

**Blue Ribbon Analytical and Advisory Centre**  
*Project funded by EU, co-funded and implemented by UNDP*

# **POLICY RECOMMENDATIONS ON ECONOMIC AND INSTITUTIONAL REFORMS 2009**

The **Blue Ribbon Analytical and Advisory Centre (BRAAC)** is a project funded by EU, co-funded and implemented by UNDP. The Centre adheres in its activities to the principles of free and democratic market economy. It combines in-house expertise with that of leading national and international experts, and think-tanks. The Centre strengthens the national capacity in policy formulation and implementation by working with government officials and coordinates its activities with other donor organizations to ensure efficient use of resources. The Centre facilitates the emergence of public-private partnerships in the development of key policy measures, thereby providing a voice for civil society in the decision-making process. For more information about the Centre: <http://brc.undp.org.ua>

\*\*\*

The **European Union** is made up of 27 Member States who have decided to gradually link together their know-how, resources and destinies. Together, during a period of enlargement of 50 years, they have built a zone of stability, democracy and sustainable development whilst maintaining cultural diversity, tolerance and individual freedoms. The European Union is committed to sharing its achievements and its values with countries and peoples beyond its borders. For more information about the EU: <http://www.delukr.ec.europa.eu/>

\*\*\*

**UN Development Programme (UNDP)** is the UN's global development network, advocating for change and connecting countries to knowledge, experience and resources to help people build a better life. We are on the ground in 166 countries, working with them on their own solutions to global and national development challenges. As they develop local capacity, they draw on the people of UNDP and our wide range of partners. In Ukraine, four development focus areas define the structure of UNDP's assistance activities. These include democratic governance; prosperity, poverty reduction and MDGs; local development and human security; and energy and environment. In each of these thematic areas, UNDP tries to ensure balance between policy and advocacy work, capacity building activities and pilot projects. For more information about the UNDP in Ukraine: [www.undp.org.ua](http://www.undp.org.ua)

Blue Ribbon Analytical and Advisory Centre

Project funded by EU, co-funded and implemented by UNDP

**POLICY RECOMMENDATIONS ON ECONOMIC  
AND INSTITUTIONAL REFORMS 2009**

Kyiv, April 2009



This publication has been produced with the assistance of the European Union and United Nations Development Programme. The opinions, conclusions and recommendations presented in this publication are those of authors and do not necessarily reflect the views of the European Union and United Nations Development Programme or any other UN agency.



Reproduction of this publication or any part thereof for commercial purposes is not allowed in any form. The contents of this publication may be quoted provided that the full reference to the source is made.

## TABLE OF CONTENTS

Introduction	4
Acknowledgments	6
I. Key Recommendations	7
II. Analysis of selected areas	9
1. Fighting Corruption	9
2. Privatization	16
3. Enhance Management of State-owned Enterprises	21
4. Corporate Legislation	24
5. Regulatory Policy and Entrepreneurship Development	29
6. Fair Competition	32
7. Land Markets	34
8. Foreign Trade	40
9. Monetary Policy	48
10. Banking Sector	54
11. Non-bank Financial (NBF) Sector	60
12. Fiscal Policy	69
13. Tax System	80
14. Pension System Reform	88
15. Social Benefits	91
16. Judicial Reform	95
17. Administrative Reform	102
18. Energy Policy	107

## INTRODUCTION

In 2004, UNDP supported the work of the *Blue Ribbon Commission* – a group of eminent foreign and Ukrainian experts and policy makers who prepared a report on reform priorities and recommendations to the President and Prime Minister of Ukraine. Continuing the tradition of the BRC, in 2007 the Blue Ribbon Analytical and Advisory Centre – a joint project of UNDP and the EC – presented “Policy Recommendations on Economic and Institutional Reforms”. The underpinning idea for the document was to combine and consolidate the most important policy options, as viewed by international institutions and Ukrainian think-tanks, to strengthen Ukraine’s development. Although the selection of the recommendations was done by BRAAC, the document presented a consolidated vision for necessary and needed reform for the incumbent government in 2007.

The present report summarizes the progress on 2007 recommendations and also presents an updated set of recommendations for 2009. When reviewing implementation of the previous recommendations we embraced effective legislation as well as drafts pending adoption in Parliament.

Analysis shows that Ukraine’s a few remarkable achievements during 2008 and the early part of 2009 have been overshadowed by modest progress in most areas. Ukraine’s WTO accession and the launch of negotiations on FTA with the EU, adoption of a modern joint stock company law, progress in public procurement law, and transition to a more flexible exchange rate regime are seen as the most important accomplishments. Yet, the list of pending reforms remains long. There was small or no progress in combating corruption, privatization, empowering local authorities, lifting the moratorium on the sale of agricultural land, implementing the next stage of pension system reforms, instituting effective social policies, lowering inflation, abolishing the Commercial Code, and strengthening independence and impartiality of the judiciary. Authors of the report identified several draft legislative acts pending in the Verhovna Rada but not adopted. As a result Ukraine’s global ranking remains low for corruption, ease of doing business and transformation indicators which undermines the trust of foreign investors and local businesses. Yet, Ukraine’s high rankings for political freedoms and development of democratic institutions, which are higher than those of other countries in the CIS, remain unquestioned.

Ukraine was particularly vulnerable to the global financial crisis and economic turmoil because of the slow pace of reforms in recent years. This unprecedented crisis has become a litmus test demonstrating shortcomings in the country’s institutional arrangements and economic basis. At the same time there is now a unique opportunity to take on reforms in a more decisive way. In several post-communist countries crucial

reforms happened when it became clear to political leaders and civil society that existing institutional arrangements could no longer serve the wellbeing of the people.

Despite the seriousness of the economic crisis and political instability, Ukraine remains a country with enormous potential. Let us recall that in 2008, despite all deficiencies and the eruption of the financial crisis, Ukraine attracted USD 10.0 billion in foreign investments. There is no need to stress that it could have attracted more if proper legislation was in place, free trade with the EU existed, impartial legislation worked efficiently and low taxes were collected by a transparent administration.

The purpose of this document is to present a vision for further reforms to help realize Ukraine's full potential. The contributions to the present document were done by a team of international and Ukrainian experts, including BRAAC. Though we tried our best to reflect on the most recent government actions and policy responses to emerging crises, new developments may have occurred after the publication was sent to the printers.

We hope that these recommendations will serve as inspiration and guidance to decision makers responsible for Ukraine's development.

**Marcin Świącicki, Director**

A handwritten signature in black ink, appearing to read 'Marcin Świącicki', positioned to the right of the printed name.

## **ACKNOWLEDGMENTS**

This publication was prepared by a team of Ukrainian and international experts, supported by the staff of the Blue Ribbon Analytical and Advisory Centre. While UNDP and EC supported the work on the report financially and administratively the team exercised complete editorial independence. The analysis, views, estimates presented in this report are entirely those of the contributors and do not necessarily represent the views of UNDP and EC.

The main authors of the report were: Volodymyr Dubrovskiy (Chapter 1,5,6), Anatoliy Yefymenko (Chapter 1,3,4), Oleksandr Paskhaver (Chapter 2,3 ), Lydia Verkhovodova (Chapter 3), Volodymyr Artiushyn and Mykola Kobets (Chapter 7), Iryna Kobouta (Chapter 8), Inna Golodniuk (Chapters 9,10), Anastasiya Yermoshenko (Chapter 11), Dmytro Boyarchuk (Chapter 12,13), Inna Chapko (Chapter 14), Mykola Pugachov (Chapter 15), Wolfgang Tiede, (Chapter 16, 17), Viacheslau Herasymovich (Chapter 18).

Valentyn Povrozhnyuk contributed to editorial work whereas Katherine Nervig made proofreading of the English version and Tetyana Luzhanska of the Ukrainian one.

The work on the report was coordinated by Marcin Swiecicki, Director of the UNDP Blue Ribbon Analytical and Advisory Centre who was assisted by Inna Chapko and Andriy Zayika.

We would like to thank Mr. Martin Raiser, World Bank Director for Ukraine, Belarus and Moldova, who has provided valuable comments to the document.

## I. KEY RECOMMENDATIONS

### ***Provide macroeconomic stabilization***

- Implement monetary policy measures adopted in Memorandum of Economic and Financial Policies agreed with IMF:
  - Implement a flexible exchange rate regime;
    - Abolish the exchange rate band as monetary policy target;
    - Base the official exchange rate on the market exchange rate, and,
    - Adhere to transparent and predictable strategy of interventions into the interbank foreign exchange market.
  - Reduce level of inflation (CPI) to 17 percent by end-2009 by:
    - Targeting growth of monetary base by about 11 %;
    - Bringing the NBU interest rates on deposit closer to refinance rate;
    - Restoring previous reserve requirement rules; and,
    - Continuing deposit auction.
  - NBU, as a key player and regulator, on the foreign exchange market should design its actions in a way enhancing market mechanisms
- Gradually reduce the ratio of recurrent spending to GDP.
- Reduce tax rates over time, subject to the expansion of the tax base and/or reductions in government spending, and balanced budget.
- Undertake reforms of the pension system: assure financial stability of the first pillar, enact the second pillar, and increase retirement age.
- Strengthen the financial sector's prudential and supervisory framework to increase the sector's resilience to adverse shocks.

### ***Enhance market institutions***

- Make fighting corruption a priority issue of national policy; develop and implement a detailed plan for implementing the national anti-corruption strategy.
- Commit to and undertake transparent and competitive privatization. Adopt the State Program of Privatization
- Develop and implement judicial reform aimed at strengthening the independence, impartiality, and efficiency of the judiciary; ensure non-interference in the work of the courts at all levels.

- Complete the creation of administrative courts, which need to be adequately staffed and funded.
- Decentralize public administration according to the principles of the European Charter of Local Self-government in order to increase efficiency and accountability of local self-government
- Create transparent land and real estate markets in Ukraine by lifting the moratorium on the sale of agricultural land and establishing a single registry for real estate and agricultural land property rights.
- Abolish the Commercial Code. (The Code establishes an outdated and peculiar system of legal entities and hampers modernization of economic legislation in various areas of regulation.)
- Adopt a limited liability company law.
- Amend the Law “On Joint Stock Companies” to comply with the EU Company Law directives and improve the mechanisms that protect the rights of minority shareholders and their involvement in governance in order to increase competitiveness of Ukrainian issuers at the world financial markets.
- Establish “one-stop shops” for business registration and streamline the registration process by reducing the paperwork and permits required. Compile a complete and exhaustive list of permits into a single law to reduce the numbers of permits and activities subject to mandatory licensing.
- Continue improvement of the public procurement law.
- Increase energy security by promoting competition among private producers and stimulating energy savings by allowing prices to reflect costs.

***Improve Ukraine’s integration into the world economy***

- Continue and finalize negotiations on a new enhanced agreement with the European Union (EU) (including a deep and comprehensive Free Trade Area as a core element of the agreement); reduce the number of exceptions and transition periods, and fully open trade of agricultural and food products.
- Accelerate of harmonization of Ukraine’s certification and standardization system with international and European ones.

## **ANALYSIS OF SELECTED AREAS**

### **1. Fighting Corruption**

Overall, there were only a few improvements in the policy of corruption combating in 2008. Recommendations aimed at increasing of punitive powers of authorities had a greater chance of being implemented. On the contrary, systemic changes were hardly addressed, except for some improvement in the clarity of the decision-making process. Several draft laws were prepared in line with recommendations, some as early as 2006, but none of them even went through the first reading in 2008.

The most effective, although partial, accomplishments in-line with recommendations of BRAAC that can have systemic effect were: the abolishment of the heavily corrupted state procurement system and improvements in the political independence of the Chief Prosecutor (CP). Additionally, the Law "On the Cabinet of Ministries" has, to some extent, clarified the responsibilities of authorities and decision-makers. Furthermore, the draft Law "On the Normative and Legislative Acts", aimed at systematizing the way how the government acts are prepared and adopted, is close to adoption. This can also improve transparency in the administrative process.

#### **1.1. Develop a detailed plan for implementing the national anti-corruption strategy**

and

#### **1.2 Establish a body, distinct from law enforcement functions, with the responsibility of overseeing the implementation of national anti-corruption strategies and related action plans, as well as proposing new strategies and measures for fighting corruption.**

#### ***Not implemented***

The Presidential Concept "On the Way to Honesty" (No. 742/2006 of 11 September 2006) was further developed in the similarly named Cabinet's Plan of Actions for fighting corruption (No. 657-2007-p of 15 August 2007). The President's Order No. 414/2008 of 5 May 2008 has directly stipulated the necessity of a number of amendments to it, particularly regarding the establishment of anti-corruption body, prevention of corruption in law enforcement agencies, etc. However, the Plan of Actions was amended only in 2009 by the Cabinet of Ministries' Order No. 44-2009-p of 21 January 2009 and requires a number of ministries and other government bodies to conduct regular open telephone calls in order to increase their transparency.

No substantial amendments were developed, not to mention a comprehensive and well-thought out long-term strategic plan, which could serve as the framework for

more detailed and timely documents in the future. The draft Law “On the Anti-Corruption Bureau” (No. 2222 of 17 March 2008) formally proposes to establish a body responsible for overseeing the implementation of the national anti-corruption strategies and action plans as well as for the task of proposing new strategies and measures to fight corruption. However, the proposed agency is (a) empowered with law enforcement functions, and (b) subordinated to the Ministry of Interior Affairs – both provisions emasculate the strategic and systemic role that the bureau could play.

**1.3 Review the system of administrative liability for corruption in order to clearly establish the cases of corruption that are to be treated as criminal offences.**

***Not implemented***

**1.4. Impose criminal responsibility for trading influence.**

***Not implemented***

**1.5. Strengthen coordination between the various law enforcement authorities involved in the investigation of corruption offences.**

***Partially implemented.***

The President of Ukraine’s Decree No. 370/2008 of 17 April 2008 established the Inter-Agencies Working Group on Confronting Corruption. Its task is to “...prepare the propositions concerning improvement of coordination between ... [law enforcement and other authorities] ... on the issues of fighting with, and prevention of, corruption”. Notably, the Group is hosted by the Security Service of Ukraine (SSU). It is co-headed by a Chief Prosecutor, and a Chief of the SSU, while the representatives of the Ministry of Interior Affairs (MIA) are of the lower level. This might be interpreted that this group is countervailing MIA. This might help to prevent corruption in this Ministry. However, it has not been publicly active until recently, when in the midst of political crisis, the Group became famous with public accusations against a number of MPs. In January 2009 the work of this Group was severely criticized by the President for its low efficiency.

**1.6. Enhance the independence of the Procuracy from political influence and provide it with clear mandates focused on leading pre-trial criminal investigations and prosecutions.**

***Partially implemented***

The Law No. 502-VI of 4 September 2008 has restored symmetry in the appointment and dismissal of a Chief Prosecutor (CP). Before, the President needed Parliament’s approval for appointment of a CP, but could dismiss him or her unilaterally; now parliamentary approval is required in both cases. This amendment certainly makes the CP’s Office less dependent on the President. Instead, however, it becomes more

dependent on the MPs. Therefore, while the new arrangement makes the system of state power somewhat more transparent, the effect on fighting corruption is not significant.

Firstly, dismissals of CPs in the past were usually made through the formal abolishment of the acts on their appointment. The new arrangement will hardly be used without a more general provision that makes it impossible to abolish of adopted acts which have already had legal consequences.

Secondly, no institutional arrangement can ensure truly independent appointments free from any political influences. The new procedure simply establishes a balance of power over the CP in accordance with the Constitution.

### **1.7. Review public procurement legislation in order to bring it into compliance with European norms and standards with respect to policy, accountability, and transparency.**

#### ***Partially implemented***

State procurement was regulated by the Law No. 1490-14 which was adopted in 2000 and had been permanently amended since then. The initial arrangement fell short of best practices of transparency and accountability. Amendments introduced in the Law "On Amending of Certain Legislative Acts of Ukraine Concerning Additional Guarantees of the Financial Interests of the State" No. 2664-IV of 16 June 2005 have actually worsened the situation further. In particular, the Tender Chamber was introduced establishing a highly monopolized and non-transparent system for public procurement.

In 2008 this arrangement and the previous law were abolished by Law No. 150-VI of 20 March 2008. This happened with electoral pledges and on the demand of local authorities. At the end of 2008 the situation operated as it had before 16 June 2005 and was not transparent and, most certainly, was heavily corrupt. The state procurement is now regulated by the Cabinet's Decree No. 921-2008-p of 17 October 2008. Its initial version was cancelled by the Constitutional Court (because procurement is regulated by the law) but was immediately restored. It was welcome as a good step forward, however it is too early to assess whether the amendments have decreased the corruption.

On the one hand, abolishment of the Tender Chamber arrangement should be welcomed. On the other hand, the assumption that the ministries and local authorities, whose decision-making power has been restored, are less corrupt and more transparent than they used to be is questionable. The practice of kick-backs was well established. Thus, the main difference in the arrangements might just be the distribution of kick-backs (centralized vs. decentralized) rather than their volume. Therefore, BRAAC recommendations 1.8, 1.11, and 1.17 should be applied. Moreover, the new legislation preserves so-called "methodological councils" at every government body entitled with decision-making rights in procurement. They mix advisory and executive functions

(including decision making) but do not bear any responsibilities as executives should. There is also a non-transparent structure and composition.

Therefore, although the abolishment of corrupt procedures is certainly good news, the current success in fighting overall corruption is unclear.

**1.8 Apply controlled delivery of bribes, tapped telephone conversations and other special investigative techniques that have proved effective tools in identifying corrupt officials in other countries.**

***Implemented but not supported by court system***

Ukrainian law enforcement agencies have been using various investigative techniques for some time. In 2008 there were a series of successful operations which caught officials accepting bribes. Nevertheless, the perception of corruption continued to deteriorate (the Transparency International index fell to 2.5 in 2008 from 2.7 in 2007, and the country has dropped by 16 positions in international rating). This outcome is in-line with research on fighting the systemic corruption. Scholars acknowledge that as long as corrupt practices are widespread and have deep historical roots, as with former Soviet republics, punitive measures result in very little improvement to the overall situation.

It has an effect only if the corruption is not a systemic problem. If it is common practice, the punishment can only be selective and at the discretion of some authority. However, colleagues of those caught accepting bribes conclude that the real cause of his or her misfortune is insufficient political loyalty, or unwillingness to work with powerful people rather than the corruption itself. Yet another problem with investigative techniques so far is how they are poorly supported by the quality of further investigations, and moreover, by the court system. Those officials who were caught accepting bribes have yet to be convicted, although this might be because little time has passed since they were initially caught

**a. Introduce regulations regarding the confiscation and seizure of proceeds from crime.**

***Partially implemented***

Legislation exists but does not function properly and was not rectified. The courts rarely apply the sanction of confiscation of the assets because gaps in legislation make possible to protect illicitly acquired assets against confiscation as property of the legal entities.

**1.10. Oblige all public officials to declare all financial interests: income, acquisition of real estate, and other valuable assets, both their own and that of their closest relatives; check accuracy of declared assets with legal income.**

and

**1.16. Introduce clear guidelines for all public officials to report suspicions of corruption and introduce protections for those who report their suspicions (“whistle blowers”), in good faith, from adverse consequences.**

and

**1.17. Set rules that mandate that officials disclose any conflicts of interest; envisage immediate resignation for violation of these rules.**

***Not implemented but drafts prepared***

Several BRAAC recommendations were, to some degree, included into law drafts, most of them submitted for the first time in 2006. Namely, No. 0877 of 23 November 2007 regards the responsibility of officials convicted of corruptions crimes; No. 0876 of 3 November 2007 on the Principles of Prevention and Fighting Corruption (includes provisions for conflict of interests and protection of the “whistle blowers” and requires public officials to declare all financial interests); No. 0875 of 23 November 2007 regards the liability of corruption charges (reinforces confiscation and seizure of proceeds from the crime, which was previously included in the criminal law<sup>1</sup>; introduces criminal responsibility for trading influence). Despite the President’s support, however, (Decree No. 414/2008 of 5 May 2008), none of the respective bills were even considered for the first reading<sup>2</sup>.

This group of recommendations aims to increase the price of corruption for state officials. One of the reasons that they have not been adopted and properly implemented is that some state officials and legislators had been involved in corruption themselves. The chance of adopting new punitive measures may depend on adding legal guarantees that protect officials from prosecution for past corruption.

**1.11. Enhance the public’s right to access official information; introduce less cumbersome request procedures, and consider introducing an independent pre-court review mechanism for decisions that refuse access to information.**

and

**1.15. Provide free public access to information about the capital participation of Single Registry of Legal Entities and registries of shareholders of joint-stock companies.**

***No implementation, but draft only.***

The draft Law “On Access to Public Information” (No. 2763 of 11 July 2008) takes into accounts all of BRAAC’s recommendations. Access to information about founders of legal

---

<sup>1</sup> Article 368 pp. 2, 3 of The Criminal Code of Ukraine stipulates that for a sufficiently large bribe, or any kind of bribe taken by a government servant of the category higher than third, a person is liable to seizure of property. In practice, it is hardly possible to distinguish the proceedings from crime from other kinds of wealth.

<sup>2</sup> The first reading made by previous convocation of the Parliament is not taken into account – for this reason, the drafts were re-submitted to the new Rada.

entities is already available although one must pay for the information<sup>3</sup>. Registering capital participation, especially for open joint stock ventures, is a far more difficult task, because it requires a workable system of accounting for all equity transactions. It is discussed too, but is still far from an implementation phase.

**1.12. Adopt a clear set of rules governing the administrative process and decision-making, as well as clear guidelines regarding the hierarchy of different legal norms and standards governing public administration.**

***Partially implemented***

A new edition of the Law “On the Cabinet of Ministries” (No. 279-17) was adopted on 16 May 2008 and corrected some inconsistencies in the decision-making process that were notorious in the previous law. It made an important step towards clarifying the responsibilities of various authorities. Furthermore, the draft Law “On the Normative and Legislative Acts” (No. 1343-1 of 21 January 2008) was submitted and passed in two readings. This law, if adopted, will unify the procedure of preparing and adopting normative acts. It will also significantly improve the transparency of regulations by establishing a free and accessible (including the Internet) Single State Register for the Normative Acts.

Unfortunately, however, this draft does not stipulate obligatory expertise for corruption vulnerabilities. Such an expertise should be mandatory for all normative acts and conducted by a government body that is independent, to the extent possible, from executive power. Elimination of corruption vulnerabilities at the level of the law is the most effective measure to prevent corruption and strengthen legal order. It is closely connected to measures to improve regulation and the business climate, but goes broader to embrace all spheres and not just business regulation.

**1.13. Introduce transparency to the biggest state holdings (such as UkrZaloznytsia, UkrTelecom, etc.) by preparing and issuing annual public reports and passing audits conducted under internationally recognized rules by certified auditing firms.**

and

**1.14 Improve the management of state-owned enterprises in order to prevent stealing funds and property that belong to the people of Ukraine.**

***Not implemented.***

State holdings remain major sources of income for state officials and their business associates (in fact – their own business are often formally managed by their associates).

---

<sup>3</sup> [http://ukrstat.gov.ua/control/uk/localfiles/display/edrpoj/ukr/norm/polog\\_korist\\_dan.htm](http://ukrstat.gov.ua/control/uk/localfiles/display/edrpoj/ukr/norm/polog_korist_dan.htm). It is disputable whether a taxpayer should or should not pay for this service instead of interested persons.

The introduction of the contradictory and confusing set of “indicators of social and economic development of an enterprise” as a measure to discipline managers will only deepen inefficiency in the state sector.

See more comments in chapter 3 on “Improving Governance in State-Owned Enterprises”.

### **2009 Updated Recommendations:**

1.1. Develop a detailed plan for implementing the national anti-corruption strategy.

1.2. Establish a body, distinct from law enforcement functions, and independent from executive branch of power, responsible for gathering and analyzing available information on corruption-related issues; identify the main causes of corruption and particular corruption vulnerabilities along with their legislative and institutional sources; oversee implementation of national anti-corruption strategies and related action plans, as well as propose new strategies and measures to fight corruption, including improve anti-corruption legislation. .

1.3. Review the system of administrative liability for corruption in order to clearly establish the cases of corruption that are to be treated as criminal offences.

1.4. Impose criminal responsibility for trading influence.

1.5. Strengthen coordination between the various law enforcement authorities involved in the investigation of corruption offences; secure sufficient checks and balances to prevent law enforcement officers from colluding with corrupted officials, their corrupted colleagues, or participating in corrupt activities themselves.

1.6. Enhance the independence of the Procuracy from political influence and provide it with clear mandates focused on leading pre-trial criminal investigations and prosecutions.

1.7. Monitor public procurement with respect to accountability, and transparency.

1.8. Use special investigative techniques (such as authorized controlled delivery of bribes and tapped phone conversation) to ensure efficient follow up action

1.9. Develop expertise to monitor vulnerabilities and possible corrupt influence for existing and proposed legislation, including normative acts of executive authorities at all levels. Expertise should be independent from executive power and focus on the most acute issues (see 1.2.). Lobbyists should be subject to registration and careful monitoring to ensure transparency of their activities.

1.10. Improve regulations for confiscation and seizure of proceeds from crime.

1.11. Require all public officials to declare all of their financial interests and that of their closet relatives including income, acquisition of real estate, and other valuable assets;; check accuracy of declared assets with legal income.

1.12. Enhance the public's right to access official information; introduce less cumbersome request procedures, and introduce an independent pre-court review mechanism for decisions that refuse access to information.

1.13. Adopt a clear set of rules governing the administrative process and decision-making, as well as clear guidelines regarding the hierarchy of different legal norms and standards governing public administration.

1.14. Introduce transparency to the biggest state holdings (such as UkrZaliznytsia, UkrTelecom, etc.) by preparing and issuing annual public reports and passing audits conducted under internationally recognized rules by certified auditing firms.

1.15. Improve the management of state-owned enterprises in order to prevent stealing funds and property that belong to the people of Ukraine.

1.16. Provide free public access to information about the capital participation of Single Registry of Legal Entities and registries of shareholders of joint-stock companies.

1.17. Introduce clear guidelines for all public officials to report suspicions of corruption and introduce protections for those who report their suspicions ("whistle blowers"), in good faith, from adverse consequences.

1.18. Legally define conflict of interest; set rules to mandate that officials disclose any conflicts of interest; envisage immediate resignation for violation of these rules.

## **2. Privatization**

### **2.1. Develop a comprehensive privatization program**

***Recommendation is partially implemented.***

The attempt of the Government to organize the speeded up sale of the strategic enterprises in order to finance the large-scale payouts to population became the reason for the new privatization program development. This created risks for national interests and could be the additional factor for inflation growth, according to the opinion of some experts. The accelerated and simultaneous sale of the strategic objects decreases competition between the investors and, therefore, decreases the sale prices. In order to prevent these risks the decision of the National Security and Defense Council of Ukraine

(NSDCU) of 15 February 2008<sup>4</sup> and Decree of the President of Ukraine of 6 March 2008<sup>5</sup> introduced a temporary moratorium on privatization of strategic enterprises until the adoption of the State Program of Privatization for 2008-2012. At the same time, the “Conceptual Basis for Ensuring the Realization of National Interests in the Sphere of Privatization” (hereinafter referred to as the Conceptual Basis) was adopted by the President<sup>6</sup>. The new Program of Privatization was supposed to be developed in accordance with the Conceptual Basis.

The Conceptual Basis determined the strategic aim of privatization: create a competitive economic system able to effectively respond to global challenges and develop a new strategy for privatization with the goal to finish the privatization as such within the next 5 years. The Conceptual Basis presented the necessity to transition from a fiscal to an investment-innovative privatization model. The tasks of synchronizing privatization with market transformation in strategic sectors and the economy in general were set. The key processes for privatization were determined including equal access for investors, a transparent process, and buyer responsibility for compliance with state purchase agreements.

The draft State Program of Privatization for 2008-2012 was prepared in a short period of time and on 7 April 2008 the government transferred it for the President’s consideration.

The government’s draft of the program drew criticism from the President, opposition and some experts. In the draft of the State Program of Privatization for 2008-2012 the strategic aim and strategic development of Ukrainian privatization were determined for the next five years in full accordance with the Conceptual Basis. However, it was not reflected in the privatization mechanism. The procedure is still based on the fiscal model and does not provide the necessary legal framework to fulfill the new strategic goals and tasks. In addition, the program lacks clear legislative norms leaving considerable room to use “manual” methods in the privatization process. There is nothing in place to prevent the alienation of state property by methods other than open privatization and does not provide the mechanisms to change ownership guaranteeing transparency.

However, the government’s program passed the first reading<sup>7</sup> in the Parliament on 3 June 2008. A formal motive was used to pass the program – without the ratification of the

---

<sup>4</sup> Decision of the National Security and Defense Council of Ukraine of 15 February 2008 “On ensuring the national interests and national security in the sphere of privatization and conceptual basis for their realization”

<sup>5</sup> Decree of the President of Ukraine of 04 February 2008 No. 90/2008 “On the working group of the development of the concept of improving legislation on privatization”.

