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*Marek Dabrowski*

**Ukraine at a Crossroads**

*Warsaw, September 2007*



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## **Abstract**

The Orange Revolution in the fall of 2004 built great hopes for a better future for Ukraine. However, three years later those hopes have been replaced by disappointment, frustration and confusion. Although progress in the areas of political freedom, pluralism, civil rights and freedom in the media remains unquestionable the record of economic, institutional and legal reforms is much more problematic. The key macroeconomic indicators are not better than they were few years ago and the business climate has barely improved. The WTO accession process remains incomplete. The perspectives of Euro-Atlantic integration are continually subject to heated domestic political controversies. The political situation remains unstable, mostly due to the hasty constitutional changes that were adopted during the Orange Revolution.

The purpose of this paper is to analyze the state of the Ukrainian economy at the end of 2007 and reflect upon what kind of reform program the Ukrainian government should consider, regardless of its political color. The reforms suggested in this paper involve a broad agenda of macroeconomic, social, structural and institutional measures. This agenda goes beyond the purely economic sphere and also addresses issues of legal, administrative and political reforms. The politics and political economy of any future reform effort will not be easy because the country is deeply divided in political, cultural, regional and ethnic terms. In such an environment, crucial reforms and strategic decisions will require a wider cross-party political consensus.

## Introduction

The Orange Revolution in the fall of 2004 built great hopes for a better future for Ukraine, both within its borders and in its relations with other countries. The analogy with the series of peaceful revolutions that took place in Central Europe in 1989, often referred to as the “Autumn of Nations,” seemed obvious for many observers. Expectations that Ukraine would follow the path of its more successful post-communist neighbors were high.

Three years after this great event, those hopes have been replaced by disappointment, frustration and confusion. Although progress in the areas of political freedom, pluralism, civil rights and freedom in the media remains unquestionable (although not irreversible – see below) the record of economic, institutional and legal reforms is much more problematic. The key macroeconomic indicators are not better than they were few years ago and the business climate has barely improved. The WTO accession process remains incomplete. Although the perspectives of Euro-Atlantic integration seem slightly better than before, they are continually subject to heated domestic political controversies.<sup>1</sup> The political situation remains unstable, mostly due to the hasty constitutional changes that were adopted during the Orange Revolution. The lengthy political stalemate which began after the March 2006 parliamentary elections was finally resolved through the formation of a majority government at the beginning of August 2006. Yet this did not put an end to the ongoing constitutional conflict between the strengthened Prime Minister and weakened President. On the contrary, the next round of this conflict erupted in the spring of 2007 and led to early parliamentary elections at the end of September 2007. At the time of writing this paper (early September 2007), the question of whether the new parliament will be able to form a stable and reform-committed majority remains unanswered. Furthermore, independent observers are expressing doubts over whether the September 2007 election will be as clean and fair as the March 2006 election appeared (NDI, 2007).

In this paper, I argue that the current problems should not be surprising given the previous poor reform record and the persistent difficulties in building a broad political consensus in favor of a systematic pro-market and pro-democratic transition. The Orange Revolution was not the first political window of opportunity which was lost for reforms. The same happened immediately after Ukraine gained independence in 1991-1993, and after the presidential elections in 1994. Even the most reform-oriented cabinet so far, appointed in

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<sup>1</sup> This relates, in particular, to future NATO membership, which has been questioned by the parties forming a parliamentary majority in the parliament elected in March 2006.

1999 and led by Prime Minister Victor Yushchenko, had a very short political life (only 16 months) and limited political ability to implement crucial reforms.

Why does Ukraine face such major problems in building a stable pro-reform coalition and implementing market-oriented economic reforms in a systematic way (in comparison to other post-communist countries)? The answer to this question would require a complex historical, political and sociological analysis and would need to consider factors such as ethnic, language and regional differences. Unfortunately, taking into account my economic background and experience, this is not a task which I am willing to attempt.

Rather, the purpose of this paper is to analyze the state of the Ukrainian economy at the end of 2007, sixteen years after gaining independence and three years after the victory on the Maidan,<sup>2</sup> and reflect upon what kind of reform program the Ukrainian government should consider, regardless of its political color.

The paper is structured as follows: Section 2 offers a historical overview of Ukraine's transition after independence, including the period following the Orange Revolution. Section 3 deals with the macroeconomic problems of Ukraine's economy, including the limited results of the anti-inflationary effort and the inconsistency of the actual monetary/exchange rate regime, fiscal imbalances and high level of fiscal redistribution of GDP, excessive social welfare commitments which remain the root cause of the actual and future fiscal tensions. In Section 4, I analyze the sources of the poor business climate in Ukraine and evaluate policy measures which could help overcome this major obstacle to future rapid growth. To a large extent, the effectiveness of these policies will depend on the reforms of state institutions, including the legislative, executive and judiciary branches of government, as well as administrative reform in local and regional self-governments (Section 5). In Section 6, I will turn to perspectives for Euro-Atlantic integration. The discussion will include the geopolitical aspect, the aspect most frequently and heatedly discussed, but will also touch on other elements which can help to anchor the domestic reform process (particularly in the institutional sphere), which will determine Ukraine's position in the international division of labor for many decades to come. Section 7 will present final conclusions and policy recommendations.

In the paper, I will draw mostly from my own experiences in the area of policy research and policy advising in numerous post-communist countries over the last 20 years, including my extensive engagement in Ukraine's reforms since 1993. However, even the

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<sup>2</sup> Maidan Nezalezhnosti (the Independence Square) in Kiev where the main events of Orange Revolution took place became the symbol of this revolution and its victory.



best personal insight is not sufficient to give a complete picture of a country's problems and, most importantly, a comprehensive set of policy recommendations. Drawing on the analyses, observations and proposals of other experts is an obvious necessity and thus I have drawn on the research of economists from CASE and CASE Ukraine. In the historically crucial period of 2004-2006, I participated in joint-research projects with distinguished scholars and experts involved in the UNDP Blue Ribbon Commission project (which resulted in two comprehensive reports – see UNDP 2005a, 2005b) and the UNDP-sponsored Blue Ribbon Commission II International Advisory Group, coordinated by CASE and CASE Ukraine.<sup>3</sup> This study partly draws on several detailed studies and analyzes conducted under this project<sup>4</sup>.

When relevant, I will make more detailed references to particular sources of information, opinions and recommendations. However, I assume sole responsibility for this paper's content and quality. The presented opinions and recommendations are entirely my own and do not necessarily reflect the position of my colleagues, CASE, CASE Ukraine, UNDP and the other institutions with which I have cooperated.

## **1. The history of the Ukrainian transition: a comparative perspective**

### **1.1. The 'lost decade' of the 1990s**

Of all the former communist countries, Ukraine's transition to a market economy has been one of the most difficult and painful. Adaptative output decline, an unavoidable phenomenon after the collapse of a command economy, lasted for 10 years in the case of Ukraine (the longest period out of all the transition economies) and amounted to 61.5% (the second largest, after Moldova, among countries not involved in military conflicts – see Dabrowski, 2004b, Table 1). The enormous scale of this so-called 'transformation recession' is largely due to the unfavorable starting conditions, i.e. the costs of overcoming Soviet structural distortions and institutional legacy. The exceptional length of output decline was caused by a slow and unsystematic pace of reforms in the 1990s.

The first years of Ukrainian independence under the presidency of Leonid Kravchuk (1991-1994) were almost totally lost in terms of market transition. This was in sharp contrast with the rapid economic reforms in the Baltic countries at the same time, which had quite similar starting conditions to those of Ukraine. A lot of political energy was spent on the superficial transformation of the former Soviet institutions into the Ukrainian (national) ones,

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<sup>3</sup> See [http://www.case.com.pl/strona--ID-ukraina,projekt\\_id-8820735,nlang-710.html](http://www.case.com.pl/strona--ID-ukraina,projekt_id-8820735,nlang-710.html);

<sup>4</sup> I would like also to thank Paulina Szyrmer for her excellent editorial assistance in preparing this paper.

instead of building and importing the institutions of liberal capitalism from the West, as was done in Central Europe and the Baltic region.

Economic policy was dominated by populism: irresponsible social entitlements, price controls, subsidies and other spending commitments, huge fiscal deficits, multiple exchange rates, netting-out operations (*vzaimozachet*), crediting loss-making state owned enterprises, and money printing.

As a result, Ukraine suffered hyperinflation at the end of 1993 (see Dabrowski, 1994). By December 1993, twelve months of inflation amounted to 10.155%. It was the fourth highest in the post-communist world (see Dabrowski, 2003: 9). The cumulative inflation during the first five years of transition (December 1991 – December 1996) was one of the highest even among CIS countries (Koen & De Masi, 1997). Privatization became effectively frozen and trade liberalization was only partly implemented. In terms of the overall transition progress, Ukraine lagged behind not only Central Europe and the Baltic countries, but also behind Russia and smaller CIS countries such as Kyrgyzstan, Armenia, Moldova and Georgia.

The fall of 1994 and 1995 (after 1994 Presidential elections ended with the victory of Leonid Kuchma), brought the first more comprehensive attempt to speed up the transition process. This included price liberalization and exchange rate unification, limited trade liberalization, and credit tightening. The authorities also curbed fiscal deficit, introduced a new currency (*hryvna*), and launched a large scale voucher privatization program. However, the pace of implementation was rather slow and uneven, due to frequent changes in the composition of the government and extensive political bargaining.

When the perspective of economic recovery seemed to be around the corner, Ukraine suffered a serious currency and debt crisis in the second half of 1998 and beginning of 1999, following similar developments in Russia and many other CIS countries. This delayed economic take off by at least one year.

