REFORMS IN UKRAINE AFTER REVOLUTION OF DIGNITY

What was done, why not more and what to do next
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Foreword
Foreword

Matteo Patrone and Peter M. Wagner

When in mid-2014 the revolutionary dust started to settle, Ukraine’s new leadership was confronted with a host of unprecedented challenges. With the signature of the EU-Ukraine Association Agreement and the Deep and Comprehensive Free Trade Area, the government made every effort to channel the post-Maidan enthusiasm into a wider societal and political consensus around the direction of key reforms – to bring the country closer to Europe.

Since then, the European Union (EU) and the European Bank for Reconstruction and Development (EBRD) have been leading supporters of reform in Ukraine. This has included innovative approaches such as the EBRD-driven National Reform Council as an early-day platform for reform champions from all branches of government, parliament and society, as well as unprecedentedly large EU-supported programmes in crucial reform areas such as decentralisation and public administration reform. Recognising that significantly strengthened implementation capacity was needed to translate the ambitious reform agenda into tangible improvements for Ukrainian citizens, the EU and the EBRD came together in mid-2016 to design a mechanism to boost Ukraine’s reform implementation capacity. The Ukraine Reforms Architecture (URA) was tailored to the country’s specific needs as well as its vast potential. This was the first comprehensive attempt of its kind in Ukraine to provide a coherent and aligned framework for reform implementation – one that would increase capacity within the public administration to carry out reforms more efficiently, while engaging stakeholders across the board more substantially in the reform process.

At its core are the Reform Support Teams (RSTs), currently active in eight ministries and public agencies. They have filled critical capacity gaps in Ukraine’s public administration and stand on the frontline of the reform implementation drive. They have notably attracted young reform talent from the country’s impressive pool of highly skilled “leaders in the making”, harnessing their enthusiasm and commitment to improving lives of their fellow citizens.

At the same time, the Reforms Delivery Office (RDO), the architecture’s second component, was entrusted with coordinating, facilitating and monitoring the reform process across the administration and ensuring that reform plans turn into outcomes felt by ordinary Ukrainians.

Complementing the dynamism and local insight of the RSTs and RDO, as the URA’s third component, the Strategic Advisory Group for Support of Ukrainian Reforms (SAGSUR) has been providing high-level advice and guidance to the top political leadership of the country. Drawing on their vast experience in leading successful reform processes in neighbouring countries (Poland and Slovakia) as well as in Ukraine, SAGSUR experts have offered invaluable perspective to Ukrainian decision-makers on the challenges, risks and rewards that such endeavours entail. SAGSUR’s experience teaches us countless lessons, many of which are shared by the group’s members themselves on the following pages.

Since 2014, the EU has mobilised around €14 billion, including more than €1 billion in grants. Over the same period, the EBRD has invested in 147 projects in Ukraine, totaling over €4 billion.

As a first insight, the EU-EBRD partnership demonstrates the power of joining forces in a common effort to support a country’s progress on its reform path. Drawing on complementary areas of expertise of the EBRD and the EU, we have been able to provide a better-targeted and better-timed support than we would have been had we acted in isolation. Stepping out of our usual siloes has brought undeniable benefits to the way we use our limited resources and the progress that can be made when we leverage on one another.

Our second insight relates to the recognition that any reform support must be tailored to each country’s unique circumstances. Being cognisant of the context in which we operate is a necessary, but not a sufficient, precondition for the support offered to bear the desired fruits. The help provided by
international reform supporters must not only be a good fit for the needs, constraints and potential of a partner country, but also align with the wider goals to which its society aspires. In the case of Ukraine we have built on this societal momentum by empowering reformers with genuine commitment to moving the country closer towards its desired destination.

Finally, reform delivery can seldom be executed by a single branch of the government system. Engagement of different branches in the reform process is vital for a legislative change or a policy to bring about the intended results. To effectively provide support to reform efforts this means assisting the executive, legislative and, as required, the judiciary in designing, enacting and enforcing the necessary changes. In the case of SAGSUR, involvement of its members in contributing to the Verkhovna Rada’s legislative work has proven to be instrumental in building and maintaining the consensus needed for the adoption of several ground-breaking pieces of legislation.

Our innovative and unique experiment in Ukraine and its wide recognition has strengthened our belief that by partnering up to provide tailored and comprehensive assistance in support of reform-minded leaders, international development stakeholders can make a tangible contribution to boosting the chances of reform success.

As Ukraine takes the next steps on its reform journey, we hope that the many lessons accumulated over the two and a half years of SAGSUR’s engagement, and shared in this publication, will be a useful resource for all those striving to create a prosperous future for all Ukrainians.

**Matteo Patrone**, Managing Director Eastern Europe and the Caucasus, European Bank for Reconstruction and Development (EBRD)

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May 2019
Introduction
What was done, why not more and what to do next: Ukrainian reforms after the Revolution of Dignity

Ivan Miklos

Five years have passed since the Revolution of Dignity (also commonly referred to as Euromaidan), a watershed moment in Ukraine's history that took place at the turn of 2013 and 2014. A hundred ordinary Ukrainians died in the Maidan square, just because they wanted to live in a normal society. They protested against the corrupt Yanukovych regime that was robbing the country not only of its resources but above all the hope for a better future.

I first came to Ukraine just a few weeks after the Revolution of Dignity, and in early 2015 I started to work as an adviser to the Minister of Finance Natalie Jaresko and the Minister of Economy and Trade Aivaras Abromavičius. In 2016, I became chief economic adviser to the new Prime Minister Volodymyr Groysman. Together with Leszek Balcerowicz we were asked by President Petro Poroshenko and Prime Minister Groysman to create and lead a small group of foreign and Ukrainian experts (the Strategic Advisory Group for Support of Ukrainian Reforms – SAGSUR). For one year I co-led SAGSUR together with Leszek Balcerowicz, and following his departure I continued as the group's chairman.

The main purpose of this publication is to share SAGSUR's views on the progress, achievements and failures of the reform effort undertaken in the five years following the Revolution of Dignity.

Opinions on the degree to which the reform process has succeeded vary. The question whether the glass is half full or half empty is a legitimate one. However, the widespread narrative, both in Ukraine and abroad, that nearly nothing or not enough has been done is greatly inflated. As the dominant discourse goes, Ukraine is still a corrupt, dysfunctional and oligarchic country with bleak prospects for successfully integrating itself with the EU and NATO. This so-called Ukrainian fatigue is further exacerbated by the many challenges the Western world has been confronted with in recent years, including the rise of populism, the ever-looming threat of trade wars, migration pressures, Brexit and the Eurozone crisis, to name the most consequential ones. A very important contributing factor to this negative narrative is the fact that Ukraine continues to grapple with myriad problems. The transformation process of the country's system from oligarchic, corrupt and dysfunctional to one operating on the principles of a functioning market economy is ridden with obstacles and remains far from completed.

Ukraine does not currently occupy the top spot on the global media radar, but when the global news does zoom in on the country, it is mostly concerned with the continuing battle in the Russian-occupied territories in eastern Ukraine, conflict stand-offs like the most recent one in the Azov sea, or yet another corruption scandal. War, corruption, oligarchs and scandals. For many media outlets only bad news is news. This is the reality, and Ukraine has not done enough to communicate the positive results of reforms to audiences within and outside its borders. This is feeding into the prevailing negative image of Ukraine in general and Ukrainian reforms in particular.

Another reason for the harsh assessments of the post-Euromaidan changes lies in the underestimation of the inherited systemic problems, thus creating unrealistic expectations for the speed and impact of reforms. We consider this phenomenon to be an important reason for the dissatisfaction of both domestic and foreign audiences with reform progress. The dysfunctional and corrupt oligarchic system that was built in Ukraine in over twenty years prior to the Revolution of Dignity is so deeply rooted, widespread and potent that removing it is an arduous and long-term process. This is why we pay great attention to explaining the inherited legacy of the oligarchic system – how and why it was created and how it worked, but also what has been done in the process of the so-called deoligarchisation that has taken place in the last five years.

Our overall positive assessment of course does not mean that the negative narrative has no relevance and that the reform progress could not have been better (faster, deeper and wider). On the contrary, Ukraine could have advanced further than it has in
building a functioning market economy and fighting corruption. The biggest obstacle to greater progress has been weak political will and courage of the current political elite; lack of leadership, ownership and communication of reforms. On the other hand, we are convinced and we want to demonstrate in this publication that given the inherited systemic conditions the progress achieved is tangible and significant.

It is also worth stressing what is not the goal of this publication. We do not aim to cover all areas of Ukraine’s economic and political transition and EU integration process.

We focus here solely on the areas covered by SAGSUR experts in their work with Ukrainian and international policymakers. Within the areas we analyse we concentrate only on the most relevant challenges and changes that are systemically important for the transition from an oligarchic and corrupt rent-seeking system to a functioning market economy based on rule of law and fair competition.

The main message of this publication is that this time (after the Revolution of Dignity) is different, and despite all of the struggles Ukraine, for the first time in its history, is laying the necessary foundations to utilise its potential and build a functioning market economy. Progress is real and significant, but still neither sufficient nor irreversible. The election year of 2019 will be a serious litmus test for the sustainability of the reform process and Ukraine’s determination to become a successful and prosperous country.
Chapter 1

Political economy of reforms: political system, governance and corruption

Ivan Miklos

The main goal of this chapter is to show what kind of system was created in Ukraine in the period between the fall of communism and the Revolution of Dignity (Euromaidan) and how this system has changed over the last five years. It will analyse what has been done to change the dysfunctional, corrupt oligarchic system, look at the progress that has been made, the limitations of that progress, and what further change is required to move Ukraine towards a functioning market economy and liberal parliamentary democracy.

Inherited legacy

After the fall of communism Ukraine was considered to be one of the most promising of the former Soviet Republics.¹ There were a lot of objective reasons for this positive assessment: the country had a strong and relatively advanced industrial base supporting the production of aircraft, rockets and space exploration equipment among others; the most productive soil in Europe – rich raw materials and energy sources (especially iron ore, high quality anthracitic coal, gas and oil); a young and highly educated labour force; and an ideal geographical location at the crossroads between the east and west, north and south.

Unfortunately, this positive legacy was not maintained in the years after the collapse of communism and the creation of the independent state.² Ample evidence supports the very pessimistic appraisal by Oleh Havrylyshyn, professor of economics and former Deputy Finance Minister of Ukraine, whose paper, “Ukraine – Greatest Hopes, Greatest Disappointment”,³ discusses Ukrainian economic development during the 25 years between the fall of communism and the Revolution of Dignity.

What happened and why?

At the beginning of the 1990s when Ukraine was created as an independent state (along with Slovakia and Latvia), Ukraine, Poland, Romania and Latvia were approximately at the same economic level (measured by GDP per capita), while the economic level of Slovakia was slightly higher.

Table 1.1

<table>
<thead>
<tr>
<th>Country</th>
<th>1992 (%)</th>
<th>2017 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ukraine</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Latvia</td>
<td>98</td>
<td>316</td>
</tr>
<tr>
<td>Romania</td>
<td>101</td>
<td>281</td>
</tr>
<tr>
<td>Poland</td>
<td>107</td>
<td>339</td>
</tr>
<tr>
<td>Slovakia</td>
<td>133</td>
<td>371</td>
</tr>
</tbody>
</table>

Source: IMF, 2018

The figures in Table 1.1 demonstrate that Ukraine lags far behind all the other comparable countries. The main reason for this is a lack of comprehensive reforms, and the related absence of integration into the European Union (EU).

Unlike Ukraine and Romania, Poland and the Slovak Republic (in 1989-92 as part of Czechoslovakia) underwent a comprehensive reform programme (the so-called radical, or “shock” therapy) from the beginning based on the liberalisation of prices and foreign trade. This consisted of managed devaluation, an imposed internal currency convertibility as well as a restrictive fiscal and monetary policy.⁴

This programme, despite its political risk, proved to be very successful and after an immediate and relatively short transition recession, it brought macroeconomic stabilisation and economic growth. Thanks to these programmes Poland and Czechoslovakia (later the Slovak Republic as an

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¹ In 1992 analysts at Deutsche Bank rated Ukraine’s future prospects as being by far the greatest among former Soviet Republics (O. Havrylyshyn, 2014, p.165).
² See more in A. Aslund (2009)
³ O. Havrylyshyn (2014)
⁴ In Poland the programme was launched on 1 January 1990 in leadership of Leszek Balcerowicz, in Czechoslovakia one year later by Vaclav Klaus.
independent state) avoided hyperinflation, political and economic chaos and macroeconomic destabilisation.

In the case of Romania, missing reforms in the initial phases of transition were replaced by new reform efforts especially connected with Romanian ambitions to join the European Union. The EU integration process (which finally succeeded in 2007) was the strongest reason and incentive for reforms in Romania and led to very successful economic development afterwards.

In Poland, the reform process continued after the first stage of reform in 1990-91, although slower, and was connected with the successful integration into the EU and NATO.

In Slovakia’s case, the first successful stages of reforms in 1991-92 were followed by it becoming an independent state from 1 January 1993. The new Slovak government neither continued the reforms nor achieved successful integration into the EU. The Slovak Republic, unlike the rest of its Visegrad Four (V4) neighbours (Poland, Czech Republic and Hungary), was not invited to enter the Organisation for Economic Co-operation and Development (OECD) and to start negotiations for EU and NATO memberships in 1996. Vladimir Mečiar's anti-reform government lost power in 1998, which opened up the possibility for speedy reforms and integration. The Slovak Republic eventually joined the EU as part of the largest single enlargement on 1 May, 2004 (together with other V4 and Baltic countries, Slovenia, Malta and Cyprus).\(^5\)

The Slovak experience demonstrated that the path to attaining EU membership could be successfully completed in just six years if there is a strong enough will and demand on both sides – the EU and the applicant country.

In Ukraine, unlike Poland, Slovakia and Romania, over the entire period between the collapse of communism and the Revolution of Dignity, almost zero progress was made in either area – reforms or EU integration. It is important to understand the key reasons for this.

First, Ukraine had stronger historical and cultural, as well as economic, social and personal relations with Russia, on all levels. This created a weaker demand for EU membership, especially in the eastern part of the country. Ukraine was under communist rule for a lot longer than peer countries and thus had little experience in self-governance, public service and other critical areas. Another important reason was that heavy industry was concentrated in eastern Ukraine, which was dependent on economic relations with Russia.

Second, just like in Romania and Bulgaria (but unlike in Poland or Czechoslovakia), there was an absence of new political elites and prepared technocrats (such as Leszek Balcerowicz or Václav Klaus and people around them) with the skills, will and courage to initiate and drive reforms. In Ukraine, there were no economists among the new post-communist elites. These were dominated by historians, writers or similar intellectuals. This was also related to the absence of so-called “institutional memory”. Unlike other central European countries, the former Soviet Republics (Baltic states excluded) did not have a previous history of functioning state institutions prior to the Second World War.

It is not a coincidence that those former communist countries which removed the old communist structures from power succeeded in the first stages of reform, avoiding hyperinflation and macroeconomic turmoil (and in certain respects the oligarchic system). Among these countries were Czechoslovakia, Hungary, Poland, Slovenia, Estonia, Latvia and Lithuania.

After the collapse of communism Ukrainian politics (including economic policy) was managed by old elites – former communist leaders and directors of Soviet state-owned companies – the so-called “red directors”. This was a legacy left by the Soviet Union after the Soviet state collapsed in 1990-91, while the Soviet economy had itself already collapsed in the 1980s.

Another problem was the spontaneous privatisation that increased the wealth and power of the red directors. Even before the breakdown of communism,

\(^5\) The Slovak Republic’s experience in overcoming legacy of corrupted, anti-reform governments under Vladimir Mečiar (1992-98), and the speeding up of reforms after 1998, can be a useful reference for Ukraine as there were some important similarities between the post Mečiar and post-Euromaidan fallout in respect of economy and politics.
in the second half of the 1980s during the so-called “Perestroika”, Mikhail Gorbachev, former General Secretary of the Communist Party of the Soviet Union, eased the conditions for new business, thus allowing the large state enterprises to conduct foreign trade independently. Later on (in 1988), the Law on Cooperatives legalised a wide range of private enterprises. Finally at the end of 1989 a “series of laws on leasehold were adopted that made it possible for state enterprise managers to purchase their enterprises for the profit of those companies”.

Anatoly Chubais, a Russian politician and businessman of influence, wrote about this period at the end of the Soviet era (of which Ukraine was a part): “At the end of 1991, the spontaneous privatisation was steamrolling all over. It was the theft of the common property, but this theft was not illegal, because legal schemes of “deetatisation” did not exist.”

On 1 December 1991 Ukrainians voted for national independence (90 per cent voted in favour) and the former communist chairman of the Ukrainian parliament, Leonid Kravchuk, was elected as president.

Kravchuk’s government had very little interest in economic reforms, arguing that the first priority was to build institutions of the new, independent state. In his words, “a baby must crawl before it can walk”. Another explicitly expressed reason was the effort to “protect society from the pain of the so-called shock therapy”. Both of these reasons were erroneous as demonstrated by the experience of the Baltic states (and the Slovak Republic) which simultaneously did both with success – building new state institutions and implementing economic reforms along with integration into the EU and Eurozone. In addition, the shock therapy was much less socially painful than absence of reforms.

The primary reason for poor reform progress in Ukraine from the outset was a lack of expertise (national economic thinking was absent as it had previously been undertaken by Moscow) as well as insufficient political will, understanding and courage to tackle a challenge of such magnitude. At the beginning of the post-communist economic transition, the reform process was both a technical and a political challenge. There was no empirical evidence refer to and no practical guidelines on how to do it successfully; in this regard the so-called “Balcerowicz Plan” in Poland was really a pioneering attempt. There was also political unease because the fall of communism was linked to the so-called “transitional recession” which left an unavoidable legacy over decades – an uncompetitive economy and enormous open and hidden, direct and indirect debt.

In this regard, Ukraine at the beginning of the transition period was missing both technical and political preconditions, for a successful reform. Even in Russia there was a partially successful attempt to carry out a comprehensive reform programme from the beginning of 1992. Deputy Prime Minister and Finance Minister, Yegor Gaidar, was the driving force of this reform, which was very similar to the Balcerowicz Plan, launched in 1990, and Klaus’ programme initiated in 1991. The conditions in Soviet Russia meant the programme ultimately failed because of a lack of political support, insufficient control over the central bank and the persistence of the rouble zone that caused hyperinflation in all 15 former Soviet republics.

Unlike Russia, Ukraine made no attempt at any kind of comprehensive reform programme. Apart from the absence of technical expertise, political will and courage, another important reason for the absence of reforms was the increasing power of the “new elites” created from the old communist “nomenklatura”, the red directors of state-owned companies and also the “new businessmen”, often coming from the secret police and organised crime circles. Milking these state-owned companies by establishing parallel private businesses was the usual everyday practice of the red directors and new businessmen by the end of the 1980s. By the 1990s these practices had reached mass proportions. Huge volumes of resources were funnelled, in this way, into the new private sector. “In the Kravchuk years the amounts were not large

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6 A. Aslund (2014), p91
7 A. Aslund (2014), p93
8 It is important to note that Kravchuk was never a reformer, even during Gorbachev’s Perestroika he was more a critic than a supporter.
9 O. Havrylyshyn (2014), p172-173
enough for the new capitalists to reach oligarch status, but their embryonic rise dates to his presidency.¹⁰

Simeon Djankov’s evaluation of the Bulgarian experience can be applied to Ukraine as well: “The biggest mistake in ... [the] transition process was the failure to adopt a lustration law...".¹¹

In 1994 Leonid Kuchma became the new president. He served as Prime Minister during the Kravchuk years and prior to that he was one of the most influential red directors. At the beginning of his first term in 1994-95, some progress was achieved in macroeconomic stabilisation. A new economic team led by Deputy Prime Minister, Viktor Pynzenyk, in cooperation with the National Bank of Ukraine (headed by Viktor Yushchenko) and backed by the International Monetary Fund (IMF) programme, achieved significant results: inflation was brought back under control (from 10,000 per cent in 1993, to 182 per cent in 1995); a new convertible currency, the Hryvnia, was introduced together with a more liberalised foreign exchange market; prices and trade were deregulated; and a reduced fiscal deficit achieved. The problem was that these changes were not strong and comprehensive enough and the opposition to the “new elites” was so influential that these reform efforts survived only until the summer of 1996, when Prime Minister Pavlo Lazarenko was appointed and regulation and stimulus-based policies won over real reforms, liberalisation and deregulation.¹²

The biggest factor that contributed to the creation of the most powerful oligarchs was privatisation, which was never transparent, open and competitive. The process was fully controlled by the new elites and managed in their favour. Even the mass “voucher privatisation” that was introduced but eventually collapsed, did not result in the redistribution of the national property into the hands of the ordinary people. Instead, it became just another tool for expanding the wealth and influence of the oligarchs who were able to use the chaos and mismanagement connected with this process to their advantage and finally to gain the most of vouchers and then also state property.

The potential of the “Orange Revolution” in 2004-05 was completely lost during the presidency of Viktor Yushchenko, and as a result of this Viktor Yanukovych came to power and misused his stronger presidential competences in an attempt to establish an authoritarian regime, in turn elevating himself and his family to become one of the most powerful oligarchs in the country.

On the eve of the “Revolution of Dignity” Ukrainian political and economic system was a textbook example of a failed state captured by a narrow group of immensely powerful oligarchs. They concentrated economic and political power, controlling the media and creating a system that allowed for the misuse of their political and economic monopolistic position for the further extraction of rent for themselves.

One of the most characteristic features of this dysfunctional, corrupt oligarchic system was of the absence of free and fair competition in both the political and economic arenas. Free and fair competition is a necessary precondition for a liberal democracy and a functioning market economy. The state plays a decisive role in the creation of an institutional framework that shapes the behaviour of the subjects of political and economic life. An institutional framework that protects free and fair competition (in both arenas), punishes those who refuse to respect the rules and try to misuse their political or economic power for the sake of their own narrow interests.¹³

In this regard, the post-communist transition was a process of creating a new institutional framework after the breakdown of the old institutional framework of the command economy, which provided no space for free and fair competition, neither politically nor economically. The biggest problem of this transition was that after the very quick, and in principle, unexpected, collapse of communism, the old institutional framework disappeared and the building of a new one (vital for a functioning market economy and liberal democracy)

¹⁰ O. Havrylyshyn (2014), p172
¹¹ S. Djankov (2014), p144
¹² O. Havrylyshyn (2014), p175
¹³ According to Acemoglu and Robinson’s terminology, Ukrainian system was based on the predominance of exclusive over inclusive institutions.
was very difficult, full of conflicts, misunderstandings and hardships. If the new elites are not creating this new institutional framework intentionally and deliberately with a goal of protecting political and economic freedom (thus free and fair competition in both areas), then spontaneous, unmanaged development unavoidably leads to the creation of a dysfunctional, corrupt oligarchic system. One of the most significant features of this corrupt system was the absence of the rule of law and poor protection of property rights.

This is exactly what happened in Ukraine between the collapse of communism and the Revolution of Dignity in 2013-14

An oligarchic system does not necessarily mean that corruption and extraction of rent was only carried out by the highest representatives of the new elite, especially the oligarchs. They are, of course, the most visible, most influential and richest representatives of the oligarchic system of elites. But corruption, in all aspects and definitions of this phenomenon, was an inherent feature of the entire system. Corruption was a deeply rooted and widespread on all levels within Ukrainian society.

Box 1. Corruption in the healthcare system

Investigative journalist Oliver Bullough\textsuperscript{14} wrote about corruption within Ukrainian healthcare.

He met an SBU (security service) agent that was responsible for the preparation of a report on the state of corruption in the healthcare sector in 2008. He described a "system devoted not to treating the needs of an ailing population, but instead to making money for a caste of privileged insiders". Ukrainian healthcare costs are socialised, in that the government pays for the facilities, the buildings and the infrastructure. The profits, however, are privatised, in that the doctors get to keep what they earn, of course illegally, mainly by unofficial payments that are not taxed at all.

Also, government purchases within healthcare (as well as in other areas) were ineffective and corrupt. For example, "anti-corruption activists worked out that, in 2012, Ukraine's health ministry was overpaying for HIV and TB (tuberculosis) medications by 150-300 per cent, compared to the charities that bought the same drugs; and it was at a time when there wasn't enough money to provide anti-retroviral medicines to everyone who needed them".

The system was so dysfunctional that the state was not even able to provide basic goods and services for its people and as a result, even doctors who were not normally corrupt, were forced to ask patients for unofficial payments for providing them with necessary drugs or equipment. The common practice in Ukrainian state hospitals became such that patients had to first buy the necessary drugs or equipment at the pharmacy and only then the doctor would treat the wound in the hospital.

With regards to corruption, the agent continues: "I don't think there's corruption in Ukraine and I'll explain why. Corruption exists when you have a healthy state; and it takes up just 10, or maximum of 15, per cent of the country. When it takes up 99 per cent of the country, that's not corruption, that is the state. Do you understand the logic? It's total. It's total at all levels. Even an old granny selling sunflower seeds is part of this, because the policeman going past takes five or ten hryvnias from her. She gives, he takes and this suits them both fine, because she knows she's got someone looking out for her."

The destiny of the above-mentioned secret service agent is also very illustrative. His report (with concrete names of doctors, persons and companies) was confidential, only intended for the government, but somebody leaked it to the media and even in Ukrainian conditions where people were accustomed to bad behaviour from their officials, it created a very strong and negative response.

The reaction to the report was immediate. In October 2008 an assailant threw a grenade at the agent's car. The agent survived but suffered serious injuries. Afterwards he said, "The pharmaceutical mafia ordered the hit. But the investigation was never finished. It was closed, someone paid for that, and so it never led to anything... It would have been in the interest of any one of the clans that are still working the system."

\textsuperscript{14} O. Bullough (2018), p107-108.
A dysfunctional corrupt system is not only ineffective and passive in the protection of the public interest; it is almost the opposite, becoming a tool for destroying public interest, for the sake of a few and their narrow interests.

For example, law enforcement institutions were not only passive in the protection of property rights; they were misused, and actively engaged in the process of property rights violation. Tax authorities were not only tolerating tax evasion, they also were active in bribes, creating tax evasion schemes and loopholes as well as blackmailing businesses. Control and regulation institutions were actively creating new permissions and licences for demanding bribes and so on. The most serious as well as the most difficult problem was the intertwining of law enforcement institutions and organised crime.

Corruption was omnipresent, but there were some areas where economic corruption was the most prevalent, especially in respect of costs.

The first and maybe the most important was the energy sector including electricity, oil and in particular, natural gas. Gas imports from Russia were not only an enormous avenue for corruption but also a tool for interfering with Ukrainian politics, violating the independence and sovereignty of the country.¹⁵

There were a lot of schemes in the energy sector that milked the state, consumers and taxpayers. The most notorious being the one by the state-owned company Naogaz, who had the monopoly on gas and regulated the price of gas for households.

Until 1 April 2015 the average price for households was only 12 per cent of the market price (for companies and export). For more than two decades the gap between the full commercial price and the regulated price for households was enormous and created vast opportunities for “dirty business” where gas was bought for households at the regulated low price and then sold at the full commercial price either to other companies, or for export. This kind of “business” was finally paid for by the taxpayers to cover the mounting debt of Naogaz.

In 2014 the Ukrainian public finance deficit exceeded 10 per cent of GDP, the biggest item being the deficit of Naftogaz at a level of 5.5 per cent of GDP. Apart from the fiscal deficit disarray, Naftogaz also had a profound impact on external accounts. 2012-13 saw the total bill for imported gas amount to US$ 25 billion, so it was the major reason behind the drain in foreign exchange reserves.

Before the Revolution of Dignity, the second source of big corruption was the banking system. Ukraine had around 180 banks, but the majority of them did not serve as traditional commercial banks, but as ATM machines for the bank owners. The model was very simple in principle. Banks collected money from savers and companies and then gave the same money out as credits, mostly to companies directly or indirectly controlled by bank owners (related party lending). Borrowers did not return money and savers then had to be compensated by the state-guarantee fund, which meant, in principle, by state, or taxpayers’, money. The amount of money milked in this way out of taxpayers was enormous.

The National Bank of Ukraine (NBU), for example, regarding PrivatBank in January 2018, announced, “an independent probe of the bank’s historical operations found [it] had been used for “large-scale and coordinated” fraudulent schemes spanning at least a decade before the bank’s nationalisation in December 2016 and resulting in losses of at least US$ 5.5 billion”.¹⁶

Other problems included state-owned banks which provided loans under political influence.

The third largest area of big corruption was in tax administration. There were many methods used, probably the most prolific of which was blackmail with regard to VAT rebates. The typical precondition for a VAT refund was a bribe at a return of 20-30 per cent of the sum.

Another "Eldorado" of corruption was public procurement, where the state and its institutions purchased goods, services and investments at higher prices but usually at a lower quality in comparison with private counterparts.

¹⁵ For more details see Box 3 on page 20.
¹⁶ Ahead of its nationalisation in December 2016, more than 95 per cent of PrivatBank’s corporate lending was to parties related to former shareholders and their affiliates, with 75 per cent of the loan book consolidated into loans for 36 related-party borrowers. The majority of these loans remain overdue and unpaid, resulting in a loss to the bank of at least US$ 5.5 billion. National Bank of Ukraine.
Customs was yet another area that experienced high levels of corruption, with smuggling and bribes being more the rule than the exception.

Yet another of the biggest sources of corruption were the state-owned companies. Ukraine still has around 3,500 state-owned companies that are, in principle, outdated, ineffective and loss-making. More than half of them are not functional at all. State-owned companies are still being milked for the sake of private companies and the political parties that control them, in the name of the state.

**How the oligarchic system works**

Despite the fact that the whole political and economic system is corrupt, the most important systemic feature of corruption is the almost unlimited power of the oligarchs. Power comes from the capitulation of political and state institutions to the narrow interests of a few of the richest and most influential people, who captured the state and shaped the rules of the game. On the flip side, only the oligarchs are strong enough to stand up and defend themselves against the predatory state, making it somewhat a two-way street.

In the beginning, Ukrainian oligarchs accumulated the biggest part of their wealth from the commodity-based industries¹⁷ that became a quick and easy source of large profit – without investment, entrepreneurship and real competition. Later on, once they almost fully occupied the sector, they shifted their interest and money away from commodity production and towards less profitable areas like banking, retail, energy supply, airlines, chemicals and construction. A few of the biggest oligarchs quickly monopolised these industries and took control of significant parts of the economy and continued in their “rent-seeking” style of doing business. At the same time they gained control over the media to influence public opinion in their favour.

According to the data of the Anti-monopoly Committee for 2013-14, the following markets were fully occupied by monopolies or oligopolies in Ukraine: extractive industries, power, gas, heat supply, water supply and sewage. Transport and infrastructure were more than 80 per cent controlled by monopolies or oligopolies. In these areas oligarchs played a decisive role either as direct owners of the companies, or by de facto controlling (in cooperation with politicians) the most important state-owned companies (like Naftogaz, Ukrainian Railways or UkrGasVydobuvannya – a gas extraction company).

**Box 2. State capture by oligarchs**

How poorly state institutions functioned and how the state, in reality, was a servant of the oligarchs, is illustrated by the article from Ukrainian Week¹⁸ published on 31 August 2012.

“A good example is the position of Rafael Kuzmin, First Deputy Chair of the Anti-monopoly Committee, who insists that Dmytro Firtash and Rinat Akhmetov, two Ukrainian tycoons referred to as key Party of Regions’ sponsors until recently, are not monopolists. Meanwhile, independent economists estimate that DTEK, a group of power plants owned by Rinat Akhmetov, controls over 35 per cent of the electricity supply market. Dmytro Firtash’s entities control 100 per cent of facilities producing ammonium nitrate and nearly 50-60 per cent of ammonia and urea production facilities. Meanwhile, Mr Kuzmin refers to the Privat Group as a monopolist. The group is owned by Ihor Kolomoyskyi and Hennadiy Boholiubov who are still outside the Party of Regions. However, Mr Kuzmin admitted that the Anti-monopoly Committee had no proof of Privat Group’s monopolistic activity because its different companies are owned by various offshore entities.

“Ukrtelecom, a major Ukrainian telephone operator, has recently been bought by a little-known company linked to the president’s family, according to The Ukrainian Week’s sources. Prior to being sold to private investors, Ukrtelecom had been on the list of natural monopolies dominating the nationwide markets for local telephone service and telecommunication channel rental. However, it was removed from that list in June 2011 although the company controls nearly 70 per cent of the city landline telephone market and 75 per cent of the

¹⁷ Especially in metallurgy and the chemical industry concentrated in Eastern Ukraine.
¹⁸ O. Kramar (2012)
intercity and international telephone connection markets.

“Another factor that hampers the struggle against monopolists is Ukraine’s legislation, which, unlike American antitrust laws, does not qualify a company’s monopolist position as a violation. Thus, a company may control 50 per cent of the market and nobody will pay attention provided that it tolerates other players (at least from the Anti-monopoly Committee’s standpoint, even though the Committee may be encouraged to take a selective approach).

“Anti-monopoly authorities in developed countries disclose the registers of private corporations displaying elements of domination. Even the Russian Anti-monopoly Service keeps a record of commercial entities whose share on a certain market exceeds 35 per cent or commercial entities that dominate in specific markets. Meanwhile, the Ukrainian Anti-monopoly Committee’s press service told The Ukrainian Week that “Under the effective Law on Natural Monopolies, the Committee is required to keep a record of natural monopolies, but not other monopolies.” How effectively can the state protect competition by following this procedure?”

A very significant systemic feature and a reason for the poor performance of the Ukrainian economy was the lack of investment in the export-oriented tradeable goods sectors that could help significantly improve economic productivity and boost growth.

Many factors could be held responsible for this but the most important were very poor protection of property rights, macroeconomic instability and lack of interest or ability of new elites to develop their business and, therefore, the country’s economy as a whole.

Oligarchs in principle do not develop their businesses, invest, restructure or modernise their own companies (or the state-owned enterprises controlled by them). They are focused much more on making a quick return; and instead of then investing this money back into the Ukraine, they move it to safe havens abroad. According to various sources, around 80 per cent of the capital made in 2013 by the five biggest oligarchs was siphoned off abroad.

Table 1.2
Cumulative amount of FDI per capita in Ukraine, Romania, Poland, Latvia and Slovakia (1993-2017 in US$)

<table>
<thead>
<tr>
<th>Country</th>
<th>FDI per capita in 1993-2017 (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ukraine</td>
<td>1.878</td>
</tr>
<tr>
<td>Romania</td>
<td>4.901</td>
</tr>
<tr>
<td>Poland</td>
<td>6.734</td>
</tr>
<tr>
<td>Latvia</td>
<td>9.226</td>
</tr>
<tr>
<td>Slovakia</td>
<td>10.449</td>
</tr>
</tbody>
</table>

Source: World Bank open data

The figures in Table 1.2 demonstrate how Ukraine attracted much less foreign direct investment (FDI) compared to other countries. Even then, about one third of the figures shown were from Cypriot investments, that is, mostly funds of Ukrainian oligarchs previously taken out from Ukraine.¹⁹ Protection of property rights was not the only reason behind the low FDI in Ukraine. The active resistance by the oligarchs to potential competitors acted as an additional barrier. In the extractive industries, for instance, corruption in the process resulted in problems with receiving licences, standard production sharing agreements and international arbitration clauses among other issues.

Other reasons why the rate of investment from the non-oligarchic sector was very low include: macroeconomic instability; poor prospects for small and medium-size business development; high levels of informal economy; an underdeveloped banking sector with widespread corrupt practices (such as related-party lending); very high indebtedness; and poor payment discipline.

Public investment was also limited, especially due to slow economic growth, depleted funds as a result of high corruption, low efficiency of use of public resources, widespread tax evasion, as well as unsustainably high expenditure in unreformed social security system (for example, pension expenditures were at 18 per cent of GDP in 2010, while a sustainable level is around 8 per cent, but not more than 10 per cent).

¹⁹ See more at: https://bank.gov.ua/doccatalog/document?id=73849830 (Ukrainian)
The result of this underinvestment in economic development is a lack of competitiveness, degradation of assets, obsolete equipment and an inflexible structure of the economy and industry. Instead of the “creative destruction” that is characteristic of a free and fair competitive system, the Ukrainian oligarchic system can be defined only by “destruction”.

This kind of uncompetitive economy reduces export ability and potential as shown in Table 1.3.

Table 1.3
Overall export in Ukraine, Poland, Slovakia, Romania and Latvia

<table>
<thead>
<tr>
<th>Country</th>
<th>1996 (US$ billion)</th>
<th>2017 (US$ billion)</th>
<th>1996 (%)</th>
<th>2017 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ukraine</td>
<td>20.3</td>
<td>53.7</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Poland</td>
<td>35.3</td>
<td>280</td>
<td>173</td>
<td>521</td>
</tr>
<tr>
<td>Slovakia</td>
<td>14.5</td>
<td>92.2</td>
<td>92</td>
<td>171</td>
</tr>
<tr>
<td>Romania</td>
<td>9.7</td>
<td>87.8</td>
<td>17</td>
<td>163</td>
</tr>
<tr>
<td>Latvia</td>
<td>2.4</td>
<td>1.3</td>
<td>12</td>
<td>34</td>
</tr>
</tbody>
</table>

Source: World Bank open data

Under these conditions, the Ukrainian industrial potential, that was relatively strong at the end of the communist era, was largely destroyed over the last few decades. Thirty years ago the Ukrainian machinery industry was more developed and advanced than the Polish, Slovak or Romanian industries. Ukraine produced aircraft and rockets while Slovakia’s production was predominantly in tanks and canons. How this changed is shown in Table 1.4.

Table 1.4
Structure of export in Ukraine, Poland, Slovakia and Romania (2017,²⁰ in per cent)

<table>
<thead>
<tr>
<th>Country</th>
<th>Advanced products (%)</th>
<th>Commodities (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ukraine</td>
<td>9.8</td>
<td>63.9</td>
</tr>
<tr>
<td>Poland</td>
<td>41.6</td>
<td>17.2</td>
</tr>
<tr>
<td>Slovakia</td>
<td>51.5</td>
<td>14.5</td>
</tr>
<tr>
<td>Romania</td>
<td>51.6</td>
<td>16.6</td>
</tr>
</tbody>
</table>

Source: Calculations based on the World’s Top Exports: http://www.worldstopexports.com/ukraines-top-10-exports/

It is clear from Table 1.4 that while in Poland, Slovakia and Romania, the most important export items are industrial products, in Ukraine commodities hold a prominent position in the country’s export mix. The reason is simple – the competitiveness of commodity items is possible to sustain without investment (or with low investment) and without reforms. This competitiveness is sustained by permanent devaluation which allows for low labour costs.

Table 1.5
Currency rate appreciation (+) or depreciation (-): local currencies against US$ in per cent (1995 = 100 per cent)

<table>
<thead>
<tr>
<th>Currency</th>
<th>2008 (%)</th>
<th>2017 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech crown (CZK)</td>
<td>+35.7</td>
<td>+11.9</td>
</tr>
<tr>
<td>Polish złoty (PLN)</td>
<td>+0.65</td>
<td>-55.8</td>
</tr>
<tr>
<td>Slovak crown (SKK)</td>
<td>+28.1</td>
<td>€ from 2009</td>
</tr>
<tr>
<td>Ukrainian hryvnia (UAH)</td>
<td>-358</td>
<td>-1.805</td>
</tr>
</tbody>
</table>

Source: Calculations based on the World Bank open data

In the case of Ukraine, a significant portion of its export commodities (that is the biggest part of the overall export) is either directly or indirectly controlled by oligarchs.

How much Ukraine lost during the last nearly three decades is evident from an analysis of the Top 500 companies in central Europe (CE).²¹

The figures in Table 1.6 show very clearly how much Ukraine is lagging behind. Poland has 182 companies among the CE top 500, Ukraine has only 29 and even Slovakia, eight times smaller in population than Ukraine, has 32. In respect of multi-national companies among the CE Top 500, Slovakia has 25 and Poland 92, whereas Ukraine has only three.

²⁰ Calculated from the 10 biggest export items of the listed countries and a share of these items in total export.
²¹ Deloitte, Central Europe Top 500
Table 1.6
Top 500 companies in central Europe – Ukraine, Poland, Slovakia and Romania (2016)

<table>
<thead>
<tr>
<th>Country (population)</th>
<th>CE comparator</th>
<th>External industry</th>
<th>Local</th>
<th>Local industry</th>
<th>Multi-national company</th>
<th>State-owned enterprise</th>
<th>Together</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ukraine (45.00 million)</td>
<td>1</td>
<td>3</td>
<td>15</td>
<td>3</td>
<td>7</td>
<td>29</td>
<td></td>
</tr>
<tr>
<td>Poland (37.97 million)</td>
<td>3</td>
<td>21</td>
<td>32</td>
<td>92</td>
<td>34</td>
<td>182</td>
<td></td>
</tr>
<tr>
<td>Romania (19.7 million)</td>
<td>2</td>
<td></td>
<td>2</td>
<td>37</td>
<td>5</td>
<td>46</td>
<td></td>
</tr>
<tr>
<td>Slovak Republic (5.43 million)</td>
<td>2</td>
<td></td>
<td></td>
<td>25</td>
<td>5</td>
<td>32</td>
<td></td>
</tr>
</tbody>
</table>


As mentioned earlier, Ukraine and Slovakia at the beginning of the 1990s found themselves in very similar situation. Their economic level was approximately the same, both countries were faced with the need to build institutions of newly-established independent states, and both countries were in transition from centrally planned to market economies. At that time, the industrial base and development was more advanced in Ukraine. But what is the situation now? The economic level measured in GDP per capita is almost four times higher in purchasing power parity in the Slovak Republic (and almost seven times higher in dollars in nominal GDP). Slovak exports in absolute terms are almost twice as high as Ukrainian exports and while the majority of Slovak export consists of advanced machinery and industrial products, dominant export articles in Ukraine are commodities and agricultural products.

Looking in detail at the Ukrainian and Slovak companies listed among the Top 100 companies by revenue in Central Europe, we can see how the differing industries reflect the economic disparity.

Coincidentally, Ukraine and Slovakia both have seven companies among the CE Top 100,²² but their ownership, production and advancement is very different.

Among the seven Ukrainian companies, three are state-owned – 1. Naftogaz, 3. Energorynok and 6. Ukrainian Railways. Slovakia has no state-owned company among its seven. But while five out of seven Slovak companies are owned by multinational concerns – 1. Volkswagen, 2. Kia, 4. Samsung, 5. Peugeot and 7. US Steel – Ukraine only has one – 5. ArcelorMittal. Lastly, among these seven biggest Slovak companies, four are advanced industrial producers. Ukraine has no such kind of company among its top seven.

As the same source²³ indicates, the financial sector shows an even bleaker picture. Out of the top 50 banks in Central Europe there are fifteen in Poland, six in Romania, four in Slovakia but only two in Ukraine. While the assets of the Slovak Republic’s four banks are €45.5 billion, the assets of the two Ukrainian banks amount to €16.5 billion. The situation among the top 50 insurance companies in Central Europe is even worse – sixteen of them are in Poland, five in Romania, four in Slovakia but none in Ukraine.

Investment, especially foreign direct investment, is important and without a significantly higher FDI influx Ukraine cannot successfully restructure its economy and unlock its potential. For this, a change in its institutional framework is needed. Ukraine features very low down in the global value chain, which means that its participation in global production and trade with complex, sophisticated products and services is highly insufficient. As the World Bank’s Global Value Chain Report showed, “higher technology industries that produce a more specialised product are more sensitive to institutional quality... whereas poor institutions can constrict the

²² World Bank (2016). Ukraine has 45 million inhabitants, while the Slovak Republic has only 5.43 million.
²³ Deloitte, Central Europe Top 500.
domestic production of these types of intermediate goods.²⁴ The reason being that more advanced and complex products and services that have stronger and complex value chains are more contract-intensive. Countries with better institutions, such as property rights and rule of law, participate more in the global value chains. Ukraine needs to graduate from exporting primary commodities to become a major participant in global value chain exports. While global value chain exports account for less than 10 per cent of Ukraine's total, other comparable countries lead the way with Poland at 27 per cent, Romania and Turkey at 38 per cent and Vietnam at 59 per cent.

Box 3. The story of Dmytro Firtash

On 26 November 2014 Reuters published a special report²⁵ analysing the story of successful Ukrainian oligarch Dmytro Firtash, based on a very detailed analysis of Cypriot, Russian and Ukrainian customs and tax documentation.

In July 2004, a new company, RosUkrEnergo [RUE], became the intermediary for gas deals between Russia and Ukraine. The owners of RUE were unknown at first, but it later emerged that nearly all of the company was owned by Firtash and [Russian energy company] Gazprom. RUE bought gas cheaply and sold it on at a higher price in Ukraine and Europe. This arrangement guaranteed profits for RUE and was hugely controversial among Ukrainians who saw RUE as an unnecessary intermediary. Another US diplomatic cable, from March 2009, described RUE as a "cash cow" and a "serious source of... political patronage." In a website posting, RUE said that in 2007 it sold nearly US$ 10 billion worth of gas and had a net income of US$ 795 million.

After Yulia Tymoshenko, herself a former gas trader, became prime minister of Ukraine in 2008, she reacted to public anger about the gas trade and moved to cut Firtash and RUE out of the business. She struck her own gas deal with then-Russian Prime Minister Vladimir Putin in 2009.

By that time, Firtash was rich. In the country’s 2010 presidential election, Firtash, by his own admission, aided the pro-Russian Viktor Yanukovych. A US diplomatic cable described Firtash as a "major financial backer" of Yanukovych.

The report continues with accounts suggesting that without Firtash there would not have been a Yanukovych victory.

With Yanukovych president, Tymoshenko stepped down as prime minister. Business associates of Firtash were appointed to influential positions in the new administration. He had allies in the corridors of power, and ambitious plans to expand his business empire and get back into the gas trade. His friends in Russia were happy to help him...

In June 2010, Firtash established a company called Ostchem Investments in Cyprus. A month later, Gazprombank registered a credit line to the company of US$ 815 million, according to Cypriot documents. In September, Ostchem Investments bought a 90 per cent stake in the Stirol fertiliser plant in Ukraine. It was perfect synergy: Firtash knew the gas business, and natural gas is a major feedstock for making fertiliser.

Further loans and deals with Firtash companies followed.

Reuters found that by March 2011, Gazprombank had registered credit lines of up to US$ 11.15 billion to Firtash’s companies. The companies may not have borrowed that whole sum, but the documents indicate that loans up to that amount were available, according to Cypriot lawyers.

In the space of seven months in 2011 alone, Firtash acquired control of two more fertiliser plants in Ukraine: Severodonetsk Azot and Rivne Azot. He also bought the Nika-Tera sea port, through which fertiliser and other dry bulk goods are shipped. He acquired a lender called Nadra Bank and invested in the titanium processing industry.

Such was his expansion that Firtash became the fifth largest fertiliser producer in Europe. When asked in 2011 where the money came from to pay for his acquisitions, Firtash was coy. At a press conference

²⁵ See more at: https://www.reuters.com/investigates/special-report/comrade-capitalism-the-kiev-connection/
called to announce his purchase of the Severodonetsk plant, he declined to name his major lenders. "It's a secret," he told Ukrainian journalists.

But a Gazprombank manager told Reuters that the Russian bank had led a consortium of lenders which in 2011 agreed to lend about US$ 7 billion to Firtash. The official said Gazprombank itself lent Firtash US$ 2.2 billion, and that Firtash still owed the bank US$ 2.08 billion. The official declined to name other lenders in the consortium.

Firtash had money, political connections and businesses that relied on large supplies of gas. What he needed next was fuel.

In January 2011, Firtash signed an unpublished agreement – seen by Reuters – with Gazprom to buy gas through a company called Ostchem Holding in Cyprus, of which he is the sole listed director.

The gas deal was later extended to include sales to Ostchem Gas Trading AG in Switzerland. This was also agreed by Naogaz, Ukraine's state-owned gas firm, where Yanukovych had installed new senior management. Firtash needed Naogaz's sign-off because it controlled pipelines delivering gas and, until that point, had an exclusive deal to import gas from Gazprom.

Russian customs records seen by Reuters show that in 2012, Moscow sold the gas to Firtash for US$ 230 per 1,000 cubic metres (the standard unit used in gas sales). In 2013 the average cost was US$ 267 per unit. Those prices were at least one-third less than those paid by Ukraine's Naogaz.

Ukrainian customs documents and corporate filings show that Firtash's Ostchem companies in Cyprus and Switzerland resold the gas to his chemical plants in Ukraine for US$ 430 per unit. The prices and volumes suggest that the two offshore Ostchem companies made an operating profit of approximately US$ 3.7 billion in two years.

The real loser in the deal, though, was Gazprom. The arrangement, which Putin described during a press conference as having been made with the "input of the Russian leadership," meant Russia sold its gas to Firtash for at least US$ 100 per unit less than it could have made in western Europe, according to Emily Stromquist, head of Russian energy analysis at Eurasia Group, a political risk research firm.

In addition, the profits from the subsequent resale of the gas were all reaped offshore by companies that did not benefit the Russian taxpayer. Those profits in 2012 and 2013 would have meant an additional US$ 2 billion for Gazprom, whose ultimate majority owners are Russia's citizens.

The loss Ukraine incurred due to absence of reforms in the decades after the fall of communism can be illustrated by looking at the average salary, pension, life expectancy, income inequality and emigration figures. During the last 25 years the life expectancy of people in European post-communist countries has increased by 5-7 years on average. The only exceptions are Ukraine, Belarus and Moldova where the life expectancy has increased much less, or not at all.

Political parties and state institutions

Ukraine, since independence in 1991, has been a country with a pluralistic parliamentary democracy and a mixed semi-presidential and semi-parliamentary political system. The power of the president has varied over time, but the executive power has remained divided between the president and the government. On one hand, it serves as an insurance against a potential usurpation of absolute power by one person, as happened in Belarus and Russia. However, on the other hand this semi-presidential system creates a lot of tension between the key power holders at the helm of the state, and imposes transaction costs, conflicts and difficulties in the reform process that is, by definition, politically very difficult and sensitive.

Political parties in Ukraine were replacing each other in power and in opposition, some old parties disappeared and new ones were established but the core problem was that almost all parties, as well as a majority of their MPs and government representatives, did not want to put an end to the oligarchic institutional system. What they wanted was purely to participate in, and take advantage of it. Even after the Orange Revolution in 2004, no real change came because the oligarchs and "new elites"
were strongly rooted and did not have any interest in real change. In essence, the political parties in Ukraine were not important influencers within the political system. The three biggest oligarchic groups (Donetsk, Dnipro and Kyiv) and the president held real political power. It was especially the case when the Ukrainian political system was a presidential one (during the reigns of Kuchma and Yanukovych). Those four centres of power controlled the political parties, government and parliament. The only attempt to change this system was when the president lost some of his power – in the first instance, after the Orange Revolution and in the second after the Revolution of Dignity.

Another reason for such a weak demand for reform was that Ukraine was to some extent a divided country in respect of its geopolitical orientation. Historically western Ukraine was always more inclined towards Europe and the European Union and the east favoured Russia and the Commonwealth of Independent States. Even ethnically a strong proportion of Ukrainian citizens identified as Russian and Russian interference in Ukrainian business and politics was deep-rooted (as disclosed in the report in Box 3). Ukraine's economic dependence on Russia was significant. Half of the gas and oil came from there and Russia was also the country's biggest and most important trade partner. Russian propaganda against the EU and especially against NATO was also influential in Ukraine.

The Ukrainian political system has been pluralistic with elections (including all presidential elections) being open and competitive in the sense of the uncertainty of who will win, but this did not mean competition was free and fair. The key reason of this was the influence of oligarchs (through money and the media – especially TV channels) on the election process. At the end of the day, it was irrelevant who won the elections as all political parties were under the influence of particular oligarchs, while the strongest of them supported the parties or politicians most useful to them. Therefore, after any elections the only change was in the relative strength of influence over the state and state institutions among the different oligarchic groups. Under these circumstances there was no real chance for systemic change, or there being any criminal consequences for the oligarchs.

However, some changes in the society did occur. A strong civil society (CSO) sector was created and its influence grew particularly after the Orange Revolution. Another strong agent of change was the journalists at the time, especially the new generation of journalists. Although the TV channels and majority of other media outlets were controlled by the oligarchs, they did not like each other, which meant that any revelation of corruption and scandal about other oligarchs was allowed and sometimes even encouraged. Apart from the media owned by the oligarchs, there were also some independent media outlets whose influence was growing because of their professionalism and independence. Despite all of the above-mentioned distortions within the political system, pluralistic parliamentary democracy in Ukraine, unlike Russia or Belarus, survived thanks to a strong civil society.

Business associations were another factor that created growing pressure and a demand for change, particularly those of them who united foreign business with non-oligarchic and non-rent-seeking businesses.

All those change agents had more and more arguments in favour of real change because as time went on it increasingly obvious how dysfunctional and corrupt the Ukrainian oligarchic system was. The latter was chief among the root causes for Ukraine's falling behind other countries that undertook reforms and successfully integrated themselves into the EU.

Preconditions for change gradually grew and for the first time, during the Orange Revolution, the pro-reform and pro-European groups within society demonstrated their zeal for change. At that time, their efforts did not yield a major transformation and the oligarchic forces prevailed. The second opportunity presented itself during and after the Revolution of Dignity. The question is whether this time things are different. Is Ukraine able to succeed in making change happen? Can it make the necessary reforms? Will it be able to harness its potential and finally complete its transformation into a modern and prosperous European country?

The conclusion, in principle, is YES. But...

26 And even more after Revolution of Dignity.
What has been done

For the first time in Ukrainian history, in the five years after the Revolution of Dignity there is evidence of real shift away from the dysfunctional, corrupt, oligarchic institutional system based on rent-seeking, and towards a functional market economy based on free and fair competition. The glass is still only half full. A lot has been done but there remains a lot to do. The concern is that what has been achieved is not free of risk of reversal.

Geopolitical reorientation

One of the biggest obstacles to succeeding in the implementation of reforms and the EU integration was the lack of national consensus on the geopolitical orientation of the country before the Revolution of Dignity. Especially after Putin came to power, a more aggressive opponent of the West and the EU than his predecessors, it became clear that an ambivalent “in between” position could not work. Close historical, cultural, political, economic and trade relations, as well as very similar systems of crony capitalism, did not allow for the creation of a solid pro-European consensus, despite it being very clear that without reforms and EU integration, Ukraine was predestined for failure.

In this respect, the Revolution of Dignity, as well as the annexation of Crimea by Russia and its aggression towards eastern Ukraine, were decisive factors in the creation of a national consensus to join forces with the EU and NATO and to undertake the necessary reforms to achieve this goal.

It is thus possible to say that by annexing Crimea and military aggression in eastern Ukraine Putin made the biggest strategic mistake of his life – he gained Crimea, but in doing so he lost Ukraine.²⁷

During the last five years, relations between Ukraine and Russia have declined significantly, which is understandable as a consequence of the open and heated economic and trade wars. On one side, it has deepened the recession with all related costs, but on the other side it has sped up the reorientation of Ukrainian trade and economic relations towards the more advanced and demanding markets of EU and Asia (see Table 1.7). Economic relations with these countries are beneficial not purely from a trade or an economic perspective, but also for broader economic and geopolitical reasons. More demanding export markets are pushing for higher quality products; therefore it is helpful for modernisation and provides a boost to the competitiveness of Ukrainian producers. Trade relations are also helpful for encouraging an influx of foreign direct investment from partner countries.

Table 2.1
Trade reorientation after the Revolution of Dignity
(2013, 2018 in per cent)

<table>
<thead>
<tr>
<th></th>
<th>2013 (%)</th>
<th>2018 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Export to Russia</td>
<td>26.06</td>
<td>11.60</td>
</tr>
<tr>
<td>Import from Russia</td>
<td>28.90</td>
<td>13.35</td>
</tr>
<tr>
<td>Export to EU</td>
<td>28.12</td>
<td>40.60</td>
</tr>
<tr>
<td>Import from EU</td>
<td>37.90</td>
<td>41.50</td>
</tr>
</tbody>
</table>

Source: http://www.ukrstat.gov.ua

The substantial positive effect of economic reorientation away from Russia and towards the EU and Asian countries lies also in the diminishing risk of political and economic interference of the Russian regime and oligarchs in Ukrainian politics and economy. In this respect it has been of great importance for Ukraine to significantly reduce its dependency on Russian gas over the years, and instead import it by reverse flow from Poland, Slovakia and Hungary.

Deoligarchisation

After the Revolution of Dignity there was a strong demand for the so-called “deoligarchisation” of society. The majority of voters welcomed the end of Yanukovych’s regime and they expected change, with deoligarchisation and the prosecution of oligarchs, as well as an improvement in their own social and economic situation. Reality has not satisfied this demand, but the question remains. How realistic were these expectations?

Ukraine started reforms but faced a deep recession immediately after the Revolution of Dignity. This situation was unavoidable, not as a result of, or

consequence of reforms, but as a consequence of the absence of reforms many years prior to the Revolution of Dignity. It was also the price paid for Russian aggression against Ukraine and the annexation of Crimea. This was the same kind of transition recession that came after the breakdown of communism and meant only recovering debt and accounts that were accumulated and hidden during the non-reform period.

While Ukraine is still a country with high levels of corruption and a strong formal and informal power of oligarchs, there are good reasons for arguing that significant progress has been achieved in decreasing the oligarchs’ power and interference. The current state of affairs is far from ideal and is certainly not irreversible, but progress is real.

The power the oligarchs hold (both economically and politically) is related to their wealth and the opportunities available for them to continue in their old rent-seeking practice. Both wealth and rent-seeking opportunities have been reduced over the last five years.

While the wealth of the top 100 richest Ukrainians was around 52 per cent of GDP in the last year of Yanukovych’s regime, today (2018) it is at about 20 per cent, and the wealth of the top 10 richest Ukrainians fell from 29 per cent to 10 per cent of GDP.²⁸

Much more important than the figures are reasons behind them. What has changed over the last five years and what is the impact of the new conditions, not only on the level of wealth and power of the oligarchs, but on their ability to continue their rent-seeking practices?

Economic recession after the Revolution of Dignity, the Russian war, the annexation of Crimea and conflict in eastern Ukraine are among many of the reasons for the richest Ukrainians’ fall in wealth. Many of their assets were destroyed or lost. On one hand it had a negative effect not only on the oligarchs’ fortune but also on the economy as a whole. On the other hand, it helped to change the conditions and rules of the game. Donbass, for instance, was the centre of a classic oligarchic model of business practice. Obsolete and abandoned commodity companies without investment, modernisation and qualified management, served their owners only as cash cows. They were sustainable only thanks to a cheap labour force and permanent devaluation.

An important effect of the new situation (after the Revolution of Dignity) was the increasing mobility and flexibility of the labour force.

Crisis and conflict increased the internal and external migration of people²⁹ and completely changed the labour market – while before the Revolution of Dignity it was a buyer’s market, after it became a seller’s market. Employers had to compete for labour, therefore there was a permanent pressure to increase wages, also supported by a minimum wage increase.

Currency rate development is a new phenomenon as well. The country has been plagued by a regime overseeing a fixed exchange rate for almost 20 years, which led to the accumulation of enormous macroeconomic imbalances. The dramatic devaluation and loss of FX reserves in 2014-15 prompted the central bank to abandon the fixed exchange rate regime and adopt an inflation targeting policy combined with a flexible exchange rate. As a result, while the exchange rate is volatile from day to day, it has remained rather stable over the last three years, balancing external accounts and contributing to sustainable disinflation.

During the last four years the currency has not only stabilised, but in real terms even strengthened (due to higher inflation rather than nominal depreciation). In this situation, the old business model, based on cheap labour and a weak currency, cannot work and oligarchs will either have to invest, modernise and better manage their companies, or they will lose their competitiveness.

