the solution of urgent issues have become additional signs of the Government's growing interest in issues of transparency and cooperation with entrepreneurs.

3. An important step toward establishment of confidence between state power and the business environment is the adoption by the Parliament and signing by the President of a law that restored simplified tax regime for single tax payers that was effective until January 2005.

### ***Problematic issues***

Government authorities are not using regulatory policy mechanisms as a practical tool to improve operational efficiency or democratize public administration.

1. In the last months, the new Government has developed a considerable number of different programs. However, **public discussion of the programs (required by the principles of state regulatory policy) either did not take place at all or was held to an insufficient degree.** That is, the Government itself failed to meet regulatory norms that require a thorough analysis of the regulatory impact of new legislation before a program or legislative initiative is adopted. In the course of adoption of 23 regulatory acts out of 52 resolutions and instructions of the Cabinet of Ministers adopted during February-May 2005, the foundations of state regulatory policy in the economic sphere were violated. In addition, these regulatory acts were not coordinated with the State Committee for Entrepreneurship Development and Regulatory Policy.

2. The **Government program is not backed up with sufficient implementation and follow-up mechanisms.** For some reason, the Prime Minister personally carries out the practical organization of all program activities. Mechanisms to assess program impact are lacking, delegation of responsibilities is weak and control of program implementation is inefficient. The lack of such mechanisms results in unsystematic and chaotic management and failure to achieve goals.

**3. The government's program and action plan do not include appropriate mechanisms to guarantee that the goals of regulatory policy are achieved.** In particular, no concrete measure has been proposed to strengthen regulatory bodies' and civil servants' criminal, administrative and professional responsibility for violation of the principles of regulatory policy adopted by law, or for illegal intervention into economic activity. Effective mechanisms for executive monitoring of regulatory environment, analysis of efficiency of existing regulations or abolishing inefficient regulations in various sectors of entrepreneurial activities have not yet been implemented. Positive presidential initiatives in this context will require substantial efforts for their implementation in practice.

4. There is a problem of the skewed nature of regulatory measures envisaged by the presidential Decree "On liberalization of entrepreneurial activities and state support of entrepreneurship" and the problems they are designed to address. The power of vested interests and corruption of resources allocation are substantially greater than the regulatory capacity of the mechanisms defined by the decree. The important issues of access by entrepreneurs to state and communal property, and the increase in efficiency in utilization of budgetary resources require more concrete, systemic, transparent, predictable, and purposeful regulatory measures and mechanisms, which are suitable for control over their implementation.

**5. Insufficient attention is paid to engaging public associations, economic entities, and scientific institutions in the implementation of state regulatory policy.** The Government plans to conduct training programs for civil servants on the methods of regulatory impact assessment and efficiency evaluation. However, the role of civil society in the implementation of regulatory policy is still underestimated. There are no plans to organize training programs for civil society representatives that will provide them with basic knowledge of regulatory procedures and ways to protect their economic rights. The importance of such programs cannot be overestimated because they increase the quality of public monitoring of state regulations.

**6. Old approaches to decision-making persist.** Development of new legislative acts is not yet accompanied by implementing control over laws that have been passed earlier as well as with revision of existing regulations in the area of entrepreneurship development, cancellation of normative barriers, contradictions, inaccuracy, equivocations, anachronisms and lack of correspondence of conditions to contemporary conditions. This is the result of poor implementation of the Law of Ukraine "On principles of regulatory policy in economic activities".

Unfortunately, the Government has resorted relatively frequently to direct intervention into market relations. While the system of state control and supervision in the field of economic activity is not consistently regulated, intensive control over the activity of market participants can lead to illegitimate interference in entrepreneurial activities and misuse of authority, and result in disruption of the delivery of goods and services to the final consumers.

**7. The Government has not heeded the Blue Ribbon Commission recommendation to limit strictly the amount of information that officials can request from companies.** Such requirements to supply excessive information constitute a part of the considerable administrative pressure that business faces. In addition, misuse of information that constitutes a commercial secret can cause critical damage to private businesses. Regrettably, so far protection of enterprises against excessive information requests is not considered in the government's programs.