The 1998-1999 crisis proved that the earlier fiscal adjustment was insufficient, and the recently achieved exchange rate and price stability - unsustainable. In fact, the macroeconomic fragility of the second half of the 1990s was deeply rooted in the microeconomic, structural and institutional spheres. Economic recovery was delayed due to slow privatization, soft budget constraints, lack of payment discipline (particularly in an energy sector), tax, budget, wage and pension arrears, widespread barter and netting out operations, using money surrogates, and persistent trade barriers. These phenomena also had a negative impact on fiscal and monetary equilibria. (see Dabrowski et al., 1999).

## 1.2. Rapid post-recovery catch up in the early 2000s

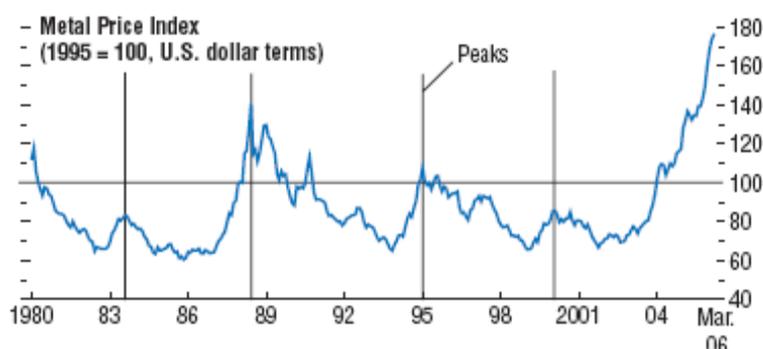
Finally, the post-adaptation growth recovery came at the end of 1999, almost 8 years later than in Poland, 7 years later than Slovenia, 6 years later than the Czech Republic, Slovakia, Hungary and Armenia, 5 years later than Estonia, Lithuania, and Georgia, 4 years later than Latvia, Azerbaijan, and Kyrgyzstan, and with a only a half year lag, when compared with Russia (Dabrowski, 2004b). A unique feature of the Ukrainian recovery was its exceptionally high rate of growth in 2000-2004 (one of the highest in the region). Parallel to the high rate of economic growth, some other key macroeconomic indicators (current account balance, international reserves of the NBU, exchange rate, inflation, fiscal deficit, public debt to GDP ratio) represented either a good or at least an acceptable record (see **Table 1**)<sup>5</sup>.

**Table 1: Ukraine: Basic Macroeconomic Indicators, 1999-2007**

Indicator	1999	2000	2001	2002	2003	2004	2005	2006	2007f
real GDP growth in %	-0.2	5.9	9.2	5.2	9.6	12.1	2.6	7.1	6.8
annual inflation in %	19.2	25.8	6.1	-0.6	8.2	12.3	10.3	11.6	11.3
UAH/USD exchange rate, eop	5.22	5.4	5.3	5.33	5.33	5.31	5.05	5.05	5.05
current account balance in % of GDP	5.3	4.7	3.6	7.7	5.8	10.6	3.1	-1.5	-3.8
fiscal balance in % of GDP	-1.5	-0.6	-0.3	+0.7	-0.2	-2.9	-1.7	-0.7	-1.9

Source: Ukrainian Economic Outlook (UEO), subsequent issues, [http://www.case-ukraine.com.ua/index.php?mode=static\\_page&pid=10](http://www.case-ukraine.com.ua/index.php?mode=static_page&pid=10)

**Figure 1. Composite metal price index, 1980-2006**



Source: WEO (2006 April), Figure 1.24, p.62

The high growth rate and positive macroeconomic developments of the early 2000s may be attributed to several factors (see Dabrowski, Jakubiak et al., 2003). Part of them had

<sup>5</sup> In preparing the macroeconomic part of my analysis I drew extensively from statistical data, information and opinions provided in the “Ukrainian Economic Outlook,” a quarterly publication produced by a team of experts from CASE Ukraine (see [http://www.case-ukraine.com.ua/index.php?mode=static\\_page&pid=10](http://www.case-ukraine.com.ua/index.php?mode=static_page&pid=10)), led by Dmytro Boyarchuk. However, the earlier disclaimer on my sole responsibility for the content and quality of this paper also applies to this particular component.

a temporary (windfall) character and were generated by factors such as import substitution and real depreciation of a significant part of the budget expenditure commitments as a result of the 1998-1999 *hryvna* devaluation. Other windfall factors such as high international prices of metallurgy products (see **Figure 1**), and indirectly - through Russia's import demand - high international oil prices, persisted over the entire period analyzed.

Beyond the windfall factors, the Ukrainian economy began to benefit, at last, from the reform efforts undertaken in the second half of 1990s, particularly from the privatization of the manufacturing industry, trade and service sectors, and agriculture (though the latter was privatized with a significant delay and has numerous remaining barriers). On the top of this, the second wave of reforms undertaken mostly in 2000-2001 by the cabinet of Victor Yushchenko helped to address some of the afore-mentioned structural and institutional flaws of the Ukrainian economy. This relates, in the first instance, to an improved budget, tax and payment discipline, including energy payments and other infrastructure services. Secondly, the simplified tax regime and some progress in the area of deregulation helped in the development of small and medium size enterprises (SME) and pushed many small businesses to legalize their previously unregistered economic activity in 2000-2001.

The early years of 2000s also brought an intensification of cash privatization in the metallurgy, chemical and petrochemical industries and partly in the energy distribution sector. However, this process lacked sufficient openness and transparency and was subordinated to the interests of those oligarchs who were closely associated with the President and Government. Corruption and nepotism had to provoke an anti-privatization backlash during and after the Orange Revolution (see below). The metallurgical giant Krivorozhstal became the most spectacular example of non-transparent and unfair privatization of the late Kuchma presidency. It was sold in 2004 to the consortium formed by the System Capital Management and Interpipe (two biggest oligarchic conglomerates very close to President Leonid Kuchma and Prime Minister Viktor Yanukovich) for USD 800 million (see Paskhaver & Verkhovodova, 2006). Renationalized a year later it was sold again in October 2005 in the open and transparent international tender to the Mitall Steel Germany GmbH for USD 4.8 billion (six times more).

Finally, in 2004, Ukraine launched a Russian-type reform of the personal income tax (with single tax rate of 13%), which created the opportunity to make the tax system more business-friendly and limit incentives to move to a shadow economy. However the remaining elements of the tax system and the entire system of tax administration remained hostile to business activity and continued to be perceived as one of the major sources of corruption and poor investment climate (Golodniuk et al., 2005).



In 2004, the year of the presidential elections, the rate of GDP growth (12.1%) reached its highest historical level in independent Ukraine, due to very favorable external factors and at the cost of deteriorating domestic macroeconomic equilibria. The high international demand and high prices for metallurgical products were additionally supported by an exchange rate policy conducted by the NBU: pegging the hryvna to the USD meant its nominal depreciation to other currencies at that time.

Loose monetary and fiscal policies boosted private consumption and the latter became the main engine of economic growth in 2004 and 2005. Most of the rapidly increasing budget spending was directed to increase public sector wages and salaries and social transfers, which had unavoidable inflationary consequences. After reaching its lowest (i.e. negative) level in the summer of 2002 (mostly due to exceptionally good harvest in 2001 and rapid decrease in food prices), the annual CPI inflation systematically increased, already reaching two-digit levels in Q3 2004. Inflation began to decelerate only in the fourth quarter of 2005

### **1.3. Economic Developments after the Orange Revolution**

Economic developments during and after the Orange Revolution were characterized by contradicting trends and decisions, such as: (1) the increased fragility of property rights on top of a political campaign demanding the review and revision of major privatization deals conducted under the Kuchma presidency; (2) the halt of the privatization process; (3) the elimination of many tax distortions; (4) social populism; (5) some progress in WTO accession and EU integration; (6) and increased inflow of FDI.

As mentioned in the previous subsection, unfair and intransparent privatization practices under Kuchma's presidency triggered the revolutionary demand to review the past deals and return "stolen" national property to the Ukrainian state. Renationalization calls have been shared by virtually all the leaders of the Orange revolution<sup>6</sup>. However, many of them withdrew their support for renationalization during the course of 2005, after realizing how dangerous this idea was for the investment climate. The differences in views between individual politicians related to the scale of revision of the past deals: from just a few of the biggest and most spectacular transactions to hundreds or thousands (see Paskhaver & Verkhovodova, 2006 for details of this debate).

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<sup>6</sup> In Ukraine the notion of "reprivatization" is used rather than "renationalization". The former implies that renationalized property will be privatized again soon (as really happened in the case of Krivorozhstal). However, outside Ukraine, "reprivatization" usually has a different meaning – the restitution of private ownership in relation to property nationalized by communist regimes in the past. To avoid confusion, I will use the term "renationalization" as it better reflects the essence of the analyzed phenomenon – reversing the previous privatization transaction by the state (regardless of the subsequent steps in respect to the seized property).

The first post-revolutionary Prime Minister Yulia Timoshenko became the main and most aggressive advocate of large-scale renationalization in the first half of 2005. After her dismissal in September 2005, the new Prime Minister Yuriy Yekhanurov undertook a mostly successful effort to calm down emotions and uncertainty created by the renationalization campaign. Even if the actual renationalization on the national level has been limited to the three major cases so far,<sup>7</sup> the entire debate and controversy seriously deteriorated the perception of property rights protection, which had already been poor prior to the campaign. In addition, a tendency to question past ownership transactions spread throughout the country, undermining property rights on the local level<sup>8</sup>.