<sup>6</sup> Decree of the President of Ukraine of 07 March 2008 No. 200/2008 “On ensuring the national interests and national security in the sphere of privatization and conceptual basis of their realization”

<sup>7</sup> Draft Law No. 3233 of 07 April 2008 “On the State Program of Privatization for 2008-2012”

State Program of Privatization Parliament could not introduce changes to the State Budget for 2008.

On 18 June 2008 the President provided amendments to the Draft Program of the Government, corresponding to the Conceptual Basis. However, the draft of the State Program of Privatization, prepared for the second reading, did not include the President's amendments.

The State Program of Privatization has not been adopted by the Parliament, due to the parliamentary crisis. Additionally, the conflict between the President and the Prime-Minister over the nomination of the Head of the State Property Fund of Ukraine (SPFU) has further delayed the privatization process.

The development of the new State Program of Privatization is strategically important to Ukraine's economy. It should reflect the new strategy – completing of privatization within the next 5 years. The absence of a legislatively approved program increases political conflict and paralyzes the privatization process. The delay in privatization process due to blocking of privatization legislation results in alienation of state property by other methods.

The global financial crisis, which started to develop in the fall of 2008, affects privatization and results in the fiscal option gaining support. The anti-recessionary law of 31 October 2008 includes privatization as the important source for forming the Stabilization Fund<sup>8</sup>. As a result of the financial crisis, foreign and domestic investment activities have also decreased. This will affect the demand for privatization objects and consequently the sale price.

Privatization of strategic objects without preliminary preparation is a risk for both the economy and defense of the country. Therefore, it is reasonable to sell strategic enterprises under the condition of the preliminary estimation of demand on the side of investors and after determining the minimum price.

Although the financial crisis is unfavorable for the investment-innovation option, it makes sense to prepare for the privatization of the strategic industries now and to create effective measures to stop the alienation of the state property by other means.

As a final note, the Stabilization Fund can benefit from the privatization of land plots. Therefore we recommend that land plots are included as the privatized objects and establish a procedure enabling companies to buy the land plots, on which previously privatized by them objects are located.

---

<sup>8</sup> Art. 1 of the Law of Ukraine of 31 October 2008 No. 639-IV "On Immediate Measures to be Taken to Prevent Negative Consequences of Financial Crisis, and Amendments to Certain Legislative Acts of Ukraine"

## **2.2. Set clear and fair policy requirements for bidder selection of to avoid the abusive practice of artificial limitations of number of bidders by setting unjust specific requirements**

### ***Several measures concerning the recommendation were elaborated but not adopted.***

Until the State Program of Privatization for 2008-2012 is adopted, the legislative norm on the obligatory sale of state property to the special category of buyers “industrial investors”, the preliminary selection of which is being executed through the introduction of the qualifying requirements, will continue. This selling method contains wide possibilities for abuses by setting artificial limitation for the number of bidders.

The method of selling the state objects to the “industrial investors” is continuously applied in the practice of the Ukrainian privatization. In 2008 there were three state property objects for sale that used the “qualifying requirements for the bidders”.

The Conceptual Basis, adopted by the Decision of the NSDCU and approved by the Presidential Decree, among the important tasks mentions the claim to eliminate the requirements, which limits the participation of the potential buyers. For the purpose of this claim fulfillment, the “industrial investor” category is eliminated from the government’s draft State Program of Privatization for 2008-2012, which passed the first reading of the Parliament. However, in the draft program there are no clear and fair requirements of the bidders’ selection during the sale process of the strategic objects. The obscure methods of buyer qualification were not substituted with a clear method for potential buyer selection.

It is necessary that qualification guarantees the protection of the national interests and will effectively develop the asset after the privatization process is completed. Additional requirements that artificially limit the number of bidders should be avoided.

The applicant has to prove his ability as an investor/buyer through the provision of the Program of the Enterprise Development for 3-5 years. Setting up the clear sanctions for non-fulfillment of the obligations on the enterprise’s development, which are listed in the purchase agreement including the grounds for returning the privatized object back to the state property, can serve as the guarantee. The list of requirements is determined by legislation and is exhaustive.

## **2.3. Use reputable international advisors to prepare large scale privatization tenders in a way that secures competitiveness, assures proceeds to the state budget, and protect employees’ interests**

### ***The recommendation was not implemented.***

There is no legislative basis to hire international advisors to oversee privatization, since the Law of Ukraine of 15 December 2005 No. 3205-IV “On Amending the Law of

Ukraine “On the Purchase of Goods, Work and Services at the Expense of the State” was abolished.

Additionally, during the analyzed period there was no practical need for international advisors, since no strategic enterprises were privatized during the past two years. A moratorium on preparation of the strategic enterprises for privatization has been introduced in March 2008 the.

The Conceptual Basis and the draft State Program of Privatization for 2008-2012, which already passed the first reading, do not contain any recommendations to hire international advisors to prepare state objects for privatization.

However, at the final stage, when the privatization is planned to be pushed towards the strategic industries, natural monopolies, social sphere, the international advisors can become the transmitters of the positive international experience.

It should be noted that the use of international advisors will incur additional expenses and lengthen the privatization process.

#### **2.4. Ensure fully transparent procedures for all privatization tenders**

##### ***The recommendation is partially implemented.***

The legal field<sup>9</sup>, which regulates the organization of tenders, ensures that sales process of state enterprises is transparent. The SPFU guarantees that information on the tenders is published; ensures that the sale procedures are video and/or audio taped. The Fund provides open access for representatives of the mass media and other interested persons.

Information on the tenders is announced on the official website of the SPFU. The “Vidomosti pryvatyzatsii” publishes preliminary information about the most significant objects of the SPFU and invites potential bidders to participate in the development of the competition conditions.

In 2005 a new competitive sale method for strategic objects was introduced, which was the free establishment of the sale price<sup>10</sup>. This ensures the maximum transparency in the competition, since there are no conditions for bidder selection and the winner is determined by the highest sale price.

However, legal conditions, which allow the shady division of the state property in those cases, when the attractive for investments objects are sold to “industrial investors”,

---

<sup>9</sup>Article 19 of the Law of Ukraine “On the Privatization of State Property”, Regulation “On the Order of Carrying Out Competition for the Sale of controlling Packages of Shares of Stock Companies”, ratified by decree of the SPFU of 31 August 2004 No. 1800.

<sup>10</sup>Regulation “On the Order of Carrying out Tenders with a Free Setting of the Price”, ratified by a decree of the State Property Fund of Ukraine of 11 July 2005.

remain valid. This practice will be abolished when the State Program of Privatization for 2008-2012 is adopted.

### **2009 Updated Recommendations:**

2.1. Adopt the State Program of Privatization, which will determine the strategy, tasks, and mechanism of privatization at the final stages of the large-scale socio-economic project.

2.2. Set clear and fair requirements for bidder selection to prevent the artificial limitation of bidders with unfair and specific requirements.

2.3. Engage international advisors to prepare the privatization process in order to secure fair and competitive conditions in the industry, increase budget revenues, attract significant investment, and protect the interests of workers.

2.4. Require public hearings for strategic privatization issues.

2.5. Sell the strategic enterprises under condition of the preliminary estimation of demand on the side of investors and after determining the minimum price. Sell strategic enterprises when investor interest is established and after a minimum price is determined.

2.6. Finance the Stabilization Fund with revenues from privatizing of the state-owned assets through the fast standard methods. Privatized assets should include the land on which the assets are located.

2.7. Ensure that privatization of strategic industries is based on programs of privatization and market transformation. Introduce effective methods to counteract alienation of the state property by means other than privatization.

### **3. Enhance management of state-owned enterprises**

**3.1. Prior to privatization, transform all state-owned enterprises into joint-stock companies or limited liability companies, and replace the direct ministerial administration of a state-owned enterprise by a more efficient and transparent mechanism of corporate governance;**

and

**3.2. Abolish the Ukrainian Law “On Management of State Property Objects”, eliminating all privileges and exemptions for state-owned companies;**

and

### **3.3. Create a monitoring and oversight system for financial risks in state-owned enterprises; impose mandatory requirements for independent annual audits for state-owned companies.**

#### ***Not implemented***

Efforts aimed to regulate the ineffective use of state-owned property, including the adoption of the Law of Ukraine "On Management of State-Owned Objects" (21 September 2006 p) and the Law of Ukraine "On Holdings in Ukraine" (15 March 2006), preserved the old and ineffective administrative and departmental system of managing state-owned property. The Economic Code of Ukraine upholds ineffective legal structures based on concepts of Soviet socialistic enterprise. The code does not: envisage effective distribution of powers within an enterprise; regulate the legal status of participants; or provide an effective mechanism for external and internal control. The Economic Code of Ukraine and the Law "On Management of State-Owned Objects" declare property independence of "economic entities", and at the same time reserves broad rights for state agencies to interfere in the economic activity of seemingly independent legal entities. The result is a system where no one accepts responsibility for managerial decisions. Endowment of state enterprise using the Economic Code with the surrogates of ownership rights – the so-called "right of economic control" and "right of operational management" - creates additional risks. On the order of state administrative bodies managers of state enterprises are selling or transferring surrogate rights as if the surrogates had full ownership rights. This creates a lot of uncertainty in property turnover, and increased seizures of state-owned or privatized enterprises. The take-over of joint-stock companies by "leasing" the votes of state-owned blocks of shares is a common practice because of the ineffective system of policy-making and the lack of control and responsibility of state officials. The Law of Ukraine "On Holdings in Ukraine" legalizes the shadow privatization scheme through seizure of state-owned blocks of shares as contributions to the capital of "holdings". All these mechanisms do not conform to commonly accepted practices of corporate governance and efficient management.

It is ineffective to preserve the state's majority share in enterprises just to ensure more effective regulation. As soon as possible the state should dispose of share blocks in the majority of privatized companies since their governance can not be effectively controlled.

Supervisory board members of joint-stock companies should have the right to elect and dismiss executives and should bear the responsibility for the company's performance. State official should be prohibited from serving on supervisory boards of joint-stock companies since their oath as a state official creates a conflict with board member duties to act in the best interests of the company.

The practice of granting privileges and advantages for public sector enterprises is based on the effort to compensate for their inability to compete with private enterprises. Ukraine has had a negative experience supporting state-owned enterprises. Privileges for state-owned enterprises have led to a distortion of fair competition, flourishing corruption and ineffective production and governance to the detriment of state budgets and the national economy.

The ineffective legal structures of “economic entities” (especially state-owned and public enterprises) eliminates the possibility of creating an effective systems of monitoring and controlling financial risks and neglects to implement even the simplest corporate governance techniques to reduce exposure to management abuses (stripping assets and profit skimming).

### **2009 Updated Recommendations:**

3.1 Accelerate the process of withdrawing the state from commercial activity by the way of privatization, concessions, public private partnership; state owned minorities share blocks in all enterprises should be sold.

3.2. Prior to privatization, transform all state-owned enterprises into joint-stock companies or limited liability companies, and replace the direct ministerial administration of a state-owned enterprise by a more efficient and transparent mechanism of corporate governance;

3.3 Establish mandatory requirements for companies, in which state-owned block of shares exceeds 50 % to apply a management model, independent audit, financial reporting system as envisaged by the Law of Ukraine “On Joint-Stock Companies” for public companies; create a system to monitor and oversee the financial risks in state-owned enterprises;

3.4. Organize open hearings (parliament debates) to discuss expediency of state-owned holding companies and financial results.

3.5. Separate the government’s function as owner from policy regulator; set up a separate state institution to manage state-owned shares; consider creating a roster of associations that can propose experts to sit on supervisory boards of state owned enterprises

3.6. Abolish the Laws “On holdings in Ukraine” and “On Management of State Property Objects”, eliminating all privileges and exemptions for state-owned companies;

3.7. Grant supervisory boards the responsibility to control management (including the right to elect and dismiss executive bodies without cause) of state-owned companies’

performance. Establish the liability of supervisory boards' members for breaching their duty to act exclusively in the interests of company. Prohibit participation of state officials on supervisory boards of state-owned companies.

3.8. Forbid unequal treatment of state and non-state owned enterprises in new legislation and policy measures aimed at combating crisis; the government should avoid financially supporting inefficient state-owned companies.

#### **4. Corporate legislation**

##### **4.1 Enact the Joint-Stock Company Law based on EU Company Law directives and OECD principles of corporate governance**

###### ***Substantially implemented***

The adoption of the Law "On Joint-Stock Companies" on 19 September 2008 was a big step forward for Ukraine. The concept and detail differ noticeably from other legislative acts regulating joint-stock companies. The advantages of the new law include: regulation of the preemptive rights of the shareholders to purchase additionally issued shares; the requirement on placement of shares at market price; the strengthened role of supervisory boards to effectively and promptly protect shareholders' interests; well-defined regulation for decision-making processes in a company with a single shareholder; provisions for representing minority interest shareholders in the supervisory board through a requirement to elect the supervisory board by cumulative voting; the establishment of significant contracts and contracts with interest present; clear and detailed regulation for shareholders general meeting, procedure for winding up of joint-stock companies. The Law "On Joint-Stock Companies" created new standards for Ukrainian law and provided an important conceptual base for further development of corporate legislation.

At the same time the law contains substantial gaps and does not fully correspond to EU Directives on Company Law and best practices of corporate governance.

The provision to have a special majority of 75% of the total number of shareholder (par.5 Article 42) instead of such a majority of shareholders attending the general meeting (as envisaged by the Law "On Business Associations" and the Civil Code) for particular issues can paralyze the activity of joint-stock companies. Both joint-stock companies and the Ukrainian securities market will be damaged by the mandatory listing of shares of all public joint-stock companies and on the sale of their shares at stock-exchanges only (par. 1 Article 24), which will lead to mass escape of potential issuers from joint-stock companies as a legal vehicle, imitation of trade activity and false liquidity.

The Law "On Joint-Stock Companies" does not reflect such important mechanisms as fiduciary duties of company's officials, derivative lawsuit, exclusive right of supervisory

board to elect the executive body, mechanism of authorized shares, tender offer for purchase of controlling block of shares, absentee voting of shareholders (by post). Including these mechanisms eliminates major risks in the system of governance, reduces the cost of the decision-making process and improves the investment appeal of Ukrainian issuers.

The sale of additionally issued shares is the right way to attract additional funds into the banks to address the problems of a difficult financial condition (articles 2 and 3 of the Law of Ukraine “On Immediate Measures to be Taken to Prevent Negative Consequences of Financial Crisis, and Amendments to Certain Legislative Acts of Ukraine”), however, the decision making procedure for issuing additional shares and shares registration outlined in the Law is imperfect and includes unrealistic timeframes. The Law will be more efficient and practical with the following improvement included: utilization of the institute of external manager (it would be expedient to allow designation of external management by participant’s application), a longer timeframe for the registration of documents, and the right of the SSMSC to verify documents filled in by issuers. The present wording of the Law forces the Commission to accept any documents.

#### **4.2 Assure the implementation of principle of full transparency of ownership and free public access to the information about shareholding in reformed national depository and registration of securities.**

##### ***Partially implemented***

Creation of the Unified Register of legal entities, which should contain basic information (including identity of participants) on all legal entities envisaged by the Law of Ukraine “On State Registration of Legal Entities and Individuals – Entrepreneurs” of 15 May 2003, is almost complete. It is planned to provide free public access to the Register via internet and the possibility to obtain certified printed documents for a small fee. But due to the specifics of registering the rights on shares, not to hamper circulation of securities, information about shareholders of joint-stock companies is not incorporated in Unified Register. The current system of registering securities established by Law of Ukraine “On National depository system and peculiarities of circulation of securities in electronic form” (10 December 1997) proves to be inefficient and unreliable. The plans to replace the current system of registering securities materialized in a draft Law of Ukraine “On System of Depository Accounting” No. 3021 of 27 August 2008, which was submitted to the Verkhovna Rada by the Cabinet of Ministers of Ukraine. Unfortunately the draft extremely limits access to the register of shareholders. The proposal to centralize records (creation of Central Depository) is not accompanied by mechanisms to facilitate access to the services of the Central Depository by small shareholders making shares of Ukrainian joint-stock companies an unattractive investment instrument for small private investors. The lack of a clear and reliable mechanism for obtaining information on identity of share owners

undermines the effectiveness of many mechanisms of the Law “On Joint-Stock Companies”.

**4.3. Reform the public audit system to improve reliability and public trust by requiring audit firms to function only in the form of partnerships with unlimited liability and limit the scope for disclaimers used in audit contracts.**

***Not implemented***

After the credibility crisis caused by “Enron”, “World.com”, and “Parmalat”, most countries took measures to reform auditing activities in order to increase the responsibility of professional auditors and provide for their independence and public accountability. Unfortunately, even with the large number of draft laws on amendments to the Law “On Auditing Activity” none of them address the liability and independence of auditors. There are two factors that allow audit firms to easily avoid responsibility for incorrect statements. Firstly, audit firms can become a joint-stock or limited liability company with a very small capital. Secondly, they include disclaimers in audit contracts exempting them from any liability. In addition there is no separation of consulting and audit services. Many audit firms also provide consulting services to the same client on taxes, credit, internal audit, etc. Therefore firms have no incentive to provide a critical audit and risk losing a client. Therefore, Ukrainian auditors do not perform their main function – to research and guarantee the reliability of financial reports of joint-stock companies – that ruins investor trust in financial reporting and suppresses the investment process.

The obligatory partnership form of audit firm, as exists in other countries, would substantially strengthen the financial responsibility in auditing reports of all partners.

**4.4. Solve the problem of “corporate raidering” by adopting legislation with clear take-over rules, which facilitate the creation of civilized markets for corporate control (tender-offer, breaking-in, sell-out and squeeze-out mechanisms).**

***Problem acknowledged but not resolved***

“Hostile take-over” scenarios should be clearly separated from so called “raidering”. In developed economies a “hostile take-over” is generally perceived as a positive phenomenon where blocks of shares are bought from a poorly performing company and incompetent management is replaced for the benefit of shareholders. However, Ukrainian “raidering” is the unlawful seizure of property from shareholders, often by dishonest managers, on formally legal foundations but, in fact, based on crime, abuse of the law or gaps in legislation. Effective prevention of “raidering” requires a complex approach to eliminate the gaps in various laws as well as to implement measures to ensure proper motivation for judges and law-enforcement bodies.

The new Law “On Joint-Stock Companies” limits opportunities for “raidering”, but does not prevent the wide spread take-over schemes to seize assets (see comments in

recommendation 4.1). At the same time the section of law dedicated to the regulation of purchasing a controlling block of shares (take-over) actually contains fragmentary provisions which are not consistent with EU Directive “On take-over bid” and are not sufficient for establishing clear and educated rules for the corporate market.

The draft Law of Ukraine “On Amending of Certain Legal Acts of Ukraine on Countering Unlawful Acquisition and Seizure of Enterprises” No. 3011, which is under review of the Verkhovna Rada of Ukraine, prohibits the application by judges for certain measures of securing claims, however it does not resolve a judge’s responsibility for the abuse of authority. To combat “raidering” requires the proper motivation and effective mechanisms to ensure the responsibility of judges and law-enforcement officials (see also recommendation 17.1).

Preserving the concept of “economic entity” in the Economic Code of Ukraine facilitates the seizure of state property. “Economic entity” is a form of Soviet enterprise shaped to benefit an administrative command economy. It allows direct government intervention in an enterprise’s activity without any responsibility and creates the opportunity for corruption, nontransparent property transactions and “raidering” schemes (see also recommendation 4.5).

#### **4.5 Abolish the Commercial Code that establishes an outdated and peculiar system of legal entities (enterprises); improve the market-oriented Civil Code.**

##### ***Not implemented***

The Ministry of Justice of Ukraine developed the draft Law “On Main Principles of Economic Activity” to eliminate the provisions in the main wording of the Economic Code that overlap with sector laws. Drafters, looking to compromise, tried to preserve alternate to the Civil Code system of legal entities. Nevertheless, the draft was declined by the Parliamentary Committee for Economic Policy because it insisted on preservation of the Economic Code. The negative impact of the Economic Code includes such dangerous elements as: strengthening the primacy of state property and administrative methods of running the economy; primitive methods of administrative interference in economy; existence of the alternative inept system of legal entities based on non-functional criteria of “patterns of ownership”; and attempts to squeeze out the Civil Code from the sphere of regulating property turnover between legal entities. Outdated law provisions in the Economic Code lack regulatory sense and impede development and modernization of many sectors of economic legislations (insurance, banking, foreign trade, securities, communal sector, etc). The code preserves an out of date and ineffective system of administrative and departmental management of state property. Abolishment of Commercial Code is necessary precondition for development of many sectoral laws which regulate economic activity on sound principles and common European legal concepts.

## **4.6 Adopt limited liability company law.**

### ***Not implemented***

One of the most important components of a favorable climate for the development of small and medium sized businesses is the availability of a simple, reliable and effective structure for limited liability companies. The current Law “On Business Associations” and provisions of the Civil Code do not provide detailed, reliable and flexible regulation for limited liability companies. As a result, there are numerous conflicts between the participants of limited liability companies and often result in the liquidation of business. The elimination of this important shortcoming, which impedes the development of small and medium sized businesses, did not attract enough attention from Parliament or government authorities. The draft laws submitted to the Parliament include a questionable proposal to cancel limitations for the maximum number of participants in limited liability companies, while the problem of unsuitability of a limited liability company to respond to conflicts of interests and the collective action of many participants is ignored. Proposals of the Ministry of Economy of Ukraine that introduce amendments to the Law “On Business Associations” to improve the business climate by reducing the minimum amount of chartered capital for limited liability companies do not resolve the issues of regulation within limited liability companies.

### **2009 Updated Recommendations:**

4.1 Amend the Law of Ukraine “On Joint – Stock Companies” to comply with the EU Company Law directives and improve the mechanisms that protect the rights of minority shareholders and their involvement in governance in order to increase competitiveness of Ukrainian issuers at the world financial markets.

4.2 Assure the implementation of principle of full transparency of ownership and free public access to the information about shareholding in reformed national depository and registration of securities.

4.3. Reform the public audit system to improve reliability and public trust by requiring audit firms to function only in the form of partnerships with unlimited liability and limit the scope for disclaimers used in audit contracts.

4.4. Solve the problem of “corporate raid” by making judges and law enforcement officers responsible. Request the Supreme Court develop explanations for court applications for the concepts of “innocent buyer”, establish connections between legal entities and persons, “prevention of violator from using proceeds acquired by breaking the law”, “violator should be identified and damage must be compensated”, and the “abuse of legal right”.

4.5. Abolish the Commercial Code that establishes an outdated and peculiar system of legal entities (enterprises); improve the market-oriented Civil Code.

4.6. Adopt limited liability company law.

4.7. Amend Chapter XI of Law of Ukraine "On Joint – Stock Companies" on acquiring control of blocks of shares or pass a separate law on take-overs based on the EU Directive "On Take-over Bids". The law should clearly outline the rules of take-over, including tender offer, "break-through", "sell-out" and "squeeze-out", and foster the creation of a civilized corporate control market.

## **5. Regulatory Policy and Entrepreneurship Development**

**5.1. Reduce and compile a complete and exhaustive list of permits in a single law, as well as refine the definition of an authorizing document by embracing all existing permits. No other authorizing documents should be allowed.**

### ***Implementation is initiated***

The purpose of draft Law No. 3224 of 25 September 2008 "On the List of Permissive Documents for Business Activities" is to codify all business permissions into a single law. It passed the first reading. However, the very idea of such a law is worthwhile only if it will eventually reduce (not increase) the number business regulations and replace (not augment) numerous and contradictory laws. There is a threat that the law may serve as an additional tool to increase regulations which happened to the Law "On Business Licensing" 10 years ago. The total number of permissions listed in the adopted draft exceeds two hundreds.

The Law "On State Regulatory Policy" and the Law "On Business Permissions" abolished requirements which are not directly stipulated in the later but still remain at the level of bureaucratic reconciliations. The Act of the Cabinet of Ministers No. 824-r of 11 June 2008 requires several state agencies to accomplish this task in three months. It was further reinforced by the President's Decree No. 698 of 9 August 2008. However, the process is not finished yet.

At the same time, abeyance of the abovementioned Law "On Business Permissions" and the Law "On the Principles of the State Supervision (Control) in the Realm of Business" (No. 877-V of 5 April 2007) remains the most problematic issue.

**5.2. Considerably improve compliance of state regulatory policy by the central executive bodies, their local branches, state local administrations and local governments.**

### ***Not implemented***

**5.3. Amend legislation to clarify the specific powers of each control authority to carry out inspections and define the scope of the inspections.**

***Not implemented***

There were no improvements in the way in which inspections are conducted. Moreover, tax authorities openly oppose to any kind of restrictions on their inspection processes. They argue that such restrictions would prevent them from fulfilling tax collection.

**5.4. Review legislation to identify obsolete, bureaucratic, unrealistic, and unjustifiably costly requirements on which inspections are based.**

***Not implemented***

Nothing was done to eliminate or simplify the “obsolete, bureaucratic, unrealistic, and unjustifiably costly requirements”. Meanwhile, impractical legislation is a source of the most dangerous corruption allowing for business extortion, selective punishment for political reasons, elimination of competitors to crony businesses, and other widespread abuses. Inspections are the vehicle for these abuses.

**5.5. Widen the approach of inspections by developing the advisory and preventive functions in addition to imposing sanctions.**

***Not implemented***

**5.6. Extend the scope of the declaratory principle and simplify or abolish obsolete, complicated and unduly expensive requirements.**

***Implementation is initiated***

Draft amendments to the Law “On Business Permissions” (No. 1362 of 17 January 2008) introduces the concept of a declaratory principle. It passed in the first reading. But as of the end of 2008, only Fire Inspection has implemented a declaratory principle at the formal level<sup>11</sup>. It is too early to assess how well it will work.

**5.7. Improve the operations of locally established permit centers and business registration offices in order to simplify entering and exiting the market; amend existing laws on business registration and the permit system.**

***Not implemented***

The “one-stop shop” concept for business registration and permissions was formally opened across the country<sup>12</sup>. However, in practice “one-stop shop” does not work

---

<sup>11</sup> [http://www.firehelp.org.ua/normative\\_rs/norm\\_rs0002.html](http://www.firehelp.org.ua/normative_rs/norm_rs0002.html) article 11<sup>1</sup>

<sup>12</sup> <http://docu.com.ua/map/link.htm>

as it should due to lack of implementation and coordination among the different entities involved. Moreover, the local administration often obstructs work of “one-stop shops”. Applicants complain of long queues, inconvenient and scarce working hours, or even blunt refusals to process applications through this procedure. For these reasons the traditional ways of proceeding are still used. This could serve as a criterion for the true effectiveness of one-stop shops. Another reason is the price for facilitating services which did not decrease.

**5.8. Classify business activities according to the level of risk to the public and/or the environment; establish a maximum frequency and duration of inspections for all risk categories.**

***Partially implemented***

The criteria to assess business activities according to the level of public or environmental risk was introduced in a series of Cabinet’s Acts<sup>13</sup> (one corresponding to each area), and should be used by all controlling authorities except for the tax authority. However, the Cabinet’s Acts puts the most active businesses into the most risky categories. This largely reduces the effect of the accomplishment. As of now, there was no significant change in the frequency or duration of inspections, although it is probably too early to judge. However, this progress is an important step for the future, since it brings the dialog between the business sector and controlling authorities to a new more constructive level. Going forward both sides will have to provide rationales and support for their proposition based on actual risk which can be objectively assessed.

Additionally, it is worth mentioning that in its present status the State Committee for Regulatory Policy and Entrepreneurship is inferior to the Cabinet of Ministries. Thus it is excessively compliant to the demands of the Cabinet. It succumbs to pressure and does not use its veto right on normative acts or drafts that tend to worsen entrepreneurial climate. Moreover, it is currently responsible for management functions, primarily the distribution of funds channeled to support entrepreneurship. These distinct functions should be separated to a smaller agency within the Ministry of Economy. The proposed government body should control these activities.

**2009 Updated Recommendations:**

5.1. Compile a complete and exhaustive list of permits into a single law to reduce the numbers of permits and activities subject to mandatory licensing. Refine the definition

---

<sup>13</sup> No. 75 of 22 February 2008; No. 315 of 9 April 2008; No. 483 of 21 May 2008; No. 698 of 6 August 2008; No. 747 of 27 August 2008; No. 790 of 3 September 2008; No. 843 of 10 September 2008; No. 895 of 8 October 2008; No. 212 of 19 March 2008; No. 365 of 17 April 2008; No. 493 of 28 May 2008; No. 699 of 6 August 2008; No. 775 of 3 September 2008; No. 835 of 17 September 2008; No. 848 of 24 September 2008; No. 1324 of 14 November 2007.

of an authorizing document by embracing all existing permits so no other authorizing documents are allowed.

5.2. Introduce substantial sanctions to state officials for not respecting the Law “On Business Permissions”, the Law “On the Principles of the State Supervision (Control) in the Realm of Business”, and the Law “On State Regulatory Policy”. Make compliance of these laws an essential criterion for evaluation of central executive bodies, their local branches, state local administrations and local governments.

5.3. Amend legislation to clarify the specific powers of each control authority to carry out inspections and define the scope of the inspections.

5.4. Establish a routine procedure to review inspection legislation that is obsolete, bureaucratic, unrealistic, and unjustifiably costly.