**8. Developments around the simplified system of taxation, accounting and reporting have caused special concern as the result of legislative changes to the budget 2005.**

Proposed changes in fact were leading to structural minimization of this important mechanism of tax regulation of small entrepreneurship development (see Chapter 5.1 for more details). Broad public and expert discussions have brought hopeful results. In June 2005, the Parliament adopted and the President signed a law that restores the principles of simplified taxation that were in effect until January 2005. Despite this happy end, these developments demonstrate the high risk of doing business in Ukraine and underline once again the need to implement the foundations of state regulatory policy in practice to secure the predictability of the regulatory environment.

## **Conclusions**

Although most of the Blue Ribbon Commission's recommendations are reflected in Government declarations, they have not been translated into policy or implemented. It is necessary to move from the manual mode in handling tactical problems to formulation of strategic principles in the regulatory area and their implementation. Importantly, implementation mechanisms of state regulatory policy should, first, correspond to the main statutory principles of this policy.

1. Efficient enforcement of the Law "On the principles of regulatory policy in economic activities" is of utmost importance. All regulatory bodies, including the government, must adhere to state regulatory policy principles in the field of economic activity. This will secure simplification and predictability of regulatory environment.

2. There is a need to establish consolidated and effective system of administrative and public control over fulfillment of norms of the presidential Decree "On some measures to secure implementation of state regulatory policy". The status of the execution of its provisions by regulatory bodies is a good indicator of the degree of bureaucratic resistance to real liberalization of the regulatory environment and the formation of a state regulatory system in Ukraine.

3. Promote public monitoring of Government regulatory activities through the development of independent advisory institutions. Follow best practices of non-governmental agencies that work well in developed countries.

4. Government programs should be supported by sufficient organizational mechanisms to implement them (including through the delegation of functions), impact assessment across all stages of implementation, and control mechanisms that include public supervision.

5. The focus should gradually move from regulation toward self-regulation, from administrative control and responsibility toward the self-control and self-responsibility of market entities. This requires development of civil society's regulating capacities and the social self-organization of citizens. It is therefore necessary to introduce comprehensive training programs to teach the citizens basic principles of regulatory policy and its impact assessment and monitoring, as well as ways to protect citizens' economic rights.

6. The issue of access by entrepreneurs to state and communal property requires more concrete regulatory measures and mechanisms, which are suitable for control over their implementation. It is expedient to design and introduce special regulatory acts for that purposes.

7. Official information requests to companies should be restricted. In this respect, it is important to pass the Law of Ukraine "On control (supervision) over the activities of economic entities". Representatives of state authorities should be made accountable (in the administrative

and criminal sense) for preventing legitimate economic activities, for illegal requests for information that contains commercial secrets, and for abuse of power.

### **6.3. COMPETITION POLICY AND REGULATION OF NETWORK INDUSTRIES**

#### ***Positive developments***

**Competition policy.** The Government plans to increase the powers of the Anti-Monopoly Committee (AMC) to fight cartels and market collusion. The Government plans to give the AMC the right to control tariff-setting procedures in network industries. The AMC is to draft a Cabinet of Ministers decree on improving the mechanism of control over the regulation of prices and tariffs for goods and services produced or sold by the natural monopolies, and the telecommunications and postal services. However, this step pre-supposes the creation and/or strengthening of independent regulators in the respective markets of the network industries—something that unfortunately is not included in the government’s plans for 2005.

The Government intends to limit the scope of information that state authorities are allowed to request from firms. This will be done by finalizing and adopting a law on the main principles of control over the activities of the subjects of entrepreneurial activity, which will clearly establish procedures for the conduct of checks and inspections of economic units by the state authorities. This law will limit the amount of information that state authorities (including the AMC) are able to demand from firms.

**Network industries.** The Government intends to improve competition in the network industries.

Ukravtodor, Ukraine’s state road service, is expected to introduce open, competitive bidding on contracts for the renovation and construction of the motor highways in order to promote competition. Continued liberalization is planned for telecommunication services. Attention is to be devoted to the restructuring of the public utilities sector, including the following:

- Development of a draft concept on regulatory mechanisms in the sector of public utilities;
- Improvement in contractual relations between service providers and clients in the domain of public utilities; and
- Creation of standards for the provision of heating, cold and hot water, and wastewater removal.

The Committee for Public Utilities is made responsible for all these tasks.

Though all the listed measures represent a step in the right direction, they cannot be successfully implemented before an independent regulator is created in the sector of public utilities.