The negative growth effects of the renationalization campaign and some of the other populist moves made by the Timoshenko government (attempts to impose an administrative price control of oil and meat products in spring 2005) could not surprise anybody. If one looks for quarterly GDP data, the annual growth rate reached its highest level in Q3 2004 (14.2%), then rapidly decelerated: to 9.1% in Q4 2004, 4.9% in Q1 2005, 3.4% in Q2 2005, 1.4% in Q3 2005, 1.7% in Q4 2005. Recovery came in 2006: GDP started accelerate again quarter by quarter – 4.1% in Q1 2006, 6.8% in Q2, 6.9% in Q3, 9.5% in Q4 and 8.0 in Q1 2007 (UEO, 2007 Q2, table 1, p.38). Investment stagnation and negative net export proved an effective counterweighted to the highly dynamic private consumption of 2005.

Political instability and the controversy around past privatization deals also paralyzed the new privatization projects. Apart from very high revenue obtained from the repeated Krivorozhstal tender (see above) few other minor transactions brought a limited amount of budget proceeds in 2005 and 2006 (see Paskhaver & Verkhovodova, 2006). The first major privatization decision in respect to six regional energy distributing companies was taken by the Cabinet of Ministers only in April 2007.

In the fiscal policy sphere Timoshenko's government undertook several measures aimed at disciplining the revenue side: they eliminated numerous tax loopholes (like free economic zones), tax exemptions and special tax regimes<sup>9</sup>, increased discipline and started to fight corruption in the tax and customs administration, decreased and simplified import tariffs, etc. As result, the total revenue of the consolidated budget (not including the Pension Fund) increased from 26.5% of GDP in 2004 to 32.0% in 2005 (UEO, 2006 Q1, Table 8.1, p.

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<sup>7</sup> I.e. Krivorozhstal, the Insurance Company "Oranta" and the Nikopol Ferroalloy Plant (unfinished case) - see Paskhaver & Verkhovodova (2006).

<sup>8</sup> The low level of professionalism, widespread corruption and systemic chaos in the judiciary further undermined the stability of property rights.

<sup>9</sup> Part of this progress was reversed in 2006 and 2007.

15). Increasing tax discipline and eliminating numerous tax distortions (meaning a more equal treatment of various categories of taxpayers) should be considered a great policy success. On the other hand, additional revenues have been immediately spent on wage and pension increases and other social programs instead of decreasing general tax rates or eliminating the most distortive taxes.

**Table 2: Dynamics of social expenditures (2002-2005) in % of GDP**

Item	2002	2003	2004	2005	2005-2002
GG expenditure	37.7	38.7	41.1	45.2	+7.5
Social protection	15.6	14.8	16.6	20.9	+5.3

Source: IMF (2007c), Table 18, p.22

The major expansion of social transfers (see **Table 2**) resulted from both the populism of Yanukovich’s government in 2004 and the additional wage and social obligations adopted by the new administration already after the Orange Revolution (for example, transfers of ca. USD 1,500 for each new-born child). If not for higher-than-expected inflation in 2005, which helped to limit the real fiscal consequences of the new social commitments in the short-term, the real expenditure expansion would be even higher. In the longer term, the already-granted social entitlements, especially those related to a pension system, are fiscally unsustainable (see Section 3).

In early 2005, President Yushchenko launched a very aggressive diplomatic campaign in order to bring Ukraine closer to the European Union and NATO. It resulted, among other things, in signing the EU-Ukraine Action Plan in February of 2005 (under the umbrella of the European Neighborhood Policy) and obtaining Market Economy Status in the EU and US for anti-dumping purposes. However, implementation of the Action Plan is moving with a mixed speed and effects (see Jakubiak, Kolesnichenko et al., 2006). Accession to the World Trade Organization is an important condition and milestone on the road to future trade liberalization between the EU and Ukraine. Although the negotiations are advanced, the accession has not been completed yet, mostly due to legislation obstacles faced by subsequent governments in the Verkhovna Rada<sup>10</sup>. The NATO accession process was effectively frozen by Prime Minister Victor Yanukovich in the second half of 2006.

In spite of the limited progress in improving business climate, the rather slow pace of Euro-Atlantic integration and a high level of political uncertainty, the post-revolutionary period brought an increase in foreign direct investment (FDI), particularly in the financial sector. The FDI annual inflow increased from USD 1.4 billion in 2003 and 1.7 billion in 2004 to USD 7.5

<sup>10</sup> The full list of the proposed legislative changes is presented at UEO (2006 Q3), Table 2.8.1

billion in 2005 (including the *Krivorozhstal* transaction of USD 4.8 billion) and USD 5.3 billion in 2006 and reached the cumulated stock of some USD 22 billion (about USD 470 per capita) by the end of 2006 (UEO, 2006 Q1, p. 19; UEO, 2007 Q2, Table 9, p.46 and author's own estimation). This is still below the level achieved by the Central European, Baltic and Balkan countries but may signal an improving international perception of Ukrainian economic perspectives and the further acceleration of FDI inflow in future. A parallel increase in net portfolio investment has been also recorded (Lozovoi & Kudina, 2007).

## 2. Medium and Long-Term Macroeconomic Challenges

A superficial analysis of key macroeconomic indicators (see Table 1) may suggest that Ukraine will not face serious macroeconomic tensions in the near future. However, such an opinion would be wrong. The period of post-adaptation output recovery associated with the fast remonetization of the economy and the high pace of budget revenue increase seems to be over. Fundamental inconsistencies in the actual monetary/exchange rate regime, which systematically cumulated during the past seven years, will become even more harmful with the increasing financial and investment openness of the Ukrainian economy. Modest fiscal imbalances will also become more acute if economic growth decelerates at some point<sup>11</sup> and as result of unfavorable demographic trends. These challenges need an adequate and timely response if Ukraine wants to avoid more serious macroeconomic tensions in the future.

### 2.1. Looking for a more consistent monetary regime

As mentioned earlier, Ukraine has had problems in bringing inflation to a sustainable low one-digit level. This seems to be closely linked to the fundamental problems and inconsistencies experienced by monetary policy. If one looks into money supply statistics, one will find a very high growth rate of monetary aggregates through the entire post-1998-1999-crisis period. A broad money aggregate M3 increased by 35.1% in 1999, 46.4% in 2000, 37.7% in 2001, 42.8% in 2002, 47.9% in 2003, 44.9% in 2004, 38.6% in 2005 and 39.2% in 2006. Monetary base grew by 41.4% in 1999, 39.1% in 2000, 35.3% in 2001, 42.0% in 2002, 29.0% in 2003, 36.5% in 2004, 37.8% in 2005 and 25.0% in 2006 (UEO 2005 Q4, Table 14, p.47; 2006 Q3, Table 14, p.45; 2007 Q2, Table 14, p.51). The faster rate of the growth of M3 than the monetary base reflected increasing financial intermediation and, therefore, of the money multiplier: from 1.91 in 2000 to 2.66 in 2006 (UEO 2007 Q2, Table 14, p.51). The rapidly growing official international reserves of the National Bank of Ukraine

<sup>11</sup> Referring to an analytical framework frequently used in more developed market economies one can argue that the "cyclically adjusted" fiscal deficit has been higher than the actual one. While the question of whether Ukraine's economy has already experienced a regular business cycle is highly debatable, there is little doubt that high growth rates in 2000-2004 and 2006-2007 helped to mask actual fiscal imbalances.



(NBU) (up to USD 27375.39 million at the end of July 2007<sup>12</sup>) were the main factor contributing to this extraordinary pace of monetary expansion, in spite of quite intensive sterilization in 2004-2005 which was mostly aimed at reducing the NBU net claims to government.

This brings us to an exchange rate policy which focused on defending the hryvna against appreciation pressure through the entire post-crisis period<sup>13</sup>. The UAH/USD nominal exchange rate was relatively stable through the entire 2000-2007 period, with one discretionary revaluation conducted in March and April 2005 (from 5.30 to 5.05 UAH for 1 USD), which partly offset the inflationary effects of substantial USD depreciation vis a vis the EUR in 2003-2004.

As any exchange rate target in an economy with a high degree of de facto capital mobility,<sup>14</sup> the fixed but adjustable peg of the UAH to the USD makes money supply and inflation mostly exogenous, i.e. outside the central bank's control. On the other hand, the UAH/USD peg helped in rapid remonetization: M3/GDP more than doubled – from 19.0% in 2000 to 49.8% in 2006 (UEO 2007 Q2, Table 14, p.51), which absorbed most of the rapidly growing money supply. However, the dollarization of commercial banks assets and liabilities remains high<sup>15</sup>. The same seems to be true for cash transactions although, for obvious reasons, this observation is based on anecdotal evidence rather than on comprehensive statistics. Political turbulences and subsequent election campaigns caused periodical confidence mini-crisis and flights from hryvna to dollar (the biggest one was observed in November and early December 2004).

One can argue that a fixed exchange rate provides an automatic mechanism which adjusts the money supply to money demand through a balance-of-payments channel and it should sooner or later bring a far-reaching inflation convergence with an anchor currency area<sup>16</sup>. This is true in the case of stable and credible pegs, mostly the so-called “hard pegs”, i.e. currency boards or adopting either a common currency or other country's currency.

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<sup>12</sup> [http://www.bank.gov.ua/ENGL/SDDS/Dates/dates\\_e.htm](http://www.bank.gov.ua/ENGL/SDDS/Dates/dates_e.htm)

<sup>13</sup> This pressure was additionally enhanced by the substantially undervalued exchange rate of the hryvna after the 1998-1999 financial crisis.

<sup>14</sup> Formally, Ukraine continues various capital account restrictions but their effectiveness in controlling capital movement is very problematic.

<sup>15</sup> According to the IMF (2005b, Table 4, p. 76) while the share of foreign exchange deposits in total deposits decreased from 39.0% at the end of 2000 to 32.1% in June 2005 the similar ration for foreign exchange denominated credits increased from 33.8% to 38.0 for the same period.