5.5. Widen the approach of inspections by developing the advisory and preventive functions in addition to imposing sanctions and motivation for inspectors.

5.6. Extend the scope of the declaratory principle and simplify or abolish obsolete, complicated and unduly expensive requirements.

5.7. Improve the operations of locally established permit centers and business registration offices in order to enforce implementation and coordination among the different entities involved; amend existing laws on business registration and the permit system.

5.8. Establish a government body separate from executive power to oversee implementation of regulatory policy and other business-enabling legislation and facilitate entrepreneurial development; make it distinct from management of funds or creating regulations other than for bureaucrats. The existing State Committee of Ukraine for Regulatory Policy and Entrepreneurship can be a model.

## **6. Fair Competition**

**6.1. Improve the performance of the Antimonopoly Committee clearly stating that its primary goal is to create and sustain an environment of fair competition by:**

**a. Punishing unfair competition;**

**b. Preventing monopolization.**

### ***Not implemented***

There were no significant improvements in the performance of Antimonopoly Committee (AC) in 2008. The main weakness of the committee was the inability of the Parliament to appoint a committee head. The AC is ineffective and lacks power. This was

clearly apparent when the committee failed to protect the interest of Volia customers (the monopoly operated cable provider) from a forced move from analog TV to digital which was more than twice as much expensive. In other words, Volia forced people to buy a service using its monopoly power even though this is prohibited by the law. Despite numerous complaints, the committee has only recommended that Volia postpone discontinuing analog broadcasting for 3 months. However, it looks like Volia has ignored even this meager recommendation.

**6.2. Following the EU approach, promote competition in the rail transport sector by separating railroad maintenance from carriers and allowing many carriers to compete.**

***Not implemented***

The Law on Railways (No. 273/96-вр) was adopted in 1996 and last amended in 2006. It allows private carriers to operate. The State Program for Reform of Railways (adopted by the Cabinet's Act No. 651-p of 27 December 2006) stipulates some measures to separate carriers from railroad maintenance, but not for their privatization. There was no significant progress to fulfill this program in 2008. In the meantime, existing private carriers were given privileges or discriminated against depending on their influences. Since 1 April 2008 the state railway company of UkrZaliznytsia has set same rates for access to the railroad and other services that private carriers need for all carriers. Still, the private companies have to pay for a license and bear some other additional costs. As of now, all private cargo carriers are daughter companies of major railway clients (mostly large metallurgical, chemical, or agrarian firms) and operate in the interest of their mother companies. Other clients have no choice. There is also no competition in passenger transportation because it is not profitable and cross-subsidized by the cargo transportation. The system of subsidizing carriers competing for regional passenger transport services by regional authorities does not exist.

**6.3. Following the EU and US approach, allow low-fare air companies to operate in Ukraine in order to massively widen access to air transportation and facilitate tourism development and business cooperation.**

***Implementation is started***

Two low-fare air companies have successfully entered the Ukrainian market, in-line with BRAAC recommendations (Wizz Air and Air Arabica). Therefore, the important step to demonopolize an overregulated market was accomplished.

Still, access to international connections is regulated by bilateral intergovernmental agreements that stipulate certain carriers and, in some cases, also prices. Such agreements complicate entry into the market for new carriers, including the low-fare ones.

**6.4 Following EU directives, initiate, develop and implement regulations that allow competition to emerge in electricity and gas markets.**

***Not implemented***

## **2009 Updated Recommendations:**

6.1 Improve the performance of the Antimonopoly Committee clearly stating its primary goal is to create and sustain an environment of fair competition by:

- punishing unfair competition;
- preventing monopolization;
- investigating and punishing price collusion;
- protecting clients from abuses of monopoly power of the natural monopolies;
- investigating excessive or artificial impediments (legal and others) to market entry and proposing changes.

6.2. Avoid encouragements from government bodies to assist collusion in setting prices or market division.

6.3 Continue to lower the barriers for low-fare air companies to enter Ukraine in order to boost competition, widen access to air transportation and facilitate tourism development and business cooperation.

6.4 Following the EU approach, promote competition in the rail transport sector by transforming Ukrzaliznytsia into joint stock company in order to ensure transparent accounting and financial reporting; separating railroad maintenance from carriers and allowing many carriers to compete; securing equal access to railroad infrastructure by adopting rules governing access, based on the best practises in EU to prevent corruption;

6.5 Following EU directives, initiate, develop and implement regulations that allow competition to emerge in electricity and gas markets.

## **7. Land markets**

### **7.1. Adopt legislation facilitating the development of land markets**

and

### **7.2. Lift the moratorium on trade in agricultural land.**

***No substantial progress is observed in the implementation of these two recommendations.***

The most important laws are either not adopted (On land market, On state land cadastre, On buyout of private land plots for public needs and in view of social necessity), or not applied (the Law of Ukraine "On delimitation of lands of state and communal property" No. 1457-IV of 05.02.2004, the Law of Ukraine "On State Registration of the Proprietary Interests in the Real Estate and the Limitations Thereof" No. 1952-IV of 01 July 2004)

The Law of Ukraine “On Amending of Certain Legislative Acts of Ukraine” No. 309-VI of 3 June 2008 made cancellation of the moratorium on sale of agricultural land directly depending on the adoption of and taking effect by the Laws of Ukraine “On Land Market” and “On the State Land Cadastre”. In late 2008 (23 December 2008), the Verkhovna Rada considered and adopted as a whole the draft Law of Ukraine “On Amending of Certain Laws of Ukraine to Prevent Negative Consequences of the Global Financial Crisis for Development of the Agro-Industrial Complex” No. 3353 of 11 November 2008, one of the provisions of which suggested further extension of the moratorium on sale of agricultural land until 1 January 2010.

The President of Ukraine did not sign this law and sent it back, together with his comments, to the Verkhovna Rada for reconsideration. The Verkhovna Rada reconsidered the draft law on 4 February 2009 and adopted the paragraph relating to validity of the moratorium with account for the President’s proposal, namely in the wording presented in the existing Land Code of Ukraine.

Thereby these **two recommendations are closely connected and remain valid.**

On 20 October 2008 the Council of National Security and Defense of Ukraine (CNSDU) adopted a Decision “On High Priority Measures on Strengthening Financial and Budget Discipline and Minimization of Negative Implications of World Financial Crisis on the Economy of Ukraine”, which insists on the necessity of soonest lifting of the moratorium on sale of agricultural land. Already on 24 October 2008 by the Decree of the President of Ukraine No. 965/2008 this Decision was enacted.

On 21 November 2008, CNSDU adopted a Decision “On the implementation of decisions of the Council of National Security and Defense of Ukraine concerning the regulation of land relations, use and protection of lands” that was put in force on 12 January 2009 by the Decree of President of Ukraine No. 5/2009.

Generally, by the Decision of CNSDU, 52 mandates in the sphere of regulating land relations were developed; however, 35 of them remain unexecuted – which constitutes 67% of their general number. Only 9 mandates are considered fully executed (17%), and 2 (4%) – partly executed.

As a whole, in 2008 the 13 Resolutions of the Government and 10 Decrees of the President of Ukraine regarding establishment of the land market and rational utilization of land resources were issued. However, almost half of Presidential Decrees were pointed at termination of Resolutions of the Cabinet of Ministers of Ukraine.

In 2008 three draft laws on land market were submitted to and reviewed by the Verkhovna Rada Committee on Agrarian Policy and Land Relations, namely the draft Law (reg. No. 2143) prepared by the Cabinet of Ministers of Ukraine, the draft Law (reg. No. 2143-1) prepared by the people’s deputies of Ukraine P. Sulkovskiy, V. Bevzenko, E. Sigal,

S. Tereschuk, R. Tkach and M. Tymoshenko, and the draft Law (reg. No 2143-2) prepared by the people's deputy of Ukraine I. Zayets.

Based on the results of the above draft laws review the draft Resolution of the Verkhovna Rada of Ukraine was prepared, which proposes to take as basis the draft Law of Ukraine «On land market» submitted by the group of people's deputies of Ukraine (reg. No. 2143-1)<sup>14</sup> and refine the draft Law taking into account certain provisions of draft Laws (reg. No. 2143 and reg. No. 2143-2).

Main points needing additional elaboration include the following:

- preventing excessive concentration of land in a single person's ownership and averting speculation in agricultural land;
- reasonability of introducing limitations for foreign physical and legal persons on the right of ownership for agricultural land;
- establishing a preemptive right to acquire agricultural land plots;
- regulating changes of agricultural land designation.

As of 30 January 2009, 25 draft Laws related to further development of land legislation were registered in the Verkhovna Rada and were in various stages of elaboration and consideration. Apart from the Law of Ukraine "On Land Market", the following draft Laws are the most important ones:

- On Amending of Certain Legislative Acts of Ukraine (Concerning Powers of Executive Authorities in Land Relations), reg. No. 3378 of 18 November 2008;
- On Land Auctions, reg. No. 3666 of 28 January 2009;
- On Alienation of Privately Owned Land Plots for Public Needs and for the Reasons of Social Necessity, reg. No. 3682 of 30 January 2009<sup>15</sup>;
- On Amending the Land Code of Ukraine Concerning the Right of Ownership of Foreign Nationals, Stateless Persons and Foreign Legal Persons to Agricultural Land Plots, reg. No. 1273 of 25 December 2007;
- On Amending of Certain Legislative Acts Concerning Change of Land Plots Designation, reg. No. 2028 of 11 July 2008.

---

<sup>14</sup> This draft law is more systemic and better regulates relations arising in the land market; it take into account all substantial provisions of the draft law No. 2143 whereas the draft law No. 2143-2 conceptually differs from other draft laws because it provides for depriving legal persons of the right to own agricultural land and contains internal discrepancies.

<sup>15</sup> The relevant Law of Ukraine "On Buyout of Privately Owned Land Plots for Public Needs and for the Reasons of Social Necessity (reg. No. 861 of 12 September 2006) was adopted by the Verkhovna Rada on 19 April 2007 but it was not signed by the President and did not take effect.

The Memorandum, which was signed between the Cabinet of Ministers of Ukraine and the International Monetary Fund in late 2008, emphasizes that creation of a full-fledged agricultural land market is one of the main preconditions for structural transformation of Ukrainian economy.

### **7.3. Establish a single registry of real estate property rights**

#### ***No progress is observed in the implementation of this recommendation.***

A system that guarantees proprietary rights in real estate has not been created in Ukraine yet<sup>16</sup>.

Adoption of Law of Ukraine “On State Land Cadastre” is one of the prerequisites for lifting the moratorium on alienation of agricultural land. This Law is not adopted yet.

The Verkhovna Rada of Ukraine on March 20, 2007 adopted a Law of Ukraine “On State Land Cadastre” (reg. № 948 of 25.05.2006). However, the President of Ukraine did not sign this Law and on April 13, 2007 returned it with proposals as regards its improvement. On 27 June 2007 the Law was sent for revision. The Verkhovna Rada Committee on Agrarian Policy and Land Relations on 30 September 2007 reviewed the draft Law with President’s proposals and on 17 October 2007 submitted it for the review of Verkhovna Rada; however it has not yet been heard and thus not adopted.

According to the contents of the above-mentioned draft Law of Ukraine “On State Land Cadastre” (wording of 30 September 2008 with comments from the President of Ukraine), a unified cadastre and registration system must be implemented in Ukraine.

Administration of the State Land Cadastre on the local, regional and state-wide level is assigned to the central executive authority for land resources (the State Committee of Ukraine for Land Resources – Derzhkomzem) whereas, according to the Law of Ukraine “On the State Registration of the Proprietary Rights for the Real Estate and the Limitations Thereof (No. 1952-IV of 1 July 2004), administration of the State Register of Property Rights for Land Plots and Other Real Estate and the Limitations Thereof, which is a component of the State Land Cadastre, is assigned to a self-sustaining state enterprise with a consolidated balance sheet – the Center of the State Land Cadastre under the State Committee of Ukraine for Land Resources.

---

<sup>16</sup> A system guaranteeing the proprietary rights for real estate shall be understood as a set of means of identification and description of land and real estate (cadastre) and means of formalization (confirmation, provision) of proprietary rights for land and real estate (register of rights).

A cadastre focuses on physical properties of land (form, size, coordinates, plot boundaries, soil quality, monetary appraisal, contamination, available buildings, structures, water facilities, plantations) whereas a register of rights concentrates on its legal characteristics (title to a land plot, third-party claims to it, public encumbrances).

These two systems may exist in parallel but absence of one of them (or both) makes functioning of a land market in particular and a real-estate market as a whole impossible. This is because the cadastre secures certainty as to which exactly entity is a subject of a transaction whereas the registration system secures certainty in the fact that an authorized party performs the transaction.

However, provisions of the Law of Ukraine “On the State Registration of the Proprietary Rights for the Real Estate and the Limitations Thereof (No. 1952-IV of 1 July 2004), which determines the basics for creation of a unified system of state registration of proprietary interests in land plots and other real estate and limitations thereof within the State Land Cadastre, are not complied with: the Ministry of Justice of Ukraine remains to be the holder of the Register of Property Rights for the Real Estate whereas the administration of this Register is still provided by state enterprise “Information Centre” of the Ministry of Justice of Ukraine.

The draft Law of Ukraine “On State Land Cadastre”, prepared for consideration, fails to solve the tasks set because it does not establish any unified procedure, any clear system of bodies and funding sources for maintenance of the State Land Cadastre, so it requires further elaboration.

As of 25 November 2008 in the Verkhovna Rada Committee on Agrarian Policy and Land Relations the following draft laws concerning the development and interaction of cadastral and registration systems are being reviewed:

- The draft Law “On Amending of Certain Legal Acts of Ukraine Regarding State Registration of Land Lease Agreements” reg. No. 2412 of 21 April 2008. Status: the conclusion of the Main Scientific Department as regards expediency of sending the draft Law for revision with further submission for repeated first reading was obtained.
- The draft Law “On Amending the Article 125 of the Land Code of Ukraine Regarding the Limitation of the Term of State Registration of Documents Certifying the Title to Land” reg. No. 2641 of 13 June 2008. Status: submitted for Committee’s review (08 July 2008)
- The draft Law “On Amending the Land Code of Ukraine and Certain Legal Acts of Ukraine” reg. No. 3044 of 07 August 2008. Status: submitted for Committee’s review (02 September 2008)
- The draft Law “On Amending of Certain Legal Acts of Ukraine (Regarding Authority of Executive Bodies in the Sphere of Land Relations)” reg. No. 3378 of 18 November 2008. Status: submitted for Committee’s review (20 November 2008)

On 13.01.2009, the Verkhovna Rada of Ukraine adopted as a basis the draft Law “On Amending Some Legislative Acts” (concerning documents that certify the proprietary right for land plot as well as the procedure of division and merging of land plots) (reg. No. 2606 of 20 June 2008). The draft suggests a new wording for Article 126 of the Land Code of Ukraine “Documents certifying the proprietary right for a land plot” according to which the proprietary right for land plot (the right for permanent use) shall be certified not only by a state act but also by civil law agreements.

#### **7.4. Stimulate the use of environmentally friendly agricultural technologies and prevent predatory overexploitation activities.**

##### ***No progress is observed in the implementation of this recommendation.***

As to 30 January 2009, 9 draft Laws were submitted to Verkhovna Rada. At present they are under consideration in the relevant committee (Committee for Agrarian Policy and Land Relations), and 6 more draft laws are in other committees. The following draft Laws are the most topical among them:

- The draft Law "On organic production" reg. No. 0959 of 23 November 2007
- The draft Law "On National Program of Utilization and Protection of Land" reg. № 3310 of 23 October 2008.
- The draft Law "On state agrochemical passportization of agricultural land" reg. No. 2627 of 10 June 2008.
- The draft Law "On conservation of land" reg. No. 2628 of 10 June 2008.

Concerning improvement of efficiency of the state policy in the use and protection of lands, 2 CNSDU decisions were passed, 2 decrees of the President of Ukraine were issued, and 4 resolutions of the Cabinet of Ministers of Ukraine were adopted. The most important of them are following ones:

- Resolution of Cabinet of Ministers of Ukraine "On Amending of the Provision on the State Inspection for Control over Utilization and Protection of Land" No. 927 of 16 October 2008 and
- CNSDU decision "On Implementation of Decisions of the Council of National Security and Defense of Ukraine Concerning the Regulation of Land Relations, Use and Protection of Lands" that was put in force on 12 January 2009 by the President's Decree No. 5/2009.

Currently, no perfect mechanism to secure rational and efficient use of land has been shaped due to imperfect legislation and because of the lack of clearly divided powers.

An overwhelming majority of land owners and land users ignore major laws of arable farming, first of all as to putting the nutrients, which were taken out with harvest, back into soil; only some enterprises take soil-protecting actions.

Scientifically grounded crop rotations are violated actually everywhere, and the structure of sown areas is not maintained, it being overloaded with sunflower and other energy-consuming crops. Areas of eroded, acid and alkaline soils expand every year. At the same time, considerable areas of arable land are not used for agricultural production.

In 2008, the Government planned to create a State Service for the Protection of Soil Fertility under the Ministry of Agrarian Policy for the introduction of clear state control over the use and protection of land, and it wanted to assign UAH 95.0 million for those purposes, which was to be provided for in the draft State Budget 2009. However, the actually approved budget does not provide for funding of such a service at all whereas only UAH 790.0 thousand (against UAH 7.9 million in 2008, i.e. ten times less) is appropriated for agrochemical passportization of agricultural land. At the same time, funding for the State Committee of Ukraine for Land Resources, namely for the purposes of preservation, restoration and rational use of land resources, equals to UAH 470.0 thousand against UAH 9.5 million in 2008, i.e. the funding has been reduced 20 times.

### **2009 Updated Recommendations:**

7.1. Adopt legislation facilitating the development of land markets

7.2. Lift the moratorium on trade in agricultural land.

7.3. Develop effective and reliable system of state registration of land plots and guaranteeing title to land

7.4. Ensure sustainable utilization and effective protection and preservation of land.

## **8. Foreign trade**

### **8.1. Complete the World Trade Organization (WTO) accession process by the beginning of 2008.**

#### ***Implemented but threatened by non-compliance***

In 2007 the negotiations on Ukraine's WTO accession, originally launched in 1993, were brought to a successful conclusion. On 5 February 2008 at the meeting of the WTO General Council a decision on Ukraine's entry to the Marrakesh Agreement Establishing the World Trade Organization was adopted and the Protocol of Ukraine's WTO accession was signed. On 10 April 2008 the Verkhovna Rada of Ukraine ratified the Protocol on Ukraine's WTO accession and on 16 May 2008 Ukraine attained official membership in the WTO.

From 2005-2008 55 Laws of Ukraine and several resolutions of the Cabinet of Ministers of Ukraine were adopted to comply with WTO rules. By the end of 2008 only a few draft laws remained to fulfill accession obligations. The outstanding draft Laws are: No. 3322 of 28 October 2008 "On Amending the Article 1 of the Law of Ukraine "On Safety and Quality of Food Products" as regards refinement of the term "standard" in compliance

with Annex 1 "Terms and Definitions" of the WTO Agreement on Technical Barriers to Trade; No. 2297 of 31.03.2008 "On Amendment of the Law of Ukraine "On Fish, Other Living Aquatic Resources and food made of them"; No. 3301 of 20 October 08 "On Amending the Article 1 of the Law of Ukraine "On Establishing a Tariff Quota on Importing Raw Cane Sugar into Ukraine".

Immediately after official accession to the WTO Ukraine had to comply with the import duty rates determined by the schedule of Ukraine's tariff commitments and amend the Law of Ukraine "On Customs Tariff". The draft Law for such amendments, developed by the Government (No. 2351), was rejected by the VRU. Instead, on 3 June 2008 the VRU adopted a draft Law No. 2351-1, prepared by the members of Parliament; however the President of Ukraine vetoed this Law because the import duties' rates for particular goods did not comply with agreements outlined in Ukraine's accession to the WTO. Provisional import duties that do not exceed rates provided by the international agreement on Ukraine's accession to the WTO were applied on the basis of the order of the CMU to the State Customs Service of Ukraine until the 17 December 2008. At that time the VRU adopted the Law No. 676-VI "On Amending the Law of Ukraine "On the Customs Tariff of Ukraine" so that the rates of import duty were in compliance with the WTO accession commitments. The critical comments of the President were taken into account.

The Resolution of the CMU of 30-October 2008 N 1381-r "On Approval of the Action Plan of Adjusting Ukrainian Economy to WTO Requirements" commissions ministries to accelerate the implementation of the provisions of sector programs adopted in past years.

The negative foreign commodities trade balance for 2008 was USD18.5 billion, which is 62% higher than it was in 2007. In an effort to stop the negative tendencies in foreign trade development the Government of Ukraine approved the Resolution "On Adoption of the Action Plan on Lowering the Negative Foreign Trade Balance". This Plan applies strict control over the import of commodities to eliminate and prevent the import of commodities that do not conform to national veterinary, sanitary, phyto-sanitary, ecological and pharmacological standards. The set of proposed anti-crisis activities includes proposals that do not comply with commitments on opening the internal market undertaken by Ukraine at WTO accession. If the situation worsens with a balance of payments GATT allows use of safeguard measures but in compliance with provisions of Articles XII and XVIII:B of GATT. Application of quantitative restrictions on import is not allowed by WTO agreements even as a measure to improve the balance of payments in regarding with par.2 of WTO agreement "Understanding the Balance-of-Payments Provisions of the GATT 1994". Because several law provisions passed by VRU in December

2008<sup>17</sup> did not comply with the commitments to the WTO and GATT they were vetoed by the President of Ukraine in January 2009. In February VR overrode the Presidential veto.

Then the President sent few laws to the Constitutional Court because of noncompliance issue with the Constitution of Ukraine and international agreements.

As of April 2009 it was not known what WTO's response was to the 13% temporary surcharges to custom value of imported goods, except for the goods of critical import, which were established in accordance with the Law "On Amending of Certain Legislative Acts of Ukraine in Regard to the Improvement of the Situation with Balance-of-Payments of Ukraine Due to the World Financial Crisis".

## **8.2. Accelerate the establishment of a Free Trade Area with the EU, maximally reduce the number of exceptions and transition periods.**

### ***Progress in negotiations but too many exemptions expected in agro-products trade***

In February 2008 official negotiations to create a free trade area between Ukraine and the EU began. The parties declared that the format and content of the future free trade agreement shall be directed on achieving maximum economic integration and shall have no analogs in the previous practices. In 2008 four rounds of negotiations on the FTA were held to discuss the following issues: free movement of commodities, services and investments, creation of companies, capital flow, trade rules and institutional aspects. The Government arranged a round of consultations with Ukrainian business associations and sector producers to develop Ukraine's position for the negotiations with the EU.

In 2008 the new agreement between Ukraine and the EU was discussed. At the Ukraine – EU Summit (Paris, September 2008) a new agreement was named "an association". Ukrainian negotiators are willing to make the best use of the FTA and association agreements as pre-accession tools to joining the European Union, to provide the same content as other entrants to the EU and adapt legislation, create relevant institutions and ensure effective implementation of decisions.

In negotiations on Free Trade Agreement both sides declared the goal to liberalize as much as 95% of trade and exempt 5% from the free trade agreement for specific goods, in particular agro-products. This would prevent integration of Ukrainian agriculture with EU agriculture. The potential for Ukrainian agriculture, estimated by FAO and World Bank experts as double or even triple today's production level, would remain heavily

---

<sup>17</sup> Laws of Ukraine: "On making amendments to certain legislative acts of Ukraine in regard to the minimization of the influence of the financial crisis on the development of the national industry"; "On Amending of Certain Legislative Acts of Ukraine in Regard to the Improvement of Situation with Balance-of-Payments of Ukraine Due to the World Financial Crisis"; "On Amending of Certain Legislative Acts of Ukraine in Regard to the Prevention of Negative Effects from World Financial Crisis on the Development Agro-Industrial Complex".

underutilized. Production would be lower and consumers would not fully benefit from increased competition, lower prices, and varied assortments. The sum of benefits for producers and consumers in both partners under restricted trade will be lower that might have been under fully free trade regime. Under the free trade for agro-products the main factors for limiting Ukrainian export is the EU's high sanitary-hygienic requirements that guarantee the safety of food products and fodder for consumers in EU countries. Access to the EU market requires considerable investments to ensure conformity to EU sanitary and phyto-sanitary regulations. If the new FTA preserves import duties and tariff quotas for the import of agricultural produce from Ukraine into the EU, there will be no incentive for agrarian businesses in Ukraine to apply European standards, especially for meat and milk products as those requirements are very expensive to implement. On the contrary, the FTA between Ukraine and the EU without exemptions for agricultural goods would stimulate investments in agricultural and food sectors.

In order to improve the coordination of the European Integration Policy, the Government of Ukraine established the Coordination Bureau for European and Euro-Atlantic Integration (the Resolution of the Cabinet of Ministers of Ukraine of 16 July 2008 No. 649). The bureau's goal is to ensure systemic cooperation of executive authorities with European integration; relevant schedules of monthly meetings of the Ukrainian Committee for Cooperation with EU as well as quarterly subcommittee meetings.

### **8.3. Implement protocols eliminating exemptions and barriers to trade with Russia, Moldova, Belarus.**

#### ***Not implemented***

Previous trade agreements with CIS countries focused on free trade regime without any exemptions. The Ukrainian government has already agreed on cancelling exemptions from the free trade regime with Moldova (as of the date of Ukraine's accession to WTO), Belarus (2007) and Russia (since 2009). In order to maintain Ukrainian producers' position at the markets of CIS countries it is necessary to implement these agreements and not reinstated exemptions (as at the end of 2008 year claims were received from sector associations on prolonging exemption terms for example on sugar between Ukraine and Russia).

In the beginning of 2009 the Government of the Russian Federation extended the exemption of sugar from the scope of the free trade regime with Ukraine, which was due to be abolished with effect from January 1, 2009. The Russian authorities have decided to extend the validity of the duty until 2013. At present, the duty on the import of white sugar into Russia comes to USD 340 per ton, into Ukraine – 50% of custom value. In regard to spirit, the exclusion of it from the scope of the free trade regime is also in effect and is due to be abolished with effect from January 2010.

#### **8.4. Ensure the prompt and accurate refund of VAT to exporters.**

##### ***Some progress***

In 2008 the Government only partially ensured VAT refunds to exporters. The Resolution of the CMU of 6 August 2008 No. 1082-r outlines a rapid procedure of VAT refunds to grain exporters. The State Tax Administration of Ukraine (STA of Ukraine) developed a scheme of VAT refund to grain traders – grain exporters, which purchased grain directly from agricultural producers at the commodity exchange prices not lower than the defined minimum state purchased prices.

As of 1 January 2009 the state debt on unrecovered VAT refund equaled 3 billion UAH (as of 1 January 2008 the sum was 4.1 billion UAH)<sup>18</sup>. Outstanding of the state debt before exporters of grain makes about 1 bln UAH<sup>19</sup>. Debt on VAT refund before enterprises of mining and metallurgical industries made 797.5 million UAH as of 1 January 2009.<sup>20</sup> The STA of Ukraine links the arrears with the cancellation of the payment by drafts and increase in export.

In the framework of the Anti-Crisis Order No. 965/2008 of October 24<sup>21</sup> the President of Ukraine commissioned the government to ensure within a month timeframe the refund from the budget of the amount demanded by VAT payers, confirmed by the check-ups and the availability of the returned within a 60-days timeframe foreign currency receipts from export of commodities and services.

#### **8.5. Develop policies to increase trade diversification by increasing the activities of Ukraine's trade economic missions and widely disseminating information about external market tendencies.**

##### ***Some progress***

The Ministry of Economy by means of Trade-Economic Missions (TEMs) monitors external commodities markets and prices; releases the annual time-schedule of international fairs and exhibitions in the country as well as the main trade partners of Ukraine; publishes monthly bulletins, etc. In order to support the participation of Ukrainian enterprises in tenders abroad the government defines the list of Ukrainian Associations of Commodity Producers that are potentially interested in regularly obtaining information on

---

<sup>18</sup> In accordance with The State Tax Administration of Ukraine

<sup>19</sup> In accordance with Ukrainian Grain Association

<sup>20</sup> In accordance with the Ministry of Industrial Policy of Ukraine

<sup>21</sup> By this Order the President of Ukraine enacted the Decision of the Council of National Safety and Defense of Ukraine of October 20 "On Immediate Measures on Strengthening Financial Budget Discipline and Minimization of the Impact of the World Financial Crisis on the Ukrainian Economy".

international tenders. However, without a budget increase to finance the maintenance of TEMs abroad the issue of increasing diversification of trade will not be resolved.

#### **8.6. Continue streamlining customs procedures and formalities to make tariff administration more efficient, transparent, and less costly**

and

#### **8.7. Abolish multiple agency inspections and solve logistics problems at the borders**

##### ***Some progress***

Ukraine is losing its foreign trade advantage due to complex legal procedures to fulfill administrative requirements (time for export - 31 days, time for import - 39 days)<sup>22</sup>, which deteriorates the quality of customs servicing and commodities flow capacity. In 2007 the procedure was longer for both (33 days for export and 46 days for import). As a point of reference, Poland's time to export is equal to 19 days and to import is 26 days.<sup>23</sup> Another complex issue is the inferiority of the legal and regulatory base which understates the actual value of commodities for import and export.