Another important change over this period has been new relations between state institutions and condions and rules of the game. Donbass, for instance, was the centre of a classic oligarchic model of business practice. Obsolete and abandoned commodity companies without investment, modernisation and qualified management, served their owners only as cash cows. They were sustainable only thanks to a cheap labour force and permanent devaluation.

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²⁸ See more at: https://ukrainianweek.com/Economics/222503
²⁹ The Ministry of Social Policy calculated that about 3.2 million Ukrainians work abroad on a permanent basis. With 16 million Ukrainians working inside Ukraine, this would mean that 17 per cent of the total workforce is abroad, largely in the EU. The ministry reported that 7 to 9 million people a year participate in the migration process. Many work part time in the EU under the new 90-day visa-free tourism rules (Ukrainian Business News, 31.12.2018).
businesses (especially oligarchic business). The best and also the strongest example comes from the banking sector and the National Bank of Ukraine (NBU). NBU is doubtlessly the most successful example of reform after the Revolution of Dignity, showing how a truly independent and professionally managed institution can and should operate and how significantly it can change outdated rules by imposing new relations and regulations on the oligarchs and the government. The cleaning up of the banking system meant that many oligarchs lost their own banks that they used as a tool for siphoning public money into their own pockets. The closing of more than 100 banks, the nationalisation of Privatbank, imposition of strict supervision over commercial banks, enforcement of the new rules, but also an independent and professional monetary policy are all new phenomena in the Ukrainian banking system.

In the case of Ukraine, this change is important not only for monetary policy and the financial sector, but for serving as an example of how to change an old institution that used to serve the short-term interests of politicians and tycoons into an independent, professional institution protecting the public interest – in this case a stable currency, low inflation and a sound financial sector.

NBU also illustrated how big a problem overemployment was, as well as inefficiency within the Ukrainian public sector and how it is possible to tackle this in a short period of time. The number of employees at the NBU was reduced by 70 per cent after the Revolution of Dignity whilst professionalism and performance increased significantly at the same time.

Another new institution (in this case really new) that played a fundamental role in change at this time is the National Anti-corruption Bureau of Ukraine (NABU) which investigates large-scale corruption cases. It is no surprise that the NBU and its former head Valeriy Gontarev, as well as the NABU and its head Artem Sytynik, were and still are, the main targets of anger and attacks from the proponents and beneficiaries of the old corrupt oligarchic system.

There are, of course, many more positive institutional changes that have been achieved during the last five years. Examples are the implementation of the Association Agreement with the European Union as well as technical assistance and investment from international financial institutions like the IMF, World Bank, the European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), International Finance Corporation (IFC) and others.

Another way of measuring the level of “oligarchisation” within the economy was by The Economist’s “crony-capitalism index”. It measures the proportion of billionaire wealth in the country that comes from the so-called “crony sectors”. In 2014 Ukraine attained second place in the world with 89 per cent, only Malaysia faring worse with 98 per cent.

<table>
<thead>
<tr>
<th>Country</th>
<th>2014</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Malaysia</td>
<td>98%</td>
<td>51%</td>
</tr>
<tr>
<td>Ukraine</td>
<td>89%</td>
<td>142%</td>
</tr>
<tr>
<td>Russia</td>
<td>84%</td>
<td>136%</td>
</tr>
<tr>
<td>Singapore</td>
<td>80%</td>
<td>7%</td>
</tr>
<tr>
<td>Poland</td>
<td>75%</td>
<td>36%</td>
</tr>
<tr>
<td>USA</td>
<td>16%</td>
<td>17%</td>
</tr>
<tr>
<td>South Korea</td>
<td>6.5%</td>
<td>44%</td>
</tr>
<tr>
<td>Japan</td>
<td>51%</td>
<td>9%</td>
</tr>
</tbody>
</table>

Source: The Economist and Transparency International

A high position on the crony-capitalism index does not automatically denote a high level of corruption. Singapore, for example, which is very high on the crony-capitalism index (80 per cent in 2014 and 72 per cent in 2016), at the same time occupies a very low position on the Corruption Perceptions Index (7th lowest in the world). But in case of Ukraine (and Russia) it is clear that there is a strong connection between crony-capitalism and corruption. In other words, the oligarchs have played a very destructive role in Ukraine's economy as well as society as a whole. Deoligarchisation is therefore a very real challenge.

The power of oligarchs in Ukrainian society has, however, declined in the last five years due to the non-oligarchic part of the economy growing much faster than the so-called crony sectors.

Among the rent-seeking, or crony sectors, are construction, real estate, gambling, mining, steel,
aluminium and other metals, oil, gas and other commodity industries that mainly involve extracting natural resources from the ground.³⁰

Good, or profit-seeking sectors, include technology, manufacturing, pharmaceuticals, telecoms, retail, e-commerce and entertainment. The figures in Table 2.3 show that the rent-seeking sectors grew much more slowly over the last five years than the profit-seeking sectors.

Table 2.3
The development of the "profit-seeking" and "rent-seeking" sectors after the Revolution of Dignity in per cent of growth (+) or decline (-)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Technology and telecoms</td>
<td>-0.6</td>
<td>+29.8</td>
<td>+29.2</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>-23.8</td>
<td>+14.5</td>
<td>-9.3</td>
</tr>
<tr>
<td>Retail</td>
<td>-29.5</td>
<td>+24.7</td>
<td>-4.8</td>
</tr>
<tr>
<td>Mining</td>
<td>-29.2</td>
<td>-0.5</td>
<td>-29.7</td>
</tr>
<tr>
<td>Electricity and gas</td>
<td>-20.5</td>
<td>+2.6</td>
<td>-17.9</td>
</tr>
</tbody>
</table>

Source: Calculations based on Ukrstat - http://www.ukrstat.gov.ua/

According to the data in Table 2.3, all sectors besides technology hit a deep recession between 2014-15, but recovery was significantly stronger in the profit-seeking sectors (that were immune to the cronny practices) and much weaker in the rent-seeking sectors (mining and electricity and gas).

Even before the Revolution of Dignity, Ukraine had very developed and dynamic cronny-free sectors, where, in principle, there was healthy free and fair competition, such as in agriculture, retail, taxi services, currency exchange among other services, but especially in IT. During the last few years these sectors have flourished and growth has been remarkable.³¹

Another important step in deoligarchisation was made by improving corporate governance in the most important state-owned enterprises (SOEs).³²

It is important to stress that despite these companies being the epicentre of large-scale systemic corruption early on, as previously mentioned, systemic changes were made within the two biggest SOEs – the unbundling of Naogaz and restructuring of Ukrainian Railways. Although much remains to be done, improvements in the last year have been significant.

The most important areas of achievement, which are changing the old institutional system to a new one, are as follows:

Macroeconomic stabilisation
Reducing the share of redistribution, curbing and stabilising the public finance deficit and public debt, creating an independent and professional central bank, implementing a floating currency rate regime, stabilising the currency rate under a floating regime, stabilising and decreasing inflation, cleaning up the banking sector, imposing independent and professional supervision over commercial banks and increasing foreign currency reserves. All of these developments at a macroeconomic level have been a tremendous success and, for the first time in the history of Ukraine, are changing the system.³³

Anti-corruption policy
Any country that wants to fight corruption has to do it on three fronts at the very least:
- Through prosecution
- By reducing the space for corruption
- Through transparency and public control.

The most significant progress has been made on the second front – reducing space for corruption.³⁴

³⁰ R. Sharma (2016), p110-111
³¹ The IT industry grew by 30 per cent during the first half of 2018 (UBN, 1.11.18). E-commerce is the most dynamic sector this year according to Novoye Vremya’s annual listing of Ukraine’s top 100 brands (UBN, 28.11.18). Four million Ukrainians – more than 10 per cent of the adult population - have signed up with BlaBlaCar. Nicolas Brusson, a founder of the online marketplace for carpooling, told the Kyiv International Economic Forum “we have seen phenomenal growth here... Ukraine is the fastest growth country of the 22 countries where we work.” (UBN, 19.10.18)
³² A more detailed analysis can be found in Chapter 6 on page 101.
³³ For more detail see Chapter 2 on page 35.
³⁴ For prosecution see Chapter 3 on page 48 and transparency and public control.
The biggest sources of large-scale corruption were gas, banks, taxes, public procurement, customs, state owned-enterprises and overregulation.

Gas

The natural gas sector was for many years the most corrupt part of the Ukrainian economy, at least regarding the amount of money stolen by crony players. The biggest sources were import contracts with Russian energy company, Gazprom, a price arbitrage based on the significant gap between regulated household tariffs and market price tariffs for businesses, as well as production sharing agreements between UkrGasVydobuvannya (UGV – a subsidiary of the state-owned Naftogaz) and private companies.

Over the last five years, these three of the biggest corruption channels have been fully or almost shut:

- There is no gas imported from Russia (thanks to the reverse flow from Slovakia, Poland and Hungary).
- The price gap was closed in April 2016 and any additional gap created since then until October 2018 was smaller (approximately 60 per cent). The first part of this gap was reduced on 1 November 2018 (tariffs increased by 23.5 per cent) and as of spring 2019 there is no difference between household gas tariffs and market price of gas.
- Production sharing agreements that milked UGV in favour of private companies were cancelled.

Despite corruption schemes still existing,³⁵ their size is incomparable with the past and implemented measures have resulted in a significant reduction in government losses. Ukrainian Institute for Economic Research and Policy Consulting (IER) estimates that in the gas sector alone this is estimated at US$ 3 billion per annum.³⁶

Banks

As already mentioned, the banking sector was another source of large-scale corruption.³⁷ This channel has been almost³⁸ completely cut-off after NBU closed more than 100 out of 185 commercial banks and imposed strict supervision rules, increased capital adequacy, strengthened risk control and restricted related party lending. As a result of these changes there is not only much lower corruption in this area, but a cleaned-up banking sector. 2018 saw its recovery as it finally began working adequately and producing profit.³⁹

Taxes

Between 2015-17, the government prepared and implemented systemic measures for reducing corruption in tax administration through:

- the introduction of electronic VAT administration (from 2016)
- the automatic VAT refund (from 2017)
- the introduction of the special risk assessment criteria monitoring system.

Several measures were implemented to eliminate tax evasion, formerly controlled by the tax administration (and so-called conversion platforms). It has been calculated that the tax revenues collected as a result of decreasing corruption within the tax system amount to approximately US$ 3 billion.⁴⁰

Public procurement

The electronic public procurement system, ProZorro, was implemented for all central executive authorities in April 2016 and for all other public institutions (including local government) from August 2016. The system has significantly reduced abuse in public spending and as estimated by the Ministry of

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³⁵ “The old game of selling gas to factories at household rates still costs Naftogaz about US$ 350 million a year”, Andriy Kobolyev, the company CEO, said [on 13 November 2018] at a conference organised in Kyiv... “Although abuses have largely ended, middlemen companies still manage to sell 1-2 billion cubic meters of subsidised ‘household’ gas every year to companies”, the Kyiv Post reports. See more: https://www.ubn.news/thursday-november-15/.
³⁷ Privatbank alone, according NBU, stole about US$ 5.5 billion of taxpayer’s money in ten years.
³⁹ “From 1 December 2018,] Ukrainian banks made US$ 715 million in profits – eleven times more than in the same period the year before. Kateryna Rozhkov, First Deputy Governor of the National Bank of Ukraine, reported on Facebook. ‘Of course, the year is not over yet,’ she wrote, awaiting full year numbers. But, she said, ‘the banking sector is gradually, but surely recovering.’ 2 January 2019, UBN, https://www.ubn.news/wednesday-january-2/.
⁴⁰ IERPC, 2018, 8.
Economic Development and Trade, yearly savings are US$ 2 billion. Reform of the public procurement system, and ProZorro, are still a work in progress.⁴¹

Deregulation and open data from state registers

Significant progress has been achieved in deregulation and as a result of this also corruption sources for bureaucrats have been reduced, although there is still a lot of room for improvement. Ukraine improved its position in the World Bank’s Doing Business rating from 112 in 2014 to 76 in 2018, by reducing the number of mandatory licences and permits.⁴² Another area of progress is an open data portal that offers access to a number of state registers that were previously closed, allowing bureaucrats tremendous opportunities for manipulation and corruption.

Customs

Despite attempts to improve customs regulation, results are insufficient and customs (together with SOEs) remain a significant avenue for major corruption. For the future, this has to be one of the key priorities, not only in the fight against corruption, but also for the improvement of the business environment, the increase of public revenues and exports and smooth integration into EU value chains.

State-owned enterprises

State-owned enterprises (SOEs) are at present the biggest source of corruption (as regularly asserted by NABU). Since 2014 some progress has been made in the corporate governance of the biggest SOEs, and since 2018 significant progress made within small privatisation. However, progress has been close to zero within large privatisation, despite new privatisation laws that have been in place since the beginning of 2018 which introduced procedures for standard international tenders with the assistance of foreign advisers.⁴³ Committing to the process of reducing corruption in order to gain serious, strategic, investors for these companies has to be one of the most important priorities for the next government.

As highlighted above, the majority of avenues for large economic corruption have been significantly reduced over the last five years. Insufficient progress has been achieved within customs and state-owned enterprises although some changes have been made in these areas, or at least preconditions set up for future changes to be instigated.

Why more has not been done

There are two reasons for why slow progress has been made in the process of institutional change from the old, rent-seeking (oligarchic) model to a new functioning market economy and a parliamentary democracy based on free and fair competition.

The first reasons are objective ones (impossible to change, or overcome in a short period of time) and the second are subjective (based on insufficient will and courage and/or the prevailing narrow private interests among new political leaders).

The objective reasons for slower than expected progress being made (especially by Ukrainians as well as Western partners), are very strong. In principle, the problem was, and still is, that unlike the situation after the breakdown of communism, there was no institutional vacuum after the Revolution of Dignity in which new elites could relatively quickly introduce a new institutional framework (rules of the game). The country was at war with Russia and in severe recession and key economic sectors were under the direct, or indirect, control of oligarchs. At the beginning of the Russian aggression, Ukraine did not have a real army capable fighting, and at least one oligarch (Kolomoyskyi), was helped by his own private sources to stop separatists from annexing more territory than they had gained before in the Eastern Ukraine. Law enforcement institutions and public administration were corrupt, ineffective and also serving the narrow private interests of insiders or outsiders, rather than the public interest. The media, especially TV channels (which are the most influential) were and still are predominantly owned

⁴¹ “In the latest battlefront between geeks and corruptors, ProZorro is applying new software that uses 35 indicators to review all government tenders for potential fraud. Suspicious tenders are automatically forwarded to the State Audit Service for review.” Makysm Nefyodov. First Deputy Minister of Economic Development and Trade, told UNIAN: “It’s even more suspicious when several indicators are triggered simultaneously.” 31 October 2018 – UBN, https://www.ubn.news/wednesday-october-31/.

⁴² See more in Chapter 5 on page 87.

⁴³ See more in Chapter 6 on page 101.
by the oligarchs⁴⁴ and served their interests alone.

In these circumstances the oligarchs were well equipped and had the resources to protect themselves and their interests.

Another objective reason is that, despite the reform of formal institutions (laws, decrees and so on) taking place relatively quickly, the immediate effect was small and making it difficult to see real positive results. The main reason is that the implementation and enforcement of new formal rules depends on the change of old institutions which is often gradual. Another, even more long-term issue is the relationship between formal and informal (voluntarily shared and accepted) rules and values. In the least corrupt countries the majority of people are honest, they do not steal and bribe, not because it is prohibited by law but because they do not consider it morally correct. In these countries, correct, informal rules and values were cultivated over generations⁴⁶ when there was in principle very little distinction between formal and informal rules. The legacy left to Ukraine (as well as in other post-communist countries) was much more problematic⁴⁶ in this area – informal rules were deformed and destroyed over decades and changing this will take generations.

Even if new elites had come into power in Ukraine after the Revolution of Dignity, with a strong vision, will and courage to build a new system, with no connections to the old system of elites and oligarchs, it would have been extremely difficult, or even impossible, for systemic change to take place with any speed.

The subjective reasons for slower than expected progress in deoligarchisation are based on the fact that in principle there were no new elites who took power after the Revolution of Dignity. The majority of the key political positions that were filled after the (free and fair) elections in 2014, were held by more progressive, pro-reform and pro-EU politicians, but also still by some who were from the old system.

Reforms today are much more of a political challenge than a purely technical one. Experience and knowledge have informed which reforms (both successful as well as failed) implemented in dozens of post-communist countries have worked and have not worked. Everything Ukraine needs to do to make change happen has been written in official documents that were passed and signed after the Revolution of Dignity.⁴⁷ The challenge of course is the practical political implementation of these promises and commitments.

Practical experience from successfully reformed countries shows that the most important political preconditions of success in the reform process are strong leadership, ownership and communication of reforms.⁴⁸ Leadership means leaders (politicians who are reformers) with the vision, will and courage to implement reforms despite political risk and conflict. Ownership means a strong conviction in seeing necessary reforms through. Lastly communication should be resolute and tireless, citing clear goals and the reasons for reforms. Being prepared for a public fight against anti-reform forces that might be profiting from an unreformed system and therefore use all their power to prevent systemic change, is necessary.

An example of both objective and subjective obstacles hindering quicker and deeper reforms (especially deoligarchisation) can be illustrated in the area of privatisation over the last five years.

As explained in Chapter 7 on page 112 there has been almost no progress achieved within large privatisation following the Revolution of Dignity despite this goal being clearly articulated by all government and coalition programmes.

The reasons are very complex but in principle it has been because of insufficient public demand for privatisation as well as a very weak desire to privatise. In Ukraine privatisation had become synonymous with the oligarchs' abuse of the system, buying companies for peanuts and then not developing them, only to use them as cash cows (covered earlier in this report). This reputation is the

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⁴⁴ TV channels owned by the four biggest oligarchs (Akhmetov, Kolomoyskyi, Firtash and Pinchuk) control 75 per cent of the TV market. (http://ukraine.mom-rsf.org/ua/ukraine/)

⁴⁵ In Sweden, the “Freedom of Information Act” was passed by parliament in 1773.

⁴⁶ “Who doesn’t steal is robbing his own family” was a popular proverb in Czechoslovakia during the communist regime.


⁴⁸ I. Miklos (2014), p131-133
main reason why the majority of the population still does not support the privatisation of large companies. At the same time, those politicians (and businessmen including oligarchs), who profit from having control over SOEs, also do not want to lose this source of personal enrichment and a tool for political party financing.⁴⁹ The importance of SOEs as a source of "rent exploitation" is also connected with reducing space in other areas such as gas, public procurement, tax administration, the banking sector, as a consequence of reform and the deoligarchisation progress.

An additional problem is that there is no privatisation ministry, nor any privatisation minister in the Ukrainian government. Nobody owns this agenda and nobody is personally responsible for this effort. Line ministries and ministers have a conflict of interest because they do not want to lose control over "their" companies and the State Property Fund of Ukraine is not a political institution, it only has to execute the political decisions of the government. Apart from weak public demand there is also an additional fear for those who want to, and who have the right to privatisate (like State Property Fund representatives) and that is the threat of public accusation or potential criminal prosecution. In case of a corrupt and dependent judiciary system, particularly with the media being under the control of those whose interest is prolonging the status quo, this is not simply a theoretical threat.

Prior to 2018, the old privatisation laws created a serious obstacle for any potential desire to privatisate. After a long fight, new privatisation laws that unlocked the possibility for privatisation were passed.⁵⁰ After that point, from mid-2018, electronic auctions (using the ProZorro system) were launched which instigated a quick and fruitful development within small privatisation.⁵¹ However, the progress in large privatisation was negligible, the main reason being that, in case of small privatisation, the public had no real objections and those in power also had no interest in such small investments. Whereas, as detailed earlier, it was in the area of large privatisation where trust was lacking, so few changes were made.

Lack of leadership and ownership leads to weak will and courage to stand up to privatisation opponents. In that case, communication is also very weak and defensive and as a result public opinion cannot be swayed in favour of privatisation. There is a strong contradiction here because, at present, one of the biggest, if not the biggest source of corruption (especially political corruption) in Ukraine are the large-scale SOEs (as repeatedly stressed by NABU). Effective communication is crucial in order to convince people that transparent, open and competitive privatisation is in place which will attract reputable foreign investors, leading to positive results for the country, economy and the SOEs themselves. The reduction of corruption, especially political corruption,⁵² is what people want to see evidence of before they can trust in these systems on a larger scale.

Specific to Ukraine are the relationships between the three centres of power within the legislative process (president, government and parliament). As SAGSUR's member Yaroslav Zheleznyak's analysis shows,⁵³ the cooperation between government and parliament during all the election periods aer the country attained independence was crucial. The approval rate of the government's legislative proposals during this time was very low – between 22 per cent and 37 per cent (for the three governments aer the Revolution of Dignity –Yatsenyuk's two and the Groysman governments). While during last three governments before the Revolution of Dignity (Tymoshenko's and two Azarov governments) it was between 20 per cent and 55 per cent.

It is a very unusual result in comparison with other developed or successfully transitioning countries,
where the approval rate is usually significantly higher, more than 90 per cent. Ukrainian figures show that there is insufficient trust and cooperation between the government and parliament, as well as non-standard coalition-opposition relations. Normally the majority of the legislation (especially reform legislation) is prepared by the government and then approved by the coalition MPs that are backing their coalition government. In Ukraine it is very different: coalition and opposition support varies from case to case and usually new laws are approved or rejected by ad hoc majorities across all parties whether they are part of the coalition or not. Another anomaly is that the majority of new legislation proposals are not prepared by the government but by various groups of MPs.

Between January 2015 and November 2018, parliament approved 272 pro-reform legislative proposals, 10 per cent of which were proposed by the president, 33 per cent by the government and 57 per cent by the parliament (groups of MPs).

The legitimate question is why and how, in this situation, was Ukraine able to pass so many pro-reform laws. The explanation is that a decisive role was played by new, mostly young pro-reform MPs (so called young blood). What is interesting and key, is that these members hail from all parties (coalition and opposition) and some of them are independent MPs. They played a decisive role not only in supporting pro-reform legislation, but also in the struggle against dangerous anti-reform legislative proposals that aimed to cancel or deform some of the reforms that had been passed before, or proposals that intended to introduce corruption and rent-seeking schemes for crony businessmen and their political allies.

For future reform progress it is essential to harness the force of these pro-reform MPs in parliament.

What to do next?

The state of affairs described above demands continued implementation of systemic changes by reducing the space for rent-seeking practices and expanding the space for free and fair competition, in both political as well as economic arenas.

In economic terms, the most important mission will be to sustain macroeconomic stability and the independence of the central bank as well as to continue reforms to strengthen the protection of property rights, law enforcement, deregulation, liberalisation, privatisation, an open market for new domestic and foreign business, professional and independent regulation where necessary (natural monopolies), strong anti-monopoly policy and institutions and competent and effective public administration among others. Much has been done in these areas, but still not enough, and the situation is still not irreversible.

There are many domains in which reforms are needed but what is crucial is to identify which ones are fundamental for real and definitive change in the system – delivering the Ukraine from the corrupt, oligarchic kleptocracy into a healthy, modern, competitive market economy. In this author’s opinion, apart from sustaining and protecting all the reforms and achievements that have been made over the last five years (as described in this publication), there are six crucial areas indispensable for success going forward:

- Rule of law and protection of property rights.
- Privatisation.
- Land market liberalisation.
- Restructuring, demonopolisation and opening regulated and closed sectors such as the energy sector and railway transport.
- Tax administration and customs reform (especially customs where very little has been done until now).
- Public administration and public sector reform.

If there is progress in the above-mentioned areas in the next few years, Ukraine can expect much higher foreign direct investment influx and higher, sustainable economic growth. If not, reversal back to the old system will be very difficult to avoid.

International institutions have played significant roles in aiding Ukraine’s reform process after the Revolution of Dignity. The European Union and IMF especially helped with the necessary reforms. The IMF’s influence was particularly strong due to Ukraine’s financial vulnerability. Without IMF money it would have been impossible to cover debt

For more details see Yaroslav Zheleznyak’s analysis in Annex 2 on page 167.
repayments and avoid default. This support was conditional upon delivering on the reform commitments agreed between IMF and Ukraine.

EU (and NATO) membership is very important for Ukraine and its people, as well as being in the interest of the Western world. Therefore it is key to offer Ukraine realistic euro and euro-Atlantic perspective to motivate its leaders and citizens to persist through the difficult but much needed reform process.

Looking ahead to the future, it is important to understand that Ukrainian dependence on IMF and other official creditors (mainly the World Bank and European Union) will last through to the 2019 election year, and likely through to 2020 and 2021, due to high debt repayments. As Ukraine's position in global markets has not improved, it is fair to expect that any new political representation that will come to power after the 2019 presidential and parliamentary elections will have to accept this situation and commit to the reform path.

Even anti-reform populists who have promised to halve gas tariffs and want to remove the independent status of the NBU will have to choose between two options – either do it, lose the IMF programme and support and unavoidably face default (with high devaluation and inflation as consequence), or continue with reforms and sustain the IMF programme.

This harsh reality decreases the risk of reform failure in the short term, although some risk still exists. However, much bigger risk is potential reform deprivation in the medium term when the IMF leverage in Ukrainian conditions will not work. If reforms continue after 2019, we can expect growth of around 3.5-4.0 per cent, which is sufficient to bridge the most vulnerable period and dependence on IMF financing. The question is, however, what happens next? This is, in this author's opinion, the most important challenge and task for all pro-reform forces in Ukraine as well as abroad.

Supporting “young blood” in politics and public administration, supporting pro-reform NGOs, think tanks and independent media and communicating the necessity of reform will be crucial.

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Ретроспективний аналіз даних щодо обсягів прямих іноземних інвестицій, в яких кінцевим контролюючим інвестором є резидент (round tripping) за 2010р. - 2018р. (Retrospective analysis of data on volumes of direct foreign investments in which the ultimate controlling investor is a resident (round tripping) for 2010-18)


Chapter 1
Chapter 2
Macroeconomic policies

Pavlo Kukhta

Despite reform efforts in recent years, Ukraine's relative position among European economies can only be described as dismal. At US$2,656 as of 2017, the country's nominal GDP per capita in US dollars is the lowest in Europe.¹ Because of this underdeveloped economy, its people are some of the poorest in Europe: while mean wages in Ukraine were less than €300 in 2018, all of its EU neighbours just across the Western border enjoyed much higher mean wages of above €1,000.

Official numbers show very little or no economic growth since the country's independence in 1991. The official GDP per capita in PPP terms was only 36 per cent higher in 2017 than in 1991, compared with, for example, 490 per cent in Poland or 540 per cent in Romania.² Growth can be partially concealed by the large shadow economy, but even accounting for that it is obvious that Ukraine has fallen far behind its neighbours.

How did Ukraine's economic conditions become so dire? The systemic political economic reasons are covered in detail in the first part of this report, while here we will review the macroeconomic policies that led to this outcome.

Bad legacy: Ukraine's economy before 2014

It is important to note that Ukraine started its post-communist period at approximately the same level of economic development as Poland and higher than Romania (though not Russia, which had higher per capita GDP from the beginning). It is the country's abysmal economic performance afterwards, particularly during the 1990s, that has led to it falling back so significantly behind its neighbours.

The GDP slump in Ukraine was deeper during the 1990s than in its neighbouring countries and its macroeconomic conditions were significantly less stable. While most post-communist countries suffered from hyperinflation, Ukraine experienced it on a larger scale and it took longer than most Eastern European countries (though comparable to the post-Soviet states) to return inflation to at least double digits, which took until 1996.

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¹ IMF World Economic Outlook, October 2018. On a PPP basis the GDP numbers are larger though, 8,340 international dollars per capita in 2017.
² World Bank World Development Indicators
³ IMF World Economic Outlook Database October 2018
⁴ World Bank World Development Indicators
This difference can be explained by the very slow start of market reforms in Ukraine, which led to much less sound economic policy than in other transition countries. The average of six EBRD Transition Indicators, each of which is a score of the country on a scale from 1 to 4+ on a specific transition metric,\(^5\) such as privatisation or price liberalisation, is a good illustration of this late progress, with Ukraine only catching up (even with such relatively late starters as Romania and Russia) by the second half of the 1990s.

**Chart 2**

**Average of six EBRD Transition Indicators**

Unreformed communist institutions and legislative norms, with their omnipresent opportunities for political interference in the economy and largely informal governance (known infamously as "telephone rule"), were thus combined in Ukraine with the cancellation of Soviet restrictions on private property and private economic activity. This resulted in massive opportunities for rent-seeking and rampant populism, which were the driving force behind the economic destruction of early 1990s and have been constantly present in Ukraine ever since.

Some of the most harmful policies born out of these opportunities in the early 1990s were:

- arbitrage of the, on average, about 10 times price differential between the regulated domestic prices of commodities and their prices in the world market, via the state licensing of exports (with rents estimated at up to 20 per cent of GDP)
- arbitrage of the price differential between imported Russian natural gas and its higher domestic price
- massive subsidised credits from the state (for example, with an interest rate of 20 per cent in 1992, when inflation amounted to 10,155 per cent)
- direct budget subsidies, which amounted to 8-10 per cent of GDP\(^6\) at the time.

These policies were largely responsible for the devastating economic collapse during the early years of Ukraine’s independence. They were also the initial breeding ground for corruption and oligarchic businesses that have plagued the country ever since. A large shadow economy and massive illegality were another result, further undermining the already weak rule of law and weakening the property rights throughout the country.

**Box 1: New York Times articles on the chaos of Ukraine’s early years**

The economic chaos and mismanagement caused by the absence of proper market reforms was well covered by Western press during the early years of Ukraine’s independence. For example, these three articles with very telling names from the New York Times: “Ukraine Questions the Price of Independence”\(^7\), “A Ukrainian Could Envy Russia’s Economy”\(^8\), “Ukraine’s Miners Bemoan the Cost of Independence”\(^9\).

The quotes from these articles are no less telling:

“So retrograde is Ukraine on the questions of reform, that some economists reckon it resembles a little Soviet Union.”

“The Parliament has issued decrees blocking privatisation of medium and large-scale industry.”

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\(^5\) [www.ebrd.com/cs/Satellite?c=Content&cid=1395237866249&d=&pagename=EBRD%2FContent%2FContentLayout [05-04-2019]]

\(^6\) “Ukraine: What Went Wrong and How to Fix It”, Anders Aslund


"In Ukraine there is little talk of cutting huge state credits to hopelessly bankrupt state industries. [...] So far this year, economists say, credits have already exceeded the total gross national product the Government rather optimistically predicted for 1993."

Even a cursory glance at these reports by the Western press shows an extremely bleak picture. Without a proper transition to a market-based system, the economy became totally dysfunctional, with enterprises living on barter schemes, lacking money for basic investment and paying their workers with their own produce. The reports speak of workers at a tyre factory in Bila Tserkva (a small town not far from Kyiv) trying to sell the tyres they've produced to passing motorists. People speak of their savings being wiped out in half a year, just to buy food.

Another dimension is also clear from the media reports: that of Ukraine's inability to reform the economy making the country extremely weak and vulnerable in the international arena, especially, in its dealings with Russia. With a ruined economy and total dependence on imports of Russian energy, the country was forced to give up half of its Black Sea fleet and agree to start dismantling its nuclear arsenal – both considered important military assets that were "part of Ukraine's claim to a place of importance in the world" as one article put it.57 Even worse, for some citizens the self-inflicted economic collapse has become a source of disappointment in the idea of Ukrainian independence itself, especially in the Donbass region in the east.

Finally, the media reports very clearly illustrate the massive corruption generated by heavy-handed government regulation of the economy. The state was buying coal from the coal mines at US$ 9 per tonne, yet the price on the world market was US$ 22 per tonne – clearly a huge opportunity for arbitrage and corruption. One of the New York Times articles openly says that "Ukrainian bureaucrats enriched themselves last year by selling cheap Russian oil at world prices on the world market", while the country accrued a debt of more than US$ 2 billion to Russia for that subsidised oil. The pharmaceutical plants were on their knees and major cancer operations at one of the hospitals were, unbelievably, carried out without anaesthetics; yet health officials were reported to have embezzled millions of dollars.

Basic market reforms, which limited all these excesses somewhat, were implemented quite late compared with other countries, only after 1994, when Leonid Kuchma became president. These included monetary stabilisation, launching the first IMF programme and large-scale privatisation. After inflation started dropping, a new currency - hryvnia - was introduced. The second dose of reform came as a response to the Russian financial crisis of 1998, which hurt Ukraine's economy badly. This included further liberalising measures and a large-scale fiscal stabilisation, which steadied the economy and returned the country's public finance to a healthy state.

By 2001, Ukraine was in relatively good macroeconomic condition: a fiscal deficit of a little less than 3 per cent of GDP, relatively low burden of public spending (general government spending stood at 35 per cent of GDP), single digit inflation, a stable currency rate and current account surplus of 3.6 per cent of GDP, with most of the country's exports being commodity-based. It was therefore positioned quite well to take advantage of the global commodity price boom that was just beginning. In 2000-08 commodity prices almost tripled,¹⁰ fuelling massive growth in commodity producers, such as Ukraine.

At first glance, Ukraine's economy was doing extremely well during that period. The average annual real GDP growth stood at 7 per cent. Inflation was relatively high at 12.5 per cent per year, though if the years 2000 (when high inflation was a legacy of the 1998 crisis) and 2008 (when high inflation was caused by an incoming world financial crisis) are taken out, average inflation in 2001-07 stood at 9.5 per cent, not unreasonable considering the country was receiving massive capital inflows and had a fixed currency rate regime. Budget deficits were relatively low at 2.4 per cent of GDP and government debt was falling fast, from 44 per cent of GDP in 2000 to its trough of just 12 per cent of GDP in 2007.

Yet hidden behind these numbers was an accumulation of economic imbalances, an almost

¹⁰ Based on the Commodity Price Index as calculated by the IMF in World Economic Outlook Database October 2018
total absence of structural reforms and a gradually deteriorating competitiveness of the economy. Despite the Orange Revolution of 2004, very little institutional development had taken place. Indicators such as the Index of Economic Freedom\(^\text{11}\) or World Governance Indicators\(^\text{12}\) demonstrate only a slight improvement throughout the period. Essentially, the opportunity to introduce reforms during rapid economic growth, which would have been much easier politically, was squandered.

Despite nominally healthy public finances, problems and imbalances were quickly accumulating in the fiscal sector. The burden of public spending grew from 35.5 per cent of GDP in 2000 to 45.4 per cent of GDP in 2008, with public revenues growing in parallel from 32.3 per cent of GDP to 42.4 per cent of GDP, with obviously negative implications for the competitiveness of the economy. This massive expansion in public spending was largely driven by social expenditure, fuelled by rampant populism in the political class and exacerbated by the worsening demographic situation. In particular, pension spending doubled from 8 per cent of GDP in 2000 to almost 16 per cent of GDP in 2008, becoming one of the highest in the world and clearly unsustainable for Ukraine’s underdeveloped economy.

The National Bank of Ukraine (NBU) remained politically dependent and relatively weak as regulator. Lending was growing at extraordinary pace – the amount of outstanding credit grew by more than 17 times in 2002-08,\(^\text{13}\) which, coupled with weak oversight, led to huge malpractices in the financial sector and the prevalence of “oligarchic banking”.\(^\text{14}\) A large part of that lending became non-performing after the 2008 financial crisis – the large volume of non-performing loans haunts the Ukrainian banking system to this very day.

The fixed currency exchange rate regime was maintained throughout the whole period, which contributed to the build-up of imbalances. The current account surplus first rose from 4.5 per cent of GDP in 2000 to a peak of 10.3 per cent of GDP in 2004, after which it started dropping and turned into a deficit by 2006, dropping fast afterwards (to -6.8 per cent of GDP when the financial crisis hit in 2008) – a very sharp adjustment, hinting at a loss of external competitiveness.

It is therefore no surprise that Ukraine was one of the worst-hit economies in the world during the 2008-09 financial crisis. In 2009, Ukrainian GDP dropped by 15 per cent according to IMF data, the largest recorded decline in the world that year. The fiscal position deteriorated dramatically, with deficit of 6 per cent of GDP in 2009-10 and government debt growing to 41 per cent of GDP by 2010. The Ukrainian currency lost about 40 per cent of its value, with the currency rate dropping from 5 UAH per US dollar to 8 UAH per US dollar during the crisis.

A short economic revival followed in 2010-11, driven by a rebound in world commodity prices and global demand, with GDP growth averaging 4.8 per cent per annum. The revival was short-lived, however, and by 2012 world commodity prices went into longer-term decline, driving economic growth in Ukraine to zero\(^\text{15}\) and bringing to an end the economic model built on exploitation of natural resources and inherited Soviet heavy industry.

The Yanukovych regime, which came to power in the beginning of 2010, tried, nevertheless, to sustain that defunct economic model. Instead of executing the necessary fiscal, currency and monetary adjustments, it tried to keep in place the imbalances present in the economy, despite them worsening in the zero-growth environment of 2012-13.

The currency, which remained pegged to the US dollar in the fixed exchange rate regime, was clearly overvalued, driving the current account deficit from -2.2 per cent of GDP in 2010 to -9.2 per cent of GDP in 2013, the highest in the country’s history. To sustain this overvalued exchange rate, reserves were spent quickly, from US$ 34.5 billion at the end of 2010 to US$ 20.4 billion at the end of 2013. The

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\(^{11}\) https://www.heritage.org/index [05-04-2019]


\(^{13}\) According to the National Bank of Ukraine data.

\(^{14}\) All major financial-industrial oligarchic groups had their preferred banks which were used to raise money from the depositors and then lend it to connected businesses from the same group, with the depositors and the state Deposit Guarantee Fund taking the risks of such undiversified lending to related parties. Needless to say, most such loans were quickly classed as non-performing once the economic boom ended.

\(^{15}\) IMF World Economic Outlook Database October 2018.

\(^{16}\) Ukraine had zero per cent economic growth in 2012 and 2013.
independence of the NBU was totally destroyed, with political cronies of the Yanukovych family taking over its leadership.

Fiscal deficits were persistently high, averaging 4.4 per cent of GDP in 2010-13. While the overvalued exchange rate kept the debt-to-GDP ratio relatively stable, the government debt (measured in US dollars) was growing quickly, from US$ 40 billion at the end of 2009 to US$ 73 billion in 2013. The situation was clearly unsustainable – Ukraine was headed for a massive economic crisis and it was only a matter of time until it would hit.

Crisis and reforms: aftermath of the Revolution of Dignity

In a somewhat ironic twist, the economic crisis towards which Ukraine was being driven by the unsustainable policies of the Yanukovych period mostly unfolded after Yanukovych was ousted. In addition to the unwinding of Yanukovych-era imbalances, it was deepened significantly by Russian military and economic actions.

Table 2

The economic crisis of 2014-15 in data¹⁷

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth, year on year, %</td>
<td>0.0</td>
<td>-6.6</td>
<td>-9.8</td>
<td>2.4</td>
<td>2.5</td>
</tr>
<tr>
<td>Inflation, end of period, %</td>
<td>0.5</td>
<td>24.9</td>
<td>43.3</td>
<td>12.4</td>
<td>13.7</td>
</tr>
<tr>
<td>US$ to UAH exchange rate, end of period</td>
<td>7.99</td>
<td>15.62</td>
<td>23.41</td>
<td>26.21</td>
<td>27.52</td>
</tr>
<tr>
<td>Budget deficit (Naogaz deficit in brackets), % of GDP</td>
<td>-4.8 (-6.4)</td>
<td>-4.5 (-10)</td>
<td>-1.2 (-2.2)</td>
<td>-2.2</td>
<td>-1.4</td>
</tr>
<tr>
<td>Government expenditure, % of GDP</td>
<td>48.1</td>
<td>44.8</td>
<td>43</td>
<td>40.6</td>
<td>41.5</td>
</tr>
<tr>
<td>NBU reserves, end of period, US$ billion</td>
<td>20.4</td>
<td>7.5</td>
<td>13.3</td>
<td>15.5</td>
<td>18.8</td>
</tr>
<tr>
<td>Current account deficit, % of GDP</td>
<td>-9.2</td>
<td>-3.9</td>
<td>1.7</td>
<td>-1.5</td>
<td>-2.2</td>
</tr>
</tbody>
</table>

¹⁷ IMF and NBU data.


The signs of the coming crisis were already evident in 2013 and by early 2014 it has already started unfolding, before the end of revolutionary turmoil and the beginning of Russian military action.

Reserves had fallen to less than three months of imports by the end of 2013 and then a further quarter of them was lost during the first two months of 2014, before Yanukovych was ousted. The first round of devaluation happened in January-February 2014 (before the Yanukovych regime fell), with the US$ to UAH exchange rate peaking above 10 at the end of February, before falling back somewhat in early March until news of Russian military action in Crimea sent it upwards again.

Almost half of the country’s GDP was being redistributed through the inefficient and corrupt government sector. The budget deficit – including the deficit of Naogaz, created by the level of household tariffs being below the market prices or even cost-recovery–stood at 6.4 per cent of GDP, with the level of government debt at an all-time high of US$ 73.2 billion. Public finances were suffering from an acute liquidity crisis – when the new post-revolutionary government came in at the end of February 2014, it found the treasury account contained less than US$ 10,000.¹⁸

Perhaps, with determined actions by the new government and support of international financial organisations, a macroeconomic crisis could have been contained at this point, but in March 2014 a new major factor came into play – massive Russian military action against Ukraine.

On February 27, 2014, the same day that the new post-revolutionary government was formed in Ukraine, masked Russian troops without insignia took over the local parliament of the Crimean region. This was the start of a sustained period (ongoing, as of 2019) of intensely hostile Russian activity against Ukraine: the annexation of Crimea, military action in Donbass, extensive efforts to destabilise the country through information warfare, trade war, cyber-attacks¹⁹ and other actions.
Russian military action has made the economic situation in Ukraine progressively worse, with more and more hostile actions unfolding throughout 2014-15. Overall, the war in Donbass, the annexation of Crimea (through direct loss of GDP-producing territory) and the trade war seem to have had the worst impact on the economy. With the annexation of Crimea, Ukraine lost 3.8 per cent of its GDP, while the war in Donbass directly caused more than half of the GDP loss from the 2014-15 crisis!

Box 2: Contribution of Russian military action to the economic crisis

Russian aggression has generated economic losses for Ukraine both directly and indirectly, by impacting the country’s investment attractiveness, deepening financial instability and other indirect effects. The latter are harder to estimate and would require deeper numerical analysis than is envisaged by this publication. The major categories of direct losses, on the other hand, are easier to estimate, though the analysis below is by no means comprehensive and only includes a few big and easy to identify categories of losses, mainly to illustrate their scope and impact.

In terms of GDP lost, the largest clearly identifiable economic losses from the Russian aggression are the loss of the annexed Crimea (as a GDP-producing territory) and the loss of territories, labour force and productive assets in Donbass.

In 2013, the combined gross regional product of Crimea and the city of Sebastopol (which was a separate administrative entity situated in the peninsula) constituted 57.5 billion UAH, or 3.8 per cent of Ukraine’s GDP. Due to the fact that the peninsula was fully occupied by Russia in 2014, all of this output was lost by Ukraine, thus a loss of 3.8 per cent of GDP was solely from the occupation of Crimea.²⁰

The losses caused directly by warfare in the Donbass region can also be inferred from the regional national accounts data, which allows us to disentangle the loss of GDP that occurred in the war-torn Donetsk and Luhansk regions from the GDP loss in the rest of the country, where no military action occurred. The data also conveniently excludes the parts of Donbass occupied by Russian-backed separatists, counting them as temporarily lost to the country as GDP-producing territories.

<table>
<thead>
<tr>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP decline in Ukraine, % year on year</td>
<td>-6.6</td>
</tr>
<tr>
<td>GDP decline in Donbass, % of Ukraine’s overall GDP year on year</td>
<td>-5</td>
</tr>
<tr>
<td>GDP decline in Ukraine ex-Donbass, % of Ukraine’s overall GDP year on year</td>
<td>-1.6</td>
</tr>
</tbody>
</table>

As clearly shown by the GDP data, more than half of all economic decline in Ukraine during the crisis of 2014-15 actually occurred in the Donbass region and was a direct product of military action by the Russians and Russian-backed separatists. If we bear in mind the indirect effects on investment, broken production chains and other economic parameters, it is clear that the severity of the recession in Ukraine in 2014-15 was more than doubled by Russian military action.

Compounded by this new factor, the economic crisis in Ukraine has started to become much more acute. In 2014, GDP has declined by 6.6 per cent (without including losses in Crimea), while in 2015 an even worse decrease of 9.8 per cent has happened. Devaluation became intense, with UAH to US$ rate above 15 by the end of 2014 (a devaluation of almost 100 per cent in one year) and a further drop into mid-20s in 2015. With such massive devaluation came substantial inflation: 24.9 per cent in 2014 and 43.3 per cent in 2015.

With devaluation and falling GDP came a massive banking crisis. In 2014-16 almost half of the country’s banks which held 30 per cent of the sector’s assets went bankrupt²² and were cleaned up from the market.

²⁰ To provide a clearer picture, the GDP of Crimea and Sebastopol was excluded from the national accounts data in 2014 and for the previous several years. Its loss thus wasn’t calculated into the official numbers for 2014 output loss. Still, the economic output of the region was lost to Ukraine.

²¹ Author’s calculations based on Ukrainian official National Accounts data.

by the NBU. Losses by the state and by the banks' clients exceeded US$ 20 billion (about 22 per cent of Ukraine's 2016 GDP), with an undetermined, but large, part of this sum stolen via various schemes. At the end of 2016, the government had to nationalise the largest bank in the country – Privatbank, which, combined with the already existing state-owned banks, made more than 60 per cent of the banking sector government controlled. To a large extent, such a massive banking crisis was caused by the malpractices which existed in the sector, in particular, oligarchic banking coupled with corrupt and inefficient regulation, with very weak protection of lenders (in terms of legislation, prosecutorial and judicial practices and so on) also playing a strong negative role.

In response to the economic crisis, the post-Maidan governments have implemented an impressive programme of macroeconomic stabilisation and reform, which has stabilised the economy and returned it to healthy (albeit somewhat weak) economic growth by 2016. These reforms were executed under the framework of several IMF programmes, with the first two-year programme under the Stand-By Arrangement launched in 2014 and then converted into a new four-year programme under the Extended Fund Facility in 2015,²³ set to expire in March 2019. The latter programme was than succeeded in late 2018 by the new 14-month Stand-By Arrangement, which is set to expire in March 2020, allowing Ukraine to have the IMF support throughout and beyond the 2019 election period.²⁴

The first major component of Ukraine's macroeconomic stabilisation and reform was large-scale fiscal consolidation, driven by a sharp decrease in the ratio of general government spending to GDP, from almost 50 per cent in 2013 to less than 41 per cent in 2016. The overall deficit has dropped from 10 per cent of GDP in 2014 to 2.2 per cent of GDP in 2016 and below that in 2017 and 2018. The normalisation of the ratio of pension spending to GDP, from an extraordinarily high 17 per cent in 2013 (one of the highest in the world) to about 10 per cent in 2015, contributed strongly to fiscal consolidation. This was solidified for the longer term by a pension reform in 2017 that introduced gradual tightening of the eligibility requirements for minimum length of service (unfolding until 2028) and an automated de-politicised mechanism for pension indexation.

Another important component of the spending consolidation was the financial revitalisation of Naftogaz, executed by raising household gas prices to market levels based on import parity (completed by spring 2016), switching to importing gas from European markets rather than Russia and by internal improvements within the group, in particular, in the gas producer UkrGasVydobuvannya. Thanks to these efforts, Naftogaz group ceased to be a drain on state coffers (in 2014 its deficit stood at 5.5 per cent of GDP) and became the largest taxpayer in Ukraine²⁵ and a huge source of revenue for the country's budget. This happened despite the fact that, due to a doubling of natural gas prices in the European markets, the level of household gas prices again fell significantly below market levels, which forced the government to start increasing them again at the end of 2018.

The ratio of government revenues to GDP has also dropped somewhat (from 41.9 per cent in 2015 to 38.3 per cent in 2016) after a significant cut in the labour tax burden, which was implemented in 2015 as part of a tax reform to increase Ukraine's economic competitiveness and to improve the business climate. The rate of the Single Social Contribution, paid by companies to the Pension Fund and other social funds as surcharge on top of their employees' wages, was unified and cut from about 40 per cent to 22 per cent.

Devaluation has led to a sharp increase in the debt-to-GDP ratio, which has grown from 41 per cent of GDP in 2013 to a peak of 76 per cent of GDP in 2016. At the same time, thanks to fiscal consolidation, the government debt in nominal US dollar terms has ceased its upward trend (which it had been in since 2008) and remains somewhat above US$ 70 billion, at approximately the same level as it was in 2013. Coupled with double-digit growth in nominal GDP, this allowed the debt-to-GDP ratio to decrease, with a 20 per cent haircut as part of the 2015 Eurobond restructuring also helping. The debt-to-GDP ratio was stood at 61 per cent of GDP at the end of 2018.

The second major component of post-Maidan macroeconomic stabilisation and reform happened at the National Bank.

The NBU executed a massive banking sector clean-up, which has consolidated the banking sector, restored it to a viable state and largely removed the oligarchic and corrupt banking practices that were typical of the pre-2014 era. As mentioned above, the number of banks in the country dropped by about half, while the country’s largest bank, Privatbank, was nationalised. The unintended consequence of the clean-up and Privatbank nationalisation was a sharp increase in the share of state-owned banks in the system, which increases risks to the financial stability from political meddling and corruption in these banks and needs to be resolved in due course.

The NBU has abandoned a fixed exchange rate policy, which was one of the prime generators of imbalances in the country’s economy and one of the key reasons behind the economic crisis. Instead, the National Bank has implemented a modern inflation targeting framework, which is better suited for preserving price stability and financial stability. Inflation has dropped, from its peak of 43.3 per cent in 2015 to 12.4 per cent in 2016, although by the end of 2018 the NBU had still not been able to reduce inflation to its target of 5 per cent. NBU reserves have grown significantly, from the trough of US$ 7.5 billion in 2014 to close to their pre-crisis level by 2017 (US$ 18.8 billion versus US$ 20.4 billion in 2013). Surprisingly, Ukraine’s hryvnia has performed quite well after it stabilised against the US dollar in 2016, and during the rout in emerging market assets in 2018 it has even become something of a stellar performer among the emerging market currencies.²⁷

Finally, the NBU has undergone a major internal transformation. The Bank’s internal structure was rationalised and its governance was reformed, with a flatter hierarchy and a more transparent committee-based decision-making system.²⁸ Regional units were reorganised and unnecessary functions were cut, which has allowed the number of personnel on the Bank’s payroll to be reduced by more than half. Internal processes were reorganised and streamlined to increase the Bank’s efficiency. New legislation passed by Parliament significantly increased the central bank’s autonomy, making it – for the first time in Ukraine’s history – truly politically independent. Overall, in the course of just a few years the NBU has been transformed into a modern and highly capable central bank.

Early 2019: current situation

Thanks to the reforms and macroeconomic stabilisation conducted by the successive post-Maidan governments, Ukraine has achieved

²⁶ Several capital and exchange rate controls were introduced though, that were being slowly lifted up until the start of a systematic liberalisation of capital flows in early 2019.
The share of fixed asset investment in GDP, a key determinant of growth in Ukraine's capital-starved economic environment, is gradually climbing upwards, from its trough of 13.5 per cent in 2015 to 16.6 per cent in Q3 2018 (on a trailing 12-month basis). Levels above 20 per cent are considered sufficient to sustain high economic growth, while levels above 25 per cent indicate an economic boom.

Thanks to the efforts of the National Bank, inflation has dropped to single-digits, though it is still above the NBU's target of 5 per cent per annum. This forces the National Bank to keep interest rates high, though the gradual decrease in the inflation rate suggests that this policy will ultimately be successful.

Due to the nationalisation of Privatbank and the clean-up of the banking sector, the share of state-owned banks in the sector on such metrics as net assets, net liabilities and the number of personnel is above 50 per cent. This creates big risks going forward, as historically state-owned banks were a constant source of non-transparent quasi-fiscal financing of bloated government sector expenditures.

The high level of government debt, as well as its significant dollarisation, – legacies of flawed pre-2014 policies – remains a big problem and a major source of risk for macroeconomic stability. In 2019-21 this is amplified by the "peak debt" period of high repayments on the government’s foreign debt, which constitute more than US$ 10 billion (3.8 per cent of nominal GDP forecast by the IMF for that period).²⁹ Coupled with the need to finance the budget deficit, foreign currency denominated domestic bonds and government guaranteed debt, the "peak debt" payments are a significant challenge for Ukraine.

Despite its sharp moderation after 2014, the size of GDP redistribution by general government still remains somewhat high for a country at Ukraine’s level of economic development. Government expenditures are estimated to have constituted about 43 per cent of GDP in 2018,³⁰ while research shows 37 per cent of GDP to be the most appropriate level for the country.³¹

After the moderation of the pension expenditure level and the decrease in the rate of labour taxation, the structure of both government revenues and expenditures in Ukraine is broadly comparable to other European countries. The efficiency of both spending and revenue collection remains rather low, though.

Tax administration, in particular, is a big problem. The majority of complaints – in fact, more than half of all complaints – received by Ukraine's Business Ombudsman Council³² concern the State Fiscal Service. Data from the World Bank's Doing Business ranking shows that in the "Paying Taxes" category Ukraine scores badly in terms of time required by the medium-sized businesses to prepare, file and pay all taxes – 327.5 hours per year, significantly higher than the average for European and Central Asian regions (214.8 hours per year) and more than double the number for OECD High Income countries (159.4), implying significantly less efficient processes within the Ukrainian tax authority.

Weak property rights protection and poor tax administration have bred a rather large shadow economy in Ukraine. The Ministry of Economic Development and Trade estimated³³ the shadow GDP to be about 32 per cent of the official GDP based on the calculation by several different methods. The most reliable of these methods, which is based on a direct comparison between spending reported by the population in the household survey and official retail turnover numbers, shows shadow GDP to be higher, at 48 per cent of the official GDP number. The shadow economy seems to have increased

²⁹ IMF World Economic Outlook Database October 2018
³² An organisation created in Ukraine to help protect companies from unfair treatment by officials.
³³ http://www.me.gov.ua/Documents/List?lang=uk-UA&sid=e384c5a7-6533-4ab6-b56f-50e5243eb15a&tag=TendentsiiTinovoiEkonomiki [05-04-2019]
significantly in 2014 in response to the economic crisis (a similar thing also happened in Ukraine during the deep recession in 2008-09) and has been falling since then, dropping lower than the levels seen in Yanukovych times by 2017-18. This trend is somewhat encouraging, as shadow businesses create an uneven playing field for businesses that operate fully legally, and the shadow economy is especially problematic for those domestic producers that have to compete with untaxed smuggled imports.

With its high dependency on external financing, vulnerability to exchange-rate volatility and an open economy with predominantly commodity-based (hence exposed to the volatility of commodity prices) exports, Ukraine is quite vulnerable to external factors, such as slowdowns in global or EU economic growth, a new financial crisis and so on. As of early 2019 the risks of such events happening seem to be rising, with a slowdown evident in EU economic data and financial markets having been in a slump throughout late 2018. If these trends continue and worsen, this will undoubtedly have an impact on the economic situation in Ukraine. Acute external crises could potentially lead to a new recession and domestic economic crisis, which in turn will affect the political economy of Ukraine's reforms.

Nevertheless, looking beyond short-term external risks and into the medium-term perspective, it is mainly the process of reform and the endogenous factors affecting it that will determine how quickly Ukraine will develop and whether it will be able to catch up with its Eastern European peers.

Currently, there are at least two big endogenous risks faced by the economy.

One of these is the twin elections in 2019 and risks to the functionality of the political system and sustainability of the course of modernisation and European integration. If the election results are so polarised that they produce an entirely dysfunctional parliament and system of government, this will have an adverse effect on the country's ability to even continue with current reforms, while any kind of broadening of the development agenda will likely be out of question. At the same time, many political forces campaign on a populist agenda that is incompatible with modernising Ukraine. If these forces manage to take sufficient control of the government and parliament (and actually try to implement some of their destructive proposals), this could stop or even reverse the reforms in Ukraine and lead to a new economic crisis in the short-to-medium term.

The second risk stems from the "peak debt" period of high payments on external government debt, which started in 2018 and will continue at least until 2020, after which the burden of these payments will reduce gradually. Throughout this period Ukraine's macroeconomic and financial stability will be extremely dependent on foreign financing, both official and market-based, with the IMF programme serving as an anchor and a condition for the availability of such financing. Thus, a freeze in the implementation of the IMF programme could have extremely detrimental effects on the country's economy, opening way to debt default and a new full-blown economic crisis. Moreover, high dependence on external financing makes Ukraine's macroeconomic environment riskier and more susceptible to negative external factors.

These political and financial factors create risks for investors in Ukraine, thus suppressing investment and economic growth. Nevertheless, they are temporary, as the election period will pass in 2019 and the debt financing burden will start alleviating after 2021. Thus, if both risks are successfully tackled, they will become much less acute by 2022, which will in turn lower the investment risks, drive investment up and speed up economic growth. Since GDP growth in 2018 is already projected (as of early 2019) to be about 3.5 per cent, it is likely that the alleviation of major risks would raise the rate above 4 per cent per annum, which would be high enough for Ukraine to start catching up with its EU neighbours and other peer countries.

To be realised, this scenario requires that the 2019 elections produce a functional parliamentary majority and sufficiently competent government to maintain the political course towards reforms, modernisation and European integration. It would also require that the IMF programme is maintained at least until 2021, and possibly beyond. If both of these conditions are met, Ukraine has a reasonable chance of achieving high (above 4 per cent per annum) rates of growth by 2021 and finally starting to catch up with the other European countries.
Macroeconomic policies: goals and priorities

The main goal of macroeconomic policies in Ukraine for the foreseeable future can be summarised as follows: to achieve and maintain high enough long-term economic growth to catch up with and possibly overtake other Eastern European countries, in particular EU member countries, in terms of per capita GDP. The necessary long-term growth rate can be roughly estimated at 4 per cent per annum or higher.³⁴

Attaining and maintaining sufficient investment is the key condition for this goal to be achieved. As mentioned previously, the share of fixed asset investment in GDP at 20 per cent can be considered to be the minimum threshold for a high growth rate, while generating an economic boom would require the rate of investment to be upwards of 25 per cent of GDP. Since the financial resources available to the government are quite limited and prone to be misused due to high levels of corruption, the vast majority of new investment will have to come from private sector sources, both domestic and foreign.

To attract large-scale private sector investment, Ukraine will need to conduct structural and institutional reforms (in particular, strengthen the protection of property rights, privatise state-owned enterprises – see Chapters 5 and 6 – and launch the land market) and pursue growth-friendly macroeconomic policies, mainly concentrated on maintaining macroeconomic stability and lowering the state burden on the private sector. Structural reforms and the maintenance of macroeconomic stability are interconnected: maintaining long-term stability is impossible without long-term growth, which, in turn, is unachievable without reforms.

Based on the above, the key priorities for macroeconomic and fiscal policies in Ukraine are outlined below. It is important to note though, that by themselves these won’t be enough to attract enough investment to attain high growth rates, as weak property rights and other structural factors impede investment. It is only by coupling the correct macroeconomic and fiscal policies with structural reforms (which are outlined in other chapters of this publication) that Ukraine can genuinely start growing fast.

1. Continuing fiscal consolidation and achieving a balanced budget, which will allow the country to lower its government debt burden as share of GDP. The recently introduced medium-term budget planning framework can become a helpful tool in managing this process; introducing stricter fiscal rules limiting budget deficits and spending would also be quite useful. It is important to note that (as outlined below) fiscal consolidation should be executed by downsizing the share of general government expenditures in GDP; by no means should the burden of government revenues on the economy be increased.