<sup>16</sup> Under a fixed exchange rate regime inflation differences can originate from: (i) initial under- or overvaluation of fixed exchange rate, i.e. PPP differences in respect to tradables; (ii) Balassa- Samuelson effect; (iii) changes in exchange rates between major currencies if a country's foreign trade transactions are denominated in various currencies.



Ukraine's soft peg is far from this model because (i) the exchange rate can be formally changed at any time; (ii) NBU continues operations on its domestic assets.

The current monetary/ exchange rate regime belongs to the broad category of intermediate (hybrid) regimes, which seem to be incompatible with mostly unrestricted capital mobility. Its first flaw is that hybrid regimes are unlikely to provide the same advantages as pure ones, i.e. neither an exchange rate anchor nor sufficient discretion in managing domestic liquidity. Second, compromised regimes are technically very difficult to manage because of fluctuating demand for money and changing market expectations. Moreover, political pressure may cause temptation to go beyond the compromise. Third, the transparency, and, therefore, the credibility of intermediate regimes is lower than that of the 'corner' solutions. This last weakness has been evident in financial crises of the 1990s (see Dabrowski, 2001 for general discussion; Jakubiak et al., 2005 in respect to Ukraine).

As a result, hybrid regimes may provoke a speculative attack against the hryvna at the time of serious macroeconomic or political turbulences. The afore-mentioned episodes of political instability and speculative pressure on the foreign exchange market (for example, at the end of 2004) provide clear evidence that this is not a purely hypothetical threat.

Thus, Ukraine should depart from the current hybrid regime towards one of the 'corner' solutions as fast as it can by either choosing a sovereign monetary policy with a free float or adopting a 'hard' peg (see Frankel, 1999; Mundell, 1999; Krugman, 1999; Eichengreen, 1999). The IMF (2005a, pp. 21-22) supports the first option and recommends moving to direct inflation targeting (DIT) and a flexible exchange rate. This regime has been tried in recent decade in a number of transition and developing countries (including the Czech Republic and Poland) and has brought satisfactory disinflation results.

However, adopting DIT requires a lot of preparatory steps (see IMF, 2005a, Box 2, p. 22) such as implementing legal and institutional changes (a higher degree of NBU independence from both executive and legislative branches of government), developing and deepening the money and foreign exchange market, liberalizing capital accounts, moving to a free floating exchange rate, making radical changes in the monetary policy operational framework and instruments, developing statistical, analytical and forecasting capacities of the NBU and independent analytical centres. Some of these steps, like making the exchange rate flexible, may prove politically difficult to carry out. All of them will take time: approximately 2-3 years from the beginning of implementation to complete adoption (see Dabrowski, 2006).

The opposite ‘corner’ solution, i.e. a ‘hard’ peg seems to be technically easier to adopt as it would continue using the existing exchange rate anchor. However, its adoption would require, however, abandoning any discretionary monetary policy operations (in fact, giving up sovereign monetary policy and any active role for the NBU in this sphere) and fixing the exchange rate forever. This should involve a serious discussion on the choice of an anchor currency; while the US dollar is the dominant currency of global financial transactions and investment decisions, as well as savings and trade with CIS and developing countries, the importance of the Euro will increase after Ukraine’s deeper trade and economic integration with the EU.

Both ‘corner’ solutions have their advantages and disadvantages (see Dabrowski, 2004) which must be balanced and analyzed carefully before making a definite regime choice decision.

## **2.2. Fiscal policy dilemmas**

Fiscal expansion constituted another important source of inflationary pressure. Until 2003, the Ukrainian budget was relatively balanced with the deficit not exceeding 1.5% of GDP (see Table 1) although in conditions of such a high rate of economic growth it should record a substantial surplus rather than deficit. Due to new expenditure commitments, the fiscal situation deteriorated dramatically in the second half of 2004 during the election campaign and Orange Revolution,. In Q4 2004, fiscal deficit accounted for 8.5% of GDP and for all of 2004 it amounted to 2.9% of GDP. As mentioned in Section 2.3, expenditure expansion continued in 2005 but was counterbalanced by the fact that revenues were increasing even faster, which helped to bring some fiscal consolidation (fiscal deficit of 1.7% GDP). Similar trends, i.e. rapidly increasing expenditures and even faster-growing revenues<sup>17</sup> were observed in 2006.

As a result, Ukraine has already joined the group of high-spending countries of Western and Central Europe, disregarding its much lower level of income per capita, when compared to those countries. This will not help in sustaining a high rate of economic growth as higher expenditures must mean higher taxes sooner or later (see below). This, in turn, will decrease the rate of private saving and investment, push business activity to the “shadow” zone, and decrease labor market participation (see Rohozynsky, 2007).

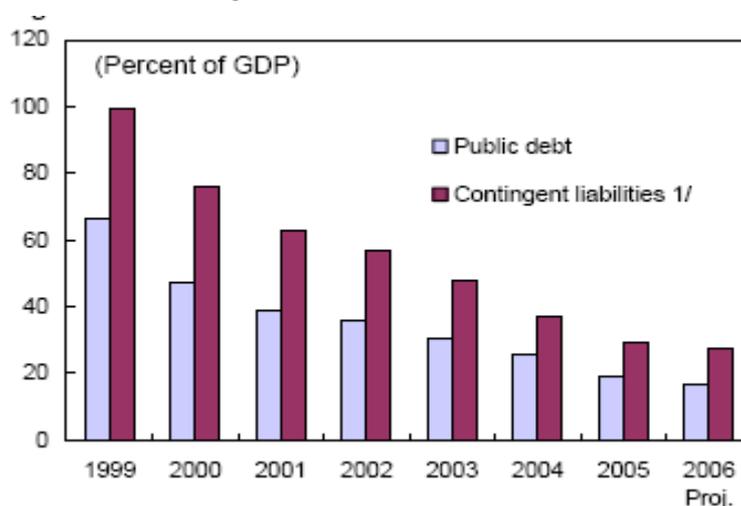
The level of public debt is not very high by international standards and is continuously diminishing in relation to GDP from its peak level in 1999, i.e. immediately after the currency

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<sup>17</sup> Acceleration of economic growth also contributed to a rapid increase in revenue in 2006.

crisis and near-default (see Figure 2). The government can borrow relatively cheaply on both domestic and international financial markets. However, this quite comfortable picture will not necessarily last forever. First, the early 2000s were marked by extraordinary low interest rates and financial calm on international markets. At least the first part of this characteristic seems to be definitely over: interest rates are systematically going up. Second and more important, apart from official public debt, Ukraine accumulated the substantial implicit debt of the PAYG pension system (unfunded pension liabilities), which will further increase due to unfavorable demographic trends in the next several decades. The recent expansion of social spending additionally complicates this picture because once granted, social entitlements cannot easily be withdrawn in bad fiscal times. Third, contingent liabilities in the financial sector constitute another form of the implicit public debt. They originated mostly from the political commitment to compensate Ukrainian citizens' heavy losses in the real value of their saving deposits due to hyperinflation in the first years of independence. Although the amount of these liabilities is not precisely determined and is not indexed against the current inflation it still remains at levels well exceeding the official public debt (see Figure 2 and IMF, 2007a, Box 2, p. 17). Furthermore, as this issue continues to be the subject of heated political debate, especially during the subsequent elections one cannot estimate the ultimate fiscal consequences and timetable of its resolution.

**Figure 2. Public debt and contingent liabilities, % of GDP, 1999-2006**



Source: IMF (2007a), Figure 6, p.16

All the above described circumstances urgently call for a new round of substantial fiscal adjustment, which should focus mostly on an expenditure side, especially on social spending. Unfortunately, this has not been the case. The reduction and rationalization of social spending have been consequently opposed by subsequent governments and parliaments over the last fifteen years and these policy ideas have become taboo in

Ukraine's reform debate. Instead, both politicians and professional economists have discussed various scenarios of tax reduction, either totally disregarding their negative revenue consequences, or taking excessively optimistic assumptions in respect to the size and speed of a positive supply-side response (a naive hope in a strong Laffer curve-type effect). A leading motive of many "radical" proposals, especially those elaborated and discussed by the National Committee for Tax Reform (the ad-hoc advisory body appointed by President of Ukraine in 2005) and advertised by Vodomyr Lanovoi, the Advisor to the President of Ukraine (Margalyk, 2005) has been: Cut tax rates and get almost immediately higher tax revenue because of "de-shadowing" of informal economy

It is worth remembering that the original Laffer curve idea (Laffer, 2004) represented a rather supply-side concept: increased output and employment as a result of a lower tax burden. However, in the specific context of transition economy, one can expect an additional effect: the "de-shadowing" of the economy due to lower tax rates, which can bring additional revenue gains (see Walewski, 2001). The "optimists" in a tax reduction debate clearly expect that such a "de-shadowing" would immediately overcompensate losses caused by the reduction of tax rates in the case of an economy with a large unregistered sector like Ukraine. "Skeptics" or "realists" call for a realistic estimation of the positive effect in terms of its expected size and time lag. First, in the case of particular tax one must know at which concrete point of a Laffer curve the Ukrainian economy is at now. This may be not so easy to assess with a wide margin of uncertainty in respect to possible fiscal consequences. Second, taxpayers' reaction will depend not only on the reduction of tax rates but also on many other accompanying measures and factors such as quality of tax administration, expected stability of the new rates and rules, deregulation of business activity, protection of property rights, political stability and predictability, etc. Third, no positive reaction can be expected to happen overnight.

Calls for deep unilateral tax cuts became particularly strong during subsequent election campaigns and in the period of political radicalization following the Orange Revolution. On the other hand, a sharp increase in the level of fiscal redistribution of GDP during and after the Orange Revolution has dramatically narrowed the room for maneuver for any tax reform. A country which redistributes more than 40% of its GDP through its budget and off-budgetary funds, cannot have low and non-distorting taxation, unless the level of public expenditures is substantially reduced.