The draft Law of Ukraine "On Amending of Certain Legal Acts of Ukraine to Conduct Preliminary Documentary Control at the Check Points at the Customs Border" was further developed to speed up the customs procedure processes by simplifying cargo transfers at border check points as well as standardize and simplify border crossing documentation related to compliance with the international law and practices of joint control.

#### **8.8. Prevent the re-use of quantitative export restrictions or the introduction of export duties**

##### ***Implemented after accession to WTO***

From 2006-2008 the government introduced export quotas for grain and oil crops to avoid a price increase on food products in the country. The grain quotas in 2007/08 MY was almost equaled to banning the export, as it proposed only 12,000 tons of grain. The Resolutions of the CMU on 12 March 2008 No. 189 "On the Approval of the Amount of Quotas on Sunflower Oil and Seeds, the Export of which is Subject to Licensing by 1 July 2008 and the Procedure of Issuance of Licenses" approved export quotas for sunflower seeds in the amount of 1,000 tons and for sunflower oil in the amount of 300,000 tons. The Resolution was terminated by the Decree of the President of Ukraine No. 481 of 28 May 2008.

---

<sup>22</sup> Report "Doing business 2008", IBRD and World Bank

<sup>23</sup> Report "Doing business 2007", IBRD and World Bank

According to World Bank estimation<sup>24</sup> agricultural producers lost USD1.8 billion on wheat and barley and USD0.66 billion on sunflower seeds as a result of export restrictions for grain crops and sunflower seeds in 2007/08 MY.

Shortly after WTO accession the EU cancelled quotas on the import of steel products in EU from Ukraine determined by an agreement between the Government of Ukraine and the European Community on trade of certain steel products. On its side Ukraine abolished licensing the export of Ukrainian metal products to the EU (for which the quotas were established in the Resolution of the Cabinet of Ministers of 04 June 2008 No. 529).

At the time of WTO accession Ukraine committed to gradually decrease the approved schedule of export duties on sunflower seeds, live cattle, animal hides, and on ferrous scrap and non-ferrous scrap, preserving the right to apply export duties in the future. In order to fulfill these commitments the rates of export duty on flax seeds, sunflower seeds were decreased to 14% of the customs value in 2008. Moreover, the rate of export duty on the seeds of the above crops will decrease annually by 1% until the duty is 10 %. Export duties on live cattle and animal skin have begun to decrease as of 1 January 2009.

Export duties for waste and scrap of ferrous metals will decrease to comply with the Laws of Ukraine No. 400-V of 30 November 2006 and No. 1105-V of 31 May 2007. Export duties for scrap of ferrous and non-ferrous metals and semi-finished products manufactures with their use will also decrease to comply with the Laws of Ukraine No. 441-V of 13 December 2006 and No. 1106-V of 31 May 2007.

### **8.9. Implement the Plan for full compliance of the national system of standardization and technical regulation with the WTO Agreement on Technical Barriers to Trade for 2005 – 2011**

and

### **8.10. Harmonize Ukraine's certification and standardization system with international norms and requirements.**

#### ***Small progress***

Most export producers still have to comply with the double standards of Ukraine and the country to which they are importing. The State Committee of Ukraine for Technical Regulation and Consumer Policy is attempting to harmonize the national, international, and European standards in view of the State Program of Standardization for

---

<sup>24</sup>Competitive agriculture and state control: Ukraine's response to the food crisis. Document of the World Bank, May 2008, page 15 <http://siteresources.worldbank.org/INTUKRAINE/Resources/WorldFoodCrisisandRoleofUkraine.pdf>

2006-2010. As of the beginning of November 2008, 472 national standards meet with international and European standards and were approved (in total 5,015 standards were enacted constituting 20% of the general number of Ukrainian standards). 19 technical regulations were approved during 2007-08. The annual budget of the State Committee of Ukraine for Technical Regulation and Consumer Policy allotted on this purpose does not exceed 12 million UAH; however, sector ministries also receive funds from the state budget for to harmonize sector standards. European technical aids and other donors can become a substantial source of financing. The international principle of voluntary standards is not legally regulated in Ukraine. The majority of obligatory technical regulations are in the development stage.

**8.11. Promote the experience and advantages of implementing international ISO standards in quality management and product quality systems by private companies.**

***Some progress***

Key industrial enterprises in Ukraine have already taken measures to comply with international standards of quality management and product safety ISO. ISO 9000-9003 standards assist in defining enterprises which provide high-quality products. Produce of the enterprises certified under ISO 9000 are trusted by consumers. ISO 9000 standards define requirements for the producers to follow in order to guarantee the quality of their product. Recommendations on dissemination of these practices remain relevant.

**8.12. Implement remaining provisions of the Kyoto Convention on the simplification and harmonization of Customs procedures.**

***Some progress***

In October 2006 Ukraine joined the International Convention to simplify and harmonize custom procedures (Kyoto Convention) as well as foster foreign trade development and implement customs principles defined by the WTO Agreements. The government should focus on Kyoto Convention recommendations 8.4-8.5 (listed below) which provides a general framework of further simplification of customs procedures and addresses a decrease in the rates of customs duties and logistical issues to reduce delays in customs clearance and issuance of documents. This will gradually develop the transit potential of Ukraine.

## **2009 Update Recommendations:**

8.1. Accelerate the establishment of a Free Trade Area with the EU, reduce the number of exceptions and transition periods, and fully open trade of agricultural and food products.

8.2. Implement protocols eliminating exemptions and barriers to trade with Russia, Moldova, and Belarus.

8.3. Ensure the prompt and accurate refund of VAT to exporters.

8.4. Continue streamlining customs procedures and formalities to make tariff administration more efficient, transparent, and less costly.

8.5. Cancel the multi check-ups and resolve the issues related to border logistics; implement clear distribution of the power of authority between controlling agencies.

8.6. Prevent the re-use of quantitative export restrictions or the introduction of export duties.

8.7. Accelerate of harmonization of Ukraine's certification and standardization system with international and European ones.

8.8. Implement the plan for full compliance of the national system of standardization and technical regulation with the WTO Agreement on Technical Barriers to Trade for 2005 – 2011.

8.9. Promote the experience and advantages of implementing international ISO standards in quality management and product quality systems by private companies.

## **9. MONETARY POLICY**

**9.1. Gradually increase exchange rate flexibility, then shift to a monetary policy regime backed by an inflation targeting framework with a clear medium-term inflation objective at a level below 5 percent.**

and

**9.2. Provide the National Bank of Ukraine (NBU) with a clear mandate to pursue price stability as its primary objective, as well as with operational independence to attain this objective.**

### ***Small progress***

Despite the unanimous voice of leading international and Ukrainian experts on the necessity to move away from a fixed exchange rate towards inflation targeting, limited progress has been made since our last recommendations.

NBU's Monetary Policy Fundamentals for 2008 were adopted with a clear aim to keep the price of hryvnia within the 4.95-5.25 UAH/USD band. To maintain the exchange rate at the target the central bank continued interventions in the foreign exchange market, thus increasing supply of hryvnia in circulation and contributing to increased inflation.

Monetary policy goals were not reconsidered later in the year despite the obvious macroeconomic threats of keeping a fixed rate including significant negative account balance, volatile speculative capital flows earning virtual returns on the back of accelerating prices and fixed exchange rates, and adverse liquidity consequences because of attempts to sterilize domestic currency issued to buy out the excess dollar supply. These factors created strong pressure for the NBU to abandon the policy of a fixed exchange rate or to devalue the hryvnia; the hryvnia is steadily depreciating.

The Monetary Policy Fundamentals for 2009, approved by the NBU in September 2008, maintained the central bank's intentions to continue to control the exchange rate using managed float so that a floating exchange rate can be gradually achieved. It was announced that the UAH/USD exchange rate should be maintained at 4.85+/-5%. The financial crisis invalidated this assumption. At the end of 2008 the exchange rate grew to around 8 hryvnias per U.S. dollar.

Creating macroeconomic and institutional prerequisites to move to inflation targeting is considered a task of a medium-term perspective. In particular, the 2009 Fundamentals specify that measures to enable transition to the new monetary regime be elaborated in the first half of 2009. The measures should include: achieve macroeconomic and financial stability, develop domestic capital markets and develop a statistical, modeling and forecasting apparatus to meet higher data requirements presented by inflation targeting operations. These tasks are to be accompanied by bank law amendments providing the NBU with a clear mandate to pursue price stability and grant operational independence to attain its objectives. Such amendments should bring needed improvements to the independence of the NBU. Operationally and politically, NBU has achieved quite little in recent years.

Recent crisis developments forced the NBU to modify the previously announced course for monetary policy. Ukrainian authorities regard a flexible exchange rate regime, backed by appropriate monetary policy and foreign exchange intervention, as a way to help absorb external shocks and avoid disorderly exchange market developments, even though this contradicts negotiated terms of the Stand By Arrangement (SBA) with the IMF.

At the same time, NBU's progress to move to inflationary targeting needs to be acknowledged. In January 2008, the Green Book on Strengthening NBU's Role in Attaining Price Stability was published. The book outlines possible policy scenarios and different

options for NBU's mandate and actions to achieve policy targets, and it also solicits input from business and academic communities.

Stand-By Arrangement approved by the IMF should serve as a catalyst to accelerate progress towards inflation targeting and enhance the independence of the National Bank of Ukraine, both are key to establishing the nominal anchor under the flexible exchange rate regime in the medium term.

Cooperation between Ukraine and the IMF regarding the implementation of the Stand-By Arrangement encountered serious difficulties in February 2009. The second tranche of the IMF loan has not been provided as planned. According to the statement issued by the IMF Mission to Ukraine on 6 February 2009 "the currency has undergone a large adjustment, which has improved the outlook for Ukraine's export industries. The current account deficit has started to narrow and despite currency depreciation inflation has continued to decline. Significant progress has been made in discussions on fiscal, monetary, and exchange rate policies, and on measures to strengthen confidence in the banking system, but a few issues remain outstanding. Discussions between the Ukrainian authorities and Fund staff on these issues will continue in the coming weeks". In particular, the size of 2009 budget deficit and its financing was not agreed upon.

### **9.3. Publish regular inflation reports with forward-looking macroeconomic analysis**

and

### **9.4. Ensure that the NBU receives timely and reliable advance information about government actions that affect banking system liquidity and about planned adjustments to administered prices.**

#### ***Substantial progress in survey, mismanagement in exchange rate and information policy***

Inflation reports are now prepared on a regular basis and published on NBU's web page supplemented by monthly express reviews of inflationary developments. The Inflation Reports provide detailed analysis of developments in the key areas affecting inflation. Other major achievements in this respect are:

- Refined and regular surveys of business expectations, including possible reactions to monetary policy actions; results are presented to the public on a regular basis;
- Beginning in January 2008 core inflation indicators are published; a full range of core inflation indicators is yet to be developed and finalized; and
- Updated macroeconomic survey to assess the short-term outlook.

NBU announcements explaining monetary policy steps, short-term outlook, and expectations have remained vague and for the most part inconsistent. This is particularly true of NBU's public statements commenting on exchange rate stability and inflation. Announcements to continue exchange rate targeting were not followed with interventions on the foreign exchange market when the hryvnia was depreciating in value, this created market panic and uncertainty, conditions which hardly contribute to hryvnia stability. Even worse, banks were prohibited to sell foreign currency at a price exceeding the official exchange rate by more than 1.5%. Such measure resulted in a vast shortage of currency for sale and the rapid development of an underground market with the NBU losing control of the market situation.

These market disturbances caused by uncoordinated announcements by policymakers of different camps and the lack of consistent actions by the NBU proved detrimental to the domestic currency market and certainty in the economy. In December, market participants experienced a deficit and absence of foreign currency supply in the banks, while the black market's price for US dollar and Euro far exceeded the exchange rates announced by the NBU. This divergence between the official and market exchange rates, unseen since aftermath of the financial crisis in 1999, has exacerbated the uncertainty and confusion about the monetary regime.

#### **9.5. Abolish the foreign exchange transaction tax to help deepen the foreign exchange market**

##### ***Some progress***

Foreign exchange transaction tax was decreased from 1% to 0.5% in February 2008 as determined in the Law "On the State Budget for the Year 2008."

#### **9.6. Shift budget deficit financing toward domestic borrowing and develop benchmark issues to create deeper and more liquid domestic securities markets.**

##### ***Some progress***

Law on the State Budget (2008) provides that the government shall issue some 15 billion hryvnias of state debt; roughly half of the 15 billion needs to be funded by borrowing from the domestic market. An emphasis on domestic borrowing is continued in the 2009 Budget – out of UAH 90 billion to be borrowed against the state debt some 70 billion is to be raised internally. In our opinion, this allocation decision is a positive development and, if sustained, should increase the weight of internal deficit financing and contribute to better liquidity and efficiency of the domestic securities markets.

Up until recently, the government has increasingly relied on borrowing from abroad. The share of domestic debt dropped from one third of total state debt (year-end

2004) to approximately 25% (year-end 2007) and has remained at this level throughout 2008 (and as of 2008 year-end).

Currently, domestic debt financed through debt securities composes about 23% of the total outstanding state debt (as of December 2008; total state debt does not include guarantees provided by the government) suggesting there is a vast capacity for the government to solidify its presence in the domestic debt market. Not only does the domestic debt issue reduce government transaction costs, but more importantly, it supplies financial instruments to the domestic capital markets, where the lack of reliable instruments is identified as one of the major problems.

**9.7. Improve the independence of the NBU by extending the term in office for the President of NBU to 8 years and eliminating dismissal options for political reasons.**

***Drafts ready, not implemented***

A number of important and high-priority tasks still need to be addressed, including improving the political independence of the NBU by extending the governor's term in the office and eliminating possibilities for political pressures. Draft Law suggesting amendments to the Law "On the National Bank of Ukraine" (No. 0851 of 23 November 2007) is under consideration by the Parliament's Finance and Bank Commission. The draft extends the governor's term from five to seven years and narrows circumstances when council members can be dismissed (possibilities of dismissal for political reasons are restricted substantially). The draft Law also suggests several amendments to reduce the sources of conflict of interest for management and employees of the National Bank: no employee, including the governor and deputy governors, can work for both the NBU and the government, parliament, or commercial enterprise. The governor and top managers of the NBU cannot own shares in commercial banks, hold loans from commercial banks or perform managerial duties for a commercial bank. Although the appropriateness of the specific formulations and restrictions is a matter of further and deeper analysis, overall, the suggested amendments are a step in the right direction and will help to strengthen political and operational independence of the central bank, both as the monetary policy authority and commercial bank supervisor.

The attempt to remove the Governor of the National Bank of Ukraine with the Verhovna Rada law annulling the nomination of the governor was declared unconstitutional by the Constitutional Court.

**2009 Updated Recommendations:**

9.1. Implement policy measures adopted in Memorandum of Economic and Financial Policies agreed with IMF, regarding monetary policy:

- Publicly reaffirm and implement a flexible exchange rate regime:
  - Abolish the exchange rate band as monetary policy target;
  - Base the official exchange rate on the market exchange rate (preceding day); and,
  - Adhere to transparent and predictable strategy of interventions into the interbank foreign exchange market.
- NBU, as a key player and regulator, on the foreign exchange market should design its actions in a way enhancing market mechanisms
- Reduce level of inflation (CPI) to 17 percent by end-2009 by:
  - Targeting growth of monetary base by about 11 %;
  - Bringing the NBU interest rates on deposit closer to refinance rate;
  - Restoring previous reserve requirement rules; and,
  - Continuing deposit auctions.

9.2. Provide the National Bank of Ukraine with the unambiguous mandate to pursue price stability as the primary objective.

9.3. Work on creating the necessary macroeconomic and institutional conditions to fully shift to inflation targeting.

9.4. Enhance macroeconomic forecasting capacity and prepare statistical sources to respond to data requirements of inflation targeting.

9.5. Emphasize consistency and caution with market announcements. Develop internal policy to formalize the procedures for information releases, public announcements, and authorizations to comment on forecasts, intended actions etc. to ensure the central bank does not serve as a source of additional uncertainty and risks to the economy.

9.6. Strengthen operational and political independence of the National Bank, approve changes to legislation to increase the governor's term and immunity to political pressures; reform the NBU council transforming it into a narrower technical body.

9.7. Intensify efforts to expand the scope of available capital market instruments, including government bonds and certificates of deposits; implement all related policies, e.g., government debt management, accounting for the effects in the securities market.

9.8. Fully abolish the foreign exchange transaction tax.

9.9. Elaborate the long-term vision defining the government's role in the domestic securities markets as the market regulator and a market participant.

## **10. BANKING SECTOR**

### **10.1. Strengthen banking sector liquidity and risk management capacity.**

#### ***Little progress***

Strengthening the banking sector's capacity to manage liquidity and risks has proven its vital importance, as the liquidity crisis persists with a high probability of solvency problems in the near future. A casual glance at the structure of maturity terms, currency denomination of bank assets and liabilities shows ongoing and growing problems in risk management.

Share of bank claims on long-term credits<sup>25</sup> has constantly grown since 2000 and constituted almost 70% of bank credit portfolios as of July 2008, whereas the share of long-term liabilities has grown at a substantially lower rate reaching 45%.

At the same time, between 2000-2008 (and, especially, 2006-2008) bank credits grew at higher rates than borrowed funds implying growing liquidity risks and lack of effort by banks to address the issue.

The very rapid growth of credit portfolio (174% in 2007 compared to 2006) is a concern by itself. Usually this high growth implies deterioration of credit quality unless accompanied by a more stringent screening process of potential borrowers, which raises substantial concerns about the future level of non-performing bank loans.

High interest rates on hryvnia deposits combined with the fixed exchange rate fueled an increase in exchange rate risks throughout 2008. The relative proportion of hryvnia-denominated liabilities was steadily rising, as were interest rates on deposits in hryvnia. At the same time, in the structure of credit portfolio one observed hryvnia-denominated loans being replaced by loans issued in foreign currencies (primarily, US dollar) and stable, sometimes falling, credit interest rates. Given the fixed exchange rate or appreciation of the domestic currency vis-a-vis the US dollar in the mid of 2008, the described currency compositions of credits and deposits implied increasing liability coupled with the same or decreasing assets.

---

<sup>25</sup> Bank claims on loans are clients' outstanding debt including repayment principal and interest payments. This indicator is usually used to describe bank credit activity and serves as a proxy measure for loans issued during a period in question.

**(a) Currency and Term Structure of Bank Credits and Borrowed Funds**

		<b>Hryvnia</b>	<b>Foreign Currency</b>	<b>Short-term</b>	<b>Long-term</b>
<b>2000</b>	Credits	54%	46%	82%	18%
	Borrowed funds	63%	37%	93%	7%
<b>2003</b>	Credits	58%	42%	55%	44%
	Borrowed funds	69%	31%	70%	30%
<b>2006</b>	Credits	51%	49%	35%	65%
	Borrowed funds	61%	39%	58%	42%
<b>Q2 2008</b>	Credits	51%	49%	31%	69%
	Borrowed funds	70%	30%	55%	45%

Source of data: Bulletin of the National Bank of Ukraine.

Note: Borrowed funds include deposits and accounts of physical and legal entities and funds borrowed from other banks.

The National Bank and the government made little progress to address the banking sectors declining capacity to manage risks. When currency disproportions became troublesome the NBU simply put restrictions on lending in foreign currencies which contributed to a slow growth rate of foreign currency loans in 2008. Although this measure can bring faster results compared to monitoring risks and forcing banks to meet prudential ratios, it does not benefit the banking system in the long run, especially while the NBU works to implement the Basel principles.

On the other hand, supervisors currently have limited tools to audit risk management practices and force banks to follow best practices. In order to monitor and influence risk management practices of commercial banks, supervisors need to have the authority to set standards and requirements for bank risk management and corporate governance, as outlined in Basel principles.

NBU's resolution № 319 "On Additional Measures in Respect of Banking Activities" was a quick reaction to a rapidly deteriorating macroeconomic environment and a bad liquidity situation in the banking system. The resolution intended to neutralize the impact of the global financial crisis and minimize the possibility for domestic bank runs and a potential liquidity crisis. The key provisions in the resolution are:

- To support bank liquidity the NBU shall provide short-term credit facilities (maturity of up to one year) to banks at a fixed interest rate of 15% or higher and in the amount of up to 60% of a bank's required capital level;
- Banks are required to cap loans to borrowers that do not have foreign currency revenues;
- Early withdrawal of deposits is put on temporary hold;
- Prohibit the purchase of foreign currency to be used as an advance payment to non-residents;
- Bid-ask spread for foreign currency exchange rates may not exceed 5%; and,
- Suspend the 20% reserve requirement on short-term foreign loans obtained by Ukrainian banks.

The follow-up Law No. 639-VI "On Priority Measures to Prevent Negative Impacts of Financial Crises and Changes to Selected Legislation", the so called "anti-crisis package", substantially expanded the possibilities for the government to intervene into the economy and markets. Most of the law provisions are quite controversial and create easy possibilities for abuse of power and manual steering of the banking system. Examples of such measures include:

- The possibility for the government to buy out shares in bank capital; to pay for the acquired shares state budget funds or government bonds can be used. If bonds are used as a payment, the National Bank is obliged to buy these bonds back at the request of the bank;
- National Bank shall develop procedures governing crisis management and, possibly, liquidation of a bank that has serious solvency issues. Crisis management is to be a joint responsibility of a temporary administrator and bank shareholders. The government can purchase shares of a troubled bank, if necessary;
- The National Bank can impose specific terms to implement measures to enhance bank capitalization. The terms specified by the Bank shall override the terms required by Ukrainian legislation, if conflicts arise;
- Dividend payments shall not be allowed for troubled banks or banks having liquidity problems.

Despite the discretionary nature of the provisions, the Law does not stipulate the conditions under which the government and the central bank can implement these measures or their restrictions in such an administration. Also, the Law creates loopholes allowing government interference with the central bank mandate, which may poorly impact the bank's operational independence.

On the other hand, the preliminary steps specified in resolution № 319 and undertaken by the government to address the growing uncertainty and liquidity crises were quite adequate, including the temporary freeze on before-term deposit withdrawals helped to avoid massive bank runs and panic, which proved paralyzing even in strong economies, like the United States. Other measures in the resolution proved less appropriate and, possibly, detrimental for the long-run development of the domestic financial sector. As already discussed, restrictions on foreign currency transactions aggravated the situation in the domestic market and, even more so, increased uncertainty and bank risks. The impact of measures to support short-term liquidity is difficult to assess at this point. If many banks are eventually insolvent, then providing short-term credit facilities just prolonged bank restructuring. Measures like capping loans to clients with hryvnia revenues and restrictions on foreign currency purchases for advance bill payments are short-term fixes in the absence of healthy risk management practices in banks. These short-term fixes usually work up until banks develop contractual mechanisms allowing avoidance.

Part of the anti-crisis measures includes the diagnostic phase of the bank recapitalization program (approved by the IMF) which has been completed. Its effective implementation should help restore confidence in the banking system.

The conditions of the IMF's two year Stand-By Arrangement under the Emergency Financing Mechanism are in line with recommendations leading to healthier bank supervision and risk management. In particular, the government accepted to:

- Monitor banks' liquidity position and intensify supervision of banks that increasingly rely on central bank liquidity support;
- Resolve problems with banks facing capital/solvency difficulties. Authorities are advised to start discussions on potential capital participation by the EBRD and/or other international financial institutions to restructure Prominvestbank in a transparent manner; and,
- Deliver the diagnostic reports for systemic banks by the end of 2008 as part of comprehensive bank recapitalization scheme.

## **10.2. Introduce consolidated supervisory reporting and move banking supervision to a consolidated and risk-based basis.**

### ***Some progress***

As domestic financial system grows in complexity it is increasing necessary to deepen consolidated reporting and risk-based supervision while a large number of smaller and weaker banks still exist.

A welcomed recent development to strengthen reporting and disclosure requirements approved in December 2007 was a resolution to govern the procedures for preparation and disclosure of financial statements by Ukrainian banks<sup>26</sup>. The resolution details the content requirements and format of mandatory financial information as well as the frequency and procedures for disclosure. Most provisions in the resolution are consistent with IFRS guidelines and are regarded as the way to narrow the gap between Western standards and practices and those used by Ukrainian banks.

Supervisors need to continue work to fully move to a system of unified risk-based analysis and supervision of commercial banks. The following measures still need to be addressed:

- Extend the scope and improve formats/standards for information subject to mandatory disclosure by commercial banks; monitor and publicly report on banks' compliance;
- Complete analytical work necessary to implement risk assessment methodology using risk-weights depending on riskiness of each particular asset category;
- Move to capital adequacy ratio based on risk-weighted measure of total assets;
- Mandate supervisors to require troubled banks keep higher capital to satisfy minimum capital adequacy; and,
- Review, analyze and amend the definition of non-performing loans.

**10.3. Amend the Law to clarify that all supervisory staff of the NBU have legal protection for actions taken while discharging their duties in good faith.**

***Not implemented***

**10.4. Amend the banking law to require the identification of ultimate bank owners and to allow the NBU to assess the suitability of direct and indirect bank shareholders.**

***Some progress***

Draft Law (registered 23 November 2007) "On Amending of Certain Laws of Ukraine (regulating bank activities)" currently under consideration in Verkhovna Rada introduces extensive regulation on providing information about bank shareholders. Provisions of the current draft Law require banks to fully disclose identities of shareholders possessing more than 10% ownership (or substantial control over a bank), their audited financial statements (income tax filings for individuals) as well as identities of their

---

<sup>26</sup> Resolution of the NBU No. 480 (December 27, 2007) "On approval of Instruction for preparing and publicizing financial statements of the Ukrainian banks".

relatives. The same requirement applies to potential shareholders applying to buy a substantial number of shares. Also, the draft Law grants the NBU the right to refuse issuing a bank license if the bank's ownership structure and the ultimate owners are not fully disclosed or cannot be reliably verified.

If voted in the parliament, the draft Law should substantially improve bank transparency and facilitate the National Bank's assessment of the suitability of bank shareholders.

Despite the lack of formal regulations in place, the National Bank has already made substantial progress towards disclosure of bank ownership. In January 2008, they first published the information on bank owners. The report is prepared on a quarterly basis and released on the Bank's web page continuing their public promise to publish the information on a regular basis. The report has a simple and clear structure and is easy to navigate and understand for market participants and the general audience.

#### **10.5. Strengthen banking supervision in order to eliminate opaque and risky lending and deposit practices.**

***Not implemented***

#### **10.6. Enact stringent rules for related-party lending.**

***Not implemented***

The rules governing lending to a related party remain largely unchanged. Provisions of the Law "On Banks and Banking Activities" and the Directive of the National Bank "On Regulating Commercial Bank Activities in Ukraine" are still high-level formulations defining insiders and specifying maximum allowed loans and guarantees per a single related person and total loans and guarantees to all related persons. The regulations of terms and conditions of lending to related parties and enforcement of these regulations do not exist, except for a general mention that terms and conditions should not differ from those set for non-related parties.

#### **10.7. Strengthen prudential and supervisory norms by introducing prudential limits for banks on loan-to-value and debt-service-to-income ratios for mortgage loans.**

***Not implemented***

### **2009 Updated Recommendations:**

10.1. Implement bank recapitalization program and transparent bank restructuring, and other commitments assumed under IMF's Stand-By Arrangement.

10.2. Continue to monitor bank liquidity and capital standing for possible elevation of temporary restrictions enacted in October-November 2008.

10.3. Enhance the National Bank of Ukraine's high frequency monitoring system, step up targeted on-site inspections, and improve cross-border supervisory cooperation

10.4. Enact stricter regulations on related-party lending, including defining terms and conditions; implement risk-weighted risk analysis and capital adequacy based on Basel principles;

10.5. Strengthen banking supervision in order to eliminate opaque and risky lending and deposit practices.

10.6. Strengthen prudential and supervisory norms by introducing prudential limits for banks on loan-to-value and debt-service-to-income ratios for mortgage loans;

10.7. Work to approve the draft Law introducing new standards for disclosure of bank owners; develop supplemental regulatory acts required to make the Law operational;

10.8. Strengthen NBU's capacity to enforce risk management standards;

10.9. Amend the Law to clarify that all supervisory staff of the NBU have legal protection for actions taken while discharging their duties in good faith.

10.10. End the fixed exchange rate regime;

10.11. Closely monitor bank risk management practices, deepen consolidated risk-based supervision and reporting; apply risk weights to account for different riskiness of asset categories;

10.12. Implement improved standards on disclosing bank information, monitor timeliness of information by the banks.

## **11. Non-bank Financial (NBF) Sector**

### **11.1. Increase the political and financial independence of the State Commission for Regulation of Financial Services Markets (SCRFSM) and the State Securities and Capital Market Commission (SSCMC).**

#### ***Not implemented***

The draft Law of Ukraine "On Amending the Law of Ukraine on Financial Services and State Regulation of Financial Services" (to provide a clear definition of the SCRFSM's status and improve its structure) aimed to improve state regulation of financial services and identified the need to make further amendments to enhance the institutional capacity and efficiency of SCRFSM.