2. Downsizing the share of GDP redistributed through the general government sector and keeping it structurally lower, to make the economic environment more growth-friendly. Research³⁵ shows the level of general government expenditure at 37 per cent of GDP to be optimal for Ukraine, while it is estimated to have amounted to 43 per cent of GDP in 2018.³⁶

To be compatible with the goal of fiscal consolidation, the general strategy for such downsizing should be based on decreasing government expenditure as share of GDP. At the same time, the share of government revenues in GDP should be kept stable or decreased at a slower pace, which doesn’t preclude using the additional revenues from improved tax administration and other revenue enhancing measures to decrease the rates of the most distortionary direct taxes.

On the expenditure side, a certain amount of fiscal space will be created naturally by the contraction of the energy subsidies system, as people grow out of being eligible for subsidies due to incomes generally growing faster than prices and tariffs in a normal economic environment.³⁷ The pension reform that

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³⁶ For example in 2017-18 the mean wage increased by 68 per cent on an annual basis, the mean pension by 46 per cent on the same basis, while the average annual CPI (which includes regulated utility tariffs covered by subsidies as its component) has only grown by 27 per cent. Consequently, despite growing utility tariffs (including a 23 per cent increase in household gas prices in November 2018 and electricity prices growing by about 55 per cent in 2017-18) the subsidies bill has decreased from 2.3 per cent of GDP in 2017 to an estimated 2 per cent of GDP in 2018.
was introduced in 2017 will similarly help decrease or keep down spending, due to its gradual tightening of the eligibility requirements for minimum length of service ongoing until 2028. Finally, a whole range of efficiency-enhancing reform options are available in nearly all areas of government spending, such as better targeting and verification of social assistance, optimisation of the school network, reform of higher education financing, healthcare financing reform and so on, provide opportunities for savings that can generate additional fiscal space.

3. Preserving the National Bank’s independence and letting it focus on its goals of inflation targeting and maintaining financial stability. As shown in the first part of this chapter, modern Ukrainian economic history is a textbook example of how weakness and political dependency of the central bank leads to massive corruption and chronic macroeconomic instability. An independent and professional National Bank is one of biggest achievements of post-revolutionary reforms in Ukraine. Undermining this achievement and compromising the NBU’s independence would very quickly lead to a loss of macroeconomic stability and a new crisis. This would be exacerbated by the loss of access to external financing: given the track record of economic mismanagement by Ukrainian political elites, neither official nor private creditors would be willing to finance any government that removes the central bank’s independence.

Gradual privatisation of the state-owned banks is also quite important for the long-term health and stability of the banking system, as well as the broader economy.

4. Continuing to implement the IMF programme in order to maintain access to external financing throughout the “peak debt” period of 2019-21. Without the IMF programme being reasonably on track, ruinous default would be almost unavoidable for Ukraine in current conditions.

5. Reforming the tax system by gradually cutting rates of direct taxes, as fiscal space emerges. Labour taxes are the most logical point to start with, as the direct tax burden on labour income is significantly higher in Ukraine than the direct tax burden on capital income. For the latter, switching from profits to dividends taxation (a proposal developed in Ukraine under the name of exit capital tax) is preferable to simply cutting rates, as it can potentially stimulate investment while being less costly, with revenues picking up as amassed dividends are paid out.

If necessary, a limited increase in the rates of consumption taxes, in particular VAT, can be used to partly finance the decrease in direct tax rates. While doing this, attention needs to be paid to distributional consequences, as relying mainly on consumption taxes makes the tax system regressive and can create higher income inequality.³⁸ A good way to mitigate this, while making the tax system more growth friendly, is to gradually introduce higher taxation of capital assets, starting with land; but solutions still have to be developed in that area. Another problem with increasing the VAT rate is tax evasion, as any kind of tax rate increase would also increase the differential in tax burdens between those who pay the tax (or, rather, dutifully forward it to the state, in the case of businesses that mostly act as agents on consumption taxes) and those who don’t, which is a big challenge for Ukraine’s business environment. The best approach would be to couple any kind of compensatory VAT rate increases with measures to combat VAT fraud and tax evasion.

Tax administration improvements, customs reform and other measures to combat tax fraud and evasion are a big potential source of additional revenue to compensate for cutting direct tax rates, as well as a great way to improve the business climate. Given limited resources and political capital, using tax gap analysis to target the areas with the largest revenue losses is the right way to approach this exercise, as it would allow to maximise the effect of broadening the tax base.

³⁸ It is notable that, based on official data, income inequality in Ukraine is quite low, with the GINI Index calculated by the World Bank standing at 25 in 2016, which is one of the lowest in Europe and comparable to Scandinavian countries. Properly accounting for shadow incomes would probably show higher levels of income inequality though.
Chapter 3

Rule of law

Luba Beardsley

Inherited legacy

The collapse of the Soviet Union in 1991 found Ukraine ill-prepared to manage its transformation to a democratic state and market economy. The socialist legacy (Box 1) was one of the main reasons why little systemic rule of law (RoL) reform occurred in Ukraine prior to the Revolution of Dignity (2014).

During the 1990s two distinct but interrelated processes determined Ukraine’s development: the pursuit of sovereignty and defining the outline of the new Ukrainian state. Both processes were influenced by power conflicts between the Parliament and executive branches, hegemonised by the Presidency.¹

The judiciary, fresh from gaining new freedom and struggling with self-identity, took a back seat. To reflect the results of the power struggle and to allow for further progress towards an independent Ukraine, a “mini” Constitution was enacted in 1995, followed by a fully-fledged Constitution in 1996. The latter provided the basis for:

- separation of powers (the judiciary was composed of the Constitutional Court and courts of general and specialised jurisdiction)
- transition to a market economy (through protection of property rights)
- protection of human rights and freedoms.

Box 1. Socialist legal systems

A socialist legal system builds on a positivist legal doctrine. This doctrine does not imply ethical justification for the content of the law and requires blind loyalty to the law on books. The law is developed to suit the state and its political elite. To allow for selective application, it reserves broad discretionary powers for the officials responsible for its enforcement. The main purpose of a socialist legal system is to protect “state socialism” that is based on a command economy (with nationally or collectively owned means of production) and a political regime controlled by the communist party.

The main legal characteristics of a socialist state are the abolition of property rights; limited personal freedoms of citizens; and the intrusive role of the state in lives of its citizens, hence a robust public and small private law sector. Socialist legal institutions lack independence. Courts are controlled by the communist party (through the appointment system and politicisation by the party membership) and/or by the executive branch which is fully in charge of court administration. The public prosecution is perceived as a provider of justice. Additional functions stemming from this role makes the office the most powerful institution in the socialist law sector.

The powers of the public prosecution were still defined broadly, so it could continue serving as a useful tool to the executive.² The Constitutional Court was given exclusive authority for constitutional jurisdiction. This was considered, by many, to be one of the biggest achievements of the Constitution. Indeed, since its creation (1997), the Constitutional Court has come to play a pivotal role in adjudicating on the disputes of other two branches. This, however, resulted in it being politicised and discredited.

Ukraine joined the Council of Europe (CoE) in 1995 and became a member of the European Convention for the Protection of Human Rights in 1997. By doing so Ukraine made a commitment to the CoE’s common standards and policies, subscribed to the jurisdiction of the European Court of Human Rights, and became eligible for CoE assistance, all of which was important in carrying out RoL reform.

Judiciary

In 2004, in the context of the Orange Revolution, the Parliament enacted constitutional amendments that

¹ Wolczuk (2013); R. Kuibida (Ed) (2016).
² Ibid.
changed the power equilibrium in its favour. In October 2010, the Constitutional Court ruled the 2004 political changes unconstitutional. The ruling was highly controversial for a few reasons, among them, the unexpected resignations of four Constitutional Court judges. Without doubt this ruling – as well as many other follow-on Constitutional Court decisions – was instrumental in cementing President Yanukovych’s grip on power and capturing the justice sector.

As for the rest of the justice sector, most of the transformation from socialist-style institutions occurred in “Potemkin Village” style – pro forma only, with little impact on the ground. Both the courts and prosecution remained ill-equipped to carry out their responsibilities and/or resist the increasing pressure of other branches as well as interest groups which were continually taking control over state resources and capturing state institutions.

It was the legacy of the socialist legal culture based on a positivist principle that “law is law” that sucked judges and prosecutors right into the centre of those interest groups in order to give their operations the appearance of legitimacy. As a result, the courts and the prosecution became a synonym of servitude to the powerful, inefficiency, corruption and rent-seeking.

In 2011 the law “On the Courts and Judges” was prepared by the Office of the President and enacted by the Parliament. On one hand the law embraced several progressive principles such as competitive merit-based selection of judges, mandatory declaration of income and integration of the court administration into judicial structure. On the other hand, it reduced the jurisdiction of the Supreme Court (SC), considered the only “unsubordinated” (to the President) court in the country. It also designed the selection and performance incentives and intrinsic motivation structures for judges and judicial bureaucracy in a way which made them even more susceptible to bribery and undue influence (Box 2).

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Box 2. Capturing justice

The 2011 reform introduced strict timeframes for case processing. The timeframes were unrealistic as they did not consider elements such as quality and overall workload of judges. If the timeframes had been applied consistently, practically all judges were destined to fail. Court presidents continued monitoring and evaluating judges' performance. They also controlled the initiation of judges' disciplinary proceedings. The reform introduced an "automated random assignment" of cases. However, additional policies were introduced to give court presidents wide flexibility in overriding the system.

The court presidents were selected by the Judicial Council which was assembled from the President's loyalists. Although the Judicial Council's authority was not in compliance with the Constitution, the Constitutional Court chose to ignore that. The selection of court presidents was de facto agreed among the Judicial Council, Councils of Judges and the Office of the President. The combination of the concentration of authority in the hands of the court presidents, unrealistic performance expectations, vast discretion in interpreting and enforcing rules and undue influence over key appointments were central to the capturing of the judiciary by the President.

Public prosecution

Reforms of the public prosecution were driven by Ukraine’s international obligations to make it conform with the requirements of human rights protection and CoE standards. From 2001 to 2013 the public prosecution lost, de jure, its control over court decision-making, judges' disciplinary proceedings as well as its influence on some parts of criminal proceedings. In practice, prosecutors continued exercising most of their original powers.

Property registration

Private ownership was recognised by the 1996...
The Property Registry was separated from the cadastre and placed under the Ministry of Justice (MoJ). In 2011, the Cabinet of Ministers (CoM) adopted a new system of registration of property rights⁹ based on a "single window" concept. Subsequently, the MoJ launched a reform of the property and business registries with the objective of improving the business environment. More specifically, the reform aimed to improve registries' efficiency through streamlining and automating the registration process. The later phase of the reform was implemented in the context of a few other parallel reforms: the reform targeting access to information as well as administrative decentralisation and e-governance reforms.

In 2013, to allow for the institutional unification and consolidation of information about immovable properties, the Property Registry absorbed several other registers. Registrations of properties were performed by state registrars and notaries overseen by the MoJ.¹⁰ The cadastre reform was launched at the same time under the lead of the State Land Agency although with a different objective: strengthening property rights and land administration. In 2011, Parliament enacted the law “On State Land Cadastre”. In 2013, an e-cadastre map¹¹ was introduced as a publicly accessible database of land plots.

Despite their rivalry over the scope of responsibilities, the MoJ and the State Land Agency were able to cooperate and coordinate their respective reforms at the level of policymaking. However, they did not accomplish the establishment of an "umbilical cord" between the cadastre and ownership registries operations that were needed to have a functioning land management system.

**Enforcement of judgments**

The non-enforcement of court judgements has been an enduring feature of Ukrainian RoL. In 2011, according to estimates by the Ombudsman of Human Rights, in Ukraine, about 60 per cent of court decisions were not enforced. In 2014, this estimate increased to 70 per cent.¹² As of May 20, 2016 there were UAH 560 billion (around €20 billion) worth of unenforced court rulings in Ukraine.

In May 2012, in response to the pressure stemming from the European Court of Human Rights decision, Ukraine took steps to address the problem by changing the execution process.¹³ The changes, however, were not effective enough to address the underlying causes of the problems, which included: a lack of political will; commitment and capacity among state actors to address restrictions on the forced sale of debtor assets (mainly the prohibition of forced sales of property of state enterprises and the property of the state, and sales of enterprises in energy and related sectors); and budgetary shortfalls in the system of social benefits.¹⁴

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⁸ In 2001, in response to the absence of a reliable legal and institutional infrastructure the sale of agricultural land was banned. Since 2001, the moratorium has been extended on annual basis. See also Chapter 6 on land reform.

⁹ Resolution No. 703 “On Approving the Procedure for State Registration of Rights to Real Estate and Their Encumbrances” and “The Procedure on Issuance of Extracts from the State Registry of Corporeal Rights to Real Estate”.

¹⁰ State registrars were responsible for “initial” registration while notaries registered rights which arose/changed/were terminated based on the deeds certified by such notaries. Notaries were not authorised to maintain registration files and/or issue ownership certificates.

¹¹ The law “On State Land Cadastre”, from 1 January 2013. The cadastre contains information on the size and designated use of land plots, their owners, encumbrances, as well as other features of land plots.

¹² Estimates of the State Enforcement Agency. These data should be treated with caution.

¹³ A pilot decision was issued in 2009 in the case of Yuriy Nikolayevich Ivanov vs. Ukraine regarding unpaid social benefit. By the beginning of 2012 the European Court of Human Rights (ECHR) issued 432 similar judgments; in total 1,400 cases were decided against Ukraine based on the original pilot decision. The 2011 and 2012 laws No 9127 and No 4901-VI “On Guarantees of the State Concerning the Execution of Court Decisions.”

¹⁴ The 2007 assessment of the Department for Enforcement of Judgments of the ECHR at the Committee of Ministers.
first post-revolution steps of the Parliament were
aimed at the thorough vetting of judges and
prosecutors and the disabling of discredited justice
organisations.¹⁵

In February 2014, the Parliament approved two
documents allowing a return to the constitutional
structure of 1996.¹⁶ President Poroshenko¹⁷ also set
up a Justice Reform Council charged with navigating
RoL reform. The first fruits of this effort — a
comprehensive Justice Sector Strategy 2015-20
emerged in 2015.¹⁸ The bar, in terms of expectations,
was set high: the repositioning of the culture towards
RoL by creating a justice system whose goal was to
establish the trust and support of the Ukrainian
people. In March 2015, a constitutional commission
was established to advise the President on
constitutional reform. A political consensus also
emerged that further constitutional reform should
address safeguards for the independence of the
judiciary and human rights.

The main challenge of RoL reform was strong
opposition from the inner circles of the institutions
that needed to be reformed (the judges and
prosecutors). Donors, particularly the EU, led the
reform and it was carried out with the active
involvement of civil society.

Judiciary

In February 2015, the Parliament passed the Law "On
Assuring the Right to a Fair Trial" to open the courts to
younger legal professionals, which was seen as a
precondition for much-needed cultural change within
the judiciary. However, according to experts, while
the new legislation rightly set better qualification
criteria for selecting judges, the "old judges" delayed
the process and eventually managed to limit the law's
implementation to the establishment of additional
training for judges.

The problem was that, technically, sitting judges
could not be removed unless the constitution was
changed first.¹⁹

In June 2016, the Parliament enacted the Law "On
the Amendment of the Constitution (Regarding Justice)",
the Law "On the Amendment of the Law on Court and
Judges" and some other laws to kick off the next, so
far, most significant phase of the RoL reform. The
2016 legislative changes opened the Constitutional
Court to individual complaints. They also
strengthened the independence of the courts and
judges.²⁰ The self-governing institutions – the
Superior Council of Justice (SCJ) and the High
Qualification Commission of Justice (HQCJ) were
empowered with additional authority over court
management while the opportunities for legislative
and executive branches of the government to
influence their decision-making were reduced. For
instance, the President’s role in appointing judges
was limited to a ceremonial function and he was
stripped of the power to create and/or close the
courts. Parliament’s power to appoint and dismiss
judges and consent to their detention or arrest was
shifted to the SCJ.

The court system was consolidated at both the
central and sub-national levels. At the central level,
the SC absorbed the three high specialised courts
which allowed the number of judges to be halved. At
the regional and local levels, the number of courts
was cut from 764 to 380.²¹ The purpose of the
consolidation was to mitigate the impacts of the new
organisation of courts (switch to a three-level court
system), the historic reliance on the rich network of
small ineffective courts and the (perceived) shortage
of judges. Almost 3,000 judges (one third) appointed
prior to the 2016 amendments decided to resign.

Versions from June 28,1996 as amended by the Laws from December 8, 2004” (No.2222-IV. From 1 February 2011 No.2952-VI
and from 19 September 2013 No.2013 No586-VII.
¹⁷ President Poroshenko assumed office on 7 June 2014.
¹⁸ The strategy 2015-20 is based on the following pillars: (I) increasing judicial independence; (II) streamlining judicial governance system
and appointment of judges; (III) boosting judges' competence; (IV) increasing the transparency and accountability of the judiciary;
and (V) increasing the efficiency of justice (in all jurisdictions).
²⁰ This included: abolition of the five-year probationary period for judges; introduction of a transparent competitive selection process with tough
professional and integrity requirements and involvement of civil society representatives; and a blanket re-evaluation of professional and integrity
qualities of all sitting judges. For the first time selection was open to non-judges.
²¹ Statistics of State Court Administration and the Office of the President.
While the court consolidation was key to determining the overall size of the workforce, the human resources reforms focused on workforce quality through the selection of incoming judges of the SC and other courts, and the evaluation of sitting judges. The process of selection and evaluation was redesigned to reflect advice from the CoE’s Venice Commission and good practice across the EU. Both procedures were equipped with several additional safeguards, including the direct involvement of civil society.

The Public Integrity Council (PIC) was created in response to popular demand for “vetting the compromised judges of the courts”. The PIC’s role is to buffer the selection and evaluation of judges. The PIC is composed of representatives of non-governmental organisations (NGOs) and public personalities with political impartiality and proven integrity credentials. According to the law, the PIC assists the HQCJ in determining the compliance of judges and judges-to-be with professional ethical and integrity requirements. To do this job, the PIC carries out its own independent “investigation” which is summarised in a formal opinion addressed to the HQCJ. The HQCJ can disregard the PIC’s explicitly “negative” opinion only by a decision of a qualified majority of its members. So far, the PIC has only participated in the selection of the SC judges. In protest at the approach of the HQCJ, the PIC refused to take a part in the evaluation of sitting judges²² (Box 3).

The new Supreme Court became operational in December 2017 with 115 freshly appointed judges (as of 30 March 2019 it had 118 judges). The selection of an additional 79 judges was finalised in May 2019). A similar process, involving the High Court of Intellectual Property, was carried out at the same time for 21 specialised judges. The HQCJ has preselected 700 judges for 600 judicial positions in local courts (to fill the most critical capacity gaps). The process for a blanket evaluation of around 1,486 judges (out of about 5,500) of the first and second instance courts was launched in October 2017. As of August 2018, the evaluation was completed with about 84 per cent of judges meeting the criteria to hold office.

In October 2017, the Parliament enacted three Procedural codes (Administrative, Civil and Commercial)²³ to accommodate the reform progress made so far. In June 2018, after intense negotiation with donors led by the EU and International Monetary Fund (IMF) the Law “On a High Anti-corruption Court” was passed.²⁴ The selection of judges for this court was completed in March 2019. It was carried out by the HQCJ but also involves a group of international experts nominated by donors aiding Ukraine’s fight against corruption (a public council of international experts). The judges were appointed by the President in May 2019. The court became operational in April 2019.

In summary, in a period of three years (2016-18) Ukraine has:

- developed policies and a basic legal framework for the justice system and all procedural codes (except for the Criminal Procedural Code)
- reorganised the first and second instance courts
- established the new Supreme Court and the High Anti-corruption Court and is in the process of creating the Court of Intellectual Property
- launched and/or partially carried out about 12,000 human resources (HR) proceedings (selection, evaluation, transfer of judges and/or judges to be).

All the above reforms are technically and politically extremely difficult. They have rarely, if ever, been implemented simultaneously and/or in such a short period of time. The most contentious reforms were: the first round of the selection of the SC judges (Box 3) and the establishment of the anti-corruption courts. In both cases, the core challenges have been a lack of political commitment to the reforms which translated in numerous attempts to subvert the reforms’ original intent and how to balance safeguards of judicial independence (self-governance) and accountability in the context of a compromised

²² Prior to its withdrawal the PIC collected information about 1,082 judges; prepared/submitted to the HQCJ 83 negative opinions and 67 opinions on judges. In March 2019 the PIC began participating in qualification evaluation of judges. Since then, the PIC has assessed 1,700 judges and submitted around 350 opinions to the HQCJ. (Source: Reanimation Package of the Reforms).


²⁴ The law No. 7440. “On Anti-corruption Court”. 
judicial corporate culture and weak "soft infrastructure".

Box 3. The fight for integrity: selection and evaluation of SC judges

On November 11, 2017 the President of Ukraine appointed 113 judges to the Supreme Court (SC). His ceremonial decision concluded a rather lengthy, contentious selection process carried out by the High Qualification Commission of Justice (HQCJ) and finalised by the High Council of Justice.

The process started in September 2016 for 120 positions. Out of 1,436 initial applicants 846 qualified to compete; 613 took the first round of examinations in theoretical knowledge; 520 took the test in practical skills; 381 were admitted for evaluation of personal qualities and predispositions and integrity qualification; 320 were put on the list for final evaluation/rating and finally, 120 were proposed for appointment. 113 of the candidates were appointed to the court.

The process was extremely competitive on two levels. In addition to the contest between judges-to-be, a fierce competition took place between the HQCJ and the Public Integrity Council (PIC) over the goal of the selection and the process and methods that lead to achieving this goal. While the HQCJ armed itself with formal (international) standards often interpreted to accommodate interests of judges, the PIC carried moral authority. It referred to the state of Ukraine’s court system (culture of servitude to other branches and interest groups, incompetence and wide spread corruption) and Maidan’s promise to overhaul the court system starting with “cleaning it of the compromised judges”.

Eventually, 25 new SC judges (22 per cent) were appointed despite being vetoed and 60 (53 per cent) objected to by the PIC. A lack of clarity on the selection rules (for example, the standards and methods by which the applicants’ competence, integrity and ethics are assessed) and the regulatory and hence interpretation of the rules monopoly of the HQCJ coupled with very high level of discretion of its members (80 per cent of decision-making was discretionary) allowed this to happen.

But this was not the end of the story. The PIC was supposed to play the same role in the evaluation of 5,700 sitting judges. Shortly after the evaluations began, in March 2018, the PIC pulled out of the process: this was caused by a lack of funding, frustration stemming from its previous experience (PIC’s opinions were not taken on board by the HQCJ), lack of transparency (a function of the high level of discretion wielded by the HQCJ), lack of clarity of the process and unrealistic deadlines that were beyond the capacity of both institutions (see also footnote 23). However, this did not stop the evaluation process from going ahead as the PIC’s participation is not mandatory in law.

The dispute between the PIC and HQCJ ended up in the court itself. In September 2018 the SC upheld three out of the PIC’s six demands. But the HQCJ appealed the discussion to the Grand Chamber of the SC. In October 2018, the HQCJ amended its regulations regarding the methodology applied to the calculation of scores. So far, the HQCJ has no plans to give up its broad discretionary powers, address its members’ conflicts of interest or an approach to the burden of proof regarding indications of judges’ illicit enrichment or misbehaviour (shifting it from the PIC to applicants, where it should be).

So, who are the winners and losers in this situation? Certainly, winners include the judges who were or will be (re)appointed for a life-term without the scrutiny of the PIC or having to prove that their lifestyle is proportional to their means. The life of the HQCJ would also be easier without having to deal with the PIC’s demands, which to be fair are sometimes excessive. As for the losers, without doubt the biggest losers are the Ukrainian people.

Public prosecution

In October 2014, the new law “On Public Prosecution” was passed to continue in the effort of bringing the institution’s functions, operation and practice into conformity with EU practices and CoE standards and to adjust its use of resources to contemporary business needs.²⁵ The adoption of the law was followed (in 2015), by an attempt to implement a

²⁵ The law came into force in July 2015.
comprehensive organisational reform based on recommendations by the above institutions. The reform centred on “right-sizing” an overly robust institution and creating a self-governing system to guarantee a sufficient level of prosecutorial independence. It involved:

- establishing a reform management unit
- streamlining business operations
- consolidating sub-national offices
- reducing personnel
- merit-based competitive hiring of new prosecutors, chief prosecutors and their deputies.

The reform was implemented only partially with rather mixed results. Leading reasons for this outcome were insufficient political will, waveriting commitment to the reform and weak leadership. Five prosecutors general (two in acting capacity) have led the office since 2014. The 2015 organisational reforms were conceived and led by deputy prosecutor general who not only did not enjoy the support of the prosecutor general but had to deal with his and his loyalists’ active opposition to the reform (Box 4).

**Box 4. Diamond prosecutors**

“Everything started with the inspection by Prosecutor’s office of the Chysty Grunt and LLC Hydro Eco Resource Enterprises”, one of the witnesses told Kyiv’s district court at the hearing regarding the case known as “Diamond prosecutors”. “In April 2015, it became clear to us [the owners of the above companies] that we had exhausted all legal options to fight off the consequences stemming from the inspection that could ruin both businesses. We found the way to approach the office of prosecutor and we learned that US$ 200,000 could solve our problems. The money was agreed to be paid in three tranches. First US$ 50,000 was paid for removing security service forces from our premises; then, US$ 100,000 was paid for the criminal charges being dropped and the documents taken from us returned, and finally, US$ 50,000 was paid on top of the previous payments.”

Subsequently, in July 2015, two high level prosecutors – the first deputy of the Investigation Department of the Office of the Prosecutor General Volodymyr Shapakin and Deputy Chief Prosecutor of Kyiv Region Oleksander Korniyets (both with ties to the sitting Prosecutor General) were detained and charged with the crime of accepting a bribe of UAH 3,150,000. A search of their properties discovered US$ 400,000 in cash and a large amount of jewellery, including 65 diamonds (hence the nickname).

The operation was overseen by the two Deputies of the Prosecutor General who happened to lead the reform process in the sector of public prosecution. Since the case, they have both left the public prosecution. David Sakvarelidze was first transferred to Odesa and later he was dismissed by the Prosecutor General, literally a few hours before he himself was dismissed by the Parliament. Vitaly Kasko resigned in February 2016 out of frustration caused by the decision of the prosecutor general to diminish his responsibilities followed by a string of attacks by the “old establishment” within the prosecutorial service which included his criminal investigation.

But back to the diamond prosecutors. Their case was brought to the court in at the end of 2015-16 and it has not yet been completed. Recently, Novoye Vremya (New Time) published an article about the daughter of Mr Korniyets who studies in the UK. The newspaper asked a simple question: how he [Mr Korniyets] with a salary of UAH 200,000 (US$ 7,600) a year, pays more than £120,000 (US$ 158,000) for his daughter’s schooling? In response, the Office of the Prosecutor General – on the grounds that New Time had disclosed confidential information about the ongoing investigation – asked the Kyiv district court to allow prosecutors to access all editorial materials related to the article. New Time claimed that the article relied on data from a British criminal agency. The court, to dismay of many human rights activists and supporters, decided in favour of the prosecution. This decision, however, has since been changed on appeal in favour of New Time.

In May 2016, the President appointed the new prosecutor general – Yuriy Lutsenko an experienced politician who, unfortunately, did not meet the legal

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26 Yuriy Lutsenko is former leader of the Bloc of Petro Poroshenko party and a former leader of its faction in parliament. He is also a former minister of internal affairs.
prerequisite for this position (he did not have a law degree). In order to appoint him, the Parliament, at the request of the President amended (in a fast-track one-day legislative process) the law on public prosecution. The way the appointment was carried out sent two important messages to an already sceptical public: in Ukraine, political loyalty is above required qualifications, and political interests are above the rule of law.

The appointment of the prosecutor general was followed by constitutional amendments (June 2016) which addressed the status, authority and independence of the public prosecution: the public prosecution became a part of the justice sector,\(^\text{27}\) the authority of the public prosecution was reduced to oversight of pre-trial investigations\(^\text{28}\) and prosecution of criminal cases and representing the interest of the state before courts in all criminal and other cases as defined by law. The risks of politicisation were addressed through an extended non-renewable term for the prosecutor general\(^\text{29}\) and by abolishing Parliament’s power to cast a no-confidence vote in the prosecutor general.

However, the constitutional principles, so far, have not trickled down to the level of laws and sub-laws, thus have had little tangible effect on the way the public prosecution operates. The public prosecution is perceived by many as continuing to have an unhealthily close relationship to executive powers and it also continues dominating judiciary using various “informal” avenues (Box 5).

**Box 5. Undue pressure from prosecutors on judges\(^\text{30}\)**

The GRECO report draws attention to the use by prosecutors of certain criminal offences – in particular, Article 375 of the criminal code “Delivery of a knowingly unfair sentence, judgment, ruling or order by a judge” – as a mean of pressure against judges. Even though the letter of the law is limited to “knowingly unfair” decisions, many stakeholders have stated that this provision is abused by prosecutors against judges in order to influence their decision-making.

According to a 2016 survey of judges, 5.5 per cent of all judges (and 6.6 per cent of trial court judges) indicated that they had been threatened by the prosecution for refusing to make the “necessary decision”; almost 3 per cent pointed to the fact that allegations made against them or proceedings launched had been done so under Article 375; a similar number of respondents indicated that in their case other criminal code provisions had been applied. Indeed, even in 2017 the acquittal rate at criminal courts was extremely low (around 1 per cent).

The new prosecutor general joined the service as a politician, and he remained a politician, causing difficulty with the reputation of the public prosecution as an autonomous and impartial institution. He reset the goals of the public prosecution to: freeing itself of corruption and abuses of power; establishing a General Inspection Office; and speeding up stolen asset recovery. He also changed the reform focus from structural and systemic changes to capacity-building activities. Little explanation was given as to how these objectives fit into achieving the ultimate goal, which is to transform the Ukrainian public prosecution into a modern European procuracy.

The Reform Management Unit and General Inspection Office are now operational, but the GIO has been criticised for its preoccupation with “annual integrity checks” of prosecutors which are seen as a rather formalistic exercise. The self-governing institutions (the Conference and Council of Prosecutors and the Qualification and Disciplinary Commission of Prosecutors) were also put in place. There is, however, little evidence that would suggest any improvement in day-to-day operations of the Ukrainian public prosecution. The GRECO 2017

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\(^\text{27}\) Historically, the public prosecution had a separate chapter in the constitution. Incorporating the public prosecution into the justice sector is indicative of the status of the institutions with regard to the court system.

\(^\text{28}\) The powers of pre-trial investigation were transferred to the National Anti-Corruption Bureau of Ukraine (NABU) and State Bureau of Investigation by the law on public prosecution.

\(^\text{29}\) The Prosecutor General is appointed and/or dismissed by the President with the approval of Parliament.

\(^\text{30}\) GRECO (2017)
Report\textsuperscript{31} identifies the persistence of a general perception that the prosecutors’ office is politicised and corrupt and that misconduct by prosecutors mostly goes unpunished.\textsuperscript{32}

Meanwhile, the prosecutor general has made several attempts to circumvent obligations to complete structural changes, to reduce the public prosecution’s power or staff,\textsuperscript{33} or replace old practices (for example, salary calculations) with new ones. He also picked a very public “fight” with the National Anti-corruption Bureau, in which he attempted to curb its authority. All that, in the context of his habit of commenting on politics which do not relate to public prosecution further reinforces the perception of his political affiliation and biases.

**Box 6. Ukraine’s public prosecution service: the case for reform**\textsuperscript{34}

In 2016, Ukraine, with 23.8 prosecutors per 100,000 of the population had one of the most robust prosecutorial systems in the EU. The average and median number or prosecutor in EU was 11.7 and 11 respectively. Ukraine also belonged to a marginal group of European countries with more prosecutors than judges. In 2016 the number of judges in Ukraine per 100,000 of the population was 14.8, which in contrast to prosecutors, compared negatively to the EU average or median (average 21.5 and median 17.8).

The number of prosecutors was also high relative to the functions they perform. Ukrainian prosecutors executed 10 out of 14 prosecutorial functions, which is not unusual across Europe. The coefficient for the scope of work for Ukraine prosecutors was 2.38 (23.8/10). The EU average and median was 1.7 and 1 (the lower number the better productivity). For comparison, Russia’s performance was worse than Ukraine’s at 4.2 (25.2/6); Lithuania scored 1.9 (24.4/13); and Latvia 1.7 (22.9/13). Ukraine’s number of incoming criminal cases prepared by prosecutors was one of the lowest in the EU (0.3 per 100,000 of the population) and it was decreasing.

Furthermore, in Ukraine, the prosecutors have very few staff to assist them with their tasks – 0.4 per 100,000 of the population, which means 0.4 support staff per 23.8 prosecutors. The explanation is that many support staff enjoy the formal status of a prosecutor in order to receive a higher salary.

The average gross salary of prosecutors in relation to the national average salary was within the bracket 1.7-4.4 (in relation to the national gross salary) while in the case of judges it was 3.1-4. The median for both was pretty much the same. However, the formal salary structure bears a little significance as a big part of prosecutors’ remuneration comes from a complex system of bonuses.

As for the budget, in 2016, the allocation for courts represented 64 per cent of the judicial budget (budget allocated to courts, the public prosecution service and legal aid). The public prosecution allocation was 34 per cent. Compared to EU countries the court allocation was within normal limits while the allocation for the public prosecution service was extraordinarily high.

In summary, the public prosecution service emerges from this short analysis as: too big and too expensive for the work it does.

There is little doubt that the reform of the public prosecution is of the utmost importance and hence it should be one of the country’s top priorities. But such a reform will not be possible without a strong leadership that is genuinely committed to the necessary reforms (adjusting organisational structures, business operations and capacities of prosecution to its functions). Based on previous experience, one of the key risks to this reform is strong opposition from inside the public prosecution

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\textsuperscript{31} Council of Europe’s Group of States Against Corruption (GRECO), Fourth Evaluation Round Report, Corruption prevention in respect of members of parliament, judges and prosecutors, 2017.

\textsuperscript{32} The authorities disagree and stress that during the period January 2016 to March 2017, seven prosecutors were found to be criminally liable. Moreover, 89 indictments against prosecutors are pending in court.

\textsuperscript{33} According to law, and in compliance with the reform process, the number of prosecutors nationwide was not supposed to exceed 15,000 by the end of 2015 (down from 18,000) and should have been down to 10,000 by January 2018. The relevant provisions of the law were amended in December 2018.

\textsuperscript{34} CEPEJ (2016, 2018).
service itself. Both risks should be accepted and carefully managed (Box 6).

Legal aid

Ukraine’s commitment to human rights and freedoms gave a boost to the creation of legal aid under the MoJ.³⁵ The law “On Free Legal Aid”³⁶ came into force in 2011. It provided for legal counselling and representation for both criminal and non-criminal cases subject to “generous”³⁷ eligibility criteria. Ukraine opted for a mixed legal aid approach, combining the state-run system (employed managers and providers) with the market-based services of private attorneys. The public prosecution continues aiding the most disadvantaged segments of population as outlined by the law. Legal aid reform started with 27 regional and 100 local legal centres.

In 2016 legal aid schemes expanded to legal empowerment of local communities through enhancing individual and business access to legal information and education. By 2018, through 550 contact points some 1,600 in-house lawyers and 5,000 subcontracted attorneys served about 0.5 million Ukrainians.³⁸

The legal aid reform, if measured by the scope of service provided before and after its completion is one of the most successful reforms in Ukraine. The question is whether the programme has grown too fast, in the wrong direction (legal empowerment as defined by Ukrainian authorities may not necessarily meet the internationally recognised criteria of legal aid) and/or without due consideration of its impact on the market for legal services,³⁹ efficiency⁴⁰ and sustainability concerns.⁴¹

Property registration

In 2015 the Parliament passed a law⁴² aimed at demonopolisation and decentralisation of state registrations.⁴³ This reform was also driven by efficiency concerns and business interests. The registration functions related to real estate were transferred from the state (MoJ) to notaries with nationwide geographical jurisdiction. The law also replaced the 2013 property register with a new one and legislated for the data transfer between these two registries. The reform was implemented in tandem with the similar changes to the business registries.

By 2016, Ukraine found itself in the middle of many “corporate raiding” scandals through abuses of the property and business registrations, which pointed to the alarming vulnerabilities of the system in terms of its ability to protect property rights of end users of both registries. In response, at the end of 2016 the “Anti-raiding law” was passed with several measures aimed at improving the efficiency and effectiveness of registrations and reducing the risk of abuse.⁴⁴ Since, the MoJ and CoM have taken numerous actions (legislative and non-legislative) to (re)address the problem. The reoccurrence of “raiding” and other abuses indicates that not all underlying causes of the problems – particularly the insufficient legal and institutional safeguards of protection of property rights – have been satisfactorily addressed.

³⁵ Under socialist regimes the public prosecution service was the main provider of free legal assistance.
³⁶ The law ”On Free Legal Aid” No. 51 Art. 577.
³⁷ In some instances, legal aid has a form of entitlement granted, for example to veterans, regardless of their actual needs and income.
³⁸ Presentation of the Director of Legal Aid Centre published on https://www.legalaid.gov.ua/en/. (Date accessed 30 January 2019).
³⁹ In 2016 the MoJ increased the price for services of private attorneys contracted under legal aid. The only reason that would justify such a decision would be that the MoJ was not able to retain the services of enough attorneys. This, however, was not the case. Given the scope of services and the number of lawyers subcontracted by the MoJ (about 4,000 registered) this has impacted (price increase) on the legal service market.
⁴⁰ Ukraine did not consider some other forms financing of legal aid such as: pro bono service; exemption from court fees; and covering the costs of experts.
⁴¹ Legal aid receives substantial assistance from donors. According to CEPEJ 2016 central European countries spend about €1 per inhabitant on legal aid. Ukraine spent €5.
⁴² The law ”On Amendment of the Law on State Registration of Property Rights to Real Estate and their Encumbrances” and some other laws. The law took effect on 1 January 2016, with a transition period until 30 April 2016.
⁴³ Registration of businesses was delegated to local self-government and state administrations, notaries and entities, accredited by the MoJ.
⁴⁴ The law No. 1666-VIII ”On Amendments to Certain Legislative Acts of Ukraine on Improving the State Registration of Rights to Real Estate and Protection of Ownership Rights”. Measures introduced by the law include increased verification, legalisation of and access to relevant documents, including court decisions criminalising certain forms of behaviour of registrars and owners/owners to be; abolition of the principle of extraterritoriality; mandatory notification of owners when actions are taken regarding their property; and establishing a permanent commission in the MoJ to review complaints and decide on appropriate actions.
According to the Support to Registries Report⁴⁵ the underlying problem of Ukrainian property registration is the absence and/or insufficient flow of timely and reliable information about the properties and their owners. For example, Ukraine has not yet mapped land plots. According to the UNITER Project Corruption Survey, in July-October 2015, around the time the property registries were decentralised, if measured by actual experience, notaries and property registries were the 9th and 10th most corrupt public institutions in the country (by comparison, courts and prosecutors took 16th and 17th place).

A quick enquiry into EU countries’ practices shows that for historic and practical reasons most EU countries maintain a land inventory (cadastre) and registration of relevant information about ownership under strict state control, mainly because the state bears direct responsibility for the integrity of those systems’ outcomes and is liable for registries’ mistakes. Therefore, they are rarely privatised.⁴⁶ If they are privatised (for example, Denmark), additional safeguards – legal, procedural and institutional – are introduced to limit the opportunities for abuse. The state normally executes its responsibilities through a central (administrative or judicial) office with a network of regional branches. In short, EU countries are very careful not to address the efficiency deficits (for example speed and cost) of their property registries at the cost of security of ownership rights. This can be also documented for example by the performance of Germany, France and Denmark on the World Bank’s Doing Business Property Registration Indicator.⁴⁷

According to the 2019 Doing Business report, to make registrations “safer” Ukraine needs to improve the geographical coverage of registries, increase transparency of information and improve the quality of registration infrastructure. More specifically, Ukraine needs to abolish assessments of property value (requested by notaries at the beginning of the registration process), introduce “bona fide” protection⁴⁸ and create an effective, decentralised, easy-to-access complaint system.⁴⁹

Enforcement of court judgments

The Maidan Revolution mobilised social capital to pursue the reform of non-enforcement of court judgments. The reform was launched by creating a legal framework⁵⁰ (part of the 2016 reform package). The strategy was to complement the already existing State Enforcement Service (SES) with about 4,500 professional staff with a system of private enforcers (bailiffs) operating on market principles. The initial plan was to license about 3,000 bailiffs by the end of 2020. It was believed that the coexistence of these two groups would lead to healthy competition, which in turn improves the enforcement of court decisions and debt collection.

However, there was very little clarity in terms of details of the strategy. The SES was given a broad monopoly to collect debt from the biggest and most influential debtors; the state, state enterprises and municipalities and in socially sensitive cases. The competitiveness of bailiffs was further undermined by the requirement to accept only cases whose value did not exceed their insurance premium. The MoJ remains in control of the fee schedule for the SES. The compensation of the bailiffs is set at a fixed amount (in case of enforcement of a non-monetary decision), a percentage of the amount to be enforced, or the value of the property.
At the beginning of 2017, the MoJ began designing a licensing process and establishing a private bailiffs' professional organisation. Due to the novelty and complexity of the system and a certain level of confusion and unpredictability of the process, the total number of private bailiffs is very low (136), well below the MoJ's own target of 800 by the end of 2018. As of now, this organisation has little capacity to oversee and protect this newly emerging profession. The MoJ continues to regulate the market for bailiffs' services using typical command-control approaches. It also routinely and arbitrarily intervenes in selection and disciplinary proceedings and the (re)distribution of cases between SEO and private bailiffs.

The MoJ claims it continues to be committed to and supportive of enforcement reform⁵¹ as conceived in 2016. However, until recently, the situation on the ground, particularly the MoJ's attitude towards bailiffs, contradicted this claim. A few months ago, the MoJ (in cooperation with the EU-funded Pravo Project) enacted a roadmap for the reform of forced enforcement which, in addition to strengthening the private enforcement system and streamlining business operations, intends to address the preferential treatment of certain categories of debtors (for example through enforcement moratoria or by-laws or court decisions). However, “too little, too late” applies to this otherwise advisable step as, due to the approaching general election, the Minister of Justice cannot guarantee the implementation of his commitment. Table 1 compares performance of services provided by SES and private bailiffs.

### Table 1
**Performance of state and private bailiffs**

<table>
<thead>
<tr>
<th></th>
<th>SES 2017</th>
<th>SES 1st half of 2018</th>
<th>Bailiffs 2017</th>
<th>Bailiffs 1st half of 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Received</strong></td>
<td>2,224,517 cases</td>
<td>1,295,773 cases</td>
<td>3,424 cases</td>
<td>11,841 cases</td>
</tr>
<tr>
<td><strong>Value in UAH</strong></td>
<td>333,122,846,875</td>
<td>181,926,553,736</td>
<td>716,199,864</td>
<td>5,725,660,753</td>
</tr>
<tr>
<td><strong>Completed</strong></td>
<td>2,450,329 cases</td>
<td>1,156,039 cases</td>
<td>269 cases</td>
<td>2,159 cases</td>
</tr>
<tr>
<td><strong>Value in UAH</strong></td>
<td>258,463,712,704</td>
<td>86,935,520,095</td>
<td>57,638,974</td>
<td>915,208,192</td>
</tr>
<tr>
<td><strong>Executed</strong></td>
<td>823,135 cases (38.2%)</td>
<td>441,191 cases (38.2%)</td>
<td>223 cases (82.9%)</td>
<td>1,217 cases (56.4%)</td>
</tr>
<tr>
<td><strong>Collected</strong></td>
<td>12,665,422,139 UAH</td>
<td>12,665,139 UAH</td>
<td>50,710,676 UAH</td>
<td>352,074,009 UAH</td>
</tr>
</tbody>
</table>

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53. The World Justice Project.
54. The code introduced a simplified procedure for small claims and pre-trial conferences as part of the case management techniques used in all commercial courts.
55. Kim et al (2019): Rule of Law Cluster, Property Rights Sub-Index. The Economic Freedom Index is composed of four clusters of indexes: rule of law (property rights; government integrity and judicial effectiveness); government size; regulatory efficiency; and open markets.
cent. The approval rating of legal professionals for specific reform interventions ranks between 52 and 70 per cent.⁵⁴

Despite these and other achievements, the overall picture of the RoL in Ukraine is unclear at best. The 2018 RoL Index⁵⁷ ranked Ukraine 8th (out of 13 countries) in the European and Central Asia Region (ECA) and 77th (out of 110 countries) in the world. Ukraine is performing relatively well on the sub-indicators: “fundamental rights” (3rd in the ECA); “open government” (4th in the ECA); and “civil justice” (6th in the ECA). Ukraine is rather underperforming in following areas: “regulatory enforcement” (13th in the ECA); “order and security” (11th in the ECA) and “absence of corruption” (10th in the ECA). According to the RoL Index, the "Achilles heels" of Ukraine RoL are: corruption in the legislature; lack of respect for due process (judicial as well as administrative); and a "second fiddle" relationship of courts with other government branches. The latter translates into, on one hand, undue pressure on courts; and on the other hand, a lack of judicial oversight regarding these branches. High cost and unaffordability of justice is emerging as Ukraine's new challenge. The World Bank's Doing Business report echoes this claim. For example, according to the 2019 Contract Enforcement Index it costs businesses 46 per cent of the claim value to collect debt while the ECA and OECD average are 23.3 and 21.2 per cent respectively.

The 2019 Economic Freedom Index, RoL Cluster Indicators (Table 2) points to the fact that "corruption in the Ukrainian public sector (including justice sector)" and "judicial inefficiencies", are to be blamed for the country's poor results. Ukraine's rating is 147th (among 189) in terms of economic freedom. The good news is that Ukraine's rating has increased slightly thanks to improvements, among others, in property rights. The bad news is that Ukraine is ranked 44th among 44 countries in the Europe region, and its overall score is below the regional and world averages. The 2019 report stresses that Ukraine needs to improve both its legal framework and the rule of law itself. In this context, contract enforcement (high costs and lengthy process); susceptibility of the judiciary to undue influence; lack of public confidence in court effectiveness; weak criminal penalties for corruption; and the depth of corruption are singled out as the most critical of Ukraine's problems. Both RoL indexes show a lot of ups and downs in the reform results which supports the view of many experts and donors that RoL reform in Ukraine is underperforming, and more importantly, that the results of reforms may not be sustainable and could be reversed.

The public’s views on RoL reform and its achievements are also more nuanced than presented above. For instance, 42 per cent of respondents to the same survey with court experience had to use their relationships, acquaintances and other means to influence a desirable result – which is higher than in 2017, when it was "only" 33 per cent. Some 53 per cent of legal professionals sought an intervention of a disciplinary body against a judge; almost half of their complaints related to delays in court proceedings or other procedural violations. Also, other surveys show more modest gains in court confidence. According to the Ukrainian Institute of Sociology the public's confidence in courts grew between 2014 and 2018 from 5.3 to 7.9 per cent only.

Table 2

<table>
<thead>
<tr>
<th>Rule of law</th>
<th>Score (out of 100)</th>
<th>Rank (out of 189 countries)</th>
<th>Trend</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property rights</td>
<td>43.9</td>
<td>113</td>
<td>Increase by 2.9</td>
</tr>
<tr>
<td>Government integrity</td>
<td>29.6</td>
<td>128</td>
<td>Increase by 0.6</td>
</tr>
<tr>
<td>Judicial effectiveness</td>
<td>21.6</td>
<td>135</td>
<td>Increase by 2.1</td>
</tr>
<tr>
<td>Total</td>
<td>99.5</td>
<td></td>
<td>Increase by 5.6</td>
</tr>
</tbody>
</table>

⁵⁴ Council of Europe/CEPEJ (2018). USAID funded the new Justice Project Survey 2018. Note the approval is about the reform measures as such and not approval of the specific results.

⁵⁷ 2018 RoL Index (under the World Justice Project) is composed of eight clusters of indexes with 44 sub-indicators. The clusters are: constraints to powers; absence of corruption; open government; fundamental rights; order and security; regulatory order; civil justice; and criminal justice.
Why not more?

So, why, despite all the effort, has Ukraine not achieved more progress in establishing the rule of law? To answer that question, we need first to discuss the premise on which the question is based: that we know what has been achieved and that Ukraine could and should achieve more. In other words, we need to discuss the expectations and the monitoring and evaluation of RoL reform progress.

RoL reforms penetrate the very foundation of society – its culture, values, formal and informal rules, institutions and power structures. Therefore, they are difficult and lengthy. In the words of Gordon Brown,⁵⁸ “In establishing the rule of law, the first five centuries are always the hardest”. As such, to be successful, RoL reforms need to create a broad coalition of participants and supporters, which is a difficult task. It is even more difficult to sustain this coalition throughout the lengthy reform process.

“Anger always comes from frustrated expectations”.⁵⁹ The best answer to the risk of losing support is setting up and managing expectations for support (of reforms). Expectation management in its essence is a form of truthful disclosure regarding decisions, risks (including failures) and preconceptions.⁶⁰ This brings us to the issue of the monitoring and evaluation of reform results. In Ukraine, the expectations of results of RoL reform were set very high – too high to be credible, particularly for local frustrated and impatient stakeholders who have already experienced a lot of unfulfilled promises. Several monitoring and evaluation systems were set up by the government, professional organisations and civil society to measure reform results. Yet, reliable information about the RoL reform activities is scarce and insufficient to inform and influence stakeholders’ expectations.

Another challenge is that the Ukrainian people do not trust the government and legal institutions, and they are eager to see tangible results of the reform. And they want them today! But Ukrainian RoL reform was designed as a typical comprehensive institutional reform with aspirational goals and a predominantly prescriptive top-down approach. The reform began with policies and laws; then it turned to implementation, starting with the structural and systemic institutional and procedural reforms in the priority sub-sectors – the courts and prosecution services – the pillar legal institutions. Indeed, both institutions are organised in centralised systems and some changes, particularly structural and systemic reforms, are better done centrally. The downside of the approach is that it takes too long for the changes to trickle down and translate into tangible results (services) that occur predominantly at the bottom. Not only that, experience suggests that often, these reforms cause a temporary slow-down of systems before the first results become evident.

In addition, this type of reform involves a lot of complex interrelated tasks which must be prioritised and implemented in a specific order so that they, on one hand, do not to interrupt day-to-day operations, and on the other, generate a new cumulative output. And this is expected to be done by institutions with less than optimal capacity and corporate culture. So, usually, the results of such reforms are uncertain and difficult to predict.

The focus on the institutions (as opposed to services and users) also means that those in the institutions are the first beneficiary of the reforms (for example judges or prosecutors are better educated, they have better working conditions and higher salaries). It is somehow assumed that because of new conditions, judges and prosecutors will provide a better service. This, however, may not be the case, if, for instance, these beneficiaries are corrupt, or the prevalent institutional corporate culture is not conducive to the expected behavioural change. For instance, a corrupt judge excelling in law (due to great training) is unlikely to stop taking bribes if all around him still do so. Or, even a substantive increase of salary may not stop a prosecutor from taking bribes because the corrupt network they are a part of does not let them “off the hook”.

This chapter began by talking about cultural change – a goal that the 2015-20 strategy aspires to achieve. The strategy is correct in that, in order to generate desirable results, Ukraine’s RoL reform must cause an irreversible cultural shift not only among prosecutors.

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⁵⁸ The First Five Centuries, Global Trends 2030; Jul 24, 2012.
and judges but in the whole of society – because the culture of legal institutions reflects the society they exist in. The strategy is incorrect that this can be achieved in five years. We are, after all, only in the beginning of the fifth year of implementation of the post-Maidan RoL reform.

Yet, there is something that can be done, besides resetting and managing expectations, to speed up this process. Ukraine should consider combining the current approach to the RoL reform with the so-called “problem driven” approach: a “bottom-up” method that would focus on a particular problem identified at lower levels (where the public has the most contact with the system) solvable without (or alongside) bigger systemic changes using low-cost, locally created solutions. Because, using this approach, solutions tend to emerge “as a puzzle, over time, given the accumulation of many individual pieces”⁶¹ its application requires a de-concentration of the decision-making and unlightening “the hands” of sub-national institutions.

The current transformation of the SC (the reform which through smaller organisational changes focused on the needs of court clients and efficiency gains within an existing framework) and the legal aid reform (the large-scale innovative organisational reform which leverages services through external relationships with private lawyers and municipalities) set a precedent for the above approach. The legal aid reform also proves that this approach generates more services and more satisfied users which, without a doubt, is a must for Ukrainian legal institutions if they want to gain the trust of society and for the reforms if they are to continue.

Finally, it is the time to answer the original question: why not more? As already discussed, prior to the Revolution of Dignity the Ukrainian context was not conducive to the structural and systemic reforms that would lay down the foundation of RoL. Several attempts were made – usually under pressure from the international community - to address the most pressing issues (such as the broad scope of powers of the public prosecution service). However, these initiatives never had much influence on the day-to-day lives of ordinary people. The only reforms from that period that “stuck” and were felt by ordinary people were those that did not challenge the existing power structure, such as the reforms of legal aid and property registration. These reforms however, perhaps because of a narrow window of opportunity, were prepared hastily and implemented in a “learning by doing” style without full appreciation of their risks and impacts. And they pay a price for that. Could Ukraine have achieved more back then? There is no answer to this question.

As for the time after the Revolution of Dignity, the list of the RoL reforms prepared and partially implemented by Ukraine is truly unprecedented. Ukraine made a strategic choice to focus reform efforts on the judiciary. The choice is fully justified by the role the judiciary plays in the legal system, the impact of dysfunctional courts on the economy and society and popular preference. The sequence of the reform (legislation/institutions/human resources) is also strategically sound.

But as said before, the reform is extremely centralised and lacks focus on the users, tangible results and services that are necessary for sustaining popular support and momentum. Also, the key reform policies were mostly conceived externally (to the sector) by local political elites and technocrats with the help of donors but with little coordination and cooperation with judges and other critical players. Excluding these players from the bargaining table was a deliberate choice made on the basis of judges’ and/or prosecutors’ collective lack of moral credibility and their prevalent “anti-reform” attitude.

Today, we know that about 80-90 per cent⁶² of judges appointed before 2014, will likely remain on the bench and will participate in the new judicial self-governing structures, in which capacity they assume the role of policymakers. In other words, power distribution in the policy arena of the justice sector has changed significantly compared to the situation in 2016. Several signals sent by justice institutions (for example the unwillingness of HQCJ to give up excessive discretionary powers; the Constitutional Court's decision which declares the concept of “illegal enrichment” unconstitutional; or the refusal of members of the SCJ to recuse themselves from the process of judicial appointments) reduce the potential for solutions to emerge from within the judicial institutions. This decline in the role of judges in shaping RoL reforms is a critical challenge that needs to be addressed in order to ensure the success of the ongoing judicial reforms.

⁶² The estimate is based on the results of the re-evaluation of judges as of April 1, 2019 (R. Kuybida, M. Sereda, 2019) and HQCJ statistics for the first round of 2017 selection of the SC judges. It should be treated with caution.
appointment process they participate in as one of the competitors) indicate that “the going gets tougher”.

Overall, not enough time has passed for the reform to generate significant outputs and outcomes in the form of faster court proceedings, better judgments or reduced corruption, for example. Actually, only very few reforms have been completed. The evaluation of judges’ qualifications is an example of a rushed reform with questionable results. As of now, using various processes, about 2,459 judges have been assessed of which 156 (6 per cent) were recommended for dismissal but only 15 (0.6 per cent) were actually dismissed. As for written knowledge tests – 4,158 judges have undertaken tests since 2016. The success rate of applicants has been 98 per cent. By comparison, the success rate of Slovak judges after knowledge testing is below 30 per cent.

This explains, at least to some extent, why Ukraine’s ratings continue to be stubbornly poor. But given the time and local context – for example power imbalances (that induce additional uncertainty regarding ability to implement the reform); absorption capacity of Ukrainian institutions and the severity of the challenges faced – the real question is: “Shouldn’t Ukraine do less?” to be able to make sure that each piece of the mosaic falls in its place and all loose ends are tied up. In development, often “less is more”.

However, there are a few reforms of which we may say: “More could have been done”. The list of neglected reforms includes the areas of: legislative drafting, the public prosecution service and enforcement of judgments. The reason for delays in the implementation of all three reforms is a lack of political will and courage, commitment and leadership. Also, Ukraine has not paid enough attention to a new challenge that emerged from the ruins of socialist legacy where “justice was for free”: an economic barrier to justice. The RoL Index, the CEPEJ reports and some local surveys and measurements point to the high costs/unaffordability of justice as the new Ukraine RoL challenge (Box 7).

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**Box 7. Reforming court fees**

In pursuit of the economic self-sustainability of the court system, between 2012 and 2016, Ukraine increased court fees twice; most recently in 2016 by 142 per cent. As a result, in 2017, 57 per cent of courts’ costs were paid for by court users (EU average cost recovery is 18 per cent and median 12 per cent). The current national policy is the full recovery of court expenses. While paying fees for court services is common practice, full recovery of court costs through the court fee is not. There is only one country in Europe which recovers 117 per cent of the court budget through court fees – Austria. However, Austria was able to apply a self-financing model because 80 per cent of cases in courts are non-litigious (for example registrations of property rights) disposed in extremely streamlined process by non-judges and high levels of court automation.

The number of non-litigious cases in Ukraine’s courts is negligible. In the Ukrainian context, (a high level of distrust in courts because of their inefficiencies and an extremely high level of corruption) the increase in court fees should be reflected in a commensurate increase in the quality of service the users receive. Nothing suggests that the quality of the service of Ukraine courts has justified the radical increases in court fees. More importantly, any raising of court fees should take into consideration its impact on court users.

There are also indications that the increase in fees was applied selectively to disputes of the state, litigations involving taxes and criminal prosecutions which can hardly be seen as “a self-financing” model in the sense of absence of financial injections from the state budget.

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63 Center of Policy and Legal Reforms: Qualification Assessment of Judges. Summary of Interim Results.
64 Council of Europe European Commission for the efficiency of justice (CEPEJ).
65 This section is not a comprehensive analysis of Ukraine’s Anti-corruption Reforms. In synch with Chapter 1 “Political economy of reforms, governance, political system, sources of corruption” it focuses on three elements of anti-corruption approach: scope for corruption; transparency and accountability.
Anti-corruption policy

Corruption was one of the catalysts for the Ukraine's Revolution of Dignity. In 2014, capitalising on the momentum sparked by the Revolution, Ukraine enacted a National Anti-corruption Strategy 2014-17 and moved toward creation of integrity institutions. In 2018 the National Agency for Prevention of Corruption (NACP) prepared a new strategy which, however, has not been adopted by the parliament.

Ukraine's anti-corruption strategy mirrors the anti-corruption programmes of the Organisation for Economic Cooperation and Development (OECD) and the Council of Europe's Group of States Against Corruption (GRECO) carried out in Ukraine since 2004 and 2006, respectively. The goals of the strategy are ambitious. The approach to corruption is determined by meeting international obligations and standards. The strategy assumes that the aggregate level of corruption can be reduced by creating a legal and institutional framework; providing incentives to outweigh gains from corrupt practices; and reducing space for corruption by streamlining administrative processes. The implementation of the strategy has focused mainly on creating a formal institutional and legal framework. The progress has been lagging and results achieved in terms of reducing corruption in public life have been rather modest.

According to the OECD, Ukraine's main accomplishments since 2015 are the formation of the legislative, policy and institutional foundations for fighting and preventing corruption and putting in place various transparency initiatives. GRECO echoes the OECD's conclusion and points to Ukraine's poor results in reducing impunity for corruption. Both organisations agree that the most pressing challenge is how to preserve and strengthen the new institutional framework and boost anti-corruption efforts. They identify two critical risks to the anti-corruption reforms: weakening support from some top officials/institutions and Ukrainian elite; and a lack of measurable outcomes particularly in terms of reduced perception of and/or actual corruption.