The additional constraint comes from the structure of public expenditures. As almost half of them are directed towards various forms of social programs and social transfers (see **Table 2**) this limits the room for reduction of high payroll taxes, which are so direly needed

from the point of view of “de-shadowing” the informal sector and labor relations. The Pension Fund already runs a deficit of around 5% of GDP and cutting the Pension Fund contribution rate without a reduction of pension entitlements would mean a further increase in budget transfers financed from other sources. Hypothetically, such a transfer could be financed from VAT but (i) the VAT rate is already high (20%) and cannot be further increased; (ii) such a maneuver would further weaken the link between pension contributions and future benefits and the chance to build an insurance or quasi-insurance type of pension system.

Without an expenditure reduction, only minor changes in tax rates are possible. First, a further elimination of remaining tax exemptions, of which there are not many (in terms of their value) might allow for some decrease in basic tax rates (enterprise profit tax in the first instance). Second, one can consider moving the tax burden between various taxes, i.e. decreasing the rate of some existing taxes at the expense of increasing others or creating new taxes. While some moves of this kind seem to be possible and justified, one must be extremely careful in estimating their immediate fiscal effects. For example, the introduction of a real estate tax, which would finance local budgets, could create some room for lowering other taxes. However, this kind of reform requires a lot of time and effort before the new tax will become operational.

Some proposals of the tax reform neglect the external institutional constraints such as the consequences of the expected WTO accession or the country’s ambitions to advance its economic integration with the EU. If Ukraine wants to become deeply integrated into a global and European economy and improve its business climate for foreign investors it must make its tax system compatible with the European ones. This means the ideas to replace VAT with a turnover or sales tax advocated by some Ukrainian politicians and lobbyists during subsequent election campaigns will go exactly in the opposite direction (besides the many other serious flaws of this proposal).

Apart from a fiscal adjustment based on expenditure reduction, Ukraine needs a further strengthening of fiscal management rules, which would help to avoid continuation of fiscal imbalances and further build up of explicit and implicit public debt. On the other hand, it would provide more transparency in fiscal accounts and an institutional framework for increasing effectiveness and improving targeting of public expenditure. This set of measures can include:

- legal limits on the size of the deficit (or the zero-deficit principle) and public debt (in nominal terms or in relation to GDP);

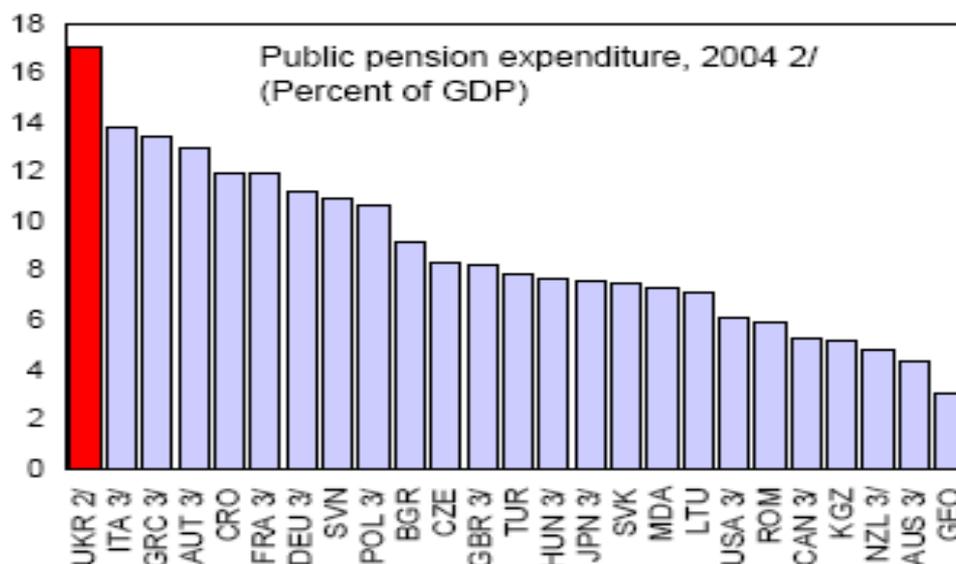
- a legal obligation to estimate the fiscal consequences of new legislation by an independent accounting (actuarial) office/ agency; this kind of provision is particularly important in case of social and tax legislation;
- strengthening formal prerogatives of the Minister of Finance inside the government and the Budget Committee inside the parliament;
- the exclusive right of government to propose legislation initiatives, which bring serious fiscal consequences (or the right of government to veto such initiatives of MPs);
- mandatory medium-term fiscal planning (especially in respect to public investment projects and social programs)
- full harmonization of the fiscal classification and reporting rules with the international standards

Depending on the nature of the concrete measure, the proposed fiscal rules require legislative changes (including changes in the Constitution), executive orders, internal parliamentary regulations or informal political consensus between political parties.

### **2.3. Social policy reform**

A complex social reform should aim at achieving the following goals: (i) decreasing total social expenditures in relation to GDP; (ii) better targeting of various social welfare programs, which should provide support to the most vulnerable groups in the population; (iii) diminishing the negative microeconomic and social side-effects of welfare programs, mostly related to dependency culture, shadow economy and the de-activation of the labor force.

Among various social welfare schemes, the publicly financed PAYG system plays the most important role. It has one of the highest levels of current expenditures in the world (see **Figure 3**) and an enormous size of long-term financial liabilities.

**Figure 3: Public pension expenditure as % of GDP in 2004**

Note: (2) 2005 for Ukraine, including military pensions, (3) data of 2001

Source: IMF (2007a), Figure 6, p.16

The excessive liabilities of the pension system can be reduced by either decreasing the replacement rate (i.e. relation between the average pension and the average wage) or the dependency ratio (i.e. relation between the number of people receiving pension benefits and those contributing to the system). So far, unavoidable adjustments occurred spontaneously mainly through the first channel, i.e. either through inflationary depreciation of only partly and irregularly indexed pension benefits or through slower growth of real pensions when compared to real wages and salaries<sup>18</sup>. However, this approach seems to represent serious flaws in the area of social fairness.

First, correcting the Pension Fund imbalances through decreasing the replacement rate means decreasing the relative purchasing power of the average pension, when compared to the average wage and salary, which if goes too far, could mean increasing the poverty vulnerability of pensioners. This would also inevitably cause the flattening of the structure of individual pension benefits (assuming that some minimal, socially justified, size of pension benefit must exist). This, in turn, would decrease incentives to comply with payroll tax rules among middle- and higher-income groups of population.

Second and more important, partial and irregular indexation often leads to faster real depreciation of the earlier granted benefits compared to those newly granted. In practical terms, this means that older pensioners (representing the “old pension portfolio” and having

limited or no ability to earn additional money) become disadvantaged when compared to “newcomers”, many of whom can continue work officially or unofficially.

Taking into consideration the above arguments and the rapidly aging population structure of Ukrainian society (which represents one of the most dramatic national demographic scenarios in Europe) one should think, first and foremost, about improving the dependency ratio (or at least stopping its deterioration). This could be done through the increase of both the official and effective retirement ages (the latter is much lower than the official due to the existence of various early retirement privileges), which would decrease the number of pensioners and increase the number of contributors to the Pension Fund, other things being equal. Another measure of similar character should aim at tightening eligibility criteria for receiving disability pensions, which could reduce the record-high number of disability pensioners in Ukraine.

Although not politically easy to implement, the proposed measures (like any kind of serious social policy adjustment) would mean a better targeting of social benefits (pensions in this particular case) to the most vulnerable groups in the population (the truly old and actual invalids) at the expense of the “shadow” zone, of relatively young pensioners, which can and do continue working, as well as people who abuse the disability pension system. The measures could also help to stop or limit the otherwise unavoidable tendency to decrease the replacement rate (see above). Indirectly, they would also decrease incentives to take up informal employment practices and help to eliminate various kinds of distortions on the Ukrainian labor market.

Better social targeting should be also the leading principle of reforming other kinds of social transfers like, for example, various forms of family support. Unfortunately, the political decisions taken in 2004-2005, such as substantial benefits for each newly born child (see Section 2.3), went in the opposite direction<sup>19</sup>.

### **3. How can the business climate be improved?**

Although it was overcome the following year, the economic slowdown of 2005 (see Section 2.3) served as the warning signal that the high pace of economic growth observed between 2000 and 2004 was not guaranteed forever. Apart from windfall factors (high world prices for metallurgy products), the rapid growth at this period could be attributed, to a

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<sup>18</sup> Such an approach has been also assumed by Rohozynsky (2007) who analyzes various macroeconomic scenarios of adjusting social expenditures in the forthcoming years.

<sup>19</sup> International experience demonstrates the failure of these kinds of incentives to increase fertility rates.

phenomenon of post-adaptation catching-up recovery, as argued in Section 2.2. However, the experiences of other transition economies demonstrates that this phenomenon is limited in time and long-term growth prospects depend on investment dynamics, competitiveness and more sophisticated qualitative factors.

Ukraine has already experienced an investment boom, these investments have come mostly from the reinvested profits of existing enterprises as well as from domestic and off-shore resources of Ukrainian and Russian oligarchs. Other foreign investors, multinational corporations (MNC) and the stock exchange played a marginal role until very recently. It is still too early to say whether increased interest in Ukraine among Western investors after the Orange Revolution (see Section 2.3) indicates a sustainable change in earlier unfavorable trends.