#### ***Problematic issues***

**Competition policy.** So far the Government has paid no attention to strengthening the independence of the AMC and restructuring its activities in order to increase its effectiveness as a “watchdog” of competition policy. At the moment, there is a danger that the AMC will be used

to curb price increases in selected markets, for example for interventions in the fuel market to secure cheap diesel fuel for agriculture.

**State aid.** The fight against sector- and region-specific state aid, especially in the indirect form of tax privileges, became one of the main directions of Government activities in February-March 2005. Unfortunately, this approach to dealing with state aid lacked strategic perspective and was driven mainly by fiscal considerations.

1. Amendments to the 2005 state budget law were used to suspend some previous laws that granted sector-specific aid privileges associated with the free economic zones (FEZs). This type of "cavalry attack" on tax privileges shows that the Government works in an emergency regime without having a clear strategic picture. Though the abolition of FEZs was long considered and recommended, this "overnight approach" will reduce the credibility of the Government in ensuring the security of investors' property rights. Abolition of tax privileges in FEZs after the investment has been made can be interpreted as a breach of contract by the government.

Unfortunately, the Government ignored the proposal to abolish FEZs gradually, by not prolonging the contracts for old FEZs, freezing the opening of new FEZs, and gradually reducing privileges within existing FEZs.

The "overnight approach" left no room for easing the impact of lost tax privileges for a select group of activities (e.g., innovations), which might require Government support.

2. While the issues of state aid received much attention, no visible efforts were devoted to creating a basic regulatory framework in this area. No attempt was made to finalize and promote the adoption of the draft Law On State Aid that is expected to make the state aid process more transparent and insulated from political bargaining.

3. In contrast to Blue Ribbon Commission recommendations, direct subsidies to the agricultural sector were not cut. Instead, in the 2005 budget they were raised by more than 60% compared to 2004. In addition, their distribution over the course of the year seems unjustified: the major part of expenditures (60%) is intended for October-December, while only 11% of annual budget expenditures are to be allotted during the first half of the year.

The policy of state budget support to agriculture does not fully correspond to the strategic intentions of Ukraine with respect to WTO accession and European integration. For example, the largest share of budget-supported programs represents direct support ("yellow," in the WTO classification) to agricultural production, while the recipients are predominantly the large agricultural producers that inherited the drawbacks of former collective and state farms.

**Independent regulators in network industries.** The creation of independent regulators for network industries seems to have been put on hold:

1. The Government has shown no interest in creating create regulatory bodies for the public utilities and the railroads sector, although the need for the latter has become urgent, especially given recent debates on tariff increases for freight traffic. The debate has clearly shown the necessity to distinguish between tariffs that cover costs and those that reflect Ukrzaliznytsia's monopolistic position and/or the preferences of clients with vested interests. Tariff regulation should be delegated to an independent authority, which must be insulated from both immediate political pressures and the risk of capture by market actors (either clients or service providers).

2. The independence of the newly created regulator in the sector of communications is under threat. It is the Minister of Transport and Communications who proposes the candidates to serve as head of the commission and as its members, and who has a clear advantage compared to other market actors.

**Payment discipline.** Two issues should be given proper attention:

1. As before, local budgets are to compensate service providers if local authorities set tariffs at levels below those sufficient to cover costs. However, the 2005 budget includes no funds for targeted transfers to local authorities to cover the losses of public utility providers. This heightens the risk of low payment discipline in public utilities.

2. Payments for public utilities are intended to be used in the compensation scheme for individual savings lost in Oshadbank. The 2005 budget allocates UAH 6 billion to compensate individuals for the lost Oshadbank savings through cancellation of their debts for public utilities accumulated before 1 September 2004. Non-debtors are entitled to a 20% discount in their payments for current consumption of public utilities. On the one hand, this scheme might ease the problem of accumulated debts and thus improve the financial standing of the service providers. On the other hand, this step is rather risky, should timely compensation to the service providers on behalf of the Government not be ensured. Though the Government has taken on more responsibility for the sustainability of short-term operations of service providers, so far there are no clear guidelines on how the compensation process will take place.

**Promoting competition in network industries.** This major concern is related to the postponement of de-monopolization of the energy sector and privatization in network industries.

1. **Power sector.** The Government's reform strategy is not yet clear. The Energy Company of Ukraine has not started viable operations; it has been dismantled.

