

Reforming the Ukrainian State and Improving the Business Climate

Marek Dąbrowski

Low Scores for Ukraine

In spite of the impressive economic growth recorded in the first decade of the 2000s, Ukraine is not considered a business-friendly country. This is reflected, for example, in the Heritage Foundation Index of Economic Freedom, which ranked Ukraine 125th in its 2007 rankings (out of 157 countries), and placed it in the category of “mostly unfree” economies, behind most other CIS countries. Scores in the categories of “Fiscal Freedom” and “Trade Freedom” were above the world average. However, in categories such as “Freedom from Corruption,” “Property Rights,” and “Investment Freedom,” Ukraine’s record looks dismal.

The World Bank’s Doing Business in 2007 report is another ranking which confirms the pessimistic outlook provided by the Heritage Foundation. Ukraine is ranked 128th out of 175 countries, and located in the group of countries where the business environment is characterized as “difficult.” It once again lags behind most other CIS countries. Only in the category of ‘Enforcing Contracts’ is Ukraine ranked quite favourably (26th position). It performed worse in respect to ‘Paying Taxes’ (174th), ‘Protecting Investors’ (142nd), ‘Closing a Business’ (139th), and ‘Registering Property’ (133rd). Both rankings (HF and WB) demonstrate little improvement in the last few years.

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), an excessive number of administrative permissions and administrative inspections, non-transparent tax and custom systems and their poor administration (especially in respect to the VAT refunding mechanism), an unstable, poorly enforced and non-transparent legal system, a weak and corrupt public administration and judiciary, weak contract enforcement and insufficient property rights protection, excessive prerogatives of law enforcement agencies and excessive militarization of the state, an underdeveloped financial sector and underdeveloped and monopolized basic infrastructure services.

The poor business climate in Ukraine has its roots in the unreformed post-Soviet state; the state apparatus continues to interfere in the details of business activity and the daily

- life of citizens. At the same time, the state is unable to
- provide people with basic public goods such as law and
- order, security, judiciary, equal and fair treatment under
- the law and basic technical and social infrastructure. This
- kind of bureaucratic patrimonialism creates fertile ground
- for corruption, which is widely considered the number
- one social and economic disease in Ukraine. The 2007
- Transparency International Corruption Perception Index
- placed Ukraine in the 118th position among 179 analyzed
- countries, together with the African countries of Benin,
- Malawi, Mali and Sao Tome and Principe.

- In spite of major democratization after the Orange
- Revolution, Ukraine still faces serious weaknesses in this
- sphere, such as an underdeveloped civil society, an unstable
- and immature system of political parties (penetrated by
- powerful business elites and representing their interests),
- and an inefficient and corrupted judiciary. The Freedom
- House “Nations in Transit” ranking reveals the country’s
- vulnerabilities in four important areas – “Judicial Framework
- and Independence,” “National Democratic Governance,”
- “Local Democratic Governance” and “Corruption.”

Modernizing the State

- Political and institutional reforms should start from revising
- and clarifying the constitutional division of power to avoid
- the repetition of political stalemates observed in 2006-
- 2007. The shift from the presidential-parliamentarian
- model towards the parliamentary-presidential model was
- the right choice but the concrete wording of constitutional
- amendments hastily adopted in December 2004 proved
- vague and incomplete. Most importantly, the suggested
- constitutional amendments should relate to the process
- of forming a parliamentary majority, the appointment of
- the prime minister and government, the dissolution of
- parliament, the political control of armed forces and law
- enforcement agencies and the role of the presidential veto
- in the legislative process.