In its 2018 report “Are Ukraine's Anti-Corruption Reforms working?” Chatham House states that some of Ukraine's anti-corruptions reforms are slow. But this is not atypical as a transition of this kind often takes around 50 years. Ukraine's biggest anti-corruption accomplishment so far, according to the report, has been restricting the opportunities for corruption. The success stories include: the cleaning up of Naogaz and reforms in administrative services, banking, police patrols, procurement and taxation. Chatham House also stresses that punitive measures alone have limited impact on the level of corruption, hence they should be considered in the

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64 The Law "On the Principles of State Anti-Corruption Policy in Ukraine (the Anti-Corruption Strategy for 2014-2017)".
65 The integrity network included the National Agency for Corruption Prevention; the National Anti-corruption Bureau of Ukraine; the Specialised Anti-corruption Prosecutor's Office; and the Agency for Recovering and Management of Assets. In 2016, Ukraine decided to create a specialised anti-corruption court which became part of the network.
67 Ukraine joined the Organization for Economic Cooperation and Development Anti-corruption Network (OECD ACN) for Central and Eastern Europe (the Istanbul Anti-corruption Program) in 2003; became a member of the CoE’s Group of States Against Corruption (GRECO) in 2006, ratified the UN Convention Against Corruption in 2009 and joined the Open Governance Initiative in 2011.
68 The anti-corruption strategy 2014-17 pledged to “reduce the level of corruption, increase public confidence in the government and increase the level of foreign investment in the state's economy.” Examples of specific reforms included in the strategy are: financing of political parties; regulating lobbying; addressing conflicts of interest; improving the quality and integrity of civil servants, judges and prosecutors; reducing their immunities; adjusting the remuneration system; introducing monitoring of lifestyle of public officials; strengthening whistleblowers’ protection; and liability/accountability mechanisms.
69 In 2018, Ukraine was ranked 120th most corrupt country in the Transparency International corruption perception index (scoring 32 out of 100 points), a five-point improvement since 2015. Throughout the entire period, Ukraine was lagging behind both ECA (30 countries) as well as the EU average score. A more detailed assessment of Ukraine’s implementation progress can be found at https://ti-ukraine.org/en/project/control-over-public-procurement/.
context of an overall strategy for reducing the space for corruption to occur. In the future Ukraine should focus more on the prevention of corruption. The overall approach should be based on increasing competitiveness in the economy and politics, reducing opportunities to exercise discretion and increasing accountability for corruption.⁷²

Vox Ukraine agrees with Chatham House’s emphasis on good results in the arena of public procurement, deregulation and banking sector clean-up.⁷³

The “Reanimation Package of Reforms” (RPR)⁷⁴ holds that Ukraine has underperformed in both institution building and reducing opportunities for corruption. It agrees with the OECD and GRECO that the first priority should be to salvage the progress made so far. This should include enabling the criminal anti-corruption institutions to do their job and “fixing” the NACP. RPR’s proposal for future reforms includes strengthening all integrity institutions, addressing political corruption, strengthening enforcement of right and access to information and carrying out structural reforms to reduce opportunities for corruption.

Three things undermine the effectiveness of the strategy:

* detachment of the anti-corruption reform from Ukraine’s overall developmental process
* lack of commitment from Ukraine’s ruling elite to anti-corruption reform
* weak institutional capacity to produce and implement a more effective strategy and policies.

**Anti-corruption, development and reducing opportunities for corruption.**

Experience and research show that anti-corruption reforms as described above (though effective in the most developed and prosperous founding countries of OECD) do not work well in countries such as Ukraine where development lags and rule of law is applied selectively according to individual status. This is because they do not tackle the underlying causes of corruption, which relate to Ukraine’s overall socioeconomic development,⁷⁷ including prevailing social norms (for example, higher tolerance of corrupt behaviour), power structures (for example, persistent power imbalances), and a lack of commitment of the ruling elite to forego their privileges.⁷⁸

The relationship between corruption and development runs deep. There is evidence that development, by redistributing power and changing norms in the policy arena, explains as much as half of the variation in the control of corruption. This makes development the key factor that matters in reducing corruption. The fact that development addresses “only” 50 per cent of corruption means that even countries at lower levels of development (such as Ukraine) can be successful in implementing anti-corruption reforms provided they choose an appropriate strategy.⁷⁷

Ukraine ranks 88th among 189 countries on the Human Development Index which measures overall development.⁷⁸ The comparison of Ukraine’s development status with the absence of corruption (measured by the Governance Indicator of Absence of Corruption) shows that Ukraine (along with for example, Russia and Azerbaijan) greatly underperforms on control of corruption given its level of development.⁷⁹ This signals, on one hand, that the current anti-corruption reform strategy (with focus on the formal institutional system) may not be

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⁷⁴ The largest coalition of leading non-governmental organisations and experts from all over Ukraine who have pooled their efforts to facilitate and implement reforms.
⁷⁵ Development is multidimensional; it encompasses the need and the means by which to provide better lives for people. It includes not only economic growth but also human development—providing for health, nutrition, education and a clean environment. By UN, World Bank and IMF classifications, Ukraine is lower-middle-income developing country.
⁷⁷ World Bank (2017).
⁷⁸ Ibid.
⁷⁹ The Human Development Index (HDI) is a statistic composite index of life expectancy, education and per capita income indicators, which are used to rank countries into four tiers of human development. It involves three main cluster indicators: Long and healthy lives; Access to knowledge and Decent standards of living. In 2017, on the HDI, Ukraine ranked 88th among 189 countries with a score of 0.751. In 1990 Ukraine’s score was 0.7. http://hdr.undp.org/en/content/human-development-index-hdi
⁸ World Bank (2017) pp. 79 Figure S1.1.
the best fit for Ukraine. On the other hand, it points to the existence of a window of opportunity for a different anti-corruption reform in Ukraine.

**Commitment of Ukraine’s elite to fighting corruption.**

Disengagement of Ukraine’s ruling elite from the anti-corruption reform has to do with the fact that new anti-corruption rules undermine their interests. Ukraine’s reality is that oligarchs can still comfortably generate rents in informal ways through their political connections. Judges can still accumulate unexplained wealth without being dismissed. And political parties still depend on revenue raised informally (from oligarchs and interest groups) and/or by breaking the law. Therefore, neither group would support and/or enforce rules that significantly change the status quo. But there is also evidence that anti-corruption policies can be effective only when their enforcement is aligned with the interests of the ruling elite. Simply put, the buy-in of the ruling elite is necessary for the anti-corruption strategy to be successful and that involves the exchange of commitment of the elite for their personal benefits.⁸⁰

What can be done? Doubtless the state has important role to play in confronting corruption which calls for formal rules and institutions. Hence building a state system capable of fulfilling state responsibilities must be a part of an anti-corruption reform. However, Chatham House⁸¹ and the World Bank⁸² make a convincing argument that in the context of Ukraine, building institutions is not enough and that Ukraine should focus on reducing opportunities for corruption by implementing problem- and/or sector-focused reforms that contribute most to its overall development. In other words, Ukraine’s new anti-corruption strategy needs to be more aligned with the country’s overall development programme and should attack corruption at critical points where anti-corruption is both feasible and has a high impact on development. It must also accommodate the interests of the ruling elite.

**Institutional capacity to produce and implement the anti-corruption strategy.**

The NACP is responsible for the prevention of corruption, including designing relevant strategies and policies.⁸³ Since its creation NACP has been subject to heavy criticism on the grounds of lacking operational capacity, transparency, independence and integrity. Indeed, since 2016 when it was established, NACP has failed on many critically important tasks, producing an effective anti-corruption strategy among them. NACP’s failures are a function of several factors including: inadequate policies (for example, it was obvious that the e-asset declaration system involving millions of individuals was too ambitious for a completely new institution); large portfolio of different responsibilities; less than optimal institutional architecture (for example, collective decision-making); weak capacities and confusing leadership (for example, rotating mechanism of several leaders). To address this challenge, the institutional concept of NACP has to be reviewed and the institution “rebooted”.

**Transparency and access to information**

Ukraine’s quest for greater transparency started in 2011 with passing the law “On Access to Public Information”. As of now, Ukraine has achieved an unparalleled level of transparency by introducing the e-asset disclosure, e-procurement, opening of the public registries with property rights information (land cadastre, immovable property rights, vehicle and business registrations), and making a number of datasets publicly available in open data format (data.gov.ua comprises more than 300 data sets).

In 2014, Ukraine introduced a concept of “ultimate beneficiary owners” forcing businesses to reveal who owns, controls and benefits from their companies. A year later the same measure was applied to the broadcasting companies to mitigate the negative

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⁸⁰ Ibid.
⁸² Often, when policies and technical solutions fail to achieve their intended outcomes, institutional failure takes the blame, and the solution usually proposed is to “improve” institutions.
⁸³ NACP’s explicit responsibilities include overseeing formation and implementation of anti-corruption policies; monitoring the lifestyle of public officials; regulating conflicts of interest; protecting whistleblowers; and preventing political corruption.
The concentration of their ownership in the hands of four oligarchs (Kolomoisky, Pinchuk, Firtash and Akhmetov). In 2017, Ukraine was the first country to join a cross-country database of beneficiary owners. In 2015, the Parliament enacted the Law “On Open Use of Public Funds” to prevent corrupt practices in the public sector. Some positive steps were later taken regarding taxation and customs, for example, the electronic register for VAT reimbursement. In 2018, the Law “On Transparency of Extractive Industries” was adopted.

In 2018, the Open Data Barometer (ODB) included Ukraine among 30 leading open data countries. With a score of 47 (out of 100) Ukraine ranked 18th in the group. ODB praised Ukraine for “tremendous” progress it made between 2015 and 2018 during which time its score increased by 25 points. Ukraine received 60 (out of 100) points on “Readiness”, 52 points on “Implementation” and 28 on “Impact” of its policies.

The ODB evaluation points to the strength but also to further opportunities for Ukraine’s commitment to transparency and openness. Ukraine is performing well in making data available and accessible. However, Ukraine still faces a challenge to make these data actionable, which can be evidenced, for example, by a low number of convictions stemming from e-asset disclosure or minimal impact of the regime of ultimate beneficiary owners, mainly due to the ineffective penalties for non-compliance with rules and the absence of criminal liability. The ODB measure also points to Ukraine’s uneven performance across different areas/sectors as well as to the rather weak management of data.

The ability of Ukraine’s citizens to use online tools and social media and thus make the best of e-services provided by the government and/or exercise social accountability is key to the effectiveness of open data policies. However, according to the 2017 Index of Public integrity indicator Ukraine (sub-indicator e-citizenship) the use of online tools by Ukrainian citizens is low.

Accountability and impunity

Strengthening institutional accountability is one of the most efficient ways to combat corruption. A functional accountability system involves a complex and interrelated vertical (accountability of the parliament to the people), horizontal (accountability among the branches of the government) and diagonal (media and NGOs) accountability mechanisms. Ukraine’s main challenge is a lack of basic understanding of the situation (both de jure and de facto) in this area and the absence of a systemic approach to building and/or strengthening accountability systems. It is a common trend (and Ukraine is not different) that it takes a long time for de jure accountability to translate into a functional de facto system, and that accountability systems evolve differently.

The leading open data countries are evaluated by three cluster indicators: “Readiness”; “Implementation” and “Impact” of their open data policies and actions against 31 sub-indicators. For the “Readiness” indicator, Ukraine scored the highest score (72) on the sub-indicator “Government actions” and the lowest score (52) on “Government policies” and “Enterprises and businesses”. Regarding the “Implementation” indicator, Ukraine’s highest score was on “Public contract” (85 per cent) and “Legislation” (80 per cent) and the lowest on “Land ownership data” (5 per cent) and “National environment statistics” (25 per cent). In terms of data management, Ukraine achieved the highest score on “Existence” and “Availability” of data (100 and 96 per cent respectively) and the lowest score on “Provision of identifiers for key elements in the datasets” and “Licensing data” (4 per cent) and on “Availability of machine-readable and reusable data” (12 per cent). As for the impact, the best score was received on “Economic” and the worst on “Social impact” - 45 and 5 per cent respectively.

For details regarding e-procurement see Chapter 1 on page 10.

Index of Public Integrity, on the e-citizenship indicator Ukraine’s performance is among the worst in the region of 14 countries. Only the Kyrgyz Republic and Tajikistan score worse. https://integrity-index.org


Staffan et al. (2017) On the grounds of experience from 173 countries from 1900 to 2017 the paper concludes that: de facto vertical accountability can evolve before other types of accountability; horizontal accountability is contingent on progress in vertical and diagonal accountability; without fully free and fair elections, autonomous opposition parties and a developed civil society and media, no country in the world has achieved effective government oversight through independent high courts, vigorous parliaments or other institutions. This suggests that efforts to improve freedom and fairness of elections and the situation of opposition parties can have positive repercussions for other areas of accountability as well. The judiciary and legislature have stronger incentives to oversee the actions of the executive if members of parliament are held accountable through free elections and functioning political parties, and if, at the same time, the media scrutinises the work of judges and legislators, and civil society organisations push for implementing the checks and balances between institutions. The best anti-corruption tools are those which do not rely on the government alone, rather they cut across state and society.
Lack of progress in enforcement of criminal accountability is primarily a function of the lagging reform of accountability measures, including the system of criminal justice (investigation, apprehension and prosecution of embezzlers, bribe-payers, bribe-takers and those laundering the proceeds of corruption).

A lack of progress in reducing impunity for corruption has been recognised as a downfall of Ukraine’s anti-corruption reform. It took quite a long time for Ukraine to bring its framework for criminalisation of corruption in line with international standards (achieved in 2014). A few issues remained to be addressed (mainly clearer definition of the corruption crimes and a statute of limitations)⁸⁹ when in February 2019 the Ukrainian Constitutional Court declared the articles of the Criminal Code that provided for liability for illegal enrichment to be unconstitutional. All donors and international institutions as well as a group of local experts expressed the view that this decision was both unconstitutional and in violation of international standards, pointing to the example of similar legal frameworks in other countries. Regardless, the decision is irreversible. Since February 2019, 65 criminal proceedings regarding illicit enrichment were fully or partially closed. Even if a new law could revive its criminalisation, one of the key RoL principles – that the law must not have a retroactive effect – will prevent it from bringing the perpetrators to justice. The overall impact of the decision remains to be seen.

Box 9. NABU’s statistics

According to NABU statistics since 2016, the office initiated 635 investigations; 176 cases were sent to the courts; the cases involved 153 suspects and 292 accused out of which 28 were indicted. The value of damage caused by these cases is UAH 220 billion, out of which so far only UAH 452 million was recovered. Statistics for the second half of 2018 – 577 investigations, 32 submissions to the courts, 61 accused and 44 suspects – indicate improvements in the ability of the enforcement system to bring perpetrators of corruption to justice. The NABU statistics also suggest that out of 176 cases pending in the courts (as of the end of 2018) in 46 cases (26 per cent) the courts have not scheduled/carried out a hearing; only 36 cases have been decided, out of which in 25 cases the court upheld the NABU’s/SAPO’s conviction. In three “serious cases” the court hearing has not been scheduled – with time lapses of 25, 24, and 21 months. (NABU https://nabu.gov.ua/en/reports)

NABU and the Specialised Anti-corruption Prosecutor’s Office (SAPO) investigate and prosecute high level corruption. Courts are the weakest link in the chain of integrity institutions involved in criminal proceedings as the judges – generalists who carry out this jurisdiction – have few incentives to proceed on corruption cases. This is just one of the reasons why a specialised anti-corruption court (homogenisation and concentrated adjudication and, possibly, harsher punishment) is needed for Ukraine. But even a complete chain of integrity institutions may not be enough to cut through the vicious circle of corruption if underlying causes of corruption are not addressed.

What to do next?

Ukraine should consider the following approaches to RoL reforms/activities.

Reform policies and reform management

Challenges to be addressed:

- RoL reform is a long-term complicated endeavour involving multiple levels of institutions, beneficiaries and other stakeholders, and its objective extends beyond one political cycle. The success of the reform requires consistent implementation over time (regardless of changing circumstances) which in turn, relies on credible commitment by all actors to play their respective roles. In addition, the reform is not possible

⁸⁹ The statute of limitation for corruption offences is mostly three or five years; for administrative offences, two years. The OECD recommendation has been to expand a statute of limitation for all corruption offences to at least five years and provide for suspension of the statute of limitations during the period an official enjoyed immunity from criminal prosecution. See also EU 3DCTAs, anti-corruption policies in Georgia, Moldova and Ukraine, 2017, http://www.3dctas.eu/
without effective leadership, coordination and cooperation between all actors.⁹⁰

• The 2015 strategy is the umbrella RoL policy document. The credibility of the policies have been less than optimal due to a lack of reliable underlying research, understanding and communication of the underlying causes of problems, over-ambitious goals, weak strategic focus and prioritisation of reform interventions, ineffective leadership, as well as fragmented oversight of implementation and consequently poor cooperation and coordination among the key players.⁹¹ Monitoring and evaluation of implementation has been incomplete, and inconsistent (in terms of time and accuracy of information).

Recommendations:

• A new RoL strategy is due in 2020. Ukraine should use this as an opportunity to address the above challenges. The new strategy should be prepared in a participatory process, it should be informed by solid empirical research; it should be prepared using a credible methodology that would allow consideration of most, if not all, relevant factors (include political economy analysis for example); the implementation structure should be consolidated and have sufficient capacities to perform the key functions, including the effective monitoring and evaluation system.

• The strategy should clarify the role of civil society and make sure that their representatives have access to sufficient information and capacity to perform their respective functions.

• Legislative reform could become a part of the RoL reform.⁹² In any case, these two reforms should be closely coordinated and the new strategy could provide a platform for this union.

Justice sector

Overall, the justice reform should build on the progress that has been achieved so far through structural changes. To do so, however, may require a major stocktaking analysis and broad consultations with stakeholders (including the ruling elite) to build a consensus as to what does or does not work and hence should be corrected.

Economic barriers to justice

Challenges to be addressed:

• Growing economic barriers to justice due to the rapid increase of court fees (a result of the misplaced policy of court fiscal self-sufficiency), costs associated with legal services, particularly representation in courts and costs associated with the enforcement of judgments.⁹³

Recommendations:

• Evaluate the impact of all policy decision/laws and sub-laws on the price and/or costs accruing to the users of courts (citizens and businesses) and receivers of legal services (provided by attorneys, notaries and other legal professionals) or the state.

• Remove the legal constructs that impose unnecessary and/or unreasonable burdens on users/clients of the justice sector and or allow for rent-seeking behaviour.

• Make sure that the evaluation of above impact is a part of policy/decision-making.

Judiciary

Challenges to be addressed:

• The modernisation of the selection and evaluation of judges is the most important reform implemented since the Maidan Revolution. The

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⁹⁰ World Bank (2017). The World Development Report 2017 defines commitment as backing consistent policies over time to ensure promises are delivered; coordination as shaping expectations to enable complementary action; and cooperation as providing its due contribution and limiting opportunistic behaviour to prevent free-riding.

⁹¹ The RoL reforms have been coordinated by the Office of the President (the constitutional reform, court reform, the regulation of market for legal services by attorneys and the codification were overseen by the Office of the President; the reforms implemented by the Ministry of Justice (for example, the reforms of civil judgment enforcement, registrations (including land and business registrations) legal aid and penitentiary reform were overseen by the Cabinet of Ministers and the reform of public prosecution lacked any oversight.

⁹² World Bank WDR (2017): “Law and the legislative process are powerful instruments for balancing powers and the reshaping of the policy arena. Law can be used as a commitment and as a coordination device to promote accountability and foster equitable bargaining space. Law can play a role in shaping incentives to comply with agreements [societal]; it orders desirable behaviour and reshapes preferences and coordinates expectations.”

⁹³ Regarding court fees see Box 7. Regarding the cost of legal representation and enforcement of court decisions see "A bird’s eye view" section and DB 2019 Report on Contract Enforcement Indicators.
results of the reform are mixed. It had a promising start: around one third of sitting judges has left the judiciary following announcement of the reform. But then, up to 96 per cent of sitting judges who underwent re-evaluation have been so far re-appointed and only one per cent of them were proposed for dismissal. The vast majority of newly selected judges are judges from pre-Maidan times. The court corporate culture does not seem to have changed much and the evidence points to continuing lack of judicial independence and corruption in the courts. The court accountability system is ill prepared to mitigate the fallout of a less than fully successful attempt to vet judges who do not meet the necessary requirements to sit on a judicial bench.

- The follow-on reforms will increasingly refocus from structural to capacity building efforts. Inadequate understanding of the performance of courts in the post-Maidan reform context results in ill-informed policies in such areas of court management as: due process; court fees schedule; the concept of court/judge performance; and the role of civil society in monitoring the judiciary.

Recommendations:

- Stop and/or slow down the re-evaluation and appointment of judges.
- Review and revise the relevant policies and regulations from the point of view of their functionality – the ability to deliver desirable results. The review should also reflect on the lessons learned from previous processes; advice of international experts and donors and proposals of the PIC and broader stakeholders such as business community and professional organization.
- Review the regulation on the PIC. Make the PIC’s participation in the process of judicial evaluation mandatory and significantly reduce the HQCJ’s discretionary powers. Make sure that the PIC’s capacity matches the scope of its responsibilities. Make sure that the interpretation and application of the principles of “burden of proof” and “reasonable doubt” are applied consistently across all selections in the same way they were applied to the selection of judges for the anti-corruption court.
- Develop a human resources (HR) strategy. The HR strategy should articulate staffing needs and immediate- and mid-term staffing goals. One of the goals should be improving the integrity of personnel and the strategy should provide a roadmap of how to achieve this.
- Create a performance monitoring and evaluation system. The new system should extend to individual performance and should focus on ethics. It should include monitoring of judges’ ethics by civil society and regular user satisfaction surveys.
- Review and strengthen accountability systems in the sector, for example, conduct an in-depth sector corruption diagnostic, strengthen complaint mechanisms and improve the effectiveness of disciplinary systems.
- Review and revise, as necessary, the law on court fees.
- Review and revise the policies regarding the role of civil society in the selection and evaluation of judges. Make sure that the rules (laid down in laws but also regulations of HQCJ) are developed in close consultation and based on consensus with civil society.

Public prosecution

Challenges to be addressed:

- Lack of coordination between reform of the public prosecution and the rest of the RoL reforms.
- Insufficient progress on structural and systemic reforms.

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95 For instance, according to HQCJ statistics, 74 out of 113 candidates appointed to the SC in November 2017 were sitting judges.
96 The 2018 Rule of Law Indicator; the New Justice Project Survey 2018 and the 2018 edition of CEPEJ Evaluation of Judicial Systems Report all point to the fact that a due process is a major issue in the Ukraine courts. The CEPEJ Report shows that Justice expenses (costs related to the court process for example reimbursement of experts, witnesses) were as low as 0.01 per cent – far below what other countries spent on their courts.
97 The same sources also identify unaffordability/high costs as an emerging concern for Rule of Law.
98 According to the 2016 CEPEJ Evaluation Report, between 2010 and 2016 Ukraine increase court fees twice – in 2012 by 1,273 per cent and in 2017 by 142 per cent.
Recommendations:

- Make sure that the efficiency review which was (according to information from the prosecutor general) launched at the beginning of 2019, in cooperation with the EC, is completed and made publicly available.
- Conduct an in-depth corruption survey in public prosecution to allow for better understanding of the problems and more effective targeting of reforms.
- Based on the above review, but also on experience from the 2015 reform attempts and the judicial reform, develop a reform plan for a rapid and comprehensive reform of public prosecution.
- The direction and the content of the reform should be informed by objective analysis of the status quo (including the above efficiency review), previous advice and the recommendations of the EU, CoE/the Venice Commission (and or other donors) and public consultations with stakeholders and donors. Future reform efforts should include the revision of selection and appointment procedures for the prosecutor general as well as the rest of the prosecutors.⁹⁹
- Review and revise the map of prosecutorial offices so it corresponds with the recently created court map.

Property rights protection

Property registration

Challenges to be addressed:

- Insufficient security of property rights due to suboptimal flow of timely and accurate information among state registries and databases; incomplete mapping of land plots; inadequate institutional set-ups and supervision of registers; weak capacity of notaries; lack of transparency of and access to information; weak legal safeguards.

Recommendations:

- Consider merging land and property rights registration under one state agency.
- Speed up mapping of land plots.
- Improve interconnectivity among registers.
- Introduce additional safeguards for securing property rights (for example a two-step process for contract drafting; cross checking the quality of information entered into the system and so on).
- Build a decentralised complaint mechanism for both registries.
- Curb the practice of property value assessment at the beginning of the registration process.

Enforcement of civil judgments

Challenges to be addressed:

- A lack of overall commitment and political will to the reform.
- A lack of fair competition due to the excessive monopoly of state executors; deteriorating commitment of the MoJ to the reform of private executors resulting in the slow pace of this reform; abuse of regulatory power by the MoJ; weak capacity of the professional bailiff's organisation; high costs and lengthy judgement enforcement process by state executors.

Recommendations:

- Review and revise the Reform roadmap adopted by the MoJ; carry out necessary research and consultations with all stakeholders to gain their support.
- Consider revising the distribution of responsibilities between state and private executors;¹⁰⁰ if this is not feasible, reduce the monopoly of state executors.
- Review the fee schedule of state executors and reduce the fee.

⁹⁹ Council of Europe/GRECO (2017). According to CoE: “It is important that the method of selection and appointment of the prosecutor general is such as to gain the confidence of the public and the respect of the judiciary and the legal profession.” To achieve this, “Professional, non-political expertise should be involved in the selection process,” for example by seeking advice on the professional qualifications of candidates from relevant sources such as representatives of the legal community (including prosecutors), the prosecutorial self-governing bodies, or at the level of parliament, through preparatory work by a parliamentary committee.

¹⁰⁰ The current division of responsibilities between the public and private enforcement system guarantees “special treatment” for the state and its entities, municipalities and some of the most vulnerable segments of population (for example, children). The MoJ/CoM should consider whether state enforcement should be employed only in the areas where the market fails to operate for example because of low demand for services or because such provision does not generate enough profit. The need for subsidised services for vulnerable individuals can be addressed through expanding legal aid to the execution of judgments.
• Assess the reasons for the slow pace of the reform with regard to private executors; review and revise the MoJ’s policies and regulations regarding private executors to reduce opportunities for inappropriate interventions by the MoJ.

Anti-corruption

Challenges to be addressed:
• Lack of country-specific in-depth understanding of corruption; ineffective strategy and lack of results in its implementation; wavering commitment of the ruling elite to the anti-corruption effort; weak institutions, particularly, NACP; lagging impact of relatively high level of transparency and broad access to information; weak accountability across the government and impunity.

Recommendations:
• Conduct a comprehensive anti-corruption assessment followed by an in-depth priority sectors/problems corruption assessment. The sectors/problems should be aligned with Ukraine’s developmental strategy and prioritised based on the impact on development. The assessment should also seek to make available data sets easier to use and particularly to encourage Ukrainian citizens to use online tools.
• Based on the above, implement two-three problem/(sub)sector reforms.
• Produce a mid- and long-term anti-corruption strategy that reflects on the results of the most recent research on corruption and Ukraine-specific context. The strategy should build on the above assessments.
• Restructure NACP. Restructuring should be based on the comprehensive functional and efficiency reviews.
• Provide maximum support for the rest of the integrity institutions.

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Chapter 4
Chapter 4

Energy policy

Karel Hirman

Legacy

Between Ukraine’s independence in 1991 and the Revolution of Dignity (Maidan Revolution) in 2014, no fundamental systemic changes took place in the Ukrainian energy sector. This stands in stark contrast to the transformation experienced by the neighbouring Visegrad Group (V4) countries¹ over the same period. The Ukrainian energy sector, including its consumption sub-sector, entered 2014 under more or less the same conditions seen in V4 countries at the beginning of the 1990s. The country lacked the basic preconditions for a well-functioning energy sector – there were no basic legislative rules, independent regulation for gas, electricity and heat had not been established and lack of transparency was a problem.

Hence Ukraine began its fundamental reforms and implementation of the Association Agreement with the EU² from the bedrock of structures created during pre-1991 socialist times. Making matters worse still, both the energy production and consumption sectors entered the post-Maidan period with enormous historical debt, as no significant financial resources had been invested into their modernisation and improvement of efficiency since the dissolution of the USSR.³ The results of this lack of investment and reform were artificially low energy prices for consumers, maintained by the government to compensate for poor quality energy supplies, as well as their inefficient use by consumers.

Table 1

<table>
<thead>
<tr>
<th>Country</th>
<th>Price (€/gigacalories, August 2015)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lithuania</td>
<td>96.3</td>
</tr>
<tr>
<td>Estonia</td>
<td>77.8</td>
</tr>
<tr>
<td>Romania</td>
<td>75.0</td>
</tr>
<tr>
<td>Poland</td>
<td>55.6</td>
</tr>
<tr>
<td>Ukraine</td>
<td>24.1</td>
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</tbody>
</table>

Source: Ministry of Regional Development, Construction and Housing of Ukraine. See footnote 8.

Result of privatisation: monopolies and out-of-date production and distribution

The only reform process, which partially occurred in Ukraine, was the privatisation of some parts of the energy sector. However, it was unavailable to and unattractive for foreign investors as a result of its non-transparent organisation and corruption.

The privatisation process in V4 countries was also, and continues to be, very problematic. In both the Slovak Republic and the Czech Republic, the energy sector was privatised with the presence of reputable European investors. Despite the fact that in the Slovak Republic the activities of some of the investors were wound down over time and many of them eventually sold their shares, their activity made a positive contribution to energy sector reform and helped connection with the European market. On the other hand, the extent of energy sector privatisation in Poland was smaller and Warsaw concentrated more on the creation of state energy holdings. However, in all the countries, independent regulators and a basic legal framework were already in place at the beginning of 2000.⁴

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¹ The Visegrád Group comprises the Czech Republic, Hungary, Poland and the Slovak Republic. For a detailed comparison, see: Institutional Reform of Ukraine’s Energy Sector in the Light of Visegrád Group Experience. September 15, 2016, Kyiv, Ukraine to the Project of The International Visegrád Fund.

² The Association Agreement with the EU was signed on 1 November 2014.

³ According to data from Regionalnoi gazovoi kompanii (a group of gas distribution companies), the financial requirements just for the exchange of emergency sections of the gas distribution pipeline for the upcoming five years amount to UAH 19.3 billion according to technical assessment of the Ministry of Energy and coal industry in Ukraine no. 640 from 24 October 2011.) The distribution companies would need an additional UAH 5.3 billion annually in tariffs for renovation of gas pipelines, however, revenues currently amount to only UAH 0.8 billion (as of 2016).

⁴ See footnote 1.
The almost total exclusion of well-known foreign investors⁵ from the privatisation in Ukraine led to the accumulation of all the privatised assets in the hands of Ukrainian companies, or in Russian entrepreneurial structures, which were subsequently labelled as “oligarchic”. It was primarily a question of the regional distribution of electricity and gas. In addition, there was also privatisation of a substantial portion of thermal power stations (TPS) and some of the coal mines providing fuel for them.⁶

This privatisation did not lead to an increase in competition and effectiveness of energy production and its distribution, nor did it lead to the connection of the Ukrainian energy market with European markets. On the contrary, the monopolistic market structure was strengthened. Electricity production was divided between the state corporations Energoatom (nuclear power plants) and Ukhrhydro, (hydroelectric power stations) and DTEK, a company owned by the Ukrainian tycoon Rinat Akhmetov, having control over more than 70 per cent of electricity production in coal-fired TPS.

Privatisation did not improve the technical level and efficiency of power stations. The majority of TPS were commissioned in the 1960s and lack even basic pollution control. Under EU regulations, most of these plants, if not all, would not be permitted to operate due to unacceptable levels of dust, SO₂ and NOx emissions. Even without a carbon tax, these plants are increasingly becoming obsolete assets.⁷

Low gas prices did not stimulate domestic extraction, which had been stagnating or even dropping for a long time. The main argument against the inevitability of gas price increases centres on the low cost of domestic gas extraction. In 2015, information published by Naftogaz showed that in order to be profitable, prices from domestic extraction would have to be around UAH 5,430/thousand cubic metres (tcm) – approximately US$ 200, while critics state it is roughly half that level. According to the 2014 annual report of Naftogaz, the cheapest gas is conventional gas extracted from old deposits, which costs around US$ 25-30/tcm. Gas extraction from geologically composite layers with new boreholes ranges from US$ 180 to 280/tcm. The logical conclusion is that if average costs for gas extraction in Ukraine really are so low (about UAH 2,500-2,800 /tcm, approximately 100 US$/tcm), as opponents of the need for consumer price increases claim, there would have been a gas extraction boom a long time ago, because its sale would have been very profitable.

A similar situation emerged in the gas industry, in which sale and extraction was marked by the dominance of the vertically integrated state holding, Naftogaz. Within regional gas distribution, dominance was achieved by a controversial Ukrainian-Russian Dmytro Firtash. As for thermal energy, an overwhelming proportion of municipal heating power stations remained in the hands of towns and cities; yet, a significant part of them was “rented” to various private companies. The result was a halt of long-term investment and modernisation programmes in heat production and also in distribution networks.⁸

Former Ukrainian Prime Minister Pavlo Lazarenko’s corruption “gas” case

The most famous proven corruption case in Ukrainian politics so far was the sentencing of the former Prime Minister Pavlo Lazarenko in the USA. Lazarenko held several governmental posts, including that of prime minister, in the second half of the 1990s. In February 1999, he was arrested at John F. Kennedy airport in New York. In August 2006, a US

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⁵ One of the few positive examples of the participation of a renowned western investor in the privatisation process was the purchase of two regional distribution companies (oblenergos) by the American company AES corporation. AES, in 2001, bought from the state, for US$ 70 million, a majority of over two-thirds of the shares in Kyivoblenergo and Rivneoblenergo. At the beginning of 2013, they sold their shares to the Russian-Ukrainian company VS Energy. The official justification was the sale of all energy assets which AES had acquired in the countries of the former USSR. See for example: https://www.aes.com/investors/press-releases/press-release-details/2013/AES-Agrees-to-Sell-Its-Ukraine-Assets/default.aspx or https://www.ft.com/content/050b37ae-0fc-359b-b3c0-742338889c0. Accessed: 29 March 2019.


court sentenced Lazarenko to nine years in prison not only for breaking immigration laws, but also for the abuse of position, blackmail and money laundering connected with the gas industry in Ukraine. Almost half a billion dollars were confiscated from his accounts in the USA. In his absence, he was also tried in Switzerland.

Moreover, his name recently surfaced in the leaked secret documents, known as the Panama Papers, in a long-running corruption case involving the alleged theft of Ukraine's natural gas resources for himself and his political allies.³

Also involved in the case is the former prime minister Yulia Tymoshenko, who, during Lazarenko’s reign, founded the company United Energy System of Ukraine (UESU). UESU became the largest importer of natural gas to Ukraine with an annual turnover reaching US$ 10 billion.

This is how corruption within this company was described by a US court:¹⁰

“When Lazarenko, in 1995 and 1996 as the first vice prime minister, was in charge of the energy sector of the Ukrainian economy and presided over a re-organisation of the natural gas import and distribution system, he used that position to award highly lucrative energy contracts to certain companies. In particular, Mr Lazarenko conferred upon UESU, a corporation controlled by Lazarenko’s associate Yulia Tymoshenko and others, the exclusive right to distribute natural gas to the Dnepropetrovsk region of Ukraine. In order to exercise that right, UESU entered into contracts, Gazprom supplied natural gas to UESU from late 1995 through to 1997. During the relevant time period, UESU was 85 per cent owned by United Energy International Ltd. (UEIL), an entity created on October 17, 1995, at the direction of Lazarenko’s associate Yulia Tymoshenko. UESU transferred the title to the natural gas it had purchased from Gazprom to UEIL. Payments from Ukrainian consumers who used that natural gas were in turn collected in bank accounts registered to UEIL.

In 1996, UEIL transferred some US$ 140 million from those accounts to Somolli Enterprises, a Cypriot company registered on October 8, 1992, was controlled by Yulia Tymoshenko and others. Ms Tymoshenko and affiliated individuals in turn used Somolli Enterprises and other business entities under their control as vehicles for payments to Mr Lazarenko of least US$ 162 million in 1996 and 1997.”

Martha Boersch, the former lead prosecutor on the money-laundering case, in 2016, during a lecture in Kyiv explained the connections of the entire process. With regard to Yulia Tymoshenko, the former prosecutor explained that she deemed Tymoshenko to be a victim of Lazarenko. In accordance with US laws, Lazarenko’s proceedings towards Tymoshenko are considered to be money recovery: if a businessman does not pay, they will complicate the life of their company. According to Mrs Boersch, Ms Tymoshenko was not the subject of an investigation since Lazarenko was in control of all the bank accounts. Ms Tymoshenko was involved in the entire case, however there was no investigation against her due to the fact that she was not present in US territory at that time.¹¹

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Ineffective consumption and low prices

The same way as there was no reform to the extraction, production and transmission of energy, there was no modernisation on the side of consumption either. Industry, the public sector as well as households became very inefficient. Energy demand of Ukrainian businesses became many times higher in comparison to EU countries. The reason for this is not only the industry’s structure with a great share of energetically demanding production (metallurgy, chemistry, heavy engineering), but also huge levels of inefficiency. These key sectors of the Ukrainian economy consume far more energy than their European or world competitors.¹²


Similarly, energy (heat) consumption in Ukrainian apartment blocks is many times higher than in V4 countries. Again, this is not the result of more difficult climatic conditions. And neither is it caused by the wide utilisation of district heating systems as the same system dominates in the towns of V4 countries. It is caused by a lower quality of apartment blocks and district heating systems in Ukraine, as unlike the V4 countries, there had been no complex modernisation performed.¹³ As a result of low gas prices and revenues, the state budget was repeatedly used to cover revenue losses, instead of supporting energy efficiency programmes for households. Unlike the V4 countries, Ukrainian housing sector legislation did not create the conditions for effective administration of privatised housing funds by the owners themselves, by means of associations of apartment owners. Residential fund administration remained under control of “residential administrations”, the so-called “zhek”. The result is that many Ukrainians (owners of apartments) live in luxury renovated (inside) private apartments, but the exterior of the apartment building, their common areas and infrastructure are in a dismal state.

Consequences: loss of Crimea and Donbass

This blend of out-of-date production and distribution infrastructure together with inefficient energy consumption led to the fact that energy prices were held artificially low by all Ukrainian governments. Governments before 2014, by means of price suppression, tried to compensate for the consumers’ decreasing competitive ability and quality of life. This however led to a further fall of competitiveness in Ukrainian industry and living standards of Ukrainians, compared to their neighbours from V4, dropped significantly.

There have been no changes in the structure of the energy sector in Ukraine over the last 20 years of independence. Little to no effort was made to modernise the energy sector, as the economy was in deep decline and there was no political motive to strategically develop alternative sources of energy. This declining energy sector also became a security threat under growing pressure from Russia.

What has been done?

In 2014, Ukraine began thorough structural energy reforms, some 20 years after its V4 neighbours. Notably, the reform process was unfolding under the shadow of armed conflict with Russia, a burden neither of the Baltic or V4 states had to contend with. Even the countries of former Yugoslavia (Slovenia or Croatia) began only their structural reforms in the second half of the 1990’s after reaching ceasefire.

Therefore, it was unrealistic to expect that reforms would progress quickly and Ukraine would be catching up with the V4 countries. Ukraine had only one advantage up its sleeve: by taking a look at its European neighbours, Ukraine knew exactly what to expect, a reform “recipe” had already been developed and verified in practice. Ukraine, in theory, had the benefit of selecting what would work best in its context and avoiding the mistakes of its neighbours. However, the reality did not quite pan out that way.

Greatest achievements

The basic “road map” for the reform process (not only in energy) is laid down by the Association Agreement with EU. From 2014 to 2018 the Ukrainian parliament succeeded in passing a few fundamental laws which implemented European legislation (the aquis communautaire). Basic conditions for a functional energy market were thus created. They are mainly:

- Gas market and electricity market laws.
- Package of laws for communal energy and living.
- Laws supporting the use of renewable energy sources.
- Law on the creation of an Energy Efficiency Fund for the modernisation of apartments.
- Laws on the support of domestic hydrocarbon exploitation.

Also essential was progress to diversify the import of strategically important materials – gas and nuclear fuel. After the technical and commercial opening of

¹³ See footnote 1.
reverse gas supplies from Europe through gas pipeline connections with Poland, Hungary but mainly the Slovak Republic in 2014 and 2015, Ukraine was able, for the first time since its independence, to face up to the "gas pressure" from Moscow. Also, as a consequence of the arbitration process between Naftogaz and Gazprom, direct import from Russia was completely stopped. According to Naftogaz’s commercial director Yuriy Vitrenko, gas purchases from the EU were, during the last few years, US$ 1.3 billion cheaper than buying from Gazprom would have been, under the contract signed in 2009.

Energoatom also started, for the first time, a regular purchase of nuclear fuel from the Swedish plant of the Japanese-American company Westinghaus Electric. Its share was gradually approaching as much as one half of Energoatom’s needs. Together with the successful process to extend the technical lifetime of nuclear reactors, under the supervision of international organisations, nuclear energy, with its rising share of electricity production (above 50 per cent), is becoming a solid pillar of Ukrainian energy security.

For the state holding Naftogaz, as well as for the Ukrainian state budget, victory in the arbitration process with Gazprom in Stockholm at the end of 2017 and beginning of 2018 was crucial. From two lawsuits regarding the purchase contract and gas transit contract, Naftogaz should receive over US$ 2.5 billion from the Russian giant. However, Gazprom has refused to pay for now and it is trying to contest the arbitration result in Swedish courts.

Underrated and almost unnoticed is the huge success of Ukrainian transmission operators (TsO) of gas and electricity networks – Ukrtransgaz (UTG) and Ukrenergo. During the armed conflict with Russia, by technical “cutting” from networks in the occupied areas of Crimea and Donbass, TsO managed to provide continuous gas and electricity transmission not only in Ukraine but also with gas transit to Europe.

Progress occurred also in the transparency of hydrocarbon exploitation licence allocation, which had been a huge source of corruption since independence. By the end of 2018, the state geology service Derzhgeonadra started electronic auctions through the state public procurement system ProZorro.¹⁴

After 2015, the issues of energy efficiency and support for the use of renewable energy sources became a priority in legislative and policy formulation processes, including in the new energy strategy covering the period until 2035.

Key gas prices

The most politically and socially sensitive topic of the entire four-year period was the level of energy prices for household consumption, mainly gas. The adoption and implementation of the law on the gas market brought about crucial market liberalisation for industry and business. Out of a total yearly gas consumption of about 30 billion m³ (bcm), industry and business consume approximately one-third. Tens of suppliers operate in this market and it is completely liberalised in terms of prices. However, the market for households which, directly or by means of central heating, uses about 18 bcm of gas (the remaining roughly 2 bcm are used by public and church institutions), remains fully price-regulated.

Arseniy Yatsenyuk’s government took the first step in increasing gas prices. Volodymyr Groysman’s government made two gas price increases for households: in April 2016 and October 2018. On 1 November 2018, the gas price for inhabitants (including VAT) reached UAH 8,550/tcm. This corresponds to a 23.5 per cent rise compared to the price from April 2016 (UAH 6,879/tcm).¹⁵ The price increase in autumn 2018 was the result of lengthy negotiations with the International Monetary Fund (IMF).¹⁶

The IMF insisted, in its loan programme, that gas prices for households should be at so-called import parity (the gas price on the Ukrainian border with

¹⁶ President Petro Poroshenko declared as early as January 2018 that the Ukrainian government was ready to increase gas prices for households according to IMF rules. See also: https://www.rbc.ua/rus/news/kredit-doveriya-ukraina-dogovarivaetsya-novoy-1540238726.html Accessed: 20 December 2018.
EU), from which the price for Ukrainian industry is derived. According to data from the Ukrainian Ministry of Economic Development the trade price of imported gas in November 2018 climbed to as much as UAH 9,471.9/tcm (US$ 339.2/tcm),¹⁷ so import parity was not even reached after the increase in November. However, according to Eurostat data, Ukraine (together with Georgia and Turkey) had the lowest gas price for households in the first half of 2018, at approximately 0.02 €/kWh (including taxes). In Poland, the Slovak Republic and Hungary, the price was twice as high and the average price in EU was reaching 0.06 €/kWh.¹⁸

The significant increase in the gas price for households, despite huge popular criticism from the opposition and a considerable part of media, sharply limits the viability of long-term corruption schemes based on price arbitration between the market for industry and inhabitants.

Although the price for households still has not fully reached the price level for industry, Naftogaz has become profitable. While back in 2015 it made a clear loss due to the low gas price for households, it made a clear profit (UAH 26.5 billion) in 2016. In 2017, Naftogaz paid over UAH 100 billion in taxes and dividends to the state budget. In 2018 and 2019, an even higher payment is expected, as the government wants to transfer as much as 90 per cent of Naftogaz profits into the budget in the form of dividends.¹⁹

Up to 2015, Naftogaz had received more than US$ 13 billion in subsidies from the state budget.¹⁶ The company, together with the entire country, found itself on the brink of bankruptcy, when its fiscal deficit reached 5.7 per cent of GDP, which exceeded the state budget deficit (4.6 per cent of GDP). It is crucial that after the increase in prices, the total profit transfer of Naftogaz into the state budget is higher than state energy subsidies for inhabitants.

According to Prime Minister Groysman, the state spends UAH 55 billion on subsidies for 6.9 million households.²⁰

Principal failures

Generally the biggest failure is a slow, insufficient and often also unequal implementation (secondary legislation and executive regulations) of basic laws. Ukrainian authorities often take the necessary steps only under pressure from foreign partners (EU, USA, G7). Also, while legislation progresses according to the European aquis, Ukraine is unable to define its own interests. This is why it struggles to explain its specific needs to its European partners, including the necessity of transition periods. The result is often mutual disappointment and misunderstanding.

According to a report by the Ukraine Center of European Policy as of 1 November 2018 (four years since signing the Association Agreement with the EU) Ukraine has aligned its national legislation to EU rules (full implementation of the aquis) on average by 24 per cent. From the sector viewpoint, energy was one of the worse ones, with only 6 per cent progress.²¹ This was only thanks to progress in the gas industry, where exactly a third of required legislative measures was taken. However, in all remaining areas (electricity, energy regulator, oil, exploration and the development of hydrocarbon exploitation, energy efficiency and nuclear energy) the total implementation of the aquis is zero.²²

Interrupted unbundling and the uncertain future of transit

Despite the progress in gas industry reform, by the end of 2018, there was no significant progress in the unbundling of Naftogaz – that is, separation of the network operator UTG from the parent company Naftogaz (the biggest gas trader in Ukraine). The Ukrainian government had already approved the unbundling plan in mid-2016 according to the

²¹ See previous note.
ownership method, which supposes the transfer of assets from UTG into the newly created company MGU. However, since then, apart from the creation of MGU itself, and the creation of its supervisory board, there has been no significant progress.

Interviews with both supervisory board chairs – Naftogaz (British citizen Clare Spottiswoode) and MGU (Austrian Walter Boltz), published in December 2018 on the website rbc.ua, reveal that significant differences remain between the two supervisory boards regarding the process and meaning of unbundling.¹³ Unbundling plans, which were presented by Naftogaz top management with the support of the supervisory board, were strongly criticised at the beginning of December 2018 also by Janez Kopač, head of the Energy Community Secretariat. This international organisation was created by the EU for energy sector cooperation with neighbouring countries and has the power, together with the Ukrainian regulator (NEURC), to certify the unbundled operator.²⁴

The result of the arbitration with Gazprom has had a notable effect on the unbundling process. Moreover in 2018, Naftogaz filed further arbitration actions which are also supposed to be connected with the expected changes in transit after the termination of its current contract with Gazprom in 2019. New legal action might also greatly affect unbundling plans, transfer of assets and transit execution to MGU.

Towards the end of 2018 there was no clarity as to the operator of the Ukrainian transit system after January 2020. This uncertainty has affected negotiations with Gazprom about the new transit contract, organised by the vice-president of European Commission Maroš Šefčovič, and complicates negotiations about the creation of a consortium of Ukrainian transmission operators (TsO) and European operators. Concurrently, Gazprom continues to build new gas pipelines (“Nord Stream 2” and “Turkish Stream”), which bypass Ukraine via the Baltic and Black sea while supplying gas to the EU. This is why there is a growing likelihood that after 2020, Ukraine will lose the transit portion completely or will retain only negligible volumes. Revenues from the transit for Naftogaz-UTG are US$ 2-3 billion annually. The Ukrainian Ministry of Finance has calculated the losses from gas transit for Ukraine to amount to over 2.5-3 per cent of GDP.²⁵

Inadequate metering and non-transparent gas consumption standards

Following the gas price increase in April 2016, subsidies for inhabitants became a very sensitive political as well as fiscal question. As a considerable number of consumers do not yet have gas meters (some 24 per cent of households, mainly in apartment buildings), in 2017 the government set new standards for these households.²⁶ These apply to household subsidies as well. However, the standards were considerably lower than in the past and significantly below those of the surrounding post-Soviet countries (see Table 2):

<table>
<thead>
<tr>
<th>Household type</th>
<th>Gas cooker with central heating</th>
<th>Gas cooker with central and water heating</th>
<th>Gas cooker with water</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ukraine (before 10/2014)</td>
<td>9.8</td>
<td>18.3</td>
<td>23.6</td>
</tr>
<tr>
<td>Ukraine (9/2017-12/2018)</td>
<td>3.3</td>
<td>5.4</td>
<td>10.5</td>
</tr>
<tr>
<td>Ukraine (2019) non-heating/ heating season (planned)</td>
<td>5.8/8.8</td>
<td>8.3/13.7</td>
<td>20/25</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>15.0</td>
<td>18.5</td>
<td>25.0</td>
</tr>
<tr>
<td>Belarus</td>
<td>8.0</td>
<td>13.0</td>
<td>23.0</td>
</tr>
<tr>
<td>Moldova</td>
<td>10.0</td>
<td>20.0</td>
<td>38.0</td>
</tr>
<tr>
<td>Russia (Briansk region)</td>
<td>11.8</td>
<td>17.7</td>
<td>30.0</td>
</tr>
</tbody>
</table>


²⁷ The government suddenly cancelled increasing of standards of consumption due to the pre-election situation and campaign in January 2019.
As a consequence of poor administration, according to data from the Ministry of Energy and Coal Industry, at least 383 million m3 of gas worth UAH 2,681 billion were consumed but not charged for.²⁸

Gas consumption measurement constitutes another challenge – about a quarter of households have gas meters that are 15 to 20 years old, providing unreliable measurements of gas use. This means that altogether about half of Ukrainian households do not have an exact gas consumption measurement. This is the origin of multi-billion financial losses for Naftogaz, distribution companies as well as the state budget.²⁹

Unreformed electricity and coal market

Even though the Ukrainian parliament passed the law on the electricity market in April 2017, its implementation has been lengthy and complicated. Wholesale electricity supply should begin in 2019.

The electricity sector in the last few years has quite considerably "outperformed" the gas industry in lack of transparency and scandals. The price regulation of domestic coal which is used in TPS, determined by the regulator (NEURC), has become a post-Maidan symbol of non-transparency. The "Rotterdam+" price formula based on the coal index API2 at the stock exchange in Rotterdam plus coal transport costs from the Dutch port to Ukraine, was strongly criticised immediately after its introduction in March 2016. This regulatory method was also investigated by a special anti-corruption police unit, NABU (National Anti-Corruption Bureau of Ukraine), in 2017. At the beginning of October 2018, its head Artem Sytnyk declared in the Ukrainian parliament that by using Rotterdam+ (according to the preliminary results of the investigation) illegitimate costs totalling as much as UAH 15 billion were included in the regulated electricity price. Nevertheless, use and correctness of the methodology were confirmed also by the regulator's new management in autumn 2018 because the principle of this method is the same as for gas price regulation (German gas hub NCG plus pipeline transport costs to Ukrainian border)³⁰ – an import parity basis.

Despite this price methodology, coal mining in Ukraine has been on a downward trend in recent years and imports have been rising. Disturbances in Donbass bear a fair share of responsibility for this. Since spring 2014, the central government in Kyiv has lost control over coal mines. Those were the only ones exploiting anthracite, which was widely used in TPS. The final termination of supplies happened only after Kyiv's decision to introduce an embargo on goods transported from the separatist area of Donbass in March 2017.

As a result, the total coal import in 2018 is estimated to rise by 11 per cent to approximately 5.6 million tonnes, a significant burden for the Ukrainian trade balance and foreign exchange reserves. Providing over 80 per cent of supplies, Russia is the biggest supplier.

Table 3

Ukrainian international business with coal and anthracite (in US$ billion)

<table>
<thead>
<tr>
<th>Year</th>
<th>Import</th>
<th>Export</th>
<th>Deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>2.761</td>
<td>0.775</td>
<td>1.986</td>
</tr>
<tr>
<td>2012</td>
<td>2.637</td>
<td>0.609</td>
<td>2.028</td>
</tr>
<tr>
<td>2013</td>
<td>1.973</td>
<td>0.737</td>
<td>1.236</td>
</tr>
<tr>
<td>2014</td>
<td>1.773</td>
<td>0.521</td>
<td>1.252</td>
</tr>
<tr>
<td>2015</td>
<td>1.632</td>
<td>0.054</td>
<td>1.578</td>
</tr>
<tr>
<td>2016</td>
<td>1.467</td>
<td>0.045</td>
<td>1.422</td>
</tr>
<tr>
<td>2017</td>
<td>2.744</td>
<td>0.105</td>
<td>2.639</td>
</tr>
<tr>
<td>2018 (Jan-Sept)</td>
<td>2.192</td>
<td>0.008</td>
<td>2.184</td>
</tr>
</tbody>
</table>


It is very likely that a significant part of the anthracite supplied through Russia since March 2017 has come from Donbass, supplies which previously went directly to Ukrainian TPS.

Coal exploitation in mines which have remained under Kyiv's control was decreasing though. During the first nine months of 2018, exploitation fell by a further five per cent compared to the same period in the previous year. The government therefore decided

²⁸ See note 26.
²⁹ Personal discussions of the author with representatives of Ukrainian state authorities and gas companies.
to support domestic coal production by a decree on priority electricity take-off from TPS, which will convert from using imported anthracite into using domestic types of coal.

Like the already mentioned price regulation based on Rotterdam+, this plan has provoked considerable criticism. Critics claim that TPS, whose almost monopoly owner is DTEK group owned by Rinat Akhmetov, will receive additional revenues amounting to over UAH 4 billion annually at the expense of other electricity producers and consumers.³¹

The situation has also been complicated by the government’s unwillingness to implement a comprehensive restructuring plan for coal mines, which had been prepared in summer 2016. According to the plan, the state was supposed to keep eight profitable mines. A further 14 mines, which have a good potential but need restructuring in order to become profitable, were supposed to be privatised. And finally, 11 hopelessly loss-making mines were supposed to be closed. The whole plan was going to cost UAH 25.2 billion by 2020, UAH 10.5 billion of which was to have been funded by the state budget. “Realisation of this plan will ensure coal mining of 9.2 million tonnes in 2020,” claimed the Ministry of Energy and Coal Industry of Ukraine.³²

Non-transparent support mechanisms for thermal energy, unreformed coal mining and very slow electricity market reform led to the wholesale price of electricity in Ukraine exceeding the price on the neighbouring European markets. At the turn of 2017 and 2018, for example, the price at the stock market in Prague, which belongs to the referenal price making bases for common market (market coupling) with the electricity of Czech Republic, the Slovak Republic, Hungary and Romania, oscillated between 40-45 US$/MWh.³³ An illustrative example of the price difference is the contract price for electricity export to Moldova, obtained by the company DTEK. According to information from the Moldovan Ministry of Economy, in the period from 1 April 2017 to 31 March 2018, DTEK was supposed to sell electricity for the price of US$ 50.2/MWh. During that period, though, the price on the Ukrainian wholesale market oscillated between 50 and 80 US$/MWh. The export price for TPS was supposed, on top of that, to be cross-subsidised through the domestic wholesale market.³⁴ The inappropriate tariff favouritism of coal TPS at the expense of nuclear power plants was repeatedly sharply criticised also by the Energoatom boss Yuriy Nedashkovskiy.³⁵

What to do next?

Reform policies and reform management

The fundamental short- and also long-term priority of energy policy should be to improve energy efficiency along the whole chain from the exploitation, production and energy distribution to all consumption sectors. It particularly applies to communal energy, from the production and distribution of heat to residential and public buildings. District heating systems have to undergo a radical modernisation and optimisation, which will require long-term development strategies from towns, as well as participation from well-known investors. The entire sector should gradually become a target for support through the newly created Energy Efficiency Fund, which must focus on households first. A radical modernisation of the apartment fund with a noticeable decrease in energy consumption is also needed to make the further gradual liberalisation of energy prices socially bearable (see Table 4):

Table 4
Estimated costs and savings for energy efficiency programme for households

<table>
<thead>
<tr>
<th>Modernisation of apartment buildings</th>
<th>Investments (US$ billion)</th>
<th>Potential gas savings (bcm)</th>
<th>Saving of gas on US$ 1 billion investments (million m³)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Modernisation of individual houses</td>
<td>17.0</td>
<td>2.3</td>
<td>135.0</td>
</tr>
<tr>
<td>Modernisation of individual boilers</td>
<td>28.0</td>
<td>4.7</td>
<td>168.0</td>
</tr>
<tr>
<td>Modernisation of public buildings</td>
<td>4.0</td>
<td>1.7</td>
<td>425.0</td>
</tr>
<tr>
<td>Modernisation of production and distribution of heat</td>
<td>6.0</td>
<td>2.4</td>
<td>400.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>57.0</strong></td>
<td><strong>11.4</strong></td>
<td><strong>400.0</strong></td>
</tr>
</tbody>
</table>

Source: Ministry of Regional Development, Construction and Housing (see footnote 7).

A simple step would contribute to making the unavoidable price increases more socially bearable: a transfer to monthly prepayments for the supplies of all energies (including heat) and communal services, as is standard in V4 countries. This would prevent the annual “financial shock” for households at the beginning of heating season. Energy companies would at the same time receive a balanced year-long cash flow to cover investment projects and the state budget would avoid enormous pressure on subsidies in the winter season.

Unbundling Naftogaz and keeping the gas transit

A short-term priority for 2019-21 should be preserving the transit of Siberian gas through Ukraine. An unavoidable precondition is the unbundling of Naftogaz and the creation of a transparent and independent TsO based on UTG-MGU. This would, with the support of the European Commission, create a consortium with European TsOs and sign a long-term contract for gas transit with Gazprom. The creation of the TsO is also a precondition for increasing domestic production and another gas industry reform, including the introduction of two-component standard regulation (fixed and variable costs) with the aim of liberalising the gas market for households.

Implementation of the electricity market with the aim of integration into ENTSO-E

In the short-term, it is necessary to carry out the plan to introduce an electricity market. First of all, it means to fully launch the wholesale market in 2019. In the long-term, the fundamental part of the reform “road map” should become the plan to connect Ukrainian electricity grid with the European system and full membership in ENTSO-E. Realisation of this plan will require a radical modernisation of TPS (including ecological measures) and an end to the lifetime extension of the safe operation of nuclear reactors. These measures will subsequently have an influence on another unavoidable restructuring of coal mining. In addition, the involvement of Ukraine in the European market will affect the further development of “green energy”, including the transfer to auctions.