2. **Railroads.** The separation of Ukrzaliznytsia from the Ministry of Transport and Communication and its corporatisation has not been properly addressed. However, so long as the railroads are technically within the Government and no independent regulatory body has been formed, discretionary decision-making is likely to continue, while the profitability and sustainability of operations will not be the focus of attention for railroad management.

3. **Gas sector.** Currently, the Government has no intention to de-monopolize the gas market and allow for competition in the market. Transit remains tied to internal consumption via barter payments from Russia; Naftogaz controls both transit and barter gas and dominates the retail gas market in Ukraine.

**Administrative interference in commercial activities.** The practice of state interference in private-sector commercial activities has not been stopped.

1. On 16 February 2005, the Government banned re-exports of oil, thereby canceling its own decision of 30 March. Though banning the re-export of oil was announced as an instrument to fight violations in this sphere of entrepreneurial activity, it cannot justify stopping the activity as such.

The Government also temporarily banned the export of diesel fuel in order to force oil refineries to supply diesel fuel to farmers at below-market prices. Cabinet of Ministers Decree Number 265 of 9 April 2005 limits the retail trade surcharge to 15% of the producer's wholesale

price or the customs value of diesel fuel and engine petrol. Under Government pressure, representatives of agricultural producers and suppliers of agricultural resources have concluded a memorandum aimed at price restriction. The possible losses of oil-processing enterprises are estimated at the level of UAH 180-230 million. This type of intervention increases the risk of violation of contractual obligations between the fuel producers and “non-privileged” customers, as well as an increase in fuel prices for “non-privileged” customers and deterioration in fuel quality. In May, the President Victor Yushenko cancelled practice of direct regulation of prices for fuel by his decree. However, that practice did not pass unnoticed and influenced negatively the decision on granting Ukraine a market economy status.

Instead of using administrative interventions, the Government should concentrate on further trade liberalization and strengthening of anti-trust institutions and practices that help to prevent collusion on the market.

2. Another example of state interference is represented by Government plans to create stocks of goods (e.g., oil and meat) for conducting intervention in the markets in order to curb speculative price hikes. Maintaining reserves to tame price hikes through interventions cannot be considered an appropriate instrument. International experience shows that oil reserve funds can only be used effectively if the price hike is caused by a physical disruption of supply (not by the price fluctuations). In case of a permanent price increase, Government interventions in the marketplace will yield financial losses without any meaningful impact on price levels.

## **Conclusions**

**1. A comprehensive Government policy on competition should be developed.** Strengthening of the AMC’s independence is of utmost importance in protecting competition and preventing discretionary actions on the side of the government

In terms of network industries, the gas market, which is currently almost fully monopolized by the state, is in dire need of reforms to promote competition.

**2. A systematic approach to regulation of state aid should be implemented.** This can be done through the adoption of a Law on State Aid. The abolition of indirect subsidization should be enacted in a careful and, if necessary, gradual way in order to avoid violation of contracts and any deterioration of the investment climate.

**3. Independent regulators should be created in the transportation and public utility sectors.** Creating an independent regulator in transportation should accompany the corporatization of Ukrzaliznytsia and its separation from the Ministry of Transportation and Communication. In the course of corporatization, non-core businesses should be transferred to the State Property Fund for further privatization. Ancillary businesses currently under the control of Ukrzaliznytsia can also be transferred to State Property Fund management or an alternative management scheme could be devised.

Creating an independent regulator in public utilities will help to launch the restructuring of the sector and the revision of tariff-setting for households. While developing the regulatory institutions, it is important to use the experience gained in creating a similar authority in the energy sector (NERC), especially with regard to the openness of the newly created regulatory body to external control by civil society.

The standardization of services and the establishment the contract relations between customers and service-providers are increasingly urgent requirements. These measures will

contribute to the improvement of payment discipline, especially in public utilities, where contractual obligations are presently very weak.

**4. Promote competition in network industries.** The Government should widen opportunities for attracting private sector expertise and investment capacity to the network industries. Concessions and public-private partnerships can be employed along with privatization processes.

De-monopolization of the gas sector should be put on the reform agenda. The initiative to monetize payments for Russian gas transit has to be implemented. Increasing the transit fee and receiving it in cash would make the deal more transparent. It would be also advisable to deal with two important tasks—gas for domestic consumption, and transit operations across Ukraine’s territory—separately.