## **11.2. Raise technical and professional capacity of the NBF regulator's supervision.**

***Not implemented***

## **11.3. Provide capacity of the regulator needed for carrying out risk based supervision of the NBF institutions.**

***Not implemented***

We should note initiatives aimed to create the modern elements of a system of the prudential supervision over the non-bank financial institutions and requirements to corporate management as a part of the risk management system (draft Law of Ukraine "On Amending the Law of Ukraine on Financial Services and State Regulation of Financial Services").

## **11.4. Develop comprehensive regulatory framework for the NBF institutions' activities.**

***Not implemented***

## **11.5. Improve the NBF institutions' regulation on activities related to attracting financial assets and deposits in order to reduce risks and prevent illegal operation in credit unions, investment funds, and building societies.**

***Partially implemented***

Two draft laws were developed. The first, "On the Investment Guarantee Fund in the Capital Market, on the Guarantee Fund for Credit Unions' Deposits" (No. 3265 of 8 October 2008), and the second, "On Amending of Certain Legislative Acts of Ukraine on the Activities of the Credit Cooperation System" (No. 2256 of 20 March 2008). The latter draft is based on the conceptual idea of reconciling the provisions of the Civil Code of Ukraine, the Economic Code of Ukraine, and Ukrainian Laws "On Financial Services and State Regulation of Financial Services", "On Credit Unions", "On State Registration of Legal Persons and Natural Person Entrepreneurs", and "On the Organization of Formation and Circulation of Credit Histories".

## **11.6. Increase transparency of the capital market infrastructure.**

***Partially implemented***

The following legislative initiatives have been adopted:

1. Work continued to develop a long-term strategy for the development of Ukraine's financial sector (a draft Strategy of Development of Ukraine's Financial Sector through 2015). The strategy outlines an efficient system for the protection of investors' legitimate interests by enhancing information transparency in the market and implementing compensation mechanisms according to EU law requirements.

2. A draft law “On Amending the Law of Ukraine on the Securities and the Capital Market” (to disclose information in the capital market) was developed with specifications to disclose regular and specific information on a security issuer.

3. A draft Law “On the Investment Guarantee Fund in the Capital Market” was developed, to regulate the creation and operation of the Investment Guarantee Fund. This fund will finance compensation payments to investors in case of loss, this includes – funds and securities delivered to a securities dealer under a securities management agreement and funds invested in securities of co-investing institutions.

**11.7. Improve accounting, auditing and reporting standards for the NBF institutions in compliance with the IAS/IFRS standards.**

*Not implemented*

**11.8. Enact a new Law “On Insurance” compatible with the EU directives and regulatory principles endorsed by the International Association of Insurance Supervisors (IAIS).**

*Not implemented*

**11.9. Improve transparency and consumer protection in the insurance industry.**

*Partially implemented*

In 2008, the following progress developed:

1. A legislative framework was developed to implement a protective rights system for consumers of non-bank financial services (a draft executive order by the Cabinet of Ministers of Ukraine “On the Approval of a Concept of Protective Rights for Consumers of Non-bank Financial Services in Ukraine”). The concept establishes a single system of protective rights for consumers of the financial services, increases the level of protection, improves consumer access to quality financial services, reinforces confidence, and protects against financial services abuse.

2. Components to supervise financial institutions on a consolidated basis (draft LU “On Financial Services and State Regulation of Financial Services”) were introduced. Supervision on a consolidated basis should protect the rights of financial services consumers but the objective of this supervision is to secure the financial stability of the financial institutions.

3. Measures were taken to prevent the impact of the global financial crisis on the non bank financial sector (draft Law “On Immediate Measures to be Taken to Prevent Negative Consequences of Financial Crisis, and Amendments to Certain Legislative Acts of Ukraine”, No. 3306 of 23 December 2008 to amend the existing regulatory legal framework of Ukraine’s Insurance Law and to establish the Guarantee Fund under the Long-term Insurance Contracts).

In order to protect the property rights and interests of insurance consumers, the SCRFMS developed the draft Amendment “On Insurance Activity Licensing Terms” (approved by SCRFMS Executive Order No. 805/8126 of 28 August 2003). The draft suggested amendments to unify the approach towards regulation of insurance licensing.

**11.10. Increase efficiency and transparency of the NBF markets; ensure compliance with the capital adequacy requirements.**

***Partially implemented***

In order to strengthen the capital adequacy and liquidity requirements for insurance companies as well as handle problems regulating investments of insurance reserve funds in safe, liquid, profitable and income-generating asset categories, the SCRFMS developed the draft Regulation “On Criteria and Standards of Capital Adequacy, Diversity and Quality of Insurer Assets” in 2008. The main objective is to secure stable operations of insurance organizations, protect the rights of the insurance consumer, and prevent possible capital losses due to insurance risks.

The SCRFMS issued Executive Order “On the Approval of the Regulations on Promulgation of Information on the Activity of a Non-state Pension Fund” (No. 1218 of 23 October 2008) to improve the procedure for promulgation of information on the NBF activities; to create a system to publicly evaluate NBF activity; and to raise public awareness on the NBF activities by placing information on the official SCRFMS website quarterly, free of charge.

The draft Executive Order of the SCRFMS “On the Approval of the Additional Requirements of Reporting and Investing Pension Assets and Funds Intended for Payment of Pension for a Fixed Term” was developed to establish additional requirements for the investment of pension assets; to prevent devaluation of pension savings; and provide additional guarantees for this category of savings.

In order to more clearly specify the provisions of how to disclose regular and specific information on securities issuers, a draft LU “On Amending the Law of Ukraine on the Securities and the Capital Market” developed.

In order to implement the modern elements of a system of prudential supervision over the non-bank financial institutions and requirements to the corporate management as a part of the risk management system a draft Law of Ukraine on Amending the Law of Ukraine “On Financial Services and State Regulation of Financial Services to the extent of the draft LU “On Amending of Certain Laws of Ukraine on the Regulation of Financial Services Markets” No. 3124 of 8 September 2008. The relevant document suggests regulation of peculiarities of the corporate management systems in financial institutions on the legislative level, financial institutions’ disclosure of information on corporate management, and disclosure of information to the financial service consumers according to the international standards, etc.

A draft Law “On the Guarantee Fund for Credit Unions’ Deposits” (No. 3265 of 8 October 2008) developed to assist in the financial stability of the credit system as a whole and of credit unions, in particular, and to increase financial protection for individuals.

**11.11. Provide the local NBF institutions with relevant methodological base, opportunity to increase professional skills (namely risk assessment and risk management).**

***Not implemented***

**11.12. Provide regulation of the actuarial profession.**

***Not implemented***

**11.13. Ensure adequate reporting of the NBF institutions; improve obligatory data collecting and analysis by the SCFSMR.**

***Partially implemented***

The following **regulatory legal acts** to improve data collection and analysis by the SCFSMR were adopted in 2008:

1. The SCFSMR issued the order “On Provisional Measures for Operational Monitoring of Insurers’ Financial Situation” (No. 1417 of 4 December 2008) in order to monitor the impact of the financial crisis on insurance companies and to protect insurers’ property interests. However, this assumes that insurance companies will compile and then submit the SCFSMR form “Information on basic indicators of an insurer’s activities”.

2. The SCFSMR Executive Order “On Temporary Measures to Secure Stability of Credit Unions’ Activities” (No. 1203 of 15 October 2008) aims to neutralize the impacts of the external financial crisis, secure stability, reliability and safety of credit unions’ activities, and protect their members’ interests.

3. As discussed in the review of recommendation 11.10, the SCFSMR issued Executive Order “On the Approval of the Regulations on Promulgation of Information on the Activity of a Non-state Pension Fund” (No. 1218 of 23 October 2008) to improve the procedure for promulgation of information on the NBF activities; to create a system to publicly evaluate NBF activity; and to raise public awareness on the NBF activities by placing information on the official SCFSMR website quarterly, free of charge.

4. The SCFSMR Executive Order “On the Approval of the Procedure for Calculation and Accounting of Profit (Loss) from Investment of a Non-state Pension Fund’s (NPF) assets” (No. 424 of 2 April 2008) specifies procedures for calculating and accounting for NPF’s profits (or loss) by the NPF administrator as direct by the LU on Non-state Pension Provision.

Additionally, the following draft regulatory legal acts to improve NBF institutions reporting, data collection and analysis by the SCRFSM developed in 2008:

1. Draft Executive Order of the SCRFSM “On the Approval of Amendments to the Regulations on Administering a Non-state Pension Fund” to improve the procedure to account for members of the non-state pension funds and establish a unified mechanism for accounting for pension savings with a mandatory daily calculation contribution.

2. SCRFSM Executive Order of the Draft “On the Approval of Amendments to the Regulations on Submission of the Non-state Pension Provision Reports by a Non-state Pension Fund Administrator” to increase efficiency of supervising the NPF administrators’ work and their compliance to compile and submit non-state pension provision reports, and to obtain more reliable information on NPF operations.

3. Draft Executive Order of the SCRFSM “On the Approval of Amendments to the Regulations on Entering Information about the Non-state Pension Fund Administrators in the State Register of Financial Institutions” expects to improve the data entering procedure for administrators of the NPFs and their detached units in the State Register of Financial Institutions, and to perfect the state’s regulation of NPF administrators’ work by establishing transparent and understandable registration procedures.

4. Draft Executive Order of the SCRFSM “On the Approval of Amendments to the Regulations on Criteria and Financial Ratios of the Credit Institutions’ Activities” goal is to improve credit institution requirements to refinance primary mortgagees and include primary assets to calculate the solvency ratio.

#### **11.14. Broaden access to reliable advisory information on financial services.**

##### ***Partially implemented***

In 2008 work continued to develop a legislative framework to implement a system to protect the rights of consumers in the non-bank financial market (the draft executive order by the Cabinet of Ministers of Ukraine “On the Approval of a Concept of Rights Protection for Consumers of Non-bank Financial Services in Ukraine”).

As discussed in the review of recommendation 11.10 and 11.13, the SCRFSM issued Executive Order on the Approval of the Regulations on Promulgation of Information on the Activity of a Non-state Pension Fund (No. 1218 of 23 October 2008) to improve the procedure for promulgation of information on the NBF activities; to create a system to publicly evaluate NBF activity ; and to raise public awareness on the NBF activities by placing information on the official SCRFSM website quarterly, free of charge

The SCRFSM Executive Order “On the Approval of the Regulations on the Delegation by the SCRFSM of Powers to an Insurers’ Association” (No. 1000 of 21 August 2008) suggests a possible delegation to the insurers’ association and implementation of

the rules of conduct in the insurance services market, which can, *inter alia*, broaden access of insurance market entities to reliable advisory information on insurance services.

**11.15. Develop a sustainable Credit Guarantee Fund facilitating access of small and medium-size enterprises to loans.**

*Not implemented*

**11.16. Develop government and municipal bonds markets and alternative partial credit guarantee facilities for municipal bonds.**

*Not implemented*

**11.17. Develop alternative equity mobilization instruments, partial risk guarantee facilities for Public-Private Partnerships.**

*Partially implemented*

The draft LU “On General Basics of the Development of Public-Private Partnership in Ukraine” created the legislative grounds to encourage cooperative development between the public and private sectors to increase the competitiveness of the national economy’s and direct investments to Ukraine’s economy; however, the draft lacks the partial risk guarantee for public-private partnerships.

**11.18. Amend the Ukrainian Law “On Profit Taxation of the Enterprises” introducing a mechanism of accelerated amortization for the 3<sup>rd</sup> group of fixed assets when it is a subject of financial leasing; normalize taxation for non-residents carrying out leasing activities in Ukraine.**

*Partially implemented*

The draft LU “On Amending of Certain Legislative Acts of Ukraine on the Regulation of Leasing Relations” (No. 3006 of 23 July 2008) suggests amending the LU “On Profit Taxation of the Enterprises” to introduce taxation of the nonresident lessor under the financial leasing agreements only for the remuneration received by the lessor within a leasing payment.

**11.19. Amend the Ukrainian Law “On the Value Added Tax” (VAT) abolishing taxation of leasing interests and commissions in leasing payments.**

*Partially implemented*

Two draft laws developed in 2008 that offer different solutions to the problem of VAT taxation on leasing interests and commissions in leasing payments:

1. The draft LU “On Amending of Certain Legislative Acts of Ukraine on the Regulation of Leasing Relations” (No. 3006 of 23 July 2008) proposes to amend sub-item 3.2.2, item 3.2 LU “On the Value Added Tax” to include remuneration payments to the

lessor and interests within a financial leasing (rent) agreement in the category of operations not subject to the VAT.

2.The draft LU “On Immediate Measures to be Taken to Prevent Negative Consequences of Financial Crisis, and Amendments to Certain Legislative Acts of Ukraine” (No. 3306 of 23 December 2008), Article 33 recommends amending the LU “On the Value Added Tax” and proposes not to include in the taxable objects category interests payments or leasing commissions, not to exceed the triple NBU discount rate, calculated by the value of the leasing object, instead of the double NBU discount rate used today.

**11.20. Improve bookkeeping standards in compliance with international standards and adopt methodical recommendations on the application of the national accounting standard on rent.**

***Not implemented***

The government has not adapted Ukraine’s legal system any further to meet the European Union’s legislative framework (the CMU Executive Order “On the Approval of the Action Plan for the Implementation in 2008 of the National Program of Adaptation of Ukrainian Legislation to the EU Law”, No. 821-r of 11 June 2008), nor has the government prepared draft amendments to accounting regulations(standard) No. 14 on how to account for company rent using internationally recognized reporting accounting and reporting standards.

**11.21. Join UNCITRAL Convention on Assignment of Receivables in International Trade; ratify UNIDROIT Convention on International interests in Mobile Equipment.**

***Not implemented***

**2009 Updated Recommendations:**

11.1. Complete adoption of the Strategy of Development of Ukraine’s Financial Sector through 2015 and the Concept of Rights Protection for Consumers of Non-bank Financial Services in Ukraine.

11.2. Increase the political and financial independence of the State Commission for Regulation of Financial Services Markets (SCRFMS) and the State Securities and Capital Market Commission; provide capacity of the regulators needed for carrying out risk based supervision of NBF institutions.

11.3. Raise technical and professional capacity of the NBF regulators’ supervision.

11.4. Develop comprehensive regulatory framework for the NBF institutions’ activities.

11.5. Increase transparency of the capital market infrastructure.

11.6. Improve the NBF institutions’ regulation on activities related to attracting

financial assets in order to reduce risks and prevent illegal operations in credit unions, investment funds, and building societies.

11.7. Improve accounting, auditing and reporting standards for the NBF institutions in compliance with the IAS /IFRS standards.

11.8. Enact a new wording of the Law of Ukraine “On Insurance” compatible with the EU directives and regulatory principles endorsed by the IAIS.

11.9. Provide the local NBF institutions with a relevant methodological base, and an opportunity to increase professional skills (namely risk assessment and risk management).

11.10. Continue work to improve reporting of the NBF institutions and the processes of data collection and analysis by the SCRFSM.

11.11. Broaden access to reliable advisory information on financial services.

11.12. Increase efficiency and transparency of the NBF services market; ensure compliance with capital adequacy requirements.

11.13. Provide regulation of the actuarial profession.

11.14. Create a Credit Guarantee Fund facilitating access of the SME to loans.

11.15. Develop government and municipal bond markets and alternative partial credit guarantee facilities for municipal bonds.

11.16. Develop alternative equity mobilization instruments, partial risk guarantee facilities for public-private partnerships.

11.17. Improve bookkeeping standards to comply with international standards and adopt methodical recommendations on the application of the national accounting standard on rent.

11.18. Join UNCITRAL Convention on Assignment of Receivables in International Trade; ratify UNIDROIT Convention on International interests in Mobile Equipment.

11.19. Amend the Law of Ukraine “On the Value Added Tax” abolishing taxation of leasing interests and commissions in leasing payments.

11.20. Amend the Law of Ukraine “On Profit Taxation of the Enterprises” introducing a mechanism of accelerated amortization for the third group of fixed assets when it is a subject of financial leasing; normalize taxation for non-residents carrying out leasing activities in Ukraine.

11.21. Amend the existing legislative framework that regulates insurance fraud and introduce liability for fraudulent insurance; in particular, amend the new wording of the draft Law Ukraine “On Insurance” and the Criminal Code of Ukraine.

11.22. Promote professional development of insurance intermediaries, particularly by improving the legal provision for regulation of their activities, and complete creation of a system of training and certification of insurance intermediaries.

11.23. Improve the compulsory insurance system in Ukraine by analyzing the socioeconomic relevance of each type of compulsory insurance and by studying the experiences of countries, particularly EU member states, which have developed insurance services markets.

11.24. Broaden the range of financial instruments in the securities market to secure effectiveness and sufficient profitability for investment assets of the non-bank financial market participants, especially in the context of the NPF investment operations.

11.25. Complete the implementation of pension reform elements, namely to introduce the accumulative system of general mandatory state pension insurance.

11.26. Continue work on implementation of information transparency and quality system of the NPF operations.

11.27. Continue outreach work among the Ukrainian citizens and legal persons concerning the non-state pension provisions.

11.28. Strengthen the role of asset management companies and co-investing institutions, by creating a legal space for increased activity and increased operational transparency.

11.29. Bring the regulatory legal framework that governs co-investing institutions and asset management companies in line with EU Directives.

11.30. Promote development of the leasing infrastructure and intensify its usage by market participants; encourage implementation of the modern risk management systems by leasing companies.

## **12. Fiscal policy**

**12.1 Tighten a fiscal stance until growth abates to a sustainable pace; in the medium-term, target a general government fiscal deficit of no more than 2 ½ percent of GDP, and gradually reduce the ratio of recurrent spending to GDP. (Some specific recommendations how this can be done you can find below and in Chapter 14 on Pension System Reform and Chapter 15 on Social Benefits).**

### ***Modest improvement until the financial crisis***

Despite traditional rhetoric, Ukrainian authorities are usually fiscally conservative with the level of budget deficit. Ukraine's technical default in 2000, which stemmed from carelessly loose fiscal policies in the 90s, made policy-makers cautious about public debt and budget deficits. Only in 2004 did fiscal authorities break the 2.5% ceiling of GDP for deficit level. However, on the heels of aggravating economic problems the government attempts to resurrect the poor practice of an unsustainable budget deficit (-1.5% of GDP in 2008).

Although deficit statistics looked safe through most of 2008, this was not because of a successfully executed budget. Traditionally authorities play with transfer distributions throughout the year. The major bulk of expenses are usually postponed until the second half and, in case of a funds' shortage, some items are underfinanced. This approach helps the Finance Ministry to keep deficit (and debt) numbers in good shape. The deficit policy has been unchanged for the last seven years and we do not see any tendency for the government to abandon the approach.

Although the deficit by itself was not a problem in 2008, public finances suffered extremely high levels of recurrent expenditures. On-going outlays account for more than 80% of the annual budget leaving very little funds to invest. The problem stems from Soviet privileges and the continued social policy by the authorities. In fact more than 60% of recurrent spending is public sector wages and social transfers. Although there was a positive tendency to reduce the recurrent outlays beginning in 2006 through 2008, the result is not a real improvement. Broadly speaking, the authorities just cut the excessive social outlays which increased during the 'post-revolutionary' period of 2004-2005.

For significant reductions in recurrent spending the government needs to address social privileges reform and pension reform; however, little progress has been observed in these areas for many years.

**12.2. Consolidate the budget. Gradually eliminate revenues earmarking, and over time, integrate General and Special Funds into the budget. These steps would increase budget management efficiency and improve the implementation of public investment programs.**

***No implementation***

Current Ukrainian fiscal policy is characterized by short-term planning and spontaneous changes to revenues and spending plans. Special Fund and earmarking specific revenues for some specific needs (mainly social) serves to protect selected spending during stormy political times.

In 2008 there were no changes introduced to alter the practice of special funds and earmarked revenues.

**12.3 Reinvigorate intergovernmental fiscal reforms by improving the allocation of expenditure responsibilities between oblasts, rayons, towns and villages and improving the predictability and simplicity of the equalization transfer formula.**

***No implementation of basic reforms, but small improvements***

Roughly speaking, inter-budgetary relations have remained unchanged since fiscal decentralization reform in 2001. Since decentralization local authorities of the second and third level (i) receive access to the budget planning process, (ii) obtain significant leveling

transfers and (iii) receive subventions from the central budget for special programs (usually social protection). This is a considerable improvement compared to the inherited Soviet inter-budgetary mechanism. However, even decentralized, the budget system remains difficult for local communities. Local authorities are still very dependent on the central government. The Budget Code envisaged significant local budgets' liabilities. At the same time, a shallow revenue base has created a permanent deficit for locals (more than 40% of local spending). The gap is covered at the expense of leveling transfers and support from the central budget. However, the mechanism of transfers is not perfect.

The leveling scheme – so called “leveling formula” – is a complicated and subsequently vague tool for calculating the leveling transfers. Many different coefficients of the formula make it impossible for locals to predict their revenues. Moreover, different lobbyists usually try to introduce/correct coefficients for strengthening financing of their regions. In other words, the formula is inefficient as a leveling mechanism. It does not solve the problem of manual distribution of funds among the different regions.

Subventions are also subject to the centralized distributing process. Traditionally, locals overestimate their needs claiming excessively high subventions, thus hoping to get at least part of the requested funds. Naturally, the Finance Ministry has only partially satisfied the overestimated claims and the level of financing, to large extent, is subject to the arbitrary decision of the central authorities. Obviously, this situation gives the central powers huge influence at the local level.

Although the inter-budgetary relations have many obvious drawbacks, there has been no progress in the last seven year to reform the system. Meanwhile the existent leverages comprise a part of the so called “administrative resource” which is a favorite tool among politicians. However, positive steps are possible. The real estate property tax (defined in the draft budget for 2009), for example, could significantly strengthen local budgets.

Resolution No. 1157 introduces coefficient which is applied to local budget revenues due to economic crisis. If a local budget demonstrates a drastic decline in revenues it is expected to be compensated to some extent from the central budget. The resolution also contains many other minor corrections to the mechanism of inter-budgetary transfers.

#### **12.4 Improve local government borrowing, consistent with good international practice. In particular, incorporate local government debt in public debt statistics.**

##### ***No implementation***

The central government strictly controls borrowing activities of local authorities. Locals can attract money only for development programs and for treating liquidity problems. In addition, only large cities can get loans at foreign markets while others are

obliged to borrow only domestically (which is usually more expensive). All local borrowing projects should be approved at the Finance Ministry. The central government does not provide any guarantee on local liabilities.

Cautious fiscal policy stands behind the strict regulations. Local budgets cannot be fully responsible for their liabilities if they are dependent on central transfers and subventions. The centralized budget system creates soft budget constraints for locals. Under this arrangement local authorities are stimulated to overestimate their borrowing needs.

During 2008 there was no progress in fiscal decentralization.

### **12.5 Reduce budget subsidies: increase administered energy and communal service prices toward cost recovery level.**

#### ***No Implementation (Worsened)***

In 2008 the government continued to subsidize energy and utility prices for the population. The cost of these energy resources has been covered with (i) industry surcharges, (ii) subsidies from the state budget (iii) suppressed profits, if any, for domestic energy producers, or (iv) they are hidden in arrears.

The scheme of price-subsidizing has evolved in recent years. Until 2004 authorities financed the policy at the expense of industry, charging higher tariffs for energy resources. However, with the gas price increase (in 2005) and subsequent changes to the natural gas supplies (in 2006), the state energy company Naftogaz has been forced out of the industrial consumers' market. As a consequence, the government lost a critical source for cross-subsidizing. Naturally, Naftogaz promptly started accumulating huge arrears.

As the situation progressed the government was reluctant to transfer energy costs to households and authorities initiated direct budget support to Naftogaz starting in 2007 (UAH 1.2 billion) to compensate for price-subsidies losses. By 2008 compensation increased almost five times (to UAH 5.9 billion).

Although Ukraine regained some part of the industrial consumers' market (which improved the financial stance of Naftogaz) in 2008, the situation remained unsustainable. Naftogaz has been increasing indebtedness for the last three years and survived only because of state support. By the end of 2008 tariffs remained far below the cost level and showed only a modest growing tendency. Discussions in 2008 with the IMF could create pressure for leveling utility tariffs.

## **12.6 Coordinate and integrate capital budgeting into the overall budgeting process.**

### ***No implementation***

The key mechanism for investing Ukrainian government funds works through Performance (Targeted) Programming. Although there are separate projects that also comprise a considerable part of capital investments. The Performance Programming consists of projects which target officially prioritized goals. To receive financing the programs need Verchovna Rada approval. Usually, the central budget is responsible for financial support of the approved programs; however, co-financing with local budgets also takes place. The projects in the programs are coordinated with line Ministries and State local administrations.

The key problem with Performance Programming is the excessive number of programs. Different groups manage to lobby parliament with hundreds of projects. As a result, only some of them receive sufficient and sustainable financing. For many years officials have been discussing the acute necessity to reduce the number of projects; however, so far almost three hundred different programs receive state financing.

## **12.7 Provide project planning and strengthening of capital projects:**

- a) Enforce existing multi-year ceilings for total spending and for line ministry spending (including capital and recurrent spending);**

### ***No implementation***

Budgeting process in Ukraine is based on short-term (one year) planning. The approach is convenient for the prompt revision of recurrent expenditures but is unacceptable for sustainable capital investments. Although the government has approved plenty of strategic plans, implementation is not possible with unstable financing and yearly budget revisions. There were no successful efforts to extend the time horizon for budget planning, although several draft laws to improve budget planning are pending in parliament.

- b) Introduce multi-year sector strategies and planning for all line ministries;**

### ***Minor implementation***

Line ministries undertook activities on developing of sector strategies and planning. The Ministry of Economy has made an effort to cluster key priorities for Ukrainian economy development. However, so far all strategic planning efforts remained in theoretical terms. Although the majority of line Ministries have their strategies (the quality of the documents varies), there is no financial support for implementation. The short-term budget planning is the very center of the problem.

- c) Enforce existing a central database of current assets with links to all line ministries;**

***Possible progress***

There is no reliable data on state owned assets. The government has only a rough idea about their assets in large state enterprises and companies where the state owns shares. Medium and small assets remain beyond the government's control and accountability. The State Property Fund (SPF) is attempting to systematize a database on state assets. However, the result of the initiative is unclear.

In addition to the SPF, the Finance Ministry plans to improve accountability of public finances. The Ministry intends to integrate public finance management into a centralized information-analytical system. The plan should be implemented within the Public Finance Modernization Project for Ukraine (financed by the World Bank). So far it is not clear how state assets will be considered in the system; however, apparently this innovation should also address the issue of state assets. The loan agreement on this project was signed in March 2008 and ratified in September.

- d) Enforce the use of economic project evaluation (using cost benefit analysis) in the line ministries as part of their project submission to the Ministry of Finance and the Ministry of economy;**

***Gradual implementation***

The Ministries provide analytical support to the projects submitted to the Finance Ministry and the Ministry of Economy. However, the level of analysis is not thorough. Moreover, there is no unified methodology to assess the projects.

The issue of personal qualification is under permanent attention of the Ministries. The Ministries continue to address qualification issues. They have implemented many educational and/or training projects and, step-by-step, are improving the qualifications of public servants. Although professionalism at state institutions is increasing, there were no efforts to unify assessment methodology.

**12.8 Realize the capital project implementation, execution and monitoring:**

- a. Strengthen coordination between the Ministry of Finance and the Ministry of Economy to closely monitor the implementation of capital projects, during the year, with line ministries;**

***Gradual implementation***

The Ministry of Economy and the Ministry of Finance cooperate closely on to develop capital projects and to finance and supervise their implementation. The division of responsibilities is clearly defined. The Ministry of Economy selects (or develops) highly

prioritized projects. Later, the Ministry of economy supervises the economic effect of the project. The Ministry of Finance is responsible for financing of the projects and controlling the allocation of funds. When working together the two institutions usually create working groups which include competent experts and officials.

**b. Review the current budget execution procedures for capital projects;**

***Possible implementation***

Public Finance Modernization Project (see 12.7 c) includes a review of budget execution procedures for capital projects. The World Bank requested strengthened joint monitoring (for the Finance Ministry and the Ministry of Economy) for the implementation of capital projects. The Public Finance Modernization Project can bring progress in this area.

**c. Improve the monitoring and assessment of operations and maintenance adequacy;**

***Gradual implementation***

Monitoring and assessment issues are closely connected to the problems of the state's assets database, public servants' qualifications, and formalized methodologies for analysis and procedures of jointly supervised capital projects (for the Finance Ministry and the Ministry of Economy). As mentioned above, the authorities have made some progress on these issues (see 12.7 d and 12.8 a,b).

**12.9 Strengthen the analytical capacity in line ministries to perform capital project evaluations.**

***Gradual implementation***

As mentioned above, public servants permanently improve their qualification through study tours or training programs. Although the level of professionalism is increasing, the analytical work lacks a unified methodology for a consistent assessment of capital projects (See 12.7 d).

**12.10 Design and implement a medium-term department management strategy, based on a systematic approach under different economic and financial assumptions, to reduce risk exposure and debt servicing costs.**

***No implementation***

Medium-term management strategy is a part of medium- and long-term budget planning which should improve the sustainable performance of public finances. Fiscal authorities continue to adhere to short-term budgeting (see 12.7 a).