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34 ENTSO-E, the European Network of Transmission System Operators for Electricity, represents 43 electricity transmission system operators (TsOs) from 36 countries across Europe. ENTSO-E was established and given legal mandates by the EU’s Third Legislative Package for the Internal Energy Market in 2009, which aims at further liberalising the gas and electricity markets in the EU. [Accessed 1 April 2019]
Strengthening of the regulator's (NEURC) position and demonopolisation

A permanent necessary condition for the sustainable and transparent development of energy markets is a professional and independent regulator. Strengthening of its position has to go hand in hand with increasing the transparency of its decisions. This is a vital precondition for the successful introduction of regulation based on the regulated asset base method. However, in order to deepen the liberalisation of Ukrainian energy sector, anti-monopoly bureau intervention and final legal solutions for disputable privatisation cases will be needed.
Chapter 5
Chapter 5

Business environment

Alexander Skurla

Legacy

After gaining independence in 1991 Ukraine inherited a fully regulated socialist economy. The Soviet system was based on total control of everything that could be controlled. For businesses this meant a lot of bureaucratic permits to be signed and stamped at different state institutions. Officially the new and independent Ukraine declared its readiness to develop a modern market-based economy. But what kind of modernisation was it?

In 1991 Leonid Kravchuk, a former high-ranking official of the Communist Party of Ukraine, became the first President of independent Ukraine after the crash of the Soviet Union. At this time private entrepreneurship appeared but Kravchuk did not implement deep market-oriented economic reforms which resulted in negative economic consequences: hyperinflation, increase of the state deficit, strikes by miners and early elections.

Leonid Kuchma started his decade-long presidency in 1994. It would be difficult to estimate the entirety of his influence in terms of the country’s business climate, but main themes can be mentioned. Under his presidency, in 1998 a simplified taxation system was introduced aiming to support small and medium-sized business and to curb the “shadow” economy. At the same time the roots of the later oligarchic and protectionist economy can be found during his presidency. Parts of state industries were handed to connected persons through non-transparent auctions at cheap prices and created the basis for the oligarchic system that prevails in some form in the present day.

Leonid Kuchma on oligarchs

“There is no capitalism without capitalists, without national bourgeoisie including big tycoons. But during all 15 years of our independence there were attempts to create capitalism of small merchants, small entrepreneurs, capitalism without big national bourgeoisie. Like in Poland. I spoke about it many times. This model would be unacceptable for Ukraine. Such model would be unacceptable for Ukraine even from the point of view of the structure of the Ukrainian economy, as its base is created by industrial giants.”

Leonid Danilovich Kuchma: “After Maidan 2005-06. President’s remarks.”

The oligarchic system in Ukraine has a direct connection to state support and incentives of fully regulated economy based on corruption. Pavlo Lazarenko, Prime Minister during Kuchma’s presidency, allowed the penetration of corruption deep into Ukrainian government and society. It was in the interest of oligarchs to retain the Soviet-style bureaucracy that maintains high barriers to entry into the market for other players and thus protects oligarchic positions in the market and guarantees large long-term monopolistic or oligopolistic profits. That was the reason why real deregulation of the economy did not happen.

Oligarchic systems usually do not welcome foreign capital that brings in competition and transparency, therefore improvements to the investment climate of the country at that time were not a priority. Tax rates were high. The standard rate of profit tax was 30 per cent. Maximum rate of physical entities’ income tax should have been decreased from 40 per cent to 30 per cent based on the agreement with the IMF in 1997, but it was not done. At the same time tax preferences were widespread, like VAT exemptions for imported goods, import duties exemptions for specific domestic industries, VAT exemptions for newly built housing, profit tax incentives for special economic zones (either an unlimited 20 per cent tax discount or three-year 100 per cent tax holiday followed by three-year 50 per cent tax incentive). According to the IMF, in 2003 tax preferences reached 3.5 per cent of GDP.
Significant incentives for certain sectors under Kuchma

On 14 July 1999 Parliament adopted the Law "On implementation of economic experiment on enterprises of metallurgic complex of Ukraine" that temporarily provided generous incentives to metallurgic companies until 1 January 2002: profit tax was reduced from 30 per cent to 9 per cent, ecological tax was reduced by 70 per cent, debts prior to 1 July 1999 were paid by the state.

At the same time only 10 per cent of resources gained by those state incentives were directed into capital investments. Due to incentives, metallurgic companies lowered the value of their products for export to foreign markets to such a level that major importers (European Union, Canada, Russia, Mexico and China) started anti-dumping proceedings towards Ukrainian metallurgic production.¹

In 2004 the Orange Revolution won in Ukraine when in repeated second round of presidential elections Viktor Yushchenko became President. In May 2005 Prime Minister Yulia Tymoshenko cancelled special tax and customs regimes within special economic zones and priority development zones. It was a move towards stopping the deformation of state economic policy, giving priority to only selected businessmen. The law "On basic principles on creation and functioning of special economic zones" had been adopted by Verkhovna Rada in October 1992. The first special economic zone (SEZ) was established in Crimea in 1995. Since 1998, 11 SEZ were created, each SEZ by a separate law. So it took more than 12 years for the country to stop the evasion of billions of hryvnia from the state budget through tax, customs and currency incentives for certain businesses. By 2003 some 11 SEZ and 66 priority development zones covered 10 per cent of Ukraine's territory.

The period of Viktor Yanukovych's presidency (2010-14) known as times of "Family" became infamous for the destruction of the business environment, pressure of state controlling bodies upon business and corruption. The priority of economic policy was directed towards heavily subsidised hryvnia exchange rate (US$ 1=8 UAH) creating the illusion of stability while rapidly increasing state debt; state aid to support projects of socio-economic development in fact was a “shadow” mechanism to legalise state expenditure. One example of this is the special-purpose administrative state structure the Currency-Credit Council, through which the National Agency on European Integration distributed credits on projects for socio-economic development amounting to around US$ 4 billion. Projects were financed against state guarantees and almost nothing was paid back. Providing tax incentives to specific domestic sectors was also popular during that period. In 2011 alone loss of income of the state budget due to tax incentives reached UAH 58.8 billion or 4.5 per cent of GDP. More than 15 sectors were benefiting from tax incentives in that period, some sectors received incentives for 10 years.

Fraud and prosecution from high places under Yanukovych

Oleksandr Klimenko became Minister of Income and Assembly of Ukraine in 2012. He introduced an illegal scheme known as “tax squares” or “fiscal holes” based on tax fraud when businessmen could register artificial costs in order to lower taxes, but have to pay cash bribery to the Ministry.

Another of Klimenko’s schemes was based on illegal VAT returns. According to MP Viktor Chumak, cash briberies from businessmen have been carried to a cellar of a state building. With part of that money Klimenko was building leisure complex including a zoo with tigers and bears. Later on the Ministry announced that Klimenko and his team, in 2013 alone, stole up to UAH 16 billion.

The State Military Prosecution finished investigating Klimenko on 14 March 2018 and included 52 subordinate state servants of the former Ministry of Income and Assembly of Ukraine in the criminal investigation. The investigation concluded that the state lost UAH 104 billion as a result of Klimenko's schemes as of 2014.

¹ VoxUkraine: https://petrimazepa.com/privilegesandpreferences.html
² IMF Country Report No. 03/173, June 2003
What has been done?

Real economic changes started in Ukraine only after 2014, when a democratic government took over after the victory of the Maidan Revolution. The government of that time initiated serious deregulation processes in order to get rid of the total state control of businesses inherited from the Soviet past, to attract external investment and to boost economic growth. In 2016 the system of state control and surveillance was significantly liberalised by adopting draft Laws No. 2418a, 2531a, 3153 saving companies up to UAH 500 million annually. In 2017 a specific state control system was adopted for controlling compliance with safety and quality standards within the food sector, implementing relevant EU regulations and directives. In 2018 other important draft laws were adopted by the Verkhovna Rada that could further improve the business climate of Ukraine, especially the draft laws: “On implementation of “single window” ...”, “Code on bankruptcy procedures”, “On Limited liability companies”, “On the creation and operation of the credit register of National Bank of Ukraine” and “On currency and currency operations”. Improvements in the business environment were confirmed by recognised international rankings. Ukraine jumped five places in a year to 71st place in the internationally recognised Doing Business 2019 report; in Doing Business 2012 Ukraine had been in 152nd place.

Since 1 April 2017 the Cabinet of Ministers has implemented a single electronic register of applications on VAT refunds (http://minfin.gov.ua/reestr). The new register aims to get rid of the previous corrupt system based on two non-public registers, guaranteeing an automatic refund of VAT to all applicants based on chronological order on a daily basis. Now businesses can check the progress of their VAT refund online. If there is an agreement on a refund sum within 30 days (in special cases 60 days), the VAT refund should be transferred the next day.

The Cabinet of Ministers obliged the State Fiscal Service in 2018 to determine risk criteria, which were adopted on 5 November 2018, as well as risk criteria of operations and list of indicators of positive tax history of taxpayer. Based on the information from business associations, the system of VAT refund blocking is still not ideal and there is room for further improvement.

The big success of the government in increasing transparency in public procurement was the implementation of the electronic public procurement system, ProZorro. This procurement system became compulsory for all state and communal organs, institutions and companies on 1 August 2016. YouControl analysed eight product categories with regard to price tendencies on public procurement markets and discovered that the savings compared to market value of the acquired goods increased from UAH 5 million in 2013 to UAH 144 million in 2017. The analysis concludes that at present the state and communal buyers save on average 10.8 per cent in respect to retail market prices.³ Contracts signed through public procurement in 2017 reached UAH 500 billion. ProZorro is a big step forward in creating equal and transparent access for companies to public procurement, but needs to be improved further as dishonest businessmen are trying to find ways to win in an unfair competition. In autumn 2016 the monitoring portal DoZorro was established in order to monitor feedback from participants and to be able to discover breaches of ProZorro platform.

Some success has been achieved by stopping of some bad legislative initiatives that have appeared in Parliament. Especially dangerous was the draft law “Buy Ukrainian, pay to Ukrainians” which was adopted at the first reading on 7 December 2017. The draft law proposed the introduction of “local content” that would add at least 20 per cent to public procurement evaluation of domestic participants of procurement tender compared to foreign participants. The formula to be calculated is complicated and requires participants to submit 23 additional documents. This draft law contradicts the Association Agreement between the EU and Ukraine and the WTO Agreement on government procurement.

An attractive business climate should result in making credit cheaper. We all know that finance is as

important for business as is blood for humans. Time differences between selling the product and receiving payment require flexible financing; acquiring new technologies that keeps companies competitive often depends on the ability to get proper financing. In Ukraine the price of money is still rather high and that hampers economic growth. In order to lower interest rates on commercial credit the National Bank of Ukraine is concentrating on curbing inflation (2016: 12.4 per cent, 2017: 13.7 per cent, 2018: 9.8 per cent) and therefore its basic rate is still kept at 18 per cent. Other than high inflation there are also risks to the business environment that keep high-margin credit in place. There are also other available instruments to reduce inflation and make credit more affordable: such as improving the business climate and increasing competition in various sectors.

The Government of Ukraine and Verkhovna Rada reacted to the signals coming from business environment and made some important steps in suppressing dishonest activities of law enforcement agencies and raider attacks with the aim to improve business climate of the country. First “anti-raider” law was adopted by Verkhovna Rada in November 2016 and two “Mask Show Stop” laws in November 2017 and September 2018. The Law No. 2213-VIII (Mask Show Stop-1) implements compulsory video and audio recording of court hearings and investigation searches; compulsory access of lawyers to investigation searching process; ban on take-away of original documents and servers from a company being searched; increase in competences of the Cabinet of Ministers to control law enforcement agencies etc. The Law No. 2548-VIII (Mask Show Stop-2) implements a mechanism that forces prosecutors and investigators to personally compensate losses caused by their dishonest investigation of a criminal case; possibility to submit a claim to a court if an investigator repeatedly opens criminal case on the same matter; possibility to claim inactivity of the investigative organs.

Deregulation and effective regulation:

Deregulation is the cheapest and fairest way to improve the business environment in Ukraine. Distribution of state subsidies is less fair and more expensive. Ukraine was a socialist economy for many years with a deep-seated suspicion that in practice manifested as a total regulation of business activities. After the Maidan Revolution in 2014 the government of Ukraine began systemic work on deregulation. After analysing the actual regulations and needs of business environment the Decree No. 615-p of the Cabinet of Ministers “On action plan of deregulation of economic activities” was adopted on 23 August 2016 comprising 112 measures on deregulation in different sectors, later on 7 deregulation measures have been cancelled by the Decree´s amendments.

The main achievements of deregulation of the business environment in Ukraine between 2014-18 are the following:

- number of licences reduced by 39 per cent (from 54 to 33)
- number of permit documents reduced by 45 per cent (from 143 to 79)
- number of planned and unplanned inspections of state control in 2016 was reduced by 66 per cent compared to 2014 (from 600 thousand to 205 thousand)
- more than 90 per cent of obligatory certifications have been scrapped (without certification agrarians can save about 7 billion UAH annually)
- position of Ukraine in the World Bank’s Doing Business rating has improved by 41 positions (from 112th to 71th).

There were some other victories in simplifying the licensing process after 2014: licensing bodies are forbidden to require the licensee to provide documents that are issued by another state or communal body; the licensee can submit required documents to licensing body electronically; terms of licence validity have been amended to have no end date.

The Cabinet of Ministers of Ukraine, within its legislative remit, has been executing regular “deregulation sessions” with the aim of getting rid of still excessive state regulation, cancelling archaic and out-dated legislative acts inherited from the Soviet past, and implementing effective regulatory norms. In 2018 alone the Cabinet of Ministers, during these sessions, for example:

- Scrapped the obligation for small winemakers to arrange for manufacturing certificates.
• Stopped state price regulation of numerous goods and services.
• Simplified the system of issuing special permit for extracting mineral resources.
• Removed obligation to use seals by companies in specific sectors.
• Changed the methodology of the State Land Cadastre in order to state all the reasons for rejecting claims on entering remarks in the cadastre.

Analysis of the regulatory impact on business, to control necessity of new or existing regulations, and evaluation of effectiveness of regulatory acts were introduced by the Cabinet of Ministers in 2004. Analysis of the regulatory impact on small business (so called M-test) has been implemented by amended methodology on execution of regulatory impact analysis since 15 March 2016 as an instrument to protect small businesses from excessive regulation. The M-test should first consult the small business, then analyse data and calculate the costs to the small business connected with implementation of a particular regulatory act and be able to stop implementation of harmful regulatory acts or to implement corrective measures. The M-test can be used only if a particular regulation tackles more than 10 per cent of small businesses compared to the total number of companies influenced by the regulation.

This positive tendency was confirmed by the State Regulatory Service which estimates the quality of draft regulatory acts prepared by regulatory organs. In 2017, it rejected 34 per cent of draft regulatory acts because of non-compliance with legislative methodology. In 2018 this number was only 19 per cent, meaning that the quality of draft regulatory acts improved in 2018 by almost 23 per cent. In 2018 it prevented the implementation of draft regulatory acts that would have created additional costs to business amounting to UAH 43.5 billion.

For good business environment effective regulation is needed, especially where human health, environmental preservation, protection of fair competition, consumer protection, quality of products and safety of the country are concerned.

New regulation in the European Union

One of the characteristics of a strong state is to react quickly to changing conditions in the world. In that respect the example of new EU regulation can be a good illustration of effective state regulation in its dynamic development while fulfilling its main tasks. Taking into account the deterioration of the environment, accumulation of waste in the world’s oceans and seas, the European Commission is prepared to adopt stricter regulations in that area.

Every year in the EU the following are consumed: 580 billion plastic cigarette filters, 46 billion plastic bottles, 2.5 billion plastic boxes for food, 16 billion plastic caps, 36.4 billion of plastic sticks. More than 70 per cent of plastic waste ends up either in landfill or in nature. There are about 268 thousand tonnes of plastics or 5.2 billion individual plastic items in the world's oceans and seas. According to Pavel Poc, member of the Committee on Environment of the European Parliament: “Air, soil and water are today contaminated by invisible fragments of plastics that we eat, drink and breathe with unknown effects on our health.”

On 19 December 2018 the Council of the EU and the European Parliament reached provisional agreement on a directive that should drastically curb single-use plastics through a ban on the most problematic single-use plastics by 2021 and through necessary systemic changes. Targets are set to reduce the consumption of plastics, manufacturers should contribute to costs connected with plastic handling, there are new requirements for marking of products, new requirements on education, new targets for waste collection: member states are obliged, by 2025, to collect separately for recycling 77 per cent of single-use plastics in the market, and 90 per cent of single-use plastics in the market by 2029. On 12 February 2019, British think tank the Institute for Public Policy Research published a report warning that interventions of human beings into environment are so big that economic instability could be a direct result.

https://www.ippr.org/research/publications/age-of-environmental-breakdown
Reform of state control and surveillance:
The start of real business deregulation took place on 10 September 2014 when the Cabinet of Ministers adopted the Decree "On optimisation of system of central organs of executive power" and 12 state control bodies were either cancelled or merged. On 3 November 2016 the system of state surveillance and control was substantially liberalised by adopting the draft Laws No. 2418a, 2531a and 3153. The main amendments were the following:

- regularity and duration of state inspections were reduced
- entrepreneurs gained new rights not to grant access to inspectors under certain conditions
- principles of creation and operation of an integrated automated system of state control and surveillance were adopted
- complex planned inspections were adopted
- production, provision of services or carrying out of works can be stopped only by court decision
- increased administrative responsibilities of inspectors of state surveillance and control bodies
- inspectors and entrepreneurs are allowed to record on video or audio the progress of a planned or unplanned inspection
- transparent procedure of inspections based on check-list implemented
- State Regulatory Service was given the right to control the state control bodies
- 6 areas of economic activities left that are not covered by the law on state control and surveillance
- implemented moratorium on planned controls till 31 December 2018.

On 18 May 2017 draft Law No. 0906 was adopted implementing state control for food products, feedstuff, by-products of animal origin, health and wellbeing of animals. At the end of 2018 the Cabinet of Ministers adopted the strategy for reform of state surveillance and control that confirms further reduction of number of state controlling bodies and declares the need to change the behaviour of state inspectors from repressive into consultative, especially for start-up businesses.

Reforms in state surveillance and control should go much further. According to integrated automated system of state supervision there are now 39 state controlling bodies (including the State Fiscal Service) active at the central level, 418 at the territorial level and 101 on the local level. This is still too many. Ukraine needs to conduct a proper analysis of all supervisory bodies, their functions and efficiency and scrap those where there is duplication, breach of market economy principles or conflict of interest (for example managerial and control functions are mixed). That process should lead to a reduction in the number of controlling bodies and improved treatment of businesses.

Implementation of a risk-oriented approach and standardisation of inspection protocols in state supervision is an important step forward as the degree of risk associated with an economic activity determines the regularity of planned inspections. The process was initiated by the Cabinet of Ministers in August 2013, by adopting the first methodology to determine the criteria for risk evaluation of different types of economic activities and to unify formulas issued on results of inspections. In May 2018 the new methodology to determine risk criteria was adopted. Until now out of 85 spheres of state surveillance and control the State Regulatory Service has approved 76 draft decrees on confirmation of criteria of risk evaluation based on the new methodology and the Cabinet of Ministers has already approved risk criteria in 53 spheres of state surveillance and control.

In 2019 the Ukrainian government stopped prolonging the moratorium on planned state inspections. State controls should be conducted continuously, concentrating on high-risk business entities, but the character of state inspections should change from punitive to consultative in order not to create unjustified pressure on business. Therefore a special kind of partial moratorium on planned state inspections has been implemented in previous periods in order to allow time to reform the state supervision system. In 2015-16 state inspections of State Fiscal Service and State Financial Inspection and their territorial organs were only allowed to inspect businesses with turnover of less than UAH 20 million with the approval of the Cabinet of

$h$://inspections.gov.ua
Ministers. At the end of 2016 this moratorium was extended until the end of 2017, but 14 state controlling bodies were excluded. On 7 December 2017 the moratorium on state planned inspections was again and for the last time extended till the end of 2018, but 22 inspectorates were excluded.

There is still space for reducing number of planned and unplanned inspections using a risk-oriented approach. The State Fiscal Service (SFS) is not willing to act according to the basic law of state surveillance and control in the sphere of economic activities, nor is it ready to publish its planned controls within the complex plan of inspections that is prepared and published annually by the State Regulatory Service of Ukraine. SFS refused to publish the list of its planned inspections of businesses in 2017, arguing that 10 calendar days’ notice before the inspection is held is sufficient. Thanks to the amendment of the Tax Code in 2016 SFS was obliged to publish the list of its planned inspections first time for 2018. While in 2016 SFS intended to conduct around 10,000 planned inspections of legal and physical entities, in 2018 it was reduced to 8,621 planned inspections and in the plan for 2019 SFS names only 6,947 planned inspections, working with more than 50 risk criteria.

**Table 1**

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of planned state inspections</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>21,664</td>
</tr>
<tr>
<td>2017</td>
<td>48,268</td>
</tr>
<tr>
<td>2018</td>
<td>108,758</td>
</tr>
<tr>
<td>2019</td>
<td>110,497</td>
</tr>
</tbody>
</table>


**Good example of state control from Romania**

On 29 November 2017 the Romanian Parliament adopted the so-called “Prevention Law”, based on which state inspectors should first issue warnings instead of applying direct fines to business entities for less serious breaches of regulations. Such companies are given a grace period by the state inspecting authority in order to comply with the state regulation requirements. The law scraps the initial fines in the case of several hundred regulation breaches, replacing them with warnings and allows fines only for repeated less important breaches. [https://www.romania-insider.com/deputies-prevention-law/](https://www.romania-insider.com/deputies-prevention-law/)

**Liberalisation of currency regulation**

Currency deregulation is an important part of the general deregulation process creating better conditions for attracting investors into Ukraine as well as for encouraging more businesses to export goods and services abroad. The independent position of the National Bank of Ukraine and its monetary policy is clear and acknowledged. And it is obvious that a steady hard currency inflow is crucial for the country’s macroeconomic stability. Nevertheless, overly strict regulatory policy on currency creates a big burden for conducting business activities and could expel domestic business entities abroad. Therefore concentration on the simplification of foreign currency regulations in essential. The negative foreign trade deficit is growing rapidly: in 2018 it reached almost US$ 8.9 billion. Fortunately, some measures towards currency liberalisation have already been taken.

The National Bank of Ukraine (NBU) has decreased the limits for compulsory sales of foreign currency incomes on 9 June 2016 from 75 per cent to 65 per cent of the total hard currency income. On 4 April 2017 this limit dropped to 50 per cent and starting from 1 March 2019 should have dropped to 30 per cent. Exporting companies need to keep hard currency to buy either raw materials or technologies abroad or to invest abroad in order to support their exports. In June 2016 the NBU allowed the repatriation of dividends to foreign investors for the period of 2014-15, limiting it to the equivalent of US$ 1 million a month or 10 per cent of the total dividend. In May 2017 NBU allowed the transfer of dividends for the period of 2014-16, limiting it to US$ 5 million a month and for the period until 2013 curbing it to US$ 2 million a month. Based on its Decision No.19 from 1 March 2018 NBU allowed the repatriation of dividends amounting to a maximum of US$ 7 million a month; allowed to pay back foreign credits in advance restricting this to US$ 2 million a month and extended a list of business transactions that were not subject to duty of compulsory 50 per cent sales of hard currency.
On 21 June 2018 the Verkhovna Rada adopted a new and progressive law “On currency and currency operations” and created space for the central bank to proceed further in currency liberalisation. The law entered into force on 7 February 2019. Liberalised currency conditions would support investors and foreign trade companies, and as a consequence should stabilise the macroeconomic situation of the country.

**Why not more?**

Improvement of business and investment climate should be one of the highest priorities in Ukraine's economic policy. The state should create and guarantee a transparent, simple and attractive business climate as the main prerequisite for activating domestic and foreign investments and reaching sufficient and sustainable economic growth. When taking into consideration the fact that only during two recent years (2014 and 2015) Ukraine’s GDP declined by 16.4 per cent, and later on it grew at around 2-3 per cent annually, it becomes clear that the present growth rate is not enough. It has to be much stronger and sustainable in order to improve living standards of citizens. Reforms in Ukraine are going in the right direction, but it would be reasonable to increase pace of the reforms. There are some objective reasons for that. First, there is still resistance from those who would lose if progressive changes happened, so they are benefiting from the “status quo”. Secondly, the current coalition has slim majority and low voting discipline in the Verkhovna Rada. And thirdly, quality of executive power of central and municipal levels could be further improved while pushing on administrative reform.

**Some reforms went half way**

The Business Ombudsman Council was established in Ukraine in December 2014 based on a memorandum of understanding of Ukrainian Anti-corruption Initiatives from 12 May 2014. Since its launch the Business Ombudsman Council has received 5,055 complaints, 67 per cent of which have been closed by accepting recommendations of the Ombudsman. The financial effect of the ombudsman's activity for the business community working in Ukraine reached almost UAH 13.5 billion by 2019. With the aim of defining mutual relations of Business Ombudsman with state bodies, local self-governing entities and companies and to strengthen its position, the Ministry of Economic Development and Trade prepared a draft law “On the Business Ombudsman Council” and registered it on 5 May 2016. Almost three years have passed, but the draft law has still not been fully approved by the Verkhovna Rada.

Derzgeonadra and Derzgeocadaster started pilot projects of e-auctions to sell mineral resources, geological research and extraction rights as well as agrarian land lease rights. This initiative should be welcomed, and it would be desirable to transfer those pilot projects into regular usage. Ukraine's Cabinet of Ministers adopted on 26 July 2018 the “Methodology of sales of electronic special permissions on mineral resources” for the period from 1 September 2018 only until 1 September 2019. **Switching to online auctions, on 25 October 2018 the Derzgeonadra unexpectedly sold an oil and gas exploration permit for 4.3 times the expected price.** It is thought that previously permits were sold in backdoor deals, often to companies unqualified to develop the fields. **On 18 October 2018 the first electronic auction of a state agrarian land lease was organised by Derzgeocadaster and performed well when the average lease price reached 34.3 per cent of nominal-monetary land evaluation. E-auctions of state and communal agrarian land should be adopted for regular usage through amendments to the Land Code.**

**Impact of concentration**

Another crucial reason for improving the business environment is to create conditions for healthy competition. Competition built on a simple and fair business environment where all businesses have equal rights and obligations is the biggest driver of competitiveness, innovation development as well as consumer satisfaction and curbing inflation. If business regulation is simple and transparent, more companies are willing to enter the market. If the regulations are excessive, oligarchs often use them to expel competitors; in principle only companies with “proper political ties” are able to enter or stay in such markets.

The Anti-monopoly Committee of Ukraine, created by law in 1993, should protect economic
The World Bank’s 2018 analysis on the influence of so-called “godfather capitalism” on economic development in Ukraine showed the following results: 2 per cent of “politically connected” companies in Ukraine control more than 20 per cent of goods turnover and more than 25 per cent of total assets in the country. The biggest concentration of politically connected companies works in extraction industry, energy sector and transportation where they control more than 40 per cent of turnover and more than 50 per cent of assets.

Monopolies, for example in railway transportation, are having a harmful effect on the business climate of the country. Implementing corporate governance in Ukrzaliznytsia is fine, but the real solution should be to liberalise the sector and to let competitors in. Liberalisation should be the way of improving the quality of services and reducing prices, not vice-versa while curbing competition. Instead, Verkhovna Rada on 18 October 2018 voted down a draft law “On railway transport in Ukraine” that wanted to allow private trains to carry freight on state-owned tracks in 2019 in a pilot programme. Ukrzaliznytsia’s representatives alleged that private freight trains could endanger the financial stability of the company. Thanks to the efforts of the State Regulatory Service of Ukraine and major business associaions, Ukrzaliznytsia has only increased tariffs for cargo transportation by 15 per cent since 31 October 2017, otherwise cargo tariffs would have been increased by 22.5 per cent. In 2019 Ukrzaliznytsia plans to increase cargo tariffs by another 14.2 per cent.

A foreign investor’s view of state monopolies

ArcelorMittal Ukraine reported an unpleasant situation with regards to relations to the state railroad carrier Ukrzaliznytsia. ArcelorMittal’s shipments are down by 25 per cent due to the inability of Ukrzaliznytsia to settle the issue. The company has 100 of its own locomotives and many wagons, but Ukrzaliznytsia did not allow it to use them. The company has planned to send 300,000 tonnes of ore concentrates to Eastern Europe a month, but they ship only one third of this amount—about 100,000 tonnes due to lack of means of transportation.

Equal conditions should be compulsory

The government has to guarantee equal conditions for doing business. When there are equal conditions entrepreneurs are motivated to do business. This rule is twice as important for Ukraine, as the economy has signs of oligarchic structures in many sectors and therefore the temptation to have different rules in each marketplace could be present. State executive power should strictly reject any attempt to introduce different rules for different groups of businesses. Strategically it is important to have equal access of companies to state-owned or communal-owned assets including land and mineral resources, to reduce significantly all exemptions in Ukrainian legislation, to avoid too vigorous concentration of market share in one person’s hands.

When we look at the Ukrainian legislation, there are a lot of progressive rules that are quickly curbed with numerous exemptions. For example, if a company wants to get special permission to extract mineral resources, the company has to win the obligatory auction. However, there are 12 exemptions that allow them not to go through the auction. Another example: if an agrarian would like to lease a piece of state-owned or communal-owned agrarian land, the agrarian has to win the auction, but there are 20 exemptions where the auction is not obligatory. Or if a company is going to build a commercial or residential building, it has to pay a so-called “infrastructure development fee” of up to 10 per cent or up to 4 per cent of the building’s value, but there are 13 exemptions to this rule (including three new exceptions valid since 2019). A thorough review of all economic legislation, existing and proposed, is strongly recommended in order to root out and reject statements with double-standards and ambiguous meaning. It will pay off multiple times in terms of economic development.
Progressive changes, but only for some

On 3 November 2016 a progressive draft law “On cancellation of administrative barriers for export of services” was adopted by the Verkhovna Rada, bringing some much-needed simplifications: foreign trade contract for services providers (except for transporting services) could be reached in electronic form, through exchange of electronic messages or by submitting invoices including electronically. If administrative barriers regarding export of services exist, do they not exist in relation to export of goods or import of services?

On 1 March 2018 the Verkhovna Rada adopted a draft law that removed some administrative barriers for the gas and oil sector. Most important improvements are: improved procedure to get land, the principle of servitude is allowed to be used, obligation to get act of mining permission is cancelled, right to use land after agreement with owner before getting decision on change of targeted purpose of usage etc. The question is: do other areas of geological research and extraction of mineral resources, apart from oil and gas, not need simplification of administrative barriers? On 23 November 2018 a law was adopted including an amendment initiated by MP Oleksij Muchak: cancellation of “infrastructure fee for development of urban units” for constructions of agriculture and food processing industry. What about other buildings and constructions?

Too many changes

The VIII convocation of the Verkhovna Rada is registering a tremendous number of new draft laws: already by 13 September 2017 their amount exceeded 10,000. It is much more when compared to previous convocations of the Verkhovna Rada and is metaphorically called in public a “legislative tsunami”. For comparison: Parliament of the VII convocation registered 7,400 draft laws, Parliament of IV convocation registered 7,600 draft laws. The Tax Code of Ukraine has been amended 124 times since 2011. The Land Code has been changed 117 times since 2003.

Reforms are about changing an old system, but too many changes are bad. Business is eager to welcome positive changes, but at the same time business likes stability. Entrepreneurs prefer to concentrate on doing business as their core activity instead of studying changes in the regulatory legislation. Too many changes, sometimes contradicting each other, do not inspire trust among investors. On the contrary, numerous changes could deter investors.

Turning the reforms around

In 2014 the Verkhovna Rada of Ukraine increased the royalty on gas extraction for private companies from 28 per cent to 55 per cent (extracted from deposits up to 5,000 metres) and from 15 per cent to 28 per cent (from deposits over 5,000 metres), and later on in March 2015 also for state-owned companies from 20 per cent to 70 per cent. The purpose of this increase was the replenishment of the state budget. On 24 December 2015 by Law No. 909 the royalty on gas extraction was decreased to 29 per cent (from deposits up to 5,000 metres) and to 14 per cent (deposits over 5,000 metres). In 2017 the royalty on crude oil extraction was lowered from 45 per cent to 29 per cent (deposits up to 5000 metres) and from 21 per cent to 14 per cent (deposits over 5,000 metres). Draft Law No.6776-d after being adopted has lowered the royalty for gas extraction since 1 January 2018 for new drills from 29 per cent to 12 per cent (up to 5,000 metres) and from 14 per cent to 6 per cent (over 5,000 metres). Also the law has lowered the royalty for gas condensate extraction since 1 January 2019 from 45 per cent to 29 per cent (deposits up 5,000 metres) and from 29 per cent to 14 per cent (deposits over 5,000 metres). And later on an increase of the royalty on crude oil and gas condensate by 2 per cent was adopted by Verkhovna Rada from 1 January 2019: from 29 per cent to 31 per cent (deposits up to 5,000 metres) and from 14 per cent to 16 per cent (deposits over 5,000 metres).

Shadow economy and corruption

Ukraine’s shadow economy continues to gradually decline, hitting 32 per cent of GDP in 2018, down from 43 per cent in 2014, based on information from the Ministry of Economic Development and Trade. The Finance Ministry says the lion’s share of the informal economy is driven by a desire to avoid paying taxes. According to the State Statistics Service, 31 per cent of Ukrainian workers (8 million out of 26 million) are paid partially or fully in cash.
Corruption and distrust of the courts are the top two obstacles to investing in Ukraine according to a survey conducted by the Dragon Capital, the European Business Association and the Center for Economic Strategy. For the third year running corruption ranks first among investors’ problems. Other investor worries are: hryvnia exchange rate instability, monopolisation of power by oligarchs and conflicts of interests between politicians and business. In fifth place was the military conflict with Russia. Even if the state system of control and surveillance has been changed for more transparent and business-friendly, the system is still subject to corruption, therefore has to be reformed further.

Let’s consider the forest sector. The State Agency of Forest Resources of Ukraine (Derzhlisagenstvo) is in charge of around 285 state forest entities working on 7.6 million hectares (ha) of Ukrainian forests. Derzhlisagenstvo has a conflict of interest as it manages state forest enterprises dealing in economic activities in state forests and at the same time controls forests through the State Forest Protection Service. Derzhlisagenstvo should guarantee equal access to cut wood as raw material for wood-processing companies. According to an investigation report from British NGO Earth Sight, illegal timber from Ukraine is fuelling European markets: despite the moratorium posted in Ukraine on log exports, export of wood from Ukraine to the European Union grew by 75 per cent in the last four years breaking €1 billion in 2017, 40 per cent of which was illegal.

Intermediaries thanks to political ties

The draft law “On state budget 2019” was adopted by the Verkhovna Rada on 23 November 2018, and only later on it became clear that amendments between the first and second readings brought some surprisingly unfair amendments aiming to serve the interests of some MPs. Amendments No. 151 and 152 strengthened the position of so called “authorised electronic places” (AEPs) in the area of real estate evaluation that are in fact intermediaries between seller/buyer of real estate and the database of the State Property Fund.

Even if the obligation to check prices of real estate in the database of the State Property Fund (SPF) has been introduced since July 2018, only with those amendments of 23 November 2018 the position of present intermediaries becomes monopolistic as new AEPs have to obtain consent from four existing AEPs and the value of real estate will be determined by the State Property Fund, not by the Cabinet of Ministers. That means a fee on real estate transactions has effectively been introduced which goes to the four private companies: PP “Information Consulting Center ASBOU”, TOV “VIP Department”, TOV “Akcent online”, TOV “For procurement”. Misusing their monopolistic intermediary position, at the end of 2018 AEPs significantly increased prices for evaluators.

Raider attacks

Raider attacks or hostile takeovers are a problem that still persists in Ukraine and constitute significant obstacles for businessmen to invest and develop their businesses. According to data from the Ministry of Justice there were up to 3,000 hostile takeovers in Ukraine in 2015 and 90 per cent were, unfortunately, successful. Again according to the Ministry of Justice of Ukraine, in 2017 there were 4,794 complaints of raider attacks received by the Anti-Raider Units at the Oblast State Administrations, in 2018 the number of complaints dropped to 3,718 and in 2019 (until the middle of April) 564 complaints had been received. There are couple of reasons why this unpleasant situation still persists.

First, broad liberalisation of the registration of companies and real estate has been implemented. Registration responsibilities were transferred to notaries, municipalities and authorised subjects. Starting from 1 January 2013 notaries are authorised to register ownership rights and other rights and responsibilities. Since 1 April 2015 notaries have been able to register lease agreements on agrarian land plots even without notary confirmation of such lease agreements. There are 5,606 private notaries and 773 state notary offices at present. A raider attack without collaboration with a state registrar is practically impossible. Argument in favour of transfer of state registration rights to private and municipal registrars with the aim of speeding up the registration process is questionable, especially when it jeopardises proper protection of private ownership and related rights. Besides that, the system of two state registers: The State Land Cadastre and the
State Register of Real Estate Rights and its Burdens is often misused by raiders.

Secondly, persons and subjects participating in raider attacks are not properly prosecuted and punished, including registrars. The majority of victims of such attacks are simply trying to, with huge support from professional lawyers; rebuff an attack with minimal losses. Raiders’ victims have neither the additional financial resources nor the free time to pursue litigation until the raiders and all their collaborators are finally punished. Under such circumstances, when raiders see lack of punishment and passivity, they tend to continue their crime.

Thirdly, structures that the government created in order to fight against raider attacks should be assessed for effectiveness. Since 1 January 2016 the Commission on State Registration Claims Review under the Ministry of Justice started to operate. From its establishment until 11 March 2019 the Commission has met 249 times, therefore successful rate of claims from raiders’ victims could and should be examined. In 2007 the Inter-Governmental Commission on Protection of Investors Rights and Fight against Hostile Takeovers and Raiders Attacks on Companies was established.

What to do next?

It is highly recommended to pay more attention to proper communication with the public, expert environment, NGOs, business associations, state institutions and self-governing bodies in order to explain reasons why Ukraine badly needs to continue the process of business climate improvement and to make that process deeper and more complex, guaranteeing equal conditions of doing business for all. This communication should also explain the risks of halting the reforms, undertaking half-baked reforms or allowing reform reversals to happen. Without proper reforms Ukraine will simply not be able to leave the position of the poorest country in Europe, as it ranks now in the IMF rating (occupying 134th place in the world with GDP per capita of US$ 2690). Public communication could help push for the adoption of progressive laws in the Parliament. But reforms are not only about adopting or amending legislation. They should also be about people and changing the behavioural patterns and mentality inherited from the Soviet era. Today there are no easy solutions with quick wins.

It would be advisable to go further in reducing the number of licences and permits needed for conducting business activities and to implement more frequently declarative instead or permitting principle to start a business. Law of Ukraine “On licensing of economic activities” declares that licensing implies the highest level of state regulation and should be implemented only in cases when other tools of state regulation are not sufficient. For example, conducting a business as tour operator, processing of household waste, storage of household waste or serving as intermediary for finding a job abroad could be regulated on lower and less strict regulatory level, not by licenses.

A favourable business climate requires Ukraine to further reduce the number of control bodies that are allowed to conduct state supervision of economic activities, to remove duplications of competences and to change the character of their work from repressive into consultative and helpful in accordance with a valid strategy of reform of state surveillance and control. Business requires the replacement of the different state organs investigating breaches of financial security legislation (National Police of Ukraine, SBU, State Service of Financial Monitoring of Ukraine, Prosecutor General’s Office, National Anti-corruption Bureau of Ukraine, State Auditing Service of Ukraine and Accounting Chamber of Ukraine) with one professional organisation that would have sole responsibility for dealing with economic crimes. It would be crucial to concentrate on the adoption of the draft Law “On National Bureau of Financial Security of Ukraine” that resolves this task.

Analysis of regulatory impact should be obligatory for all new regulatory acts including those being prepared by the Verkhovna Rada of Ukraine and by self-governing territorial bodies. In addition, it would be necessary to continue increasing the quality of draft regulatory acts including analysis of regulatory impact.

Electronic public procurement system ProZorro should be improved further. On 23 November 2018
Beer protection of private property rights including intellectual property rights is of utmost importance for a good business environment. Ukraine has to strongly suppress any attempt at raider attacks as the safety of the business environment is crucial. Comprehensive reform in the area of property rights protection is needed including improvement of activity of the Commission on State Registration Claims Review under the Ministry of Justice of Ukraine and unification of the State Land Cadastre with the State Register of Real Estate Rights and its Burdens in order to avoid duplication and significantly curb the space for corruption and dishonest activities of state registrars.

It would be advisable for the Cabinet of Ministers to adopt missing unified protocols and criteria to determine risk while evaluating entrepreneurial activities regarding state control and surveillance according to the new methodology adopted by the Cabinet of Ministers' Decree of 10 May 2018. By 18 January 2019 only four unified protocols and 37 risk criteria out of total 85 spheres of state control and surveillance were adopted by the Cabinet of Ministers. Adoption of the missing documents would enable to implement risk approach in conducting state control and surveillance.

The same simplifications as were adopted for export of services could be adopted for the export and import of all services and goods. By the same logic it would be essential to adopt the same deregulation measures as were adopted for the oil and gas sector for geological research and extraction of all mineral resources. It would be appropriate to scrap the infrastructure fee on development of urban units for all buildings and constructions, as it was recently done by an amendment for agriculture and food industry buildings.

In order to streamline customs formalities and accelerate movement of goods through the border for honest exporters and importers, and therefore increase their competitiveness and fulfil the requirements of the EU-Ukraine Association Agreement, it would be desirable to implement the status of "authorised economic operator" through the adoption of the draft Law "On amending Customs Code of Ukraine regarding some question of implementation of Chapter 5 of Title IV of Association agreement between Ukraine and EU" registered at the Verkhovna Rada on 29 December 2017 and its respective sub laws.

To foster investments, especially in infrastructure, it would be essential to adopt at its second reading the draft Law "On concessions" that should replace the present one adopted in 1999. The new law implements additional guarantees for investors, simplifies obtaining a land plot for public-private partnership projects and other updates.

Based on the need to reform state regulation of financial services markets it is advisable to abolish the National Financial Service and to split its powers between the National Bank of Ukraine and the National Commission on Securities and Stock Market by adopting the draft Law No. 2413a in the Verkhovna Rada at its second reading.

The management system of state forest enterprises should be improved significantly. There is an urgent need to implement obligatory electronic accounting of wood from point of cutting to its processing or final consumption for all permanent forest users. Equal access to state wood for all wood processing manufacturers through electronic auctions should be guaranteed and implemented. The State Forest Protection Service should be detached from Derzhlisagenstvo and from state forest enterprises in order to secure its independence: the Decree of the Cabinet of Ministers No. 976 from 16 September 2009 should be amended accordingly. Amending the Code of Ukraine on Administrative Offence and the Criminal Code of Ukraine could help resolve the issue of continued illegal logging by increasing the responsibility of the offenders.

Mps did not support progressive draft law that tried to improve existing regulation on ProZorro. Therefore it would be appropriate if the Parliament supports that draft law "On public procurement" implementing EU Directives 2014/24 and 2014/25 and the EU-Ukraine Association Agreement with the following main improvements: simplification of requirements for procurements below a threshold, return of participants’ fee on receipt of a satisfactory complaint, possibility of fixing formal mistakes within 24 hours, and a new instrument to determine if a price is too low.

Better protection of private property rights including intellectual property rights is of utmost importance for a good business environment. Ukraine has to strongly suppress any attempt at raider attacks as the safety of the business environment is crucial. Comprehensive reform in the area of property rights protection is needed including improvement of activity of the Commission on State Registration Claims Review under the Ministry of Justice of Ukraine and unification of the State Land Cadastre with the State Register of Real Estate Rights and its Burdens in order to avoid duplication and significantly curb the space for corruption and dishonest activities of state registrars.
Land reform began in Ukraine 28 years ago, when the Verkhovna Rada of, at that time, the Ukrainian Soviet Socialist Republic, adopted on 18 December 1990 the Decree “On land reform”. Since 1995 land reform was carried by way of privatisation: 6.9 million citizens of Ukraine received the right to privatise 27 million hectares (ha) of formerly collective agrarian land as compensation for working for soviet agricultural enterprises “kolkhoz” and “sovchoz” that no longer existed. But the remuneration did not translate into full ownership of agrarian land due to the introduction of a moratorium on sales/purchases of agrarian land on 1 January 2002, initially intended to last three years.

At the beginning the moratorium was targeted only private agrarian land plot owners, but later on was extended to all land of agricultural production with the aim of regulating the implementation of rights of both citizens and legal bodies to agrarian land plots. Since its adoption the moratorium has been prolonged 10 times. The land moratorium bans not only sales/purchases of agrarian land, but also any change of usage of private agrarian land and insertion of private agrarian land plot into equity capital of companies.

The current agrarian land moratorium resembles the Soviet “Decree on Land” adopted by II. All-Russian Soviets meeting on land on 26 October 1917 and signed by Vladimir Ulianov-Lenin. The first Article states: “Private property on land is cancelled forever, land cannot be sold, bought, leased or submitted as collateral or taken by any other way.”

Lifting the moratorium on sales/purchases of agrarian land should have been a key tool in the dismantling of communist structures. Unfortunately, this has not yet happened. The issue of the land sale moratorium became politically very sensitive. Ukrainian populists have been trying to persuade the public for years that it is very dangerous to lift the moratorium on agrarian land sales/purchases, pretending to act in public interest. Numerous votes of the Ukrainian Parliament have gone in favour of extending the land moratorium, confirming the “status quo”. Ukraine possesses around 27.8 million ha of black soil (67.7 per cent of all agrarian land in Ukraine), the highest amount in Europe and fourth highest in the world (Ukraine has 8.7 per cent of the world’s black soil reserves). Ukraine’s biggest asset has effectively been frozen for more than 18 years. That hinders economic growth.

Since 2005, benefiting mostly from the land moratorium due to cheap lease fees as well as from better financing opportunities, agroholdings (agrarian enterprises above 10 thousand ha) began to develop quickly. The biggest boom of agroholdings was from 2005 to 2010 when they increased fourfold the amount of cultivated agrarian land. Later on, the amount of agrarian land cultivated by agroholdings continued to increase, from 1.7 million ha (8 per cent of all land cultivated by agrarian enterprises) in 2007 to 6.25 million ha (29 per cent of all land cultivated by agrarian enterprises) in 2017.

The State Land Cadastre was adopted by the Verkhovna Rada in July 2011. By 1 January 2013 a single information system of the State Land Cadastre should have been created, transferring all data on land registration and administrative-territorial frontiers from the previous state land register. In January 2013 an electronic State Land Cadastre was introduced under the state agency “Derzcomzem”. Land documentation that was mostly kept on paper in local district departments of land resources, were to be digitised. In the first month of the transformation alone 10,962 information errors were detected. Since 1 January 2013 unified state register on real estate rights and its burdens has been created, where rights to a land plot can be registered only after previous registration at the State Land Cadastre.

Former Prime Minister Arseniy Yatsenyuk announced in 2016 an idea to sell one million ha of state-owned agrarian land at open auction in order to fight “black” leasing of state-owned agrarian land. This attempt to scrap the agrarian land moratorium did not result in a concrete legislative proposition.
What has been done?

In 2018 the process of transfer of state-owned agrarian land to “unified territorial units” was started by the initiative of the Cabinet of Ministers. That is an important supportive step towards the opening of an agrarian land market, as local self-governing units want to manage local land by themselves. Almost 1.5 million ha of state-owned land covering territories of so called “unified territorial communities” were passed to 647 “united territorial communities” in 2018. This governmental decision has had a positive multiplication effect: as well as improving land management in the regions it also motivates further establishment of “unified territorial communities”. Looking at Germany’s experience can also give us a view on the importance of involving local decision-makers in land reform. In late 1967, the Constitutional Court of Germany announced that a fair regulatory system regarding management of land requires much stronger consideration of interests of local stakeholders compared to usage of other means of production.

One of the positive achievements of Derzgeocadaster in 2018 was the implementation of a pilot project of electronic auctions to sell lease rights on state-owned agrarian land. Excellent results were achieved on e-auction of 18 October 2018 when lease rights on 10 land plots amounting to 210 ha were for sale. **Whilst starting price was determined at 8.3 per cent of nominal-monetary land evaluation, the average lease price reached was 34.3 per cent of nominal-monetary land evaluation. The highest lease price of that e-auction was 70.73 per cent (UAH 12,138/around €400) of nominal-monetary land evaluation of the plot in question.**

Ukraine became the 5th country in the world to transfer its land cadastre into Blockchain technology. On 3 October 2017 Derzgeocadaster successfully completed transfer of the State Land Cadastre into Blockchain technology, implementing the Decree of Cabinet of Ministers adopted on 21 June 2017. Blockchain technology enables safe synchronisation of the cadastre's data while at the same time saving them in different electronic bases. Any attempt of external intervention should therefore be eliminated. The new technology also enables the public to control the cadastre online.

Recently there has been some progress in the fulfilment of the State Land Cadastre mentioned: in 2015 there were only 15.75 million land plots registered at the cadastre, by October 2018 this number had increased by 23 per cent and reached 19.3 million land plots. The situation with registration in the cadastre is much better with private agrarian land thanks to the privatisation of up to 27 million ha of state-owned agrarian land by citizens. Private land owners had to pay costs linked to the preparation of land plot documentation. Registration of state-owned agrarian land used to lag behind, mostly due to lack of budgetary resources for that purpose.

Fulfilment of the State Land Cadastre is often mentioned as a precondition for land market opening. But from a technical point of view it should not have strong negative influence on land market opening as only registered land plots could be sold/purchased anyway.

A working group headed by the Ministry of Agrarian Policy and Food of Ukraine has been working on the preparation of draft law “On agrarian land circulation” and another “On land consolidation” since the beginning of 2017. Numerous meetings with agrarians, their business associations, farmers, representatives of land owners and banks were held in that period, at the level of the Cabinet of Ministers. By the summer of 2017 both draft Laws were ready, containing safeguards on lifting the moratorium. Having analysed perception of open land market by different stakeholders, taking into account the very long period that the land moratorium has been in force, considering high political sensitivity of the issue, trying to minimise a potential criticism of Ukrainian populists on lifting the land moratorium and taking into account the current structure of the Parliament in order to break long lasting resistance towards lifting the land moratorium, the working group came to the conclusion that at that period of time a prudent model of land market opening would have the best chance of being adopted and would satisfy the majority of stakeholders. Were there a stronger public support for lifting the land moratorium and less political manipulation on that issue, the working group would probably agree on a more liberal model of moratorium lifting.
The main safeguards of the draft law “On agrarian land circulation” agreed by the working group were:

- Agrarian land could only be owned by Ukrainian citizens, Ukrainian municipalities, the state of Ukraine and Ukrainian legal bodies, at least in the transition period.
- There should be a maximum amount of agrarian land that could be owned by a single entity.
- State and communal agrarian land could only be sold through e-auctions.
- The maximum size of an auction lot in ha should be determined.
- Warranty fee should be implemented for auction participants based on a certain percentage of normative-monetary evaluation of auctioned land plot.
- The minimum price for purchase/sales of agrarian land should be on the level of normative-monetary evaluation of the land plot in transition period.
- There should be a state tax on reselling of agrarian land, amounting to a certain percentage of normative-monetary evaluation of land plot, if the owner sells it during a certain period after land ownership is registered.
- Actual lease agreements should be guaranteed to agrarians leasing land plots in case the owner of a land plot changes.
- The amount of leased agrarian land by one agrarian cannot exceed a certain percentage of the total agrarian land of “raion”/“united territorial unit”.
- There should be a stimulus for young farmers participating in e-auctions.
- The price of sold/purchased agrarian land should be monitored.

Thanks to expert communication campaigns in the media and at various events, supporters of the agrarian land moratorium within the Verkhovna Rada are losing power. There are fewer and fewer MPs who vote for the extension of the moratorium: in 2015 there were 309 MPs who voted in favour of extending the moratorium, in 2016 there were 297 votes, in 2017 only 236 and in 2018 only 231 votes. Last time the moratorium was extended until 1 January 2020. Also the attitude of the public towards lifting of the moratorium is changing in a positive direction. In the poll organised by the USAID project at the end of 2015 on 2,041 respondents (citizens of Ukraine in 108 towns in all regions of Ukraine) 63 per cent were against lifting of the land moratorium and 18 per cent were in favour. In October 2018, based on a GfK Ukraine poll, 44.7 per cent of respondents were against lifting of the land moratorium and 19.9 per cent of respondents were in favour. On the question of whether they would like to have a right to dispose freely of their agrarian land, 21.6 per cent of respondents were for and 40.3 per cent were against. The same GfK Ukraine poll of October 2018 made several interesting findings: 78 per cent of respondents who are agrarian land plots owners are renting out their land plots; 52.1 per cent of them agree that because of the moratorium they lose part of their lease income; 50.8 per cent of renting agrarian land plot owners agree that because of the moratorium agroholdings are able to control more and more agrarian land while the number of farm enterprises diminishes.

On 21 June 2018 the Citizens Coalition for Lifting of the Land Moratorium was created by 20 organisations, including SAGSUR, and a memorandum against the moratorium was signed. Today the Coalition comprises 42 organisations representing close to 1,500 agrarian companies, entrepreneurs, banks, associations, MPs, NGOs including the Ukrainian Club of Agrarian Business, the Ukrainian Agrarian Confederation, the Seed Association of Ukraine and the “Ukrkadprom” Association. Not all agrarians are against opening of agrarian land market. Some of them, including some agroholdings are drivers in promotion of open land market, especially those that would like to secure future investments while differentiating their business to perennial or permanent crops, niche crops, animal breeding or food-processing.

In 2018 some important legislative changes were adopted by the Verkhovna Rada. On 10 July 2018 a draft law was adopted to settle the issue of collective ownership of agrarian land; where ownership of land utilised for field roads, yards, forest lines has been transferred to communal ownership of municipalities.

¹ The biggest market research organisation in Germany and the 4th biggest market research organisation in the world.
It was a positive step forward as every piece of land has to have a real owner. But at the same time the draft law introduced the possibility of concluding sublease agreements without the consent of landlords, to rent field roads without auctions. Agrarians who own/use more than 75 per cent of the tract in case of land plots crossing get priority lease rights regarding other agrarian land plots in that tract over other users. Privileged agrarians can exchange land plots in question.

On 10 July 2018 the Verkhovna Rada adopted the draft law “On stimulating the creation and operation of family farms” that tries to transform 4.1 million “specific village units” operating on 6.5 million ha of agrarian land into entrepreneurs – physical entities with the opportunity to register under a simplified tax system (payer of single tax of 4th group)² using state incentives to partly cover social security for a certain period.

Ukraine’s own standard for organic production, circulation and labelling was adopted by the Verkhovna Rada on 10 July 2018. Organic operators in Ukraine should have the right to choose which organic standard to use. Due to stronger organic demand in developed countries, higher added value and respectively higher prices on organic products on the world market Ukraine is in an excellent position to develop this opportunity. As organic production is a more long-term investment that requires a minimum of three years just for the land to be certified as organic and then a focus on proper cultivation techniques according to strict organic standards, the opening up of the land market could foster development of that sector. Ukrainian agrarians are gradually increasing the amount of land available for organic production: in 2017 the amount of organic land increased by 10 per cent and reached 420,000 ha; export of organic products also went up by 10 per cent reaching 330,000 tonnes. But the gap between Ukraine and developed countries still remains: while in Ukraine there are 426 organic operators, in France there are about 55,000 of them cultivating around 1.5 million ha. In Poland there are about 25,000 organic operators and around 500 organic processing enterprises. In Bulgaria the amount of land under organic production has increased by 310 per cent in 5 years, in Croatia by 193 per cent (until 2016).

During 2018 a country-wide normative-monetary evaluation of agrarian land took place on 35 million ha, by order of the Cabinet of Ministers of 7 February 2018. The previous exercise of this type took place in 1995. Up to two million ha of agrarian land were without normative-monetary evaluation. Since 2019 it is no longer necessary to draw up technical documentation on normative-monetary evaluation on single land plots. Now it should be possible to calculate online the country-wide normative-monetary value of agrarian land plots registered in the State Land Cadastre (https://ngo.land.gov.ua). On 16 November 2018 Ministry of Agrarian Policy and Food issued Decree No. 552 based on which the country-wide normative-monetary evaluation of agrarian land entered into force on 1 January 2019.

Why not more?

Moratorium on sales/purchases of agrarian land

The term “moratorium” was first introduced in the Roman Empire in order to freeze repayment of debts by persons close to the ruling class, but was usually issued for a maximum period of 5 years. In Ukraine the moratorium has halted transactions with agrarian land, the biggest asset of the country, for more than 18 years. There should be some reasons for halting the full extent ownership of agrarian land for such a long period of time.

The inability of politicians to stop the moratorium on sales/purchases of agrarian land while adopting the Law “On agrarian land circulation” is the biggest failure of land reform in Ukraine. The Cabinet of Ministers (CoM) was obliged by the Verkhovna Rada to prepare and register draft Law “On agrarian land circulation” by 1 March 2016. Due to the fact that CoM did not fulfil this task, the Verkhovna Rada extended the deadline until 1 July 2017. With the latest amendment to the Land Code of 20 December 2018 the Verkhovna Rada gave the CoM a new deadline to work out and register the draft Law, by 1 March 2019.

There is resistance to lifting the land moratorium from different kinds of agrarian companies including agroholdings, agrarian enterprises and farm

² A type of simplified taxation applicable to the Ukrainian agricultural sector.
enterprises that benefit from cheap leasing of agrarian land. In principle, agricultural land owners have only two basic possibilities: either to work in agribusiness by themselves or to rent the land plots to others. Only around 20 per cent of all land owners are actually working on their land. Because of the moratorium banks are not willing to accept agrarian land as collateral for issuing credit. Almost 1.4 million ha of privatised land plots are neither rented nor cultivated by owners. Such a situation is advantageous for agribusiness as the majority of land owners are therefore forced to lease their land.

According to data of Derzgeocadaster the average lease fee for private agrarian land in 2017 amounted to UAH 1,369 (€43) per ha.

There is significant burden from a past period when some agrarians were able to rent state and communal agrarian land for long periods and for cheap prices. Almost 50 per cent of rent agreements on renting state-owned agrarian land were concluded for up to 49 years, 27,000 agreements on renting state-owned land were signed for a lease fee of between 1-3 per cent of the normative-monetary land evaluation which means average lease fee on such state-owned agricultural land reached UAH 940 (€30). Lease fees for state and communal-owned agrarian land have been growing in recent years, if transactions go through compulsory land auctions. In 2017, 1,837 lease agreements have been finalised on leasing state- and communal-owned agrarian land through land auctions covering only 0.4 per cent of all state-owned agrarian land (42.5 thousand ha) for an average rent fee of 14.73 per cent of the normative-monetary evaluation of land. In first half of 2018 the average rent fee increased to 18.75 per cent.

Table 1
Average lease fee on agrarian land per ha in some countries (in € per annum) in 2016

<table>
<thead>
<tr>
<th>Country</th>
<th>Lease fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ukraine</td>
<td>41</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>96</td>
</tr>
<tr>
<td>Hungary</td>
<td>151</td>
</tr>
<tr>
<td>France</td>
<td>202</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>225</td>
</tr>
</tbody>
</table>

Source: Eurostat: https://ec.europa.eu/eurostat, Derzgeocadaster

According to the “Strategy on improvement of management mechanism in the sphere of usage and protection of state-owned agrarian land” adopted in 2017 state-owned agrarian land amounted to 10.4 million ha (at present less due to transfer of state land to communal ownership of “unified territorial communities”), out of which 3.2 million ha are in regular usage by state enterprises and organisations, 2.5 million ha are reserved (not transferred to ownership or usage) and the remaining 4.7 million ha should have been leased. State land in regular usage by state enterprises and organisations is used ineffectively, also through agreements of common cultivation and unregistered rights of land usage that could lead to a “shadow” economy. There could be a similar situation in the case of state-owned land in reserves as the inventory of state land was not completed. For agribusinesses involved in such schemes, the continuation of the land moratorium suits their needs.