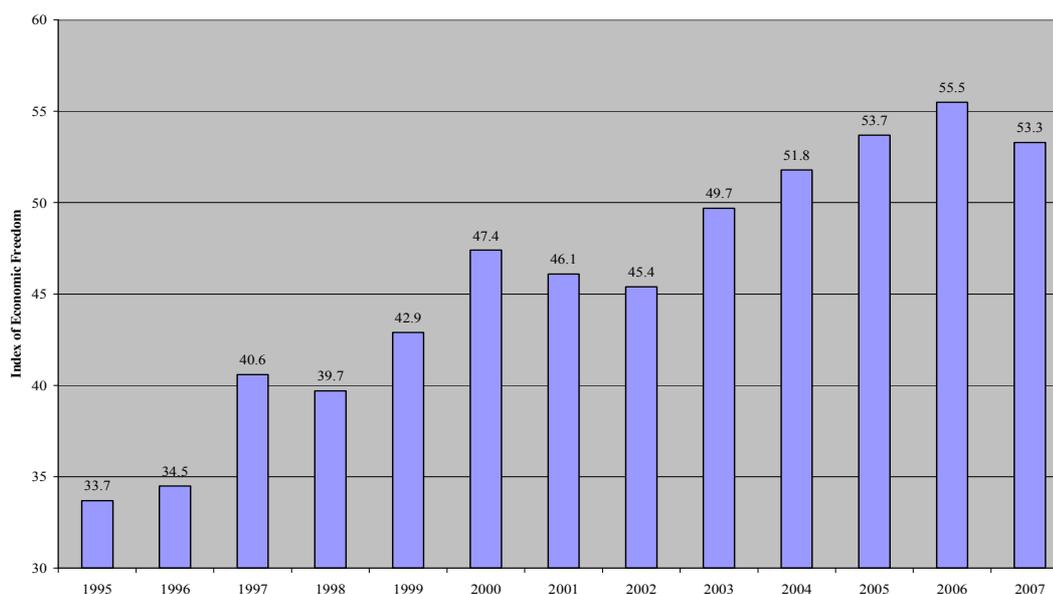
The same disappointment concerns the other side of the investor spectrum, i.e. the insufficient dynamic of the SME sector, compared to that observed in Central Europe, Baltic countries and recently – in the Balkan region. The weakness of FDI and SME can impede the further restructuring of the Ukrainian economy and increase its international competitiveness. Most importantly, it reflects a continuous poor business climate in Ukraine, in spite of some deregulation reforms undertaken in early 2000s and the repeated deregulation effort in 2005-2006 (see Balcerowicz & Ustenko, 2006).

The poor business and investment climate results from various institutional and systemic deficiencies such as numerous barriers to market entry (for example, registration and licensing regimes), various administrative permissions, an excessive number of administrative inspections, non-transparent tax and custom systems and their poor administration (especially in respect to VAT),<sup>20</sup> an unstable and intransparent legal system and its poor implementation, weak and corrupted public administration and judiciary, weak contract enforcement and insufficient property rights protection, excessive prerogatives of law enforcement agencies and excessive militarization of the state, the underdevelopment of financial sector and the underdevelopment and monopolization of infrastructure.

At first glance, Ukraine's problems with business climate look similar to those observed in many other transition and less developed countries. However, Ukraine's situation in this respect seems to be extremely bad, even when compared to other CIS countries.

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<sup>20</sup> Numerous flaws in the VAT refunding mechanism have been considered as a particularly serious obstacle to business activity, especially in relation to large exporters. Some improvement in tax refunding practices was observed in 2005-2006 but was later reversed.

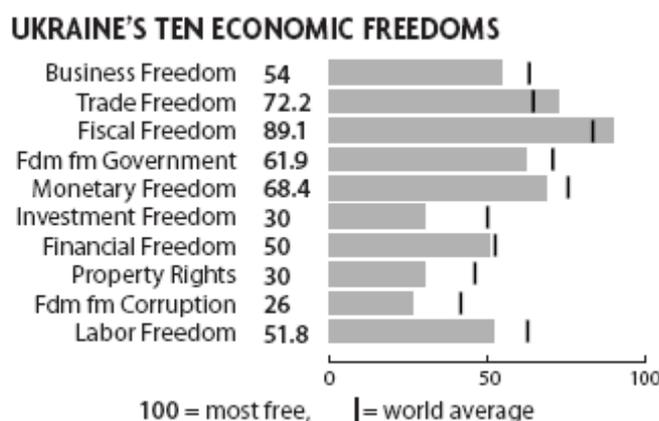
**Figure 4: Heritage Foundation Index of Economic Freedom, 1995-2007**

Source: [http://www.heritage.org/research/features/index/searchresults\\_past.cfm](http://www.heritage.org/research/features/index/searchresults_past.cfm)

Various comparative rankings of the international perception of Ukraine's business climate are extremely negative. This is reflected, for example, in the Heritage Foundation Index of Economic Freedom, which in its 2007 ranking, placed Ukraine in the 125th position (out of 157 countries ranked), in the category of "mostly unfree" economies, behind most of the other CIS countries Armenia (32nd position in the ranking), Georgia (35), Kazakhstan (75), Kyrgyzstan (79), Moldova (81), Azerbaijan (107) and Russia (120). Although Ukraine's index improved over the reported period of 1995-2007 (see Figure 4), the pace of improvement was rather slow and the 2004 Orange Revolution did not accelerate this process to the extent observed in Georgia after its "Rose Revolution" in 2003. The last rating (of 2007) was worse than the previous one, which signals a stagnation in economic and institutional reforms.

Looking at the components of the HF IEF (Figure 5), Ukraine has a decent score in the categories of "Fiscal Freedom" (89.1) and "Trade Freedom" (72.2), both above the world average. In all other categories, however, Ukraine performs below the world averages. "Freedom from Corruption" (26.0), "Property Rights" (30.0) and "Investment Freedom" (30.0) are the components where Ukraine's track record looks especially poor.

**Figure 5: Heritage Foundation Index of Economic Freedom, 2007, components**



Source: <http://www.heritage.org/research/features/index/countryFiles/pdfs/Ukraine.pdf>

The World Bank Doing Business is the second important ranking, which generally confirms the pessimistic outlook provided by the HF IEF. According to WB Doing Business 2007 publication (Doing Business, 2006), which presents survey data for 2006, Ukraine is ranked on the 128th position among 175 countries examined, behind Armenia (34), Georgia (37), Kazakhstan (63), Kyrgyzstan (90), Russia (96), Azerbaijan (99), and Moldova (103). It belongs to the group of countries where the business environment is characterized as “difficult”. Only in one category (“Enforcing Contracts”) Ukraine is ranked quite favorably (26th position). The worse performance is scored in respect to “Paying Taxes” (174th position), “Protecting Investors” (142), “Closing a Business” (139) and “Registering Property” (133). The 2006 ranking demonstrates a slight improvement compared to the previous year, mostly in the categories of “Starting a Business” and “Dealing with Licenses”. However, the unavailability of 2007 survey results at the moment of writing this paper does not allow for verifying the HF observation that the business climate deteriorated in 2007.

Looking at the potential strategies aimed at improving business and investment climate, one must remember that the room for maneuver for quick fixes is limited due to the fundamental flaws of many basic state institutions such as public administration or judiciary (see Section 5). For example, the judicial control of administrative decisions, which constitutes the basic protection mechanism of business freedom in developed countries, is not available to Ukrainian entrepreneurs because of the very poor performance of the Ukrainian court system and - more generally – a lack of respect for the rule of law. This bottleneck only can be partly substituted by the monitoring provided by civil society organizations and by the special administrative agency, which plays the role of “entrepreneur ombudsman”, i.e. the State Committee of Ukraine for Regulatory Policy and Entrepreneurship.



The above circumstances mean that more sophisticated regulatory solutions copied from the developed countries might not necessarily work well in Ukraine, at least in the near future. Instead, they call for simple and radical deregulation measures such as abandoning some non-priority areas of regulations and closing down or substantially downsizing institutions in charge of these regulations (to avoid bureaucratic attempts of reversing deregulation). This approach was successfully adopted in Georgia after the Rose Revolution in 2003 (see Lessons, 2006).

The regular verification of all existing regulations where ministries and agencies must justify prolongation of each single executive order (the so-called “Guillotine” principle adopted, among others, in Moldova in early 2000s) is another good measure protecting economic freedom. Finally, widespread application of online e-procedures (in business registration and licensing, applying for administrative permissions, tax and custom reporting and settlements, public procurement, etc.) could make compliance with various administrative procedures more transparent, less expensive and less time-consuming for both public administration workers and business people.

#### **4. Reforming a post-Soviet state**

As mentioned previously the poor business climate in Ukraine has its roots in the unreformed post-Soviet state which continues to perform several functions typical for a command economy and non-democratic political regime. As in the Soviet or even pre-Soviet era, the Ukrainian state apparatus still tries to interfere in the details of business activity and the day-to-day life of its citizens while it is unable to provide them with basic public goods such as law and order, security, judiciary, equal and fair treatment of all citizens and firms, basic technical and social infrastructure, etc. This kind of bureaucratic patrimonialism creates a fertile ground for corruption (see Dubrovskiy, 2006), which is widely considered the number one social and economic disease in Ukraine.

The Transparency International Corruption Perception Index of 2006 gave Ukraine 99-104th position among 163 analyzed countries, together with the Dominican Republic, Georgia, Mali, Mongolia and Mozambique. It was behind Moldova (79-83th position) and Armenia (93-98), and ahead of other CIS countries. The score of 2.8 in 2006<sup>21</sup> represents a modest improvement compared to 2005 (2.6) and 2004 (2.2).

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<sup>21</sup> In the scale of 0-10 where 0 means highly corrupt and 10 – highly clean country – see [http://www.transparency.org/policy\\_research/surveys\\_indices/cpi/2006](http://www.transparency.org/policy_research/surveys_indices/cpi/2006)

In addition, due to slow privatization, many enterprises remain state-owned and are thus easy targets of rent seeking and rent extraction, and create development bottlenecks in some important infrastructure sectors, such as telecommunication, energy production and distribution and transportation.