## **12.11 Provide medium-term fiscal planning to make the best use of fiscal space**

### ***No implementation***

Fiscal planning continues to be based entirely on a one year time horizon (see 12.7 a, 12.10)

## **12.12 Revamp the management of donor-financed investments and projects.**

### ***Gradual implementation***

Management of donor-financed projects is gradually improving. However, there are many issues to improve to make allocation of donor-funds more efficient.

The key requirements are (i) integrate donor-funds into the general public financial management system, (ii) synchronize project cycles with budgeting process, (iii) simplify processing and approval of donor financed investments.

Integrating donor-funded projects into the public financial management system will streamline donor funds into the state's general investment policy and therefore state controlling institutions, like KRU and the Accounting Chamber, will monitor and control the funds. Currently many projects have been partially integrated to the public financial management system. Complex local procurement rules still have the donors use international procurement procedures. However, to a large extent, the Ministries deal with the funds according to the local public funds management rules.

Synchronizing project cycles with the budget process is essential to streamline the investment process. However, so far there has been little progress to improve this. The budgeting process by itself is affected by political dialog and is highly irregular.

Processing and approval of donor-financed investment is incredibly time-consuming. The process includes negotiations, authorization, and approval of the projects by numerous ministries and state institutions. The formal procedures make the initiation stage of the project extremely complicated and inefficient. So far there has been little progress to simplify the procedures.

## **12.13 Implement modern public procurement law**

### ***Improved but with caveats***

Public procurements remain an unresolved issue. During 2005-2007 the Law "On public procurements of foods, services and works" was subject to frequent revisions. With every update to the procurement procedure, the situation became even more complicated. Finally, by the middle of 2007 the procurement system was paralyzed by amendments introduced in June 2007. The key issues were related to (i) extremely low procurement volumes subject to the tendering mechanisms; (ii) tightened requirements

to tender procedures; and (iii) expensive, complicated, and obligatory consulting services. The shortcomings of the updated law drastically increased administrative costs for vendors. As a consequence, small and medium size procurements became unprofitable for commercial companies. Broadly speaking, in the second half of 2007 procurement procedures affected the supply of goods and services for public and state companies. State institutions accumulated huge funds (about UAH5.0 billion by August 2007) but were unable to use them because of low participation of vendors. The situation was further aggravated when a troublesome obligatory consultancy services for procurements was required by law (delivered by members of Tender Chamber of Ukraine (TCU). Public concern over rent-seeking schemes made the authorities look for mechanisms which would unblock the procurement process. In March 2008 the Cabinet of Ministers approved temporal regulations for public procurements eliminating the above procedure<sup>27</sup>.

The temporal procedures have, in fact, resolved the problem. Procurements are operational. The Ministry of Economy regained the coordinating role in the procurement process (instead of the TCU). The most important step was to cancel the obligatory consultancy services which eliminated burdensome administrative costs. Vendors received free access to tender announcements and all payments for tender documentation have been cancelled. Moreover, a new free-of-charge internet portal was established to publish procurement information. In addition, the minimum limits for application of tendering procedures have been raised to UAH 100,000 for goods and services (previously UAH 20,000) and up to UAH 300,000 for work (previously UAH 50,000).

Although significant progress has been achieved to disseminate information and procurement procedures, the mechanism needs to be elaborated further. In fact, the improvement comes at the expense of decreased transparency and public control. In Ukraine this means a high level of corruption. There should be a trade-off between simplicity/flexibility and the controlling mechanism; however, authorities shifted the balance too far in favor of simplicity.

#### **12.14 The law shall provide for public procurement from one contractor only as exceptions for specific cases**

##### ***Implemented***

The framework for one contractor procurements was fixed by the Cabinet Decree on temporal procurement procedures. Currently, the one contractor approach can be applied only (i) if it is necessary to continue the work or services, (ii) if there is an absence of competition, (iii) in case of an emergency, (iv) to purchase of art work or other issues

---

<sup>27</sup> Decree of the Cabinet of Ministers No. 274 "On procurements of goods, works and services"

related to intellectual property. The established framework appears reasonable; however, control over the procedures could be strengthened in the future to improve how procedures are monitored and controlled.

## **2009 Updated Recommendations**

12.1. Tighten a fiscal stance; reduce wage and transfer increases, reduce subsidies, concentrate income support where most needed; gradually reduce the ratio of recurrent spending to GDP.

12.2. Make sure that budget deficit has non-inflationary sources of funding

12.3. Keep constant wage level for the first grade public sector employees

12.4. Postpone for two years the planned equalization of the minimum wages with the minimum subsistence level

12.5. Revise backward-looking indexation arrangements for various social transfers (and refocus increases on forward-looking inflation measures)

12.6. Unify the price for domestic and imported gas by end-2011

12.7. Consolidate the budget. Gradually eliminate revenues earmarking, and over time, integrate General and Special Funds into the budget. These steps would increase budget management efficiency and improve the implementation of public investment programs.

12.8. Decrease the level of recurrent spending in budget structure.

12.9. Enforce a mid-term budget planning mechanisms.

12.10. Increase the revenue base for local budgets; reinvigorate intergovernmental fiscal reforms by improving the allocation of expenditure responsibilities between oblasts, rayons, towns and villages and simplify leveling transfer formula for local budgets

12.11. Improve local government borrowing, consistent with good international practice. Incorporate local government debt into public debt statistics.

12.12. Reduce price subsidies for imported natural gas consumed by communal heating entities through quarterly tariff adjustments and eliminate them by July 1<sup>st</sup>, 2010

12.13. Coordinate and integrate capital budgeting into the overall budget process.

12.14. Cut all unrealistic programs; integrate the prioritized programs into the general budgeting process; extend budget planning horizon to medium-term for securing implementing of the programs.

12.15. Provide project planning and strengthen the evaluation of capital projects:

a. Enforce existing multi-year ceilings for total spending and for line ministry spending (including capital and recurrent spending);

b. Improve multi-year sector strategies and planning for all line ministries;

c. Enforce the existing central database of current assets with links to all line ministries;

d. Strengthen the use of economic project evaluation (using cost-benefit analysis) in the line ministries as part of their project submission to the Ministry of Finance and the Ministry of Economy.

12.16. Realize the capital project implementation, execution and monitoring:

a. Strengthen coordination between the Ministry of Finance and the Ministry of Economy to closely monitor the implementation of capital projects, during the year, with line ministries;

b. Review the current budget execution procedures for capital projects

c. Improve the monitoring and assessment of operations and maintenance adequacy.

12.17. Strengthen the analytical capacity in line ministries to perform capital project evaluations.

12.18. Design and implement a medium-term department management strategy, based on a systematic approach under different economic and financial assumptions, to reduce risk exposure and debt servicing costs.

12.19. Provide medium-term fiscal planning to make the best use of fiscal space.

12.20. Integrate the donor-funded projects to the public financial management system.

12.21. Continue to improve procurement procedures.

12.22. The law shall provide for procurement from one contractor only as exceptions in specific cases.

12.23. Enforce stabilization fund formation (through prosperous period).

12.24. Increase penalties and punishment for inconsistency between discharged money and achieved results.

## **13. Tax System**

### **13.1 Reduce tax rates over time, subject to the expansion of the tax base and/or reductions in government spending**

#### ***No implementation concerning reducing government spending***

Consolidated revenues are consistently high. Through 2004-2005 the outlays surged on the heels of election promises (from 28.4% of GDP in 2003). For the last three years expenditures have fluctuated around 31 to 32% of GDP. In 2009 the government does not plan to decrease public spending below 31.0% of GDP.

#### ***No implementation concerning tax rates reducing***

The government has not changed tax rates (except excise duties) since 2007 when the personal income tax (PIT) rate was raised to 15% (from 13%). That was the final stage of the PIT reform initiated in 2004.

#### ***Partially implemented concerning tax base expanding***

At the same time the tax base has been under permanent revision. The VAT underwent the most drastic changes in recent years. The most serious revisions took place in 2005 when the government eliminated tax privileges for Special Economic Zones (SEZ). In addition, in 2006 Ukraine and Russia moved to new schemes on natural gas supplies. According to new arrangements, gas supply was subject to VAT taxation, which was not the case before. As a result, the VAT revenues almost doubled in 2006 to 9.3% of GDP vs. 4.8% in 2004. In 2008 the new VAT reforms changed the tax base. The government abolished the VAT promissory notes for imported products, which stimulated prompt increase in the VAT inflow (up to 10.6% of GDP in the first half of 2008); however, subsequently, on the heels of hryvnia devaluation, imports decreased and the VAT revenues reduced slightly by the end of 2008 (9.5% of GDP in 2008). At the same time the VAT share in the structure of government budget revenues increased from 27% in 2007 to 30.9% in 2008.

By the end of 2008 there was growing pressure to reduce the tax base. The authorities consider a lower tax a way to overcome economic problems, and some legislative initiatives envisaged shrinking the tax base for the VAT, PIT and enterprise profit tax.

### **13.2 Broaden the tax base for social funds; ensure that those participating in the Simplified and Fixed Agricultural Tax System contribute fully.**

#### ***No implementation***

Although the simplified taxation system (STS) proved to be an extremely efficient instrument for facilitating small business development, the introduced within the system

mechanism of tax collections appeared to be a convenient tax avoidance tool for entrepreneurs. Broadly speaking, the STS has been widely applied to reduce tax obligations for both personal income and enterprise income tax. The system proved to be most attractive for decreasing social payments obligations, which remained at extremely high level. An enterprise could economize up to 40% of wages using the STS.

Under this system, social funds and the Pension fund receive significantly less money. The STS, in fact, envisages some contributions to social funds; however, the payments are negligible and, in perspective, those who use the STS will not receive pensions unless they are subsidized.

The situation is being watched closely by both the government and international organizations. These institutions recommended increasing the effective tax rate for the STS and restricting the list of economic activities eligible for the STS. This type of reform would eliminate the tax avoidance component of the system. However, no real steps have been taken to date. For the majority of private entrepreneurs the system offers the opportunity to avoid paying company income tax.

**13.3 Maintain a broad corporate tax base; avoid reintroducing tax preferences in special economic zones; eliminate costly loopholes for insurance, and for financial institutions.**

***No implementation***

The tax base for an enterprise's profit has legislatively remained almost unchanged. Although in 2005 the government managed to eliminate almost all tax privileges for sectors and special economic zones (SEZ), in 2006-2007 businesses claimed the elimination illegal in court and large parts of their privileges were renewed at the local level. As a result, the tax base for corporate profits has shrunk (see 13.1). Recent tendencies show that many new loopholes could use anti-crisis measures as the rational.

**13.4 Broaden the base for VAT; introduce new VAT regime on agriculture, in line with WTO and EU requirements; eliminate non-standard preferences.**

***Partial implementation***

The most obvious area to broaden the VAT tax base is to tax agriculture. As a reminder, agrarians (i) enjoyed the VAT zero rate for milk and meat products; (ii) had the option to keep accrued the VAT for agro-products in special accounts and use them for investment needs only; (iii) received the VAT charged to the final consumers from meat and milk producers (the funds were allocated in a special account). In addition to these benefits, they could claim VAT credit for purchases. Following the WTO accession authorities eliminated the VAT zero rate for milk and meat products sold to processors. At the same

time the rates within the Special VAT regime for agricultural producers and fishery products (9 and 6 per cent relatively) were also replaced by a standard rate of 20%<sup>28</sup>.

A recommendation to provide subsidies to producers directly from the budget (and not through the VAT scheme) was not implemented. The Law “On priority measures for preventing negative consequences....” prolonged the same VAT reimbursement mechanism. Milk and meat producers apply the 20% VAT rate but are then reimbursed with the VAT collected by milk and meat processing companies.

In addition to agriculture, there are other potential areas to increase the VAT base. First, some companies managed to restore their special economic zone privileges through local courts decisions. Reversing these privileges would broaden the VAT coverage. However, the issue relates to judicial reform rather than fiscal policy (see 13.1).

Another possibility relates to the taxation of natural gas imports. The World Bank claims that the VAT is charged only at the third stage of gas supply chain<sup>29</sup> which creates considerable losses in the VAT collections. Reforming the VAT collection mechanism for gas imports will also increase the tax base.

In addition to gas imports, yet another option for improvement is to address the VAT preferences. For instance, exemptions for scrap metal are still present and are likely to be continued for the next year.

The economic down turn creates a need for authorities to look for new ways to broaden the VAT tax base.

**13.5 Reform the Simplified Tax System to better target it to truly small- and medium-sized businesses; align its thresholds with the VAT; reduce the threshold for physical persons; rationalize eligibility criteria for the regime and set up a graduation rule from the system.**

#### ***No implementation***

The current design of the Simplified Tax System (STS) leaves significant room for tax avoidance (see 13.2). Although the STS is an obvious “loophole” of the overall tax system, reforming the system is complicated. The STS amendments face considerable social opposition. As a consequence, no progress has been observed.

Among the most important issues for reform are (i) thresholds for natural persons, (ii) eligibility criteria for different businesses and (iii) discrepancies between thresholds for the STS and the VAT obligations.

---

<sup>28</sup> The Law of Ukraine “On priority measures for preventing negative consequences of financial crisis and on introducing amendments to some legislation of Ukraine”, No. 639-VI, 31 October 2008

<sup>29</sup> Creating Fiscal Space for Growth: A Public Finance Review, Report No. 36671-UA, 14 September 2006 (page 16)

The high level of turnover under fixed taxation (UAH 300,000 per year) is among the most discussed problems in the fight against the STS tax avoidance. Broadly speaking, the effective tax rate for these businesses does not exceed 0.8% per year while for traditional taxation varies from 15% to 40% (including social funds). Naturally, for entrepreneurs there is a huge motivation to migrate to the STS. Reform options include reducing the threshold or increasing fixed tax payments. However, in 2008 the situation remained unchanged.

Changing the eligibility criteria for the STS regime is also a reform option. Traditionally, the government and the State Tax Administration targeted to exclude the most profitable businesses from the list of eligible for the STS. Audit services, as well as law and business consultants have been under particular scrutiny since their revenues are pure profit. In contrast, other small businesses traditionally undergo solid input costs. Again, although the problem is obvious and widely discussed, authorities have not addressed the issues.

Discrepancies between the thresholds for the STS and the VAT have also created the opportunity for tax avoidance. Legal entities can enjoy the STS of up to UAH 1,000,000 turnover per year. In this case the VAT is not obligatory but optional. Normally, the VAT is obligatory if turnover exceeds UAH 300,000 for the last consecutive 12 months. This option, naturally, incentivizes medium businesses to stay with the STS, even if their revenue is high enough to operate under the traditional taxation regime. To date, the issue remains unchanged.

### **13.6 Eliminate financial transaction taxes that stand in the way of financial sector development**

#### ***Gradual implementation***

Charges on foreign exchange transactions (F/X) are gradually being reduced and are expected to be abolished after 2009. In 2008 charges on F/X transactions comprised 0.5% of exchange operations (1.5% in 2005; 1.3% in 2006; 1.0% in 2007). The 2009 budget envisaged a 0.2% fee with elimination of this tax in the near future.

### **13.7 Drastically improve the administration of the VAT, including timely refunds in full**

#### ***Partially implemented***

Although the debt on the VAT reimbursement to exporters remains high<sup>30</sup>, there has been noticeable progress in the VAT administration in recent years. The most important was introduction of the VAT electronic reporting in April 2008. Taxpayers are

---

<sup>30</sup> UAH 11.0 billion by October 1<sup>st</sup> vs. UAH 8.5 billion at the beginning of 2008

obligated to submit detailed reports on the VAT credit listing all contractors to the State Tax Administration (STA). The system should make the VAT chains more transparent and help facilitate fraud detection. Indeed, since April 2008 the STA reported the faster VAT reimbursement process. Although provisional results of this reform seem to be positive, it is too early to reach a final conclusion on the efficiency of electronic reporting.

Another 2008 reform which has had questionable effect was abolishing the VAT promissory notes' for importing operations. Promissory notes were a crucial part of one more the VAT fraud scheme. The government decided to solve the problem by eliminating the instrument. As a result, the VAT revenues surged (by more than 10% of the GDP in the first half of 2008 vs. 8.3% in 2007), however importers' liquidity was hurt by their inability to finance the VAT charges. Naturally, this revision created considerable pressure on businesses. Although the problem with the promissory notes' fraud seems to be resolved, the new approach is inefficient. In addition to eliminating schemes, the State Customs Service deprived "white" businesses of an important instrument for their performance and development. The government should choose more profound instruments for targeting VAT administration problems.

### **13.8 Strengthen the large taxpayer office under the State Tax Administration**

#### ***Gradual implementation***

Large taxpayers constitute the bulk of tax collections (63.2% for the first half of 2008) while comprising only 0.4% of all taxpayers in Ukraine. Traditionally, Tax Offices approach such enterprises on an individual basis and tax obligations are negotiated. Naturally, large-scale production creates room to minimize taxes. Moreover, traditional tools like inspecting and charging for tax violations do not have results. Broadly speaking, a general taxation framework is not efficient for large taxpayers.

As a result, the Large Taxpayers Office was created to communicate with companies with solid turnover. The main task of the office is to find a reasonable balance between the government's budget interest and the private interest of taxpayers. The role of Large Taxpayers Office is gradually strengthening. In particular, some support to the office was envisaged by the World Bank project "Modernization of State Tax Service of Ukraine". But there is still significant room to upgrade the communication process with financial groups and large enterprises.

### **13.9 Adopt regulations to support transfer-pricing audits in line with OECD guidelines.**

#### ***No implementation***

Transfer-pricing is very popular among Ukrainian companies. Many enterprises actively use the mechanism to avoid taxes. Ukrainian legislation does not have basic norms to control or even monitor the operations between closely related firms. The Law "On Enterprise Profit Tax" has a "fair price" norm to prevent fraud for import/export operations. However, this instrument is inappropriate and insufficient for transfer-pricing operations.

### **13.10 Prepare and adopt International Accounting Standards for large corporations**

#### ***Gradual implementation***

In 1998 the Cabinet approved a program to reform the accounting system in Ukraine, and subsequently the International Accounting Standards have been gradually implemented. By the end of 2007 the government developed and approved approximately 32 accounting norms in accordance with the International Accounting Standards. Although gradual progress has been observed, companies still continue to use both national and international book keeping standards. Usually, national standards are used for tax reporting while international standards are applied for communication with investors and partners.

In October 2007 the Cabinet also approved a strategy to apply international standards in Ukraine<sup>31</sup>. The program seeks to harmonize accounting standards, improve regulations, and introduce training programs for accountants. It is expected that Ukraine will complete the reform by 2010.

### **13.11 Implement consistent and coordinated measures to ensure the predictability of the tax system and its reform for investors; provide crucial access to reliable information on proposed changes to tax legislation and compliance with the declared intentions (or prior notification of any changes of such intentions).**

#### ***No implementation***

Unfortunately, tax legislation has not been systematized so far. For many years politicians and officials have discussed the necessity of adopting the Tax Code, however, there had been no progress. As a result, spontaneous permanent amendments to the tax legislation are introduced. A new version of the draft Tax Code to systematize the system was registered at Verhovna Rada but was not adopted in 2008.

---

<sup>31</sup> Strategy for application of international standards in Ukraine, decree of the Cabinet of Ministers, 24 October 2007, No. 911-p

In 2007 there was minimal progress in reforming the tax system. The only progress relates to the Constitutional Court's prohibition of introducing amendments (including tax legislation) in conjuncture with approval of state budget<sup>32</sup>. The Cabinet used to introduce significant tax amendments every year connected to voting on the State Budget project. This approach was politically motivated since approving amendments is much easier under the shadow of voting on the State Budget. Although the Constitutional Court decision is mandatory, the Law on State Budget (2008) still contains a significant section with corrections to acting legislation.

**13.12 Improve the procedure for public debate on the draft Tax Code, comprising the proposals of interested parties, NGO's and international organizations.**

***Implemented (at least nominally)***

In March 2007 the Cabinet of Ministers restored development and improvement of the draft Tax Code. The Ministry of Finance initiated round-table meetings, working groups, conferences and other public events to discuss a draft Tax Code with associations, parties, experts and other interest groups. From March to October 2007 there were numerous public events focused on this issue throughout Ukraine. Although the Ministry of Finance presented their position without consulting with these interest groups, considerable work has been accomplished around the draft Tax Code issue. Unfortunately, consecutive political crises beginning in the fall of 2007 have frozen all activities.

**13.13 Systemize the terminology and definitions used in different chapters of draft Tax Code in correspondence with other national legislation.**

***Partial implementation***

The work on the draft Tax Code stopped in 2007 for political reasons (see 13.12). At the time the work was suspended the draft was subject to corrections and revisions.

**13.14. Adopt a new Tax Code along these lines.**

***No implementation***

Progress on the draft Tax Code stopped at the end of 2007 during consecutive political crises (see 13.12)

**2009 Updated Recommendations**

13.1. Reduce tax rates over time, subject to the expansion of the tax base and/or reductions in government spending and stabilization of budget (see 12.1-12.8).

---

<sup>32</sup> Decision of Constitutional Court of Ukraine No. 6-pn/2007, on 9 July 2007

13.2. Implement one effective tax rate for personal income tax, enterprise profit tax and simplified taxation system in order to reduce stimulus (and possibilities) for tax avoidance.

13.3. Broaden the tax base for social funds; ensure that those participating in the Simplified and Fixed Agricultural Tax system contribute fully.

13.4. Maintain a broad corporate tax base; avoid reintroducing tax preferences in special economic zones; eliminate costly loopholes for insurance, and for financial institutions.

13.5. Broaden the base for the VAT; eliminate support of agricultural producers through VAT tax regime; use state budget for any type of subsidies in order to ensure transparent and comparable with other expenditures form of subsidizing.

13.6. Reform the Simplified Tax System to better target it to truly small- and medium-sized businesses; align its thresholds with the VAT; reduce the threshold for physical persons; rationalize eligibility criteria for the regime and set up a graduation rule from the system.

13.7. Eliminate fully financial transaction taxes that stand in the way of financial sector development.

13.8. Improve the administration of the VAT, including timely refunds in full.

13.9. Strengthen the large taxpayer office under the State Tax Administration.

13.10. Adopt regulations to support transfer-pricing audits in line with OECD guidelines. Elaborating a mechanism for transfer-pricing auditing will be a huge step for fighting large-scale tax avoidance.

13.11. Continue adoption of the International Accounting Standards for large corporations.

13.12. Implement consistent and coordinated measures to ensure the predictability of the tax system and its reform for investors; provide crucial access to reliable information on proposed changes to tax legislation and compliance with the declared intentions (or prior notification of any changes of such intentions).

13.13. Continue the public debate on the draft Tax Code, comprising the proposals of interested parties, NGO's and international organizations.

13.14. Systemize the terminology and definitions used in different chapters of draft Tax Code in correspondence with other national legislation.

13.15. Adopt a new Tax Code along these lines.

## **14. Pension System Reform**

**14.1. Avoid discretionary increases in the minimum pension; establish indexation rules linking pension increases with the consumer price index computed for adequate income brackets.**

***Enacted, to be implemented in 2009***

Minimum wage and the subsistence level are the basis for the old-age pension benefits and contribution calculations. They are now indexed at the rate of inflation because of the Law of Ukraine No. 639 of 31 October 2008 "On Immediate Measures to be Taken to Prevent Negative Consequences of Financial Crisis, and Amendments to Certain Legislative Acts of Ukraine".

The pension replacement rate increased to 49.3% in 2008 because of legislation that accounted for an average salary increase and increase in the value of coefficient for each year at work used for pension calculation from 1% to 1.35%.

**14.2. Gradually increase statutory retirement ages and bring the retirement age for women into line with that for men.**

***Not implemented***

This recommendation was the subject of public discussion but no legal acts developed to increase statutory retirement ages.

**14.3. Lengthen the contribution period for eligibility for a full pension.**

***Not implemented.***

**14.4. Reduce early retirement and privileged pensions.**

***Not implemented.***

Instead of reducing the number of early retirement and privileged pension schemes, a special mechanism was introduced to finance early retirement pensions for employees who work under harmful or heavy conditions in Draft Law No. 1306 "On Compulsory Professional Pension System" and submitted to Parliament. This draft law provides for an additional pension account for workers in non-state pension funds in order to reduce the financial load on the solitary pension system.

A draft law to introduce an early retirement plan for some types of agriculture work was also submitted to Verkhovna Rada. If adopted, it will increase the number people who qualify for early retirement plans.

#### **14.5. Revise the contribution system for self-employed, part time and seasonal workers *Partially implemented.***

People registered as private entrepreneurs have the option to make additional payments to the pension fund but this opportunity should be promoted widely. In 2008 pension changes were implemented for seasonal workers. Adopted Law of Ukraine No. 799, 25 December 2008, "On Amending of Certain Laws of Ukraine Regarding Minimization of Influence of the Global Financial Crisis on the Employment of Population" introduced a new procedure for calculating the services of seasonal agricultural workers. However, this policy needs to be promoted, understood and implemented by employers.

The contributions of private entrepreneurs deducted from to the single tax are not sufficient enough to cover minimum pension payments. To cover this deficit in the Pension Fund of Ukraine, the single tax rate or level of contributions should be raised. However, the differentiated single tax rate proposed by a draft Tax Code of Ukraine which was submitted to Verkhovna Rada in 2008 and legislation on pension system did not address this problem.

#### **14.6. (a) Enact necessary legislation to introduce the Accumulation Pension Fund**

##### ***Small progress***

Implementation of Accumulation Pension Fund was proposed in a draft law submitted to Verkhovna Rada of Ukraine in late 2007 but was not considered in 2008.

The main document to address continued pension reform is the draft "Concept on Further Conducting of Pension Reform in Ukraine". It was widely discussed in the government but has not been approved yet. Meanwhile some measures indicated in the draft were implemented in 2008, including approved normative acts directed towards strengthening the regulation of the financial services market and a list of other preconditions needed to introduce accumulation account schemes.

The draft concept outlines consistent reform and designates 2010-2011 as the period to fully implement pension accumulation accounts within the mandatory pension provisioning system, and 2012-2016 as the period to implement a unified legal system for the new pension system and mandatory occupational pension schemes for professions working under harmful conditions. This timeline is unrealistic given the limited progress in 2008. In order to meet this schedule, Draft Concept should be revised and adopted by the Parliament in the mid of 2009.

#### **and (b) assure the sustainability of the first pillar Pension Fund.**

##### ***Some progress***

More than 80 draft laws on Pension System issues were submitted to Verkhovna Rada of Ukraine in 2008 and 9 were adopted. A variety of Orders of Regulators - State Commission for Regulation and Financial Services Market of Ukraine (SCRFSMU) and

Securities and Stock Market State Commission (SSMSC) have been issued. Adopted legislation is mainly directed at to prevent unfortunate consequences of current and future financial crises; some of them also include measures to further develop the pension system in line with BRAAC recommendations.

To raise financial discipline of contributors to the Pension Fund of Ukraine the draft Law of Ukraine “On Enhancement of Responsibility for Untimely Payment or Groundless Non-Payment of Wages, Scholarship, Pension or other Legislatively Established Payments” and amendments to the Code of Ukraine on Administrative Infringements and the Criminal Code proposed financial sanctions for and criminal responsibility of managers of enterprises, organizations and institutions. Another draft law regarding the financial responsibility of contributors was approved by Verkhovna Rada in the first reading.

Control over the timely transfer of contributions to the Pension Fund of Ukraine by banks servicing contributor accounts was strengthened by Law of Ukraine No. 795 of 24 December 2008 “On Amending the Article 20 of the Law “On Obligatory State Pension Insurance”.

The proposal to change the contribution rate to the Pension Fund of Ukraine for several groups of payers was widely discussed but has not been implemented.

**14.7. Improve the regulation of and supervision over pension funds relying on international experience and advice (Also see chapter on Non-bank financial sector).**

***Some progress***

Several orders to strengthen supervision and regulation over pension funds were adopted by SCRFSMU. They aimed to increase regulatory and supervisory efficiency, obtain more reliable reports of NPF activities, and reporting procedures; as well as licensing activity reports for non-state pension funds administrators, on accounting and investments of assets; and on registration procedure, etc..

**14.8. Enact legislation to unify the collection of all social security contributions under the Pension Fund.**

***Not implemented***

**14.9. More actively disseminate information on pension reforms, including non-state pension funds, as the existing distrust of non-state pension funds is closely related to the lack of understanding of how these organizations operate.**

***Some progress***

The Ministry of Labor and Social Policy of Ukraine together with Pension Fund of Ukraine and State Commission on Regulation of Financial Services Markets of Ukraine organized a range of round table discussions on pension reform for journalists, NGOs and the public to promote the necessity and urgency for pension reform.

In order to increase transparency of non-state pension funds activities, the SCRFSMU Order No. 1218 of 23 October 2008 "On the approval of the Regulations on disclosure of information on activities of a non-state pension fund" introduced unified requirements of NPF activities to be posted on SCRFSMU's website.

It is very important to provide this information, however, in order for it to be useful and effective it needs to be written so that the average person and local media understand the difference between various pension products..