**5. Administrative interference in commercial activities should be stopped.**

# CHAPTER 7. UKRAINE'S INTERNATIONAL ECONOMIC INTEGRATION

## ***Positive developments***

The Government agenda on strengthening Ukraine's international economic integration has received high priority in the Government's first four months and seems to be rather solid in terms of both intentions and actions already undertaken.

1. **Facilitating foreign direct investment.** The Government program "Towards the People" reflects a determination to improve the regulatory framework for foreign direct investment by unifying registration procedures for domestic and foreign investments and reducing barriers for capital movement. The latter is to be achieved by amending regulations on currency convertibility and by permitting free transfer of income abroad by non-residents, provided the income is legally earned.

These proposals are fully in line with the basic principles of World Trade Organization (WTO) agreements (such as GATS and TRIMS) and, if implemented, could significantly improve the regulatory environment for foreign direct investment.

2. **Ukraine's WTO accession.** Ukraine has declared its intention to become a WTO member by the end of 2005. During the last four months, several important steps have been taken to reach this goal. At the recent working party meeting (21-25 March 2005), Ukraine discussed the issues that need to be resolved to conclude WTO accession negotiations. Ukraine has a good chance to conclude these negotiations if the efforts of the negotiation team are supported by relevant changes in legislation.

During President Yushenko's visit to the US in early April this year, both sides reiterated the necessity to accelerate Ukraine's WTO accession. The US side agreed to elaborate during the final stage of Ukraine's WTO accession a special joint action plan aimed at concluding all the necessary arrangements before the WTO Ministerial Conference in Hong Kong. Gaining US support is crucial for Ukraine's WTO accession.

At the same time, Ukraine has again requested that the US grant the country the status of a market economy. Analysis of the relevant documents submitted by the Ukrainian side is expected to take two months.

In March 2005, Ukraine liberalized currency regulations by abolishing the mandatory sale of 50% of export proceeds. Recently Ukraine has adopted a number of laws reducing import tariffs (for example, the Law on the State Budget for 2005). Though these steps were motivated mainly by fiscal concerns and attempts to combat smuggling, they helped to contribute to the liberalization of the trade regime.

Issues of Ukraine's accession to the WTO were discussed at the National Security and Defense Council meeting. The Government approved a set of legal initiatives necessary to accelerate Ukraine's joining the WTO and submitted them to the Parliament.

3. **Policies towards the EU.** Ukraine has declared its resolve to create all the necessary preconditions to become a member of the European Union (EU). As this is a long-term goal, the Government has focused in the shorter term on facilitating the establishment of a free trade area with the EU. In this respect, there are two achievements to mention. The European Commission has adopted an EU-Ukraine "action plan" for 2005-2007. This document envisages "deepening

trade and economic relations, including a review of the feasibility of establishing a free trade area following Ukraine's accession to the WTO." This plan envisages a review of a joint economic feasibility study on the establishment of an EU-Ukraine free trade agreement, and a review of the implementation progress. After the review is completed, there will be consultations aimed at setting priorities for the deepening of EU-Ukraine trade and economic relations.

The second step forward in relations with the EU was the signing of an agreement on trade in textile goods on 9 March 2005. This agreement lifts the last remaining restrictions on trade in textiles and clothing products, and commits both sides to matching low levels of customs duties. Although quantitative restrictions were already lifted in early 2001, the agreement is important, as it completes import and export licensing requirements for all textiles and clothing products.

After long negotiations, Ukraine and the EU on 13 June 2005 initialed an agreement on trade in steel and some steel products. The agreement defines quotas for Ukrainian steel exports to the EU for 2005 and 2006.

In keeping with an agreement signed on 14 June 2005, cooperation between Ukraine and the European Investment Bank should play an important role.

It is necessary to note that joining the Bologna process will enable Ukraine to bring its national system of education into line with internationally recognized norms.

Initialing of an agreement on Ukraine's participation in the European satellite radio navigation program and an agreement on cooperation in the sphere of civil aviation are also steps toward the expansion of Ukraine-EU cooperation. The last agreement gives European air transportation companies access to the Ukrainian air transportation market and is the first step to create a common Ukraine-EU air space.