Some agrarians, especially smaller farmers, do not support the lifting of the land moratorium because they are uncertain as to whether state officials would be able to provide them with cheap credit once they decide to buy agrarian land, using either state aid (in the form of credit interest rates payments) or state guarantees for issued credits.

The attitude of private agrarian land owners on the abolition of the land moratorium is still rather passive or weak, even if improving. This could be explained by their fragmentation, weak political backing and hesitation due to perceived corruption in the court system and continuing “raider” attacks in the agrarian sector. It is not surprising that citizens do not want to be involved in an unstable and non-transparent situation despite the fact that their ownership rights are being abused.

Opening up the agrarian land market was one of the top priorities of the Memorandum of Economic and Financial Policies, part of “Ukraine: Letter of intent to

3 Decree of Cabinet of Ministers No. 413 from 7 June 2017
4 German-Ukrainian agro-political dialogue, “Agrarian sector of Ukraine and Germany: facts and comments”
Finally some populist politicians are either against the opening up of the land market or pretending to support it while requiring many new legislative prerequisites to be fulfilled before it happens, despite the fact that many of them have already been singing for some me in the Verkhovna Rada, the organ that adopts legislation. The number of progressive members of parliament supporting agrarian land opening is growing (69 MPs went to the Constitutional Court in September 2018 to claim nonconformity of the land moratorium to the Constitution of Ukraine; on 17 January 2019, 81 MPs voted for draft Decree No. 9355-P calling for cancellation of the dra law “On prolongation of the land moratorium”), but their number is at present still not sufficient for the draft law “On agrarian land circulation” to be adopted, which would result in the land moratorium being cancelled.

Ukrainian reality

On 1 November 2018 the Constitutional Court of Ukraine decided not to open a constitutional procedure in the matter of 69 members of parliament who claimed nonconformity of the agrarian land moratorium to the Constitution of Ukraine. The Constitution of Ukraine, in articles 14 and 22, guarantees private property on land and bans limitation of existing rights and freedoms while adopting new laws or amending them.

Oleksij Mushak, MP of the Verkhovna Rada commented that the decision of the Constitutional Court of Ukraine was disgraceful, given that the matter that concerns almost seven million citizens of Ukraine was not considered by the court to be a sufficient reason for initiating a constitutional procedure, despite the fact that taxpayers’ money finances the post of a judge of the Constitutional Court significantly.

Negative impacts of the current moratorium and possible advantages of lifting it

More than 1.4 million owners of privatised land plots (20 per cent) according to data of Derzgeocadaster have already died since the moratorium was introduced, and did not succeed in obtaining full ownership rights on their land. Currently the average age of land plot owners is around 60 years, 25 per cent of them are over 70 years old and 65 per cent of them are retired. Ten years from now only 50 per cent of original land plot owners are likely to still be alive.

Comparing Ukraine with other countries we can see what Ukraine is losing every year that the moratorium is in force, taking into account also the difference in crop yields. It is understandable that crop yields are influenced by many different factors other than the preservation of the land moratorium, like climate conditions, soil quality, machinery availability and quality, adherence to crop rotation principles and so on. Basic calculations by the Ministry of Agrarian Policy and Food of Ukraine made in 2017, based on a comparison of Ukrainian crop yields with those of countries with an open agrarian land market, show that Ukraine loses approximately US$ 3.3 billion annually due to the persistence of the land moratorium.

If we take into consideration, for example, wheat as the third most important Ukrainian export agroproduct: the average wheat harvest in Ukraine in 2017-18 was 4 tonnes/ha (early wheat yields diminished to 3.8 tonnes/ha) and in 2018 harvest of wheat declined to 3.73 tonnes/ha, whilst in Germany in 2017 the average wheat harvest was almost 8 tonnes/ha; in the United Kingdom average winter wheat yields reached 10.55 tonnes/ha; and in Romania for that period the average wheat harvest reached 4.84 tonnes/ha. The record winter wheat yield of 16.7 tonnes/ha was reached in New Zealand.

Potatoes offer another example of Ukraine’s agricultural yields being understood in comparison: while in Germany potato yields reached 45 tonnes/ha in 2017, in Ukraine yields were less than half that. A similar situation could be seen in milk...
production: while in Germany in 2017 it reached more than 7 tonnes/cow/year,⁵ in Ukraine it was only 4.7 tonnes/cow/year. Besides that, the number of cattle in Ukraine has decreased by 60.5 per cent since the introduction of the land moratorium. As of 1 May 2019 there were only 3.73 million head of cattle and only 1.93 million head of cows according to data from the State Statistics Service of Ukraine. As cattle breeding for milk or meat production means long-term investment, the above-mentioned development in Ukraine is direct evidence that preservation of the land moratorium negatively influences long-term investments in agriculture, including cattle breeding.

To get the full picture it would be necessary to consider, in addition to the quantity of yields, also quality of crops/animal products and climate conditions. For example the hard wheat content of proteins should be at least 10-14 per cent, humidity at maximum of 14.5 per cent. The superior black soil quality and reasonable climate conditions in Ukraine should allow to for higher yields of quality crops. To understand beer the current stage of agriculture development in Ukraine it is reasonable to see the picture in comparison to another countries. The table below gives us an additional perspective on the present situation and future prospects for agricultural production in Ukraine.

Table 2
Crop production of wheat, maize, soya beans in tonnes per hectare, in 2017

<table>
<thead>
<tr>
<th>Country</th>
<th>Wheat</th>
<th>Maize</th>
<th>Soya-beans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ukraine</td>
<td>4.1</td>
<td>5.4</td>
<td>1.9</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>1.2</td>
<td>2.3</td>
<td>2.1</td>
</tr>
<tr>
<td>Russia</td>
<td>3.1</td>
<td>4.4</td>
<td>1.5</td>
</tr>
<tr>
<td>USA</td>
<td>3.1</td>
<td>11.1</td>
<td>3.3</td>
</tr>
<tr>
<td>Turkey</td>
<td>2.8</td>
<td>8.9</td>
<td>4.3</td>
</tr>
<tr>
<td>Ethiopia</td>
<td>2.8</td>
<td>3.9</td>
<td>2.0</td>
</tr>
<tr>
<td>Israel</td>
<td>2.8</td>
<td>30.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Canada</td>
<td>3.3</td>
<td>10.0</td>
<td>2.6</td>
</tr>
<tr>
<td>Chile</td>
<td>5.3</td>
<td>11.2</td>
<td>1.0</td>
</tr>
<tr>
<td>China</td>
<td>5.4</td>
<td>6.1</td>
<td>2.1</td>
</tr>
<tr>
<td>Switzerland</td>
<td>6.0</td>
<td>8.4</td>
<td>2.5</td>
</tr>
<tr>
<td>New Zealand</td>
<td>10.0</td>
<td>10.9</td>
<td></td>
</tr>
</tbody>
</table>

Source: OECD data: https://data.oecd.org/agrooutput/crop-production.htm

The World Bank estimates that a free market for farmland would generate at least US$ 1 billion a year in rural investments. As Ukrainian agrarian land is “frozen” by legislation, necessary resources in terms of technology and proper agro-management are limited, especially for smaller agrarian companies. Commercial banks working in Ukraine do not accept land under the moratorium as collateral for issuing credits, and this is one of the reasons why banks are usually not keen to finance farmers with cultivation below 500 ha. Farmers do not feel stability towards the future under the land moratorium, therefore their ability and willingness to invest is limited. Lease agreements do not give sufficient stability for investment projects. The table below shows the continuous orientation of Ukrainian agrarian exports towards commodity products under the land moratorium, but the data confirm ability of Ukrainian producers to reorient exports to new markets. Investments into food processing should benefit from the cancellation of the moratorium.

Table 3
Export of ready-made food products from Ukraine (IV chapter of Ukrainian classification of goods of foreign economic activities)

<table>
<thead>
<tr>
<th>Year</th>
<th>Export in US$ billion</th>
<th>Percentage of total exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>3.56</td>
<td>5.6%</td>
</tr>
<tr>
<td>2014</td>
<td>3.10</td>
<td>5.7%</td>
</tr>
<tr>
<td>2015</td>
<td>2.47</td>
<td>6.5%</td>
</tr>
<tr>
<td>2016</td>
<td>2.45</td>
<td>6.7%</td>
</tr>
<tr>
<td>2017</td>
<td>2.83</td>
<td>6.5%</td>
</tr>
<tr>
<td>2018</td>
<td>3.02</td>
<td>6.4%</td>
</tr>
</tbody>
</table>

Source: www.ukrstat.gov.ua

Agrarian development requires stability and knowledge. If there is no stability there is also no drive for knowledge. A continuous increase of professional agri-technical knowledge is needed. Agrarians should be prepared to face climate change: during the last 20 years the average air temperature has risen in Ukraine by 0.8 °C, and in summer time

⁵ Data from the Ukrainian Club of Agrarian Business.
even by 1.3 °C.⁶

Also thanks to the land moratorium, the concentration of agrarian land in the hands of agroholdings has increased in recent years. Even after the “agroholding boom” of 2005-10, their number and cultivated land size continue to grow. In 2017 there were 93 agro-holdings in Ukraine (cultivating land over 10 thousand ha), up from 80 in 2012.⁷ The volume of agrarian land under cultivation by agroholdings increased in the last six years from 5.6 million ha to 6.25 million ha in 2018. Agroholdings concentrate mostly on one-year crops with rather limited added value.

Without a doubt, agroholdings are playing an important role in Ukraine, creating an important part in export proceedings and thus guaranteeing the macroeconomic stability of the country. A model of coexistence of agrarian companies of different sizes could be a good solution for Ukraine, preserving the principle of equal conditions for doing business. There should be space for enough players in the agrarian market that would guarantee fair competition, better food quality and lower prices for consumers. There should also be the opportunity for four million households active in cultivation and breeding to turn into physical entities – entrepreneurs or family farms.

Table 4
Average size of agrarian enterprise in different countries in ha

<table>
<thead>
<tr>
<th>Country</th>
<th>Average size of enterprise</th>
<th>Number of enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ukraine</td>
<td>417⁸</td>
<td>47.730</td>
</tr>
<tr>
<td>Romania</td>
<td>3.6</td>
<td>3.629.700</td>
</tr>
<tr>
<td>Poland</td>
<td>10.1</td>
<td>1.429.000</td>
</tr>
<tr>
<td>Austria</td>
<td>19.4</td>
<td>140.400</td>
</tr>
<tr>
<td>Ireland</td>
<td>32.4</td>
<td>137.500</td>
</tr>
<tr>
<td>Finland</td>
<td>41.5</td>
<td>54.400</td>
</tr>
<tr>
<td>Germany</td>
<td>60.5</td>
<td>276.000</td>
</tr>
<tr>
<td>Slovakia</td>
<td>80.7</td>
<td>23.600</td>
</tr>
<tr>
<td>England</td>
<td>90</td>
<td>101.000</td>
</tr>
</tbody>
</table>

⁶ Balabuch V.O., Ukrainian Hydrometeorology Institute of National Academy of Science: “Change of climate conditions in Ukraine and its influence on agricultural production.”
⁷ Data of Ukrainian Club of Agrarian Business
⁸ Legal bodies only.
⁹ International Land Coalition: “The concentration of land ownership in Latin America: An approach to current problems”.

Source: Eurostat: www.ec.europa.eu/eurostat
Ministry of Agrarian Policy and Food of Ukraine

A lesson from Latin America

Governments of Latin American countries pursuing agrarian reforms opened land markets for domestic and foreign investors, but underestimated the complexities of that transformation that often had unexpected consequences.

High land concentration was the result: the highest concentration is in Paraguay (0.94 Gini coefficient), followed by Brazil (0.86), Uruguay (0.84) and Panama (0.84).⁹ According to data from the Brazilian Institute of Geography and Statistics, up to 43 per cent of Brazilian agricultural land is in the hands of latifundists (single owners of over 500 ha). Such land concentration creates another extreme: orientation on monoculture commodity export, pushing up domestic food prices.

On 22 May 2018 the European Court of Human Rights (ECHR) decided in the case of two Ukrainian citizens "Zelenchuk and Cjucjura against Ukraine" that an absolute ban on sales/purchases of agrarian land in Ukraine equates to a breach of human rights on private property which are protected by the European Convention on Human Rights. The ECHR also stressed the necessity to keep a justified balance between the state's interests and private property rights of the claimants and recommended that Ukraine adopt more balanced land legislation in a reasonable length of time.

ECHR decisions are legally binding for Ukrainian courts within three months of the ECHR's ruling. That means that since 22 August 2018 Ukrainian agrarian land owners could turn to the Ukrainian courts based on that particular ECHR decision. A representative of the Ministry of Justice of Ukraine predicts that the ECHR can start awarding financial rewards from €2,000 to €75,000 to each claimant based on the evaluation of each particular claim, which could create a serious burden on the state budget.

Another unpleasant possible consequence of the moratorium is deterioration of the quality of...
Ukrainian soil. According to data of the Ministry of Agrarian Policy and Food of Ukraine and the Institute of Soil Protection of Ukraine, the amount of humus, the most precious part of soil, has diminished in Ukraine during the last 20 years by 0.22 per cent which represents significant deterioration; to increase 0.1 per cent of humus under natural conditions takes 25-30 years. Moreover, many agrarians in southern and eastern parts of Ukraine use only sunflower and wheat in rotation, skipping other plants. Sunflower are often grown in the same place every three years, while the recommended interval is every 6-7 years. Much of the arable land is affected by water erosion (13.3 million ha) and wind erosion (6 million ha). Rate of ploughing of arable land in Ukraine is very high, reaching 90.3 per cent in Cherson region and around 85-87 per cent in the Cherkassy, Kirovograd, Vinnitsa, Zaporizhzhya, Dnipropetrovsk and Mykolaiv regions, despite the fact that agronomic principles recommend no more than 60 per cent. It can be assumed that a real owner would be more likely to care for his own land (as he cares for his house, car or factory) and treat it not only to maintain fertility but also to increase it, in order to preserve the land for the next generations.

Other aspects of land reform

According to the “Conception on development of farm enterprises and agricultural cooperation for the period of 2018-20”, adopted by the Cabinet of Ministers on 13 September 2017 the number of farm enterprises in Ukraine (cultivating less than 100 ha) during the last 10 years declined by more than 20 per cent. The Conception introduced state aid to farm enterprises amounting to UAH 1 billion annually. To stop diminishing and to start developing farmers is not so much about state aid, it is more about the state guaranteeing property and leasing rights, providing equal rights for agrarians, improving business environment and vigorously blocking any attempts of “raider” attacks.

The number of rural inhabitants in Ukraine is declining due to urbanisation and emigration. At the beginning of 2018 only 30.7 per cent of inhabitants of Ukraine (13,015 million) lived in rural areas; a drop of 23.3 per cent over the last 27 years. The state should address this tendency through more balanced development of rural territories where proper local land management, development of farm enterprises including family farms, fostering local investments and strict protection of private property should be among the priorities. Creation of attractive conditions for living in rural areas is listed as one of the 15 priorities of state agrarian policy in the draft Law “On basic principles of state agrarian policy and state policy on rural development” registered in the Verkhovna Rada on 4 October 2018.

On 12 February 2015 the Verkhovna Rada of Ukraine amended the Land Code of Ukraine inserting a minimum lease term of seven years for the cultivation of agrarian land while conducting farming or “special village units” activities. This change weakened the position of state, communal and private agrarian land owners with regards to disposal of ownership and the level of lease fees. On the other hand, the amendment improved position of lessees, mostly agrarian companies.

What to do next?

The Cabinet of Ministers of Ukraine should register at the Verkhovna Rada of Ukraine the draft law “On agrarian land circulation” that has been prepared by the expert working group headed by the Ministry of Agrarian Policy and Food of Ukraine.

The adoption at the second reading by the Verkhovna Rada of the draft law No. 8121 “On amending Land Code” and other laws regarding acting against “raiders” should significantly curb legislative bottlenecks being used by “raiders”.

Within the state banking sector it would be reasonable to open a state aid programme to cover interest rates (up to the current base rate of the central bank) of long-term credits (up to 15 years) to small and medium-sized Ukrainian farmers for agrarian land acquisition.

Derzgeocadaster should conduct an immediate and complex inventory of all state-owned agrarian land to work out illegitimate usage or holding of state-owned land, missing or incorrect registration of state-owned land plots at the State Land Cadastre.

As Derzgeocadaster still disposes of the major part of state-owned agrarian land, it should offload its responsibility for conducting surveillance and control
on agrarian land to another state institution in order to avoid a conflict of interest.

It would be reasonable to implement obligatory electronic auctions for the sale of lease rights of all state-owned and communal-owned agrarian land by amending the Land Code of Ukraine and respective laws.

The current seven-year minimum term of leasing agrarian land should be cancelled by amending the Land Code of Ukraine.

It is essential to amend the Law "On land management" and Law "On topographic-geodetic and cartographic activity" in order to cancel the obligatory certification of engineers-surveyors and engineers-land managers as it could create space for corruptive and restrictive activities in the certification process.

In order to support soil protection and sustainable agrarian land usage it is essential to work out and adopt the draft Law "On economic stimulation of sustainable agrarian land usage".

As the Constitution of Ukraine requires to pay taxes according to laws and normative-monetary evaluation of agrarian land value has a direct connection to taxes (single tax of IV group; land tax; state tax on exchange, inheritance and donation), the Decree No.552 of the Ministry of Agrarian Policy and Food from 16 November 2018 "On confirmation of technical documentation of all-national (all-Ukrainian) normative-monetary evaluation of agrarian land" should be confirmed by law.

State aid for agriculture should be limited to each agricultural company up to a threshold of maximum number of hectares cultivated. State aid itself should be distributed based on the hectares cultivated up to the adopted edge. Public servants who have never been engaged in farming should not decide on so-called "priority areas" where state aid on agriculture is eligible.

It would be reasonable to implement recommendations of the United Nations Food and Agriculture Organisation (FAO) as well as of the United Nations Economic Commission for Europe (UNECE) on proper state management of land resources.
Chapter 7

Privatisation and SOE reform

Andriy Boytsun

Legacy

As a post-Soviet country, Ukraine had a very difficult legacy. First of all, all major assets had been owned by the state, hence private ownership was absent. Second, the country had a command-and-control economy, so there was no market. Consequently, Ukraine had no legal framework to govern private property or market transactions, as well as no institutions to support and enforce this. In other words, in the early 1990s, the country had none of the infrastructure of a market economy whatsoever.

Privatisation

Privatisation was one of the three elements of the “transition” recipe.¹ The idea was to hand over formerly state-owned assets to individuals so that a class of private owners would be created. As the international experience has demonstrated, the method of privatisation matters a great deal here.²

In Ukraine, the privatisation process was ill-designed and distorted by parliament during the implementation phase.³ As a result, strategic investors rarely became owners of high-quality assets, while the shares of most citizens lingered in trust funds. Such privatisation had cemented the position of “red directors”, provided politically connected individuals access to the state assets and – in this manner – has laid the foundation of the oligarchy in Ukraine.

The privatisation of state assets⁴ started with the privatisation law adopted in March of 1992. In 1992-94, the privatisation was often based on the preferred share allocation mechanism, when the employees (effectively, the incumbent management) bought out the company on preferential terms. Out of nearly 12,000 companies privatised in 1992-94, some 80 per cent were privatised in this manner, leaving strategic investors out of the equation.

These incumbent positions had been built earlier, in 1989-92, when management and employees were allowed to lease their state-owned enterprises (SOEs) on a long-term basis. That lease was then used as the basis for preferential privatisation and as a mechanism to reduce the attractiveness of the SOE to external investors. The institutions running this process were the Ministry of Privatisation (as a policymaker) and the State Property Fund (as the implementer of the policy).⁵

In 1994, two changes took place. First, mass privatisation through vouchers (privatisation certificates) was launched by a presidential decree. Second, the law was changed to shift the policymaking powers to the State Property Fund. Technically, during the voucher privatisations, some 50,000 SOEs were privatised in 1995-98. However, the actual change of ownership (transfer of more than 70 per cent of ownership into private hands) only took place in a third of these companies and the state remained a very significant owner.⁶

In addition, the voucher procedure was rather cumbersome. As a consequence, out of the 46 million people who received the vouchers, only 19 million became owners of shares. Moreover, most vouchers would end up in the hands of intermediaries or incumbent management, which created a basis for the consolidation of ownership in respective SOEs. This was relatively straightforward, as – after the serious economic decline – citizens were often tempted to sell their privatisation vouchers for cash. Formally, the vouchers could not be sold, but the intermediaries – the trust funds – quickly devised a mechanism of exchanging the vouchers for a share in the trust fund. As of the end of 1996, these funds were able to concentrate about 20 million vouchers.

The “red directors”, that is, former top executives of

¹ The other two are price liberalisation and macroeconomic stabilisation.
² Havrylyshyn and McGettigan (2000).
³ VoxUkraine (2016).
⁴ For the purpose of this paper, we ignore the privatisation of citizens’ own housing, which had also been the property of the state.
⁵ The Ministry of Privatisation was disbanded in 1994, as we discuss below.
⁶ VoxUkraine (2016).
the privatised companies, have been able to concentrate their SOEs' shares in their hands, often by using intermediaries to purchase shares from employees and/or diluting minority shares via additional share issues. For example, Vyacheslav Boguslayev has been the CEO of Motor Sich since 1988. The first 27 per cent of Motor Sich shares were purchased in 1994 by 25,000 employees of the plant.⁷ It was fully privatised by the year 2000, still formally owned by the employees. In 2017, the Security Service of Ukraine suspected Vyacheslav Boguslayev of the illegal sale of 56 per cent of the enterprise's shares to a Chinese investor.⁸

As a result, the mass privatisations of the 1990s have helped to create a class of oligarchs rather than private owners and left a perception of unfairness.

The crony privatisations of large SOEs in the 2000s are likely to have further discredited the privatisation process in Ukraine. In 2004, as the second term of President Kuchma was ending,⁹ a very large steelmaker, Kryvorizhstal, was sold at an artificially low price of some US$ 800 million in an opaque auction to a consortium of Ukraine's largest oligarch, Rinat Akhmetov and the president's son-in-law, Viktor Pinchuk. This privatisation was reversed after the 2004 Orange Revolution and the company was re-privatised in 2005 at a price of US$ 4.8 billion, which was 5.7 times as much as the 2004 selling price. The winning buyer was Mittal Steel, one of the world's largest steelmakers. Nonetheless, this remains perhaps Ukraine's only exemplary privatisation of a large SOE.

In 2011, another national giant, the national telecom operator Ukrtelecom was sold for US$1.3 billion in a questionable privatisation auction to unknown buyers (a company named ESU owned by a subsidiary of EPIC Invest, an Austrian-based investment company) and later ended up in the hands of Rinat Akhmetov.

As a result, popular support for privatisation of small enterprises has declined steadily from 56.2 per cent in 1992 to 32.2 per cent in 2016. Those against privatisation tripled from 13.6 per cent in 1992 to 36.7 per cent in 2016. In fact, the number of opponents exceeded the number of supporters in 2016 (see Figure 1).

For large SOEs, the situation was even worse: as Figure 2 shows, some 25.1 per cent of Ukrainians exhibited a positive attitude towards privatisation of large enterprises in 1992, but this support halved to 13.8 per cent in 2016. At the same time, the negative attitude increased from only 31.6 per cent in 1992 to an astonishing 62.3 per cent in 2017.¹⁰

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⁹ According to the Ukrainian Constitution, the president can serve a maximum of two terms.

¹⁰ Parashchevin (2016).
The most dramatic change has been in the popular support for privatisation of land (see Figure 3). Although a vast majority of 63.5 per cent had supported this reform in 1992 (with 13.9 per cent against), the tables have turned to produce almost a mirror image in 2016, with some 58.9 per cent of Ukrainians opposing and only 16.7 per cent supporting land privatisation. Not surprisingly, the support for a land market also plummeted from 38.5 per cent in 1994 to 23.1 per cent in 2016, with the percentage of opponents growing from 44.4 per cent to 63.1 per cent respectively (see Figure 4).¹¹

A common explanation is that the opaque sales of SOEs to insiders, red directors and politically connected individuals in the early 1990s have created an image of privatisation as something very unfair and have seriously undermined public trust in it. Anecdotal evidence also shows that the general public will often attribute the fortunes of Ukrainian oligarchs to these privatisations.

Note that there was a very strong upsurge in popular support for privatisation of both large and small SOEs after the Revolution of Dignity in 2014 (Figures 1 and 2), which can likely be attributed to the greater trust that the public had in reforms in general and, in particular, in fair and transparent privatisation. It is notable that this upsurge cannot be attributed to targeted communication: there was no massive communication of the benefits of transparent privatisation at the time. It is likely to be the result of a greater general awareness and appetite for structural reforms. However, general trust in reforms has waned since 2014, which may explain the further decline in the support for privatisation that made it less attractive to politicians.

At first sight, there seems to be a paradox: on one hand, citizens are strongly against corruption and perceive SOEs to be a major source of corruption.¹² On the other hand, they are very likely to perceive the privatisation process itself as another, possibly even larger, source of corruption, leading them to oppose the idea of privatisation at all. Citizens would welcome transparent and fair privatisation and the government needs successful cases of privatisation to demonstrate that this is possible.

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¹¹ No data are available for 1992, 2002 and 2004.

¹² In a survey by the Centre for Economic Strategy, 84 per cent of respondents agreed with the following statement: “Politicians steal money from state-owned enterprises, and then use this money to finance elections. As a result, honest politicians have little chance of winning the elections.” 74 per cent agreed with the statement: “Private enterprises invest much more in new technologies, expand production, and create more jobs than state-owned enterprises.” 74 per cent agreed with the statement: “Under state ownership, enterprises are often plundered, which the private owner will not allow.” Available online at: https://ces.org.ua/en/wp-content/uploads/2017/11/report_critical_thinking_ENG-for-web.pdf.
Interestingly, the design of the privatisation framework and corporate governance in SOEs seems to have been appropriate in 1992. Originally, the State Property Fund was established – as the name suggests – for the purpose of managing state property – that is, running the assets owned by the state – including SOEs, non-corporatised infrastructure and real estate. The fund would sell these assets when instructed by the policymaker and, otherwise, manage them.

A Ministry of Privatisation was established along with the State Property Fund, with the former responsible for policymaking and the latter for policy implementation. However, this design was quickly “reformed” in 1994, when parliament significantly enlarged the powers of the State Property Fund, including the policymaking functions. The Ministry of Privatisation was abolished at the proposal of the then privatisation minister Roman Shpek.

Due to the asset management function of the fund, it quickly ran into conflict with line ministries that held SOEs in the respective industries and saw themselves as responsible for managing these SOEs. The line ministries and incumbent management protected their position by asking the parliament to include their SOEs on the list of SOEs whose privatisation is forbidden by law.

As a result, despite the privatisations described above, the state has remained the country’s largest owner of SOEs. In 2018, the State Property Fund reported that 3,530 companies were owned state by the state at the central level of government.¹⁴ In 2017, the total assets of the top 100 SOEs were UAH 1.5 trillion, which is 15 per cent of the assets of all Ukrainian enterprises. The revenue of the top 100 SOEs in 2017 was UAH 584 billion, which was 8 per cent of the revenue of all Ukrainian enterprises. Note that these numbers do not account for the thousands of enterprises owned by regional and local governments, for which no statistics are available.¹⁵

Most of Ukraine’s really large and important assets have stayed in the hands of the state. These include the national oil and gas champion Naftogaz of Ukraine, the national railway operator Ukrzaliznytsia, the electricity transmission system operator Ukrenergo, the national postal operator Ukrposhta, the nuclear power generator Energoatom and the hydropower generator Ukrhydroenergo. The privatisation of these SOEs is prohibited by law.

However, the state’s portfolio also includes numerous other large and smaller SOEs that cannot be privatised by law. Examples include Artemsil, a large salt-mining company, or Konyarstvo Ukrainy, a horse breeding company that owns about 40,000 hectares of land.

The list of such SOEs is extensive and includes about 1,400 companies. Nevertheless, the state has been reluctant to approach corporate governance issues in these SOEs, letting them function pretty much in the same fashion as they did under the Soviet rule. Often, they were similar to extensions of line ministries, bureaucratic monsters poorly adapted to the new workings of the market and shielded from market forces by the state.

At the end of 2008, as the “gas war” between Russia and Ukraine was approaching, the author of this chapter organised a public discussion of corporate governance at Naftogaz of Ukraine.¹⁶ Nearly all Ukraine’s major economic and gas experts of the time took part in the gathering. Yet, the idea of better corporate governance for a state-owned company seemed too novel, strange, and, perhaps, naïve to most of them in 2008. Most of those present said that it “would not fly in our country”. In fact, it seems that the idea itself was quite clear to those in power, but they were simply unwilling to relinquish their control. At the same time, the quality of the expert community was too low, and its influence too weak, to affect the decision of the incumbents.

Although we were discussing just one SOE, it was the largest and the most visible one, especially in light of the rapidly growing gas dispute with Russia. What

¹³ The full name was “The Ministry of the Ukrainian SSR for the De-statisation of Ownership and the De-monopolisation of Production”. See the scope of its functions at https://zakon.rada.gov.ua/laws/show/147-91-%D0%BF.
¹⁴ See http://www.spfu.gov.ua/ua/content/spf-stateproperty-Subiekty-gospodaruvannya.htm.
¹⁵ The Anti-monopoly Committee of Ukraine has recently estimated that Ukraine had around 11,000 regional and local SOEs, but this appears to be an informal estimate.
about other SOEs, then? It appears that, in Ukraine, no expert cared to understand the importance of good corporate governance in companies that had remained state-owned, despite the fact that they were very large (as demonstrated by the size of their assets), abundant (as shown by the numbers above), poorly run (as shown by the low profitability of the state’s portfolio and the large number of loss-making SOEs),¹⁷ and constituted one of the greatest – if not the greatest – sources of corruption (see Box 1).

Against the poor record of privatisation, public opinion has increasingly favoured state ownership. However, there was little or no sense of ownership on the part of the citizens. State property was perceived as nobody’s property rather than the property of the people of Ukraine. Consequently, there was no demand for accountability from Ukraine’s SOEs: The public did not know their financial results (not even if they were profitable or loss-making), not to mention their strategies or even the reason why the state chose to own them.

In particular, state-owned banks (SOBs) were heavily misused for financing SOEs, diverting funding to private companies affiliated with political patrons or outright stealing. Ukraine has had to spend US$ 15.5 billion to prop up its state-owned banks since 2008. In particular, US$ 5.8 billion was injected into the capitalisation of PrivatBank, US$ 3.5 billion in Oschadbank, US$ 2.8 billion in Ukreximbank, US$ 1.6 billion in Rodovid Bank, US$ 1.4 billion in Ukrgasbank and US$ 0.5 billion in Bank Kyiv.²⁰

The amount of money lost by other SOEs is largely impossible to estimate. Much of the loss is hidden in the loans given by SOBs and regularly restructured to avoid insolvency of both SOEs and SOBs. The government has also provided continued state aid to some SOEs. The most recent example is the provision of US$ 18 million to state-owned coal mines to repay salary arrears.

However, in many cases, the magnitude of state aid is very difficult to estimate, as it has come in the form of tax breaks, preferential tariffs for monopolies, or market entry barriers for potential competition. Suffice it to say that Naogaz alone had lost US$ 9.7 billion in 2013-15. After a successful turnaround and corporate governance reform, it made a profit of US$ 2.3 billion in 2016-17.

Box 1: Corruption in Ukrainian SOEs

The scale of this problem is evidenced by the statistics of the National Anti-corruption Bureau (NABU). The Bureau has investigated over 100 criminal proceedings against corruption in state-owned enterprises (SOEs). According to NABU’s preliminary estimates, the total losses incurred by these SOEs exceed UAH 20 billion (about US$ 800 million at the date of the NABU report). This makes SOEs not only a source of corruption, but the largest source of corruption.¹⁸

However, the advancement of these cases is hampered by the courts. Among the NABU’s five largest cases, four are related to the management of SOEs: the State Food and Grain Corporation of Ukraine, Zaporizhzhya Civil Project, UkrGasVydobuvannya and Chervony Zemlerob.

According to Artem Sytnyk, Head of the NABU, the damages from corruption in SOEs are greater than the amounts of loans received from the IMF.¹⁹

Among the investigations that have already been submitted to the courts are the cases related to UkrGasVydobuvannya (UAH 3 billion), Ukrzaliznytsia (almost UAH 0.5 billion), the Ukrainian Seaport Authority (UAH 247 million in potential losses) and Oschadbank (US$ 20 million, or around UAH 500 million at the date of the NABU report).

¹⁷ See VoxUkraine (2018).
¹⁹ Zbytky vid koruptsiyi u derzhavnykh pidpryyemstvakh bilshi, nizh tranship MVF, – Sytnyk. [in Ukrainian; English translation: Losses from corruption in state-owned enterprises are larger than IMF tranches, says Sytnyk], Espreso TV, 08/02/2019. Available online at: https://espreso.tv/news/2019/02/08/zbytky_vid_korupciyi_u_derzhavnykh_pidpryyemstvakh_bilshi_nizh_transhi_mvf_sytnyk.
²⁰ Boytsun et al. (2017).
Consequences

Limping privatisation, mismanagement and corruption in SOEs are among the major reasons why Ukraine has experienced slow, fragile and very volatile economic development. In particular, the country has had a miserable record of attracting foreign direct investment (FDI), which was the engine of economic growth in post-Communist countries, such as Poland or Slovakia.²¹

Figure 5
Cumulative FDI inflow per capita in Poland, Slovak Republic and Ukraine, US$ million.

This has given rise to state capture and grand corruption.²² Ukraine is ranked 99th among 140 countries on favouritism²³ in decisions by government officials. The country is ranked 130th out of 180 countries on Corruption Perception Index²⁴ (see Figure 6). As a result of state capture and corruption, Ukraine often has monopolised or uncompetitive markets, with higher prices and lower quality of products and services. Foreign investors rate monopolisation²⁵ as the fourth biggest obstacle after corruption, distrust for the judiciary and an unstable financial system.

In addition, access to finance for the private sector has been very problematic, leading to slow development of small and medium-sized businesses. Poor liquidity,²⁶ which could be resolved by bank loans, is mentioned as a problem by 49 per cent of Ukrainian businesspeople. By way of example, the average interest rate on loans is 16.4 per cent in Ukraine, while it is 2.5 per cent in Slovakia.²⁷

Figure 6
Corruption perception in Poland, Slovak Republic and Ukraine

According to the State Statistics Committee, there were 1.5 million registered private entrepreneurs (almost all micro-businesses) and 338,000 enterprises (including 278,000 micro-businesses) in Ukraine in 2017. There were only 399 large enterprises (0.02 per cent of all business entities), but they employed 24 per cent of workers and produced 35 per cent of the revenue. Despite the relatively large proportion of small and medium businesses, they are still not very active, say, compared to the

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²¹ Boytsun and Yablonovsky (2018a).
²² Boytsun and Yablonovsky (2018b).
²⁶ Kuziakiv (2018).
German Mittelstand. Ukrainian SMEs are focused mainly on local markets and are often engaged in simple trade, while the German Mittelstand businesses often grow to become national and then global champions in specific market niches.

Worse, this is largely responsible for the dysfunctional and polluted political system. Because control over the SOEs created vast opportunities for graft and gave immense power, the political system has attracted the type of politician that was looking for exactly such opportunities. This also distorted the system itself. Specifically, Ukraine ended up with a system of diluted accountability, which manifests itself in at least two respects.

First, parliamentary elections are based on the so-called mixed system and that mix is very unfortunate. Half of the parliament (225 seats) is elected by majoritarian rules, while the other half is elected by proportional rules. As a result, it is entirely unclear who the parliament members are accountable to. It is also unclear how the parliament coalition is formed. Second, the division of powers and responsibilities between the president and the prime minister is unclear. This further dilutes accountability and embeds competition between these two institutions in the very political configuration.

As a result, in such a system, it is easy to block any reform effort, as this only requires that one or two of the stakeholders should block it. On the contrary, it is difficult to get any reforms done as this requires the agreement of all stakeholders.

The economic consequences of this setup are very real. First, because the SOEs are inefficient and uncompetitive – and a very large share of the national economy is made up of them – the entire economy has been uncompetitive. Specifically, Ukraine ranks 81st among 137 countries in the Global Competitiveness Index. This is reflected in the poor international presence of Ukrainian products and services and in low growth numbers (see Figure 7).

Figure 7
GDP per capita in Poland, Slovak Republic and Ukraine, US$.

Second, the economic structure of Ukraine is skewed into natural resources and basic products rather than value-adding high-tech industries or services, possibly because there is little incentive for SOEs to innovate and to take risks (see Chapter 2 on page 35). Besides making the economy poorer, this also increases its dependence on the world economic cycles and global commodity prices, which can be especially volatile because Ukraine is not a global geopolitical player and is a price taker in global markets. Any fall in global prices for wheat or metals creates pressure on local currency, resulting in a negative trade balance and declining GDP.

Finally, the net fiscal result from state-owned assets is very modest. According to our calculations, the annual return on SOEs' total assets was negative in 2014-15. Although it became positive in 2016, it reached only 2 per cent, which is a very low number.

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28 Mittelstand commonly refers to small and medium-sized enterprises in German-speaking countries, especially in Germany, Austria and Switzerland. Most definitions define the Mittelstand as a statistical category and most commonly suggest that Mittelstand firms are small and medium-sized enterprises with annual revenues up to €50 million and a maximum of 499 employees.

29 Zholkver, Nikita (2009), Maly i sredni biznes ostayetsya fundamentom nemetskoy ekonomiki [in Russian; English translation: Small and medium-sized businesses remain the foundation of the German economy], in Deutsche Welle, 17/04/2009. Available online at: https://www.dw.com/ru/малый-и-средний-бизнес-остается-фундаментом-немецкой-экономики/a-4184020


32 The Ukrainian exports in 2017 made up 40 per cent of GDP, of which 26 per cent was services and 74 per cent goods. The main goods exported were ferrous metals (20 per cent of merchandise exports) and grain (15 per cent of merchandise exports). To compare, Poland, which is also an open economy, is mainly exporting machinery (24 per cent of merchandise exports) and transport equipment (14 per cent of merchandise exports).
compared to the bank deposit rate of 18 per cent that Ukrainian banks were offering that year. It is even lower than the inflation rate of 12.4 per cent in 2017, de facto making the return on assets negative.

What has been done

SOE reform

Background

After the Revolution of Dignity, presidential elections and parliamentary elections in 2014, there was a massive demand for reform in nearly all areas; and privatisation and SOE reform was no exception. Nonetheless, like in many other countries, this turned out to be one of the most difficult areas of reform due to very tangible vested interests.

At the end of 2014, the Ukrainian state was the largest owner of enterprises and other assets in the country. The top 100 state-owned enterprises generated a total loss of UAH 117 billion in 2014 and UAH 53 billion in 2015. The total assets of these SOEs were some UAH 870 billion, with about 70 per cent of the total assets concentrated in the energy sector (such as Naftogaz, Ukrenergo or Energoatom) and 15 per cent in infrastructure (such as Ukrzaliznytsia, Ukrposhta, airports and sea ports). The top 100 SOEs accounted for about 90 per cent of the total assets of all SOEs. According to the Ministry of Economy, in 2014, Ukraine had 3,350 registered SOEs, out of which 1,833 were operating SOEs, with a total workforce of more than one million employees.

Corporate governance reform in Ukrainian SOEs showed a promising start at Naftogaz in 2014. Although it generated very visible performance improvements, it was slowed down considerably in 2016. In other SOEs, it came to a halt (for example, no supervisory boards were established in other large companies) in 2016.

Biggest achievements

Although the Naftogaz case was the only case in 2014-16, it was a success story of corporate governance reform. The company boasted an independent supervisory board, composed of three world-class international members, with profound experience in the oil and gas industry and two Ukrainian state representatives: the former Minister of Energy and the First Deputy Minister of the Economy.

The Naftogaz reform has also spurred action at the national level. After lengthy debates in late 2015, the parliament adopted a new law on corporate governance in SOEs. The law introduced three fundamental changes in SOEs, even when such enterprises were not corporatised: (I) it increased disclosure requirements, (II) it made auditing of SOEs mandatory and (III) it required that major SOEs establish supervisory boards, with a majority of independent directors. The last element is crucial in severing the link between politicians and SOEs. However, the president vetoed the law, asking for it to exclude military companies from its coverage. At the second attempt, the amended law was signed by the president (Law 1405-VIII, dd. 02/06/2016), thus becoming effective.

For the Groysman Cabinet, appointed in April 2016, it now became a matter of putting this law into practice, which required developing and adopting secondary legislation. This work progressed as the prime minister declared privatisation and SOE reform as one of the cabinet’s top five priorities in 2017. As a result, the secondary legislation was approved, with the cabinet resolutions governing the nomination of supervisory board members in SOEs being the most important part.

As a quick solution, the cabinet had attempted to reform the SOE Nomination Committee, which had been established by the previous government. Because the reform was restricted to a changed composition of the Committee, this turned out to yield little fruit. The new composition of the Committee included almost half of the Cabinet of Ministers (nine deputy prime ministers or ministers) and an equal number of non-government representatives (including the heads of regional offices of the IMF, the EBRD, the World Bank and the IFC).

The very first meeting of the Committee resulted in a robust difference of opinion between the ministers and the non-government representatives, bringing its work to a halt for a year. In particular, the pre-selection of board candidates by line ministries with the shortlist presented to the Committee lacked transparency and professionalism. In addition, the administrative capacity of the Committee whose work was supported by the Ministry of the Economy was weak. Finally, the Committee itself was too large (18 members) to allow a structured and organised discussion.

It appeared that a more profound change was necessary; the cabinet approved the nomination procedures in March 2017 and fundamentally reformatted the working of the Committee in March 2018. This included:

- raising it to the level of the Cabinet of Ministers
- transparent pre-selection of board candidates assisted by a respected international executive search company
- a strong Committee secretariat
- a new composition of four government representatives and four international observers (heads of regional offices of the IMF, the EBRD and the IFC, as well as the Business Ombudsman).

The new nomination process started very well. As a result, the government has been able to establish independent supervisory boards in four very large and important SOEs – Ukrzaliznytsia, Ukrenergo, Ukrposhta and Ukrainian Sea Port Authority – fairly quickly and was completing the establishment of a supervisory board in Airport Boryspil at the time of writing.

Finally, the state owns four large banks: Oschadbank, Ukreximbank, Privatbank and Ukrgasbank. Until recently, the law did not only not mandate, but effectively prohibited independent supervisory boards in Oschadbank and Ukreximbank. Their boards had been composed of purely political appointees (five appointed by the president, five by the parliament and five by the cabinet). Supposedly the most important governance body of the state-owned bank, the board has been little more than a rubber stamp: board members had to vote according to the voting instructions they were receiving from the body that appointed them and they were not allowed to receive any remuneration.

After three years of pressure from the international financial institutions (IFIs), the parliament has finally adopted the law on corporate governance in state-owned banks. The cabinet quickly adopted most of the secondary legislation required to establish such boards, much in the same vein as it did for SOEs. At the time of writing, the executive search companies were selected, the Nomination Committee for SOBs was established, and the selection process was on, with the aim to appoint it the new supervisory board members by 10 May 2019.

Biggest failures

Although the above achievements are real, they took an enormous amount of time, some four years after the parliamentary coalition was formed at the end of 2014. If the SOE reform were only a technical problem, these results could have been achieved in a year or so. However, vested interests benefiting from state ownership in Ukraine are so powerful and so intertwined with the politicians and state bureaucracy that they can be most effective at building up resistance.

As a result, although independent supervisory boards have been established in several major SOEs and the nomination process works well today, these boards lack fully-fledged powers to be completely independent of the politicians and thus to fend off political meddling and graft. Consultants and the EBRD had developed a draft law to give these powers to the supervisory boards – most importantly, the power to appoint the CEO and approve the annual budget (financial plan) – as early as 2015 as part of the corporate governance of Naftogaz. However, the proposal met with very fierce resistance from vested interests who successfully opposed it at all stages: through the government bureaucracy and in the parliament. Ultimately, the law was watered down and finally blocked in the parliament’s anti-corruption committee.

This experience is not unique to Ukraine. The parliament declared the intention to base its
corporate governance reform on OECD standards,³⁴ when it included this in the Coalition Agreement.³⁵ However, besides the problem of vested interests opposing the change, another problem is that incumbent politicians feel responsible for the SOEs that they oversee. They fear relinquishing control to independent “strangers”, when ultimately it may be them who end up bearing political responsibility for the SOEs.

In the Ukrainian political context of distrust, in their eyes, it may not be a replacement of old-school political controls with controls based on OECD standards, but rather losing control to someone else. All in all, as the international corporate governance practice demonstrates, many OECD countries themselves still fall short of OECD standards, with the Nordic countries being the best example.

Another problem was the failure to adopt an explicit and binding state ownership policy, explaining the rationale for the state owning each of its largest SOEs. This task sounded very abstract at the onset of the reform in 2014, but became very concrete as the corporate governance changes unfolded. Like in many other countries, the state found it difficult to formulate explicitly why it chose to own individual SOEs. In 2017, the cabinet approved an overarching state ownership policy, but it is more of a useful guide than a strictly enforceable instrument.

Having such a policy would make a lot of difference, as it would create clarity for citizens, as well as the supervisory board and management of the respective SOEs on what objectives they should be achieving and, consequently, how their performance will be judged. For example, if the rationale for owning Naftogaz is to achieve energy independence of the country, then the company will have to invest billions of dollars in the gas production infrastructure and energy saving. If the rationale is to maximise financial profits, then the company will invest nothing in gas production, but will encourage massive use of gas and import as much gas as possible. These are very different behaviours depending on the ownership policy.

The core of the matter is in the public policy objectives that the state is trying to achieve through its SOEs, typically via implicit or explicit public service obligations imposed on the SOEs. For example, Ukrposhta is obliged to deliver pensions in rural areas, but it claims that performing that function causes the company to lose UAH 1 billion annually. The solution to this issue lies in the explicit and separate accounting for the cost of the public service obligation, for which the state pays if it imposes it.

If the costs of the public service obligations are accounted for separately, then profit becomes the best criterion for evaluating the performance of an SOE. Otherwise, there is no level playing field between SOEs and their private counterparts. At times, the state could misuse SOEs to achieve public policy objectives; at other times, it could help them out when they run into trouble. Ultimately, competition is distorted and the overall competitiveness of the economy suffers.

Yet another problem was the failure to counter resistance on the part of conservative forces that have been trying to hold back reform. Resisting a reform is, in a way, easier than implementing it: to complete a reform, you need all the critical elements to be present; to stall it, you only need to obstruct one or a few critical elements. In addition, the pain of the losers from the reform is very real; the joy of the winners is often less tangible.

One example of such resistance is the adoption of the legal requirement for supervisory board members to submit e-declarations and disclose all their holdings, in the same manner as civil servants and politicians have had to do according to the 2014 anti-corruption law.³⁶ This requirement for board members was never proposed as part of the reform or debated publicly. It was introduced in a sneaky manner (popular in the Ukrainian law-making practice) and only came to light when changes to the anti-corruption law were adopted in 2017. As a result, this effectively discouraged a great deal of applicants for the supervisory board positions. Based

³⁴ For the sake of brevity, we refer to the OECD Principles of Corporate Governance and the OECD Guidelines on Corporate Governance of SOEs collectively as OECD standards.
³⁵ Verkhovna Rada of Ukraine (2014).
on the pure number of applications observed in the nomination process, some 25 per cent of the candidates approached by the executive search consultants declined to apply for a supervisory board position in Ukrainian SOEs because of these requirements. More importantly, these were usually the best candidates.

Another way of resisting was to **decrease the proposed remuneration of board members** to unattractive levels. The board remuneration in Ukraine’s two largest SOEs, Naftogaz and Ukrzaliznytsia, was very attractive (up to US$ 240,000 a year). However, any smaller state-owned companies would end up with a ceiling that prevented them from attracting world-class professionals. For example, the national postal operator Ukrposhta, employing about 73,000 people, had a ceiling of some US$ 48,000 a year. The same went for Ukrenergo, the national transmission system operator for electricity.

The upshot was that many qualified candidates would be put off by either limited board powers, unclear company objectives, the cumbersome requirement to declare the candidate’s and their family’s holdings, internationally uncompetitive remuneration levels or a combination of these conditions. In addition, in 2017, after lengthy talks at the top level, almost the entire supervisory board of Naftogaz stepped down citing the lack of progress in corporate governance reform as the reason for their decision.

Finally, resistance has been strongest on the front of **state-owned banks**. Although consultants had drafted the law and secondary legislation that were necessary to enable independent supervisory boards in such banks as far back as February 2016 and the reform was strongly supported by the IFIs, it was held back at every step. The parliament’s anti-corruption committee was used to kill the draft law in April 2016.

Regaining momentum with the new cabinet was very difficult. Unlike with SOEs, the cabinet was not the only party involved in the governance of state-owned banks and nominating their boards; the president and parliament were also involved. After the new cabinet was appointed in 2016, the topic became less urgent and disappeared from the priority list for almost two years. It was revived in 2018 under continued pressure from the IFIs and the law eventually became effective at the end of the year.

Why not more

The answer to this question boils down to four things:

- poor understanding of the benefits of the reform
- weak political will
- strong resistance from vested interests
- informal rules.

The **poor understanding of the benefits of the reform** was, perhaps, the least problematic element. To be sure, it took quite some time to communicate the essence of the modern corporate governance system that was proposed. Since the proposed changes were quite radical, relative to the old and obsolete system, it naturally entailed the fear that things could go wrong. However, it helped that the “recipes” were known: reformers were not reinventing the wheel, but proposing to implement a set of mechanisms that had proved to work well in developed economies.

For convenience, the reformers referred to the OECD standards of corporate governance. This had at least three advantages. Firstly, this framework was understandable to outsiders and the standards were very concrete when applied in practice. Secondly, it was a convenient external reference point that made it easy to formalise commitment: for example, it could be used for formulating a covenant in a loan agreement. Thirdly, having that reference as a guideline minimised the possibility for vested interests to “imitate” a reform and bend it in their favour.

That is, the benefits of the reform were amenable to explanation. The problem was, however, that while the benefits would accrue to the common citizens, the SOEs themselves and the reformist politicians, the “costs” would have to be borne by the incumbent politicians and cronies who were already benefiting from the SOEs. Some people, usually referred to as the **vested interests**, were profiteering from these SOEs through intermediary companies that were purchasing inputs at inflated prices, selling outputs at lower than market prices, or simply siphoning off their assets.
These vested interests were controlled by, or tied to, politicians who were in charge of SOE appointments and could influence the legislation related to corporate governance in SOEs. Obviously, they objected the reform: they could not admit to stealing, they had nothing to gain from the reform and they had everything to lose. Consequently, resistance from vested interests came not through vocal arguments, but through latent sabotage of the proposed legal changes and clandestine bureaucratic inertia. Therefore, the reform processes described earlier moved very slowly at best and would stop or even reverse at worst.

At times, it was clear that a reform initiative would not progress without a compromise. The type of compromise mattered a great deal. Very often, compromise on the part of the vested interests consisted of blocking an essential element of the reform initiative, thus invalidating the entire initiative. Another problem was that an attempt to achieve yet another compromise was made at every step, gradually diluting the reform initiative.

For example, the experts working on the Naftogaz corporate governance reform in 2014-15 proposed comprehensive changes to the legislation on corporate governance of SOEs, including independent, politically insulated and fully empowered supervisory boards. However, at the end of 2015, the Ministry of the Economy – the agency tasked with drafting a law on this issue – proposed its own, weak version of the law, dismissing the bolder draft. The ministry yielded to a compromise: to have a law that introduced the requirement for the largest SOEs to have a supervisory board, but to delay critical changes.

The ministry’s original version included the requirement to have only one or two independent board members (depending on the type of company) and retained the requirement for state nominees on the board to vote according to voting instructions. It did not propose to give the supervisory board the power to appoint the CEO and approve the financial plan, which would stay with the state as shareholder. Before the second reading, the reformist groups and active parliament members were able to strengthen the law by introducing the requirement that a majority of the supervisory boards should be composed of independent members and removing the voting instructions. However, the board powers to appoint the CEO and to approve the financial plan were postponed “until a more suitable time.”

Although the government was able to achieve supervisory boards composed of a majority of independent members and a good nomination process afterwards, the boards were not fully effective. As mentioned, in the Naftogaz case, the board eventually stepped down. Vested interests tend to drag their feet on the reform as long as possible so that the patience of the supervisory board members and the reform-minded forces wears out.

Just after the Revolution of Dignity in 2014-15, reform momentum was very strong (recall the increased popular support for privatisation in 2014, shown in Figures 1-2). Bolder reforms had a very good chance and some of them took off quickly, such as the corporate governance reform of Naftogaz. Part of the success is that the old system lacked an understanding of the corporate governance reform in the beginning and did not realise how costly to them that reform would turn out to be. However, the costs became apparent very quickly. Stealing from public tenders and making deals with Gazprom became impossible. Realising that it was possible not only to avoid punishment and prosecution, but also to fight back, the old system gradually adapted. This is largely why the corporate governance reforms in other SOEs were not as successful.

However, the costs became apparent very quickly. Stealing from public tenders and making deals with Gazprom became impossible. Realising that it was possible not only to avoid punishment and prosecution, but also to fight back, the old system gradually adapted. This is largely why the corporate governance reforms in other SOEs were not as successful.

Finally, one cannot underestimate the role of the informal rules deeply rooted in the fabric of society. Extensive research has shown that informal institutions are very slow to change. Even when

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37 See the history of changes to Draft Law No. 3062 (later adopted as Law No. 1405-VIII, dd. 02/06/2016), available on-line at: http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=56416.

38 Williamson (2000).
new laws (formal rules) are enacted, the enforceability of these rules runs into the informal rules governing society. In particular, researchers have shown that like-for-like transplantation of legal rules may not work because they need to be adapted to local societal conditions.³⁹ In particular, in the transition countries, the increased difficulty of change in post-Soviet economies, when compared with central European countries, is attributed to the much longer communist rule.⁴⁰ And in the context of corporate governance, different informal rules appear to have a significant effect on the corporate governance choices made by companies.⁴¹ Thus, the pace of corporate governance reform in Ukraine has also been moderated by “old thinking” at the level of businesses and SOEs. For example, not only politicians but also business owners find it difficult to grasp that the independent supervisory board members should act in the interest of the company rather than the interest of the party that appointed them; that the owner may not intervene in the inner working of the supervisory board; and the board may not interfere with day-to-day matters of company management. In other words, when old practices are found to be acceptable, it is much more difficult to push for new ones.

Privatisation

Background

Over the nine years preceding the Revolution of Dignity, no single major SOE in Ukraine was privatised. The only exception was the privatisation of Ukrtelekom in 2011. However, during the two and half years after the Revolution, almost nothing has been done on this front either.

As before, the state would set quite ambitious privatisation plans, which were never implemented, despite the vast apparatus involved in running state property (the State Property Fund alone employs over 2,000 people). In addition, most SOEs were held by line ministries, with large numbers of ministry personnel engaged in SOE management. Such ministries were very unwilling to transfer these SOE to the State Property Fund (SPF) for further privatisation.

The privatisation record in 2014-17 was miserable. In each of the first three years, the government was only able to collect around one per cent of the privatisation proceeds planned. In 2017, that number was about 20 per cent, but that was only possible due to sales of minority shares in five oblenergos, regional electricity distribution companies, to the incumbent majority shareholder Rinat Akhmetov, Ukraine’s wealthiest oligarch.

Biggest achievements

Like with SOE corporate governance reform, the biggest achievement of privatisation is the new privatisation law that became effective in March 2018. The cabinet promptly followed up on the law by adopting new secondary legislation to make the law operational. This has laid the foundation for new privatisation practices.

The law had been a very long fight. In 2015, the previous cabinet submitted three modest legal changes to the privatisation law effective at that time. It took the parliament 18 voting attempts to finally approve those changes. However, since they were essentially cosmetic and the will to privatise against the resistance by the vested interests was not there, this had no effect on the privatisation results.

At that time, a group of reformers and IFIs started working on the new privatisation law. Although the law was formally submitted by the SPF, most of the job was done by the Ministry of Economy and the government’s advisers. It took some two years to have the law discussed between the SPF and the cabinet. The head of the SPF was replaced twice during this process.

The cabinet finalised the draft law in June 2017. Because the law was so important, the cabinet sent it for the discussion at the National Reform Council in September 2017 rather than sending it straight to the parliament. At the Council meeting, the President challenged some of the unpopular, but key provisions of the draft law. First, the draft proposed mandatory use of English law in the sale and purchase

³⁹ Berkowitz et al. (2003).
⁴⁰ Berglöf and Bolton (2002).
⁴¹ Boytsun et al. (2010).
agreement if the bidder insisted on it, a provision that exposed Ukraine’s poor legal framework and judiciary. Second, it was politically unacceptable that the law allowed for the starting price of smaller assets to be zero, even if the balance-sheet values were negative.

After explanations and debates following the Council meeting, the law was finalised and submitted to the parliament. It took four months to be passed by the parliament and another six weeks to have it signed by the president to make it effective.

As a result of the new law and secondary legislation, privatisation of smaller assets and companies – the so-called small-scale privatisation – was launched almost immediately. As at 18 April 2019 (eight months after the first auction on the Prozorro.Sale platform), 744 successful auctions had taken place, generating revenue of UAH 926 million. ⁴² On average, the selling price was about two-thirds higher than the starting price, showing strong competition during the auctions. This was entirely due to the new legal provisions which eliminated any manual intervention in the privatisation auctions.

The achievements of large-scale privatisation have been more modest, as the fundamental problem here was the dysfunctional State Property Fund, the manual decision-making involved in any large privatisation deal and the time required to prepare a large SOE for privatisation. A proper reform of the SPF involves legal changes to the constitution and the law. In the interim, mechanisms to supervise the work of the SPF and help the cabinet to steer it have involved various working groups. Ultimately, the Privatisation Working Group established by a 2015 resolution of the Yatsenyuk government was reformatted in February 2018.

The working group has proved to be quite effective, despite the limited legal powers that it had. Its effectiveness relied on the presence of the IFIs – represented mostly by their country and regional heads in Ukraine – and a set of reform-minded Ukrainian members.

The group has made a number of important decisions since its inception and stopped a few bad deals, including the poorly prepared privatisation of a minority stake in Odesaoblenergo. Perhaps, the most important outcome of the work of the group was the hiring of investment advisers to prepare large SOEs for privatisation. This process, too, was far from smooth.

For Centrenergo, a large power generating company, a consortium led by the Polish office of EY was retained. The SPF signed the contract with the advisers in the summer of 2017, but it took more than half a year to pass inter-ministerial approvals before the Cabinet of Ministers approved it in January 2018.

As the new privatisation law made the hiring of advisers mandatory, the SPF held a first series of adviser selection competitions in June-August 2018. Advisers for six SOEs – Odessa Portside Plant (OPZ), United Ore Mining Company, Elektrovazhmash, President Hotel, Indar and Coal Mine Krasnolymanska – were selected and the SPF signed the contracts with the selected advisers in early September.

The procedure requires that the contracts with the advisers should be approved by the Cabinet of Ministers. At this stage, the ill-willed participants to the competitions – those who entered the competition and lost – sued the SPF for allegedly incorrect evaluation of the results, and the results of five competitions (all except President Hotel) were blocked in the court in October. Based on two plaintiffs’ claims, the court prohibited the SPF, as well as the Ministry of the Economy, the Ministry of Finance and the Ministry of Justice, from undertaking any actions related to the preparation of the cabinet’s decision on these contracts and from proposing such a decision for the consideration of the cabinet.⁴³

Biggest failures

The biggest problem with privatisation is that it had not been at the top of the reform agenda from the onset of the post-Maidan government in 2014.

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⁴² These statistics include the sales by both the SPF and the local authorities. 44 per cent of the revenues were generated by SPF sales and 56 per cent by local authorities. See Prozorro.Sale data at https://bi.prozorro.sale/#/analysisSSP, last accessed on 18 April 2019.