### **2009 Updated Recommendations:**

14.1 Assure stabilization of the first pillar of the Pension System

14.2 Prepare and enact the second pillar in pension system based on individual accounts

14.3 Gradually increase statutory retirement ages and bring the retirement age for women into line with that for men.

14.4 Lengthen the contribution period for eligibility for a full pension.

14.5 Improve the regulation of and supervision over pension funds relying on international experience and advice.

14.6 More actively disseminate information on pension reforms, including non-state pension funds, as the existing distrust of non-state pension funds is closely related to the lack of understanding of how these organizations operate.

14.7 Raise contributions to the pension fund by private entrepreneurs.

14.8 Review and Adopt Draft "Concept on Further Conducting of Pension Reform in Ukraine" and draft Law "On Introduction of Accumulating of mandatory state pension provision of Ukraine".

14.9 Promote voluntary postponement of retirement age in order to raise pension benefits.

### **15. Social Benefits**

**15.1. Firmly align Ukraine's social protection system with requirements of poverty alleviation (persons living above the poverty line must be excluded from the specific protection measures); replace unjustified social mandates with a targeted social protection system.**

***Some measures implemented. Measures to replace unjustified social mandates with a targeted social protection system have not been taken.***

In times of financial and economic crisis it is important to prevent the significant deterioration of the population welfare. This increases the meaning and role of a well targeted social safety net. In this regard, the Government of Ukraine prepared and submitted to the Verkhovna Rada of Ukraine the draft Law of Ukraine "On Amending the Law of Ukraine "On State Social Aid to Low Income Families", which was adopted on 24 December 2008 (No. 796-VI). This law limits the number of persons entitled to state social aid and is not provided if:

- Able-bodied members of the low income families do not work, serve, study full-time at general, vocational and higher educational establishments of I-IV accreditation levels within three months prior to application for state social aid;
- Additional sources of subsistence of a low income family have been established as well as the fact that any member of such family within 12 months prior to application for state social aid purchased commodities or paid for services in amounts exceeding the subsistence level for the family by 10 times;
- The low income family owns or possesses a second flat (or house) with a total floor area of more than 21 square meters per one family member and additional 10.5 square meters per family, or more than one car or vehicle;
- The low income family (except for families consisting of children only or persons of 65 years of age, or disabled persons of the I and II categories, or families with disabled children) owns or possesses a land plot of more than 0.6 hectares, except for cases when this land plot does not produce a profit due to reasons beyond family's control.

Measures limiting the number of people entitled to state social aid are accompanied by an increase in the general level of social security payments. This, inter alia, was fostered by the adoption of the Resolution of the Cabinet of Ministers of 22 February 2008 No. 57 "Issues related to assignment and payment of allowances to families with children", which increased allowances for families with three or more children to 50% of the subsistence level for children of a certain age. The average allowances for low income families with three or more children increased 1.7 times compared to December 2007 (to UAH 775.40 a month. Beginning in 1 January 2008 child care allowance increased by 20.6% compared to 2007 – to UAH 316.50 for low income families, and by the end of 2008 it was raised to UAH 334.50 a month. A unified approach to determine the amount of child care allowance for insured and uninsured persons was applied.

## **15.2. Reduce the number of benefits and monetize them.**

### ***Not implemented***

A reduction in the number of benefits as well as their monetization did not take place.

On the contrary, 2008 is characterized by an increase in the number of benefits. Resolution of the Cabinet of Ministers of Ukraine of 30 July 2008 No. 1052-r "On approval of the action plan on realization of the Concept of reforming the system of social services by 2012" envisaged development of the state regulations of social services activities, involvement of non-profit organizations to administer social services, a strengthened role of local authorities in the organization of social services provision etc. However, measures to reduce the number of benefits and to monetize them have not been included.

## **15.3. Develop instruments of indirect estimation of beneficiaries' incomes**

### ***Not implemented***

Measures to improve the mechanisms of determining a family's income to prove eligibility to receive social aid (the instruments of indirect estimation of beneficiaries' incomes) have not been stipulated. Even though the Ministry of Labor and Social Policy of Ukraine in cooperation with the Ministry of Economy of Ukraine, the Ministry of Finance of Ukraine, the State Statistics Committee and the Ministry of Ukraine for Families, Youth and Sport issued an Order of 17 June 2008 No. 304/221/805/188/2447 to approve amendments to the "Methodology of Calculation of the Total Income of Families for All Types of Social Benefits". However, the amendments do not address the instruments of indirect estimation of beneficiaries' incomes.

## **15.4. Envisage responsibility for unlawfully received benefits.**

### ***Not implemented***

There have been no measures to increase responsibility for unlawfully received benefits. Thus, the abovementioned draft Law No. 2408 of 18 April 2008, stipulates "In case a family deliberately submits inaccurate information or concealed information that influences or could have influenced the establishment of a right to state social aid and estimation of its amount, the payment of such aid shall be terminated as of the month in which the violation was revealed". Except for the termination of payment no other sanctions are outlined.

Analysis indicates that lawmakers often apply the formulation "made accountable in compliance with current legislation of Ukraine" while imposing sanctions. However, the current criminal legislation does not envisage such responsibility.

**15.5. Tighten income policy: implement a more restrained minimum wage policy. Spread out to 2012 the equalization of the minimum wage and subsistence levels.**

***Some attempts undertaken but then contested***

The state policy of Ukraine was directed at increasing the minimum wage and social income. Thus, the Law of Ukraine "On the State Budget of Ukraine for 2008 and Amending of Certain Legal Acts of Ukraine" envisaged increasing the minimum wage as follows: as of 1 January to UAH 515.00 a month; as of 1 April to 525.00, as of 1 October to UAH 545.00 and as of 1 December to UAH 605.00. According to Ukrainian government estimations, the general wage increase in 2008 was 31.5% compared to 15% in 2007. By September 2008 the minimum wage increased three times equaling an 18.5% increase. As of 1 October it was UAH 545.00 a month, which is 81.5% of the subsistence level for an able bodied individual, and at the end of 2008 the minimum wage reached 90.4 % of the subsistence level for an able bodied individual. The average monthly wage in 2008 compared to 2007 increased 33.7% to UAH 1806.00 (in August it was UAH 1872.00). Taking inflation into account, the increase was 6.3 %.

In October 2008 measures were taken to restrain wage increases. The Law of Ukraine "On Immediate Measures to be Taken to Prevent Negative Consequences of Financial Crisis, and Amendments to Certain Legislative Acts of Ukraine" of 31 October 2008 No. 639-VI envisaged the amount of subsistence and minimum wage levels changes to be in compliance with the inflation index (consumer price index). However, provisions of this law to implement a more restrained minimum wage policy were sharply criticized by the Parliament of Ukraine. In December 2008 the Parliament of Ukraine adopted the Law "On Measures to Prevent the Negative Consequences of the Financial Crisis in the Sphere of Social Security, Remuneration of Labour, and Employment", which adjusted the minimum wage level to the subsistence minimum level beginning 1 January 2009. The President of Ukraine vetoed the Law.

**2009 Updated Recommendations:**

15.1. Firmly align Ukraine's social protection system with requirements of poverty alleviation (persons living above the poverty line must be excluded from the specific protection measures); replace unjustified social mandates with a targeted social protection system.

15.2. Reduce the number of benefits and monetize them.

15.3. Develop instruments of indirect estimation of beneficiaries' incomes.

15.4. Envisage responsibility for unlawfully received benefits.

15.5. Tighten income policy: implement a more restrained minimum wage policy. Spread out to 2012 the equalization of the minimum wage and subsistence levels.

## **16. Judicial and Administrative Reforms**

**16.1 Develop and pass amendments on procedural legislation (Code of Civil Procedure and Code of Economic Procedure) assuring the clear allocation of jurisdiction, the balance of procedural rights of parties, and the prevention of appearance of concurring decisions on a same case by different courts; facilitate access to judicial protection by introducing Class action and Derivative lawsuit mechanisms.**

### ***Not implemented***

An efficient and reliable judiciary needs a clear allocation of jurisdiction between the different court levels. Concurring decisions must be avoided. The draft of the Law "On the Judicial System of Ukraine" from 2006 was supposed to improve the situation but got highly politicized and was viewed with mistrust and ended in a political deadlock. The latest version of the draft<sup>33</sup> proposes changes to the Ukrainian court system. Although the proposed system is simpler than the existing one, which provides for separate courts of cassation, there are still, in fact, four levels of courts and each level is itself subdivided between economic, civil, administrative and criminal courts. The three-level court system based on European standards is currently being discussed in Ukraine. But in order to reduce the number of courts levels, Article 125 of the Constitution needs to be amended<sup>34</sup>, which seems to be a very difficult task under the current political conditions.

#### **1. Clear Allocation of Jurisdiction – *no progress***

Several amendments have been made to the Code of Economic Procedure (CEP) and to the Code of Civil Procedure (CCP) since the beginning of 2008. However, none of these amendments relate to the problem of a clear allocation of jurisdiction. The amendments include changes to the procedures for the filing a claim (Art. 67 CEP) and the publication of court decisions (Art. 85 CEP) which contribute to a better design of procedural rights. Furthermore, the amendments contain preparatory stipulations for hosting the European Football Championship in 2012, e.g. the courts of commercial jurisdiction have jurisdiction on decisions concerning the violation of intellectual property of the Union of European Football Associations (UEFA).

#### **a) Jurisdiction of Commercial and Administrative Courts – *small progress***

The Parliament of Ukraine is currently reviewing a draft law concerning further amendments to the CEP and the Code of Administrative Procedure (CAP). This draft law deals with an efficient allocation of jurisdiction between commercial and administrative

---

<sup>33</sup>Draft Law No. 916 of 23 November 2007 approved for second reading on 8 July 2008

<sup>34</sup>Venice Commission, Opinion on the Draft Law on the Judiciary and the Legal Status of Judges of Ukraine, CDL-AD 2007 (003), Opinion Number 401/2006 of 20 March 2007.

courts.<sup>35</sup> Problems with the creation of administrative courts, the Code of Administrative Procedures, and legal terminology, in particular, will be tackled in this draft law. In addition to other modifications, changes related to Art. 12 CEP will assign the jurisdiction on disputes arising out of the transfer of property (including state or municipal property) to the commercial courts.<sup>36</sup>

But problems with jurisdiction allocation cannot be solved unless clear criteria for dividing jurisdiction is developed, which is impossible in the case of civil and commercial courts. Also problematic is a clear division of jurisdiction between commercial and administrative courts if the Commercial Code - based on the concepts of the Soviet-type administrative economy denying protection of private interest in economy - will not be abandoned. It should be understood that commercial courts were inherited from Soviet times with its firm and clear division between physical persons and legal entities and therefore lost its foundation when Ukraine moved to a free market economy. The plan to preserve commercial courts as a separate branch of judiciary at any cost resulted in numerous attempts to hand-tailor jurisdiction for commercial courts which led to confusion and legal uncertainty.<sup>37</sup> In order to fulfil the policy recommendation of BRAAC efficiently legal reforms should aim to eliminate commercial courts since these courts require a completely different approach to the one chosen in the draft described above.

## 2. Procedural Rights – ***small progress***

Amendments to the CEP and the CCP introduced since 2007 contribute to a better design of procedural rights by improving the procedures for the filing a claim (Art. 67 CEP) and the publication of court decisions (Art. 85 CEP). The draft laws currently being discussed will allow for better protection of the claimant's assets and reduce the possibility to reject a claim.<sup>38</sup>

## 3. Class Action and Derivate Lawsuit Mechanisms – ***small progress***

Some elements of class action and derivative lawsuit mechanisms are present in Ukrainian legislation, but their effectiveness depends on further legislative development.

### a) Class Action – ***partially implemented***

---

<sup>35</sup>Draft Law No. 1403 of 30 September 2008.

<sup>36</sup>The Ukrainian Parliament might change the jurisdiction for disputes relating to property, available at <http://dom.ria.ua/news/133889>.

<sup>37</sup>Draft Law No. 2178 of 6 March 2008.

<sup>38</sup>Draft Law No. 2178 of 6 March 2008.

The Ukrainian Law “On Consumer Rights”<sup>39</sup> introduces consumer class action as the right of consumer civil society organizations. However, absence of private interest for lawyers and consumers to get compensation for the damage, lack of threat of high compensation payments for producers turn class action mechanism unclaimed in Ukraine, which proves absence of court practice in this field.

b) Derivate Lawsuit – ***partially implemented***

In many countries, shareholders may protect their rights indirectly, by bringing lawsuits against management or controlling shareholders on behalf of the company itself (derivative lawsuit). The CCP requires that the shareholder’s right to apply to court on behalf of the interests of a joint stock company must be provided by law. The new Law “On Joint Stock Companies” signed by the President of Ukraine on 22 October 2008 provides the shareholder with this right, but gives no mechanism to utilize it.

**16.2 Raise educational and qualification requirements for judicial candidates; impose the mandatory publication of property and financial interests in an annual declaration.**

1. Qualification requirements for judicial candidates – ***no progress***

Since 2007 no changes to the Law “On the Status of Judges”<sup>40</sup> outline a precise definition of higher legal education and work experience required for judicial where made. Judicial candidates are not required to take special preparatory courses to improve their knowledge and expertise essential for the position of a judge. The role of the Academy of Judges as the specialised state educational establishment, whose purpose is to train potential judiciary staff, has not clarified with regard to the quality and quantity of courses that should be offered to the judicial candidates. Most law faculties do not provide students with solid theoretical background or a sufficient level of practical skills. Few schools offer special courses concerning the status and role of judges in society.

There are also several problems concerning the requirement of “work experience in the sphere of law,”<sup>41</sup> which is not limited to having practiced<sup>41</sup> before the court. No legal definition of what constitutes such experience exists, and it is often loosely interpreted. For example, there are instances when candidates with no courtroom experience (in-house corporate attorneys, local government officials or even female-students who took several years of maternity leave after graduation) are recommended as judges.

---

<sup>39</sup>Law “On Consumer Rights Protection” No. 1023-XII of 12 May 1991 in force since 1 October 1991, available at <http://zakon.rada.gov.ua/cgi-bin/laws/annot.cgi?nreg=1023-12>, last access 14 December 2008.

<sup>40</sup>The Law “On the Status of Judges” No. 2862-XII of 15 December 1992 in force since 10 February 1993.

<sup>41</sup>CEELI, Judicial Reform Index 2005 of December 2005, p. 13.

2. Mandatory Publication of Property and Financial Interests in an Annual Declaration – *no progress*

**16.3 Consider introducing elements of public involvement into the process of selecting judges (elections) and other measures needed to raise the ethical standards of the judiciary, in an attempt to make judges more accountable and to prevent the transformation of the judiciary into nontransparent corporation.**

1. The Selection of Judges (Elections) – *small progress*

The process of electing judges is generally regarded as non-competitive, inefficient, lacking transparency, and guided by subjective factors rather than by professionalism and the moral character of individual candidates.<sup>42</sup> Even though no amendments have been made since 2007 to the Law “On the Status of Judges”, drafts of possible amendments exist attempting to change the current unsatisfying situation. A draft law was submitted to Parliament by the President and introduces amendments to the current version of the Law “On the Status of Judges”. The draft law introduces the idea of public involvement in the election of judges. However, the draft law does not substantially solve the problem of the highly politicised selection process. The idea of public hearings, at which many people can be present and question candidates for judicial office, foreseen in the draft law will further politicise the process.

The draft law foresees more power for the High Council of Justice in the selection process of judge candidates. The selection intends to assign one High Qualification Commission for the whole country, thus abolishing the current regional qualification commissions. The new High Qualification Commission will be composed of 15 members including eight judges, two members appointed by Parliament, two members appointed by the President of Ukraine, one member appointed by the Ombudsman, one member appointed by the Ministry of Justice and one by the Chamber of Advocates. The High Qualification Commission will be attached to the High Council of Justice as an independent body of judicial self-government. However, the provisions governing the election of judges should also state the qualification criteria the commission must apply in order to appoint a judge. This way judges who are not elected can check for inconsistencies and seek judicial protection. Then a transparent selection procedure can be guaranteed.

Ukraine’s current judiciary system exhibits several negative features dangerous to the rule of law: corruption among judges, ignoring public opinion, and disregarding legal norms. In order to restore public trust in the judiciary, the vicious circle of judicial solidarity should be broken by the wider and deeper involvement of the public in the

---

<sup>42</sup>For more details on selection process see CEELI, Judicial Reform Index 2005 of December 2005, p. 14 et seqq., available at <http://www.abanet.org/rol/publications/ukraine-jri-2006-eng.pdf>, last access 14 December 2008

selection process of judges (elections) as well as broader use of public juries to hear the most grave cases (especially cases regarding judicial corruption).

## 2. Accountability of the Judiciary – *no progress*

The Code of Professional Ethics for Judges<sup>43</sup> remains a mere declaration that fails to effectively address major issues such as conflicts of interests or *ex parte* communications. No changes to the provision that govern the accountability of judges have been introduced since 2007. Several drafts of laws amending the current version of the Law “On the Status of Judges” are under discussion but Parliament did not pass a consistent defining law in 2007 or 2008.

### **16.4 Complete the creation of administrative courts, which need to be adequately staffed and funded.**

#### Creation of Administrative Courts – *partial progress*

In 2005 the Parliament outlined the Code of Administrative Proceedings in Ukraine thus establishing the administrative courts and the High Administrative Court of Ukraine.<sup>44</sup> By the end of 2008, 12 of the planned 27 local administrative courts were in place. The budget granted the State Court Administration cover 65% of their requested budget and thus did not meet the expectations and needs of local and appeal courts (780 courts altogether). The financial situation also remains tense. In 2008, UAH230.0 million was approved for all local administrative courts including 352 judges. An essential problem in Ukraine is the lack of court buildings and court rooms. The number of judges needs to be adjusted to the number of cases and this relationship is closely linked to the number of court rooms available. New buildings and courtrooms are necessary to manage the number of cases and make the judiciary more efficient. This is especially important for the newly developed administrative branch where 11 of 27 of the planned administrative local courts do not have court buildings or court rooms at all.

The existing courts are poorly equipped with technical facilities including computers, printers, scanners etc. Most of the written work and correspondence in court is still managed by hand or with typewriters especially in rural areas. This means that court rulings must be written by the judge personally and consume valuable time. The inadequate budgeting of the administrative courts in Ukraine is reflected in the low salaries of judges. The lack of financial incentives does not attract qualified and motivated judicial candidates. Thus, the development of a qualified administrative judicial branch is hampered.

---

<sup>43</sup>Adopted by Fifth Congress of Judges in 2002.

<sup>44</sup>The Code on Administrative Proceedings in Ukraine No. 2747 IV of 6 July 2005 in effect since 1 September 2005.

## **16.5. Reform the system of execution of judgment, pre-judicial inquiry, public prosecution, admission to the legal profession, and the penitentiary system.**

### 1. Effectiveness of the State Enforcement Service in Ukraine – *no progress*

There have been no changes to the system since the beginning of 2007. In Ukraine civil rulings are very poorly enforced. This is due to a lack of employee motivation caused by low pay, large workloads, poor incentives, limited possibilities for advancement, and an unsupportive working environment rooted in both agency mismanagement and the intrinsic difficulties of collection in Ukraine. Very limited training combined with a highly formalistic procedural code, and multiple opportunities for appeals against bailiff actions for non-compliance with procedural requirements (including against the SEO directly) has led to SEO behaviour that is hostile to innovation and unresponsive to the collection requirements.

The typical monthly caseloads for each SEO is between 100 and 150, which suggests that the average SEO must issue several thousand notices, orders and other documents in the course of an ordinary month, most of which could, and frequently, are appealed. Even though the Law “On State Executive Service” provides for guarantees to protect health, honour, dignity and accommodation, the SEOs perform their work with low total pay and with almost no incentive pay.

### 2. Public prosecution, admission to the legal profession, and the penitentiary system.

No progress in reforming public prosecution, the penitentiary system, or mechanisms of admission to the legal professions was achieved in 2008.

## **16.6 Provide adequate funds to the judiciary to raise salaries; train judges; encourage systematization and quality of higher court recommendations; develop legal databases and adequate computer facilities and make databases available to outsiders.**

### 1. Database of Court Decisions<sup>45</sup> – *substantial progress*

In 2006, a Law “On the Access to Court Decisions” was adopted by Parliament defining the procedures for accessing court decisions and establishing the Unified State Register of Judicial Decisions.<sup>46</sup> The law requires that every judgment of every Ukrainian court, regardless of the court’s level, be forwarded for inclusion in the Register within 15 days from the ruling date. The Register is accessible 24 hours a day via the internet on the

---

<sup>45</sup> The database is available in Ukrainian at <http://www.court.gov.ua/>.

<sup>46</sup> Law of Ukraine on Access to Judicial Decisions No. 3262-IV of 22 December 2005 in force since 1 June 2006.

official website of the judicial branch of government<sup>47</sup>, but not all courts are incorporated into the network yet. Exaggeration of secrecy and protection of personal information caused de-personification of information about cases, which makes it unsuitable for certain statistical analyses. However, further improvement to the database is expected. Permanent free of charge access to the database for Ukrainians will contribute to a transparent and accountable judiciary if awareness and interest in the database is raised.

2. Adequate funding of judiciary, additional training of judges, improvement the quality of higher court recommendations – **no progress**

### **2009 Updated Recommendations:**

16.1 Consider the option of solving the problem of clear allocation of jurisdiction by incorporation of commercial courts into the branch of civil courts; amend procedural legislation to assure the clear allocation of jurisdiction, the balance of procedural rights of parties, and the prevention of concurring decisions on a same case by different courts; facilitate public access to judicial protection by introducing Class action and Derivative lawsuit mechanisms.

16.2 Raise educational and qualification requirements for judicial candidates; impose the mandatory publication of property and financial interests in an annual declaration.

16.3 Consider introducing elements of public involvement in the process of selecting judges (elections) and other measures needed to raise the ethical standards of the judiciary to make judges more accountable and to prevent the transformation of the judiciary into nontransparent corporation.

16.4 Complete the creation of administrative courts, which need to be adequately staffed and funded.

16.5 Reform the system of execution of judgment, pre-judicial inquiry, public prosecution, admission to the legal profession, and the penitentiary system.

16.6 Provide adequate funds to the judiciary to raise salaries; train judges; encourage systematization and quality of higher court recommendations; develop adequate computer facilities and make legal databases available to the public.

---

<sup>47</sup> The database is available at <http://www.court.gov.ua/>.

## **17. Administrative Reform**

### **17.1 Decentralize the public administration according to the principles of the European Charter of Local Self-government in order to ensure more efficiency and accountability at local self-government level**

#### ***Studies and debates but no progress in implementation***

The European Charter of Local Self-Government was ratified by Ukraine in 1997.<sup>48</sup> The Charter commits ratifying member states to guarantee the political, administrative and financial independence of local authorities. It provides that local self-governments shall be recognised in domestic legislation and, where practicable, in the constitution. Local authorities are to be elected by universal suffrage, and allocation of competence among various levels of government should be based on the principle of subsidiarity.

The main principles of the charter have been included in article 140 of the Constitution of Ukraine. But the Law "On Local State Administration"<sup>49</sup> adopted in Ukraine in 1999 contradicts the basic principles of self-governance because the real administrative and finance power remains in the hands of those appointed by the President at local state administrations, independent from self-government bodies. The concepts "On Local Self-Government Reform", "On Administrative-Territorial System Reform" were developed. The National Association of Regional Development Agencies (NARDA) in cooperation with Ministry of Regional Development organised discussions on the "Concept of Territorial and Administrative Reform" to address the problem of decentralisation and sustainability of local self-government. Unfortunately drafts of laws developed under these concepts are not consistent with each other. Draft Law No. 1313 (10 January 2008) "On Introducing Amendments into the Law of Ukraine "On Local Self-Government" proposes to increase the power of local self-government bodies and to improve the accountability mechanisms (referendum, plebiscite, withdrawal) whereas the draft Law of Ukraine "On Grounds of State Regional Policy", developed by Ministry of Regional Development and Construction, proposes creation of set of bodies of questionable nature with regard to consistency with subsidiarity principle and sources of financing. At the same time the draft law "On Amending the Law of Ukraine "On Local State Administrations" No. 1311 (10 January 2008) proposes to increase the competence of local state administrations at the expense of local self-governance institutions. None of these drafts were adopted by Verhovna Rada in 2008.

---

<sup>48</sup> See full text of the European Charter of Local-Self Government at <http://conventions.coe.int/Treaty/EN/Treaties/Html/122.htm>.

<sup>49</sup> Law of Ukraine on Local State Administration No. 586-XIV of 9 April 1999 in force since 12 May 1999.

## **17.2 Adopt a new Civil Service Law.**

### ***Not implemented***

Currently the Law on Civil Service of 1993 govern state service in Ukraine.<sup>50</sup> Since this law was adopted in 1993 the organisation and functions of the state service do not meet the requirements of modern public administration. The provisions governing remuneration and other incentives for civil servants as well as the provisions covering admission and promotion in civil service are outdated. The Law on Civil Service lacks effective mechanisms to disclose and verify information about income, property and expenditures of civil servants. Ukraine should also abandon the harmful practice to establish peculiarities for legal status, social benefits and remuneration of employees of different state agencies by separate legal acts. There are more than 800 regulatory acts and other legislative texts that now govern state service in Ukraine.

Since 2007 there have been several proposed changes introduced to the Law on Civil Service but none of them address the above mentioned problems. The draft of the new version of Law on Civil Service was rejected in October 2008 by Parliament consequently reform of civil service in Ukraine, including a new Civil Service Code, will drag on into the future.

## **17.3 Undertake Functional, Operational and Civil Service Reviews**

### ***Small Progress***

The Main Department of Civil Service in Ukraine is in charge of carrying out civil service reviews in order to improve the efficiency of the civil service in Ukraine.<sup>51</sup> In 2008, 161 reviews were completed by the Main Department according to the Law "On Civil Service in Ukraine" with particular attention give to sources of corruption in civil service.<sup>52</sup> In 2007 the Main Department also carried out extensive reviews.<sup>53</sup> This shows that the review process is taking place and its results are accessible to the public.

In 2006, the Cabinet of Ministers of Ukraine adopted a resolution governing the ongoing functional review of central executive authorities.<sup>54</sup> A coordination committee was created to govern the procedures of the functional revision. Since 2007 several authorities were examined according to these procedures.

---

<sup>50</sup> The Law of Ukraine on State Service No. 3724-XII of 16 December 1993 in force since 4 January 1994.

<sup>51</sup> Resolution of the Cabinet of Ministers of Ukraine No. 1180 of 26 August 2007.

<sup>52</sup> For more details see [http://www.guds.gov.ua/control/uk/publish/article?art\\_id=103028&cat\\_id=57862](http://www.guds.gov.ua/control/uk/publish/article?art_id=103028&cat_id=57862).

<sup>53</sup> For more details see [http://www.guds.gov.ua/control/uk/publish/article?art\\_id=103028&cat\\_id=57862](http://www.guds.gov.ua/control/uk/publish/article?art_id=103028&cat_id=57862).

<sup>54</sup> Resolution of the Cabinet of Ministers of Ukraine No. 570-p of 16.11.2006.

In addition to these reviews, the Cabinet of Ministers has established the renamed Centre for Development of Civil Service in Ukraine into the Centre for Adaptation of the Civil Service to the Standards of the European Union.<sup>55</sup> The Centre is subordinated to the Main Department of Civil Service and plays an important role in reforming the civil service of Ukraine. For this purpose there is progress on new legislation for a new civil service. Furthermore aid mechanisms e.g. twinning, matching the European Union's, have been implemented and refined enhancing the quality of advice and counsel provided by the Centre resulting in a more modern public administration in Ukraine.

#### **17.4 Avoid the duplication of ministries in the Secretariat of the Cabinet of Ministries**

##### ***Very small progress***

A new Law "On the Cabinet of Ministers" was adopted in 2008 in Ukraine.<sup>56</sup> Article 50 of the Law "On the Cabinet of Ministers" governs the functions of the Secretariat of the Cabinet of Ministers. The structure of the Secretariat is set up by a resolution of the Cabinet of Ministers.<sup>57</sup>

The structure of the Secretariat of the Cabinet of Ministers has changed since 2007 but the changes only partially eliminated the duplication of responsibilities and tasks of the ministries. Since 2007 only the Administration of Strategic Projects and the Department for the Preparation for the 2012 Football Championship in Ukraine have been liquidated. This is why one of the most important objectives of the ongoing operational review carried out within the central executive organs (see Point C. III.) is to detect inconsistencies in the division of competencies and eliminate them.

One possible solution to the problem of duplication within ministries in the Secretariat of Ministers is to precisely regulate the number and the tasks of the ministries as well as other central bodies of executive power drawing clear lines between the areas of responsibility and reducing the number of central government bodies to enhance executive power efficiency. Presently five different types of central executive authorities exist with overlapping competencies and tasks: ministries, central governmental authorities, central authorities with special status, and departments of the central authorities with special status and state committees of Ukraine. Very often the responsibility to determine and design the policy in one sector is assigned to a ministry and another central authority at the same time creating confusion and legal uncertainty. A

---

<sup>55</sup> See official website at <http://www.center.gov.ua/main/en/news/top.htm>.