- The modernization of the Ukrainian state also requires
- other institutional reforms such as:

- i. A complex administrative reform to improve the efficiency
- of government agencies and to refocus them on providing
- basic public goods and services that cannot be supplied

by the market mechanism. To achieve this, the 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. Administrative reform must be supplemented by systematically strengthening the professional, stable and apolitical civil service corps at the central, regional and local levels. This includes 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 clearly define the principles for their careers and remuneration.

iii. Failure to build a modern system of local and regional self-government has substantially weakened the Ukrainian democracy and state. A reasonable level of decentralization could increase efficiency in governing this large, populous and ethnically and culturally differentiated country, bring democracy closer to citizens, and alleviate at least some of the inter-regional tensions. Above all, this requires overcoming the post-Soviet tradition of centralism and the unjustified fears that excessive decentralization may lead to the disintegration of the Ukrainian state. Successful decentralization requires not only clear delimitation of prerogatives and public tasks between central, regional and local government but also the parallel transfer 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 and delegated tasks, while revenues should be ensured through their own 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 incorporate a variety of measures, in particular: improved anti-corruption legislation, the deregulation of business activity, increased transparency of national and local budgets, public tenders, administrative procedures and decisions by developing e-government instruments and free access to information by individuals, enterprises, NGOs and media.

vi. A radical improvement of the judiciary is absolutely critical to ensure the effective enforcement of constitutional rights and freedoms, an improvement in the rule of law and business climate (especially the protection of property rights and contract enforcement), and to limit the arbitrary and predatory behavior of public administration and law enforcement agencies. This reform must encompass

- improvement of legal education, material and procedural
- legislation, as well as the reform of law enforcement
- agencies such as the prosecutor's office, police forces, and
- the Security Service of Ukraine (SBU). It should also ensure
- improved execution of court decisions, the penal system,
- and legal services (including the Bar and notary services).
- An independent judicial system must include regular courts,
- magistrate courts, and specialized judicial and quasi-judicial
- bodies, with clearly defined legal mandates and court hierarchy.
- 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 be better trained and
- remunerated (to resist the temptation of corruption).

• Adopting International Best Practices

- While undertaking measures aimed at improving the
- business climate in the short-term, one must take into account
- the above mentioned fundamental flaws of many state
- institutions. Solutions that work well in developed countries,
- such as judicial control of administrative decisions, will not
- necessarily work in Ukraine, at least in the near future.
- Rather, simple and radical deregulation measures, such as
- abandoning some non-priority regulations and substantially
- downsizing institutions in charge of these regulations (to
- avoid bureaucratic attempts to reverse deregulation), the
- approach adopted successfully in Georgia after the Rose
- Revolution in 2003, would bring about a real improvement.

- Regular verification of all existing regulations, where
- ministries and agencies must justify the prolongation of
- every single executive order (the so-called "Guillotine"
- principle adopted in Moldova, among other places, in the
- early 2000s) is another good measure that can be used
- to protect economic freedom. Finally, the widespread
- application of online e-procedures (in business registration
- and licensing, applying for administrative permissions, tax
- and custom reporting and settlements, public procurement)
- would make compliance with various administrative
- procedures more transparent and less expensive and
- time-consuming for both public administration officials and
- business people.

- For more on Ukrainian reforms, please see CASE
- Network Studies and Analyses No. 350 by Marek
- Dabrowski - Ukraine at a Crossroads, available at
- <http://www.case-research.eu>

- *Marek Dabrowski is Chairman of the Supervisory Council*
- *of both CASE and CASE Ukraine and is a member of*
- *the Board of Trustees of the Institute for the Economy in*
- *Transition. Previously, he has served as a member of the*
- *Monetary Policy Council of the National Bank of Poland*
- *(1998-2004), the Chairman of Poland's Governmental*
- *Council of Ownership Changes (1991-1996), a World*
- *Bank Consultant in the Policy Research Department of*
- *the Transition Economy Division (1994-1995), a member*
- *of the Polish Parliament (1991-1993) and First Deputy*
- *Finance Minister of Poland (1989-1990). He has led*
- *advisory missions in nearly all of the transition countries.*
- *Dr. Dabrowski is one of the founders of CASE.*