**4. Promoting free trade within the CIS.** Ukraine has declared its intention to promote the creation of a free trade area with Russia and to use free trade agreements as a tool to "structure" economic relations both at the bilateral level and within regional groupings. During the most recent meeting of the CIS Economic Council in Moscow on 11 March 2005, Ukraine proposed the following provisions for a draft agreement on the gradual abolition of exemptions from the free trade regime:

1) To abolish duties imposed on exports to the CIS countries no later than on 1 January 2006;

2) To support a Russian proposal to postpone the elimination of the exemption of "white sugar" from the free trade regime until 1 January 2009 (earlier it was decided to abolish this exemption no later than 1 January 2007).

The CIS Economic Council had earlier agreed, in March 2004, to eliminate all non-tariff barriers to trade within the free trade area by 2010, and all tariff barriers by 2012.

It is very important that Ukraine is planning **to reconsider its involvement in the Single Economic Space (SES)** as well as its further cooperation within the CIS framework. The Government has clearly stated that Ukraine's participation in the SES will be limited to full-scale implementation of a free-trade regime among the four SES member-states. Ukraine does not intend to pursue the development of a customs union under the SES arrangement, hence its

proposal to exclude all 13 draft documents referring to the customs union from the total list of 29 draft documents to be signed, while including in the list an agreement on trade in services.

These steps are in line with the Blue Ribbon Commission recommendations.

### ***Problematic areas***

**1. Facilitating foreign direct investment.** Some of the government's recent initiatives in domestic economic policy conflict with its declared intentions to improve the regulatory framework for foreign direct investment. The best example is the re-privatization campaign; this showed that protection of property rights in Ukraine is far from guaranteed. The abolition of free economic zones during the 2005 budgetary process has provided additional proof that high political risk for investment activity might persist even under a more democratic regime. The state has violated the contract rights of investors that had been granted for a specific period of time, and this action will trigger a number of lawsuits against the state. Even taking into account the best intention of the Government to cut indirect subsidization (assuming it prevailed over the fiscal consideration!), it should be clear that such "cavalry" attacks can bring nothing but the instability and uncertainty that are the enemies of investment decisions.

The extraordinary round table organized in Kyiv by the World Economic Forum was a positive step in attracting the attention of the foreign business elite to Ukraine. It is necessary to admit that participants' policy recommendations in fact added up to a repetition of well-known ideas with respect to immediate measures needed to improve the investment climate.

**2. WTO accession.** There is a danger that the Ukrainian Government is losing momentum in its cooperation with the Parliament. Preoccupied with the revision of the 2005 budget, the Government has failed to initiate the legislative changes that are necessary to secure WTO accession. For example, no steps have been taken to adopt a Law on State Aid setting a clear regulatory framework for the provision of direct and indirect subsidies. Time is passing quickly, and the amount of work to be done in order to gain WTO membership in 2005 is still considerable.

Significant changes in the structure of the Government have led to a decline in its overall efficiency, including in trade negotiations. In addition, contradictory statements made by different top-level governmental officials have sent mixed signals to Ukraine's foreign counterparts. A clear-cut unified position within the Government on key policy issues (including WTO accession) needs to be established.

Some steps clearly contradict Blue Ribbon Commission recommendations and need to be approached with utmost caution. This concerns the recent presidential decree (issued in April 2005) dissolving the Intra-Agency Commission on Ukraine's WTO accession. Since no new mechanism of intra-governmental cooperation has been proposed, there is a danger that the coordination of activities related to WTO accession will be weakened, and that this will hamper preparatory processes.

**3. Policies towards the EU.** Although Ukraine has declared ambitious plans to fulfill conditions for EU membership, a new European integration strategy has yet to be adopted. The lack of such a document sends confusing signals and makes coordination of relevant efforts problematic. Efforts to harmonize legislation with EU norms are far from sufficient. Importantly, some recent developments in domestic economic policy (noted above) clearly contradict the European integration vector of reforms. For example, the recent surge of state intervention in

price setting on fuel and some food products as well as the re-privatization campaign could undermine efforts to gain market economy status for Ukraine.

Ukraine has expressed its intention to create a special ministry on issues of European integration and foreign economic relations. The new ministry could play an important role in accelerating measures aimed at EU and WTO accession, provided responsibilities are allocated rationally and a more transparent distribution of functions between ministries and other central executive bodies is implemented

## **Conclusions**

1. Practical implementation of the European Choice strategy presupposes that domestic economic policy measures conform to international practice. The Government should pay special attention to securing the property rights of domestic and foreign investors. A first step in this direction would be to stop the re-privatization campaign and to solve the problem of cancelled privileges for investors in free economic zones. A reasonable compromise should be found. This could be based on agreement between the state and investors to cancel some privileges provided the Government ensures stability of economic rules and efficient protection of private property rights.