The weakness of state institutions is caused, among others, by insufficient democratization, weak civil society, an unstable and immature system of political parties (penetrated by powerful business elites representing their interests), and an inefficient and corrupted judiciary. In spite of major political improvement after the Orange Revolution, Ukraine still lags, in many respects, behind not only mature Western democracies but also the countries of Central and Eastern Europe, which recently joined the EU.

According to the Freedom House “Freedom in the World” 2007 annual report,<sup>22</sup> Ukraine belongs to the group of “free” countries<sup>23</sup> but its scores (3 for political rights and 2 for civil rights) lag behind the EU standard of 1 for both categories, which all countries meet apart from Bulgaria and Romania. However, the regional “Nations in Transit” ranking run by the same institution and covering a wider set of indicators reveals some important vulnerabilities of the young Ukrainian democracy. As shown in Table 3, Ukraine’s performance in four specific areas – “Judicial Framework and Independence”, “National Democratic Governance”, “Local Democratic Governance” and “Corruption” – continues to be disappointing and shows little or no improvement compared to the early 2000s.

**Table 3: Ukraine: Freedom House Nations in Transit Ratings, 1999-2007**

Nations in Transit Ratings and Averaged Scores								
	1999	2001	2002	2003	2004	2005	2006	2007
Electoral Process	3.50	4.00	4.50	4.00	4.25	3.50	3.25	3.00
Civil Society	4.00	3.75	3.75	3.50	3.75	3.00	2.75	2.75
Independent Media	5.00	5.25	5.50	5.50	5.50	4.75	3.75	3.75
Governance*	4.75	4.75	5.00	5.00	5.25	n/a	n/a	n/a
National Democratic Governance	n/a	n/a	n/a	n/a	n/a	5.00	4.50	4.75
Local Democratic Governance	n/a	n/a	n/a	n/a	n/a	5.25	5.25	5.25
Judicial Framework and Independence	4.50	4.50	4.75	4.50	4.75	4.25	4.25	4.50
Corruption	6.00	6.00	6.00	5.75	5.75	5.75	5.75	5.75
Democracy Score	4.63	4.71	4.92	4.71	4.88	4.50	4.21	4.25

<sup>22</sup> <http://www.freedomhouse.org/uploads/fiw/FIWAllScores.xls>

<sup>23</sup> As of 2006. Earlier it belonged to the category of “partly free countries”.

Source: [http://www.freedomhouse.hu/images/fdh\\_galleries/NIT2007/nt-ukraine-proof-ii.pdf](http://www.freedomhouse.hu/images/fdh_galleries/NIT2007/nt-ukraine-proof-ii.pdf)

These vulnerabilities determine the suggested agenda of future political and institutional reforms. They should start from the attempt to revise and clarify the constitutional division of power to avoid the repetition of political stalemates observed in 2006-2007.

Constitutional amendments adopted in the wake of the Orange Revolution (on December 8, 2004) changed Ukraine's political regime from the presidential-parliamentarian to the parliamentary-presidential one. The general direction of these changes can be considered correct. The transition experience of post-Soviet countries has demonstrated numerous flaws of strong presidencies such as the danger of authoritarian drift, unavoidable conflict between the executive and legislative branches of government, dysfunctionality of a two-head executive power (unclear division of responsibility between president and prime minister, ambiguous role of presidential administrations), impediments to building stable political parties, the oligarchization of political life, etc. However, the concrete wording of constitutional amendments hastily adopted in the revolutionary atmosphere of December 2004 proved vague and incomplete. As a result, it led to a severe political crisis just after the parliamentary election of 2006 when the new constitutional arrangements finally became operational.

This unfortunate experience should serve as the warning signal and background for the reexamination of constitutional checks and balances between legislative and executive branches and within the latter, i.e. between president and prime minister. First and foremost, a constitutional review should relate, in first instance, to a process of forming a parliamentary majority, appointment of the prime minister and government, dissolution of parliament, political control of armed forces and law enforcement agencies and the role of presidential veto in the legislative process.

Apart from further constitutional changes, the modernization of the Ukrainian state requires several other institutional reforms such as:

- i. A complex administrative reform in order to improve the efficiency of government agencies and to focus them on providing basic public goods and services that cannot be supplied by the market mechanism. To achieve this, the government and public administration structure must be simplified, redundant and unnecessary functions eliminated, the number of personnel reduced, and the resulting budget savings used to increase the salaries of the remaining civil servants.
- ii. The administrative reform must be supplemented by the consequent building of the professional, stable and apolitical civil service corps on the central, regional and local

levels. This includes, among others, drawing a clear distinction between political and non-political positions in the government apparatus. The selection of candidates for public service must be based exclusively on professional criteria and on an open, competitive mechanism. It is also necessary to modernize the professional training of civil servants, and to define clear principles for their professional careers and remuneration.

- iii. Failure to build a modern system of local and regional self-government has substantially weakened Ukrainian democracy and the Ukrainian state. A reasonable level of decentralization could increase the efficiency of governing such a large, populous and ethnically and culturally diverse country as Ukraine, bring democracy closer to citizens, and at least partly soften inter-regional conflicts., First and foremost, this would require overcoming the post-Soviet tradition of centralism and the unjustified fears of some politicians that excessive decentralization may lead to the disintegration of the Ukrainian state. Successful decentralization requires not only a clear delineation of prerogatives and public tasks between central, regional and local government but also a parallel transferring of financial resources needed to carry out these prerogatives and tasks. Regional and local legislative bodies should approve their own budgets, and the expenses should be directed toward executing their own tasks, as well as delegated ones. Meanwhile revenues should be ensured through regional and local taxes and grants.
- iv. The excessive militarization of many state functions, one of the legacies of the Soviet period, should be overcome by bringing the armed forces and various law enforcement agencies under effective democratic control, following dominant European standards. Their mandate and tasks should be clearly defined and strictly limited to providing public goods such as external and internal security and efficient law enforcement.
- v. Anti-corruption policy must include a variety of measures, in particular, improved anti-corruption legislation and deregulation of business activity. Individuals, enterprises, NGOs and media should have free access to information. Increased transparency of national and local budgets, public tenders, administrative procedures and decisions could be achieved through the use of e-government instruments

However, special attention should be given to a comprehensive legal and judicial reform. A radical improvement of the judiciary is absolutely critical to ensure the effective enforcement of constitutional rights and freedoms, improvement in rule of law and business climate, particularly protection of better property rights and contract enforcement, curbing arbitrary and predatory behavior of public administration and law enforcement agencies. This

reform must encompass reforms of legal education, material and procedural legislation, reform of law enforcement agencies such as the prosecutor's office, various branches of police forces, the Security Service of Ukraine (SBU), etc.), better execution of court decisions, the penal system, and legal services (including the Bar, notary services, etc.). Because such complex institutional changes require a lot of time to be implemented and bring substantial improvement, implementation should begin as soon as possible, drawing on foreign expertise and technical assistance.

An independent judicial system must include regular courts, magistrate courts, and specialized judicial and quasi-judicial bodies, with clearly defined legal mandates<sup>24</sup>. Both prosecutors and judges should enjoy independent status (lifetime nominations after scrupulous selection and examination of candidates), be accountable only to the law and code of professional ethics, and much better trained and remunerated (to resist corruption temptation).

## 5. The challenge of globalization and economic integration

Another potential obstacle to the future economic growth of Ukraine is connected with its insufficient trade and economic relations with developed countries, particularly with the enlarged European Union. As demonstrated in **Table 4**, the geographic structure of Ukraine's trade changed very little in the first half of the 2000s. In fact, the share of total exports to EU and EU candidates (Turkey playing the most prominent role among the latter) decreased over the analyzed period. Russia and other CIS and developing countries remain the main destinations of Ukrainian export.

Export geography is closely linked with its commodity structure (see **Table 5**); low-processed ferrous and non-ferrous metals, chemicals, food and other raw-materials continue to represent almost two-thirds of the total. If we add the technically outdated products of the machine building industry and fuel and energy products (part of which are re-exported after being produced in other CIS countries), we get a picture of the weak international competitiveness of the Ukrainian economy and its continues dependence on intra-CIS markets. Most of the export products have a limited chance to be sold in developed countries. They can still be exported to CIS and some developing countries but this window of opportunity will not last indefinitely, especially when taking into consideration the

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<sup>24</sup> In the last couple of years, one could observe such legal paradoxes such as a ruling on the legality of a Presidential decree by an ordinary district court instead of the Constitutional Court.

increasing openness of developing countries and increasing trade competition on world markets.

More changes have been observed on the import side in the analyzed period, with the share of fuel and energy products from CIS slowly diminishing, and the share of machinery from the EU slowly increasing (see **Tables 4** and **5**). Nevertheless, the import structure (in terms of geography and commodity composition) also looks different from most of the EU new member states and EU candidates in South Eastern Europe (SEE). SEE countries trade mostly with the EU and manufacturing products (including intra-industry trade) prevail in their trade flows. The continuous high energy-intensiveness (one of the highest in the world), especially in export-oriented industries such as metallurgy and chemical products, makes the Ukrainian economy strongly dependent on oil and gas import from Russia, and vulnerable to changes in oil and gas prices.