<sup>56</sup> Law of Ukraine on the Cabinet of Ministers No. 279-XVII of 16 May 2008.

<sup>57</sup> Resolution of the Cabinet of Ministers No. 761 of 6 May 2000.

mandatory reduction of the number of the authorities would help to streamline the central government.

### **17.5 Split the State Agency on Investment and Innovation into two separate institutions:**

**a) Investment Promotion Agency would concentrate on attracting foreign investors, analyzing legislative and administrative barriers to investment flows, preparing annual reports on investment climate, and assisting foreign investors in bringing their complaints to the attention of authorities;**

**b) and State Committee on Innovation would support innovations.**

#### ***Substantial Progress***

The State Agency on Investment and Innovation was created in 2005 by the Presidential Decree Nr. 1873/2005 as a central body of executive power with the special status in the field of innovation.<sup>58</sup> The Centre for Foreign Investments was subordinated to the State Agency in 2006 combining the two responsibilities under one umbrella agency.<sup>59</sup>

The need to separate the State Agency on Investment and Innovation into two institutions became obvious since the development of innovation requires a lot of resources without bringing substantial results. At the same time the agency concentrates most of its efforts on acquiring money and overseeing other agencies which regulate the capital market and not on creating an attractive image of Ukraine for foreign investors or developing measures to improve investment climate of Ukraine. The strategy to attract foreign investors to Ukraine should be changed and a separate institution needs to be created to more efficiently promote investment opportunities to foreign investors.

On 28 January 2009 the National Agency of Ukraine for Foreign Investments and Development was created by Cabinet of Ministers of Ukraine (Decision No. 48). The tasks and skills of the new Agency generally corresponds to BRAAC recommendation, but analysis of regulations issued by the agency reveal a weakness in the mechanisms for receiving feed-back from foreign investors on regulatory policy, investment climate etc. Addressing this problem at the operational level should be a priority of the new agency.

---

<sup>58</sup> Presidential Decree No. 1873/2005 of 30 December 2005.

<sup>59</sup> Resolution of the Cabinet of Ministers No. 771 of 31 May 2006.

## 17.6 Implement the Electronic Government

### *Small Progress*

The introduction of e-government in Ukraine started in 1998 with the Law “On the National Programme for an Information-Oriented Society”.<sup>60</sup> Since 2007 twenty regulatory acts have been passed in order to implement e-government in Ukraine. Two of the most important legislative acts out of these 20 documents are the Law “On the Basic Principles for the Development of an Information-Oriented Society in Ukraine for 2007–2015 of 2007”<sup>61</sup> and the Resolution of the Cabinet of Ministers establishing a register of national programmes on the creation of an information-oriented society in Ukraine including their buyers and their source of financing<sup>62</sup>. In addition, a national committee on the creation of an information-oriented society in Ukraine was established in 2008.<sup>63</sup>

The development of e-government is financed through the state budget, non-governmental organisations (NGO) in Ukraine and international organisations (like the EU). According to the criteria for the development of e-government by the United Nations Division for Public Economics & Public Administration Ukraine’s progress so far is ranked between step one and step two (emerging presence and enhanced presence).<sup>64</sup> However, several legislative projects could bring Ukraine closer to step three (interactive presence) by enacting the draft law on electronic signature, the draft law governing data protection and the status of electronic documents.

### **2009 Updated Recommendations:**

17.1 (2) Reform the system of management of municipal property introducing reliable management techniques and efficient mechanisms for local self-governments authorities to perform audits and assume control. Assure alienation of local self-governance property only through auction procedures.

17.2 Adopt a new Civil Service Law.

17.3 Undertake functional, operational and civil service reviews

17.4 Avoid the duplication of ministries in the Secretariat of the Cabinet of Ministries

---

<sup>60</sup> Law of Ukraine on the National Programme for an Information-Oriented Society No. 74/98-BP of 4 February 1998.

<sup>61</sup> Law of Ukraine on the Basic Principles for the Development of an Information-Oriented Society in Ukraine for 2007–2015 of 2007 No. 537-V of 9 January 2007 in force since 6 February 2007.

<sup>62</sup> Resolution of the Cabinet of Ministers No. 805-p of 26 September 2007.

<sup>63</sup> Resolution of the Cabinet of Ministers No. 272 of 26 March 2008.

<sup>64</sup> UN Global E-Government Survey of 2003, p 13, available at

<http://unpan1.un.org/intradoc/groups/public/documents/un/unpan016066.pdf>.

17.5 Amend documents which establish the State Agency on Investment and Innovation competence to avoid overlap and duplication of functions in the recently created National Agency of Ukraine for Foreign Investments and Development. National Agency of Ukraine for Foreign Investments and Development should emphasize “investment promotion agency” functions in its activities concentrating on establishing a working mechanism for foreign investors’ feedback.

17.6 Implement the Electronic Government.

## **18. Energy Policy**

### **18.1. Increase Ukraine’s energy security and make Ukraine less vulnerable to energy import price shocks.**

#### ***Modest progress***

Ukraine remains too reliant on natural gas imports. Repeated conflicts with Russia over natural gas supplies raised concerns early in 2009 about the reliability of Russia as an energy supplier and emphasized the unstable nature of energy trade. The current situation is one of mutual dependence: Russia needs Ukraine’s infrastructure and Ukraine needs Russian gas. Furthermore, Russia is dependent on the EU for revenue and because of this Russia will not stop supplying gas to Ukraine. However Ukraine is vulnerable too, since it relies on Russian imported gas for 65-75% of total gas consumption. Moreover Ukraine’s manufacturing sector is notoriously inefficient and its energy sector remains overly politicized, lacks transparency and suffers from conflicts of interests making Ukraine very vulnerable to external factors.

Ukraine’s attempts to increase domestic gas production were unsuccessful because domestic land basins are almost exhausted and off-shore projects are currently on hold. Besides, depressed gas prices for domestic suppliers, which are less than half of the price paid to foreign suppliers, did not encourage domestic extraction of gas and oil. However, a gradual decrease in consumption volumes is expected as gas prices increase and new energy saving technologies are introduced. If domestic producers are allowed to match the prices paid to foreign suppliers it will encourage an increase in domestic extraction and also attract foreign investors to participate in off-shore extraction projects.

Another opportunity for Ukraine is its coal reserves. Coal extraction recovered after its biggest decline at the beginning of the century and reached 77.7 million tons in 2008 (a yearly increase of 2.8%). Although coal is an important power industry for Ukraine it cannot, by itself, significantly decrease Ukraine’s vulnerability to energy import price shocks.

In January 2009 Russia and Ukraine finally signed a long-term energy supply contract which had been a goal for some time. The major advantage of the contract is the agreed upon formula for the price of gas, which makes it a more predictable and transparent arrangement.

The International Court's solution to the division of the sea basin around the Zmiyinyy Island, accepted by both Ukraine and Romania, now opens exploration in this corner of the Black Sea.

### **18.2. Promote energy efficiency measures by:**

**a. Finalizing the liberalization process (including tariff reforms) to attract investments;**

#### ***Not implemented***

To date the government has failed to create a favorable investment climate through liberalization, this will be further elaborated in 18.4 and 18.6. Additionally, tariff changes, described in 18.3, are not considered a significant step towards an efficient energy policy

**b. Implementing energy efficiency stimulating policy (subject to differences between energy resources and main consumer groups);**

#### ***Not implemented***

**18.3. Reduce cross-subsidization among different categories of consumers; eliminate all privileged power (gas) tariffs for industrial users; promote competition.**

#### ***Not implemented***

Ukraine's practice of cross-subsidization is a major problem with the tariff-setting system for gas and electricity; the general population is the most subsidized consumer. One of the most negative results is the absence of electricity saving incentives, and unlike natural gas, power is subsidized at the full amount independent of actual consumption.

Another example of cross-subsidization is the introduction and development of flat rates for bulk electricity independent of oblenargo location, which contradicts the bilateral contracting principle described in 18.11.

Gas price privileges in the industrial sector developed through different price increments for different consumer groups. Beginning in January 2007 gas prices for the industrial sector was supplemented by a target increment of 2%, aimed to compensate Naftogaz's losses through a special budget fund. In 2008 this compensation was increased three times (in January, April and June) and reached 12% for industry and 6% for public

organizations of selected chemical industry enterprises and 4% for population<sup>65</sup>. Then beginning in May 2008 another gas price calculation was introduced, this time for industrial consumers – initially it was UAH 86.95 but was increased on 15 October to UAH 121 (without VAT) and aimed to compensate for the cost for gas selling. All of the different incremental increases actually worsened the cross-subsidization situation in Ukraine. However in September 2008 the government temporarily cancelled target increments as part of the anti-crisis measure for approximately 100 selected mining, smelting and chemical enterprises<sup>66</sup>. The privilege is granted until the end of the year when its effectiveness will be analyzed.

The 13.5% gas price increase for the general population in September 2008 is a positive step in reducing cross-subsidization. It was the first price increase since 2006.

**18.4. Ensure cost-recovery tariffs to make investment in energy saving facilities economically effective. Consider two-tier pricing for households in transitory period that is lower price for basic consumption of energy per household and full cost recovery price for consumption above basic level.**

***Partially implemented***

Tariffs on the energy industry exceed the cost-recovery level and allows for the cross-subsidization of the population and housing sector at the expense of machinery and metallurgy. Rapid growth and high demand profited industrial enterprises and gave little reason to invest in energy saving measures. During a recession, however, the stimuli for investing in cost saving are expected to increase significantly.

Household gas prices depend on consumption averages, but cover only the cost of domestically extracted gas, which is kept at an artificially low price. Electricity tariffs for communal purposes do not depend directly on consumption levels but take into account some appliances used at home, like electric cookers and heaters.

**18.5. Improve national energy security by decommissioning obsolete equipment and generating capacity rehabilitation.**

***Some preparatory measures have been undertaken***

The Ukrainian Energy Strategy until 2030 presumes that in the first five years there will be an annual investment of UAH10 billion into the power energy sector. In reality, not even half of this amount was invested in 2006-2007. Today the only source of investments in the electricity sector is an investment constituent in tariffs of “Ukrenergo”,

---

<sup>65</sup> Cabinet of Ministers. Decree of 11 June 2005 No. 442 on approval of the procedure of addition of fee - special-purpose increment on natural gas - to the special fund of state budget (with changes).

<sup>66</sup> Cabinet of Ministers. Decree of 14 October 2008 No. 925 regarding first-priority measures for stabilisation of the mining and smelting and chemical complex situation.

“Energoatom” and distribution companies as well as small part of investment increments which are redistributed to power plants through the budget. Investments from these sources can hardly be increased.

There has been some progress in the coal mining. Parliament provided a state guarantee<sup>67</sup> for technical re-equipment of coal mining enterprises for the sum up to UAH 3.1 billion. The Ministry of the Coal Industry claims negotiations on the capital formation with investment companies has started.

## **18.6. Privatize the energy sector; invite strategic investors.**

### ***Some unsuccessful attempts to implement***

Privatization is a major challenge for energy sector development. Coal-mine privatization will not be described here as it represents a separate topic.

The government initially planned to sell 25-27% of six distribution companies in 2008<sup>68</sup>. Before the sale the government changed the Energy Strategy of Ukraine until 2030 and included the obligation of the investors to increase modernization effectiveness in electricity plants, reduce emissions and finance actions directed to join the European energy system. The auction of 25% of “Poltavaoblenergo” was scheduled on 2 April 2008, but it did not happen since a minority of shareholders blocked the process through a court decision. After this event the government dropped the idea to privatize other energy companies. The auction announcement process and its results were accompanied by mutual fraud accusations by the President, the Government and the State property fund. In 2009 the Cabinet of Ministers planned to sell 25%-60% of the shares in ten distribution companies<sup>69</sup>. However the sale of 60% of shares of four different distribution companies was later suspended by the president’s decree<sup>70</sup> on the basis of strategic importance for national security. These events have not created a transparent and understandable environment for investors. Moreover Ukraine’s existing energy strategy for 2007-2030 is unrealistic given the excessive sector regulations that block potential investors.

---

<sup>67</sup> Law of Ukraine of 2 September 2008 No. 346-VI regarding changes in the budget of Ukraine for the year 2008 and changes in some legislative acts of Ukraine.

<sup>68</sup> Cabinet of Ministers. Decree of 19 March 2008 No. 196 regarding the transfer of holding shares of a public corporation to the State Property Fund.

<sup>69</sup> Cabinet of Ministers Order of 3 December 2008 No. 1517 regarding approval of the list of companies and associations -- which are subject to be sold -- and state enterprises, holding companies and joint stock ventures which are subject to be prepared for sale in 2009.

<sup>70</sup> Decree of the President of Ukraine of 19 December 2008 No. 1178 regarding suspension of certain provisions of the Cabinet of Ministers Order of 3 December 2008 No. 1517.

## **18.7. Foster private sector investment through more open government policy and increased regulatory transparency.**

### ***Not implemented***

As described in 18.5, the budget does not provide sufficient levels of investments into the energy sector. All potential progress is dependent on private investments, which is absent because of i) the long list of investment obligations, ii) incomplete reform of the industry and iii) absence of market mechanisms to predict profitability of investments.

In addition to the lack of improvements in regulatory transparency, the unstable political situation makes the sector development even less predictable, which decreases private investor interest.

## **18.8. Join Union for Coordination of Transmission of Electricity (UCTE) and the Energy Community Treaty; promote Ukrainian convergence with EU regulations in the energy sector to catalyze important reforms, as well as to allow Ukraine to trade more energy with Western neighbors.**

### ***Partially implemented***

There have been some preparatory studies for the Union for Coordination of Transmission of Electricity (UCTE). A working group created in December 2006 is currently working to improve the technical level of Ukraine's energy system and develop a "road map" for the integration process.

On 22 April 2008 ministerial negotiations between Moldova and Ukraine included discussions on joining UCTE. In September 2008 State enterprise "National power company Ukrenergo" announced tender on technical solutions to account for the exchange of power between Ukraine's power supply system and UCTE. Still the Ministry of Fuel and Energy does not expect Ukraine to join UCTE earlier than 2012.

Ukraine's accession to the Energy Community Treaty is regularly discussed at EU-Ukraine meetings, such as EU-Ukraine summit and Energy Community Ministerial Council. Ukraine has been granted observer status which is the first stage of the accession negotiations.

Market transparency and the reliability of transit through Ukrainian territory are currently the main issues in Ukraine's possible membership.

## **18.9. Enact a law enhancing the independence of the National Electricity Regulatory Commission.**

### ***Preparatory measures have been undertaken***

The independent status of the regulator is a very important condition for any strategic investor. In Ukraine this is particularly true because of its political instability and diametrically opposite approaches to economic development from different political forces. Although there is currently no plan to enact a separate law on the special status of NERC, the action plan described in 18.11 presumes a significant increase in its authority.

## **18.10. Reduce the loss of electricity when transmitted through power grids.**

### ***Very modest progress, unconnected to changes in the system***

The level of loss of electricity when transmitted was reduced by 0.21% during the first 5 months of 2008 down to 12.75%, saving 124.2 million kilowatts of electricity.

By the end of September 2008 the total electricity losses on main-line grids reached 56.5 million kilowatt-hours which is 48% more than was planned by "Ukrenergo". Major losses occur on distribution grids because of wear on the grids and, most importantly, lack of control over electricity spending. Excessive wear on the grids is partially caused by outstanding payments due to energy companies resulting in limited or no funds for investment. The lack of control with the current cost-based method of setting tariffs for Oblenergo companies does not stimulate energy savings.

## **18.11. Further develop the Wholesale Electricity Market Concept legislation to allow bilateral contracting.**

### ***Some initial measures have been undertaken***

The Ukrainian wholesale electricity market currently has only one buyer. This system was introduced in 1996 and, up until recently, proved to be very effective. However, the system does not allow the wholesale tariff to be defined by market forces as it involves extensive administrative interventions and does not provide the possibility to choose contracting parties. This restricts market development and does not create the necessary incentives for investments.

In order to increase efficiency the market has to be reformed to follow the Wholesale Electricity Market Concept adopted in 2002. However transformation of the market is not possible without changes in current legislation, but instead of changing the existing legislation the government has developed new laws. According to the Action Plan of Concept Realization<sup>71</sup> new laws are to be developed and adopted by the parliament in 2008-2009, these laws will focus on state regulation of natural monopolies activities in energy sphere, electricity market of Ukraine, as well as changes to laws on electricity and on natural monopolies. In December 2008 NERC upheld regulation projects to ensure the first stage of transition to the new model of electricity market as outlined in the action plan. Proposed changes address entrepreneurial activity of bulk electricity production and supply including those under unregulated tariffs. According to the action plan, NERC will play a much bigger role in the new market scheme, and will be responsible for the development of almost all the rules of market functioning including codes for main and distribution grids, rules for accounting for electricity and the form of bilateral contracts.

---

<sup>71</sup> Cabinet of Ministers. Order of 28 November 2007 No. 1056-p regarding action plan approval of concept provisions for the function and development of wholesale market of electric power of Ukraine.

**18.12. Allow all entities to enter gas transportation agreements and trade gas on national markets at their discretion.**

***Preparatory measures have been considered***

Transportation function of Naftogaz is currently inseparable from its other functions -storage, extraction and selling of natural gas. While internal gas consumers are heavily subsidized, transportation of gas returns some profit. A subsidiary company Ukrtransgaz retains its gas transportation monopoly position and absorbs all the money made on the pipeline. In the result of the common budget of Naftogaz with all its subsidiaries internal gas prices are kept low partially at the expense of transportation profitability. However in agreement with the EU signed by Ukraine in March 2009 separating Naftogaz from Ukrtransgaz is set as a necessary precondition for pipeline modernization. As soon as resources earned by pipeline operator remains at the company's disposal, it will not be crucial for Naftogaz to maintain the monopoly on gas transportation market, which may be considered as a very first step towards right of access for other companies.

**18.13. Amend licensing procedures to provide guarantees on production rights following exploration activities.**

***Measures which conflict with BRAAC recommendation have been attempted***

Licenses for exploration activities, including those on coal extraction, are currently sold at open auctions by the Ministry for Environmental Protection, costs range from USD7.0 million to USD12.0 million and it takes six months to actually receive the license. The deficit for coking coal resulted in a different licensing procedure proposed by the Ministry of Industrial Policy. It involves the introduction of a decreased flat license rate and a significant time reduction to receive the license; however the initiative presumes leases of only five years, which is against the investors' interest. On 3 September, the Cabinet of Ministers rejected the project and sent it back for improvements leaving the issue unchanged.

In May 2008 Ukraine cancelled a contract awarded to the Vanco Company to explore a deep-water shelf off the Crimean peninsula in the Black Sea for oil and gas, citing national security concerns and suspicions of its questionable dealings with the previous government. The deal was Ukraine's first production-sharing agreement and appeared to lead to a conflict of interest rather than achieve energy diversification goals. As of February 2009, several companies including Shelton and CNOOC were at different negotiation stages to extract natural gas from the Black Sea shelf; however the details of the future agreements were not made public and it is possible that those companies will act more like lenders than investors.

## **18.14. Implement Ukraine's coal mine restructuring plan.**

### ***Modest progress in legal base development held back by some inconsistency***

The government developed a concept for coal industry development in which mines would be privatized in groups containing both profitable and unprofitable mines. However privatization attempts were blocked by the President's decree<sup>72</sup> to prohibit privatization of energy enterprises until the program for industry development is adopted. As a step forward, the Ministry of Coal Industry developed a law project "on the development and peculiarities of coal mining enterprises denationalization". The project gives special attention to the privatization process including investment obligations and social protection for miners. However the project was rejected by the Ministry of Economy and State Property Fund and in September 2008 was returned for further improvements.

An additional part of the 2008 restructuring plan was to close down 14 out of 116 state-owned coal mines. The process stopped, after only two of the mines were closed in the first half of 2008, because of a lack of financial resources and opposition from local administrations.

Some of the pilot projects can be considered preparatory work for improvements to coal industry. According to government instructions<sup>73</sup> the Ministry of Coal Industry introduced experimental hourly wages at seven mines around the country. The experiment lasted three months and received poor analysis results. Another pilot project regarding restructuring the industry involves the market price of coal at the Frunze mine.

## **18.15. Provide coal pricing and price controls in conjunction with other energy pricing and the global coal market.**

### ***Partial implementation***

Coal pricing and price controls are conditioned by the low price of Ukrainian coal, which is deliberately kept low to provide industries and the population with cheaper energy. This leads to a deteriorating financial situation for the coal industry followed by increasing arrears, unprofitable results, and an ineffective use of budget resources.

An initiative of the Ministry of Coal Industry began in March 2008 to trade coking coal at auctions which resulted in a 50% price increase.

---

<sup>72</sup> Decree of the President of Ukraine of 6 March 2008 No. 200/2008 regarding the decision of National Security and Defense Council of Ukraine of 15 February 2008 on safeguarding of national interests and national security in privatization sphere and conceptual methods of its realization.

<sup>73</sup> Cabinet of Ministers. Order of 11 June 2008 No. 858-p regarding plan approval of first-priority measures relative to the improvement of safety measures and labour protection on coal and mine-delving enterprises.

In August 2008 the President of Ukraine signed a decree<sup>74</sup> instructing the Cabinet of Ministers to introduce new methodology for setting the price of coal. The new methodology has to account for the energy value of coal, prices for alternative fuel and coal prices abroad. According to the decree the new law has to provide coal trading at the commodity exchange using an open auction procedure. This matches the conception of reforming the coal industry approved earlier by the government<sup>75</sup>.

#### **18.16. Improve the governance and the transparency of the NAK Naftogaz Ukraine system and promote its commercialization.**

##### ***Not implemented***

NAK Naftogaz is Ukraine's biggest company, its revenues in the first half of 2008 reached UAH39 billion, which is approximately 9% of GDP. At the same time it is one of the largest borrowers with UAH14 billion in credits. Beginning in 2005 the company lost money. This fact combined with its huge debts, unpredictability of the company's future in supplying gas to Ukrainian industry, and enormous delays in financial reporting indicates poor company governance. Naftogaz is very dependent on Ukraine's political situation and the government uses the company to support social policies, such as communal tariffs subsidization, leading to financial losses and a lack of transparency. However, the permanent negative economic state of Naftogaz cannot be explained by external factors alone, as was favorable to do in the past. The poor shape of the company is also the result of unsatisfactory governance, lack of transparency, lack of control, and most importantly, the absence of strategic goals.

It needs to be noted that all measures proposed in the latest legislative act on Naftogaz<sup>76</sup> were directed to improve the financial state of the company with special incremental increases on the price of gas, and not on the company's commercialization.

#### **18.17. Increase the use of domestic oil, gas and clean coal technologies (e.g. modern coal to gas technology and cleaner power plant conversion).**

##### ***Not implemented***

Ukraine is a big consumer of natural gas and oil and relies heavily on foreign supply. NAK Naftogaz tries hard to increase domestic production, but outdated equipment and insufficient natural reserves leave little hope for success. The most

---

<sup>74</sup> Decree of the President of Ukraine of 5 August 2008 No. 685/2008 regarding the decision of National Security and Defense Council of Ukraine of 30 May 2008 on the state and perspectives of coal industry development and urgent measures relative to the increase of its labor protection.

<sup>75</sup> Cabinet of Ministers. Order of 14 May 2008 No. 737-p regarding the concept of coal industry reforming.

<sup>76</sup> Decree of the President of Ukraine regarding the decision of National Security and Defense Council of Ukraine of 26 September 2008 on the progress of National security council implementation of 1 February 2008 on measures to improve the financial situation of NAK Naftogaz Ukraine, the natural gas market situation and state of Russian natural gas import negotiations for Ukrainian consumers.

promising projects to decrease foreign dependence involve energy saving initiatives and international cooperation in the Black Sea's shelf development. During 2008 oil extraction and petroleum gas production decreased by 4.7%/y down to 4.2 million tons because of the depletion of resources.

During the same period of time natural gas extraction increased by 1.2% up to 21 billion cubic meters. This was the result of a special policy for capacity expansion, an increase in drilling production and surface arrangements, as well as the stimulation of production, extensive repairs to existing wells and operating previously abandoned holes. However Ukraine's primary gas fields are currently depleted and the majority of gas fields with large and medium reserves have entered a decreasing extraction phase which makes the possibility of any significant increase of on-shore extraction highly unlikely, while offshore reserves remain underexplored and require significant financing.

**18.18. Reconstruct and modernize the transit infrastructure to ensure energy security; promote energy efficiency and provide better metering control for transparency and government.**

***Preparatory measures have been considered***

The need to modernize Ukrainian transit infrastructure has existed for many years, but became even more vital in 2008, when nine months of natural gas transit reached record-breaking numbers (92.6 billion cubic meters, a growth of 15.8%/y). The growth rate dropped in the fourth quarter and by year-end was 3.8%. During 2008 oil transit to Europe reduced by 17.4%/y.

The Ministry of Fuel and Energy is considering both internal and foreign sources of financing for modernization. The main issue with internal financing is the ineffective use of budget resources while foreign investment is considered to be against national interests. Even though it requires significant resources to maintain the Ukrainian transit infrastructure, it is still a very attractive investment opportunity. Russia openly stated its interest in Ukrainian gas pipelines and offered a reduced gas price for a share in the transit system; the Czech Republic and Great Britain are also interested investors. To obtain independent financing, the President called on the European Union to consider participating in the modernization of the transit system to reduce technological losses. The initiatives received a positive response from the EC in December 2008.

The Ministry of State's preliminary assessments estimated reconstruction of the gas transit infrastructure at USD4.5billion. The Ministry of Fuel and Energy does not plan to attract foreign companies to this sector.

However, agreement reached in Brussels with European Union in March 2009 gives hopes for financing from international economic organizations. The agreement on transforming system of gas pipelines into economically and legally separate unit, although

still owned by state, constitutes a substantial progress in economic transparency and predictability of gas transit system and meets European Union standards. New arrangement will allow for calculation of the return on investment and therefore will facilitate to attract capital needed for modernization of the gas transit network.

### **Updated Recommendations:**

18.1 Increase Ukraine's energy security and make Ukraine less vulnerable to energy import price shocks.

18.2 Promote energy efficiency measures by:

- a. Finalize the liberalization process (including tariff reforms) to attract investments;
- b. Implement energy efficiency policies (subject to differences between energy resources and main consumer groups).

18.3 Reduce cross-subsidization among different categories of consumers; eliminate all privileged power (gas) tariffs for industrial users; promote competition.

18.4 Ensure cost-recovery tariffs to make investment in energy saving facilities economically effective. Consider two-tier pricing for households in transitory period that is a lower price for basic consumption of energy per household and full cost recovery price for consumption above basic level.

18.5 Improve national energy security by decommissioning obsolete equipment and generating capacity rehabilitation.

18.6 Privatize the energy sector; invite strategic investors.

18.7 Foster private sector investment through more open government policy and increased regulatory transparency.

18.8 Join Union for Coordination of Transmission of Electricity and the Energy Community Treaty; promote Ukrainian convergence with EU regulations in the energy sector to catalyze important reforms, as well as to allow Ukraine to trade more energy with Western neighbors.

18.9 Enact a law enhancing the independence of the National Electricity Regulatory Commission.

18.10 Reduce the loss of electricity when transmitted through power grids.

18.11 Further develop the Wholesale Electricity Market Concept legislation to allow bilateral contracting.

18.12 Allow all entities to enter gas transportation agreements and trade gas on national markets at their discretion.

18.13 Amend licensing procedures to provide guarantees on production rights following exploration activities.

18.14 Implement Ukraine's coal mine restructuring plan.

18.15 Provide coal pricing and price controls in conjunction with other energy pricing and the global coal market.

18.16 Improve the governance and the transparency of the NAK Naftogaz Ukraine system and promote its commercialization.

18.17 Increase the use of domestic oil, gas and clean coal technologies (e.g. modern coal to gas technology and cleaner power plant conversion).

18.18 Reconstruct and modernize the transit infrastructure to ensure energy security; promote energy efficiency and provide better metering control for transparency and government.

18.19 Activate transparent licensing for offshore extraction of gas and oil.

18.20 Introduce financial stimuli to promote energy savings for regional distribution companies.

18.21 Specify privatization conditions for co-generation plants and small hydropower plants.

18.22 Enact a law to use alternative energy sources.

18.23 Introduce regulation of land allocation for energy objects including transmission lines.

18.24 Stimulate rules for wholesale electricity market elaboration by NERC.

18.25 Diminish the influence of political changes on the energy sector's economy.

### III. LOGISTICS

**The Blue Ribbon Analytical and Advisory Centre (BRAAC)** was created in 2005 to assist Ukrainian authorities in implementation of recommendations of the Blue Ribbon Commission for Ukraine. The mission of the Centre is to support the next generation of social and economic transformations in Ukraine by assisting policy formulation, building capacity of national stakeholders and energizing, and facilitating a broad dialogue on economic development issues.

**Director:** Marcin Swiecicki, marcin.swiecicki@undp.org, tel. +380-44-253-5482;

**Contact person:** Andriy Zayika, andriy.zayika@undp.org, tel. +380-44-253-5866

Other BRAAC publications are available at <http://brc.undp.org.ua>