An increase in the transparency of decision-making on the main issues of economic policy is crucial to lower the risks of investment activity in Ukraine.

2. It is necessary to push forward the adoption of legal acts that are necessary to complete negotiations on WTO accession. First of all, this concerns the Law on State Aid, which is expected to set a regulatory framework for state subsidies.

The Government should refrain from undertaking measures that could endanger efforts to secure market economy status. A new mechanism of intra-governmental cooperation on issues related to WTO accession should be proposed; this would play the role of gatekeeper in preventing decision-making that violates WTO norms and principles.

The Government and the President could initiate an extraordinary session of the Parliament to accelerate the discussion of necessary legal initiatives.

3. Ukraine needs to intensify its efforts to harmonize its legislation with EU standards. All related activities require sufficient financing. In the short run, it would be important to make a clear estimate of the potential costs of these activities.

The Government should launch a series of discussions with representatives of the business community on the establishment of a free trade area with the EU. This would help to gain support from both potential "winners" and "losers."

4. The Government should continue its efforts to move forward towards establishing a free trade area with SES-member states. As a part of these activities, the state should promote relevant business-to-business contacts and establish an efficient consultation mechanism between the Government and the business community.

5. In order to raise awareness in the domestic and foreign business community concerning the government's priorities in trade policy, the Government should consider preparation of a White Book on Ukraine's trade policy priorities.

6. Recommendations of participants of the extraordinary round table organized in Kyiv by the World Economic Forum should be included in the list of priorities to be implemented for purposes of improving the investment climate in Ukraine.

## ATTACHMENT

The most urgent specific reform recommendations are:

1. To make government more effective and efficient, an administrative reform is needed. Its goals should include greater accountability, transparency, professionalism, the protection of ordinary citizens, and a clear distinction between political appointments and a professional civil service.
2. To secure access to effective and efficient justice, a judicial reform is essential, both to make judges independent and impartial, and to make the court administration more efficient.
3. To improve the delivery of public services, a territorial-administrative reform should be enacted. This would make the lowest administrative levels financially viable, while decentralizing powers and financing from the central government to regional and local governments.
4. To enhance the efficiency and quality of health care, mandatory public medical insurance should be introduced, using a multi-level insurance-based approach for health care financing that provides for competition among care providers.
5. To encourage Ukrainians to work legally and stimulate economic growth and investment, a liberal tax code should be enacted. This would reduce the number of taxes, lower the tax rates, eliminate exemptions, decentralize the tax system, and eliminate competing revenue services.
6. Public expenditures should be reduced substantially over the next five years. Non-essential and harmful spending, such as enterprise subsidies that impede structural reform, should be cut. Social transfers to the wealthy should end; social spending should target poverty reduction.
7. To resolve conflicts among shareholders, secure the rights of minority shareholders, and attain transparency of ownership, corporate legislation needs to be improved. A modern Law on Joint-Stock Companies and other legal company forms needs to be adopted.
8. To resolve the conflict between two contradictory legislative frameworks, the Economic Code, which hails from the old command economy, should be abolished, while the Civil Code, which provides a legal foundation for a normal market economy, should be developed.
9. Proper property markets need to be established, primarily by abolishing the moratorium on the sale of agricultural land and by establishing a functioning, unified property registry.
10. A level playing field for economic activity should be created, through the abolition of regulatory discrimination and subsidies directed to enterprises. Discretionary state intervention in pricing, trade, and enterprise should be prohibited except where regulated by law.
11. To achieve true integration with the world economy, Ukraine should join the WTO in 2005.
12. Ukraine should make the European Choice a reality by adopting European legal standards. Agreement should be reached with the European Union on an initial action plan that will pave the way to a free trade agreement and make future membership of the EU a real opportunity.

13. Preserving fiscal and monetary stabilization is a necessary condition for sustainable economic growth. It is important to strengthen independency of the National Bank that should concentrate its efforts on maintaining price stability. Ukraine needs a new round of substantial fiscal adjustment and well-considered budget correction measures.
14. It is necessary to ensure protection of private property rights and a consistent continuation of privatization process to foster economic reforms. Revision of privatization deals should be guided by court decisions using transparent procedures and proposing, whereas is possible, concluding amicable agreements