**Table 4: Ukraine: Geographic Structure of Trade, 2001-2005, % of total**

Region/Country	Exports			Imports		
	2001	2002	2005	2001	2002	2005
CIS	28.7	24.4	31.3	56.0	52.8	47.1
Russia	22.6	17.8	21.9	36.9	37.2	35.5
Belarus	1.5	1.5	2.6	2.6	1.5	2.6
Other	4.6	5.2	6.9	16.6	14.1	9.0
EU + EU candidates	40.1	42.4	35.8	31.0	33.6	35.4
Germany	4.4	4.2	3.8	8.7	9.8	9.4
Turkey	6.2	6.9	5.9	0.9	1.2	1.7
Other	29.5	31.3	26.1	21.4	22.7	24.4
Rest of the World	31.2	33.2	32.9	13.0	13.6	17.5
USA	3.5	2.9	2.8	2.9	2.8	2.0
China	3.3	3.9	2.1	1.2	1.5	5.0
Other	24.4	26.4	28.0	8.9	9.3	10.5

Source: IMF (2007c), Table 30, p.34, Table 32, p.36

**Table 5: Ukraine: Commodity Structure of Trade, 2001-2005, % of total**

Commodity group	Exports		Imports	
	2001	2005	2001	2005
Fuel and energy products	9.9	12.8	41.8	31.4
Machinery	14.4	13.5	21.0	28.0
Wood and wood products	3.2	2.9	3.9	3.3
Industrial products	5.2	3.6	6.0	6.0
Chemicals	11.5	11.3	12.4	14.6
Food items and raw materials	11.2	12.6	7.1	7.4
Ferrous and nonferrous metals	41.3	41.0	5.2	6.8
Other	3.3	2.3	2.6	2.6

Source: IMF (2007c), Table 31, p.35, Table 33, p.37

Summing up, in spite of the high level of openness of the Ukrainian economy (the ratio of exports plus imports to GDP equaled ca. 120% in 2003<sup>25</sup>) it remains partly isolated from Western markets and its international competitiveness is rather low. Contrary to EU NMS and EU candidates, Ukraine experienced only limited trade restructuring in the transition period. This was caused by both the slow and uneven pace of domestic reforms (see above) and by the protectionist attitude of the West, particularly of the EU to the whole CIS region in the 1990s and early 2000s. Unfinished WTO membership negotiations do not help to decrease the international perception of risk in trading with Ukraine and investing in this country. As a result, Ukraine's trade relations are less stable, badly institutionalized and lacking in legal instruments which could defend national interests, for example, against the anti-dumping measures regularly adopted by countries importing Ukrainian metallurgy and chemical products. On the other hand, weak trade relations with developed countries, including the EU, create an additional obstacle to the deep restructuring and modernization of the Ukrainian economy and increasing its long-term growth potential.

Coming back to EU policy, one must notice a fundamental difference between the EU trade policy on offer to Central European, Baltic and Balkan countries on the one hand and CIS countries on the other. In the 1990s and early 2000s, the CIS countries, including Ukraine, were left completely outside of the EU integration process and were not even given the opportunity to liberalize their trade with the EU. The Partnership and Cooperation Agreement (PCA) which Ukraine signed in 1994 and which entered into force in 1998 was the only legal platform of bilateral relations. It included standard trade and economic provisions like the most-favored-nation (MFN) clause but not limited trade liberalization. Furthermore, the EU did not offer CIS countries the opportunity to negotiate and sign free trade agreements (FTA) prior to, or in parallel with, their WTO accession. The official EU policy was: WTO accession first and only afterwards can free trade feasibility studies and negotiations begin. This was a major difference compared to the attitude adopted towards EU candidates – some of them were allowed to sign a comprehensive FTA agreement with the EU parallel to, or even before formally completing the WTO accession process.

Excluded from the global and European trade liberalization processes, CIS countries made several, largely unsuccessful attempts to build their own regional trade block. The CIS itself, had, among other goals (such as being the mechanism for the peaceful political dissolution of the former Soviet Union) the goal to forming a kind of post-Soviet common market. However, the subsequent multilateral and bilateral free trade agreements between

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<sup>25</sup> CASE ENEPO WP1 database based on the Penn World Table 6.1 (PWT 6.1), [http://pwt.econ.upenn.edu/php\\_site/pwt62/pwt62\\_form.php](http://pwt.econ.upenn.edu/php_site/pwt62/pwt62_form.php)

CIS countries were never fully implemented. The same concerned the more ambitious integration projects like the Single Economic Space between Belarus, Kazakhstan, Russia and Ukraine (which has the Russian acronym EEP). Their failure was caused by a number of political, economic and institutional reasons: lack of political trust between partners, asymmetry of the countries' economic and political potentials, a divergence of national economic interests, the varied pace of economic reforms, the lack of effective enforcement and arbitration mechanisms and others. Although intra-CIS regional trade liberalization does work to limited extent, it helps very little in restructuring and modernizing CIS economies, because all the partners have development problems. In this respect CIS trade liberalization mechanisms, although important for the Ukrainian economy, cannot be considered a substitute for global or European trade and economic integration.

The EU attitude towards the European part of the CIS, particularly Ukraine, has started to change only very recently, after the EU Eastern Enlargement in 2004 and 2007. Now Ukraine shares land borders with four EU members: Poland, Slovakia, Hungary and Romania. For geographic and geopolitical reasons, the new EU members are, on average, more interested in developing close economic and political relations with the CIS than countries of Western or Southern Europe. These geopolitical changes and the positive international expectations created by the Orange Revolution opened a new window of opportunity for Ukraine to build closer trade, investment and institutional relations with the EU.

The European Neighborhood Policy, which was officially launched in 2004, became the new EU institutional policy framework towards its direct neighbors. According to the official public statement<sup>26</sup>, the EU offers its neighbors “...a *privileged relationship, building upon a mutual commitment to common values (democracy and human rights, rule of law, good governance, market economy principles and sustainable development)*. The ENP goes beyond existing relationships to offer a deeper political relationship and economic integration. The level of ambition of the relationship will depend on the extent to which these values are effectively shared.” Originally this general declaration was followed by a clear statement that the ENP is not about the next EU enlargement and does not offer an EU accession perspective. Recently it was replaced by a more flexible approach: “*The ENP remains distinct from the process of enlargement although it does not prejudge, for European neighbors, how their relationship with the EU may develop in future, in accordance with Treaty provisions.*” The door has been hypothetically opened for European CIS countries such as Ukraine. However, this seems to portray a very distant and unclear perspective,

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<sup>26</sup> [http://ec.europa.eu/world/enp/policy\\_en.htm](http://ec.europa.eu/world/enp/policy_en.htm)



especially if one takes into consideration the “enlargement fatigue” phenomenon, recently observed in some countries of Western Europe<sup>27</sup>.

Under the ENP initiative, the EU-Ukraine Action Plan was signed in February 2005 (see Section 2.3). On March 5, 2007 the EU and Ukraine started to negotiate a comprehensive new Enhanced Agreement, which is going to replace the old PCA. The EU negotiation mandate includes the proposal of a deep FTA, i.e. an agreement which would go beyond simply reducing or eliminating import tariffs. It should also touch on most of the existing non-tariff barriers, remove investment obstacles and initiate far-reaching institutional harmonization in the selected sectors. This type of agreement, if concluded and implemented, would not only bring substantial welfare gains to Ukraine (4-7% according to Emerson et al., 2006 modelling exercise) but also facilitate a far-reaching restructurization and modernization of the Ukrainian economy and closer harmonization of Ukraine’ economic and legal system with the EU *acquis*. This, in turn, would make the future EU accession perspective more realistic and feasible.

## Conclusions

Sixteen years after obtaining independence and three years after the Orange Revolution, Ukraine has reached a crossroads. It has broken with the Soviet and totalitarian past but its democracy is still relatively young and fragile, and therefore vulnerable to various political shocks. Basic civil and economic freedoms are not well protected due to numerous legal and institutional imperfections, most notably a poorly performing judiciary. Ukraine has succeeded in building the basic institutional foundations of a market economy. However, its capitalism is heavily distorted and its economic transition is far from complete. The economic landscape is dominated by large financial-industrial groups, the so called ‘oligarchs,’ whose short term interests override the interests of SME owners, foreign investors and consumers thanks to non-transparent political mechanisms. After ten years of transformation output decline, the economy is growing at a relatively high pace, but the long-term sustainability of this growth will depend on an improvement in investment climate. In geopolitical terms, Ukraine did not make its final choice yet – whether it is going to participate seriously in the Euro-Atlantic integration or remain in the ‘grey zone’ of the European periphery. Even making a firm political commitment in favor of the first choice does not guarantee that it will be given the chance to materialize quickly. For many reasons, Ukraine’s road to EU and NATO membership will be more difficult than that of countries of Central and Eastern Europe. The

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<sup>27</sup> This anti-enlargement sentiment works particularly strongly against the EU membership aspirations of Turkey, for historical and cultural reasons. However, one can expect a similar reaction in respect to the hypothetical EU membership aspirations of Ukraine.

external incentives for Ukraine are much weaker than those enjoyed by those countries which joined the EU in 2004 and 2007.

Similarly to other CIS countries, Ukraine urgently needs a new round of reforms which would primarily address the institutional and structural weaknesses. Compared to the earlier stage of economic transition, Ukrainian policymakers must go well beyond the purely economic agenda and also address issues of legal, administrative and political reforms. These are absolutely critical to create a healthy business environment and integrate Ukraine with the world and European economy. Failure to design, launch and implement such reforms can undermine prospects of economic growth in both the medium and long term perspective as well as the chances to speed up the modernization processes.

The politics and political economy dimensions of taking the strategic decisions outlined above will not be easy. The country is deeply divided in political, cultural, regional and ethnic terms. There is little chance that a clear winner will emerge from the September 2007 parliamentary elections. Thus, forming a stable government with coherent and consistent program will not be an easy task. The political struggle will probably continue at least until the 2009 presidential election. In such an environment, crucial reforms and strategic decisions – whether subsequent constitutional reform, major institutional changes or Ukraine's relations with the EU and NATO – will require a wider cross-party political consensus.

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