⁴³ It is quite common in Ukraine to participate in a public tender or competition purely for the sake of being able to block that tender/competition in court. The reason that the results were blocked for five (not all six) competitions is that neither of the plaintiffs participated in the sixth competition (President Hotel), meaning that they cannot claim any damage from that competition.
Speaking of specific failed reform efforts, four things are worth mentioning.

First, the Yatsenyuk Cabinet named Odesa Portside Plant (OPZ) as the flagship case of new privatisation. The company had been well run by the then management and appeared to be very attractive to investors, including foreign investors. However, mired in corruption schemes that were divided among vested interests, the privatisation of OPZ failed miserably. During the first attempt in 2016, OPZ was (probably deliberately) overvalued so that the starting price of around US$ 800 million did not attract any bidders.

During the second attempt, at the end of 2016, the price was reduced to some US$ 500 million, but another serious problem became apparent. OPZ owed a toxic debt of about US$ 300 million to Dmytro Firtash, a controversial oligarch who was an indicted criminal according to the US Department of Justice. No serious buyer was willing to pay that toxic debt to an indicted criminal, so there were no bidders for the second auction, either. As a result, instead of becoming a stellar case of privatisation, OPZ became a symbol of failure.

Secondly, the State Property Fund (SPF) has remained unreformed. After the Maidan revolution in 2014, Ukraine has seen the head of the SPF replaced four times, but this has not affected the fund’s performance. One problem is that the SPF is tasked with both designing the privatisation policy and implementing it. As a result, the SPF has been subject to serious political pressure. Another problem is that, historically, it has had no capacity for effecting large, complex merger and acquisition deals, or even retaining high-calibre professional advisers to assist in such deals.

Even today, when the new privatisation law is place, the SPF’s organisational structure does not reflect the privatisation logic of that law. Finally, in order to avoid criminal responsibility, the SPF’s officials have a greater incentive not to privatisate rather than to privatise. To reform the SPF properly, the constitution and the Law on the State Property Fund needed to be amended (or a new law on the SPF had to be passed), which appeared to be an unsurmountable obstacle.

Thirdly, the legal changes that were proposed in 2015 to revamp privatisation were very modest. In 2015, the previous cabinet submitted three specific legal changes to the privatisation law effective at that time. The parliament approved those changes after 18 voting attempts. However, since they were quite superficial, they had essentially no impact on the privatisation progress, especially when no politician was willing to push strongly for privatisation.

Fourth, public assets offered for privatisation were meagre. In fact, the “triage” of SOEs proposed to privatisate only 8 per cent of the total asset value of Ukrainian SOEs. The most attractive and valuable SOEs, such as Ukrzalinytsia, Ukrposhta, Ukrenergo, Energoatom, sea ports, airports and the like were to remain state owned. In other words, if privatisation was to be a solution to major problems, such as corruption of lack of foreign direct investment, then it was only solving 8 per cent of those problems – and even then only if these modest privatisation targets were hit.

Why not more?

As in case of the corporate governance reform, let us walk through the four elements that, in this author’s view, explain the modest progress of privatisation: poor understanding of the benefits of privatisation, weak political will, strong resistance from vested interests and informal rules.

Contrary to what it may seem, the understanding of the benefits of privatisation was poor. Privatisation was commonly seen as a way of replenishing the state budget, and the only metric used to measure its success was the revenue from privatisation. At best, policymakers would see it as a way of dumping the ballast of SOEs from the state’s shoulders and as a way of attracting foreign direct investment.

Strikingly, in 2014, privatisation was not seen as a way of fighting corruption or as a tool for improving the competitiveness of the national economy.

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44 Triage is a medical term of French origin that refers to the process of “sorting” of patients, that is, determining the priority of patients’ treatments based on the severity of their condition. The term was introduced during the Napoleonic Wars and was used further during World War I by French doctors treating the battlefield wounded at the aid stations behind the front. In the context of Ukrainian privatisation and SOE corporate governance reform, it refers to the sorting of SOEs into groups, including SOEs to remain state owned, SOEs to be privatised and SOEs to be liquidated.
Although it was possible to explain these benefits in 2016-17 and the experience of other countries was available, there was no pre-existing momentum to carry this forward.

In addition, vested interests were very strong and informal rules have hampered improvements to formal rules, as described earlier in the section on corporate governance in SOEs.

Finally, there was the issue of political will. Here, there are perhaps three key differences that explain the varying the progress of the corporate governance reform in SOEs and privatisation:

- At the onset of the reforms, there was no flagship case of successful privatisation to demonstrate success and motivate further reform, whereas the Naftogaz case clearly spurred corporate governance reform in SOEs at the national level.
- In contrast to corporate governance reforms in SOEs (where the new law in 2016 laid the foundation for governance reforms in SOEs) there was no fundamental change in the law on privatisation or the State Property Fund. (Note that this and the previous point are similar in the case of the corporate governance reform of state-owned banks, which had been put off until late 2018).
- Corporate governance reform is less painful for incumbents and vested interests than privatisation. They hope that governance changes are temporary. While privatisation, in most cases, ensures a definite severance of the link between the politician and the company, corporate governance improvements may be reversed or imitated de facto preserving the status quo. (Indeed, the experience with the establishment and further degradation of the SPF in the 1990s supports this view.) In fact, vested interests have often tried to substitute corporate governance reform in SOEs, although important per se, as a softer medicine instead of privatisation.

What needs to be done next

Privatisation

Privatisation should be a top priority of the reform, as state-owned assets form the basis of political meddling and graft. As corporate governance reform is only a second-best solution compared to privatisation (see above), policymakers should favour privatisation over corporate governance improvements whenever possible.

In particular, the following needs to be done:

- The government needs to complete one large privatisation in order to demonstrate success and motivate further reform. For that purpose, it should aim to have to have a pipeline of several privatisation targets to avoid depending on one case (such as with OPZ in 2016). These SOEs should be selected on the basis of the following criteria:
  - allowed for privatisation by law
  - attractive to foreign investors today
  - operating in non-regulated industries
  - burdened with a minimum of toxic characteristics.

The best candidates for this pipeline are: United Ore Mining Company, Elektrovazhmash, and Turboatom.

- The list of SOEs whose privatisation is forbidden by law needs to be reduced to nearly zero. In fact, the best solution would be to abolish that list altogether and create a new one, using the following three criteria:
  - State ownership is an exception. This means that state ownership for each potential candidate company would have to be firmly justified on an individual basis before it would be included on the new list.
  - The share of assets offered for privatisation should be at least 50 per cent of the state’s portfolio. This implies that major privatisation targets would include Ukrposhta, the cargo business and real estate of Ukrzaliznytsia, UkrGasVydobuvannya and other SOEs of similar magnitude.
  - All state-owned banks, including Oschadbank, Ukreximbank, Privatbank and Ukrgasbank, should be fully privatised.

- Institutionally, three important changes are required (all require changes to law):
  - A major overhaul of the institutions in charge of privatisation is needed. If the government is to
be responsible for privatisation results, then it must control the privatisation agency. This is not the case with the SPF today. Instead, it should create a **Ministry of Privatisation** that would exist for several years until major public assets are privatised.

- Clear deadlines (for example, two months) should be set for the **transfer of SOEs from the privatisation list to the Ministry of Privatisation**. If the respective line ministry does not perform the preparatory procedures for an SOE, it should automatically be transferred to the Ministry of Privatisation and that Ministry will be responsible for completing those preparatory procedures.

- The new privatisation law distinguishes between large and small SOEs, each group prescribed a distinct privatisation procedure. The **organisational structure of the new ministry must reflect that distinction** and include distinct organisational units to accomplish these tasks.

Small privatisation essentially requires filling up the pipeline of SOEs to be privatised, with the rest of the work done by electronic auctions such as those on the **Prozorro.Sale** platform. Consequently, the focus needs to be on the transfer of SOEs from line ministries to the privatisation agency and the liquidation of inactive and bankrupt SOEs, with active support from lawyers.

Large privatisation requires major preparation of the large SOEs for sale, ranging from vendor due diligence to massive restructuring. That work can take between several months and a couple of years and needs to be performed by a small team of highly qualified investment bankers and lawyers, assisted by world-class advisers hired via competitive procedures.

This is not the case with the SPF today. If this cannot be repaired quickly, the government should abolish the SPF altogether or narrow down its functions, perhaps limiting them to lease of state real estate and infrastructure and valuation.

- **Privatisation should include parts of large organisations in the infrastructure or their main assets** (for example, in railways, road transportation, gas and so on), SOEs that have subsidiaries must be allowed to sell their non-core assets in order to operate efficiently.

- Finally, the government should launch a **massive awareness campaign** and seriously **improve communication** of the importance of fair and transparent privatisation for fighting corruption and improving the competitiveness of the Ukrainian economy. This will make this reform more popular and thus more attractive to politicians.

**SOE reform**

In respect of the corporate governance of SOEs, the following is required:

- The **corporate governance reforms** that have been started at Ukrenergo, Ukrzaliznytsia and Ukrposhta should be **pursued further**. They should result in a fully-fledged ecosystem around the newly established supervisory boards – such as internal audit, compliance and risk management – and, ultimately, lead to visible performance improvements, such as better quality of services and better financial results.

- It is necessary to ensure that corporate governance rules for SOEs are in **compliance with OECD standards of corporate governance**. This requires approving legislative changes, which:

  - create a level playing field for SOEs and private companies
  - clarify the ownership rights to subsidiaries of SOEs to make sure that their daughter companies have full control and are fully accountable for them
  - ensure that the CEO is appointed by the supervisory board, not by the line ministry
  - ensure that SOEs’ financial plans are approved by their supervisory boards, not by the Cabinet of Ministers
  - solve the issue of dividends paid by subsidiaries of SOEs according to standard corporate practices
  - forbid political intervention in the businesses of SOEs.
• It is necessary to establish a National Wealth Fund which will manage state-owned enterprises/assets in such a way as to maximise their value. The fund’s activities must be depoliticised: in particular, the nominating committee selecting supervisory board members should consist of professionals with a high international reputation and experience in the global financial markets. The supervisory board will appoint the management of the fund and the fund will be accountable to parliament.

• As in the case of privatisation, it will help a great deal to raise public awareness through improved communication of the wide-ranging benefits of better corporate governance in SOEs and SOBs, including minimised opportunities for corruption, better enterprise performance and higher taxes collected by and dividends paid to the state, which can be used to finance public policy aims.

This is certainly a great deal of work that requires political will, strong conceptual understanding, commitment, endurance, and communication. However, this will make Ukraine a much better, more prosperous, and democratic country.

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Chapter 8
The state of healthcare in Ukraine differs from that in other European countries. This is confirmed by the following basic comparative analysis of statistical data of selected countries: large and rich countries of Western Europe (Germany, Great Britain and France), countries of Central Europe, which started their systemic reforms in the early 1990s (Czech Republic, Hungary, Poland, Slovakia) and data for the entire European Union. The analysis is based on WHO data for 2000, 2010 and 2014 (the year of the Ukrainian Spring).¹ The numbers used below are all drawn from this data source.

Figure 1
Disability – adjusted life expectancy

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2010</th>
<th>2014</th>
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<td>UA</td>
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<td>69.8</td>
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<td>77.1</td>
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<tr>
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<td>78.6</td>
</tr>
<tr>
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<tr>
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<td>77.3</td>
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<tr>
<td>SK</td>
<td>73.0</td>
<td>75.1</td>
<td>76.4</td>
</tr>
</tbody>
</table>

Source: WHO

The above graph shows the evolution of life expectancy of Ukrainian residents over a 15-year period, from 2000 to 2014. Ukraine, unfortunately, deviates from the EU average by about 10 years.

Importantly, this difference has not been reduced over time. It should be noted that in addition to the effectiveness of the healthcare system itself, life expectancy is also influenced by the living and working conditions in the country. The low quality of the healthcare system should therefore not be considered the sole culprit of the unsatisfactory health status of the Ukrainian population.

Figure 2
Infant mortality per 1,000 live births

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<tr>
<th></th>
<th>2000</th>
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<td>SK</td>
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<td>5.8</td>
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</table>

Source: WHO

The second comparison highlights a serious problem in the field of obstetrics and neonatology. Even though Ukraine reduced the number of neonatal deaths by almost 50 per cent between 2000 and 2014, the 2014 values are still at the level of Hungary, Slovakia and Poland in 2000. This is a major challenge for the Ukrainian healthcare system, pregnant women and maternity wards in hospitals. Improvement of these services would have a significant positive impact on the average life expectancy discussed above.

¹ https://gateway.euro.who.int/en/hfa-explorer/
Of course, the state of the healthcare system is intimately linked to budget expenditures. An important indicator is the ratio of public expenditure on healthcare to GDP. Ukraine has the lowest healthcare spending among the comparator countries, Russia's actions and the political situation in Crimea and Donbass have forced Ukraine to increase defence spending, which negatively affects healthcare expenditure. This is one more reason to optimise all expenses on medical services as soon as possible.

Ukraine’s expenditure on PPP (purchasing power parity) in US$. It represents about 10 per cent of average expenditure in the European Union and over 3.5 times less than in Poland and Hungary, countries with the lowest budget expenditure on health. With such low expenditure, it is not possible to provide the required volume and quality of services. Limited access to services is one of the sources of corruption among medical professionals.
Despite such low expenditure on medical services in Ukraine, the number of patients treated in hospitals (per 100 residents), which provide the most expensive medical services, is higher than the average in the European Union. In the United Kingdom 30 per cent fewer people use hospital services than in Ukraine. This practice in Ukraine cannot be sustainably maintained because it results in indebtedness of the entire healthcare system.

An even bigger problem in Ukraine is the length of hospital treatment. Although in the 15 years under scrutiny here the length of treatment has been lowered by over 20 per cent, it is still more than 50 per cent longer than the average length of hospital stays in the European Union. Long-term treatment is more expensive and is not always better for the patient. In a country with such a low level of funding of treatments from the budget, shortening of hospital stays is an indispensable task.
Long-term hospital treatment time translates into a large number of hospital beds, which in turn translates into increased hospital costs and investment in the construction of additional hospitals instead of the purchase of new medical equipment. Although the number of beds in Ukraine decreased by 15 per cent in the 15 years studied, there were still over 50 per cent more beds than the EU average. The difference is even starker when Ukraine is compared to the United Kingdom; the former’s hospital beds per 100,000 inhabitants exceed those of the latter’s by about 70 per cent.

The above analysis of selected indicators describing the Ukrainian healthcare system indicates that despite having a very high number of doctors and hospital beds per 10,000 inhabitants, Ukraine's average life expectancy is about 10 years lower than the average in EU member states.² This demonstrates a very inefficient use of resources by units of the healthcare services, especially by hospitals, which are the most expensive units in the entire healthcare system.

In 2016, a survey³ performed on a sample of the population showed that the public considers the healthcare reform to be the most important and most urgent reform in Ukraine. The respondents indicated that illness in the family is currently the greatest threat to the financial security of that family. Despite medical treatment being free of charge according to the law currently in force, in reality individuals and families shoulder about 50 per cent of the cost, on average.⁴ Given the relatively low average earnings, pay for treatment is often associated with the need to take a loan from a bank, which often results in long-term indebtedness. Those with the lowest income often drop out of treatment, due to the inability to obtain a bank loan.

Principles on the financing of public healthcare services are very ineffective. Hospitals and clinics still receive a subsidy from the state budget, just like in the Soviet era. The mediator who decides where the finance directed is the local authority. The amount of the subsidy does not depend on the number of patients and the cost of treatment, rather on the organisational structure of health units and the number of employees. Such a payment method does not incentivise improvements in the quality of treatment, on the contrary, it creates perverse incentives to over prescribe hospital treatment and prolong hospital stays.

The non-transparent allocation of subsidies opens up avenues for corruption, and that on many levels of decision-making, including both local and central level government bodies as well as in the hospitals and clinics themselves.

Salaries of healthcare professionals, when compared to other professions that require high levels of education and entail great amounts of responsibility for potentially irreversible effects (should mistakes occur), are very low. Low wages do not encourage improving qualifications and motivation. The result is a low commitment to learning new technologies and continuously upgrading professional qualifications.

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² Ibid.
³ Executed by the Rating Group polling company for the Ministry of Healthcare. The results of the survey have not been officially published.
⁴ WHO data.
What is the purpose of the reform?

The healthcare reform aims to:

1. Improve the sense of security among Ukrainian citizens
2. Raise the level of dignity of the medical profession
3. Improve the quality of medical services
4. Increase the efficiency of allocation of resources (taxpayers' money)
5. Significantly reduce corruption in healthcare at all levels (civil servants, medical personnel, patients)

Ukraine, like other European countries which have previously undergone healthcare reforms, aims to achieve universal healthcare, ensuring the provision of the widest possible range of quality health services funded by public finance. In brief, the goal is a system based on social solidarity that guarantees the right to use publicly funded healthcare services in case of life-threatening or life-altering disease.

The reform principles

The first principle of the reform is an equal right for all residents of Ukraine to use medical services in hospitals and clinics throughout the country, which has concluded an agreement with the state on the provision of healthcare services funded by the state budget. This is a fundamental departure from the rules that were in place previously, where the availability of free medical services had been limited to healthcare units operating closest to the patient's place of residence. The reform has enabled the patient to seek treatment at the best healthcare unit (as judged by the patient), taking into account not only the closeness of this unit but also the quality of its medical services.

In this way, residents feel that they can freely enjoy the constitutional right to treatment, and are not permanently administratively assigned to one medical unit with a monopolistic position, which does not have to care about patient satisfaction simply because the patient must always use its service. In short, it can be said that the reform destroys the monopoly in healthcare and introduces market freedom for the patient to choose the best service provider.

The second principle of the reform is equal access of healthcare units to public funding. The inhabitants, with their choices, indicate their preference for the place of treatment. The selected healthcare unit in turn receives state funding for their treatment. Until now, other rules governing the distribution of public money have been applied. The basis for the allocation of funding was the potential treatment, not the actual treatment; taking into consideration the organisational structure and the number of staff rather than the volume and nature of services delivered. This provided an incentive to reduce the number of patients, because actual treatment would increase the costs incurred by healthcare units while the amount of state subsidies remained the same. The reform introduces a different rule – each time the patient's healthcare unit provides him treatment, it receives more public money. This changes the motivation to heal – if the patients choose this unit as a place of treatment, the unit will perform more services and therefore will receive more money. The reform rewards the best and most industrious.

The third principle of the reform is the equal treatment of public and private healthcare units. So far, only public healthcare units have received public financing and patients have been able to receive treatment free of charge only in those units. Private clinics were accessible only to richer Ukrainians as they required payment for treatment. Society divided healthcare into private (better paid and available only for the rich) and public (worse, but, in theory, free and available for most residents). The reform does not distinguish between public and private healthcare units, the only distinction is based on the quality of treatment. If the entity meets the conditions of the quality of treatment – medical staff with appropriate training and experience, has the required medical equipment and the like – it has the right to bid for a contract with the government for the treatment of Ukrainian citizens, financed from the state budget. This approach increases competition in the market of medical services through the participation of private entities, usually possessing better medical equipment and employing workers with better skills and professional experience. This forces the public healthcare units to improve the quality of their services through investment, maintenance of facilities and above all
The fourth principle is the widespread introduction of electronic recording and exchange of medical information in the entire healthcare system. So far, healthcare units have kept all medical, financial and organisational documentation in paper form. Because of this, access to information was difficult, time-consuming and costly. Therefore, virtually no healthcare unit conducted internal analyses of the quality and costs of medical services. Management decisions were made arbitrarily. The same problem concerned decisions taken at the self-government level, that is the owners of healthcare units, and the central administration, which should shape the state’s health policy. The decisions were not justified by actual data regarding the functioning of the healthcare system, and the changes and investments introduced were not analysed in terms of their expected results.

An even bigger problem was the exchange of medical records between healthcare units treating the same patient. Theoretically, the patient would have to provide another doctor treating him with paper medical documents describing the treatment prescribed by previous doctors. In practice, the basic source of information about the patient’s health and current treatment is the patient and not his medical documentation, which has a negative impact on the quality and cost of treatment. The reform radically changes the situation. All medical documents are created in digital form. The only paper document can be a copy of a digital document for a patient who cannot use an electronic document. The others who create a document or use this document must do so electronically. Thanks to this, creating a document, making it available and archiving it is cheap and fast, and providing access to it to authorised persons is possible anywhere, anytime.

The fifth principle is to reduce the doctor’s bureaucratic duties to a minimum. Until recently, doctors spent a lot of their time filling in complex and often repetitive forms. Because of that they had less time to talk to the patient or and treated fewer patients on a daily basis. The reform radically changes the scope of doctors’ duties. It allows them to focus on treatment and minimises medical documentation to a single electronic document. Administrative duties are limited only to entering the patient identification code. All other administrative data is supplied via the IT system, using registers of residents, doctors and healthcare units. Also, secondary medical documents, such as prescriptions, referrals for diagnostic tests, referrals to specialist doctors and the like are automatically created by the information system using electronic medical records. In addition, all documentation created during the patient’s visit to the doctor is archived in the patient record: a single register of all medical events from birth to death. In short, it can be said that the reform restores the time doctors can spend on treating the patients, obliging them to produce only one document; a description of the disease and the method of treatment.

The adoption of these basic reform principles required a profound change in the law, the system of financing of medical services, public healthcare units, the work of the Ministry of Health, but above all a change of mentality of all stakeholders in the healthcare system. So a complex reform, involving the whole of society as customers and close to one million people working in the healthcare system, takes a lot of time and requires constant control over its implementation, including adjusting course if necessary. Therefore, the Minister of Health adopted a strategy for the gradual implementation of the reform, dividing it into 6 steps:

- Step 1: political agreement on reform and its main rules
- Step 2: changes to the law, implemented at the level of Parliament, the decrees of the Cabinet Minister and the Minister of Health
- Step 3: a detailed concept of the functioning of the healthcare system after the reform and of the implementation of the reform
- Step 4: changes in the Ministry of Health, the expected cooperation with other ministries and central state bodies, and the creation of new state entities necessary for the implementation of the reform
- Step 5: three-point implementation of the reform in healthcare units at:
family medicine
• ambulatory (outpatient) medicine
• stationary (inpatient) medicine
• Step 6: review of the reform impact.

Each of the three degrees of implementation of the reform in healthcare units includes:
• independence of the healthcare unit,
• implementation of an IT system that supports medical services
• implementation of an IT system supporting the management of a healthcare unit
• signing of a contract for the provision of medical services
• implementation of medical services
• analysis of the effects of reform implementation
• possible corrections to the reform.

What has been done?

In 2016, the reform of the healthcare system was included in the government’s list of priority reforms. The four-year implementation period of the reform was to run from 2017-20. The basis for the reform was the concept of changes in financing principles of the Ukrainian healthcare system, prepared by the working group of the Ministry of Health under the previous government in February 2016. The concept assumed the central financing of healthcare services from the state budget with the amount of financing to be determined by the quantity and quality of services provided.

From August 2016 to March 2017 extensive consultations were carried out with employees of healthcare units in the regions, devoted to providing information about the goals and ways of introducing changes in the healthcare system, as well as discussions about the preparation of healthcare units for independent decision-making. Thanks to these consultations, the medical community felt supported by the reform and the necessary organisational changes in the healthcare units were accelerated.

At the same time, the Ministry of Health prepared a set of the key legal acts necessary for initiating the implementation of the reform.

In March 2017, the government submitted to the parliament a draft law on the financing of medical services “On State Financial Guarantees of Public Healthcare,” a basic law for the whole reform, which, in addition to the rules for the funding of medical services, specified the patient’s rights, organisation of healthcare units and deadlines for implementing the next stages of reform. The parliament adopted this law in October 2017, but the president only signed it in December 2017, so the act only came into force on 30 January 2018. The delay had a very negative impact on the implementation of the reform. Interest in the reform among the medical community dropped and some of its members expressed doubts over its implementation. Only very intensive communication by the Ministry of Health and constant meetings with medical personnel in all provinces sustained the activity of local reform leaders.

Very intense legislative work of the Ministry of Health in the last quarter of 2017 and the personal involvement of the prime minister in accelerating the work of the government helped to stick to the calendar of reform implementation in 2018.

In addition to the legislative work, over 100 basic business processes have been defined for healthcare units working according to the new principles of patient service, cooperation with other healthcare units and central organs of the healthcare system. This task has shown that it is necessary to modify or create a dozen new central registers, such as, for example, doctors registers, and introduce about 100 uniform dictionaries to describe medical and organisational activities of physicians and healthcare units. Both processes, concerning dictionaries and registers, will last until at least 2020, as the next stages of the reform are implemented.

In the first quarter of 2018, the state enterprise “e-Health” was created. It is responsible for the preparation and operation of the central database and information systems necessary for the Ministry of Health and the National Health Service of Ukraine (NHSU), the central body ordering medical services.
The reform in 2018 focused solely on family doctor services. The first step of the reform consisted of the separation of the part dealing with family medicine from the previous healthcare units and the creation of a new healthcare unit dealing with family medicine only. It involved obtaining the status of an independent healthcare unit, which means the right to self-management of financial resources obtained for medical services and independent decision-making on organisational changes to optimise the use of resources for the treatment of patients. Of course, the right to make decisions by yourself involves full responsibility for the consequences of these decisions.

By the end of 2018, despite opposition pressure, almost 100 per cent of the family healthcare units became independent. This is a surprisingly good result given that only a year prior to that many of the local authorities opposed such a change.

The second step, which began in April 2018, concerned healthcare units obtaining declarations of a choice of family doctor from Ukrainian citizens. This was a breakthrough – residents got the right to choose the best, in their opinion, family doctor, located at a comfortable distance from their place of residence. In practice, the freedom of choice benefitted mostly urban residents who have access to a large number of family doctors within a small radius. In many rural areas there is only one family doctor and so the freedom of choice is rather cosmetic in nature.

By the end of 2018, over 23 million residents of Ukraine, or around 60 per cent, had chosen their family doctor. This is a very positive sign of public involvement in healthcare reform.

The third step was the establishment of the National Health Service of Ukraine (NHSU), the central executive body of the state, subordinate to the Ministry of Health and implementing its health policy through three basic streams:

- ordering medical services for the next year in all healthcare units that want to finance treatments from the patients' state budget
- supervising the provision of medical services
- paying for medical services.

NHSU has the right to access the central database of medical services and therefore has up-to-date statistics of therapeutic needs in individual areas of the country and the capabilities of healthcare units that meet the quality of treatment (medical personnel, medical equipment and previous treatment outcomes), which allows it to identify areas of excess and areas of scarcity of medical services. This analysis will form the basis for the restructuring of existing healthcare units and implementation of investment projects for the construction of new units.

NHSU obliged healthcare units to exchange information on organisational and financial matters only in digital form. As a result, it shepherded healthcare services into the era of computerisation. As a result, although employing only about 100 people, the NHSU can handle over 600 contracts with healthcare units, treating over 20 million people.

It should be emphasised that the creation of NHSU, despite the complicated internal structure and a very important role in the reform (about 30 business processes), was very fast; three months in total. Thanks to this, NHSU had already finalised the agreements for the provision of medical services of family doctors in June 2018.

The fourth step was to finalise an agreement between the healthcare unit and NHSU. This step was divided into three stages: June, August and December. As the number of independent healthcare units and the number of family doctor choice declarations increased, more and more medical units reported willingness to finalise a service contract. In June 2018, 161 contracts were signed, which entered into force on 1 July 2018, including 149 with municipal healthcare units, seven with private healthcare units and five with individual
entrepreneurs (ФОП). In August 2018, 462 contracts were signed, in force from 1 October 2018, including 389 with municipal healthcare units, 40 with private healthcare units and 33 with ENP. In December of that year, 1,207 contracts were concluded to enter into force in January 2019, including 994 with municipal healthcare units (that is, over 95 per cent of all municipal healthcare units of family medicine), 110 with private healthcare units and 103 with the ENP.

It can be concluded that the reform, in the sense of organisational change and financing rules for family doctor services, has been completed. Public money from the state budget goes to the doctors whom the Ukrainians are able to choose. The objective of equal treatment of public and private healthcare units was achieved, thanks to which over 200 private entities finalised a contract, which sparked competition between public and private entities in obtaining doctor choice declarations, and incentivised public entities to improve the quality of treatment.

Another result is a truly free-for-patients medical service. In mid-2017, 20 per cent of patients had to “line the doctor’s pocket” to receive treatment, in September 2018 it was only 7 per cent. Why? Because by receiving money directly from patients, doctors break their contract with NHSU and thus disqualify themselves from public funding. Salaries of the best doctors and nurses increased by about 100 per cent and in some cases even more. This is not the effect of increased spending from the state budget, only a more optimal allocation of resources.

In parallel to the ongoing systemic reform of the healthcare system, a number of changes were introduced to the weakest points of current treatment practices. From April 2017, new rules for the pharmacological treatment of chronic diseases were introduced under the “affordable medicines” programme. The programme focuses on the treatment of: cardiovascular diseases, which is the cause of 65 per cent of deaths in Ukraine; type II diabetes affecting about one million people; and bronchial asthma, which occurs in over 200,000 people. The reason for the introduction of the programme was irregular drug use by patients who, due to the high price of the drugs and lack of money, bought medicines only from time to time, resulting in the absence of treatment effects and further development of the disease.

The programme consisted of three components: procurement of medicines by the Ministry of Health by way of a tender, transfer of medicines to pharmacies that had declared their willingness to participate in the programme, and reimbursement of medicines by local governments from the state budget fund.

The Ministry of Health’s analysis showed that prices of medicines in Ukraine are significantly higher than prices of identical medicines in other European countries. These discrepancies can be explained by the collusion of producers and importers of medicines with pharmacists and the likely distribution of profit among the involved parties. Therefore, the Ministry of Health was forced to set up an international tender commission (guaranteeing resistance to corruption), which, via a tender, ordered the same medicines at a significantly lower price. The resulting savings made it possible to order more drugs for a higher number of patients, which improved the availability of medicines in all regions of the country.

The introduction of drug reimbursement required the pharmacies to decide whether they want the patient to pay for the medicines sold (as before) or whether they wish to enter the “affordable medicines” programme and receive money from the state. In the first few months, a very low percentage of pharmacies decided to be paid by the state. This shows how low the level of trust in the state was among the pharmacies. However, every month, the number of pharmacies joining the programme grew, so that by the end of 2017 over 6,000 pharmacies were participating, rising to over 9,000 by the end of 2018.

Money for drugs sold under the “affordable medicines” programme in 2017 and 2018 was received by the pharmacies from the state through local authorities with whom they signed appropriate agreements. From April 2019, pharmacies will receive money directly from the NHSU as the central body of the state responsible for paying for medical services from the state budget, including medicines.

https://gateway.euro.who.int/en/hfa-explorer
The two years since the launch of the reform brought positive health and financial outcomes. As the price of medication has been lowered by producers and the state budget's possibilities for increasing the amount of spending on affordable medicines have expanded, the programme has grown significantly. In April 2017, the affordable medicines programme included 153 drugs, including 23 free (17 medicines for cardiovascular diseases, three medicines for type II diabetes and three medicines for bronchial asthma) and 130 partially paid. From August 2018, the programme includes 261 drugs, including 59 free (45 medicines for cardiovascular diseases, nine medications for type II diabetes, five medicines for bronchial asthma) and 202 partially reimbursable drugs. It is estimated that after two years of the programme, almost all patients with the above diseases regularly take the prescribed drugs while prescriptions have increased by 70 per cent.

The second weakness of the existing treatment practices was the high overall cost of laboratory tests and diagnostics. The key consequence was that the patients were forced to pay for these services. In many cases, the price of laboratory and diagnostic examinations exceeded the financial capacity of the patient. The result was an intuitive diagnosis by the doctor, which negatively affected the speed and accuracy of their treatment.

Therefore, as part of the reform of the family doctor practice, a set of ten free basic tests was introduced for the most common diagnoses at the level of family medicine. The NHSU doctor is reimbursed for these tests in annual payments for each patient who, through their declaration, chose them as their family doctor. This is the first step in regulating which tests are free for the patient and which are paid, in whole or in part. So far as the financial possibilities of the state budget are concerned, the diagnostics funded by the NHSU will be expanded.

The third weakness of the current treatment practice is the neglect of vaccination of both children and adults. For several years, a large number of cases of tuberculosis has been registered and the long-term failure to vaccinate children brought Ukraine to the verge of a measles epidemic in 2018. Over 50,000 cases of measles were registered in western Ukraine alone. Since July 2018, parents and family doctors have a schedule of children's vaccinations against tuberculosis, poliomyelitis, diphtheria, pertussis, tetanus, measles, hepatitis B, haemophilic infection, rubella and mumps.

**What remains to be done?**

2019 is the year of presidential (in March) and parliamentary (in October) elections in Ukraine. The electoral year is not particularly propitious for implementing difficult changes such as the reform of the healthcare system. That is why it is necessary to prepare carefully for the next stages of the reform and adjust its pace to the current context in order to avoid any potential hindrances to doctors' work. On the other hand, one should be mindful of potential changes to the reform agenda as a result of the two elections in 2019, as well as of possible reform reversals or interruptions.

In 2018, IT companies did not succeed in finalising the necessary IT systems for the servicing of family doctor surgeries. Medical documentation was thus still recorded on paper, which made it impossible to achieve the goal of reducing the physician's administrative burden. In addition, the possibility of passing medical records to other doctors treating the same patient was not operationalised. It is therefore necessary to implement the appropriate IT systems as soon as possible in 2019. Without the implementation of this component, the reform of outpatient treatment cannot be initiated.

NHSU pays for outpatient services in line with the “fee for service” principle. This requires the classification of medical services (a dictionary of services) and the calculation of the costs of all medical services (price list services). This task can be performed only with the participation of several well-managed outpatient treatment units, separately for all medical specialties. Such analyses require testing for at least three months and should be performed in the first half of the year.

In 2019, prophylactic examinations should also be conducted by family physicians and specialist doctors. This requires costly imaging diagnostics, which entails including additional expenses in the budget for 2020.
The hospital treatment reform should be launched in 2020. Given the challenges in the implementation of this reform component, it is reasonable to expect progress only with regards to a few selected medical specialties and to re-engage on the remainder post elections.

The tasks for the coming months are demanding. The pre-election atmosphere that creates a fertile ground for populism may be an obstacle, and in the event of a change in political leadership, back-tracking on reform is possible. The second obstacle may be the lack of budget for the implementation of the reform due to slow economic growth. Previous changes in the healthcare reform did not require large budget expenditures but without any money it is impossible to restructure such complex systems.

In conclusion, Ukraine has launched a much-awaited reform of its healthcare system, introduced incentive mechanisms for the optimisation of the healthcare system from below, encouraged competition among physicians and healthcare entities, public and private, as well as introducing reimbursements for a number of critical medicines. As a result, citizens have started to enjoy better quality and accessibility of healthcare services. More importantly, the reform has restored the dignity of the patient who no longer has to bribe a doctor to receive the treatment they need, and the dignity of a doctor who does not have to coax money from the patient to provide them with treatment and earn a fair wage.

The reform gave the patient the right to choose the healthcare unit in which they would like to be treated and the doctor who will treat them. It diversified the revenues of healthcare units and the earnings of all medical workers, rewarding the better and more diligent. The reform forced healthcare units to invest in the modernisation of medical technologies and treatment conditions because competition removes obsolete and ineffective ones from the market. Now reform, like any major change, requires patience, because the effects of reforming such a complex system as medical services are usually only seen after many years.
Chapter 9

Ukraine and the European Union

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This year we celebrate five years since the dramatic February 2014 events at Maidan, a square in the heart of Kyiv that gave its name to the popular revolt by ordinary Ukrainians who demonstrated for a better life, for the elimination of corruption and cronyism, and for a European future. The violent government crackdown to suppress the protest resulted in the deaths of roughly 100 demonstrators. It came after weeks of non-violent demonstrations in sub-zero temperatures that had started late November 2013. These were triggered by the decision of the former President, Viktor Yanukovych, to decline, citing Russian pressure (and sweetened by a financial support package and lower energy prices), an offer to Ukraine from the European Union to enter into a close political association and a free trade agreement; in EU terms, the Association Agreement and the Deep and Comprehensive Free Trade Area (DCFTA).¹ The initialling of those agreements by two other countries of the “Eastern Partnership”,² notably the Republics of Georgia and Moldova, took place at the summit in the Lithuanian capital Vilnius on 28-29 November 2013. The Joint Declaration of the summit, attended by the leaders of the EU and the Eastern Partnership countries laconically: “[t]ook note of the decision by the Ukrainian government to suspend temporarily the process of preparations for signature of the Association Agreement and Deep and Comprehensive Free Trade Area between the EU and Ukraine.”³

The same Declaration, however, recognised the strong desire of the Ukrainian population for a future closely aligned with the European Union. Noting “the unprecedented public support for Ukraine’s political association and economic integration with the EU,”⁴ it expressly left the door open for Ukraine to sign these agreements at a later point.⁵

This strong public desire and pressure ultimately pushed Yanukovych not only out of office, through a parliamentary vote on 22 February 2014,⁶ but made him flee to Russia, leaving his opulent residence purchased with his vast amassed wealth (which included a private zoo), as well as a country laden with large amounts of debt and on the brink of economic collapse. In quick succession, thereafter, a new interim government and new hope were ushered in.

This chapter addresses two stories that have defined the relationship between the EU and Ukraine and its reforms over the last five years.⁷ One is the story of institutions. The other is the story of bureaucratic innovation and support for reforms.

The political and economic agreements with the EU were signed by the new Ukrainian leadership: the political part of the Association Agreement by the then new Prime Minister Arseniy Yatsenyuk on 21 March 2014,⁸ and the economic part by the new President, Petro Poroshenko, on 27 June 2014. Ukraine joined the trade agreement, the DCFTA, on 1 January 2016. The Association Agreement formally came into force on 1 January 2017, having finally garnered a unanimous approval from the 28 EU member states, including overcoming a negative vote against the agreement in a 2016 referendum in The Netherlands. (This chapter refers to all these above agreements as the EU-UA agreements).

The signing of the EU-UA agreements created a lot of expectations on the side of the Ukrainian public, the Ukrainian government and the international community. While they stopped short of opening the prospect of membership, they offered Ukraine (and the other two signatories, Georgia and Moldova) a

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² Idem.
⁴ Idem.
⁵ Idem.
⁶ About 73 per cent of MPs voted to oust Yanukovych from office, 328 of 447 members of the Verkhovna Rada.
⁷ This chapter does not address the important issue of military and security reform.
⁸ EU & Ukraine 17 April 2014 FACT SHEET of the European External Action Service (17 April 2014) with the EU.
privileged relationship with the explicit goal of integrating Ukraine’s economy with that of the EU. In the post-Maidan euphoria, it seemed only natural to many that becoming “more European” and moving closer to the EU would happen rapidly through the full implementation of the complex and lengthy EU-UA agreements. Signature of the agreements was widely seen as a proxy for a commitment to a fundamental transformation of the country. These expectations, however, have to date not been fulfilled, at least not to their full extent, despite an extensive roster of reforms that have been adopted and carried out by the governments of prime ministers Arseniy Yatsenyuk and Volodymyr Groysman that have been in power since Maidan. The question to ask is why?

There are three interrelated reasons which will be covered this chapter. All are, in essence, of an institutional nature. The first one relates to the overall weak institutional environment in Ukraine and the strong and entrenched vested interests fighting against the take up of the reforms embedded in the EU-UA agreements; the second one relates to the demanding nature of the EU-UA agreements themselves; and the third reason relates to the fact that by their design, the agreements do not address the “fundamentals” of reforms. This chapter discusses these in turn.

First story – institutions

Institutional weakness

Elsewhere this book, notably in the chapter on the political economy, a clear case is made about the difficult starting point for reforms in Ukraine post Maidan. Unlike many other ex-communist countries (notably the ones in central Europe that have joined the EU in the meantime), Ukraine did not only have to grapple with the still-massive economic imbalances and legacies of decades of communism: inefficient industries, a bloated and ineffective public sector, dilapidated infrastructure and a widespread lack of public trust. It also suffered through two decades of the build-up of an oligarchic and rent-seeking system based on corruption as an organising principle, with eroded public institutions and trust of the Ukrainian population. This uneasy situation has been further compounded by the toxic political economy cocktail of the need to transform a country in a state of war. Fundamentally reforming a country is always a lengthy and complicated process; with over 13,000 casualties in the last five years and spending over five per cent of GDP per annum on defence, the task becomes exponentially harder.

Many of the new Ukrainian officials that took over after Maidan were new to governing and policy development and coordination. They lacked the experience and expertise necessary to prepare and carry out the massive reform agenda. It ranged from macroeconomic stabilisation through the reform of the legislative process, the judiciary, police and prosecution, to reforms of the health, pension and social sectors, through the banking, industrial and agriculture sectors, to the investment and business climate. Yet, all these areas desperately needed attention and reform. Also, there were only several dozens of reformers, too small a number for the scale of the tasks. In simple terms, Ukraine, its people and its institutions were expected to fire on all cylinders while lacking the means to do so.

Jean Monnet, a founding father of what became the European Union famously said: “Nothing is possible without men; nothing is lasting without institutions.”⁹ Ukrainian men and women brought down the corrupt regime of Yanukovych and thus gave a tremendous boost to democratic change in the country. But to sustain the changes, they needed to be embedded in institutions. And institutions consist of people that need expertise in areas such as policy development and design that were hitherto not practised. Violent democratisations are often followed by the dilemma of how to “turn revolutionaries into managers”. Ukraine’s blessing in the wake of Maidan was the expertise that existed in the civil society which initially substituted the lack of government capacity in, for example, legislative drafting or policy analysis and strategy development. The most notable among the think-tanks that helped develop many government reform strategies and action plans has been the Reanimation Package of Reforms (RPR), coordinating the work of 83 NGOs and 22 expert groups. RPR calls itself the largest coalition of leading

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⁹ New World Encyclopedia, Jean Monnet, http://www.newworldencyclopedia.org/entry/Jean_Monnet, accessed on 5 April 2019
non-governmental organisations and experts that facilitate the design and implementation of reforms.¹⁰ Some members of civil society organisations and also the private sector even joined the government. The most prominent example is Ivanna Klympush-Tsintsadze, a former prominent member of civil society who took the post of Deputy Prime Minister for European Integration, responsible for coordinating the implementation of the Association Agreement.

The EU-UA agreements, however, presented the Ukrainian administration with a significant paradox. The agreements laid out a broad reform agenda and expectations.¹¹ However the government, and also the think-tank community, lacked the capacity to transform the many reform demands contained in the agreement’s 15 chapters, 14 annexes and three protocols into reality.¹² This chicken and egg problem has plagued both the implementation of the commitments in the EU-UA agreements and also the task of coordinating and monitoring their compliance from the very beginning. The situation was further complicated by many of the weak institutions being captured or corrupted by vested interests, be it officials extracting rents from sometimes mundane administrative tasks or oligarchs controlling not only economic interests but often also capturing the policymaking and legislative processes. The vested interests fought against reforms and reformers, as they were interested in maintaining the status quo and hence frustrating any further reform efforts.¹³

As Kataryna Wolczuk, writing extensively on Ukraine, puts it: "...institutions are used by insiders to extract rents rather than to deliver public goods for society as a whole. Where reforms threaten to curtail the flow of rents, they meet strong and persistent resistance from state officials and much of the current political elite."¹⁴ As the World Bank pointed out in its flagship publication on lessons from the transition countries after ten years; "As long as the stock of rents was not depleted, these winners had a strong incentive to preserve their advantages . . . [and] block reforms that threatened those advantages."¹⁵

The phenomenon of entrenched interests that fight against reforms (and reformers) that would undermine their privileged position and take away the rents they can extract in a corrupt and oligarchic regime is not new and is not isolated to Ukraine.¹⁶ To various degrees, similar processes were observed in most former Communist countries transitioning from a planned to a market economy. What made Ukraine stand out is the extent and depth of the oligarchic structures, state capture and entrenched interest across the economy and public administration that were built up and solidified after the collapse of the Soviet Union.¹⁷ It was, particularly in the 20 years leading up to Maidan, that the oligarchs expanded their influence and wealth. In fact, they filled the relative power vacuum that existed in Ukraine while its elites played their balancing act with its multi-vector foreign policy.

¹² Idem. The agreement extends beyond the trade aspects to energy, environment, public procurement, competition and state aid, intellectual property and financial, telecommunications, postal, courier and maritime services.
¹³ A telling illustration of this phenomenon is the difficulty in maintaining the investigative powers of the new National Anti-Corruption Bureau of Ukraine (NABU), and the so far successful attempts to frustrate its findings being followed up by the courts. And also attacks on its personnel. Sources from media.
¹⁶ The World Bank called pre-Maidan Ukraine a “concentrated political regime” noting that such regimes “exhibit consistently higher state capture . . . [and] oligarch and insiders capture the state . . .”. Idem. p. 105.
**Box 1. The fight against corruption**

In its 2017 flagship publication, the *World Development Report on Governance and the Law*, the World Bank clearly states that the success of anti-corruption strategies depends on the level of development of each specific country. To successfully fight corruption, one needs to "recognise that corruption is not a social 'malady' ... but rather a built-in feature of governance interactions." It further notes that "the complete autonomy of state from private interests [is] relatively recent, [as] all societies start from being "owned" by a few individuals who control all resources."¹⁸

In institutionally weak environments of the less developed or transition countries, it is, therefore, invariably much more effective to fight corruption before it occurs, rather than punish corrupt behaviour after it has taken place. How? On one hand, by systematically reducing opportunities for corruption and rent-seeking in the public and private sectors. On the other hand, by introducing as much transparency as possible into public life and the provision of public services, among other things by employing digital tools that are now widely available. The simple reason is that for the state to be able to punish corrupt behaviour effectively, it needs strong institutions, from investigative bodies through prosecution to courts.

While the will of Ukraine's executive powers to build and make effective enforcement institutions operational has been ambivalent to date, the Cabinet of Ministers has shown strong will and ability to systematically close opportunities for corruption and rent-seeking through a variety of reforms. Among the most notable is the reform of the gas tariffs and restructuring of the state gas monopoly Naftogaz; eliminating the arbitrage among different fixed exchange rates by allowing the Hryvnia float; introducing an electronic public procurement system ProZorro; restructuring the banking system and taking away licenses from over 90 banks; and deregulating and opening economic sectors to competition. On the transparency front, the most notable has been the extensive requirement to publish electronic asset declarations of all public officials and their families.

The critical importance of these preventative reforms cannot be overstated. Punishing fraud, corruption and theft, breaking up the oligarchic structures in the country, and overcoming the existing sense of impunity is also critical for Ukraine's moral fabric. This is particularly true due to societal expectations and impatience with not seeing those responsible for graft and corruption behind bars. The reality of deep institutional change, however, is that it will take time to developed the whole chain of enforcement institutions (from investigation through prosecution to courts) and staff it with people able to take on the mighty and powerful. As the 2017 *World Development Report* notes: "If the most powerful groups in a country do not want the enforcement of formal rules, it is unlikely that the rule of law will emerge through enforcement efforts from above."¹⁹ The trouble is that people's patience in Ukraine is running short.

**Complex agreements: Best practice or best fit?**

The EU-UA agreements lay the groundwork for a complex and sophisticated contractual relationship between the EU and a third country,²⁰ resulting in a far-reaching political association and economic integration with the EU. The Association Agreement provides for a shared commitment to a close and lasting relationship with the EU, based on common values; in particular, full respect for democratic principles, rule of law, good governance, human rights and fundamental freedoms. More recently, as is the case with the Association Agreements signed as part of the Enlargement policy with the states of the Western Balkans²¹ and the European Neighbourhood Policy²² with Ukraine, Georgia and

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¹⁹ Idem. p78.
²¹ So called Stabilisation and Association Agreements.
Moldova, a Free Trade Agreement becomes part of the overall package. In both cases, Enlargement and Neighbourhood countries that adopted association agreements entered also into DCFTAs. Entering into these agreements entails eliminating tariff and non-tariff barriers to trade, liberalising trade in services and investment rules and extensively harmonising rules and regulations.

During the negotiations of the agreements, the EU was driven by the desire to offer Ukraine (and Georgia and Moldova) a strong and meaningful framework for a future relationship without, in fact, providing a membership perspective in the short run. For Ukraine, signing the EU-UA agreements became a potent political symbol, especially in light of the Maidan events that were initially triggered by the failure of the previous President to sign the same agreements. Therein, however, lies another paradox. The political desire to associate with the EU does not put a country in a good negotiating position for agreements that are complex and also technical in nature, as the EU-UA agreements are. When the act of signature itself politically carries the day, political economy analysis suggests that countries tend to accept the offer on the table, rather than negotiate over concrete terms.

In exchange for greater access to the EU market, the Association Agreement and, even more, the DCFTA, require Ukraine to adopt a big percentage of the vast body of the acquis communautaire, the set of EU laws and regulations developed over time that regulate the single market and various other aspects of the Union’s common activities. This process of adoption of the EU norms is called legal approximation. In fact, “approximation of Ukraine to EU legislation, norms and standards, will be the method,” declared an EU quick guide to the Association Agreement. To go through the process of approximation to EU legislation is a tall order for any country, even one with much stronger administrative capacity than Ukraine had. The constraining impact of institutional weakness has become apparent also through the successive enlargements of the EU. One commentator noted that given Ukraine’s institutional realities, bureaucratic culture and capacity at the time of entering into the EU-UA agreements, that they presented “best practice as opposed to best fit.” This should not come as a surprising observation. It has taken the newer members of the EU a number of years to learn the codes that are implicit in the way the EU negotiates with third countries (countries that are not members of the EU) and gets things done.

One of the by-products of the interplay between the weaknesses of the institutions tasked with implementing the EU-UA agreements and the built in complexity of the demands of legal and institutional approximation have been unrealistic or inflated expectations, and sometimes impatience, on the side of locals as well as the international donors and observers. (The sense of impatience was magnified by the memories of the stop-and-go reforms and disappointments with Ukraine on previous occasions, in the early 2000s and in 2005-06, after the Orange revolution.) When complex reforms and their progress are judged through the lenses of such expectations, one tends to reach a more negative assessment. Over the last five years, Ukraine has been subject to a lot of criticism. Much of it was justified, while some resulted from an underestimation of the challenges faced by Ukraine and the time it takes to make such transformative

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²³ This applies also to adjustments that need to be made in the agreements overtime to reflect the economic developments in Ukraine. For example, the quotas on agricultural products, in EU jargon “autonomous trade measures”. The quotas negotiated prior to the 2014 signature of the EU-UA agreements proved too constraining as the Ukrainian economy started growing. Getting the quotas increased proved politically difficult both in the Council representing EU Member States and in the European Parliament. The final quota increase agreed upon in September 2017, was lower than the initial proposal by the trade department of the European Commission. Commission Press Release, IP/17/3482 (29 Sept 2017).

²⁴ EU-Ukraine Association Agreement, Quick Guide to the Association Agreement, 25 September 2016, EEAS homepage/Ukraine/EU-Ukraine Association Agreement “Quick guide to the Association Agreement.”


²⁶ Andrew Wilson was among the chorus of observers calling on the West “to be more aware of priorities, sequencing, and trade-offs, [as] not everything can be achieved at once.” Survival of the richest: How oligarch block reform in Ukraine, European Council on Foreign Relations, ECFR Policy Brief, London, April 2016.
steps. Furthermore, there are no blueprints for such extensive legal and regulatory approximation without a concrete accession perspective.

No acquis communautaire on fundamentals

The organising principle of EU agreements, whether with the associated countries (Ukraine, Georgia and Moldova) or with countries negotiating entry into the EU (currently, the countries of the Western Balkans and Turkey), is the acquis communautaire discussed above. This is logical: the EU can only enter into agreements that fall into its purview. The same organising principle is reflected also in the set-up of the individual departments of the European Commission, called Directorates-General (DGs). As the acquis communautaire evolved and expanded over time, new Directorates-General were added to address them (such as climate action, home affairs or digital issues).

The area one does not find either in the acquis, or among the Commission departments, is “fundamentals”. Fundamentals of the rule of law, the building-blocks of democratic institutions, basic structures of the judiciary, market economy, and public administration. Nor would one find provisions demanding the political elites to abide by high standards of integrity and decency in the internal political discourse. The reason is simple. Countries that established the EU or joined later had mastered the fundamentals long before. The acquis communautaire they created together hence does not include many of the issues that countries transitioning from an autocratic communist state with planned economies need to address.

With the benefit of hindsight, one can say that five years ago Ukraine was at a level of development and institutional weakness, combined with the strength of vested interests and oligarchic structures, where it needed assistance precisely on the “fundamentals”. Without having addressed the basic underpinnings of a modern competitive market economy and a state based on the rule of law, it was difficult to turn its attention to the specific obligations required by the extensive agreements, notably the economic sectoral parts of the Association Agreement and the DCFTA.

As one commentator put it: “Until 2013, international assistance in general, and EU assistance in particular, was insufficiently geared towards addressing the fundamental problems facing Ukrainian state institutions.”²⁷ It is therefore no surprise that the implementation of the EU-UA agreements picked up pace only relatively recently. First Ukraine needed to address the reform fundamentals and only then it could build the administrative capacity needed to manage and steer the implementation of the agreements.²⁸

For countries in transition, if the acquis communautaire is the only normative framework, there is a gap, notably in the areas this chapter refers to as “fundamentals”. Since the EU normative basis, for example, for the rule of law or public administration or judicial institutions, consists only of the main principles, one looks to international standards. If these exist (for example within the Council of Europe, OECD or SIGMA), they can be followed. But frequently, the international standards are not of sufficient depth and detail to offer concrete guidance to reformers in transition countries. What has often happened in transition environments is that specific reforms were guided by various consultants from different partner organisations. They tended to come with their own practices, with limited understanding of the local context and balance of power among various groups in society and local behavioural codes. Often, they would bring their own agendas and biases. This put further onus on weak local institutions to coordinate the advisers and arbitrate among the often divergent, while well meant, advice. Ukraine was no exception.

The next section discusses how the EU addressed this weakness through some critical innovations in the way it has supported Ukraine’s reforms and reformers, starting with the creation of the Support Group for Ukraine.

Second story – bureaucratic innovations

The previous section discussed how the oversized dimensions of Ukraine’s challenges after Maidan and the scale of Ukraine’s integration ambitions were

²⁸ Info on the current coordination mechanism, Roadmap, and so on.
neither matched by the capacity of Ukraine's state institutions to design, develop, adopt and implement reform measures in line with EU-UA agreements entered into force in 2014, nor by the nature of the agreements themselves. This section points out how the necessary “fundamentals” of Ukraine’s transformation were, instead, addressed through a series of innovations in the way the EU has delivered its financial assistance and its support for a broad range of reforms.

Since Maidan, the European Union, together with its partners (notably the IMF and the US government) managed to wield considerable leverage and influence over Ukraine’s reform processes through a mix of tools at its disposal: from political dialogue and often public pressure, through the use of conditionality in its financial assistance and the use of the normative aspects of the EU-UA agreements, to the support of non-state actors, such as the vibrant Ukrainian civil society and free media. The annual EU-UA summits (presided over by the Presidents of Ukraine, the European Council and the European Commission) and Association Councils (the highest annual forum for dialogue stemming from the EU-UA agreements, chaired by the Prime Minister on the side of Ukraine, and High Representative and Vice President Federica Mogherini and Commissioner Johannes Hahn on the side of the EU) proved to be particularly useful for both policy dialogue and for delivering political messages. Not insignificant is also the fact that the EU is Ukraine’s largest partner and donor.

Arguably, the biggest impact by the EU on reform developments in Ukraine over the last five years, however, has been the result of what this chapter calls “bureaucratic innovations;” first among them, the creation in April 2014 of the Support Group for Ukraine (SGUA); second, the reorientation of more traditional development assistance to comprehensive institution and capacity building, in line with the revised European Neighbourhood Policy; and third, using the EU convening power to develop and implement assistance programmes in a much closer alignment with EU member states, the international financial institutions (IFIs) and other bilateral partners, such as the US or Canada.

The combined impact of these innovations in the way EU external aid is delivered helped to better tailor EU assistance to areas where it was most needed. It resulted in the support of several systemic reforms with transformative impact on the country. It is beyond the scope of this chapter to go into details about, or even list, all the reform results and achievements of the governments of Yatsenyuk and Groysman which, on several counts, defied the observer’s expectations. In April 2016, Andrew Wilson of the European Council on Foreign Relations (ECFR) called “the elevation of Volodymyr Groysman … the failure of Kyiv’s reform process”, referring to him as “Ukraine’s old guard” who would not attract reformists to work in his government.

While the reform dynamics indeed entered a new, post-euphoric phase in April 2016, when Groysman succeeded Yatsenyuk as Prime Minister, reforms did not stop. In fact, in several areas, they were accelerated. Using his previous post as Speaker of the Rada, Groysman and his team were able to form/reform alliances with the Rada in some important areas, such as health, education and pension reforms; decentralisation; energy reforms in...
part and further macroeconomic stabilisation; VAT reform and overall public finance management. An important leverage factor that enabled many reforms, especially in the fight against corruption, has been Ukraine’s dire financial need fuelled by massive debt repayment obligations. This has put the IMF, the World Bank, the EU and the US government in a strong position to demand many reform concessions, including in areas that are very sensitive for the ruling elite, such as the verification of the electronic asset declarations.

Starting in April 2016, with the two-in-one step increase in gas tariffs – putting the residential tariffs at import parity level with commercial ones within the first month in his office³⁵ Groysman eliminated one of the most notorious sources of corruption that had plagued Ukraine for most of the two previous decades. The state monopoly Naogaz became profitable for the first time. Instead of requiring fiscal transfers, Naogaz became the largest taxpayer in the country. This reform also offered a rare opportunity for the expert community to quantify the decrease in corruption, in the case of gas, a literal siphoning off of state assets.³⁶

Eliminating the spaces for corrupt behaviour and rent-seeking took place similarly in several other areas over the five years (banking, public procurement, VAT refunds, licensing to name a few), under the purview of the executive (also addressed in Box 1 and in Chapter 3 of this publication).

While on a number of fronts important reforms were legislated and also implemented, including in the area of the fight against corruption, it would be a mistake to paint too rosy a picture. Even now, five years after Maidan, the fight between the reformers trying to change the rules of the game, and the oligarchs with a continued stronghold on a number of sectors of the economy, continues. Setting up effective institutions to investigate, prosecute and adjudicate corruption and graft, is the most visible battleground. Thanks to the combined pressure of the international community and the domestic reform constituency, including the strong Ukrainian civil society and media, Ukraine took a number of legislative and institutional decisions, including setting up, in 2014, an investigative body – National Anti-Corruption Bureau (NABU); in 2015, a policy and prevention body – the National Agency on Prevention of Corruption (NAPC); and more recently, in 2018, the High Anti-corruption Court. Of these, NABU has been the most successful and, hence, also a frequent target of attacks from forces trying to frustrate investigations into corrupt behaviour.

The most recent example of this battle is the disappointing ruling in February 2019 by the Constitutional Court of Ukraine, striking down as unconstitutional a provision of the Criminal Code on illicit enrichment by public officials.³⁷ This ruling, in effect, stopped further prosecution of the 65 already investigated cases by NABU. The G7 and the World Bank immediately condemned the ruling, calling it “a serious setback in the fight against corruption in Ukraine … [which] has weakened the impact of the whole anti-corruption architecture, including the soon to be established High Anti-Corruption Court...”³⁸

This attack on the investigative powers of NABU and a decision that perpetuates the sense of impunity in Ukraine is, unfortunately, not an isolated occurrence. The political economy of transition teaches us a clear lesson – once oligarchs or politicians (or even state officials) feel threatened by the continuation of reforms, they fight back and try to block them from being adopted or, once adopted, from being implemented.³⁹ This can, and does, also lead to reform reversals, as the real “threat” of some reforms may become apparent only with time. But one result of the reforms aimed at curbing the space for corruption is certain: the rents the oligarchs are able to extract from the economy now are smaller compared with pre-Maidan times. While very far

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³⁵ An IMF requirement.
³⁶ Chatham House report and Ukraine think-tank.
³⁷ The law was first introduced, in response to an IMF demand.
³⁹ As the World Bank explains, “policymakers and political parties ... may be able to raise significant revenues only in informal and deals-based ways because powerful groups prevent the implementation of formal rules. As a result, the most feasible way for policymakers and political parties to reward their supporters is to allow them to violate rules.” The World Bank, World Development Report 2017: Governance and the Law, Washington, USA, Spotlight 1 Corruption, p.78.
from being dispossessed, “they are not as rich as they were.”⁴⁰ A popular saying in Kyiv is that some of the oligarchs became "minigarchs", both financially, and in terms of political influence. A worrying trend that has emerged instead, and is ascending, is the domination of the media space by individuals, or groups of oligarchs.

Support Group for Ukraine (SGUA)

Ukraine is the only “third country”, that is not a member of the European Union, for which the European Commission set up a special taskforce and charged it with providing EU assistance and supporting its reform development and implementation. SGUA is staffed by a combination of seconded officials from Commission’s sectoral Directorates-General and temporary expert staff. The importance of this innovation cannot be overstated. SGUA’s internal expert capacity for Ukraine is, as a result, far greater than for other countries in the European Neighbourhood, or elsewhere. This internal capacity has in turn allowed SGUA to test and experiment with new approaches in supporting reforms in Ukraine. It has also allowed its staff to spend far greater amount of time and energy corralling other partners (bilateral and international) and aligning their support with the EU.

Institutional capacity is not built overnight, as we discussed in previous sections. The same, of course, applies to SGUA. It took about two years, the transfer of the responsibility for the management of the EU’s bilateral support funds, and a change of leadership, for it to reach its full potential. Also, as the new kid on the block, SGUA was initially viewed with some suspicion by other institutional players. Overtime, SGUA developed the kind of expertise and understanding of the reform dynamics in Ukraine the EU had previously lacked. This, in turn, allowed its experts much greater access and influence on the local policymakers. Five years on from its creation, SGUA is widely respected among Brussels institutions, EU member states and their agencies, IFIs, other bilateral partners and, last but not least, the Ukrainian administration and other stakeholders.⁴¹ Setting up SGUA also facilitated the opening of channels for a faster communication/information flow between officials, civil society, media and Western backers. When anti-reform forces sought to undermine certain reform laws, this would become public knowledge within hours. This helped to quickly mobilise support for the reform laws which made the political costs for local "veto-players" too high.

While SGUA’s capacity cannot be easily replicated, some of the approaches developed by SGUA now serve as an inspiration for programmes in other parts of the Eastern Partnership.

New approach to programming

As previously stated, after Maidan Ukraine was in a dire need of finding, or cultivating, a sufficient number of qualified personnel and overall institutional capacity across the government. Assisting in setting up institutions and nurturing them along is, however, not usually the approach taken by the EU in its development assistance, which typically engages on individual projects and/or technical assistance. Institution building is usually left to other development players.⁴²

Thanks to the combined capacity and expertise of SGUA and the related staff of the EU delegation in Kyiv, the EU was able to experiment with larger-scale, more comprehensive support to systemic reforms in areas such as: public administration, public finance management, judiciary, energy efficiency, decentralisation, governance and anti-corruption. Support for these reform efforts typically started by accompanying the authorities and often involving the local civil society and think-tank community in the reform design phase. In the design stage, SGUA would often link up with other strategic partners, notably member states, other bilateral partners and IFIs. Later, SGUA/the EU delegation would assist in building reform alliances, raising public awareness, supporting the drafting, and making the case for any new legislation, all the way through to implementation. The close links between SGUA officials and their respective sectoral “home” services elsewhere in the Commission also facilitated the

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⁴¹ For a detailed analysis of the functioning of SGUA, see Kataryna Wolczuk and Darius Žeruolis (2018), Rebuilding Ukraine: An Assessment of EU Assistance; Chatham House, London.

⁴² Idem.
Over the last three years, the EU has endowed these systemic reforms with generous assistance packages. Two case studies (attached as annexes) can be used to illustrate this new approach in EU assistance. The first deals with the decentralisation reform and the second one with the energy efficiency transformation. Both reforms have received EU support in the order of about €100 million in grants. The case studies identify the main success factors that have led the government to achieve the reform results it set for itself. They also illustrate well the importance of the three inter-related innovations discussed here. The systemic reforms in the case studies are transformative, with a positive long-term impact on Ukraine.

The one EU-supported reform that stands out due to its cross-cutting nature is the Ukraine Reforms Architecture. It originated in the context of the EU public administration reform and has been further developed jointly with the European Bank for Reconstruction and Development (EBRD). The latter is also managing the related EU (and other donors’) funding.

The development of the reform of public administration post-Maidan is interesting. Initially, discussions were already held under the Yatsenyuk government on the critical need to develop policy formulation and implementation capacity in the administration. At that time, the government pleaded simply for topping up the very low salaries of public officials. This position was legitimately resisted by the EU, which insisted that any support given in the form of budget support (budget transfer in exchange for fulfilling certain conditions) could come only with a serious reform effort to change the way public officials and institutions function. In 2017, such an agreement was found with the new government.

After the successful preparation of a reform strategy under Deputy Prime Minister for European Integration, Ivanna Klympush-Tsintsadze, the reform implementation was transferred to the Cabinet of Ministers. Oleksandr Saienko, Minister of the Cabinet of Ministers, was appointed to coordinate the reform, working, among other things, with reform leaders in several “pilot ministries”.

At the same time, the Ukraine Reforms Architecture became a strong complementary reform push factor. It consists of three different components:

- The first are the Reform Support Teams (RSTs) of young and well-educated Ukrainians who are embedded in eight ministries and public agencies, whose leaders adopt the reform and sign up to certain reform principles which are also reflected in RSTs’ dual role: to assist the Minister and the existing staff in the ministries to design, develop and implement relevant sectoral reforms and also to support the implementation of the new public administration reform strategy within their ministry.
- The second element is the Reforms Delivery Office attached directly to the Prime Minister and working closely in coordination with Minister Saienko, who is also operationally supported by dedicated new staff in the Secretariat of the Cabinet of Ministers.
- The third element is the Strategic Advisory Group for Support of Ukrainian Reforms (SAGSUR) under the leadership of Ivan Miklos, former Deputy Prime Minister and Minister of Finance of Slovakia, advising the Prime Minister of Ukraine (initially the President) on his key reform priorities. For the first year, SAGSUR was co-led by Miklos’s Polish counterpart, Leszek Balcerowicz, also former Deputy Prime Minister and Minister of Finance. Both were key architects of the economic transformations in their countries.

The interplay and combined impact of the public administration reform and the elements of the reform architecture have been a key driver of the development and/or acceleration of reform agendas in the ministries that opted in.

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44 Among good examples are: (I) one of the major anti-corruption steps made in 2017 was the new VAT refund system, an online electronic register on the Finance Ministry’s website. Developed jointly by the RST and the Ministry, it introduced a new and transparent system into VAT refunds which excluded any opportunities for corruption; (II) The RST in the Ministry of Infrastructure, jointly with the new Directorate for Strategic Planning and Coordination, developed the new National Transport Strategy 2030.
One may argue that bringing people from the outside of a system, paying them better salaries and having them carry out reforms is not a systemic approach. While that may be a legitimate view in countries with a strong administrative culture, a version of this approach was also adopted in other transition economies; it was not unusual to have outside advisers embedded in the administration, designing and developing reforms. When systems are so inefficient, ineffective and lacking the skills needed (not to mention vested interests maintaining the status quo and preserve their rents), as was the case with the Ukrainian administration, it is hard to imagine a profound change without bringing people in from the outside.

Designing a model where 20 to 30 young, motivated Ukrainians with the requisite skills to provide additional impetus to reforms while, at the same time, adjusting the ministries to new standards, is rather ingenious. It is less costly compared to much paid foreign advisers. Perhaps most importantly, it addresses the usual criticism mounted against international partners that reforms are not plugged into the local social structures. Intensive participation and leadership of a great number of local activists demonstrate the organic link between the reformist drive and local ownership of reforms. The Ukraine Reforms Architecture has been closely linked to the overall EU-supported public administration reform. This introduced new “reform positions” in each of the participating ministries. These positions have been recruited through transparent procedures. They are paid at levels similar to the RSTs. The idea behind this is to, over time, transition the RSTs into the staff reform positions and, hence, embed the reform spirit and higher efficiency within the ministries. The EU has to date supported the public administration reform with a €104 million programme (in the form of a budget transfer) to help create the fiscal space for this comprehensive reform. Eventually, the efficiency gains and “rightsizing” of the administration should cover the continued costs of the reform. This model is worth studying in greater detail and emulating in other countries with weak administrations. For Ukraine, one may consider adopting in the future a similar approach also at a sub-national level where capacity is equally limited, as was the case in Kyiv at the beginning of the reform.

One aspect of innovation in EU assistance that merits mentioning is strategic communication. Invariably, a key success factor embedded in all large systemic reforms has been public awareness raising and strategic communication. Since the illegal annexation of Crimea five years ago and the onset of the war in Donbas, the need to communicate strategically about the EU, its values and its support for the country, as well as dispel disinformation, has become a necessity. With the help of the East Stratcom team, the European External Action Service (EEAS), the EU launched a professional communication campaign, “Moving forward together”, which is being well received across Ukraine.

The next frontier where the EU will need to continue expanding its assistance is its investment in the real economy. For the moment, there are a number of small and medium-size enterprise (SME) support programmes run from the regional pot of the European Neighbourhood Instrument. One such programme is a DCFTA Finance Facility developed to assist SMEs in Ukraine, Georgia and Moldova to invest in the upgrades necessary to export into the European market. For the standard of living of ordinary Ukrainians to improve, the economy will need to grow, for which it will need both financing and foreign direct investment (FDI). As has been seen in most transition countries, the best way to attract FDI is through transparent privatisation of state assets.

Privatisation is curiously one reform area where Ukraine has been lagging behind, by at least two years. Since Maidan, the existence of an old law on privatisation was used as an excuse for not proceeding with the sales of state assets. It has been thanks to the Ukraine Reforms Architecture, notably SAGSUR working with the Ministry of Economic Development and Trade and the Reforms Delivery Office, that a new law was adopted: small-scale privatisation launched through the ProZorro platform with credible advisers chosen for several large-scale privatisations.

[4] The DCFTA Finance Facility is being implemented by the EIB and the EBRD.
Stronger alignment with EU member states and IFIs

In the rush to help Ukraine after Maidan, there were many competing projects from different donors, often in the same area, sometimes offering different solutions. In the first two post-Maidan years the coordination among donors took place mostly in Kyiv among embassies and local offices of various agencies. A lot more complicated was the coordination among the headquarters that many partner agencies are in charge of strategic as well as allocation decisions. As SGUA matured, it increasingly played an active role in coordinating the efforts of different partners at HQ level. In 2015 in Kyiv, a local G7 coordination group was set up, mainly for political messaging, by the heads of states and government.

The EU, together with its member states, is by far the largest supporter of Ukraine's reforms. SGUA not only actively coordinates among member states and their agencies. It also organises regular coordination meetings with member states. Interested member states with particular expertise on a given topic can join the EU either as implementers, or they can even co-finance programmes with the EU, as Germany has done with the energy efficiency reform or Denmark with the programme on anti-corruption which provides support to new anti-corruption bodies. In the case of decentralisation, the EU programme is operationally and financially supported by Germany, Denmark, Poland, Sweden and Estonia. In addition to member states, SGUA actively coordinates its reform support with other bilateral actors, notably the United States, Canada, Norway and Switzerland.

Just like with bilateral partners, SGUA has become very active in better aligning its programmes with IFIs. One avenue has been the long-established blending platform, the Neighbourhood Investment Platform, where European financial institutions apply for grants to “blend” with their loans to investment projects and technical assistance. The newer variety is a closer alignment with IFIs active in the policy field, notably the EBRD and the World Bank Group. With both institutions, as well as with the European Investment Bank (EIB), SGUA holds regular Ukraine “country days” (these are now used also for other Neighbourhood and Enlargement countries beyond Ukraine). This allows for better collaboration in the development and implementation of programmes. In a number of instances, this leads to either joint projects or IFIs implementing parts of EU programmes. This trend has been strongly supported by Commissioner Hahn's high-level initiative with IFIs which started early in his mandate in 2015 and helped bridge the usual barriers of communication and collaboration among large institutional players. (The energy efficiency case study sets out the positive impact of joint missions and messaging by members of the initiative.)

Conclusion

In conclusion, since Maidan, Ukraine has embarked on an extremely challenging reform path. The list of achievements is long, but equally significant are the areas that still need to be addressed, notably breaking with the oligarchic past and making functional institutions that investigate, prosecute and adjudicate corruption and graft. Looking ahead, it is important not only to sustain the reform momentum but also prevent as much as possible, reform reversals. Not only to placate Western partners, but mainly to restore the trust and belief of ordinary Ukrainians in their country and in political representation. In other words, to live up to the expectations of Maidan.

Supporting Ukraine over the last five years has also been a good opportunity for the EU to learn and adjust when faced with unprecedented challenges and changing circumstances. To come back to and rephrase Jean Monnet, the depth and scale of the crisis in Ukraine has provided that “necessity” that...
made the EU innovate in its approaches and become a stronger, more targeted and more reflective actor.⁵¹

After several false starts over the last two decades, Ukraine now has a chance to finish its transition to become a more stable and prosperous country with a fully functioning market economy. For this to happen, reforms must continue. Interrupting them is like stopping cycling uphill; you can quickly slide back down. The EU, through the Association Agreement and the DCFTA, provides a strong anchor and guide for reforms, significant financial support, as well as unrelenting pressure.

Ukraine has committed itself irreversibly to the European path, which will, in all likelihood, be followed by the newly elected President and the new government that will come out of the 2019 parliamentary elections. The new leadership in Ukraine will need continued Western support and pressure, but also understanding in order for it to maintain its stability and territorial integrity and to successfully overcome the considerable headwinds against reforms.

Case study 1: Decentralisation

Until 2014, Ukraine was a highly centralised country. Most of the fiscal, taxation and administrative powers, as well as service delivery, were under central state administration. The regional, district and local councils had only limited powers and little influence on budget and administration. Real local self-governance existed only in roughly 180 so called “cities of regional significance”. As part of the broad democratisation movement in the wake of Maidan, in April 2014 the newly appointed Yatsenyuk government adopted a concept on the “Reformation of local self-government and territorial organisation of powers”. This reform blueprint set the path for an ambitious decentralisation reform, combining fiscal decentralisation with broad devolution of powers and establishment of local self-governance bodies (hromadas) across Ukraine. The reform concept was subsequently translated into legislation adopted by the Rada, amendments to the budget and tax code, laws on voluntary cooperation and amalgamation of local communities, the law on state regional policy and the law on accession of rural councils to larger cities.

The first stage of the reform, the amalgamation of hromadas has advanced much faster than expected by most experts. Since 2015, almost 4,000 village councils have amalgamated into more than 800 new hromadas, representing roughly 20 per cent of the population. At the same time, local budgets have increased. Thanks to revenues from new local taxes, the reform has also created incentives for local leaders to deliver quality public services and foster local economic development. A new concept of “horizontal fiscal equalisation” was introduced, reducing the space for arbitrary transfers from central government to local governments.

From 2007 onwards, the EU supported early efforts that created the ground for the broader decentralisation that came after Maidan. Through UNDP the EU supported projects in the area of community development and partnerships between citizens and authorities at local level. As part of the reorientation of EU assistance and focus on large systemic reforms, in 2015, the EU launched a large-scale support measure, the “U-LEAD with Europe: Ukraine Local Empowerment, Accountability and Development Programme”. With a budget of €102 million, this programme is the largest support measure to Ukrainian decentralisation, but its real innovation is its federating power as it receives funding or contributions in kind and expertise from Denmark, Estonia, Germany, Poland and Sweden. U-LEAD covers capacity building and support to the amalgamation process and enhancement of administration and service delivery at local, regional and central level. It pays special attention to the newly amalgamated municipalities. U-LEAD supports local government development centres established in 24 regions with experts providing advice and training on financial, legal, planning and strategic issues. The programme is also funding the establishment of 600 administrative service centres in the newly amalgamated municipalities. Interestingly, the most westerly region of Zakarpattia is the slowest moving,

⁵¹ Les hommes n’acceptent le changement que dans la nécessité et ils ne voient la nécessité que dans la crise.”
while some of the eastern regions are amalgamation leaders.

Success factors:

First, the democratisation movement of Maidan and broad dissatisfaction with the previous national political leaders fuelled a high demand for local self-governance that would allow for greater scrutiny of political decision making and administration by citizens. Secondly, the strong political support of national politicians, including the President and leadership by both Prime Ministers, Yatsenyuk and Groysman (the latter having served as Deputy PM and responsible minister in the previous government) were fundamental to the kick-off as well as implementation of the reform. Thirdly, the swift, broad and well-coordinated support from the international donor community helped build up, in a very short time, a critical mass of expertise urgently needed by the new local governments. Finally, the important focus placed on the communication and public education aspect of the reform effort from the very beginning strongly impacted on its broad understanding and acceptance among the Ukrainian population.

Case study 2: Energy efficiency reform

Improving energy efficiency in the three most energy intensive sectors of industry, transport and buildings (both residential and commercial) is an urgent priority for Ukraine. Why? Eastern Europe is the most energy intensive part of the world. Ukraine uses three times more energy per unit of GDP than an average EU member state. The carbon intensity of Ukraine’s economy is four times higher. The problem is especially acute in residential⁵² and public buildings. Worldwide, this sector is usually the last one to adjust to new efficiency standards, due to a mix of information asymmetry and the lack of incentives for individuals to invest in renovations. Ukraine, in addition, still suffers from decades of collective organisation that were characterised by subsidised heating, where in the dead of winter the temperatures were regulated by opening windows. In Ukraine, buildings still consume 40 per cent of the total energy supply (with residential buildings consuming 30 per cent of all natural gas supplies), a proportion which is much higher than in the EU. Estimates show that if Ukraine achieved energy efficiency performance equal to the lowest level among EU member states, it would not need to import any gas at all. Crucially, Ukraine imports 40 per cent of all its primary energy needs. Thus, apart from all the other benefits of energy efficiency transformation, in the case of Ukraine, saving energy has a compelling energy security and a broader security dimension.

Improving energy efficiency, however, has many additional benefits. It is a great example of a “no regret” public policy. Investments in energy efficiency in residential or public buildings (such as schools and hospitals) improve the daily lives of citizens by lowering the cost of energy, and thus making it more affordable while also saving the environment. Moreover, local communities benefit from energy efficiency investments, as renovations of private residencies tend to be made by small local firms, using locally produced energy efficient materials. Energy efficiency reforms thus spur employment in construction and the creation of new industries for energy efficient building materials. They also give rise to new professions, such as energy auditors, and new banking products to finance renovations. All of these factors, combined with the overall lower energy intensity, have a direct positive impact on the competitiveness of local economies. The cheapest energy is always the one not consumed. Energy security and economic factors are the dominant reform motives in today’s Ukraine. Energy efficiency also generates other positive externalities, such as favourably impacting climate change and air quality. These factors are likely to grow in importance in Ukraine over time, especially with the young generation’s growing impact on public discourse.

⁵² Residential buildings account for more than 40 per cent of Ukraine’s heat consumption. In 2015, fewer than 20 per cent of these buildings had heat meters or control systems even at the level of entire buildings. Without control systems, occupants were unable to adjust heating levels. In early 2019, the share of buildings equipped with heat meters exceeded 60 per cent. A number of energy efficiency projects in the residential sector in Ukraine have already shown that cost-effective reduction of heat consumption can easily reach 50-70 per cent.
Over the past four years, Ukraine has seen a significant increase in energy tariffs. At the moment, the tariffs largely cover energy production costs. In line with the IMF agreement, gas prices for households are still regulated under a public service obligation scheme. They should reach market level in January 2020, after an earlier increase to 80 per cent of the market level in May 2019. The increase in tariffs has made a number of energy-saving measures economically viable. It has also helped make the population aware of the need to save energy. In fact, raising public awareness has been a key aspect of energy efficiency reforms. Additional important factors have been the shifting of decision-making to the local level and reducing corruption in the communal sector, especially thanks to the implementation of the laws on metering and consumption-based billing and the law on housing and communal services.

Energy efficiency reform is an excellent example of sustained and comprehensive support by the EU, in close collaboration with a variety of other partners and working hand-in-hand with the Ukrainian reformers, to achieve systemic impact.

After Maidan, notably among the civil society and some members of the Rada, there was a keen awareness of the strategic necessity to improve energy efficiency in Ukraine and thus decrease the over-dependence on Russian energy imports. Energy experts of SGUA/EU Delegation, together with Ukrainian authorities and other partner representatives in Kyiv, established in 2016 a working group on energy efficiency.

As a consequence of the dramatic increases in gas and centralised heat tariffs since 2015, the number of "vulnerable energy consumers" has been increasing. By 2019, the budgets of a majority of households in Ukraine were under stress. To address this situation, in 2015, the government put in place a support scheme consisting of housing and utilities subsidies paid to households. The number of households requiring this support in early 2019 was around 4.5 million, reaching 35 per cent of the population. The budget allocations to this support scheme totalled approximately UAH 77 billion (€2.6 billion) in 2018 or approximately 2.5 per cent of GDP. While this has put an enormous burden on the state budget, this subsidy scheme did not incentivise households to save energy. That only came as part of the overall energy efficiency reform.

The law introduces a requirement for the installment of building-level heat and water meters within two years from the moment of enforcement. The law transposes a major part of the EU Energy Performance Directive, including the introduction of an obligation to certify the energy performance of public buildings, newly built residential buildings and buildings whose owners seek state aid for the renovation. It is also a legal basis for the introduction of new minimum efficiency standards for buildings and building elements (windows, thermal insulation materials, in-house heating systems, and so on."

The EEF will focus on providing grants to homeowners’ associations aimed at supporting thermal refurbishment of multi-apartment buildings in Ukraine, with a robust monitoring and verification system.
a high-level EC-IFI initiative⁹ on enhanced collaboration in key sectors in the European Neighbourhood and Enlargement countries. The first topic collectively chosen for this enhanced framework was energy efficiency. All the institutions agreed that many projects have been successfully implemented in this area. So far, however, none has reached the scale necessary to show the true impact that energy efficiency transformation offers. Four pilot countries were chosen for the joint initiative: Ukraine, Georgia, Serbia and Tunisia. SGUA was assigned to lead and coordinate the planned joint efforts in Ukraine. If the energy efficiency reform proceeded as planned by the government, the EU was ready to invest around €100 million in grants to support it.

In 2017, the EU led a joint mission with IFIs to Kyiv to discuss the key parameters of the reform. The combined pressure of the EU and IFIs influenced the design of the reform in three important ways:

- First, the future EEF was initially envisioned as a state institution that would distribute grants directly to final beneficiaries, the home-owners’ associations. Through the discussions with the government, a less potentially market-distorting model was chosen: the EEF was going to channel government and donor funding via local branches of commercial banks. The extensive branch networks of several banks would ensure a much quicker roll out of the financial support across the country. The banks could also develop and customise their products to better fit the different needs in different parts of Ukraine.

- Secondly, the system of heat subsidies to vulnerable households (an alarmingly large percentage of the total households) was not paid out in cash. Instead, the state covered the cost of heat. For the reform it was important to “monetise” these subsidies to make their costs transparent, first at the level of energy utilities and, later, at the level of households. While this was a long-standing requirement of the IMF, it was not until the IFIs and the EU used their combined pressure that the monetisation at the level of utilities took place in 2018. As of March 2019, monetisation at the level of households has now also commenced. When the energy bills of many citizens were paid directly by the state, there was little motivation to save on utilities. The monetisation should thus create a much stronger incentive for the Ukrainian people to save energy.

- Thirdly, the government insisted on having a credible international partner for the EEF who would ensure full transparency of all processes and, especially, the allocation of resources. Due to their long-standing involvement in the sector in Ukraine, the International Finance Corporation (IFC), the private arm of the World Bank Group, was selected as the main partner, jointly by the Ukrainian government, the German environment ministry and the EU.

The EEF was officially established and registered in July 2018. By early 2019, all secondary acts necessary for its functioning have also been adopted. The EEF’s current statutory capital is around UAH 1.5 billion. An additional UAH 1.6 billion is foreseen in the 2019 state budget. The total EU contribution, in two tranches, is €104 million. Of this amount, €80 million will go to EEF grants and €24 million will go to various types of expert support by: the IFC and the World Bank (support to the EEF, management of donor resources, financial and technical monitoring and selection and training of commercial banks); UNDP (training and support for the local homeowners’ association); GIZ (training and support for the new profession of energy auditors); and the Polish Fund for Environmental Protection (training of the technical staff of the EEF). The first projects under the “Early-Movers” Programme (set up to test the procedures of the EEF) started in January 2019.

Success factors:

- Political will and commitment from the highest levels of government – a key ingredient in any comprehensive reform. Deputy Prime Minister Hennadiy Zubko was the clear reform champion who has worked on the reform from its inception through implementation. At key moments, the personal support of Prime Minister Volodymyr Groysman and Finance Minister Alexandr Danylyuk were critical to its success.

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⁹ The enhanced collaboration initiative started by Commissioner Hahn included the IMF, the World Bank, IFC, EIB and the EBRD.
• Active involvement of key reform stakeholders at every stage of the reform process, including the civil society and members of the Verkhovna Rada (both coalition and opposition deputies). More recently, during the implementation phase, various associations of local authorities and the Covenant of Mayors⁶⁰ (with close to 200 mayors active in Ukraine) are actively promoting the reform.

• Institutional support from the energy efficiency working group was critical. Over more than two years the group, led by the EU delegation in cooperation with other donors and the Ukrainian government, developed the reform concept and legislative proposal.

• Well-coordinated support from main partners was key. Too often, efforts of international partners do not align well. In this case the close collaboration between SGUA/EU delegation and the German government (including financial support for technical assistance) in the early stages was important. The US and Switzerland also supported the reform. Later, under Commissioner Hahn’s EC-IFI initiative on enhanced collaboration, a robust collaboration framework under the leadership of SGUA helped channel support from IFI partners to the outstanding reform measures.

• EU support, through the first and second Energy Efficiency for Ukraine programmes (totalling €104 million), was conditional on the adoption of sector-related reform laws; setting up the EEF and the monetisation of subsidies at the utility level. All the conditions of both tranches of the programme were fulfilled ahead of deadlines.

• Improving the incentives for the reform allowed its implementation. Most notable among these were the increases in gas tariffs to reflect actual costs (an IMF condition) and the monetisation of subsidies.

• Assistance from the IFC, a strong international partner, in the setting up and running of the EEF is key for the fund’s credibility and also for any future donor support.

⁶⁰ EU-supported programme for local authorities in the Eastern Partnership countries.
Leszek Balcerowicz

I formulate below some observations and recommendations based on my own analysis and on the materials provided by the other members of SAGSUR as well as by international institutions and individual experts. Needless to say, my remarks are inherently selective and to some extent subjective. However, I have tried to focus on what I consider to be especially important for the future stability and growth of the Ukrainian economy and – which is strictly related – on the quality of its government institutions.

1. The economic situation in Ukraine in 2014 was very bad because of the legacy of the Yanukovych regime and the Russian military and economic aggression (including bans on Ukrainian exports to Russia). These two factors were sufficient to cause a very deep decline in GDP (about 17 per cent decline). I do not see any realistic policies which would have been able to prevent it during 2014 and 2015. In addition, given the Yanukovych legacy and the Russian shocks, Ukraine was also threatened by a true economic catastrophe:

- First, by continued deficits which would have to be financed by the accelerated printing of money – which would result in hyperinflation.
- Second, by the collapse of the banking sector which was heavily infected by the related lending, fraud and a heavy dose of non-performing loans.

If these risks had materialised, the collapse in GDP would have been much deeper endangering the social stability and the position of the new authorities which emerged in 2014. Their greatest achievement, in my view, was to purse tough policies which prevented these catastrophic developments and have improved the stability of the economy.

It is all too easy to criticise the economic developments after 2013 if one does not compare them with the truly catastrophic developments which were prevented by the Ukrainian authorities during this period.

Domestic and foreign experts could, and should, do a better job in communicating this message to the Ukrainian and international public. Obviously, this should not prevent them from urging quicker improvement in policies whenever it is justified.

2. The improvement in policies, that is in stabilisation policies and in the structural reforms of the state and the economy, has been very uneven depending on the sector. Generally speaking, achievements in macroeconomic stabilisation has been much greater than in structural reforms, although their pace has differed, too. Somewhat arbitrarily I distinguish four categories:

- The greatest achievements.
- The moderate or modest improvements.
- The delayed starts.
- Outright failures.

3. The greatest achievements include, first, policies which have allowed Ukraine to avoid economic catastrophe:

- Thanks to the monetary and fiscal policy adopted the pace of money creation has receded and inflation declined sharply from above 60 per cent in 2014 to just over 10 per cent in 2017.
- The budget deficit was reduced from about 10 per cent of GDP to about 3 per cent last year. And this has happened while the expenditures on national defence have been sharply increased and hundreds of thousands of refugees from the occupied territories were absorbed.
- The central bank has made a successful transition to inflation targeting, has performed a major cleaning operation in the banking sector while reducing its staff by more than 50 per cent. These are outstanding achievements on the world scale.
- One of the major structural reforms has occurred in the gas sector and allowed a sharp reduction in the quasi-fiscal deficit, previously high due to massive fraud, corruption and waste. Together with the elimination of subsidies to households gas (and heat) prices it also reduced the consumption of gas thus limiting Ukraine’s dependence on its imports from Russia.
- Another major achievement, in my view, has been the creation of the new public institutions: NABU
and other anti-corruption bodies, Business Ombudsman, and so on.

- The package of laws enacted during the summer of 2016 created the legal basis for the cleaning and restructuring the court system.
- However controversial, the introduction of electronic declarations signalled the determination of the Ukrainian authorities to fight corruption and the basis to do it.
- Finally, I would single out the creation of ProZorro and its application in public procurement.

4. All these major achievements require the consolidation and completion:

- The great achievements of the central bank have to be strengthened especially with respect to the cleaning up the banking sector (PrivatBank). This and further anti-inflationary monetary policies obviously require a continued competent leadership and the independence of NBU.
- Further fiscal consolidation demands more structural reforms, especially pension reform. A professional spending review would help to target and prepare the necessary measures on the spending side.
- In the gas sector, Naftogaz requires unbundling which is related to creating more scope for the private sector.
- The new public institutions should be protected and strengthened when necessary. Better co-operation arrangements between them and the existing institutions in the same field have to be established and followed, especially between the NABU and Central Prosecution, which requires further restructuring.
- Judicial reform is entering the implementation phase which will decide the shape of the judicial system in Ukraine, a key component of the state.
- Clear and fair rules on how to deal with the information provided in electronic declarations should be worked out, communicated and applied.
- The potential of ProZorro should be used more broadly, including in the privatisation process.

5. Under the “moderate and modest improvement” category I would like to mention two important market policies: deregulation and demonopolisation.

- Deregulation is widely and officially recognised as a key priority. And, indeed, it is very important for improving the business climate in Ukraine and for the eradication of corruption. However, the improvement so far, as measured by the World Bank’s “Doing Business” Report is modest. Clearly a concentrated effort is needed which should focus on those aspects of the regulatory environment where Ukraine is lagging the most. In my view, the Business Ombudsman is doing a very good job trying to identify and remove the impediments to business. However its potential, and its legal position, should be strengthened. A legislative proposal to this effect had not been so far accepted in parliament.
- There is a vast scope for demonopolisation of the economy, which is crucial for improving its efficiency but the progress in this respect has been modest, too. I think that the anti-monopoly office has a competent leadership and strong support from international experts but it is very much constrained in its activity because insufficient funding does not allow it to hire more professionals. This constraint should be quickly relaxed. The additional funds should be regarded as an important investment in improving the efficiency, and thus economic growth, of the Ukrainian economy. This is all the more important as Ukraine has made a commitment to the EU to raise its competition law to the European level. Besides, a stronger anti-monopoly effort is necessary to identify and remove the monopolistic positions of the oligarchs. The same obviously applies to state-owned enterprises.
- Moderate improvements also include e-government and local government reforms. In the first case Ukraine has great potential for leapfrogging because it has many competent and highly motivated IT-specialists and a vast scope for improvement. What is lacking so far is concentrated support from the top of administration. In the second case, the focus should be put on the basic level of the local government. One should accelerate the integration of the “hramady”. Also, the government should design and introduce a rule-based system of local finances with a higher share of their own resources for the communities and the cities.
6. “Delayed starts” include institutional reforms in transport infrastructure and health.

- Transport infrastructure is a serious economic bottleneck in Ukraine and its improvement would at the same time enjoy wide popular support. Crisis management has probably distracted the attention of the top policymakers from this priority. Also, the improvement was hampered not only by the lack of funds but also by the inherited and hugely inefficient organisational structures and their related personnel. However, there are new teams both in railways and road infrastructure. If they are allowed to continue the reforms, rapid progress in transport infrastructure is possible.

- So far there have been few reforms in health. As a result, it is very inefficient and plagued by the massive informal payments (petty corruption). However, a competent team in the Ministry of Health, helped by external advisers, has prepared a reform project for the basic level of healthcare: the family doctor. A similar reform was introduced in Poland years ago and worked very well. It is, therefore, very important, that the reform proposal in Ukraine is introduced, as planned, that is in the middle of 2019.

7. “Outright failures” include two fundamentally important market reforms: privatisation of state-owned firms and the introduction of the land market.

- The economic rationale for the privatisation of the SOE’s is beyond reasonable doubt. There is a massive body of empirical research on the comparative efficiency of private versus state-owned firms, including in the post-socialist economies. It is also very indicative that western European countries, where historically the state-enterprise sector accounted for up to 20 per cent of GDP, tried various unsuccessful reforms of the sector and finally opted for the privatisation of the least some state firms in the 1980s and 1990s. And in Ukraine there is an additional argument for their privatisation: state-owned firms have been subject to exploitation by private interests. It is unclear to what extent this harmful process has been reduced. But it is clear, that only privatisation (that is transferring the property rights from politicians and bureaucrats to genuinely private entities), can end it.

Improving the corporate governance of the SOE’s should not be regarded as a substitute for their privatisation. No such reforms can be effective on a large scale. Corporate governance reforms can and should be introduced and maintained in the few selected cases of the larger state companies (Naftogaz, railways, post-office). But even in these cases the privatisation of their parts or assets can and should be performed.

Privatisation of state-owned banks deserves a special mention. After the necessary nationalisation of the Privatbank, the state accounts for more than 50 per cent of banking assets. This is dangerous situation as state ownership of banks allows their politicisation which ends in deep crises. Research by the World Bank (Finance for Growth 2001) has shown that the higher the participation of the state in a country’s banking sector, the higher the risk of a banking crisis. The recent example of the collapse of the state-dominated banking sector in Slovenia, or “cajas” in Spain provide dramatic warnings against the state-ownership of banks. Therefore, the Ukrainian authorities should urgently prepare a privatisation plan for banks.

- Ukraine is probably the only country in the Europe (besides Belarus) which bans the sale of agricultural land by extending each year the moratorium on its sale. This blocks a great potential for improvement in agriculture – an important sector of the Ukrainian economy.

The introduction of the land market is unpopular in Ukraine but this was also true of slashing of the budgetary spending or eliminating the subsidies to gas and heat – measures which have already been introduced. It appears that – for some reason – the Ukrainian authorities have so far made no serious effort to introduce the land market, that is, work out a serious reform proposal and to prepare and launch a professional anti-populist communication campaign before it is introduced. Time will tell what will be done this year.

8. It is not easy to explain, without much deeper investigation in the realm of political economy, why such striking differences have occurred in the pace of the improvement of various policies in Ukraine. It is not very surprising that success in the stabilisation of
the economy has so far been much greater than – on average – in structural reforms. The situational pressures in the first case were much more intense than in the second one. In addition, Ukraine was very lucky in having outstanding leaders responsible for stabilisation, especially in the central bank and – during 2015 – in the Ministry of Finance. However, why such have large differences appeared in the pace of structural reforms?

Instead of engaging in intellectual speculation let me generally say what are the necessary conditions for the success of reforms:

- A highly motivated and competent leader. There are no reforms without the reformers.
- A highly motivated and competent team, which is possible only if there is a good leader. Also, sufficient funds to hire professionals are needed.
- Sufficient room for manoeuvre due to the determination of the leader, the institutional independence of the institutions they lead and/or relatively weak resistance to reforms.
- A reform coalition which accepts the reform package and strongly monitors its implementation.

For the success of the reforms all these conditions have to be met at the same time while the failure to meet just one of them is sufficient to prevent a successful reform. It would be very useful to know more on what factors accounted for relatively successful reforms and which ones explain the reform failures or only modest successes. As an example, I would only mention that the failure of privatisation is due to the non-fulfilment of the condition (a), while the limited results in demonopolisation can be explained by the insufficient resources of the Anti-monopoly Committee.

Generally speaking, the acceleration of reforms in Ukraine requires replacing of non-reformers with reformers, when needed and a stronger coordinating and monitoring activity by the leaders of the reform coalition, that is the reform centre.

9. After a deep and largely unavoidable decline in GDP, the Ukrainian economy has started to grow in 2016 and 2017, although at a rather slow pace. Further and sustained growth is crucially important for Ukraine. Let me finish by stressing what are its crucial determinants. Long-term economic growth depends on labour supply and investment and, which is partly related to that, on the dynamics of the overall productivity. Given its demography Ukraine cannot count on the positive contribution of employment (although pension reform is very important to avoid a decline in employment). Therefore, future growth will crucially depend on the investment-productivity nexus. If improvements in this nexus are slow, the economic growth in Ukraine will be slow, too. The improvement in the investment-productivity nexus depends on the government and market reforms, where, as I mentioned, the progress so far has been very uneven. In crucially important respects it has been only modest (deregulation, demonopolisation) or none at all (privatisation, land market).

One can say that in these spheres Ukraine has important and untapped “reform reserves”. If they are finally are tapped, that is reforms are quickly accelerated, economic growth would accelerate, too. If the missing reforms are further delayed growth would remain slow and fragile. Needless to say, economic growth also requires that macroeconomic stability is further strengthened. And this, in turn, depends on structural reforms, especially in public finance with a special focus on spending (pensions and other major items of social spending).
The role of the government and MPs in reform implementation in Ukraine

Yaroslav Zheleznyak

There is no quantitative criterion for the assessment of effectiveness of the parliament or cooperation between the government and the parliament.

The available statistical data allow us to count the number of decisions taken by the parliament, but not the quality of such decisions.

Based on these statistics we can, however, compare the levels of coordination between the government and the parliament during different prime ministerial tenures.

Based on the data presented in Figure 1 we can identify two different approaches to parliamentary relations – before and after the Revolution of Dignity. We compare the mandates of three prime ministers both from before and after the Revolution, taking into account the following performance indicators:

- Number of legislative initiatives of the government during its mandate.
- Rate of approval / rejection of the governmental initiatives.

Table: Approaches to parliamentary relations – before and after the Revolution of Dignity

<table>
<thead>
<tr>
<th>Author of initiative</th>
<th>Pieces of pro-reform draft legislation</th>
<th>Reform points (qualitative assessment of stakeholders’ impact on reform implementation)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government</td>
<td>91</td>
<td>180.7</td>
</tr>
<tr>
<td>Mps</td>
<td>154</td>
<td>226.9</td>
</tr>
<tr>
<td>President</td>
<td>27</td>
<td>57</td>
</tr>
</tbody>
</table>

Source: https://rada.gov.ua/

These data are then related to two important indicators (which describe the political situation at the moment of government appointment) – the number of MPs who voted for the government appointment and the size of the coalition in the parliament.

The analysis shows that there is no direct correlation between the political situation at the moment of appointment and the effectiveness of coordination between the executive and legislative branches of power.

Out of six governments only three had an approval rate higher than 35 per cent for their initiatives: the second Timoshenko government, the first Azarov government and the second Yatsenyuk government. It is important to point out that despite the fact that the first two governments were appointed by a very weak coalition (and vice versa, the Yatsenyuk government was appointed by a strong coalition) all of them are united by a single factor – a significant change in the political situation (appointment of a new president or beginning of the mandate of a new parliament) which opened a window of opportunity for legislative change.

And at the same time the highest approval rate for governmental initiatives ever recorded was a mere 55 per cent (the first Azarov government). This is significantly lower than approval rates observed in other pro-reform countries. For example, in 2017 the Slovak government submitted 96 governmental draft laws, of which 83 were passed (an approval rate of more than 86 per cent), while the remainder continued through the legislative process in 2018. This rate was even higher (in some cases even reaching 99 per cent) for periods when those countries (Poland, Slovak Republic, Georgia and others) were in the process of active reform implementation.

According to this data all of the six governments (especially the three following the Revolution of Dignity) were faced with a difficult situation: striving to implement much-needed reforms while having only a one-third chance of their initiatives succeeding in parliament.

In this scenario, MPs become key to reform progress. It is when they become the authors/imitators of pro-reform legislation that the laws have a good chance of successfully making it through the parliament. The MPs thus, in a way, substitute for the government where the latter struggles to garner sufficient support.
for its reform initiatives. During the VIII convocation of the parliament (held on 5 November 2018) 452 pieces of draft legislation, submitted by MPs, were approved. That is 1.6 times more than the number of approved governmental draft legislative acts (281) and 3.3 times more than the number of approved presidential draft laws (133).

This means that MPs’ initiatives represent a significant share of the overall legislative agenda and, consequently, exert sizeable influence on the speed of reform implementation.

In such cases the number of reform-oriented MPs or so called “young blood” in the parliament is a strong determining factor in further reform development. According to the VoxUkraine’s Index for Monitoring Reforms (iMoRe) from January 2015 until November 2018 MPs’ initiatives were doubtlessly the most impactful in achieving reform implementation, both in quantitative and qualitative terms (see Figure 2). A significant number of laws required for the implementation of energy, anti-corruption, deregulation, tax liberalisation and other reforms were prepared and submitted by MPs.

This was largely made possible by the fact that there are a lot of young pro-reform MPs in the current convocation of the parliament. Such MPs not only vote for positive draft legislation, but also:

- act as reform ambassadors in their factions
- provide their expert views/amendments during consideration of such laws in the parliament
- promote issues on the agenda
- help government representatives in the process of going through the parliament with their initiatives
- block negative/anti-reform initiatives both during the discussions in the committees and during the voting.

Moreover, one of the unique features of the current convocation is the “blurred” line between the opposition and the coalition. Many votes on draft laws of great importance to the government/coalition have been supported by opposition factions (the latter sometimes lending even stronger support than the coalition). The draft legislation on the anti-corruption court is a case in point. It was supported by five factions/groups from the opposition with average level of support amounting to 84 per cent. The same situation occurred with such complex political issues as the medical and pension reforms, both of which were supported with greater zeal by the opposition than by the coalition.

That is why in the current political climate (when the government does not enjoy the necessary level of support in parliament) it is crucial for further reform sustainability that the numbers of such “young blood” MPs do not decrease in next convocation.

Moreover, there is one more significant role for the “young blood” MPs in current convocation of parliament. As the average number of votes for a law is usually slightly higher than the minimum required 226, the persistence of such MPs is crucial in counteracting the adoption of anti-reform laws. They have blocked many such initiatives, including the law on special confiscation (#4057), tax police restoration (#0940, amendment #10), and internet censorship (#6688). A large number of regressive initiatives were not even proposed to the parliament for consideration, given their low chances of success. A significant share of MPs’ draft legislation which have been evaluated by iMoRe’s rating as pro-reform were submitted by the “young blood” MPs.

At the same time, many positive initiatives received a green light thanks to the principled positions of such MPs. This was the case for the laws on the payment of dividends to joint-stock companies (#1310), reform of public procurement (#3559), medical procurement by the international organisations (#2150) and other positive draft laws.

It is worth noting that this group of MPs also became “watchdogs” in parliament, demanding compliance with regulations, for example by opposing non-personal voting.

Young deputies in the current convocation reached the minimum critical amount, thus becoming a distinguishing feature of this parliament and bringing about positive results.
Despite the fact that this convocation of parliament has not outdone others in the number of decisions adopted, it is distinguished by the quality of the decisions made. Thus, due to many factors, including the Revolution of Dignity and the arrival of a large number of "new faces" to the parliament, most of the decisions taken were reformist in nature and were aimed at improving the quality of the country’s regulations.

The key difference between the "old" approach to parliament coordination and the "new" one that took root after the Revolution of Dignity is the absence of plutocratic tendencies of the latter (a small group of oligarchs had exclusive impact on almost all members of the coalition). This means that even though some MPs maintain relations with financial industry groups the parliament often takes decisions that are beneficial for the country’s economy while not necessarily profitable for the interest groups.

Nevertheless, there have been instances of the plutocratic approach even in this convocation. For example, on 23 November 2018 the parliament adopted amendments to the Tax Code, which, among other things, entrenched the monopoly of existing electronic property valuation sites. The amendments were adopted in favour of one political group with strong links to the oligarchs. Similarly, at the end of 2017 "soy amendments", which provide for the abolition of VAT refunds on oilseed exports and destroy fair competition in the agricultural market, were adopted. This was done for the benefit of one financial group.

There are many more such cases, but compared to other conventions, they have become much less frequent.

Consider the case of government procurement regulation. In almost every convocation (IV-VI), initiatives were taken to reduce competition in this area, increasing corruption risks. Only in 2011-12, some 17 amendments and additions to the law on state procurement were introduced, which resulted in significant distortion of the principles of competition, efficiency of use of funds and transparency of procurement procedures.

At the same time, the decision was taken to create the ProZorro electronic system of public procurement, which was recognised as the best in the world.

The same applies to other regulations as well. According to the data from the Doing Business rating, the decisions taken by the parliament considerably reduced administrative barriers for businesses in Ukraine (see Figure 3).
Figure 3
Administrative barriers for businesses in Ukraine

<table>
<thead>
<tr>
<th>Years</th>
<th>Starting a Business – Procedures</th>
<th>Starting a Business – Time</th>
<th>Paying Taxes – Payments (number per year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019</td>
<td>6</td>
<td>6.5</td>
<td>5</td>
</tr>
<tr>
<td>2018</td>
<td>6</td>
<td>6.5</td>
<td>5</td>
</tr>
<tr>
<td>2017</td>
<td>6</td>
<td>6.5</td>
<td>5</td>
</tr>
<tr>
<td>2016</td>
<td>5</td>
<td>8</td>
<td>5</td>
</tr>
<tr>
<td>2015</td>
<td>7</td>
<td>22</td>
<td>5</td>
</tr>
<tr>
<td>2014</td>
<td>7</td>
<td>22</td>
<td>28</td>
</tr>
<tr>
<td>2013</td>
<td>8</td>
<td>23</td>
<td>28</td>
</tr>
<tr>
<td>2012</td>
<td>10</td>
<td>25</td>
<td>135</td>
</tr>
<tr>
<td>2011</td>
<td>11</td>
<td>28</td>
<td>135</td>
</tr>
<tr>
<td>2010</td>
<td>11</td>
<td>28</td>
<td>147</td>
</tr>
<tr>
<td>2009</td>
<td>11</td>
<td>28</td>
<td>147</td>
</tr>
<tr>
<td>2008</td>
<td>11</td>
<td>28</td>
<td>147</td>
</tr>
<tr>
<td>2007</td>
<td>11</td>
<td>34</td>
<td>147</td>
</tr>
<tr>
<td>2006</td>
<td>16</td>
<td>35</td>
<td>147</td>
</tr>
</tbody>
</table>

Source: Doing Business rating

The requirements of international partners to adopt a number of important systemic pieces of legislation in conjunction with the effective struggle of “new faces” against regressive and corrupt initiatives resulted in the adoption of a large number of far-reaching changes.

The gas market, the electricity market, healthcare reform, the strengthening of anti-corruption control, business deregulation, public procurement, control of political parties and government officials – these are among the many areas that have historically been examples of poor regulation and corrupt practices and that have been significantly reformed by this convocation of the parliament.

There is not a single solution to boosting the numbers of “young blood” MPs in the parliament. It is a complex issue that is highly dependent on electoral preferences of voters and evolution of the political system. However, the following measures stand a good chance of shaping the composition of future parliaments in the positive direction:

- Changes to the election law, including abolition of the single-member (regional) system.
- Strengthening of independent media and equal access of political representatives to them.
- State budget funding for political parties.
- Increasing cense for submission of populist (budget) fuses: law can be registered only if accompanied by a financial and economic justification, and a mandatory conclusion of the Budget Committee for consideration in the first reading. The conclusion of the Budget Committee would in turn not be possible without a position letter from the Ministry of Finance (deadlines for preparation of the letter could be fixed at for example maximum 10 days).
- Prohibiting or significantly limiting political advertising and tightening control over election law violations.
- Cancellation of parliamentary immunity.
- Increasing the salaries of MPs as well as parliamentary staff.

The current convocation has made scant progress on this list (only budget funding for political parties has been approved) and failed to create conditions for a significant change in parliament composition.

Parliamentary reform

Numerous analyses and recommendations have been produced (including by respected international organisations) concerning the need to change the current parliamentary procedures. Many of them are crucial for improving the qualitative and quantitative indicators of the parliament's effectiveness. These are the key 15 recommendations:

1) Introduce voting by simple majority (both for first and second reading), except for an exclusive list of decisions.

2) Increasing cense for submission of laws. For example, the law could be submitted by a group of MPs of the size of the smallest faction (15 deputies or more). The coalition MPs could not be authors of laws without government resolution.

3) Anti-populist (budget) fuses: law can be registered only if accompanied by a financial and economic justification, and a mandatory conclusion of the Budget Committee for consideration in the first reading. The conclusion of the Budget Committee would in turn not be possible without a position letter from the Ministry of Finance (deadlines for preparation of the letter could be fixed at for example maximum 10 days).

4) Agenda formulation: prioritisation of laws – list of top 50 laws, which cannot be modified until all laws on the list have been fully considered.
5) Establish rights of the opposition in the process of agenda formulation. The opposition has the right to “n” per cent (for example, in proportion to the number) of the top 40 laws. Apply (a representative of the opposition, or the opposition council – one person from each faction, group or non-factional) list from the top 20 per week. The coalition chooses in order of filing.

6) Strengthening the role of the government: the need for a letter from the government for laws originating from the coalition to fall into the Top 40 Agenda and / or to be included in the agenda of the committee.

7) The Regulatory Commission: to set and guarantee compliance with the rules during plenary sessions.

8) Reading and publishing the conclusions of the compulsory committees to be a prerequisite for consideration by the parliament.

9) Voting on all proposals in one day / at a certain time, not only after debates on the law.

10) Strengthening the role of parliamentary hearings. Indications during the hearings can be used further as evidence in court.

11) Reform of the majoritarian electoral system towards a proportional system or open list system.

12) Abolition of parliamentary immunity.

13) Significant (three/fourfold) increase of MP salaries.

14) Conduct an administrative reform of the apparatus of the Ukrainian parliament, including a reduction in the number of staff and wage increase for those that remain.

15) Amendment of the Constitution to give MPs the right to retain their mandate during / after their post in the executive branch of government.

Changes 1) 2), 12), 15) require changing Constitutional provisions, which is a long process and requires a vote of two-thirds of MPs (more than 300).

This is not an exhaustive list of all the changes required to reform the parliament. Rather, these are the key changes that could significantly improve its effectiveness in the current political reality.

**Figure 4  Statistics before and after the Revolution of Dignity**

<table>
<thead>
<tr>
<th>Governments</th>
<th>Number of MPs in the coalition</th>
<th>Number of votes for appointment</th>
<th>Submitted draft laws</th>
<th>Approved and signed (%/DLs)</th>
<th>Rejected (%/DLs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Groysman’s government (16 April 2016 – today (31 October 2018))</td>
<td>near 226</td>
<td>257</td>
<td>555</td>
<td>22%</td>
<td>122</td>
</tr>
<tr>
<td>Second Yatsenuk government (2 December 2014 – 16 April 2016)</td>
<td>302</td>
<td>341</td>
<td>408</td>
<td>37%</td>
<td>150</td>
</tr>
<tr>
<td>First Yatsenuk government (27 February 2014 – 2 December 2014)</td>
<td>near 250</td>
<td>371</td>
<td>169</td>
<td>31%</td>
<td>52</td>
</tr>
<tr>
<td>Total AFTER the Revolution of Dignity</td>
<td></td>
<td></td>
<td>1.132</td>
<td>29%</td>
<td>324</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Governments</th>
<th>Number of MPs in the coalition</th>
<th>Number of votes for appointment</th>
<th>Submitted draft laws</th>
<th>Approved and signed (%/DLs)</th>
<th>Rejected (%/DLs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Second Azarov government (18 December 2012 – 28 January 2014)</td>
<td>near 240</td>
<td>357</td>
<td>310</td>
<td>20%</td>
<td>61</td>
</tr>
<tr>
<td>First Azarov government (11 March 2010 – 18 December 2012)</td>
<td>near 226</td>
<td>242</td>
<td>744</td>
<td>55%</td>
<td>406</td>
</tr>
<tr>
<td>Second Timoshenko government (18 February 2007 – 3 March 2010)</td>
<td>near 226</td>
<td>226</td>
<td>592</td>
<td>36%</td>
<td>211</td>
</tr>
<tr>
<td>Total BEFORE the Revolution of Dignity</td>
<td></td>
<td></td>
<td>1.646</td>
<td>41%</td>
<td>678</td>
</tr>
</tbody>
</table>
About SAGSUR
In April 2016, upon request from President Petro Poroshenko and Prime Minister Volodymyr Groysman the Strategic Advisory Group for Supporting Ukrainian Reforms (SAGSUR) was established, initially co-headed by two successful reformers – Leszek Balcerowicz, the former Deputy Prime Minister and Minister of Finance of Poland, and Ivan Miklos, the former Deputy Prime Minister and Minister of Finance of Slovakia.

The new Groysman Cabinet made a commitment to continue with an ambitious reforms agenda in order to secure financial, economic and political stability of the country, emphasising a pragmatic strategic, consensus-based and results-oriented approach to the transformation process.

Based on this commitment, the Ukrainian authorities have asked the EBRD and the EU to help with speedy conceptualisation and implementation of the reform process. To this end new reform support architecture has been conceived (URA), which consists of SAGSUR, a Reform Delivery Office of the prime minister (RDO) and the Reform Support Teams (RSTs) in selected priority ministries. The members of the reform support architecture provide mutual support to each other, with SAGSUR helping coordinate the reforms effort on a high level.

SAGSUR consists of a team of advisers providing crucial expert advice to the prime minister on the content and implementation of the key reforms in Ukraine based on first-hand experience gained in reform implementation of reforming countries, notably those in central Europe. Since April 2017 SAGSUR has been headed by Ivan Miklos as the sole chairman.

The team of experts comprises the following:

- **Ivan Miklos:**
  Chairman, Chief Economic Adviser to the Prime Minister of Ukraine

- **Pavlo Kukhta:**
  Deputy Chairman, Fiscal Policy

- **Jerzy Miller:**
  Deputy Chairman, Governance and Institutional

- **Luba Zimanova Beardsley:**
  Adviser, Anticorruption and Justice Sector

- **Karel Hirman:**
  Adviser, Energy Reform

- **Alexander Skurla:**
  Adviser, Business Environment and Land Reform

- **Andriy Boytsun:**
  Adviser, Privatisation and State-owned Enterprise Reform

- **Zlata Fedorova:**
  Adviser, Public Communications

- **Yaroslav Zheleznyak:**
  Adviser, Parliamentary Communications

- **Olena Kondratiuk:**
  Administrative Assistant

About SAGSUR
(Strategic Advisory Group for Support of Ukrainian Reforms)
AEP – authorised electronic places (in an online auction)
bcm – billion cubic metres
CE – central Europe
CEPEJ – Council of Europe
CoE – Council of Europe
CoM – Cabinet of Ministers (Ukraine)
DCFTA – Deep and Comprehensive Free Trade Agreement
DoZorro – monitoring portal for public procurement site ProZorro
EBRD – the European Bank for Reconstruction and Development
EC – European Commission
ECFR – European Council on Foreign Relations
ECHR – European Court of Human Rights
EEAS – European External Action Service
EEF – Energy Efficiency Fund
EIB – European Investment Bank
ENTSO-E - European Network of Transmission System Operators for Electricity
EU – European Union
FDI – foreign direct investment
GDP – gross domestic product
GIO – general inspection office
GIZ – Deutsche Gesellschaft für Internationale Zusammenarbeit GmbH
GRECO – Group of States Against Corruption
ha – hectares
HDI – Human Development Index
HQCJ – High Qualification Commission of Justice
HR – human resources
IER – Ukrainian Institute for Economic Research
IFC – International Finance Corporation
IFI – international financial institution (e.g. World Bank, EBRD)
IMF – International Monetary Fund Home
iMoRe – VoxUkraine's Index for Monitoring Reforms and Trade
MGU – Mahistralni Gazoprovody Ukrainy
MoJ – Ministry of Justice (Ukraine)
Mwh – Megawatthour
NABU – National Anti-corruption Bureau of Ukraine
NACP – National Association for the Prevention of Corruption
NAPC – National Agency on Prevention of Corruption
NATO – North Atlantic Treaty Organisation
NBU – National Bank of Ukraine
NEURC – National Energy and Utilities Regulatory Commission
NGO – non-governmental organisation
ODB – Open Data Barometer
OECD – Organization for Economic Cooperation and Development
OPZ – Odessa Portside Plant
PIC – Public Integrity Council
ProZorro – electronic public procurement system
RoL – rule of law
RPR – Reanimation Package of Reforms
RST – reform support team
<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>SAGSUR</td>
<td>Strategic Advisory Group for Support of Ukrainian Reforms</td>
</tr>
<tr>
<td>SAPO</td>
<td>Specialised Anti-corruption Prosecutor’s Office</td>
</tr>
<tr>
<td>SBU</td>
<td>Ukrainian Security Service</td>
</tr>
<tr>
<td>SC</td>
<td>Supreme Court of Ukraine</td>
</tr>
<tr>
<td>SCJ</td>
<td>Superior Council of Justice</td>
</tr>
<tr>
<td>SES</td>
<td>State enforcement service</td>
</tr>
<tr>
<td>SEZ</td>
<td>Special economic zone</td>
</tr>
<tr>
<td>SFS</td>
<td>State fiscal service</td>
</tr>
<tr>
<td>SGUA</td>
<td>Support group for Ukraine</td>
</tr>
<tr>
<td>SME</td>
<td>Small and medium-sized enterprise</td>
</tr>
<tr>
<td>SOB</td>
<td>State-owned bank</td>
</tr>
<tr>
<td>SOE</td>
<td>State-owned enterprise</td>
</tr>
<tr>
<td>SPF</td>
<td>State property fund</td>
</tr>
<tr>
<td>tcm</td>
<td>Thousand cubic metres</td>
</tr>
<tr>
<td>TPS</td>
<td>Thermal power stations</td>
</tr>
<tr>
<td>TsO</td>
<td>Ukrainian gas transmission operator group</td>
</tr>
<tr>
<td>UAH</td>
<td>Ukrainian hryvnia</td>
</tr>
<tr>
<td>UGV</td>
<td>UkrGasVydobuvannya</td>
</tr>
<tr>
<td>UNECE</td>
<td>United Nations Economic Commission for Europe</td>
</tr>
<tr>
<td>UTG</td>
<td>Ukrtransgaz</td>
</tr>
<tr>
<td>V4</td>
<td>Visegrad 4 (Czech Republic, Hungary, Poland and Slovak Republic)</td>
</tr>
<tr>
<td>Verkhovna Rada</td>
<td>Ukrainian parliament (also called the Rada)</td>
</tr>
</tbody>
</table>